



OFFICE OF THE CONTROLLER
CITY OF HOUSTON
TEXAS

To: Mayor Annise D. Parker
City Council Members

From: Ronald C. Green
City Controller

Date: October 29, 2010

Subject: **September 2010
Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2010.

GENERAL FUND

The Controller's Office is projecting an ending fund balance of \$85.5 million for FY2011. This is \$8.3 million lower than last month's projection. We increased our projection for Property Taxes based on the current tax roll property values by \$1.9 million. This is also \$32 million lower than the projection of the Finance Department. The difference is due to the Finance Department's \$16 million higher revenue projection and a \$16 million higher projection for the Sale of Capital Assets. Based on our current projections, the fund balance will be \$41 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, and drawdown of fund balance of \$54 million, both approved as part of the FY2011 Adopted Budget.

The major differences are in two categories: (1) Miscellaneous/Other revenues are \$5 million lower, as the Controller's office has not recognized new fee increases, which have yet to be identified, and approved by Council; (2) Sale of Capital Assets reflects a difference of \$16 million, as the Controller's Office has not recognized some large proposed land sales, which have yet to be finalized and approved by Council.

Expenditure projections are now at \$1.905 billion, which is \$9.6 million above the adopted budget total. This month's projection for PWE has increased \$1.6 million for higher electricity costs, and General Government has increased \$8 million, for budgeted management initiative savings which will not be realized.

ENTERPRISE FUNDS

In the Convention & Entertainment Facilities Operating Fund, we are increasing our projection for Services by \$1.5 million for additional construction project costs, which are offset by a decrease in Interfund Transfers.

Our projection for Combined Utility System Operating Revenues decreased \$16.4 million, mainly in Water and Sewer revenues, from lower water consumption in the first quarter of the fiscal year. We have also decreased our projection for Personnel by \$3.2 million for delays in filling vacant positions. Our projection for Operating Transfers decreased \$37.6 million, reflecting a delay in the expected issue date of the 2010D series bonds, as well as lower rates than expected in many of the variable rate bonds.

**Mayor Annise D. Parker
City Council Members
September 2010 Monthly Financial and Operations Report**

The projection for the Stormwater Fund decreased \$800,000 in Operating Transfers In, reflecting lower funding from the Combined Utility System.

There are no material changes in the Aviation and Parking Management 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. Convention and Entertainment maintains a higher percentage of variable rate debt due to agreements with the hotel corporation. As of September 30, 2010, the ratio of unhedged variable rate debt for each type of outstanding debt was:

General Obligation	11.5%
Combined Utility System	8.0%
Aviation	17.0%
Convention and Entertainment	31.1%

Respectfully submitted,



Ronald C. Green
City Controller

City of Houston, Texas
Quarterly Swap Agreements Disclosure
September 30, 2010

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, 2010, the City earned \$927,000 in swap revenue for its 2004B swaps and paid \$412,000 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 4.66%. 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 \$167.7 million on September 30, 2010. 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	\$ (90,677,000)	A1 /A /A+
JP Morgan Chase	150,000,000	(38,496,000)	Aa1/ AA-/AA-
UBS AG	150,000,000	(38,496,000)	Aa3 /A+ /A+
	<u>\$ 653,325,000</u>	<u>\$ (167,669,000)</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, 2010, the average variable rate paid on the underlying tax-exempt bonds was 0.25%, 0.31% lower than the average 0.56% LIBOR-based rate received for the swap. On September 30, 2010, the interest rate in effect for the underlying bonds was 0.26%, 0.27% lower than the 0.53% 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, 2010 the City earned \$143,000 in swap revenue for its 2010B swap and paid \$172,000 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 5.11%.

Fair value. Because interest rates have changed, the swap had an estimated negative fair value of \$59.3 million on September 30, 2010. 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 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 ended September 30, 2010, the average variable rate paid on the underlying tax-exempt bonds, excluding the fixed credit spread component, was 0.27%, 0.04% higher than the average 0.23% LIBOR-based rate received for the swap. At

September 30, 2010, the overall rate in effect for the underlying bonds, excluding the fixed spread component, was 0.27%, 0.03% higher than the 0.24% 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.