

Public Utility District No. 1 of Chelan County

Interest Rate Swap

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Why are we here?

- Opportunity to use interest rate swaps to secure debt service savings
 - Bonds callable in 2008 or later that cannot be advance refunded now due to federal tax law limitations
 - Forward-starting swap is only way to achieve debt service savings

- Refresher on swap mechanics, benefits and risks

- Identify bonds as swap candidates for District debt portfolio enhancement

- District's capacity for swaps under the Board approved Swap Policy

- Request for Board approval for resolutions authorizing the swap and related bonds

- Swap Report

Comparison of Refinancing Alternatives

■ Forward-Delivery Fixed Rate Bond Transaction

- Agree *today* on the rates at which the **fixed rate debt** will be issued on or about the call date in 2008 or after
- Future rates equal today's rate PLUS a forward premium
- 10-year call/prepayment feature
- Length of forward period is beyond the market's current appetite – not obtainable

■ ~~Advance Refunding (Not permissible)~~

- ~~Issue fixed rate bonds today and escrow the proceeds to the July 1, 2008 call date~~
- ~~10-year call/prepayment feature~~
- ~~Negative arbitrage (the difference between the allowable investment yield on the escrow account and the actual yield achieved) reduces savings~~

■ Forward Starting Swap (70% LIBOR)

- Enter into swap contract today that becomes effective on or about the call date
- Variable rate debt will be issued which is callable on short notice
- Cost of 10-year call option included in swap pricing
- Estimated savings ranging from \$12-\$28 million (depends on bonds refunded)

■ Forward Starting Swap (BMA)

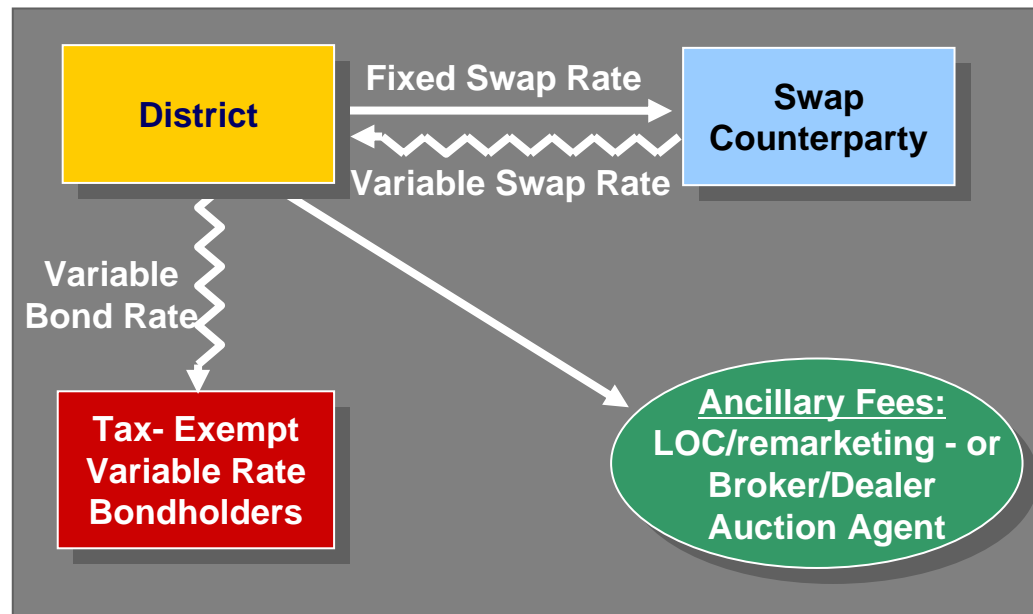
- Similar to the 70% of LIBOR swap, but the District would pay the Bond Market Association's (BMA) weekly variable *tax-exempt* index
- Avoid tax risk at the expense of savings
- Cost of 10-year call option included in swap pricing
- Estimated savings ranging from \$9-\$22 million (depends on bonds refunded)

Recommendations for Consideration

- After evaluating economics and risks of alternative refinancing options, we recommend authorizing using forward-starting interest rate swaps to refinance the Series 1998, 1999, 2001, and/or 2003 bonds to achieve significant debt service savings
 - Expected savings from using swaps estimated to equal \$12.6-\$35 million, depending on the amount of bonds refunded (no obtainable savings using a forward-starting, fixed rate refunding bond transaction)
- Use swap insurance that guarantees the District's swap payments
- Use a percentage of a LIBOR index and reserve portion of the expected gain compared to using the BMA index
- Use pre-qualified, highly rated swap counterparties
- Evaluate use of auction rate bonds vs. variable rate tender option bonds as 2008 (or later) call date approaches

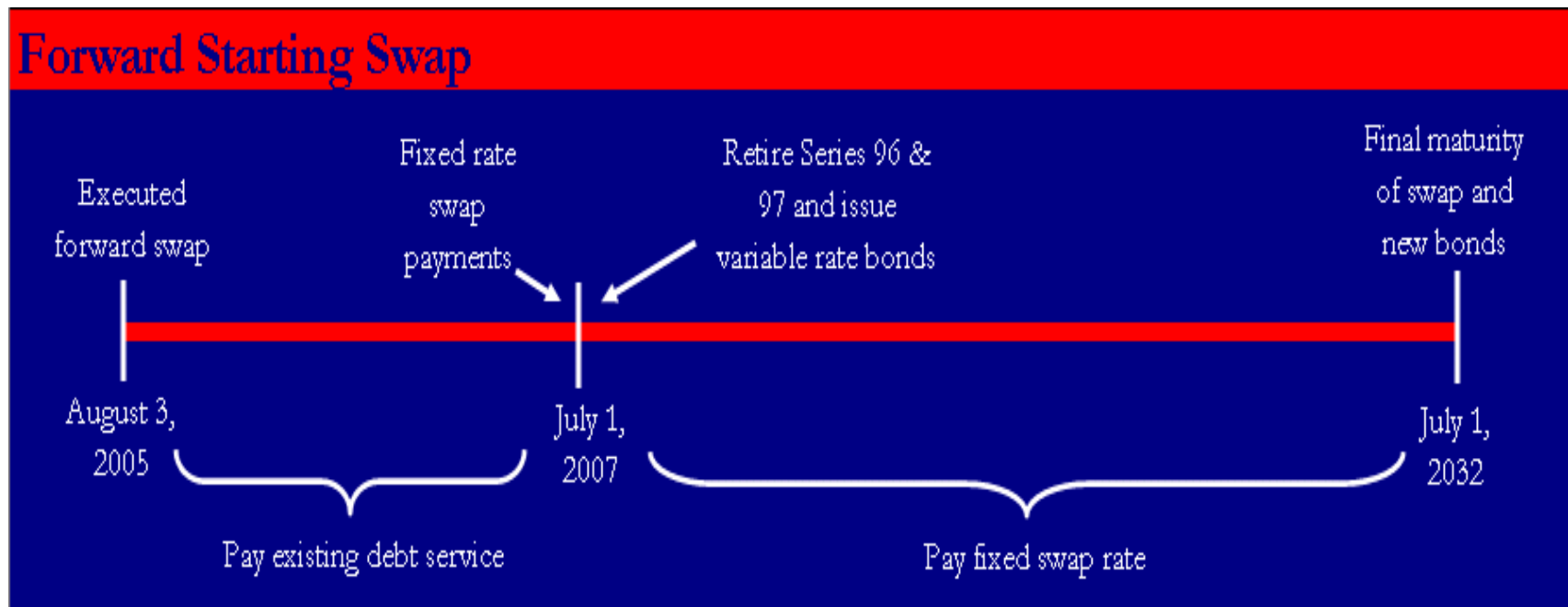
Refresher on Mechanics Of A Swap

- A floating-to-fixed interest rate swap allows the District to structure “synthetic” fixed rate debt.
- The District becomes a “fixed rate payer,” receiving a floating rate payment from a counterparty and paying a fixed rate.
- If the variable rate received by the District offsets the variable rate paid to bondholders, the District’s debt cost equals the fixed swap rate plus any fees.



Refresher on Forward Swap

- Execute swap today and lock in favorable rates but issue refunding bonds in the future when refunded bonds are callable
- Illustration of Forward Starting Swap refunding done by the District in 2005



Common Swap Transaction Participants

■ Swap/Bond Counsel

- Bill Doyle, Orrick Herrington & Sutcliffe
- Ensures compliance with bond resolutions and state statutes
- Prepares and reviews closing documentation
- Ensures compliance with federal tax laws

■ Independent Financial/Swap Advisor

- John Bonow, PFM Asset Management
- Transaction analysis and procurement
- Prepares and reviews closing documents with swap counsel
- Oversight and valuation

■ Swap Provider or “Counterparty”

- Major financial institutions with high credit ratings
 - Execute contracts with the District
 - Selected through a competitive bid process
-

Pre-Qualified Municipal Swap Providers

Long Term Debt Ratings

Financial Institution	Moody's	S&P
Bank of America	Aa1	AA
Bear Stearns ¹	A1	A
Goldman Sachs ¹	Aa3	A+
JP Morgan Chase	Aa2	AA-
Lehman Brothers ¹	A1	A+
Merrill Lynch ¹	Aa3	A+
UBS	Aa2	AA+

¹ also has AAA-rated Derivative Products Company (DPC), which may be used

Elements of the District's Swap Policy

- Incorporates RCW requirements
- Defines goals and objectives of using swaps
 - Hedging – Variable rate or future borrowings
 - Savings – Outperforms conventional financing alternatives
 - Structure – Meets objectives unattainable through traditional markets
- Identifies permitted transactions
- Requires authorizations
- Identifies transaction risks
- Sets swap constraints and limitations
 - Overall counterparty exposure
 - Specific counterparty exposure
 - Term of agreements
 - Counterparty credit rating requirements
 - Collateral requirements
- Identifies swap procurement methodology
 - Negotiated vs. Competitive
 - Eligibility/Qualifications
- Provides for ongoing oversight and reporting
 - Periodic reporting (GASB Technical Bulletin 2003-1)
 - Mark-to-market valuations

Risks Associated with a Swap

What are the major risks in the swap?	How will the District mitigate these risks?
Tax Risk – tax law changes could increase the interest rate on the variable rate bonds without an offsetting increase in the swap rate.	Set aside a portion of the “gain” from the lower swap rate to hedge against tax law changes or keep a like amount in reserve.
Basis Risk – the variable swap rate (% of LIBOR) may not match the tax-exempt variable rate on the refunding Bonds.	Use a LIBOR rate that is based on the actual and expected future trading levels of comparable variable rate bonds.
Termination Risk – the Counterparty could terminate the swap under circumstances that would result in a payment due by the District.	Use swap insurance, if cost effective. Craft swap documents to limit termination events to credit factors.
Counterparty (Credit) Risk – the District could be left with an unhedged variable rate bonds if the Counterparty defaults.	Use a highly rated Counterparty. Use a Credit Support Annex with collateral provisions.
Remarketing Risk – there may be a failed auction or remarketing which could force acceleration or amplify Basis Risk.	Use an experienced remarketing agent or broker/dealer. Anticipate events that could cause a remarketing failure.

Documentation

- ISDA Standard Master Agreement –standard terms & provisions common to all interest rate swaps, such as payment provisions, representations, covenants, events of default, termination and other provisions.
- Counterparty Schedule – standard terms & conditions for municipal swaps including any necessary amendments to the Master Agreement that may be negotiated.
- Credit Support Annex – standard terms & provisions that would apply for collateral posting by swap counterparty.

2006 Best Bond Candidates For Swap

Bond Series	Maturity	Par Amount	Coupon	Call Date	PV Savings*	% Savings*
1998A	7/1/2033	\$ 28,050,000	5.25%	7/1/2008	\$ 4,141,890	14.8%
1998B	7/1/2033	6,500,000	5.00%	7/1/2008	710,183	10.9%
1999A	7/1/2034	21,855,000	6.20%	7/1/2009	5,853,786	26.8%
1999B	7/1/2034	8,500,000	6.20%	7/1/2009	2,276,695	26.8%
2001A	1/1/2036	65,620,000	5.60%	7/1/2011	11,504,942	17.5%
2001B	1/1/2036	45,375,000	5.40%	7/1/2011	6,605,043	14.6%
2001B	1/1/2036	33,000,000	5.60%	7/1/2011	5,785,783	17.5%
2001C	7/1/2032	28,655,000	5.65%	7/1/2011	4,735,230	16.5%
2003A	7/1/2032	29,440,000	6.05%	7/1/2013	6,077,896	20.6%
2004A	1/1/2039	5,510,000	5.30%	7/1/2012	666,458	12.1%

Total Par \$ 272,505,000

Total PV Savings \$ 48,357,906

*Based on swap rates as of March 23, 2006 of 4.30% or less.

District Swap Capacity

- Over \$272 million principal amount of bonds with savings potential of each series of 10-26%, for a total of up to \$48 million
- District has a comprehensive Swap Policy, under which the amount of swaps cannot exceed 50% of the District's outstanding bonds
- Maximum authority under the policy: \$478 million
- Total currently in interest rate swaps: \$94 million
- Remaining swap capacity: \$384 million
- April 3, 2006 Resolutions to authorize up to approximately \$140 million in additional swaps
- Total interest rate swaps after execution would be no more than \$234 million or 24% of outstanding bonds

Board Resolution Parameters

- Consistent with Section 39.96.030(2) of the Revised Code of Washington - the Swap must be expected to:
 - Reduce the amount or duration of the District's exposure to changes in interest rates, and/or
 - Result in a lower net cost of borrowing for the Refunding Bonds
- Notional amount no greater than the Refunding Bonds par amount
- Swap must commence after 3/1/2008
- Swap must terminate when Refunding Bonds mature
- Swap fixed rate cannot exceed 5.5%
- Regularly scheduled swap payments will be on the same lien as the Refunding Bond interest payments
 - Termination payments, if any, will be subordinate to the bond/swap payments

Conditions Required For Swap

- CFO will certify that the swap transaction complies with the District's Swap Policy
- PFM Asset Management, as the District's independent swap advisor, will provide written certification that:
 - The terms and conditions of the Swap Documents and any ancillary agreements are commercially reasonable in light of then existing market conditions; and
 - The Swap Documents will reduce the amount or duration of the District's exposure to changes in interest rates and/or result in a lower net cost of borrowing with respect to the Refunding Bonds

Next Steps

- If Board approves the resolutions:
 - Distribute swap term sheet to qualified counterparties
 - Conduct competitive bidding - swap procurement
 - Execute swap *within acceptable parameters*
 - Cash flows become effective in 2008 and/or 2009 when refunding bonds are issued
 - Potential termination exposure begins when swap is executed and would vary due to movements in prevailing interest rates
 - PFM Asset Management provides District with written report concerning swap's fairness and market-based pricing
- May-June 2008, 2009, 2011 and/or 2013
 - Variable rate bonds are issued to refinance the selected Series of Bonds beginning on July 1, 2008 and/or 2009

Questions?