TEXAS TRANSPORTATION COMMISSION

ALL Counties

MINUTE ORDER

ALL Districts

Pursuant to various provisions of Texas law, the Texas Transportation Commission (commission) is authorized to issue and incur obligations for transportation, mobility and other projects.

To ensure that all financing programs undertaken by the commission and/or the Texas Department of Transportation (department) are completed in accordance with the highest standards of industry, law and government practice; and to confirm the intent of the commission and department to adhere to sound financial management practices, the commission has been presented a Debt Management Policy for consideration, attached as Exhibit A.

The Debt Management Policy establishes parameters in which to administer the commission's financing programs considering acceptable levels of risk, minimizing interest costs and optimizing future flexibility with consideration to achieving and maintaining the best possible credit ratings.

Pursuant to Chapter 1371, Texas Government Code, as amended, and other applicable Texas law, the commission is authorized to execute credit agreements including interest rate swap and other similar agreements. A proposed Derivative Management Policy has been developed and is attached to this order as Exhibit B.

The policy establishes responsibilities, objectives and guidelines for the use of interest rate swap and other similar products to efficiently and prudently manage the commission's asset/liability profile for each financing program.

IT IS THEREFORE ORDERED by the commission that the Debt Management Policy and Derivative Management Policy have been reviewed and are hereby approved.

Submitted and reviewed by:

John Munoz for JMB

Chief Financial Officer

Recommended by:

M. W. Behrens

Executive Director

110656 AUG 24 06

Minute Number | Date Passed

Exhibit A

Texas Department of Transportation

TEXAS TRANSPORTATION COMMISSION

Debt Management Policy

August 24, 2006

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1. Policy Objectives and Philosophy

The purpose of this Debt Management Policy ("Policy") is to ensure that all Financing Programs (as defined herein) undertaken by the Texas Transportation Commission ("TTC" or "Commission") and/or the Texas Department of Transportation ("TxDOT" or "Department") are completed in the most efficient manner and in accordance with the highest standards of industry, law and government practice. This Policy confirms the intent of the Department and the Commission to adhere to sound financial management practices including full and timely payment of all borrowings, and achieving the lowest cost of capital within prudent risk parameters.

The Commission intends to use its Financing Programs efficiently to maximize the delivery of transportation and mobility projects throughout the State within acceptable levels of risk, balancing the best possible credit ratings, minimizing interest costs and optimizing future flexibility. Due to the wide variety of projects and available Financing Programs, this policy sets parameters within which flexibility is retained to respond to specific circumstances.

2. Scope and Authority

This Policy shall govern the management of all Financing Programs of the Commission or TxDOT. This Policy pertains to all new money obligations and refunding obligations and has been reviewed and approved by the Commission as of the date specified on the cover of this document. The Commission will review this Policy annually and may amend when they conclude that doing so advances TxDOT's fiscal management goals and objectives and is fiscally prudent based upon recommendations from the Chief Financial Officer or his designee ("CFO"). Such amendments shall be evidenced in writing with copies delivered to the rating agencies.

Management responsibility for this Policy is hereby delegated to the CFO. The CFO shall have responsibility and authority as provided by the Commission for structuring, implementing, and managing all Financing Programs, and for ensuring compliance with this Policy.

3. Currently Authorized Financing Programs

The Commission has authority to issue bonds, notes and other obligations for several Financing Programs as briefly described below:

a. **Texas Mobility Fund Bonds:** Authorized by Article III, Section 49-k of the Texas Constitution and Subchapter M of Chapter 201, Texas Transportation Code. Secured by revenues deposited into the Texas Mobility Fund and, at the option of the Commission, the full faith and credit of the State of Texas. The proceeds of bonds may be used to fund state highway improvement projects, publicly owned toll roads, and other public transportation projects and to establish a loan program for qualified mobility projects. Mobility Fund bonds may have a maturity no longer than 30 years and bonding capacity is constrained by statutory debt service coverage requirements as certified by the Comptroller.

b. **State Highway Fund Revenue Bonds:** Authorized by Section 222.003, Texas Transportation Code. Obligations are secured by a pledge of and are payable from revenues deposited to the State Highway Fund. Proceeds may be used for state highway improvement projects, however $600 million must be used for safety projects. State Highway Fund Revenue Bonds may have a maximum maturity of 20 years and up $3 billion may be issued pursuant to current statutory authority.

c. **Short-Term Obligations:** Section 201.115, Texas Transportation Code authorizes the Commission and the Department to issue notes or borrow money from any source to carry out the functions of the Department. Such obligations are payable only from State Highway Funds appropriated for that purpose and must mature within two years of issuance. The amount of a loan may not exceed an amount which is two times the average monthly revenue deposited to the State Highway Fund for the twelve months preceding the month of the loan.

d. **Highway Tax and Revenue Anticipation Notes (HTRANs):** Section 201.961, Texas Transportation Code authorizes the Commission to issue HTRANs in anticipation of a temporary shortfall in the State Highway Fund during any fiscal year. Obligations are payable from the State Highway Fund and are subject to approval of the Cash Management Committee. Proceeds may be in the amount of the projected cash shortfall and such obligations must be repaid within the fiscal biennium in which they were issued.

e. **Project Revenue Bonds**: Chapter 228, Texas Transportation Code authorizes the Commission to issue toll revenue bonds to finance, in part or in whole, toll revenue projects. Chapter 227, Texas Transportation Code authorizes the Commission to issue revenue bonds to finance facilities and systems on the Trans-Texas Corridor. Chapter 91, Texas Transportation Code authorizes the Commission to issue revenue bonds for the purpose of financing state owned rail facilities.

f. **State Infrastructure Bank Revenue Bonds:** Subchapter D, Chapter 222, Texas Transportation Code authorizes the Commission to issue bonds to capitalize the State Infrastructure Bank, such bonds to be pledged and payable from income derived from the State Infrastructure Bank.

g. **Texas Rail Relocation and Improvement Fund:** The Commission is authorized under Subchapter O, Chapter 201, Texas Transportation Code to issue bonds to finance the costs of relocating, constructing, reconstructing, acquiring, improving, rehabilitating or expanding publicly or privately owned rail facilities. Bonds are payable from revenues deposited to the Fund and the full faith and credit of the State of Texas may be pledged to bondholders.

h. **Private Activity Bonds:** The Commission is required to develop and administer a program for private activity bonds issued to finance highway facilities or surface freight transfer facilities. Bonds may be issued by the Commission or pursuant to

Chapter 431, Texas Transportation Code, a Transportation Corporation may be formed by the Commission to act as a conduit issuer of Private Activity Bonds. If the Commission chooses to create a Transportation Corporation, separate debt policies and guidelines will be established.

i. **Real Property Financings:** The Commission is authorized under Section 201.1055, Texas Transportation Code, and Section 1232.111, Texas Government Code, to enter into agreements with a private entity for the acquisition, design, construction, or renovation of a building located on TxDOT property or to acquire from a private entity real property, including any improvements, in exchange for TxDOT owned real property and improvements. In the event that any project is not wholly paid for by an exchange of TxDOT owned real property, TxDOT may finance the project by issuing obligations through the Texas Public Finance Authority.

4. Allowable Purposes of Debt Issuance

The statutory authority for the Commission's Financing Programs are outlined in Section 3, however the general purposes for which the Commission may issue debt are as follows:

a. Interim or long-term financing of the construction and acquisition of eligible projects (including feasibility and engineering studies, other preliminary engineering and design activities and the purchase of right-of-way);
b. Reimbursement of the State Highway Fund for qualified expenditures;
c. Major capital improvements or repairs to existing Department facilities;
d. Cash management (to the extent permitted by federal tax law); and
e. Refunding of outstanding debt.

Long-term tax-exempt debt may not be used to fund routine operations or maintenance, for the purpose of investing, or for the purpose of earning arbitrage.

5. Eligible Projects

As described in more detail in Section 3, each Financing Program has specifically authorized purposes that may utilize bond proceeds:

a. State Highway improvement projects;
b. Mobility projects (such as new roadway capacity or public transportation projects) approved by the Commission in the Metropolitan Mobility Plans;
c. Publicly-owned toll projects;
d. Public or privately owned rail facilities;
e. Projects on the Trans-Texas Corridor; and
f. Capitalization of the State Infrastructure Bank.

6. Long Term Debt Planning

Annually, the CFO shall review and update the long-term debt profile for each Financing Program. The information to be updated includes annual debt service requirements, pledged revenues, planned future issuances and projections of debt service coverage. For natural variable rate bonds, an assumed interest rate will be used as prescribed in the legal documents for such Financing Program.

To the extent possible, these updates shall be considered complete if required as part of the Commission's annual continuing disclosure or other reporting undertakings or as a component of its rating updates..

7. Refunding Procedures and Practices

Refunding of outstanding debt will be considered in order to:

a. Achieve interest rate savings;
b. Restructure principal including conversion of short-term obligations to long-term obligations;
c. Make termination payments due under swap agreements as authorized by the legal documents for such Financing Program and in compliance with the Derivative Management Policy; or
d. Amend or close an existing Trust Indenture or Master Resolution.

a. <u>Achieve Interest Rate Savings</u>

The number of refundings which may be undertaken to achieve interest rate savings are limited by federal regulations. Therefore, savings should be sufficient to offset reduced future refunding flexibility. The Commission sets forth the following savings guidelines as a measure for evaluating refunding proposals, however the CFO shall have discretion in determining whether to undertake refunding transactions that are below the relevant savings target. Consideration will be given to compliance with Commission policy and/or the financial objectives of each Financing Program.

For current refundings, ie bonds that are callable within 90 days, the net present value savings target is 3% of the refunded par amount of bonds.

Bonds may only be advance refunded once on a tax-exempt basis, therefore the net present value savings target is 5% of the refunded par amount of bonds.

For refundings which include the use of derivative products such as interest rate swaps, the transaction must be in compliance with the Commission's Derivative Management Policy. In order to reflect the additional risks associated with such transactions, the net present value savings target is 6% of the refunded par amount of bonds and 8% of the refunded par amount of bonds for transactions in which the Commission assumes tax risk.

Each refunding may also be evaluated using a call option pricing model. When using the call option pricing model, the target savings from any refunding candidate must be in the range of 80% of the expected value of the call option, net of all transaction costs.

The manner in which savings are realized (up front, deferred or on an annual basis) will be determined by the CFO based upon the overall needs and objectives for the specific Financing Program.

b. Restructure Principal

Refundings involving a restructuring of principal shall be considered if the Commission can achieve a more favorable matching of revenues or other resources pledged to meet debt service payments. Consideration shall be given to the effect of such restructuring on the credit rating (if any) or credit perception of the Financing Program. Any transactions involving the restructuring of principal shall seek to minimize the amount of refunding debt to be issued.

c. Make Termination Payments

To the extent permitted by law refunding bonds may be issued to make a payment due by the Commission to a qualified counterparty in the event of a termination, whether voluntary or involuntary, for any interest rate swap agreements or similar derivative structures. The Commission shall only do so when insufficient other funds are legally available to make such a termination payment; the issuance of the refunding bonds does not negatively impact the debt service coverage or credit of the Financing Program; or such refunding is contemplated when the derivative product is executed and complies with the Commission's Derivative Management Policy.

d. Amend or Close Trust Indenture or Master Resolution

Refundings undertaken to respond to a change of legal covenants or to make pledged reserves available for other purposes by closing an existing Indenture or Resolution should determine any economic impact as measured by present value savings or loss, inclusive of cash contributions and any debt service reserve fund earnings. Such economic effects include:

i. Limitations imposed by the Internal Revenue Code;
ii. Use of reserves;
iii. Future financing capacity; and
iv. Future marketability of related debt.

Other Refunding Considerations

Any debt service reserve funds which are released after a refunding shall be used to reduce the amount of Refunding Bonds to be issued and under no circumstances will be used for operating expenses.

8. Limitations on Level of Indebtedness

The Commission and the Department will comply with statutory limitations on the level of indebtedness for each Financing Program. For Financing Programs that are not statutorily limited, the maximum level of indebtedness will be governed by available pledged revenue streams and rate covenants or additional bonds tests contained in the legal documents for such Program. In the case of new financing programs, consideration will be given to the desired credit rating for the program and purpose and use of the revenue stream or fund.

9. Credit Objectives

It is the goal of the Commission to provide sufficient flexibility to meet the objectives of each Financing Program while striving to secure and maintain the highest possible ratings for each Financing Program. It is the objective of the Commission to maintain its positive presence in the credit markets through the maintenance of and improvement of all relevant credit characteristics within its control.

10. Permissible Types of Debt for Financing Programs

a. Variable Rate Debt

Factors to be considered in determining the use of variable rate debt shall include cash flow risk, liquidity risk and tax risk.

The targeted total percentage of unhedged variable rate debt is twenty-five percent of all outstanding debt for each Financing Program. For purposes of this limitation, variable rate debt is considered hedged if it is subject to an interest rate cap or if short-term investments offset variable rate debt exposure. Short-term investments for purposes of this limitation shall include money invested in money market funds, overnight funds, repurchase agreements, and all other TxDOT investments with an average weighted maturity of one year or less. Variable rate debt that is hedged by an interest rate cap or short-term investments is not considered to be subject to tax risk.

The targeted total percentage of variable rate debt hedged by interest rate swap products is 25% of all outstanding debt for each Financing Program. These targets may be exceeded if the CFO determines doing so to be prudent and consistent with the liquidity and capacity constraints of each Financing Program.

The targeted total percentage of debt for each Financing Program that may be subject to tax risk is 50%.

b. Commercial paper

Commercial Paper may be issued for any Financing Program:

i. To minimize the interest cost or the use of capitalized interest during the design phase or construction period of eligible projects;
ii. For certain equipment purchases or capital improvements;
iii. Cash management; or
iv. To diversify the Commission's debt portfolio.

c. Fixed rate debt

Current interest bonds may be used for both new money and refunding transactions and may be structured to meet investor demand at the time of pricing. Capital appreciation and zero coupon bonds, which typically result in higher interest costs, shall be used in limited circumstances after an analysis is undertaken that indicates the needs or objectives of a particular Financing Program are met through their use. .

d. Derivative products

The Commission will consider the use of interest rate swaps and other interest rate risk management tools after carefully evaluating the risks and benefits of any proposed transaction in accordance with the Derivative Management Plan. By using swaps in a prudent manner, the Commission can take advantage of market opportunities to minimize expected costs and manage interest rate risk. The Commission will not enter into swap transactions for speculative purposes.

Subject to compliance with the Derivative Management Plan and subject to state law, the Commission may utilize products such as:

i. Current or forward starting interest rate swaps;
ii. Options on Interest Rate Swaps; and
iii. Caps/Floors/Collars

e. Hedging products

Subject to state law, the Commission may utilize hedging products for the purpose of protecting future debt issuance from interest rate risk. Such products may include, but are not limited to forward delivery bonds or rate locks based on either a taxable or tax-exempt bond index.

11. Permissible Types of Debt for Short Term Financing Programs

The following types of debt and other obligations are permitted for Section 3 (c) Short Term Obligations and Section 3(d) Highway Tax and Revenue Anticipation Notes:

a. Fixed Rate Notes;
b. Variable Rate Notes;
c. Commercial Paper; and
d. Bank or other Loans

12. Structural Objectives

a. <u>Maturity:</u> Term of debt may not exceed expected useful life of the project or equipment financed, or as statutorily prescribed.

b. <u>Variable rate debt instruments:</u> As long as variable rate debt is outstanding, the CFO will actively monitor and evaluate market conditions and shall determine if it is appropriate and cost efficient to convert the variable rate debt to fixed interest rates or fixed rate debt to variable rate debt either through the issuance of fixed rate bonds, variable rate bonds or synthetically upon entering into a swap Transaction in compliance with the Derivative Management Policy.

c. <u>Structural elements:</u> Use of specific structural elements (capital appreciation bonds, variable rate bonds, call features, forward delivery bonds, derivative products, etc.) will be based on analysis and recommendation of staff, financial advisor, senior underwriter(s) and bond counsel, as applicable. For derivative structures, compliance with the Derivative Management Policy is required.

d. <u>Lien levels:</u> Multiple liens of debt may be utilized for any Financing Program if the resulting debt structure optimizes certain critical debt constraints, typically either cost or capacity, or is needed to maintain credit ratings on existing debt. The use of multiple liens is also permitted when derivative products are utilized if the Commission will become liable for termination payments or other obligations under such agreements.

e. <u>Capitalized interest</u>: When possible, the Commission will avoid using capitalized interest. The CFO shall determine when the use of capitalized interest is warranted in order to meet the objectives of any Financing Program.

f. <u>Premium and Discount Bonds:</u> While premium and discount bonds may reduce the interest cost of the bonds they should only be used when economically justified and upon recommendation by the financial advisor and senior underwriter(s) to efficiently issue the bonds. Bonds which carry significant Original Issue Discount (OID) may be rendered nonrefundable, a significant disadvantage to the Commission for which a commensurate benefit should be received.

g. <u>Debt Service Reserve Fund</u>: Debt service reserve funds may be funded by proceeds of bonds, available cash or cash equivalents or the purchase of a surety bond. Debt service reserve funds will be created only when required to market a specific type of debt, achieve a desired credit rating or provide a needed liquidity source for a bond issue. Factors to be considered in evaluating the use of a debt service reserve fund include arbitrage yield restrictions, current interest rates, availability and cost of a surety policy and future opportunities for the use of funds released from the fund. Typically debt service reserve funds will be used to make the final debt service payment, fund a new debt service reserve fund or reduce the amount of any refunding bonds issued.

h. Call provisions: In general, a call provision at the Commission's option must be included for all bonds or obligations with maturities longer than 10 years. The optional redemption date will be a maximum of 10 years from the date of issuance or a market acceptable date as recommended by the financial advisor and senior underwriter(s) on the transaction. Prior to issuing bonds without a call provision, the CFO will evaluate and document expected interest savings in relation to the expected savings from a refunding, as based on the theoretical value of the call option.

i. Credit Enhancement:

   a. Bond insurance: Bond insurance will be used when it provides an economic advantage to a particular bond maturity or entire issue. The decision to use bond insurance shall be based upon the value it adds to a specific transaction. The analysis of that value shall compare the present value of the prospective interest savings produced due to the insurance to the cost of the insurance premium. Insurance may be purchased when the premium cost is less than the projected interest savings. Bond insurance may be purchased for the entire par amount of an issue or for specific maturities thereof, based on a recommendation to TxDOT from the financial advisor regarding the most cost-effective approach or upon a recommendation from the senior underwriter(s) that insurance is desirable to attract investors who are willing to pay for such insurance. In no case will TxDOT purchase insurance if there is a cost to the Department. Bids for bond insurance will be solicited from at least three providers rated "AAA" by S&P or "Aaa" by Moody's. The CFO will authorize the purchase of bond insurance if it is deemed prudent, reasonable and cost effective.

   b. Liquidity/Credit facilities: The issuance of variable rate debt, including variable rate bonds and commercial paper, requires the use of a liquidity and/or a credit facility. Letters of Credit ("LOC") and Stand-by Bond Purchase Agreements ("SBPA") will be considered as credit enhancement based on the specific need of the short-term instrument and cost effectiveness. The Department will solicit bids from qualified financial institutions established in this line of business and select the "best value" based on price, financial stability, terms and conditions and service. Qualified financial institutions must have long-term ratings of Aa3/AA-/AA- from two of the three nationally recognized rating agencies and short-term ratings from two rating agencies of at least P-1, A-1 or F1.

13. Method of Sale

The Commission recognizes that each issuance of obligations has unique characteristics that will provide the basis for determining the appropriate method of sale. Such methods include competitive sale, negotiated sale, or private placement. The conditions which indicate the appropriate method of sale are generally described below:

a. Competitive Sale:

   i. The bond market is stable and/or demand for bonds is strong;
   ii. Market timing and interest rate sensitivity are not critical to the pricing;

iii. Women or minority owned firm participation is on a best efforts basis only and is not required for winning bid;
iv. There are no complex explanations required during marketing regarding the project, funding mechanism or credit quality;
v. Credit is well-known to investors;
vi. Bond type and features are conventional; and/or
vii. The transaction size is manageable.

b. Negotiated Sale:

i. Bond market is volatile, demand for bonds is weak and/or the supply of competing sales is high;
ii. Market timing and interest rate sensitivity is high, such as refunding bonds;
iii. Coordination of multiple components of the financing is required;
iv. Participation by women or minority owned firms is desired or enhanced;
v. Substantial education of investors will be required as to the project, the credit or the structure of the transaction;
vi. Credit is weak or unknown to investors;
vii. Structural features are unconventional, such as forward delivery bonds or derivatives; or structure is not conducive to competitive sale, such as variable rate bonds;
viii. The Commission has a pre-qualified pool of underwriters available;
ix. Large transaction size; and/or
x. Retail participation is expected or desired to be high.

c. Private Placement:

A private placement with a sophisticated investor including a bank loan, may be appropriate when:

i. Credit is weak or credit ratings cannot be obtained;
ii. A loan provides more advantageous terms than the capital markets;
iii. A favorable innovative or proprietary structure is proposed that is unavailable in the markets generally;
iv. Time is of the essence and a private placement can be consummated more quickly than a public offering.

14. Use And Investment Of Bond Proceeds

Any investment of bond proceeds shall be executed in accordance with the Commission's Investment Policy, Investment Strategies, legal covenants, state and tax law limitations. The proceeds of debt or other obligations of all of the Commission's Financing Programs are subject to the Public Funds Investment Act.

15. Escrow Structuring

The Commission shall utilize the least costly securities available in structuring refunding escrows. A certificate shall be delivered to the CFO from the financial advisor or qualified third party agent, who is not a broker-dealer, on each refunding issue. The certificate shall state that the securities were procured through an arms-length, competitive bid process (in the case of open market securities), that such securities were more cost effective than State and Local Government Obligations (SLGS), and that the price paid for the securities was reasonable within Federal guidelines. The CFO shall take all steps necessary and legal to optimize escrows in order to avoid negative arbitrage in its refundings.

16. Compliance with Arbitrage Rebate

The use and investment of bond proceeds for all Financing Programs shall be monitored to ensure compliance with arbitrage restrictions. Existing regulations generally require that issuers calculate annual rebate requirements related to any bond issues and pay any required rebate every five years. Therefore, the CFO shall ensure that bond proceeds and investments are traced in a manner which facilitates the completion of accurate rebate calculations, and rebate payments, if any, are made in a timely manner. A nationally recognized Arbitrage Rebate services firm may be used to consult, calculate and report the required arbitrage rebate requirements as specified by the IRS.

17. Continuing Disclosure

The Commission shall comply with U.S. Securities and Exchange Commission (SEC) Rule 15c2-12 by filing with each Nationally Recognized Municipal Securities Information Repository (NRMSIR) and State Information Depository (SID) annual financial statements and other financial and operating data for the benefit of its bondholders no later than six months after the end of the fiscal year. The inability to make timely filings must be disclosed promptly.

18. Rating Agency and Investor Communications

The CFO will have primary responsibility for maintaining the Commission's relationships with the credit rating agencies then rating any outstanding debt. The CFO will update the rating agencies at least annually and provide such other updates or pertinent project, financial or programmatic information as and when necessary or requested.

In order to ensure uniform market access to information that may be relevant to the valuation of the Commission's obligations, the release of any information, whether in response to an ad hoc question or self initiated, that may be potentially relied upon by the market to impute the credit worthiness of the Commission's debt, whether intended for that purpose or not, shall be reviewed by the CFO and Disclosure Counsel to determine whether or not:

- The information is already in the public domain;

- The information is a disclosure event as defined by the SEC, requiring prompt notification of the Municipal Securities Rulemaking Board (MSRB) for NRMSIR filing; and
- The information is full, accurate, complete and not misleading.

19. Selection of Consultants

Pursuant to applicable state law, the Department shall select its financial advisor, investment banking firms, bond counsel and disclosure counsel by a competitive process through the issuance of a Request for Proposals. Selection may be based on a best value approach for professional services or the lowest responsive cost-effective bid based upon predetermined criteria.

a. Financial Advisor

The Finance Division will have the responsibility of selecting an independent advisor (or advisors) to assist with the issuance of all debt and debt administration processes relating to any or all of its Financing Programs.

b. Investment Banking Firms

The Finance Division will select a pool of investment banking firms to serve as senior manager, co-senior and/or co-manager or as a counterparty for derivative transactions pursuant to the terms of the Commission's Derivative Management Policy. The pool will include a broad representation of national, regional, and women or minority owned firms. The Commission reserves the right to add or remove firms from the pool at any time, to shorten or lengthen the period of time for which the pool is in place pursuant to the terms dictated by each solicitation and the Financing Programs in which the pool will participate. The Commission may add or remove firms from the pool at any time based on factors including, but not limited to: performance, or change in staff or firm organization. No joint proposals will be permitted.

c. Bond/Disclosure Counsel

Debt or obligations of the Commission shall be issued with a written opinion by legal counsel affirming that the Commission is authorized to issue the proposed debt, that the Department has met all constitutional and statutory requirements necessary for issuance, and a determination regarding the debt's federal income tax status. Disclosure Counsel will also be used to prepare offering documents and will be responsible for ensuring compliance with all applicable disclosure rules, regulations and guidelines. The Office of General Counsel will have the responsibility of selecting such counsel and may appoint a pool of nationally recognized bond counsel firms and select qualified firms from the pool to act as either Bond or Disclosure Counsel for each transaction.

20. Underwriting Procedures

d. Underwriting Syndicate

The size and composition of each syndicate will be based on 1) initiation and implementation of innovative financing ideas or structures; 2) the expertise of bankers required for the transaction; 3) the underwriting capabilities, as determined by excess net capital and distribution networks, relative to the size of the transaction; and 4) performance of each syndicate member in past transactions.

e. Transaction Marketing Activities

The senior book-running manager must provide a marketing plan to the CFO in advance of each transaction. The marketing plan should be developed in collaboration with the entire syndicate to ensure meaningful participation of the entire syndicate. The marketing plan should include potential target investors, pre-marketing activities, structural recommendations such as call features and use of term bonds, a recommendation as to the use of retention, designation rules and proposed liabilities. All decisions regarding retention, designation policies and liabilities will be made by the CFO.

f. Post-Sale Evaluation

After the completion of each transaction, the senior manager will be required to present a post-sale analysis including but not limited to pricing, orders and allocations, comparable sales and indices, designations and market conditions at pricing. The CFO and financial advisor will evaluate the success of the underwriting versus the market at the time of sale and analyze each syndicate member's contribution with regard to sales performance.

g. Unsolicited Proposals

The Commission encourages the submission of financing options and ideas from any firm and may accept proposals from firms that are not in the pool. A copy of each proposal will be provided to the CFO and the financial advisor. All proposals should include a full analysis of risks and benefits associated with each transaction, and a description of previous experience with such financing technique, if any.

The Department reserves the right to issue RFPs for any product or transaction. If the firm submitting an innovative proposal that is implemented by the Department is not a member of the pool, the Department may consider a structuring fee and/or inclusion as a co-manager or co-senior manager as compensation.

Exhibit B

Texas Department of Transportation

TEXAS TRANSPORTATION COMMISSION

Derivative Management Policy

August 24, 2006

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DERIVATIVE MANAGEMENT POLICY

1. Introduction

This Derivative Management Policy ("Policy") is a subsidiary component of and should be read in conjunction with Texas Transportation Commission's ("TTC" or "Commission") Debt Management Policy. The purpose of this Policy is to establish responsibilities, objectives, and guidelines for the use of interest rate swaps and similar products to manage the Commission's asset/liability profile for each Financing Program (Financing Programs are described in the Debt Management Policy). As used in this document, TTC or Commission also includes debt or other obligations issued by the Texas Department of Transportation ("TxDOT" or "Department") on behalf of the Commission. Financing Programs where the Commission may act as a conduit issuer will be governed by separate Derivative and Debt Management Policies.

The Commission is authorized pursuant to Chapter 1371, Texas Government Code, as amended, to enter into credit agreements that include interest rate swap and other similar agreements.

2. Policy Objectives and Philosophy

This Policy describes guidelines within which each interest rate swap and other similar transaction, including termination of an interest rate swap or other similar transaction ("Transactions") may be used to manage the Commission's asset/liability portfolio by 1) balancing risk exposures related to fluctuating interest rates and other economic variables, 2) minimizing debt service cost, 3) balancing or rebalancing the ratio of fixed and variable rate debt, 4) responding to market conditions or interest rate cycles that offer value to the Commission and 5) hedging future interest rate conditions. Transactions will not be employed as investment instruments or for the purpose of speculation.

This Policy shall govern the use and management of all Transactions. While adherence to this Policy is required in applicable circumstances, we recognize that changes in the law, capital markets, Commission programs and other unforeseen circumstances may from time to time produce situations that are not covered by this Policy and will require modifications or exceptions to achieve policy goals. In these cases, management flexibility is appropriate provided specific authorization from the Commission is obtained.

It is the Commission's intention to enter into Transactions in a prudent and professional manner that will take into account the Commission's objectives in managing its assets and liabilities, relevant risk factors, and market conditions. All Transactions shall comply with State statutes and Commission policies governing such transactions.

3. Management and Oversight

Management responsibility for the Derivative Management Policy is hereby delegated to the Chief Financial Officer or his designee ("CFO").

A committee will be formed with a minimum of one representative from each of the following divisions: Debt and Financial Reporting sections of the Finance Division, Office of General Counsel and a Commissioner or his/her delegate (the "Derivative Committee").

Responsibilities:

The CFO will have the following responsibilities:

- making recommendations to the Derivative Committee prior to the execution of any Transaction;
- monitoring each outstanding Transaction on at least a monthly basis;
- making recommendations to the Derivative Committee when early indicators signal action may be required or necessary; and
- providing a quarterly report to the Derivative Committee detailing the status and other matters relating to each outstanding Transaction, if any.

The Derivative Committee is responsible for the following:

- oversight of all Transactions to ensure compliance with the guidelines and restrictions established by this Policy;
- approval of each Transaction, including the termination of any Transaction;
- annual review of the Commission's asset/liability portfolio;
- annual review of this Policy.

4. Reporting Requirements

The CFO will be responsible for compliance with the following reporting requirements:

- Monthly monitoring of all outstanding Transactions pursuant to Section 10 of this Policy;
- Quarterly Report to the Derivative Committee pursuant to Section 10 of this Policy;
- Annual review of Commission's asset/liability portfolio and this Policy.

At least annually, the CFO shall report to the Commission on the status of all outstanding Transactions, provide any recommendations to rebalance the Commission's asset/liability portfolio and recommend any changes to this Policy.

5. Guidelines

The Commission may enter into any of the following Transactions: interest rate swaps, basis swaps, interest rate caps, interest rate floors, interest rate collars, options on interest rate swaps, forward-starting interest rate swaps or other similar Transactions.

The Commission may from time to time shorten, terminate, extend, or otherwise modify Transactions in order to manage its risk exposure, balance assets and liabilities, or reduce debt cost.

Approved Purposes for Transactions

1. To achieve savings as compared to a product available in the cash/bond market. Savings shall be calculated after adjusting for (a) applicable fees, including takedown, remarketing fees, credit enhancement and legal fees, and (b) the value of call options that may be forgone on the bonds.
2. To prudently hedge risk in the context of a particular financing or the overall asset/liability management. Examples include, but are not limited to, interest rate caps, rate locks and forward starting swaps.
3. To incur variable rate exposure within prudent guidelines, such as selling interest rate caps or entering into a swap in which the Commission's payment obligation is floating rate.
4. To achieve more flexibility in meeting overall financial objectives than can be achieved in conventional markets. An example may include a basis swap.
5. To achieve diversification of the Commission's asset/liability portfolio.

General Guidelines

1. Each Transaction must comply with this Policy and all applicable legal documents, insurance covenants, and state and federal law;
2. The Commission will consider published rating agency guidelines in connection with each Transaction;
3. All Transaction documents must contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, Schedules to the Master Agreement, Credit Support Annex and confirmation, as appropriate and consistent with industry standards;
4. Except as otherwise permitted in Section 7 of this Policy, each Transaction must be a market transaction for which competing good faith market quotations may be obtained;
5. Early termination provisions must be included in each Transaction. Generally such provisions will provide for a termination at the sole option of the Commission at market. Should the Commission exercise its sole right to optionally terminate a Transaction, a benefit to the Commission must be demonstrated;

6. A Transaction should not be assignable without the consent of the Commission;
7. Aside from customary market termination provisions, the Commission will not enter into a Transaction which will impair its utilization of call features on outstanding bonds.
8. Generally, the Commission will not enter into Transactions requiring two-way posting of collateral. However, if and when market provisions such as the credit quality of the underlying bonds or obligations dictate, the CFO may recommend two-way collateral posting.

Legality

Enforceability opinions acceptable to the Commission and the Counterparty will be required for each Transaction.

Aspects of Risk Exposure Associated with Such Transactions

Before entering into a Transaction, the CFO shall evaluate all the risks and requirements inherent in the Transaction. (See Exhibit I for a more detailed review of risks.)

Counterparty Exposure Limitation

The Commission shall endeavor to diversify its exposure to counterparties. To that end, before entering into a Transaction, the CFO should determine the Commission's exposure to the relevant counterparty or counterparties and determine how the proposed Transaction would affect such exposure.

The CFO will evaluate counterparty exposure based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing and proposed Transaction on an ongoing basis as well as prior to any proposed Transaction. For outstanding Transactions, exposure will be based on the market value as of the last quarterly report to the Derivative Committee or such other method of determining Value at Risk. Projected exposure shall be calculated quarterly based on the Transaction's potential termination value taking into account possible adverse changes in interest rates.

If exposure to any counterparty for any reason is determined by the CFO to be excessive, the CFO, in consultation with its legal counsel and financial advisor, shall explore remedial strategies to mitigate such exposure.

Long-Term Implications

In evaluating a particular Transaction, the Derivative Committee shall review the long-term implications associated with each Transaction, including costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations, counterparty exposure and other similar considerations.

Methods to be Used to Reflect Such Contracts in TxDOT's Financial Statements

The Department shall reflect the use of Transactions on its financial statements in accordance with Generally Accepted Accounting Principles ("GAAP").

6. Approval of Transactions

The Department desires to establish an approval structure that provides adequate Commission oversight of Transactions while maintaining flexibility to execute such Transactions in a timely manner.

The following structure and Transaction approval procedures are established.

a. The Commission, from time to time and upon recommendation of the CFO and approval by the Derivative Committee, shall authorize general parameters for Transactions or a program of Transactions to be executed by the CFO.

b. The Derivative Committee shall review specific parameters for Transactions within the authorized general parameters set forth in the term sheet approved by the Commission. Any specific parameters that the Derivative Committee deems significant should be detailed in the Term Sheet.

c. The CFO shall structure specific parameters for the termination of any existing Transaction upon determination that such action is in the best interests of the Commission. Such recommendations will be reviewed and approved by the Derivative Committee.

7. Methods of Soliciting and Procuring Transactions

The Commission will have International Swaps and Derivatives Association, Inc. (ISDA) Master Agreements and associated schedules for each Financing Program. In order to be considered a pre-qualified counterparty, execution of these agreements will be required prior to the execution of any Transaction. In each ISDA Master Agreement, the Commission may pledge all legally available funds specific to each Financing Program or otherwise provide security for its obligations under the ISDA Master Agreements governing the Transactions.

In general, the Department should employ a competitive bidding process. A competitive bid procurement will require the number of firms solicited to no fewer than three.

TxDOT shall determine which parties it will invite to participate in a competitive transaction. At its own discretion for the purposes of rewarding a particular firm for a directly related innovative proposal, achieving diversification of counterparty exposure or encouraging competition, the CFO may allow the second and third place bidders to match the winning bid up to a specified amount of the notional amount. The parameters for the bid and the conditions for any matching bid process must be disclosed in writing to all potential bidders.

Notwithstanding the above, the Commission may enter into Transactions by negotiated methods in the following situations:

1. The CFO makes a determination that due to the size or complexity of a particular Transaction, a negotiated transaction would result in the most favorable execution. In this situation, the Department should attempt to price the Transaction based upon a methodology agreed to by the CFO and the counterparty relying on available pricing screens to obtain inputs to a financial model. The CFO may use the Department's Financial Advisor to assist in price negotiations or to verify bids.
2. A proposed Transaction is embedded within a refunding bond issue and meets the Commission's savings target.
3. The CFO determines, in light of the facts and circumstances of a particular Transaction, that a negotiated Transaction will promote the interests of the Department/Commission by encouraging and rewarding innovation.
4. In order to achieve counterparty diversification.

Regardless of the method of procurement, the Department's Financial Advisor or other qualified independent advisor will provide a certification that the terms and conditions of any Transaction entered into reflect a fair market value of such Transaction as of the date of its execution.

8. Counterparty Requirements

The following conditions should apply to each Transaction:

a. An attempt will be made to have the counterparty fully disclose all costs including associated fees and costs. All fees and expenses paid by the counterparty to designated third parties will be fully disclosed in writing to the Commission in the confirmation for each Transaction;

b. Provisions for protection in the event of a counterparty downgrade, including collateral or credit support;

c. The counterparty shall disclose relationships with other third parties which may affect the Transaction, such as broker dealers, insurance companies, other swap providers and the Commission's Financial Advisor;

d. The counterparty shall provide its financial audit and credit ratings, which shall be acceptable to the Commission.

e. At the time of entering into a Transaction, the counterparty shall be rated at least AA-/Aa3/AA- by at least one of the three nationally recognized rating agencies or have, as support for their obligations, a "AAA" subsidiary or other entity (e.g. bond insurer) as rated by at least one nationally recognized rating agency.

9. Restrictions

a. The Commission will not enter into Transactions for speculation.

b. The Commission will not execute any Transactions with a term greater than the then-current final maturity of its related outstanding long-term indebtedness.

c. The Commission will not enter into a Transaction for an investment-related purpose.

d. The total "net notional amount" of all swaps related to bonds or other indebtedness should not exceed the amount of outstanding bonds or indebtedness. For purposes of calculating the net notional amount, credit shall be given in situations where there are off-setting swaps.

10. Early Warning Monitoring and Reporting for Existing Transactions

The CFO will monitor existing Transaction cash flows, market values and early warning indicators on an ongoing basis and will report the results to the Derivative Committee at least quarterly. The CFO will provide a recommended course of action when early warning indicators dictate action is required. The list of "early warning indicators" can be expanded as needed but will include the following at a minimum:

a. A market movement that requires a collateral deposit or is within 10% of such requirement.

b. Any rating action with respect to a counterparty that may result in a rating downgrade to a level lower than the requirements specified in Section 8 of this Policy.

c. A rating action on any Financing Program that could result in a collateral deposit as may be required under an ISDA agreement.

d. A change in tax law or a likely permanent market shift that produces or is likely to produce negative cash flows.

e. Any unforeseen event that significantly, negatively impacts the expected results of the Transaction and that is likely to continue.

The Derivative Committee must approve any action resulting in an early termination of a Transaction.

11. Exit Strategies

In the event of termination, whether voluntary or involuntary, the Derivative Committee, upon recommendation of the CFO, will evaluate the best possible strategy given the market, tax, legal and economic environment at the time of termination. The following is a general guideline for both voluntary and involuntary termination strategies:

a. Voluntary Termination: The CFO will monitor market rates, termination values, tax changes, counterparty credit ratings, and any other relevant factors to determine if Voluntary Termination is warranted. Generally, an early termination will be warranted if it is economically advantageous for the Commission to do so, a more beneficial underlying debt structure can be attained or it will alleviate a current or anticipated risk inherent to the Transaction. Based upon expected market conditions at the proposed termination date, the CFO will establish a strategy prior to termination to hedge any exposure that is created by the termination.

b. Involuntary Termination: If certain events occur, such as a substantial ratings downgrade of any of the Commission's Financing Programs, involuntary termination may occur. Depending on market conditions, this may result in an obligation of the Commission to make a significant termination payment to the counterparty. In the event of a termination payment, the source of payment will be from legally and currently available sources for each Financing Program, including any collateral posted, insurance and/or reserves set up for this purpose. As soon as early warning monitoring indicators show that an involuntary termination may occur in the near term, the CFO will establish a strategy to hedge any exposure based on then-prevailing market conditions. This strategy shall be monitored and updated regularly in order to ensure that the strategy appropriately reflects changing market conditions.

EXHIBIT I

Risks Associated with Derivatives

- Counterparty Risk - Risk that the counterparty cannot make future payments or cannot make a termination payment due to the Commission.

  Mitigation of Risk - Risk is reduced by a highly rated counterparty and by ISDA (International Swaps and Derivatives Association) contract terms addressing collateral limits and credit ratings. Selecting more than one counterparty will diversify risk. The high rating requirements set forth for qualified counterparties will increase the likelihood that their financial commitments will be met.

- Basis Risk - Risk that the payment on the variable rate bonds will exceed the swap receipt (BMA or a percentage of LIBOR) due to an issuer specific credit event or tax code change.
  - Tax Event Risk - A form of basis risk - risk of higher tax-exempt interest rates (an increase in BMA Index) if tax law changes lower the taxation rate on interest income. In the extreme scenario, if a change in tax law eliminated tax-exempt interest income, the market would adjust "tax-exempt" security pricing so that there would be no material difference between the BMA Index and LIBOR.
  - Credit Risk - Credit deterioration of the underlying bonds or any bond insurer insuring the bonds would result in basis risk discussed above.

  Mitigation of Risk – Specify in the agreement a % of LIBOR rate which reflects historical trading relationships and scheduled future tax cuts or consider using a BMA based rate. Manage operations and cash reserve balances as efficiently as possible and analyze and implement procedures to maintain credit stability. Only utilize AAA-rated insurers to the extent practical based on the credit quality of the underlying debt or obligations.

- Variable Rate Bond (Liquidity) Risks – A remarketing failure that would result in a penalty rate and/or the liquidity facility which may not be renewed at expiration.

  Mitigation of Risk - Purchase bond insurance and, if available, enter into a long-term liquidity facility with a highly rated provider.

- Termination Risk - Termination risk exists if (i) the Commission opts to terminate the swap prior to maturity; (ii) credit ratings for any Financing Program are lowered to below investment grade and the Department is unable or is not required to post collateral, as may be required by the swap agreements, to protect the counterparty against the risk resulting from the lowered rating; (iii) the counterparty is downgraded and the counterparty is unable to post collateral; or (iv) the counterparty is downgraded to a level that causes an involuntary termination. Early termination would be solely at the option of the Commission (except in certain credit events described in (ii) above). The counterparty will not have the option to terminate at any time without cause.

Mitigation of Risk – the Commission's strong financial standing makes the likelihood of early involuntary termination remote for the majority of its Financing Programs, however lower rated credits such as Project Revenue Bonds may be vulnerable to termination risk. In the event of a termination TxDOT may be required to make a termination payment to the swap provider. In the absence of market changes, the magnitude of the termination payment generally decreases over time as the Transaction approaches maturity. If a termination payment were to be made, the financial impact would be mitigated by the savings which had been gained through the swap prior to termination. If the swap is allowed to mature, there will be no termination payment. The possibility of a future termination payment puts more pressure on the Department to maintain sufficient reserves and to maintain investment grade credit ratings on all of its Financing Programs. Risk of involuntary termination due to counterparty downgrade is mitigated by a collateral posting requirement, and the use of a diverse group of highly rated counterparties.

- Rollover Risk – Potential rollover risk exists if the swap maturity does not match the maturity of the hedged debt or asset. If the Commission chooses to enter into another swap transaction to hedge the related debt or asset, the Commission may not be able to have the same counterparty or achieve the same economic benefit with the next swap transaction.

  Mitigation of Risk – Rollover risk may be mitigated by structuring swap transactions to mirror the maturity of the underlying debt obligations and/or related assets of the Commission.

- Disclosure Risk - Accounting standards are under development which may require balance sheet and income statement entries for swap agreement interim values. For example, if an upfront payment structure were considered and legally acceptable, then TxDOT would have to show a negative value for the first several years even if rates remained the same.

  Mitigation of Risk - Retain a reasonable cash reserve in case of termination and structure the swap to minimize the impact of early termination.

EXHIBIT II

SUMMARY TERM SHEET
Date XX, 20XX

Title of Proposed Issue or Transaction

INDICATIVE TERMS AND CONDITIONS

***Issuer*:**	Texas Transportation Commission or Texas Department of Transportation
***Issue/Contract*:**	
***Amount*:**	Par and/or Notional Amount not to exceed $XXX.X
***Use of Proceeds*:**	If debt obligations are being issued.
Structure:	
Rate:	
***Bonds Refunded (if any)*:**	
***Refunded Par (if any)*:**	
***Amortization*:**	
***Average Life/Term*:**	
Debt/Swap Instruments:	
Revenue Pledge:	
Estimated Synthetic Fixed/Variable Rate PV (Upfront?) Savings:	
Upfront Costs of the Transaction:	
On-going Costs of the Transaction:	
Benefits/Reasons for Transaction:	

Risks and Mitigation Measures:

Proposed Counterparties and Selection Method: