- **Board of Directors**
  Business and Finance Committee

June 10, 2008 Board Meeting

7-2

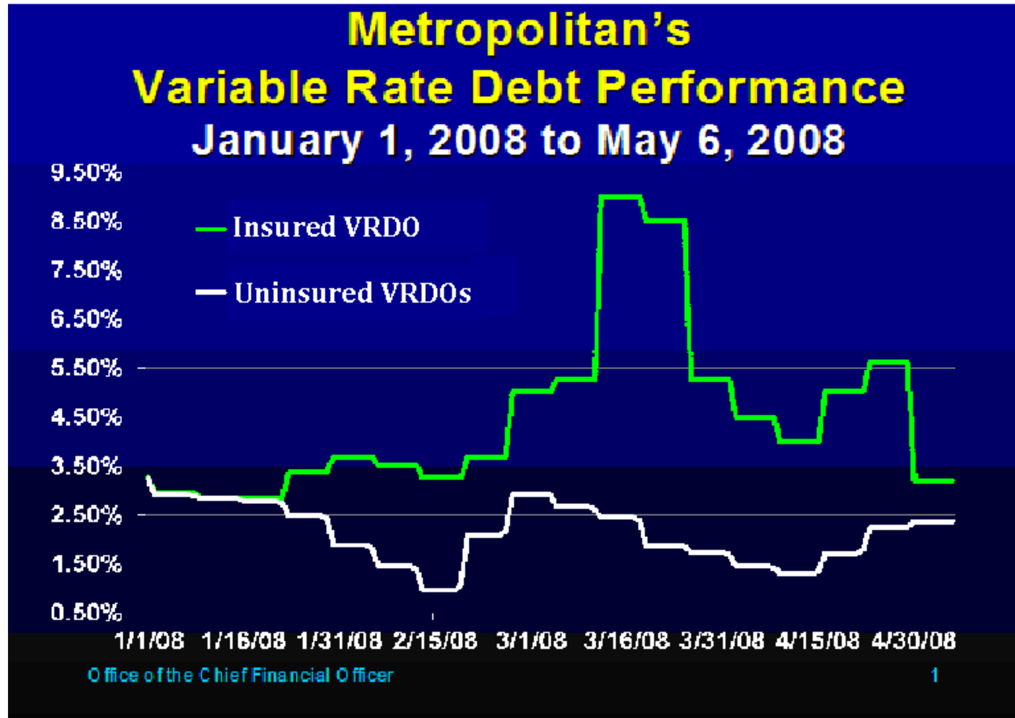
Subject

Approve Appropriation No. 15455 in the amount of $625,000 to pay costs of issuance for Water Revenue Refunding Bonds through June 30, 2009

Description

As discussed over the past few months at the Business and Finance Committee, municipal bond insurance companies such as XLCA, Ambac, FGIC, MBIA and ACA have experienced an erosion of their capital base due to losses from their exposure to debt related to sub-prime mortgages and structured investment vehicles. As a result of these losses, the bond credit rating agencies are questioning whether the capital of these insurers is adequate to cover potential future losses. These insurers' credit ratings have been downgraded since early January 2008 by at least one of the three major rating agencies. The credit downgrades of the monoline bond insurers have had a ripple effect on investors, municipalities, and other issuers throughout the country.

Due to Metropolitan's strong underlying credit ratings of "AAA/Aa2/AA+", Metropolitan has not used municipal bond insurance companies nearly as much as other lower rated municipalities. Metropolitan's primary use of bond insurance has been to support auction rate securities and a small portion ($70 million) of outstanding variable rate debt obligations (VRDOs). Metropolitan refunded $500 million of auction rate securities that had been insured by XLCA, leaving only the $70 million of variable rate revenue bonds insured by Ambac to be resolved. Metropolitan's uninsured variable rate revenue bonds are performing significantly better (lower interest rates) than the $70 million insured variable rate revenue bonds. Ambac is currently rated "AAA" by Standard & Poor's and Moody's Investors Service, and "AA" by Fitch Ratings. All three of the bond rating agencies has Ambac on "negative outlook". The difference in the interest rate of uninsured VRDOs compared to the Ambac insured VRDOs is a clear indication of the value and demand for Metropolitan's high stand-alone credit ratings. In fact, from January 1, 2008 to May 6, 2008, Metropolitan's uninsured VRDOs have averaged 2.13 percent or 239 basis points lower than the average cost of Metropolitan's Ambac insured 1996 Series A VRDO issue. The following chart illustrates the cost difference between Metropolitan's uninsured VRDOs and the Ambac insured 1996 Series A VRDOs from January 1, 2008 to May 6, 2008.



While the interest rate on the Ambac insured bonds has been higher than the uninsured bonds, Metropolitan's cash flow has not been affected because the Ambac bonds are associated with a "cost-of-funds" swap with AIG Financial Products. In conjunction with the issuance of the 1996 Series A VRDOs, Metropolitan entered into a "cost of funds" interest rate swap agreement with AIG whereby Metropolitan pays a fixed rate of 4.99 percent to AIG and, in return receives a variable rate payment from AIG that equals the variable rate payment on the 1996 Series A VRDOs. The "cost of funds" swap is effective through June 2023 (the term of the VRDOs). But, given the financial status of Ambac, Metropolitan does have some financial risk associated with the 1996 Series A VRDOs.

The interest rates on the Ambac insured VRDOs are re-set on a weekly basis, and provide the bond investor (primarily tax-exempt money market funds) with the ability to "put" or demand payment for the bonds on any interest payment date. A remarketing agent is responsible for finding investors for the VRDOs and setting the rate on the bonds. Due to the nature of the variable rate bond requirements, municipalities are required to have a dedicated line of credit on the bonds through a bank liquidity facility. The liquidity facility provides assurances to the investor that both principal and interest payments will be made if the bonds are "put". But, due to default provisions in these liquidity agreements, many investors no longer will purchase Ambac insured bonds. Should UBS, the remarketing agent for the 1996 Series A VRDOs, fail to remarket the bonds or decide not to support the bonds by putting the bonds into its inventory, the 1996 Series A bonds would be "put" to the liquidity bank. Under the terms of the liquidity agreement with the bank (in this case, Lloyd's TSB Bank) the bonds would become "bank bonds" and Metropolitan would be forced to pay an interest rate based on the prime rate. Under the terms of the swap agreement with AIG, once the bonds are "put" to the liquidity bank, AIG no longer pays the cost of funds. Instead, AIG would pay based on a rate equal to 60 percent of the one-month LIBOR rate. The payment received from AIG would be significantly less than the interest payment Metropolitan would be making to the bank.

Due to the likelihood that Ambac's financial condition will continue to deteriorate, and that further downgrades are imminent, staff has determined that Metropolitan should pursue a bond refunding of the 1996 Series A VRDOs and modify the interest rate swap agreement with AIG to reduce Metropolitan's financial risk. The primary near-term risk is that the remarketing agent is unable to place or hold the bonds, resulting in higher interest payments. This issue has become more urgent as UBS has announced it will be exiting from the

municipal market. The longer term risk is that Ambac becomes insolvent, triggering a termination event on the interest rate swap. A termination event could result in a payment by Metropolitan to AIG.

Metropolitan's authority to enter into water revenue refunding bond transactions is provided through the Fourth Supplemental Water Revenue Bond Resolution (Resolution 8387). The Fourth Supplemental Resolution authorizes the Ad Hoc Committee made up of the Chairman of the Board, the Chairman of the Business and Finance Committee, and the General Manager to approve the aggregate principal amounts, terms, and conditions of sale of each series of Water Revenue Refunding Bonds.

Appropriation No. 15455 for Transaction Costs

An appropriation will be required to pay expenses associated with the issuance of Water Revenue Refunding Bonds. Appropriation No. 15455 will be designated for the potential refunding of Metropolitan's Water Revenue Refunding Bonds, 1996 Series A issue. The appropriation will have an expiration date of June 30, 2009.

The following table provides a breakdown of estimated expenses for Appropriation No. 15455:

Item	Amount
Rating Agency Fees	$240,000
Financial & Swap Advisory Fees	135,000
Legal Counsel Fees	125,000
Liquidity Bank Counsel Fees	50,000
Liquidity Bank Closing Fees	25,000
Printing/Mailing	25,000
Paying Agent/Verification/Other	25,000
Total	$625,000

Estimated expenses are based on past experience and estimates of current market conditions. Expenses for bond refunding transactions are incorporated into the savings analysis reported to the Board (savings are reported net of all expenses).

Policy

Chapter 1.6 of Part 5 (Sections 235-239.4) of the Metropolitan Water District Act: Revenue Bonds
Metropolitan Water District Administrative Code Section 5108: Capital Project Appropriation

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed action is not defined as a project under CEQA because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, where it can be seen with certainty that there is no possibility that the proposed action in question may have a significant effect on the environment, the proposed action is not subject to CEQA (Section 15061(b)(3) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA pursuant to Sections 15378(b)(2) and 15061(b)(3) of the State CEQA Guidelines.

CEQA determination for Option #2:

None required

Board Options

Option #1

Adopt the CEQA determination and

a. Authorize General Fund Appropriation No. 15455 in the amount of $625,000 to cover the expenses associated with the water revenue refunding bond transaction; and
b. Authorize reimbursement of expenses paid from the General Fund by bond proceeds. The appropriation will expire on June 30, 2009.

Fiscal Impact: Reduction of financial risks and debt service payments.

Business Analysis: Authorization to fund costs associated with the issuance of water revenue refunding bonds is required in order to proceed with the transaction. This transaction would lower the risk of higher interest payments and termination payments under the cost of funds swap.

Option #2

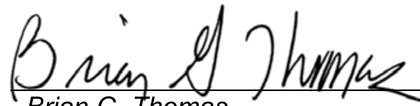
Do not proceed with authorization for the appropriation to fund a water revenue refunding bond transaction.

Fiscal Impact: Increased financial risk to Metropolitan, resulting in higher debt service costs in the future.

Business Analysis: Delaying or otherwise limiting the ability to refund the insured bonds increases the risk that Metropolitan will pay higher costs in the future.

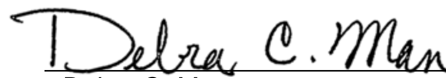
Staff Recommendation

Option #1



5/27/2008

Brian G. Thomas *Date*
Chief Financial Officer



5/27/2008

Debra C. Man *Date*
for *Jeffrey Kightlinger*
General Manager

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