**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 30, 2009

**Subject:** **September 2009 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2009.

**GENERAL FUND**

We are projecting a revenue shortfall of $102.4 million. This consists of the $50.7 million planned drawdown of the fund balance City Council approved in adopting the FY 10 budget and an additional $51.7 million gap between the Controller's Office and the Administration. Their revenue projections are $14 million higher than ours. In addition, they are including $15.7 million of transfers not yet approved by City Council, $14.7 million of Sale of Capital Assets not yet finalized, and a drawdown of $7.3 million from the fund balance that was not part of the Adopted Budget.

Our revenue projections remain unchanged from last month.

Expenditure projections are approximately the same as last month, but there are several changes to report including the transfer of the $4.8 million Bureau of Animal Regulation and Control from the Health Department to the Department of Administration & Regulatory Affairs. Projected spending for General Services is down $1 million, due to electricity savings. The projection for the Parks Department decreased $788,000 to account for electricity and health benefits savings. Solid Waste is down $552,000 due to savings in Refuse Disposal Fees and Personnel costs. Finance has seen an increase of $378,000, reflecting the addition of three auditing and accounting positions. Police has increased $631,000, the net impact of $2 million in additional funding for forensics testing and a decrease of $1.4 million in Civilian personnel costs. Finally, our projection for Public Works and Engineering spending is up $2 million due to electricity costs.

**ENTERPRISE FUNDS**

Our projection for Aviation Department Operating Revenues decreased $1.7 million. This is net impact of increases in Landing fees and decreases in revenues from Building and Grounds, Parking and Concessions. Operating Expenses have decreased $3.6 million due to savings in Services and Supplies. We are also decreasing Interest Income by $3 million for continued lower rates on investments.

In the Convention & Entertainment Facilities Operating Fund our projection for Services is $667,000 less than last month, reflecting 1st quarter savings in electricity, security, and janitorial services. We are also anticipating additional continued declines in HOT revenues of $864,000. This is the end result of a $1.5 million decrease in our projection for HOT tax collections and coupled with a corresponding decrease of $633,000 in the contractually-mandated Advertising and Promotion contract expenses. Finally, we are decreasing our projection for Interfund Transfers by $682,000 to reflect capital project costs moved to actual accounts.

Our projection for Combined Utility System Operating Revenues has increased $1.7 million due to higher than expected 1st quarter pumpage rates. The projection for Total Operating Expenses did not change, although savings in Supplies for chemical costs were moved to cover increases in Electricity and Contract costs.

**Mayor Bill White**
**City Council Members**
**September 2009 Monthly Financial and Operations Report**

There are no material changes to our projections for Parking Management and Stormwater funds.

## 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. As of September 30, 2009 the ratio of unhedged variable rate debt for each type of outstanding debt was:

| | |
|---|---|
| General Obligation | 3.4% |
| Combined Utility System | 4.6% |
| Aviation | 16.9% |
| Convention and Entertainment | 29.8% |

Respectfully submitted,

Annise D. Parker

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City Controller

**City of Houston, Texas**
**Quarterly Swap Agreements Disclosure**
**September 30, 2009**

## I. General Obligation Swap

On August 28, 2009, the City elected to terminate this swap. The City received a termination payment of $2.4 million. The original terms of the transaction are listed below.

Objective. On February 20, 2004 the City entered into a basis swap referred to as a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC"). The objective of the swap was 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 paid an amount equal to the market standard SIFMA Index rate divided by .667, up to a maximum of 10%, and received the taxable six-month US Dollar LIBOR rate plus a constant of 69 basis points. Payments were made every six months based on indices for the prior budget period. The original agreement became effective on March 1, 2004.

Receipts. Revenue earned on this swap totaled $7.6 million including a $2.4 million termination payment to the City.

## 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 had 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 three months ended September 30, 2009, the City earned $900,000 in swap revenue for its 2004B swaps and paid $576,000 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 4.00%. 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 $116.1 million on September 30, 2009. 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. If a counterparty's credit rating falls below rating thresholds established by the agreements, 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 | $ (62,763,000) | A1 /A /A+ |
| JP Morgan Chase | 150,000,000 | (26,645,000) | Aa3/ AA-/AA- |
| UBS AG | 150,000,000 | (26,645,000) | Aa2 /A+ /A+ |
| | $ 653,325,000 | $ (116,053,000) | |

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. For the three months ended September 30, 2009, the average variable rate paid on the underlying tax-exempt bonds was 0.35%, 0.19% lower than the average 0.54% LIBOR-based rate received for the swap. On September 30, 2009, the interest rate in effect for the swap receipts was 0.53%, 0.21% higher than the 0.32% rate in effect for the underlying bonds.

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. For the three months ended September 30, 2009, the City earned $131,000 in swap revenue for its 2008A swap and paid $203,000 of 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 4.32%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of $39.1 million on September 30, 2009. 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. For the three months ended September 30, 2009, the average variable rate paid on the underlying tax-exempt bonds was 0.32%, 0.11% higher than the average 0.21% LIBOR-based rate received for the swap. At September 30, 2009, the interest rate in effect for the underlying bonds was 0.32%, 0.13% higher than the 0.19% rate in effect for the swap receipts.

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.