



An Energy Efficiency Workshop & Exposition

Palm Springs, California

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*Setting and Hedging
Interest Rates*

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Setting the Interest Rate

- Spread to UST determined by the following factors:
 - Term
 - Amount
 - Project Risk
 - Contractor Risk
 - Contract Terms



- Lenders/Investors price to “weakest link”:
 - Term – longer is more risky
 - Amount – small is diminished profit potential
 - Project Risk – M & V, set-off risks
 - Contractor Risk – credit, construction risk
 - Contract Terms – cancellation, non-appropriation



Holding the Interest Rate

- After the spread has been determined the interest rate can be set
- The spread will not be constant in the time period between Proposal and receipt of Task Order
- The interest rate cannot be held during the time between receipt of Task Order and funding



Minimize Impact on Rate

- Time periods should be as short as possible:
 - Allow adjustment to spread/rate during evaluation
 - Fund into escrow
 - Include hedge costs in Project Costs

Adding a “contingency” to the spread/rate is inefficient and too costly....



Hedging Interest Rates

- There are three basic methods to hedge rates:
 - I. Forward Starting Libor Swap
 - II. Swap Option
 - III. Treasury Lock



Forward Starting Libor Swap

- A Forward Starting Libor Swap protects the borrower from higher UST rates and changes in corporate credit spreads:
 - Borrower determines locked level i.e. 10 basis points higher
 - At settlement borrower receives/pays cash from/to counterparty and Swap cancels
 - No up-front cost but credit approval needed



- The Swap Option allows the borrower to lock in an interest rate for a fee:
 - The wider the spread to current rates the lower the price of the Swap Option
 - At settlement, if rates have risen borrower exercises option and issues at the locked rate
 - If rates have fallen Swap Option expires



- A Treasury Lock does not protect borrower against spread volatility:
 - Borrower has the right to “sell” USTs at a date certain at the locked rate
 - At settlement borrower will either have a profit from selling the USTs (rates are higher), or a loss (rates are lower)
 - The profit/loss complements the lower/higher financing proceeds



I. Forward Starting Libor Swap

....most liquid market however must settle even if financing does not occur.

II. Swap Option

....costs are up-front but fixed if financing does not take place.

III. Treasury Lock

....cheap but not a good option if credit spreads are changing.