



The Houston Aeros have two championships, one in the American Hockey League and the other in the International Hockey League.  The Aeros, Comets and Rockets share Toyota Center, downtown Houston's newest sports and entertainment arena.

**CITY OF HOUSTON, TEXAS**
**NOTES TO THE BASIC FINANCIAL STATEMENTS**
**June 30, 2005**

**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 | Brief Description of Activities, Relationship to the City and Key Inclusion Criteria |
|---|---|
| ***Houston Area Water Corporation***<br>***611 Walker, Suite 2100***<br>***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.<br><br>**Reporting Fund:** Business Type, Non-Major |
| ***Houston Firefighters’ Relief & Retirement Fund***<br>***4225 Interwood North Parkway***<br>***Houston, TX 77032*** | 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.<br><br>**Reporting Fund:** Houston Firefighters’ Relief and Retirement Pension Trust Fund. |

| Blended Component Units Reported with the Primary Government | Brief Description of Activities, Relationship to the City and Key Inclusion Criteria |
|---|---|
| ***Houston Municipal Employee's Pension System*** <br> ***1111 Bagby, Suite 2450*** <br> ***Houston, TX 77002*** | 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. <br><br> **Reporting Fund:** Houston Municipal Employee's Pension Trust Fund. |
| ***Houston Police Officer's Pension System*** <br> ***602 Sawyer, Suite 300*** <br> ***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. <br><br> **Reporting Fund:** Police Officer's Pension Trust Fund. |

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")*** <br> ***c/o George R. Brown*** <br> ***Avenida De Las Americas*** <br> ***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")*** <br> ***9545 Katy Freeway, Suite 105.*** <br> ***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.*** <br> ***1513 N. MacGregor*** <br> ***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*** <br> ***c/o Hawes Hill Calderon LLP*** <br> ***P.O. Box 22167*** <br> ***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. |

| Discretely Reported Component Units | Brief Description of Activities, Relationship to City, and Key Inclusion Criteria |
|---|---|
| ***Cultural Arts Council of Houston ("CACH")/Harris County 3201 Allen Parkway, Suite 250 Houston, TX 77019*** | 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. |
| ***East Downtown 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 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. |
| ***Fourth Ward Redevelopment Authority c/o Zinetta Burney, General Counsel Burney & Foreman 5445 Almeda Suite 400 Houston, Texas 77004*** | 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. |
| ***Greater Greenspoint Redevelopment Authority 16945 Northchase Dr, Suite 1900 Houston, Texas 77060*** | 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. |
| ***Greater Houston Convention and Visitors Bureau 901 Bagby, Suite 1005 Houston, Texas 77002*** | A non-profit organization established in 1963 and funded by both private sector memberships and a portion of the hotel bed tax. Their mission is to improve the economy of Greater Houston by attracting conventions, tourists, film projects and international government officials to the area through sales and marketing efforts. |
| ***Gulfgate Redevelopment Authority c/o Knudson & Associates 8588 Katy Freeway, Suite 441 Houston, Texas 77024*** | 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. |
| ***HALAN - Houston Area Library Automated Network Board Houston Central Library 500 McKinney Houston, TX 77002*** | 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. |
| ***Houston Business Development Corp. 5330 Griggs Road Houston, Texas 77021*** | 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. |
| ***Houston Downtown Park Corporation 2217 Welch Houston, TX 77019*** | Local government corporation created by the City in 2004 in accordance with Chapter 431 of the Texas Transportation Corporation Act to aid and act on behalf of the City to accomplish the City's governmental purpose of providing for the acquisition, development, operation, and maintenance of a new public park, open space and related amenities and facilities to provide recreational, educational and tourism opportunities within, and beautification of the Central Business District of the City. |

| Discretely Reported Component Units | Brief Description of Activities, Relationship to City, and Key Inclusion Criteria |
|---|---|
| ***Houston Library Board*** <br> ***Houston Central Library*** <br> ***500 McKinney*** <br> ***Houston, TX 77002*** | 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. |
| ***Houston Parks Board*** <br> ***2001 Kirby Dr., Suite 814*** <br> ***Houston, Texas 77019*** | 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. |
| ***Lamar Terrace Public Improvement District*** <br> ***City of Houston*** <br> ***Box 1562*** <br> ***Houston, Texas 77251*** | 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. |
| ***Main Street Market Square Redevelopment Authority*** <br> ***909 Fannin St., Suite 1650*** <br> ***Houston, Texas 77002*** | 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. |
| ***Memorial City Redevelopment Authority*** <br> ***c/o Knudson & Associates*** <br> ***8588 Katy Freeway, Suite 441*** <br> ***Houston, Texas 77024*** | 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. |
| ***Memorial-Heights Redevelopment Authority*** <br> ***c/o Knudson & Associates*** <br> ***12 Greenway Plaza, Suite 1500 Houston, Texas 77046-1287*** | 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. |
| ***Midtown Redevelopment Authority*** <br> ***3401 Louisiana, Suite 355*** <br> ***Bienville Building*** <br> ***Houston, Texas 77002*** | 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. |
| ***Old Sixth Ward Redevelopment Authority*** <br> ***c/o Parke Patterson Consultants, Inc.*** <br> ***P.O. Box 994*** <br> ***Sugar Land, Texas 77487*** | 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. |
| ***OST/Almeda Corridors Redevelopment Authority*** <br> ***5445 Almeda Suite 502*** <br> ***Houston, Texas 77004*** | Local government corporation created by the City in accordance with Chapter 431 of the Texas Transportation Corporation Act to assist the OST/Almeda 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. |

| Discretely Reported Component Units | Brief Description of Activities, Relationship to City, and Key Inclusion Criteria |
|---|---|
| ***Saint George Place Redevelopment Authority c/o Hawes Hill Calderon LLP P.O. Box 22167 Houston, Texas 77227-2167*** | 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. |
| ***Sharpstown Economic Development Authority c/o Hawes, Hill & Associates P.O. Box 22167 Houston, Texas 77227-2167*** | 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. |
| ***South Post Oak Redevelopment Authority c/o Knudson & Associates 8588 Katy Frwy. Houston, Texas 77024*** | 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. |
| ***Southwest Houston Redevelopment Authority c/o Hawes Hill Calderon LLP P.O. Box 22167 Houston, Texas 77227-2167*** | 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. |
| ***Upper Kirby Redevelopment Authority 3015 Richmond Avenue, Suite 200, Houston, Texas 77098-3114*** | 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. |
| ***Uptown Development Authority 1980 Post Oak Blvd., Suite 1580 Houston, Texas 77056*** | 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. |

**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.

**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.

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.

Proprietary funds and pension trust funds of the primary government and blended Component Units 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 interfund services provided and used 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. 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 statement of net assets 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 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 2005, the capitalized interest cost for the Airport System Facilities was $32.6 million, Combined Utility System Fund was $25.0 million and Convention & Entertainment Facilities Fund was $1.07 million.

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

| Assets | Years |
|---|---|
| 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. 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.

**F. 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.

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.

**G. Statement of Cash Flows — Cash and Cash Equivalents**

The City considers cash and cash equivalents to be 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 for the proprietary operating funds.

**H. 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.

**I. 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.

**J. New Accounting Pronouncements**

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 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 has been implemented in the City's fiscal year ending June 30, 2005 to meet GASB requirements.

In December 2004, the GASB issued Statement No. 46, "Net Assets Restricted by Legislation – an amendment of GASB Statement No. 34." Statement No. 46 enhances the usefulness and comparability of net asset information reported by state and local governments by clarifying the meaning of the phrase 'legally enforceable' as it applies to restrictions imposed on net asset use by enabling legislation and by specifying the accounting and financial reporting requirements for those restricted net assets. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2005. The City has not determined the impact, if any, upon its financial position, results of operations or cash flows upon adoption.

In July 2004, the GASB issued Statement No. 47, "Accounting for Termination Benefits." Statement No. 47 requires employers to disclose a description of the termination benefit arrangement, the cost of the termination benefits (required in the period in which the employer becomes obligated if that information is not otherwise identifiable from information displayed on the face of the financial statements), and significant methods and assumptions used to determine termination benefit liabilities. For termination benefits provided through an existing defined benefit OPEB plan, the provisions of this Statement should be implemented simultaneously with the requirements of Statement 45. For all other termination benefits, this Statement is effective for financial statements for periods beginning after June 15, 2005. The City has not determined the impact, if any, upon its financial position, results of operations or cash flows upon adoption.

**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, 2005, were (in thousands):

| | |
|---|---|
| Unamortized bond issuance cost | $ 10,998 |
| Sectiojn 108 receivable | 23,395 |
| Deferred revenue | 97,463 |
| | $ 131,856 |
| Internal Service Fund total assets | 46,140 |
| Internal Service Fund liabilities | (44,846) |
| Cumulative asset resulting from undercharging the enterprise funds | 712 |
| | $ 2,006 |
| Bonds, notes, and capital lease payable | $ (2,490,636) |
| Arbitrage rebate payable | (86) |
| Accrued interest | (42,951) |
| Compensated absences not reported at the fund level | (347,374) |
| Claims and judgments not reported at the fund level | (146,781) |
| Net pension obligation (liabilities less assets) | (263,084) |
| | $ (3,290,912) |

**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, 2005 were (in thousands):

| | |
|---|---|
| Debt issued: | |
| Public Improvement Bonds | $ 178,295 |
| Pension Obligations | 284,788 |
| Commercial paper | 195,000 |
| Premium on bonds | 10,546 |
| Capital appreciation bonds accretion | 354 |
| Capital appreciation bonds retired | (155) |
| | 668,828 |
| Repayments: | |
| Refunded commercial paper | (160,900) |
| Refunded pension obligations | (22,900) |
| Principal payments | (141,077) |
| | (324,877) |
| Amortization of: | |
| Deferred gain | 1,978 |
| Premium | (4,062) |
| Net adjustment | $ 341,867 |

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 | $ | 46,794 |
| Ambulance fees earned but not available | | 5,408 |
| Fines and forfeits earned but not available | | 14,991 |
| Other (primarily assessments) earned but not available | | 30,270 |
| Total revenue not reported at fund level | $ | 97,463 |
| Property taxes for prior periods | $ | (53,257) |
| Ambulance fees for prior periods | | (7,186) |
| Fines and forfeits for prior periods | | (11,701) |
| Other (primarily assessments) for prior periods | | (16,701) |
| Total revenue for prior period transactions | $ | (88,845) |
| Interest on long-term debt | $ | (20,840) |
| Municipal Employees pension | | (44,403) |
| Police Officers' pension | | (69,248) |
| Firefighters' pension | | (19,523) |
| Claims and judgments | | 9,311 |
| Debt issuance costs | | 1,915 |
| Amortization of debt issuance costs | | (648) |
| Compensated absences | | (26,080) |
| Other liabilities | | 55 |
| Total differences in accrued expenses | $ | (169,461) |

**Note 3**: **Deposits and Investments**

## A. Deposits

At June 30, 2005 the carrying amount of the City's deposits was $13,806,903. The City's bank balance is the sum of three accounts which total $39,665,521. The three accounts that comprise this balance are described by the following:

| Accounts | Bank | Collected |
|---|---|---|
| Conc. 00103333903 | 15,375,568 | 10,000,000 |
| Sec 108 00103336856 | 372,544 | 372,544 |
| JPM MM Account | 23,917,409 | 23,917,409 |
| Subtotal | 39,665,521 | 34,289,953 |
| | | |
| Mkt Value Collateral | 14,178,302 | 14,178,302 |

The first account is a demand deposit account with JP Morgan Chase bank that as of June 30, 2005 had a ledger balance of $15,375,568 and a collected balance of $10,000,000. The difference between the ledger and collected balance of $5,375,568 represents checks deposited in this bank account for which the collection of available funds had not been obtained as of June 30, 2005. A Depository Pledge Agreement is in effect by which collateral is pledged by JP Morgan Chase to the City to cover collected balances. The collateral is in the form of high quality fixed income securities, are held by a third party, and as of June 30, 2005 had a market value of $14,178,302. According to the terms of the pledge agreement the City is granted a security interest in the pledged securities. In the event of a default by JP Morgan Chase, the City may sell the pledged securities to satisfy any indebtedness owed to the City by JP Morgan Chase, provided at least 3 business days written notice and opportunity to cure the default is given.

The second account is a demand deposit account with JP Morgan Chase Bank for the City's Housing and Urban Development section 108 account, which had a collected and ledger balance as of June 30, 2005 of $372,544. This balance was collateralized by the same Depository Pledge Agreement described above.

The third account is an SEC registered money market fund. The City has an agreement with JP Morgan Chase that any collected balances in its concentration bank account at the end of a day over $10,000,000 will automatically be swept into this money market fund. The balance in the money market fund as of June 30, 2005 was $23,917,409. There is no custodial risk associated with this money market fund.

The carrying amount of the pension trust fund component unit deposits was $4,061,000 and the bank balance was $4,115,978. The carrying amount of the discretely presented component unit deposits was $49,299,006 with a bank balance of $46,463,798 of which $1,595,025 was uncollateralized.

**B. Investments and Risk Disclosures**

The following describes the investment positions of the City's operating funds as of June 30, 2005. As of that date, the City had approximately $1.7 billion in fixed income investments in four separate investment pools, each serving a specific purpose as described below. All investments are governed by Texas state law and the City's Investment Policy, which dictates the following objectives, in order of priority:

1. Safety
2. Liquidity
3. Return on Investment
4. Legal Requirements

The City’s investment policy does not address concentration of credit risk.

These funds are managed internally by City personnel.

### I. General Investment Pool 960

The General Investment Pool consists of all working capital, construction and debt service funds which are not subject to yield restriction under IRS arbitrage regulations. The funds of the City's enterprise systems, as well as the general fund are commingled in this pool in order to gain operational efficiency. Approximately 98% of the City's total investable funds are contained in this portfolio.

| City of Houston Investments As of June 30, 2005 | Credit Quality Ratings(1)(2) | Market Value | WAM ( yrs ) |
|---|---|---|---|
| U.S. Treasury Notes | n/a | $ 18,412,665 | 0.776 |
| Housing & Urban Development Dept ("HUD") | n/a | 6,338,434 | 0.771 |
| Government National Mortgage Association | AAA | 4,535,262 | 9.572 |
| Certificate of Deposits (less than $100,000 each) | FDIC Insured | 298,569 | 0.153 |
| Commercial Paper | A-1+ | 134,561,895 | 0.008 |
| Agency Notes (4) | AAA | 1,008,046,103 | 1.227 |
| Agency Notes (3) (4) | not rated | 282,624,501 | 0.395 |
| Collateralized Mortgage Obligations (3) (4) | not rated | 7,049,171 | 7.305 |
| Mortgaged Backed Securities (3) (4) | not rated | 89,009,031 | 11.918 |
| Municipal Bonds | AAA | 52,028,602 | 1.552 |
| | AA | 12,430,838 | 2.125 |
| | SP-1+ | 41,193,047 | 0.923 |
| **Total Investments** | | **$ 1,656,528,118** | **1.604** |

(1) Standard and Poor's Rating Services has assigned an AAAf credit quality rating and S1 volatility rating to the City's General Investment Pool. The AAAf signifies the highest level of credit protection, and the S1 rating signifies volatility consistent with a portfolio of government securities maturing from one to three years.

(2) All credit ratings shown are either actual S&P ratings, or if an S&P credit rating is not available, the equivalent S&P credit rating is shown to represent the actual Moody's or Fitch credit rating.

(3) These securities are not individually rated by the rating agencies. The issuers of these securities, which includes the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Corporation ("Fannie Mae"), are rated AAA by the rating agencies. Federal Agricultural Mortgage Corporation ("Farmer Mac"), which comprises 1.3% of this portfolio, is not rated by the credit rating agencies as to the individual securities or as an issuer. Farmer Mac is a government sponsored enterprise and is a permitted investment under state law and City investment policy.

(4) These are securities issued by government sponsored enterprises, including the Federal Home Loan Bank, Freddie Mac, Fannie Mae, Farmer Mac, and Federal Farm Credit Bank System.

**Risk Disclosures:**

*Interest Rate Risk.* In order to ensure the ability of the City to meet obligations and to minimize potential fair value losses arising from rising interest rate environments, the City's investment policy limits this investment portfolio's dollar-weighted average stated maturity to 2.5 years maximum. As of June 30, 2005, this investment portfolio dollar-weighted average stated maturity is 1.6 years. Modified duration for the same period is 1.074. Modified duration can be used as a multiplier to determine the percent change in price of a bond portfolio for every 100 basis point (1%) change in yield. For example, a portfolio with a modified duration of 1.074 would experience approximately a 1.074% change in market price for every 100 basis point change in yield.

*Credit Risk:* The US Treasury Notes and securities issued by HUD and the Government National Mortgage Association. are direct obligations of the United States government. The Certificates of Deposit are for amounts less than $100,000 and guaranteed by the FDIC, an arm of the US Government. The Commercial Paper, which is limited by law to maturities of 270 days or less, has the highest short-term rating of A-1+. The Agency Notes, Collateralized Mortgage Obligations and Mortgage Backed Securities are issued by government sponsored enterprises but are not direct obligations of the US Government. The Municipal Securities that were issued as long-term securities are rated AAA or AA. The Municipal Securities that were considered short-term securities as time of issue, and thus were not given a long-term credit rating, have the highest short-term credit rating of MIG-1.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005 none of the City's investments in the General Investment Pool 960 were subject to custodial credit risk.

### II. Tax Exempt Pool 971

The Tax Exempt Pool consists of those funds which are subject to yield restrictions and arbitrage regulation under the1986 Tax Reform Act.

| City of Houston<br>Investments As of June 30, 2005 | Credit Quality<br>Ratings | Market<br>Value | WAM |
|---|---|---|---|
| Fidelity Tax-Exempt Money Market Mutual Fund | SEC 2a-7 fund (unrated) | 5,302,384 | 1-Day |

**Risk Disclosures:**

*Interest Rate Risk.* In order to ensure the ability of the City to meet obligations and to minimize potential fair value losses arising from rising interest rate environments, the City's investment policy limits this investment portfolio dollar-weighted average stated maturity to 1.0 years maximum. As of June 30, 2005, this investment portfolio's dollar-weighted average stated maturity is 1 day. Modified duration for the same period is 0.003 year.

*Credit Risk.* Due to the nature of municipal bonds (more risk, less liquidity), the City investment policy limit its investments in the Tax-Exempt Pool with high quality, short maturity securities (generally less than 1 year) and a minimum rating of A, if the yield is reasonably higher than that of tax-exempt money market mutual funds. Otherwise, funds in this pool will be invested in one or more tax-exempt money market mutual funds that are SEC registered and regulated under rule 2a-7. In sum, rule 2a-7 requires that the fund have a weighted average maturity of less than 90 days to maturity, individual securities cannot be more than 397 days to maturity and must have a rating by nationally recognized rating agencies in one of the two highest short-term rating categories.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005 none of the City's investments in the Tax Exempt Pool 971 were subject to custodial credit risk.

### III. Housing Department Section 108 Pool 974

The Housing Department Pool was created to comply with rules of the US Department of Housing and Urban Development ("HUD"), which requires that funds provided by HUD must be held in a separate custodial account for HUD's benefit. The primary goal of this fund is to meet the cash and investment needs of the City's Housing and Community Development HUD program cash flows.

| City of Houston<br>Investments As of June 30, 2005 | Credit Quality<br>Ratings | Market<br>Value | WAM |
|---|---|---|---|
| U.S. Treasury Bills | AAA | 1,040,901 | 14-Day |

**Risk Disclosures:**

*Interest Rate Risk.* In order to ensure the ability of the City to meet obligations and to minimize potential fair value losses arising from rising interest rate environments, the City's investment policy limits this investment portfolio's dollar-weighted average stated maturity to 6.0 months maximum. As of June 30, 2005, this investment portfolio dollar-weighted average stated maturity is 14 days. Modified duration for the same period is 0.036 year.

*Credit Risk.* Pool 974 only consists of U.S. Treasury Bills with maturities less than 6 months. HUD requires that investment of their funds must be in direct obligations of the United States Government.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005 none of the City's investments in the Housing Dept. 974 Pool were subject to custodial credit risk.

### IV. Convention Center and Hotel Reserve Fund Pool 979

The Convention Center and Hotel Reserve Fund Pool consists of proceeds from the 2001 Series A, B and C Hotel Occupancy Tax and Special Revenue Bond issues designated as reserve funds.

| City of Houston<br>Investments As of June 30, 2005 | Credit Quality<br>Ratings | Market<br>Value | WAM<br>( yrs ) |
|---|---|---|---|
| MBIA Flex Repo | not rated | 22,207,693 | 6.175 |

**Risk Disclosures:**
*Interest Rate Risk.* This is a 5.64% fixed rate investment provided by MBIA Inc. The market value of this investment is held at a constant value because it is collateralized for 105% of its par value (see credit risk below).

*Credit Risk.* This investment is collateralized with fixed income government securities that are held by a third party. The market value of that collateral is maintained at least 105% of the par value of this investment, and is monitored monthly.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005, the City's investments that were subject to custodial credit risk were the collateral securities for the MBIA Flex Repo, held by an independent third party custodian (Wells Fargo) with whom the City has a current custodian agreement.

### V. Miscellaneous Money Market Account

The City maintains several separate money market account balances for various purposes described below:

| City of Houston<br>Investments As of June 30, 2005 | Credit Quality<br>Ratings | Market<br>Value | WAM<br>( yrs ) |
|---|---|---|---|
| JP Morgan US Government Money Market Fund:<br>Airport System Special Facilities Revenue Bonds<br>Series 1997A Reserve Fund. | AAA | $ 6,681,455 | < 90 days |
| JP Morgan US Government Money Market Fund:<br>Balances held for auction rate debt service. | AAA | 293,816 | < 90 days |
| JP Morgan US Treasury Plus Money Market Fund:<br>TNRCC Trust Fund for held for utility projects. | AAA | 3,833,373 | < 90 days |
| First American Treasury Obligation Money Market Fund:<br>Balances held for commercial paper debt service. | AAA | 277,995 | < 90 days |
| Total Miscellaneous Money Market Funds | | $ 11,086,639 | |

**Risk Disclosures:**
Interest Rate Risk. These money market funds maintain an average maturity of less than 90 days and seek to maintain a stable net asset value of $1.00. These funds are redeemable on a same day notice.

*Credit Risk*. These funds hold only US dollar denominated securities that present minimal credit risk. They have the highest credit ratings Standard & Poor's and Moody's of AAAm and Aaa respectively.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005 none of the City's investments in the above noted money market funds were subject to custodial credit risk.

**VI. Houston Foundation**

The Houston Foundation consists of two trusts, of which the Hill Trust is reported on this schedule. The Hill trust was established by will in the early 1900's as a general purpose charity trust. The foundation's board usually designates that the money be used for a specific purpose, such as the purchase of medical supplies or to fund Meals on Wheels, rather than for administrative or staff salaries. The City's Finance and Administration staff provides administrative support to the foundation and its board.

| **City of Houston**<br>**Investments As of June 30, 2005** | **Credit Quality**<br>**Ratings** | **Market**<br>**Value** | **WAM**<br>**( yrs )** |
|---|---|---|---|
| Cash and Equivalents | not rated | $ 53,895 | > 90 days |
| Fixed Income | not rated | 1,212,681 | 2.14 |
| Equities | n/a | 1,328,446 | n/a |
| Total Assets | | $ 2,595,022 | |

**Risk Disclosures:**
*Interest Rate Risk.* The fixed income portion of this portfolio is invested in two mutual funds, about 80% of which is invested in a short-term bond fund with a modified duration of 1.6. The remaining 20% is invested in an intermediate bond fund with a modified duration of about 4.3.

*Credit Risk*. The allocation of assets among various asset classes are set by the board. The mutual funds containing the fixed income investments are not rated, but the average credit quality of the specific securities held by the mutual funds is Aa2. The equity assets are split among five mutual funds with their respective objectives as follows: International Value, Growth, Midcap Index, Smallcap Index, and Domestic Value. The fund's managers consider broad diversification as a measure of safety and balance in the investment of funds.

*Custodial Credit Risk.* The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the City of Houston will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are not registered in the name of the City, and are held by either the counterparty or the counterparty's trust department or agent but not in the City's name. As of June 30, 2005 all of the foundation's holdings in the above noted mutual funds were subject to custodial credit risk.

## VII. Investments – Houston Area Water Corporation

As of June 30, 2005, the Corporation had the following investments:

| Investment | Weighted Average<br>Maturity | Fair value |
|---|---|---|
| JP Morgan U.S. Government Money Market Fund | 37 days | $ 75,458 |
| JP Morgan Prime Money Market Funds | 44 days | 3,050,712 |
| Pool managed by the City of Houston | 1.7 yrs. | 4,277,210 |

*Interest Rate Risk.* The Corporation does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

*Credit Risk.* State law limits investments in commercial paper, corporate bonds, and mutual bond funds to the top two ratings issued by nationally recognized statistical rating organizations. The corporation has no investment policy that would further limit its investment choices. As of June 30, 2005, Standard & Poor's Investment Services has assigned its AAAf credit rating and S1 volatility rating available from Standard & Poor's and reflects the extremely strong protection that the Pool's portfolio investments provide against losses from credit defaults or credit deterioration. The S1 volatility rating recognizes the Pool's sensitivity to changing market conditions as a result of its low market risk profile and conservative investment policies. The corporation's investment in the U.S. Government Money Market Fund was rated AAAm by S&P Rating and Aaa by Mood's Rating. The corporation's investment in the Prime Money Market Fund was rated AAAm by S&P Rating and Aaa by Moody's Rating.

### VIII. Investments – Municipal Employees Pension System (the "System")

Portions of the System's investments are classified as security investments. A security is a transferable financial instrument that evidences ownership or creditorship. Investments in commingled funds, limited partnerships, real estate trusts, and loans and mortgages are investments that are evidenced by contracts rather than securities.

The fair values of the System's investments at June 30, 2005 are presented by type, as follows:

| | | |
|---|---|---|
| United States government securities | $ | 62,840,296 |
| Corporate bonds | | 73,687,436 |
| Capital stocks | | 458,701,513 |
| Commingled funds | | 420,920,132 |
| Limited partnerships, real estate trust, and loans and mortgages | | 372,737,677 |
| Short-term investment funds (cost) | | 97,408,425 |
| | $ | 1,486,295,479 |

The System's Board (Board), in accordance with the power and authority conferred under the Texas Statutes, employed State Street Bank and Trust Company (Custodian) as custodian of the assets of the System, and in said capacity, the Custodian shall be a fiduciary of the System's assets with respect to its discretionary duties including safekeeping the System's assets. The Custodian shall establish and maintain a custodial account to hold, or direct its agents to hold, for the account of the System all assets that the Board shall from time to time deposit with the Custodian. All right, title and interest in and to the System's assets shall at all times be vested in the System's Board.

In holding all system assets, the Custodian shall act with the same care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in like capacity and familiar with matters of this type would use in the conduct of an enterprise with a like character and with like aims. Further, the Custodian shall hold, manage and administer the System's assets for the exclusive purpose of providing the benefits to the members and the qualified survivors of the System.

The Board shall manage the investment program of the System in compliance with all applicable Federal and State statutes and regulations concerning the investment of pension assets. The Board has adopted a Statement of Investment Policies and Objectives (Investment Policy) to set forth the factors involved in the management of investment assets for the System and is made part of every investment management agreement.

*Custodial credit risk*. For an investment, custodial credit is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the System, and are held by either the counterparty or the counterparty's trust department or agent but not in the System's name. At June 30, 2005, the System's investments that were not subject to custodial credit risk were the investments in U.S. government securities and corporate bonds as they are registered in the name of the System and held in possession of the Custodian.

*Concentration of credit risk*. The allocation of assets among various asset classes are set by the Board. For major asset classes (e.g., U.S. equity, international equity, fixed income, real assets, and alternative investments), the System will further diversify by employing managers with demonstrated skills in complementary areas of expertise.

The managers retained will utilize varied investment approaches, but, when combined will exhibit characteristics that are similar, but not identical, to the asset class proxy utilized in the strategic asset allocation plan. The Investment Policy of the System provides that no investment manager shall have more than 15% (at market value) of the System's assets in one investment style offered by the firm, with the exception of passive management.

Significant guidelines by type of investment are as follows:

U.S. equity managers

1. A manager's portfolio shall contain a minimum of twenty-five issues.
2. No more than 5% of the manager's portfolio at market shall be invested in American Depository Receipts.
3. No individual holding in a manager's portfolio may constitute more than 5% of the outstanding shares of an issuer.
4. No individual holding may constitute more than 5% of a manager's portfolio at cost or 10% at market.
5. Short sales, purchases on margin, non-negotiable or otherwise restricted securities are prohibited, other than where expressly permitted.
6. While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10%.

*International equity managers*

1. Not more than 5% at cost and 10% at market value of a manager's portfolio shall be invested in the securities of any one issuer.
2. Not more than 30% of the assets of a manager's portfolio (at market value) shall be invested in any one country with the exception of Japan.
3. While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10%.
4. Currency forwards and futures will be limited as follows:
    a. Limits on net forward and future sales of currencies will be addressed in each manager's respective Guidelines and Objectives,
    b. Forward and future exchange contracts of any currencies, other than Yen, Sterling and Euro shall be limited to the manager's underlying equity position in the local market,
    c. Foreign exchange contracts with a maturity exceeding 12 months are prohibited, and
    d. Currency options may be entered into in lieu of or in conjunction with forward sales of currencies. The same effective limitations specified in (a) through (c) above will apply to currency options.

*Fixed income managers*

1. No more than 10% of a manager's portfolio at market shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.
2. No individual holding in a manager's portfolio shall constitute more than 10% of the market value of an issue.

*Global opportunistic fixed income/high yield managers*

3. No more than 5% at cost and 10% at market value of a manager's portfolio shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.

There is no security issued by a single issuer that is being held with market value over 5% of the System's plan net assets as of June 30, 2005.

*Interest rate risk.* The System invests in fixed income securities including, but not limited to, investments representing instruments with an obligated fixed rate of interest including public and private debentures, mortgages, investments in life insurance general accounts and guaranteed investment contracts, with maturities greater than one year, and options/futures. Instruments may have an investment grade or non-investment grade rating. Purchases and sales, investment selection and implementation of investment strategies are delegated to the discretion of the investment manager, subject to compliance with its management agreement and the Investment Policy.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of the investment. Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price.

The greater the duration of a bond, or a portfolio of bonds, the greater its price volatility will be in response to a change in interest rates and vice-versa. Duration is the measure of a bond price's sensitivity to a 100-basis point change in interest rates. The duration of the System's debt securities are managed by the active managers.

At June 30, 2005, the following table shows the System's investments by type, amount and the effective duration rate calculated using the software Wilshire Axiom.

| | Effective Duration | Domestic | International | Fair Value |
|---|---|---|---|---|
| Collateralized mortgage obligations | 3.99 | $ 11,604,049 | 94,240 | 11,698,289 |
| Convertible bonds | 3.25 | 4,122,076 | 1,689,463 | 5,811,539 |
| Corporate bonds | 6.89 | 45,458,947 | | 45,458,947 |
| Corporate bonds (International) | 2.25 | 123,089 | 1,422,355 | 1,545,444 |
| GNMA/FNMA/FHLMC | 2.28 | 21,906,214 | | 21,906,214 |
| Government issues | 4.59 | 34,435,711 | | 34,435,711 |
| Government issues (International) | 6.30 | | 4,797,481 | 4,797,481 |
| Misc. receivable (auto/credit card) | 0.99 | 1,265,178 | | 1,265,178 |
| Options-futures | | (233,658) | | (233,658) |
| Other asset backed | 3.54 | 9,331,750 | 510,837 | 9,842,587 |
| | 4.80 | $ 128,013,356 | 8,514,376 | 136,527,732 |

*Credit risk.* The quality ratings of investments in fixed income securities are set forth in the Investment Policy as follows:

1. All issues purchased must be of investment grade quality Baa (Moody's) or BBB (S&P) unless expressly authorized by the Board, in which case a minimum B rating shall apply, with a maximum limit of non-investment grade credits of 20% at market.

2. For global opportunistic fixed income/high yield securities, more than 50% of a manager's portfolio at market shall be invested in non-investment grade fixed income securities, i.e. those with ratings of BA1 (Moody's), BB+ (Standard & Poor's), or lower, or unrated bonds, including corporate bonds, convertible bonds, and preferred stocks.

The quality ratings of investments in fixed income securities as described by nationally recognized statistical rating organizations at June 30, 2005 are as follows:

| Quality Rating | Fair Value | Percentage of Holdings |
|---|---|---|
| AAA | $ 26,746,361 | 19.58 % |
| AA+ | 182,910 | 0.13 % |
| AA- | 557,981 | 0.41 % |
| A | 1,170,123 | 0.86 % |
| A- | 953,692 | 0.70 % |
| A+ | 1,432,390 | 1.05 % |
| BBB | 3,014,419 | 2.21 % |
| BBB- | 4,208,705 | 3.08 % |
| BBB+ | 2,143,098 | 1.57 % |
| BB | 5,887,768 | 4.31 % |
| BB+ | 6,715,068 | 4.92 % |
| BB- | 1,881,936 | 1.38 % |
| B | 4,937,965 | 3.62 % |
| B+ | 5,814,350 | 4.26 % |
| B- | 7,943,678 | 5.82 % |
| CCC and below | 4,549,622 | 3.33 % |
| Not rated | 3,179,075 | 2.33 % |
| Rating not available | 5,173,004 | 3.79 % |
| Total credit risk debt securities | 86,492,145 | 63.35 % |
| U.S. government fixed income securities* | 50,035,587 | 36.65 % |
| Total fixed income securities | $ 136,527,732 | 100.00 % |

*Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not have purchase limitations.

*Foreign currency risk.* International securities investment managers are expected to maintain diversified portfolios by sector and by issuer using the System's Investment Policy.

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. Each investment manager, through the purchase of units in a commingled investment trust fund or international equity mutual fund, establishes investments in international equities. The System has an indirect exposure to foreign currency fluctuation as of June 30, 2005 as follows:

| | Fair Value | Percentage of Holdings |
|---|---|---|
| EURO Currency | $ 64,743,286 | 36 % |
| Japanese Yen | 39,341,395 | 22 % |
| Pound Sterling | 24,551,143 | 14 % |
| Swiss Franc | 15,199,722 | 8 % |
| Norwegian Krone | 5,455,402 | 3 % |
| Canadian Dollar | 5,086,231 | 3 % |
| Hungarian Forint | 4,973,540 | 3 % |
| Singapore Dollar | 3,733,631 | 2 % |
| Hong Kong Dollar | 3,487,281 | 2 % |
| Australian Dollar | 3,221,610 | 2 % |
| Other foreign currencies | 9,945,068 | 5 % |
| Total securities subject to foreign currency risk | $ 179,738,309 | 100 % |

*Securities Lending.* State Statues allow the System to participate in securities lending transactions and the Board has authorized its custodian to lend the System's securities to broker-dealers and banks pursuant to a form of loan agreement. During the year ended June 30, 2005, the System's custodian lent, at the direction of the Board, the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrowers default. Borrowers were required to deliver collateral for each loan equal to: (i) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

The Board did not impose any restrictions on the amounts of the loans that the System's custodian made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions. Moreover, there were no losses during the year resulting from a default of the borrowers or the custodian.

During the year ended June 30, 2005, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested together with the cash collateral of other qualified tax-exempt plan lenders, in a commingled investment pool. As of June 30, 2005, such investment pool had an average duration of 40 days and an average weighted maturity of 410 days, respectively. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. On June 30, 2005, the System had no credit risk exposure to borrowers. The collateral held and the fair value of securities on loan as of June 30, 2005, was $96,629,097 and $92,807,489, respectively.

The fair values of the underlying securities lent as of June 30, 2005 are as follows:

| | 2005 |
|---|---|
| U.S. government securities | $27,699,150 |
| Domestic equity | 34,267,743 |
| Domestic fixed income | 10,089,776 |
| International equity | 20,750,820 |
| | $92,807,489 |

**IX. Investments – Houston Firefighters' Relief and Retirement (HFRRF) Fund**

Statutes of the State of Texas authorize the HFRRF to invest surplus funds in the manner provided by the Government Code, Title 8, Subtitle A, Subchapter C. This subchapter provides for the investment of surplus assets in any investment or investments that are deemed "prudent" by the HFRRF Board. The investment policy of the HFRRF Board does not restrict the types of investments authorized to be made on behalf of the HFRRF; however, the Board seeks to produce a return on investments that is based on prudent and reasonable investment risk and the cash flow requirements of the HFRRF given prevailing capital market conditions. While the HFRRF Board recognizes the importance of the preservation of capital, it also adheres to the theory of capital market pricing which maintains that varying degrees of investment risk should be rewarded with incremental returns. Consequently, prudent risk-taking is justifiable.

The HFRRF Board has employed Mellon Trust (HFRRF Custodian) as HFRRF Custodian of the assets of the HFRRF, and in said capacity, the HFRRF Custodian shall be a fiduciary of the HFRRF's assets with respect to its discretionary duties including safekeeping the HFRRF's assets. The HFRRF Custodian shall establish and maintain a custodial account to hold, or direct its agents to hold, for the account of the HFRRF all assets that the HFRRF Board shall from time to time deposit with the HFRRF Custodian. All right, title and interest in and to the HFRRF's assets shall at all times be vested with the HFRRF's Board.

In holding all HFRRF assets, the HFRRF Custodian shall act with the same care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in like capacity and familiar with matters of this type would use in the conduct of an enterprise with a like character and with like aims. Further, the HFRRF Custodian shall hold, manage and administer the HFRRF 's assets for the exclusive purpose of providing the benefits to the members and the qualified survivors of the HFRRF Fund.

The HFRRF Board shall manage the investment program of the HFRRF in compliance with all applicable Federal and State statutes and regulations concerning the investment of pension assets. The HFRRF Board has adopted an Investment Policies and Procedures (Investment Policy) to set forth the factors involved in the management of investment assets for the HFRRF. The HFRRF Board has established an Investment Committee to act on all matters related to investments.

The fair values of the HFRRF's investments as of June 30, 2005 by type, are as follows:

| | | |
|---|---|---|
| Short-term investment funds | $ | 116,398,655 |
| Fixed Income | | 737,221,349 |
| Common equity | | 975,558,275 |
| Preferred equity | | 7,122,422 |
| Alternative investments - partnerships | | 299,765,798 |
| Real Estate | | 121,489,048 |
| Total investments | $ | 2,257,555,547 |

Portions of the HFRRF's investments are classified as security investments. A security is a transferable financial instrument that evidences ownership or creditorship. Investments in partnerships and real estate are investments that are evidenced by contracts rather than securities.

*Custodial credit risk.* For an investment, custodial credit is the risk that, in the event of the failure of the counterparty, the HFRRF will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the HFRRF, and are held by either the counterparty or the counterparty's trust department or agent but not in the HFRRF's name. At June 30, 2005, the HFRRF's security investments that were not subject to custodial credit risk were the investments in fixed income and equity investments.

*Concentration of credit risk.* The allocation of assets among various asset classes are set by the HFRRF Board with the objective of optimizing the investment return of the HFRRF within framework of acceptable risk and diversification. For major asset classes (e.g., domestic equities, international equities, fixed income, alternative investments, and real estate), the HFRRF will further diversify by employing investment managers who implement the strategies selected by the Investment Committee.

Significant guidelines are as follows:

*Public market investments*

1. Specific guidelines will be developed cooperatively by the HFRRF's investment staff, legal counsel, and investment manager and shall be incorporated into the Investment Management Services Contract executed by the Chair of the Investment Committee, Executive Director and the investment manager.

2. In case of conflict between the specific manager guidelines and the general guidelines, the specific guidelines, as approved by the Investment Committee, shall supersede. The general guidelines are as follows:

    a. Manager investment philosophy, style, and strategy shall remain consistent and shall not change without the Investment Committee's approval. The manager shall have discretion to manage the portfolio consistent with the style presented to the Investment Committee at the time of selection and further subject to the restrictions established by the policy herein.
    b. The following transactions are prohibited: short sales, selling on margin, put and call options, and the use of derivatives for speculation unless authorized by the Investment Committee.

    c. Transactions that involve a broker acting as a principal, where such broker is also affiliated with the manager who is making the transaction are prohibited, unless specifically approved by the Investment Committee.

    d. Transactions shall be executed at competitive costs, or within the parameters established for directed brokerage transactions by the Investment Committee.

    e. Managers shall maintain cash levels consistent with their style as presented to the Investment Committee at the time of selection. Any deviation shall be allowed only after notifying the Chief Investment Officer and Executive Director and should be related to unusual market conditions. The cash level held by each manager will be addressed in the Investment Management Services Contract.

3. The Investment Committee with the assistance from the HFRRF staff shall monitor each investment manager's performance and adherence to style, strategy, and manager specific guidelines. It is the Investment Committee's discretion to take corrective action by replacing an investment manager if they deem it appropriate at any time.

*Alternative and real estate investments*

a. The investment specific guidelines for each manager will be incorporated in a Limited Partnership Agreement, Limited Liability Company Agreement, or other binding agreement as is appropriate for the investment. The Chair of the Investment Committee and the manager execute this document.

b. In case of conflict between the specific manager guidelines and the general guidelines, the specific guidelines, as approved by the Investment Committee, shall supersede. The general guidelines are as follows:

    1. Manager investment philosophy, style, and strategy shall remain consistent and shall not change without the Investment Committee's approval. The manager shall have discretion to manage the portfolio consistent with the style presented to the Investment Committee at the time of selection and further subject to the restrictions established by the policy herein.

    2. The Chair of the Investment Committee may execute amendments and consents if the resulting changes or allowances are provided for in the governing documents as previously accepted by the Investment Committee. Otherwise, such changes are to be approved by the Investment Committee. The Investment Committee will be notified on a quarterly basis of all executed amendments.

c. The Investment Committee with assistance from the HFRRF staff shall monitor each Alternative and Real Estate manager's performance and adherence to strategy and manager specific guidelines. It is the Investment Committee's discretion to take corrective action by replacing an investment manager if they deem it feasible and appropriate at any time. Alternative and Real Estate investment manager retention is governed in most cases by Limited Partnership Agreements, Limited Liability Company Agreements, or other binding agreements. In these cases, the Investment Committee with assistance from the HFRRF staff shall identify available options as allowed by the governing documents and determine the impact and consequences of these options.

As of June 30, 2005, the HFRRF Fund's investments of $119,666,229 in an individual U.S. Treasury Bond exceeded 5% of HFRRF net assets.

*Interest rate risk.* The Fund invests in fixed income securities including, but not limited to, investments representing instruments with an obligated fixed rate of interest including public and private debentures, mortgages, investments in life insurance general accounts and guaranteed investment contracts, with maturities greater than one year, and options/futures. Instruments may have an investment grade or non-investment grade rating. Purchases and sales, investment selection and implementation of investment strategies are delegated to the discretion of the investment manager, subject to compliance with its management agreement and the HFRRF's Investment Policy.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of the investment. Interest rate risk is the greatest risk faced by an investor in the fixed income market. The price of a fixed income security typically moves in the opposite direction of the change in interest rates. The weighted average maturity expresses investment time horizons (when the investment come due and payable) in years, weighted to reflect the dollar size of individual investments within the investment type. The HFRRF does not have a formal investment policy that limits investment maturities as a means of managing its exposure to potential fair value losses arising from future changes in interest rates, but rather mandates such limits within the Investment Management Services Contract.

At June 30, 2005, the following table shows the HFRRF's investments by type, with weighted average maturity and fair value:

| | Weighted Average Maturity | | Fair Value |
|---|---|---|---|
| U.S. government issues | 10.94 | $ | 352,853,759 |
| Corporate debt | 9.14 | | 236,284,791 |
| Non-U.S. government issues | 3.44 | | 38,820,794 |
| Asset backed securities | 4.95 | | 33,662,412 |
| General obligations | 17.62 | | 25,636,309 |
| U.S. private placements | 14.84 | | 18,462,880 |
| FHLMC/FNMA | 3.30 | | 16,174,875 |
| Revenue bonds | 19.29 | | 15,325,529 |
| Total fixed income securities | 10.03 | $ | 737,221,349 |

*Credit risk.* Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The HFRRF does not have a formal policy limiting investment credit risk, but rather mandates such limits within the Investment Management Services Contract.

The HFRRF's exposure to investment credit risk in fixed income securities as of June 30, 2005 is as follows:

| Quality Rating | | Fair Value | Percentage of Holdings |
|---|---|---|---|
| Aaa | $ | 102,629,555 | 4.55 % |
| Aa1 | | 20,633,205 | 0.91 % |
| Aa2 | | 21,502,751 | 0.95 % |
| Aa3 | | 8,916,013 | 0.39 % |
| A1 | | 4,677,978 | 0.21 % |
| A2 | | 16,076,632 | 0.71 % |
| A3 | | 3,438,580 | 0.15 % |
| Baa1 | | 12,160,835 | 0.54 % |
| Baa2 | | 14,855,742 | 0.66 % |
| Baa3 | | 26,495,592 | 1.17 % |
| Ba1 | | 16,148,864 | 0.72 % |
| Ba2 | | 15,382,990 | 0.68 % |
| Ba3 | | 30,060,416 | 1.33 % |
| B1 | | 18,876,577 | 0.84 % |
| B2 | | 18,996,109 | 0.84 % |
| B3 | | 25,265,596 | 1.12 % |
| Caa1 | | 5,791,107 | 0.26 % |
| Caa2 | | 4,365,818 | 0.19 % |
| Caa3 | | 4,913,523 | 0.22 % |
| Ca | | 114,100 | 0.01 % |
| Rating not available | | 13,065,607 | 0.58 % |
| Total credit risk debt securities* | $ | 384,367,590 | 17.03 % |

*Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and therefore, have not been included in this disclosure.

*Foreign currency risk.* Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. International securities investment managers are expected to maintain diversified portfolios by sector and by issuer using the HFRRF's Investment Policy. The HFRRF's exposure to foreign currency fluctuation as of June 30, 2005 is as follows:

| | | Fair Value | Percentage of Holdings |
|---|---|---|---|
| EURO Currency | $ | 111,242,262 | 4.93 % |
| British Pound Sterling | | 93,786,763 | 4.15 % |
| Japanese Yen | | 57,408,173 | 2.54 % |
| Canadian Dollar | | 44,885,887 | 1.99 % |
| Swiss Franc | | 31,252,035 | 1.38 % |
| Australian Dollar | | 27,962,587 | 1.24 % |
| South Korean Won | | 21,283,947 | 0.94 % |
| Singapore Dollar | | 14,553,404 | 0.64 % |
| Mexican New Peso | | 14,316,690 | 0.63 % |
| Hong Kong Dollar | | 13,646,305 | 0.60 % |
| Norwegian Krone | | 13,378,602 | 0.59 % |
| Brazil Real | | 12,777,475 | 0.57 % |
| New Taiwan Dollar | | 11,565,215 | 0.51 % |
| Thailand Baht | | 9,509,435 | 0.42 % |
| New Zealand Dollar | | 8,922,327 | 0.40 % |
| Swedish Krona | | 6,473,212 | 0.29 % |
| Hungarian Forint | | 6,431,204 | 0.28 % |
| South African Rand | | 4,522,012 | 0.20 % |
| Czech Koruna | | 3,258,751 | 0.14 % |
| Israeli Shekel | | 1,410,356 | 0.06 % |
| Indonesian Rupian | | 1,408,732 | 0.06 % |
| New Turkish Lira | | 1,382,067 | 0.06 % |
| Danish Krone | | 10,563 | 0.00 % |
| Total securities subject to foreign currency risk | $ | 511,388,004 | 22.62 % |

*Securities Lending Arrangement*
The HFRRF had the following securities on loan and held the following related cash collateral balances, at fair value, as of June 30, 2005:

| | Securities Lent | Collateral Held |
|---|---|---|
| Fixed Income | $ 466,887,790 | $ 477,737,216 |
| Common and preferred stocks | 61,243,760 | 64,346,716 |
| | $ 528,131,550 | $ 542,083,932 |

State statutes and Board policies permit the HFRRF to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The HFRRF's Custodian lends securities of the type on loan for collateral in the form of cash or other securities of 101% to 109%, which varies based on the types of securities lent. The HFRRF has no credit risk exposure to borrowers because the amounts the HFRRF owes the borrowers exceed the amounts the borrowers owe the HFRRF as of June 30, 2005. The contract with the HFRRF's Custodian requires it to indemnify the HFRRF if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay the HFRRF for income distributions by the securities' issuers while the securities are on loan.

All security loans can be terminated on demand by either the HFRRF or the borrower. Cash collateral is invested in the lending agent's collateral investment pool, which has a weighted-average maturity of approximately 31 days as of June 30, 2005. The risk associated with the HFRRF's participation in the securities lending program is investment risk, which affects the yield spread on the investments within the loan investment pool. The HFRRF cannot pledge or sell collateral securities received unless the borrower defaults. At June 30, 2005, securities lending transactions were collateralized in cash.

## X. Investments – Houston Police Officers' Pension (HPOP)

### Summary of Significant Accounting Policies

*Investments.* Statutes of the State of Texas authorize the HPOP System to invest surplus funds in a manner provided by the Government Code, Title 8, Subtitle A, Subchapter C. Investments are reported at fair value. Securities traded on national or international exchanges are valued at the last reported sales price at current exchange rates. Investments that do not have an established market value are reported at estimated fair value.

Dividend income is recorded on the ex-dividend date. Income from other investments is recorded when earned. Gains and losses on sales of securities are recognized on the trade date. The cost of investments sold is determined using the first-in, first-out cost flow method. Short-term investments include funds held in the Northern Trust Short Term Investment Fund (STIF) and commercial paper with maturities not exceeding one year. Fixed income investments include government securities such as Treasury securities, Federally sponsored agency issued discount notes, bonds, agency pass-through securities and collateralized mortgage obligations; US corporate bonds such as term bonds and asset backed securities; and foreign securities such as dollar denominated and non-dollar denominated issues of non-US governments and private corporations. Call options on fixed income securities give the holder the right but not the obligation to purchase US Treasury securities during the term of the option contract. The holder pays a premium for this right, which is carried as an asset of the System, subject to daily mark-to-market adjustments, during the contract term. The issuer of the option has an obligation to the holder to settle the option position in cash at the fair value of the underlying security in exchange for the price specified by the option, until the contract is exercised or expires. Equity securities consist of individual shares of equity securities plus units of commingled stock funds of both US and foreign entities. Alternative investments consist of investments in real estate and venture capital and private equity limited partnerships.

The System's investments have been categorized to address deposit and investment risks related to custodial credit risk, credit risk, concentration of credit risk, interest rate risk, and foreign currency risk.

*Custodial Credit Risk.* Custodial credit risk for deposits is the risk that in the event of a bank failure, the HPOP System's deposits may not be returned to them. The HPOP System considers only demand deposits as cash. As of June 30, 2005, the HPOP System had a balance of $131 thousand on deposit at a financial institution. The Federal Depository Insurance Corporation covered cash on deposit up to $100 thousand at this financial institution. As of June 30, 2005, $31 thousand of the System's bank balance of $131 thousand was exposed to custodial credit risk as it was uninsured and uncollateralized. In addition, at June 30, 2005, the System has approximately $811 thousand on deposit and an overdraft of approximately $976 thousand with other financial institutions, which is subject to custodial credit risk, as it is not covered by depository insurance and is uncollateralized.

*Credit Risk.* Credit risk is the risk that the counterparty will not fulfill its obligations. As of June 30, 2005, the System's fixed income assets that are not government guaranteed represented 99.9% of the System's fixed income portfolio. The following tables summarize the System's fixed income portfolio exposure levels and credit qualities.

**Average Credit Quality and Exposure Levels of Non-U.S. Government Guaranteed Securities ($000's)**

| Fixed Income Security Type | Market Value June 30, 2005 | Percent of All Fixed Income Assets | Weighted Average Credit Quality |
|---|---|---|---|
| Corporate Bonds | $ 207,280 | 40.9% | B |
| International | | | |
| Government Agencies | 1,027 | 0.2% | A |
| Government Bonds | 159,636 | 31.5% | AA |
| Mutual Bond Funds | 138,445 | 27.3% | Not Rated |
| Total | $ 506,388 | 99.9% | |

**Ratings Dispersion Detail**
**($000's)**

| Credit Rating Level | Corporate Bonds | International Government Bonds | Mutual Bond Funds | International Government Agencies |
|---|---|---|---|---|
| AAA | $ - | $ 55,448 | | |
| AA | - | 76,749 | | |
| A | 486 | 6,038 | | $ 1,027 |
| BBB | 1,084 | 12,645 | | |
| BB | 44,194 | 6,282 | | |
| B | 129,164 | 2,474 | | |
| CCC | 17,106 | - | | |
| C | 772 | - | | |
| D | 544 | - | | |
| SD | 100 | - | | |
| Not Rated | 13,830 | - | $ 138,445 | |
| Total | $ 207,280 | $ 159,636 | $ 138,445 | $ 1,027 |

The HPOP System's investment policy allows Investment managers full discretion in adopting investment strategies to deal with these risks. Unless otherwise provided in the individual investment manager agreement, the average quality rating of each individual fixed income portfolio on a weighted value basis shall be A-rated or higher, and no issue should have a rating below investment grade (Baa or higher). Certain managers, such as high yield managers, may be exempted from these requirements as provided for in their contracts.

Credit risk for derivative instruments held by the HPOP System results from counterparty risk, essentially that the counterparty will be unable to fulfill its obligations, assumed by the HPOP System. Information regarding the HPOP System's credit risk related to derivatives is found under the derivatives disclosures.

Policies regarding credit risk pertaining to credit risk associated with the HPOP System's securities lending program are found under the securities lending disclosures.

*Concentration of Credit Risk.* Concentration of credit risk is the risk of loss attributable to the magnitude of the HPOP System's investment in a single issue. The HPOP System's operational guidelines for each specific portfolio limits investments in any one single domestic equity issue to 15% of each portfolio at market value and for any one single international equity issue to 5% of the HPOP System's investments. For fixed income investments, the HPOP System's policy limits, by each specific portfolio, investment in any one single fixed income security to 10% of each portfolio at market value. As of June 30, 2005, the HPOP System did not have any investments in any one organization which represented greater than 5% of plan net assets.

*Interest Rate Risk.* Interest rate risk is the risk that changes in interest rates will adversely affect the fair values of the HPOP System's financial instruments. This risk is managed within the portfolio using the modified duration methodology. It is widely used in the management of fixed income portfolios and estimates the sensitivity of a bond's price to interest rate changes. All of the HPOP System's fixed income portfolios are managed in accordance with guidelines that are specific as to the degree of interest rate risk taken. The reporting of modified duration found in the tables below quantifies the interest rate risk of the HPOP System's fixed income investments. Interest rate risks associated with derivative instruments are found in the derivatives disclosures of these notes.

**Modified Duration of Fixed Income Assets by Security Type**
**($000's)**

| Fixed Income Security Type | Market Value June 30, 2005 | % of All Fixed Income Assets | Weighted Average Modified Duration (years) |
|---|---|---|---|
| US Treasuries | $ 921 | 0.2% | 0.1 |
| Corporate Bonds | 207,280 | 40.9% | 4.9 |
| International | | | |
| Government Agencies | 1,027 | 0.2% | 5.5 |
| Government Bonds | 159,636 | 31.4% | 4.8 |
| Mutual Bond Funds | 138,445 | 27.3% | 7.0 |
| Total | $ 507,309 | 100.0% | 5.9 |

**Modified Duration Analysis - Corporate and International Government Bonds**
**($000's)**

| Corporate Bonds | Market Value June 30, 2005 | Average Modified Duration | Contribution Modifed Duration |
|---|---|---|---|
| Less than 1 year to maturity | $ 1,163 | 0.6 | 0.0 |
| 1 to 10 years maturities | 191,232 | 4.7 | 4.3 |
| 10 to 20 years maturities | 8,523 | 7.8 | 0.3 |
| Greater than 20 years maturities | 6,362 | 11.3 | 0.3 |
| Total | $ 207,280 | | 4.9 |

| International Government Bonds | Market Value June 30, 2005 | Average Modified Duration | Contribution Modifed Duration |
|---|---|---|---|
| Less than 1 year to maturity | $ - | 0.0 | 0.0 |
| 1 to 10 years maturities | 112,463 | 4.7 | 2.6 |
| 10 to 20 years maturities | 10,778 | 11.3 | 0.6 |
| Greater than 20 years maturities | 36,395 | 12.7 | 2.2 |
| Total | $ 159,636 | | 5.4 |

*Foreign Currency Risk.* Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. The books and records of the HPOP System are maintained in US dollars. Foreign currencies and non-dollar denominated investments are translated into US dollars at the bid prices of such currencies against US dollars at each balance sheet date. Realized and unrealized gains and losses on investments which result from changes in foreign currency exchange rates have been included in the net appreciation in fair value of investments. Net realized foreign currency gains and losses resulting from changes in exchange rates include foreign currency gains and losses between trade date and settlement date of investment securities transactions, foreign currency transactions and the difference between the amounts of interest and dividends recorded on the books of the HPOP System and the amount actually received.

The HPOP System's exposure to foreign currency risk in U.S. dollars as of June 30, 2005, is shown in the table below:

**Foreign Currency Exposure by Asset Class**
**($000's)**

| Currency | Short Term Investments | Equities | Fixed Income | Options on Foreign Currencies | Total |
|---|---|---|---|---|---|
| Australian dollar | $ 157 | $ 2,055 | | $ 41,232 | $ 43,444 |
| British pound sterling | 227 | 82,602 | $ 9,179 | 47,977 | 139,985 |
| Canadian dollar | (50) | 4,517 | 2,127 | (16,859) | (10,265) |
| Chinese yuan renminbi | | | | 38,864 | 38,864 |
| Czech koruna | | | | 1,658 | 1,658 |
| Danish krone | | | 1,448 | (1,452) | (4) |
| Euro | 228 | 186,545 | 69,013 | (189,308) | 66,478 |
| Hong Kong dollar | | 3,861 | | | 3,861 |
| Hungarian forint | | | | 1,036 | 1,036 |
| Japanese yen | 270 | 90,686 | 53,176 | 21,741 | 165,873 |
| Mexican peso | | | | 6,740 | 6,740 |
| New Taiwan dollar | | | | 2,339 | 2,339 |
| New Zealand dollar | | 4,675 | | (1,913) | 2,762 |
| Norwegian krone | | 2,630 | | | 2,630 |
| Polish zloty | | | | 1,663 | 1,663 |
| Singapore dollar | | 8,523 | | | 8,523 |
| South African rand | | | | 2,112 | 2,112 |
| South Korean won | | 6,847 | | 4,519 | 11,366 |
| Swedish krona | | | 1,492 | 7,652 | 9,144 |
| Swiss franc | 168 | 31,422 | | 21,446 | 53,036 |
| | $ 1,000 | $ 424,363 | $ 136,435 | $ (10,553) | $ 551,245 |

*Securities Lending Program –*

| *June 30, 2005* | Fair Value ($000's) |
|---|---|
| Investments held by System's agent in System's name: | |
| Short-term investments | $ 168,342 |
| Fixed income | 424,028 |
| Equities | 1,527,437 |
| Alternative investments | 267,806 |
| Foreign currency contracts | 2,694 |
| Securities lending collateral investment pool | 288,266 |
| | $ 2,678,573 |
| Investments held by brokers under securities loans with cash collateral: | |
| Fixed income | $ 83,281 |
| Equities | 165,385 |
| | $ 248,666 |

The HPOP Board of Trustees' policies permit the HPOP System to lend securities (domestic and international equities and fixed income) to securities firms on a temporary basis through its custodian bank. The HPOP System receives fees for all loans and retains the right to all interest and dividend payments while the securities are on loan. Cash, letters of credit or various government securities having market values equal to or exceeding 102 and 105 percent of the value of the loaned securities for domestic and international securities, respectively, collateralize all security loan agreements. Whenever market value of the securities on loan changes, the borrower must adjust the collateral accordingly. At June 30, 2005, the HPOP System had no credit risk exposure to borrowers because the amounts the HPOP System owes the borrowers exceed the amounts the borrowers owe the HPOP System.

The HPOP System's bank pools all collateral received from securities lending transactions and invests any cash collateral. The HPOP System holds an undivided share of the collateral provided by the borrowers of the securities. At June 30, 2005 the weighted-average maturity of the collateral pool was 29 days. The relationship between the maturities of the collateral pool and the HPOP System's loans has not been determined. Cash collateral invested in the custodian bank collateral pool at June 30, 2005 and 2004, was $256,170 thousand and $305,144 thousand, respectively. The balance of the collateral at June 30, 2005 of $32,096 thousand consists of treasury securities and letters of credit.

The HPOP System cannot sell or pledge the collateral unless the borrower fails to return the securities borrowed. The market value of securities on loan at June 30, 2005 was $279,405 thousand.

*Derivatives* – The HPOP System's investment managers may invest in derivatives if permitted by the guidelines established by the HPOP System's Board of Trustees. The HPOP System's staff monitors guidelines and compliance. From time to time the HPOP System's investment managers will invest in foreign currency contracts, options, swaps, reverse repurchase agreements, index linked bonds, collateralized mortgage obligations and mortgage-backed securities. No derivatives are purchased with borrowed funds.

These derivative instruments are subject to the following risks:

- *Credit Risk* – The risk that the counterparty will not fulfill its obligations. The HPOP System's investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures.
- *Interest Rate Risk* – The risk that changes in interest rates will adversely affect the fair values of the HPOP System's financial instruments or cash flows.
- *Basis Risk* – The risk that arises when variable interest rates on a derivative and an associated bond or other interest-paying financial instrument are based on different indexes.
- *Termination Risk* – The risk that a derivative's unscheduled end will adversely affect an investment manager's strategy.
- *Rollover Risk* – The risk that a derivative associated with the HPOP System's fixed income investments does not extend to the maturity of those investments.

Foreign currency contracts are used to hedge against the currency risk in the HPOP System's investments in foreign equity and fixed income securities and also as part of a total return strategy that seeks absolute returns from relative changes in the prices of foreign currencies. The other derivatives are used to enhance yields and provide incremental income.

The HPOP System is invested in a total return strategy utilizing various foreign currency derivative instruments. The strategy is managed by a third party investment management firm in an account managed by a prime broker. At June 30, 2005, the HPOP System has approximately $13,000 thousand on deposit with the prime broker and this amount changes monthly as the HPOP System and the prime broker swap cash flows each month equal to the profit or loss in the account. This amount is subject to custodial credit risk, as it is not covered by depository insurance and is uncollateralized. At June 30, 2005, the HPOP System held units in this commingled fund that represent approximately $95,000 thousand in foreign currency exposure pursuant to this strategy. As the HPOP System holds units in this fund, the underlying foreign currency contracts are not reflected in the accompanying schedule of derivative instruments.

Futures on investments are used to take advantage of mis-pricing opportunities. When a position is taken in a futures contract, a margin is posted and the contract is subject to daily mark-to-market adjustments. To liquidate the contract prior to expiration an offsetting position in the same contract must be taken. At expiration the holder of the futures contract accepts delivery of the underlying asset at the agreed-upon price**.**

The average futures balance outstanding, not including foreign currency contracts, during the fiscal year ending June 30, 2005 was $284,442 thousand. Futures outstanding, not including foreign currency contracts at June 30, 2005 were $790,033 thousand.

The contract or notional amounts of these instruments reflect the extent of the HPOP System's involvement in each class of financial instrument as of June 30, 2005 as follows ($000's):

| Contracts | Description | Notional Value | Exposure |
|---|---|---|---|
| 54 | Futures on Treasury Bills and Equivalents | $ 684,323 | $ – |
| 27 | Fixed Income Futures | 97,225 | – |
| 23 | Commodity Futures | (16,284) | – |
| 9 | Equity Futures | 8,485 | – |
| 1,122 | Long foreign currency contracts | 679,832 | (5,168) |
| 1,122 | Short foreign currency contracts | (677,138) | 7,863 |
| | | $ 776,443 | $ 2,695 |

**Note 4: Allowance for Doubtful Accounts**

The following were the allowances for doubtful accounts receivable by fund as of June 30, 2005 (in thousands):

| Fund | Amount |
|---|---|
| General | |
| Uncollectible general property taxes | $ 44,600 |
| Ambulance charges | 209,218 |
| Fines and forfeits | 163,754 |
| Demolition liens | 28,120 |
| Others | 3,092 |
| Grant revenue | 74,272 |
| Airport System | 891 |
| Convention and Entertainment Facilities | |
| Accounts receivable | 653 |
| Hotel occupancy tax | 180 |
| Combined Utility System | 82,269 |
| | $ 607,049 |

**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 tax lien attaches to all property on January 1 of each year to secure the payment of all taxes, penalties and interest that is ultimately imposed on the property. The tax rate established by the City Council for the 2004 tax year was $0.65 per $100 of assessed value with $0.46573 for operations and $0.18427 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.

**Note 6: Capital Assets**

**A. Governmental activities of the Primary Government**

A summary of changes in capital assets for the year ended June 30, 2005 follows (in thousands):

| | Balance July 1, 2004 | Additions | Retirements | Transfers | Balance June 30, 2005 |
|---|---|---|---|---|---|
| **Primary Government** | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | $ 351,744 | $ 7,782 | $ (473) | $ (91) | $ 358,962 |
| Land associated with capital lease | 3,200 | - | - | - | 3,200 |
| Right of way | 1,565,119 | 10 | - | 91 | 1,565,220 |
| Construction Work in Progress | 325,708 | 151,628 | - | (123,758) | 353,578 |
| Total capital assets not being depreciated | 2,245,771 | 159,420 | (473) | (123,758) | 2,280,960 |
| Other capital assets: | | | | | |
| Buildings | 416,704 | 2,209 | - | 35,966 | 454,879 |
| Buildings associated with capital lease | 50,179 | - | - | - | 50,179 |
| Improvements and Equipment | 597,430 | 38,910 | (16,899) | 1,971 | 621,412 |
| Streets, Storm Sewers, Bridges | 4,513,803 | 4,879 | (3,573) | 89,324 | 4,604,433 |
| Total other capital assets | 5,578,116 | 45,998 | (20,472) | 127,261 | 5,730,903 |
| Less accumulated depreciation for: | | | | | |
| Buildings | (218,864) | (18,206) | - | 78,694 | (158,376) |
| Buildings associated with capital lease | (3,684) | (2,007) | - | - | (5,691) |
| Improvements and Equipment | (313,252) | (33,814) | 17,006 | (78,694) | (408,754) |
| Infrastructure | (1,788,009) | (96,355) | 3,127 | - | (1,881,237) |
| Total accumulated depreciation | (2,323,809) | (150,382) | 20,133 | - | (2,454,058) |
| Other capital assets, net | 3,254,307 | (104,384) | (339) | 127,261 | 3,276,845 |
| Primary Government capital assets, net | $ 5,500,078 | $ 55,036 | $ (812) | $ 3,503 | $ 5,557,805 |

**B. Business-type Activities**

| | Balance July 1, 2004 | Additions | Retirements | Transfers | Balance June 30, 2005 |
|---|---|---|---|---|---|
| **Airport System** | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | $ 170,087 | $ 22,844 | $ - | $ 279 | $ 193,210 |
| Construction Work in Progress | 703,073 | 253,336 | - | (518,796) | 437,613 |
| Total capital assets not being depreciated | 873,160 | 276,180 | - | (518,517) | 630,823 |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 2,579,150 | 55,386 | (2,865) | 518,517 | 3,150,188 |
| Total other capital assets | 2,579,150 | 55,386 | (2,865) | 518,517 | 3,150,188 |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (844,510) | (106,127) | 2,495 | - | (948,142) |
| Total accumulated depreciation | (844,510) | (106,127) | 2,495 | - | (948,142) |
| Other capital assets, net | 1,734,640 | (50,741) | (370) | 518,517 | 2,202,046 |
| Airport System capital assets, net | 2,607,800 | 225,439 | (370) | - | 2,832,869 |
| **Convention and Entertainment Facilities** | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | 130,493 | 7,974 | (41,371) | 2,661 | 99,757 |
| Construction Work in Progress | 23,943 | 4,935 | - | (8,012) | 20,866 |
| Total capital assets not being depreciated | 154,436 | 12,909 | (41,371) | (5,351) | 120,623 |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 425,327 | 1,334 | (39) | 4,873 | 431,495 |
| Total other capital assets | 425,327 | 1,334 | (39) | 4,873 | 431,495 |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (112,779) | (10,035) | 39 | - | (122,775) |
| Total accumulated depreciation | (112,779) | (10,035) | 39 | - | (122,775) |
| Other capital assets, net | 312,548 | (8,701) | - | 4,873 | 308,720 |
| Convention and Entertainment Facilities capital assets, net | 466,984 | 4,208 | (41,371) | (478) | 429,343 |

| | Balance July 1, 2004 | Additions | Retirements | Transfers | Balance June 30, 2005 |
|---|---|---|---|---|---|
| **Combined Utility System** | | | | | |
| Capital assets not being depreciated: | | | | | |
| Land | 99,479 | 1,372 | - | - | 100,851 |
| Construction Work in Progress | 568,534 | 293,040 | - | (224,185) | 637,389 |
| Total capital assets not being depreciated | 668,013 | 294,412 | - | (224,185) | 738,240 |
| Other capital assets: | | | | | |
| Buildings, Improvements and Equipment | 227,734 | 4,801 | (8,347) | 1,304 | 225,492 |
| Plants and Lines | 6,690,654 | 18,330 | (18,745) | 219,855 | 6,910,094 |
| Total other capital assets | 6,918,388 | 23,131 | (27,092) | 221,159 | 7,135,586 |
| Less accumulated depreciation for: | | | | | |
| Buildings, Improvements and Equipment | (115,377) | (10,094) | 7,565 | - | (117,906) |
| Plants and Lines | (3,136,704) | (202,570) | 14,299 | - | (3,324,975) |
| Total accumulated depreciation | (3,252,081) | (212,664) | 21,864 | - | (3,442,881) |
| Other capital assets, net | 3,666,307 | (189,533) | (5,228) | 221,159 | 3,692,705 |
| Combined Utility System capital assets, net | 4,334,320 | 104,879 | (5,228) | (3,026) | 4,430,945 |
| **Houston Area Water Corporation** | | | | | |
| Capital assets not being depreciated: | | | | | |
| Construction Work in Progress | 126,406 | 30,546 | - | - | 156,952 |
| Total capital assets not being depreciated | 126,406 | 30,546 | - | - | 156,952 |
| Houston Area Water Corporation capital assets, net | 126,406 | 30,546 | - | - | 156,952 |
| Business-type activities capital assets, net | $ 7,535,510 | $ 365,072 | $ (46,969) | $ (3,504) | $ 7,850,109 |

### C. Depreciation Expense

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

| | |
|---|---|
| **Governmental activities** | |
| General government | $ 2,949 |
| Public safety | 27,686 |
| Public works | 10,775 |
| Health | 2,190 |
| Parks and recreation | 8,435 |
| Library | 1,992 |
| Infrastructure | 96,355 |
| Total depreciation expense - governmental activities | $ 150,382 |
| **Business-type activities** | |
| Airport System | $ 106,127 |
| Convention & Entertainment Facilities | 10,035 |
| Combined Utility System | 212,664 |
| Total depreciation expense - business-type activities | $ 328,826 |

### 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 $9,086,063 is being depreciated over 30 years. The accumulated depreciation for the building as of June 30, 2005 amounted to $1,302,528.

**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, 2005, was as follows (amounts in thousands):

| | Balance July 1, 2004 | Issued | Redeemed | Balance June 30, 2005 |
|---|---|---|---|---|
| Tax and revenue Anticipation notes | $ - | $ 180,000 | $ 180,000 | $ - |

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

## Note 8: Long-Term Liabilities

### A. General Long-Term Liabilities

Changes in General Long-Term Liabilities for the year ended June 30, 2005 are summarized as follows (in thousands):

| | Balance July 1, 2004 | Additions | Retirements/ Transfers | Balance June 30, 2005 | Amounts Due within One Year |
|---|---|---|---|---|---|
| **Governmental Activities** | | | | | |
| Bonds and notes payable | | | | | |
| General tax obligation debt | $ 2,031,539 | $ 658,083 | $ (322,316) | $ 2,367,306 | $ 120,585 |
| Accretions, net | 1,318 | 354 | (155) | 1,517 | - |
| HUD Section 108 Loans | 24,865 | - | (1,470) | 23,395 | 1,515 |
| Houston Emergency Center capital lease | 52,344 | - | (1,091) | 51,253 | 1,156 |
| Plus premium on bonds | 60,405 | 10,546 | (4,062) | 66,889 | - |
| Less deferred amount on refundings | (21,702) | - | 1,978 | (19,724) | - |
| Total bonds and notes payable | 2,148,769 | 668,983 | (327,116) | 2,490,636 | 123,256 |
| Other liabilities: | | | | | |
| Claims and judgments | 168,117 | 45,403 | (57,089) | 156,431 | 56,645 |
| Compensated absences | 338,163 | 80,393 | (67,868) | 350,688 | 115,696 |
| Arbitrage rebate | 140 | - | (54) | 86 | 74 |
| Pension liability | 179,175 | 196,552 | (82,901) | 292,826 | - |
| Total other liabilities | 685,595 | 322,348 | (207,912) | 800,031 | 172,415 |
| **Governmental Activities Long-Term Liabilities** | $ 2,834,364 | $ 991,331 | $ (535,028) | $ 3,290,667 | $ 295,671 |
| **Discretely Presented Component Units:** | | | | | |
| Notes payable | 34,324 | 1,225 | - | 35,549 | 10,846 |
| Revenue bonds | 126,615 | - | (13,565) | 113,050 | 2,835 |
| **Discretely Presented Component Units Long-Term** | $ 160,939 | $ 1,225 | $ (13,565) | $ 148,599 | $ 13,681 |

(Continued)

| | Balance July 1, 2004 | Additions | Retirements/ Transfers | Balance June 30, 2005 | Amounts Due within One Year |
|---|---|---|---|---|---|
| **Business-type activities** | | | | | |
| Bonds and notes payable | | | | | |
| Airport System debt | $ 2,211,380 | $ 221,371 | $ (113,510) | $ 2,319,241 | $ 30,920 |
| Convention and Entertainment debt | 636,820 | 3,489 | (6,590) | 633,719 | 13,680 |
| Combined Utility System debt | 3,933,580 | 416,072 | (54,032) | 4,295,620 | 20,356 |
| Houston Area Water Corporation | 130,260 | - | - | 130,260 | 2,365 |
| Long-term contracts - Combined Utility | 246,250 | 40,385 | (17,547) | 269,088 | 18,596 |
| Premiums, discounts and deferred amount on refundings | (39,176) | 57,594 | 2,515 | 20,933 | - |
| Total bonds and notes payable | 7,119,114 | 738,911 | (189,164) | 7,668,861 | 85,917 |
| Other liabilities: | | | | | |
| Claims and judgments | 11,878 | 3,728 | (7,729) | 7,877 | 3,728 |
| Compensated absences | 24,159 | 10,061 | (10,461) | 23,759 | 8,105 |
| Arbitrage rebate | 2,151 | - | (1,103) | 1,048 | - |
| Pension liability | 45,103 | 38,710 | (19,750) | 64,063 | - |
| Total other liabilities | 83,291 | 52,499 | (39,043) | 96,747 | 11,833 |
| **Business-type activities long-term liabilities** | $ 7,202,405 | $ 791,410 | $ (228,207) | $ 7,765,608 | $ 97,750 |
| **Total Reporting Entity long-term liabilities** | $ 10,197,708 | $ 1,783,967 | $ (776,800) | $ 11,204,875 | $ 407,102 |

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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 7/1/2004 | FY05 Issued/ Increased |
|---|---|---|---|
| **General Tax Obligation Debt** | | | |
| General obligation bonds | 5.40 | $ 1,365 | $ - |
| Public improvement bonds | 2.00 to 7.00 | 1,556,435 | 178,295 |
| Pension obligations | 5.31 to 8.5 | - | 284,788 |
| Commercial paper | 2.72 to 10.0 | 427,800 | 195,000 |
| Annexed district bonds | 3.90 to 8.25 | 12,420 | - |
| Tax and revenue certificates of obligation | 3.00 to 6.00 | 33,519 | - |
| **Total General Tax Obligation Debt** | | $ 2,031,539 | $ 658,083 |
| **HUD Section 108 Loans** | | $ 24,865 | $ - |
| **Houston Emergency Center Lease** | 5.95 to 6.40 | $ 52,344 | $ - |
| **Revenue Bonded Debt** | | | |
| **Airport System Bonds** | | | |
| Subordinate lien refunding revenue bonds | 2.40 to 6.00 | $ 2,191,380 | $ 92,900 |
| Senior lien commercial paper | 2.90 to 10.00 | 20,000 | 28,500 |
| Inferior lien contractual obligation | 5.38 to 6.00 | - | 63,165 |
| Pension obligations | 5.31 to 8.50 | - | 36,806 |
| | | 2,211,380 | 221,371 |
| **Convention and Entertainment Facilities** | | | |
| Senior lien hotel occupancy tax/parking facilities | 2.41 to 5.75 | 614,320 | - |
| Hotel and parking revenue commercial paper | 3.02 to 10.00 | 22,500 | - |
| Pension obligations | 5.31 to 8.50 | - | 3,489 |
| | | 636,820 | 3,489 |
| **Combined Utility System** | | | |
| Combined Utility System first lien bonds | 2.55 to 5.25 | 3,029,170 | - |
| Water and Sewer System junior lien revenue bond | 0.25 to 7.00 | 864,410 | 181,090 |
| Combined Utility System commercial paper | 2.94 to 10.00 | 40,000 | 180,000 |
| Pension obligations | 5.31 to 8.5 | - | 54,982 |
| | | 3,933,580 | 416,072 |
| **Houston Area Water Corporation** | 3.75 to 5.50 | 130,260 | - |
| **Long-Term Contracts-Water and Sewer System** | | | |
| Coastal Water Authority | 2.00 to 7.50 | 214,085 | 40,385 |
| Trinity River Authority | 5.75 to 6.75 | 8,000 | - |
| Other long term contracts | 3.22 to 5.87 | 24,165 | - |
| | | 246,250 | 40,385 |
| **Total Revenue Bonded Debt and Long-Term Contracts, Primary Government** | | $ 7,158,290 | $ 681,317 |
| **Total Bonds and Long-Term Contracts Payable, Primary Government** | | $ 9,267,038 | $ 1,339,400 |

(Continued)

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

| FY05 Redeemed/Refunded | Face Value Outstanding 6/30/05 | Adjustments[1] | Net Outstanding 6/30/2005 |
|---|---|---|---|
| $ 1,365 | $ - | $ - | $ - |
| 116,730 | 1,618,000 | 47,165 | 1,665,165 |
| 22,900 | 261,888 | | 261,888 |
| 177,100 | 445,700 | - | 445,700 |
| 770 | 11,650 | - | 11,650 |
| 3,451 | 30,068 | 1,517 | 31,585 |
| $ 322,316 | $ 2,367,306 | $ 48,682 | $ 2,415,988 |
| $ 1,470 | $ 23,395 | $ - | $ 23,395 |
| $ 1,091 | $ 51,253 | $ - | $ 51,253 |
| | | | |
| $ 110,410 | $ 2,173,870 | $ (39,798) | $ 2,134,072 |
| - | 48,500 | - | 48,500 |
| 3,100 | 60,065 | - | 60,065 |
| - | 36,806 | - | 36,806 |
| 113,510 | 2,319,241 | (39,798) | 2,279,443 |
| 6,590 | 607,730 | 37,375 | 645,105 |
| - | 22,500 | - | 22,500 |
| - | 3,489 | - | 3,489 |
| 6,590 | 633,719 | 37,375 | 671,094 |
| - | 3,029,170 | (126,428) | 2,902,742 |
| 14,032 | 1,031,468 | 152,891 | 1,184,359 |
| 40,000 | 180,000 | - | 180,000 |
| - | 54,982 | - | 54,982 |
| 54,032 | 4,295,620 | 26,463 | 4,322,083 |
| - | 130,260 | (818) | 129,442 |
| 15,460 | 239,010 | (2,289) | 236,721 |
| 2,000 | 6,000 | - | 6,000 |
| 87 | 24,078 | | 24,078 |
| 17,547 | 269,088 | (2,289) | 266,799 |
| $ 191,679 | $ 7,647,928 | $ 20,933 | $ 7,668,861 |
| $ 516,556 | $ 10,089,882 | $ 69,615 | $ 10,159,497 |

### 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 bonds are payable from ad valorem tax revenues. 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. Pension Obligation Bonds

The City issued General Obligation Taxable Pension Bonds and a Collateralized Pension Obligation Note in Fiscal Year 2005. The proceeds were used to reduce the unfunded actuarial accrued liability of the Houston Municipal Employees Pension System and the Houston Police Officers Pension System. Interest is payable semi-annually, and principal is payable in varying amounts through 2035. Although these obligations have an ad valorem tax pledge, a portion of the liabilities is recorded in the enterprise funds because the liabilities are directly related and expected to be paid from those funds based on percentages of payroll.

#### 4. General Obligation Swap Agreements

On February 20, 2004 the City entered into a basis swap referred to as a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC").

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 notional principal value of the swap is $200,000,000, with the underlying bonds being various maturities of PIBS issued between 1998 and 2002. The City pays an amount equal to 5% plus the tax-exempt market standard BMA Index rate divided by .667 minus the taxable six-month US Dollar 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 variable payments based on BMA and receiving variable payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2025. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023. Payments will be received or made every six months based on the indexes for the prior budget period.

As of June 30, 2005 the swap created synthetic variable-rate exposure as follows:

| | TERMS | RATE (%) |
|---|---|---|
| Variable rate payment to counterparty | Fixed Rate | 5.000 |
| | BMA/0.667 | 3.622 |
| | -LIBOR | (3.150) |
| | -Constant | (0.690) |
| Net payment to counterparty | | 4.782 |
| Receipt from counterparty | Fixed | (5.000) |
| Net interest rate swap (receipt) | | (0.218) |
| Fixed rate bond coupon payments | | 5.190 |
| Synthetic variable interest rate on bonds | | 4.972 |

Fair value. The fair value of the swap was negative $3,405,000 as of June 30, 2005. 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, 2005, 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. RFPC, swap counterparty, has not been rated by the rating agencies. To mitigate this potential credit risk for an unrated counterparty, the City required RFPC to purchase a surety bond from a 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 counterparty. The City's obligations under the swap are also insured. Should the insurance company's rating decline in the future, the RFPC will be required to post collateral for the City's benefit.

<u>Interest rate risk</u>. 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.

<u>Basis risk</u>. 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.

<u>Termination risk</u>. The City may terminate the swap for any reason. The RFPC may terminate the swap if both the City and the City's insurer fails 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 counterparty 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.

<u>Swap receipts and associated debt</u>. As of June 30, 2005, 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.

**5. General Obligation Commercial Paper**

The City currently issues Commercial Paper Notes ("Notes") under its $219,000,000 General Obligation Commercial Paper Program, Series A, its $25,800,000 General Obligation Commercial Paper Program, Series B, its $385,000,000 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 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 2005 the weighted average interest rate for the General Obligation Notes, including dealer and credit fees, was 2.094%. The average year-end rate, including fees, was 2.717%. 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.

**6. 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. The final maturity date is October 1, 2021.

**7. 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.

**8. Housing and Urban Development Section 108 Loan (HUD)**

The City's Housing and Community Development Department has borrowed money from HUD and loaned it to the Houston Small Business Development Corporation (HSBDC). HSBDC in turn makes small business loans to under-served areas of the community. In fiscal year 2005 there were no new loans.

**9. 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.

**10. 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.

Airport System Subordinate Lien Revenue Bonds, Series 2000P1 and 2001P2, 2002C, 2002D-1, and 2002D-2, have been issued as auction rate securities with current 7-day resets. Series 2005A has been issued as Variable Rate Demand Obligations with a 7-day reset. These bonds may all be converted to other modes including fixed rate bonds. The City has a liquidity facility in place for the Series 2005A bonds with a termination date of July 1, 2010. The maximum interest rate permitted under the ordinance is 10%.

The City has purchased municipal debt service reserve fund policies that unconditionally guarantee the payment of principal and interest on all current outstanding airport system subordinate lien issues. 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.

**11. 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 have 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, 2005, $48.5 million in Airport Commercial Paper is outstanding. During fiscal year 2005 the weighted average interest rate for the General Obligation Notes, including dealer and credit fees, was 2.459%. The average year-end rate, including fees, was 2.899%.

The Series A and B Notes are collateralized by revolving credit agreements convertible to direct pay letters of credit issued by a bank, and a lien on the net revenues of the Airport System. The Letter of Credit will terminate on January 4, 2008 for Series A and B.

**12. 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 2002C-2, have been issued as 7-day auction rate securities and 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. The maximum interest rate permitted under the ordinance is 10%.

**13. Convention and Entertainment Hotel and Parking Revenue Commercial Paper**

Hotel Occupancy Tax and Parking Revenue Commercial Paper Notes Series A have 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, 2008. During fiscal year 2005 the weighted average interest rate for the Notes, including fees, was 2.400%. The average rate in effect at year-end was 3.021%.

### 14. 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 and debt service on Water and Sewer Junior Lien bonds. Net Revenues must equal 110% of the First Lien Revenue Bonds debt service.

The Combined Utility System Revenue Refunding Bonds, Series 2004B and 2004C, were initially issued as 7-day and 35-day Auction Rate Securities. The maximum rate allowed under ordinance is 10%.

### 15. Combined Utility System Commercial Paper

The Combined Utility System Commercial Paper Notes Program Series A has been authorized for $900 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 2005 the weighted average interest rate for the Notes, including credit and dealer fees, was 2.440%. The rate in effect at year-end was 2.944%.

### 16. 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, 2005, the effective rate on the bonds associated with the swap was computed as follows:

| | TERMS | RATE (%) Received (Paid) |
|---|---|---|
| Variable rate payment from counterparties | LIBOR x 57.6% | 1.8547 |
| | + Constant | 0.3700 |
| Swap receipt | | 2.2247 |
| Fixed rate paid to counterparties | Fixed | (3.7784) |
| Net rate (paid)/received for swap | | (1.5537) |
| Average variable rate paid on 2004B bonds | | (2.2915) |
| Plus dealer and auction fees on 2004B bonds | | (0.2530) |
| Effective rate of 2004B bonds | | (4.0982) |

In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, which have a comparable maturity, was 5.080%.

Fair value. Because long-term interest rates have declined, the swaps had a negative fair value of $74,612,000 as of June 30, 2005. 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.

Credit risk. As of June 30, 2005, 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, 2005, 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 Amount | Fair Value | Counterparty Credit Rating (Moody's /S&P /Fitch) |
|---|---|---|---|
| Goldman Sachs Capital Markets | $353,325,000 | ($40,350,000) | Aa3 /A+ /AA- |
| Bear Stearns Financial Products | 150,000,000 | (17,131,000) | Aaa/AAA/-- |
| UBS AG | 150,000,000 | (17,131,000) | Aa2 /AA+ /AA+ |
| TOTAL | $653,325,000 | ($74,612,000) | |

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 2.292% (not including dealer and auction agent fees) as of June 30, 2005, whereas the associated LIBOR-based rate of the swap was 2.225%.

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, 2005, 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.

**17. Water and Sewer System 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 $153,070,000 at June 30, 2005 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 $85,940,000 of CWA Revenue Refunding Bonds, Series 1999 and Series 2004, 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, 2034.

**19. Trinity River Authority ("TRA")**

The contract payable to TRA represents the outstanding principal balance at June 30, 2005 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 HAWC Series 2002 Bonds are special obligations of the City that were issued to provide financing for the acquisition of rights-of-way and real property interests, and the design, construction and equipping of the Northeast Water Purification Plant and a water conveyance system.

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 a long period, and the project was not completed until 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 with final payment due January 1, 2053. 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 2004 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 will be made in 2036.

**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 | Public Improvement Bonds Principal | Public Improvement Bonds Interest | General Obligation Swap Agreements Payment Receipts | Pension Obligation Bonds Principal | Pension Obligation Bonds Interest |
|---|---|---|---|---|---|
| 2006 | $ 116,270 | $ 84,930 | $ (499) | $ - | $ 18,458 |
| 2007 | 124,350 | 78,636 | (436) | - | 20,615 |
| 2008 | 132,720 | 71,628 | (436) | - | 20,615 |
| 2009 | 131,955 | 64,234 | (436) | - | 20,615 |
| 2010 | 129,260 | 57,524 | (436) | - | 20,615 |
| 2011-2015 | 489,090 | 198,576 | (2,180) | - | 103,074 |
| 2016-2020 | 330,155 | 87,766 | (1,814) | - | 103,074 |
| 2021-2025 | 164,200 | 20,039 | (435) | - | 103,074 |
| 2026-2030 | | | | 15,450 | 102,674 |
| 2031-2035 | - | - | - | 246,438 | 79,920 |
| Total | $ 1,618,000 | $ 663,333 | $ (6,672) | $ 261,888 | $ 592,734 |

| Year Ending June 30 | General Obligation Commercial Paper Principal | General Obligation Commercial Paper Interest | Annexed District Bonds Principal | Annexed District Bonds Interest | Tax and Revenue Certificates of Obligation Principal | Tax and Revenue Certificates of Obligation Interest |
|---|---|---|---|---|---|---|
| 2006 | $ - | $ 12,110 | $ 815 | $ 560 | $ 3,500 | $ 1,131 |
| 2007 | 445,700 | 10,299 | 860 | 517 | 1,075 | 987 |
| 2008 | - | - | 900 | 472 | 1,645 | 944 |
| 2009 | - | - | 875 | 429 | 3,390 | 874 |
| 2010 | - | - | 940 | 383 | 1,230 | 755 |
| 2011-2015 | - | - | 4,060 | 1,319 | 8,188 | 6,735 |
| 2016-2020 | - | - | 2,840 | 329 | 8,020 | 2,073 |
| 2021-2025 | - | - | 360 | 20 | 3,020 | 200 |
| Total | $ 445,700 | $ 22,409 | $ 11,650 | $ 4,029 | $ 30,068 | $ 13,699 |

| Year Ending June 30 | Total Future Requirements Principal | Interest | Swaps (Receipts) | Total Future Requirements |
|---|---|---|---|---|
| 2006 | $ 120,585 | $ 117,189 | $ (499) | $ 237,275 |
| 2007 | 571,985 | 111,054 | (436) | 682,603 |
| 2008 | 135,265 | 93,659 | (436) | 228,488 |
| 2009 | 136,220 | 86,152 | (436) | 221,936 |
| 2010 | 131,430 | 79,277 | (436) | 210,271 |
| 2011-2015 | 501,338 | 309,704 | (2,180) | 808,862 |
| 2016-2020 | 341,015 | 193,242 | (1,814) | 532,443 |
| 2021-2025 | 167,580 | 123,333 | (435) | 290,478 |
| 2026-2030 | 15,450 | 102,674 | - | 118,124 |
| 2031-2035 | 246,438 | 79,920 | - | 326,358 |
| | $ 2,367,306 | $ 1,296,204 | $ (6,672) | $ 3,656,838 |

**2. HUD Section 108 Loans (in thousands):**

| Year Ending June 30 | Section 108 Loans Principal | Interest | Total Future Requirements |
|---|---|---|---|
| 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 | 2,125 | 866 | 2,991 |
| 2011-2015 | 7,140 | 2,940 | 10,080 |
| 2016-2020 | 5,090 | 1,284 | 6,374 |
| 2021-2024 | 1,820 | 175 | 1,995 |
| | $ 23,395 | $ 9,651 | $ 33,046 |

**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 Inferior Lien Contract | |
|---|---|---|---|---|---|---|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2006 | $ 27,665 | $ 103,416 | $ - | $ 1,406 | $ 3,255 | $ 3,231 |
| 2007 | 28,385 | 101,630 | - | 1,406 | 3,450 | 3,030 |
| 2008 | 29,825 | 100,199 | 48,500 | 724 | 3,660 | 2,816 |
| 2009 | 41,515 | 98,368 | - | - | 3,880 | 2,602 |
| 2010 | 43,020 | 96,262 | - | - | 4,085 | 2,388 |
| 2011-2015 | 260,165 | 445,348 | - | - | 23,975 | 8,294 |
| 2016-2020 | 336,775 | 371,825 | - | - | 17,760 | 1,500 |
| 2021-2025 | 436,365 | 278,236 | - | - | - | - |
| 2026-2030 | 563,200 | 161,164 | - | - | - | - |
| 2031-2035 | 406,955 | 29,484 | - | - | - | - |
| | $ 2,173,870 | $ 1,785,932 | $ 48,500 | $ 3,536 | $ 60,065 | $ 23,861 |

| Year Ending June 30 | Airport System Pension Obligations | | Airport System Total Future Requirements | | |
|---|---|---|---|---|---|
| | Principal | Interest | Principal | Interest | Total Future Requirements |
| 2006 | $ - | $ 2,735 | $ 30,920 | $ 110,788 | $ 141,708 |
| 2007 | - | 3,065 | 31,835 | 109,131 | 140,966 |
| 2008 | - | 3,065 | 81,985 | 106,804 | 188,789 |
| 2009 | - | 3,065 | 45,395 | 104,035 | 149,430 |
| 2010 | - | 3,065 | 47,105 | 101,715 | 148,820 |
| 2011-2015 | - | 15,322 | 284,140 | 468,964 | 753,104 |
| 2016-2020 | - | 15,322 | 354,535 | 388,647 | 743,182 |
| 2021-2025 | - | 15,322 | 436,365 | 293,558 | 729,923 |
| 2026-2030 | 601 | 15,307 | 563,801 | 176,471 | 740,272 |
| 2031-2035 | 36,205 | 12,536 | 443,160 | 42,020 | 485,180 |
| | $ 36,806 | $ 88,804 | $ 2,319,241 | $ 1,902,133 | $ 4,221,374 |

| Year Ending June 30 | Convention and Entertainment Facilities Revenue Bonds | | Convention and Entertainment Facilities Commercial Paper | | Convention and Entertainment Pension Obligations | |
|---|---|---|---|---|---|---|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2006 | $ 13,680 | $ 21,495 | $ - | $ 680 | $ - | $ 259 |
| 2007 | 14,775 | 20,766 | - | 680 | - | 291 |
| 2008 | 17,540 | 19,921 | 22,500 | 372 | - | 291 |
| 2009 | 18,620 | 18,954 | - | - | - | 291 |
| 2010 | 21,230 | 17,954 | - | - | - | 291 |
| 2011-2015 | 136,650 | 69,013 | - | - | - | 1,452 |
| 2016-2020 | 93,566 | 85,293 | - | - | - | 1,452 |
| 2021-2025 | 94,606 | 105,895 | - | - | - | 1,452 |
| 2026-2030 | 103,598 | 123,261 | - | - | 57 | 1,451 |
| 2031-2035 | 93,465 | 104,540 | - | - | 3,432 | 1,189 |
| | $ 607,730 | $ 587,092 | $ 22,500 | $ 1,732 | $ 3,489 | $ 8,419 |

| Year Ending June 30 | Convention and Entertainment Total Future Requirements | | |
|---|---|---|---|
| | Principal | Interest | Total Future Requirements |
| 2006 | $ 13,680 | $ 22,434 | $ 36,114 |
| 2007 | 14,775 | 21,737 | 36,512 |
| 2008 | 40,040 | 20,584 | 60,624 |
| 2009 | 18,620 | 19,245 | 37,865 |
| 2010 | 21,230 | 18,245 | 39,475 |
| 2011-2015 | 136,650 | 70,465 | 207,115 |
| 2016-2020 | 93,566 | 86,745 | 180,311 |
| 2021-2025 | 94,606 | 107,347 | 201,953 |
| 2026-2030 | 103,655 | 124,712 | 228,367 |
| 2031-2035 | 96,897 | 105,729 | 202,626 |
| | $ 633,719 | $ 597,243 | $ 1,230,962 |

| Year Ending June 30 | Combined Utility System Revenue Bonds | | Combined Utility System Commercial Paper | | Combined Utility System Swap Agreements |
|---|---|---|---|---|---|
| | Principal | Interest | Principal | Interest | Net Swap Payment |
| 2006 | $ 9,000 | $ 128,641 | $ - | $ 5,299 | $ 9,949 |
| 2007 | 9,000 | 127,632 | 180,000 | 4,980 | 9,949 |
| 2008 | 9,000 | 128,136 | - | - | 9,908 |
| 2009 | 15,000 | 127,317 | - | - | 9,949 |
| 2010 | 39,665 | 126,348 | - | - | 9,949 |
| 2011-2015 | 159,910 | 608,787 | - | - | 49,704 |
| 2016-2020 | 197,460 | 568,301 | - | - | 49,663 |
| 2021-2025 | 717,595 | 459,512 | - | - | 49,704 |
| 2026-2030 | 900,340 | 256,842 | - | - | 48,287 |
| 2031-2035 | 972,200 | 73,592 | - | - | 17,859 |
| | $ 3,029,170 | $ 2,605,108 | $ 180,000 | $ 10,279 | $ 264,921 |

| Year Ending June 30 | Combined Utility System Pension Obligations Principal | Combined Utility System Pension Obligations Interest | Water and Sewer Jr. Lien Revenue Bonds Principal | Water and Sewer Jr. Lien Revenue Bonds Interest |
|---|---|---|---|---|
| 2006 | $ - | $ 4,076 | $ 11,356 | $ 48,740 |
| 2007 | - | 4,566 | 16,563 | 54,437 |
| 2008 | - | 4,566 | 16,363 | 54,859 |
| 2009 | - | 4,566 | 21,028 | 62,000 |
| 2010 | - | 4,566 | 25,757 | 66,182 |
| 2011-2015 | - | 22,828 | 299,957 | 274,862 |
| 2016-2020 | - | 22,828 | 510,415 | 79,284 |
| 2021-2025 | - | 22,828 | 104,726 | 74,209 |
| 2026-2030 | 1,013 | 22,801 | 25,303 | 98,572 |
| 2031-2035 | 53,969 | 18,631 | - | - |
| | $ 54,982 | $ 132,256 | $ 1,031,468 | $ 813,145 |

| Year Ending June 30 | Combined Utility System Total Future Requirements Principal | Interest | Net Swap Payment | Total Future Requirements |
|---|---|---|---|---|
| 2006 | $ 20,356 | $ 186,756 | $ 9,949 | $ 217,061 |
| 2007 | 205,563 | 191,615 | 9,949 | 407,127 |
| 2008 | 25,363 | 187,561 | 9,908 | 222,832 |
| 2009 | 36,028 | 193,883 | 9,949 | 239,860 |
| 2010 | 65,422 | 197,096 | 9,949 | 272,467 |
| 2011-2015 | 459,867 | 906,477 | 49,704 | 1,416,048 |
| 2016-2020 | 707,875 | 670,413 | 49,663 | 1,427,951 |
| 2021-2025 | 822,321 | 556,549 | 49,704 | 1,428,574 |
| 2026-2030 | 926,656 | 378,215 | 48,287 | 1,353,158 |
| 2031-2035 | 1,026,169 | 92,223 | 17,859 | 1,136,251 |
| | $ 4,295,620 | $ 3,560,788 | $ 264,921 | $ 8,121,329 |

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

| Year Ending June 30 | Coastal Water Authority Principal | Coastal Water Authority Interest | Trinity River Authority Principal | Trinity River Authority Interest | CWA/TRA Total Future Requirements Principal | CWA/TRA Total Future Requirements Interest | CWA/TRA Total Future Requirements Total |
|---|---|---|---|---|---|---|---|
| 2006 | $ 16,505 | $ 13,366 | $ 2,000 | $ 346 | $ 18,505 | $ 13,712 | $ 32,217 |
| 2007 | 18,390 | 12,263 | 2,000 | 221 | 20,390 | 12,484 | 32,874 |
| 2008 | 19,470 | 11,076 | 2,000 | 97 | 21,470 | 11,173 | 32,643 |
| 2009 | 18,155 | 9,948 | - | - | 18,155 | 9,948 | 28,103 |
| 2010 | 14,825 | 8,991 | - | - | 14,825 | 8,991 | 23,816 |
| 2011-2015 | 67,025 | 32,051 | - | - | 67,025 | 32,051 | 99,076 |
| 2016-2020 | 29,655 | 16,158 | - | - | 29,655 | 16,158 | 45,813 |
| 2021-2025 | 22,805 | 10,772 | - | - | 22,805 | 10,772 | 33,577 |
| 2026-2030 | 16,435 | 5,423 | - | - | 16,435 | 5,423 | 21,858 |
| 2031-2035 | 15,745 | 1,939 | - | - | 15,745 | 1,939 | 17,684 |
| | $ 239,010 | $ 121,987 | $ 6,000 | $ 664 | $ 245,010 | $ 122,651 | $ 367,661 |

| Year Ending June 30 | Houston Area Water Corporation Principal | Interest | Total Future Requirements |
|---|---|---|---|
| 2005 | $ 2,365 | $ 6,710 | $ 9,075 |
| 2006 | 2,485 | 6,591 | 9,076 |
| 2007 | 2,585 | 6,492 | 9,077 |
| 2008 | 2,680 | 6,395 | 9,075 |
| 2009 | 2,790 | 6,288 | 9,078 |
| 2010-2014 | 16,290 | 29,091 | 45,381 |
| 2015-2019 | 21,260 | 24,127 | 45,387 |
| 2020-2024 | 27,525 | 17,859 | 45,384 |
| 2025-2029 | 35,430 | 9,946 | 45,376 |
| 2030-2032 | 16,850 | 1,306 | 18,156 |
| | $ 130,260 | $ 114,805 | $ 245,065 |

| | Water & Sewer System Contracts | | | | Other Contracts Total | | |
|---|---|---|---|---|---|---|---|
| | U.S. Army Corps of Engineers | | Texas Water Development Board | | Future Requirements | | |
| Year Ending June 30 | Principal | Interest | Principal | Interest | Principal | Interest | Total |
| 2006 | $ 91 | $ 325 | $ - | $ 164 | $ 91 | $ 489 | $ 580 |
| 2007 | 93 | 322 | - | 164 | 93 | 486 | 579 |
| 2008 | 97 | 319 | - | 246 | 97 | 565 | 662 |
| 2009 | 100 | 316 | - | 327 | 100 | 643 | 743 |
| 2010 | 103 | 316 | - | 450 | 103 | 766 | 869 |
| 2011-2015 | 566 | 1,510 | - | 3,724 | 566 | 5,234 | 5,800 |
| 2016-2020 | 664 | 1,413 | - | 7,484 | 664 | 8,897 | 9,561 |
| 2021-2025 | 778 | 1,299 | 1,935 | 5,341 | 2,713 | 6,640 | 9,353 |
| 2026-2030 | 911 | 1,165 | 4,055 | 3,086 | 4,966 | 4,251 | 9,217 |
| 2031-2035 | 1,068 | 1,009 | 5,385 | 1,756 | 6,453 | 2,765 | 9,218 |
| 2036-2040 | 1,251 | 825 | 2,625 | 233 | 3,876 | 1,058 | 4,934 |
| 2041-2045 | 1,467 | 610 | - | - | 1,467 | 610 | 2,077 |
| 2046-2050 | 1,719 | 358 | - | - | 1,719 | 358 | 2,077 |
| 2051-2055 | 1,170 | 76 | - | - | 1,170 | 76 | 1,246 |
| | $ 10,078 | $ 9,863 | $ 14,000 | $ 22,975 | $ 24,078 | $ 32,838 | $ 56,916 |

**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 2005 described below, has been removed from the City's books.

Airport System Inferior Lien Contract. On July 1, 2004 the City and Continental Airlines, Inc. entered into a Sublease Agreement associated with the Special Facilities Lease for the Automated People Mover System and the City's Airport System Special Facilities Revenue Bonds (Automated People Mover System) Series 1997A ("1997A Special Facilities Bonds"). As part of the Sublease, the City agreed to make sublease payments that include amounts equal to the debt service on the 1997A Special Facilities Bonds. The payments are payable from Airport system net revenues on the same priority as inferior lien bonds. Accordingly, the principal amount of the 1997A Special Facilities Bonds, $63,165,000 was recorded as an Inferior Lien Contract. See Note 15, Conduit Debt Obligations.

Water and Sewer Junior Lien Revenue and Refunding Bonds, Series 2004A. On August 19, 2004 the City closed the sale of $181,090,000 in Water and Sewer 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 3.049%. 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 refunding was undertaken to lower variable interest rate exposure on the refunded Commercial Paper Notes rather than for savings. The remaining proceeds were designated to fund other TWDB approved water and sewer projects and to pay cost of issuance of the bonds.

Coastal Water Authority Revenue Bonds, Series 2004. On October 20, 2004 Coastal Water Authority ("CWA") closed the sale of $40,385,000 in Revenue Bonds, Series 2004. 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, 2034. 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. By the terms of a contract between the City and CWA, the City's Water and Sewer System ("the System") makes these debt service payments and records them as maintenance and operations expenses of the System. The bonds are recorded as a Long Term Contract Liability in the Combined Utility System.

Collateralized Pension Obligation Note. On November 10, 2004 the City issued a $300,000,000 collateralized note ("The Collateralized Note") to Houston Municipal Employees Pension System ("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 Collateralized Note bears 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, have been 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 and contributions from proprietary funds. Because the liability is directly related to and expected to be paid from the Airport System Fund, the Combined Utility Fund, and the Convention and Entertainment Fund, part of the liability for the Collateralized Note has been allocated among these funds based on percentage of payroll for HMEPS contributions.

Pension Obligation Note, Series 2004. On December 10, 2004 the City issued a $22,900,000 Pension Obligation Note, Series 2004 ("the Note") as part of a funding agreement with Houston Police Officers Pension System ("HPOPS") to reduce the unfunded actuarial accrued liability of its pension plan. Maturity date was February 15, 2006. The Note bore interest at a rate equal to the one-month Dollar LIBOR plus 45 basis points, which averaged 2.98% during the time the Note was outstanding. The Note, a general obligation of the City, was refunded with proceeds of the Taxable General Obligation Pension Bonds, Series 2005, on March 30, 2005.

Public Improvement Refunding Bonds, Series 2004B. 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 4.40%. The bonds are due in varying amounts from years 2010 to 2024. Proceeds of the bonds were used 1) 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, 2) to fund the first installment of the Vela Settlement Agreement, and 3) to pay costs of issuances on the bonds. The Commercial Paper refunding was undertaken to reduce the City's exposure to variable interest rate exposure rather than for savings.

Tax Notes, Series 2004C. 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 were used to purchase a TASER law enforcement weapon system, including related support equipment, and to pay costs of issuance of the Series 2004C Notes.

Taxable General Obligation Pension Bonds, Series 2005. On March 30, 2005 the City issued $57,165,000 in Taxable General Obligation Pension Bonds, Series 2005. The bonds mature in varying amounts between 2029 and 2035. The stated interest rate and the yield is 5.31%. Proceeds were used 1) to fund a portion of the unfunded actuarial accrued liability of the Houston Municipal Employees Pension System ("HMEPS"); 2) to refund the City's $22,900,000 Taxable Pension Obligation Note, Series 2004, which was issued to fund a portion of the unfunded actuarial accrued liability of the Houston Police Officers Pension System ("HPOPS"), and 3) to pay costs of issuance related to these bonds, including the cost of negotiating agreements with HMEPS and HPOPS. The refunding of the Note was undertaken to lower variable interest rate exposure rather than for savings.

The City pledged to assess and collect property taxes sufficient to pay debt service on these bonds. Because the liability is directly related to and expected to be paid from the Airport System Fund, the Combined Utility Fund, and the Convention and Entertainment Fund, part of the liability for the Collateralized Note has been allocated among these funds based on percentage of payroll for HMEPS contributions.

Airport Subordinate Lien Revenue Refunding Bonds, Series 2005. On June 2, 2005 the City issued $92,900,000 in Airport System Subordinate Lien Revenue Refunding Bonds, Series 2005. Proceeds of the bonds were used to currently refund a portion of Airport System Subordinate Lien Revenue Refunding Bonds, Series 2000A, and to pay costs of issuance. The bonds mature on July 1, 2030. The bonds were issued as variable rate demand obligations with a weekly interest reset. The initial interest rate was 2.70%. Using a certified average rate of 4.85% for similar fixed rate debt issued at the same time, the cash savings on future debt service was $16,842,000 and the net present value saving of the transaction was $9,632,000. The acquisition price of the new debt exceeded the carrying value of the old debt by $1,719,000. This amount is being amortized over the life of the refunded debt.

### 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 2005 the City has complied with the requirements of all revenue bond ordinances and related bond restrictions.

### G. Voter Authorized Obligations

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. On September 8, 2004, City Council passed Ordinance 2004-0944 authorizing an additional $110,000,000 to be issued as General Obligation Commercial Paper Series D for a total authorized issuance of $385,000,000.

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, 2005, the City's legal debt limit was 10% of assessed property valuation totaling $121,806,056,000. The City's legal debt margin was $7,494,063,000.

**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):

| Year ended June 30 | Operating Lease Payments |
|---|---|
| 2006 | $ 9,565 |
| 2007 | 5,081 |
| 2008 | 3,070 |
| 2009 | 2,866 |
| 2010 | 1,359 |
| 2011-2015 | 3,337 |
| 2016-2020 | 2,439 |
| 2021-2025 | 2,539 |
| 2026-2030 | 2,381 |
| 2031-2035 | 2,000 |
| 2036-2040 | 2,000 |
| 2041-2045 | 2,250 |
| 2046-2050 | 2,250 |
| 2051-2055 | 2,500 |
| 2056-2060 | 2,500 |
| 2061-2065 | 2,750 |
| 2066-2070 | 2,750 |
| 2071-2075 | 3,000 |
| 2076-2080 | 3,000 |
| Total | $ 57,637 |

**2. City as Lessor**

The Convention and Entertainment Facilities department is a lessor of four facilities. 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):

| Year Ended June 30 | Operating Leases Minimum Rental Income |
|---|---|
| 2006 | $ 31,219 |
| 2007 | 30,527 |
| 2008 | 29,621 |
| 2009 | 28,340 |
| 2010 | 26,775 |
| 2011-2015 | 112,836 |
| 2016-2020 | 96,147 |
| 2021-2025 | 89,599 |
| 2026-2030 | 46,222 |
| 2031-2035 | 10,643 |
| 2036-2040 | 10,751 |
| 2041-2043 | 5,998 |
| Total | $ 518,678 |

The contingent income associated with these non-cancelable operating leases was $7,128,638 in Fiscal Year 2005. 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 2005 was $234,880,954.

### 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 | (5,691) |
| Net Total | $ 47,688 |

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 |
|---|---|
| 2006 | $ 4,339 |
| 2007 | 4,339 |
| 2008 | 4,339 |
| 2009 | 4,339 |
| 2010 | 4,339 |
| 2011-2015 | 21,693 |
| 2015-2020 | 21,693 |
| 2021-2025 | 21,693 |
| 2026-2027 | 8,677 |
| Total minimum lease payments | 95,451 |
| Less: Amount representing Interest | (44,198) |
| Present value of minimum lease payments | $ 51,253 |

## 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.

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 collateralized note bears interest at 8.5% per year unless the rate of adjustment formula based on U.S. Treasury securities maturing in 2003, 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, is pledged as collateral on the collateralized notes. Interest on the collateralized 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 appraisal 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 appraisal 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.

**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 30 years from July 1, 2004 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 109 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, 2005, were different from the actuarially determined requirements based on July 1, 2004 actuarial valuation for all three plans. Contributions are as follows:

| **Percentage of Payroll** | **Firefighters** | **Municipal** | **Police** |
|---|---|---|---|
| City of Houston normal cost | 20.7% | 20.9% | 16.7% |
| Amortization of unfunded actuarial accrued liability (surplus) | 10.4% | 8.5% | 14.5% |
| Required employer contribution rate | 31.1% | 29.4% | 31.2% |
| Employer contribution made | 18.0% | 16.9% | 11.3% |
| Employee contribution made | 9.00% | 5.0% | 8.77% |
| **Contribution Amounts (in thousands)** | | | |
| Net contribution required | $ 69,293 | $ 150,419 | $ 133,106 |
| Total city contribution | $ 32,699 | $ 66,006 | $ 36,645 |
| Total employee contribution | 16,355 | 23,488 | 28,410 |
| Total contribution | $ 49,054 | $ 89,494 | $ 65,055 |

**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):

| | **Houston Firefighters' Pension** | **Houston Municipal Employees' Pension** | **Houston Police Officers' Pension** |
|---|---|---|---|
| Annual required contribution | $ 52,938 | $ 126,932 | $ 104,696 |
| Interest on net pension obligation | (4,188) | 14,261 | 4,802 |
| Adjustment to annual required contribution | 3,472 | (11,824) | (3,605) |
| Annual pension cost | 52,222 | 129,369 | 105,893 |
| Contribution made | 32,699 | 66,006 | 36,645 |
| Change in net pension (obligation) asset | (19,523) | (63,363) | (69,248) |
| Net pension (obligation) asset beginning | 49,265 | (167,781) | (56,497) |
| Net pension (obligation) asset end of year | $ 29,742 | $ (231,144) | $ (125,745) |

### 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 |
|---|---|---|---|---|
| 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% |
| 2005 | $52.2 | 62.5% | $29.7 | 31.1% |

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, 2004 |
| Actuarial cost method | Entry age Normal Cost |
| Amortization method | Level percent of payroll over 30 years |
| Remaining amortization period | Rolling 30 year |
| 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 |
|---|---|---|---|---|
| 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% |
| 2005 | $129.4 | 51.1% | $231.1 | 29.4% |

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, 2004 |
| Actuarial cost method | Entry age |
| Amortization method | Level percentage closed |
| Remaining amortization period | Rolling 30 year period ending, June 30, 2035 |
| Asset valuation method | 5 year smoothed market |
| Actuarial assumptions:<br>investment rate of return | 8.5%, net of expenses |
| Payroll growth factor | 3.0% |
| Projected individual salary increases | Graded rates based on years of service |
| General inflation rate | 3.0% |

**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 Obligation | Annual Required Contribution as a % of Base Pay |
|---|---|---|---|---|
| 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% |
| 2005 | $105.9 | 34.6% | $125.8 | 31.2% |

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, 2004 |
| 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:<br>Investment rate of return | 8.5%, net of expenses |
| Payroll growth rate, attributable<br>entirely to inflation | 3.5 % |
| Annual increase attributable to seniority/merit | 0.0% to 9.55% |
| Annual cost of living adjustment | 3.0% |
| Projected salary increases | Graded rates based on years of service |

**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 premiums incurred by the City amounted to approximately $49,891,440 for the year ended June 30, 2005. Retiree health care is accounted for in the Health Benefits Fund, an Internal Service Fund. At June 30, 2005, there were 8,125 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 between an HMO Plan with all benefits covered by third party purchased insurance or a substantially self-insured with specific individual aggregate stop loss features Preferred Provider Organization Plan (PPO). Specific and aggregate stop loss insurance is provided for the PPO plan of $300,000 and approximately $8,000,000 based on enrollment, respectively. Premiums paid (employer and subscriber) for current employees to third party administrators totaled approximately $138,794,794 for the year ended June 30, 2005. 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 $5,187,088 for the year ended June 30, 2005.

**PPO/POS and PPO/OOA**
**Schedule of Changes in Liability**
**(in thousands)**

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| Beginning actuarial estimate of claims liability, July 1 | $ 1,011 | $ 809 |
| Incurred claims for fiscal year | 9,153 | 7,513 |
| Payments on claims | (9,959) | (7,301) |
| Actuarial adjustment | 737 | (10) |
| Ending actuarial estimate of claims liability, June 30 | $ 942 | $ 1,011 |

**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, 2005 | June 30, 2004 |
|---|---|---|
| Beginning actuarial estimate of claims liability, July 1 | $ 5,799 | $ 5,262 |
| Incurred claims for fiscal year | 1,890 | 1,085 |
| Payments on claims | (688) | (774) |
| Actuarial adjustment | (650) | 226 |
| Ending actuarial estimate of claims liability, June 30 | $ 6,351 | $ 5,799 |

### 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 funds are 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, 2005 the City has an accumulated liability in the amount of $62.3 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, 2005 | June 30, 2004 |
|---|---|---|
| Beginning actuarial estimate of claims liability, July 1 | $ 56,095 | $ 56,462 |
| Incurred claims for fiscal year | 16,202 | 14,956 |
| Payments on claims | (18,337) | (21,065) |
| Actuarial adjustment | 8,347 | 5,742 |
| Ending actuarial estimate of claims liability, June 30 | $ 62,307 | $ 56,095 |

## Note 12: Interfund Transactions

### A. Transfers

Transfers during the year ended June 30, 2005, were as follows (in thousands):

| | Transferred to: | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Transferred from:** | **General Fund** | **Nonmajor Governmental Funds** | **Debt Service** | **Capital Projects** | **Grants Fund** | **Convention & Entertainment Facilities** | **Houston Area Water Corporation** | **Total Transfers Out** |
| General Fund | $ - | $ 7,659 | $ 188,674 | $ 352 | $ - | $ 442 | $ - | $ 197,127 |
| Grants Fund | - | - | 6,502 | - | - | - | - | 6,502 |
| Nonmajor Funds | 1,029 | - | 2,721 | - | - | 2,500 | - | 6,250 |
| Capital Projects | - | - | 13,409 | - | 575 | - | - | 13,984 |
| Convention & Entertainment | 709 | - | - | - | - | - | - | 709 |
| Combined Utility System | 3,025 | 30,000 | 27,822 | - | - | - | 26,567 | 87,414 |
| Total transfers in | $ 4,763 | $ 37,659 | $ 239,128 | $ 352 | $ 575 | $ 2,942 | $ 26,567 | $ 311,986 |

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.

The Combined Utility System and Convention Entertainment Facilities transferred capital assets valued at $3.025 million and $709 thousand, respectively to the General Fund.

**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, 2005 totaled $8,172,032.

**C. Interfund Charges**

The General Fund charges the Airport System, Convention and Entertainment Facilities, Combined Utility System, 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 $80,248,000 for the year ended June 30, 2005, 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 2005 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 | $ 2,389 | $ 442 | $ 1,236 | $ 6,964 | $ 11,031 |
| Fire Services | 10,087 | - | - | - | 10,087 |
| Police Services | 18,704 | - | - | - | 18,704 |
| Engineering Services | - | 14 | 11,025 | 7,916 | 18,955 |
| Fleet Maintenance | 264 | 35 | 726 | 7,838 | 8,863 |
| Legal | - | - | 14 | 426 | 440 |
| Other | 467 | 67 | 4,606 | 7,028 | 12,168 |
| Total | $ 31,911 | $ 558 | $ 17,607 | $ 30,172 | $ 80,248 |

**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, 2005 is as follows (in thousands):

| Receivable Fund | Payable Fund | Amount |
|---|---|---|
| General Fund | Combined Utility System | $ 739 |
| | Grants revenue | 1,197 |
| | Nonmajor Governmental Funds | 934 |
| | Capital Projects Fund | 834 |
| | Health Benefits Fund | 2 |
| | Airport System | 2,609 |
| | Convention and Entertainment Facilities | 37 |
| | | $ 6,352 |
| Health Benefits | General Fund | $ 2 |
| | | $ 2 |
| Grants Revenue | General Fund | $ 126 |
| | | $ 126 |
| Capital Projects Fund | General Fund | $ 1,100 |
| | Grants revenue | 1,303 |
| | | $ 2,403 |
| Airport System | General Fund | $ 3,336 |
| | Nonmajor Governmental Funds | 1,696 |
| | | $ 5,032 |
| Convention and Entertainment Facilities | General Fund | $ 438 |
| | Airport System | 1 |
| | Nonmajor Governmental funds | 8 |
| | | $ 447 |
| Combined Utility System | General Fund | $ 5,087 |
| | Grants revenue | 1 |
| | Nonmajor Governmental Funds | 12 |
| | Debt Service | 389 |
| | | $ 5,489 |
| HAWC | Combined Utility | 5,941 |
| | | $ 5,941 |
| Nonmajor Governmental Funds | General Fund | $ 2,437 |
| | Airport System | 253 |
| | Grants revenue | 32 |
| | | $ 2,722 |

**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 $161.8 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 $76.3 million for potential litigation losses arising from various lawsuits.

In 2004, Houston voters approved two ballot propositions limiting City revenue growth. Proposition 1 limits annual growth in property taxes to the lesser of the actual revenues in the preceding fiscal year, plus 4.5 percent, or the revenues received in the previous fiscal year, plus the cumulative combined rates of inflation and the city's population growth. Proposition 2 caps growth in all City revenues, including the General Fund, Special Revenue Funds and Enterprise Funds. Under Proposition 2, any annual increase in total revenues above the consumer price index and population growth would require a 60 percent vote at a regular election. Although both propositions received a majority of votes in the 2004 election, it is the City's position that only Proposition 1 prevails because it received a higher number of favorable votes. Supporters of Proposition 2 have sued in State District court to enforce the provisions of Proposition 2. The district court ruled in favor of the plaintiffs and ordered that both propositions be in effect. The City will appeal the ruling. According to an analysis conducted by the City Controller's Office, the Fiscal Year 2006 budget complies with the requirements of both propositions.

Included within the Claims and Judgments liability line item is an accrual of $55.7 million related to the settlement of litigation styled as *Juan E. Vela v. City of Houston* which was filed in 1995 with a settlement reached during fiscal year 2005. The settlement relates to Houston Fire Department paramedics lawsuit against the City for past due overtime pay and liquidated damages, and calls for the remaining liability to be paid during fiscal years 2006 and 2007.

**B. Environmental Liabilities**

The City is aware of various sites contaminated by asbestos or other hazardous materials. The City has recorded accrued liabilities of $16.1 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, 2005, the City had appropriated but not yet spent from Capital Projects and Enterprise Funds approximately $1,265,856,000 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 $400 million. Such insurance provides deductibles as follows: $2.5 million per occurrence for all perils 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 5 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). Insurance reimbursed the City $32.6 million for property damage. The current sub-limit for flood is $50 million, of which $35 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, 2005** | **June 30, 2004** |
| Unpaid claims, beginning of fiscal year | $112,223 | $134,852 |
| Incurred claims (including IBNRs) | 1,114,092 | 646,874 |
| Claim payments | (1,110,804) | (669,503) |
| Unpaid claims, end of fiscal year | $115,511 | $112,223 |

### 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.

## Note 14: Related Organization Transactions

### A. Metropolitan Transit Authority ("Metro")

The City and Metro have an interlocal agreement under which Metro would fund up to $20 million of revenue for street maintenance and traffic control during the fiscal year ended June 30, 2005. The City received $16.695 million from Metro under this contract in FY05. The money is accounted for in the general fund.

### B. Trinity River Authority ("TRA")

As described in Note 8C, 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, 2005 the City paid $2.5 million for debt service and $2.3 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, 2005, the City paid CWA $29.1 million for debt service and $14.5 million for maintenance and operating expenses.

## Note 15: Conduit Debt Obligations

To provide for the airport facilities, the City has issued eight series of Special Facility Revenue Bonds. These bonds are limited special 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, except for the City of Houston Special Facility Revenue Bonds (Automated People Mover System), Series 1997A, which are reported as an Inferior Lien Obligation because the City has contracted with Continental Airlines to operate certain facilities and pay related debt service. See Note 8D.

At June 30, 2005, the aggregate value of Special Facility Revenue Bonds outstanding was $654,630,000, which includes $60,065,000 of City of Houston Special Facility Revenue Bonds (Automated People Mover System), Series 1997A, bonds.

**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.

**Net Assets**
**Major Component Units - Discretely Presented Governmental**
**June 30, 2005**
(in thousands)

| | Cultural Arts Council of Houston | Greater Houston Convention & Visitor's Bureau | Houston Downtown Park Corporation |
|---|---|---|---|
| Cash, receivable and other current assets | $ 2,628 | $ 3,487 | $ 12,556 |
| Noncurrent assets | - | - | - |
| Capital assets, net of accumulated depreciation | 29 | 285 | 56,986 |
| Total assets | 2,657 | 3,772 | 69,542 |
| Current liabilities | 968 | 2,059 | - |
| Long-term liabilities | - | - | - |
| Total liabilities | 968 | 2,059 | - |
| Net assets | | | |
| Invested in capital assets, net of related debt | - | - | 56,986 |
| Restricted | 1,038 | - | - |
| Unrestricted (deficit) | 651 | 1,713 | 12,556 |
| Total net assets (deficit) | $ 1,689 | $ 1,713 | $ 69,542 |

(Continued)

| Midtown Redevelopment Authority | Uptown Revelopment Authority' | Nonmajor Component Units | 2005 |
|---|---|---|---|
| $ 28,673 | $ 11,609 | $ 101,816 | $ 160,769 |
| 1,471 | 1,352 | 11,035 | 13,858 |
| 6,759 | 1,800 | 21,081 | 86,940 |
| 36,903 | 14,761 | 133,932 | 261,567 |
| 3,020 | 6,196 | 35,756 | 47,999 |
| 38,690 | 38,630 | 79,214 | 156,534 |
| 41,710 | 44,826 | 114,970 | 204,533 |
| 2,933 | 1,800 | 17,237 | 78,956 |
| 11,517 | 4,830 | 35,089 | 52,474 |
| (19,257) | (36,695) | (33,364) | (74,396) |
| $ (4,807) | $ (30,065) | $ 18,962 | $ 57,034 |

**Change in Net Assets**
**Major Component Units - Discretely Presented Governmental**
**For the Year Ended June 30, 2005**
(in thousands)

| Component Units | Expenses | Charges for Services | Operating Grants and Contributions | Capital Grants and Contributions | Cultural Arts Council of Houston/Harris County |
|---|---|---|---|---|---|
| Cultural Arts Council of Houston/Harris County | $ 8,900 | $ 97 | $ 9,130 | $ - | $ 327 |
| Greater Houston Convention & Visitors Bureau | 12,569 | 570 | 11,514 | | - |
| Houston Downtown Park Corporation | 4,104 | - | 32,274 | 41,371 | - |
| Midtown Redevelopment Authority | 5,717 | - | 815 | | - |
| Uptown Development Authority | 10,026 | - | - | - | - |
| Nonmajor Component Units | 26,614 | 1,785 | 5,866 | 15 | - |
| **Total component units** | $ 67,930 | $ 2,452 | $ 59,599 | $ 41,386 | $ 327 |
| **General Revenues:** | | | | | |
| Taxes | | | | | |
| Property taxes levied for general purposes | | | | | - |
| Intergovermental - grants | | | | | - |
| Contributions | | | | | - |
| Unrestricted investment earnings | | | | | - |
| Other | | | | | 64 |
| Loss on sales of assets | | | | | - |
| Transfers | | | | | - |
| **Total general revenues, special items and transfers** | | | | | 64 |
| Change in net assets | | | | | 391 |
| Net assets beginning | | | | | 1,298 |
| New component unit & restatement | | | | | |
| Net assets ending | | | | | $ 1,689 |

(Continued)

**Net (Expense) Revenue and Change In Net Assets**

| Greater Houston Convention & Visitors Bureau | Houston Downtown Park Corporation | Midtown Redevelopment Authority | Uptown Redevelopment Authority | Nonmajor Component Units | Total Component Units |
|---|---|---|---|---|---|
| $ - | $ - | $ - | $ - | $ - | $ 327 |
| (485) | - | - | - | - | (485) |
| - | 69,541 | - | - | - | 69,541 |
| - | - | (4,902) | - | - | (4,902) |
| - | - | - | (10,026) | - | (10,026) |
| - | - | - | - | (18,948) | (18,948) |
| $ (485) | $ 69,541 | $ (4,902) | $ (10,026) | $ (18,948) | $ 35,507 |
| | | | | | |
| - | - | 6,943 | 7,137 | 25,029 | 39,109 |
| - | - | - | - | - | - |
| - | - | - | - | 60 | 60 |
| 211 | 1 | 297 | 128 | 2,395 | 3,032 |
| 1,987 | - | 146 | - | 726 | 2,923 |
| - | - | - | - | - | - |
| - | - | - | - | - | - |
| 2,198 | 1 | 7,386 | 7,265 | 28,210 | 45,124 |
| 1,713 | 69,542 | 2,484 | (2,761) | 9,262 | 80,631 |
| - | - | (7,291) | (27,304) | 9,700 | (23,597) |
| - | | | | - | - |
| $ 1,713 | $ 69,542 | $ (4,807) | $ (30,065) | $ 18,962 | $ 57,034 |

**Net Assets**
**Major Component Units - Discretely Presented Business-type**
**June 30, 2005**
(in thousands)

| | Houston Convention Center Hotel Corp. | Houston Housing Finance Corp. | Houston Zoo Inc. | Total |
|---|---|---|---|---|
| Cash, receivable and investments | $ 24,527 | $ 18,521 | $ 14,878 | $ 57,926 |
| Noncurrent assets | 26,768 | 9,874 | - | 36,642 |
| Capital assets, net of accumulated depreciation | 272,146 | - | 12,759 | 284,905 |
| Total assets | 323,441 | 28,395 | 27,637 | 379,473 |
| Current liabilities | 19,789 | 436 | 3,515 | 23,740 |
| Long-term liabilities | 325,368 | 2,962 | - | 328,330 |
| Total liabilities | 345,157 | 3,398 | 3,515 | 352,070 |
| Net assets | | | | |
| Invested in capital assets, net of related debt | (23,071) | - | 10,348 | (12,723) |
| Restricted | 5,440 | 1,310 | 10,428 | 17,178 |
| Unrestricted (deficit) | (4,085) | 23,687 | 3,346 | 22,948 |
| Total net assets (deficit) | $ (21,716) | $ 24,997 | $ 24,122 | $ 27,403 |

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**Change in Net Assets**
**Major Component Units - Discretely Presented Business-type**
**For the Year Ended June 30, 2005**
(in thousands)

| **Component Units** | **Expenses** | **Charges for Services** | **Operating Grants and Contributions** |
|---|---|---|---|
| Houston Convention Center Hotel Corp. | $ 77,312 | $ 57,669 | $ - |
| Houston Housing Finance Corp. | 5,469 | 843 | 4,313 |
| Houston Zoo Inc. | 18,481 | 16,413 | 7,839 |
| Totals | $ 101,262 | $ 74,925 | $ 12,152 |

**General Revenues:**
**Taxes**
Property taxes levied for debt service
Unrestricted investment earnings
Other
Transfers
**Total general revenues, special items, and transfers**
Change in net assets
Net assets (deficit) beginning
Net assets (deficit) ending

| Houston Convention Center Hotel Corp. | Houston Housing Finance Corp. | Houston Zoo Inc. | Total |
|---|---|---|---|
| **Net (Expense) Revenue and Change in Net Assets** | | | |
| $ (19,643) | $ - | $ - | (19,643) |
| - | (313) | - | (313) |
| - | - | 5,771 | 5,771 |
| $ (19,643) | $ (313) | $ 5,771 | $ (14,185) |
| | | | |
| - | 750 | - | 750 |
| 1,402 | 571 | 128 | 2,101 |
| 9,239 | - | - | 9,239 |
| - | - | - | - |
| 10,641 | 1,321 | 128 | 12,090 |
| (9,002) | 1,008 | 5,899 | (2,095) |
| (12,714) | 23,989 | 18,223 | 29,498 |
| $ (21,716) | $ 24,997 | $ 24,122 | $ 27,403 |

**Note 17. Subsequent Events**

**A. Tax and Revenue Anticipation Notes**

On July 6, 2005, the City closed the sale of $180,000,000 Tax and Revenue Anticipation Notes ("TRANS"), Series 2005. 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 4.00% to 5.75%, and the average yield was 2.63%. The notes will mature on June 30, 2006.

**B. Public Improvement Refunding Bonds**

On July 7, 2005 the City closed the sale of $100,025,000 of Public Improvement Refunding Bonds, Series 2005A. Stated interest rates ranged from 4.0% to 5.125%, and the average yield was 4.19%. The bonds are due in varying amounts from March 1, 2014 to March 1, 2025. Proceeds were used to fund the second installment of a judgment against the City relating to firefighters overtime pay, to refund certain Public Improvement Bonds and Certificates of Obligation issued from 1999 to 2001, and to pay costs of issuance. The cash savings of the transaction was $3,860,000, and the net present value savings of the transaction was $3,384,000, or 4.43%.

On November 15, 2005 the City closed the sale of $95,740,000 of Public Improvement Refunding Bonds, Series 2005E with a stated interest rate of 5.0%. The average yield was 4.54%. The bonds mature in varying amounts from 2013 to 2025. Proceeds were used to refund $100,000,000 of General Obligation Series A Commercial Paper Notes, and to pay costs of issuance. The Bonds were issued to lock in long term fixed rates rather than to achieve debt service savings.

**C. Taxable Public Improvement Refunding Bonds**

On July 7, 2005, the City closed the sale of $7,770,000 of Taxable Public Improvement Refunding Bonds, Series 2005B. The stated interest rate was 5.125%, and the yield was 5.237%. The bonds are due in varying amounts from March 1, 2032 to March 1, 2035. Proceeds were used to fund the pension costs related to firefighters overtime judgment and to pay costs of issuance.

**D. Certificates of Obligation**

On July 7, 2005 the City closed the sale of $3,310,000 of Certificates of Obligation, Series 2005C. The stated interest rate was 5.0%, and the yield was 3.2%. The bonds are due on March 1, 2010. Proceeds will be used to fund the demolition of dangerous buildings within the City and to pay costs of issuance.

On November 15, 2005 the City closed the sale of $53,445,000 of Certificates of Obligation, Series 2005D. Stated interest rates ranged from 3.50% to 5.00%, and the average yield was 4.54%. The bonds are due in varying amounts from 2008 to 2027. The proceeds were used to pay the purchase option price of the Houston Emergency Center Lease and to pay costs of issuance of the Certificates and exercise of the purchase option. Cash savings over future lease payments will be $4,484,000, and the net present value savings will be $4,128,000, or 8.1%.

**E. Water Sewer Junior Lien Revenue Bonds**

On July 18, 2005 the City closed the sale on $1,965,000 in Water Sewer Junior Lien Revenue Bonds, Series 2002C2 in a private placement with the Texas Water Development Board ("TWDB"). The City had contracted with TWDB in June 2002 for a line of credit of $6,180,000 to be drawn when the City has completed certain work related to drinking water improvements. Previously the City drew $180,000 on this line, leaving $4,035,000 to be drawn in the future. Stated interest rates ranged from 2.0 to 3.05%, and the average yield was 2.78%. The bonds mature in varying amounts between 2006 and 2013.

**F. Combined Utility System Revenue Refunding Bonds**

On September 28, 2005 the City closed the sale on $250,855,000 in Combined Utility System First Lien Revenue Refunding Bonds, Series 2005. Stated interest rates ranged from 4.375 to 5.00%, and the average yield was 4.52%. The bonds are due in varying amounts from 2013 to 2035. The proceeds were used to currently refund Water and Sewer Jr. Lien Revenue Bonds Series, 1996C, to currently refund $200,000,000 of Combined Utility System Commercial Paper Notes, Series A, and to pay costs of issuance.

Cash savings on bond debt service payments related to refunding the Water and Sewer Jr. Lien bonds will be $5,648,000, and the net present value savings will be $3,870,000, or 6.22%. The portion of bonds related to the Notes refund was issued to lock in long term fixed rates rather than to achieve debt service savings.

On October 11, 2005 the City closed the sale on $144,915,000 in Combined Utility System First Lien Revenue Refunding Bonds, Series 2005A. Stated interest rates ranged from 5.0 to 5.25%, and the average yield was 3.84%. The bonds are due in varying amounts from 2011 to 2017. The proceeds were used to advance refund Water and Sewer Jr. Lien Revenue Bonds, Series 1996D, and to pay costs of issuance. Cash savings on bond debt service payments will be $10,556,000, and the net present value savings will be $6,854,000, or 4.3%.

**G. Taxable Pension Deferred Interest Certificates**

On October 1, 2005 the City elected to defer $16,702,500 in interest payments on its $300,000,000 Collateralized Pension Obligation Note, and to allocate such deferred interest to the Uncollateralized Deferred Interest Certificate, as allowed by the ordinance authorizing issuance of the Note. (The City made a partial payment of $6,035,000 on the $22,737,500 interest incurred on the Note.) The Deferred Interest Certificate will bear interest at the greater of a) 8.5%, b) the yield on April 1 of each year for the Treasury obligation maturing closest to December 1, 2033, plus a predefined rate adjustment. Under the authorizing ordinance, the City is allowed to defer up to $150,000,000 in interest on the Note. The City will pay down the Certificate by December 1, 2033.

**H. Combined Utility System Forward Interest Rate Swap**

On November 1, 2005 the City entered into a forward interest rate swap transaction with RBC Dain Rauscher. The swap will begin on December 3, 2007. The transaction was conducted through a competitive bid process. It is intended to hedge the interest rate on a portion of the City's variable rate Combined Utility System First Lien Revenue Bonds, Series 2004C. Under the terms of the contract, the City will pay a fixed rate of 3.761% on a par value of $249,075,000, and it will receive variable payments based on 70% of one-month LIBOR. The City's scheduled net swap payments are insured by Ambac Assurance Corporation.

**I. Pension System Updates – Houston Police Officer's Pension System**

In August 2005, the Board approved a plan to alter the System's asset allocation by decreasing exposure to the US and international public equity markets and adding or increasing exposure to inflation indexed securities, emerging market debt, commodities, real estate and a structured beta investment strategy. Assets allocated to US and international equity markets will be decreased from 58.0percent to 40.5 percent of plan assets.

The System has interest in Refco Group Ltd, LLC, a subsidiary of Refco Inc., through the System's investment in the Thomas H Lee V private equity partnership (the Partnership). In October 2005, Refco, Inc.'s chief executive officer was arrested for allegedly executing and concealing a fraud which led to a liquidity crisis for Refco, Inc. Subsequently Refco, Inc. and numerous subsidiaries including Refco Group Ltd, LLC, filed for Chapter 11 bankruptcy protection. Pursuant to these events the System intends to write down its investment in the Partnership, which has a preliminary valuation of $19.2 million, by approximately $3.7 million during the 2006 fiscal year. This write-down represents the System's proportionate interest in Refco Group Ltd, LLC through the System's investment in the Partnership. The Partnership is a named defendant in numerous class action filings that have been made pursuant to the situation, however, the System expects no further material loss as a result of Refco, Inc. and Refco Group Ltd, LLC bankruptcy or the attendant class action proceedings.

**J. City of Houston's response to Hurricanes Katrina and Rita**

On August 29, 2005, Hurricane Katrina struck the coasts of Louisiana, Mississippi and Alabama. The destruction caused by the hurricane led to unprecedented numbers of evacuees seeking refuge in the City of Houston. The City mobilized its efforts with Harris County and various State and federal agencies and nonprofit organizations to coordinate needed resources to assist the evacuees. As part of its response, the City offered temporary housing to thousands of evacuees in shelters in the days immediately following the storm. The City provided equipment, food, medical supplies, facilities, and City Emergency and civilian personnel. The City is currently providing temporary housing to over 30,000 evacuees for periods of six to twelve months based on evacuees eligibility provided by FEMA. President Bush issued a declaration of emergency for the State of Texas which resulted in federal assistance becoming available to the City for 100% of eligible costs incurred in providing shelter and care to victims of the hurricane. The eligible costs include interim short term sheltering, interim sheltering for a period of up to one year, medical costs, transportation costs and temporary increases in the provision of governmental services such as public safety, education and judicial expenditures. The costs of the City's effort to assist the evacuees are estimated to be $350 million. To date the City has received advances of approximately $145 million from FEMA and another $1 million in private donations to the City to help pay the costs of assisting the evacuees. The City expects to receive reimbursement for substantially all of its costs associated with sheltering and housing the evacuees from Hurricane Katrina.

On September 24, 2005, Hurricane Rita caused extensive damage to the coastal regions of Texas and Louisiana. The City of Houston was included in a declaration of emergency that made the City eligible for federal assistance to reimburse the City 100% of the costs of debris removal and emergency protective measures taken by the City for a period of 34 days through and including October 27, 2005. Emergency protective measures include the costs of police overtime and emergency access and communication. The City believes that FEMA advances and reimbursements will be sufficient to cover substantially all of the costs associated with the City's response to Hurricane Rita.

**K. Clean Water Act**

On August 19, 2005, the City executed an Agreed Order with the Texas Commission on Environmental Quality to resolve alleged violations of the Clean Water Act concerning Sanitary Sewer Overflows (SSOs) in the City's collection basins. Under the terms of the Agreed Order, the City will implement a plan over the next 10 years to correct causes of SSOs. The City will structurally "renew" (i.e., replace or rehabilitate) its wastewater collection system. It will also increase preventative maintenance activities for lift stations and force mains, and improve management information systems. The value of the Capital Improvement Project is estimated to be $755.4 million over the next 10 years. Funding for this project will be provided by the Water and Sewer Fund.

## Required Supplemental Information

**CITY OF HOUSTON, TEXAS**
**GENERAL OPERATING FUND**
**Schedule of Budgeted and Actual Revenues and Expenditures**
**For the Year Ended June 30, 2005**
***amounts expressed in thousands***
**(unaudited)**

| | Budgeted Amounts Original | Budgeted Amounts Final | Actual Budget Basis | Variance with Final Budget- Pos (Neg) |
|---|---|---|---|---|
| **Revenues** | | | | |
| Taxes and assessments | | | | |
| Property Taxes | $ 671,553 | $ 671,553 | $ 671,294 | $ (259) |
| Industrial Assessments | 14,406 | 14,406 | 14,635 | 229 |
| Sales Tax | 371,548 | 371,548 | 370,583 | (965) |
| Franchise Tax | 160,399 | 160,399 | 162,263 | 1,864 |
| Mixed Beverage Tax | 8,200 | 8,200 | 8,343 | 143 |
| Bingo Tax | 275 | 275 | 270 | (5) |
| Hotel Occupancy Tax | - | - | - | - |
| Total taxes and assessments | 1,226,381 | 1,226,381 | 1,227,388 | 1,007 |
| Licenses and permits | | | | |
| General | 8,735 | 8,735 | 11,584 | 2,849 |
| Health Permits | 6,620 | 6,620 | 6,108 | (512) |
| Total licenses and permits | 15,355 | 15,355 | 17,692 | 2,337 |
| Charges for services | | | | |
| Ambulance service | 24,175 | 24,175 | 22,740 | (1,435) |
| Library fees | - | - | - | - |
| Parking | 4,047 | 4,047 | 3,223 | (824) |
| Services performed for other funds | | | | |
| Direct | 65,961 | 65,961 | 61,234 | (4,727) |
| Indirect | 10,419 | 10,419 | 11,031 | 612 |
| Rents and royalties | 1,010 | 1,010 | 1,005 | (5) |
| Others | 12,302 | 12,302 | 12,964 | 662 |
| Total charges for services | 117,914 | 117,914 | 112,197 | (5,717) |
| Intergovernmental - grants | 22,189 | 22,189 | 18,881 | (3,308) |
| Fines and forfeits | | | | |
| Municipal Courts | 47,601 | 47,601 | 48,827 | 1,226 |
| Others | 4,540 | 4,540 | 2,424 | (2,116) |
| Total fines and forfeits | 52,141 | 52,141 | 51,251 | (890) |
| Contributions | 1,680 | 1,680 | 1,780 | 100 |
| Interest | 5,000 | 5,000 | 6,414 | 1,414 |
| Other | | | | |
| Sale of Property | 2,649 | 2,649 | 3,091 | 442 |
| Other | 7,610 | 7,610 | 11,382 | 3,772 |
| Total Other | 10,259 | 10,259 | 14,473 | 4,214 |
| **Total revenues** | 1,450,919 | 1,450,919 | 1,450,076 | (843) |
| **Other financing sources (uses)** | | | | |
| Transfers in | 3,500 | 3,500 | 1,029 | (2,471) |
| Transfers from primary government | - | - | - | - |
| Other financing sources (uses) | - | - | 48,600 | 48,600 |
| **Total other financing sources (uses** | 3,500 | 3,500 | 49,629 | 46,129 |
| **Total revenues and other financing source** | $ 1,454,419 | $ 1,454,419 | $ 1,499,705 | $ 45,286 |

* See note to Required Supplementary Information*

**CITY OF HOUSTON, TEXAS**
**GENERAL OPERATING FUND**
**Schedule of Budgeted and Actual Revenues and Expenditures**
**For the Year Ended June 30, 2005**
***amounts expressed in thousands***
***(unaudited)***

| | Budgeted Amounts | | Actual | Variance with Final Budget- |
|---|---|---|---|---|
| | Original | Final | Budget Basis | Pos (Neg) |
| General government | | | | |
| Legislative and executive | | | | |
| Personnel services | 3,999 | 4,148 | 4,036 | 112 |
| Other current expenditures | 204 | 266 | 230 | 36 |
| Total legislative - council | 4,203 | 4,414 | 4,266 | 148 |
| Legislative - Mayor's Office | | | | |
| Personnel services | 1,655 | 1,779 | 1,748 | 31 |
| Other current expenditures | 149 | 148 | 101 | 47 |
| Total executive - mayor's office | 1,804 | 1,927 | 1,849 | 78 |
| Total legislative and executive | 6,007 | 6,341 | 6,115 | 226 |
| Affirmative Action | | | | |
| Personnel services | 1,535 | 1,582 | 1,576 | 6 |
| Other current expenditures | 97 | 152 | 138 | 14 |
| Total affirmative action | 1,632 | 1,734 | 1,714 | 20 |
| Judicial | | | | |
| Municipal Courts Judges | | | | |
| Personnel services | 3,720 | 4,003 | 3,948 | 55 |
| Other current expenditures | 272 | 272 | 265 | 7 |
| Total municipal court judges | 3,992 | 4,275 | 4,213 | 62 |
| Municipal Courts Administration | | | | |
| Personnel services | 14,438 | 14,411 | 14,310 | 101 |
| Other current expenditures | 1,777 | 2,077 | 2,030 | 47 |
| Equipment acquisition | 2 | 10 | 10 | - |
| Total municipal court administration | 16,217 | 16,498 | 16,350 | 148 |
| Total judicial | 20,209 | 20,773 | 20,563 | 210 |
| Elections | 1,000 | 1,000 | 1,334 | (334) |
| Finance administration | | | | |
| Controller | | | | |
| Personnel services | 4,912 | 5,217 | 5,067 | 150 |
| Other current expenditures | 925 | 925 | 892 | 33 |
| Total controller | 5,837 | 6,142 | 5,959 | 183 |
| Finance and Administration | | | | |
| Personnel services | 18,272 | 18,633 | 17,748 | 885 |
| Other current expenditures | 1,845 | 1,811 | 1,682 | 129 |
| Equipment acquisition | - | - | - | - |
| Total finance and administration | 20,117 | 20,444 | 19,430 | 1,014 |
| Information Technology | | | | |
| Personnel services | 10,164 | 10,699 | 10,209 | 490 |
| Other current expenditures | 2,230 | 2,153 | 2,069 | 84 |
| Total information technology | 12,394 | 12,852 | 12,278 | 574 |
| Audits | 608 | 608 | 890 | (282) |
| Bond and Legal | 2,262 | 2,262 | 2,282 | (20) |
| Total finance administration | 41,218 | 42,308 | 40,839 | 1,469 |
| Legal | | | | |
| Personnel services | 9,693 | 9,978 | 9,634 | 344 |
| Other current expenditures | 1,105 | 1,279 | 1,041 | 238 |
| Total legal | 10,798 | 11,257 | 10,675 | 582 |

*See note to required Supplementary Information*

**CITY OF HOUSTON, TEXAS**
**GENERAL OPERATING FUND**
**Schedule of Budgeted and Actual Revenues and Expenditures**
**For the Year Ended June 30, 2005**
***amounts expressed in thousands***
***(unaudited)***

| | Budgeted Amounts | | Actual | Variance with Final Budget- |
|---|---|---|---|---|
| | **Original** | **Final** | **Budget Basis** | **Pos (Neg)** |
| City Secretary | | | | |
| Personnel services | 619 | 634 | 529 | 105 |
| Other current expenditures | 88 | 88 | 97 | (9) |
| Total city secretary | 707 | 722 | 626 | 96 |
| Planning and Development | | | | |
| Personnel services | 10,482 | 6,831 | 6,465 | 366 |
| Other current expenditures | 2,974 | 686 | 630 | 56 |
| Equipment acquisition | - | 60 | 60 | - |
| Total planning and development | 13,456 | 7,577 | 7,155 | 422 |
| Human Resources | | | | |
| Personnel services | 2,056 | 2,180 | 2,014 | 166 |
| Other current expenditures | 231 | 237 | 203 | 34 |
| Total human resources | 2,287 | 2,417 | 2,217 | 200 |
| **Total general government** | 97,314 | 94,129 | 91,238 | 2,891 |
| Public safety | | | | |
| Police | | | | |
| Personnel services | 490,715 | 493,454 | 470,877 | 22,577 |
| Other current expenditures | 25,138 | 30,189 | 26,784 | 3,405 |
| Equipment acquisition | 150 | 203 | 206 | (3) |
| Total police | 516,003 | 523,846 | 497,867 | 25,979 |
| Fire | | | | |
| Personnel services | 275,325 | 273,421 | 272,077 | 1,344 |
| Other current expenditures | 17,599 | 19,630 | 19,089 | 541 |
| Equipment acquisition | 18 | 191 | 186 | 5 |
| Total fire | 292,942 | 293,242 | 291,352 | 1,890 |
| **Total public safety** | 808,945 | 817,088 | 789,219 | 27,869 |
| Public Works | | | | |
| Administration | | | | |
| Personnel services | 46,189 | 42,484 | 42,341 | 143 |
| Other current expenditures | 42,483 | 46,764 | 46,461 | 303 |
| Equipment acquisition | - | 38 | 38 | - |
| Total administration | 88,672 | 89,286 | 88,840 | 446 |
| Building Services | | | | |
| Personnel services | 8,448 | 9,631 | 9,515 | 116 |
| Other current expenditures | 14,493 | 15,051 | 15,054 | (3) |
| Equipment acquisition | - | 63 | 63 | - |
| Total building services | 22,941 | 24,745 | 24,632 | 113 |
| Solid Waste | | | | |
| Personnel services | 25,311 | 26,021 | 26,262 | (241) |
| Other current expenditures | 35,819 | 40,975 | 40,682 | 293 |
| Equipment acquisition | - | 45 | 45 | - |
| Total solid waste | 61,130 | 67,041 | 66,989 | 52 |
| **Total public works** | 172,743 | 181,072 | 180,461 | 611 |

*See note to required Supplementary Information*

**CITY OF HOUSTON, TEXAS**
**GENERAL OPERATING FUND**
**Schedule of Budgeted and Actual Revenues and Expenditures**
**For the Year Ended June 30, 2005**
***amounts expressed in thousands***
***(unaudited)***

| | Budgeted Amounts | | Actual | Variance with Final Budget- |
|---|---|---|---|---|
| | Original | Final | Budget Basis | Pos (Neg) |
| Health | | | | |
| Personnel services | 37,886 | 37,672 | 36,878 | 794 |
| Other current expenditures | 11,544 | 13,295 | 13,162 | 133 |
| Equipment acquisition | - | 275 | 272 | 3 |
| **Total health** | 49,430 | 51,242 | 50,312 | 930 |
| Parks and Recreation | | | | |
| Personnel services | 34,188 | 34,503 | 34,598 | (95) |
| Other current expenditures | 12,768 | 13,320 | 12,640 | 680 |
| Equipment acquisition | - | 353 | 354 | (1) |
| **Total parks and recreation** | 46,956 | 48,176 | 47,592 | 584 |
| Library | | | | |
| Personnel services | 22,178 | 22,843 | 22,638 | 205 |
| Other current expenditures | 6,560 | 6,623 | 6,452 | 171 |
| Equipment acquisition | 4,153 | 4,133 | 4,132 | 1 |
| **Total library** | 32,891 | 33,599 | 33,222 | 377 |
| Retiree Benefits | | | | |
| Hospital and life insurance | (191) | 29,609 | 28,997 | 612 |
| **Total retiree benefits** | (191) | 29,609 | 28,997 | 612 |
| Other current expenditures | | | | |
| Tax appraisal fees | 5,489 | 5,489 | 5,003 | 486 |
| Limited-purpose Annexation Districts | 13,128 | 13,128 | 12,654 | 474 |
| Insurance | 1,470 | 1,470 | 1,153 | 317 |
| Claims and judgments | 6,000 | 6,517 | 5,813 | 704 |
| Membership dues | 780 | 755 | 656 | 99 |
| Advertising and promotion | 200 | 225 | 278 | (53) |
| Zoo Contract | 7,494 | 7,494 | 7,494 | - |
| Consultants | 372 | 372 | 335 | 37 |
| Miscellaneous support services | 9,538 | 9,038 | 8,184 | 854 |
| **Total other current expenditures** | 44,471 | 44,488 | 41,570 | 2,918 |
| Debt service | | | | |
| Debt service principal | 1,090 | 1,090 | 1,090 | - |
| Debt service interest | 5,249 | 5,249 | 6,443 | (1,194) |
| **Total debt service** | 6,339 | 6,339 | 7,533 | (1,194) |
| **Total expenditures** | 1,258,898 | 1,305,742 | 1,270,144 | 35,598 |
| **Other financing sources (uses)** | | | | |
| Transfers out | 196,009 | 196,629 | 197,073 | (444) |
| **Total other financing sources (uses)** | 196,009 | 196,629 | 197,073 | (444) |
| **Total expenditures and other financing use** | $ 1,454,907 | $ 1,502,371 | $ 1,467,217 | $ 35,154 |

*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, 2005**
***amounts expressed in thousands***
**(unaudited)**

| | | |
|---|---|---|
| **Revenues** | | |
| Actual amounts (budgetary basis) "revenues" from the budgetary comparison schedules | $ | 1,450,076 |
| Revenues of non-budgeted funds | | |
| Equipment Acquisition | | 88 |
| Revolving Funds | | 8,711 |
| Rainy Day | | 526 |
| Grant Matching Fund | | 1,124 |
| Vendor Overpayment | | 709 |
| Houston Downtown Public Improvement District | | 4 |
| Planning and Development Special Projects | | 3 |
| Commercial Paper | | 175 |
| Dangerous buildings demolition programs | | 54 |
| Total revenues of non-budgeted funds | | 11,394 |
| Interest on pooled investments from non-budgeted revenues | | (706) |
| Total revenues as reported on the statement of revenues, expenditures, and changes in fund balances | $ | 1,460,764 |
| **Expenditures** | | |
| Actual amounts (budgetary basis) "expenditures" from the budgetary comparison schedules | $ | 1,270,144 |
| Expenditures of non-budgeted funds | | |
| Equipment Acquisition | | 35,253 |
| Dangerous building demolition programs | | 1,892 |
| Revolving Funds | | 8,785 |
| Firefighter’s Judgement Bond | | 24,075 |
| Planning and Development Special Projects | | 18 |
| Grant Matching Fund | | 505 |
| Vendor Overpayment | | 780 |
| Total expenditures of non-budgeted funds | | 71,308 |
| Total expenditures as reported on the statement of revenues, expenditures, and changes in fund balances | $ | 1,341,452 |
| **Other financing sources (uses)** | | |
| Actual amounts (budgetary basis) "other financing sources and uses" from the budgetary comparison schedules | $ | (147,444) |
| Proceeds from Issuance of Debt | | 62,551 |
| Total other financing sources and uses as reported on the statement of revenues, expenditures, and changes in fund balances--governmental funds | $ | (84,893) |

*See note to Required Supplementary Information*

## 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 March 16, 2005, City Council approved the Fiscal Year 2005 general appropriation ordinance in the amount of $1.503 billion for the General Fund. In addition, City Council amended the Fiscal Year 2005 Annual Budgets to reflect additional financing sources and additional expenditures related to the Houston Municipal Employee Pension System as well as a transfer from the General Fund to the Convention and Entertainment Fund of $438 thousand to be used for expenditures related to the Miller Outdoor Theatre.

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 2005 results for both budgeted and non-budgeted Special Revenue Funds (in thousands):

| | Revenues | Expenditures | Other Sources (Uses) |
|---|---|---|---|
| Budgeted Special Revenue Funds | $ 60,711 | $ 92,457 | $ 36,850 |
| Non-budgeted Disaster Recovery Fund | 7,701 | 486 | (2,500) |
| Non-budgeted Grants Revenue Fund | 143,360 | 138,685 | (5,927) |
| Non-budgeted Health and Housing | 737 | 1,811 | 2 |
| Non-budgeted Other Funds | 9,645 | 5,197 | (1,264) |
| Total Special Revenue Funds - Actual | $ 222,154 | $ 238,636 | $ 27,161 |

## 2. General Fund Budgetary Highlights

While revenues were only $843 thousand below budget (pgs. 112-115), there were some significant differences between some of the budgeted and actual revenue numbers. Some of the increases/decreases from budget include:

- $1 million increase in taxes and assessments
- $2 million increase in licenses and permits
- $6 million decrease in charges for services
- $3 million decrease in intergovernmental grants
- $1 million increase in interest
- $4 million increase in other revenues

Budgeted expenditures increased by $47 million during the fiscal year. The most significant changes in the budget were:

- $3 million decrease in general government
- $8 million increase for public safety
- $8 million increase for public works
- $4 million increase for health, parks and recreation and library
- $30 million increase in retirement benefits

Ultimately, total expenditures for the General Fund were $36 million below the final expenditure budget.

**CITY OF HOUSTON, TEXAS**
**REQUIRED PENSION SYSTEM**
**SUPPLEMENTARY INFORMATION**
**June 30, 2005**

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

| 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 | $1,970.1 | $47.8 | 98% | $190.6 | 25% |
| July 1, 2004 | $2,000.3 | $2,266.8 | $266.5 | 88% | $181.5 | 147% |

* 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, 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% |
| July 1, 2004 | $1,501.2 | $2,633.8 | $1,132.5 | 57% | $366.1 | 309% |

## 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, 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% |
| July 1, 2004 | $2,466.0 | $3,339.2 | $873.1 | 74% | $329.8 | 265% |