THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

BOARD ACTION

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

July 14, 2009 Board Meeting

8-1

Subject

Adopt resolution authorizing amendment of Metropolitan's Master Swap Policy

Summary

Staff recommends that the Board adopt the attached resolution (**Attachment 1**) amending the Master Swap Policy to enable Metropolitan to execute risk reducing interest rate swaps with existing counterparties that may have current credit ratings below established credit rating thresholds. These transactions would only be executed if the resulting position would reduce Metropolitan's exposure to the swap counterparty. This change would provide needed flexibility to respond to changing market conditions, while maintaining Metropolitan's historic interest rate management position. In particular, this change would allow Metropolitan to execute interest rate swaps to achieve variable rate exposure targets, reduce the need for standby bond purchase agreements, and reduce Metropolitan's put risk with variable rate water revenue bonds.

Description

Section 5922 of the California Government Code permits government agencies to use interest rate swaps to reduce debt service costs and reduce the amount or duration of interest rate risk. In September 2001, Metropolitan adopted its Master Swap Policy describing the conditions under which Metropolitan may enter into an interest rate swap agreement. The Master Swap Policy defines the purpose of the swap program and the parameters under which the program operates. The swap policy outlines the terms and conditions associated with use of such contracts, including:

- Transaction approval parameters
- Payment terms
- Term of swap agreement
- Security, including collateral requirements
- Termination provisions
- Credit rating guidelines for counterparties
- Counterparty requirements, qualifications, and exposure limitations
- Reporting requirements

Metropolitan may execute interest rate swaps to reduce interest rate risk by hedging variable rate bonds and to reduce overall interest costs. Currently, Metropolitan has 17 interest rate swap agreements with four swap counterparties for a total notional amount outstanding of $1.41 billion. Though interest rate swap agreements entail risk (as does all debt and investments), the existing swap policy has served Metropolitan well, enabling Metropolitan to generate $59 million in debt service savings through May 31, 2009.

One important risk, swap counterparty risk (that is, the risk that the counterparty will not be able to meet its obligations), has been effectively managed by diversifying swap counterparties, limiting exposure to any one swap counterparty, and by requiring a swap counterparty to have minimum credit rating thresholds of "Aa3" or "AA-", or equivalent, by any two of the nationally recognized credit rating agencies.

However, given the recent turmoil in the financial markets, the credit ratings of three of Metropolitan's swap counterparties have been lowered to levels below these minimum credit rating thresholds. In addition, the fourth swap counterparty has decided not to enter into any additional interest rate swap agreements in the public sector, eliminating them as a potential swap counterparty in the future. The following is a listing of Metropolitan's existing swap counterparties and their respective credit ratings:

- Citigroup Financial Products Inc. A/A3/A+
- JPMorgan Chase Bank AA-/Aa1/AA-
- Morgan Stanley Capital Services Inc. A/A2/A
- UBS AG A+/Aa2/A+

As discussed at the May 11, 2009 meeting of the Business and Finance Committee, Metropolitan has not escaped the impacts of the financial turmoil in the capital markets. But, given Metropolitan's favorable credit ratings and ability to move quickly to respond to changing market conditions, Metropolitan has been able to avoid many of the pitfalls that other issuers have encountered. For example, Metropolitan has selectively refunded variable rate water revenue bonds that were supported with standby bond purchase agreements from liquidity banks that have suffered from credit ratings downgrades. Two recent refunding issues utilized fixed rate water revenue bonds and SIFMA Index bonds to eliminate the ongoing risks associated with liquidity supported variable rate water revenue bonds. However, given the rising costs of liquidity in the current market, Metropolitan has recently refunded variable rate bonds with fixed rate bonds which has, as a consequence, reduced Metropolitan's ability to maintain its variable rate exposure at desirable levels. With the rising cost of liquidity necessary to support variable rate debt programs (e.g., fees for standby bond purchase agreements or bank letters of credit), the credit issues associated with liquidity banks in the market, the upcoming need for additional liquidity, and the potential for limited access to short-term markets, Metropolitan may need to issue fixed rate water revenue bonds to refund a portion of its variable rate water revenue bonds, reducing variable rate exposure to levels lower than desired.

Fixed receiver swaps can help reduce risk and meet variable rate objectives. In order to maintain variable rate exposure at desirable levels, Metropolitan in conjunction with the issuance of fixed rate water revenue bonds may enter into an interest rate swap agreement that would effectively convert the fixed rate cost of the bonds to a variable interest rate. As illustrated in Figure 1 below, Metropolitan would receive from a swap counterparty a fixed interest rate payment that would be approximately equal to the interest rate on a fixed rate water revenue bond, and in exchange Metropolitan would pay a variable rate equal to the weekly national index of tax-exempt variable rate bonds, or SIFMA. The net result of the transaction would be a variable rate payment by Metropolitan that would approximate the variable rate interest payments made for Metropolitan's variable rate water revenue bonds, but without the need for bank liquidity and the associated risks:

Fixed to Floating Rate Swap

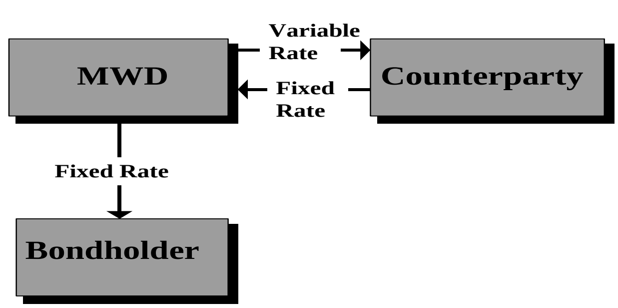

Figure 1

Metropolitan may enter into a fixed to floating interest rate swap with any swap counterparty that meets the qualified swap counterparty requirements detailed in the Master Swap Policy. However, as most of Metropolitan's existing interest rate swaps are floating to fixed interest rate swaps, another consideration for entering into fixed to floating interest rate swaps with existing swap counterparties is to mitigate the mark to market risk for a swap counterparty (thereby reducing swap counterparty risk to Metropolitan). By executing such an "offsetting swap" with an existing swap counterparty, Metropolitan would reduce the mark to market risks on existing trades, maintain or increase variable rate exposure without the need for costly liquidity facilities, help hedge the volatility of interest income in the investment portfolio, and eliminate any other risk associated with variable rate bonds (e.g., the risk that the bonds are tendered to a liquidity bank and Metropolitan must pay significantly higher bank rates).

The amendment to the swap policy that would allow Metropolitan to enter into offsetting interest rate swaps with existing swap counterparties is provided in the attachment to the resolution.

Policy

The Master Swap Policy describes the conditions under which Metropolitan may enter into an interest rate swap agreements and defines the purpose of the swap program and the parameters under which the program may operate. Board approval is required to amend the Master Swap Policy.

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed actions are not defined as a project under CEQA because they involve continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed actions are not subject to CEQA because they involve other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed actions are not subject to CEQA pursuant to Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

CEQA determination for Option #2:

None required

Board Options

Option #1

Adopt the CEQA determination and the attached resolution authorizing amendment to the Master Swap Policy as described in **Attachment 1**.

Fiscal Impact: Allows Metropolitan to reduce swap counterparty risk and maintain variable rate exposure at desirable levels.

Option #2

Do not amend the Master Swap policy.

Fiscal Impact: Potential lost opportunities to reduce Metropolitan's cost of debt and to mitigate swap counterparty risk with existing swap counterparties.

Staff Recommendation

Option #1

	6/29/2009
Brian G. Thomas	*Date*
Chief Financial Officer	

	6/29/2009
Jeffrey Kightlinger	*Date*
General Manager	

Attachment 1 – Resolution of the Board of Directors of The Metropolitan Water District of Southern California Authorizing Amendment of the Master Swap Policy

BLA #6775

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

RESOLUTION ______

RESOLUTION OF THE BOARD OF DIRECTORS
OF THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
AUTHORIZING AMENDMENT OF MASTER SWAP POLICY

THE METROPOLITAN WATER DISTRICT OF
SOUTHERN CALIFORNIA

RESOLUTION ______

RESOLUTION OF THE BOARD OF DIRECTORS
OF THE METROPOLITAN WATER DISTRICT OF
SOUTHERN CALIFORNIA
AUTHORIZING AMENDMENT OF
MASTER SWAP POLICY

WHEREAS, pursuant to Section 5922 of the Government Code of the State of California (the "Government Code"), in connection with the issuance or carrying of its bonds or the acquisition or carrying of any investment or program of investment, The Metropolitan Water District of Southern California ("Metropolitan") may enter into various arrangements, including interest rate swap agreements, forward payment conversion agreements, futures or contracts providing for payments based on levels of, or changes in, interest rates or other indices, or contracts to exchange cash flows or a series of payments or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, rate, spread or similar exposure;

WHEREAS, pursuant to Resolution 8329 adopted by Metropolitan on July 9, 1991 (the "Master Resolution"), Metropolitan has authorized the issuance of Water Revenue Bonds (the "Bonds") on behalf of Metropolitan by adoption of supplemental resolutions from time to time, with the payment of the principal of, interest on, and any redemption premiums thereon being secured by and payable solely from the Net Operating Revenues (as defined in the Master Resolution) of Metropolitan;

WHEREAS, pursuant to Resolution 8773 adopted by Metropolitan on September 11, 2001 (the "Master Swap Resolution"), the Board of Directors (the "Board") of Metropolitan found and determined that it is prudent and advisable for Metropolitan to enter into one or more interest rate swap agreements or other arrangements from time to time authorized under the Government Code in accordance with the terms and conditions set forth in the Master Swap Resolution and the Master Swap Policy adopted thereby (the "Swap Policy"). Interest rate swap agreements entered into pursuant to the Master Swap Resolution and the Swap Policy are referred to herein as "Authorized Swaps" and each is an "Authorized Swap"); and

WHEREAS, pursuant to the Master Swap Resolution, the Board determined that the Authorized Swaps are designed to reduce the amount or duration of the interest rate risk or result in a lower cost of borrowing when used in combination with the issuance or carrying of the Bonds or enhance the relationship between the risk and return with respect to Metropolitan's investments or programs of investment;

WHEREAS, the financial turmoil in the credit markets has affected Metropolitan's financing opportunities and its existing swap counterparties. Metropolitan has issued fixed rate water revenue refunding bonds to refund variable rate water revenue bonds and eliminate the ongoing risks associated with liquidity support for those variable rate bonds. Existing swap counterparties have been downgraded by the nationally recognized credit rating agencies or decided not to enter into any additional interest rate swap agreements with public agencies;

WHEREAS, Metropolitan may offset, hedge or reduce risks of swaps with existing counterparties by entering into interest rate swaps with existing counterparties with terms that counterbalance the terms of the existing swap or swaps with such counterparties;

WHEREAS, Metropolitan desires to enter into offsetting interest rate swap agreements with existing swap counterparties whose credit ratings have dropped below the levels required for qualified swap counterparties under the Swap Policy, to reduce counterparty risk; and

WHEREAS, the attached amendment to the Swap Policy is necessary to permit Metropolitan to enter into such offsetting interest rate swap agreements;

NOW, THEREFORE, the Board of Directors of The Metropolitan Water District of Southern California, DOES HEREBY RESOLVE, DETERMINE AND ORDER as follows:

SECTION 1. Amendment. Section 5 of the Swap Policy is hereby amended to read as shown in the attachment to the Resolution.

SECTION 2. Government Code Section 5922 Determinations. In accordance with Section 5922 of the Government Code of the State of California, the Board hereby determines that the Authorized Swaps contemplated by the Master Swap Resolution, as amended by this Resolution, are designed to reduce the amount or duration of the interest rate risk or result in a lower cost of borrowing when used in combination with the issuance or carrying of the Bonds or enhance the relationship between the risk and return with respect to Metropolitan's investments or programs of investment.

SECTION 3. Ratification; Continuing Requirements. The Master Swap Resolution, as amended hereby, is in all aspects ratified and approved. No Authorized Swap shall be entered into unless such Authorized Swap satisfies the collateral requirements, minimum provider credit ratings, and such other criteria applicable to swaps and similar arrangements as may be set forth in the Swap Policy, as amended hereby. Furthermore, no Authorized Swap shall be entered into if, after giving effect to such Authorized Swap, it would violate the limitations on frequency of trades or total exposure or other limitations set forth in the Swap Policy.

I HEREBY CERTIFY that the foregoing is a full, true and correct copy of a Resolution adopted by a two-thirds (2/3) vote of the total vote of the Board of Directors of The Metropolitan Water District of Southern California at its meeting held on July 14, 2009.

Board Executive Secretary
The Metropolitan Water District
of Southern California

Attachment to

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Amendment to MASTER SWAP POLICY

July 14, 2009

5. Qualified Swap Counterparties

Metropolitan shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. Qualified swap counterparties are identified in Metropolitan's Board approved investment banking team. The composition of the approved swap counterparties will change from time to time as changes are made to Metropolitan's investment banking team. Qualified swap counterparties must be rated at least "Aa3" or "AA-", or equivalent by any two of the nationally recognized rating agencies (i.e. Moody's, Standard and Poor's, or Fitch); or have a "AAA" subsidiary as rated by at least one nationally recognized credit rating agency. In addition, the counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty shall have minimum capitalization of at least $150 million.

Metropolitan may enter into interest rate swap transactions with existing swap counterparties whose credit ratings have dropped below the required levels if the additional swap transaction is an "offsetting" and risk reducing interest rate swap. For example, if Metropolitan has $100 million of floating to fixed interest rate swaps with an existing swap counterparty whose rating has dropped below qualified levels, then Metropolitan may enter into up to $100 million of fixed to floating interest rate swaps to "offset" the risk to Metropolitan with the swap counterparty. The Chief Financial Officer has discretion to determine the tenor of such offsetting swap, but in no case may the final maturity be longer than the existing swap which is being offset.

Metropolitan may negotiate or competitively bid an interest rate swap transaction based on a review of the market impact to Metropolitan of such competitive bid.