

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 28, 2008

Subject: September 2008
Financial Report

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2008.

GENERAL FUND

We are currently projecting a shortfall of \$55 million. This is down by about \$11 million from last month. The change is due almost entirely to an \$11.5 million increase in our overall revenue projection. The projection for Property Tax revenues is up by \$9.4 million to account for a higher than expected tax roll. There are also increases of \$750,000 in Intergovernmental revenues for additional TIRZ service fees and an increase of \$2 million in Misc/Other revenues to reflect receipt of a settlement payment from Republic Waste. Our projection for Sales Tax is down by \$710,000 due to lower consumer spending in August. This line item is extremely sensitive to economic conditions and will require careful scrutiny over the next three months.

There are no changes in our total General Fund expenditure projections. Preliminary Hurricane Ike projections are reported on page 5. The reimbursements are estimates, pending FEMA approval.

The FY 09 budget adopted by City Council anticipated drawing down the fund balance by \$51 million. This is not reflected in our projections, which is part of the reason we are projecting such a large shortfall.

ENTERPRISE FUNDS

The projection for Aviation Department Operating Revenue has decreased \$10.8 million, primarily in Building and Ground Area fees and Parking and Concession fees, reflecting not only Hurricane Ike's effect, but also a lower than expected passenger volume attributed to the slowdown in the economy. Our projection for Operating Expenses increased \$908,000. This is tied to higher costs for electricity and natural gas. Finally, our projection for Interest Income is down \$1.5 million due to lower than anticipated interest rates.

In the Convention & Entertainment Facilities (CEF) Operating fund we have decreased our revenue projection for Facility Rentals by \$250,000 to account for event cancellations due to Hurricane Ike. Higher electricity and natural gas costs are the reason for an increase of \$588,000 in our projection for the Services line item.

Our projection for Combined Utility System (CUS) Operating Expenses is up by \$4 million. This is for Equipment Services and Equipment Acquisition. This is offset by a decrease of \$4 million in Operating Transfers for equipment acquisition.

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 approximately \$400M of its GO Commercial paper next month. Plans to refund its Airport System commercial paper and \$250 million of Airport's auction rate debt have been on hold pending improvements in market conditions. Convention and Entertainment maintains a higher percentage of variable rate debt due to agreements with the Hotel Corporation.

At September 30, 2008, the ratio for each type of outstanding debt was:

General Obligation	21.0%
Combined Utility System	7.9%
Aviation	23.4%
Convention and Entertainment	29.2%

Respectfully submitted,



Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
September 30, 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 \$3.6 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 negative \$4.3 million on September 30, 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 September 30, 2008, Ambac was rated Aa3 by Moody's and AA by Standard and Poor's. 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 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 bonds, leaving the fixed payment on the swap, plus dealer and liquidity 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, 2008, the City earned \$3.0 million in swap revenue for its 2004B swaps and paid \$3.9 million of interest on the underlying 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 liquidity fees, reduced by swap receipts, was 4.20%. 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 \$65.6 million on September 30, 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.

<u>Counterparty</u>	<u>Notional Amount</u>	<u>Fair Value</u>	<u>Counterparty Credit Rating (Moody's/S&P/Fitch)</u>
Goldman Sachs Capital Markets Inc.	\$ 353,325,000	\$ (35,451,000)	Aa3 /AA- /AA-
JP Morgan	150,000,000	(15,050,000)	Aa2 / AA- / --
UBS AG	150,000,000	(15,050,000)	Aa2 /AA- /AA-
	<u>\$ 653,325,000</u>	<u>\$ (65,551,000)</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. As a result of disruptions in the credit markets, expenses on the underlying variable rate demand bonds increased significantly. For the quarter ended September 30, 2008 the average variable rate paid on the underlying tax-exempt bonds was 2.32%, 0.53% higher than the average 1.79% LIBOR-based rate received for the swap. At September 30, 2008, the interest rate in effect for the underlying bonds was 7.89%, 6.09% higher than the 1.80% rate in effect for the swap receipts. Interest rates on the underlying bonds have since declined to 4.5%.

Remarketing risk. The City faces a risk that the remarketing agent will not be able to sell the variable rate demand bonds 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 its Combined Utility System Series 2008A Bonds ("the 2008A Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt. This swap was originally assigned to \$249.1 million of the 2004C auction rate bonds, which were refunded by the 2008A variable rate demand bonds in May 2008. The City's goal is that its variable receipts under these swaps equal the variable payments made on the bonds, leaving the fixed payment on the swap, plus dealer and liquidity fees, as its net interest cost.

Terms. The notional amount of the swap is \$249.1 million with the underlying bonds being the Series 2008A Bonds. The swap agreement contains scheduled reductions to the outstanding notional amount that follows anticipated payments of principal of the 2008A 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 \$4.8 million in swap revenue for this swap and paid \$8.3 million interest on the underlying securities. The contractual rate for the City's swap payment is 3.761%. The average effective rate for the bonds, including interest for the bonds, the City's swap payments, and its dealer and liquidity fees reduced by swap receipts, was 4.29%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of \$17.0 million on September 30, 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. As a result of disruptions in the credit markets, interest rates on the underlying bonds have increased. For the quarter ended September 30, 2008 the average variable rate paid on the underlying tax-exempt bonds was 2.33%, 0.60% higher than the average 1.73% LIBOR-based rate received for the swap. At September 30, 2008, the interest rate in effect for the underlying bonds was 7.25%, 5.51 % higher than the 1.74% rate in effect for the swap receipts. Higher interest rates on the underlying bonds have been partially offset by increases in the Libor-based receipt rates. By mid-October 2008 rates on the underlying bonds had declined to 3.25%.

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 September 16, 2008, the City elected to terminate this swap. The City received a termination payment of \$7 million. The original terms of the transaction are listed below.

Objective. This swap essentially traded receipts on the swap with RBC for receipts based on a longer index from Goldman Sachs. The objective of the swap was to minimize interest expense associated with the 2004C Bonds.

Terms. The notional amount of the swap was \$249.1 million with the underlying bonds being part of the 2004-C2 Bonds that converted to tax-exempt status in December 2007.

Under terms of the swap, the City paid a variable rate of 70% of One-Month LIBOR (equal to its receipts on the RBC forward rate lock swap) and received a variable rate equal to 64.29% of Ten-Year US Dollar LIBOR. The agreement became effective December 3, 2007.

Receipts and Payments. Revenue earned on the constant maturity swap totaled \$8.2 million including a \$7 million termination payment to the City.