OFFICE OF THE CITY CONTROLLER

CITY OF HOUSTON
INTEROFFICE CORRESPONDENCE

To: Mayor Bill White
City Council Members

From: Annise D. Parker
City Controller

Date: July 25, 2008

Subject: June 2008 Financial Report

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

GENERAL FUND

We are now projecting an end of year budget surplus of $22.6 million, up $10.5 million from last month's report. This is the net impact of a $8.9 million decrease in projected departmental expenditures and a $1.6 million increase in our overall revenue projections.

Based on year-to-date trends, we are increasing our projections for Industrial Assessments and Licenses and Permits by $500,000 and $790,000, respectively. Our projection for Municipal Courts Fines and Forfeits revenue is up $400,000 to reflect higher than anticipated collections. This is somewhat offset by a $299,000 decrease in our projection for Direct Interfund revenues that is directly tied to a decline in reimbursements from Public Works to the General Fund for allowable Capital Improvement Project costs.

On the expenditure side, we are projecting personnel savings totaling $2.6 million for the following departments: Controllers, Finance, Library, Mayor, Parks and Solid Waste. However, higher termination pay costs have pushed projected spending in the Fire Department up by half a million dollars and higher fuel costs have increased the Police Department budget by about $1.5 million. Other departments with notable changes are Information Technology (IT) and Municipal Courts where ERP/SAP and the Integrated Case Management System are pushing overall spending higher. Public Works anticipates decreased spending of $5.1 million due to lower than expected electricity charges. Finally, our projection for General Government is down $3.8 million to reflect transfers to other departments to help offset the increased costs detailed above.

ENTERPRISE FUNDS

The projection for Aviation Department Operating Revenue has increased $416,000. This is attributed primarily to year-end true-ups for Landing Area and Building and Ground charges, using final rates and charges for FY2007. Our projection for Operating Expenses has decreased by $2.1 million, mainly due to lower than expected charges for Electricity, Interfund IT, Management Consulting, and Advertising services. These changes are the driving force for the noted $2.5 million increase in transfers to the Capital Improvement line item.

In the Convention & Entertainment Facilities (CEF) Operating fund we have increased our revenue projection for Facility Rentals by just under half a million dollars due to new bookings for events. Our projection for Supplies is down by $278,000 because a lighting project has been delayed until FY2009. These changes are offset by increases in Personnel and Services. We have also increased our projection for Other Non-operating Revenue by $4.4 million, reflecting funds received from FEMA, $3 million of which was previously projected as Transfers from Special Funds. Finally, we have reduced the projections for Transfers for Interest by $1.6 million and Transfers for Principal by $1.1 million. These two adjustments are tied to changes in the way CEF handles its commercial paper financing.

Our projection for Combined Utility System (CUS) Operating Revenues is down by $2.3 million. As was the case in previous months, this is tied to lower water and sewer sales. In addition, there is a $10.1 million increase in projected Operating Expenses to offset higher fuel, chemical, electricity, water contract and engineering costs. Non-Operating Revenues have decreased $5.2 million due to delays in the sale of obsolete vehicles. Operating Transfers have declined nearly $16 million because the CUS decided to use interest received from the Texas Water Development Board to cover required debt payments instead of making a transfer.

In the Stormwater Fund, we are decreasing our projection for Operating Expenses by $731,000 from last month to account for delays in Capital Outlay purchases. There is a $1.2 million increase in Operating Transfers In and a corresponding decrease in Operating Transfers Out to reflect lower than expected discretionary debt payments.

We are not projecting any significant changes in the Parking Management 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. The City plans to refund most of its Airport System commercial paper in the next several months, as well as $250 million of auction rate debt. Convention and Entertainment maintains a higher percentage of variable rate debt due to agreements with the Hotel Corporation.

As of June 30, 2008 the ratio for each type of outstanding debt was:

General Obligation	20.3%
Combined Utility System	6.8%
Aviation	23.1%
Convention and Entertainment	29.4%

As of June 25, 2008 the City has converted or refunded all $1.3 billion of its Combined Utility auction rate bonds with variable rate demand bonds and special term bonds. Variable rates on tax-exempt bonds have come down from highs over 6% to current rates of 1.4%. The three-year term bonds priced at a yield of 3.9%.

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 March 31, 2008 is attached.

Respectfully submitted,

Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
June 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 $3.1 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 $1.8 million on June 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 June 30, 2008, Ambac was rated Aa3 by Moody's, AA by Standard and Poor's, and AA by Fitch. Should Ambac's ratings decline in the future and fair value reaches certain positive threshholds, 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 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 twelve months ended June 30, 2008, the City earned $18.7 million in swap revenue for its 2004B swaps and paid $25.8 million 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, auction and liquidity fees, reduced by swap receipts, was 5.15%. 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 $50.7 million on June 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.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's/S&P/Fitch)
Goldman Sachs Capital Markets Inc.	$ 353,325,000	$ (27,417,000)	Aa3 /AA- /AA-
Bear Stearns Financial Products Inc.	150,000,000	(11,640,000)	Aaa / AAA / --
UBS AG	150,000,000	(11,640,000)	Aa1 /AA- /AA-
	$ 653,325,000	$ (50,697,000)	

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. Cost savings were not realized during the past fiscal year because of disruptions in the auction rate market and downgrading of the insurer, XL Capital. The City has converted all of the 2004B auction rate bonds to variable rate demand obligations. For the twelve months ended June 30, 2008 the average variable rate paid on the underlying tax-exempt bonds was 3.89%, 1.08% higher than the average 2.81% LIBOR-based rate received for the swap. At June 30, 2008, the interest rate in effect for the underlying bonds was 1.55%, 0.24% lower than the 1.79% 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 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 $3.7 million in swap revenue for this swap and paid $6.8 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, auction, and liquidity fees reduced by swap receipts, was 6.16%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of $10.3 million on June 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. Cost savings were not realized during the past two quarters because of disruptions in the auction rate market and downgrading of the insurer, Ambac. At June 30, 2008 the interest rate in effect for the underlying variable rate demand bonds was 1.55%, while the rate in effect for the swap receipts was 18bps higher at 1.73%.

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.

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 2004-C2 Bonds that converted to 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 pays a variable rate of 70% of One-Month LIBOR (equal to its receipts on the RBC forward rate lock swap) and receives a variable rate equal to 64.29% of Ten-Year US Dollar LIBOR. The agreement became effective December 3, 2007 with a termination date of May 15, 2034.

Receipts and Payments. Through June 30, 2008, revenue earned on the constant maturity swap was $580,000.

Fair value. As a result of changes in the swap yield curve, the estimated fair value of the swap at June 30, 2008 was positive $3.6 million. The amount was calculated using the zero-coupon method.

The authorizing ordinance allows the Mayor and City Controller to terminate this swap if they deem appropriate. The Mayor and City Controller recently authorized the staff to terminate the swap when the market is propitious for the City.

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 is 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.