



OFFICE OF THE CITY CONTROLLER
CITY OF HOUSTON
TEXAS

To: Mayor Annise D. Parker
City Council Members

From: Ronald C. Green
City Controller

Date: November 4, 2011

**Subject: September 2011
Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2011.

GENERAL FUND

The Controller's office is projecting an ending fund balance of \$116.1 million for FY2012. This is \$23.0 million lower than the projection of the Finance Department. The difference is due to a \$20.1 million higher revenue projection from the Finance Department and a \$2.9 million higher projection for the Sale of Capital Assets from the Finance Department. Based on our current projections, the fund balance will be \$5.0 million below the City's target of holding 7.5% of total expenditures, excluding debt service, in reserve. This amount includes the undesignation of the \$20 million in the Rainy Day Fund.

Our revenue projection increased \$8.8 million. Property Tax was increased \$1.8 million reflecting current property values and a collection rate of 97%. We also increased Sales Tax \$5 million to recognize July and August receipts, which were higher than expected. Indirect Interfund was increased \$314,000 for higher Grant reimbursements. Finally, we increased Transfers from Other Funds \$1.5 million to reflect an additional transfer from Building Inspection of \$2.5 million for a sale of land in July, and a decrease of \$1 million from Parking Management from lower revenues due to a delay in the parking meter rate increase.

The major differences are in six categories: (1) Property Tax revenues are \$5.2 million lower than the Finance Department due to Controllers using a collection rate of 97% versus 97.5% for Finance. (2) Sales Tax revenues are \$4.7 million lower, as the Controller's office is using Barton Smith's latest growth estimate, discounted by his stated margin of error, and recognizing July and August receipt amounts over projection. (3) Finance is reporting Licenses and Permits \$4.3 million higher than the Controller's projection. The Controller's office recognizes the fee increases, but until we see the effect on the number of licenses we will not modify our projection. (4) Finance is reporting Charges for Services \$1.6 million higher than the Controller's projection. Ambulance fees are the largest single revenue in this category. (5) Finance is reporting Miscellaneous/Other revenues \$1.5 million higher than the Controller's projection. Many of these revenue sources are non-recurring. (6) Sale of Capital Assets are \$2.9 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 projections are \$6.1 million above the Adopted Budget. Our projection for Health increased \$755,000 for higher than budgeted security costs. We also increased Neighborhoods \$259,000 for higher personnel costs, which will be reimbursed. Parks was increased \$4.8 million primarily for tree removal costs and annualization of

**Mayor Annise D. Parker
City Council Members
September 30, 2011 Monthly Financial and Operations Report**

community center staffing. Police was increased \$3.3 million for additional traffic enforcement, and to reduce the backlog at the crime lab. We increased our projection for General Government \$5.7 million. This was an increase of \$9.2 million reclassified from Debt Service Transfer, for Dedicated Drainage & Street Renewal, with a decrease of \$3.5 million for lower than expected termination pay. Therefore, our projection for Debt Service Transfer decreased \$9.2 million.

Please remember that all FY2011 numbers are preliminary estimates and subject to change until the annual audit is completed and the Comprehensive Annual Financial Report is published.

ENTERPRISE FUNDS

In the Aviation Operating Fund, we have decreased our projection for Operating Revenues \$3.1 million for lower than expected landing fees, and building and grounds fees, along with a corresponding decrease of \$3.1 million in Operating Transfers.

Within the Combined Utility System, we have increased our projection for Operating Revenues \$16.9 million to reflect higher revenues related to the drought, and increased Operating Expenses \$11 million for increased costs from water main repairs. Non-Operating Revenues decreased \$1.9 million, for lower interest rates and higher CWA costs. Operating Transfers decreased \$4.1 million related to several refundings completed.

Our projections of expenditures for the Dedicated Drainage & Street Renewal Fund decreased \$948,000 mainly for personnel costs. Other Financing Sources decreased \$9.2 million, which is net of a decrease in Transfers In and Transfers Out reflecting funds going directly to the CIP fund, and the calculated captured revenue of \$9.2 million.

There were no material changes in the Convention & Entertainment Operating Fund and Stormwater Fund.

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. Convention and Entertainment maintains a higher percentage of variable rate debt due to agreements with the hotel corporation. As of September 30, 2011, the ratio of unhedged variable rate debt for each type of outstanding debt was:

General Obligation	8.8%
Combined Utility System	3.2%
Aviation	17.0%
Convention and Entertainment	18.3%

Respectfully submitted,



Ronald C. Green
City Controller

**Quarterly Swap Agreements Disclosure
September 30, 2011**

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 three months ended September 30, 2011, the City earned \$804,000 in swap revenue for its 2004B swaps and paid \$211,000 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 4.52%. 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 \$212.2 million on September 30, 2011. 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&P/Fitch)</u>
Goldman Sachs Capital Markets Inc.	\$ 353,325,000	\$ (114,778,000)	A1 /A /A+
JP Morgan Chase	150,000,000	(48,728,000)	Aa3/ A+/AA-
UBS AG	150,000,000	(48,728,000)	Aa3 /A+ /A+
	<u>\$ 653,325,000</u>	<u>\$ (212,234,000)</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 three months ended September 30, 2011, the swap generated positive cash flow with the average variable rate paid on the underlying tax-exempt bonds at 0.13%, or 0.35% lower than the average 0.48% LIBOR-based rate received for the swap. On September 30, 2011, the interest rate in effect for the underlying bonds was 0.49%, 0.35% lower than the 0.14% 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 three months ended September 30, 2011, the City earned in \$86,300 swap revenue for its 2010B swap and paid \$88,500 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 5.06%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of \$81.6 million on September 30, 2011. 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 three months ended September 30, 2011, the average variable rate paid on the underlying tax-exempt bonds, excluding the fixed credit

spread component, was 0.14%, which was equivalent to the LIBOR-based rate received for the swap. At September 30, 2011, the overall rate in effect for the underlying bonds, excluding the fixed spread component, was 0.29%, 0.14% lower than the 0.15% 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.