

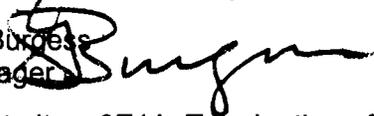
# Memorandum



**Date:** September 15, 2009

**To:** Honorable Chairman Dennis C. Moss,  
and Members, Board of County Commissioners

Supplement to  
Agenda Item No. 8(E)1a

**From:** George M. Burgess  
County Manager 

**Subject:** Supplement to Item 8E1A: Termination of certain AMBAC-enhanced Rice Interest Rate Swaps and Authority to Select and Enter into Agreements with one or more Counterparty(s)

**This supplemental report provides an update on events regarding the Ambac-Rice interest rate swaps being considered by the Board. The report also updates the total revenues the County received from each of the seven transactions, updates the termination values, and provides estimates of future swap revenues for the life of each transaction.**

### Recommendation

It is recommended that the Board authorize the County Mayor or his designee to follow the authorization and delegation of the Resolution to competitively select one or more counterparties for six of the seven Ambac-Rice swaps, and to enter into replacement swaps. It is also recommended that the Board authorize the Mayor or his designee to negotiate and accept Rice's proposal to replace Ambac with Bank of New York Mellon (BNY Mellon) for the swap associated with the Water and Sewer Series 1999A/2007 bonds (the seventh Ambac-Rice swap). This authorization would also allow the County, after consultation with County's swap advisor, bond counsel and the Office of the County Attorney, to replace BNY Mellon with a new counterparty if BNY Mellon exercises its option to terminate the agreement after 10 years. If these negotiations fail to result in a mutually acceptable contract, authorization is being sought to replace this swap using the open market competitive process contained in the Resolution.

### Financial Performance of Ambac-Rice Interest Rate Swaps

The County entered into nine interest rate swap transactions with Rice Financial Products Company (Rice) from which the County has been receiving revenues since 1998. The structure of these swaps is such that the County would receive or make quarterly payments to Rice depending on market rates. Payments to the County from seven of the Rice swaps, the Ambac-Rice swaps, are guaranteed by Ambac Assurance Corporation (Ambac). The remaining two swaps are guaranteed by BNY Mellon and General Reinsurance respectively.

The County has benefited from a long and rewarding relationship with Rice and has received more than \$63 million in payments from the seven Ambac-Rice contracts. In 2009 alone, the County received more than \$11 million in net swaps income. Total swap receipts for each of the seven Ambac-Rice transactions are shown in Table 1. Since 1998, when the County entered into these contracts, the total net income to the County has been consistently positive and has proven very beneficial to the County. All but one of these transactions have returned net income to the County for each year of the contract. The exception is the Solid Waste swap for which the County made payments to Rice for the four year period 2004 through 2007 totaling \$1.392 million. This was expected as the contract was designed to allow the County to receive larger swap payments in the beginning of the term, smaller payments in the middle years and larger payments in the latter years. Over the twelve year life of this swap to date, the County has received net total income of more than \$6.53 million for the Solid Waste Swap. Hence it is strongly recommended that the County continue to invest in these types of transactions.

Table 1  
 Annual Actual and Projected Revenues from Ambac-Rice Interest Rate Swaps

Department/Entity (Associated Bond Series)	Water and Sewer (1997)	Solid Waste (1996)	Convention Development Tax (CDT)				BAC (2000A)	Totals
			1996	1997	1996	1997		
Swap Start Date	7/18/1998	10/22/1997	5/12/2000	7/21/2004	7/21/2004	8/1/2002		
Swap Termination Date	10/1/2026	10/1/2013	10/1/2022	10/1/2022	10/1/2010	10/1/2030		
<b>Swap Income (Loss) Through August 2009</b>								
1998	144,194	877,698					\$1,021,892	
1999	1,396,534	1,367,338					2,763,872	
2000	1,162,079	741,406					1,903,485	
2001	1,506,225	1,428,474					2,934,699	
2002	1,293,929	1,500,133	\$626,104	\$1,856,589			5,276,754	
2003	1,978,465	1,688,426	1,031,657	3,150,000		\$156,115	8,004,663	
2004	1,067,249	(233,201)	1,004,640	3,176,769		178,446	5,193,904	
2005	798,455	(516,525)	756,735	2,413,883	\$158,248	122,248	4,523,404	
2006	1,652,037	(384,445)	785,820	2,557,452	166,746	157,945	5,942,098	
2007	1,716,780	(258,208)	785,919	2,648,403	159,678	166,817	6,381,415	
2008	2,321,313	160,259	961,103	3,408,398	167,728	218,922	8,894,041	
2009	2,995,510	157,331	1,201,383	4,161,954	117,880	279,744	11,138,479	
Total Receipts	\$18,032,770	\$6,528,686	\$7,153,361	\$23,373,447	\$770,280	\$1,280,237	\$63,978,706	
Termination Value as of 9/10/09	\$3,071,186	\$1,600,372	\$2,425,609	\$9,719,116	\$40,029	\$303,921	\$23,751,470	
<b>Projected Swap Receipts Trough Termination Date</b>								
2010	2,093,223	553,235	906,582	3,422,210	11,198	188,956	9,017,876	
2011	1,638,311	416,861	714,124	2,832,146		141,185	7,358,912	
2012	1,263,446	369,439	574,192	2,396,384		101,120	6,147,794	
2013	976,910	320,777	486,246	2,136,348		68,841	5,341,236	
2014	788,167		474,922	2,045,647		44,371	4,724,972	
2015	708,081		516,353	2,177,595		27,652	4,958,452	
2016	749,192		619,333	2,554,742		18,560	5,801,904	
2017	926,041		794,722	3,203,503		16,878	7,354,503	
2018	1,255,597		1,056,097	4,155,805		22,246	9,738,969	
2019	1,757,778		1,420,655	6,277,923		34,143	13,935,168	
2020	2,456,123		1,910,508	7,142,476		51,851	17,660,419	
2021	3,378,657		2,554,568	9,294,213		74,419	23,646,023	
2022	4,245,461		3,391,389	11,925,383		100,565	31,087,441	
2023	5,044,347					128,673	5,173,020	
2024	5,778,046					156,608	5,934,654	
2025	6,349,816					181,614	6,531,431	
2026	6,629,438					200,306	6,829,745	
2027						208,272	208,272	
2028						200,133	200,133	
2029						168,899	168,899	
2030						106,045	106,045	
Total Projected Swap Receipts	\$46,038,636	\$1,660,312	\$15,419,690	\$59,564,375	\$11,198	\$2,241,337	\$171,925,867	
Present Value of Projected Swap Receipts	\$26,265,570	\$1,488,035	\$10,033,626	\$39,076,068	\$10,665	\$1,003,318	\$107,722,612	

**Current Situation:**

As stated previously, the Ambac credit rating downgrade has triggered the need to replace the swaps which is no fault of Rice's. On September 1, 2009, it was recommended that the Board approve termination and replacement of the seven Ambac-Rice swaps due to the severe downgrade in Ambac's credit rating on June 25, 2009. This downgrade required Rice to post additional collateral or to replace Ambac as the guarantor on these transactions. Since the downgrade, the County, its financial advisors, and legal counsel have worked diligently with Rice to expeditiously resolve the issue. While this was occurring in July 2009, Ambac's credit ratings were further downgraded as reported to the Board on September 1, 2009 and make an Ambac bankruptcy filing eminent. To date Rice has not posted additional collateral and has so far failed to successfully replace Ambac.

Rice initially proposed replacing Ambac with Deutsche Bank at no cost to the County. This would eliminate the County's exposure to an Ambac insolvency and allow the County to continue receiving future swap receipts. However, on September 9, 2009, Rice informed the County that the replacement of Ambac with Deutsche Bank may take three to four additional weeks. This delay, with no guarantee that an acceptable agreement will be reached, leaves the County exposed to Ambac's potential insolvency for an unacceptable period of time.

Over the last two weeks, the County's financial team continued to work with Rice and to also identify and evaluate options available to the County to minimize the effects of an Ambac insolvency. On September 9, 2009, Rice also submitted a proposal to replace Ambac with BNY Mellon on the Water and Sewer swap. The proposal could be acceptable to the County provided certain terms and conditions were negotiated. Since the County has had a long and profitable relationship with both Rice and BNY Mellon, and since expeditious replacement of Ambac is in the best financial interest of the County, authorization is being sought to complete these negotiations with Rice and to replace Ambac on this swap. BNY Mellon proposes to have an option to terminate the agreement after 10 years. This authorization would also allow the County Mayor after consultation with County's swap advisor, bond counsel and the Office of the County Attorney, to replace BNY Mellon with a new counterparty if BNY Mellon exercises this option.

Since Rice has been unable to provide acceptable proposals to replace Ambac on the remaining swaps, the six swaps would be replaced using the open market process described in the Resolution.

**Termination and Replacement**

In order to replace these swaps, it is necessary to terminate the existing contracts and to solicit bids on the open market for replacement contracts. Table 1 shows the termination value (amount payable to the County) on September 10, 2009. The table also shows the estimated revenues the County would receive by continuing its investment in similar swap transactions. While simply terminating the swap contracts could result in payments to County totaling approximately \$23.75 million, the County would forego more than \$171 million in future revenues over the remaining term of the swaps.

It should be noted that termination allows the County to replace the Ambac-Rice Swaps when the market is most favorable for the County. In such case, the County could terminate the transaction when the interest rates provide the highest termination value which could and also make it attractive for the County to enter into new swap contracts. However, if Ambac declared bankruptcy prior to the County terminating the agreements, pursuant to the swap documents, Ambac would be the party to determine when to terminate the transactions. Ambac would most likely choose market conditions that are more favorable to itself. Consequently, County control of

the termination provides an opportunity for the County to replace the swaps while market conditions favor the County. The County's swap advisor estimates the County could realize benefits of between \$5 and \$10 million by controlling the termination. However, based on the heightened risk of and Ambac bankruptcy and Ambac's severely impacted financial capacity to pay the termination costs, the County may not be paid in a timely manner or may not be paid at all. Therefore, in order to continue to receive swap revenues, it is in the County's best interest to replace the swaps as opposed to simply terminate the contracts.

Interest rate swaps, not unlike other investments present risks to the County. However, the structure of these swaps has allowed to County to benefit substantially. The primary risk associated with the transaction is the ability of the counterparty to make future swap payments. However, the County has to ability to replace a counterparty whenever the need arises. Currently, the County has 10 swaps outstanding of which Rice is the counterparty on nine and Ambac the guarantor on seven of these. The County now has the opportunity to replace seven of these swaps with different counterparties thereby reducing its exposure to any one counterparty. Swaps are also exposed to interest rate risks and the probability that federal tax laws could be changed to make these transactions less attractive. For example, if the US Congress were to reduce the maximum marginal income tax rate or eliminate the tax exemption on municipal bonds, the attractiveness of these interest rate swaps would diminish. Again, the County has the option to terminate the contracts should it become necessary. However, as demonstrated in the returns on our swap investment, the interest rate risks are perceived to be small.

**County Options:**

Based on the positive cash flows and discussions with our swap advisor, we recommend a two-prong solution.

The first allows Rice to replace Ambac with BNY Mellon on the Water and Sewer swap. BNY Mellon is a highly rated bank and is the guarantor on another Water and Sewer swap with the Rice. This transfer could be made as soon as possible following final discussion with Rice and BNY Mellon. The proposal under review would transfer the Water and Sewer Ambac-Rice Swap to the existing BNY swap documents. Additionally, BNY Mellon has proposed an option to terminate the contract after 10 years at their discretion. Our advisors have recommended that the County complete negotiations and accept this proposal, inclusive of the option, provided BNY Mellon agrees to exercise the option using market quotations. Market quotations would allow the County to replace BNY Mellon with an identical swap at no cost to the County.

The second is to adhere to the authority and delegation of the accompanying Board resolution to select new counterparties through a competitive process, and to enter into replacement swaps. The replacement swaps will, to the extent possible, reduce counterparty risks by contracting with multiple counterparties, if possible. The solicitation will also require that counterparties have credit ratings of AA or better by either Moody's Investment Services or Standard & Poor's, that the swaps have the same economic terms as the current Ambac-Rice swaps, and that the County not incur any costs as a result of these transactions.

  
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Assistant County Manager