

## **APPENDIX A**

### **Truckee Meadows Water Authority, Nevada INTEREST RATE SWAP POLICY June 30, 2008**

#### **1. Introduction**

The purpose of this Interest Rate Swap Policy (the “Policy”) is to establish guidelines for the execution and management of the Truckee Meadows Water Authority’s (the “Authority”) use of interest rate swaps or similar products (“Swap Products”) and related transactions to meet the financial and management objectives as outlined herein.

This policy confirms the commitment of Authority management to adhere to sound financial and risk management practices.

#### **2. Scope**

The Authority recognizes that Swap Products can be appropriate financial management tools to achieve the Authority’s financial and management objectives. This Policy sets forth the manner in which the Authority shall enter into transactions involving Swap Products. The Authority shall integrate Swap Products into its overall debt and investment management programs in a prudent manner in accordance with the parameters set forth in this Policy.

This Policy applies to any interest rate swap; swap option or related transaction that the Authority may undertake.

#### **3. Authorizations and Approvals; Compliance with Bond Documents and Covenants**

The Authority shall obtain the approval of the Truckee Meadows Water Authority Board of Trustees (the “Trustees”) prior to entering into any interest rate swap, swap option or related transaction. The Authority, in consultation with its Bond Counsel, and financial advisors will determine whether a proposed swap agreement complies with State law and any other applicable law and any other applicable provisions of the Authority’s bond resolutions and agreements with respect to its outstanding debt. All swap transactions will be subject to an independent finding that the terms and conditions are fair and reasonable at the time of trade execution.

#### **4. General Objectives**

The Authority may execute an interest rate swap, swap option or related transaction to the extent the transaction can be reasonably expected to achieve one or more of the following objectives:

- Result in a lower net cost of borrowing with respect to the Authority’s debt, or achieve a higher net rate of return on the investment of Authority moneys.
- Reduce exposure to changes in interest rates either in connection with a particular debt financing or investment transaction or in the management of interest rate risk with respect to the Authority’s overall debt and investment portfolios.
- Enhance financing flexibility for future capital projects.

## **5. Prohibited Uses of Interest Rate Swaps and Related Instruments**

The Authority shall not execute interest rate swaps agreements or related instruments under the following circumstances:

- When a swap or other financial instrument is used for speculative purposes, such as potential trading gains, rather than for managing and controlling interest rate risk in connection with Authority debt or investments;
- When a swap or other financial instrument creates extraordinary leverage or financial risk;
- When the Authority lacks sufficient liquidity to terminate the swap at current market rates; or
- When there is insufficient price “transparency” to permit the Authority and its financial advisors to reasonably value the instrument, as a result, for example, of the use of unusual structures or terms.

## **6. Permitted Financial Instruments**

The Authority may utilize the following financial products, if then permitted by law, on either a current or forward basis, after identifying the objective(s) to be realized and assessing the attendant risks, if permitted by law:

- Interest rate swaps, including fixed, floating and/or basis swaps
- Interest rate caps, floors and collars
- Options, including on swaps, caps, floors and/or collars and/or cancellation or index-based features

## **7. Identification and Evaluation of Financial and Other Risks**

Prior to execution of an interest rate swap, swap option or related transaction, the Authority and its financial advisors shall identify and evaluate the financial risks involved in the transaction, and summarize them, along with any measures that will be taken to mitigate those risks. The types of questions that should be evaluated in connection with the identification and evaluation of financial risks shall include:

- **Market or Interest Rate Risk:** Does the proposed transaction hedge or create exposure to fluctuations in interest rates?
- **Tax Law Risk:** Is the proposed transaction subject to rate adjustments, extraordinary payments, termination or other adverse consequences in the event of a future change in Federal income tax policy?
- **Termination Risk:** Under what circumstances might the proposed transaction be terminated (other than at the option of the Authority)? At what cost? Does the Authority have sufficient liquidity to cover this exposure?

- Risk of Uncommitted Funding (“Put” risk): Does the transaction require or anticipate a future financing(s) that is dependent upon third party participation? What commitments can be or have been secured for such participation?
- Legal Authority: Is there any uncertainty regarding the legal authority of any party to participate in the transaction?
- Counterparty Credit Risk: What is the credit-worthiness of the counterparty? What provisions have been made to mitigate exposure to adverse changes in the counterparty credit standing?
- Ratings Risk: Is the proposed transaction consistent with the Authority’s current credit ratings or its desired future ratings and with related rating agency policies?
- Basis Risk: Do the anticipated payments that the Authority would make or receive match the payments that it seeks to hedge?
- Tax Exemption on Authority Debt: Does the transaction comply with all Federal tax law requirements with respect to the Authority’s outstanding tax-exempt bonds?
- Accounting Risk: Does the proposed transaction create any accounting issues that could have a material detrimental effect on the Authority’s financial statements? Would the proposed transaction have any material effect on the Authority’s rate covenant calculation or compliance? How are any such effects addressed?
- Administrative Risk: Can the proposed transaction be readily administered and monitored by the Authority’s finance team consistent with the policies outlined in the Authority’s Interest Rate Swap Policy?
- Subsequent Business Conditions: Does the proposed transaction or its benefits depend upon the continuation or realization of specific industry or business conditions?

## **8. Risk Limitations**

The total notional amount and term of all Swap Transactions executed by the Authority shall not exceed the notional amount and term specified from time to time by the Authority’s Chief Financial Officer (the “CFO”). It is expected that the Authority’s total variable rate exposure, net of Swap Transactions which have the economic effect of reducing variable rate exposure, will be established from time to time based upon an evaluation of all relevant factors, including investment allocations, risk tolerance, credit strength, and market conditions.

## **9. Form of Swap Agreements**

Each interest rate swap executed by the Authority shall contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement, including the Schedule to the Master Agreement and a Credit Support Annex, as supplemented and amended in accordance with the recommendations of the Authority’s finance team. The swap agreements between the Authority and each qualified swap counterparty shall include payment, term, security, collateral, default, remedy, termination,

and other terms, conditions and provisions as the Authority, in consultation with its financial advisors and Bond Counsel deems necessary or desirable.

#### **10. Qualified Swap Counterparties**

The Authority shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. At least one of the ratings of the Authority's counterparties (or their guarantors) must be in the "AA" category, or at least Aa3/Aa- and no lower than A2 or A. In addition, each counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty (or guarantor) shall have a minimum capitalization of at least \$250 million.

In order to diversify the Authority's counterparty credit risk, and to limit the Authority's credit exposure to any one counterparty, limits will be established for each counterparty based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing and proposed swap transaction. The guidelines below provide general termination exposure guidelines with respect to whether the Authority should enter into an additional transaction with an existing counterparty. The Authority may make exceptions to the guidelines at any time to the extent that the execution of a swap achieves one or more of the goals outlined in these guidelines or provides other benefits to the Authority. In general, the maximum Net Termination Exposure to any single Counterparty should be set so that it does not exceed a prudent level as measured against the gross revenues, available assets or other financial resources of the Authority.

Such guidelines will also not mandate or otherwise force automatic termination by the Authority or the counterparty. Maximum Net Termination Exposure is not intended to impose retroactively any terms and conditions on existing transactions. Such provisions will only act as guidelines in making a determination as to whether or not a proposed transaction should be executed given certain levels of existing and projected net termination exposure to a specific counterparty. Additionally, the guidelines below are not intended to require retroactively additional collateral posting for existing transactions. Collateral posting guidelines are described in the "Collateral" section above. The calculation of net termination exposure per counterparty will take into consideration multiple transactions, some of which may offset the overall exposure to the Authority.

Under this approach, the Authority will set limits on individual counterparty exposure based on existing as well as new or proposed transactions. The sum of the **current market value** and the **projected exposure** shall constitute the Maximum Net Termination Exposure. For outstanding transactions, current exposure will be based on the market value as of the last quarterly swap valuation report provided by the Financial Advisor. Projected exposure shall be calculated based on the swap's potential termination value taking into account possible adverse changes in interest rates as implied by historical or projected measures of potential rate changes applied over the remaining term of the swap.

For purposes of this calculation, the Authority shall include all existing and projected transactions of an individual counterparty and all transactions will be analyzed in aggregate such that the maximum exposure will be additive.

The exposure thresholds, which will be reviewed periodically by the Authority to ensure that they remain appropriate, will also be tied to credit ratings of the counterparties and whether or not collateral has been posted as shown in the table below. If a counterparty has more than one rating, the lowest rating will govern for purposes of the calculating the level of exposure. A summary table is provided below.

<b>Counterparty Credit Exposure Recommended Limits</b>			
<b>Credit Ratings</b>	<b>Maximum Collateralized Exposure</b>	<b>Maximum Uncollateralized Exposure</b>	<b>Maximum Net Termination Exposure</b>
Aaa/AAA	NA	\$100.0 million	\$100.0 million
Aa/AA Category	\$70.0 million	\$30.0 million	\$100.0 million
A/A Category	\$50.0 million	\$20.0 million	\$70.0 million
Below A3/A-	\$50.0 million	None	\$50.0 million

If the exposure limit is exceeded by counterparty, the Authority shall conduct a review of the exposure limit per counterparty. The Authority, in consultation with its Swap Counsel and Financial Advisor, shall explore remedial strategies to mitigate this exposure.

The Authority's swap exposure to any single counterparty will be limited to 25% of the counterparty's capitalization.

## **11. Procurement Process**

The Authority may either negotiate or competitively bid interest rate swap transactions with qualified swap providers. The qualified swap providers will be selected by the Chief Financial Officer of the Authority and General Manager for consideration by the TMWA Board..

## **12. Termination Provisions and Authority Liquidity**

Optional Termination: All interest rate swap transactions shall contain provisions granting the Authority the right to optionally terminate a swap agreement at any time over the term of the agreement. In general, exercising the right to optionally terminate an agreement produces a benefit to the Authority, either through receipt of a payment from a termination, or if a termination payment is made by the Authority, in connection with a corresponding benefit from a change in the related Authority debt or investment, as determined by the Authority. The CFO, as appropriate, in consultation with the Authority's finance team, shall determine if it is financially advantageous for the Authority to terminate a swap agreement.

Termination Events: A termination payment to or from the Authority may be required in the event of termination of a swap agreement due to a default by or a decrease in the credit rating of either the Authority or the counterparty. Prior to entering into the swap agreement or making any such termination payment, as appropriate, the CFO shall evaluate whether it would be financially advantageous for the Authority to enter into a replacement swap as a means of offsetting any such termination payment.

Any swap termination payment due from the Authority shall be made from available Authority monies. The CFO shall report any such termination payments to the Authority's Board of Directors.

Available Liquidity: The Authority shall consider the extent of its exposure to termination payment liability in connection with each swap transaction, and the availability of sufficient liquidity to make any such payments that may become due.

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

The Authority shall determine the appropriate term for an interest rate swap agreement on a case-by-case basis. The slope of the interest rate 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 the Authority shall be considered in determining the appropriate term of any swap agreement. For any swap agreement entered into in connection with the issuance or carrying of bonds, the term of such swap agreement shall not extend beyond the final maturity date of such bonds.

### **14. Collateral Requirements**

As part of any swap agreement, the Authority may require collateralization or other credit enhancement to secure any or all swap payment obligations of the counterparty. As appropriate, the Authority may require collateral or other credit enhancement to be posted by each swap counterparty under the following circumstances:

- Each counterparty shall be required to post collateral, in accordance with its (or its guarantor's) credit rating, equal to the positive net termination value of the swap agreement.
- Collateral shall consist of cash, U.S. Treasury securities and U.S. Agency securities.
- Collateral shall be deposited with a custodian, acting as agent for the Authority, or as mutually agreed upon between the Authority and each counterparty.
- The market value of the collateral shall be determined on at least a monthly basis.
- The Authority will determine reasonable threshold limits for the initial deposit and for increments of collateral posted thereafter.
- The CFO shall determine on a case-by-case basis whether other forms of credit enhancement are more beneficial to the Authority.

In connection with any collateralization requirements that may be imposed upon the Authority in connection with a swap agreement, the Authority may post collateral or it may seek to obtain swap insurance in lieu of posting collateral. The CFO shall recommend a preferred approach to the Authority on a case-by-case basis.

### **15. Reporting Requirements**

The Authority's finance team will monitor any interest rate swaps that the Authority enters into on at least a monthly basis.

The Authority's CFO will provide a written report to the TMWA Board regarding the status of all interest rate swap agreements on at least a quarterly basis and shall include the following information:

- Highlights of all material changes to swap agreements or new swap agreements entered into by the Authority since the last report.
- Market value of each of the Authority's interest rate swap agreements.

- For each counterparty, the Authority shall provide the total notional amount position, the average life of each swap agreement, the available capacity to enter into a swap transaction, and the remaining term of each swap agreement.
- The credit rating of each swap counterparty and credit enhancer insuring swap payments, if any.
- Actual collateral posting by each swap counterparty, if any, under each swap agreement and in total by that swap counterparty.
- A summary of each swap agreement, including but not limited to the type of swap, the rates and dollar amounts paid by the Authority and received by the Authority, and other terms.
- Information concerning any default by a swap counterparty under a swap agreement with the Authority, and the results of the default, including but not limited to the financial impact to the Authority, if any.
- A summary of any planned swap transactions and the projected impact of such swap transactions on the Authority.
- A summary of any swap agreements that were terminated.

#### **16. Swaps Accounting Treatment**

The Authority shall comply with any applicable accounting standards for the treatment of swaps and related financial instruments. The Authority and the Authority's external auditors shall implement the appropriate accounting standards.

#### **17. Periodic Review of Interest Rate Swap Policy**

The CFO and the Authority's financial advisors shall review its swap policy on a periodic basis and recommend appropriate changes to the General Manager and TMWA Board.