OFFICE OF CITY CONTROLLER

CITY OF HOUSTON
INTER OFFICE CORRESPONDENCE

To	Mayor Bill White City Council Members	**From**	Annise D. Parker City Controller
		Date	January 28, 2005
		Subject	**December 2004 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending December 31, 2004.

GENERAL FUND

We are currently projecting a $17.2 million shortfall for the general fund in FY05, or $6.5 million less than predicted in November 2004. Overall, we are projecting a net $387 thousand increase in revenues and a net decrease of $6.1 million in expenditures. The more significant changes can be summarized as follows:

Revenues

- The property tax estimate has increased by $1.269 million based on updated property value estimates received from HCAD and an increase in our estimate of delinquent collections.
- The sales tax estimate increased by $2.5 million based on higher than anticipated receipts through December.
- Electric franchise revenues have increased by $1 million and gas franchise revenues have increased by $500 due to higher than anticipated receipts.
- Charges for services (primarily ambulance fees) have decreased by $3.4 million and Municipal Courts fines and forfeits have decreased by $1.388 million. Based on year-to-date activity, we do not believe that ambulance fees and moving violations will come in at levels originally expected.

Expenditures

- The Police Department's expense projection was decreased by $5.4 million (back to current budget) to reflect the use of bond funds to purchase the tasers and to reflect departmental savings.

Note that General Government expenses are shown to have increased by $22.4 million. This is because the negative police pension expense budget that was shown in previous MFORS ($22.9 million) has been removed since the City has now received the pension bond proceeds ($22.8 million) that this line item represented. This is not an actual increase in expenses, but rather a presentation issue. General Government expenses actually decreased by $483 thousand for various minor projection changes.

ENTERPRISE FUNDS

There are no significant changes in the Aviation or Convention and Entertainment Facilities Funds this month.

Revenues for the Combined Utility System Fund were reduced by $21.8 million based on an analysis of year to date receipts by PWE.

COMMERCIAL PAPER AND BONDS

In December, the City refunded $160.9 million of general obligation commercial paper with Public Improvement Bonds Series 2004B. The City also issued a $22.9 million variable rate note for the Houston Police Pension Officers Pension System.

The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. At month-end, the ratio for each type of outstanding debt was:

General Obligation	14.5%
Combined Utility System	19.5%
Aviation	17.4%
Convention and Entertainment	27.4%

SWAP REPORT

The City's Swap Policy specifies that the City will track and report on the financial implications of its swap agreements on a quarterly basis. The report is to include a summary of key terms of the agreements, mark-to-market value, exposure to counterparties, credit ratings of counterparties or guarantors, and any collateral posted as a result of the Swap agreements. The report for December 31, 2004 is included as an attachment to this letter.

Respectfully submitted,

Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
December 31, 2004

I. General Obligation Swap

On February 20, 2004 the City entered into a basis swap referred to as a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC"). This swap was a negotiated transaction.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. The City will pay a variable rate and receive a fixed rate of return on a notional principal value of $200,000,000, with the underlying bonds being various maturities of PIBS issued between 1998 and 2002. The City pays an amount equal to 5% plus the tax-exempt market standard BMA Index rate divided by .667 minus the taxable six-month US Dollar LIBOR rate minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5% from RFPC. Because the two 5% fixed rates offset one another, the City is effectively making payments based on BMA and receiving payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2025. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023.

Receipts. Based on the initial agreement, the City will receive its first payment of $500,000 on March 1, 2005. After that date a payment will be received or made every six months based on the indexes for the prior budget period. The receipt on September 1, 2005 will be $297,200, resulting in an effective rate of 4.89% for the underlying bonds, or a savings of 30 basis points (0.30%).

Fair value. The fair value of the swap was negative $2,403,000 as of December 31, 2004. The value was calculated using the zero coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of December 31, 2004, the City was not exposed to credit risk because the swap had a negative fair value. However, if interest rates change and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. RFPC has not been rated by the rating agencies. To mitigate the potential credit risk, the City required RFPC to purchase a surety bond from Ambac Assurance Corporation, a AAA rated insurance company. Ambac also insures the City's obligations under the swap. Should Ambac's rating decline in the future, RFPC will be required to post collateral for the City's benefit.

Interest rate risk. The City has an exposure to interest rate risk because it is paying a variable rate on the swap. However, this risk is mitigated because the payment formula has a BMA-based variable component that is offset by subtracting a LIBOR variable component.

Basis risk. The City is exposed to basis risk based on changes in the relationship between the taxable six-month US Dollar LIBOR index and the tax-free BMA index. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of BMA and LIBOR in different interest rate, tax, and economic environments over the past two decades. If, however, future trading patterns prove to be significantly different from historical ones, the City's anticipated savings could fail to materialize, and it could be exposed to additional costs. Among the factors that could cause this trading relationship to change would be a major reduction in marginal income tax rates, repeal of the tax-exemption for municipal bond interest, or other changes in federal policy that would reduce the benefit that municipal bonds currently enjoy in comparison to taxable investments.

Termination risk. The City may terminate the swap for any reason. RFPC may terminate the swap if both the City and the City's insurer fail to perform under the terms of the contract. If the swap has a negative fair value at the time of termination, the City will be liable to RFPC for that payment. The City's termination risk is significantly mitigated by a provision in the swap agreement that allows the City to make the termination payment in equal annual installments from time of termination up to the termination date of the agreement in 2025.

II. Combined Utility System Swaps

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements with identical rates. The City pre-qualified six firms to submit competitive bids on the swap. The bidding took place on June 7, 2004. The three firms selected all matched the lowest fixed rate bid of 3.7784%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates in conjunction with the City's Combined Utility System 2004B auction rate variable interest bonds ("2004B Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt at time of issuance of the 2004B Bonds.

Terms. The notional amounts of the swap agreements total $653,325,000, the principal amount of the associated 2004B Bonds. The City's swap agreements contain scheduled reductions to outstanding notional amounts that follow anticipated payments of principal of the 2004B Bonds in varying amounts during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.7784% (lower than the rate for fixed rate debt at time of issuance) and receive a floating rate equal to 57.6% of One-Month US Dollar LIBOR plus 37 basis points. All agreements were effective June 10, 2004, the date of issuance of the 2004B Bonds. The termination date is May 15, 2034.

Receipts and Payments. The City received $5.0 million total in swap receipts for its Combined Utility System, Series 2004B swap, through December 31, 2004, and it paid $5.4 million on the underlying auction rate securities. The contractual rate for the City's swap payment is 3.78%. Its average effective rate for the 2004B bonds, including payments for the Series 2004B variable rate bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 4.09%. In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, which have a comparable maturity, was 5.08%.

Fair value. Because interest rates have declined, the swaps had a negative fair value of $41,800,000 as of December 31, 2004. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of December 31, 2004, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase and the fair value of the swap become positive, the City would be exposed to credit risk on the swap in the amount of its fair value. The City's swap policy generally requires that swap counterparties be rated double-A or better by at least one nationally recognized rating agency. As of December 31, 2004, the ratings of the three swap counterparties all met this standard (see below). Also, under the agreements, if a counterparty's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's /S&P /Fitch)
Goldman Sachs Capital Markets LP	$353,325,000	$(22,606,000)	Aa3 /A+ /AA-
Bear Stearns Capital Markets Inc.	150,000,000	(9,597,000)	Aaa / AAA / --
UBS AG	150,000,000	(9,597,000)	Aa2 /AA+ /AA+
TOTAL	$653,325,000	$ (41,800,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. The City has issued tax-exempt auction rate bonds with an average rate of 1.78% (not including dealer and auction agent fees) on December 31, 2004, whereas the associated LIBOR-based rate of the swap receipts at that time was 1.75%.

Termination risk. The City may terminate for any reason. A counterparty may terminate a swap if the City fails to perform under the terms of the contract. The City's on-going payment obligations under the swap (and to a limited extent, its termination payment obligations) are insured, and counterparties cannot terminate so long as the insurer does not fail to perform. If a swap should be terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.