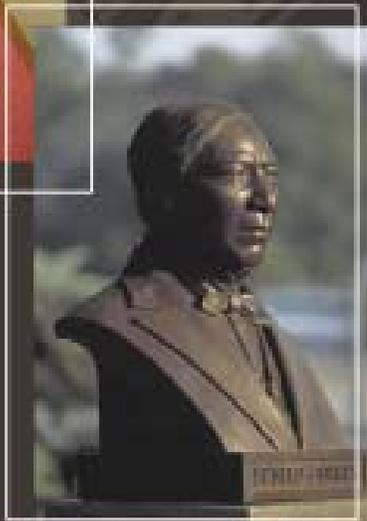
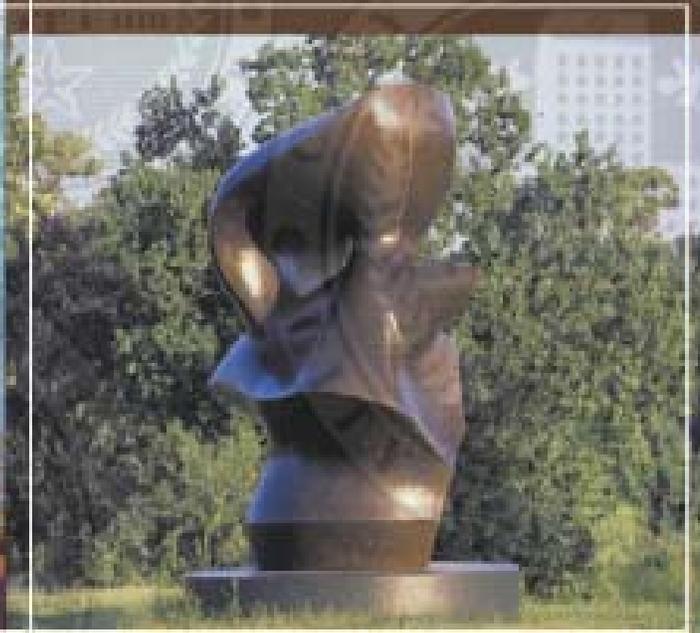


"Art is an adventure into an unknown world, which can only be explored by those willing to take the risks."

Mark Rothko, American Abstract Expressionist painter



CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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CITY OF HOUSTON, TEXAS
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Note 1: Summary of Significant Accounting Policies

The City of Houston, Texas ("City") was incorporated under the laws of the Republic of Texas in 1837 and again under the laws of the State of Texas in 1905. The City operates under a Home Rule Charter with a Mayor-Council form of government and provides the following services as authorized or required by its charter: public safety (police and fire), highways and streets, sanitation, water, airports, health services, culture-recreation, storm drainage, solid waste disposal, planning and inspection, civil defense, public improvements, and general administrative services, including pension and other benefits for its employees.

The financial statements presented in this report conform to the reporting requirements of the Governmental Accounting Standards Board ("GASB"), which establishes combined statements as the required reporting level for governmental entities that present financial statements in accordance with generally accepted accounting principles.

The significant accounting policies of the City are as follows:

A. Principles Used in Determining the Reporting Entity for Financial Reporting Purposes

The accompanying financial statements include financial statements for related organizations in accordance with GASB Statement No.14, *The Financial Reporting Entity* and GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. Organizations are included if they are financially accountable to the City, or the nature and significance of their relationship with the City are such that exclusion would cause the financial statements to be misleading or incomplete. Inclusion is determined on the basis of the City's ability to exercise significant influence. Significant influence or accountability is based primarily on its operational or financial relationship with the City (as distinct from legal relationship).

The City is financially accountable if it appoints a voting majority of an organization's governing body and is able to impose its will on that organization, or there is a potential for the organization to provide specific financial benefits to or impose specific financial burdens on the City. Blended component units (although legally separate entities) are, in substance, part of the City's operations. Blended component units provide services exclusively or almost exclusively for the City. Both governmental and business-type discretely presented component units are reported in separate columns in the government-wide financial statements to emphasize their legal separateness from the City.

B. Basis of Presentation - Financial Reporting Entity

1. Component Units

Most component units of the City issue separately audited financial statements. Component units are reported in the City's Comprehensive Annual Financial Report ("CAFR") as shown in the following tables. Additional information is available from the addresses shown. Following are the City's blended component units:

Blended Component Units Reported with the Primary Government

Houston Firefighters' Relief & Retirement Fund
 4225 Interwood North Parkway
 Houston, TX 77032

Houston Municipal Employee's Pension System
 1111 Bagby, Suite 2450
 Houston, TX 77002

Brief Description of Activities, Relationship to the City and Key Inclusion Criteria

Responsible for administration, management, and operation of the pension system solely for active and retired City of Houston firefighters. One member of the Board is either the Mayor or an appointed representative, five members are elected by active firefighters, one member is elected by retired firefighters, two members are citizen representatives, and one member is the City Treasurer.

Reporting Fund: Houston Firefighters' Relief and Retirement Pension Trust Fund.

Responsible for administration, management, and operation of the pension system solely for active and retired municipal (non-classified) employees of the City. One member of the Board is appointed by the Mayor, four are elected by active employees, two are elected by retirees, one is appointed by the elected trustees and one is the City Treasurer.

Reporting Fund: Houston Municipal Employee's Pension Trust Fund.

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Blended Component Units Reported with the Primary Government

Brief Description of Activities, Relationship to the City and Key Inclusion Criteria

Houston Police Officer's Pension System
602 Sawyer, Suite 300
Houston, TX 77007

Responsible for administration, management, and operation of the pension system solely for active and retired police officers of the City. One member of the Board is appointed by the Mayor, three are elected by employees, two are elected by retirees, and one is the City Treasurer.

Reporting Fund: Police Officer's Pension Trust Fund.

Houston Area Water Corporation
611 Walker, Suite 2100
Houston, TX 77002

The Corporation is organized for the purpose of: providing treated, potable water to the City of Houston for sale to customers located wholly or partially in Area Three of the Harris-Galveston Coastal Subsidence District, and; aiding and assisting the City of Houston in performing its obligations with respect to a regional groundwater reduction plan by, among other things, constructing, improving, equipping, repairing, operating and maintaining water treatment and distribution facilities and purchasing and selling water in connection therewith.

Reporting Fund: Business Type, Non-Major

Following are the City's discretely presented business type component units:

Discretely Reported Component Units

Brief Description of Activities, Relationship to City, and Key Inclusion Criteria

Houston Convention Center Hotel Corporation ("HCCHC")
c/o George R. Brown
Avenida De Las Americas
Houston, TX 77010

Local government corporation created by the City in accordance with the Texas Transportation Corporation Act and Chapter 394 of the Texas Local Government Code authorized to construct, improve, enlarge, equip, repair, operate and maintain a hotel in downtown Houston within one thousand feet of the George R. Brown Convention Center. Board members are appointed by the Mayor and confirmed by City Council.

Houston Housing Finance Corporation ("HHFC")
9545 Katy Freeway, Suite 105.
Houston, TX 77024

Non-profit corporation incorporated by the City in accordance with the Texas Housing Finance Corporation Act to finance residential mortgage loans to low or moderate-income persons through the sale of revenue bonds collateralized by the mortgage loans. The Board is nominated by the Mayor and confirmed by City Council. The City has financial accountability because it appoints a voting majority of the Board and the City can impose its will.

Houston Zoo, Inc.
1513 N. MacGregor
Houston, TX 77030

Houston Zoo, Inc. (HZI) is a 501 (c)(3) corporation and has a contract with Houston Zoo Development Corp to operate the Zoo. The Mayor may appoint up to 20% of the Board of Directors of HZI. Houston Zoo Development Corporation (HZDC) is a local government corporation that leases the zoo from the City. The lease provides for the City to make payments in support of capital and operating expenses over the lease term, which it makes available to HZI.

Following are the City's discretely presented governmental fund component units.

Discretely Reported Component Units

Brief Description of Activities, Relationship to City, and Key Inclusion Criteria

City Park Redevelopment Authority
c/o Hawes Hill Calderon LLP
P.O. Box 22167
Houston, Texas 77227

Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the City Park Tax Increment Reinvestment Zone Board in the redevelopment of a neighborhood northwest of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by the City Council and the operations provide financial benefit to the City.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

| Discretely Reported Component Units | Brief Description of Activities, Relationship to City, and Key Inclusion Criteria |
|--|--|
| <p><i>Cultural Arts Council of Houston</i> <i>("CACH")/Harris County</i> <i>3201 Allen Parkway, Suite 250</i> <i>Houston, TX 77019</i></p> | <p>Non-profit organization that is the officially designated arts agency of the City. The City does not appoint a voting majority, but is financially accountable because CACH is fiscally dependent on the revenues provided from a portion of hotel occupancy tax, which is levied by the City.</p> |
| <p><i>East Downtown Redevelopment Authority</i> <i>c/o Hawes Hill Calderon LLP</i> <i>P.O. Box 22167</i> <i>Houston, Texas 77227</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the East Downtown Tax Increment Zone Board in the redevelopment of a blighted neighborhood east of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>Fourth Ward Redevelopment Authority</i> <i>c/o Zinetta Burney, General Counsel</i> <i>Burney & Foreman</i> <i>5445 Almeda Suite 200</i> <i>Houston, Texas 77004</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Fourth Ward Tax Increment Reinvestment Zone Board in the redevelopment of a blighted neighborhood adjacent to Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council, the operations provide financial benefits to the City, the City has investment authority for the Zone's assets, and the City maintains the books and records.</p> |
| <p><i>Greater Greenspoint Redevelopment Authority</i> <i>16945 Northchase Dr, Suite 1900</i> <i>Houston, Texas 77060</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Greater Greenspoint Tax Increment Reinvestment Zone Board in the redevelopment of the Greenspoint Mall and blighted adjacent neighborhood in North Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>Gulfgate Redevelopment Authority</i> <i>c/o Knudson & Associates</i> <i>8588 Katy Freeway, Suite 441</i> <i>Houston, Texas 77024</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Gulfgate Tax Increment Reinvestment Zone Board in the redevelopment of the Gulfgate Mall and blighted adjacent neighborhood southeast of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>HALAN - Houston Area Library Automated Network Board</i> <i>Houston Central Library</i> <i>500 McKinney</i> <i>Houston, TX 77002</i></p> | <p>Provides review and guidance to the operation, funding and development of the Houston Area Library Automated Network, which provides library services to Houston and surrounding communities. Three members are appointed by City Council, two by the County, and one elected by the smaller libraries. The City does not appoint a voting majority, but is financially accountable for this organization because HALAN is fiscally dependent on the City for all revenues and the City can impose its will.</p> |
| <p><i>Houston Library Board</i> <i>Houston Central Library</i> <i>500 McKinney</i> <i>Houston, TX 77002</i></p> | <p>Solicits and manages funds raised privately for library improvements. Advises the Mayor and City Council on additions and improvements to the library system that provide a direct benefit to the City. Board members are nominated by the Mayor and confirmed by City Council.</p> |
| <p><i>Houston Parks Board</i> <i>2001 Kirby Dr., Suite 814</i> <i>Houston, Texas 77019</i></p> | <p>Solicits and manages funds raised privately for park acquisitions and advises the Mayor and City Council on park acquisitions and improvements, which provide a direct benefit to the City. Board members are nominated by the Mayor and confirmed by City Council.</p> |
| <p><i>Houston Small Business Development Corp.</i> <i>5330 Griggs Road</i> <i>Houston, Texas 77021</i></p> | <p>A non-profit organization established by the City of Houston in 1986, providing loans and management counseling to small and emerging businesses, and encouraging the expansion of commercial and industrial enterprises. The City has financial accountability because the voting majority of the board members is appointed by City Council and the operations provide financial benefits to the City.</p> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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| Discretely Reported Component Units | Brief Description of Activities, Relationship to City, and Key Inclusion Criteria |
|---|---|
| <p>Lamar Terrace Public Improvement District City of Houston Box 1562 Houston, Texas 77251</p> | <p>Special district organized under state statute to redevelop a blighted neighborhood in Southwest Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Main Street Market Square Redevelopment Authority 909 Fannin St., Suite 1650 Houston, Texas 77002</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Main St./Market Square Tax Increment Reinvestment Zone Board in the redevelopment of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Memorial City Redevelopment Authority c/o Knudson & Associates 8588 Katy Freeway, Suite 441 Houston, Texas 77024</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Memorial City Tax Increment Reinvestment Zone Board in the redevelopment of the Memorial City Mall and Town & Country Mall areas, west of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Memorial-Heights Redevelopment Authority c/o Knudson & Associates 12 Greenway Plaza, Suite 1500 Houston, Texas 77046-1287</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Memorial Heights Tax Increment Reinvestment Zone Board in the redevelopment of a blighted neighborhood adjacent to Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Midtown Redevelopment Authority 3401 Louisiana, Suite 355 Bienville Building Houston, Texas 77002</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Midtown Tax Increment Reinvestment Zone Board in the redevelopment of a blighted neighborhood south of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Old Sixth Ward Redevelopment Authority c/o Parke Patterson Consultants, Inc. P.O. Box 994 Sugar Land, Texas 77487</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Old Sixth Ward Tax Increment Reinvestment Zone Board in the redevelopment of a neighborhood adjacent to Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council, the operations provide financial benefits to the City, the City has investment authority for the Zone's assets, and the City maintains the books and records.</p> |
| <p>OST/Alameda Corridors Redevelopment Authority 5445 Alameda, Suite 502 Houston, Texas 77004</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the OST/Alameda Corridors Tax Increment Reinvestment Zone Board in the redevelopment of a blighted neighborhood south of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p>Saint George Place Redevelopment Authority c/o Hawes Hill Calderon LLP P.O. Box 22167 Houston, Texas 77227-2167</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the St. George Place Tax Increment Reinvestment Zone Board in the redevelopment of a blighted neighborhood in southwest Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council, the operations provide financial benefits to the City, the City has investment authority for the Zone's assets, and the City maintains the books and records.</p> |
| <p>Sharpstown Economic Development Authority c/o Hawes, Hill & Associates P.O. Box 22167 Houston, Texas 77227-2167</p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to manage and administer the Sharpstown Public Improvement District (the "PID"), created under Chapter 372 of the Local Government Code. Board members are appointed by the Mayor and approved by City Council.</p> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

| <u>Discretely Reported Component Units</u> | <u>Brief Description of Activities, Relationship to City, and Key Inclusion Criteria</u> |
|---|--|
| <p><i>South Post Oak Redevelopment Authority</i> <i>c/o Knudson & Associates</i> <i>8588 Katy Frwy.</i> <i>Houston, Texas 77024</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the South Post Oak Tax Increment Reinvestment Zone Board in the development of an affordable housing project in Southwest Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>Southwest Houston Redevelopment Authority</i> <i>c/o Hawes Hill Calderon LLP</i> <i>P.O. Box 22167</i> <i>Houston, Texas 77227-2167</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Southwest Houston Tax Increment Reinvestment Zone Board in the redevelopment of the Sharpstown Mall and adjacent neighborhoods southwest of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>Upper Kirby Redevelopment Authority</i> <i>3015 Richmond Avenue, Suite 200,</i> <i>Houston, Texas 77098-3114</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Upper Kirby Tax Increment Reinvestment Zone Board in the redevelopment of a neighborhood west of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |
| <p><i>Uptown Development Authority</i> <i>1980 Post Oak Blvd., Suite 1580</i> <i>Houston, Texas 77056</i></p> | <p>Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the Uptown Tax Increment Reinvestment Zone Board in the redevelopment of the Galleria Mall area, west of Downtown Houston. The City has financial accountability because the voting majority of the board members are nominated by City Council and the operations provide financial benefits to the City.</p> |

2. Related Organizations

The following entities are related organizations to which the City appoints board members but for which the City has no significant financial accountability. Some of these organizations are Access Houston Cable Corporation, Coastal Water Authority, Employees Deferred Compensation Plan, Harris County–Houston Sports Authority, Metropolitan Transit Authority of Harris County, Houston Clean City Commission, and the Miller Theater Advisory Council. All transactions with these related organizations are conducted in the ordinary course of business. Further financial information is available from the respective organizations.

C. Basis of Presentation – Government-wide and Fund Financial Statements

The government-wide financial statements (i.e., the statement of net assets and the statement of changes in net assets) report information on all of the nonfiduciary activities of the primary government and its component units. For the most part, the effect of interfund activity has been removed from these statements. *Governmental activities*, which normally are supported by taxes and intergovernmental revenues, are reported separately from *business-type activities*, which rely to a significant extent on fees and charges for support. Likewise, the *primary government* is reported separately from certain legally separate *component units* for which the primary government is financially accountable.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. *Direct expenses* are those that are clearly identifiable with a specific function or segment. *Program revenues* include 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not properly included among program revenues are reported instead as *general revenues*.

Separate financial statements are provided for governmental funds, proprietary funds, and fiduciary funds, even though the latter are excluded from the government-wide financial statements. Major individual governmental funds and major individual enterprise funds are reported as separate columns in the fund financial statements.

The accounts of the City are organized on the basis of funds, each of which is accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balance/retained earnings, revenues, and expenditures/expenses. Government resources are allocated to and accounted for in individual funds for the purpose of carrying on specific activities in accordance with special regulations, restrictions, or limitations. The type and purpose of funds is described below.

CITY OF HOUSTON, TEXAS
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Fund Accounting

1. The City reports the following major governmental funds:
 - (a) **General Fund** - is the principal operating fund of the City and is used to account for all financial resources except those required to be accounted for in another fund.
 - (b) **Debt Service Fund** - is used to account for the accumulation of resources for, and the payment of principal, interest, and related costs of tax supported debt.
 - (c) **Capital Projects Fund** - is used to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds and trust funds). Such resources are derived principally from proceeds of public improvement bonds and from special assessments.
 - (d) **Grants Fund** - The Grants Fund is used to account for grant resources received from various local, state and national agencies and organizations. The use of these resources is restricted to a particular function of the City by each grantor.
2. The City reports the following major enterprise funds:
 - (a) **Airport System Fund** - is used to account for the operations of the City's Airport System. The system is comprised of George Bush Intercontinental Airport, William P. Hobby Airport, and Ellington Field.
 - (b) **Convention and Entertainment Facilities Fund** - is used to account for the operations of the City's major entertainment facilities, outdoor venues, and parking garages and surface lots. These assets include, but are not limited to, the following: George R. Brown Convention Center, Gus S. Wortham Center, Jesse H. Jones Hall, Houston Center for the Arts, Talento Bilingue de Houston, Jones Plaza, and Theater District parking garages.
 - (c) **Combined Utility System Fund** - is used to account for the production and transmission of water and the treatment of wastewater for City residents and businesses as well as for other governmental entities located in the Houston area.
3. The City reports the following fund types:
 - (a) **Nonmajor Special Revenue Funds** - are used to account for the proceeds of specific revenue sources (other than major capital projects) that are legally restricted to expenditures for specific purposes.
 - (b) **Internal Service Funds** - are used to account for the financing of goods or services provided by one department to other departments of the City on a cost-reimbursement basis.
 - (c) **Fiduciary Fund Types** - Trust and Agency Funds are used to account for assets held by the City in a trustee capacity or as an agent for individuals, private organizations, other governmental units and other funds. These include the following:
 - (1) **Pension Trust Funds** - are used to account for the assets held in trust for the members and beneficiaries of the City's three defined benefit pension plans.
 - (2) **Agency Funds** - are custodial in nature and do not involve measurement of results of operations.

D. Measurement Focus and Basis of Accounting

The government-wide financial statements display information about the City of Houston as a whole. Government-wide statements exclude both fiduciary funds and fiduciary component units. The statement of net assets and the statement of activities are prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions are recognized when the exchange takes place, regardless of the timing of related cash flows. Revenues, expenses, gains, losses, assets and liabilities resulting from non-exchange transactions are recognized in accordance with Statement of Government Accounting Standards No. 33, Accounting and Financial Reporting for Nonexchange Transactions. Program revenues include (1) amounts received from those who purchase, use, or directly benefit from a program, (2) amounts received from parties outside the City of Houston's citizenry that are restricted to one or more specific programs and (3) earnings on investments that are legally restricted for a specific program. Program revenue is divided into three categories: (1) charges for services, (2) operating grants and contributions and (3) capital grants and contributions.

All governmental funds are accounted for using the current financial resources measurement focus. This means that only current assets and current liabilities are generally included on their balance sheets. Their reported fund balances (net current assets) are considered a measure of "available spendable resources." Governmental fund operating statements present increases (revenues and other financing sources) and decreases (expenditures and other financing uses) in net current assets. Accordingly, they are said to present a summary of sources and uses of "available spendable resources" during a period.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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Non-current portions of certain long-term receivables, primarily property taxes and special assessments, are reported on the balance sheets of governmental funds in spite of their spending measurement focus. Special reporting treatments are used to indicate that they should not be considered "available spendable resources," since they do not represent net current assets. Recognition of governmental fund revenues represented by noncurrent receivables is deferred until they become current receivables.

Because of their spending measurement focus, expenditure recognition for governmental fund types is limited to exclude amounts represented by non-current liabilities. Since they do not affect net current assets, such long-term amounts are not recognized as governmental fund type expenditures or fund liabilities.

All proprietary funds and pension trust funds are accounted for on a cost of services or "economic resources" measurement focus. This means that all assets and all liabilities (whether current or noncurrent) associated with their activity are included on their balance sheets. In accordance with GASB Statement No. 20, the City has elected to follow all Financial Accounting Standards Board (FASB) pronouncements issued prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The City has elected not to follow FASB pronouncements issued subsequent to that date. All proprietary funds define operating revenues consistent with the precepts of Statement of Government Accounting Standards No. 9 paragraphs 16 – 19 and 31: cash receipts from customers, cash receipts from quasi-external operating transactions with other funds and other operating cash receipts. All other revenue recognized is non-operating.

Basis of accounting refers to when revenues and expenditures or expenses are recognized in the accounts and reported in the financial statements, regardless of the measurement focus applied. All governmental funds use the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual; i.e., both measurable and available. Available means collectible within the current period or soon enough thereafter to pay current liabilities. The City considers receivables collected within sixty days after year-end to be available and recognizes them as revenues of the current period. Expenditures are generally recognized under the modified accrual basis of accounting in the accounting period in which the fund liability is incurred, if measurable. Claims, judgments and compensated absences are recognized when matured. The following types of revenues are susceptible to accrual under the modified accrual basis of accounting: delinquent property taxes (including penalty and interest); services billed to other funds; sales tax; mixed beverage tax; franchise fees; fines and forfeits; ambulance receipts; and investment earnings. Intergovernmental revenue from reimbursable grants and capital projects is recognized when the related expenditure is incurred.

All proprietary and pension trust funds use the full accrual basis of accounting. Their revenues are recognized when they are earned, and their expenses and related liabilities, including claims, judgments, and compensated absences, are recognized when they are incurred.

When restricted and unrestricted resources are available to cover expenses, unrestricted resources are first applied. Administrative overhead charges are included in direct program expenses.

E. General Fund

For the year ended June 30, 2004, General Fund expenditures exceeded appropriations by \$6.3 million. These excess expenditures were funded by greater than anticipated sales tax revenues.

F. Assets, Liabilities, and Fund Equity

1. Deposits and Investments

The City's investment policy requires all deposits to be fully collateralized with depository insurance; obligations of the United States of America or its agencies and instrumentalities (excluding those mortgage backed securities prohibited by the Public Funds Investment Act); or in any other manner and amount provided by law for the deposits of the City. At all times, such securities are to have a fair value of not less than 102% of the amount of the deposits collateralized thereby, adjusted by the amount of applicable depository insurance.

Substantially all cash, except for imprest accounts, is deposited with financial institutions in interest bearing accounts or is invested. The majority of the City's cash and investments are administered using a pooled concept, which combines the monies of various funds for investment purposes. Interest earnings of the pool are apportioned to each fund, unless otherwise required by bond covenants, based on the fund's relative share of the investment pool. Amounts on deposit in interest bearing accounts and other investments are displayed on the combined balance sheet as "Equity in pooled cash and investments" and in accordance with GASB Statement No. 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools, are carried at fair value. The blended and discretely presented component units separately invest their funds and report investments pursuant to their respective investment policies described in their separately audited financial statements at their fair values.

Investments authorized by the City's investment policy, which is guided by state laws and city ordinances, generally include: obligations of the United States of America or its agencies and instrumentalities; fully-collateralized Certificates of Deposit from

CITY OF HOUSTON, TEXAS
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June 30, 2004

City Council-approved public depositories; direct obligations of the State of Texas or its agencies and instrumentalities; other obligations, the principal and interest of which are unconditionally guaranteed or insured by, or backed by the full faith and credit of, the State of Texas or the United States or their respective agencies and instrumentalities; obligations of states, agencies, counties, cities, and other political subdivisions; no-load money market mutual funds registered and regulated by the Securities and Exchange Commission; corporate commercial paper; fully collateralized repurchase agreements; and reverse repurchase agreements within specific terms. Investments are carried at fair value based on quoted market prices.

2. Inventories of Materials and Supplies

With the exception of fuel, inventories are carried at the average cost in government-wide, proprietary and governmental funds. Inventories are presented under the consumption method. These inventories include: automobile parts, chemical and medical supplies, uniforms and their accessories, vaccines and office supplies. Fuel is carried based on the first-in, first-out inventory method.

3. Capital Assets

a. Governmental Funds - Property, Plant, Equipment, and Infrastructure

Asset valuation is based on historical costs or estimated historical costs, if original costs are not available.

Capital assets are not capitalized in the funds used to acquire or construct them. Instead, capital acquisition and construction are reflected as expenditures in governmental funds.

Capital Assets, which include land; building and improvements; improvements other than buildings, machinery and equipment; construction in progress; and infrastructure (e.g. storm drainage, streets and bridges), are reported in the applicable governmental and business-type activities columns in the government-wide financial statements. These capital assets include the estimated historical cost of infrastructure acquired prior to fiscal year 1981. Capital assets are defined by the government as assets with an initial cost of more than \$5,000 (amount not rounded) and an estimated useful life in excess of four years. Such assets are recorded at historical cost or estimated historical if purchased or constructed. Donated capital assets are recorded at estimated fair market value at the date of donation. The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized.

Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest incurred during the construction phase of capital assets of business-type activities is included as a part of the capitalized value of the assets constructed. Buildings and improvements (improvements other than buildings, machinery and equipment and infrastructure) are depreciated using the straight-line method over the following estimated useful lives:

| Assets | Useful Life |
|-----------------------------------|---------------------------|
| Buildings and improvements | Range from 15 to 45 years |
| Improvements other than buildings | Range from 15 to 30 years |
| Machinery | Range from 4 to 30 years |
| Equipment | Range from 4 to 15 years |
| Storm drainage | 50 years |
| Streets | Range from 6 to 50 years |
| Bridges | Range from 20 to 50 years |

b. Enterprise Funds – Property, Plant and Equipment

Property, plant, and equipment owned by the Enterprise Funds are stated at cost or estimated historical cost if original cost is not available. Construction costs (excluding land and equipment) are added to construction work-in-progress until the assets are substantially complete. At that point, the project is moved to the appropriate asset category and depreciation begins. Depreciation on equipment begins in the year of acquisition. Land and equipment costs are added to the capital asset base in the year of acquisition. Interest costs on funds borrowed to finance the construction of property, plant and equipment of the enterprise funds are capitalized when the costs materially exceed interest earnings on related revenue bond proceeds. For fiscal year 2004, the capitalized interest cost for the Airport System Facilities was \$43.4 million, Combined Utility System Fund was \$9.9 million and Convention & Entertainment Facilities Fund was \$2.8 million.

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Depreciation is computed using the straight-line method on the composite asset base over the estimated useful lives as follows:

| <u>Assets</u> | <u>Years</u> |
|---------------------------------------|--------------|
| Airport System Facilities | 4-45 |
| Convention & Entertainment Facilities | 4-45 |
| Combined Utility System Facilities | 5-50 |

Water rights and conveyance system rights of the Combined Utility System Fund are amortized over the life of the related contracts. These rights are reported as other assets.

4. Bond Discounts and Issuance Costs

Bond discounts and issuance costs in Enterprise Funds are amortized over the term of the bonds using the effective interest method or the straight-line method. Gains or losses on Enterprise Fund refundings are amortized over the term of the lesser of the new bonds or the refunded bonds using the effective interest method.

5. Fund Balance

- a. **Reserve** - Indicates that portion of a fund balance that has been legally segregated (e.g., by bond ordinance) for specific purposes.
- b. **Designated Fund Balance** - Indicates that portion of a fund balance for which the City has made tentative plans.
- c. **Undesignated Fund Balance** - Indicates that portion of a fund balance that is available for appropriation in future periods.

G. Transfers, Revenues, Expenditures and Expenses

1. Interfund Transactions

A description of the four basic types of interfund transactions and the related accounting policies are as follows:

- a. Loans are reported as receivables and payables as appropriate.
- b. Charges for services are reported as revenues for the performing fund and expenditures of the requesting fund.
- c. Transactions to reimburse a fund for expenditures made by it for the benefit of another fund are recorded as expenditures or expenses in the reimbursing fund and as a reduction of expenditures or expenses in the fund that is reimbursed.
- d. All other interfund transfers, such as legally authorized transfers from a fund receiving revenue to the fund through which the resources are to be expended, are transfers. Transfers are classified as other financing sources or uses (or transfers for proprietary funds) in the Statement of Revenues, Expenditures (or expenses) and Changes in Fund Balances (or net assets).

For reporting at the government-wide statements level, the City of Houston eliminates direct interfund charges for services and the balances created within the same fund categories (i.e. governmental vs. business-type). This process ensures neither business-type nor governmental funds report direct internal revenue/expenditures. Interfund activity and balances resulting from transactions with the fiduciary funds are not eliminated. Instead the fiduciary interfund activity and balances are treated as transactions with an external party. Interfund activity with discretely presented component units are handled in the same manner as fiduciary interfund activity/ balances. However, the discretely presented balances are reported on a separate line of the Statement of Net Assets. The Internal Service Fund is essentially a clearing account for income, expenses, assets and liabilities of the City's health benefits and long-term disability programs.

2. Compensated Absences

Full-time civilian employees of the City are eligible for 10 days of vacation leave per year. After five years, employees receive 15 days. The amount of vacation time gradually increases after that, reaching a maximum of 25 days per year after 18 years of service. Employees may accumulate up to 90 days of vacation leave (45 days for employees hired after December 31, 1999). Upon termination or retirement, employees are paid for unused vacation leave based on the average rate of pay during the employee's highest paid 60 days of employment. Part-time employees (those working less than 30 hours per week) are not eligible for vacation leave benefits. Firefighters accrue 15 to 22 days of vacation annually, based upon years of service. Police officers participate in a paid time off program that combines sick and vacation leave. Officers enter the program upon completion of their probationary period and then accrue 15 to 40 days annually, based upon years of service.

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The majority of full-time civilian employees and firefighters are covered under the compensatory sick leave plan and receive a leave time allowance of 2.5 hours per payroll period (bi-weekly) up to a maximum of 65 hours per year. Employees who use fewer than 65 hours during the benefit year will receive a match of additional hours equal to the number of hours accrued minus the number of hours used. Once an employee's balance has reached 1,040 hours, no additional match for unused hours is given. Upon termination, all unused sick leave time allowances in excess of 1,040 hours are payable to the employee at the employee's rate of pay at the time of termination. An employee who uses less than 16 hours of sick leave in any benefit year receives up to three days of personal leave in the next year. Personal leave may be used in place of vacation leave, but will not accumulate and will not be paid out at termination. The balance of full time civilian employees and firefighters are covered by a sick plan that was closed to employees in 1985. That plan accumulates a cash value for every sick day not used, which is payable upon resignation or retirement. As noted above, classified police officers are covered by a paid time off plan.

The City also has adopted policies of compensatory time to comply with the Fair Labor Standards Act as amended in 1985. These policies provide limits to the accumulation of compensatory time and also provide that time not used will be paid in cash. Only classified employees and civilian employees in certain pay grades routinely earn compensatory time.

To the extent that the City's obligation is attributable to employees' services already rendered and it is probable that the City will compensate the employees for the benefits through paid time off or some other means, vacation and compensatory time benefits are accrued as liabilities (on a government-wide basis) as employees earn the benefits. On a fund financial statement basis for the governmental funds, only matured liabilities and liabilities expected to be liquidated with current assets are accrued. Sick leave benefits are accrued as a liability as employees earn the benefits, but only to the extent that it is probable that the City will compensate the employees through cash payments conditioned on the employees' termination or retirement. A compensated absence is liquidated in the fund where the employee's salary was paid at termination, with all compensated absences liquidated in the general fund that are associated with employees' salaries paid from governmental funds.

H. Statement of Cash Flows ∞ Cash and Cash Equivalents

The City considers cash and cash equivalents to be unrestricted equity in pooled cash and investments which consist of cash on hand, demand deposits and all highly liquid investments which can be deposited or withdrawn without notice or penalty. Generally, restricted assets have maturities greater than three months.

I. Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

J. Internal Service Funds

The Internal Service Funds' purpose is to measure the full cost of providing health benefits and long-term disability to City employees and dependants for the purpose of fully recovering that cost through fees or charges – employee payroll deductions and expenditures in departmental personnel budgets. Any profit (loss) during a period is credited (charged) back to participating programs. All assets and liabilities are reported in the governmental activities column of the Statement of Net Assets.

K. New Accounting Pronouncement

In March 2003, the GASB issued Statement No. 40, "Deposit and Investment Risk Disclosures." This statement is an amendment to GASB No. 3, "Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements," establishing and modifying disclosure requirements related to deposit and investment risk. This Statement will be implemented in the City's fiscal year ending June 30, 2005 to meet GASB implementation requirements.

In November 2003, the GASB issued Statement No. 42, "Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries." This statement will, among other things, establish accounting and financial reporting standards for the impairment of capital assets. Under this standard, a capital asset is considered impaired when its service utility has declined significantly and unexpectedly. The City has not determined the impact, if any, upon its financial position, results of operations or cash flows upon adoption, which is required on or before the City's fiscal year ending June 30, 2006.

In May 2004, the GASB issued Statement No. 43, "Financial Reporting for Other Postemployment Benefit Plans Other Than Pension Plans" and in June 2004, the GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefit Other Than Pension Plans." Statement No. 43 establishes accounting and financial reporting standards for healthcare and other nonpension benefits provided to employees as part of their compensation for services. The statement will be implemented in the City's

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fiscal year ending June 30, 2006 to meet GASB requirements. Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expenses and related liabilities and assets, and other related disclosure requirements. This statement will be implemented on or before the fiscal year ending June 30, 2007 to meet GASB requirements. The City has not determined the impact, if any, upon its financial position, results of operations or cash flows upon adoption of these two Statements.

In May 2004, the GASB issued Statement No. 44, "Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1." This statement clarifies various issues relative to the presentation of the statistical section of the CAFR. The statement will be implemented in the City's fiscal year ending June 30, 2006 to meet GASB requirements.

Note 2: Reconciliation of Government-wide and Fund Financial Statements

A. Explanation of Certain Differences between the Governmental Fund Balance Sheet and the Statement of Net Assets

Long-term liabilities applicable to the City's governmental activities are not due and payable in the current period and accordingly are not reported as fund liabilities in the governmental fund statements. Interest on long-term debt is not accrued in governmental funds, but rather is recognized as an expenditure when due. All liabilities - both current and long-term - are reported in the government-wide statement of net assets. Also, during the year the City refunded some of its existing debt. The amount borrowed is received in the governmental funds and increases fund balance. The amount that was sent to the paying agent to be escrowed for payment of the old debt as it comes due is paid out of governmental funds and reduces fund balance. The difference between those amounts will be amortized as an adjustment to interest expense in the government-wide statement of activities over the remaining life of the refunded bonds.

Balances at June 30, 2004, were (in thousands):

| | |
|---|-----------------------|
| Unamortized bond issuance cost | \$ 9,731 |
| Deferred revenue | 112,240 |
| | <u>\$ 121,971</u> |
| | |
| Internal Service Fund total assets | 9,307 |
| Internal Service Fund liabilities | (8,609) |
| Cumulative asset resulting from undercharging the enterprise funds | 711 |
| | <u>\$ 1,409</u> |
| | |
| Bonds, notes, and capital lease payable | \$ (2,148,769) |
| Arbitrage rebate payable | (140) |
| Accrued interest | (22,111) |
| Compensated absences not reported at the fund level | (321,294) |
| Claims and judgments not reported at the fund level | (156,092) |
| Net pension obligation (liabilities less assets) | (129,910) |
| | <u>\$ (2,778,316)</u> |

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B. Explanation of Certain Differences between the Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balances and the Government-wide Statement of Activities

Bond proceeds are reported as financing sources in governmental funds and thus contribute to the change in fund balance. In the government-wide statement of net assets, however, issuing debt increases long-term liabilities and does not affect the government-wide statement of activities. Similarly, repayment of principal is an expenditure in the governmental funds, but reduces the liability in the government-wide statement of net assets.

Balances at June 30, 2004 were (in thousands):

| | |
|--------------------------------------|------------------|
| Debt issued: | |
| Refunded bonds | \$ 574,110 |
| Certificates of obligations | 2,210 |
| Commercial paper | 146,500 |
| Premium on bonds | 36,237 |
| Deferred loss on refunding | (13,838) |
| Capital appreciation bonds accretion | 396 |
| Capital appreciation bonds retired | (588) |
| | <u>745,027</u> |
| Repayments: | |
| Refunded bonds | (440,170) |
| Refunded certificates of obligation | (5,180) |
| Refunded commercial paper | (134,000) |
| Principal payments | (116,264) |
| Premium on refunded bonds | (6,604) |
| Deferred Loss on refunded bonds | 1,289 |
| | <u>(700,929)</u> |
| Amortization of: | |
| Deferred gain | 2,102 |
| Premium | (1,943) |
| | <u>44,257</u> |
| Net adjustment | <u>\$ 44,257</u> |

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Under the modified accrual basis of accounting used in the governmental funds, expenditures are not recognized for transactions that are not normally paid with expendable available financial resources. In the government-wide statement of activities, however, which is presented on the accrual basis, expenses and liabilities are reported regardless of when financial resources are available. In addition, interest on long-term debt is not recognized under the modified accrual basis of accounting until due, rather than as it accrues. The adjustment is a combination of the following items (in thousands):

| | |
|--|----------------------------|
| Property taxes earned but not available | \$ 53,257 |
| Ambulance fees earned but not available | 7,186 |
| Fines and forfeits earned but not available | 11,701 |
| Other (primarily assessments) earned but not available | <u>40,096</u> |
| Total revenue not reported at fund level | <u><u>\$ 112,240</u></u> |
| Property taxes for prior periods | \$ (68,720) |
| Ambulance fees for prior periods | (3,694) |
| Fines and forfeits for prior periods | (11,260) |
| Other (primarily assessments) for prior periods | <u>(46,575)</u> |
| Total revenue for prior period transactions | <u><u>\$ (130,249)</u></u> |
| Interest on long-term debt | \$ 7,331 |
| Municipal Employees pension | (54,438) |
| Police Officers' pension | (37,276) |
| Firefighters' pension | (7,947) |
| Claims and judgments | (93,590) |
| Debt issuance costs | 5,717 |
| Amortization of debt issuance costs | (1,417) |
| Compensated absences | 21,534 |
| Other liabilities | <u>448</u> |
| Total differences in accrued expenses | <u><u>\$ (159,638)</u></u> |

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Note 3: Deposits and Investments

A. Deposits

The City's deposits, including component units, are categorized to give an indication of the level of risk assumed by the City at year-end as follows:

- ☞ Category 1 - Insured or collateralized with securities held by the City or by its agent in the City's name.
- ☞ Category 2 - Collateralized with securities held by the pledging financial institution's trust department or agent in the City's name.
- ☞ Category 3 - Uncollateralized.

At June 30, 2004, the carrying amount of the City's deposits was \$5,544,000 and the bank balance was \$44,738,702. Of this amount, \$500,000 was covered by federal depository insurance and the balance was covered by collateral held by the City's agent in the City's name (category 1).

The carrying amount of the pension trust fund component unit deposits was \$11,863,000 and the bank balance was \$2,927,138 which is covered by collateral held by a third party in the City's name (category 1).

The carrying amount of the discretely presented component unit deposits was \$48,858,000 with a bank balance of \$42,507,879 covered by the collateral held by the City's agent in the name of the discretely presented component unit (category 1) except for \$687,053 uncollateralized (category 3).

B. Investments

The City's investments, including component units, are categorized to give an indication of the level of risk assumed by the City at year-end as follows:

- ☞ Category 1 includes investments that are insured or registered or for which the securities are held by the City's agent in the City's name.
- ☞ Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the City's name.
- ☞ Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty, or by its trust department or agent, but not in the City's name.

Certain investments, such as commingled funds, mortgage loans, and real estate limited partnerships, are not required to be categorized because they are not evidenced by securities that exist in physical or book entry form.

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A summary of investments by risk category as of June 30, 2004 follows (in thousands):

| Type of Investment | Category | | | | Total |
|---|---------------------|------------------|---------------------|---------------------|---------------------|
| | 1 | 2 | 3 | Not Categorized | |
| Primary Government | | | | | |
| <i>City of Houston</i> | | | | | |
| U.S. government and agency securities | \$ 1,411,169 | \$ - | \$ - | \$ - | \$ 1,411,169 |
| State and local government issues | 88,311 | - | - | - | 88,311 |
| Commercial Paper | 22,538 | - | - | - | 22,538 |
| Money Market Mutual Funds | - | - | - | 24,082 | 24,082 |
| Flexible repurchase agreements | - | 22,204 | - | - | 22,204 |
| Other Mutual Funds | - | - | - | 2,436 | 2,436 |
| Total City | 1,522,018 | 22,204 | - | 26,518 | 1,570,740 |
| <i>Houston Area Water Corporation</i> | | | | | |
| U.S. government and agency securities | 12,120 | - | - | - | 12,120 |
| State and local government issues | 730 | - | - | - | 730 |
| Commercial Paper | 201 | - | - | - | 201 |
| Money Market Mutual Funds | - | - | - | 474 | 474 |
| Certificate of Deposit | - | - | - | - | - |
| Total Houston Area Water Corporation | 13,051 | - | - | 474 | 13,525 |
| Total Primary Government | \$ 1,535,069 | \$ 22,204 | \$ - | \$ 26,992 | \$ 1,584,265 |
| Pension Trust Fund component units | | | | | |
| U.S. government and agency securities | \$ 88,750 | \$ - | \$ - | \$ - | \$ 88,750 |
| Corporate bonds | 100,820 | - | - | - | 100,820 |
| Other fixed income securities | 617,678 | - | 312,670 | - | 930,348 |
| Commingled equity funds | - | - | - | 291,694 | 291,694 |
| Common & preferred stock | 2,210,016 | - | 552,420 | - | 2,762,436 |
| Real estate and partnerships | - | - | - | 759,160 | 759,160 |
| Short-term investment funds | 80,834 | - | 224,016 | 271,622 | 576,472 |
| Collateral on security lending | 43,334 | - | 809,987 | 305,144 | 1,158,465 |
| Total pension trust fund component units | \$ 3,141,432 | \$ - | \$ 1,899,093 | \$ 1,627,620 | \$ 6,668,145 |
| Discretely Presented Component Units | | | | | |
| U.S. government and agency securities | \$ 42,633 | \$ - | \$ - | \$ - | \$ 42,633 |
| State and local government issues | 253 | - | - | - | 253 |
| Corporate bonds | 294 | - | - | - | 294 |
| Common stock | - | 14,195 | - | - | 14,195 |
| Commercial Paper | 65 | - | - | - | 65 |
| Land | - | - | - | 3 | 3 |
| External Investment Pool | - | - | - | 17,164 | 17,164 |
| Money market and mutual funds | - | - | - | 23,985 | 23,985 |
| Certificates of Deposit | 316 | - | - | - | 316 |
| Total discretely presented component units | \$ 43,561 | \$ 14,195 | \$ - | \$ 41,152 | \$ 98,908 |

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Note 4: Allowance for Doubtful Accounts

The following were the allowances for doubtful accounts receivable by fund as of June 30, 2004 (in thousands):

| <u>Fund</u> | <u>Amount</u> |
|---|-------------------|
| General | |
| Uncollectible general property taxes | \$ 44,455 |
| Ambulance charges | 276,781 |
| Fines and forfeits | 145,516 |
| Demolition liens | 22,683 |
| Others | 2,929 |
| Grant revenue | 41,297 |
| Airport System | 2,978 |
| Convention and Entertainment Facilities | |
| Accounts receivable | 600 |
| Hotel occupancy tax | 427 |
| Combined Utility System | 80,287 |
| | <u>\$ 617,953</u> |

Note 5: Property Tax

The City's annual ad valorem property tax is required to be levied by October 1, or as soon thereafter as practicable, on the assessed value listed as of the prior January 1 for all real and certain personal property. Taxes are due on January 31 of the year following the year of the levy. A lien is placed on taxable property if the assessment remains unpaid as of June 30 of the year following the year of the levy. The tax rate established by the City Council for the 2003 tax year was \$0.655 per \$100 of assessed value with \$0.49452 for operations and \$0.16048 for debt service.

The City Charter limits the property tax rate to \$0.50 per \$100 of assessed valuation excluding taxes levied for "debt service," as that term is defined in Section 1 of Article III of the City Charter. The Texas Property Tax Code ("Code"), with certain exceptions, exempts intangible personal property, household goods, and family-owned automobiles from taxation. In addition, the Code provides for countywide appraisal districts. Since January 1, 1983, the appraisal of property within the City has been the responsibility of the countywide appraisal district. The appraisal district is required under the Code to appraise all taxable property within the appraisal district on the basis of 100% of its appraised value and is prohibited from applying any assessment ratios. The value of real property within the appraisal district must be reviewed every three years. However, the City may, at its own expense, require annual reviews of appraised values. The City may challenge appraised values established by the appraisal district through various appeals and, if necessary, take legal action.

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Note 6: Capital Assets

A. Governmental activities of the Primary Government

A summary of changes in capital assets for the year ended June 30, 2004 follows (in thousands):

| | Balance July 1, 2003 | Additions | Retirements | Transfers | Balance June 30, 2004 |
|--|-------------------------------------|------------------|--------------------|-------------------|--------------------------------------|
| Primary Government | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | \$ 337,089 | \$ 6,057 | \$ (924) | \$ 9,522 | \$ 351,744 |
| Land associated with capital lease | 3,200 | - | - | - | 3,200 |
| Right of way | 1,558,305 | 7,218 | (404) | - | 1,565,119 |
| Construction Work in Progress | 460,640 | 146,540 | - | (281,472) | 325,708 |
| Total capital assets not being depreciated | <u>2,359,234</u> | <u>159,815</u> | <u>(1,328)</u> | <u>(271,950)</u> | <u>2,245,771</u> |
| Other capital assets: | | | | | |
| Buildings | 295,012 | 8,207 | (1,589) | 115,074 | 416,704 |
| Buildings associated with capital lease | 50,179 | - | - | - | 50,179 |
| Improvements and Equipment | 538,525 | 37,061 | (21,639) | 43,483 | 597,430 |
| Streets, Storm Sewers, Bridges | 4,387,138 | 18,782 | (3,059) | 110,942 | 4,513,803 |
| Total other capital assets | <u>5,270,854</u> | <u>64,050</u> | <u>(26,287)</u> | <u>269,499</u> | <u>5,578,116</u> |
| Less accumulated depreciation for: | | | | | |
| Buildings | (204,775) | (15,099) | 1,010 | - | (218,864) |
| Buildings associated with capital lease | (1,677) | (2,007) | - | - | (3,684) |
| Improvements and Equipment | (288,904) | (44,338) | 19,990 | - | (313,252) |
| Infrastructure | (1,704,966) | (85,711) | 2,668 | - | (1,788,009) |
| Total accumulated depreciation | <u>(2,200,322)</u> | <u>(147,155)</u> | <u>23,668</u> | <u>-</u> | <u>(2,323,809)</u> |
| Other capital assets, net | <u>3,070,532</u> | <u>(83,105)</u> | <u>(2,619)</u> | <u>269,499</u> | <u>3,254,307</u> |
| Primary Government capital assets, net | <u>\$ 5,429,766</u> | <u>\$ 76,710</u> | <u>\$ (3,947)</u> | <u>\$ (2,451)</u> | <u>\$ 5,500,078</u> |

B. Business-type Activities

| | Balance July 1, 2003 | Additions | Retirements | Transfers | Balance June 30, 2004 |
|---|-------------------------------------|------------------|--------------------|------------------|--------------------------------------|
| Airport System | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | \$ 130,959 | \$ 39,128 | \$ - | \$ - | \$ 170,087 |
| Construction Work in Progress | 742,295 | 398,737 | (8) | (437,951) | 703,073 |
| Total capital assets not being depreciated | <u>873,254</u> | <u>437,865</u> | <u>(8)</u> | <u>(437,951)</u> | <u>873,160</u> |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 2,140,240 | 1,642 | (683) | 437,951 | 2,579,150 |
| Total other capital assets | <u>2,140,240</u> | <u>1,642</u> | <u>(683)</u> | <u>437,951</u> | <u>2,579,150</u> |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (756,208) | (88,437) | 135 | - | (844,510) |
| Total accumulated depreciation | <u>(756,208)</u> | <u>(88,437)</u> | <u>135</u> | <u>-</u> | <u>(844,510)</u> |
| Other capital assets, net | <u>1,384,032</u> | <u>(86,795)</u> | <u>(548)</u> | <u>437,951</u> | <u>1,734,640</u> |
| Airport System capital assets, net | <u>2,257,286</u> | <u>351,070</u> | <u>(556)</u> | <u>-</u> | <u>2,607,800</u> |
| Convention and Entertainment Facilities | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | 99,091 | 400 | - | 31,002 | 130,493 |
| Construction Work in Progress | 171,917 | 34,120 | - | (182,094) | 23,943 |
| Total capital assets not being depreciated | <u>271,008</u> | <u>34,520</u> | <u>-</u> | <u>(151,092)</u> | <u>154,436</u> |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 272,741 | 5,335 | (6,292) | 153,543 | 425,327 |
| Total other capital assets | <u>272,741</u> | <u>5,335</u> | <u>(6,292)</u> | <u>153,543</u> | <u>425,327</u> |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (99,023) | (13,880) | 124 | - | (112,779) |
| Total accumulated depreciation | <u>(99,023)</u> | <u>(13,880)</u> | <u>124</u> | <u>-</u> | <u>(112,779)</u> |
| Other capital assets, net | <u>173,718</u> | <u>(8,545)</u> | <u>(6,168)</u> | <u>153,543</u> | <u>312,548</u> |
| Convention and Entertainment Facilities capital assets, net | <u>444,726</u> | <u>25,975</u> | <u>(6,168)</u> | <u>2,451</u> | <u>466,984</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

| | Balance July 1, 2003 | Additions | Retirements | Transfers | Balance June 30, 2004 |
|--|-------------------------------------|-------------------|--------------------|------------------|--------------------------------------|
| Combined Utility System | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | 98,842 | 644 | (7) | - | 99,479 |
| Construction Work in Progress | 704,315 | 250,834 | - | (386,615) | 568,534 |
| Total capital assets not being depreciated | <u>803,157</u> | <u>251,478</u> | <u>(7)</u> | <u>(386,615)</u> | <u>668,013</u> |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 208,438 | 4,353 | (6,946) | 21,889 | 227,734 |
| Plants and Lines | 6,360,112 | 17,801 | (51,985) | 364,726 | 6,690,654 |
| Total other capital assets | <u>6,568,550</u> | <u>22,154</u> | <u>(58,931)</u> | <u>386,615</u> | <u>6,918,388</u> |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (109,435) | (12,686) | 6,744 | | (115,377) |
| Plants and Lines | (2,989,740) | (186,756) | 39,792 | - | (3,136,704) |
| Total accumulated depreciation | <u>(3,099,175)</u> | <u>(199,442)</u> | <u>46,536</u> | <u>-</u> | <u>(3,252,081)</u> |
| Other capital assets, net | <u>3,469,375</u> | <u>(177,288)</u> | <u>(12,395)</u> | <u>386,615</u> | <u>3,666,307</u> |
| Combined Utility System capital assets, net | <u>4,272,532</u> | <u>74,190</u> | <u>(12,402)</u> | <u>-</u> | <u>4,334,320</u> |
| Houston Area Water Corporation | | | | | |
| Capital assets not being depreciated: | | | | | |
| Construction Work in Progress | 97,007 | 29,399 | - | - | 126,406 |
| Total capital assets not being depreciated | <u>97,007</u> | <u>29,399</u> | <u>-</u> | <u>-</u> | <u>126,406</u> |
| Houston Area Water Corporation capital assets, net | <u>97,007</u> | <u>29,399</u> | <u>-</u> | <u>-</u> | <u>126,406</u> |
| Business-type activities capital assets, net | <u>\$ 7,071,551</u> | <u>\$ 480,634</u> | <u>\$ (19,126)</u> | <u>\$ 2,451</u> | <u>\$ 7,535,510</u> |

C. Depreciation Expense

Depreciation expense was charged to functions/ programs of the primary government as follows (in thousands):

| | |
|---|-------------------|
| Governmental activities | |
| General government | \$ 14,428 |
| Public safety | 21,297 |
| Public works | 11,874 |
| Health | 2,172 |
| Parks and recreation | 9,840 |
| Library | 1,833 |
| Infrastructure | 85,711 |
| Total depreciation expense - governmental activities | <u>\$ 147,155</u> |
| Business-type activities | |
| Airport System | \$ 88,437 |
| Convention & Entertainment Facilities | 13,880 |
| Combined Utility System | 199,442 |
| Total depreciation expense - business-type activities | <u>\$ 301,759</u> |

D. Pension Trust Funds

In February 1998, the Firefighters' Relief and Retirement Fund purchased land in the amount of \$541,194 for use in the construction of a new office building for its operations and its members. In April of 2001, the construction of the new building was completed. The building cost of \$9,080,841 is being depreciated over 30 years. The accumulated depreciation for the building as of June 30, 2004 amounted to \$995,732.

CITY OF HOUSTON, TEXAS
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June 30, 2004

Note 7: Short-Term Debt – Tax and Revenue Anticipation Notes

The City issues tax and revenue anticipation notes (“TRANS”) in advance of property tax collections, depositing the proceeds in its general fund. These notes are necessary because the City’s operating expenses are spread over the entire fiscal year, and the collection of major revenue sources such as property and sales taxes does not coincide with these expenses.

Short-term debt activity for the year ended June 30, 2004, was as follows (amounts in thousands):

| | <u>Balance</u> <u>July 1, 2003</u> | <u>Issued</u> | <u>Redeemed</u> | <u>Balance</u> <u>June 30, 2004</u> |
|--------------------|---------------------------------------|---------------|-----------------|--|
| Tax and revenue | | | | |
| Anticipation notes | \$ - | \$ 190,000 | \$ 190,000 | \$ - |

On July 1, 2003, the City closed on the sale of \$175,000,000 Tax and Revenue Anticipation Notes (“TRANS”), Series 2003. The proceeds of the TRANS were used to pay working capital expenditures until tax revenues were received. The stated interest rate range was 1.5% to 2.0%, and the average yield was 0.86%. The notes matured on June 30, 2004.

On October 15, 2003 the City signed a private placement agreement allowing it to borrow up to \$50,000,000 for TRANS, Series 2002A. The City drew \$15,000,000 of this amount on October 15, 2003. The proceeds of the TRANS Series A were used to pay working capital expenditures until tax revenues were received. The interest rate was 0.9878%. The notes matured on March 31, 2004.

Note 8: Long-Term Liabilities

A. General Long-Term Liabilities

Changes in General Long-Term Liabilities for the year ended June 30, 2004 are summarized as follows (in thousands):

| | <u>Balance</u> <u>July 1, 2003</u> | <u>Additions</u> | <u>Retirements/ Transfers</u> | <u>Balance</u> <u>June 30, 2004</u> | <u>Amounts</u> <u>Due within</u> <u>One Year</u> |
|---|---------------------------------------|---------------------|-----------------------------------|--|--|
| Governmental Activities | | | | | |
| Bonds and notes payable | | | | | |
| General tax obligation debt | \$ 2,002,360 | \$ 722,820 | \$ (693,641) | \$ 2,031,539 | \$ 121,250 |
| Accretions, net | 1,510 | 396 | (588) | 1,318 | - |
| HUD Section 108 Loans | 25,810 | - | (945) | 24,865 | 1,470 |
| Houston Emergency Center capital lease | 53,372 | - | (1,028) | 52,344 | 1,090 |
| Plus premium on bonds | 32,715 | 36,237 | (8,547) | 60,405 | - |
| Less deferred amount on refundings | (11,255) | (13,838) | 3,391 | (21,702) | - |
| Total bonds and notes payable | <u>2,104,512</u> | <u>745,615</u> | <u>(701,358)</u> | <u>2,148,769</u> | <u>123,810</u> |
| Other liabilities: | | | | | |
| Claims and judgments | 74,307 | 115,657 | (21,847) | 168,117 | 66,069 |
| Compensated absences | 350,733 | 34,189 | (46,759) | 338,163 | 47,928 |
| Arbitrage rebate | 444 | - | (304) | 140 | 37 |
| Pension liability | 87,461 | 170,281 | (78,567) | 179,175 | - |
| Total other liabilities | <u>512,945</u> | <u>320,127</u> | <u>(147,477)</u> | <u>685,595</u> | <u>114,034</u> |
| Governmental Activities Long-Term Liabilities | <u>\$ 2,617,457</u> | <u>\$ 1,065,742</u> | <u>\$ (848,835)</u> | <u>\$ 2,834,364</u> | <u>\$ 237,844</u> |
| Discretely Presented Component Units: | | | | | |
| Notes payable | 15,398 | 18,926 | - | 34,324 | 6,005 |
| Revenue bonds | <u>87,455</u> | <u>39,160</u> | <u>-</u> | <u>126,615</u> | <u>3,935</u> |
| Discretely Presented Component Units Long-Term | <u>\$ 102,853</u> | <u>\$ 58,086</u> | <u>\$ -</u> | <u>\$ 160,939</u> | <u>\$ 9,940</u> |

(Continued)

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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| | Balance | | Retirements/ | Balance | Amounts |
|--|---------------------|---------------------|-----------------------|----------------------|-------------------|
| | July 1, 2003 | Additions | Transfers | June 30, 2004 | Due within |
| | | | | | One Year |
| Business-type activities | | | | | |
| Bonds and notes payable | | | | | |
| Airport System debt | \$ 2,209,365 | \$ 20,000 | \$ (17,985) | \$ 2,211,380 | \$ 38,865 |
| Convention and Entertainment debt | 643,085 | - | (6,265) | 636,820 | 29,090 |
| Combined Utility System debt | 3,842,819 | 3,339,170 | (3,248,409) | 3,933,580 | 14,031 |
| Houston Area Water Corporation | 130,260 | - | - | 130,260 | - |
| Long-term contracts - Combined Utility | 262,771 | - | (16,521) | 246,250 | 17,548 |
| Premiums, discounts and deferred amount on refundings | 115,906 | (113,747) | (41,335) | (39,176) | - |
| Total bonds and notes payable | <u>7,204,206</u> | <u>3,245,423</u> | <u>(3,330,515)</u> | <u>7,119,114</u> | <u>99,534</u> |
| Other liabilities: | | | | | |
| Claims and judgments | 11,306 | 4,320 | (3,748) | 11,878 | 3,832 |
| Compensated absences | 28,720 | 4,377 | (8,938) | 24,159 | 10,699 |
| Arbitrage rebate | 5,626 | 853 | (4,328) | 2,151 | - |
| Pension liability | 24,146 | 37,095 | (16,138) | 45,103 | - |
| Total other liabilities | <u>69,798</u> | <u>46,645</u> | <u>(33,152)</u> | <u>83,291</u> | <u>14,531</u> |
| Business-type activities | | | | | |
| long-term liabilities | <u>\$ 7,274,004</u> | <u>\$ 3,292,068</u> | <u>\$ (3,363,667)</u> | <u>\$ 7,202,405</u> | <u>\$ 114,065</u> |
| Total Reporting Entity | | | | | |
| long-term liabilities | <u>\$ 9,994,314</u> | <u>\$ 4,415,896</u> | <u>\$ (4,212,502)</u> | <u>\$ 10,197,708</u> | <u>\$ 361,849</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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B. Schedule of Changes in Bonds and Long-Term contracts (amounts expressed in thousands)

| | Stated Interest Rate Range | Face Value Outstanding 7/1/2003 | FY04 Issued/ Increased |
|--|-------------------------------|---------------------------------------|------------------------------|
| General Tax Obligation Debt | | | |
| General obligation bonds | 5.40 | \$ 2,365 | \$ - |
| Public improvement bonds | 2.00 to 7.00 | 1,502,635 | 574,110 |
| Commercial paper | 1.255 to 10.00 | 415,300 | 146,500 |
| Annexed district bonds | 3.8 to 8.25 | 42,532 | - |
| Tax and revenue certificates of obligation | 3.00 to 6.00 | 39,528 | 2,210 |
| Total General Tax Obligation Debt | | \$ 2,002,360 | \$ 722,820 |
| HUD Section 108 Loans | | \$ 25,810 | \$ - |
| Houston Emergency Center Lease | | \$ 53,372 | \$ - |
| Revenue Bonded Debt and Long Term Contracts | | | |
| Airport System Bonds | | | |
| Subordinate lien refunding revenue bonds | 1.21 to 6.75 | \$ 2,209,365 | \$ - |
| Commercial paper | 1.705 to 10.00 | - | 20,000 |
| | | 2,209,365 | 20,000 |
| Convention and Entertainment Facilities | | | |
| SeniorLien hotel occupancy tax/parking facilities | 1.45 to 6.0 | 620,585 | - |
| Hotel and parking revenue commercial paper | 1.506 to 10.00 | 22,500 | - |
| | | 643,085 | - |
| Combined Utility System | | | |
| Combined Utility System first lien bonds | 1.436 to 5.25 | - | 3,029,170 |
| Combined Utility System junior lien revenue bonds | 2.72 to 7.00 | 3,427,569 | - |
| Combined Utility System commercial paper | 1.393 to 10.00 | - | 40,000 |
| Combined Utility System commercial paper | 1.24 to 10.00 | 415,250 | 270,000 |
| | | 3,842,819 | 3,339,170 |
| Houston Area Water Corporation | 3.75 to 5.50 | 130,260 | - |
| Long-Term Contracts-Combined Utility System | | | |
| Coastal Water Authority | 4.35 to 7.50 | 228,190 | - |
| Trinity River Authority | 4.00 to 7.10 | 10,000 | - |
| Other long term contracts | 3.22 to 5.87 | 24,581 | - |
| | | 262,771 | - |
| Total Revenue Bonded Debt and Long-Term Contracts, Primary Government | | \$ 7,088,300 | \$ 3,359,170 |
| Total Bonds and Long-Term Contracts Payable, Primary Government | | \$ 9,169,842 | \$ 4,081,990 |

(Continued)

1) Adjustments consist of unamortized bond premiums, discounts, deferred (gains) losses from bond refundings and capital appreciation bond accretions.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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| FY04 | Face Value | Adjustments ⁽¹⁾ | Net Outstanding |
|---------------------|---------------------|----------------------------|---------------------|
| Redeemed/Refunded | Outstanding 6/30/04 | | 6/30/2004 |
| \$ 1,000 | \$ 1,365 | \$ - | \$ 1,365 |
| 520,310 | 1,556,435 | 38,703 | 1,595,138 |
| 134,000 | 427,800 | - | 427,800 |
| 30,112 | 12,420 | - | 12,420 |
| 8,219 | 33,519 | 1,318 | 34,837 |
| <u>\$ 693,641</u> | <u>\$ 2,031,539</u> | <u>\$ 40,021</u> | <u>\$ 2,071,560</u> |
| <u>\$ 945</u> | <u>\$ 24,865</u> | <u>\$ -</u> | <u>\$ 24,865</u> |
| <u>\$ 1,028</u> | <u>\$ 52,344</u> | <u>\$ -</u> | <u>\$ 52,344</u> |
| | | | |
| \$ 17,985 | \$ 2,191,380 | \$ (40,986) | \$ 2,150,394 |
| - | 20,000 | - | 20,000 |
| <u>17,985</u> | <u>2,211,380</u> | <u>(40,986)</u> | <u>2,170,394</u> |
| | | | |
| 6,265 | 614,320 | 29,859 | 644,179 |
| - | 22,500 | - | 22,500 |
| <u>6,265</u> | <u>636,820</u> | <u>29,859</u> | <u>666,679</u> |
| | | | |
| - | 3,029,170 | (168,131) | 2,861,039 |
| 2,563,159 | 864,410 | 143,304 | 1,007,714 |
| - | 40,000 | - | 40,000 |
| 685,250 | - | - | - |
| <u>3,248,409</u> | <u>3,933,580</u> | <u>(24,827)</u> | <u>3,908,753</u> |
| | | | |
| - | 130,260 | (849) | 129,411 |
| | | | |
| 14,105 | 214,085 | (2,373) | 211,712 |
| 2,000 | 8,000 | - | 8,000 |
| 416 | 24,165 | - | 24,165 |
| <u>16,521</u> | <u>246,250</u> | <u>(2,373)</u> | <u>243,877</u> |
| | | | |
| <u>\$ 3,289,180</u> | <u>\$ 7,158,290</u> | <u>\$ (39,176)</u> | <u>\$ 7,119,114</u> |
| | | | |
| <u>\$ 3,984,794</u> | <u>\$ 9,267,038</u> | <u>\$ 845</u> | <u>\$ 9,267,883</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

C. Terms of Long-Term Debt

1. General Obligation Bonds

These bonds are payable from the general revenue of the City. No new General Obligation Bonds were issued this fiscal year.

2. Public Improvement Bonds

The City has issued Public Improvement Bonds on numerous occasions. The proceeds are used for street and bridge improvements, traffic signals, municipal buildings, parks, and other capital improvements. Interest is payable semi-annually; principal is payable in various amounts annually through March 1, 2025.

3. General Obligation Swap Agreements

On February 20, 2004 the City entered into a basis swap referred to as a “synthetic reduced variance coupon swap”.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. The City will pay a variable rate and receive a fixed rate of return on a notional principal value of \$200,000,000, with the underlying bonds being various maturities of Public Improvement Bonds issued between 1998 and 2002. The City pays an amount equal to 5% plus the tax-exempt market standard Bond Market Association (“BMA”) Index rate divided by .667 minus the taxable six-month US Dollar London InterBank Offered Rate (“LIBOR”) rate minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5%. Because the two 5% fixed rates offset one another, the City is effectively making payments based on BMA and receiving payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from September 1, 2003 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. Based on the initial agreement, the City will receive its first payment of \$500,000 on March 1, 2005. After that date a payment will be received or made every six months based on the indexes for the prior budget period.

As of June 30, 2004 the swap created synthetic variable-rate exposure is as follows:

| | TERMS | RATE |
|--|------------|----------------|
| Variable rate payment to counter-party | Fixed Rate | 5.0000 |
| | BMA/0.667 | 1.5590 |
| | -LIBOR | -1.1600 |
| | -Constant | <u>-0.6900</u> |
| | Subtotal | 4.7090 |
| Fixed rate payment from counter-party | Fixed | <u>5.0000</u> |
| Net interest rate swap receipt (payment) | | <u>0.2910</u> |

The average rate for the underlying PIBS bonds is 5.19%. This swap reduces the effective rate by 0.2910% to 4.8990%.

Fair value. The fair value of the swap was negative \$1,727,000 as of June 30, 2004. The value was calculated using the zero coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2004, the City was not exposed to credit risk because the swap had a negative fair value. However, if interest rates change and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. The swap counter-party has not been rated by the rating agencies. To mitigate this potential credit risk for an unrated counter-party, the City required the counter-party to purchase a surety bond from an AAA-rated insurance company. Under the surety bond, the insurance company is unconditionally and irrevocably obligated to guarantee all payments under the swap by the counter-party. The City’s obligations under the swap are also insured. Should the insurance company’s rating decline in the future, the counter-party will be required to post collateral for the City’s benefit.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
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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 BMA-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 BMA Index and six-month US Dollar LIBOR. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of BMA 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 than 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 a major reduction in marginal income tax rates, repeal of the tax-exemption on 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. The counter-party 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 the counter-party 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 termination date of the agreement in 2025.

Swap receipts and associated debt. As of June 30, 2004, the City expected to receive swap payments as reported in Note 8D, assuming current interest rates remain the same. As rates vary, variable rate bond interest payments and net swap payments will vary. Related debt service payments on the underlying Public Improvement Bonds are included in Note 8D with other City Public Improvement Bonds.

4. General Obligation Commercial Paper

The City currently issues Commercial Paper Notes ("Notes") under its \$279,000,000 General Obligation Commercial Paper Program, Series A, its \$99,300,000 General Obligation Commercial Paper Program, Series B, its \$275,000,000 General Obligation Commercial Paper Program Series D, its \$155,000,000 General Obligation Commercial Paper Program Series E, and its \$139,500,000 General Obligation Commercial Paper Program Series F. The City refunded \$65,000,000 of Series C General Obligation Commercial Paper Notes and discontinued the program in October 2003. The Notes may be issued for a period not to exceed 270 days and will bear interest based upon the specified term of the Notes, but not to exceed 10%. Principal on the Notes is payable from ad valorem tax revenue, the issuance of new commercial paper, bond proceeds and other funds provided under the line of credit. Interest is payable as the Notes mature from ad valorem tax revenue collected by the City. Proceeds from the Notes are used to finance various capital projects and public improvements for authorized City purposes. Upon maturity, the Notes will be remarketed by the commercial paper dealers or extinguished with long-term debt.

During fiscal year 2004 the weighted average interest rates for the Series A, B, C, D, and E Notes, including dealer and credit fees, were 1.17%, 1.21%, 1.06%, 1.155% and 1.22% respectively. Year-end rates, including fees, for Series A, B, D, and E were 1.315%, 1.261%, 1.255%, and 1.275% respectively. All Series C notes had been refunded. No notes have been issued under Series F. The Credit Agreements expire on the following dates: Series A on June 9, 2007, Series B on March 30, 2007, the Series D on May 27, 2007, the Series E on November 21, 2006, and Series F on June 18, 2007.

5. Annexed District Bonds Assumed

The City has assumed general tax obligation debt of annexed districts. The payment dates and maturities vary, but in general, interest is payable semi-annually and principal is payable annually. Interest rates range from 3.80% to 8.25%, and the final maturity date is October 1, 2021.

6. Certificates of Obligation

Since 1988, the City has issued Certificates of Obligation each year to provide for the purchase of equipment utilized in general City operations including, without limitation, police vehicles, maintenance vehicles and equipment, computer equipment, and costs associated with demolishing dangerous structures. Each year the City is obligated to levy, assess, and collect ad valorem taxes sufficient to pay principal and interest on the certificates payable semi-annually until maturity. Generally, these certificates are not subject to redemption prior to final maturity on March 1, 2022.

7. HUD Section 108 Loan

The City's Housing Department has borrowed money from HUD and loaned it to the Houston Small Business Development Corp. (HSBDC). HSBDC in turn makes small business loans to under-served areas of the community. In fiscal year 2004 there were no new loans. The beginning balance of monies owed to HUD was \$25,810,000 and ending balance was \$24,865,000 after loan repayments.

CITY OF HOUSTON, TEXAS
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8. Houston Emergency Center Lease

The City has entered into a capital lease for equipment used in the Emergency Management Center. Repayment terms are laid out in Note 9 Leases.

9. Airport System Revenue Bonds

These funds are paid solely from a lien on the airport system's net revenues, which must total 110% of the debt service requirements for subordinate lien bonds for such fiscal year. The bonds have a final maturity in the year 2032.

The City purchased a Municipal Debt Service Reserve Fund Policy concurrently with the issuance of the Airport System Subordinate Lien Revenue Bonds Series 2001A, 2002A, and 2002B. The reserve policy unconditionally guarantees the payment of principal and interest on all current outstanding airport system subordinate lien issues as of the dates of the Series 2001A, 2002A, and 2002B Bonds. The reserve policies terminate upon final maturities on various dates in the future. Each of the draws made against the reserve policy shall bear interest at the Prime Rate plus two percent, not to exceed a maximum interest rate of 12%. The repayment provisions require one-twelfth of the policy costs for each draw to be repaid monthly, beginning the first month following the date of each draw.

10. Airport System Commercial Paper

Airport System Senior Lien Commercial Paper Notes Series A and B (the "Notes") have been authorized for \$150 million, and Airport System Inferior Lien Commercial Paper Notes Series C has been authorized for \$150 million to establish, improve, enlarge, extend and repair the City's Airport System, acquire land, and pay interest and cost of issuance of the Notes. As of June 30, 2004, \$20 million in Airport System commercial paper is outstanding. The year-end average interest rate for the year, including dealer credit fees, was 1.71%.

The Series A and B Notes are collateralized by revolving credit agreements convertible to direct pay letters of credit issued by two banks, and a lien on the net revenues of the Airport System. The letter of credit will terminate on January 11, 2005 for Series A and B.

11. Convention and Entertainment Facilities Bonds

These bonds are special limited obligations of the City that are paid from a lien on the pledged receipts of the Hotel Occupancy Tax (HOT) revenues collected from seven City-owned parking facilities, and rebates of certain taxes derived from operation of the Convention Center Hotel and Parking Garage. The pledged HOT receipts are equal to 5.65% of the cost of substantially all hotel room rentals in the City, plus related penalties and interest for delinquent payments. As long as any of the Senior Lien Bonds remain outstanding, the City is required to levy a hotel occupancy tax at a rate not less than 7%. The City currently levies a hotel occupancy tax at the rate of 7%. Final maturity of the bonds is September 1, 2033.

The City has obtained a debt service reserve insurance policy for the Senior Lien Hotel Occupancy Tax Revenue Bonds. The surety policy provides insurance sufficient to pay maximum annual debt service of the Bonds. The surety policy expires upon final maturity of all outstanding bonds (September 1, 2033).

The City of Houston Convention Center Revenue Bonds, Series 2001C-1 and 2001C-2, were initially issued as 35-day auction rate securities with staggered reset dates. They are subject to conversion, at the option of the City and subject to certain restrictions, to bonds that bear interest at rates other than auction rates. Notwithstanding the establishment of the applicable auction rate, the maximum interest rate permitted under the ordinance is 10%. Interest rates in effect at year-end, including the effects of fees, were 1.67% for the 2001C-1 bonds and 1.54% for the 2002C-2 bonds. Average rates for the year were 1.24% and 1.29% respectively.

12. Convention and Entertainment Hotel and Parking Revenue Commercial Paper

Hotel Occupancy Tax and Parking Revenue Commercial Paper Notes Series A has been authorized for \$75 million to finance the costs of site acquisition, construction, and improvements for convention center facilities. The Notes are issued as subordinate lien debt. The maturity of the Notes may not exceed 270 days and the maximum interest rate may not exceed 10%. Upon maturity, the Notes will be remarketed by the commercial paper dealer or extinguished with long-term debt. The Notes are collateralized by a letter of credit that expires on January 16, 2005. During fiscal year 2004 the weighted average interest rate for the Notes, including fees, was 1.398%. The average rate in effect at year-end was 1.506%.

13. Combined Utility System First Lien Revenue Bonds

City Council authorized creation of the Combined Utility System ("the System") on September 3, 2003. The Combined Utility System currently consists of the City's Water and Sewer System. In the future the City may elect to include other utility systems. Its bonds are special obligations of the City payable from net revenues of the System after payments for maintenance and operations

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and debt service on Water and Sewer junior lien bonds. Net revenues must equal 110% of the first Lien Revenue Bonds debt service.

14. Combined Utility System Commercial Paper

The Combined Utility System Commercial Paper Notes Program Series A has been authorized for \$700 million to finance costs of eligible projects for the City's combined utility system, including acquisition or construction of improvements and additions or extension for the system, and costs of issuance. The notes are issued as third lien obligations. The maturity of the Notes may not exceed 270 days and the maximum interest rate may not exceed 10%. Principal on the Notes is payable from the issuance of new commercial paper, bond proceeds and other funds provided under the line of credit available through a revolving credit agreement with four banks. The agreement expires on June 8, 2007. Interest on the Notes is payable from net revenues of the System and loans under the credit agreement. During fiscal year 2004 the weighted average interest rate and the year-end rate for the Notes, including credit and dealer fees, was 1.393%.

15. Combined Utility System Swap Agreements

Combined Utility System swaps. On June 10, 2004 the City entered into three identical pay-fixed, receive-variable rate swap agreements. The City pre-qualified six firms to submit competitive bids on the swap. The bidding took place on June 7, 2004. The three firms selected all matched the lowest fixed rate bid of 3.7784%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates in conjunction with the City's Combined Utility System 2004B auction rate variable interest bonds ("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.

Terms. The notional amount of the swap agreements totals \$653,325,000, 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 3.7784% (lower than the rate for fixed rate debt at time of issuance) 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.

At June 30, 2004, the effective rate on the bonds associated with the swap was computed as follows:

| | <u>TERMS</u> | <u>RATE (%)</u> <u>Received</u> <u>(Paid)</u> |
|---|---------------|---|
| Variable rate payment from counterparties | LIBOR x 57.6% | 0.67896 |
| | + Constant | <u>0.37000</u> |
| Swap receipt | | 1.04896 |
| Fixed rate paid to counterparties | Fixed | <u>(3.77840)</u> |
| Net rate (paid)/received for swap | | (2.72944) |
| Average variable rate paid on 2004B bonds | | (1.18333) |
| Plus dealer and auction fees on 2004B bonds | | <u>(0.2530)</u> |
| Effective rate of 2004B bonds | | <u>(4.16577)</u> |

In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds was 5.0795%, which were bonds of a comparable maturity.

Fair value. Because interest rates have declined, the swaps had a negative fair value of \$14,648,00 as of June 30, 2004. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

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Credit risk. As of June 30, 2004, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase 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 June 30, 2004, 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. No collateral has been required to date.

| COUNTERPARTY | Notional <u>Amount</u> | <u>FAIR VALUE</u> | Counterparty Credit Rating <u>(Moody's /S&P /Fitch)</u> |
|--------------|---------------------------|------------------------|--|
| I | \$353,325,000 | (\$ 7,892,000) | Aa3 /A+ /AA- |
| II | 150,000,000 | (3,378,000) | AAA / AAA / -- |
| III | <u>150,000,000</u> | <u>(3,378,000)</u> | Aa2 /AA+ /AA+ |
| TOTAL | <u>\$653,325,000</u> | <u>(\$ 14,648,000)</u> | |

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. The City has issued tax-exempt auction rate bonds with an average rate of 1.18333% (not including dealer and auction agent fees) as of June 30, 2004, whereas the associated LIBOR-based rate of the swap was 1.04896%.

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 should be terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.

Swap payments and associated debt. As of June 30, 2004, debt service requirements for the swap agreements are reported in Note 8D, assuming current interest rates remain the same. As rates vary, variable rate bond interest payments and net swap payments will vary. Expected debt service payments on the associated Combined Utility System 2004B Bonds are included with other Combined Utility System Bonds on Note 8D.

16. Water and Sewer System Commercial Paper

The Water and Sewer System Commercial Paper Notes Programs, Series A and Series B, have been discontinued as a result of the restructuring of the water and sewer system into the Combined Utility System. All outstanding notes have been refunded. During fiscal year 2004 the average interest rate (including credit and dealer fees) for the Series A Notes was 1.20%.

17. Water and Sewer System Prior and Junior Lien Revenue Bonds

These bonds are paid solely from a lien on the net water and sewer system revenues, which must total 110% of the current debt service requirements on the junior lien bonds. As part of the restructuring to the new Combined Utility System, the City refunded a substantial portion of the outstanding junior lien bonds on June 10, 2004 and reissued bonds as Combined Utility System bonds. Debt service payments on remaining Water and Sewer junior lien revenue bonds will be made after payment of operating expenses and prior to any debt service payments on the Combined Utility System bonds. The final maturity date for the remaining junior lien bonds is December 1, 2028.

18. Coastal Water Authority (CWA)

The contract payable relating to CWA represents the outstanding principal balance of \$168,040,000 at June 30, 2004 of City of Houston Water Conveyance System Contract Certificates of Participation, Series 1993, representing contract payments owed by the City to pay debt service on bonds issued by CWA, plus \$46,045,000 of CWA Revenue Refunding Bonds, Series 1999, issued by CWA, a governmental agency of the State of Texas, to finance the construction of a water conveyance system. Pursuant to a series of exchange agreements with CWA, the City issued the Certificates and endorsed the bonds and is unconditionally obligated to pay from the gross operating revenues of the City's water and sewer system all debt service payments on these Certificates and Bonds, as well as amounts necessary to restore deficiencies in funds required to be accumulated under the CWA bond resolutions. The bonds mature on December 15, 2025.

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19. Trinity River Authority (TRA)

The contract payable to TRA represents the outstanding principal balance at June 30, 2004 of certain revenue bonds issued by TRA, a governmental agency of the State of Texas, to finance construction of a dam and reservoir on the Trinity River near Livingston, Texas. Pursuant to a contract with TRA, the City has endorsed the bonds associated only with this project and is unconditionally obligated to pay from the gross operating revenues of the City's water system maintenance and operating expense of the reservoir and amounts necessary to restore any deficiencies in funds required to be accumulated under the TRA bond resolutions.

As consideration for the above obligation, the City receives a perpetual 70% beneficial interest in these reservoir facilities and the use of 70% of the reservoir water. As consideration for the remaining 30% interest in the reservoir facilities and water, TRA is obligated to allow the City credits for water usage. Consequently, the cost of the City's obligation of TRA has not been reflected in the City's accounts as a receivable or as a reduction of the cost of the City's 70% interest in the facilities. The final maturity date for the bonds is April 15, 2008.

20. Houston Area Water Corporation (HAWC)

The Houston Area Water Corporation (HAWC) Series 2002 Bonds are special obligations of the HAWC. The Bonds were issued to provide financing for: the acquisition of rights-of-way and real property interests; the design, construction and equipping of the Northeast Water Purification Plant; a water conveyance system, along with all extensions, additions, enlargements, improvements and modifications thereto ("the City Project"); repayment of interim financing of the City Project; funding for all or a portion of the amount equal to the Reserve Fund Requirement; capitalized interest; and costs of issuance relating to the Series 2002 Bonds.

The Bonds are payable both as to principal and interest solely from pledged revenues, including pledged contract payments made by the City to HAWC under the Amended and Restated Treated Water Supply Contract dated May 1, 2002. Pursuant to the Contract, the City has unconditionally agreed to pay to HAWC as maintenance and operation expenses from the gross revenues of the City's Water and Sewer System such sums as required to pay operation and maintenance expenses incurred by HAWC with respect to the City Project, debt service on the Series 2002 Bonds, amounts required to establish, restore and maintain a debt service reserve fund, and all other debt service obligation expenses. Such payments are an unconditional obligation of the City, but payable solely from gross revenues of the City's Water and Sewer System.

21. Other Contracts

On June 20, 1967 the City, TRA, and Chambers-Liberty Counties Navigation District contracted with the United States of America to have the U.S. Army Corps of Engineers build a salinity control barrier and recreation facilities at Wallisville Lake. Because of legal actions, construction was blocked for many years. The project was placed into operation as a salinity control barrier in 1999, and final completion was in April 2003. The City's share of the project cost was \$10,580,707, which will be paid to the U.S. government over 50 years at 3.222% interest beginning in January 2004. Payments will be made only after funding all maintenance and operation costs and debt service payments for the water and sewer system, including required reserves.

In April 2000 the City, Brazos River Authority ("BRA"), and the Texas Water Development Board ("TWDB") entered into an agreement to develop the Allen's Creek water supply reservoir in Fort Bend County as a regional water supply. TWDB committed to provide up to \$20,000,000, or up to 50% of funding, to provide for construction of the project. The City and BRA agreed to purchase TWDB's ownership share in future years. In 2003 the TWDB paid \$14 million for site acquisition for the project. The City will purchase TWDB's share. Interest payments on the lease-purchase will begin in 2005 at an average rate of 5.85%. Interest costs over the first eight years will be partially deferred to later years. Principal payments will begin in 2022, and the final principal payment on the contract will be made in 2036.

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D. Schedule for Debt Service Requirements to Maturity (in thousands):

1. General Long-Term Tax Obligation Debt (adjusted for Capital Appreciation and Deferred Interest Bonds reclassification of principal & interest) (in thousands):

| Year Ending June 30 | General Obligation Bonds | | Public Improvement Bonds | | General Obligation Swap Agreements | Payment Receipts |
|------------------------|-----------------------------|--------------|-----------------------------|-------------------|---------------------------------------|---------------------|
| | Principal | Interest | Principal | Interest | | |
| 2005 | \$ 1,365 | \$ 34 | \$ 116,130 | \$ 77,507 | | \$ (500) |
| 2006 | - | - | 115,730 | 76,037 | | (603) |
| 2007 | - | - | 123,795 | 69,760 | | (603) |
| 2008 | - | - | 132,155 | 62,769 | | (603) |
| 2009 | - | - | 131,375 | 55,392 | | (603) |
| 2010-2014 | - | - | 496,570 | 186,564 | | (3,015) |
| 2015-2019 | - | - | 305,425 | 79,747 | | (2,794) |
| 2020-2024 | - | - | 128,170 | 18,806 | | (899) |
| 2025-2029 | - | - | 7,085 | 354 | | (21) |
| | <u>\$ 1,365</u> | <u>\$ 34</u> | <u>\$ 1,556,435</u> | <u>\$ 626,936</u> | | <u>\$ (9,641)</u> |

| Year Ending June 30 | General Obligation Commercial Paper | | Annexed District Bonds | | Tax and Revenue Certificates of Obligation | |
|------------------------|--|------------------|---------------------------|-----------------|---|------------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2005 | \$ - | \$ 5,530 | \$ 770 | \$ 601 | \$ 2,985 | \$ 1,262 |
| 2006 | - | 5,530 | 815 | 560 | 3,500 | 1,131 |
| 2007 | 427,800 | 4,756 | 860 | 517 | 1,075 | 987 |
| 2008 | - | - | 900 | 472 | 1,645 | 944 |
| 2009 | - | - | 875 | 429 | 3,390 | 874 |
| 2010-2014 | - | - | 4,010 | 1,511 | 9,174 | 7,310 |
| 2015-2019 | - | - | 3,670 | 496 | 6,775 | 2,398 |
| 2020-2024 | - | - | 520 | 44 | 4,975 | 448 |
| 2025-2029 | - | - | - | - | - | - |
| | <u>\$ 427,800</u> | <u>\$ 15,816</u> | <u>\$ 12,420</u> | <u>\$ 4,630</u> | <u>\$ 33,519</u> | <u>\$ 15,354</u> |

| Year Ending June 30 | Total Future Requirements | | | |
|------------------------|---------------------------|-------------------|---------------------|------------------------------|
| | Principal | Interest | Swaps (Receipts) | Total Future Requirements |
| 2005 | \$ 121,250 | \$ 84,934 | \$ (500) | \$ 205,684 |
| 2006 | 120,045 | 83,258 | (603) | 202,700 |
| 2007 | 553,530 | 76,020 | (603) | 628,947 |
| 2008 | 134,700 | 64,185 | (603) | 198,282 |
| 2009 | 135,640 | 56,695 | (603) | 191,732 |
| 2010-2014 | 509,754 | 195,385 | (3,015) | 702,124 |
| 2015-2019 | 315,870 | 82,641 | (2,794) | 395,717 |
| 2020-2024 | 133,665 | 19,298 | (899) | 152,064 |
| 2025-2029 | 7,085 | 354 | (21) | 7,418 |
| | <u>\$ 2,031,539</u> | <u>\$ 662,770</u> | <u>\$ (9,641)</u> | <u>\$ 2,684,668</u> |

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2. HUD Section 108 Loans

| Year Ending June 30 | Section 108 Loans | | |
|------------------------|-------------------|-----------|---------------------------------|
| | Principal | Interest | Total Future Requirements |
| 2005 | \$ 1,470 | \$ 1,276 | \$ 2,746 |
| 2006 | 1,515 | 1,214 | 2,729 |
| 2007 | 1,680 | 1,143 | 2,823 |
| 2008 | 1,980 | 1,061 | 3,041 |
| 2009 | 2,045 | 968 | 3,013 |
| 2010-2014 | 8,215 | 3,364 | 11,579 |
| 2015-2019 | 5,185 | 1,595 | 6,780 |
| 2020-2024 | 2,775 | 306 | 3,081 |
| | \$ 24,865 | \$ 10,927 | \$ 35,792 |

3. Business-Type Funds (adjusted for Capital Appreciation and Deferred Interest Bonds reclassification of principal & interest) (in thousands):

| Year Ending June 30 | Airport System Revenue Bonds | | Airport System Commercial Paper | | Airport System Total Future Requirements | |
|------------------------|---------------------------------|--------------|------------------------------------|----------|---|--------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2005 | \$ 18,865 | \$ 101,909 | \$ 20,000 | \$ 182 | \$ 38,865 | \$ 102,091 |
| 2006 | 26,690 | 101,049 | - | - | 26,690 | 101,049 |
| 2007 | 28,285 | 99,515 | - | - | 28,285 | 99,515 |
| 2008 | 29,725 | 98,136 | - | - | 29,725 | 98,136 |
| 2009 | 41,365 | 96,376 | - | - | 41,365 | 96,376 |
| 2010-2014 | 244,200 | 449,652 | - | - | 244,200 | 449,652 |
| 2015-2019 | 318,010 | 383,600 | - | - | 318,010 | 383,600 |
| 2020-2024 | 412,160 | 299,117 | - | - | 412,160 | 299,117 |
| 2025-2029 | 533,095 | 190,775 | - | - | 533,095 | 190,775 |
| 2030-2034 | 538,985 | 51,517 | - | - | 538,985 | 51,517 |
| 2035-2039 | - | - | - | - | - | - |
| | \$ 2,191,380 | \$ 1,871,646 | \$ 20,000 | \$ 182 | \$ 2,211,380 | \$ 1,871,828 |

| Year Ending June 30 | Convention and Entertainment Facilities Revenue Bonds | | Convention and Entertainment Facilities Commercial Paper | | Total Future Requirements | |
|------------------------|--|------------|---|----------|------------------------------|------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2005 | \$ 6,590 | \$ 20,930 | \$ 22,500 | \$ 186 | \$ 29,090 | \$ 21,116 |
| 2006 | 13,680 | 20,181 | - | - | 13,680 | 20,181 |
| 2007 | 14,775 | 19,573 | - | - | 14,775 | 19,573 |
| 2008 | 17,540 | 18,718 | - | - | 17,540 | 18,718 |
| 2009 | 18,620 | 17,761 | - | - | 18,620 | 17,761 |
| 2010-2014 | 126,715 | 70,125 | - | - | 126,715 | 70,125 |
| 2015-2019 | 104,939 | 72,137 | - | - | 104,939 | 72,137 |
| 2020-2024 | 95,456 | 95,651 | - | - | 95,456 | 95,651 |
| 2025-2029 | 100,801 | 117,272 | - | - | 100,801 | 117,272 |
| 2030-2034 | 115,204 | 129,174 | - | - | 115,204 | 129,174 |
| 2035-2039 | - | - | - | - | - | - |
| | \$ 614,320 | \$ 581,522 | \$ 22,500 | \$ 186 | \$ 636,820 | \$ 581,708 |

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| Year Ending June 30 | Combined Utility System First Lien Revenue Bonds | | Combined Utility System Swap Agreements | | Combined Utility System Commercial Paper | |
|------------------------|---|---------------------|--|--|---|-----------------|
| | Principal | Interest | Net Swap Payment | | Principal | Interest |
| 2005 | \$ - | \$ 101,761 | \$ 16,024 | | \$ - | \$ 558 |
| 2006 | 9,000 | 107,866 | 17,738 | | - | 557 |
| 2007 | 9,000 | 107,263 | 17,738 | | 40,000 | 525 |
| 2008 | 9,000 | 107,357 | 17,738 | | - | - |
| 2009 | 15,000 | 107,003 | 17,738 | | - | - |
| 2010-2014 | 162,485 | 513,658 | 88,688 | | - | - |
| 2015-2019 | 130,785 | 472,794 | 88,688 | | - | - |
| 2020-2024 | 660,300 | 392,154 | 88,688 | | - | - |
| 2025-2029 | 839,675 | 195,134 | 102,348 | | - | - |
| 2030-2034 | 1,193,925 | 57,100 | 65,772 | | - | - |
| | <u>\$ 3,029,170</u> | <u>\$ 2,162,090</u> | <u>\$ 521,160</u> | | <u>\$ 40,000</u> | <u>\$ 1,640</u> |

| Year Ending June 30 | Combined Utility System Water and Sewer Jr. Lien Revenue Bonds | | Combined Utility System Total Future Requirements | | | |
|------------------------|--|-------------------|--|---------------------|---------------------|---------------------|
| | Principal | Interest | Principal | Interest | Net Swap Payment | Total |
| 2005 | \$ 14,031 | \$ 43,148 | \$ 14,031 | \$ 145,467 | \$ 16,024 | \$ 175,522 |
| 2006 | 10,881 | 43,485 | 19,881 | 151,908 | 17,738 | 189,527 |
| 2007 | 16,088 | 49,184 | 65,088 | 156,972 | 17,738 | 239,798 |
| 2008 | 15,888 | 49,611 | 24,888 | 156,968 | 17,738 | 199,594 |
| 2009 | 20,553 | 56,759 | 35,553 | 163,762 | 17,738 | 217,053 |
| 2010-2014 | 201,114 | 289,014 | 363,599 | 802,672 | 88,688 | 1,254,959 |
| 2015-2019 | 503,460 | 68,835 | 634,245 | 541,629 | 88,688 | 1,264,562 |
| 2020-2024 | 52,818 | 71,280 | 713,118 | 463,434 | 88,688 | 1,265,240 |
| 2025-2029 | 29,577 | 112,289 | 869,252 | 307,423 | 102,348 | 1,279,023 |
| 2030-2034 | - | - | 1,193,925 | 57,100 | 65,772 | 1,316,797 |
| | <u>\$ 864,410</u> | <u>\$ 783,605</u> | <u>\$ 3,933,580</u> | <u>\$ 2,947,335</u> | <u>\$ 521,160</u> | <u>\$ 7,402,075</u> |

| Year Ending June 30 | Coastal Water Authority | | Trinity River Authority | | Total Future Requirements | |
|------------------------|-------------------------|------------------|-------------------------|-----------------|------------------------------|------------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2005 | \$ 15,460 | \$ 12,510 | \$ 2,000 | \$ 471 | \$ 17,460 | \$ 12,981 |
| 2006 | 16,505 | 11,494 | 2,000 | 346 | 18,505 | 11,840 |
| 2007 | 18,150 | 10,395 | 2,000 | 221 | 20,150 | 10,616 |
| 2008 | 19,225 | 9,211 | 2,000 | 97 | 21,225 | 9,308 |
| 2009 | 17,905 | 8,090 | - | - | 17,905 | 8,090 |
| 2010-2014 | 66,965 | 27,141 | - | - | 66,965 | 27,141 |
| 2015-2019 | 35,505 | 9,327 | - | - | 35,505 | 9,327 |
| 2020-2024 | 16,550 | 4,103 | - | - | 16,550 | 4,103 |
| 2025-2029 | 7,820 | 396 | - | - | 7,820 | 396 |
| 2030-2034 | - | - | - | - | - | - |
| | <u>\$ 214,085</u> | <u>\$ 92,667</u> | <u>\$ 8,000</u> | <u>\$ 1,135</u> | <u>\$ 222,085</u> | <u>\$ 93,802</u> |

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4. Long-Term Contracts-Combined Utility System (in thousands):

| Year Ending June 30 | Houston Area Water Corporation | | |
|------------------------|---------------------------------------|-----------------|--|
| | Principal | Interest | Total Future Requirements |
| | 2005 | \$ - | \$ 6,710 |
| 2006 | 2,365 | 6,710 | 9,075 |
| 2007 | 2,485 | 6,592 | 9,077 |
| 2008 | 2,585 | 6,492 | 9,077 |
| 2009 | 2,680 | 6,395 | 9,075 |
| 2010-2014 | 15,470 | 29,912 | 45,382 |
| 2015-2019 | 20,150 | 25,234 | 45,384 |
| 2020-2024 | 26,160 | 19,225 | 45,385 |
| 2025-2029 | 33,705 | 11,674 | 45,379 |
| 2030-2032 | 24,660 | 2,570 | 27,230 |
| | \$ 130,260 | \$ 121,514 | \$ 251,774 |

| Year Ending June 30 | Combined Utility Contract U.S. Army Corps of Engineers | | Combined Utility Contract Texas Water Development Board | | Other Contracts Total Future Requirements | |
|------------------------|---|-----------------|--|-----------------|--|-----------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| | 2005 | \$ 88 | \$ 327 | \$ - | \$ - | \$ 88 |
| 2006 | 91 | 325 | - | 164 | 91 | 489 |
| 2007 | 94 | 321 | - | 164 | 94 | 485 |
| 2008 | 97 | 319 | - | 246 | 97 | 565 |
| 2009 | 100 | 316 | - | 327 | 100 | 643 |
| 2010-2014 | 549 | 1,528 | - | 3,356 | 549 | 4,884 |
| 2015-2019 | 643 | 1,434 | - | 6,806 | 643 | 8,240 |
| 2020-2024 | 753 | 1,323 | 1,255 | 6,092 | 2,008 | 7,415 |
| 2025-2029 | 883 | 1,194 | 3,830 | 3,309 | 4,713 | 4,503 |
| 2030-2034 | 1,034 | 1,042 | 5,090 | 2,054 | 6,124 | 3,096 |
| 2035-2039 | 1,212 | 864 | 3,825 | 457 | 5,037 | 1,321 |
| 2040-2044 | 1,421 | 656 | - | - | 1,421 | 656 |
| 2045-2049 | 1,665 | 412 | - | - | 1,665 | 412 |
| 2050-2054 | 1,535 | 125 | - | - | 1,535 | 125 |
| | \$ 10,165 | \$ 10,186 | \$ 14,000 | \$ 22,975 | \$ 24,165 | \$ 33,161 |

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E. Debt Issuances and Refundings

Throughout its history, the City has issued refunding bonds from time to time when there has been an operational or economic gain for the City. These refundings have been structured as legal defeasances of the old debt as ruled by the Texas Attorney General, and such debt, including the debt balances refunded during fiscal 2004 described below, has been removed from the City's books.

Public Improvement Refunding Bonds Series 2003A. On October 30, 2003, the City closed the sale of \$156,535,000 Public Improvement Refunding Bonds, Series 2003A-1. Stated interest rates for the bonds ranged from 2.00% to 5.25%, and the average yield was 4.185%. The bonds are due in varying amounts from years 2005 to 2023. Proceeds of the bonds were used to advance refund certain annexed district debt and the Public Improvement Bonds, Series 1995C; to currently refund all Series C General Obligation Commercial Paper Notes and part of Series A General Obligation Commercial Paper Notes; to fund new projects related to previously annexed districts; and to pay issuance costs. Part of the proceeds was used to purchase an escrow consisting of U.S. Government State and Local Government Securities for all future refunded debt service payments. The refunding was undertaken 1) to lower interest rate exposure on the refunded Commercial Paper Notes, 2) to restructure and extend the average life of the City's tax supported debt, and 3) to achieve gross debt service savings related to refunded Public Improvement Bonds of \$2,033,000 and present value savings of \$2,095,000. The reacquisition price exceeded the net carrying amount of the old debt by \$381,000. This amount is being netted against the new debt and amortized over the remaining life of the refunded debt.

On December 2, 2003 the City closed the sale of \$39,635,000 Public Improvement Refunding Bonds, Series 2003A-2. Stated interest rates for the bonds ranged from 2.00% to 5.00%, and the average yield was 3.126%. The bonds are due in varying amounts from years 2005 to 2012. Proceeds of the bonds were used to advance refund certain annexed district debt and Public Improvement Bonds, Series 1994A, and to pay issuance costs. Proceeds were used to purchase an escrow consisting of U.S. Government State and Local Government Securities for all future refunded debt service payments. The refunding was undertaken 1) to restructure and extend the average life of the City's tax supported debt, and 2) to provide gross debt service savings of \$2,687,000 and present value savings of \$2,522,000. The reacquisition price exceeded the net carrying amount of the old debt by \$384,000. This amount is being netted against the new debt and amortized over the remaining life of the refunded debt.

Certificates of Obligation Series 2003B. On October 30, 2003, the City closed the sale of \$2,210,000 Certificates of Obligation Series 2003B. The stated interest rate for the certificates, which mature in 2009, was 3.00%, and the yield was 2.987%. Proceeds of the certificates will be used for the demolition of dangerous buildings. The Certificates mature in 2009.

Public Improvement Refunding Bonds Series 2004A. On May 20, 2004, the City closed the sale of \$377,940,000 Public Improvement Refunding Bonds, Series 2004A. Stated interest rates for the bonds ranged from 5.00% to 5.375%, and the average yield was 4.27%. The bonds are due in varying amounts from years 2009 to 2018. Proceeds of the bonds were used to advance refund certain annexed district debt and various Public Improvement Bonds issued from 1996 to 2003 and to pay costs of issuance. Proceeds were used to purchase an escrow consisting of U.S. Obligations and Agency Obligations for all future refunded debt service payments. Cash requirements for debt service increased by \$4,016,000, but the net present value savings is \$3,928,000. The reacquisition price exceeded the net carrying amount of the old debt by \$13,073,000. This amount is being netted against the new debt and amortized over the remaining life of the refunded debt.

Combined Utility System First Lien Revenue Refunding Bonds Series 2004. On June 10, 2004, the City closed the sale of \$3,029,170,000 in Combined Utility System First Lien Revenue Refunding Bonds, Series 2004 composed of three series. The bonds were issued for the purpose of completing a restructuring of the Water and Sewer System in order to provide present value savings, minimize needed rate increases, modernize the City's bond covenants, and provide for enhanced drainage improvements.

The City issued \$1,652,220,000 in fixed rate Series 2004A bonds. Stated interest rates for the bonds ranged from 2.50% to 5.25%, and the average yield was 5.079%. The bonds are due in varying amounts from years 2006 to 2028. Proceeds were used to purchase an escrow consisting of obligations authorized under Texas law for all future refunded debt service payments in order to advance refund certain issues of Water and Sewer Junior Lien Revenue Bonds, including Series 1996A, 1997A, 1997B, 1997C, 1998A, 1998B, 1999A, 2000B, and 2002A, and 2003A. The acquisition price of the new debt exceeded the carrying value of the old debt by \$97,937,000. This amount is being netted against the new debt and amortized over the remaining life of the refunded debt.

The City issued \$723,625,000 in taxable adjustable rate bonds Series 2004C. These bonds were initially issued in an auction rate mode with 35 day reset periods. Initial interest rates, including dealer and auction agent fees, were 1.633% to 1.723%. The average rate in effect at year-end was 1.710%. The bonds are due in varying amounts from years 2028 to 2034. Proceeds of the bonds were used to advance refund various issues of Water and Sewer Junior Lien Revenue Bonds, including Series 1992C, 1997A, 1997B, 1997C, 1997D, 1998B, 2001A, and 2002B. Proceeds of the bonds were used to purchase an escrow consisting of obligations authorized under Texas law for all future refunded debt service payments. The bonds were issued as taxable securities because these refunded obligations were not eligible for a tax exempt refunding at this time. In the future, as these obligations are retired with proceeds from the escrow, the 2004C bonds may be reissued as tax-exempt bonds. The bonds may also be converted to another type of security than auction rate. The acquisition price of the new debt exceeded the carrying value of the old debt by \$103,034,000. This amount is being netted against the new debt and amortized over the remaining life of the refunded debt.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Also, as part of the restructuring, the City contributed cash from the Water and Sewer System to defease part of its Combined Utility Junior Lien Revenue Bonds Series 2001B.

As a result of issuing Series 2004A and 2004C and the cash defeasance, cash requirements for debt service decreased by \$45,787,000, and the net present value savings is \$80,873,000.

The City issued \$653,325,000 in adjustable rate bonds Series 2004B. These bonds have been issued in an auction rate mode with periods of 7 days, 28 days, and 35 days. Initial auction rates varied from 1.05% to 1.25%. The average rate in effect at year-end, including dealer and credit fees, was 1.436%. The bonds are due in varying amounts from 2028 to 2034. Proceeds of the bonds were used to advance refund \$645,250,000 of outstanding Water and Sewer Commercial Paper Notes Series A. In the future, the bonds may also be converted to another type of security than auction rate.

At the same time the City entered into swap agreements on the 2004B bonds as discussed in Section C(13), Combined Utility System Swap Agreements.

F. Bond Compliance Requirements

The revenue bond ordinances require that during the period in which the bonds are outstanding the City must create and maintain certain accounts or funds to receive the proceeds from the sale of the revenue bonds and to account for the revenues (as defined), which are pledged for payment of the bonds. The assets can be used only in accordance with the terms of the bond ordinance and for the specific purpose(s) designated therein. The City is generally required to make a monthly transfer to debt service funds equal to one-sixth of the next interest payment and one-twelfth of the next principal payment. Certain bond ordinances have additional requirements for the establishment of rates and the accumulation of principal and interest repayment amounts from surplus operating funds. Generally, the bonds may be redeemed prior to their maturities in accordance with the bond ordinances and at various premiums equal to or less than 2%. During fiscal year 2004 the City has substantially complied with the requirements of all revenue bond ordinances and related bond restrictions.

G. Voter Authorized Obligations

On November 4, 1997, voters of the City authorized the issuance of \$545,000,000 of Public Improvement Bonds. On March 4, 1998, City Council passed ordinance 98-158, stipulating that \$100,000,000 of the \$545,000,000 be issued as General Obligation Commercial Paper Series A. In fiscal year 2000, Ordinance 99-199 stipulated \$100,000,000, and Ordinance 99-949 stipulated \$108,700,000 be issued as General Obligation Commercial Paper Series A. In fiscal year 2001, Ordinance 2000-480 stipulated that \$133,000,000 be issued as General Obligation Commercial Paper Series A. In fiscal year 2002 Ordinance 2001-664 stipulated that \$103,300,000 be issued as General Obligation Commercial Paper Series B. No further authorization is available under the November 4, 1997 election.

On November 4, 2001, voters of the City authorized the issuance of \$776,000,000 of Public Improvement Bonds. On June 18, 2002, City Council passed an ordinance stipulating that \$165,000,000 of the \$776,000,000 be issued as General Obligation Commercial Paper Series D. On October 8, 2003, City Council passed Ordinance 2003-0937 authorizing an additional \$110,000,000 to be issued as General Obligation Commercial Paper Series D.

In addition, the City is authorized by the City Charter to issue \$100,000 annually in general improvement bonds without voter approval.

H. Legal Debt Margin

At June 30, 2004 the City's legal debt limit was 10% of assessed property valuation totaling \$117,784,788,000. The City's legal debt margin was \$7,627,228,000.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Note 9: Leases

A. Operating Leases

1. City as Lessee

The City has obtained office space, data processing and other equipment through long-term operating leases. The future minimum payments under these agreements are as follows (in thousands):

| <u>Year ended June 30</u> | <u>Operating Lease Payments</u> |
|---------------------------|-------------------------------------|
| 2005 | \$ 9,407 |
| 2006 | 7,893 |
| 2007 | 4,599 |
| 2008 | 3,609 |
| 2009 | 3,431 |
| 2010-2014 | 5,837 |
| 2015-2019 | 4,238 |
| 2020-2024 | 4,363 |
| 2025-2029 | 4,363 |
| 2030-2034 | 1,960 |
| 2035-2039 | 2,010 |
| 2040-2044 | 2,210 |
| 2045-2049 | 2,260 |
| 2050-2054 | 2,460 |
| 2055-2059 | 2,511 |
| 2060-2064 | 2,710 |
| 2065-2069 | 2,761 |
| 2070-2074 | 2,960 |
| 2075-2079 | 3,010 |
| 2080-2084 | 610 |
| Total | <u>\$ 73,202</u> |

2. City as Lessor

The Convention and Entertainment Facilities department is a lessor of one facility. The Airport System is the lessor of approximately 10 percent of its land and substantially all of its buildings and improvements. These lease agreements are non-cancelable operating leases with fixed minimum rentals and non-cancelable operating use and lease agreements with annually adjusted rates. Rental income is earned from leasing various parcels of land to airlines, fixed base operators and various corporations for hangars, aircraft maintenance facilities, flight kitchens and cargo buildings; to auto rental companies for their service facilities and storage lots; and to a variety of other entities for buildings and other permanent improvements. Minimum guaranteed income on such non-cancelable operating leases is as follows (in thousands):

| <u>Year Ended June 30</u> | <u>Operating Leases Minimum Rental Income</u> |
|---------------------------|---|
| 2005 | \$ 32,689 |
| 2006 | 29,353 |
| 2007 | 28,355 |
| 2008 | 27,452 |
| 2009 | 26,694 |
| 2010-2014 | 110,943 |
| 2015-2019 | 88,297 |
| 2020-2024 | 76,449 |
| 2025-2029 | 54,649 |
| 2030-2034 | 9,650 |
| 2035-2039 | 9,745 |
| 2040-2043 | 7,834 |
| Total | <u>\$ 502,110</u> |

The contingent income associated with these non-cancelable operating leases was \$6,653,821 in Fiscal Year 2004. In addition, income is earned from certain non-cancelable operating use and lease agreements for landing fees and terminal building rentals. Such income is adjusted annually based on a compensatory formula to recover certain operating and capital costs of the related facilities. Such income for fiscal year 2004 was \$154,520,598.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

B. Capital Leases

1. The City as Lessee

The City entered into a capital lease for the Houston Emergency Center. The City's annual payment is \$4,338,700 and is shared by the City's Police Department and the Fire Department.

The assets acquired through the capital lease are as follows (in thousands):

| | Governmental Activities |
|--------------------------------|------------------------------------|
| Asset: | |
| Land | \$ 3,200 |
| Building | 50,179 |
| Total Assets | 53,379 |
| Less: Accumulated Depreciation | (3,684) |
| Net Total | \$ 49,695 |

The future minimum lease obligations and the net present value of these minimum lease payments as of June 30, 2004, were as follows (in thousands):

| Year ended June 30 | Capital Lease Payments |
|---|-----------------------------------|
| 2005 | \$ 4,339 |
| 2006 | 4,339 |
| 2007 | 4,339 |
| 2008 | 4,339 |
| 2009 | 4,339 |
| 2010-2014 | 21,694 |
| 2015-2019 | 21,694 |
| 2020-2024 | 21,694 |
| 2025-2027 | 13,014 |
| Total minimum lease payments | 99,791 |
| Less: Amount representing Interest | (47,447) |
| Present value of minimum lease payments | \$ 52,344 |

Note 10: Pension Plans

A. Plan Descriptions

The City has three single employer defined benefit pension plans (Firefighters' Relief and Retirement Fund, Municipal Employees' Pension System, and the Police Officers' Pension System), which cover substantially all of its employees. These pension plans were established under the authority of Texas statutes (Vernon's Texas Civil Statutes, Articles 6243.e2 (1), 6243g, 6243g-4, respectively), which establish the various benefit provisions. All plans provide for service-connected disability and death benefits to survivors, with no age or service eligibility requirements. Employer and employee obligations to contribute, as well as employee contribution rates, are included in the statutes, and for the Municipal Employees' Pension System and the Houston Police Officers' Pension System, some requirements are delineated in new (September '04) meet and confer agreements. Additionally, these laws provide that employer funding be based on periodic actuarial valuations, statutorily approved amounts or, in the cases of the Municipal Employees' Pension System and the Police Officers' Pension System, amounts agreed to in meet and confer agreements. All pension plans provide service, disability, death, and vesting benefits. In addition, each pension plan recognizes participant and employer contributions as revenues in the period in which they are due pursuant to formal commitments and recognizes benefits and refunds when they are due and payable in accordance with the terms of the pension statutes. The specific summary plan description is available at the plan offices listed in footnote 1.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

B. Actuarially Determined Contribution Requirements and Contributions Made

Historically, the City's funding policies have provided for actuarially determined periodic contributions at rates such that, over time, they will remain level as a percent of payroll, except for the police officers pension system, which has had a statutorily limited level of employer contributions. The contribution rate for normal cost is determined using the entry age normal actuarial cost method. The firefighters' and municipal pension plans use the level percentage of payroll method to amortize the unfunded actuarially accrued liability (or surplus) over 40 years from January 1, 1983 and the police pension uses the level percentage of payroll method to amortize the unfunded actuarially accrued liability over 30 years (constant). (See "Subsequent Events" note on page 95 for further pension information related to the municipal and police pension funds.)

The reported contributions to the pension funds for the year ended June 30, 2004, were different from the actuarially determined requirements based on July 1, 2002 actuarial valuation for all three plans. Contributions are as follows:

| <u>Percentage of Payroll</u> | <u>Firefighters</u> | <u>Municipal</u> | <u>Police</u> |
|--|---------------------|------------------|---------------|
| City of Houston normal cost | 22.1% | 12.3% | 19.0% |
| Amortization of unfunded actuarial accrued liability (surplus) | 1.7% | 19.5% | 5.4% |
| Required employer contribution rate | 23.8% | 31.8% | 24.4% |
| Employer contribution made | 16.4% | 14.7% | 12.4% |
| Employee contribution made | 8.35% | 4.0% | 8.75% |
| Contribution Amounts (in thousands) | | | |
| Net contribution required | \$ 50,914 | \$ 159,290 | \$ 99,836 |
| Total city contribution | \$ 28,325 | \$ 58,061 | \$ 36,645 |
| Total employee contribution | 14,238 | 26,189 | 26,393 |
| Total contribution | \$ 42,563 | \$ 84,250 | \$ 63,038 |

C. Annual Pension Cost and Net Pension (Obligation) Asset

The annual pension cost associated with the City's three pension funds for the current year is as follows (in thousands):

| | <u>Houston Firefighters' Pension</u> | <u>Houston Municipal Employees' Pension</u> | <u>Houston Police Officers' Pension</u> |
|--|--|---|---|
| Annual required contribution | \$ 36,676 | \$ 133,102 | \$ 73,443 |
| Interest on net pension obligation | (4,863) | 7,853 | 1,634 |
| Adjustment to annual required contribution | 4,459 | (7,499) | (1,156) |
| Annual pension cost | 36,272 | 133,456 | 73,921 |
| Contribution made | 28,325 | 58,061 | 36,645 |
| Change in net pension (obligation) asset | (7,947) | (75,395) | (37,276) |
| Net pension (obligation) asset beginning | 57,212 | (92,386) | (19,221) |
| Net pension (obligation) asset end of year | \$ 49,265 | \$ (167,781) | \$ (56,497) |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

D. Houston Firefighters' Pension System

Schedule of Employer Contributions (in millions)

| Year Ended June 30 | Annual Pension Cost | Percentage Contributed | Net Pension Asset | Annual Required Contribution as a % of Base Pay |
|-------------------------------|------------------------------------|-----------------------------------|------------------------------|--|
| 2001 | \$15.6 | 157% | \$38.5 | 11.0% |
| 2002 | \$15.0 | 184% | \$51.9 | 9.9% |
| 2003 | \$22.7 | 121% | \$57.2 | 14.9% |
| 2004 | \$36.3 | 78.1% | \$49.3 | 23.8% |

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as to the actuarial valuation used for purposes of the financial statements is as follows:

| | |
|---|--|
| Valuation date | July 1, 2002 |
| Actuarial cost method | Entry age Normal Cost |
| Amortization method | Level percent of payroll, ending December 31, 2022 |
| Remaining amortization period | 18 years |
| Asset valuation method | 5 year smoothed market |
| Actuarial assumptions: | |
| Investment rate of return | 8.5%, net of expenses |
| Inflation rate | 4.0% |
| Payroll growth rate | 5.0% |
| Annual increase attributable to seniority/merit | 3% to 10% |
| Cost of living adjustment | 3% annually |

E. Houston Municipal Pension System Information

Schedule of Employer Contributions (in millions)

| Year Ended June 30 | Annual Pension Cost | Percentage Contributed | Net Pension Obligation | Annual Required Contribution as a % of Base Pay |
|-------------------------------|------------------------------------|-----------------------------------|-----------------------------------|--|
| 2001 | \$45.3 | 94.0% | \$53.8 | 9.8% |
| 2002 | \$43.3 | 95.0% | \$56.3 | 9.5% |
| 2003 | \$76.7 | 53.0% | \$92.3 | 17.7% |
| 2004 | \$133.5 | 43.6% | \$167.8 | 31.8% |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as to the actuarial valuation used for purposes of the financial statements is as follows:

| | |
|---------------------------------------|--|
| Valuation date | July 1, 2002 |
| Actuarial cost method | Entry age |
| Amortization method | Level percentage, ending December 31, 2022 |
| Remaining amortization period | 18 years |
| Asset valuation method | 5 year smoothed market |
| Actuarial assumptions: | |
| investment rate of return | 8.5%, net of expenses |
| Payroll growth factor | 4.5% |
| Projected individual salary increases | 4.5% |
| General inflation rate | 4.0% |

F. Houston Police Officer's Pension System Information

Schedule of Employer Contributions (in millions)

| Year Ended June 30 | Annual Pension Cost | Percentage Contributed | Net Pension/Asset (Obligation) | Annual Required Contribution as a % of Base Pay |
|-------------------------------|------------------------------------|-----------------------------------|---|--|
| 2001 | \$42.2 | 76.0% | \$0.5 | 16.3% |
| 2002 | \$30.0 | 109.0% | \$3.2 | 11.3% |
| 2003 | \$57.1 | 61.0% | (\$19.2) | 20.5% |
| 2004 | \$73.9 | 49.6% | (\$56.5) | 24.4% |

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as to the actuarial valuation used for purposes of the financial statements is as follows:

| | |
|--|--|
| Valuation date | July 1, 2002 |
| Actuarial cost method | Entry Age Normal Cost |
| Amortization method | Level percent of payroll Amortized over 30 years |
| Remaining amortization period | 30 years |
| Asset valuation method | 5 year smoothed market |
| Actuarial assumptions: | |
| Investment rate of return | 8.5%, net of expenses |
| Payroll growth rate, attributable entirely to inflation | 4.0 % |
| Annual increase attributable to seniority/merit | 0% to 5% |
| Annual cost of living adjustment | 2/3 of CPI-U (3.0% minimum, 8.0% maximum) |
| Projected salary increases | 4.0-9.0% |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Note 11: Other Employee Benefits

A. Post-Retirement Health Insurance Benefits

Pursuant to a City Ordinance, the City provides certain health care benefits for retired employees. Substantially all of the City's employees become eligible for these benefits if they reach normal retirement age while working for the City. Contributions are recognized in the year paid. The cost of retiree health care contributions incurred by the City amounted to approximately \$37,506,956 for the year ended June 30, 2004. Retiree health care is accounted for in the Health Benefits Fund, an Internal Service Fund. At June 30, 2004, there were 7,284 retirees eligible to receive benefits.

B. Health Benefits Internal Service Fund

The City's Health Benefits plan is currently administered by HMO Blue Texas. Employees and retirees are able to choose an HMO Plan with all benefits covered by third party purchased insurance, a substantially self-insured with specific individual aggregate stop loss features Point of Service Plan (POS), or an Out-Of-Area Plan (OOA). Specific and aggregate stop loss insurance is provided for the POS and OOA plan in the amounts of \$300,000 and approximately \$6,000,000 based on enrollment, respectively. Premiums paid for current employees to third party administrators totaled approximately \$124,006,428 for the year ended June 30, 2004. Effective May 2004, the POS plan was replaced with self-insured Preferred Provider Organization (PPO).

The City also provides one times salary of basic life insurance, with a minimum of \$15,000, at no cost to the employee. The employee, at no cost to the City, may then obtain additional life insurance up to four times their annual salary. The current cost for active employees for both basic and voluntary life insurance totaled \$5,412,352 for the year ended June 30, 2004.

| PPO/POS and PPO/OOA | | |
|--|----------------------|----------------------|
| Schedule of Changes in Liability | | |
| (in thousands) | | |
| | June 30, 2004 | June 30, 2003 |
| Beginning actuarial estimate of claims liability, July 1 | \$ 809 | \$ 1,600 |
| Incurred claims for fiscal year | 7,513 | 6,315 |
| Payments on claims | (7,301) | (6,682) |
| Actuarial adjustment | (10) | (424) |
| Ending actuarial estimate of claims liability, June 30 | \$ 1,011 | \$ 809 |

C. Long-Term Disability Plan

The long-term disability plan, accounted for as an internal service fund, is a part of the Income Protection Plan implemented effective September 1, 1985 (renamed the Compensable Sick Leave Plan (CSL) in October, 1996) and is provided at no cost to City employees who are members of CSL. Coverage is effective the later of September 1, 1985 or upon completion of two years of continuous service. When an employee cannot work because of injury or illness, the plan provides income equal to 50% of base pay plus longevity or 70% of base plus longevity when combined with income benefits available from other sources. Plan benefits may be payable after all CSL scheduled sick leave benefits, including frozen sick leave days, have been used, however, not before six months absence from work. The plan is administered by Disability Management Alternatives, Inc., which is reimbursed from the fund for claims as they are paid along with a fee for administrative services. Effective September 1, 2001 the Meet and Confer Agreement established Paid Time Off (PTO) for police classified officers. This replaces their participation in the LTD plan.

| Schedule of Changes in Liability | | |
|--|----------------------|----------------------|
| (in thousands) | | |
| | June 30, 2004 | June 30, 2003 |
| Beginning actuarial estimate of claims liability, July 1 | \$ 5,262 | \$ 4,572 |
| Incurred claims for fiscal year | 1,085 | 1,143 |
| Payments on claims | (774) | (755) |
| Actuarial adjustment | 226 | 302 |
| Ending actuarial estimate of claims liability, June 30 | \$ 5,799 | \$ 5,262 |

CITY OF HOUSTON, TEXAS
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June 30, 2004

D. Deferred Compensation Plan

The City offers its employees a deferred compensation plan (Plan), created in accordance with Internal Revenue Code Section 457 as a separately administered trust. The Plan, available to all City employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available until termination, retirement, death or unforeseeable emergency. However, the Plan now offers loans to participant employees. The maximum amount is the lesser of \$50,000 or 50% of the total account balance, less any outstanding loans. The minimum loan amount is \$1,000. Pursuant to tax law changes, the Plan's assets are no longer subject to the City's general creditors and are not included in these financial statements.

E. Workers' Compensation Self-Insurance Plan

The City has established a Workers' Compensation Self-Insurance Plan, accounted for within the various operating funds. The plan is administered by Cambridge Integrated Services Group, Inc. Funds are wire transferred to Cambridge as needed to pay claims.

At June 30, 2004 the City has an accumulated liability in the amount of \$56.1 million covering estimates for approved but unpaid claims and incurred but not reported claims (calculated on an actuarial basis) recorded in the Statement of Net Assets and Enterprise Funds. The amount of liability is based on the estimate of an independent actuary.

| | Schedule of Changes in Liability | |
|--|---|----------------------|
| | (in thousands) | |
| | June 30, 2004 | June 30, 2003 |
| Beginning actuarial estimate of claims liability, July 1 | \$ 56,462 | \$ 55,996 |
| Incurred claims for fiscal year | 14,956 | 12,147 |
| Payments on claims | (21,065) | (21,086) |
| Actuarial adjustment | 5,742 | 9,405 |
| Ending actuarial estimate of claims liability, June 30 | <u>\$ 56,095</u> | <u>\$ 56,462</u> |

Note 12: Interfund Transactions

A. Transfers

Transfers during the year ended June 30, 2004, were as follows (in thousands):

| Transferred from: | Transferred to: | | | | | Total Transfers Out |
|----------------------------|------------------------|------------------------------------|---------------------|--|---------------------------------------|----------------------------|
| | General Fund | Nonmajor Governmental Funds | Debt Service | Convention & Entertainment Facilities | Houston Area Water Corporation | |
| General Fund | \$ - | \$ 9,835 | \$ 165,000 | \$ 163 | \$ - | \$ 174,998 |
| Nonmajor Funds | - | 600 | 314 | 3,591 | - | 4,505 |
| Capital Projects | 1,200 | - | 3,301 | - | - | 4,501 |
| Convention & Entertainment | 1,500 | - | - | - | - | 1,500 |
| Combined Utility System | 4,100 | 10,100 | 29,572 | - | 6,391 | 50,163 |
| Total transfers in | <u>\$ 6,800</u> | <u>\$ 20,535</u> | <u>\$ 198,187</u> | <u>\$ 3,754</u> | <u>\$ 6,391</u> | <u>\$ 235,667</u> |

Transfers are used to (1) move receipts restricted to debt service from the funds collecting the receipts to the debt service fund and (2) use unrestricted revenues collected in the general fund to finance various programs accounted for in other funds in accordance with budgetary authorizations, (3) use unrestricted revenues in the Combined Utility fund and special revenue fund to finance general fund programs.

B. Transfers to Component Units

Transfers to the Cultural Arts Council of Houston from the Convention and Entertainment Facilities during the year ended June 30, 2004 totaled \$7,885,000.

CITY OF HOUSTON, TEXAS
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June 30, 2004

C. Interfund Charges

The General Fund charges the Combined Utility System, Airport System, Convention and Entertainment Facilities, Capital Project, Sign Administration, Auto Dealer's and Cable Television Funds for services provided by the General Fund on behalf of these funds. Such charges totaled \$92,897,000 for the year ended June 30, 2004, and are recorded as revenue in the General Fund and as expense, expenditure or capital assets in the funds assessed.

Included in the Fiscal Year 2004 total are charges to the funds for direct and indirect expenses as shown below (in thousands):

| | Airport System | Convention & Entertainment Facilities | Combined Utility Sytem | Other Funds | Total |
|----------------------|---------------------------|--|-----------------------------------|--------------------|------------------|
| General Services | \$ 3,088 | \$ 667 | \$ 4,696 | \$ 6,196 | \$ 14,647 |
| Fire Services | 10,865 | - | - | - | 10,865 |
| Police Services | 18,120 | - | - | - | 18,120 |
| Engineering Services | - | (343) | 9,975 | 6,600 | 16,232 |
| Fleet Maintenance | 194 | 28 | 943 | 7,966 | 9,131 |
| Legal | 1,952 | 775 | 3,986 | 5,925 | 12,638 |
| Other | 312 | 52 | 5,274 | 5,626 | 11,264 |
| Total | \$ 34,531 | \$ 1,179 | \$ 24,874 | \$ 32,313 | \$ 92,897 |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

D. Schedule of Amounts Due To and Due From Other Funds

The interfund balances are primarily due to charges for services between funds during the fiscal year and settled shortly after year end. The composition of interfund balances as of June 30, 2004 is as follows (in thousands):

| <u>Receivable Fund</u> | <u>Payable Fund</u> | <u>Amount</u> |
|---|---|------------------|
| General Fund | Combined Utility System | \$ 2,362 |
| | Grants revenue | 5,211 |
| | Nonmajor Governmental Funds | 3,307 |
| | Capital Projects Fund | 3,428 |
| | Health Benefits Fund | 13 |
| | Airport System | 316 |
| | Convention and Entertainment Facilities | 591 |
| | | <u>\$ 15,228</u> |
| Grants Revenue | General Fund | \$ 425 |
| | Nonmajor Governmental Funds | 8 |
| | | <u>\$ 433</u> |
| Capital Projects Fund | Grants revenue | \$ 576 |
| | General Fund | 103 |
| | | <u>\$ 679</u> |
| Airport System | Convention & Entertainment Facilities | \$ 15 |
| | General Fund | 577 |
| | Combined Utility System | 50 |
| | | <u>\$ 642</u> |
| Convention and Entertainment Facilities | General Fund | \$ 188 |
| | Airport System | 1 |
| | Health Benefits Fund | 1 |
| | | <u>\$ 190</u> |
| Combined Utility System | General Fund | \$ 32 |
| | Nonmajor Governmental Funds | 11 |
| | | <u>\$ 43</u> |
| Long-Term Disability Fund | General Fund | \$ 157 |
| | Combined Utility System | 28 |
| | Convention & Entertainment Facilities | 2 |
| | Health Benefits Fund | 1 |
| | Nonmajor Governmental Funds | 18 |
| | Airport System | 19 |
| | | <u>\$ 225</u> |
| Nonmajor Governmental Funds | General Fund | \$ 1,859 |
| | Airport System | 569 |
| | Nonmajor Governmental Funds | 33 |
| | | <u>\$ 2,461</u> |

Note 13: Commitments and Contingencies

A. Litigation and Claims

The City is a defendant in various lawsuits and is aware of pending claims arising in the ordinary course of its municipal and enterprise activities, certain of which seek substantial damages. That litigation includes lawsuits and claims alleging that the City caused personal injuries and wrongful deaths; class actions and other lawsuits and claims alleging discriminatory hiring and promotional practices and certain civil rights violations arising under the Federal Voting Rights Act; various claims from contractors for additional amounts under construction contracts; and claims involving property tax assessments and various other liability claims. Alleged damages in the lawsuits are approximately \$119.5 million. The status of such litigation ranges from an early discovery stage to various levels of appeal of judgments both for and against the City. The amount of damages is limited in certain cases under the Texas Tort Claims Act and is subject to appeal. The City intends to defend itself vigorously against the suits. There is other threatened litigation for which an amount cannot be determined. The City typically utilizes the General Fund to liquidate claims and judgments. In the Statement of Net Assets, the City has recognized a liability of \$100.4 million for potential litigation losses arising from various lawsuits.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

B. Environmental Liabilities

The City is aware of various sites contaminated by asbestos or other hazardous materials. The City has recorded accrued liabilities of \$11.5 million, to be used for: assessment and remediation of asbestos, lead and mold; Phase I and II environmental site assessments and remediation, and; remediation of radioactive material.

C. Commitments for Capital Facilities

At June 30, 2004, the City had appropriated but not yet spent from Capital Projects and Enterprise Funds approximately \$1,266,770 for capital projects.

The City leased a tract of land for 30 years with a 30-year renewal option for \$100 per year to The Houston Music Hall Foundation. On this site, the Houston Music Hall Foundation constructed the new music hall named the Hobby Center for the Performing Arts. Substantial completion occurred by October 31, 2002, as required by the agreement. The grand opening was in May of 2003. The Music Hall was granted and conveyed to the City. The City is obligated to pay from parking revenues \$1 million per year for 30 years beginning on the commencement of the lease. The City's annual obligation is secured by a pledge of the parking revenues from the Civic Center and Tranquility Park Parking Garages equal to \$1,200,000 per year for 30 years.

D. Risk Management

The City is self-insured for claims pertaining to third party liability, unemployment and workers' compensation. The City carries fidelity coverage to comply with City ordinance and purchases commercial property insurance with a per occurrence loss limit of \$300 million. Such insurance provides a \$2.5 million per occurrence deductible except for: 2% of the damaged insured value for windstorm or hail from a named storm, subject to \$2.5 million minimum and a \$10 million maximum; and a \$5 million deductible for a flood. Although no losses were sustained in excess of the \$300 million per occurrence loss limit in the last 4 years, Tropical Storm Allison caused damages in excess of the \$5 million sub-limit (in 2001) to locations in the 100-year flood plain (Flood Zone A). The current sub-limit for flood is \$50 million, of which \$25 million may apply to Flood Zone A. Emergency Management is working with the Finance and Administration Department to coordinate a claim to FEMA for the amount not covered by insurance. Self-insured claims are reported as liabilities in the accompanying financial statements when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. This determination is based on reported pending claims, estimates of claims incurred but not yet reported, actuarial reports and historical analysis. All claims are accounted for in the Government-wide Statement of Net Assets. Claims that are expected to be paid with expendable, available financial resources are accounted for in the General Fund and the appropriate Enterprise Funds.

Through its Health Benefit Plan, the City has consistently purchased commercial insurance up to certain limitations in the event of adverse loss experience.

For unemployment claims, the City pays claims as they are settled. Unemployment claim activity is as follows:

| | Unemployment Claim Activity | |
|------------------------|------------------------------------|----------------------|
| | June 30, 2004 | June 30, 2003 |
| Claims for fiscal year | 612 | 454 |
| Payments on claims | \$ 669,503 | \$ 400,042 |

E. Federal and State

Amounts received or receivable from grantor agencies are subject to audit and adjustment by grantor agencies, principally the federal and state governments. Any disallowed claims, including amounts already collected, could be a liability of the City.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Note 14: Related Organization Transactions

A. Metropolitan Transit Authority (“Metro”)

The City and Metro have an interlocal agreement under which Metro fund would fund up to \$10.0 million of revenue for street maintenance and traffic control during the fiscal year ended June 30, 2004. The City received \$9.4 million from Metro under this contract in FY04. The money is accounted for in the general fund.

B. Trinity River Authority (“TRA”)

As described in Note 6C, the City and TRA have a long-term contract under which the City is obligated to pay debt service for certain bonds as well as certain maintenance and operating expenses for a TRA dam and reservoir. During the fiscal year ended June 30, 2004 the City paid \$2.5 million for debt service and \$3 million for maintenance and operating expenses under the terms of the contract.

C. Coastal Water Authority (“CWA”)

The City has a long-term contract with Coastal Water Authority (CWA) for the acquisition of water. During the fiscal year ended June 30, 2004, the City paid CWA \$28.9 million for debt service and \$14.2 million for maintenance and operating expenses.

Note 15: Conduit Debt Obligations

To provide for airport facilities, the City has issued eight series of Special Facility Revenue Bonds. These bonds are special limited obligations of the City, payable solely from and secured by a pledge of revenue to be received from agreements between the City and various third parties. The bonds do not constitute a debt or pledge of the faith and credit of the City and accordingly have not been reported in the accompanying financial statements.

At June 30, 2004, the Special Facility Revenue Bonds outstanding aggregated was \$678,265,000.

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

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CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Note 16: Major Discretely Presented Component Units

The following discretely presented component units represent major component units. For reporting purposes, the City considers a component unit to be major if assets, liabilities, revenues or expenses exceed 10% of that component unit's class and exceed 5% of all component units combined. Saint George Place Redevelopment Authority's statements include a prior period adjustment of \$368,000 due to errors in the receivables from and the amount due to the City.

Net Assets
Major Component Units - Discretely Presented Governmental
June 30, 2004
(in thousands)

| | Cultural Arts Council of Houston | Houston Small Business Development Corp. | Midtown Redevelopment Authority | Greater Greenspoint Redevelopment Authority |
|---|---|---|--|--|
| Cash, receivable and other current assets | \$ 2,301 | \$ 11,199 | \$ 23,170 | \$ 22,015 |
| Noncurrent assets | - | - | 1,673 | - |
| Capital assets, net of accumulated depreciation | 54 | 4,661 | 11,072 | - |
| Total assets | <u>2,355</u> | <u>15,860</u> | <u>35,915</u> | <u>22,015</u> |
| Current liabilities | 41 | 287 | 2,900 | 1,070 |
| Long-term liabilities | 1,016 | 7,339 | 40,306 | 18,480 |
| Total liabilities | <u>1,057</u> | <u>7,626</u> | <u>43,206</u> | <u>19,550</u> |
| Net assets | | | | |
| Invested in capital assets, net of related debt | - | - | - | - |
| Restricted | 594 | 5,853 | 6,612 | 2,853 |
| Unrestricted (deficit) | 704 | 2,381 | (13,903) | (388) |
| Total net assets (deficit) | <u>\$ 1,298</u> | <u>\$ 8,234</u> | <u>\$ (7,291)</u> | <u>\$ 2,465</u> |

(Continued)

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

| <u>Uptown Redevelopment Authority</u> | <u>Southwest Houston Redevelopment Authority</u> | <u>Houston Library Board</u> | <u>Houston Parks Board</u> | <u>Nonmajor Component Units</u> | <u>2004</u> |
|---|--|--------------------------------------|--------------------------------|---|--------------------|
| \$ 12,019 | \$ 10,419 | \$ 17,348 | \$ 7,323 | \$ 32,374 | \$ 138,168 |
| - | - | - | 2,594 | 2,232 | 6,499 |
| - | 876 | 41 | 6,869 | 8,937 | 32,510 |
| <u>12,019</u> | <u>11,295</u> | <u>17,389</u> | <u>16,786</u> | <u>43,543</u> | <u>177,177</u> |
| 3,983 | 6,692 | 75 | 751 | 30,455 | 46,254 |
| <u>35,340</u> | <u>12,899</u> | <u>-</u> | <u>-</u> | <u>39,140</u> | <u>154,520</u> |
| <u>39,323</u> | <u>19,591</u> | <u>75</u> | <u>751</u> | <u>69,595</u> | <u>200,774</u> |
| - | - | - | - | 2,880 | 2,880 |
| 5,769 | 8,133 | 15,684 | 14,415 | 3,964 | 63,877 |
| <u>(33,073)</u> | <u>(16,429)</u> | <u>1,630</u> | <u>1,620</u> | <u>(32,896)</u> | <u>(90,354)</u> |
| <u>\$ (27,304)</u> | <u>\$ (8,296)</u> | <u>\$ 17,314</u> | <u>\$ 16,035</u> | <u>\$ (26,052)</u> | <u>\$ (23,597)</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Change in Net Assets
Major Component Units - Discretely Presented Governmental
For the Year Ended June 30, 2004
(in thousands)

| Component Units | Expenses | Charges for Services | Operating Grants and Contributions | Cultural Arts Council of Houston/Harris County | Houston Small Business Development Corp. |
|--|------------------|---------------------------------|---|---|---|
| Cultural Arts Council of Houston/Harris County | \$ 9,417 | \$ 1,183 | \$ - | \$ (8,234) | \$ - |
| Greater Greenspoint Redevelopment Authority | 1,412 | - | - | - | - |
| Houston Library Board | 2,097 | - | - | - | - |
| Houston Parks Board | 1,969 | - | 3,959 | - | - |
| Houston Small Business Development Corp. | 3,028 | - | - | - | (3,028) |
| Midtown Redevelopment Authority | 6,519 | - | - | - | - |
| Uptown Development Authority | 4,439 | - | - | - | - |
| Southwest Houston Redevelopment Authority | 961 | - | - | - | - |
| Nonmajor Component Units | 16,564 | - | 2,060 | - | - |
| Total component units | \$ 46,406 | \$ 1,183 | \$ 6,019 | \$ (8,234) | \$ (3,028) |
| General Revenues: | | | | | |
| Taxes | | | | | |
| Property taxes levied for general purposes | | | | 8,490 | 3,824 |
| Intergovernmental - grants | | | | - | - |
| Contributions | | | | - | - |
| Unrestricted investment earnings | | | | 246 | - |
| Other | | | | - | - |
| Loss on sales of assets | | | | - | - |
| Transfers | | | | - | - |
| Total general revenues, special items and transfers | | | | 8,736 | 3,824 |
| Change in net assets | | | | 502 | 796 |
| Net assets beginning | | | | 796 | - |
| New component unit & restatement | | | | | 7,438 |
| Net assets ending | | | | \$ 1,298 | \$ 8,234 |

(Continued)

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Net (Expense) Revenue and Change In Net Assets

| Midtown Redevelopment Authority | Greater Greenspoint Redevelopment Authority | Uptown Redevelopment Authority | Southwest Houston Redevelopment Authority | Library Board | Parks Board | Nonmajor Component Units | Total Component Units |
|--|--|---|--|--------------------------|------------------------|---|--------------------------------------|
| \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ (8,234) |
| - | (1,412) | - | - | - | - | - | (1,412) |
| - | - | - | - | (2,097) | - | - | (2,097) |
| - | - | - | - | - | 1,990 | - | 1,990 |
| (6,519) | - | - | - | - | - | - | (3,028) |
| - | - | (4,439) | - | - | - | - | (6,519) |
| - | - | - | (961) | - | - | - | (4,439) |
| - | - | - | - | - | - | - | (961) |
| - | - | - | - | - | - | (14,504) | (14,504) |
| <u>\$ (6,519)</u> | <u>\$ (1,412)</u> | <u>\$ (4,439)</u> | <u>\$ (961)</u> | <u>\$ (2,097)</u> | <u>\$ 1,990</u> | <u>\$ (14,504)</u> | <u>\$ (39,204)</u> |
| 5,762 | 4,517 | 7,037 | 1,442 | - | - | 14,528 | 45,600 |
| - | - | - | - | - | - | 919 | 919 |
| - | - | - | - | 1,711 | - | - | 1,711 |
| 115 | 191 | 37 | 53 | 1,816 | 86 | 1 | 2,545 |
| 268 | - | 40 | 8 | 128 | 48 | 290 | 782 |
| - | - | - | - | - | (33) | - | (33) |
| - | - | (6,447) | (302) | 50 | 223 | (205) | (6,681) |
| <u>6,145</u> | <u>4,708</u> | <u>667</u> | <u>1,201</u> | <u>3,705</u> | <u>324</u> | <u>15,533</u> | <u>44,843</u> |
| (374) | 3,296 | (3,772) | 240 | 1,608 | 2,314 | 1,029 | 5,639 |
| (6,917) | (831) | (23,532) | (8,536) | 15,706 | 13,721 | (27,449) | (37,042) |
| - | - | - | - | - | - | 368 | 7,806 |
| <u>\$ (7,291)</u> | <u>\$ 2,465</u> | <u>\$ (27,304)</u> | <u>\$ (8,296)</u> | <u>\$ 17,314</u> | <u>\$ 16,035</u> | <u>\$ (26,052)</u> | <u>\$ (23,597)</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Net Assets
Major Component Units - Discretely Presented Business-type
June 30, 2004
(in thousands)

| | Houston Convention Center Hotel Corp. | Houston Housing Finance Corp. | Houston Zoo Inc. | Total |
|---|--|--|-----------------------------|------------------|
| Cash, receivable and investments | \$ 15,472 | \$ 16,347 | \$ 9,467 | \$ 41,286 |
| Noncurrent assets | 29,031 | 11,512 | 2,814 | 43,357 |
| Capital assets, net of accumulated depreciation | 288,184 | - | 7,900 | 296,084 |
| Total assets | <u>332,687</u> | <u>27,859</u> | <u>20,181</u> | <u>380,727</u> |
| Current liabilities | 8,588 | 588 | 1,958 | 11,134 |
| Long-term liabilities | 336,813 | 3,282 | - | 340,095 |
| Total liabilities | <u>345,401</u> | <u>3,870</u> | <u>1,958</u> | <u>351,229</u> |
| Net assets | | | | |
| Invested in capital assets, net of related debt | (8,023) | - | - | (8,023) |
| Restricted | 9,711 | 1,290 | 9,582 | 20,583 |
| Unrestricted (deficit) | (14,402) | 22,699 | 8,641 | 16,938 |
| Total net assets (deficit) | <u>\$ (12,714)</u> | <u>\$ 23,989</u> | <u>\$ 18,223</u> | <u>\$ 29,498</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

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CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Change in Net Assets
Major Component Units - Discretely Presented Business-type
For the Year Ended June 30, 2004
(in thousands)

| Component Units | Expenses | Charges for Services | Operating Grants and Contributions |
|---------------------------------------|------------------|---------------------------------|---|
| Houston Convention Center Hotel Corp. | \$ 44,019 | \$ 30,422 | \$ - |
| Houston Housing Finance Corp. | 7,074 | 4,498 | 5,015 |
| Houston Zoo Inc. | 16,817 | 14,953 | 9,414 |
| Totals | <u>\$ 67,910</u> | <u>\$ 49,873</u> | <u>\$ 14,429</u> |

General Revenues:

Taxes

- Property taxes levied for debt service
- Unrestricted investment earnings
- Other

Total general revenues, special items, and transfers

- Change in net assets
- Net assets (deficit) beginning
- Net assets (deficit) ending

(Continued)

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Net (Expense) Revenue and Change in Net Assets

| Houston Convention Center Hotel Corp. | Houston Housing Finance Corp. | Houston Zoo Inc. | Total |
|--|--|-----------------------------|-------------------|
| \$ (13,597) | \$ - | \$ - | (13,597) |
| - | 2,439 | - | 2,439 |
| - | - | 7,550 | 7,550 |
| <u>\$ (13,597)</u> | <u>\$ 2,439</u> | <u>\$ 7,550</u> | <u>\$ (3,608)</u> |
| - | 750 | - | 750 |
| 1,418 | 516 | 73 | 2,007 |
| 3,252 | - | - | 3,252 |
| <u>4,670</u> | <u>1,266</u> | <u>73</u> | <u>6,009</u> |
| (8,927) | 3,705 | 7,623 | 2,401 |
| (3,787) | 20,284 | 10,600 | 27,097 |
| <u>\$ (12,714)</u> | <u>\$ 23,989</u> | <u>\$ 18,223</u> | <u>\$ 29,498</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2004

Discretely Presented Component Units - Business-Type
Statement of Cash Flows
(in thousands)

| | Houston Convention Center Hotel Corporation | Houston Housing Finance Corp. | Houston Zoo Corporation | Total |
|---|--|--|--|------------------|
| Cash flows from operating activities | | | | |
| Receipts from customers | \$ 24,385 | \$ 10,999 | \$ 220 | \$ 35,604 |
| Payments to employees | - | - | 313 | 313 |
| Payments to suppliers | - | (5,015) | 280 | (4,735) |
| Other revenues | - | - | 959 | 959 |
| Other expenses | (22,080) | (1,128) | (12) | (23,220) |
| Net cash provided by operating activities | <u>2,305</u> | <u>4,856</u> | <u>1,760</u> | <u>8,921</u> |
| Cash flows from investing activities | | | | |
| Interest income on investments | 1,240 | - | - | 1,240 |
| Purchase of investments | 6,000 | (53,422) | (6,098) | (53,520) |
| Proceeds from sale of investments | 105,008 | 50,123 | - | 155,131 |
| Collection of long-term receivables | - | (601) | - | (601) |
| Net cash provided by investing activities | <u>112,248</u> | <u>(3,900)</u> | <u>(6,098)</u> | <u>102,250</u> |
| Cash flows from capital and related financing activities | | | | |
| Contributed capital | - | - | 5,543 | 5,543 |
| Acquisition of property, plant and equipment | (109,455) | - | - | (109,455) |
| Net cash provide by (used for) capital and related financing activities | <u>(109,455)</u> | <u>-</u> | <u>5,543</u> | <u>(103,912)</u> |
| Cash flows from noncapital financing activities | | | | |
| Excess funds from Series 1988 and Series 1990 Bond Series | - | (547) | - | (547) |
| Payments on notes payable | - | (280) | - | (280) |
| Net cash provided by noncapital financing activities | <u>-</u> | <u>(827)</u> | <u>-</u> | <u>(827)</u> |
| Net increase (decrease) in cash and cash equivalents | 5,098 | 129 | 1,205 | 6,432 |
| Cash and cash equivalents, July 1 | 214 | 699 | 3,372 | 4,285 |
| Cash and cash equivalents, June 30 | <u>\$ 5,312</u> | <u>\$ 828</u> | <u>\$ 4,577</u> | <u>\$ 10,717</u> |
| Non cash transactions | | | | |
| Capitalized Interest expense | 1,376 | - | - | 1,376 |
| Total non cash transactions | <u>\$ 1,376</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,376</u> |
| Reconciliation of operating income to net cash provided (used) by operating activities | | | | |
| Operating income (Loss) | \$ (3,093) | \$ 4,253 | \$ 7,623 | 8,783 |
| Depreciation and amortization | 7,408 | 249 | 651 | 8,308 |
| Bad debt expense | - | 180 | - | 180 |
| Other revenues | (197) | - | 62 | (135) |
| Other expenses | 1,058 | - | (7,240) | (6,182) |
| Changes in assets and liabilities: | | | | |
| Accounts receivable | (6,186) | 131 | 72 | (5,983) |
| Inventory | (380) | - | - | (380) |
| Other Assets | (36) | - | - | (36) |
| Accounts payable | 574 | - | 280 | 854 |
| Accrued payroll liabilities | 5,829 | 98 | 312 | 6,239 |
| Advances and deposits | (2,672) | - | - | (2,672) |
| Accrued interest on contracts payable | - | (55) | - | (55) |
| Net cash provided by (used for) operating activities | <u>\$ 2,305</u> | <u>\$ 4,856</u> | <u>\$ 1,760</u> | <u>\$ 8,921</u> |

CITY OF HOUSTON, TEXAS
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2004

Note 17. Subsequent Events

A. Tax and Revenue Anticipation Notes

On July 1, 2004, the City closed the sale of \$180,000,000 Tax and Revenue Anticipation Notes ("TRANS"), Series 2004. The proceeds of the TRANS will be used to pay working capital expenditures until tax revenues are received in February 2005. Stated interest rates were 3.00% to 4.50%, and the average yield was 1.59%. The notes will mature on June 30, 2005.

B. Combined Utility Jr. Lien Bonds

On August 19, 2004 the City closed the sale of \$181,090,000 in Combined Utility Junior Lien Revenue and Refunding Bonds Series 2004A in a private placement to the Texas Water Development Board ("TWDB"). The bonds were issued at rates ranging from 0.75% to 4.00% with an average rate of 3.042%. The bonds are due in varying amounts from 2005 to final maturity on May 15, 2024. A portion of the proceeds were used to currently refund \$40,000,000 outstanding Combined Utility System Commercial Paper Notes which were used to fund projects previously approved by the TWDB. The remaining funds will be used to fund other TWDB approved water and sewer projects and to pay cost of issuance of the bonds.

C. Pension System Updates

In the spring of 2004, the City administration hired Mercer Human Resource Consulting (Mercer) to provide independent actuarial studies of the Houston Municipal Employee Pension System (HMEPS) and the Houston Police Officers Pension System (HPOPS). Subsequent to these analyses, and after the fiscal year end, the City entered into meet and confer agreements with both pension systems.

1. Houston Municipal Employee Pension System

Based on a report prepared by Mercer, the HMEPS unfunded liability as of July 1, 2004 is estimated to have grown to \$1.9 billion (up from projected \$1.8 billion in the HMEPS actuarial report as of July 1, 2003 as reported in the RSI on page 103). This translates into an actuarial City contribution rate for the City's fiscal year ending June 30, 2006 of 55.5% (up from the 49.9% rate for the fiscal year ending June 30, 2005 per the same Mercer report). In an effort to bring down the unfunded liability, the City and HMEPS entered into a meet and confer contract (approved by City Council on September 1, 2004) that provided for various changes, including contribution commitments by the City and modifications to the pension benefits provided to HEMPS members. The City expects to issue pension obligation bonds for a portion of the contributions. Mercer estimates that the changes agreed to in this meet and confer contract will bring down the HMEPS unfunded liability to \$1.2 billion as of July 1, 2004.

(a) Collateralized Pension Note

On November 10, 2004 the City issued a \$300,000,000 collateralized note ("The Collateralized Note") to HMEPS as part of the meet and confer agreement with HMEPS to fund part of the unfunded accrued actuarial liability of its pension plan.

The notes will bear interest at 8.5% per year unless the rate adjustment formula, based on U.S. Treasury securities maturing in 2033, calls for a higher interest rate. The promissory note from the Houston Hotel Corporation to the City, as well as the related Deed of Trust, will be pledged as collateral on the notes. Interest on the notes may be paid or deferred, at the City's option, up to a maximum of \$150,000,000 plus 75% of the amount by which the appraised value of the hotel exceeds \$300,000,000. If the interest is deferred, the City will issue uncollateralized deferred interest certificates that may be converted to assignable certificates at the request of HMEPS, up to \$150 million, or collateralized deferred interest certificates up to the limit based on the appraised value of the hotel.

The Collateralized Note constitutes a general obligation of the City with an ad valorem tax pledge, but the City may look to other revenue sources available to pay the debt, including the collateral and its proceeds as well as interest deferrals.

2. Houston Police Officer's Pension System

Based on a report prepared by Mercer, the HPOPS unfunded liability as of July 1, 2004 is estimated to have grown to \$846 million (up from projected \$480.3 million in the HPOPS actuarial report as of July 1, 2003 as reported in the RSI on page 103).

This translates into an actuarial City contribution rate for the City's fiscal year ending June 30, 2006 of 32.9% (up from the 28.5% rate for the fiscal year ending June 30, 2005 per the same Mercer report). In an effort to bring down the unfunded liability, the City and HPOPS entered into a meet and confer contract (approved by City Council on September 29, 2004) that provided for various changes, including contribution commitments by the City and modifications to the pension benefits provided to HPOPS members. The City agreed to issue pension obligation bonds for a portion of the contributions. Towers Perrin, HPOPS actuarial firm, estimates that the changes agreed to in this meet and confer contract will bring down the HPOPS unfunded liability as of July 1, 2004 to \$535 million.

(a) Pension Obligation Note

On December 21, 2004 the City issued a \$22,900,000 Pension Obligation Note Series 2004 ("the Note") as part of a funding agreement with HPOPS to reduce the unfunded actuarial accrued liability of its pension plan. The Note will bear interest at a rate equal to the one-month Dollar LIBOR plus 45 basis points. The note will mature on February 15, 2006. The Note constitutes a general obligation of the City with an ad valorem tax pledge.

D. Coastal Water Authority Contract Revenue Bonds

On October 20, 2004 Coastal Water Authority closed the sale of \$40,385,000 in Coastal Water Authority Revenue Bonds. The bonds were issued at rates ranging from 2.00% to 5.00% with an average yield of 4.708%. The bonds are due in varying amounts from June 15, 2006 to final maturity on June 15, 2028. The proceeds will be used to fund the Authority's Lynchburg and Trinity River Pump Station Expansion Projects and to pay the costs of issuance of the bonds. Debt service payments will be made as maintenance and operations expenses of the City's Water and Sewer System.

E. Houston Voters Approve Tax Cap Proposition

On November 2, 2004, the citizens of the City were presented with two propositions on the ballot that would potentially limit revenues collected by the City in future years. Proposition One would require voter approval before property tax revenues could be increased in any future fiscal year above a limit measured by the lesser of 4.5% or the cumulative combined rates of inflation and population growth. Water and sewer rates would not increase more than the cumulative combined rates of inflation and population growth without prior voter approval. The Charter Amendment also requires minimum annual increases of 10% in the senior and disabled homestead property tax exemptions through fiscal year 2009. Proposition Two would require voter approval before the City may increase total revenues from all sources by more than the combined rates of inflation and population, without requiring any limit of any specific revenue source, including water and sewer revenues, property taxes, sales taxes, fees paid by utilities and developers, user fees, or any other sources of revenues. Each of these propositions received more than 50% approval by the citizens voting on these issues. Under the City Charter, if two propositions on the ballot have inconsistent language, only the one receiving the most votes is enacted. The City's Administration has concluded that Proposition 1 and Proposition 2 are inconsistent and that Proposition 1, having received the higher number of votes, will prevail. Certain supporters of Proposition 2 have indicated that they may bring suit against the City to enforce the provisions of Proposition 2.

F. Vela Settlement Agreement

On November 3, 2004, City Council approved a settlement of Vela et al v. the City of Houston (Civil Action No. 97-3741 pending in the U.S. District Court for the Southern District of Texas) for payment of overtime to 1,615 paramedics and for the related payment of pension contributions on these wages. The settlement includes \$72.225 million for back wages, liquidated damages and attorney fees (to be paid in three equal installments in each of the three fiscal years beginning in FY05) and \$7.5 million for pension contributions (to be paid to the Houston Firefighters Relief and Retirement Fund in Fiscal Year 2006. This liability has been reported in the accompanying financial statements.

G. Public Improvement Refunding Bonds

On December 21, 2004, the City issued \$174,860,000 Public Improvement Refunding Bonds, Series 2004B. Stated interest rates for the bonds ranged from 5.0% to 5.5%, and the average yield was 4.4%. The bonds are due in varying amounts from years 2010 to 2024. Proceeds of the bonds will be used to currently refund all outstanding Series B General Obligation Commercial Paper Notes and part of Series A and Series E General Obligation Commercial Paper Notes, to fund the first installment of the Vela Settlement Agreement (see above), and to pay costs of issuances on the bonds.

H. Tax Notes

On December 21, 2004, the City issued \$3,435,000 Tax Notes Series 2004C. Stated interest rates for the notes, which mature in varying amounts from 2005 to 2010, ranged from 2.5% to 3.375%, and the yield was 2.92%. Proceeds of the certificates will be used to finance a TASER law enforcement weapon system, including related support equipment, and to pay costs of issuance of the Series 2004C Notes.

Required Supplemental Information

**CITY OF HOUSTON, TEXAS
GENERAL OPERATING FUND
Schedule of Budgeted and Actual Revenues and Expenditures
For the Year Ended June 30, 2004
amounts expressed in thousands**

| | Budgeted Amounts | | Actual Budget Basis | Variance with Final Budget- Pos (Neg) |
|---|---------------------|---------------------|------------------------|---|
| | Original | Final | | |
| Revenues | | | | |
| Taxes and assessments | | | | |
| Property Taxes | \$ 662,741 | \$ 662,741 | \$ 660,999 | \$ (1,742) |
| Industrial Assessments | 16,350 | 16,350 | 15,167 | (1,183) |
| Sales Tax | 329,657 | 329,657 | 347,982 | 18,325 |
| Franchise Tax | 173,606 | 173,606 | 161,378 | (12,228) |
| Mixed Beverage Tax | 8,000 | 8,000 | 8,095 | 95 |
| Bingo Tax | 280 | 280 | 253 | (27) |
| Hotel Occupancy Tax | - | - | | - |
| Total taxes and assessments | <u>1,190,634</u> | <u>1,190,634</u> | <u>1,193,874</u> | <u>3,240</u> |
| Licenses and permits | | | | |
| General | 8,970 | 8,970 | 8,841 | (129) |
| Health Permits | 6,364 | 6,364 | 6,430 | 66 |
| Total licenses and permits | <u>15,334</u> | <u>15,334</u> | <u>15,271</u> | <u>(63)</u> |
| Charges for services | | | | |
| Ambulance service | 22,100 | 22,100 | 23,205 | 1,105 |
| Library fees | 20 | 20 | 6 | (14) |
| Parking | 4,073 | 4,073 | 3,462 | (611) |
| Services performed for other funds | | | | |
| Direct | 62,616 | 62,616 | 57,056 | (5,560) |
| Indirect | 14,393 | 14,393 | 14,647 | 254 |
| Rents and royalties | 1,045 | 1,045 | 977 | (68) |
| Others | 12,626 | 12,626 | 12,225 | (401) |
| Total charges for services | <u>116,873</u> | <u>116,873</u> | <u>111,578</u> | <u>(5,295)</u> |
| Intergovernmental - grants | <u>12,888</u> | <u>12,888</u> | <u>11,176</u> | <u>(1,712)</u> |
| Fines and forfeits | | | | |
| Municipal Courts | 46,255 | 46,255 | 45,004 | (1,251) |
| Others | 2,815 | 2,815 | 2,131 | (684) |
| Total fines and forfeits | <u>49,070</u> | <u>49,070</u> | <u>47,135</u> | <u>(1,935)</u> |
| Contributions | <u>350</u> | <u>350</u> | <u>2,433</u> | <u>2,083</u> |
| Interest | <u>6,750</u> | <u>6,750</u> | <u>5,129</u> | <u>(1,621)</u> |
| Other | | | | |
| Sale of Property | 3,127 | 3,127 | 3,095 | (32) |
| Other | 5,532 | 5,532 | 10,519 | 4,987 |
| Total Other | <u>8,659</u> | <u>8,659</u> | <u>13,614</u> | <u>4,955</u> |
| Total revenues | <u>1,400,558</u> | <u>1,400,558</u> | <u>1,400,210</u> | <u>(348)</u> |
| Other financing sources (uses) | | | | |
| Transfers in | 4,100 | 4,100 | 6,800 | 2,700 |
| Total other financing sources (uses) | <u>4,100</u> | <u>4,100</u> | <u>6,800</u> | <u>2,700</u> |
| Total revenues and other financing sources | <u>\$ 1,404,658</u> | <u>\$ 1,404,658</u> | <u>\$ 1,407,010</u> | <u>\$ 2,352</u> |

* See note to Required Supplementary Information*

Required Supplemental Information

CITY OF HOUSTON, TEXAS
GENERAL OPERATING FUND
Schedule of Budgeted and Actual Revenues and Expenditures
For the Year Ended June 30, 2004
amounts expressed in thousands

| | Budgeted Amounts | | Actual Budget Basis | Variance with Final Budget- Pos (Neg) |
|--------------------------------------|------------------|----------|------------------------|---|
| | Original | Final | | |
| General government | | | | |
| Legislative and executive | | | | |
| Legislative - Council | | | | |
| Personnel services | \$ 3,924 | \$ 3,926 | \$ 3,715 | \$ 211 |
| Other current expenditures | 211 | 257 | 205 | 52 |
| Total legislative - council | 4,135 | 4,183 | 3,920 | 263 |
| Legislative - Mayor's Office | | | | |
| Personnel services | 1,570 | 1,531 | 1,632 | (101) |
| Other current expenditures | 218 | 217 | 227 | (10) |
| Total executive - mayor's office | 1,788 | 1,748 | 1,859 | (111) |
| Total legislative and executive | 5,923 | 5,931 | 5,779 | 152 |
| Affirmative Action | | | | |
| Personnel services | 1,591 | 1,487 | 1,518 | (31) |
| Other current expenditures | 70 | 149 | 150 | (1) |
| Total affirmative action | 1,661 | 1,636 | 1,668 | (32) |
| Judicial | | | | |
| Municipal Courts Judges | | | | |
| Personnel services | 3,721 | 3,715 | 3,736 | (21) |
| Other current expenditures | 250 | 250 | 213 | 37 |
| Total municipal court judges | 3,971 | 3,965 | 3,949 | 16 |
| Municipal Courts Administration | | | | |
| Personnel services | 14,819 | 14,387 | 14,549 | (162) |
| Other current expenditures | 1,983 | 1,997 | 1,723 | 274 |
| Equipment acquisition | 1 | 1 | 2 | (1) |
| Total municipal court administration | 16,803 | 16,385 | 16,274 | 111 |
| Total judicial | 20,774 | 20,350 | 20,223 | 127 |
| Elections | 2,000 | 2,000 | 3,440 | (1,440) |
| Finance administration | | | | |
| Controller | | | | |
| Personnel services | 5,031 | 4,988 | 4,965 | 23 |
| Other current expenditures | 978 | 904 | 821 | 83 |
| Total controller | 6,009 | 5,892 | 5,786 | 106 |
| Finance and Administration | | | | |
| Personnel services | 16,139 | 17,414 | 17,210 | 204 |
| Other current expenditures | 1,242 | 1,685 | 1,421 | 264 |
| Total finance and administration | 17,381 | 19,099 | 18,631 | 468 |
| Information Technology | | | | |
| Personnel services | 10,532 | 10,550 | 10,456 | 94 |
| Other current expenditures | 2,665 | 2,274 | 2,106 | 168 |
| Total information technology | 13,197 | 12,824 | 12,562 | 262 |
| Audits | 650 | 650 | 865 | (215) |
| Bond and Legal | 1,155 | 1,155 | 2,412 | (1,257) |
| Total finance administration | 38,392 | 39,620 | 40,256 | (636) |

See note to required Supplementary Information

Required Supplemental Information

CITY OF HOUSTON, TEXAS
GENERAL OPERATING FUND
Schedule of Budgeted and Actual Revenues and Expenditures
For the Year Ended June 30, 2004
amounts expressed in thousands

| | Budgeted Amounts | | Actual Budget Basis | Variance with Final Budget- Pos (Neg) |
|---------------------------------|------------------|---------|------------------------|---|
| | Original | Final | | |
| Legal | | | | |
| Personnel services | 9,759 | 9,812 | 10,259 | (447) |
| Other current expenditures | 1,156 | 1,156 | 865 | 291 |
| Total legal | 10,915 | 10,968 | 11,124 | (156) |
| City Secretary | | | | |
| Personnel services | 667 | 646 | 735 | (89) |
| Other current expenditures | 75 | 85 | 86 | (1) |
| Total city secretary | 742 | 731 | 821 | (90) |
| Planning and Development | | | | |
| Personnel services | 11,371 | 11,494 | 11,504 | (10) |
| Other current expenditures | 3,093 | 2,334 | 2,205 | 129 |
| Equipment acquisition | - | 277 | 277 | - |
| Total planning and development | 14,464 | 14,105 | 13,986 | 119 |
| Human Resources | | | | |
| Personnel services | 2,177 | 2,179 | 2,165 | 14 |
| Other current expenditures | 258 | 214 | 186 | 28 |
| Total human resources | 2,435 | 2,393 | 2,351 | 42 |
| Total general government | 97,306 | 97,734 | 99,648 | (1,914) |
| Public safety | | | | |
| Police | | | | |
| Personnel services | 447,620 | 445,679 | 452,749 | (7,070) |
| Other current expenditures | 20,647 | 20,656 | 20,321 | 335 |
| Equipment acquisition | 167 | 221 | 153 | 68 |
| Total police | 468,434 | 466,556 | 473,223 | (6,667) |
| Fire | | | | |
| Personnel services | 267,503 | 265,678 | 265,827 | (149) |
| Other current expenditures | 16,348 | 16,140 | 15,492 | 648 |
| Equipment acquisition | - | 207 | 207 | - |
| Total fire | 283,851 | 282,025 | 281,526 | 499 |
| Total public safety | 752,285 | 748,581 | 754,749 | (6,168) |
| Public Works | | | | |
| Administration | | | | |
| Personnel services | 45,535 | 43,825 | 44,340 | (515) |
| Other current expenditures | 42,947 | 43,145 | 42,538 | 607 |
| Equipment acquisition | 60 | 60 | 60 | - |
| Total administration | 88,542 | 87,030 | 86,938 | 92 |
| Building Services | | | | |
| Personnel services | 12,282 | 11,934 | 12,234 | (300) |
| Other current expenditures | 13,401 | 13,404 | 12,390 | 1,014 |
| Equipment acquisition | - | 4 | 5 | (1) |
| Total building services | 25,683 | 25,342 | 24,629 | 713 |

See note to required Supplementary Information

Required Supplemental Information

**CITY OF HOUSTON, TEXAS
GENERAL OPERATING FUND
Schedule of Budgeted and Actual Revenues and Expenditures
For the Year Ended June 30, 2004
amounts expressed in thousands**

| | Budgeted Amounts | | Actual Budget Basis | Variance with Final Budget- Pos (Neg) |
|--|------------------|-----------|------------------------|---|
| | Original | Final | | |
| Solid Waste | | | | |
| Personnel services | 25,221 | 24,741 | 25,662 | (921) |
| Other current expenditures | 36,959 | 36,317 | 36,011 | 306 |
| Equipment acquisition | - | - | - | - |
| Total solid waste | 62,180 | 61,058 | 61,673 | (615) |
| Total public works | 176,405 | 173,430 | 173,240 | 190 |
| Health | | | | |
| Personnel services | 39,918 | 38,200 | 39,087 | (887) |
| Other current expenditures | 12,003 | 11,952 | 12,028 | (76) |
| Equipment acquisition | - | 20 | 6 | 14 |
| Total health | 51,921 | 50,172 | 51,121 | (949) |
| Parks and Recreation | | | | |
| Personnel services | 38,615 | 33,415 | 33,031 | 384 |
| Other current expenditures | 9,948 | 10,591 | 9,981 | 610 |
| Equipment acquisition | - | 182 | 174 | 8 |
| Total parks and recreation | 48,563 | 44,188 | 43,186 | 1,002 |
| Library | | | | |
| Personnel services | 21,678 | 21,905 | 22,078 | (173) |
| Other current expenditures | 6,679 | 5,637 | 5,526 | 111 |
| Equipment acquisition | 4,868 | 4,868 | 4,852 | 16 |
| Total library | 33,225 | 32,410 | 32,456 | (46) |
| Retiree Benefits | | | | |
| Hospital and life insurance | 27,856 | 26,956 | 26,581 | 375 |
| Total retiree benefits | 27,856 | 26,956 | 26,581 | 375 |
| Other current expenditures | | | | |
| Tax appraisal fees | 5,411 | 5,411 | 5,082 | 329 |
| Limited-purpose Annexation Districts | 7,750 | 7,750 | 9,131 | (1,381) |
| Insurance | 1,630 | 1,630 | 1,191 | 439 |
| Claims and judgments | 6,000 | 9,046 | 4,550 | 4,496 |
| Membership dues | 773 | 773 | 773 | 773 |
| Advertising and promotion | 200 | 200 | 167 | 33 |
| Zoo Contract | 7,372 | 7,372 | 7,372 | - |
| Consultants | 311 | 311 | 1,107 | (796) |
| Interest on short term borrowing | 1,997 | 1,997 | 1,793 | 204 |
| Miscellaneous support services | 7,333 | 7,332 | 10,284 | (2,952) |
| Total other current expenditures | 38,777 | 41,822 | 40,677 | 1,145 |
| Debt service | | | | |
| Debt service principal | 1,028 | 1,028 | 1,028 | - |
| Debt service interest | 3,311 | 3,311 | 3,311 | - |
| Total debt service | 4,339 | 4,339 | 4,339 | - |
| Total expenditures | 1,230,677 | 1,219,632 | 1,225,997 | (6,365) |
| Other financing sources (uses) | | | | |
| Transfers out | 175,763 | 175,663 | 174,998 | \$ 665 |
| Total other financing sources (uses) | 175,763 | 175,663 | 174,998 | 665 |
| Total expenditures and other financing uses | \$ 1,406,440 | 1,395,295 | \$ 1,400,995 | \$ (5,700) |

See note to required Supplementary Information

CITY OF HOUSTON, TEXAS
REQUIRED RECONCILIATION FOR GENERAL FUND
BUDGET vs. GAAP
PRESENTATION

For the Year Ended June 30, 2004

amounts expressed in thousands

Revenues

| | |
|---|--------------|
| Actual amounts (budgetary basis) "revenues" from the budgetary comparison schedules | \$ 1,400,210 |
| Revenues of non-budgeted funds | |
| Equipment Acquisition | 6 |
| Revolving Funds | 2,084 |
| Fleet Management | 8,914 |
| Grant Matching Fund | 650 |
| Property and Casualty | 12,310 |
| Vendor Overpayment | 200 |
| Houston Downtown Public Improvement District | 2 |
| Commercial Paper | 13 |
| Total revenues of non-budgeted funds | 24,179 |
| Interest on pooled investments from non-budgeted revenues | (659) |
| Total revenues as reported on the statement of revenues, expenditures, and changes in fund balances | \$ 1,423,730 |

Expenditures

| | |
|---|--------------|
| Actual amounts (budgetary basis) "expenditures" from the budgetary comparison schedules | \$ 1,225,997 |
| Expenditures of non-budgeted funds | |
| Equipment Acquisition | 29,443 |
| Dangerous building demolition programs | 2,673 |
| Revolving Funds | 2,060 |
| Fleet Management | 8,736 |
| Planning and Development Special Projects | 66 |
| Grant Matching Fund | 1,131 |
| Property and Casualty | 12,293 |
| Vendor Overpayment | 137 |
| Total expenditures of non-budgeted funds | 56,539 |
| Total expenditures as reported on the statement of revenues, expenditures, and changes in fund balances | \$ 1,282,536 |

Other financing sources (uses)

| | |
|---|--------------|
| Actual amounts (budgetary basis) "other financing sources and uses" from the budgetary comparison schedules | \$ (168,198) |
| Proceeds from Issuance of Debt | 26,693 |
| Total other financing sources and uses as reported on the statement of revenues, expenditures, and changes in fund balances--governmental funds | \$ (141,505) |

See note to Required Supplementary Information

CITY OF HOUSTON, TEXAS
REQUIRED NOTE TO THE SUPPLEMENTARY INFORMATION
June 30, 2004

1. General Budget Policies

During January of each year, the Mayor, with City Council input, establishes budget guidelines. All departments of the City submit requests for appropriations to the Mayor and the City's Department of Finance and Administration so that a budget may be prepared. Typically during June, the City Controller certifies that funds are available for a continuing appropriation and the budget is proposed to City Council. City Council holds public hearings and a final budget is normally adopted by June 30th. A final appropriation ordinance is adopted later in the fiscal year and may include budget revisions or amendments.

The legal level of budgetary control is the departmental level within each fund, even though the budget is prepared by fund, department, and expenditure category. The Mayor is authorized to transfer unlimited budgeted amounts within departments and amounts between departments, provided such transfers do not exceed 5% of an expenditure category. Expenditure categories are personnel services, other current expenditures and capital outlay. Appropriations related to funds with annual budgets lapse at year-end except for Capital Outlay appropriations, which cover multiple years.

On May 5 2004, City Council approved the Fiscal Year 2004 general appropriation ordinance in the amount of \$1.395 billion for the General Fund. In addition, City Council approved appropriations and transfers from other funds to the General Fund totaling \$6.8 million, for a total General Fund appropriation of \$1.41 billion.

Annual operating budgets are adopted for the General Operating Fund, the Debt Service Fund, the Special Revenue Funds (except for the Grants Revenue Fund, Disaster Recovery, Health Special Fund and the Housing Special Fund) and the Proprietary Funds. The budgets are adopted on a basis consistent with generally accepted accounting principles for all governmental funds. Budgets for proprietary funds are prepared on the accrual basis, but focus on expenses relating to maintenance and operations, and equipment purchases and, accordingly, exclude depreciation and other allocations related to income determination.

The following provides actual fiscal year 2004 results for both budgeted and non-budgeted Special Revenue Funds (in thousands):

| | <u>Revenues</u> | <u>Expenditures</u> | <u>Other Sources (Uses)</u> |
|--------------------------------------|-------------------|---------------------|-----------------------------|
| Budgeted Special Revenue Funds | \$ 58,035 | \$ 96,666 | \$ 20,226 |
| Non-budgeted Disaster Recovery Fund | 1,153 | 434 | (4,191) |
| Non-budgeted Grants Revenue Fund | 128,017 | 128,501 | - |
| Non-budgeted Health and Housing | 353 | 1,117 | - |
| Non-budgeted Other Funds | 13,446 | 7,351 | - |
| Total Special Revenue Funds - Actual | <u>\$ 201,004</u> | <u>\$ 234,069</u> | <u>\$ 16,035</u> |

2. General Fund Budgetary Highlights

While revenues were only \$348 thousand below budget (pgs. 97-100), there were some significant differences between some of the budgeted and actual revenue numbers. Some of the increases/decreases from budget include:

- €\$18 million increase in sales taxes
- €\$12 million decrease in franchise fees
- €\$5 million increase in other revenues
- €\$5 million decrease in charges for services
- €\$2 million decrease in interest
- €\$2 million decrease in fines and forfeits

Budgeted expenditures were reduced by \$11 million to cover the expected revenue shortfall. The most significant changes in the budget were:

- €\$ 4 million decrease for public safety
- €\$ 3 million decrease for public works
- €\$ 7 million decrease for health, parks and recreation and library
- €\$ 3 million increase in general government

Ultimately, total expenditures for the General Fund were \$6 million above the final expenditure budget.

**CITY OF HOUSTON, TEXAS
REQUIRED PENSION SYSTEM
SUPPLEMENTARY INFORMATION
June 30, 2004**

**Houston Firefighters' Pension System Supplementary Information (unaudited)
Schedule of Funding Progress (in millions)**

| Actuarial Valuation Date | Actuarial Value of Plan Assets (a) | Actuarial Accrued Liability (AAL) Entry Age (b) | Unfunded AAL (Surplus UAAL) (b-a) | Funded Ratio (a/b) | Projected Annual Covered Payroll (c) | UAAL as Percentage of Covered Payroll ((b-a)/c) |
|--------------------------------|--|--|---|--------------------------|--|---|
| July 1, 1996 | \$1,024.5 | \$ 989.3 | (\$35.2) | 104% | \$131.6 | (27%) |
| July 1, 1997 | \$1,183.8 | \$1,128.2 | (\$55.6) | 105% | \$142.0 | (39%) |
| July 1, 1998 | \$1,347.4 | \$1,271.4 | (\$76.0) | 106% | \$149.0 | (51%) |
| July 1, 1999 | \$1,538.5 | \$1,470.6 | (\$67.9) | 105% | \$159.0 | (43%) |
| July 1, 2000 | \$1,726.3 | \$1,589.3 | (\$137.0) | 109% | \$163.6 | (84%) |
| July 1, 2001 | \$1,863.1 | \$1,650.8 | (\$212.3) | 113% | \$164.3 | (129%) |
| July 1, 2002* | \$1,922.4 | \$1,970.2 | \$47.8 | 97.6% | \$190.6 | 25% |

* No actuarial study was required or conducted for July 1, 2003.

**Houston Municipal Pension System Supplementary Information (unaudited)
Schedule of Funding Progress (millions)**

| Actuarial Valuation Date | Actuarial Value of Plan Assets (a) | Actuarial Accrued Liability (AAL) Entry Age (b) | Unfunded AAL (Surplus UAAL) (b-a) | Funded Ratio (a/b) | Projected Annual Covered Payroll (c) | UAAL as Percentage of Covered Payroll ((b-a)/c) |
|--------------------------------|--|--|---|--------------------------|--|---|
| July 1, 1995 | \$770.2 | \$963.7 | \$193.5 | 80% | \$378.5 | 51% |
| July 1, 1996 | \$857.3 | \$1,042.5 | \$185.2 | 82% | \$367.6 | 50% |
| July 1, 1998 | \$1,095.6 | \$1,240.1 | \$144.5 | 88% | \$397.7 | 36% |
| July 1, 1999 | \$1,222.2 | \$1,339.9 | \$117.7 | 91% | \$407.7 | 29% |
| July 1, 2000 | \$1,376.0 | \$1,509.4 | \$133.4 | 91% | \$432.6 | 31% |
| July 1, 2001 | \$1,490.2 | \$1,955.8 | \$465.6 | 76% | \$418.0 | 111% |
| July 1, 2002 | \$1,519.7 | \$2,515.2 | \$995.5 | 60% | \$399.8 | 249% |
| July 1, 2003 | \$1,510.3 | \$3,278.3 | \$1,768.0 | 46% | \$390.3 | 453% |

**Houston Police Officer's Pension System Supplementary Information (unaudited)
Schedule of Funding Progress (millions)**

| Actuarial Valuation Date | Actuarial Value of Plan Assets (a) | Actuarial Accrued Liability (AAL) Entry Age (b) | Unfunded AAL (Surplus UAAL) (b-a) | Funded Ratio (a/b) | Projected Annual Covered Payroll (c) | UAAL as Percentage of Covered Payroll ((b-a)/c) |
|--------------------------------|--|--|---|--------------------------|--|---|
| July 1, 1996 | \$1,168.1 | \$1,199.7 | \$31.6 | 97% | \$182.3 | 17% |
| July 1, 1997 | \$1,329.6 | \$1,258.2 | (\$71.4) | 106% | \$187.1 | (38%) |
| July 1, 1998 | \$1,518.1 | \$1,549.3 | \$31.2 | 98% | \$196.4 | 16% |
| July 1, 1999 | \$1,746.3 | \$1,773.8 | \$27.5 | 98% | \$246.6 | 11% |
| July 1, 2000 | \$2,013.5 | \$1,966.4 | (\$47.1) | 102% | \$250.7 | (19%) |
| July 1, 2001 | \$2,226.3 | \$2,306.4 | \$80.1 | 97% | \$264.2 | 30% |
| July 1, 2002 | \$2,337.1 | \$2,593.7 | \$256.6 | 90% | \$286.1 | 90% |
| July 1, 2003 | \$2,394.4 | \$2,874.7 | \$480.3 | 83% | \$300.4 | 160% |

CITY OF HOUSTON, TEXAS

