



# COMPASS

## IN THE SPOTLIGHT

### East Bay Municipal Utility District Incorporates Interest Rate Swaps in its Issuance of \$1 Billion in New Money and Refunded Bonds

KNN Public Finance partnered with Backstrom McCarley Berry and Swap Financial Group on a series of bond issues for the East Bay Municipal Utility District that combined \$550 million in new money and the current and advance refunding of three water revenue and two sewer revenue bond issues totaling over \$450 million. KNN served as the lead financial advisor, responsible for managing both the analysis and execution of the transactions.

#### Strategic Implementation

A number of alternative structures were evaluated, including fixed-rate and synthetic fixed-rate structures. As the District's existing portfolio of swaps were all based on LIBOR, a taxable interest rate index, the decision was made early on to focus on either BMA swaps or index bonds. The economics of these latter two approaches would not change if the spread between tax-exempt and taxable interest rates changed, minimizing the District's additional exposure to tax risk. As California auction rate securities (ARS) generally carry a 25 basis point advantage over variable rate demand notes (taking into account the cost of third-party liquidity), the decision was made to issue auction rate securities, to be fixed with a BMA-based swap.

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## NEWS AND NOTES

### 13th Annual Schools Finance Conference

School administrators from across the state gathered to network and learn what's new in the world of school finance at KNN Public Finance's annual conference. The event was presented at the Waterfront Plaza Hotel in Oakland's Jack London Square on September 28, 2007.

KNN's Managing Director John O'Sullivan introduced the following conference topics and speakers:

- "The New Financial Management Assessment Criteria," Gabriel Petek, Director, Credit Market Services, Standard & Poor's

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## IN THE SPOTLIGHT continued...

Swap Financial reviewed both the District's own ARS experience as well as the variable rate experience of comparable issuers to develop the appropriate swap index. The percentage rate applied to BMA was customized to best track the actual rate the District was expected to pay on the bonds. This analysis was intended to minimize the risk to the District that the swap would under perform the underlying variable-rate debt, as well as to satisfy tax counsel so the swap would be considered a qualified hedge, allowing the District to use the fixed-rate of the swap as the arbitrage yield in the refunding escrow.

While the District had entered into a number of swaps before our engagement, they did not have a written swap policy. KNN and Swap Financial drafted policies for the District, worked with staff to evaluate the various policy and financial choices embedded in such policies, designed a form of annual reporting, and completed the first series of reports for the District. In addition, the swaps were competitively bid amongst the underwriters on the transaction.

### Results

Based on the final numbers, the District achieved \$32.8 million in net present value savings or in excess of 7.3% of the refunding bonds. Prior to distribution of the final bid specifications, terms such as counterparty rating and downgrade provisions were negotiated with the proposed counterparties that were more advantageous to the District than prior swaps. The spread between the best and worst bid was approximately 4.7 basis points. The competitive bid resulted in a 1.29 basis point spread over the mid-market rate reported by Bloomberg, after taking into consideration the swap advisory fees. By comparison, the underwriters had proposed in their original responses to the District's RFP a 4 to 5 basis point spread to mid-market for a negotiated swap. We estimate that the competitive process garnered the District approximately \$1 million in additional savings.

Managing Director David Brodsky was assisted by KNN's Marian Breitbart and Dan Cox on this transaction.

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## NEWS AND NOTES continued...

- "Building Bond Support from a Skeptical Community," James C. Franco, Ed.D., Superintendent of Schools, Tracy Unified School District
- "Solar Energy in Public Schools," Enrique Palacios, Executive Director for Operations, New Haven Unified School District
- "Citizens Advisory Committee for Finance," Randy Kenyon, Assistant Superintendent, Business Services, Los Altos School District
- "An Update on the State's School Facilities Program," T.J. Rapozo, Program Services Operation Manager, Office of Public School Construction, State of California

If you'd like more information on any of the 13th Annual Schools Finance Conference presentations, please contact KNN Vice President Ruth Alahyoian at 510-208-8203 or [ralahyoian@knninc.com](mailto:ralahyoian@knninc.com).

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## IN THE SPOTLIGHT

# Oakland Unified School District Takes Advantage of Low Interest Rates for \$194 Million Refunding

Seeking to take advantage of historic low municipal bond interest rates, the Oakland Unified School District called on KNN Public Finance to refinance approximately \$194 million of the District's outstanding bonds.

### Strategic Implementation

Unique among municipal bond issuers, the Oakland Unified School District's underlying bond ratings are not particularly strong. It is rated "BBB+" by Standard & Poor's and "Baa2" by Moody's Investors Service. These ratings are a reflection of the rating agencies' concerns about the District's financial difficulties over the past few years, rather than the ability of taxpayers to repay the debt.

To improve the ratings on the bonds, KNN advised the District to purchase bond insurance and bring the ratings to "AAA" and "Aaa"—the highest possible. The cost of the insurance, though more expensive than it would have been with better ratings, was still low enough to make the entire refinancing transaction worthwhile.

KNN assisted the District in selling the bonds through an electronic competitive bidding process. Six underwriting syndicates bid on the refunding bonds and Morgan Stanley was awarded the bonds with the lowest interest rate bid of 4.43%.

### Results

The total savings to the District and its taxpayers over the life of the bonds is \$15,675,080. On a present value basis, that translates to 5.19% of the prior debt. As a result, taxes for the prior bonds will be reduced for the average taxpayer by approximately \$4.36 per year. The District's refinancing represents an ongoing commitment to prudent financial management for the taxpayers who approve, and pay for, the greatly needed school bonds.

KNN Vice President Ruth Alahydoian and Associate Janice Peters provided financial advice to the District for this transaction.

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## TELL ME MORE

### Demystifying Derivatives

Derivatives are financial contracts based on an underlying asset, reference rate, or index. As financial markets become increasingly sophisticated and global, derivatives play a growing role in allowing public agencies to manage financial risks and customize their debt. Even a conservatively managed city, county or special district may find value in

the use of derivatives to reduce their exposure to certain risks, or to accept an appropriate level of risk in order to reduce its borrowing costs.

The most common forms of derivatives in public finance are interest-rate swaps, where the counterparties to the swap

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## TELL ME MORE continued...

agreement agree to swap two different kinds of payments. Typically, the public agency will issue variable rate debt and simultaneously enter into a swap agreement in which they will pay a fixed rate, while the counterparty (a financial institution) will make payments to the public entity based on a variable-rate index. The agency's variable-rate receipts are designed to roughly match the variable-rate debt obligation issued by the public agency. The net result will be a relatively fixed-rate payment, with the variable rate debt payment and the swap receipt "canceling" each other out. This strategy is often referred to as "synthetic fixed-rate" debt.

### Benefits of Derivatives

An interest rate swap can reduce the cost of borrowing by taking advantage of one or more market dynamics. For example, combining a LIBOR-based swap (a taxable index) with variable rate tax-exempt bonds can lower borrowing cost by compensating the issuer for retaining the risk of a change in tax law while shedding the risk of other interest rate movements. This common "trade" illustrates how a swap is used to refine the risk-reward relationship. The municipal yield curve is typically much steeper than the curve for taxable interest rates, as the risk of changes in tax law is added to the overall perception of interest risk in setting rates. That is, because the risk of a change in tax law is perceived to be greater over the longer term, long term municipal rates are closer to taxable rates than short term rates. A public agency can either pay an investor to accept the risk that tax rates will be cut and thus tax-exemption be worth less in the future—through the relatively higher interest rates embedded in long-term tax-exempt rates—or the issuer can retain that tax risk. The most common method by which issuers retain tax risk is by issuing variable rate debt; municipal short-term interest rates are typically much lower than taxable rates because

tax risk is negligible in the short term.

A swap offers the issuer the opportunity to save money by taking tax risk without risking the ups and downs of interest rate risk of variable rate debt generally. The agency issues variable rate debt, but enters into a swap based on a general market (i.e., taxable) index such as LIBOR. The swap hedges general interest risk, but doesn't hedge changes due to real or perceived changes in the federal tax code.

The issuer retains the risk that the underlying variable rate debt will rise in cost due to changes in tax law or other changes in the relationship between LIBOR and municipal rates, since that risk is not hedged by a LIBOR swap. But in return, the agency saves from 40 to nearly 100 basis points on the expected cost of borrowing, depending on the market when the swap is executed. In this case, the swap offers a borrowing program that is not available in "the cash" market for bonds—a loan that is mostly fixed, but with the reward of taking some risk of variability due to changes in tax rates.

### Risks of Derivatives

To some extent, the whole purpose of a derivative is to refine the balance of risks and rewards beyond those imbedded in the most common municipal bonds. A key area of risk is "basis risk"—that the swap and the underlying bond will not perform in tandem; the tax risk described above is a form of basis risk for which the issuer is compensated. The contracts themselves will also introduce a variety of risks, including the risk of an on-going relationship with the financial institution serving as the counterparty. Swaps also limit refunding flexibility, since they typically are not callable at par, but can be unwound with a marked-to-market payment where the payments remaining under the swap are "re-priced" based on current market conditions.

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## TELL ME MORE continued...

### Establishing a Derivatives Program

A public agency considering the establishment of a derivatives program should assess its goals, risk tolerance, and method of execution. As with any financing tool, the organization should determine its savings threshold before venturing into derivatives. Additionally, the public agency needs to thoroughly examine its tolerance for tax risk, other basis risk, and counterparty risk as well as the administrative burden of administering both a variable rate and swap program. Once these risks have been examined and the organization decides to move forward, it can focus on which method of execution will result in the greatest cost savings with the appropriate risk. Many public agencies employ financial advisors, who, among other things, assist them in determining whether to issue their derivatives competitively or through negotiated placement.

KNN Public Finance is prepared to assist your public agency in reviewing the risks and rewards of entering the deriva-

tives market. We can help you take the following steps to implementing a derivative program:

- Identify goals
- Outline key policy choices
- Memorialize those choices in a draft swap policy
- Conduct study sessions with key staff
- Revise policy and presentation materials
- Lead a presentation/study session with your council or board
- Finalize your policy and annual reporting requirements

Learn more about how derivatives can help your public agency create more flexibility in its financing program. Call 510-839-8200 to discuss with our Managing Directors David Brodsky or David Leifer whether derivatives can benefit your public agency.

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## MEET OUR PROFESSIONALS



### Ruth Alahydoian

Vice President

Ruth joined the firm in November of 1995. She serves as the financial advisor for many school districts, including Los Angeles USD and

Oakland USD, several districts in Contra Costa and Alameda counties, and others throughout the State. She recently completed the refunding of \$194 million of existing bonds for the Oakland Unified School District (see story on page 3 of this newsletter).

Ruth specializes in school district finance, including:

- general obligation bonds
- certificates of participation
- tax and revenue anticipation notes
- refundings
- qualified zone academy bonds (QZABs)
- leases

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## MEET OUR PROFESSIONALS continued...

Ruth is familiar with the intricacies of school finance and accounting. She is active in the California Association of School Business Officials (CASBO) and regularly presents at the association's conferences. She is a panelist on "The ABC's of School Debt Financing" seminar presented by the California Debt and Investment Advisory Commission (CDIAC). She has also made presentations at the Coalition for Adequate School Housing (CASH) and the California School Board Association (CSBA) conferences.

Prior to joining KNN, Ruth spent eight years working in Washington, D.C. for the Federal government – four years as an economist for the Department of Housing and Urban Development and four years as a Congressional staff member.

Ruth earned an M.B.A. from Yale University and a B.A. from Occidental College in Los Angeles.



### Marian Breitbart

Vice President

Marian has 19 years of public finance experience. Since joining KNN Public Finance in 1994, she has structured a number of issues for various clients,

notably the City of Oakland and its Redevelopment Agency, the Redevelopment Agency of Alameda County, the City of Fresno, and the City of Santa Monica and its Redevelopment Agency. Her other clients include the East Bay Regional Park District, East Bay Municipal Utility District, and the Kern County Water District.

Marian was a key contributor to KNN's work as lead financial advisor to the East Bay Municipal Utility District on a series of bond issues that combined \$550 million in new money and the current and advance refunding of three water revenue and two sewer revenue bonds totaling over \$450 million (see article on page 1 of this newsletter).

Marian has played an integral role in the vast majority of lease, enterprise revenue, and redevelopment financing the

firm has worked on during the last 13 years. She has an extensive understanding of redevelopment law and practice. Marian applies her tremendous diligence to reviewing redevelopment financing to ensure the consistency of the transaction with the underlying project area plan, the integrity of the fiscal consultant report, and the quality of legal and disclosure documentation.

Prior to joining KNN, Marian spent nine years with Alameda County working in the areas of debt financing, property development, redevelopment, risk management, and departmental, capital project, and internal service fund budgeting.

Marian earned an M.B.A. from the Wharton School of Finance and Commerce of the University of Pennsylvania and a B.A. in Economics from the State University of New York at Stony Brook.



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