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 25, 2008

Subject: **March 2008 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending March 31, 2008.

GENERAL FUND

We are now projecting an end of year budget surplus of $7.6 million. This is the net impact of an increase in revenue projections of $744,000 and expenditure projection decreases of $5.4 million.

Due to final valuations being received from HCAD, we are increasing our projection for Industrial Assessments by $1.9 million. Our projection for Telephone Franchise Fees is $1 million higher than last month to reflect higher than anticipated year-to-date collections. The trend in Municipal Courts Fines & Forfeits is not quite as positive, prompting a $2.3 million decrease in our end-of-year projection for this revenue category. About $666,000 worth of increases in Direct Interfund and Miscellaneous Other revenues have been almost entirely offset by a decrease in our projection for Indirect Interfund revenues. All three of these changes are based on year-to-date collections.

Our expenditure projection for Fire has decreased $5.4 million from last month's report due to lower than anticipated costs for overtime and termination pay, as well as a delay in implementation of a telemetry contract. Lower personnel costs are also the reason for decreases of $259,000 and $352,000 in Health Department and Municipal Courts spending, respectively. Information Technology anticipates increased spending of about $1.4 million to cover additional SAP implementation costs. The portion of PWE's budget covered by the General Fund has increased $375,000 due to spending for vehicle repairs and electrical parts. Finally, we have decreased our projection for Solid Waste by $497,000 to reflect lower than anticipated debt service costs.

ENTERPRISE FUNDS

The Interest Revenue projection for the Aviation Department has decreased $600,000 from last month due to lower interest rates. This is also the reason for an $5.3 million decrease in our projection for Debt Service Interest. Renewal & Replacements costs are down by $4.7 million because a pavement replacement project has been delayed until FY 09. The decreased spending in these three areas causes a corresponding increase of $9.9 million in the Capital Improvement line item.

In the Convention & Entertainment Facilities Operating fund, we have decreased our projection for Facility Rentals by $271,000 to reflect several true-ups in the event schedule thru the end of the year. We have decreased our projection for Services expenses by $510,000 because of lower than expected spending for building maintenance services. We are projecting an increase of $2 million in current Hotel/Motel tax revenues, and a corresponding increase in Advertising and Promotion Contract expenses of $826,000. The projection for Capital Outlay expenses decreased by $981,000 due to projects transferred to the C&E construction fund. Finally, our projection for Transfers from Special funds has increased $2.8 million to reflect additional FEMA reimbursements to be received from the Disaster Recovery Fund.

Our projection for the Combined Utility System Operating Revenues decreased $1.8 million. Once again, this is due to lower than anticipated water sales. The projection for operating expenses decreased $8.8 million to adjust for decreased spending on insurance, pump repairs, site work services and non-capital equipment. Non-operating revenue increased $5 million for an anticipated property sale to Unity Church on Fairdale Street before year-end. Our projection for System Debt Service increased $2.7 million for additional closing costs associated with conversion of auction rate debt to other variable rate debt.

In the Stormwater fund, we have reduced our projection for spending on personnel by $497,000 to reflect current staffing levels. There is also a $669,000 decline for Other Services due to year-to-date spending trends.

We are not projecting any significant changes in the Parking Management fund this month.

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. The City plans to refund most of its Airport System commercial paper in the spring as well as $250 million auction rate debt. Convention and Entertainment issued a higher percentage of variable rate debt based on agreements with the Hotel Corporation.

As of March 31, 2008 the ratio for each type of outstanding debt was:

General Obligation	17.8%
Combined Utility System	12.8%
Aviation	23.1%
Convention and Entertainment	29.4%

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, 2008 is attached.

Since November 2007 the City has been paying considerably higher auction rates than it has been receiving on its LIBOR based swap indexes. Our bond documents specify that the City consider its Combined Utility System auction bonds hedged by swaps to be categorized at the swap fixed rate. When the hedges are not fully effective, the variable rate exposure is understated.

In April 2008 the City was successful in converting $653 million of Combined Utility auction rate bonds to a variable rate demand bond structure with rates that align more closely with our swap receipts. We have issued conversion notices for an additional $249 million of Combined Utility auction rate debt. By mid-May our variable rates should align much more closely with our swap receipts.

Respectfully submitted,

Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
March 31, 2008

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 to reduce the City's 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 the market standard SIFMA Index rate divided by .667, up to a maximum of 10%, and receives the taxable six-month US Dollar LIBOR rate plus a constant of 69 basis points. 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. From inception to date the City has received $3.1 million from the swap. To date, the City has always been a net recipient. Revenue for fiscal year 2009 will be $2.1 million. Future payments will be received or made every six months based on the indices for the prior budget period.

Fair value. The estimated fair value of the swap was positive $1.5 million on March 31, 2008. The value was calculated using the zero coupon method.

Credit risk. The City is exposed to credit risk when the swap has a 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, ("Ambac"). Ambac also insures the City's obligations under the swap. As of April 17, 2008, Ambac was rated Aaa by Moody's, AAA by Standard and Poor's, and AA by Fitch. All the rating agencies have Ambac on credit watch. Should Ambac's ratings decline in the future and fair value reaches certain positive thresholds, 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 SIFMA-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 SIFMA index. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of SIFMA 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 market changes in the indices, 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

A. Combined Utility System Synthetic Fixed Rate Swap

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements ("the 2004B Swaps") related to the Combined Utility System 2004B auction rate variable interest bonds ("the 2004B Bonds"). The City pre-qualified six firms to submit competitive bids on the swaps. The three firms selected all matched the lowest fixed rate bid of 3.78%. (As of April 14, 2008 the City has converted all the 2004B bonds from auction rate to variable rate demand bonds.)

Objective. The objective of the swaps is to hedge against the potential of rising interest rates associated with the 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. The City's goal is that its variable receipts under these swaps equal the variable payments made on the auction rate bonds, leaving the fixed payment on the swap, plus dealer and auction fees, as its net interest cost.

Terms. The notional amounts of the swap agreements total $653.3 million, 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. For the nine months ended March 31, 2008, the City earned $15.5 million in swap revenue for its 2004B swaps and paid $22.0 million interest on the underlying auction rate securities. 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 bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 5.33%. In contrast, the comparable fixed rate the City paid on its Combined Utility System Series 2004A bonds, was 5.08%.

Fair value. Because interest rates have changed, the swaps had an estimated negative fair value of $81.0 million on March 31, 2008. 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 change 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	$ (43,792,000)	Aa3 /AA- /AA-
Bear Stearns Financial Products Inc.	150,000,000	(18,591,000)	Aaa / AAA / --
UBS AG	150,000,000	(18,591,000)	Aa1 /AA- /AA-
	$ 653,325,000	$ (80,974,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on a different taxable index from the tax-exempt rate paid by the City on the bonds. Should the relationship between taxable LIBOR and tax-exempt rates move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. Cost savings were not realized in the most recent quarter because of disruptions in the auction rate market and downgrading of the insurer, XL Capital. The City's generally paid interest at the failed-auction rate, which is 2.5 times the LIBOR index rather than 70% of LIBOR as expected. For the nine months ended March 31, 2008 the average variable rate paid on the underlying tax-exempt bonds was 4.41%, 1.30% higher than the average 3.11% LIBOR-based rate received for the swap. At March 31, 2008 the interest rate in effect for the underlying bonds was 6.67%, 4.68% higher than the 1.99% rate in effect for the swap receipts. (As of April 15, 2008, all the auction rate bonds had been converted to variable rate demand bonds paying an average interest rate of 1.96% compared to a swap receipt rate of 1.93%.)

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. Rates may vary considerably as investors shift in and out of the tax-exempt variable rate sector.

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.

B. Combined Utility System Forward Rate Lock/Synthetic Fixed Rate Swap

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 the potential of rising interest rates associated with half of its Combined Utility System Series 2004-C2 Auction Rate Bonds ("the 2004C Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt. The City's goal is that its variable receipts under these swaps equal the variable payments made on the auction rate bonds, leaving the fixed payment on the swap, plus dealer and auction fees, as its net interest cost.

Terms. The notional amount of the swap is $249.1 million with the underlying bonds being half of the Series 2004C Bonds that converted to 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 terms of the swap, the City pays a fixed rate of 3.761% and receives a floating rate equal to 70% of One-Month US Dollar LIBOR. The agreement became effective December 3, 2007 with a termination date of May 15, 2034.

Receipts and Payments. Since inception the City has earned $2.4 million in swap revenue for its 2004C swap and paid $4.2 million interest on the underlying auction rate securities. The contractual rate for the City's swap payment is 3.761%. The average effective rate for the 2004C bonds, including interest for the Series 2004C bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 6.31%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of $22.5 million on March 31, 2008. 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 Aaa/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 tax-exempt rates move to convergence with the taxable LIBOR index (because of reductions in tax rates, for example), the expected cost savings may not be realized, resulting in a higher synthetic rate. Cost savings were not realized in the most recent quarter because of disruptions in the auction rate market and downgrading of the insurer, Ambac. The City's generally paid interest at the failed-auction rate, which is 2.0 times the LIBOR index rather than 70% of LIBOR index as expected. At March 31, 2008 the interest rate in effect for the underlying auction rate bonds was 5.36%, 3.39% higher than the 1.97% rate in effect for the swap receipts. (The City expects to refund the underlying bonds with variable rate demand obligations on May 8 and 9, 2008.)

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.

C. Combined Utility System Constant Maturity Swap

On August 31, 2006 the City priced a constant maturity swap with Goldman Sachs Capital Markets, Inc. ("Goldman") on a forward basis. Seven firms submitted bids, and Goldman submitted the highest bid of 64.29% of Ten-Year LIBOR in exchange for the City's payment of 70% of One-Month US Dollar LIBOR.

Objective. This swap essentially trades receipts on the forward rate lock with RBC for receipts based on a longer index. The objective of the swap is to minimize interest expense associated with the 2004C Bonds. The City's goal is that over time, as the yield curve returns to its normal ascending slope, receipts from this swap will exceed the payments made on the swap.

Terms. The notional amount of the swap is $249.1 million with the underlying bonds being part of the 2004-C2 Bonds that converted to 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 terms of the swap, the City pays a variable rate of 70% of One-Month LIBOR (equal to its receipts on the RBC forward rate lock swap) and receives a variable rate equal to 64.29% of Ten-Year US Dollar LIBOR. The agreement became effective December 3, 2007 with a termination date of May 15, 2034.

Receipts and Payments. Through March 31, 2008 the City has made net payments of $4,000 on the swap.

Fair value. As a result of changes in the swap yield curve, the estimated fair value of the swap at March 31, 2008 was positive $10.0 million. The amount was calculated using the zero-coupon method.

The authorizing ordinance allows the Mayor and City Controller to terminate this swap if they deem appropriate. The Mayor and City Controller recently authorized the staff to terminate the swap when the market is propitious for the City.

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, Goldman met this requirement with ratings of Aa3/AA-/AA-. Also, under the agreement, if Goldman'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 is exposed to basis risk on the swap because the variable payment received is based on a longer-term index than the rate paid by the City on the swap. The economics of the swap for the City are dependent on an upwardly sloping yield curve. If the 10-year LIBOR rate is not sufficiently above the One-Month LIBOR index, the expected cost savings will not be realized, resulting in a higher synthetic rate. This type of basis risk is also known as yield curve risk.

Termination risk. The City may terminate for any reason. Goldman may terminate a swap if the City fails to perform under the terms of the contract. If the swap is terminated, the City would revert to receipts on the One-Month LIBOR index on its 2004C Bonds. Also, if the swap has a negative fair value at termination, the City would be liable to Goldman for a payment equal to the swap's fair value.