OFFICE OF THE CITY CONTROLLER

CITY OF HOUSTON
INTEROFFICE CORRESPONDENCE

TO:	Mayor Bill White City Council Members	**From:**	Annise D. Parker City Controller
		Date:	April 28, 2006
		Subject:	**March 2006 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending March 31, 2006.

GENERAL FUND

We are currently projecting a $29.6 million surplus for the General Fund for Fiscal Year 2006.

Revenues

We have made several significant changes in our revenue projections this month to reflect ongoing economic improvements that are helping to boost property tax and sales tax revenues. Our estimate of Property Tax Revenues has grown by $11.1 million due to a higher certified tax roll from the Harris County Appraisal District. Actual Sales Tax Revenues for February were $5.4 million higher than the same month a year ago. Year-to-date sales tax revenues are running about 11% higher than last year and the trend is expected to continue. As a result, we are increasing our sales tax projection by $10 million. We are also increasing our projection for Other Fines and Forfeits by $1.3 million based on higher than expected year-to-date collections. Finally, true-ups in Gas Franchise Fees and Direct Interfund Services resulted in decreases of $2 million and $2.5 million, respectively.

Expenditures

Our projection for expenditures has decreased by a net of $4.6 million. Spending at HPD is down by $4.3 million due to lower than anticipated overall personnel costs. Staff vacancies in Finance and Administration account for another $1.7 million in personnel cost savings. These spending reductions are offset by true ups by various departments including a $1.6 million increase in natural gas costs and other maintenance expenditures within the Building Services Department and a $1 million increase in the Health Department budget that is attributed to the expenditure of grant funds that will not be reimbursed by the Texas Natural Resources Commission and The Texas Commission on Environmental Quality.

ENTERPRISE FUND

There are no significant changes this month in our projections for Aviation and Convention and Entertainment.

Combined Utility System non-operating revenues are increasing by $1 million to reflect higher than budgeted facility rental revenues from the E. B. Cape Center. Operating Expenses increased by $1.6 million, primarily due to an increase of $2.3 million for revised Electricity and Gas projections and a decrease of $627 thousand in personnel costs for unfilled positions and corresponding savings in spending on employee benefits.

OTHER FUNDS

Several of the Funds reported in the Quarterly MFOR reflect the following significant changes.

- A $1 million reduction in the Health Benefits Fund due to lower than anticipated costs.
- A $4.8 million decline in the Property and Casualty Fund to reflect lower than budgeted payments for Claims and Judgments.
- A $5.4 million reduction in projected Workers' Compensation costs due to lower year-to-date claims.
- A $2.1 million increase in the Asset Forfeiture Fund due to higher than expected Federal Judgments.
- A $2.2 million decrease in the Building and Inspection Fund to reflect due to lower than expected permit activity.
- A $2.9 million decline in projected revenues for the Police Special Services Fund is attributed to delays in implementation of the red light camera program. The delays have also caused a $5.4 million decline in anticipated expenditures

COMMERCIAL PAPER AND BONDS

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	18.7%
Combined Utility System	20.4%
Aviation	21.7%
Convention and Entertainment	28.0%

SWAP REPORT

The City's Swap Policy requires a quarterly report on the financial implications of its swap agreements. The report includes a summary of key terms of the agreements, mark-to-market values, exposure to counterparties, credit ratings of counterparties or guarantors, summary of risks, and disclosure of any collateral posted as a result of the swaps. The report for March 31, 2006 is attached.

Respectfully submitted,

Annise D. Parker

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City Controller

City of Houston, Texas
Swap Agreements Disclosure
March 31, 2006

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. On a notional value of $200 million, 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. Payments will be received or made every six months based on indices for the prior 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 received $500,000 on March 1, 2005, representing debt service savings of 50 basis points (0.5%) on the underlying bonds. Receipts for fiscal year 2006 totaled $499,000. Receipts for fiscal year 2007 will total $758,000 for a savings of 38 basis points. Future payments will be received or made every six months based on the indices for the prior budget period.

Fair value. The fair value of the swap was $601,000 on March 31, 2006. The value was calculated using the zero coupon method.

Credit risk. The City is exposed to credit risk equal to the swap's positive fair market 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-exempt 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.

IIa. Combined Utility System Swaps - Synthetic Fixed Swap

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 three firms selected all matched the lowest fixed rate bid of 3.78%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates associated with the City's Combined Utility System 2004B auction rate variable interest 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 3.78% 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 earned $13.3 million in swap receipts for its Combined Utility System, Series 2004B swaps, and it paid $13.3 million interest on the underlying auction rate securities for the nine months ended March 31, 2006. The contractual rate for the City's swap payment is 3.78%. The average effective rate for the 2004B bonds, including interest for the Series 2004B variable rate bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 4.03%. 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 changed, the swaps had a total negative fair value of $29,288,000 on March 31, 2006. This value was calculated using the zero-coupon method.

Credit risk. As of this date, 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 this date, 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 and swap fair value. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's/S&P/Fitch)
Goldman Sachs Capital Markets Inc.	$ 353,325,000	$ (15,840,000)	Aa3 /A+ /AA-
Bear Stearns Financial Products Inc.	150,000,000	(6,724,000)	Aaa / AAA / --
UBS AG	150,000,000	(6,724,000)	Aa2 /AA+ /AA+
	$ 653,325,000	$ (29,288,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on a taxable index other than the tax-exempt rate paid by the City on the bonds. Should the relationship between taxable LIBOR and tax-exempt BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. For the entire period, the variable LIBOR- based rate received for the swap was 2.67%, which equaled the rate paid on the underlying tax-exempt bonds. At March 31, 2006 the average interest rate in effect for the underlying bonds was 3.065%, which was 4 basis points lower than the rate of the swap receipts at 3.105%.

Remarketing risk. The City faces a risk that the remarketing agent will not be able to sell the auction rate debt at a competitive rate.

Supply and Demand Risk. As investors shift portfolios in and out of the tax-exempt variable rate sector, yields are impacted. This is a common problem during the April to June quarter when there is a lower supply of short-term investment funds.

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 is terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if the swap has a negative fair value at termination, the City would be liable to the counterparty for a payment equal to the swap's fair value.

IIb. Combined Utility System Swap – Forward Rate Lock

On November 1, 2005 the City priced a floating to fixed interest rate exchange agreement swap with Royal Bank of Canada ("RBC") on a forward basis. The City pre-qualified eight firms to submit competitive bids, and RBC submitted the lowest bid of 3.761%.

Objective. The objective of the swap is to hedge against rising interest rates by locking in a historically low long-term interest rate on a synthetic basis. The deal was done in anticipation of issuing fixed rate bonds to refund variable rate debt at the end of 2007.

Terms. The notional amount of the swap is $249,075,000 with the underlying bonds being part of the Combined Utility System Series 2004C Auction Rate Bonds that will convert to a tax-exempt status in December 2007. The swap agreement contains scheduled reductions to the outstanding notional amount that follows anticipated payments of principal of the 2004C Bonds during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.761% and receive a floating rate equal to 70% of One-Month US Dollar LIBOR. The agreement will become effective December 3, 2007 with a termination date of May 15, 2034.

Receipts and Payments. No receipts or payments are scheduled until December 2007.

Fair value. Because interest rates have changed, the swap had a positive fair value of $2,898,000 on March 31, 2006. This value was calculated using the zero-coupon method.

Credit risk. 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 this date, RBC met this requirement with ratings of Aa2/AA/AA-. Also, under the agreement, if RBC's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating and swap fair value. No collateral has been required to date.

Basis risk. The City will be exposed to basis risk on the swap because the variable payment received is based on a taxable index other than the tax-exempt rate paid by the City on the bonds. In the future, if the tax-exempt BMA index moves to convergence with the taxable LIBOR index (because of reductions in tax rates, for example), the expected cost savings may not be realized.

Termination risk. The City may terminate for any reason. RBC 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 RBC cannot terminate so long as the insurer does not fail to perform. If a swap is terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if the swap has a negative fair value at termination, the City would be liable to the counterparty for a payment equal to the swap's fair value.