

OFFICE OF THE CITY CONTROLLER

**CITY OF HOUSTON
INTEROFFICE CORRESPONDENCE**

To: Mayor Bill White
City Council Members

From: Annise D. Parker
City Controller

Date: October 26, 2007

**Subject: September 2007
Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2007.

GENERAL FUND

We are projecting a \$4 million budget surplus. This represents a \$1.5 million decrease from last month to correctly reflect the deposit of funds from the Bolsover Street sale in the Limited Use Mobility Fund.

Our projection for general fund expenditures have not changed from last month's report.

ENTERPRISE FUNDS

We are currently projecting the Aviation, Convention & Entertainment, and Stormwater enterprise funds at budget.

The revenue projection for the Parking Management Operating Fund has been increased \$500,000 to reflect an anticipated revenue increase from the recent installation of 440 additional parking meters.

The wet weather is continuing to impact the Combined Utility System (CUS). Rainfall for September, although lower than average, was spread out evenly over the month, prompting an \$8 million additional decrease in projected water and sewer revenues, on top of last month's decrease of \$12 million.

COMMERCIAL PAPER AND BONDS

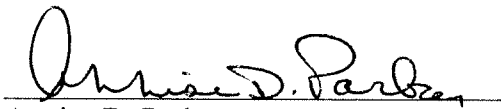
The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. The City refunded part of its Airport System Commercial Paper Notes with fixed rate debt in September and will refund the remaining notes later in the year. The Airport System also maintains high investment balances that hedge against increases in variable rate debt payments. Convention and Entertainment issued a higher percentage of variable rate debt based on agreements with the Hotel Corporation. As of September 30, 2007, the ratio for each type of outstanding debt was:

General Obligation	19.9%
Combined Utility System	15.6%
Aviation	22.0%
Convention and Entertainment	29.3%

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 September 30, 2007 is attached.

Respectfully submitted,



Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
September 30, 2007

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 the market standard BMA 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. Through September 30, 2007 the City has received \$2.3 million from the swap. Revenue for fiscal year 2008 will be \$1.4 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 \$5.3 million on September 30, 2007. 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 is rated Aaa by Moody's and AAA by Standard and Poor's and Fitch. 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.

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%.

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 quarter ended September 30, 2007, the City earned \$5.9 million in swap revenue for its 2004B swaps and paid \$6.2 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 4.19%. In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, priced a month earlier with a comparable maturity, was 5.08%.

Fair value. Because interest rates have changed, the swaps had an estimated negative fair value of \$31.3 million on September 30, 2007. 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	\$ (7,186,000)	Aa3 /AA- /AA-
Bear Stearns Financial Products Inc.	150,000,000	(7,186,000)	Aaa / AAA / --
UBS AG	150,000,000	(16,926,000)	Aaa /AA /AA+
	<u>\$ 653,325,000</u>	<u>\$ (31,298,000)</u>	

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. For the quarter ended September 30, 2007 the average variable rate paid on the underlying tax-exempt bonds was 3.69%, 16 basis points higher than the average 3.53% LIBOR-based rate received for the swap. At September 30, 2007 the interest rate in effect for the underlying bonds was 3.77%, 9 basis points higher than the 3.68% rate in effect for the swap receipts.

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 was 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 additional fixed rate bonds to refund variable rate debt at the end of 2007. On July 10, 2007 the City issued Combined Utility System Revenue Refunding Bonds Series 2007A at a rate of 4.8%.

The City is leaving the swap in effect as a synthetic fixed rate swap as a hedge against the potential of rising interest rates associated with its Combined Utility System Series 2004C Auction Rate Bonds ("the 2004C Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt.

Terms. The notional amount of the swap is \$249.1 million with the underlying bonds being part of the Series 2004C 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 terms of the swap, 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 an estimated positive fair value of \$1.6 million on September 30, 2007. 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.

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. This swap was approved by the Attorney General and executed in November 2006.

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 2004C 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 terms of the swap, the City will pay a variable rate of 70% of One-Month LIBOR (equal to its receipts on the RBC forward rate lock swap) and receive a variable rate equal to 64.29% of Ten-Year 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. If the contract were in effect at the rates effective October 22, 2007, the City's annualized net payment would be \$438,585.

Fair value. As a result of changes in the swap yield curve, the estimated fair value of the swap at September 30, 2007 was positive \$1.7 million. The amount 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, 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 will be 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.