

## **CASTAIC LAKE WATER AGENCY INTEREST RATE SWAP POLICY**

This policy has been developed to guide the Castaic Lake Water Agency (CLWA) in its use of interest rate risk mitigation products such as interest rate swaps and other such financing techniques. These financing products can increase CLWA financial flexibility and provide opportunities for interest rate savings or enhanced investment yields. The use of these financing products should be integrated into CLWA's overall debt and investment management policy. Careful monitoring of such products is required to preserve CLWA credit strength and budget flexibility.

Swaps will not be used to speculate on perceived movements in interest rates.

### **PURPOSES FOR WHICH INTEREST RATE SWAP FINANCING PRODUCTS WILL BE USED**

Interest rate swaps can be structured differently, such as to create variable rate exposure through a fixed-to-floating interest rate swap or to create fixed rate exposure through a floating-to-fixed interest rate swap. In any situation, CLWA will only undertake such a financing product to achieve one or more of the following objectives:

- ◆ Interest rate swap financing products may be used to lower interest expense of CLWA debt, for a particular financing or for the overall debt portfolio.
- ◆ Interest rate swap financing products may be used to reduce exposure to changes in interest rates.
- ◆ Interest rate swap financing products may be used to achieve an appropriate asset/liability match.

### **PURPOSES FOR WHICH INTEREST RATE SWAP FINANCING PRODUCTS WILL NOT BE USED**

- ◆ Interest rate swap financing products may not be used for speculative purposes.
- ◆ Interest rate swap financing products may not be used where they would create extraordinary financial leverage or financial risk.
- ◆ Interest rate swap financing products may not be used if they lack adequate liquidity to terminate at an acceptable market price, or
- ◆ Interest rate swap financing products may not be used if there is provide insufficient price transparency to allow for fair market valuation.

### **ANALYSIS OF RISK ASSOCIATED WITH INTEREST RATE SWAP FINANCING PRODUCTS**

CLWA will evaluate all financial products with respect to the unique risks they present. A specific determination must be made that the proposed or alleged benefits exceed the identified risks by an adequate margin over those available in the traditional cash market. The analysis will assess the risk associated with the following factors:

#### **Amortization Risk**

Amortization risk is defined as the mismatch of the expiration of the underlying obligation and its hedge, the swap agreements. Amortization risk is the possibility that, as the result of early redemption of the underlying variable rate bonds, the repayment schedule

of the bonds differs from the underlying notional amount of the swap agreements. This risk will only arise if CLWA wants to redeem the variable rate bonds ahead of schedule. This is not expected for CLWA financings.

### **Basis Risk**

Basis risk refers to the mismatch between the actual variable rate debt service and variable rate index used to determine the swap payments. Different swap indices will be evaluated as part of the analysis of the swap agreement. The analysis will identify the amount of basis risk that may result from various indices.

### **Credit Risk**

Credit risk refers to the credit worthiness of the counterparty. CLWA will only do business with highly rated counterparties. CLWA will structure swap agreements to protect itself from credit deterioration. CLWA will only enter into transactions with counterparties with a credit rating of AA or better. In the event that the credit rating falls below AA during the transaction, the policy includes remedies. For lower rated (below AA) counterparties, CLWA should seek credit enhancement in the form of:

- ◆ Contingent swap counter party providing support;
- ◆ One-way collateral;
- ◆ Ratings downgrade triggers; and,
- ◆ Minimum rating threshold of 'AA'. If the counter party's rating falls below 'AA', the deal should contain termination procedures.

### **Counterparty Risk**

Counterparty risk refers to the failure of the counterparty to make its required payments. This risk can be minimized by establishing strong minimum counterparty credit standards and diversifying CLWA's exposure to counterparties.

### **Rollover Risk**

Rollover risk refers to the potential need to find a replacement counterparty as part of the overall plan of finance if the interest rate swap does not extend to the final maturity of the underlying variable rate bonds. The rollover risk can be minimized through the initial plan of finance by not relying on the execution of future swap agreements.

### **Tax Events Risk**

Tax events risk is defined as the risk created by potential changes to the Federal and State income tax codes on the interest rates to be paid by CLWA on its variable rate bonds. Tax events risk is a form of basis risk. The evaluation should analyze the potential impact of changes in marginal tax brackets as part of its analysis of basis risk.

### **Termination Risk**

Termination risk refers to the possibility that, upon a default by the counterparty, CLWA may be required to make a large payment to the counterparty if the swap agreement is terminated prior to its scheduled maturity pursuant to its terms. For certain types of swaps, a payment by CLWA may be required if interest rates have fallen causing the market value of the remaining payments to be in favor of the counterparty.

## **INTEREST RATE SWAP FINANCING DOCUMENTATION**

CLWA will use standard International Swaps & Derivatives Association (ISDA) swap documentation including the Schedule to the Master Agreement and a Credit Support Annex. CLWA swap documentation should include the following terms:

- ◆ Downgrade provisions triggering termination of the swap should be bilateral.
- ◆ Governing law for swaps will be New York, but should reflect California authorization provisions.
- ◆ The specified indebtedness related to credit events in the master agreement should be narrowly drafted and refer only to specific debt and in no case provide recourse to CLWA.
- ◆ Eligible collateral should be limited to Treasuries and Federal Agencies.
- ◆ Collateral thresholds should be set on a sliding scale reflective of credit ratings.
- ◆ Termination value should be set by “market quotation” methodology.
- ◆ CLWA will only enter into transactions with counterparties with a credit rating of AA or better. In the event that the credit rating falls below AA during the transaction counterparties rated below ‘AA’, the transaction will use a credit support annex to document swap termination value collateralization procedures.
- ◆ Include downgrade trigger.

## **FINANCIAL CONSIDERATIONS**

### **Savings Targets**

Interest rate swap financing products should have higher savings targets, due to the greater complexity and higher risk. In calculating the prospective savings against the target for implementing a fixed-to-variable swap, the cost of re-marketing, in addition to the cost of credit enhancement and liquidity fees must be added to the projected average variable rate. The specific targets are as follows:

- ◆ Financial transactions, using swaps or other derivative products, intended to produce the effect of a synthetic advance refunding, must generate 3% or greater present value savings than the benefit threshold in effect for fixed-rate bonds.
- ◆ The notional amount shall not exceed 15% of total CLWA outstanding debt will be in interest rate swap financing products.

### **Reporting and Accounting**

The agency shall report all interest rate swap financing transactions in accordance with Governmental Accounting Standards Board and Financial Accounting Standards Board statements.

### **SWAP Procurement**

The General Manager is authorized to solicit interest rate swap financing products proposals from firms that meet or exceed the following criteria:

- ◆ The interest rate swap financing transaction provider shall have a credit rating of AA or better.



2009 – Agency completes construction of Groundwater Perchlorate Contamination Treatment Project.



2009 - Agency begins construction of the Rio Vista Water Treatment Plant expansion.



2009 – Agency creates Facebook page.