

Thank you for your hospitality Monday at your offices. I enjoyed our discussion, and only wish we had more time. The details of how swaps work, and especially of how “special entities” like governments and non-profits use them, are intricate, but are easily capable of being understood, particularly by as thoughtful a group as you have put together. I would be happy to devote more time to providing you with a more thorough picture. There are many nuances to this market – lots of gray areas – and less black and white than some of the popular commentary would have you believe.

I’m attaching two things of interest. First, as we discussed, is a sample Fairness Opinion that we, as swap advisors, provide for our clients attesting to the fairness of swap pricing. As I mentioned, our firm introduced the concept of using fairness opinions on swaps to the swap markets more than a decade ago. Over the several years, fairness opinions have come into broad use, and are looked to by tax counsel, auditors and other key professionals as a sign that the swap was properly priced. As I mentioned in our discussion, the Special Entity rules call for the “independent representative” to represent that pricing is fair and that the transaction is appropriate. Our fairness opinions do the former, but not the latter. We could, however, easily do the latter (i.e. certify as to appropriateness), assuming of course that the transaction is, in fact, appropriate. There have been times in our practice when a client wanted to do a transaction that we felt was questionable, but we still assisted to make sure that the pricing was fair. If we encounter such a situation in the future under the new rules, we will have to think long and hard about how to approach it.

Second, I’m attaching hereto a very good Q&A that was put out today by the Denver Public Schools in response to Gretchen Morgenson’s article in the New York Times last week. I mentioned at our discussion that I thought the article wasn’t very good. It was not till I read the Denver Public Schools response, however, that I realized how many factual inaccuracies the article contained. Morgenson is far from alone in having trouble grappling with swap-related issues. With the perspective of the DPS response, this appears to have been a particularly poor piece of reporting. DPS is not our client, but we understand what they did pretty well, and their response is credible.

Please let me know what further assistance my firm or I can provide to you. You have one of the most difficult rulemaking tasks in history in front of you. If there is any way we can help make your job easier, and make sure that you have all the information you need to make the tough calls required by the legislation, please let me know. We believe very strongly that it is in our clients’ interest to make sure you have everything you need.

Best,

Peter Shapiro
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June 30, 2010

City of Philadelphia
Office of the City Treasurer
1401 JFK Boulevard
Municipal Services Building, Room 640
Philadelphia, PA 19102

Attn: Rebecca Rhynhart
City Treasurer

Re: Fairness Opinion on the Pricing of the Termination of the Interest Rate Swap
Between the City of Philadelphia and Merrill Lynch Capital Services, Inc.

Dear Rebecca:

As per your request and as swap advisor to the City of Philadelphia (the "City"), in conjunction with the termination of an interest rate swap agreement (the "Swap") which the City had previously entered into with Merrill Lynch Capital Services, Inc. (the "Counterparty"), Swap Financial Group, LLC, performed a market-based valuation of market-standard interest rate swaps of the same format and structure as the Swap using market prices in effect at the time of the termination pricing on June 30, 2010 (the "Termination Pricing Date").

The Swap was originally entered into to create synthetic fixed rate debt in conjunction with the future issuance of variable rate bonds for the City's Water Department and was previously amended on December 20, 2007 and February 10, 2009. As a result of the City's decision to issue the bonds in fixed rate form, the City has determined to terminate the Swap on June 30, 2010. Under the terms of the Swap, beginning August 1, 2010 (the "Effective Date") the City is obligated to make semiannual payments at a fixed rate of 4.52275% to the Counterparty in return for receiving monthly floating rate payments based upon the USD-SIFMA Municipal Swap Index.

The notional amount of the Swap on the Termination Pricing Date was \$90,000,000 and the scheduled termination date of the Swap was January 1, 2037. The total payment that the City will make to the Counterparty in connection with the City's early optional termination of the Swap is \$[TBD], which will be due on July 2, 2010.

Our pricing valuation was based on the terms contained within the ISDA confirmation for the Swap and methodology which we believe to be consistent with accepted practice in the market for terminations of swaps comparable to the Swap. Based on these terms and the prevailing level of U.S. Treasury securities, the relevant LIBOR swap spreads, and the relevant SIFMA/LIBOR

ratios, we determined a termination value for the Swap. It is our opinion that the City is paying a fair price to terminate the Swap, and that a different counterparty, in an arms-length market transaction committed to at the time of the unwind, would have been willing to make the same respective payment in return for unwinding swaps of the same structure.

We advise you that we have performed no due diligence on the financial condition of either the City or of the Counterparty and can make no representation as to either counterparty's financial soundness. We are not a counterparty or an affiliate or agent of the Counterparty to the Swap and, in keeping with Swap Financial Group's strict ethical practices, no payment has been or will be made to us by the Counterparty in connection with the Swap or the issuance of bonds by the City.

Swap Financial Group, LLC, is an established advisor and arranger of swaps within the industry for municipal-indexed interest rate swaps, options, and derivatives, is professionally knowledgeable of the transaction types represented in this valuation and is experienced in the financial aspects and risks of swaps. As an arranger of interest rate swaps, please be aware that Swap Financial Group continually conducts transactions among participants in these markets, including both dealers and end-users, during our normal course of business operations.

Swap Financial Group, LLC

By: _____

Q&A on Pension Financing and NYT Story



In an effort to help ensure the DPS community—particularly our staff, retirees, and taxpayers—has true and accurate information regarding the 2008 financing of our pension obligations and the overall strength of our pension fund, the district is providing an FAQ sheet that provides basic facts about our 2008 pension financing and the overall strength of our pension fund, in response to the misinformation contained in last week’s New York Times article.

Q: Has Denver Public Schools lost money on the 2008 pension financing?

A: No. In fact, the financing has saved the district more than \$20 million compared to its previous pension obligations. Each additional month going forward, the District is saving \$1.4 million dollars compared to not having done the financing. The NYT story reads: “Since it struck the deal, the school system has paid \$115 million in interest and other fees, at least \$25 million more than it originally anticipated.” The facts are that, although the financial collapse of 2008 did temporarily reduce the projected savings from the financing by \$25 million, the district is still \$20 million ahead versus not having done the financing, which has allowed us to avoid the drastic budget cuts being faced by other metro-area districts. Without the pension financing, we would have paid \$136 million over this same period.

Q: Is the District’s budget being negatively impacted by the pension financing?

A: No. The District’s budget is in a much stronger position as a result of the financing. The article alleges that DPS budget “woes” from state budget cuts are being “aggravated” by the financing. In fact, where other neighboring districts are going through painful teacher layoffs and furloughs, DPS is having no layoffs and no furloughs.

Q: How has the pension financing affected teacher hiring?

A: The savings from the 2008 pension financing has allowed the district to hire new teachers and avoid the widespread layoffs and furloughs seen in many other districts across Colorado. NYT story: “(DPS Superintendent Tom) Boasberg maintains that the deal has allowed Denver to hire teachers while other school districts are cutting back. But Henry Roman, president of the Denver Classroom Teachers Association, said that fewer teachers had been hired this year than in previous years.” It is certainly true that we are not, as a result of the state budget cuts, hiring as many new teachers this year as last, but that does not in any way take away from the fact that the pension financing has allowed us to be hiring rather than laying off. DPS yesterday welcomed 400 new teachers to the District, the only school district in Colorado that is hiring new teachers on this scale.

Q: Has the pension financing undermined the health of the DPS pension fund?

A: No. A report issued last month by an independent auditor hired by PERA (the state’s pension fund) determined that the DPS Division of PERA is far healthier than the Schools Division and that we’re on track to be fully funded nearly a decade before any other division of PERA. In fact, the report revealed that the DPS pension fund is projected to be 140% funded at the end of the 30-year projection period. [Click here](#) to view a 30-year projection graph. The NYT article does not mention or acknowledge the report by PERA’s independent actuary but implies that DPS will

face additional pension expenses as a result of the financing. NYT: "If a shortfall still exists in 2015, the merger requires that it be closed." In fact, as the PERA report revealed, the DPS pension is not a shortfall position compared to the PERA school division, which is the comparison required under law, but is in a substantial surplus position. As such, DPS is projected by the PERA actuary to see a reduction in pension expenses in the future.

Q: Was the 2008 pension financing a new and different type of financing structure for DPS?

A: No. DPS copied in 2008 the structure it used in 2005. In addition, more than 100 public entities in Colorado alone have used variable rate debt over 500 different times in the last 12 years. NYT story: "Denver schools had issued pension certificates before, but this time the banks added a little spice to the recipe: an interest-rate swap that made the variable rate mimic a fixed-rate instrument." This is false. Simple background research would have revealed that DPS had done the same type of pension financing in 2005, before Mr. Bennet or Mr. Boasberg had joined DPS, as it did in 2008.

Q: Is the 2008 pension financing performing today much worse than projected?

A: No. Approval for the financing was given by the DPS Board on the basis that the rate would be 6%. The rate is currently at 6.1%. In both cases, all fees are included. NYT story: "In the end, a deal that JPMorgan said would have an interest rate of around 5 percent spiked to 8.59 percent during its first fiscal year, and has since settled down to an average rate of 7.12 percent today." There was never a 5% projection. Board approval was given on the basis of a projection of a 6% interest rate. The financing costs did spike during the financial crisis of 2008, and our all-in cost during that year of the financial meltdown was indeed 8.59% as a result of the failure of our bonds to sell during the liquidity crisis. But, since then, our rates have settled down over the last year plus to an average rate of 6.1%, not 7.12% as the article mistakenly claims. At this 6.1% rate, the District is saving \$1.4 million a month or over \$16 million a year compared to not having done the transaction.

Q: Was the pension financing essentially the same as replacing a re-financeable fixed rate mortgage with a homeowner's adjustable-rate mortgage?

A: No. The 2008 financing is the exact opposite of a variable-rate mortgage, which is at the mercy of rises or falls in market interest rates. NYT: "The Denver schools essentially made the same choice some homeowners make: opting for a variable-rate mortgage that offered lower monthly payments, with the risk that they could rise." Even the article itself later exposes the inaccuracy of this statement when it notes that the DPS financing, like most variable rate transactions, includes an interest rate hedge or "swap" to mean that the district, unlike a homeowner on an ARM, has no exposure to fluctuations up or down in market interest rates. In addition, the article erroneously claims: "Like a homeowner, Denver essentially started out with the equivalent of a standard, fixed-rate mortgage that allowed it to refinance if interest rates fell." This is not true. In 2008, Denver's pension debt it took out in 1997 was not callable and could not be refinanced like a standard home mortgage when interest rates fell.

DPS leadership takes very seriously its responsibility as financial stewards of our taxpayers' hard-earned money. We welcome and encourage honest, thorough scrutiny of how that money is being handled. And last week, an independent audit commissioned by the state's pension fund (PERA) concluded that DPS is far healthier than any other division of PERA and is on track to be fully funded almost a full decade before any of the other PERA divisions.

The 2008 pension financing has produced substantial savings that have been invested directly in the classroom, and it has provided greater security for our retirees by bolstering the long-term strength of the pension fund.