INTEREST RATE SWAP POLICY

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Table of Contents

I. Introduction 1
II. Scope and Authority 1
III. Conditions for the Use of Interest Rate Swaps 2
- A. General Usage 2
- B. Maximum Notional Amount 2
- C. Liquidity Considerations 2
- D. Call Option Value Considerations 2

IV. Interest Rate Swap Features 3
- A. Interest Rate Swap Agreement 3
- B. Interest Rate Swap Counterparties 3
- C. Term and Notional Amount 5
- D. Collateral Requirements 5
- E. Security and Source of Repayment 6
- G. Prohibited Interest Rate Swap Features 6

V. Evaluation and Management of Interest Rate Swap Risks 6
- A. Evaluation Methodology 7
- B. Managing Interest Rate Swap Risks 9
- C. Terminating Interest Rate Swaps 10

VI. Selecting and Procuring Interest Rate Swaps 10
- A. Financing Team 10
- B. Underwriter Selection 11
- C. Counterparty Selection 11

VII. Disclosure and Financial Reporting 11
Glossary of Terms 12

INTEREST RATE SWAP POLICY

I. Introduction

The purpose of the Interest Rate Swap Policy is to establish guidelines for the use and management of interest rate swaps. The Interest Rate Swap Policy is prepared in accordance with the recommended practices of the Government Finance Officers Association regarding the contents of a derivatives policy.

We are authorized under California Government Code Section 5922 to enter into interest rate swaps to reduce the amount and duration of rate, spread, or similar risk when used in combination with the issuance of bonds.

II. Scope and Authority

This Interest Rate Swap Policy shall govern the use and management of all interest rate swaps. While adherence to this Policy is required in applicable circumstances, we recognize that changes in the capital markets, agency programs, and other unforeseen circumstances may from time to time produce situations that are not covered by the Interest Rate Swap Policy and will require modifications or exceptions to achieve policy goals. In these cases, management flexibility is appropriate provided specific authorization from the Board is obtained or is authorized in this Policy. The Chief Executive Officer, the Chief Financial Services Officer, the Treasurer and Assistant Treasurer, each an "Authorized Signatory," are individually authorized to take all reasonable actions necessary to administer the swaps on an ongoing basis, including such actions (herein defined as "Administrative Actions") as amending terms and pricing, as well as terminating and replacing swaps when in the reasonable judgment of an Authorized Signatory such action will be beneficial and consistent with the original objectives for entering into the initial swap transaction.

In conjunction with the Debt Policy, the Interest Rate Swap Policy shall be reviewed and updated at least annually and presented to the Board for approval. The Chief Executive Officer and the Chief Financial Services Officer and Treasurer are the designated administrators of the Interest Rate Swap Policy. The Treasurer shall have the day-to-day responsibility and authority for structuring, implementing, and managing interest rate swaps.

The Board shall approve any transaction involving an interest rate swap, other than transactions involving Administrative Actions. We shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. Each Authorized Signatory is individually authorized to select the counterparties, so long as the criteria set forth in the Interest Rate Swap Policy are met.

III. Conditions for the Use of Interest Rate Swaps

A. General Usage

Interest rate swaps may be used to lock-in a fixed rate or, alternatively, to create additional variable rate exposure. Interest Rate Swaps may be used to produce interest rate savings, limit or hedge variable rate payments, alter the pattern of debt service payments, or for asset/liability matching purposes.

In connection with the use of any swaps, the Board shall make a finding that the authorized swaps will be used to alter interest rate risk and/or alter the cost of borrowing in a beneficial manner, and when used in combination with new or outstanding bonds, will enhance the relationship between risk and return, or achieve other policy objectives.

B. Maximum Notional Amount

The maximum notional amount for all interest rate swaps shall be limited based on criteria set forth in this Interest Rate Swap Policy regarding the proper management of risks, calculation of termination exposure, and development of a contingency plan in the event of mandatory termination.

C. Liquidity Considerations

The impact on the cost and availability of liquidity support for both new and existing variable rate programs shall be considered when evaluating the issuance of new variable rate bonds requiring liquidity support. It is recognized that there is a limited supply of letter of credit or liquidity facility support for variable rate bonds, and the usage of liquidity support in connection with an interest rate swap may result in higher overall costs.

D. Call Option Value Considerations

When considering the relative advantage of a synthetic fixed rate interest rate swap transaction to fixed rate bonds, the value of the call option that would typically be purchased for fixed rate bonds shall be compared to the present value of the savings from using a non-cancellable swap. This shall be done to ensure the benefit from use of the swap will provide sufficient compensation to offset the expected value of any foregone future refunding savings. Purchase of a swap cancellation option can mitigate the risk of foregone refunding saving, reduce the value of a swap termination payment and lower collateral posting amounts, and shall be evaluated for cost effectiveness.

IV. Interest Rate Swap Features

A. Interest Rate Swap Agreement

Terms and conditions as set forth in the International Swap and Derivatives Association, Inc. "ISDA" Master Agreement shall be used as the basis for developing the swap documentation. The swap agreements shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as an Authorized Signatory deems necessary or desirable.

Subject to the provisions contained herein, the terms of any swap agreement shall generally conform to the following guidelines.

i. Downgrade provisions triggering termination shall in no event be worse than those affecting the counterparty.
ii. Governing law for swaps will be either New York or California.
iii. The specified indebtedness related to credit events in any swap agreement should be narrowly defined and refer only to indebtedness of ours that could have a materially adverse effect on our ability to perform its obligations under the swap. The definition of Debt should typically only include obligations within the same lien as the swap obligation.
iv. Preferred collateral thresholds stipulating when collateral will be required to be posted by the swap provider and by us are described in this Policy as well as collateral requirements setting out the amount and types of collateral. Each will be established by an Authorized Signatory based on the respective credit ratings of the swap provider and us and our respective credit support providers, if any.
v. Collateral should be held by an independent third party custodian.
vi. Eligible collateral should generally be limited to cash, letters of credit from U.S. based banks rated at least "A," U.S. Treasury securities and obligations of Federal Agencies where the principal and interest are guaranteed by the full faith and credit of the United States government. At the discretion of any Authorized Signatory, other high-quality obligations of Federal agencies, not secured by the full faith and credit of the U.S. government, may be used as collateral.
vii. We shall have the right to terminate a swap agreement at "market," at any time over the term of the agreement.
viii. Termination value should be set by a "market quotation" methodology, unless we deem an alternate methodology appropriate.

B. Interest Rate Swap Counterparties

1. Credit Criteria

Qualified swap counterparties or their credit support providers will

generally be those having a credit rating of: (i) at least “Aa3” or “AA-” by at least one of the three nationally recognized rating agencies identified in this policy and not rated lower than “A2” or “A” by any of the nationally recognized rating agencies, or (ii) have a special purpose subsidiary with a triple-A credit rating by at least one nationally recognized credit rating agency. The nationally recognized rating agencies are Moody’s Investors Services, Inc., Standard & Poor’s and Fitch Ratings.

For lower rated counterparties whose highest rating from any of the three nationally recognized firms is below “AA-” or “Aa3”, additional credit enhancement will be requested in the form of:

i. Contingent credit support or enhancement;
ii. Collateral consistent with the policies contained herein;
iii. Ratings downgrade triggers;
iv. Guaranty of parent, if any.

In addition, qualified swap counterparties must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market.

2. Counterparty Termination Exposure

In order to diversify counterparty credit risk and limit credit exposure to any one counterparty, we will compute the “Maximum Net Termination Exposure” prior to executing a swap.

“Maximum Net Termination Exposure” is the aggregate termination payment for all existing and projected swap transactions that would be paid by or received from a specific counterparty, parent or guarantor. For purposes of this calculation, the aggregate termination payment is equal to: (i) the termination payment based on the market value of all existing swaps as of the first business day of the month prior to the execution of any proposed transaction, plus (ii) the expected worst-case termination payment of the proposed transaction. The expected worst-case termination payment shall be calculated assuming interest rates, as measured by the Bond Buyer Revenue Bond Index, increased (or decreased) by two standard deviations from the sample mean over the last 10 years.

The following chart provides the Maximum Net Termination Exposure to a swap counterparty based on the lowest credit rating assigned by any of the three nationally recognized rating agencies.

Credit Rating	Maximum Collateralized Exposure	Maximum Uncollateralized Exposure	Maximum Total Termination Exposure
AAA	Not applicable	$40 million	$40 million
AA	$30 million	$10 million	$40 million
Below AA	$30 million	None	$30 million

C. Term and Notional Amount

In connection with the issuance or carrying of bonds, the term of the swap agreement shall not extend beyond, but may be shorter than, the final maturity date of the related bonds. The total "net notional amount" of all swaps related to a bond issue should not exceed the amount of outstanding bonds, but may be less. The net notional amount shall not include any basis swaps or other swaps that have the economic purpose of reversing or modifying the economic impact of an existing swap, including, but not limited to, basis swaps that have the economic function of changing the floating rate under an existing swap from a LIBOR-based index to a SIFMA-based index. The net notional amount shall not include any such basis or other swaps regardless of whether they are entered into with the same or a different counterparty as the existing swap.

D. Collateral Requirements

Terms imposing collateral requirements will be based on each party's credit ratings and their respective credit support providers, if any, and will require collateralization or other forms of credit enhancements to secure any swap termination payment amount that exceeds the applicable collateral threshold. The minimum collateral requirements, including collateral thresholds, types of collateral and collateral valuation will be determined by an Authorized Signatory and may require either the swap provider or us to post collateral. Permitted collateral will consist of highly rated securities, surety bonds, letters of credit or other credit enhancement. The specific list of permitted collateral will be negotiated on a case by case basis with each swap provider. Collateral shall typically be held by a third party custodian or as otherwise mutually agreed upon.

Collateral will be required to be posted in accordance with the collateral threshold table in the credit support annex when the potential termination payment owed by the party exceeds the applicable threshold. Threshold guidelines applicable to the swap provider for various ratings levels are identified in the table below. Specific thresholds for each transaction shall be determined on a case-by-case basis. The Collateral Threshold Table for a swap provider should generally reflect the thresholds, categories and credit ratings levels shown below.

Collateral Threshold Table (guideline only)	
Credit Rating	**Threshold**
AAA	$40 million
AA+ to AA-	$10 million
A+ to A-	$5 million
Below A-	None

The collateral thresholds applicable to us on a specific swap transaction shall be determined by an Authorized Signatory on a case-by-case basis and shall generally be no worse than the collateral threshold values provided for the swap provider on the same transaction.

The market values for the swap and the collateral shall be determined at least monthly and more frequently if we determine it is in its best interest given the specific nature of the swap(s) and/or collateral security.

E. Security and Source of Repayment

Generally, the same security and source of repayment (pledged revenues) will secure the interest rate swaps as is used to secure the bonds that are hedged or carried by the swap, if any. The costs and benefits of subordinating the payments under the swap and/or termination payment shall be considered.

F. Cancellation Provisions

The benefit of incorporating the right to cancel the interest rate swap at no cost after a specified period of time, generally 5 to 10 years shall be evaluated. If the cancellation option is cost efficient relative to the cost of obtaining a bond call option for a similar starting period, it will be purchased. A cancellation provision mitigates some risks of the swap, by allowing a no-cost termination anytime after the exercise date.

G. Prohibited Interest Rate Swap Features

We will not use interest rate swaps that: (i) are speculative or create extraordinary leverage or risk, (ii) lack adequate liquidity to terminate without incurring a significant bid/ask spread, (iii) provide insufficient price transparency to allow reasonable valuation, (iv) are used as investments.

V. Evaluation and Management of Interest Rate Swap Risks

Prior to the execution of any swap transaction, but other than for transactions involving Administrative Actions, an evaluation of the proposed transaction and report of the findings shall be approved by the Board. Such a review shall

include the identification of the proposed benefit and potential risks. As part of this evaluation, the Maximum Net Termination Exposure to the proposed swap counterparty shall be calculated.

A. Evaluation Methodology

The following areas of potential risk for new and existing interest rate swaps shall be evaluated:

Type of Risk	**Description**	**Evaluation Methodology**
Basis risk	The mismatch between actual variable rate debt service and variable rate indices used to determine swap payments.	Review the current and historical differences between the swap variable rates and the bond variable rates to determine if there continues to be a high degree of correlation. Also assess the factors that could affect the correlation of the rates in the future.
Tax risk	The risk created by potential tax events that could affect the relationship of the swap index with the interest rate on our variable rate bonds.	Review of the tax events in proposed swap agreements and evaluation of the impact of potential changes in tax law and the relationship of the swap index with the interest rates on our variable rate bonds.
Counterparty risk	The failure of the counterparty to make required payments or otherwise comply with the terms of the swap agreement.	Monitor counterparty credit ratings each quarter, limit exposure levels to specific counterparties, establish collateralization thresholds and demand collateral in accordance with the terms of the credit support annex when thresholds are exceeded.
Termination risk	The risk that there will be a mandatory termination of the swap. A termination will almost always result in our either owing or being	Compute our termination exposure for all existing and proposed swaps at market value and also under an expected worst-case scenario.

Type of Risk	Description	Evaluation Methodology
	due to receive a termination payment.	Periodically update our contingency plan for swap terminations, specifying how we may fund or finance a termination payment and/or replace the hedge.
Rollover risk	The mismatch of the maturity of the swap and the maturity of the underlying bonds.	Determine, in accordance with the Debt Policy, the capacity to issue variable rate bonds that may be outstanding after the maturity of the swap.
Liquidity risk	The risk that liquidity is unavailable when needed for future renewals or that the price for the liquidity is unattractive at that time.	Use a bond structure that does not require liquidity support, otherwise evaluate the expected availability of liquidity support for hedged (swapped) and unhedged variable rate debt.
Credit risk	The occurrence of an event modifying the credit quality or credit rating of the swap provider or its credit support provider.	Monitor the ratings of swap providers, insurers, guarantors, and any other credit support providers.

1. Refunding Interest Rate Swaps

   For interest rate swaps that are used in combination with refunding bonds, we will use the refunding criteria identified in our Debt Policy.

2. Basis Swaps

   We may enter into “basis swaps” whereby we modify the economic impact of an existing swap. Such modifications would most typically be undertaken to improve the correlation of the payments to be received on the swap transaction with the payments to be made on the related bond transaction and may result in the modification of risk characteristics, and other changes that may include, but are not limited to, the modification of the rate paid on the swap from one variable rate index to a different variable rate index, from a taxable index to a tax-exempt index and vice versa, and from a variable rate to a fixed rate and vice versa. The notional

amount of the basis swap must relate to one or more specific outstanding bond issues. Basis swaps may be entered into with the same or a different counterparty as the existing swap which is being modified.

3. Options on Interest Rate Swaps

We may sell an option to a counterparty that gives the counterparty the right to put us into an interest rate swap at a specified time in the future. This transaction, commonly known as a "swaption," would provide us with an upfront, non-refundable payment in exchange for selling the option.

In the event a swaption is exercised by the provider, we would be obligated to enter into an interest rate swap and to issue variable rate bonds. Therefore, as part of the evaluation of a swaption, we will undertake all appropriate analysis as required by the Debt Policy and Interest Rate Swap Policy relating to the specific type of interest rate swap and bond issue that would be exercised under the option. In particular, for swaptions used as part of a bond refunding, we will evaluate, among other things, the estimated present value savings, tax risk, and cost of a cancellation option. Swaptions will generally only be considered for refunding transactions, and not for new money transactions due to the frequent shifts in funding and timing for capital projects.

B. Managing Interest Rate Swap Risks

1. Annual Report to the Board

An annual evaluation of the risks associated with outstanding interest rate swaps will be presented in a written report to the Board. The evaluation shall be updated at least annually and submitted to the Board for approval. This evaluation will include the following information:

i. A description of all outstanding interest rate swaps, including related bond series, types of swaps, rates paid and received, existing notional amount, the average life and remaining term of each swap agreement, and the current termination value of all outstanding swaps.
ii. Separately for each swap, the actual debt service requirements versus the projected debt service on the swap transaction; and for any swaps used as part of a refunding, the actual cumulative savings versus the projected savings at the time the swap was executed.
iii. The credit rating of each swap counterparty, parent, guarantor, and credit enhancer insuring swap payments, if any.
iv. Actual collateral posting by swap counterparty and us, if any, per swap agreement and in total by swap counterparty.

v. Information concerning any material event involving outstanding swap agreements, including a default by a swap counterparty, counterparty downgrade, or termination.
vi. An updated contingency plan to replace, or fund a termination payment in the event an outstanding swap is terminated.
vii. The status of any liquidity support used in connection with interest rate swaps, including the remaining term and current fee.

2. Contingency Plan for Mandatory Termination

Termination exposure of each swap and for the total swap termination payment exposure shall be calculated at least annually and a contingency plan prepared to either replace the swaps or fund the termination payments, if any, in the event one or more outstanding swaps are terminated. We shall additionally assess our ability to obtain replacement swaps and identify revenue sources to fund potential termination payments.

C. Terminating Interest Rate Swaps

1. Optional Termination

In consultation with our counsel, financial advisor and/or swap advisor, we may terminate a swap if it is determined that it is financially advantageous, or will further other policy objectives, such as management of exposure to swaps or variable rate debt.

2. Mandatory Termination

In the event a swap is terminated as a result of a termination event, such as a default or a decrease in credit rating of either the counterparty or us, we will evaluate whether it is financially advantageous to obtain a replacement swap, or, alternatively make or receive a termination payment and then remain unhedged.

In the event it is necessary to make a swap termination payment, we shall attempt to follow the process identified in its contingency plan for mandatory termination.

VI. Selecting and Procuring Interest Rate Swaps

A. Financing Team

The services of a nationally recognized municipal bond counsel firm, and qualified financial advisor and/or swap advisor will be utilized for all interest rate swap transactions.

B. Underwriter Selection

In the event bonds are issued in connection with interest rate swaps, the bonds will be priced in accordance with the guidelines set forth in the approved Debt Policy.

C. Counterparty Selection

A competitive bidding process will be utilized to select a swap counterparty and price a swap when we believe that this process will provide the best value for us. A negotiated process may be used to select a swap counterparty and price a swap when it is believed that market or competitive conditions justify such a process. The conditions under which a negotiated selection is best used are provided below.

i. Marketing of the swap will require complex explanations about the security for repayment or credit quality.
ii. Demand is weak among swap counterparties.
iii. Market timing is important, such as for refundings.
iv. Coordination of multiple components of the financing is required.
v. Participation from DBE / SBE firms is desired.
vi. The swap has non-standard features, such as being a forward starting swap.
vii. Bond or swap insurance is not available or not advisable under current market conditions.
viii. The par or notional amount for the transaction is significantly larger than a typical transaction for that market.

VII. Disclosure and Financial Reporting

Steps will be taken to ensure that there is full and complete disclosure of all interest rate swaps to the Board, to rating agencies, and in disclosure documents. Disclosure in marketing documents shall provide a clear summary of the special risks involved with swaps and any potential exposure to interest rate volatility or unusually large and rapid changes in market value. With respect to its financial statements, we will adhere to the guidelines for the financial reporting of interest rate swaps, as set forth by the Government Accounting Standards Board.

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Glossary of Terms

Asset/Liability Matching Matching the term and amount of assets and liabilities in order to mitigate the impact of changes in interest rates.

Bid/Ask Spread The difference between the bid price (at which a market maker is willing to buy) and the ask price (at which a market maker is willing to sell).

Call Option The right to buy an underlying asset (e.g. a municipal bond) after a certain date and at a certain price. A call option is frequently embedded in a municipal bond, giving the issuer the right to buy, or redeem, the bonds at a certain price.

Collateral Assets pledged to secure an obligation. The assets are potentially subject to seizure in the event of default.

Downgrade A negative change in credit ratings.

Forward Starting Swap Interest rate swaps that start at some time in the future. Used to lock-in current interest rates.

Hedge A transaction that reduces the interest rate risk of an underlying security.

Interest Rate Swap The exchange of a fixed interest rate and a floating interest rate between counterparties.

Liquidity Support An agreement by a bank to make payment on a variable rate security to assure investors that the security can be sold.

LIBOR The London Interbank Offer Rate. Used as an index to compute the variable rate on an interest rate swap.

Notional Amount The amount used to determine the interest payments on a swap.

Termination Payment A payment made by a counterparty that is required to terminate the swap. The payment is commonly based on the market value of the swap, which is computed using the rate on the initial swap and the rate on a replacement swap.