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**FINANCE AND BUDGET COMMITTEE
SEPTEMBER 17, 2008**

SUBJECT: DEBT AND INTEREST RATE SWAP POLICIES

ACTION: ADOPT DEBT AND INTEREST RATE SWAP POLICIES

RECOMMENDATION

- A. Adopt the Debt Policy, Attachment A;
- B. Adopt the Interest Rate Swap Policy, Attachment B; and
- C. Receive and File the Annual Report on Interest Rate Swaps, Attachment C

ISSUE

The Debt Policy and Interest Rate Swap Policy require that they be reviewed and updated annually. There are only minor editorial changes to the Debt Policy. The Interest Rate Swap Policy changes address issues that have come to light as we have been working on the Board approved restructuring of our interest rate swaps. The updates clarify that amendments of certain swap terms, replacement of providers and other ministerial actions do not require further Board approval when the end result is in our best interests and are within the objectives approved for the specific deal.

The Interest Rate Swap Policy requires an annual review of outstanding interest rate swaps. The attached report shows that our transactions are in compliance with the policy. The attached report also shows the effects of the liquidity crisis on our bond interest rates. Charts for each swap show the resulting unfavorable shift in basis cost.

POLICY IMPLICATIONS

The Debt Policy and Interest Rate Swap Policy govern the use and management of interest rate swaps as they are used in conjunction with debt issues. The policies establish guidelines to be used when considering the use of debt or swaps, as well as in the on-going management of existing obligations. Guidance is provided specifying appropriate uses, selection of acceptable debt and lease products, swap providers, negotiation of favorable terms and conditions, and stipulating annual surveillance of the swaps and the providers. The processes for selection of swap-related financial products and professional services are also specified.

OPTIONS

Properly updated policies governing the management of debt and interest rate swaps are essential to sound financial and debt management and provide guidance to effectively obtain the lowest cost of capital.

FINANCIAL IMPACT

There is no direct financial impact associated with implementing or not implementing the updates to these policies.

BACKGROUND

The Debt Policy and Interest Rate Swap Policy establish appropriate practices for the issuance and management of debt and interest rate swaps. We currently have about \$3.6 billion of debt outstanding in 33 transactions that are subject to the Debt Policy. There are seven interest rate swaps subject to the Interest Rate Swap Policy with outstanding notional amounts totaling about \$1.1 billion.

NEXT STEPS

Following adoption of the Debt Policy and Interest Rate Swap Policy we will make them available to rating agencies and other interested parties, as part of our investor relations outreach.

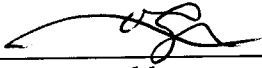
ATTACHMENTS

- A. Debt Policy (marked for changes)
- B. Interest Rate Swap Policy (marked for changes)
- C. Annual Report on Interest Rate Swaps

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Terry Matsumoto
Chief Financial Services Officer and Treasurer



Roger Snoble
Chief Executive Officer

Attachment A

ANNUAL UPDATE
of
DEBT POLICY

SEPTEMBER 2008

DEBT POLICY

I. Introduction

The purpose of the Debt Policy of the ~~Los Angeles County Metropolitan Transportation Authority (LACMTA)~~ is to establish guidelines for the issuance and management of its debt. This Debt Policy confirms the commitment of the Board, management, staff, advisors and other decision makers to adhere to sound financial management practices, including full and timely repayment of all borrowings, achieving the lowest possible cost of capital within prudent risk parameters and encouraging the use of local and California-based advisors and underwriters when appropriate and feasible. Priorities of the Debt Policy are as follows:

1. Achieve the lowest cost of capital
2. Maintain a prudent level of financial risk
3. Preserve future financial flexibility
4. Maintain strong credit ratings and good investor relations
5. Ensure that local, emerging and disadvantaged business enterprise investment banking and financial firms will be considered for, and utilized in, lead and senior manager roles when appropriate

II. Scope and Authority

This Debt Policy shall govern, except as otherwise covered by the Investment Policy, Defeased Lease Policy or Interest Rate Swap Policy, the issuance and management of all debt and lease financings funded from the capital markets, including the selection and management of related financial services and products, and investment of bond and lease proceeds.

While adherence to this Policy is required in applicable circumstances, it is recognized 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 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.

The Debt Policy shall be reviewed and updated at least annually and presented to the Board for approval. The Chief Executive Officer and Chief Financial Services Officer and Treasurer are the designated administrators of the Debt Policy. The Treasurer shall have the day-to-day responsibility and authority for structuring, implementing and managing the debt and finance program, including the issuance of commercial paper in accordance with the Board authorized programs. The Debt Policy requires that the Board specifically authorize each debt and lease financing.

III. Capital Budgeting and Debt Issuance Process

A. Capital Budgeting

1. The Capital Plan. A Capital Plan, (the “CP”), shall be developed for consideration and adoption by the Board. The CP should have a planning horizon of at least a 5-year period and shall be updated at least annually. In addition to capital project costs, the CP will include the following elements:

- a) Description and availability of all sources of funds
- b) Timing of capital projects
- c) Effect of capital projects on the debt burden
- d) Debt service requirements

It is ~~the~~ LACMTA's current practice to include the CP in the Annual Budget for consideration and adoption.

2. Authorization for Issuance. The Board's adoption of the Annual Budget does not, in and of itself, constitute authorization for debt issuance for any capital projects. Each financing shall be presented to the Board in the context of the Annual Budget.

B. Debt Financing

1. Appropriate Use of Long-Term Debt

- a) Purpose for Long-Term Debt. Long-term debt should be used to finance essential capital facilities, projects and certain equipment where it is cost effective and fiscally prudent. The scope, requirements, and demands of the Annual Budget or CP, and the ability or need to expedite or maintain the programmed schedule of approved capital projects will also be factors in the decision to issue long-term debt. Inherent in its long-term debt policies, the policy recognizes that future taxpayers will benefit from the capital investment and that it is appropriate that they pay a share of the asset cost. Long-term debt will not be used to fund operations.
- b) Lease Financing. Lease obligations are a routine and appropriate means of financing capital equipment. These types of obligations should be considered where lease financing will be more beneficial, either economically or from a policy perspective. The useful life of the capital equipment, the terms and conditions of the lease, the direct impact on debt capacity and budget flexibility will be evaluated prior to the implementation of a lease program. Efforts will be made to

fund capital equipment on a pay-as-you-go basis where feasible. Cash flow sufficiency, capital program requirements, lease program structures and cost, and market factors will be considered in conjunction with a pay-as-you-go strategy in lieu of lease financing. All leases providing tax-exempt financing are subject to this policy, as are all leases, master leases and leasing programs having a cumulative value exceeding \$10 million.

2. Use of Short-Term and Variable Rate Debt

- a) Commercial Paper. The commercial paper programs are cash management tools that are primarily used to provide interim funding for capital expenditures that will ultimately be funded from another source such as a grant or long-term bond. The Board has previously approved the use of both the tax-exempt and taxable commercial paper programs for \$350 million and \$150 million, respectively. Commercial paper may be issued from time to time, but its use will generally be restricted to providing interim financing for capital projects programmed for long-term debt or grant funding. Periodic issuances or retirements of commercial paper notes within the Board approved programs do not require further Board action.
- b) Tax and Revenue Anticipation Notes. Borrowing for cash flow purposes through the use of tax and revenue anticipation notes may be used to bridge temporary cash flow deficits within a fiscal year.
- c) Grant Anticipation Notes. Short-term notes may be issued and secured with the receipts of State or Federal grants if appropriate for the project and in the ~~our~~ best interests of the ~~LACMTA.~~ Generally, grant anticipation notes will only be issued if there is no other viable source of up-front cash for the project.
- d) Variable Rate Debt: It is often appropriate to issue short-term or long-term variable rate debt to diversify the debt portfolio, reduce interest costs, provide interim funding for capital projects and improve the match of assets to liabilities. The amount of unhedged variable rate debt will generally not exceed 20% of all outstanding debt, and the total of hedged and unhedged variable rate debt will not exceed 50% of all outstanding debt. Under no circumstances will variable rate debt be issued solely for the purpose of earning interest through arbitrage. If unhedged variable rate debt is outstanding, at least annually, it

shall be determine whether it is appropriate to convert the debt to fixed interest rates.

IV. Debt Affordability Targets and Policy Limits

Target and policy maximum amounts of revenues to be used to pay debt service are listed as percentages of the respective revenue sources. These limits in combination with the CP and multi-year planning documents ensure that the LACMTA will be able to continue providing its essential operational services while planning for replacement, rehabilitation and expansion of its capital investments.

Proposition A Sales Tax Revenue Debt Affordability Targets		
<i>Category</i>	<i>Allowable Uses & Status</i>	<i>Debt Policy Maximum</i>
Prop A Rail 35%	<i>Rail Operations & Capital.</i> Is currently committed to debt service in an amount close to the Policy Maximum.	87% of Prop A 35% Rail revenues.
Discretionary 40%	<i>Any transit purpose.</i> Current state law directs these funds to bus subsidies and incentives.	No further issuance.
Local Return 25%	<i>Any transit purpose.</i> Distributed to localities based on population.	N/A

Proposition C Sales Tax Revenue Debt Affordability Targets		
<i>Category</i>	<i>Allowable Uses & Status</i>	<i>Debt Policy Maximum</i>
Discretionary 40%	<i>Bus & Rail, Capital & Operating.</i>	40% of Prop C 40% Discretionary revenues.
Highway 25%	<i>Streets, Highways and Fixed Guideway Projects on Railroad Right-of-Way.</i>	60% of Prop C 25% Highway.
Commuter Rail 10%	<i>Commuter Rail and Park and Ride.</i> Operations or capital.	40% of Prop C 10% Commuter Rail.

Security 5%	<i>Transit Security. Operations or capital.</i>	No debt issuance.
Local Return 20%	<i>Any transit purpose and certain roadways heavily used by transit. Distributed to localities based on population.</i>	N/A

Other Revenue Debt Affordability Targets		
<i>Category</i>	<i>Allowable Uses & Status</i>	<i>Debt Policy Maximum</i>
Fare Box Revenue	<i>Any transit purpose.</i>	No further issuance.
Federal Grant Revenue	<i>In accordance with grant.</i>	No further issuance.
State Grant Revenues	<i>In accordance with grant.</i>	No debt issuance.
TDA	<i>Various transit purposes.</i>	No further issuance.
Benefit Assessment Levies	<i>Historically to support rail construction.</i>	100% of levies.
Lease Revenues	<i>Any transit purpose.</i>	Limited issuance for special projects.
Other System Revenue	<i>Any transit purpose.</i>	Limited issuance for special projects.

V. Purpose of Financing

A. New Money Financing

New money issues are those financings that generate additional funding to be available for expenditure on capital projects. These funds will be used for acquisition, construction and major rehabilitation of capital assets. New money bond proceeds may not be used to fund operational activities. The funding requirement by sales tax ordinance category is determined in the context of the CP and Annual Budget. For competitive issuances, the financial advisor will recommend the financing structure based on the type of financial

products to be used and in consideration of market conditions at the time of the sale.

The commercial paper programs are used primarily to provide interim new money funding. Proceeds from the sale of commercial paper are used to provide interim funding for capital expenditures identified in the CP and approved Annual Budget pending receipt of grant funds or long-term bond proceeds to permanently fund those expenditures. The commercial paper notes are retired upon receipt of the grant funds or bond proceeds. The retirement of commercial paper is most commonly a result of the issuance of long-term bonds.

B. Refunding Bonds

Refunding bonds are issued to retire all or a portion of an outstanding bond issue. Most typically this is done to refinance at a lower interest rate to reduce debt service. Alternatively, some refundings are executed for a reason other than to achieve cost savings, such as to restructure the repayment schedule of the debt, to change the type of debt instruments being used, or to retire an indenture in order to remove undesirable covenants. In any event, a present value analysis must be prepared that identifies the economic effects of any refunding being proposed to the Board. The target savings amounts listed below are not applicable for refunding transactions that are not solely undertaken to achieve cost savings.

The target savings amount shall be measured using either a call option pricing model or the savings as percentage of par method. When using the call option model to evaluate a refunding whose sole purpose will be to achieve cost savings, the target savings from any particular refunding candidate shall be approximately 80% or more of the expected value of the call option, net of all transaction expenses. The Treasurer shall have discretion in making the final determination to include individual refunding candidates that are above or below the target in order to optimize the policy and/or financial objectives.

Alternatively, the more traditional methodology of measuring the net present value savings as a percentage of the refunded par amount may be used with a minimum average savings of approximately 3% for each refunding candidate.

In the event that an interest rate swap or other derivative product is to be used as part of a refunding, the target savings shall be increased to account for any additional ongoing administrative costs, financial risk beyond that of a traditional fixed rate refunding, and loss of future financial flexibility. When a proposed refunding interest rate swap has a variable interest rate swap payment to ~~the LACMTA~~ that is indexed to ~~BMA~~ the Securities Industry and Financial Markets Association “SIFMA” Municipal Swap Index, then the target savings shall be 85% using the call option method or 3.5% using the percentage of par method.

When a proposed refunding interest rate swap involves a variable interest rate swap payment to the ~~LACMTA~~us that is indexed to LIBOR the target savings shall be 90% using the call option method or 5.0% using the percentage of par method.

VI. Types of Products

A. Current Coupon Bonds

Current coupon bonds are bonds that pay interest periodically and principal at maturity. They may be used for both new money and refunding transactions. Current coupon bonds may be structured to meet the demands of the investor and, thereby, reduce the cost of borrowing. Bond features may be adjusted to accommodate the market conditions at the time of sale, including changing the dollar amounts for annual principal maturities, offering discount and premium bond pricing, modifying the terms of the call provisions, and utilizing bond insurance.

B. Zero Coupon and Capital Appreciation Bonds

Zero coupon bonds and capital appreciation bonds have principal amortization that is much slower than level debt service resulting in increased interest expenditure over the life of the bond and, therefore, shall only be recommended in limited situations.

C. Lease Purchase Financing

Lease purchase financing represents a long-term financing lease that is suitable for financing capital expenditures, including the acquisition and/or construction of land, facilities, equipment and rolling stock

1. Equipment. The ~~LACMTA~~We shall have the ability to consider lease purchase transactions, including certificates of participation, long-term vendor leases, and the use of master lease programs. Financing of equipment will be limited to contracts of at least \$20,000 and a useful life that is greater than 3 years. The final maturity of equipment lease financings will be limited to the remaining useful life of the equipment.
2. Real Property. The final maturity of the financing shall not exceed the remaining useful life of the facility. A lease financing generally should not have a final maturity exceeding 30 years. Principal payments related to real property acquisition or construction are to be amortized so that there will be level debt service payments; although a more rapid amortization may be used to accelerate the repayment.

D. Derivative Products

Derivative products will be considered appropriate in the issuance or management of debt only in instances where it has been demonstrated that the derivative product will either provide a hedge that reduces risk of fluctuations in expense or revenue, or alternatively, where it will reduce total project cost. The Board approved Interest Rate Swap Policy sets forth the guidelines for interest rate swaps. For derivatives other than interest rate swaps, an analysis of early termination costs and other conditional terms given certain financing and marketing assumptions will be completed. Such analysis will document the risks and benefits associated with the use of the particular derivative product. Derivative products will only be utilized with prior Board approval.

VII. Structural Features

A. Maturity of Debt

The final maturity of the debt shall be equal to or less than the remaining useful life of the assets being financed, and the average life of the financing shall not exceed 120% of the average life of the assets being financed.

B. Debt Service Structure

Combined principal and interest payments for any particular bond issue will be structured to have approximately level annual debt service payments over the life of the bond. Exceptions will occur for refunding bonds that will have varying principal repayments structured to fill in the gaps created by refunding specific principal maturities. The objective is to have level debt service in aggregate for each lien, with the debt service declining as bonds mature.

C. Lien Levels

Senior and Junior Liens for each revenue source will be utilized in a manner that will maximize the most critical constraint -- typically either cost or capacity -- thus allowing for the most beneficial use of the revenue source securing the bond.

D. Capitalized Interest

Unless otherwise required, capitalized interest will not be employed. This avoids unnecessarily increasing the bond size. Certain types of financings such as certificates of participation, lease-secured financings, and certain revenue bond projects may require that interest on the bonds be paid from capitalized interest until ~~the LACMTA has~~ we have constructive use of the

project and project related revenues are expected to be available to pay debt service.

E. Discount and Premium Bonds

While discount and deep discount bonds may slightly reduce the interest cost of the bonds below that of non-discount bonds, the amount of discount will be structured to minimize the negative impact of the resulting lower bond coupon on the ability to subsequently refund bonds for interest savings.

The impact of certain premium bonds that are priced to their call date instead of their maturity date will be analyzed to quantify the possible increased cost of the bonds relative to pricing for par bonds, in comparison to the benefit from the higher future refunding potential from premium bonds. We will generally attempt to limit the amount of premium bonds issued, as well as the amount of the premium.

F. Debt Service Reserve Fund

The debt service reserve fund (the “DSRF”) is generally cash funded with bond proceeds. The trustee maintains the DSRF throughout the life of the bonds. A cash funded DSRF is invested pursuant to investment of proceeds guidelines within the respective indenture and interest earnings are generally used to offset debt service payments. In the final year of the bond issue, the cash available in the DSRF is usually used to make the final debt service payment. Since a cash funded DSRF generates interest income, the DSRF has the potential to be cost neutral if the interest earnings equal or exceed the interest rate of the bonds.

An alternative to having a cash funded DSRF is to use a DSRF surety policy obtained from a highly rated bond insurer. The surety policy requires an up-front fee payment to the insurer and results in a loss of future income to the DSRF. The Treasurer will evaluate and document the DSRF funding decision. Factors to be considered in this evaluation include: arbitrage yield restrictions, current interest rates, availability and cost of a surety policy, foregone interest and capital gains from a cash funded DSRF, the relative size of the reserve requirement compared to the prior reserve requirement (refunding issues only), and opportunities for the use of the funds withdrawn from the DSRF including additional capital projects or investment opportunities.

G. Amortization

Debt will be amortized within each lien to achieve overall level debt service or may utilize more accelerated repayment schedules after giving consideration to bonding capacity constraints. The use of heavily back-loaded principal repayment, bullet and balloon maturities should be avoided, except to achieve

wrapped debt service so as to level aggregate outstanding debt service.

H. Financial and Risk Analysis of Issuance

Net present value cost analysis, assessment of structural risks and complexities, and consideration of restrictions to future financing flexibility will be assessed and documented to determine the most efficient bond type and structuring features. ~~The LACMTA's~~ Our long-term pooled investment rate will be used as the discount rate when comparing alternatives.

I. Call Provisions

In general, bonds issued should not include a non-call feature which is longer than 10 years. However, if determined to be financially advantageous, bonds may be issued that are non-callable for periods longer than 10 years. Prior to the use of any non-call provision, the option-adjusted yields on the bonds with and without a non-call provision will be analyzed to determine which is most financially beneficial.

J. Credit Enhancement

1. Bond insurance. Bond insurance will be used when it provides an economic advantage to a particular bond maturity or entire issue. Bond insurance provides improved credit quality for the bonds as a result of the insurance provider's guarantee of the payment of principal and interest on the bonds. Because of the decreased risk of non-payment, investors are willing to purchase bonds with lower yields than uninsured bonds, thus providing the issuer with interest cost savings.

a) Benefit analysis. The decision to use bond insurance is an economic decision. The analysis compares the present value of the interest savings to the cost of the insurance premium. Insurance will be purchased when the premium cost is less than the present value of the projected interest savings.

b) Provider selection. The financial advisor will undertake a competitive selection process when soliciting pricing for bond insurance, or in the case of a competitive bond sale, facilitate the pre-qualification of bonds by insurance providers. It is recognized that all providers may not be interested in providing bids or pre-qualifying the issue. Generally, the winning underwriter in a competitive bond sale will determine whether it will purchase insurance for the issue. For a negotiated sale, the Treasurer shall have the authority to purchase bond insurance when deemed advantageous and the terms and conditions governing the guarantee are satisfactory.

2. Letters of Credit. When used for credit enhancement, letters of credit, (“LOC”) represent a bank’s promise to pay principal and interest when due for a defined period of time, and subject to certain conditions. In the case of a direct pay LOC, the trustee can draw upon the letter of credit to make debt service payments. A stand-by LOC can be used to ensure the availability of funds to pay principal and interest of an obligation.
- a) Liquidity Facility. The issuance of most variable rate debt, including variable rate demand bonds and commercial paper, requires the use of a liquidity facility.
 - b) Provider selection. The financial advisor will conduct a competitive process to recommend a letter of credit provider. The Treasurer will obtain contract approval in accordance with established dollar award policies. Only those banks with long-term ratings greater than or equal to ~~that of the~~ LACMTA, and short-term ratings of P-1/A-1, by Moody’s Investors Service and Standard & Poor’s, respectively, may be solicited.
 - c) Selection criteria will include, but not be limited to the following:
 - (1) the bank(s) has long-term ratings at least equal to or better than ~~the~~ LACMTA;
 - (2) the bank(s) has short-term ratings of P-1/A-1;
 - (3) the bank’s acceptance of terms and conditions acceptable to ~~the~~ LACMTA. A term sheet will be provided along with the request for qualifications to which the banks will highlight modifications;
 - (4) review of representative list of clients for whom the bank has provided liquidity facilities;
 - (5) evaluation of fees; specifically, cost of LOC, draws, bank counsel and other administrative charges and estimate of trading differential cost.

VIII. Documentation of Transactions

The decision processes used in each financing process will be fully documented. The documentation will capture information regarding the selection of the financing team, decisions on product selection and structuring features, selection of vendors providing ancillary services and selection of investment securities or products. This information will be compiled into a post-pricing book “transaction file” which will be retained for each financing.

IX. Credit Objectives

The LACMTA will actively seek to:

1. Maintain and improve the credit ratings of its outstanding bonds.
2. Adhere to benchmarks, overall debt ratios and affordability targets.
3. Have frequent communications with the credit rating agencies.

X. Method of Bond Sale

A. The competitive bond sale process will be utilized when it will provide the lowest interest cost for the bond. However, there are three methods of sale: competitive, negotiated and private placement. Each type of bond sale has the potential to provide the lowest cost given the right conditions. The conditions under which each type of bond sale is best used are provided below.

1. *Competitive Sale*

- a) Bond prices are stable and/or demand is strong.
- b) Market timing and interest rate sensitivity are not critical to the pricing.
- c) Participation from DBE / SBE firms is best efforts only and not required for winning bid.
- d) Issuer has a strong credit rating.
- e) Issuer is well known to investors.
- f) There are no complex explanations required during marketing regarding the issuer's projects, media coverage, political structure, political support, funding, or credit quality.
- g) The bond type and structural features are conventional.
- h) Bond insurance is included or pre-qualified (available).
- i) Manageable transaction size.

2. *Negotiated Sale*

- a) Bond prices are volatile.
- b) Demand is weak or supply of competing bonds is high.
- c) Market timing is important, such as for refundings.
- d) Coordination of multiple components of the financing is required.
- e) Participation from DBE / SBE firms is enhanced.
- f) Issuer has lower or weakening credit rating.
- g) Issuer is not well known to investors.
- h) Sale and marketing of the bonds will require complex explanations about the issuer's projects, media coverage, political structure, political support, funding, or credit quality.
- i) The bond type and/or structural features are non-standard, such as for a forward delivery bond sale, issuance of variable rate bonds or where there is use of derivative products.
- j) Bond insurance is not available or not offered.
- k) Early structuring and market participation by underwriters are desired.
- l) The par amount for the transaction is significantly larger than

- m) normal.
Demand for the bonds by retail investors is expected to be high.

- 3. *Private Placement* is a sale that is structured specifically for one purchaser such as a bank. While this method has not previously been used, the policy reserves to the ability to place its securities privately if the need arises.

XI. Investment of Bond Proceeds

- A. Purchase and Sale of Investments. ~~The LACMTA~~We shall competitively bid the purchase of securities, investment agreements, float contracts, forward purchase contracts and any other investment products used to invest bond proceeds. Compliance shall be maintained with all applicable Federal, State, and contractual restrictions regarding the use and investment of bond proceeds. This includes compliance with restrictions on the types of investment securities allowed, restrictions on the allowable yield of some invested funds as well as restrictions on the time period over which some bond proceeds may be invested. The Treasurer may direct the investment of bond and lease proceeds in accordance with the permitted investments for any particular bond issue or lease. Providers of structured investment products and professional services required to implement the product or agreement will be recommended based on a competitive process conducted by the financial advisor or investment advisor.
- B. Diversification. Invested proceeds shall be diversified in order to reduce risk exposure to investment providers, types of investment products and types of securities held.
- C. Disclosure. It shall be required that all fees resulting from investment services or sale of products to ~~the LACMTA~~us be fully disclosed to ensure that there are no conflicts of interest and investments are being purchased at a fair market price. Underwriters of the bonds, but not the financial or investment advisor, may bid on the sale of investment products for the proceeds. The financial or investment advisor shall document the bidding process and results and shall certify in writing that a competitive and fair market price was received.

XII. Market Relationships

- A. Rating Agencies and Investors. The Chief Executive Officer and the Chief Financial Services Officer and Treasurer shall be primarily responsible for maintaining ~~the LACMTA's~~our relationships with Moody's Investors Service, Standard & Poor's and Fitch Ratings. In addition to general communications, the Chief Executive Officer and the Chief Financial Services Officer and Treasurer, or their appropriate designees, shall communicate with the analysts of each agency providing an underlying rating at least annually, and prior to

each competitive or negotiated sale.

- B. Board Communication. As a means of providing feedback from rating agencies and/or investors regarding the ~~LACMTA's~~ our financial strengths and weaknesses as perceived by the marketplace, information will be provided to the Board by Board Box Report as material information develops.

XIII. Continuing Disclosure

It is ~~the~~ our policy of the ~~LACMTA~~ to remain in compliance with Rule 15c2-12 by filing ~~its~~ our annual financial statements and other financial and operating data for the benefit of its bondholders within 195 days of the close of the fiscal year.

XIV. Consultants

The financial advisor(s) and bond counsel will be selected by competitive process through a Request for Proposals (~~“RFP”~~). ~~The LACMTA's.~~ Our contracting policies that are in effect at the time will apply to the contracts with finance professionals. Selection may be based on a best value approach for professional services or the lowest responsive cost effective bid based upon pre-determined criteria.

- A. Financial Advisor. Financial advisor(s) will be selected to assist in the debt issuance and debt administration processes. Additionally, the financial advisor will conduct competitive processes to recommend providers of financial services and products, including but not limited to: bond underwriters, remarketing agents, trustees, bond insurance providers, letter of credit providers, investment advisors and managers, investment measurement services, and custody services. Selection of the financial advisor(s) should be based on the following:

1. Experience in providing consulting services to complex issuers.
2. Knowledge and experience in structuring and analyzing complex issues.
3. Ability to conduct competitive selection processes to obtain investment products and financial services.
4. Experience and reputation of assigned personnel.
5. Fees and expenses.

Financial advisory services provided to ~~the LACMTA~~ us shall include, but shall not be limited to the following:

1. Evaluation of risks and opportunities associated with debt issuance.
2. Monitoring of the debt portfolio and bond proceeds investments to alert ~~LACMTA~~ us to opportunities to refund or restructure bond issues or modify investments.
3. Evaluation and recommendation regarding proposals submitted by investment banking firms.

4. Structuring and pricing bond issues, financial instruments and investments.
 5. Preparation of requests for proposals and selection of providers for bond counsel, underwriters, remarketing agents, letter of credit banks, investment products, financial products and financial services (trustee and paying agent services, printing, credit facilities, remarketing agent services, investment management services, custody services etc.).
 6. Provide advice, assistance and preparation for presentations with rating agencies and investors.
- B. Bond Counsel. Transaction documentation for debt issues shall include a written opinion by legal counsel affirming ~~iswe are~~ we are authorized to issue the proposed debt, that ~~the LACMTA haswe~~ we have met all constitutional and statutory requirements necessary for issuance, and a determination of the proposed debt's federal income tax status. A nationally recognized bond counsel firm with extensive experience in public finance and tax issues will prepare this approving opinion and other documents relating to the issuance of debt. The counsel will be selected from the pool of bond counsel firms.
- C. Disclosure Counsel. When undertaking a competitive bond sale, disclosure counsel may be retained to prepare the official statement if additional independence or expertise is needed. Disclosure counsel will be responsible for ensuring that the official statement complies with all applicable rules regulations and guidelines. Disclosure counsel will be a nationally recognized firm with extensive experience in public finance. The counsel will typically be selected from the pool of bond counsel firms. Most frequently, the disclosure counsel function will administered by either bond counsel or underwriter's counsel.
- D. Disclosure by Financing Team Members. ~~The LACMTA expects~~We expect that all of ~~itsour~~ our financial advisory team will at all times provide ~~it~~us with objective advice and analysis, maintain the confidentiality of our financial plans, and be free from any conflicts of interest. All financing team members will be required to provide full and complete disclosure, under penalty of perjury, relative to any and all agreements with other financing team members and outside parties that could compromise any firm's ability to provide independent advice that is solely in ~~theour~~ our best interests of ~~the LACMTA~~ or that could be perceived as a conflict of interest. The extent of disclosure may vary depending on the nature of the transaction.

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Attachment B

**ANNUAL UPDATE
of
INTEREST RATE SWAP POLICY**

SEPTEMBER 2008

INTEREST RATE SWAP POLICY

August ~~2007~~2008

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INTEREST RATE SWAP POLICY

I. Introduction

The purpose of the Interest Rate Swap Policy of the ~~Los Angeles County Metropolitan Transportation Authority (LACMTA)~~ 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 ~~published in 2003.~~

~~The LACMTA is~~

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.

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 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 each individually authorized to take all reasonable actions necessary to administer the swaps on an ongoing basis, including such 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 to us and consistent with the original Board approved objectives for entering into the initial swap transaction, "Administrative Actions."

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. ~~The LACMTA, other than transactions involving Administrative Actions. We shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. The Chief Executive Officer, Chief Financial Services Officer and~~

~~Treasurer, and Counsel, shall have the authority~~ 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 an interest rate swap 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 savings 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 agreement between the LACMTA and each counterparty agreements shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as the LACMTA, in consultation with its legal counsel, financial advisor and/or swap advisor~~ an Authorized Signatory deems necessary or desirable.

Subject to the provisions contained herein, the terms of any swap agreement shall ~~use 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 the ~~LACMTA~~ ours that could have a materially adverse effect on ~~its~~ 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. ~~Collateral Preferred collateral~~ collateral thresholds stipulating when collateral will be required to be posted by the swap provider and by us are ~~designated described in the policy and are based on credit ratings of the swap provider. Collateral this Policy as well as collateral requirements setting out the amount and types of collateral. Each will be established for each swap based upon the by an Authorized Signatory based on the respective credit ratings of the swap provider and us and our respective credit support providers, if any guarantor.~~
- 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 the Treasurer 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. ~~LACMTA~~ We shall have the right to ~~optionally~~ 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 LACMTA deems 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 ~~general~~ 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 ~~“AAA”~~ special purpose subsidiary that is appropriately rated 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 ~~and~~ & 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 to limit credit exposure to any one counterparty, ~~the LACMTA~~ 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 the final maturity date of the related bonds, 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. For purposes of calculating the net notional amount, credit shall be given in situations where there are off-setting fixed rate and variable rate swaps and for basis swaps when the provider of the basis swap is also the provider for the related interest rate swap transaction.

D. Collateral Requirements

~~Terms imposing collateral requirements based on credit ratings of the counterparty, requiring collateralization or other forms of credit enhancements to secure any or all swap payment obligations will be included as part of any swap agreement. The collateral requirements will be determined in consultation with counsel and the financial advisor and/or swap advisor, and may require the counterparty to post securities, surety bonds, letters of credit or other credit enhancement if the highest credit rating of the counterparty, its parent, or guarantor falls below a rating of “AA” or “Aa2”. Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each counterparty in accordance with the provisions contained in the collateral support agreement of the swap agreement.~~

~~Threshold collateral amounts shall be determined on a case-by-case basis. Reasonable threshold limits will be established for the initial deposit and for increments of collateral posting thereafter. Collateral shall be deposited with a third party custodian or as mutually agreed upon between the LACMTA and the counterparty. A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty. The market value of the collateral shall be determined on a monthly basis, or more frequently if the LACMTA determines it is in its best interest given the specific nature of the swap(s) and/or collateral security.~~

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.

<u>Credit Rating</u>	<u>Threshold</u>
<u>AAA</u>	<u>\$40 million</u>
<u>AA+ to AA-</u>	<u>\$10 million</u>
<u>A+ to A-</u>	<u>\$5 million</u>
<u>Below A-</u>	<u>None</u>

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 termination provision mitigates some risks of the swap, by allowing a no-cost termination anytime after the exercise date.

G. Prohibited Interest Rate Swap Features

The LACMTA ~~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, ~~the Chief Financial Officer, Treasurer, financial/swap advisor, and bond counsel shall evaluate the proposed~~ but other than for transactions involving Administrative Actions, an evaluation of the proposed transaction and report of the findings ~~to~~ 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 of the current and historical trading differentials <u>differences between the swap variable rate bonds and the index 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.</u>
Tax risk	The risk created by potential tax events that could affect the relationship of the swap index with the interest rate on LACMTA's <u>our</u> 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 LACMTA's <u>our</u> variable rate bonds.

Type of Risk	Description	Evaluation Methodology
Counterparty risk	The failure of the counterparty to make required payments or otherwise comply with the terms of the swap agreement.	Monitor counterparty exposure levels, credit ratings thresholds, and each quarter, limit exposure levels to specific counterparties, establish collateralization requirements 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 LACMTA either owing or being due to receive a termination payment.	Compute LACMTA's termination exposure for all existing and proposed swaps at market value and also under an expected worst-case scenario. A Periodically update our contingency plan will be periodically updated for swap terminations, specifying how we would 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 its the Debt Policy, the capacity to issue variable rate bonds that may be outstanding after the maturity of the swap.
Liquidity risk	The inability to continue or renew a liquidity facility supporting the variable rate bonds that are being hedged. The risk that liquidity is unavailable when needed for future renewals or that the price for the liquidity is unattractive at that time.	Use securities 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 issuers swap provider or its counterparty credit support provider.	Monitor the ratings of counterparties swap providers, insurers, and guarantors, and any other <u>credit support providers.</u>

1. Refunding Interest Rate Swaps

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

2. Basis Swaps

~~The LACMTA~~ We may enter into a “basis swap” whereby ~~the LACMTA~~ we pay a tax-exempt rate on variable rate bonds or the swap counterparty a rate that is indexed to ~~BMASIFMA~~, and ~~receives a~~ receive a rate that is indexed to LIBOR, in order that ~~the LACMTA~~ we can have the potential to receive a net positive cash flow from the transaction. The notional amount of the basis swap must relate to a specific one of our outstanding LACMTA-bond issues. The expected present value cash flow savings from a basis swap must be at least 5.0% of the initial notional amount.

3. Options on Interest Rate Swaps

~~The LACMTA~~ We may sell an option to a counterparty that gives the

counterparty the right to put LACMTA_{us} into an interest rate swap at a specified time in the future. This transaction, commonly known as a “swaption,” would provide ~~the LACMTA_{us}~~ with an upfront, non-refundable payment in exchange for selling the option.

In the event a swaption is exercised by the provider, ~~the LACMTA_{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, ~~the LACMTA_{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, ~~the LACMTA_{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 ~~LACMTA~~ or 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, ~~LACMTA~~ 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 lowest financing cost. ~~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 offered.
- 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, ~~the LACMTA~~ we will adhere to the guidelines for the financial reporting of interest rate swaps, as set forth by the Government Accounting Standards Board.

###

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.

Attachment C

ANNUAL REPORT
INTEREST RATE SWAPS

SEPTEMBER 2008

BACKGROUND

The Interest Rate Swap Policy requires a written Annual Report to the Board, which evaluates the risks associated with outstanding interest rates swaps.

This report is the 2008 Annual Report to the Board, and addresses each of the evaluation criteria described in our Interest Rate Swap Policy.

OUTSTANDING INTEREST RATE SWAPS

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.

We have seven outstanding interest rate swaps, each of which has been issued to hedge the interest cost on underlying variable rate debt. We pay each counterparty an amount based on a fixed rate and receives an amount based on a variable rate that is equal to either the rate on the hedged variable bonds (i.e., a “cost of funds” swap) or a percentage of the London Interbank Offer Rate, “LIBOR.”

On June 24, 2008, we agreed with the swap counterparty to the Prop A 1992-A and Prop C 1993-A swaps to amend the variable rate to be 67% of one-month LIBOR. Previously the variable rate was either equal to the actual bond rate, or alternatively to 60% of one-month LIBOR when any of the bonds had failed to be remarketed and were tendered to the liquidity bank. The 1992 bonds had been tendered to the liquidity bank in April and the tender of the 1993 bonds was imminent as of June 24th. The new rate of 67% is greater than the 60% we would currently be receiving for both bond issues and is slightly greater than the historic range of 63% to 65% of one-month LIBOR that we have typically experienced, potentially yielding a slight favorable variance in the future.

Information on the type, rate paid, notional amount, average life, remaining term, and termination value for each of our outstanding interest rate swaps is provided in the table below.

SUMMARY OF OUTSTANDING INTEREST RATE SWAPS						
AS OF JUNE 30, 2008 (DOLLARS IN MILLIONS)						
BOND SERIES	TYPE	RATE PAID	NOTIONAL AMOUNT	AVERAGE LIFE	REMAINING TERM	TERM VALUE
Prop A Series 1992-A	SIFMA/60% of LIBOR	5.860%	\$ 49.3	2.28	4 years	\$ (4.2)
Prop C Series 1993-A	SIFMA/60% of LIBOR	5.155%	194.5	9.42	12 years	(37.4)
Prop C Series 2003-B	68% of LIBOR	3.444%	167.7	11.18	15 years	(2.8)
Prop C Series 2003-C	68% of LIBOR	3.382%	213.2	10.27	17 years	(3.0)
Gateway Series 2004	64% LIBOR+0.21%	3.501%	184.3	12.04	19 years	(2.8)
Prop A Series 2005 C1&2	63% LIBOR+0.14%	3.359%	132.2	13.88	23 years	(1.8)
Prop A Series 2005 C3&4	63% LIBOR+0.14%	3.358%	132.2	14.03	23 years	(1.6)
TOTAL			\$ 1,073.4			\$ (53.7)

ACTUAL VS. PROJECTED DEBT SERVICE

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.

Beginning in February 2008 and as shown on the charts below, the interest rates we pay on our variable rate bond were dramatically affected by the sub-prime related problems our bond insurers experienced. The increased weekly interest rates on our Auction Rate Securities, "ARS," and Variable Rate Demand Bonds, "VRDBs," resulted in dramatically increased costs that quickly eroded the favorable basis variance we had accumulated, meaning the variable rate receipts from our swaps were now paying us much less than the variable rate interest we were paying on our bonds. We are currently in the process of refunding three issues of ARS and two issues of VRDBs, affecting all seven of our interest rate swaps. Our current expectation is that we will be able to retain our five LIBOR indexed swaps with minimal or no changes to terms or pricing. However, our two "cost of funds" swaps have already been restructured so that they are now indexed to pay 67% of one-month LIBOR, which is similar to our LIBOR swaps. When the bond refundings and swap restructurings are complete we expect our bond interest rates to return to more normal levels and the basis variance to abate.

Proposition A Series 1992-A and Proposition C Series 1993-A

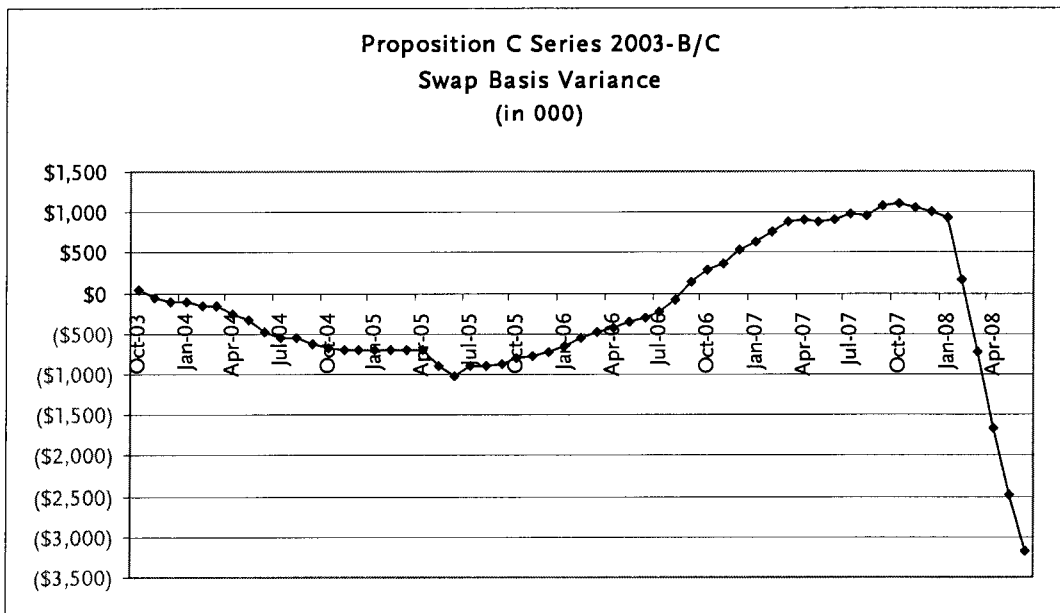
Our Proposition A Series 1992-A and Proposition C Series 1993-A interest rate swaps are described as "cost of funds," meaning we receive a payment from the swap counterparty that is equal to the interest payment on our variable rate bonds. The rate paid to us converts to a lower rate of 60% of one-month LIBOR whenever any of the bonds have failed to be remarketed and are tendered to the liquidity bank. The 1992 bonds were tendered beginning in March and the 1993 bonds were tendered beginning on June 25th. AIG Financial Products provides the swaps for both the Series 1992-A bonds and 1993-A bonds. Since the inception of both the Series 1992-A and Series 1993-A interest rate swaps, the counterparty has provided variable rate swap payments equal to the actual interest we have paid on the bonds. As a result of the matched variable rate payments and receipts, the net interest cost of the bonds is equal to the fixed rate payment we pay to the counterparty. However, as stated in the introduction, both of these swaps

were restructured in June to pay 67% of one-month LIBOR. So in the future the variable rate payments from the swap will not exactly match the variable rate payments on the bonds.

Proposition C Series 2003-B and Series 2003-C

We receive a payment from the counterparties (Wachovia Bank and Goldman Sachs Mitsui Marine Derivatives Products) equal to 68% of the one-month LIBOR rate. Through February 2008 the cumulative swap receipts had accumulated to a favorable balance of about \$1 million, as shown on the chart below. Beginning in March and continuing, weekly interest rates on the 2003 bonds increased significantly, quickly eroding the favorable basis variance. As of June 30 the balance for the basis variance was a unfavorable \$3.2 million, resulting in a decrease in projected savings of the 2003-B/C refunding transaction by that amount. The savings from the 2003-B/C refunding were originally projected to be more than \$57 million on a cash basis and \$39 million on a present value basis. Due to the unfavorable basis variance between the swap receipts and the interest paid on the bonds, actual cash savings to date are \$3 million lower than originally projected. Actual cash savings to date from the refunding are still more than \$9.5 million, inclusive of the unfavorable variance.

The chart below shows the history for the variance between swap receipts and bond interest paid. The recent dramatic unfavorable shift in the swap basis variance is a result of the higher interest rates for the bond subsequent to the significant credit ratings downgrades suffered by Ambac, Inc., the bond insurer for the 2003 bonds. Ambac was downgraded as a result of losses related to the insuring of sub-prime mortgage backed securities which have subsequently defaulted or are in danger of defaulting.

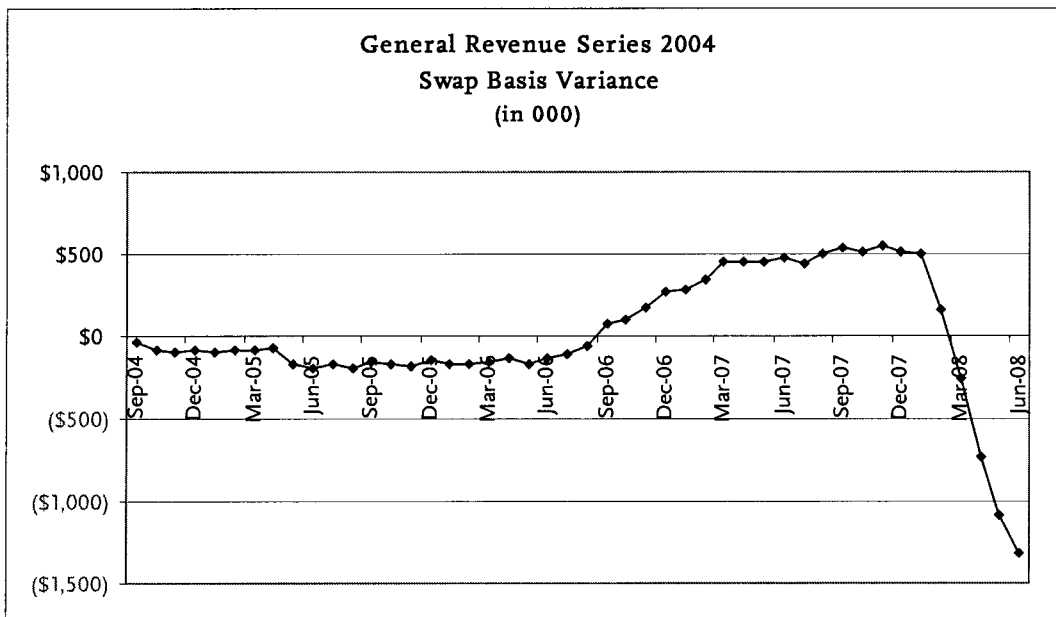


Gateway Series 2004

We receive a payment from the counterparty (Bank of Montreal) based on 64% of the one-month LIBOR rate plus 0.21 basis points of the one-month LIBOR rate.

Through February 2008 the cumulative swap receipts had accumulated to a favorable balance of about \$500,000, as shown on the chart below. Beginning in March and continuing, weekly interest rates on the Gateway bonds increased significantly, quickly eroding the favorable basis variance. As of June 30 the balance for the basis variance was a unfavorable \$1.3 million, resulting in a decrease in projected savings of the Gateway Bond refunding transaction by that amount. The savings from the Gateway refunding were originally projected to be more than \$50 million on a cash basis and \$29 million on a present value basis. Due to the unfavorable basis variance between the swap receipts and the interest paid on the bonds, actual cash savings to date are \$1.3 million lower than originally projected. Actual cash savings to date from the refunding are still more than \$5.8 million, inclusive of the unfavorable variance.

The chart below shows the history for the variance between swap receipts and bond interest paid. The recent dramatic unfavorable shift in the swap basis variance is a result of the significant credit ratings downgrades suffered by Ambac, Inc., the bond insurer for the Gateway 2004 refunding bonds. Ambac was downgraded as a result of losses related to the insuring of sub-prime mortgage backed securities which have subsequently defaulted or are in danger of defaulting.

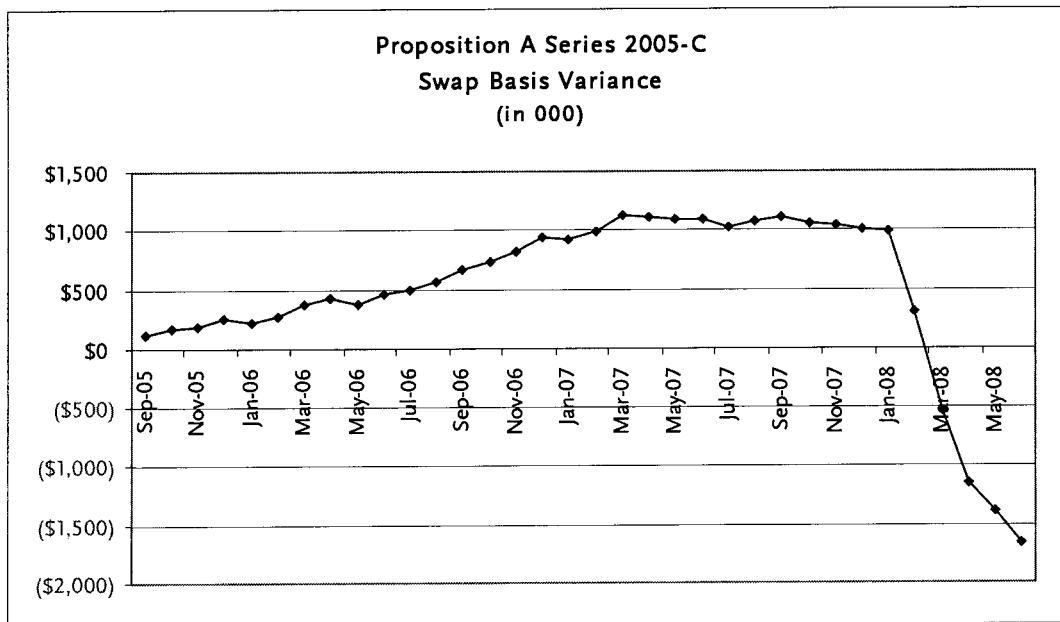


Proposition A 2005-C

We receive a payment from the counterparties (Bank of Montreal and Deutsche Bank AG - New York Branch) equal to 63% of the one-month LIBOR rate plus 0.14 basis point of the one-month LIBOR rate.

Through February 2008 the cumulative swap receipts had accumulated to a favorable balance of about \$1 million, as shown on the chart below. Beginning in March and continuing, weekly interest rates on the 2005-C bonds increased significantly, quickly eroding the favorable basis variance. As of June 30 the balance for the basis variance was an unfavorable \$1.7 million, resulting in a decrease in projected savings of the 2005-C refunding transaction by that amount. The savings from the 2005-C refunding were originally projected to be more than \$46 million on a cash basis and \$29 million on a present value basis. Due to the unfavorable basis variance between the swap receipts and the interest paid on the bonds, actual cash savings to date are \$1.7 million lower than originally projected. Actual cash savings to date from the refunding are still more than \$6 million, inclusive of the unfavorable variance.

The chart below shows the history for the variance between swap receipts and bond interest paid. The recent dramatic unfavorable shift in the swap basis variance is a result of the significant credit ratings downgrades suffered by XL Capital Assurance, the bond insurer for the Prop A Series 2005-C bonds. XL Capital Assurance was downgraded as a result of losses related to the insuring of sub-prime mortgage backed securities which have subsequently defaulted or are in danger of defaulting.



COUNTERPARTY CREDIT RATINGS

iii. The credit rating of each swap counterparty, parent, guarantor, and credit enhancer insuring swap payments, if any.

The credit ratings for all of our swap counterparties are shown in the table below. Since last year's Interest Rate Swap Annual Report, the Moody's and S&P ratings for AIG Financial Products were downgraded from "Aa2" to "Aa3" and "AA" to "AA-." S&P upgraded the rating for Deutsche Bank AG from "AA-" to "AA."

**LONG TERM RATINGS
OUTSTANDING INTEREST RATE SWAPS
AS OF JUNE 30, 2008**

Counterparty	Bond Issue(s)	Long Term Ratings	
		Moody's	S&P
AIG Financial Products	Proposition A Series 1992-A	Aa3	AA-
	Proposition C Series 1993-A	Aa3	AA-
Wachovia Bank	Proposition C Series 2003-B	Aa1	AA
Goldman Sachs Mitsui Marine Derivative Products	Proposition C Series 2003-C	Aaa	AAA
Bank of Montreal	Gateway Series 2004/	Aa1	A+
	Proposition A Series 2005-C1&C2		
Deutsche Bank AG - New York Branch	Proposition A Series 2005-C3&C4	Aa1	AA

COLLATERAL POSTING

iv. Actual collateral posting by swap counterparty, if any, per swap agreement and in total by swap counterparty.

As of June 30, 2008, no collateral was required to be posted by us or any counterparty. During July and August 2007 the Bank of Montreal was required to post collateral. As a result of it suffering a credit rating downgrade to the single-A category its collateral posting threshold dropped to \$5 million. At the time of the downgrade both of BMO's two swaps with us, the Prop A 2005-C Bonds and 2004 General Revenue Bonds, had values in excess of the \$5 million threshold amount. BMO posted as much as \$4 million. Swap rates have subsequently moved lower causing the value of the swaps to decline well below the threshold.

MATERIAL EVENTS

v. Information concerning any material event involving outstanding swap agreements, including a default by a swap counterparty, counterparty downgrade, or termination.

- 1) There have been two separate rating downgrades since the last annual report to the Board – the Moody's downgrade of AIG Financial Products from "Aa2" to "Aa3" and the S&P downgrade of AIG from "AA" to "AA-."
- 2) The swap insurance policy for the Prop A 2005-C bonds, provided by XL Capital, no longer qualifies as credit support due to the significant credit downgrades suffered by XL.

As a result, we are now subject to collateral posting. Our current threshold is \$10 million each, while the swaps are valued at \$1.8 million and \$1.6 million respectively for BMO and Deutsche Bank.

- 3) Two “cost of funds” swaps that paid the actual bond rate and are provided by AIG for our Prop A 1992-A Bonds and Prop C 1993-A Bonds, were restructured to now pay 67% of one-month LIBOR.

CONTINGENCY PLAN

vi. An updated contingency plan to replace, or fund a termination payment in the event an outstanding swap is terminated.

We will review each of our outstanding swaps annually and determine the market value (the estimated termination payment) of each. In the event we must consider a swap termination as a result of a downgrade or other credit event of the swap counterparty, an attempt will be made to replace the counterparty in accordance with the terms of the existing swap. In the event that the existing swap counterparty cannot be replaced, or as a result of a downgrade or other credit event affecting us, a refinancing of the terminated interest rate swap with unhedged variable rate bonds or fixed rate bonds will be attempted. We currently maintain sufficient debt capacity and tax-exempt bond market access to refinance the outstanding swaps and pay for the estimated termination value. As of June 30, 2008, a termination payment of \$41.5 million to terminate both the Proposition A Series 1992-A and Proposition C Series 1993-A swaps would be required. This amount can be debt financed at a lower interest cost than the existing swap rate. The termination payment would be offset by the lower interest cost on the refunding debt, which would minimize any negative financial impact on us.

STATUS OF LIQUIDITY SUPPORT

vii. The status of any liquidity support used in connection with interest rate swaps, including the remaining term and current fee.

The Proposition A Series 1992-A and Proposition C Series 1993-A bonds are issued as Variable Rate Demand Bonds (VRDBs) that require ongoing liquidity support from a commercial bank. Under the terms of the swap agreements, the counterparty AIG Financial Products is required to provide for and pay the cost of liquidity support for the entire term of the swap, at a cost of 0.25% per year of the outstanding notional amount. AIG Financial Products has contracted with Bayerische Landesbank to provide the “standby bond purchase agreement” for the Proposition A 1992-A bonds and with Dexia Credit Local for the Proposition C 1993-A Bonds. The agreements expire on July 1, 2012 for the Proposition A Series 1992-A and on July 1, 2020 for the Proposition C Series 1993-A bonds.

As a result of the effects of the sub-prime related downgrades of the bond insurers and resulting increases in our weekly rates for our ARS and VRDBs, we are refunding our four ARS issues to be VRDBs. As a result we need to acquire an additional \$850 million of liquidity support. This is in addition to the \$750 million of liquidity support we currently employ related to our two commercial paper programs and two VRDB programs. At \$1.6 billion of liquidity, we will be

utilizing most of the banks and liquidity capacity available to us. We have so far been able to locate sufficient liquidity as a result of our good credit ratings and an additional effort in reaching out to the banks.

