

Derivatives Use Report

- Summary
- Dashboard

July 31, 2014

Prepared By Enterprise Risk Management

Introduction

As determined by the University's Derivatives Use Policy (The Policy) which was approved by the Board of Trustees in July 2010, the University's exposure to an individual counterparty is measured by the Net Termination Exposure (NTE). This report provides information on the University's financial position and potential obligations should there be an early termination of any or all of its existing financial and physical derivative transactions. This includes positions held by Prairieland Energy, Inc. (PEI). This is only a picture of counterparty exposure as it relates to derivatives.

Counterparty Financial Health

Bond credit ratings are used as a proxy for counterparty financial strength. The Policy requires an A-/A3 rating to qualify as a counterparty. The financial institutions (JPMorgan Chase Bank, Loop Financial Products, and Morgan Stanley) meet this requirement. Morgan Stanley however, does have a split rating of A-/Baa2 and should be monitored by Capital Financing. The energy companies (Exelon at BBB/Baa2 and Sequent at BBB+/Baa1) do not meet the qualifying credit rating. The contracts with Exelon and Sequent were originated before or near the time of The Policy and do not include The Policy required credit terms or collateral provisions. When the energy contracts are renewed, credit support and collateral provisions should be considered. NRG secured a letter of credit from Barclays Bank to support their credit. PEI has been advised by Fellon McCord that most energy companies do not maintain a credit rating of A-/A3. PEI is currently drafting a derivatives use policy, specific to PEI as an URO.

University Total NTE

The combined current notional value of these derivative agreements is \$227.15 million. Should there be immediate termination of all agreements, the combined NTE for all outstanding agreements is (\$23.98) million, unfavorable to the University. The obligation is nearly entirely due to the MTM on the interest rate swaps, which is in line with the current market environment. The overall immediate risk of termination is low since the counterparties have no ability to terminate these transactions unilaterally unless certain triggers are met (see Financial Hedging paragraph).

Financial Hedging NTE (Interest Rate Swaps)

The total NTE of all interest rate swaps is (\$23.03) million, which would be an obligation for the University to each of the swap counterparties. This is a result of the current market environment. The immediate risk of all swaps terminating is low since the counterparties cannot unilaterally terminate these contracts unless certain triggers are met, including: (i) a University default, or (ii) the long-term rating on the University's bonds is withdrawn, suspended or reduced below BBB+/Baa1 on the COPs 2004 and UIC SC 2008 and reduced below BBB/Baa2 on the HSFS 2008 bonds.

Physical Hedging NTE (Energy Commodity Transactions)

The total NTE of all physical energy hedges is (\$0.95) million, unfavorable to PEI/The University. If the agreements were terminated as of July 31, 2014 PEI would have an obligation to Sequent and NRG of \$1.02 and \$0.36 million respectively but Exelon would have an obligation to PEI of \$0.43 million. The Exelon obligation is not collateralized (see Summary of Collateral below).

Counterparty Concentration

Morgan Stanley, with a total notional value of \$134.35 million, exceeds the 50% limit with 59% of the current notional total of \$227.15 million. The University has two interest rate swaps with this counterparty; both predate The Policy and are coincident with related bond issues. Future use of Morgan Stanley as a hedging counterparty would require approval by the VP/CFO as an exception to The Policy.

Material Events

PrairieLand Energy Inc. hedged additional gas and electricity during the month of July to take advantage of favorable market prices. Natural gas and electricity increased by \$6.2 and \$6.1 million respectively.

Summary of Collateral Posted by the University (Thresholds)

With respect to the University, the threshold requirement in all of the interest rate swap agreements is infinite, which means the University is never required to post collateral. Threshold requirements are not addressed in the energy forward purchases contracts.

The University does provide guaranty agreements to PEI's energy commodity vendors including \$35 million with Sequent, \$1 million with NRG, and an unlimited agreement with Exelon. PEI has \$1 million (increased \$250 thousand in June) collateral posted with the Midcontinent Independent System Operator (MISO), but this arrangement is for physical procurement and is unrelated to financial or physical hedging.

Summary of Collateral Held by the University (Thresholds)

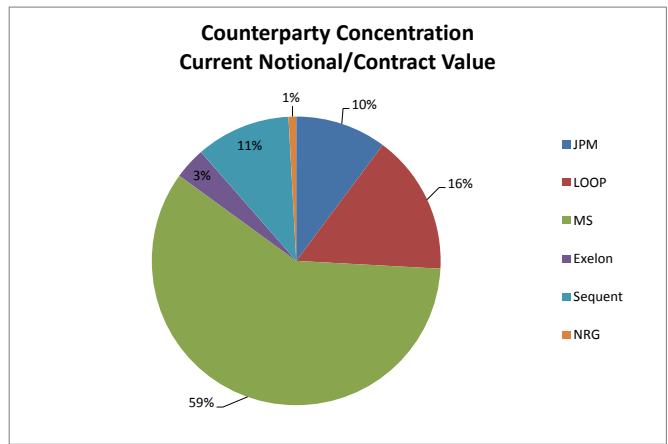
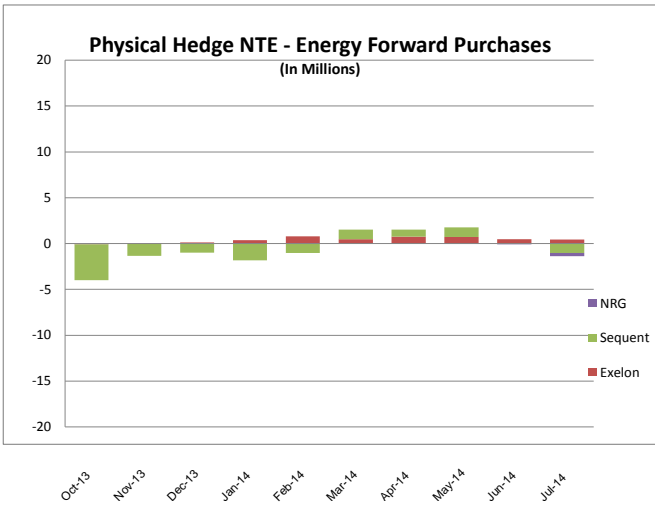
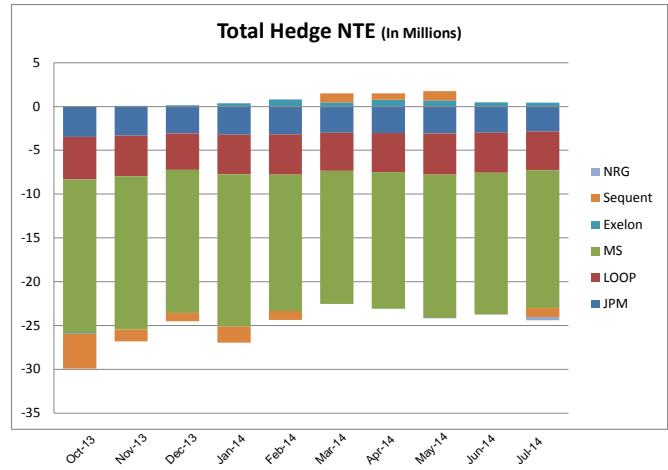
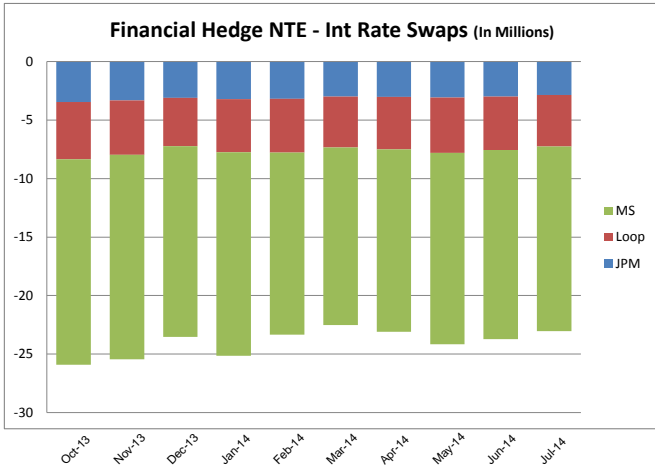
The collateral requirements for counterparties on the interest rate swaps are more risk tolerant than The Policy (see table below). All of the swap agreements were approved by the Board of Trustees and executed prior to The Policy, so this is noted as a predated-exception on the Dashboard report. Morgan Stanley's current credit rating would cause the University's exposure to exceed the contracted limits should those positions come "in the money" (that is, the counterparty would owe the University in the event of swap termination). If this were to happen, the swap agreement provides for the University to demand collateral. The pledge and delivery of collateral would mitigate the risk that Morgan Stanley would fail to perform its obligations under the swap agreement. If Morgan Stanley was unable to deliver collateral, the University would continue to be at risk. A further decline in Morgan Stanley's credit rating could trigger the transfer (Novation) of the swap agreement to a replacement counterparty.

The contracts with Sequent, Exelon, and NRG do not address collateral thresholds. Sequent and Exelon were originated prior to The Policy and therefore noted as predated-exceptions on the Dashboard report. NRG has provided a LOC. When the contracts are renewed, the collateral thresholds should be considered to protect the University/PEI.

The only collateral reported to be held by the University is the letter of credit from Barclays Bank for \$2.2 million to back the forward purchase transaction with NRG Power Marketing, LLC which expires 6/30/15. Only Exelon is "in the money" therefore exceeding the exposure limit, at \$0.43 million NTE obligation; however, collateral has not been requested since it is not addressed in the contract.

Collateral Requirements of Counterparties / Thresholds

The Policy		Interest Rate Swaps	
Counterparty Credit Rating S&P / Moody's	Maximum NTE - Net of Collateral	Counterparty Credit Rating S&P / Moody's	Maximum NTE - Net of Collateral
AAA / Aaa Category	\$35 million		
AA / Aa Category	\$30 million	A / A2 and above	Infinite
A / A Category	\$20 million	A- / A3	\$10 million
BBB+ / Baa1 or Below	\$0 million	BBB+ / Baa1 or Below	\$0 million



Org	Responsible Unit	Counterparty	Rated Entity	Qualifying Rating A- / A3	Bond Rating (S&P / Moody's)	Derivative Type	Expires	Underlying Asset/Liability	Orig Contract (in Millions)	Current Notional / Contract (in Millions)	Market Value (in Millions)	MTM or NTE (in Mill)	Univ Guarantee Limit (in Mill)	CP Threshold	
Financial Hedges (Interest Rate Swaps):															
Univ	Capital Financing	Morgan Stanley Capital Services, Inc.	Morgan Stanley Capital Services, Inc.	A- / Baa2		Int Rate Swap	8/15/2021	COPs 2004	\$ 143.67	110.75		(12.87)		Predated Exception	
Univ	Capital Financing	Morgan Stanley Capital Services, Inc.	Morgan Stanley Capital Services, Inc.	A- / Baa2		Int Rate Swap	1/15/2022	UIC SC 2008	\$ 27.40	23.60		(2.90)		Predated Exception	
									SUBTOTAL MS	\$ 171.07	134.35	(15.77)			
Univ	Capital Financing	JP Morgan Chase Bank, N.A.	JP Morgan Chase Bank, N.A.	A+ / Aa3		Int Rate Swap	1/15/2022	UIC SC 2008	\$ 26.85	23.18		(2.84)		Predated Exception	
Univ	Capital Financing	Loop Financial Products, I, LLC	Deutsche Bank	A / A2		Int Rate Swap	10/1/2026	HSFS 2008	\$ 40.88	35.59		(4.42)		Predated Exception	
									SUBTOTAL Financial	\$ 238.80	193.12	(23.03)			
Physical Hedges (Energy Forward Purchases):															
PEI	Utilities Admin	Sequent Energy Management, LP	AGL Resources (PCG)	BBB+ / Baa1		Forward Purchase	6/30/2015	Natural Gas Mult FY15	\$ 16.79	15.55					
PEI	Utilities Admin	Sequent Energy Management, LP	AGL Resources (PCG)	BBB+ / Baa1		Forward Purchase	6/30/2016	Natural Gas Mult FY16	\$ 7.69	7.69					
PEI	Utilities Admin	Sequent Energy Management, LP	AGL Resources (PCG)	BBB+ / Baa1		Forward Purchase	6/30/2017	Natural Gas Mult FY17	\$ 0.80	0.80					
									SUBTOTAL Sequent	\$ 25.28	24.04	23.02	(1.02)	35.00	Predated Exception
PEI	Utilities Admin	Exelon Generation Company	Exelon Generation Company	BBB / Baa2		Forward Purchase	6/30/2015	Electricity Mult FY15	\$ 2.75	2.43					
PEI	Utilities Admin	Exelon Generation Company	Exelon Generation Company	BBB / Baa2		Forward Purchase	6/30/2016	Electricity Mult FY16	\$ 3.61	3.61					
PEI	Utilities Admin	Exelon Generation Company	Exelon Generation Company	BBB / Baa2		Forward Purchase	6/30/2017	Electricity Mult FY17	\$ 2.01	2.01					
									SUBTOTAL Exelon	\$ 8.37	8.05	8.48	0.43	Unlimited	Predated Exception
PEI	Utilities Admin	NRG Power Marketing, LLC	Barclays Bank (LOC)	A / A2		Forward Purchase	6/30/2015	Electricity Mult FY15	\$ 2.19	1.94	1.58	(0.36)	1.00	LOC Exception	
									SUBTOTAL Physical	\$ 35.84	34.03	33.08	(0.95)	36.00	
									TOTAL	\$ 274.64	227.15	(23.98)			

*Negative termination value means the University or PEI is obligated to the counterparty (transaction is "underwater").
 LOC - Letter of Credit provided
 PCG - Parental Company Guarantee provided