



OFFICE OF THE CITY CONTROLLER  
CITY OF HOUSTON  
TEXAS

To: Mayor Annise D. Parker  
City Council Members

From: Ronald C. Green  
City Controller

Date: April 27, 2012

Subject: **March 2012  
Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending March 31, 2012.

**GENERAL FUND**

The Controller's office is projecting an ending fund balance of \$133.7 million for FY2012. This is \$28.1 million lower than the projection of the Finance Department. The difference is due to a \$17.6 million higher revenue projection from the Finance Department and a \$10.5 million higher projection for the Sale of Capital Assets from the Finance Department. Based on our current projections, the fund balance will be \$12.4 million **above** the City's target of holding 7.5% of total expenditures, excluding debt service, in reserve. This amount includes the un-designation of the \$20 million in the Rainy Day Fund in FY2011, as well as the designation of \$2.7 million of contingent funding of the DARLEP settlement, and designation of \$5 million back to the Rainy Day Fund in FY2012.

While we have increased and decreased several revenue projections, the total increased \$7.5 million over last month's projection. Property Tax was increased \$2.8 million for higher taxable values. Sales Tax was increased \$2.7 million to recognize February receipts, which were higher than expected, and we are now projecting growth of 6% for the remainder of the fiscal year. Other Taxes was increased \$300,000 for Mixed Beverage receipts above estimated. Our projection for Licenses & Permits increased \$854,000 for additional receipts of Special Fire Permits, Administrative Fees, and Dumpster permits. Charges for Services increased \$1.9 million for higher Ambulance collections. Direct Interfund was decreased \$802,000 for lower Interfund Radio Repair and Fire Protection services provided to Enterprise funds. Finally, we are decreasing Municipal Courts Fines & Forfeits \$364,000.

The major differences (over \$1 million) are still in only four categories: (1) Property Tax revenues are \$4.8 million lower than the Finance Department due to the Controller's office using a collection rate of 97.4% versus 97.7% for Finance. (2) Finance is reporting Sales Tax \$6.9 million higher than the Controller's projection. Currently four months revenues are unknown. (3) Finance is reporting Municipal Courts Fines & Forfeits \$3.2 million higher than Controller's projection. Low ticket issuance in the beginning of the fiscal year has caused the collections to be under budget. (4) Sale of Capital Assets are \$10.5 million lower than the Finance Department, as the Controller's office has not recognized all proposed land sales, which have yet to be finalized and approved by Council.

Expenditure projection increased \$346,000, primarily for Finance's increase in the amount to be paid the arts group for higher HOT Tax revenues.

Mayor Annise D. Parker  
City Council Members  
March 31, 2012, Monthly Financial and Operations Report

**ENTERPRISE FUNDS**

In the Aviation Operating Fund, we have decreased our projection for Debt Service Interest \$3.7 million for lower trending interest costs. We have also increased our projection for Capital Improvement Transfer \$3.7 million for the change above.

Within the Convention & Entertainment Facilities Operating Fund, we have increased our projection for Non-Operating revenue \$1.1 million, mainly to reflect increased HOT Tax current collections. Also, we increased our projection for Transfers to Component Unit \$3.4 million, reflecting the increased HOT Tax, as well as lower debt service.

Our projection for the Combined Utility System Operating Expenses decreased \$515,000 mainly for higher Personnel costs from line repairs, offset by decreased Contract costs for lower Water Conservation Rebate costs. We have also decreased our projection for Operating Transfers \$5.9 million mainly for lower interest costs on variable rate debt and commercial paper.

Finally, in the Stormwater Fund this month we have increased our projection for Operating Revenues \$315,000 for revenues from special projects. We also reduced our projection for Other Financing Sources \$474,000 for lower Operating Transfers In from CUS, partially offset by an decrease in Transfers Out for lower discretionary debt costs.

There were no material changes in the Dedicated Drainage & Street Renewal 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. As of March 31, 2012, the ratio of unhedged variable rate debt for each type of outstanding debt was:

General Obligation	9.6%
Combined Utility System	3.1%
Aviation	16.9%
Convention and Entertainment	18.3%

Respectfully submitted,



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Ronald C. Green  
City Controller

**City of Houston, Texas**  
**Quarterly Swap Agreements Disclosure**  
**March 31, 2012**

**I. 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 of 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 nine months ended March 31, 2012, the City earned \$2.5 million in swap revenue for its 2004B swaps and paid \$632,700 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 4.51%. 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 \$181 million on March 31, 2012. 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. 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.

<u>Counterparty</u>	<u>Notional Amount</u>	<u>Fair Value</u>	<u>Counterparty Credit Rating (Moody's/S&amp;P/Fitch)</u>
Goldman Sachs Capital Markets Inc.	\$ 353,325,000	\$ (97,880,000)	A1 /A-/A
JP Morgan Chase	150,000,000	(41,554,000)	Aa3/ A/AA-
UBS AG	150,000,000	(41,554,000)	Aa3 /A /A
	<u>\$ 653,325,000</u>	<u>\$ (180,988,000)</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 nine months ended March 31, 2012, the swap generated positive cash flow with the average variable rate paid on the underlying tax-exempt bonds at 0.13%, or 0.37% lower than the average 0.50% LIBOR-based rate received for the swap. On March 31, 2012, the interest rate in effect for the underlying bonds was 0.18%, 0.33% lower than the 0.51% rate in effect for swap receipts.

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 City entered the swap agreement to hedge against the potential of rising interest rates and to achieve a lower fixed rate than the market rate for traditional fixed rate debt. This swap was previously assigned to the 2008A variable rate demand bonds, which were refunded on March 30, 2010 with the 2010B SIFMA Indexed Notes. The addition of the SIFMA-Indexed Notes diversifies the System's variable rate debt portfolio. Rates on the notes are calculated at SIFMA +130 bps, and the notes expire in March 2013.

Terms. The notional amount of the swap is \$249.1 million with the underlying bonds being the Series 2010B Notes. The swap agreement contains scheduled reductions to the outstanding notional amount 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 nine months ended March 31, 2012, the City earned \$312,000 in swap revenue for its 2010B swap and paid \$244,000 on the underlying notes. The contractual rate for the City's swap payment is 3.761%. The average effective rate for the bonds, including the City's swap payments and a fixed component of 1.30%, was 5.01%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of \$69.3 million on March 31, 2012. 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 Aa1/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 SIFMA based 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 nine months ended March 31, 2012, the average variable rate paid on the underlying tax-exempt bonds, excluding the fixed credit spread component, was 0.13%, 0.03% lower than the average 0.16% LIBOR-based rate received for the swap. At March 31, 2012, the overall rate in effect for the underlying bonds, excluding the fixed spread component, was 0.19%, 0.02% higher than the 0.17% 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.