



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

5/11/2010 Board Meeting

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8-9

**Subject**

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Adopt resolution authorizing the second amendment of Metropolitan's Master Swap Policy

**Description**

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Staff recommends that the Board adopt the attached resolution ([Attachment 1](#)) amending and restating the Master Swap Policy ([Attachment 2](#)) to update the policy and accommodate changes in the swap markets, as described below.

**Summary of Amendments**

Much has changed in the credit markets since Metropolitan executed its last interest rate swap in 2006. Many of the parties that used to participate in the market no longer exist (e.g., Bear Stearns and Lehman Brothers), others no longer participate in the municipal market (e.g., JPMorgan and UBS), and others have been downgraded to credit ratings below Metropolitan's credit thresholds for qualified swap counterparties (e.g., Citi and Morgan Stanley). The interest rate swap market continues to evolve as new regulations are being debated and developed at the national level. In addition, litigation and the result of that litigation may affect how transactions are executed. As a result, staff is recommending that the Board amend the existing Master Swap Policy to update the policy to reflect the changes in the credit market, to enable Metropolitan to reduce risk, and to provide additional opportunities to manage the swap portfolio to reduce cost.

The attached resolution amends and restates the Master Swap Policy. The recommended changes in the policy include the following:

**Provide for additional counterparties.** Initially, the policy limited counterparties (that is, entities with whom Metropolitan could execute interest rate swap contracts) to members of Metropolitan's investment banking team. As some of the counterparties remaining in the municipal space do not provide municipal banking services, staff recommends that the policy be amended to enable Metropolitan to execute swaps with counterparties that meet all other credit requirements (including ratings thresholds and capitalization levels), but may not be members of Metropolitan's investment banking team. The addition of new counterparties at higher credit rating levels will reduce risk of failure of one of the counterparties through diversification of the portfolio.

- a. **Change in counterparty exposure limits.** As interest rates fluctuate, the mark-to-market value of a given financial instrument, including interest rate swaps, will change. In order to manage Metropolitan's exposure to any single counterparty, the policy includes limits on net exposure – the mark-to-market risk that Metropolitan faces with any given counterparty. Staff recommends that the policy be revised to reflect the events of the past three years, and change the exposure limit such that, Metropolitan shall not enter into any swap transaction if both of the following would occur: (a) the maximum net exposure for such swap counterparty would exceed \$50 million, and (b) the maximum net exposure for such swap counterparty exceeds 50 percent of the total maximum net exposure of all swap transactions (regardless of swap counterparty) of Metropolitan as of such date. Maximum net exposure is the swap counterparty's current mark-to-market termination exposure for all existing swap transactions, plus the additional termination exposure that would result from a 50 basis-point shift in the swap curve on (1) the proposed

new swap transaction, and (2) on all existing swap transactions with that counterparty. This change is proposed to enable Metropolitan to manage counterparty exposure in response to changes in market conditions, including interest rates.

- b. **Authority to assign swaps to qualified counterparties.** As the market changes and credit ratings for different counterparties deteriorate, Metropolitan may be required to move quickly to assign or “novate” an existing swap to a higher rated counterparty. Staff recommends amending the policy to enable the Chief Financial Officer to execute such an assignment or replace swaps with qualified counterparties as long as such counterparties meet Metropolitan’s credit thresholds and the duration and interest rates are the same or better than the existing swap. Staff recommends this change to enable Metropolitan to address credit concerns quickly, and to avoid potential termination payments due to the failure of a given counterparty. The Chief Financial Officer will be required to notify the Business and Finance Committee and the Board of such an event at the next Board meeting.
- c. **Authority to amend existing agreements.** Staff recommends that the Chief Financial Officer and the Ad Hoc Committee (consisting of the Chair of the Board, Chair of the Business and Finance Committee and the General Manager) be given the authority to amend existing contracts, to the extent that such an amendment would not result in a termination exposure of greater than \$2.5 million (Chief Financial Officer) or \$5 million (Ad Hoc Committee). All other amendments would require board approval. Staff recommends this change to enable Metropolitan to take advantage of, and respond to, changing market conditions through amendments of existing contracts.
- d. **Updating language to clarify and reflect current market terms and definitions.** The balance of the changes in the policy are “clean-up” in nature, reflecting current market conventions.

## **Potential Transactions**

### Novation

Metropolitan’s staff is currently reviewing the opportunity to novate all of UBS AG’s interest rate swaps. UBS is no longer active in the municipal swap market and the ability to novate swaps from UBS to another qualified swap counterparty would greatly enhance Metropolitan’s ability to take advantage of market opportunities regarding its existing interest rate swaps with UBS, while reflecting current market terms that are to Metropolitan’s advantage.

Metropolitan staff and its advisor, Swap Financial Group, have initiated discussions with additional counterparties, and would be prepared to move forward if the Board approves the proposed amendment.

### Cancellation Option

As communicated to the Business and Finance Committee at the meeting of April 12, 2010, staff is reviewing and analyzing the benefits and risks of an opportunity in the current municipal swap market. Metropolitan is considering entering into a cancellation option with one or more swap counterparties. A cancellation option entails a swap counterparty agreeing to pay Metropolitan an upfront payment, or other consideration, for the right to terminate an existing interest rate swap on a specific day in the future (the optional call date) at par. Metropolitan would be selling an option to a qualified swap counterparty to potentially cancel an existing swap at a future date. In the current low interest rate environment, all 15 of Metropolitan’s fixed payor swaps are below market value, which is reflected in the mark-to-market value of each swap. These mark-to-market values will increase and potentially become positive if, and when, mid-to long-term interest rates begin to rise. The counterparties are willing to pay Metropolitan an upfront cash payment today, because their financial models and forecasts indicate an expectation that interest rates will rise in the future to a point that, on the optional call date, the mark-to-market value of the swap will exceed the upfront payment they made to Metropolitan, thereby allowing the swap counterparty to cancel the swap at lower cost now than on the optional call date. Should the swap be cancelled, Metropolitan would be left with variable rate payments on the underlying variable rate water revenue bonds (thereby converting a fixed payment to a variable rate payment). This will enable Metropolitan to increase and improve its variable rate exposure position.

Metropolitan is in a position to absorb more variable rate debt exposure because over the last year, Metropolitan has reduced its outstanding variable rate debt in response to market conditions such as the sharp increase in bank liquidity costs. These factors resulted in the refunding of variable rate debt with fixed rate debt. Today Metropolitan has only \$683 million of variable rate debt exposure or about 15 percent of outstanding water revenue bonds. The Board policy allows for up to 40 percent. At this time last year, Metropolitan's variable rate exposure was 24 percent of outstanding water revenue bonds. Therefore, if a cancellation swap is exercised, one or more swaps will be terminated and there will be an increase in the amount of variable rate debt that is not hedged by interest rate payor swaps.

By entering into the cancellation swap, Metropolitan has limited any payment it will receive in the next 12 months to the up-front payment. If interest rates rise substantially over the 12-month period to a level whereby Metropolitan would have been better off without the cancellation option, then Metropolitan would forego the difference between the up-front cancellation payment and the termination payment at the end of the 12-month period. Metropolitan's staff, working with its swap advisor, believes that the current market provides an opportune time to enter into a cancellation swap. That is because market conditions are such that the value of the upfront swap payment would be higher than might otherwise be available. This is because there are three factors that drive the value of the upfront payment: The overall level of rates; the steepness of the yield curve; and volatility of interest rates. From the counterparty's perspective, the steeper the yield curve and the greater the volatility of interest rates, the greater the likelihood that interest rates will rise in the future, hence, the higher premium they will pay Metropolitan to cancel the swap. In the current market the yield curve has steepened considerably and is near historic highs. The difference between two-year and ten-year treasuries, an indicator of the steepness of the yield curve, is now at 280 basis points, whereas the historic average is 80 basis points. Volatility, as measured by various indices, reflects the degree to which interest rates will either increase or decrease in the future. Volatility increases in times of market uncertainty, therefore, volatility was at historic levels in the fall of 2008 at the time of the Lehman Brothers bankruptcy and heightened concerns over the stability of the financial system. Volatility levels have declined considerably since then and current levels are now just above long-term averages. Given the steepness of the yield curve, and the fact that volatility is above average, today's market is an opportune time to execute an option.

## **Policy**

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The Master Swap Policy describes the conditions under which Metropolitan may enter into 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)**

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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**

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**Option #1**

Adopt the CEQA determination and

- a. Adopt the attached resolution authorizing the second amendment to the Master Swap Policy as described in **Attachment 1**;
- b. Authorize novation of interest rate swap transactions with UBS AG to another Qualified Swap Counterparty on substantially the same terms and conditions, as approved by the General Manager; and
- c. Authorize the General Manager/Chief Financial Officer to amend existing swap transactions, which may include the transactions novated to another Qualified Swap Counterparty, to provide early cancellation options as described in this board letter.

**Fiscal Impact:** Allows Metropolitan to execute interest swap transactions with swap counterparties who are not current members of Metropolitan’s investment banking team; thereby, diversifying Metropolitan’s pool of qualified swap counterparties, accessing a wider spectrum of swap opportunities, and allowing Metropolitan to realize more competitive pricing for swap market opportunities.

**Option #2**

Do not authorize the resolution allowing for the second amendment to the Master Swap Policy.

**Fiscal Impact:** Potential lost opportunities to reduce Metropolitan’s cost of debt and to mitigate swap counterparty risk.

**Staff Recommendation**

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Option #1

  
 Brian G. Thomas 5/4/2010  
 Chief Financial Officer Date

  
 Jeffrey Lightlinger 5/4/2010  
 General Manager Date

**Attachment 1 – Resolution for the Amendment of the Master Swap Resolution and the Swap Policy**

**Attachment 2 – Metropolitan Water District Amended and Restated Master Swap Policy**

**THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA****RESOLUTION \_\_\_\_\_**

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**RESOLUTION OF THE BOARD OF DIRECTORS OF THE  
METROPOLITAN WATER DISTRICT OF SOUTHERN  
CALIFORNIA PROVIDING FOR THE AMENDMENT  
OF THE MASTER SWAP RESOLUTION AND THE  
SWAP POLICY**

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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 heretofore 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 (as amended, the "Master Swap Resolution"), the Board of Directors of Metropolitan (the "Board") approved the Master Swap Policy dated September 11, 2001, relating to interest rate swap agreements and/or other arrangements authorized by the Government Code, as such Swap Policy may be amended from time to time (the "Swap Policy") and authorized the entry 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 Swap Policy (the "Authorized Swaps" and each, an "Authorized Swap");

WHEREAS, pursuant to Resolution 9098 adopted July 14, 2009, Metropolitan amended the Master Swap Resolution and Swap Policy;

WHEREAS, Metropolitan proposes to further amend and restate its Swap Policy in the form and substance attached hereto as Attachment 1 (the "Amended and Restated Swap Policy");

WHEREAS, Metropolitan proposes to amend its Master Swap Resolution as herein provided (the "Master Swap Resolution Amendments"); and

WHEREAS, pursuant to the Government Code, the Board hereby finds and determines that each of the Amended and Restated Swap Policy and the Master Swap Resolution Amendments and the other transactions and matters contemplated herein are prudent and advisable for Metropolitan and 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;

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

## **ARTICLE I**

### **DETERMINATIONS; DEFINITIONS;**

Section 1.01 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 Amended and Restated Swap Policy and the Master Swap Resolution Amendments and the other transactions and matters contemplated herein 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 one or more series of Bonds or enhance the relationship between the risk and return with respect to Metropolitan's investments or programs of investment.

Section 1.02 Definitions. Unless otherwise defined herein, all terms shall have the meanings set forth in the Master Swap Resolution.

## **ARTICLE II**

### **AMENDED AND RESTATED SWAP POLICY**

Section 2.01 Approval of Amended and Restated Swap Policy. The Board hereby authorizes and approves the Amended and Restated Swap Policy.

## **ARTICLE III**

### **AMENDMENT TO MASTER SWAP RESOLUTION**

Section 3.01 Approval of Amendment to Master Swap Resolution. The Board hereby amends the Master Swap Resolution as follows:

(a) The definition of "ISDA Master Agreement" in Section 1.02 of the Master Swap Resolution is hereby amended and restated to read in its entirety as follows:

“ISDA Master Agreement” means any of the forms of the 1992 ISDA Master Agreement (Local Currency-Single Jurisdiction), or the 1992 ISDA Master Agreement (Multicurrency – Cross Border) or the 2002 ISDA Master Agreement, as selected by the Chief Financial Officer of Metropolitan, prepared by the International Swaps and Derivatives Association, Inc., as amended or supplemented by any schedules, confirmations or other documents relating thereto, as such form or documents may be amended from time to time.

(b) The following definition of “Replacement Swap Transaction” shall be added to Section 1.02 of the Master Swap Resolution to read in its entirety as follows:

“Replacement Swap Transaction” shall mean any swap transaction or other Authorized Swap that Metropolitan enters into for the purpose of replacing an existing swap transaction or other Authorized Swap that has been or is expected to be terminated (either by Metropolitan or the counterparty thereto).

(b) Section 2.01 of the Master Swap Resolution is hereby amended and restated in its entirety as follows:

**SECTION 2.01. Approval of Authorized Swaps and Related Agreements.** (a) Metropolitan is hereby authorized to enter into one or more Authorized Swaps on the terms and subject to the conditions contained in this Article II. Prior to execution and delivery thereof, each Authorized Swap shall satisfy the following conditions:

(i) The Authorized Swap shall satisfy the criteria set forth in Metropolitan’s Master Swap Policy dated September 11, 2001, approved by the Board on September 11, 2001 and amended on May 11, 2010, relating to interest rate swap agreements and/or other arrangements authorized by the Government Code, as such Policy may be amended from time to time (the “Swap Policy”);

(ii) The Authorized Swap shall contain the terms and conditions set forth in the ISDA Master Agreement and/or such other terms and conditions as may be approved in each case by the Board, the Ad Hoc Committee or the Chief Financial Officer of Metropolitan, as applicable, each in consultation with the General Counsel of Metropolitan, in accordance with Section 2.01(a)(iii) below;

(iii) Subject to any applicable restrictions in the Swap Policy, each Authorized Swap shall be authorized and approved by the Board, the Ad Hoc Committee or the Chief Financial Officer of Metropolitan, as appropriate, as required by and set forth in Section 4 of the Swap Policy and Sections 2.01(b) and 2.01(c) below; and

(iv) The Chief Financial Officer of Metropolitan shall file a certificate with the Fiscal Agent certifying that the Authorized Swap: (1) to the extent applicable, complies with the terms applicable to Parity Obligations set forth in the Master Resolution, including the issuance of Parity Obligations under Section 6.09 thereof, and (2) complies with the terms of the Swap Policy.

(b) Subject to the satisfaction of the conditions set forth in Section 2.01(a) above, the Ad Hoc Committee is hereby authorized and directed to empower the officers of Metropolitan to negotiate, execute and deliver, on behalf of Metropolitan (in consultation with the Chief Financial Officer of Metropolitan and the General Counsel of Metropolitan), each Authorized Swap with a notional amount greater than \$50,000,000 which satisfies the transaction approval requirements for the Ad Hoc Committee set forth in Section 4 of the Swap Policy. The Ad Hoc Committee is hereby empowered to establish on behalf of Metropolitan (in consultation with the Chief Financial Officer of Metropolitan and the General Counsel of Metropolitan) the terms and conditions of each such Authorized Swap as the members of the Ad Hoc Committee shall agree upon in their sole discretion as being in the best interests of Metropolitan, subject only to the provisions of the Government Code, the Act and this Master Swap Resolution, and shall be so empowered solely to implement the fundamental policies established by this Master Swap Resolution in a manner that is most advantageous to Metropolitan. The terms and conditions of each such Authorized Swap shall be set forth in the Authorized Swap. Such terms and conditions as so set forth, together with the other terms and conditions set forth in this Master Swap Resolution, shall, upon execution and delivery of the Authorized Swap by the Ad Hoc Committee, or its designee, on behalf of Metropolitan, be all the terms and conditions of such Authorized Swap.

(c) Subject to the satisfaction of the conditions set forth in Section 2.01(a) above, the Chief Financial Officer of Metropolitan is hereby authorized and directed to negotiate, execute and deliver, on behalf of Metropolitan (in consultation with the General Manager of Metropolitan and the General Counsel of Metropolitan), each Authorized Swap with a notional amount of \$50,000,000 or less. The Chief Financial Officer of Metropolitan is hereby empowered to establish on behalf of Metropolitan (in consultation with the General Manager of Metropolitan and the General Counsel of Metropolitan) the terms and conditions of each such Authorized Swap as the Chief Financial Officer of Metropolitan shall determine as being in the best interests of Metropolitan, subject only to the provisions of the Government Code, the Act and this Master Swap Resolution, and shall be so empowered solely to implement the fundamental policies established by this Master Swap Resolution in a manner that is most advantageous to Metropolitan. The terms and conditions of each such Authorized Swap shall be set forth in the Authorized Swap. Such terms and conditions as so set forth, together with the other terms and conditions set forth in this Master Swap Resolution, shall, upon execution and delivery of the Authorized Swap by the Chief Financial Officer of Metropolitan or his or her designee, on behalf of Metropolitan, be all the terms and conditions of such Authorized Swap.”



(c) A new Section 2.06 of the Master Swap Resolution is hereby added and shall read in its entirety as follows:

**“Section 2.06. Execution of Amendments and Assignments or Novations.** Notwithstanding any other provision of this Master Swap Resolution, any amendment of or assignment and/or novation of an Authorized Swap shall be governed by the terms of the Swap Policy.”

(c) A new Section 2.07 of the Master Swap Resolution is hereby added and shall read in its entirety as follows:

**“Section 2.07. Replacement Swap Transactions.** Notwithstanding any other provision of this Master Swap Resolution, any Replacement Swap Transaction shall be governed by the terms of the Swap Policy.”

## ARTICLE IV

### MISCELLANEOUS

Section 4.01 Execution of Related Documents; Further Action. Each Authorized Officer, be and each of them, is hereby authorized, empowered and directed to execute any other documents and agreements and to take such other actions as any such Authorized Officer deems necessary or advisable to effect or to enter into any of the Approved Matters or to otherwise carry into effect the intent of this Resolution.

Section 4.02 Ratification of Master Swap Resolution. The Master Swap Resolution, as amended hereby, is in all aspects ratified and approved.

Section 4.03 Governing Law. This Resolution shall be construed and governed in accordance with the laws of the State of California.

**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 May 11, 2010.

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Board Executive Secretary  
The Metropolitan Water District of Southern  
California

# **THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA**

## **AMENDED AND RESTATED MASTER SWAP POLICY**

**May 11, 2010**

### **1. Authority**

A Master Swap Resolution (“Master Swap Resolution”) of the Board of Directors of the Metropolitan Water District of Southern California (“Metropolitan”) authorizing the execution and delivery of interest rate swap transactions (“Swap Transactions”) and related agreements (“Swap Agreements”) was approved on September 11, 2001 and amended on July 14, 2009 and May 11, 2010. The Master Swap Resolution authorizes Metropolitan to enter into Swap Transactions from time to time to better manage assets and liabilities and to take advantage of market conditions to lower overall costs and reduce interest rate risk.

The Master Swap Resolution authorizes the execution of Swap Transactions and Swap Agreements, provides for security and payment provisions, and sets forth certain other provisions related to Swap Agreements between Metropolitan and qualified swap counterparties. In the event of a conflict between the terms of the Master Swap Resolution and the terms of this Master Swap Policy (the “Swap Policy”), the terms and conditions of the Master Swap Resolution shall control.

### **2. Purpose**

The incurring or carrying of obligations and management of investments by Metropolitan involves a variety of interest rate payments and other risks that a variety of financial instruments are available to offset, hedge, or reduce. It is the policy of Metropolitan to utilize such financial instruments to better manage its assets and liabilities. Metropolitan may execute a Swap Transaction if Metropolitan expects the Swap Transaction to result in any of the following:

- Reduce exposure to changes in interest rates on a particular financial transaction or in the context of the management of interest rate risk derived from Metropolitan’s overall asset / liability balance;
- Result in a lower net cost of borrowing with respect to Metropolitan’s debt or achieve a higher net rate of return on investments made in connection with, or incidental to the issuance, incurring, or carrying of Metropolitan’s obligations or other Metropolitan investments; or
- Manage variable interest rate exposure consistent with prudent debt practices and guidelines approved by the Board.

Metropolitan shall not enter into any Swap Transaction for speculative purposes.

### 3. Form of Swap Agreements

Each Swap Transaction and Swap Agreement executed by Metropolitan shall contain terms and conditions as set forth in an ISDA Master Agreement (as such term is defined in the Master Swap Resolution). Subject to the Approval Requirements (as defined below in Section 4), the Swap Agreements between Metropolitan and each Qualified Swap Counterparty (as defined below) shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Chief Financial Officer, in consultation with the General Counsel, deems necessary or desirable.

### 4. Swap Transaction Approval Requirements

The Chief Financial Officer, the Ad Hoc Committee (as such term is defined in the Master Swap Resolution) or the Board of Directors of Metropolitan shall approve each Swap Transaction in accordance with the approval requirements set forth in Article II, Section 2.01(a)(iii) of the Master Swap Resolution and in this Section 4. The approval requirements of any Swap Transaction will be based upon the notional amount and average life of the Swap Transaction. The following table sets forth the approval requirements for each Swap Transaction (the "Approval Requirements"):

<b>Approval Requirements</b>			
Average Life of Swap Transaction	Notional Amount		
	Board Approval	Ad Hoc Committee	CFO Approval
5 years or less	greater than \$300M	>\$50M, up to \$300M	\$50M or less
>5 years <10 years	greater than \$250M	>\$50M, up to \$250M	\$50M or less
10 years or greater	greater than \$200M	>\$50M, up to \$200M	\$50M or less

If Metropolitan proposes to enter into any Swap Transaction, then Metropolitan shall satisfy the Approval Requirements with respect to such Swap Transaction based on the average life and notional amount of such Swap Transaction and all other Swap Transactions Metropolitan has entered into over the immediately preceding three-month period (without regard to any Replacement Swap Transactions (as defined below), Offsetting Swap Transactions (as defined below) and any amendments, assignments or novations of existing Swap Transactions for which the requirements for approval are specified in Section 10 hereof).

For example, if Metropolitan enters into a \$50 million Swap Transaction for 15 years, approval for this Swap Transaction would be required from the Chief Financial Officer only. However, if within the same three-month period Metropolitan proposes to enter into a second 15-year Swap Transaction for \$50 million, then approval for the second Swap Transaction (and only the second Swap Transaction) would be required by the Ad Hoc Committee.

Notwithstanding the foregoing, the Chief Financial Officer may execute and deliver any Swap Agreement (including an ISDA Master Agreement and a Schedule and Credit Support Annex thereto) so long as the terms and conditions of each Swap Transaction entered thereunder is approved and authorized in accordance with this Section 4.

## **5. Qualified Swap Counterparties**

Metropolitan shall be authorized to enter into Swap Transactions only with Qualified Swap Counterparties. The term “Qualified Swap Counterparty” shall mean any commercial or investment bank or any other financial institution that (a) has a demonstrated record of successfully executing swap transactions, (b) is rated, or has its payment obligations under a Swap Agreement guaranteed by an entity which is rated, in each case 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

Metropolitan may enter into Swap Transactions with existing swap counterparties whose credit ratings have dropped below the required levels if the additional Swap Transaction is an Offsetting Swap Transaction (as such term is defined in Section 8 of this Swap Policy). 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 Swap Transactions to “offset” the risk to Metropolitan with the swap counterparty. The Chief Financial Officer has discretion to determine the tenor of such Offsetting Swap Transaction, but in no case may the final maturity be longer than the existing Swap Transaction which is being offset.

Metropolitan may negotiate or competitively bid any Swap Transaction based on a review of the costs and benefits to Metropolitan of such approach.

## **6. Termination Provisions**

All Swap Transactions shall contain provisions granting Metropolitan the right to optionally terminate a Swap Transaction at any time over the term of the Swap Transaction.

*Optional Termination.* Metropolitan may exercise the right to optionally terminate a Swap Transaction if it determines that it will (1) produce a benefit to Metropolitan, either through receipt of a payment from a termination, or if a termination payment is made by Metropolitan, in conjunction with a conversion to a more beneficial (desirable) debt obligation of Metropolitan or as otherwise determined by Metropolitan, (2) result in a more beneficial mix of fixed and variable rate debt consistent with prudent debt practices and guidelines approved by the Board, or (3) otherwise reduce risk as determined by the Chief Financial Officer or the Ad Hoc Committee. The Chief Financial Officer or the Ad Hoc Committee is authorized to terminate any Swap Transaction on behalf of Metropolitan as provided by Section 2.04 of the Master Swap Resolution.

*Mandatory Termination:* A termination payment to or from Metropolitan may be required in the event of termination of a Swap Transaction due to the occurrence and continuance of an event of default or termination event (including, but not limited to, a decrease in credit rating below an established level of either Metropolitan or the swap counterparty). If the event of default or

termination event is due to the swap counterparty and a termination payment would be owed by Metropolitan, before deciding to exercise its right to terminate a Swap Transaction, the Chief Financial Officer shall evaluate whether it is financially advantageous for Metropolitan to enter into a Replacement Swap Transaction (as defined and for the purposes specified below) to avoid making such termination payment or so that the swap counterparty to the Replacement Swap Transaction will make an up-front payment to Metropolitan upon entering into the Replacement Swap Transaction in an amount that will offset the termination payment that Metropolitan will be making to the original swap counterparty. As used herein, the term “Replacement Swap Transaction” shall mean any Swap Transaction that Metropolitan enters into for the purpose of replacing an existing Swap Transaction that has been or is expected to be terminated (either by Metropolitan or the counterparty thereto).

Upon the occurrence and continuance of an event of default by a swap counterparty or a termination event related to a swap counterparty whereby Metropolitan would be required to make a termination payment, Metropolitan shall proceed as follows:

- In order to mitigate the financial impact of making such payment at the time such payment is due; Metropolitan will seek to enter into a Replacement Swap Transaction such that the swap counterparty to the Replacement Swap Transaction would make an upfront payment to Metropolitan in an amount that would offset the termination payment obligation of Metropolitan under the existing Swap Transaction or the swap counterparty to the Replacement Swap Transaction will make a payment directly to the counterparty of the existing Swap Transaction pursuant to a novation agreement and Metropolitan will no longer have a payment obligation with respect to the swap counterparty to the existing Swap Transaction.

*Authorization for Replacement Swap Transactions.* Notwithstanding any other provision of this Swap Policy to the contrary (including, but not limited to, this Section 6 and Section 4 and Section 8 of this Swap Policy), the Chief Financial Officer shall be authorized to execute and deliver on behalf of Metropolitan any Replacement Swap Transaction so long as the counterparty of such Replacement Swap Transaction is a Qualified Swap Counterparty.

## **7. Term and Notional Amount of Swap Agreement**

Metropolitan shall determine the appropriate term for any Swap Transaction on a case by case basis. The slope of the swap curve, the marginal change in swap rates from year to year along the swap curve, and the impact that the term of the swap has on the overall exposure of Metropolitan shall be considered in determining the appropriate term of any swap agreement. In connection with the issuance or carrying of bonds, the term of a Swap Transaction between Metropolitan and a Qualified Swap Counterparty shall not extend beyond the latest final maturity date of existing water revenue bonds of Metropolitan. At no time shall the total notional amount of all swaps exceed the total amount of outstanding water revenue bonds.

## **8. Swap Counterparty Maximum Net Exposure Limits**

To diversify Metropolitan’s swap counterparty risk and to limit Metropolitan’s credit exposure to any one swap counterparty, Metropolitan hereby establishes limits for each swap counterparty

based upon both the credit rating of the swap counterparty and the relative level of Maximum Net Exposure (as defined below). Metropolitan shall not enter into any Swap Transaction if after giving effect to, and as of the date of the entering into of, such Swap Transaction both of the following would occur: (a) the Maximum Net Exposure for such swap counterparty would exceed \$50 million and (b) the Maximum Net Exposure for such swap counterparty exceeds 50% of the total Maximum Net Exposure of all Swap Transactions (regardless of swap counterparty) of Metropolitan as of such date.

As an example of how to calculate the Maximum Net Exposure of Metropolitan to a swap counterparty, assume Metropolitan has executed a 30-year \$150 million notional amount Swap Transaction with a swap counterparty and the Termination Exposure to that swap counterparty for Metropolitan is \$40 million and Metropolitan wants to enter into another \$150 million notional amount Swap Transaction with such swap counterparty. Now assume that if the yield curve moved 50 basis points Metropolitan's aggregate Termination Exposure to this swap counterparty on the existing Swap Transactions would increase by \$10 million and Metropolitan's Termination Exposure on the new Swap Transaction would be \$10 million. The Maximum Net Exposure of Metropolitan to such swap counterparty would equal \$60 million. Therefore, since the Maximum Net Exposure of Metropolitan to such swap counterparty would exceed \$50 million, Metropolitan would be authorized to enter into such new Swap Transaction only if the \$60 million in Maximum Net Exposure represents 50% or less of the total Maximum Net Exposure of all Swap Transactions of Metropolitan as of such date.

In addition, additional exposure provisions are as follows:

- The sum total notional amount per swap counterparty may not exceed 25 percent of Metropolitan's total revenue bond indebtedness; provided, however, that Metropolitan shall not take into consideration into the total notional amount per swap counterparty any Offsetting Swap Transactions entered into with a swap counterparty which offset other Swap Transactions entered into with the same swap counterparty; and
- The appropriate collateral thresholds in the Swap Agreement will be determined on a case by case basis, and approved by the Chief Financial Officer in consultation with the General Counsel.

If at any time the mark-to-market exposure under all Swap Transactions with a swap counterparty exceeds the limits described above, then Metropolitan shall conduct a review of its risk to that swap counterparty. The Chief Financial Officer shall evaluate appropriate strategies in consultation with the Office of the General Counsel to mitigate this exposure. Notwithstanding the foregoing, Metropolitan shall only be required to satisfy the provisions of this Section 8 at the time that it enters into a Swap Transaction.

As used in this Section 8:

The term "Termination Exposure" shall mean the total amount of mark-to-market termination payment exposure of Metropolitan under a Swap Transaction or Swap Transactions, calculated assuming market quotation/second method on a mid-market basis.

The term “Potential Termination Exposure” shall mean the total estimated additional amount of mark-to-market termination exposure of a Swap Transaction that would be caused by a change of 50 basis points in the swap curve (in the direction that would cause the greatest increase in such Termination Exposure to Metropolitan).

The term “Maximum Net Exposure” shall mean, in connection with any proposed Swap Transaction with a swap counterparty, that amount equal to the sum of (a) the aggregate amount of Termination Exposure on the date of determination for all existing Swap Transactions with such swap counterparty, (b) the aggregate amount of Potential Termination Exposure for the proposed new Swap Transaction, plus (c) the Potential Termination Exposure for all existing Swap Transactions with the swap counterparty of the new Swap Transaction; provided, however, that in calculating such Termination Exposure and Potential Termination Exposure, Metropolitan shall take into consideration the impact of any Offsetting Swap Transactions.

The term “Offsetting Swap Transaction” shall mean any Swap Transaction that Metropolitan enters into that directly or indirectly has the effect of offsetting Metropolitan’s interest rate exposure under one or more other Swap Transactions, including, but not limited to, basis risk swap transactions.

## **9. Collateral Requirements**

As part of any Swap Agreement, unless otherwise approved by the Ad Hoc Committee, Metropolitan shall require collateralization or other credit enhancement to secure any or all swap payment obligations. As appropriate, the Chief Financial Officer, in consultation with the General Counsel may require collateral or other credit enhancement to be posted by each swap counterparty. Unless the Ad Hoc Committee otherwise authorizes or requires, each Swap Agreement that Metropolitan executes and delivers after the date hereof shall be required or may be permitted to, as applicable, contain the following terms and conditions:

- Each swap counterparty to Metropolitan may be required to post collateral subject to negotiated thresholds if the credit rating of the swap counterparty or parent falls below the “AA” category. Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each swap counterparty in accordance with the provisions contained in the collateral support agreement to each Swap Agreement with Metropolitan.
- Collateral may consist of cash, U.S. Treasury securities or Agencies.
- Collateral shall be deposited with a third party custodian, or as mutually agreed upon between Metropolitan and each swap counterparty.
- A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty.
- The market value of the collateral shall be determined on at least a weekly basis.
- Metropolitan will determine reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.
- The Chief Financial Officer shall determine on a case by case basis whether other forms of credit enhancement are more beneficial to Metropolitan.

- Metropolitan may, as part of the negotiation, be required to post collateral to the swap counterparty. The terms of such collateral posting by Metropolitan will not exceed the collateral posting requirements of the swap counterparty unless the Ad Hoc Committee has approved such terms.

#### **10. Amendment or Assignment of Swap Transaction or Swap Agreement.**

a. *Amendments.* Notwithstanding any other provision of this Swap Policy, Metropolitan shall be authorized to enter into an amendment of any existing Swap Transaction (1) solely with the approval and the authorization of Metropolitan's Chief Financial Officer if such amendment does not cause an increase on the effective date of the amendment in the Termination Exposure of Metropolitan of more than \$2.5 million after adjusting for any up-front payments either made or received by Metropolitan (for example, if Metropolitan is paid \$3 million by the counterparty as a result of the amendment and concurrently the Termination Exposure increases by \$3 million, the net impact of the amendment will be deemed to be zero) and (2) solely with the approval and the authorization of the Ad Hoc Committee if such amendment does not cause an increase on the effective date of the amendment in the Termination Exposure of Metropolitan of more than \$5 million after adjusting for any up-front payments either made or received by Metropolitan.

b. *Assignments.* Notwithstanding any other provision of this Swap Policy, Metropolitan shall be authorized to enter into any assignment or novation of a Swap Transaction from one swap counterparty to another swap counterparty solely with the approval and the authorization of Metropolitan's Chief Financial Officer if the swap counterparty to which such Swap Transaction is assigned is a Qualified Swap Counterparty. Notwithstanding any other provision of this Swap Policy (including Section 4 and Section 8 of this Swap Policy), Metropolitan shall be authorized to enter into a Swap Agreement with the swap counterparty to which any Swap Transaction is assigned pursuant to the immediately preceding sentence (or otherwise amend the terms and conditions of the assigned Swap Transaction) on such terms and conditions (1) as the Chief Financial Officer of Metropolitan shall authorize and approve so long as such terms and conditions do not have the impact of increasing on the effective date of such assignment or novation the Termination Exposure of Metropolitan under the assigned or novated Swap Transactions of more than \$2.5 million and (2) solely with the approval and the authorization of the Ad Hoc Committee if such amendment does not cause an increase on the effective date of such assignment or novation the Termination Exposure of Metropolitan under the assigned or novated Swap Transactions of more than \$5 million.

#### **11. Reporting Requirements**

A written report providing the status of all Swap Transactions will be provided to the Board of Directors at least on a quarterly basis and shall include the following information:

- Highlights of all material changes to Swap Agreements and Swap Transactions or new Swap Agreements and Swap Transactions (including, but not limited to any amendments, assignments or novations to Swap Agreements or Swap Transactions) entered into by Metropolitan since the last report.
- Market value of each of Metropolitan's Swap Transactions.



- The net impact to Metropolitan of a 50 basis point movement (up or down) for each Swap Transaction with the appropriate swap index or curve.
- For each swap counterparty, Metropolitan shall provide the total notional amount position, the average life of each swap agreement, and the remaining term of each Swap Transaction.
- The credit rating of each swap counterparty and credit enhancer insuring or guaranteeing swap payments, if any.
- Actual collateral posting by swap counterparty, if any, per Swap Transaction and in total by swap counterparty.
- Actual collateral posting by Metropolitan, if any, per Swap Transaction and in total by swap counterparty.
- A summary of each Swap Transaction, including but not limited to the type of Swap Transaction, the rates paid by Metropolitan and received by Metropolitan, and other terms.
- Information concerning any default by a swap counterparty to Metropolitan, and the results of the default, including but not limited to the financial impact to Metropolitan, if any.
- A summary of any planned Swap Transactions and the expected impact of such Swap Transactions on Metropolitan.
- A summary of any Swap Transactions that were terminated.

The Chief Financial Officer together with the General Counsel shall review the Swap Policy on an annual basis and recommend appropriate changes to the Board.

## **12. Calculations.**

In calculating the Termination Exposure, Potential Termination Exposure, Maximum Net Exposure or any other calculation under this Swap Policy, Metropolitan may conclusively rely on calculations of employees of Metropolitan or on a certificate from its swap advisor certifying as to such calculation (in each case, in accordance with industry standards and customs) and any such calculation shall be conclusive for all purposes of the Master Swap Resolution and this Swap Policy.