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Memorandum

TO: BATA Oversight Committee   DATE: July 2, 2008

FR: Deputy Executive Director

RE: Resolution No. 81: Authorizing the Refunding of Ambac Insured Variable Debt Portfolio

BATA Resolution No. 81 authorizes the actions necessary to refund the existing $2.4 billion Ambac insured variable rate debt portfolio. Staff recommends that the Committee approve referral of BATA Resolution No. 81 to the full Authority Board for approval.

Since December 2007, the financial world has been dealing with billions of dollars in losses related to the sub-prime mortgages. The losses have led to credit downgrades of most bond insurance guarantee companies including those used by BATA (XL Capital and Ambac). The first to lose its “AAA” status was XL Capital, now rated below investment grade. The Authority previously authorized the refunding of the $500 million XL Capital bonds, which was completed in early June. The refunding achieved its purpose by reducing the interest rate from 3.50% to 1.68% and saving over $10 million annually in potential interest costs.

BATA still has a $2.4 billion variable portfolio insured by Ambac. Our initial strategy was to preserve as much of the Ambac insurance as possible by converting the $510 million auction rate debt to Variable Rate Demand Option (VRDO) bonds and substituting new bank facility contracts for the existing $1.9 billion variable debt portfolio. Our strategy was based on Ambac improving its ratings and financial strength. Unfortunately, Ambac, has since lost its “AAA” ratings and is now rated in the “AA” category and negative watch by all three rating agencies (Fitch, Moody’s and Standard & Poor’s).

Since there is little prospect of Ambac restoring its “AAA” ratings anytime soon, staff now proposes to replace the Ambac insured bonds with uninsured bonds. The recommended process is as follows:

- Suspend the current Ambac insurance policies.
- Replace the entire $1.9 billion VRDO portfolio with uninsured VRDO bonds utilizing the new bank facility document developed by BATA and used to refund the XL Capital bonds.
- Replace the $510 million Auction Rate Bonds (ARB) portfolio with uninsured fixed rate bonds.
- Modify the existing swap contracts for ARBs converted to fixed rate bonds through a process of terminating, renegotiating or adding to the existing swap contracts in order to maintain the existing low interest rate levels.

The process of converting the $2.4 billion Ambac portfolio has already begun. Our bank agent at J.P. Morgan believes that it may be possible to secure sufficient uninsured liquidity capacity to convert $1.9 billion insured portfolio to uninsured VRDOs. The $500 million ARBs will be refunded as uninsured fixed rate bonds.

Since the existing swap contracts were written to cover variable rate bonds, they will have to be changed or terminated given the nature of the new fixed rate debt. The purpose of the swaps is to reduce overall interest costs which does not change even though the underlying debt changes from variable to fixed. BATA has several options available, such as converting or terminating the swaps, depending on which option proves to be cost effective and will maintain the purpose of lowering overall debt costs.

While all or most of the $2.4 billion Ambac insured portfolio will be reissued as uninsured bonds, we are not completely eliminating the insurance policy altogether. Ambac has agreed to set-aside the current $2.4 billion policy, allowing BATA to re-issue the bonds on an uninsured basis. Ambac has offered two options to facilitate the transaction, a suspension of the policy for three years or issuance of a 3-year forward premium. The options can be used by BATA anytime over the next three years at no cost to BATA. In addition, the reserve surety and swap policies will continue to remain in effect regardless of the Ambac policy status.

We are also requesting the Authority to authorize the issuance of up to $200 million in new project proceeds. These funds will be used to replenish the $180 million transferred to the cash funded debt service reserve.

Resolution No. 81 authorizes the steps necessary to complete the conversion of up to $2.4 billion in Ambac insured bonds to uninsured bonds. The resolution authorizes:

- Issuance of up to $600 million in auction rate refunding bonds consisting of $510 million principal plus debt reserves and costs of issuance.

- Issuance of $200 million in new project funds.

- Purchase of auction rate bonds prior to refunding.

- Amending, restructuring or terminating existing swap agreements and entering new agreements to hedge new fixed debt.

- Entering into agreements with Ambac providing for Ambac to suspend the existing policies.

- Entering into new liquidity agreements.

- Not-to-exceed rates:
  - Fixed rate 6.00%
  - Variable rate 12.00%
  - Cost of Issuance 1.50%

- Debt service coverage not-less-than 1.50x maximum annual debt service.

The interest rate cap on the new fixed rate historically set at 5.25% has been increased to 6.00% to reflect the rising interest rate market.

The recommended actions should represent the final steps required to correct the insured debt portfolio. While the process has been difficult, we have had some success restoring interest rate levels, preserving low cost swaps and preserving the bulk of the insurance policies.

Staff recommends approving the forwarding of Resolution No. 81 to the full Commission for its consideration and approval.

Andrew B. Fremier

AF/BM/cj

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