



# DuPage Water Commission

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**NOTICE IS HEREBY GIVEN THAT A MEETING OF THE SPECIAL TASK FORCE ON REFUNDING OF THE DU PAGE WATER COMMISSION WILL BE HELD AT 8:30 A.M. JUNE 12, 2003, AT ITS OFFICES LISTED ABOVE. THE AGENDA FOR THE MEETING IS AS FOLLOWS:**

## **AGENDA**

**SPECIAL TASK FORCE ON REFUNDING  
THURSDAY, JUNE 12, 2003  
8:30 A.M.**

**600 EAST BUTTERFIELD ROAD  
ELMHURST, IL 60126**

## **COMMITTEE MEMBERS**

M. Vondra, Chair  
J. Janicik  
B. Krajewski  
W. Mueller  
A. Poole  
G. Wilcox

I. Roll Call

II. Approval of May 7, 2003 Minutes

III. Recommendation of Lead Underwriter and Underwriting Group for Current Refunding of 1993 Revenue Bonds

IV. Commission Input for Appointment of Underwriters' Counsel for Current Refunding of 1993 Revenue Bonds

V. Recommendation of Commission Bond Counsel for Current Refunding of 1993 Revenue Bonds

VI. Adjournment

Board/Agendas/Other/Special Task Force on Refunding 2003.06.12.DOC

All visitors must present a valid drivers license or other government-issued photo identification, sign in at the reception area and wear a visitor badge while at the DuPage Pumping Station.

**MINUTES OF A MEETING OF THE  
SPECIAL TASK FORCE ON REFUNDING  
OF THE DU PAGE WATER COMMISSION  
HELD ON MAY 7, 2003**

The meeting was called to order at 6:15 P.M.

Task Force members in attendance: J. Janicik, A. Poole, M. Vondra and G. Wilcox

Also in attendance: E. Chaplin, R. Thorn, J. Holzwart, R. Martin, and R. Skiba

**MINUTES OF MEETINGS – APRIL 24, 2003**

Motion by Commissioner Wilcox, seconded by Commissioner Janicik, to approve the minutes of the April 24, 2003 Special Task Force meeting. This motion carried unanimously.

**RECOMMENDATION OF UNDERWRITER**

The Special Task Force reviewed the supplemental reports requested from the underwriter candidates. Disclosure issues regarding pending legislation and the proposed bond refunding were discussed.

It was decided that the Special Task Force needed more information on a specific program. Staff is to ask the underwriter candidates for an analysis of savings for a refunding that would be 2/3 fixed rate and 1/3 variable rate bonds. The analysis should be performed for both a May 1, 2014 and a May 1, 2024 maturity. The Special Task Force would also like to see how the savings would be affected if 1/3 of the bonds called were retired instead of refunded.

The Special Task Force also recommends not trying for a rating increase to “AAA” from Moody’s Investors Service.

The Special Task Force adjourned at 6:52 P.M.



## DuPage Water Commission MEMORANDUM

TO: Chairman, Members of Special Task Force on Refunding

FROM: General Manager

DATE: June 6, 2003

SUBJECT: 1993 Revenue Bond Refunding

In anticipation of the appointment of a lead underwriter, staff has begun to put together the information that will need to be shared with the rating agencies in connection with the proposed refunding. This will consist largely of an updated Five Year Capital Improvement Program showing the impact that recent legislation will have on Commission reserves and operations.

On a preliminary basis the Commission will continue to use sales tax proceeds to fund 50% of the revenue bonds, will re-allocate \$15 million of its sales tax proceeds for the next five years and maintain a wholesale rate of \$1.65 during that period. From FY 09/10 thru FY 12/13 net asset balances range from between \$5.7 million to \$14.6 million, jumping up to \$45 million in FY 13/14 when Commission's Revenue Bonds are retired. If the Commission takes the opportunity to extend maturities on its revenue bonds from 2014 to 2024 financial projections will be further enhanced.

In that regard I am forwarding a copy of a research memorandum we received from Standard & Poors that discusses the risks associated with floating to fixed swaps and various synthetic variations. Under the circumstances it would seem to argue that the Commission limit its advance refunding to a traditional fixed rate instrument.

If you have any further questions please feel free to contact me directly.



*Jeane Kidley*

## Research:

[Return to Regular Format](#)

### Public Finance Criteria: Municipal Swaps

Publication date: 12-Nov-2002

Credit Analyst: Peter Block, San Francisco (1) 415371-5044; Colleen Woodell, New York (1) 212438-2118

Interest-rate swaps are being used in conjunction with bond issues to save interest costs, increase financial flexibility, synthetically advance refund bond issues, and access different investor markets. Swaps also are being used to lock in fixed rates of return on debt service funds and other floating-rate assets without sacrificing liquidity.

However, swaps expose issuers to counterparty credit risk, swap termination risk, basis risk, rollover risk, and for many housing bond issuers, amortization risk. If used to speculate on the direction of interest rates, or if they are not structured properly, swaps can reduce an issuer's ability to pay debt service on time, thereby hurting its credit quality.

### ☐ Swap Structures

The most common types of swaps in the municipal sector are floating-to-fixed-rate swaps and fixed-to-floating rate swaps. The floating-to-fixed rate swaps are typically used to create synthetic fixed-rate debt or a synthetic advance refunding (using a forward starting swap) while the fixed-to-floating rate swaps are typically used to create synthetic variable rate debt. Synthetic fixed-rate debt provides an alternative to issuing conventional fixed-rate debt. This structure allows the issuer to access the short-term market by issuing variable rate debt, while hedging its floating-rate exposure with floating-to-fixed-rate swaps. The variable rate index received by the issuer from the swap dealer matches or closely approximates the variable rate on the debt, leaving the issuer with a fixed-rate exposure for the term of the swap. The synthetic advance refunding with a forward swap provides an alternative to conventional advance refundings. Municipal issuers—such as investor-owned utilities, airports, and health care issuers—that are precluded from carrying out an advance refunding or have used up their advance refunding capacity can synthetically advance refund using a forward swap. Under this scenario, the municipal issuer enters into a forward swap contract today to lock in today's fixed rates. On the call date, variable rate bonds are issued, and the proceeds are used to call the outstanding high-coupon bonds. The swap payments begin on the call date, effectively converting the floating-rate exposure of the issuer to a fixed rate. Both swap structures typically result in lower interest-rate costs than conventional fixed-rate debt, but they expose the issuer to all risks associated with swaps (discussed below).

Synthetic variable rate debt is created through use of a fixed-to-floating-rate swaps. The synthetic floating-rate debt structure provides an alternative to issuing variable-rate debt. It creates non-putable variable rate debt and allows the issuer to avoid variable-rate program costs, such as credit, liquidity, and remarketing fees. This option is used to convert existing fixed-rate debt to a variable rate or as part of a new issuance. Some issuers take advantage of this structure to hedge negative arbitrage on large cash and short-term asset positions.

### Source of swap payment and swap lien

Before entering into a swap, the issuer's management should identify the revenue source for making net swap payments and budget for them. The source of termination payments should also be identified. Revenue bond issuers should include the swap payments in the rate covenant and additional bonds test covenants to avoid swaps having a negative impact on the ability of the issuer to pay debt service. Typically, for GO bond issuers, the swap payment source is the general fund, and for revenue bond issuers, the swap payments come from the same revenue source that supports the debt service on the bonds. The net swap payments should be structured so that they are junior to or on parity with the debt service obligation to ensure that debt service payments are



not affected. Much focus is also placed on the early termination of swap contracts. While the probability of this risk is hard to determine, it is important to think through a contingency plan if the swap does unwind and the issuer will owe a settlement amount that is due immediately. Termination risk and considerations are discussed below.

### Legality

It is important that the issuer has the appropriate legal power to enter into and properly authorize all swap contracts. Illegality can result in the swap being terminated, exposing the issuer to a potentially large termination payment and/or floating-rate exposure. Many states have statutes that give the issuers the authority to enter into swap agreements. By contrast, there are states that prohibit the use of swaps or have legislation that is ambiguous. If the law is ambiguous, Standard & Poor's suggests that an issuer verify its legal authority

### Swap structure risks

Standard & Poor's has identified six general risks associated with swap contracts for municipal bond issuers. These risks include:

- Counterparty risk;
- Rollover risk;
- Basis risk;
- Tax event risk;
- Amortization risk; and
- Termination risk.

Standard & Poor's will focus on all of these credit factors when analyzing a swap contract. As part of this process, Standard & Poor's must receive various documents necessary to analyze the terms of the contracts (please see "Swap Legal Documentation Review Process" below). Furthermore, we will ask all issuers who enter into swaps or other hedging contracts to prepare a Swap Management Plan as part of the Debt Management Plan (please see "Swap Management Plan" below). A discussion of the risks associated with swaps follows.

**Counterparty risk.** Counterparty risk is the risk that the swap counterparty will not fulfill its obligation to honor its obligations as specified under the contract. Under a fixed payor swap, for example, if the counterparty defaults, the issuer would be exposed to an unhedged variable rate bond position. The creditworthiness of the counterparty is indicated by its issuer credit rating (ICR). Standard & Poor's looks for swap counterparties that are rated sufficiently to support the rating on the bonds and are appropriate for the credit profile of the issuer. For revenue bond and tax-backed issuers, Standard & Poor's would expect to see issuers to maintain hedges provided by counterparties rated at least 'A/A-1'.

In cases where a counterparty is a "terminating" derivative product company (DPC), as opposed to a continuing entity, Standard & Poor's ICRs for these entities will include a 't' subscript (e.g. 'AAAt'). The 't' subscript indicates that the DPC could terminate its existence upon short notice to bond issuers with no penalty. If an issuer enters into a swap contract with a terminating DPC, Standard & Poor's will assume that termination of the hedge could occur at any time during the life of the transaction. Therefore, execution of a swap contract with a counterparty rated lower than 'A/A-1', or with a terminating DPC will result in no credit being given to the swap

**Basis risk.** Basis risk refers to a mismatch between the interest rate received from the swap contract and the interest actually owed on the issuer's bonds. For example, in a floating to fixed rate swap, the risk is that the counterparty's variable interest payments will be less than the variable interest payments actually owed on the issuer's bonds. Most floating to fixed rate swaps require the issuer to pay a fixed interest rate and in return receive a floating rate based on one month LIBOR or the Weekly BMA Municipal Swap index. Most "tax-exempt" swaps are referred to as "BMA swaps" or "percentage of LIBOR" swaps. In some cases, issuers secure "cost of funds" swaps, where the counterparty pays the exact interest rate on the bonds. If the swap is not a cost of funds swap, the



mismatch between the actual bond rate and the swap interest rate could cause financial loss to the issuer. This mismatch could occur for various reasons including, increased supply of tax-exempt bonds, credit quality deterioration of the issuer, or a reduction of federal income tax rates for corporations and individuals.

**Tax event risk.** All issuers which issue variable rate bonds that trade based on the BMA index inherently accept risk stemming from changes in marginal income tax rates. This is due to the tax code's impact on the trading value of tax-exempt bonds. This risk is also known as "tax event" risk, a form of basis risk under swap contracts. Percentage of LIBOR and certain BMA swaps can also expose issuers to tax event risk. Some BMA swaps have tax event triggers which can change the basis under the swap to a LIBOR basis from a BMA basis.

Based on historical evidence, Standard & Poor's believes that any downward shift in the top federal income tax rate for individuals and corporations could cause all variable rate bond issuers to experience "tax event" risk. Standard & Poor's has recently revised its income tax rate forecasts and tax event risk criteria (see "Tax Risk Scenarios Revised Under Municipal Swap Criteria," Ratings Direct, Oct., 17, 2001). Under these criteria, all variable rate debt issuers should assume that income tax rates are lowered over time such that the ratio of Weekly BMA to one month LIBOR increases to 69% for the first five years, 73% for the second five year period, and 75.5% thereafter. These assumptions should be incorporated into the cash flow projections discussed under Quantifying Net Variable Rate Debt and Swap Risk-Cash Flows.

**Rollover risk.** Rollover risk is the risk that the swap contract is not coterminous with the related bonds. In the case of the synthetic fixed rate debt structure, rollover risk means that the issuer would need to re-hedge its variable rate debt exposure upon swap maturity and incur re-hedging costs. The issuer should have concrete strategy to account for rollover risk. Otherwise, Standard & Poor's will assume that bonds will be unhedged at the time of swap maturity. The issuer can mitigate rollover risk by closely monitoring the interest rates and by having policies in place to extend the swap or enter into a new swap if the rates drop. The strategy of using medium-term swaps to fix the variable rate for a five-to-10-year period does not eliminate the rollover risk, but gives the issuer additional financial flexibility, reduces termination risk, and could result in a lower fixed rate than can be obtained through a long-dated swap. The issuer can fully avoid rollover risk by entering into long-dated swaps (those with a greater than 10 years) whose term matches that of the bond term, thus locking the rates for the life of the bonds. However, this strategy contains hidden costs. Issuers using long-dated swaps give up the ability to refund the debt and to take advantage of declining interest rates, unless the swap is structured with a "swaption". A swaption is an option to terminate an existing swap without having to pay a termination fee or to enter into a new swap at pre-determined rates.

**Amortization risk.** Amortization risk represents the cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding. Amortization risk is characteristic of swaps used to hedge variable rate bonds issued by state housing finance agencies for single-family mortgages, although it can also occur with variable rate bonds issued by other revenue bond issuers to finance other amortizing assets. Amortization risk occurs to the extent bonds and swap notional amounts become mismatched over the life of a transaction. This could occur to the extent an issuer has used bond proceeds to finance an asset that is liquidated and used to redeem bonds in advance of the swap notional schedule, causing an unhedged swap position. In this case, the issuer would continue to owe payments under the swap with no asset to cover such payments. Conversely, the issuer could be faced with some unhedged variable rate bonds to the extent the financed asset does not generate the expected cash flow to repay bonds in accordance with a relatively faster amortizing swap notional schedule. This scenario is most common in single-family mortgage bonds where principal prepayments are lower than expected. Amortization risk is a potential risk, which could expose the issuer to additional payments, and potentially force the issuer to terminate the swap prior to maturity under unfavorable market conditions. The amount of loss exposure due to amortization risk is determined on a case-by-case basis depending on the purpose of the issue and the issuer's intended technique to mitigate this risk. Standard & Poor's must be comfortable that the issuer will still be able to service the debt or swap in the absence of the hedge or financed asset respectively. Assuming the issuer will not terminate the swap in the event of a mismatch, reserves must be established to cover the worst-case amortization risk scenario.

Termination risk. Termination risk is the risk that the swap could be terminated by the counterparty due to any of several events, which may include issuer or counterparty ratings downgrade, covenant violation by either party, bankruptcy of either party, swap payment default by either party, and default events as defined in the issuer's bond indenture. Standard & Poor's will analyze each swap contract's legal provisions prior to execution to ensure that the events of default or termination that trigger an involuntary termination are remote possibilities. The events of default and termination, which could lead to involuntary termination of the contract should ideally only include the "big four" termination clauses:

- Failure to pay;
- Bankruptcy;
- Merger without assumption; and
- Illegality.

The aforementioned events are typically considered remote events since Standard & Poor's factors these aspects into the rating on the debt. Standard & Poor's may consider other events of default and termination to be remote events on a case-by-case basis, depending on the credit profile of the issuer and the ratings on the bonds. These events may include:

- Downgrade of issuer debt to a certain rating threshold;
- Breach of agreement;
- Misrepresentation;
- Cross default;
- Default under a specified transaction; and
- Any additional termination events.

To the extent that Standard & Poor's cannot establish the remoteness of an event of default or event of termination, which would trigger involuntary termination of the swap contract, this possibility will be assumed under the swap. In this case, Standard & Poor's would assume that bonds are unhedged and furthermore, that the issuer would have to pay a termination fee to the counterparty.

Remedies available to the swap counterparty resulting from an issuer defaulting on its swap obligation should not infringe on bondholders' rights. These remedies should be limited to the swap agreement and should not be written into the bond indenture. Default on the swap should not be an event of default under the bond indenture. Depending on how interest rates at the time of termination compare with the fixed rate on the swap, the issuer could owe a termination payment to the counterparty or receive a termination payment from the counterparty.

### Termination analysis

If Standard & Poor's does not consider termination to be remote, this risk must be quantified through a termination analysis. Standard & Poor's examines the potential termination values under different interest-rate scenarios. Termination should be assumed under unfavorable market conditions and calculated through the method as enumerated under the swap contract, typically a market quotation methodology.

Termination payment source and lien. Much focus is placed on the early termination of swap contracts. While the probability of this risk is hard to determine, it is important to think through a contingency plan if the swap does unwind and the issuer will owe a settlement amount that is due immediately. Many bond transactions that include a swap make the lien of the swap payments and termination payment on parity with the debt service. This does not cause Standard & Poor's great concern if the issuer has revenue-raising capability and good liquidity. It also is not a concern if the swap termination events have been limited to credit events that are being reflected in the rating on the bonds.

However, on the other end of the spectrum are the balance sheets that could not withstand a large cash outflow in a month's notice.

### Termination risk mitigation strategies

Two of the most common ways to mitigate the effect of termination payments to an issuer are Subordinating termination payments to the debt service on the bonds and including provisions in the swap agreement that allow the issuer to stretch out the payments over a period of time.

**Subordinated lien.** Since the termination payment can be large, and it is difficult to predict the timing and size of the payment, cash settlement of a termination payment can be subordinate to debt service. While a subordinated lien will get the issuer over the hurdle of payment of debt service for that period of time, it is important to note that the settlement payment to the counterparty still must be paid in full. This could hurt the issuer's liquidity and therefore impair its ability to pay debt service in the future.

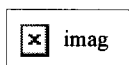
**Amortization of termination payment.** This alternative focuses on the issuer's financial flexibility to withstand the cost of an early termination regardless of its capacity to increase rates and charges. An issuer that has limited liquidity resources should include provisions in the swap agreement that allow the issuer to pay the termination value over a period of time. A stress test of an issuer's income and cash flow statements is done to determine the amount of cushion that is available to pay additional unexpected cash settlement. The worst-case termination value would be used in determining the amount and term of the payment structure. For example, repayment terms could be a five-year term with an annual maximum payment of \$10 million.

The issuer can also reduce termination risk by:

- Entering into a swap with a strong counterparty,
- Limiting the termination triggers and events of default,
- Reducing the term of the swap, or
- Developing contingency plans for making the termination payment,

### Swap legal documentation review process

Standard & Poor's will analyze all terms of the swap contract, including payment dates, interest rates, events of default and events of termination. Often, payment of regularly scheduled swap payments will not materially impact the creditworthiness of a transaction. Furthermore, involuntary termination of the swap is usually considered by Standard & Poor's to be a remote occurrence, depending on the triggers for termination. However, if after reviewing the terms of the swap, Standard & Poor's determines that the swap terms could lead to an early termination, or adversely impact the issuer's ability to service its debt, the risk must be addressed by the issuer and quantified in cash flow projections.



### ☐ Swap Management Plan

One of the most important aspects of the analysis of the use of swaps is the evaluation of the understanding and expertise that management contributes. Managing derivatives like interest rate swaps requires an ongoing commitment from the issuing entity's senior executives. All senior management—not just the chief financial officer—should become familiar with the risks and rewards of the derivatives being considered. Because of the complexities involved, some small issuers may not be in a position to develop the necessary expertise and systems to adequately manage some derivatives. In fact, smaller issuers' capital needs generally are not large enough to justify the sizable fixed costs associated with putting together these types of transactions. Therefore, as part of the Debt Management Plan, Standard & Poor's will request a discussion of the issuer's Swap Management Plan. This plan should details the issuer's knowledge of the swap contract, its risks, its rewards, and "exit strategies" in the event the swap is terminated prior to maturity.

Answers to the following questions should be addressed:



- Why does the swap make sense for this issue / issuer?
- What is the swap counterparty's Standard & Poor's rating?
- Has the issuer and its governing body reviewed and understand cash flow projections detailing costs and benefits of the swap?
- Are the issuer and its governing body aware of basis risk, rollover risk, termination risk, and counterparty risk?
- Does the issuer have a concrete plan to handle the aforementioned risks? If so, please provide details of the plan.
- Does the issuer know what events trigger an early termination under the swap documents?
- Does the issuer believe that involuntary termination due to an Event of Default or Event of Termination is a remote possibility? If so, why?
- Does the issuer know how much involuntary or voluntary termination will cost and how it would be paid?
- In the event of early termination, does the issuer know how it will re-hedge its variable rate exposure?
- Who are the key personnel involved in monitoring the terms of the swap and counterparty creditworthiness?

In addition to these questions, management should develop and implement the procedures and controls to monitor:

- The swap exposure under different interest-rate scenarios,
- The net swap payments,
- Counterparty credit and any counterparty collateral, and
- Swap covenants and debt covenants.

Good controls and procedures will allow the issuer to take remedial steps to eliminate or reduce the problems that may arise.

#### ☐ **Quantifying Net Variable Rate Debt and Swap Risk**

Standard & Poor's believes that quantification of both balance sheet and cash flow risks associated with variable rate and short-term debt as well as swap contracts, is necessary to properly evaluate an issuer's financial flexibility resources and Debt Management Plan. The quantification process includes determining net variable rate and short-term debt exposure and exposure to interest rate swaps through cash flow projections. Once quantified, the overall credit impact of variable rate debt and swaps can be factored into to an issuer's rating. This evaluation process will be made on a case-by-case basis.

#### **Net variable rate and short-term debt exposure**

Standard & Poor's will calculate net variable-rate and short-term debt exposure for an issuer by focusing on both assets and liabilities. Net variable rate and short-term debt includes, commercial paper, "unhedged" variable rate bonds, and synthetic variable rate debt. Unhedged variable rate bonds include those bonds not hedged through floating-to-fixed rate swaps or variable rate investment assets. Any variable rate bonds that are converted to fixed rate debt through a floating-to-fixed rate swap can be netted from variable rate liabilities only if Standard & Poor's has analyzed the swap contract and is comfortable that the contract fully hedges against variable rate risk exposure and furthermore, does not introduce other risks (see "Credit Factors of Swaps"). The same rule will apply to fixed rate bonds swapped to a variable rate.

Variable-rate and short-term investment assets typically help lower the interest rate risk associated with unswapped variable rate debt or synthetic variable rate debt. Increased debt service costs due to a rise in interest rates are typically offset by increases in investment income. If the issuer can show historical sufficiency of offsetting interest coverage, these variable rate assets may be netted from variable rate liabilities. Qualifying issuer accounts include operating funds, debt service funds, reserve funds, and other funds that are usually invested by the issuer in short-term securities with maturities of less than one year. Issuer accounts, which are restricted under a trust indenture, are

not counted as available accounts. Qualifying investment securities may include Treasury notes, commercial paper, certain repurchase agreements and guaranteed investment contracts. Revolving lines of credit and other forms of "soft capital" are typically not counted as short-term investments due to the fact that issuers are required to reimburse the provider for any draws made under the facilities.

An example of a net variable rate and short-term debt exposure calculation for a general revenue bond or tax-backed issuer is as follows. Assume an issuer has \$1.6 billion of total debt outstanding, composed of \$400 million of variable rate bonds, \$200 million of commercial paper, and \$1 billion of traditional fixed-rate debt. We also will assume that this issuer has a floating-to-fixed swap outstanding with a notional amount of \$200 million plus \$150 million of short-term investments, maintained in a general fund interest reserve.

- Total debt: \$1.6 bil.
- Total variable rate and short-term debt: \$600 mil. (\$400 mil. VRDOs + \$200 mil. CP)
- Total short-term and variable-rate debt as % of total debt: 37.5% (\$600 mil. / \$1.6 bil.).
- Total hedges: \$350 mil. (\$150 mil. assets + \$200 mil. swap)
- Net variable rate and short-term debt: \$250 million (\$600 mil. minus \$350 mil.).
- Net short-term and variable-rate debt as % of total debt: 15.6% (\$250 mil. / \$1.6 bil.).

### Swap risk exposure

Standard & Poor's will review pertinent swap documentation as well as the issuer's Swap Management Plan to determine whether or not any of the previously discussed swap risks are expected to occur over the life of the transaction. If Standard & Poor's determines that one or more risks associated with a swap is likely to occur, the issuer should indicate in the Swap Management Plan how they will cover these risks. Furthermore, the issuer should model these assumptions into cash flow projections. For example, if Standard & Poor's determines that there is counterparty risk under a fixed payor swap, the issuer must model those swapped variable rate bonds in the cash flows using assumed variable rates (see below) as opposed to the fixed rate under the swap contract. Another example is termination risk. If Standard & Poor's determines that involuntary termination of the swap is not a remote event, the issuer must prove sufficiency of reserves to make a termination payment and furthermore, assume those variable rate bonds are unhedged in the cash flows.

### Cash flows

Variable rate debt issuers should submit cash flow or financial projections to Standard & Poor's which show revenues, expenses, and debt service coverage and/or asset and liabilities and incorporate the appropriate risks of variable rate debt and swaps. All net variable rate and short-term debt (as calculated above) should be shown at the lesser of the interest rates forecasted by Standard & Poor's through our proprietary stochastic interest rate model, or the maximum interest rate as stated under the bond documents. Appropriately swapped variable rate debt can be shown at the fixed interest rate under the swap contract, while variable rate bonds hedged through variable rate and short-term assets can be shown at offsetting asset rates. If asset-liability rates are not assumed to completely offset each other, this exposure should be reflected in the cash flows. Additionally, if unhedged variable rate bonds are not modeled at the maximum interest rate under the bond documents, tax event risk must be adequately reflected on those bonds (please see "Credit Factors of Swaps – Tax Risk"). Finally, all risks identified under swap contracts should be incorporated into the cash flow projections as additional expenses. Issuer reserves should be shown to cover all potential shortfalls.

Cash flows should be submitted to Standard & Poor's during the ratings process. While the final terms of swaps may not be known early in the process, estimations can be made and incorporated in to the cash flows. If an issuer decides to enter into a swap contract following bond closing, this should be disclosed during the ratings process.


### Triggers

Many of the referenced agreements have ratings triggers embedded which allow for termination upon downgrades to certain rating levels, typically below investment grade. Standard & Poor's views



these triggers as having the potential for creating credit difficulties. Since the triggers are based on downgrades, the pressure from agreements collapsing will likely occur at the same time that the issuer's credit is deteriorating, thus potentially accelerating any downward trend in rating direction.

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# DuPage Water Commission

## MEMORANDUM

TO: Special Task Force on Refunding

FROM: Chairman Vondra

DATE: June 6, 2003

SUBJECT: Selection of Underwriting Team

The selection of an underwriting group will need to be determined at the June 12<sup>th</sup> meeting in order to jump start the refunding process. I wanted to offer my views on this subject in an effort to facilitate your decision making.

1. LEAD UNDERWRITER AND GROUP

I still feel that UBS Paine Webber is in the best position to assist the Commission with this refunding as the lead underwriter particularly given the additional attention that will have to be given to the rating agencies. I would, therefore, recommend allocating 40% of the book to Paine Webber. The remaining 60% should be evenly divided (20/20/20) among Loop, Baum and Baird.

2. INPUT ON UNDERWRITERS COUNSEL

The General Manager has pointed out that underwriters counsel will have an expanded role in this refunding because no disclosure has been done on the revenue bonds since they were last refunded some ten years ago. I would, therefore, consider recommending that two firms, Chapman & Cutler and Bell Boyd divide this work with one being responsible for all Commission due diligence and the other for the due diligence in connection with each charter customers water fund and its operations.

3. COMMISSION BOND COUNSEL

During the interview with underwriters I was particularly impressed with Katten Muchin Zavis' performance and would recommend their appointment as Commission Bond Counsel.