

**NEW ISSUE — BOOK-ENTRY ONLY**

**RATINGS:**

Moody's:  
S&P: A+  
(See "BOND INSURANCE"  
and "RATINGS" herein)

The delivery of the Series 2008 Bonds is subject to the opinion of Co-Bond Counsel, to the effect that interest on the Series 2008 Bonds is excludable from gross income for federal income tax purposes under existing law and is not subject to the alternative minimum tax on individuals. See "Tax Exemption" for a discussion of Co-Bond Counsel's opinion, including a description of alternative minimum tax consequences for corporations and other federal tax consequences.

**\$241,160,000\***

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY  
Senior Lien Revenue Bonds,  
Series 2008**

**Interest Accrues From: Date of Delivery**

**Due: December 15, as set forth below**

- Interest:** Interest on the North Harris County Regional Water Authority Senior Lien Revenue Bonds, Series 2008 (the "Series 2008 Bonds") accrues from the date of delivery and is payable on each June 15 and December 15, beginning December 15, 2008.
- Redemption:** The Series 2008 Bonds are subject to optional redemption on or after December 15, 2018, and the term Series 2008 Bonds, if any, are subject to mandatory sinking fund redemption as described herein.
- General:** The Series 2008 Bonds are being offered in denominations of \$5,000 and integral multiples of \$5,000 solely in book entry form through the facilities of The Depository Trust Company. Wells Fargo Bank, N.A. is the Paying Agent for the Series 2008 Bonds.
- Issuer:** The North Harris County Regional Water Authority (the "Authority") is a political subdivision of the State of Texas created to reduce use of groundwater in, and to supply surface water to, an approximately 338 square mile, largely suburban area north of Houston, Texas.
- Security for the Bonds:** The Series 2008 Bonds are limited obligations of the Authority payable solely from and to the extent, and secured equally with the Authority's outstanding and any future parity obligations by a pledge, of the Net Revenues, which consist of Gross Revenue (primarily revenue from groundwater pumpage fees and future water sales) less Operation and Maintenance Expenses of the Authority. The Series 2008 Bonds, together with the outstanding and any future parity obligations, will be additionally secured by a debt service reserve fund or surety bond. The Series 2008 Bonds are not obligations of any governmental unit other than the Authority. The Authority has no taxing power.
- Bond Insurance:** Applications for bond insurance are pending.
- Underlying Ratings:** Moody's Investors Service, Inc. and Standard & Poor's Rating Services have assigned underlying ratings of "\_\_\_" and "A+," respectively to the Series 2008 Bonds.
- Purpose:** The Series 2008 Bonds are being issued to finance (i) design, acquisition, and construction of regional water production, transmission, pumping, storage, distribution, and administrative facilities and related realty interests, (ii) capitalized interest and a debt service reserve fund or surety bond and (iii) costs of issuance of the Series 2008 Bonds.

<u>Due December 15</u>	<u>Principal Amount*</u>	<u>Interest Rate</u>	<u>Price or Yield</u>	<u>CUSIP<sup>(a)</sup></u>	<u>Due December 15</u>	<u>Principal Amount*</u>	<u>Interest Rate</u>	<u>Price or Yield</u>	<u>CUSIP<sup>(a)</sup></u>
2013	\$4,485,000	%	%		2026	\$8,830,000	%	%	
2014	4,725,000				2027	9,300,000			
2015	4,975,000				2028	9,800,000			
2016	5,245,000				2029	10,325,000			
2017	5,525,000				2030	10,875,000			
2018	5,820,000				2031	11,640,000			
2019	6,130,000				2032	12,070,000			
2020	6,460,000				2033	12,720,000			
2021	6,805,000				2034	13,400,000			
2022	7,170,000				2035	14,115,000			
2023	7,550,000				2036	14,870,000			
2024	7,955,000				2037	15,665,000			
2025	8,380,000				2038	16,505,000			

<sup>(a)</sup> CUSIP numbers have been assigned to this issue by the CUSIP Service Bureau and are included solely for the convenience of the purchasers of the Series 2008 Bonds. Neither the Authority, the Co-Financial Advisors, nor the purchasers of the Series 2008 Bonds shall be responsible for the selection or correctness of the CUSIP numbers set forth herein.

The Series 2008 Bonds are offered when, as, and if issued by the Authority and accepted by the Underwriters, subject to prior sale, the approving opinion of the Attorney General of Texas, and an opinion of Andrews Kurth LLP and Johnson Radcliffe Petrov & Bobbitt PLLC, Houston, Texas, Co-Bond Counsel for the Authority. Certain legal matters will be passed upon for the Underwriters by their counsel, Fulbright & Jaworski L.L.P., Houston, Texas. The Series 2008 Bonds are expected to be available for delivery through DTC on or about August 27, 2008.

**FIRST SOUTHWEST COMPANY**

**BANC OF AMERICA SECURITIES LLC  
J.P. MORGAN SECURITIES INC.**

**CITI  
MORGAN KEEGAN & COMPANY, INC.**

**COASTAL SECURITIES, INC.  
DEPFA FIRST ALBANY SECURITIES LLC  
RAMIREZ & CO., INC.**

\* Preliminary; subject to change

This Preliminary Official Statement and the information contained herein are subject to completion and amendment. Under no circumstances shall this Preliminary Official Statement constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction.

The information set forth herein has been furnished by the Authority and includes information obtained from other sources which are believed to be reliable but is guaranteed as to accuracy or completeness, and is not to be construed as a representation by the Underwriters. The information and expressions of opinion contained herein are subject to change without notice and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Authority or the other matters described herein since the date hereof.

For purposes of compliance with Rule 15c2-12 of the Securities and Exchange Commission (“Rule 15c2-12”), this document constitutes a Preliminary Official Statement of the Authority with respect to the Series 2008 Bonds that has been deemed “final” by the Authority as of its date except for the omission of no more than the information permitted by Rule 15c2-12.

This document, when further supplemented by adding information specifying the interest rates and certain other information relating to the Series 2008 Bonds, shall constitute a “final official statement” of the Authority with respect to the Series 2008 Bonds, as such term is defined in Rule 15c2-12.

This Official Statement includes descriptions and summaries of certain events, matters and documents. Such descriptions and summaries do not purport to be complete and all such descriptions, summaries and references thereto are qualified in their entirety by reference to this Official Statement in its entirety and to each such document, copies of which may be obtained from the Authority or from the Co-Financial Advisors to the Authority. Any statements made in this Official Statement or the appendices hereto involving matters of opinion or estimates, whether or not so expressly stated, are set forth as such and not as representations of fact, and no representation is made that any of such opinions or estimates will be realized.

Neither the Authority nor the Underwriters make any representations as to the accuracy, completeness, or adequacy of the information supplied by The Depository Trust Company for use in this Official Statement. The Underwriters have provided the following sentence for inclusion in this Official Statement. The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their respective responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

This Official Statement contains “forward-looking” statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which generally can be identified with words or phrases such as “anticipates,” “believes,” “could,” “estimates,” “expects,” “foresees,” “may,” “plan,” “predict,” “should,” “will” or other words or phrases of similar import. All statements included in this Official Statement that any person expects or anticipates will, should or may occur in the future are forward-looking statements. These statements are based on assumptions and analyses made in light of experience and perceptions of historical trends, current conditions and expected future developments as well as other factors the Authority believes are appropriate in the circumstances. However, whether actual results and developments conform with expectations and predictions is subject to a number of risks and uncertainties, including, without limitation, the information discussed under “Investment Considerations” in this Official Statement, as well as additional factors beyond the Authority’s control. The important risk factors and assumptions described under that caption and elsewhere herein could cause actual results to differ materially from those expressed in any forward-looking statement. All of the forward-looking statements made in this Official Statement are qualified by these cautionary statements.

This Official Statement is delivered in connection with the sale of securities referred to herein and may not be produced or used, in whole or in part, for any other purposes. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of the Series 2008 Bonds in any jurisdiction in which it is unlawful to make such offer, solicitation or sale. No dealer, salesman or other person has been authorized by the Authority to give any information or to make any representation other than those contained herein, and, if given or made, such other information or representation must not be relied upon as having been authorized by the Authority or any other person.

The prices and other terms respecting the offering and sale of the Series 2008 Bonds may be changed from time to time by the Underwriters after the Series 2008 Bonds are released for sale, and the Series 2008 Bonds may be offered and sold at prices other than the initial offering prices, including sales to dealers who may sell the Series 2008 Bonds into investment accounts.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER ALLOT OR EFFECT TRANSACTIONS THAT STABILIZE OR MAINTAIN THE MARKET PRICES OF THE SERIES 2008 BONDS AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

THE COVER PAGE CONTAINS CERTAIN INFORMATION FOR GENERAL REFERENCE ONLY AND IS NOT INTENDED AS A SUMMARY OF THIS OFFERING. INVESTORS SHOULD READ THE ENTIRE OFFICIAL STATEMENT, INCLUDING ALL ATTACHED APPENDICES, TO OBTAIN INFORMATION ESSENTIAL TO MAKING AN INFORMED INVESTMENT DECISION.

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## PRELIMINARY OFFICIAL STATEMENT

**\$241,160,000\***

### **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY Senior Lien Revenue Bonds, Series 2008**

#### INTRODUCTION

This Official Statement provides certain information in connection with the offer and sale by the North Harris County Regional Water Authority (the “*Authority*”) of its Senior Lien Revenue Bonds, Series 2008 (the “*Series 2008 Bonds*”). The Series 2008 Bonds are being issued pursuant to a Master Resolution adopted by the Board of Directors (the “*Board*”) of the Authority on May 19, 2003 (the “*Master Resolution*”) and a Third Supplemental Resolution to the Master Resolution adopted by the Board on July 7, 2008 (the “*Third Supplemental Resolution*”) and, together with the Master Resolution, the “*Resolutions*”).

The Authority is a special purpose political subdivision of the State of Texas created by chapter 1209, Acts of the 76<sup>th</sup> Legislature of Texas, Regular Session (1999), as amended (the “*Act*”). The Authority was created over an approximately 338 square mile, largely suburban area north of and adjacent to Houston, Texas, to reduce the area’s use of groundwater by, and to supply treated surface water to, 156 municipal, non-profit, and investor-owned entities (collectively, the “*Retail Utilities*”) that operate retail water utility systems in the area, and 95 industrial, commercial, recreational, and other institutional well owners (the “*Private Well Owners*”). To date, approximately 149 of such 156 Retail Utilities own water wells and are therefore subject to the Authority’s imposition of Pumpage Fees (as hereinafter defined), as described herein. Owners of water wells in the area (with certain exceptions) have been ordered by the Harris-Galveston Coastal Subsidence District (the “*Subsidence District*”) to convert to at least 30% alternate source (e.g., surface) water use beginning in 2010, 70% alternate source water use beginning in 2020, and 80% alternate source water use beginning in 2030. To enable the area to convert, the Authority has entered into a Water Supply Contract (the “*Supply Contract*”) with the City of Houston, Texas (the “*City of Houston*” or the “*City*”) to secure a long-term supply of treated surface water from the City, and the Authority has begun acquisition and construction of a network of facilities (the “*System*”) to convey purchased water to, and produce additional water for, the Retail Utilities and Private Well Owners. The Supply Contract extends for a 40-year term, for an additional 20-year extension term at the Authority’s option, and thereafter on reasonable terms in perpetuity. See “THE AUTHORITY” and “CAPITAL IMPROVEMENTS” herein. See Appendix B for a list of the Retail Utilities that own water wells and therefore pay Pumpage Fees.

The Series 2008 Bonds are being issued (1) to finance the design, acquisition, and construction of regional water production, transmission, pumping, storage, distribution, and administrative facilities and related realty interests, (2) to fund a debt service reserve fund or surety bond for the Series 2008 Bonds and parity obligations, (3) to fund approximately 24 months of capitalized interest, and (4) to pay costs of issuance of the Series 2008 Bonds. See “ESTIMATED SOURCES AND USES OF FUNDS” herein.

The Series 2008 Bonds are limited obligations of the Authority payable solely from and to the extent of its Net Revenues. The Net Revenues consist primarily of collections of groundwater pumpage and water import fees (“*Pumpage Fees*”) currently imposed by the Authority and future water sale revenues (“*Water Revenue*”) remaining after payment of the Authority’s maintenance and operating expenses. See “SECURITY AND SOURCE OF PAYMENT” herein. The Authority has previously issued its Senior Lien Revenue Bonds, Series 2003 and Senior Lien Revenue Bonds, Series 2005, payable from an equal and ratable lien on Net Revenues, of which \$218,560,000 principal amount remains outstanding (the “*Outstanding Bonds*”). In addition, the Master Resolution provides for the issuance by the Authority of additional parity obligations, which together with the Outstanding Bonds and the Series 2008 Bonds are referred to herein as “*Senior Lien Obligations*.” Senior Lien Obligations may be issued as “*Parity Bonds*”, “*Parity Obligations*” and “*Parity Credit Agreements*.” See “SECURITY AND SOURCE OF PAYMENT – Additional Senior Lien Obligations” herein.

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\* Preliminary; subject to change.

Scheduled payments of principal of and interest on the Series 2008 Bonds may be insured under a policy of municipal bond insurance to be issued by a “Aaa/AAA”-rated insurance company simultaneously with delivery of the Series 2008 Bonds. Applications for bond insurance are pending. Moody’s Investors Service, Inc. and Standard & Poor’s Rating Services have assigned underlying ratings of “\_\_” and “A+,” respectively to the Series 2008 Bonds. See “BOND INSURANCE” and “RATINGS” herein.

Descriptions of the Series 2008 Bonds, the Authority, the Supply Contract, and the Resolutions are included in this Official Statement. Certain terms used herein are defined in Appendix C. References herein to the Series 2008 Bonds and the Resolutions are qualified in their entirety by reference to the Resolutions and the form of the Series 2008 Bonds included therein. The Authority’s financial statements for its fiscal year ended December 31, 2007, are included in Appendix A to this Official Statement.

## **THE SERIES 2008 BONDS**

### **General**

The Series 2008 Bonds are dated as of August 15, 2008 and will mature on December 15 of the years and in the principal amounts, and will bear interest from the date of delivery, at the rates specified on the cover page. Interest on the Series 2008 Bonds will be payable on each June 15 and December 15, commencing December 15, 2008. Interest will be calculated on the basis of a 360-day year of twelve 30-day months.

The Series 2008 Bonds will be issuable only in book-entry form, in denominations of \$5,000 and integral multiples of \$5,000, through the facilities of The Depository Trust Company. See “Book-Entry-Only System” herein.

The Authority has appointed Wells Fargo Bank, N.A., as its Paying Agent (the “*Paying Agent*”) to register ownership of and make the payments on the Series 2008 Bonds.

### **Redemption**

***Mandatory Sinking Fund Redemption.*** If any Series 2008 Bonds are issued as term bonds, they will be subject to mandatory sinking fund redemption by the Authority on December 15 of the years and in the principal amounts specified on the cover page in which serial Series 2008 Bonds do not mature, at a redemption price equal to 100% of the principal amount.

The principal amount of such term Series 2008 Bonds, if any, to be redeemed on any such date may be reduced by the principal amount of such term Series 2008 Bonds which, by the 45<sup>th</sup> day prior to such date, either have been purchased in the open market and tendered by or on behalf of the Authority to the Paying Agent for cancellation or redeemed at the option of the Authority and which, in either case, have not previously been made the basis for a reduction under this sentence.

***Optional Redemption.*** The Series 2008 Bonds due on or after December 15, 2019, are subject to redemption at the option of the Authority on any date on or after December 15, 2018, at a redemption price equal to 100% of principal amount plus accrued interest.

***Redemption Procedures.*** Notice of redemption must be sent not less than 30 days before the date fixed for redemption. If notice of redemption is given and due provision is made for the payment of the redemption price of the Series 2008 Bonds called for redemption, the Series 2008 Bonds called for redemption will become due and payable on the date fixed for redemption and such Series 2008 Bonds will not bear interest after such date.

### **Payment Record**

The Authority has never defaulted in the timely payment of any previously issued bonds.

### **Source of Payment**

The Series 2008 Bonds are being issued as Senior Lien Obligations consisting of Parity Bonds under the Resolutions. The Series 2008 Bonds are limited obligations of the Authority payable solely from, and secured

(together with the Outstanding Bonds and any future Parity Bonds, Parity Notes, and Parity Obligations) by a lien on and pledge of, Net Revenues, which consist of Gross Revenues collected and received by the Authority less Operation and Maintenance Expenses, as described herein. See “Security and Source of Payment” herein. The Series 2008 Bonds are obligations solely of the Authority and are not obligations of the State of Texas, the City of Houston, Harris County, any of the Retail Utilities or Private Well Owners, or any other entity other than the Authority. The Series 2008 Bonds do not constitute a general obligation of the Authority and are not payable from funds raised or to be raised by taxation. The Authority has no taxing power. See “SECURITY AND SOURCE OF PAYMENT” herein.

### **Authority for Issuance**

The Series 2008 Bonds are being issued pursuant to the Act, Chapter 1371, Texas Government Code, as amended, and the Resolutions.

### **Paying Agent**

The initial Paying Agent is Wells Fargo Bank, N.A. If the date for the payment of the principal of or interest on the Series 2008 Bonds is a Saturday, Sunday, a legal holiday or a day when banking institutions in the city where the Paying Agent is located are authorized to close, then the date for such payment will be the next succeeding day which is not such a day, and payment on such date will have the same force and effect as if made on the date payment was due.

The Authority covenants that until the Series 2008 Bonds are paid it will at all times maintain and provide a Paying Agent. In the Resolutions, the Authority retains the right to replace the Paying Agent. Any successor Paying Agent selected by the Authority must be a bank, trust company, financial institution or other entity duly qualified and legally authorized to serve and perform the duties of Paying Agent for the Series 2008 Bonds.

### **BOOK-ENTRY-ONLY SYSTEM**

*The information in this section concerning DTC and DTC’s book-entry system has been obtained from sources that the Authority believes to be reliable, but the Authority takes no responsibility for the accuracy or completeness thereof. The Authority cannot and does not give any assurances that DTC, DTC Direct Participants or Indirect Participants will distribute to the Beneficial Owners (a) payments of interest, principal or premium, if any, with respect to the Bonds, (b) Bonds representing ownership interest in or other confirmation or ownership interest in the Bonds, or (c) prepayment or other notices sent to DTC or Cede & Co., its nominee, as the registered owner of the Bonds, or that they will so do on a timely basis or that DTC, DTC Direct Participants or DTC Indirect Participants will act in the manner described in this Official Statement. The current “Rules” applicable to DTC are on file with the Securities and Exchange Commission and the current “Procedure” of DTC to be followed in dealing with DTC Direct Participants are on file with DTC.*

### **General**

The Depository Trust Company (“DTC”), New York, NY, will act as securities depository for the Bonds. The Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond certificate will be issued for each maturity of the Bonds, in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world’s largest depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-

entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com) and [www.dtc.org](http://www.dtc.org).

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC's records. The ownership interest of each actual purchaser of each Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to DTC. If less than all of the Bonds within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to Bonds unless authorized by a Direct Participant in accordance with DTC's MMI Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Authority (or the Paying Agent on behalf thereof) as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal, premium, if any, interest payments and redemption proceeds on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Authority or Paying Agent, on payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Paying Agent, or the Authority, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, premium, if any, interest payments and redemption proceeds to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Authority or the Paying Agent, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as depository with respect to the Bonds at any time by giving reasonable notice to the Authority or the Paying Agent. Under such circumstances, in the event that a successor depository is not obtained, Bond certificates are required to be printed and delivered.

The Authority may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Bond certificates will be printed and delivered.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that the Authority believes to be reliable, but the Authority takes no responsibility for the accuracy thereof.

### **Limitations**

For so long as the Series 2008 Bonds are registered in the name of DTC or its nominee, Cede & Co., the Authority and the Paying Agent will recognize only DTC or its nominee, Cede & Co., as the registered owner of the Series 2008 Bonds for all purposes, including payments, notices and voting.

Because DTC is treated as the registered owner of the Series 2008 Bonds for substantially all purposes under the Resolutions, Beneficial Owners may have a restricted ability to influence in a timely fashion remedial action or the giving or withholding of requested consents or other directions. In addition, because the identity of Beneficial Owners is unknown to the Authority, to DTC or to the Paying Agent, it may be difficult to transmit information of potential interest to Beneficial Owners in an effective and timely manner. Beneficial Owners should make appropriate arrangements with their broker or dealer regarding distribution of information regarding the Series 2008 Bonds that may be transmitted by or through DTC.

Payments made by the Paying Agent to DTC or its nominee will satisfy the Authority's obligations, whether or not such payments are credited to Beneficial Owners.

Neither the Authority nor the Paying Agent will have any responsibility or obligation with respect to: (i) the accuracy of the records of DTC, its nominee or any DTC Participant or Indirect Participant with respect to any beneficial ownership interest in any Series 2008 Bonds; (ii) the delivery to any DTC Participant or Indirect Participant or any other Person, other than a registered owner, of any notice or other document, including, without limitation, any notice of redemption with respect to any Bond; (iii) the payment to any DTC Participant or Indirect Participant or any other Person, other than a registered owner, of any amount with respect to the principal of, premium, if any, interest on, or redemption price of any Series 2008 Bond; (iv) the selection of the Beneficial Owners to receive payment in the event of any partial redemption of the Series 2008 Bonds; or (v) any consent given or other action taken by DTC as registered owner.

Prior to any discontinuation of the book-entry system with respect to the Series 2008 Bonds, the Authority and the Paying Agent may treat DTC as, and deem DTC to be, the absolute owner of the Series 2008 Bonds for all purposes whatsoever, including, without limitation, (i) the payment of principal, premium, if any, and interest on Series 2008 Bonds; (ii) giving notices of redemption and other matters with respect to the Series 2008 Bonds; (iii) registering transfers with respect to the Series 2008 Bonds; and (iv) the selection of Series 2008 Bonds for redemption.

## **SECURITY AND SOURCE OF PAYMENT**

### **Limited Obligations**

The Series 2008 Bonds are limited obligations of the Authority payable solely from and to the extent of Net Revenues of the Authority, which consist of Gross Revenues (including revenues received by the Authority from the Retail Utilities and Private Well Owners as Pumpage Fees and System revenues) less Operation and Maintenance Expenses. For definitions of "*Net Revenues*," "*Gross Revenues*," "*System*" and "*Operation and Maintenance Expenses*", see Appendix C.

Initially, the principal source of Gross Revenues is expected to be the Pumpage Fees. The Pumpage Fee is assessed annually by the Board and is subject to modification or amendment at any time. The Authority currently bills and collects Pumpage Fees quarterly. For more than three years ending September 30, 2003, the Pumpage Fee was assessed at a rate of \$.25 per 1,000 gallons of water pumped from certain wells located within or imported into

the Authority by the Retail Utilities and the Private Well Owners. The Pumpage Fee has been increased periodically since 2003, and, effective October 1, 2007, the Pumpage Fee was increased to \$.99 per 1,000 gallon. At this time only a limited amount of water charges or System use fees are being charged or collected, because the System has not yet been completed and (except for small amounts of water purchased from the City and resold to one Retail Utility under an interim water supply contract) the Authority does not have rights to the present delivery of treated surface water. The water charges and System use fees currently being charged and collected are the result of a groundwater transfer program within the Authority's boundaries. See "FINANCIAL DATA—Groundwater Transfer Program" herein. Beginning in 2010, when the initial phase of the System is linked to City surface water supply, the Authority will purchase treated water from the City of Houston and sell such water to and collect System revenues from the Retail Utilities and Private Well Owners, while continuing to collect Pumpage Fees from the Retail Utilities and Private Well Owners pumping groundwater from covered wells located within the Authority or importing water into the Authority.

As additional security for the Series 2008 Bonds, a Reserve Fund and a Coverage Fund have been established. The Master Resolution provides that the Reserve Fund Requirement may be satisfied with cash, a Reserve Fund Obligation (as defined in the Master Resolution) or a combination thereof. See "— Reserve Fund", "BOND INSURANCE" and Appendix C. At the time of delivery of the Series 2008 Bonds, the Reserve Fund balance is expected to be increased by either the deposit of Series 2008 Bond proceeds or the purchase of a Reserve Fund Obligation from the bond insurer, if any, selected to insure payment of principal and interest on the Series 2008 Bonds in an amount equal to the additional Reserve Fund Requirement resulting from the issuance of the Series 2008 Bonds. The Coverage Fund is funded from lawfully available funds of the Authority. At the time of delivery of the Series 2008 Bonds, the balance is expected to be equal to the Coverage Fund Requirement, taking into account the Series 2008 Bonds. See "— Reserve Fund" and "— Coverage Fund" for a description of the authorized uses and funding requirements of the Reserve Fund and Coverage Fund and for a discussion of the effect of recent surety bond provider ratings downgrades on the Reserve Fund.

### **Revenue Pledge**

The Series 2008 Bonds are secured (equally and ratably with the Outstanding Bonds and any future parity obligations) by a lien on and pledge of the Net Revenues of the Authority, which consist of Gross Revenues less Operation and Maintenance Expenses. See "Flow of Funds" following.

### **Flow of Funds**

The Resolutions provide that Gross Revenues must be deposited as collected into the Revenue Fund held by the Authority. In addition, amounts transferred from the Coverage Fund on the first business day of each calendar year shall be deposited to the credit of the Revenue Fund. See "Coverage Fund."

On or before the last Business Day of each month, money credited to the Revenue Fund must be applied in the following manner and in the following order of priority:

First, to pay Operation and Maintenance Expenses;

Second, to deposit moneys into the Interest and Sinking Fund at such times and in such amounts as required by the Master Resolution to provide for the payment of (i) the principal of, premium, if any, and interest on Senior Lien Obligations, (ii) to the extent not included in the amounts transferred pursuant to clause (i), the costs and amounts due and owing during the current fiscal year under any Parity Credit Agreements and (iii) any related bank charges or other costs and expenses incurred in the current fiscal year;

Third, to deposit moneys into the Reserve Fund at such times and in such amounts as required by the Master Resolution to restore any deficiency in the balance of the Reserve Fund compared to the Reserve Fund Requirement (whether such deficiency results from a decrease in the market value of investments or a disbursement of funds to pay the principal or interest on Senior Lien Obligations);

Fourth, to deposit moneys into the Coverage Fund (i) in the first month of each calendar year to the extent sufficient funds are available in the Revenue Fund, an amount equal to the Coverage Fund Requirement and (ii) if required, in each succeeding month, an amount equal to one-twelfth (1/12) of the

Coverage Fund Requirement until either (a) the Coverage Fund Requirement has been re-established in the Coverage Fund or (b) the funds on deposit in the Coverage Fund are transferred to the Revenue Fund on the first Business Day of a calendar year;

Fifth, to make all deposits and transfers (including any required reserves therefor) as may be required by any order or resolution of the Authority authorizing the issuance of Junior Lien Obligations in order to provide for the payment of and security for such Junior Lien Obligations;

Sixth, to deposit moneys into the Operation and Maintenance Reserve Fund (if the money and the market value of investments in the Operation and Maintenance Reserve Fund is less than the Operation and Maintenance Reserve Requirement for the current fiscal year), (i) in an amount sufficient to re-establish the Operation and Maintenance Reserve Requirement, or (ii) if the deficiency resulted from a requisition of funds, in an amount equal to 1/6<sup>th</sup> of the deficiency caused by the requisition until the Operation and Maintenance Reserve Requirement is satisfied;

Seventh, to make all deposits and transfers (including any required reserves therefor) as may be required by any order or resolution of the Authority authorizing the issuance of Subordinate Lien Obligations in order to provide for the payment of and security for such Subordinate Lien Obligations; and

Eighth, on or before the last day of each fiscal year, all remaining Net Revenues shall be deposited into the Improvement Fund for use in accordance with the Resolutions.

## **Reserve Fund**

The Master Resolution establishes a Reserve Fund to secure and provide for the payment of principal of and interest on Senior Lien Obligations, including the Series 2008 Bonds, whenever the amounts on deposit in the Interest and Sinking Fund and the Coverage Fund are insufficient for such purposes.

The Master Resolution provides for the maintenance of an amount equal to the Reserve Fund Requirement in the Reserve Fund. The Reserve Fund Requirement may consist of money, one or more Reserve Fund Obligations or a combination thereof. If the market value of money and investments (together with any Reserve Fund Obligations) in the Reserve Fund is reduced below the Reserve Fund Requirement because of a decrease in market value of investments, the Authority must deposit Net Revenues into the Reserve Fund in an amount sufficient to restore the Reserve Fund to the Reserve Fund Requirement in the next month. If the Reserve Fund is used to pay the principal of or interest on the Senior Lien Obligations because of insufficient amounts being available in the Interest and Sinking Fund, the Authority must restore the Reserve Fund to the Reserve Fund Requirement by depositing Net Revenues into the Reserve Fund in equal payments (beginning with the first month following the occurrence of a deficiency) to restore any deficiency in the Reserve Fund Requirement in not more than twelve (12) months (or such shorter period as may be established by any Supplemental Resolution). If the Reserve Fund Requirement increases as a result of the issuance of additional Senior Lien Obligations, the balance of the Reserve Fund must be increased to the new Reserve Fund Requirement at the time of issuance.

A Reserve Fund Obligation may be substituted by the Authority at any time and from time to time in lieu of all or any part of the money and/or investments held for (or required to be held for) the credit of the Reserve Fund, and such money and/or investments may be withdrawn and used for any lawful purpose. If a Reserve Fund Obligation is used as provided above, any reimbursements required thereunder to be paid to a Credit Agreement Provider as a result of a draw or demand thereunder and any interest thereon and expenses payable thereunder shall be made, as provided in the Reserve Fund Obligation, from moneys deposited into the Reserve Fund until fully paid.

The Master Resolution provides that, in the event the insurer strength rating of the provider of a Reserve Fund Obligation satisfying the Reserve Fund Requirement falls below "AAA" (but not below "A"), the Authority must either: (i) deposit into the Reserve Fund cash sufficient to cause money in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the ensuing five years in equal installments at least semi-annually, or (ii) replace the surety bond with another surety bond, insurance policy, or letter of credit issued by an adequately rated provider within six months of such downgrade. The Master Resolution further provides that in the event the insurer strength rating of the provider of a Reserve Fund Obligation satisfying the Reserve Fund Requirement falls below "A," the Authority must either: (i) deposit into the Reserve Fund cash sufficient to cause the money in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the

ensuing year in equal installments on at least a monthly basis, or (ii) replace such instrument with a surety bond, insurance policy, or letter of credit issued by an adequately rated provider within six months of such occurrence.

The Authority obtained a Reserve Fund Obligation from Financial Guaranty Insurance Company (“*FGIC*”) in the amount of \$9,079,000 in connection with the issuance of the Outstanding Series 2003 Bonds and a Reserve Fund Obligation from MBIA Insurance Company (“*MBIA*”) in the amount of \$6,587,118.76 in connection with the issuance of Outstanding Series 2005 Bonds. At the times of the issuance of the Outstanding Series 2003 Bonds and the Outstanding Series 2005 Bonds, both *FGIC* and *MBIA* held insurer strength ratings of “AAA,” as rated by two nationally recognized statistical rating organizations, Standard & Poor’s Ratings Services (“*S&P*”) and Moody’s Investors Service (“*Moody’s*”).

Beginning in late February 2008, *FGIC*’s “AAA” insurer strength rating was downgraded several times by both *S&P* and *Moody’s*. On March 26, 2008, *FGIC*’s rating fell below an “A” rating. *FGIC* currently has an insurer strength rating of “BB” from *S&P* and, on June 6, 2008, was placed on CreditWatch with negative implications. *FGIC* currently has an insurer strength rating from *Moody’s* of “B1” with a negative outlook. On June 5, 2008, *S&P* downgraded *MBIA* from “AAA” to “AA” and placed *MBIA* on CreditWatch Negative. On June 19, 2008 *Moody’s* downgraded *MBIA* from “Aaa” to “A2” with a negative outlook. (See <http://www.fgic.com> for the rating assigned to *FGIC* and <http://www.mbia.com> for the rating assigned to *MBIA* by *S&P* and *Moody’s*, as such ratings may change from time to time). As a result of these downgrades, the Authority is required to fund the Reserve Fund Requirement through one of the alternatives described above.

The Authority has recently completed an analysis of these alternatives and has determined to fund the Reserve Fund Requirement with respect to the Outstanding Series 2003 Bonds and the Outstanding Series 2005 Bonds with legally available funds on hand. As required by the Master Resolution, that portion of the Reserve Fund Requirement applicable to the Outstanding Series 2003 Bonds will be funded over the ensuing year in equal installments on a monthly basis with the first monthly payment made in June, 2008. That portion of the Reserve Fund Requirement applicable to the Outstanding Series 2005 Bonds will be funded over the ensuing five years in equal semi-annual installments with the first semi-annual payment to be made in 2008. Despite the requirement that the Authority fund the Reserve Fund Requirement applicable to the Outstanding Series 2003 Bonds and the Outstanding Series 2005 Bonds, both the *FGIC* Reserve Fund Obligation and the *MBIA* Reserve Fund Obligation remain in effect and are available to secure and provide for the payment of principal of and interest on the Senior Lien Obligations.

The balance of the Reserve Fund Requirement at the time of the issuance of the Series 2008 Bonds is expected to be funded initially by either the deposit of Series 2008 Bond proceeds or the purchase of a Reserve Fund Obligation from the bond insurer, if any, selected to insure payment of principal of and interest on the Series 2008 Bonds. See “BOND INSURANCE.”

### **Coverage Fund**

The Master Resolution provides for the transfer from the Revenue Fund to the Coverage Fund of (i) on or before the last Business Day of the month in which any series or installment of Senior Lien Obligations is issued and after making all prior transfers from the Revenue Fund, an amount equal to the Coverage Fund Requirement (to the extent sufficient funds are available in the Revenue Fund for such transfer) and (ii) if required, in each succeeding month, an amount equal to one-twelfth (1/12) of the Coverage Fund Requirement until (a) the Coverage Fund Requirement has been established in the Coverage Fund or (b) the transfer of funds on the first Business Day of the calendar year occurs, as described in the next paragraph.

On the first Business Day of each calendar year, an amount equal to the Coverage Fund Requirement (or so much thereof as shall be on deposit in the Coverage Fund) must be transferred to the Revenue Fund from the Coverage Fund. Thereafter, on or before the last Business Day of the first month in each calendar year and after making all prior transfers from the Revenue Fund, an amount equal to the Coverage Fund Requirement must be transferred from the Revenue Fund to the Coverage Fund to the extent funds are available in the Revenue Fund for such purpose. If required, in each succeeding month of the calendar year an amount equal to one-twelfth (1/12) of the Coverage Fund Requirement must be transferred from the Revenue Fund to the Coverage Fund until the Coverage Fund Requirement has been re-established in the Coverage Fund.

If funds on deposit in the Interest and Sinking Fund are insufficient to pay the principal of and interest on Senior Lien Obligations as such principal and interest becomes due and payable, amounts in the Coverage Fund shall be transferred to the Interest and Sinking Fund to the extent required to pay such principal and interest.

### **Rate Covenant**

In the Master Resolution, the Authority covenants and agrees that it will fix, establish, maintain and collect Gross Revenues (after taking into consideration any capital contribution credits and other credits that the Authority may grant from time to time) sufficient:

- (1) to pay all current Operation and Maintenance Expenses;
- (2) to produce either (A) Net Revenues for each Fiscal Year at least equal to 110% of the Annual Debt Service Requirements for all Outstanding Senior Lien Obligations for the Fiscal Year or (B) Adjusted Net Revenues for each Fiscal Year at least equal to 120% of the Annual Debt Service Requirements for all Outstanding Senior Lien Obligations for the Fiscal Year;
- (3) to produce Adjusted Net Revenues for each Fiscal Year in an amount sufficient to pay all debt service on Senior Lien Obligations actually coming due during such Fiscal Year; and
- (4) to pay all other obligations of the System reasonably expected to be paid from Net Revenues.

“Adjusted Net Revenues” consist of Net Revenues plus the amounts on deposit in the Coverage Fund and the Improvement Fund on the last day of the Fiscal Year.

The Master Resolution provides that compliance with the rate coverage requirement described in clause (2) above will be measured each year and confirmed in a schedule prepared by the Authority and attached to the Authority’s audited financial statements. The Master Resolution further provides that, not later than the sixtieth (60th) day following the receipt by the Board of the Authority’s audited financial statements for a fiscal year in which the Authority has failed to satisfy the rate coverage requirement, the Authority shall appoint an Independent Rate Consultant to make recommendations to ensure compliance with the rate coverage requirement and the rate covenant. As long as the Independent Rate Consultant’s recommendations are implemented and administered by the Authority, no default will result solely from a failure by the Authority to satisfy the rate coverage requirement or the rate covenant.

### **Other Covenants**

In addition to the rate covenant described under the preceding caption, the Master Resolution contains certain other covenants which are summarized in Appendix C – “Excerpts of Certain Provisions of the Resolutions – Section 5.1 General Covenants.”

### **Additional Senior Lien Obligations**

In the Master Resolution, the Authority reserves the right to issue, execute and deliver additional Senior Lien Obligations (including Parity Bonds, Parity Obligations and Parity Credit Agreements) for any purpose authorized by law, subject to conditions described in Appendix C, including compliance with a historical or pro forma debt service coverage ratio. Such Senior Lien Obligations, if and when authorized, issued and delivered in accordance with the Master Resolution, shall be secured by and made payable equally and ratably on a parity with all Outstanding Senior Lien Obligations (including the Series 2008 Bonds) from an irrevocable lien on and pledge of the Net Revenues. In order to comply with the conditions in the Master Resolution for issuing the Series 2008 Bonds, the Authority transferred approximately \$9 million from the Improvement Fund to the Coverage Fund in December 2007. Following such transfer, the balance in the Coverage Fund was approximately \$46 million. See Appendix C – “Excerpts of Certain Provisions of the Master Resolution – Section 3.4 Issuance of Senior Lien Obligations; Additional Senior Lien Obligations.”

## **Defeasance**

The Master Resolution provides for the termination of the pledge and lien on the Net Revenues arising under the Master Resolution upon payment in full of all Senior Lien Obligations (including the Series 2008 Bonds and such Parity Bonds, Parity Obligations and Parity Credit Agreements as may be issued pursuant to the Master Resolution from time to time). Provision for the payment of Senior Lien Obligations may be made in accordance with the Master Resolution by depositing money or investments (or a combination thereof) in a special fund established for such purpose. See Appendix C – “Excerpts of Certain Provisions of the Master Resolution – Section 7.1 Discharge of Lien” and “ – Section 7.2 Provision for Payment of Senior Lien Obligations” for information concerning the provisions of the Master Resolution relating to the discharge and defeasance of Senior Lien Obligations, including the Series 2008 Bonds.

## **Bondholder’s Remedies**

The Resolutions make no provision for the acceleration of maturity of any Series 2008 Bond or appointment of (or possession of Gross Revenues or possession or operation of the System by) a trustee or other agent for owners of the Series 2008 Bonds in the event of default.

No lien has been created on the physical properties comprising the System to secure payment of principal of or interest on the Series 2008 Bonds. Moreover, in the event of default, the owners of Series 2008 Bonds have no right or claim under the laws of the State against the System or any property of the Authority other than their right to payment from Gross Revenues collected (after payment of Operation and Maintenance Expense) and certain funds pledged pursuant to the Resolutions. Accordingly, the only practical remedy in the event of default may be a mandamus or mandatory injunction proceeding to compel the Authority to increase rates and charges or to perform its other obligations under the Resolutions. Such remedy may need to be enforced on a periodic basis because maturity of the Series 2008 Bonds is not subject to acceleration. In addition, even if rates and charges are increased, the amount of revenues generated would depend upon usage of the System or pumpage of groundwater by third parties, which is beyond the control of the Authority.

The enforcement of a claim for payment of principal of or interest on any Series 2008 Bonds and the Authority’s other obligations with respect to such Series 2008 Bonds is subject to the applicable provisions of the federal bankruptcy laws and to any other similar laws affecting the rights of creditors of political subdivisions generally.

As long as any Bond Insurer has not defaulted in its payment obligations under its Bond Insurance Policy insuring a portion of the Senior Lien Obligations, such Bond Insurer shall have all the rights granted to the Owners of such Senior Lien Obligations in the Resolutions (and no consent of the Owners shall be required in the exercise by the Bond Insurer of such rights). See Appendix C – “Excerpts of Certain Provisions of the Master Resolution – Section 5.3 Owners’ Rights and Remedies.”

## **Amendments to Resolutions**

Under certain circumstances, the Authority may amend the Resolutions without the consent of or notice to registered owners of Senior Lien Obligations. In addition, the Authority may, with the written consent of the owners of a majority in aggregate principal amount of the Outstanding Parity Bonds and Parity Obligations then outstanding affected thereby, amend, add to, or rescind any of the provisions of the Resolutions. See Appendix C – “Excerpts of Certain Provisions of the Master Resolution – Section 6.1 Amendments to Master Resolution not Requiring Consent of Owners,” “ – Section 6.2 Amendments to Resolutions Requiring Consent of Owners” and “ – Section 6.3 Amendments, Changes and Modifications to Credit Agreements” for information concerning the right of the Authority to amend the Resolutions.

## **BOND INSURANCE**

Scheduled payments of principal of and interest on the Series 2008 Bonds may be insured under a policy of municipal bond insurance to be issued by a “Aaa/AAA”-rated insurance company simultaneously with delivery of the Series 2008 Bonds. Applications for bond insurance are pending.

**ESTIMATED SOURCES AND USES OF FUNDS**

The following table summarizes the estimated sources and uses of funds to effect the projects being financed by the Series 2008 Bonds. Construction and acquisition costs were estimated by the Authority’s consulting engineers.

**Sources:**

Principal amount of Series 2008 Bonds	\$241,160,000
Original issue premium (net of discount)	
Capital contributions from Retail Utilities	<u>38,000,000</u>
Total Sources of Funds	\$279,160,000

**Uses:**

Design and construction of and related realty interests for	
2010 Conversion Facilities	\$162,030,000
2020 Conversion Facilities	13,980,000
Raw Water Payment	21,800,000
Additional Treatment and Line Capacity	14,880,000
Other Project Related Costs	<u>11,810,000</u>
Sub Total	\$224,500,000
Reserve Fund	
Capitalized interest (24 months)	
Costs of issuance, including any insurance premium, reserve fund surety bond premium, and underwriters’ discount	
	_____
Total Uses of Funds	<u>\$279,160,000</u>

**THE AUTHORITY**

**General**

The Authority is a special purpose political subdivision of the State of Texas created in 1999 by the Act. The Authority has jurisdiction over an approximately 338 square mile, largely suburban area located in northern Harris County, Texas, adjacent to the City of Houston, Texas. The Authority’s area is shown on the map included in Appendix F. The Authority was created to assist the area in converting from groundwater to surface water use in accordance with a mandate imposed by the Subsidence District. See “Capital Improvements – Groundwater Reduction Mandate” herein.

**Powers**

The Authority has statutory power to conserve, preserve, protect, recharge and prevent waste of groundwater including, but not limited to, the power to acquire or develop surface water supplies; to acquire, construct, operate, and maintain a water treatment or supply system; to store, transport, treat, and sell water to others; to allocate water among participants in its groundwater reduction plan; to coordinate water services; and to exercise the power of eminent domain. The Authority is also empowered to establish and enforce a mandatory groundwater reduction plan. The plan may require reduced usage of groundwater by specified dates and identify the rates, terms, and conditions under which alternative sources of water will be provided. The Authority may also adopt rules regarding its water supply and groundwater reduction plan, establish fees and charges as described herein, and impose special assessments on defined areas that specially benefit from an improvement project or service.

**Ratemaking Authority**

The Authority has power to establish fees, rates, and charges (and to classify fee and rate-payers) as necessary to enable the Authority to achieve its purposes and fulfill its regulatory function. The Authority may impose fees, rates and charges on any person within the Authority, including governmental units. The Authority is expressly authorized to charge the owners of wells within the Authority a fee based on water pumped, except for

wells that serve a single-family dwelling, injection wells regulated under Chapter 27, Texas Water Code, wells used for the irrigation of agricultural crops, wells that produce 5 million gallons or less annually, and wells used solely for electric generation. The Authority may also exempt by rule classes of wells from payment of such fees. In addition to the classes of well exempted by the Act, the Authority has exempted by rule wells within the Authority that are owned by a municipality that does not provide service to customers within the boundaries of the Authority and wells that are not subject to the groundwater reduction requirements imposed by the Subsidence District. The Subsidence District currently exempts certain wells served by windmills, monitoring wells, lechate wells and dewatering wells. The Authority's power to impose groundwater pumpage fees is dependent on the continued application of the Subsidence District's groundwater reduction requirements to wells within the Authority's boundaries. The Authority also has the statutory power to impose fees and charges for the importation of water into the Authority's boundaries from a source located outside the Authority's boundaries. The Authority may also establish and charge rates for water purchased from the Authority. The Authority may establish fees, rates, and charges that are sufficient to achieve water conservation, discourage use of groundwater, implement a groundwater reduction plan, provide alternative water supplies, pay maintenance and operating expenses, pay debt service on Authority obligations, and satisfy related rate covenants.

In setting water rates, the Authority is bound by the legal requirements that such rates must be reasonable and that no free service may be allowed, except for facilities owned by the Authority. Rates for sales of water to the Retail Utilities are subject to the oversight jurisdiction of the Texas Commission on Environmental Quality (the "TCEQ"). Any Retail Utility or Private Well Owner may appeal to the TCEQ from Authority decisions that affect its water charges. Under Texas law, the TCEQ may not set a rate for the sale of water which is less than the amount required to meet the debt service requirements of the Authority.

**Judicial Validation of Authority**

By a final and unappealable judgment entered June 24, 2003, in a validation action brought by the Authority styled *In the Matter of North Harris County Regional Water Authority*, Cause No. 2003-26398, the District Court of Harris County, Texas, 234<sup>th</sup> Judicial District, determined that, among other authorized and valid powers and authority of the Authority, the Authority has the power and authority to issue public securities and to pledge and encumber all or any part of the Authority's revenues to secure payment of the Authority's public securities. The District Court further determined that expenditures of money for costs incurred in connection with the acquisition, construction and equipping of a surface water distribution system are legal and valid. The judgment also adjudged the GRP, the Master Resolution and the Authority's then effective rate order imposing Pumpage Fees to be legal and valid.

**Administration**

**Board of Directors.** The Authority is governed by a five-member Board of Directors. Directors are elected by the qualified voters within single member voting districts to four-year staggered terms in May of each even-numbered year. The current members and officers of the Board, their vocations, and their terms of office are as follows:

<u>Name</u>	<u>Office</u>	<u>Vocation</u>	<u>Term Expires</u>
Kelly P. Fessler	President	Software consultant	2012
Jim Pulliam	Vice President	Civil-structural designer	2012
Ron Graham	Secretary	State Farm insurance agent	2010
Al Rendl	Assistant Secretary	Retired oil & gas industry executive	2010
Lenox A. Sigler	Treasurer	Semi-retired; export sales/marketing	2010

Directors may be compensated up to \$150 per day, not to exceed \$7,200 per year, for their service.

**Management.** The Board has appointed Jimmie Schindewolf, P.E. as General Manager of the Authority. The General Manager is the Chief Administrative Officer of the Authority. The Board has delegated to the General Manager full authority to manage and operate the day-to-day affairs of the Authority, subject to orders of the Board. Mr. Schindewolf has served as General Manager since January 7, 2003. Before serving as General Manager, Mr. Schindewolf served as Project Director, Owner's Representative Team, for the construction of Reliant Stadium, Houston, Texas and Minute Maid Park, Houston, Texas and, earlier, as Chief of Staff to the Mayor of the City of

Houston and Director of Public Works and Engineering for the City of Houston, and as owner of a road paving and utility construction company.

**Employees.** The Authority has seven full-time employees in addition to the General Manager, including an engineering coordinator, a construction coordinator, a planning/GIS coordinator, a financial assistant, an executive assistant, a community relations coordinator, and a receptionist.

**Consultants.** The Authority contracts for services as follows:

**Engineer:** The Authority's consulting engineering/program manager is TCB Inc. The Authority has also engaged other firms for discrete design and planning projects.

**Auditor:** The Authority's financial statements for the fiscal year ended December 31, 2007, were audited by Null-Lairson, P.C., Certified Public Accountants. See Appendix A for copy of the Authority's audited financial statements.

**General Counsel:** Johnson Radcliffe Petrov & Bobbitt PLLC serves as the Authority's general counsel.

**Bond Counsel:** Andrews Kurth LLP and Johnson Radcliffe Petrov & Bobbitt PLLC serve as the Authority's co-bond counsel.

**Financial Advisor:** RBC Capital Markets Corporation and The GMS Group, L.L.C. serve as the Authority's co-financial advisors in connection with the issuance of bonds and other debt obligations.

**Operations:** The Authority has contracted with Severn Trent Environmental Services for operations and maintenance services for the Groundwater Transfer Program.

## **Annexation**

The Authority may annex territory within a city or district on petition of the governing body of the city or district, whether or not contiguous, if the Board determines that the annexation is feasible, practicable, and to the Authority's advantage, and that the Authority's System is or will be sufficient to supply surface water to the annexed territory without harming the Authority's existing territory. If the Board makes substantially the same findings, the Authority may also annex territory on petition of the landowner or a vote in the area to be annexed.

Under Texas law the unincorporated area within the Authority (including the area within Retail Utilities) may be annexed by the City of Houston or another city, if located within the city's extraterritorial jurisdiction, without the area's consent. When a city annexes a utility district, it generally must (i) take over all assets of the utility district, (ii) assume all debts, liabilities, and obligations of the utility district, and (iii) perform all functions and services of the utility district. The Act provides that no such annexation will affect the Authority's boundaries, contracts, or powers within the annexed territory, including the power to assess fees, rates, charges, and special assessments.

## **INVESTMENTS**

### **State Law Restrictions**

The Authority invests its investible funds in investments authorized by Texas law in accordance with written investment policies approved by the Board, a copy of which is available upon request. Both state law and the Authority's investment policies are subject to change.

Current Texas law authorizes the Authority to invest in: (1) obligations of the United States or its agencies and instrumentalities, (2) direct obligations of the State of Texas or its agencies and instrumentalities, (3) collateralized mortgage obligations directly issued by a federal agency or instrumentality of the United States, the underlying security for which is guaranteed by an agency or instrumentality of the United States, (4) other obligations, the principal of and interest on 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, (5)

obligations of states, agencies, counties, cities, and other political subdivisions of any state rated as to investment quality by a nationally recognized investment rating firm not less than A or its equivalent, (6) bonds issued, assumed, or guaranteed by the State of Israel, (7) certificates of deposit that are issued by a state or national bank domiciled in the State of Texas, a savings bank domiciled in the State of Texas, or a state or federal credit union domiciled in the State of Texas and are guaranteed or insured by the Federal Deposit Insurance Corporation or the National Credit Union Share Insurance Fund or are secured as to principal by obligations described in the preceding clauses or in any other manner and amount provided by law for Authority deposits, (8) fully collateralized repurchase agreements that have a defined termination date, are fully secured by obligations described in clause (1), and are placed through a primary government securities dealer or a financial institution doing business in the State of Texas, (9) securities lending programs if (i) the securities loaned under the program are collateralized, a loan made under the program allows for termination at any time and a loan made under the program is either secured by (a) obligations that are described in Clauses (1) through (6) above, (b) irrevocable letters of credit issued by a state or national bank that is continuously rated by a nationally recognized investment rating firm at not less than A or its equivalent or (c) cash invested in obligations described in clauses (1) through (6) above, clauses (11) through (13) below, or an authorized investment pool; (ii) securities held as collateral under a loan are pledged to the Authority and held in the Authority's name; (iii) a loan made under the program is placed through either a primary government securities dealer or a financial institution doing business in the State of Texas; and (iv) the agreement to lend securities has a term of one year or less, (10) certain bankers' acceptances with the remaining term of 270 days or less, if the short-term obligations of the accepting bank or its parent are rated at least A-1 or P-1 or the equivalent by at least one nationally recognized credit rating agency, (11) commercial paper with a stated maturity of 270 days or less that is rated at least A-1 or P-1 or the equivalent by either (a) two nationally recognized credit rating agencies or (b) one nationally recognized credit rating agency if the paper is fully secured by an irrevocable letter of credit issued by a U.S. or state bank, (12) no-load money market mutual funds registered with the Securities and Exchange Commission that have a dollar-weighted average stated maturity of 90 days or less and include in their investment objectives the maintenance of a stable net asset value of \$1 for each share, (13) no-load mutual funds registered with the Securities and Exchange Commission that have an average weighted maturity of less than two-years, invest exclusively in obligations described in this paragraph and are continuously rated as to investment quality by at least one nationally recognized investment rating firm of no less than AAA or its equivalent, and (14) guaranteed investment contracts that have a defined termination date and are secured by obligations described in clause (1) above in an amount at least equal to the amount of bond proceeds invested under such contract. The Authority may also invest in an "AAA" or "AAA-m" rated public investment pool that meets certain statutory criteria for eligibility.

State law strictly prohibits investment in: (1) obligations whose payment represents the coupon payments on the outstanding principal balance of the underlying mortgage-backed security collateral and pays no principal; (2) obligations whose payment represents the principal stream of cash flow from the underlying mortgage-backed security and bears no interest; (3) collateralized mortgage obligations that have a stated final maturity of greater than 10 years; and (4) collateralized mortgage obligations the interest rate of which is determined by an index that adjusts opposite to the changes in a market index. In addition, the Authority is prohibited from investing any portion of bond proceeds, reserves and funds held for debt service in no-load mutual funds.

### **Investment Policies**

Under State law, the Authority is required to invest its funds under written investment policies that primarily emphasize safety of principal and liquidity; that address investment diversification, yield and maturity; and also addresses the quality and capability of investment personnel. The policy includes a list of authorized investments for Authority funds, maximum allowable stated maturity of any individual investment (270 days) and the maximum average dollar-weighted maturity allowed for pooled fund groups (90 days). All Authority funds must be invested consistent with a formally adopted "Investment Strategy Statement" that specifically addresses each fund's investment. Each Investment Strategy Statement describes the investment objectives for the particular fund using the following priorities: (1) suitability of investment type, (2) preservation and safety of principal, (3) liquidity, (4) marketability of each investment, (5) diversification of the portfolio, and (6) yield.

Under State law, Authority investments must be made "with judgment and care, under prevailing circumstances, that a person of prudence, discretion and intelligence would exercise in the management of that person's own affairs, not for speculation, but for investment, considering the probable safety of capital and the probable income to be derived." Authority investments are currently managed by the Financial Assistant to the General Manager under the general direction of the Authority's Investment Officer. At least quarterly, the

investment officers of the Authority must submit an investment report detailing: (1) the investment position of the Authority, (2) that all investment officers jointly prepared and signed the report, (3) the beginning market value, any additions and changes to market value and the ending value of each pooled fund group, (4) the book value and market value of each separately listed asset at the beginning and end of the reporting period, (5) the maturity date of each separately invested asset, (6) the account or fund or pooled fund group for which each individual investment was acquired, and (7) the compliance of the investment portfolio as it relates to (a) adopted investment strategy statements and (b) State law. No person may invest Authority funds without express written authority of the Authority Board.

### **Additional Provisions**

Under Texas law, the Authority is additionally required to: (1) annually review its adopted policies and strategies, (2) require any investment officers with personal business relationships or relatives with firms seeking to sell securities to the Authority to disclose the relationship and file a statement with the Texas Ethics Commission and the Authority Board, (3) require the registered representative of firms seeking to sell securities to the Authority to (a) receive and review the Authority’s investment policy, (b) acknowledge that reasonable controls and procedures have been implemented to preclude imprudent investment activities, and (c) deliver a written statement attesting to these requirements; (4) perform an annual audit of the management controls on investments and adherence to the Authority’s investment policy; and (5) provide specific investment training for the Authority’s financial assistant or authorized representative, and the investment officer.

### **Current Investments**

As of June 30, 2008, the following percentages of the Authority’s investible funds were invested in the following categories of investments:

<u>Investment</u>	<u>Book Value</u>	<u>Market Value</u>	<u>Percentage</u>
TexSTAR <sup>(a)(b)</sup>	\$47,082,356	\$47,065,501	51%
TexPool <sup>(a)</sup>	\$4,708,568	\$4,707,955	5%
TexPool Prime <sup>(a)</sup>	<u>\$40,248,753</u>	<u>\$40,243,521</u>	<u>44%</u>
	\$92,039,677	\$92,016,977	100%

<sup>(a)</sup> Public funds investment pool operated as a money-market fund.

<sup>(b)</sup> First Southwest Asset Management, Inc., an affiliate of First Southwest Company, one of the Underwriters, currently serves as participant services administrator to TexSTAR.

## **CAPITAL IMPROVEMENTS**

### **Groundwater Reduction Mandate**

Portions of Harris County, the county in which the Authority is located, and Galveston County have experienced substantial subsidence (or sinking) of the ground. This subsidence is largely the result of extensive withdrawals of groundwater by industries, municipalities and other entities that own and operate water wells. The Subsidence District, established by the Texas Legislature in 1977, regulates the withdrawal of groundwater in Harris County and Galveston County in order to limit land surface subsidence in these counties. With certain limited exceptions, a Subsidence District permit is required to withdraw groundwater in Harris County.

On April 14, 1999, the Subsidence District adopted a new comprehensive plan (the “1999 District Plan”) to reduce groundwater withdrawals. The plan divides the Subsidence District into three regulatory areas. The Authority is located entirely in Area 3. Pursuant to the 1999 District Plan, substantial water users in Area 3 must, individually or collectively, reduce groundwater withdrawals to no more than 70% of their total water use beginning in January 2010, to no more than 30% beginning in January 2020, and to no more than 20% beginning in January 2030. They are also required to submit and obtain Subsidence District approval of a groundwater reduction plan (“GRP”) for meeting these limits. Non-exempt Retail Utilities and Private Well Owners within the boundaries of the Authority are required to comply with the 1999 District Plan.

The Authority submitted its draft GRP to the Subsidence District on July 3, 2002, as required by the 1999 District Plan, and the Subsidence District approved the Authority's GRP on June 11, 2003. The Authority's GRP was submitted on behalf of the Authority, the Retail Utilities and Private Well Owners within its boundaries. The GRP projects total water usage within these entities by each of the mandated conversion dates and establishes a plan to provide sufficient surface water to the area to meet the conversion mandates. To do so, the Authority plans to purchase treated water from the City of Houston and to develop the System, in phases, to transport the water from the City of Houston delivery point to participating Retail Utilities and Private Well Owners within its boundaries. The estimated water demand and sources are as follows. These estimates are based on various assumptions, including assumptions regarding weather patterns and population growth rates. Accordingly, the actual water demand could differ from the current estimates, and the difference could be substantial.

#### PROJECTED WATER DEMAND

<u>Year</u>	<u>Projected Population</u>	<u>Projected Average Daily Demand (mgd)<sup>(a)</sup></u>	<u>Total GRP Maximum Groundwater Share</u>	<u>Total Minimum Alternate Source Average Daily Demand (mgd)</u>
2000	397,074	65.25	100%	N/A
2010	623,202	96.50	70%	29.00
2020	749,170	116.50	30%	81.60
2030	847,260	132.40	20%	105.90

<sup>(a)</sup> Actual water pumpage in 2006 and 2007 was approximately 73 mgd and 66 mgd, respectively.

The GRP also proposes a water conservation program that initially relies primarily on public education.

#### Water Supply Contract

The Authority entered into the Supply Contract with the City of Houston, effective December 16, 2002, for the purchase of treated water from the City at points of delivery near the easternmost part of the Authority. Under the Supply Contract, the City is responsible for the design, construction, maintenance, and operation of the water facilities that are upstream of the point of delivery. The Authority is responsible for the design, construction, ownership, maintenance, and operation of its water facilities located downstream of the point of delivery. Under the Supply Contract, the City will make available to the Authority, beginning January 1, 2010, either all or a portion (as designated by the Authority) of the amount of treated water to which the Authority is entitled under the Supply Contract. Subject to the payment obligations described below and other provisions of the Supply Contract, the Authority is entitled to take 31 million gallons per day ("mgd") of treated water capacity, which was initially estimated to be sufficient to satisfy the Authority's water needs through 2019.

To satisfy its obligations under the Supply Contract, the City of Houston, through the Houston Area Water Corporation (the "HAWC"), a non-profit corporate instrumentality of the City, has constructed the first phase of the Northeast Water Purification Plant (the "Northeast Plant") and the transmission facilities necessary to deliver water from the Northeast Plant to the point of delivery to the Authority. The Supply Contract required the Authority to pay the City \$51,492,844 for its pro rata share (based on its initial 31 mgd of capacity) of the capital costs for the first phase of the Northeast Plant and the transmission facilities to the point of delivery to the Authority. The Authority used proceeds of the Outstanding Bonds and contributions from Retail Utilities to make that payment on July 1, 2003.

As a result of faster population growth in the Authority than initially projected, the Authority now anticipates that it will need up to an additional 5 mgd of treated water capacity to satisfy its water needs through 2019. The Authority expects to purchase such additional 5 mgd of treated water capacity pursuant to the terms of the Supply Contract, which requires the Authority to pay the City an amount equal to the unamortized capital costs of the treatment plant and transmission facilities attributable to such additional capacity.

The existing treatment facilities at the Northeast Plant and the transmission facilities to the point of delivery with the Authority (the "Existing Treated Water/Transmission Facilities") are sufficient to supply the Authority's projected demand for treated surface water through 2019. The Authority anticipates that the City will be required to construct additional water treatment capacity at the Northeast Plant to supply the Authority's projected water needs

for 2020 and 2030. The Authority anticipates that it will be required to pay the City for its pro rata share of the capital costs of such additional treatment capacity.

The Supply Contract also provides that the Authority must pay the City an amount (currently estimated to be \$21,799,523) for its pro rata share of the unamortized capital costs of existing City raw water facilities to be used to supply 31 mgd of raw water to the Northeast Plant (the "*Raw Water Payment*"). The total Raw Water Payment for the initial 31 mgd of capacity is due no later than December 31, 2009. Under the Supply Contract, if the Authority seeks to purchase additional raw water capacity and additional capacity is available in the City's existing raw water facilities (the "*Existing Raw Water Facilities*"), the Authority is entitled to such capacity if it pays the City an amount equal to the unamortized capital costs of the raw water facilities attributable to such additional capacity. The Water Supply Contract additionally provides that if the City for any reason constructs or acquires new raw water facilities or rights (collectively, the "*New Raw Water Facilities*"), the Authority is required to pay the City an annual payment equal to the Authority's share (its water reservation then divided by total raw water use) of the City's annual debt service for such New Raw Water Facilities, even if the Authority receives no water from the New Raw Water Facilities.

The City expects to acquire New Raw Water Facilities, consisting of the facilities necessary to transfer raw water from the Trinity River to Lake Houston pursuant to the Luce Bayou Interbasin Transfer Project (the "*Luce Bayou Project*"). The Authority anticipates utilizing these New Raw Water Facilities to meet its projected water needs through 2040. Currently, the Authority is negotiating with the City to determine the terms under which the City would provide additional raw water capacity to the Authority using the Luce Bayou Project. The Authority anticipates paying a pro rata share of the Luce Bayou Project capital costs. See "Luce Bayou Project" below.

The Supply Contract also provides that the Authority must reimburse the City on a monthly basis (based on an annual budget) for its share of the operation and maintenance expenses incurred by the City for the Existing Raw Water Facilities and the Existing Treated Water/Transmission Facilities, commencing when the Authority begins receiving water from the City on or about the last quarter of 2009. Additionally, the Authority is responsible for its share of the cost of Major Rehabilitations. "Major Rehabilitations" is defined in the Supply Contract as major capital projects required to maintain and operate the Northeast Plant or applicable transmission facilities at their current capacities or as required by applicable regulatory requirements and estimated to cost in excess of \$500,000. The Authority's share of Major Rehabilitations is calculated on a pro rata basis according to the Authority's capacity in the applicable facility.

The term of the Supply Contract is 40 years. The Authority has an option to extend the term for an additional 20 years. Thereafter, the City remains obligated to supply water to the Authority on reasonable terms in perpetuity.

### **Luce Bayou Project**

The City has obtained the rights to water in the Trinity River and proposes to transfer water from the Trinity River to Lake Houston through the Luce Bayou Project. The water will be treated at the Northeast Plant and used to serve the future needs of the residents of the City, the Authority and surrounding areas.

The City is currently negotiating with the Coastal Water Authority ("CWA"), to construct the Luce Bayou Project. The CWA was created by a special act of the Texas Legislature in 1967 with the purpose of providing raw water to the City and to industry and municipalities in the Counties of Harris, Chambers and Liberty. CWA currently provides raw water to the City and approximately 100 industrial customers in the region. It also operates and maintains the Lake Houston Dam and pump station and the Trinity River Pump Station and canal system.

The Luce Bayou Project is expected to be in service and delivering water to Lake Houston on or before 2020. The ultimate project will consist of a pump station on the Trinity River capable of pumping approximately 400 mgd, approximately 3.6 miles of dual 108-inch pipelines, and approximately 16 miles of constructed canal.

### **The Authority's Water System**

The Authority plans to design and build its water transmission and distribution system in phases as described below to achieve compliance with the Subsidence District conversion mandates and to transport increased

quantities of water as they become available for purchase under the Supply Contract and from other available sources. The order and timing of each phase may be changed by the Authority from time to time.

The first phase consisted of construction of distribution lines and related facilities to transport water among approximately 22 Retail Utilities that serve primarily residential subdivisions. This phase was placed in operation in January 2006. The lines are initially being used to enable Retail Utilities to sell surplus groundwater to the Authority, which in turn resells the water to nearby Retail Utilities with water needs. See “Groundwater Transfer Program” herein. Ultimately, the lines will form part of the Authority’s surface water distribution system.

Approximately 50% of the distribution lines needed for the 2010 conversion have been completed. The Authority is in the process of constructing or designing distribution lines and related facilities to transport water to an additional 23 Retail Utilities and expects construction of these distribution lines and related facilities to be completed by October, 2009.

The Authority has begun construction of the 54 to 60-inch water transmission lines and facilities necessary to transport water from the point of delivery from the City to the Authority’s distribution system. Such facilities include four segments of transmission line and the Spears Road Regional Pump Station, consisting of pumping facilities, ground storage tanks, an electrical substation and related improvements. Construction of two of the four line segments has commenced, a contract for the third line segment was awarded in June 2008 and the contract for the fourth line segment was awarded in July 2008. Construction of these segments is expected to take 365 days. The contract for construction of the ground storage tanks and related piping at the Spears Regional Road Pump Station was awarded in June 2008 and the contract for the remainder of the facilities at the Spears Regional Road Pump Station is expected to be awarded in August 2008. Both contracts provide for a 330 day construction period. The Authority expects the transmission facilities to be completed by October, 2009.

### **Projected Capital Expenditures**

The Series 2008 Bonds are being issued to finance the Raw Water Payment, a payment to the City for additional water capacity, and the construction costs of the transmission system, the remaining portions of the distribution system and related improvements needed to allow the Authority to deliver surface water to satisfy the Subsidence District’s 2010 conversion requirement. The Series 2008 Bonds will also finance the purchase of sites for the Authority’s future regional pump stations and regional water plants and the costs of acquiring easements and rights-of-way and possible other water system improvements.

In subsequent phases, the Authority plans to pay additional capital charges for raw water facilities and treatment facilities and for the construction and installation of wells, ground storage tanks, pumping stations, additional transmission and distribution lines and for the related sites, easements or right-of-way to supply enough surface water to Retail Utilities and Private Well Owners to comply with the Subsidence District’s 2020 and 2030 conversion mandates.

The GRP included estimates of the System capital costs required to build facilities such as transmission lines, distribution lines, connections to districts, regional pump stations, regional water plants and regional wells to comply with the Subsidence District’s conversion mandates, based on an analysis prepared by the Authority’s consulting engineers in 2001. The GRP estimate of System capital costs effectively did not include the acquisition costs of water line easements. Including an allowance for acquisition costs, the projected System capital costs to comply with the 2010, 2020 and 2030 conversion requirements were estimated at \$202,520,000, \$433,831,000, and \$39,653,000, respectively.

The Authority’s GRP estimates detailed above were preliminary and made without the benefit of detailed plans and specifications using 1999 costs without consideration for inflation. The GRP estimate did not anticipate the high rate of population growth within the boundaries of the Authority since 1999. Further, the estimates assumed most of the transmission lines would be installed using open trench construction and would be constructed in public rights of way. In fact, a major portion of the lines were installed in easements purchased by the Authority and approximately 25% of the lines have been installed using trenchless construction.

During the development of the System, the Authority has experienced conditions which have been considerably different than were anticipated when the GRP and the System capital cost discussed above were developed. The Authority’s consulting engineers’ current estimate of the System capital costs to comply with the

2010 conversion requirement is \$329,342,000, as detailed in the chart below. The Authority’s consulting engineers have not prepared a new estimate of the expected System capital costs for the 2020 and 2030 conversions, but the Authority expects such costs to be at least as great as the GRP estimates. As discussed, actual costs of the 2020 and 2030 conversions may differ substantially from the GRP estimates, which are subject to revision due to numerous factors, including those factors discussed above and those factors described under “Investment Considerations.”

In addition to the capital costs of the Authority’s water transmission and distribution system, the Authority must pay the capital costs associated with procuring and treating the water delivered to the Authority. The 2010 Raw Water Capacity, Treatment Plant Capacity and Transmission Main Capacity costs for 31 mgd of water are specified in the Supply Contract and in the chart below. While the Authority does not expect to pay additional Transmission Main Capacity costs for the 2020 and 2030 conversions, it does expect to pay for substantial additional Raw Water Capacity and Treatment Plant Capacity. In estimating the actual amount of capacity to be purchased in 2020 and beyond the Authority has applied a factor of 1.4 to the projected average daily demand. If the per unit cost of additional Raw Water Capacity and Treatment Plant Capacity were to remain constant with the costs for 31 mgd of water and based on the Authority’s projection of future water usage, the Authority would be required to pay the City \$181,639,000 for an additional 83.2 mgd of water prior to 2020 and \$74,236,000 for an additional 34.0 mgd of water prior to 2030. The per unit cost of new capacity compared to the 31 mgd currently under contract may be substantially higher in the future, given the fact that the City of Houston plans to obtain additional raw water through the Luce Bayou Project, which would transfer water approximately 20 miles from the Trinity River to Lake Houston.

**ESTIMATE OF CAPITAL COSTS FOR 2010 CONVERSION**

	<u>Capital Costs to Meet Deadline in</u>
	<u>2010</u>
<b>The System :</b>	
Transmission Lines	\$ 62,262,000
Distribution Lines	212,168,000
Pump Stations	31,030,000
Regional Water Plants	19,710,000
Regional Wells	4,172,000
<b>Subtotal</b>	\$ 329,342,000
 <b>Supply Contract :</b>	
Untreated Water Capacity	21,799,523
Treatment Plant Capacity	46,573,844
Transmission Main Capacity	4,919,000
<b>Subtotal</b>	\$ 73,292,367
 <b>Total</b>	 <u>\$402,634,367<sup>(a)</sup></u>

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<sup>(a)</sup> Proceeds of the Outstanding Bonds, the Series 2008 Bonds, and associated capital advances made by Retail Utilities in return for installment credits against Pumpage Fees are expected to fund 100% of the capital costs required to meet the 2010 conversion deadline. In addition, the Outstanding Bonds, the Series 2008 Bonds, and Retail Utility contributions are funding approximately 3% of capital costs needed to satisfy the 2020 conversion target.

**Regulation**

Design and construction of the System is subject to the regulatory jurisdiction of federal, state and local authorities, including, among others, the TCEQ, Harris County, and the City of Houston. Changes in applicable regulations could affect the scope and cost of the System.

## FINANCIAL DATA

### Annual Debt Service Requirements

The following schedule sets forth the annual debt service payments on the Outstanding Bonds plus the estimated principal and interest requirements for the Series 2008 Bonds, assuming sale of the Series 2008 Bonds at an average interest cost of 5.35% per annum.

#### ANNUAL DEBT SERVICE REQUIREMENTS

<u>Years</u>	<u>Outstanding Bonds</u>	<u>The Series 2008 Bonds</u>			<u>Total Outstanding*</u>
		<u>Principal*</u>	<u>Interest*</u>	<u>Total*</u>	
2008	\$11,054,556	\$ -	\$ 3,870,618	\$ 3,870,618	\$14,925,174
2009	11,054,556	-	12,902,060	12,902,060	23,956,616
2010	15,659,556	-	12,902,060	12,902,060	28,561,616
2011	15,661,981	-	12,902,060	12,902,060	28,564,041
2012	15,660,356	-	12,902,060	12,902,060	28,562,416
2013	15,659,106	4,485,000	12,902,060	17,387,060	33,046,166
2014	15,660,156	4,725,000	12,662,113	17,387,113	33,047,269
2015	15,659,044	4,975,000	12,409,325	17,384,325	33,043,369
2016	15,662,706	5,245,000	12,143,163	17,388,163	33,050,869
2017	15,665,094	5,525,000	11,862,555	17,387,555	33,052,649
2018	15,665,419	5,820,000	11,566,968	17,386,968	33,052,386
2019	15,662,894	6,130,000	11,255,598	17,385,598	33,048,491
2020	15,661,731	6,460,000	10,927,643	17,387,643	33,049,374
2021	15,660,881	6,805,000	10,582,033	17,387,033	33,047,914
2022	15,664,294	7,170,000	10,217,965	17,387,965	33,052,259
2023	15,658,294	7,550,000	9,834,370	17,384,370	33,042,664
2024	15,660,869	7,955,000	9,430,445	17,385,445	33,046,314
2025	15,659,619	8,380,000	9,004,853	17,384,853	33,044,471
2026	15,665,369	8,830,000	8,556,523	17,386,523	33,051,891
2027	15,661,619	9,300,000	8,084,118	17,384,118	33,045,736
2028	15,662,619	9,800,000	7,586,568	17,386,568	33,049,186
2029	15,661,869	10,325,000	7,062,268	17,387,268	33,049,136
2030	15,658,119	10,875,000	6,509,880	17,384,880	33,042,999
2031	15,660,119	11,460,000	5,928,068	17,388,068	33,048,186
2032	15,666,119	12,070,000	5,314,958	17,384,958	33,051,076
2033	15,664,369	12,720,000	4,669,213	17,389,213	33,053,581
2034	6,586,531	13,400,000	3,988,693	17,388,693	23,975,224
2035	6,586,081	14,115,000	3,271,793	17,386,793	23,972,874
2036	-	14,870,000	2,516,640	17,386,640	17,386,640
2037	-	15,665,000	1,721,095	17,386,095	17,386,095
2038	-	16,505,000	883,018	17,388,018	17,388,018
<b>TOTAL</b>	<b>\$411,163,925</b>	<b>\$241,160,000</b>	<b>\$266,370,776</b>	<b>\$507,530,776</b>	<b>\$918,694,701</b>

### Pricing Policy

On September 5, 2002, the Board adopted a short-term and a long-term pricing policy (the “Pricing Policy”) which outlines the guidelines which the Authority will use to set the price of water. The Pricing Policy introduces the concept of depreciation credits (which give a credit for the unamortized value of certain groundwater facilities which will be removed from service before the end of their useful life) and groundwater operation and maintenance credits (which give a credit for the continued operation of certain groundwater facilities after surface water deliveries commence), each to be given to qualifying Retail Utilities and Private Well Owners and to be applied against Pumpage Fees and water costs owed to the Authority from time to time. The purpose of the Pricing

\*Preliminary; subject to change.

Policy is to equalize the cost for water, to the extent possible, for all Retail Utilities and Private Well Owners, regardless of the source of water, whether groundwater pumped by a Retail Utility or Private Well Owner, groundwater supplied via the Authority, or surface water supplied by the Authority.

### **Groundwater Transfer Program—Short-Term Pricing Policy Goals**

The Groundwater Transfer Program (“GTP”) regulations, which were adopted by the Authority on September 8, 2003, implement the short-term Pricing Policy. The purpose of the short-term Pricing Policy is to (i) encourage efficiency and optimum utilization of existing groundwater wells and related water supply plants and facilities within the Authority, (ii) discourage the addition of new wells and the addition and expansion of related water supply plants and facilities and (iii) promote the transition to greater reliance on surface water supplies within the Authority which is scheduled to occur upon the commencement of water deliveries (beginning in 2010) pursuant to the Supply Contract with the City of Houston. The regulations establish terms and conditions pursuant to which Retail Utilities and Private Well Owners within the Authority may sell surplus groundwater to the Authority for resale and distribution by the Authority to other Retail Utilities and Private Well Owners within the Authority in need of additional water supplies. The GTP was implemented in January 2006. The Authority transports water that it purchases and resells in connection with the GTP using water distribution lines that were installed during the first phase of the acquisition and construction of the Authority’s System. See “Water System” herein. The GTP has reduced the cumulative investment of Retail Utilities in additional groundwater facilities which will be ultimately qualified for a depreciation credit, reducing the overall cost of conversion to surface water.

In addition to the Authority’s role under the GTP as a clearinghouse for the resale and distribution of surplus groundwater produced within the Authority, the GTP is designed to enable Retail Utilities and Private Well Owners that participate in the GTP to obtain depreciation credits for capital costs incurred in connection with the acquisition and construction of certain water production facilities. To obtain such credit, the capital cost must have been incurred by the water utility before the Authority’s adoption of the GTP (or, for depreciation credits that relate to capital costs incurred after the Authority’s adoption of the GTP, the consent of the Authority must be obtained). The depreciation credit provided under the GTP requires that the cost of a water production facility (as defined in the GTP) is to be amortized over the remaining useful life of the water production facility (as established by the Authority in accordance with the GTP) and annually applied against the price of water purchased from the Authority, subject to a ceiling.

The Authority has experienced neutral net revenue from the administration and operation of the GTP to date.

### **Long-Term Pricing Policy Goals**

As a part of the long-term Pricing Policy, upon conversion to surface water supplies in 2010, the Authority contemplates continuing the application of the depreciation credit implemented in the GTP for Retail Utilities and Private Well Owners purchasing surface water from the Authority, and, in addition, introducing a groundwater operation and maintenance credit to Retail Utilities and Private Well Owners paying the Pumpage Fee.

The groundwater operation and maintenance credit (which will be applied against the Pumpage Fee imposed by the Authority) is designed to equalize the cost of groundwater and surface water during the period of conversion, when it is expected that certain Retail Utilities and Private Well Owners within the Authority will own and continue to use groundwater production facilities capable of economically producing groundwater (prior to the expiration of their useful lives) at the same time other Retail Utilities and Private Well Owners are purchasing surface water from the Authority. The purpose of the operations and maintenance credit is to provide for equitable treatment among all water users within the Authority, as between those using groundwater and those using surface water. The current GTP, as adopted by the Authority, does not establish the groundwater operation and maintenance credit.

## Rates and Charges

The Authority has imposed Pumpage Fees at the following rates since the creation of the Authority:

<u>Effective Date</u>	<u>Rate Per 1,000 Gallons of Water Pumped</u>
January 1, 2000	12¢
April 1, 2000	25¢
October 1, 2003	34¢
April 1, 2005	59¢
October 1, 2006	84¢
October 1, 2007	99¢

The Pumpage Fees are applied to water pumped from all wells within the Authority other than wells owned by a city that does not serve customers in the Authority, wells under 5 inches in diameter that serve a single-family dwelling, injection wells regulated under Chapter 27, Texas Water Code, agricultural wells, wells (including wells under common ownership) that produce less than 5 million gallons annually, and wells used for electric generation. The Authority has also exempted wells that are not subject to the groundwater reduction requirements imposed by the Subsidence District.

The Pumpage Fee is also imposed on each person in the Authority for all water received by that person from any source (including surface water) outside the Authority's boundaries.

The Authority anticipates that the Pumpage Fee, which is currently set at \$.99 per 1,000 gallons of water pumped and is anticipated to remain at such rate through September 30, 2008 will be increased again prior to 2010 to comply with the Authority's rate covenant and to finance additional capital needs in accordance with the Master Resolution. The Authority's Pricing Policy and current cost estimates indicate that water rates in 2010 will be \$1.80 per 1,000 gallons, less applicable depreciation credits and groundwater operation and maintenance credits. The Authority's projections of future pumpage fee rates and water rates are preliminary and are based on numerous factors, including projected population growth, water consumption, the cost of constructing and financing the System, and other factors, risks and uncertainties that cannot be predicted, including those factors described under "Investment Considerations" in this Official Statement. Accordingly, the actual pumpage fees and water rates could differ from the current estimates, and the difference could be substantial.

In accordance with the Act, the Authority has elected to adopt a capital contribution procedure to provide those Retail Utilities within the boundaries of the Authority with the option to fund their share of the cost of capital projects proposed to be funded by the Series 2008 Bonds. Retail Utilities that exercised this option will receive a credit against future Pumpage Fees and/or Water Charges due to the Authority. The credit is determined based on the Authority's borrowing rate and costs of issuance and is amortized over the term of the Series 2008 Bonds to final maturity. See "ESTIMATED SOURCES AND USES OF FUNDS" herein. The receipt by the Authority of all capital contributions will not occur until after the sale of the Series 2008 Bonds. It is possible that the Retail Utilities which have agreed to make capital contributions will not make their contributions as agreed. Failure of the Retail Utilities to make their capital contributions is not material to the ability of the Authority to accomplish the purposes for which the Series 2008 Bonds were issued; however, the failure to collect the capital contributions could affect the timing of issuance of additional debt by the Authority to complete construction of the System. In the rate covenant for the Senior Lien Obligations (as set forth in the Master Resolution), the Authority covenants to fix, establish, maintain and collect fees and charges as will be necessary to produce sufficient Gross Revenues after taking into consideration any credits, including credits for capital contributions, that the Authority grants. See "SECURITY AND SOURCE OF PAYMENT – Rate Covenant." The Authority is not required to adopt a capital contribution procedure for future bond issues.

## Billing and Collection

The Pumpage Fee rate is fixed and assessed by the Board annually, subject to modification and amendment by the Board. The Retail Utilities and Private Well Owners pay Pumpage Fees to the Authority quarterly based on self-reported quantities of water pumped. Payments are due within 30 days after the end of the applicable quarter. Payments that are past due are subject to a 5% penalty after 10 days, an additional 5% penalty after 30 days, and interest at 12% per annum until paid. The Authority may collect delinquent accounts by filing suit in a court of competent jurisdiction.

Under the Authority's rules, each Retail Utility and Private Well Owner is responsible for reading its own meter to measure the amount of water pumped, accurately reporting the measurement to the Authority monthly, keeping its well meter at least 95% accurate, and paying its Pumpage Fees on or before the due date. The Authority has the right to audit well pumpage, read the well owner's meter, enter the owner's land to audit and/or measure well pumpage, and test and recalibrate, if necessary, the well owner's meter. If a Retail Utility or Private Well Owner violates a rule of the Authority, the Authority may impose a civil penalty of not more than \$5,000 for each violation or each day of a continuing violation, or seek injunctive relief.

The following table compares water pumpage reported to the Subsidence District to water pumpage reported to the Authority by the Retail Utilities and Private Well Owners and states the percentage of fees that had been collected by January 31 of the following years:

### BILLING AND COLLECTION EXPERIENCE

<b>Calendar Year Ending</b>	<b>Pumpage Reported to Subsidence District (Gallons)</b>	<b>Pumpage Reported to Authority (Gallons)</b>	<b>Percentage of Pumpage Fees Collected within 31 days of end of calendar year</b>
2002	23,385,003,226	23,304,243,101	99.65%
2003	23,922,957,131	23,919,899,118	99.99%
2004	23,055,346,850	23,002,955,882	99.77%
2005	28,356,373,609	28,351,195,157	99.98%
2006	26,834,935,391	26,822,777,163	99.95%
2007	24,218,161,044	24,199,057,244	99.92%

## Principal Water Users

The 10 Retail Utilities and Private Well Owners within the Authority's GRP that pumped the largest quantities of water and therefore paid the largest amounts of Pumpage Fees for the 12 months ending December 31, 2007, together with their respective percentages of total pumpage and Pumpage Fees, are as follows:

### PRINCIPAL WATER USERS 12 MONTHS ENDED DECEMBER 31, 2007

<u>Name</u>	<u>Pumpage (gallons)<sup>(a)</sup></u>	<u>Pumpage Fees</u>	<u>Share (%)</u>
Tomball, City of	682,395,000	\$ 599,558	2.8199%
Harris Co. FWSD 61	677,478,000	598,674	2.7996%
Harris Co. MUD 358	556,762,000	488,498	2.3008%
NW Harris Co. MUD 5	528,178,000	465,889	2.1826%
Bridgestone MUD	527,694,291	466,183	2.1807%
Harris Co. MUD 383	460,370,000	404,020	1.9024%
Harris Co. WCID 109	460,136,000	405,837	1.9015%
Timber Lane UD	443,443,000	389,035	1.8325%
Harris Co. MUD 365	426,203,000	374,522	1.7612%
AquaSource, Inc. <sup>(b)</sup>	<u>421,692,494</u>	<u>370,164</u>	<u>1.7426%</u>
Subtotal	5,184,351,785	4,562,380	21.4238%
All Other Retail Utilities <sup>(c)</sup>	18,153,075,315	13,691,219	75.0156%
All Private Well Owners <sup>(d)</sup>	<u>861,630,144</u>	<u>760,195</u>	<u>3.5606%</u>
Total	<u>24,199,057,244</u>	<u>\$19,013,794</u>	<u>100.0000%</u>

(a) Based on pumpage data provided to the Authority by Retail Utilities and Private Well Owners.

(b) Provides private water utility service to 21 communities.

(c) See Appendix B for a list of the Retail Utilities that own water wells and pay Pumpage Fees.

(d) Includes golf courses, property owner associations, and private businesses.

## Historical and Budgeted Revenue and Expense

The following table summarizes the Authority's actual revenues and expenses for its fiscal years ended December 31, 2007, 2006 and 2005. The summary is derived from audited financial statements. The summary for the fiscal year ended December 31, 2007, should be read in conjunction with the audited financial statements of the Authority included herein as Appendix A.

	<b><u>Fiscal Year Ended December 31,</u></b>		
	<b><u>2007</u></b>	<b><u>2006</u></b>	<b><u>2005</u></b>
<b>Operating revenues:</b>			
Pumpage fees	\$19,680,186	\$16,784,075	\$13,600,099
Water Sales	1,055,286	928,314	0
Other	<u>13,040</u>	<u>1,106</u>	<u>23,000</u>
<b>Total operating revenues</b>	<b><u>20,748,512</u></b>	<b><u>17,713,495</u></b>	<b><u>13,623,099</u></b>
<b>Operating expenses:</b>			
Personnel	1,133,978	1,106,957	918,809
Professional fees	1,494,284	1,556,567	1,518,470
Purchased Water	960,666	725,625	0
Contracted services	534,713	213,135	8,933
Occupancy and office	439,071	339,591	321,541
Other	270,489	262,918	301,386
Depreciation and amortization	<u>3,669,081</u>	<u>2,937,335</u>	<u>1,481,005</u>
<b>Total operating expenses</b>	<b><u>8,502,282</u></b>	<b><u>7,142,128</u></b>	<b><u>4,551,144</u></b>
<b>Net operating income (loss)</b>	<b>12,246,230</b>	<b>10,571,367</b>	<b>9,071,955</b>
<b>Non-operating revenues (expenses)</b>			
Interest and fiscal charges expense	(13,177,434)	(13,171,672)	(10,917,279)
Interest income	<u>5,759,884</u>	<u>5,901,563</u>	<u>3,958,239</u>
<b>Total non-operating revenues (expense)</b>	<b>(7,381,550)</b>	<b>(7,270,109)</b>	<b>(6,959,040)</b>
<b>Change in net assets</b>	<b>4,864,680</b>	<b>3,301,258</b>	<b>2,112,915</b>
<b>Total net assets – beginning</b>	<b><u>\$ 8,329,810</u></b>	<b><u>\$ 5,028,552</u></b>	<b><u>\$ 2,915,637</u></b>
<b>Total net assets – ending</b>	<b><u>\$13,194,490</u></b>	<b><u>\$ 8,329,810</u></b>	<b><u>\$ 5,028,552</u></b>

For the fiscal year ending December 31, 2008, the Authority has budgeted operating revenues of \$24,549,200, operating expenses (excluding depreciation and amortization) of \$4,451,042, net operating income (before depreciation and amortization) of \$20,098,158 and investment income of \$2,000,000. The Authority estimates that it will record depreciation and amortization charges of \$4,300,000 and interest and fiscal charges of \$13,407,682 in 2008, resulting in an estimated change in net assets of \$4,390,476. The budget and estimates have been prepared based on projected population growth, projected water consumption, the estimated cost of operating the System, and other factors, all of which are subject to risks and uncertainties that cannot be predicted, including unexpected expenditures for repairs as well as those factors described under "Investment Considerations" in this Official Statement. Accordingly, actual amounts of revenues and expenditures could differ from the budgeted amounts, and the difference could be substantial.

## Historical Debt Service Coverage

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net Revenues <sup>(a)</sup>	\$13,562,185	\$11,158,338	\$8,905,558
Adjusted Net Revenues <sup>(b)</sup>	\$59,819,960	\$45,850,361	\$33,920,402
Annual Debt Service Requirements <sup>(c)</sup>	\$9,474,738	\$6,315,100	\$1,315,646
Debt Service Coverage <sup>(d)</sup>	1.43x	1.77x	6.77x
Adjusted Debt Service Coverage <sup>(e)</sup>	6.31x	7.26x	25.78x

(a) Represents "Gross Revenues" minus "Operations & Maintenance Expenses" equal to "Net Revenues" all as defined in the Master Resolution for the Bonds.

(b) Represents "Gross Revenues" minus "Operations & Maintenance Expenses" equal to "Net Revenues" plus "Coverage Fund" and "Improvement Fund" balances on December 31 of the current year all as defined in the Master Resolution for the Bonds.

(c) Reflects actual "Annual Debt Service Requirements" as defined in the Master Resolution for the Bonds.

(d) Reflects "Annual Debt Service Requirements" divided by "Net Revenues"; such amount is required to be 1.10x according to the Master Resolution for the Bonds.

(e) Reflects "Adjusted Net Revenues" divided by "Annual Debt Service Requirements"; such amount is required to be 1.20x according to the Master Resolution for the Bonds.

## INVESTMENT CONSIDERATIONS

### Project Risks

To satisfy the Subsidence District's 1999 District Plan to reduce groundwater, the Authority must comply with the provisions of its GRP, including development of the System to transport water from the City of Houston delivery point to participating Retail Utilities and Private Well Owners in phases. To complete each phase of the System by the respective dates specified in its GRP, the Authority must complete detailed design and seek and obtain design approvals from various governmental agencies, acquire or condemn necessary land, right-of-way and easements, and award and pursue construction contracts, among other actions. See "CAPITAL IMPROVEMENTS—Proposed Water System." Timely completion of substantial construction projects like the System within budget are subject to a number of risks, including possible delays or inability to secure necessary government approvals or financing, possible escalation or misestimation of construction costs, unanticipated subterranean conditions, unknown environmental hazards, possible adverse weather conditions, possible insolvencies or mistakes of contractors or subcontractors, possible shortages in materials or labor unrest, possible construction period hazards such as flooding or earthquakes, and other factors which cannot be predicted. If the Authority were unable to complete each phase of the System as planned, or were able to do so only at materially higher cost, its financial condition and prospects could be materially adversely impacted. If the Authority were unable to comply with its GRP, it would be subject to the payment of a disincentive fee to the Subsidence District equal to \$3.50 per 1000 gallons of groundwater withdrawals that constitute greater than 20% of the GRP Plan participants' total water demand, which could further adversely impact the Authority's financial condition. The Authority has implemented an aggressive construction schedule to meet the 2010 conversion requirement and anticipates meeting the conversion requirement deadline. Nevertheless, a substantial amount of construction to meet the 2010 conversion requirement has not been completed. See "CAPITAL IMPROVEMENTS — Water System."

### Impact of Weather on Revenue

The amount of Pumpage Fees and, in the future, Water Revenue available to the Authority is directly dependent on the amount of water pumped or purchased by the Retail Utilities and Private Well Owners, which in turn is dependent on the amount of rainfall. The frequency and amount of rainfall experienced within the Authority, especially in summer months, varies significantly from year to year. Based on historical experience, water use

within the Authority could vary by as much as 15-20% between wet and dry years and even more in the summer months of such years. Accordingly, during a wet year the amount of Pumpage Fees and Water Revenues could be materially less than the amount budgeted by the Authority. For example, the area within the Authority experienced higher than average amounts of rainfall during the months of June, July, August and September in 2007. As a result, water pumpage has remained relatively constant despite the additional development and population growth that has taken place within the boundaries of the Authority. Accordingly, the Authority has made adjustments to its multi-year financial forecasts and Pumpage Fee rate setting models to assume no increases in water usage during 2008 and 2009, despite the continued development and population growth that the Authority anticipates will occur. Because such a large share of water use occurs in the summer months, without such adjustments the Authority may not be able to reset its rates to account for larger rainfall months in time to offset lost revenue in the same year.

### **Risk of Catastrophic Loss**

Pursuant to the Water Supply Contract, the Authority has expended capital in return for the right to purchase treated water from the City of Houston's Northeast Plant, at operating cost, and the Authority bears the risk of loss in the event a natural or manmade disaster, such as a hurricane, fire, earthquake, tornado, or war, damages or destroys the Northeast Plant or transmission line. There is no third party insurance coverage to provide funds to repair or rebuild the Northeast Plant or transmission line, should it be damaged or destroyed. In the event of a loss, the Authority would be required to contribute to repair and replacement costs to retain its rights to be supplied water, which could result in the issuance of additional Authority bonds without a corresponding increase in water demand. In addition, in the event of catastrophic loss to either City of Houston or Authority facilities, there could be a lengthy time period, while the facilities are being repaired or rebuilt, during which the Authority would have to procure another source of treated surface water or permit the Retail Utilities and Private Well Owner to utilize groundwater. Particularly if the Retail Utilities and Private Well Owners do not maintain the operational capabilities of their wells, aggregate consumption and revenue in the period could decrease by a greater amount than expenses. Accordingly, any catastrophic loss of City of Houston or Authority facilities could adversely affect the Authority's ability to pay debt service on the Series 2008 Bonds. Also, see "Project Risks" above regarding the potential effect on the Authority of the inability of the Authority to comply with the Authority's GRP.

### **Regulation of Water Sales**

Rates for sales of water to the Retail Utilities on a wholesale basis are subject to the oversight jurisdiction of the Texas Commission on Environmental Quality (the "TCEQ"). As the conversion to surface water is phased in, the amount of revenues derived by the Authority from sales of water to Retail Utilities and Private Well Owners will increase. Any Retail Utility or Private Well Owner may appeal to the TCEQ from and within 90 days after any decision by the Authority which affects the amount of water charges owed by them to the Authority. While, under Texas law, the TCEQ may not set a rate for sales of water which is less than the amount required to meet the debt service requirements of the Authority, a successful appeal could result in greater dependence on Pumpage Fees at a time when fewer of the Retail Utilities and Private Well Owners are paying Pumpage Fees or could otherwise adversely affect the Authority's ability to pay the Series 2008 Bonds.

### **Modification of Subsidence District Requirements**

Pursuant to the 1999 District Plan, the Authority must reduce groundwater withdrawals to no more than 70% of total water usage beginning in January 2010, to no more than 30% of usage beginning in January 2020, and to no more than 20% of usage beginning in January 2030. The Authority has based its capital improvement plan and budget on the requirements set forth in the 1999 District Plan. In the event the Subsidence District modifies or amends the 1999 District Plan in the future to either shorten or lengthen the dates for reduction of groundwater withdrawals or to increase or decrease the percentages of groundwater withdrawal reduction, the Authority's capital improvement plan, timing for the issuance of additional bonds, and budget may have to be revised. Any such revision could adversely impact the Authority's financial condition.

Under the Act, the Authority does not have power to impose Pumpage Fees on pumpage from wells that meet certain exemptions from the Subsidence District's conversion mandate. If the Subsidence District were to amend the 1999 District Plan to take other action to exempt additional wells in the Authority, the base from which Pumpage Fee and Water Revenue could be raised would be reduced, and the reduction could be substantial.

## **Limitations on Remedies**

Remedies available to the Authority in the event of a default by a Retail Utility or Private Well Owner in the payment of Pumpage Fees or Water Revenue are limited. See “Financial Data – Billing and Collection.” The Authority must bring an action in district court to collect fees and recover penalties for non-payment or to seek injunctive relief to prevent violation of Authority rules. In either case, such a remedy would have to be exercised upon each violation and might prove time-consuming, costly and difficult to enforce.

In the event of a default by the Authority, the Resolutions make no provision for acceleration of the Series 2008 Bonds or for the appointment of a trustee or receiver to take possession of or operate the System. Accordingly, available remedies may not be effective to protect the interests of Bondholders, should the Authority default.

## **Funding of Reserve Fund through the Use of Surety Policies**

The Reserve Fund Requirement for the Series 2003 Bonds and the Series 2005 Bonds, which are Parity Obligations with the Series 2008 Bonds, was satisfied by the purchase of surety policies from municipal bond insurance companies which have now been downgraded by certain nationally recognized statistical rating agencies. The Master Resolution requires the Authority to deposit funds to the Reserve Fund from available revenues in the event the ratings of a surety policy provider are decreased; however, consistent with the requirements of the Master Resolution, such deposit of funds will be made over a time interval which may extend as long as five years, depending upon the ratings of such surety policy providers, and will not be accomplished at the time of issuance of the Series 2008 Bonds. See “SECURITY AND SOURCE OF PAYMENT—Reserve Fund” for information concerning the Authority’s plans to fund the Reserve Fund with available revenues due to the rating downgrades of the municipal bond insurers providing surety policies to fund the Reserve Fund Requirement resulting from issuance of the Series 2003 and Series 2005 Bonds.

The Master Resolution authorizes the Authority to purchase a surety policy from the Insurer or another municipal bond insurance company to satisfy the additional Reserve Fund Requirement which results from issuance of the Series 2008 Bonds. A surety policy is an unsecured obligation of the provider. Investors should evaluate the underlying credit quality of the provider of any surety policy.

In the event the Authority elects to fund the additional Reserve Fund Requirement which results from issuance of the Series 2008 Bonds with cash, that cash will be available for payment of all Parity Obligations in the event amounts in the Interest and Sinking Fund are ever insufficient to make principal or interest payments on any Parity Obligations and will not be reserved specifically for principal and interest payments on the Series 2008 Bonds.

## **Purchase of Municipal Bond Insurance**

The Authority is considering the purchase of municipal bond insurance for the purpose of reducing its interest rate expense by utilizing the rating of a municipal bond insurance company (the “Insurer”) instead of the Authority’s rating. At the time of closing of the Series 2008 Bonds, the rating of the Insurer is \_\_\_ by Moody’s Investors Service, \_\_\_ by Standard & Poor’s and \_\_\_ by Fitch’s Rating Service. The Series 2008 Bonds may be sold in the initial offering based upon the ratings of the Insurer.

The municipal bond insurance industry is under stress with multiple municipal bond insurers having been downgraded by certain nationally recognized rating agencies within the last year. Further downgrades of one or more municipal bond insurers, including the Insurer, could occur. Any changes in the rating of the Insurer could have a material adverse impact on the price and liquidity of the Series 2008 Bonds. Accordingly, investors should evaluate the underlying credit quality of both the Insurer and the Authority. The Authority has no obligation to maintain the rating on the Series 2008 Bonds after delivery of the Series 2008 Bonds to the Underwriters. See “RATINGS.”

## LITIGATION

There is no litigation pending against the Authority or in any way contesting the validity of the Series 2008 Bonds.

## LEGAL INVESTMENTS AND ELIGIBILITY TO SECURE PUBLIC FUNDS IN TEXAS

Under Texas law, the Series 2008 Bonds are legal and authorized investments for banks, trust companies, building and loan associations, savings and loan associations, insurance companies, fiduciaries or trustees, and for the interest and sinking funds of cities, towns, villages, school districts and other political subdivisions or public agencies of the State of Texas. The Series 2008 Bonds are eligible to secure deposits of any public funds of the State, its agencies and political subdivisions and are legal security for those deposits to the extent of their market value. Most political subdivisions in the State of Texas are required to adopt investment guidelines under the Public Funds Investment Act, Chapter 2256, Texas Government Code, and such political subdivisions may impose other, more stringent requirements in order for the Series 2008 Bonds to be legal investments for such entity's funds or to be eligible to serve as collateral for their funds. The Authority has not reviewed the laws in other states to determine whether the Series 2008 Bonds are legal investments for various institutions in those states.

The Authority has made no investigation of any other laws, rules, regulations or investment criteria that might affect the suitability of the Series 2008 Bonds for any of the above purposes or limit the authority of any of the above persons or entities to purchase or invest in the Series 2008 Bonds.

## RATINGS

### Insured Ratings

If municipal bond insurance is purchased, Moody's Investors Service, Inc. and Standard & Poor's Ratings Services are expected to assign ratings of "Aaa" and "AAA", respectively, to the Series 2008 Bonds with the understanding that, upon delivery of the Series 2008 Bonds, a municipal bond guaranty insurance policy insuring the timely payment of the principal of and interest on the Series 2008 Bonds will be issued by a "Aaa/AAA"-rated bond insurance company. See "Bond Insurance" herein.

### Underlying Ratings

Moody's Investment Service, Inc. and Standard & Poor's Rating Services have also assigned underlying ratings of "\_\_\_" and "A+", respectively, to the Series 2008 Bonds.

### General

A rating reflects only the views of the rating agency assigning such rating and an explanation of the significance of such rating may be obtained from such rating agency. There is no assurance that such ratings will continue for any given period of time or that such ratings will not be revised downward or withdrawn entirely by such rating agency if, in its judgment, circumstances so warrant. Any such downward rating revision or withdrawal may have an adverse effect on the market price of the Series 2008 Bonds. None of the Authority, the Co-Financial Advisors nor the Underwriters have any responsibility to maintain the rating on the Series 2008 Bonds at any level or to oppose any revision or withdrawal of such ratings.

## TAX EXEMPTION

In the opinions of Andrews Kurth LLP Houston, Texas, and Johnson Radcliffe Petrov & Bobbitt PLLC, Houston, Texas, Co-Bond Counsel, interest on the Series 2008 Bonds is (1) excludable under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"), from gross income of the owners thereof for federal income tax purposes and (2) is not includable in the alternative minimum taxable income of individuals or corporations, except as described below.

The foregoing opinions of Co-Bond Counsel are based on the Code and the regulations, rulings and court decisions thereunder in existence on the date of issue of the Series 2008 Bonds. Such authorities are subject to change and any such change could prospectively or retroactively result in the inclusion of the interest on the Series 2008 Bonds in gross income of the owners thereof or change the treatment of such interest for purposes of computing alternative minimum taxable income.

In rendering their opinions, Co-Bond Counsel have assumed continuing compliance by the Authority with certain covenants in the Resolutions and have relied on representations by the Authority with respect to matters solely within the knowledge of the Authority, which Co-Bond Counsel have not independently verified. The covenants and representations relate to, among other things, the use of bond proceeds and any facilities financed therewith, the source of repayment of the Series 2008 Bonds, the investment of bond proceeds and certain other amounts prior to expenditure, and requirements, that excess arbitrage earned on the investment of bond proceeds and certain other amounts be paid periodically to the United States and that the Authority file an information report with the Internal Revenue Service (the “*Service*”). If the Authority should fail to comply with the covenants in the Resolutions, or if its representations relating to the Series 2008 Bonds that are contained in the Resolutions should be determined to be inaccurate or incomplete, interest on the Series 2008 Bonds could become taxable from the date of delivery of the Series 2008 Bonds, regardless of the date on which the event causing such taxability occurs.

Interest on all tax-exempt obligations, such as the Series 2008 Bonds, owned by a corporation (other than an S corporation, a regulated investment company, a real estate investment trust (REIT), a real estate mortgage investment conduit (REMIC) or a financial asset securitization investment trust (FASIT)) will be included in such corporation’s adjusted current earnings for purposes of calculating such corporation’s alternative minimum taxable income. A corporation’s alternative minimum taxable income is the basis on which the alternative minimum tax imposed by the Code is computed.

Except as stated above, Co-Bond Counsel will express no opinion as to any federal, state or local tax consequences resulting from the ownership of, receipt or accrual of interest on or acquisitions or disposition of the Series 2008 Bonds.

Co-Bond Counsel’s opinion is not a guarantee of a result, but represents a legal judgment based upon review of existing statutes, regulations, published rulings and court decisions and the representations and covenants of the Authority described above. No ruling has been sought from the Service with respect to the matters addressed in the opinion of Co-Bond Counsel, and Co-Bond Counsel’s opinion is not binding on the Service. The Service has an ongoing program of auditing the tax-exempt status of the interest on municipal obligations. If an audit is commenced, under current procedures the Service is likely to treat the Authority as the “taxpayer,” and the owners of the Series 2008 Bonds may have no right to participate in the audit process. In responding to or defending an audit of the tax-exempt status of the interest on the Series 2008 Bonds, the Authority may have different or conflicting interests from the owners of the Series 2008 Bonds. Public awareness of any future audit of the Series 2008 Bonds could adversely affect the value and the liquidity of the Series 2008 Bonds during the pendency of the audit, regardless of its ultimate outcome.

Under the Code, taxpayers are required to provide information on their returns regarding the amount of tax-exempt interest, such as interest on the Series 2008 Bonds, received or accrued during the year.

Prospective purchasers of the Series 2008 Bonds should be aware that the ownership of tax-exempt obligations, such as the Series 2008 Bonds, may result in collateral federal income tax consequences to, among others, financial institutions, life insurance companies, property and casualty insurance companies, certain foreign corporations doing business in the United States, certain S corporations with Subchapter C earnings and profits, individual recipients of Social Security or Railroad Retirement benefits, taxpayers who are deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations, taxpayers owning an interest in a

FASIT that holds tax-exempt obligations, and individuals otherwise eligible for the earned income credit. Such prospective purchasers should consult their owner tax advisors as to the consequences of investing in the Series 2008 Bonds.

If a tax-exempt obligation, such as the Series 2008 Bonds, is acquired at a “market discount” and if the fixed maturity of such obligation is equal to, or exceeds, one year from the date of issue, the Code provides ordinary income tax treatment of gain recognized upon the disposition of such “market discount bond.” A “market discount

bond” is one which is acquired by the holder at a purchase price which is less than the stated redemption price at maturity or, in the case of a bond issued at an original issue discount, the “revised issue price” (i.e., a market discount). Such treatment applies to “market discount bonds” to the extent the gain from the disposition thereof exceeds the accrued market discount of such bonds unless a statutory de minimis rule applies. The “accrued market discount” is the amount which bears the same ratio to the market discount as the number of days during which the holder holds the obligation bears to the number of days between the acquisition date and the final maturity date. The applicability of the market discount rules may adversely affect the liquidity or secondary market price of the Series 2008 Bonds. Purchasers should consult their own tax advisors regarding the potential implications of market discount with respect to the Series 2008 Bonds.

## **TAX TREATMENT OF DISCOUNT AND PREMIUM BONDS**

### **Discount Series 2008 Bonds**

Some of the Series 2008 Bonds may be offered at initial offering prices which are less than the stated redemption prices at maturity of such Series 2008 Bonds. If a substantial amount of any maturity of the Series 2008 Bonds is sold to members of the public (which for this purpose excludes bond houses, brokers and similar persons or entities acting in the capacity of wholesalers or underwriters) at such initial offering price, an initial owner who purchases the Series 2008 Bonds of that maturity (the “*Discount Series 2008 Bonds*”) will be considered to have “original issue discount” for federal income tax purposes equal to the difference between (a) the stated redemption price payable at the maturity of such Discount Series 2008 Bond and (b) the initial public offering price to the public for such Discount Series 2008 Bond. Under existing law, such original issue discount will be treated for federal income tax purposes as additional interest on such Series 2008 Bond and such initial owner will be entitled to exclude from gross income for federal income tax purposes that portion of such original issue discount deemed to be earned (as discussed below) during the period while such Discount Series 2008 Bond continues to be owned by such initial owner. Except as otherwise provided herein, the discussion regarding interest on the Series 2008 Bonds under the caption “Tax Exemption” generally applies to original issue discount deemed to be earned on a Discount Series 2008 Bond while held by an owner who has purchased such Series 2008 Bond at the initial offering price in the initial public offering of the Series 2008 Bonds and that discussion should be considered in connection with this portion of the Official Statement.

In the event of a redemption, sale, or other taxable disposition of a Discount Series 2008 Bond prior to its stated maturity, however, any amount realized by such initial owner in excess of the basis of such Discount Series 2008 Bond in the hands of such owner (increased to reflect the portion of the original issue discount deemed to have been earned while such Discount Series 2008 Bond continues to be held by such initial owner) will be includable in gross income for federal income tax purposes.

Because original issue discount on a Discount Series 2008 Bond will be treated for federal income tax purposes as interest on a Series 2008 Bond, such original issue discount must be taken into account for certain federal income tax purposes as it is deemed to be earned even though there will not be a corresponding cash payment. Corporations that purchase Discount Series 2008 Bonds must take into account original issue discount as it is deemed to be earned for purposes of determining alternative minimum tax. Other owners of a Discount Series 2008 Bond may be required to take into account such original issue discount as it is deemed to be earned for purposes of determining certain collateral federal tax consequences of owning a Series 2008 Bond. See “Tax Exemption” for a discussion regarding the alternative minimum taxable income consequences for corporations and for a reference to collateral federal tax consequences for certain other owners.

The characterization of original issue discount as interest is for federal income tax purposes only and does not otherwise affect the rights or obligations of the owner of a Discount Series 2008 Bond or of the Authority. The portion of the principal of a Discount Series 2008 Bond representing original issue discount is payable (upon the maturity or earlier redemption of such Discount Series 2008 Bond) to the registered owner of the Discount Series 2008 Bond at that time.

Under special tax accounting rules prescribed by existing law, a portion of the original issue discount on each Discount Series 2008 Bond is deemed to be earned each day. The portion of the original issue discount deemed to be earned each day is determined under an actuarial method of accrual, using the yield to maturity as the constant interest rate and semiannual compounding.

The federal income tax consequences of the purchase, ownership, redemption, sale or other disposition of Discount Series 2008 Bonds by an owner that did not purchase such Series 2008 Bonds in the initial public offering and at the initial offering price may be determined according to rules which differ from those described above. All prospective purchasers of Discount Series 2008 Bonds should consult their tax advisors with respect to the determination for federal, state and local income tax purposes of interest and accrued original issue discount upon redemption, sale or other disposition of such Discount Series 2008 Bond and with respect to the federal, state, local and foreign tax consequences of the purchase, ownership, redemption, sale or other disposition of such Discount Series 2008 Bonds.

### **Premium Series 2008 Bonds**

Some of the Series 2008 Bonds may be offered at initial offering prices which exceed the stated redemption prices payable at the maturity of such Series 2008 Bonds. If a substantial amount of any maturity of the Series 2008 Bonds is sold to members of the public (which for this purpose excludes bond houses, brokers and similar person or organizations acting in the capacity of wholesalers or underwriters) at such initial offering price, each of the Series 2008 Bonds of such maturity (“*Premium Series 2008 Bonds*”) will be considered for federal income tax purposes to have “bond premium” equal to the amount of such excess. The basis for federal income tax purposes of a Premium Series 2008 Bond in the hands of an initial purchaser who purchases such Series 2008 Bond in the initial offering must be reduced each year and upon the sale or other taxable disposition of the Series 2008 Bond by the amount of amortizable bond premium. This reduction in basis will increase the amount of any gain (or decrease the amount of any loss) recognized for federal income tax purposes upon the sale or other taxable disposition of a Premium Series 2008 Bond by the initial purchaser. Generally, no corresponding deduction is allowed for federal income tax purposes, for the reduction in basis resulting from amortizable bond premium. The amount of bond premium on a Premium Series 2008 Bond which is amortizable each year (or shorter period in the event of a sale or disposition of a Premium Series 2008 Bond) is determined under special tax accounting rules which use a constant yield throughout the term of the Premium Series 2008 Bond based on the initial purchaser’s original basis in such Series 2008 Bond.

The federal income tax consequences of the purchase, ownership, redemption, sale or other disposition by an owner of Series 2008 Bonds that are not purchased in the initial offering or which are purchases at an amount representing a price other than the initial offering prices for the Series 2008 Bonds of the same maturity may be determined according to rules which differ from those described above. Moreover, all prospective purchasers of Series 2008 Bonds should consult their tax advisors with respect to the federal, state, local and foreign tax consequences of the purchase, ownership, redemption, sale or other disposition of Premium Series 2008 Bonds.

### **LEGAL MATTERS**

The delivery of the Series 2008 Bonds is subject to the approving opinions of the Attorney General of the State and of Andrews Kurth LLP, Houston, Texas, and Johnson Radcliffe Petrov & Bobbitt PLLC, Houston, Texas, Co-Bond Counsel for the Authority, as to the validity of the issuance of the Series 2008 Bonds under the Constitution and laws of the State. The opinion of Bond Counsel will be based upon an examination of the transcripts of certain proceedings taken by the Authority incident to the issuance and authorization of the Series 2008 Bonds. Certain legal matters will be passed upon for the Underwriters by their counsel, Fulbright & Jaworski L.L.P., Houston, Texas. See also “THE AUTHORITY – Judicial Validation of Authority” herein.

### **FINANCIAL STATEMENTS**

The Authority’s financial statements for the year ended December 31, 2007, included in Appendix A to this Official Statement, have been audited by Null-Lairson, P.C., independent certified public accountants, to the extent and for the period indicated in their report thereon. The financial statements have been included in this Official Statement in reliance on their report.

### **CO-FINANCIAL ADVISORS**

RBC Capital Markets Corporation and The GMS Group, L.L.C. (the “*Co-Financial Advisors*”) have been retained by the Authority as its independent financial advisors in connection with the issuance of the Series 2008 Bonds and, in such capacity, have assisted the Authority in the preparation of documents. A portion of the Co-

Financial Advisors' fees for services rendered with respect to the Series 2008 Bonds are contingent upon the issuance and delivery of the Series 2008 Bonds.

Although the Co-Financial Advisors have read and participated in the drafting of this Official Statement, such firms have not independently verified any of the information set forth herein. The information contained in this Official Statement has been obtained primarily from the Authority's records and from other sources that are believed to be reliable, including financial records of the Authority and other entities which may be subject to interpretation. No guarantee is made by the Co-Financial Advisors as to the accuracy or completeness of any information herein. No person, therefore, is permitted to rely upon the participation of the Co-Financial Advisors as an implicit or explicit expression of opinion as to such completeness and accuracy.

## **UNDERWRITING**

Pursuant to a bond purchase agreement, First Southwest Company, Banc of America Securities LLC, Citigroup Global Markets, Inc., Coastal Securities, Inc., DEPFA First Albany Securities LLC, JP Morgan, Morgan Keegan & Co., Inc. and Ramirez & Co., Inc. (the "*Underwriters*") have agreed to purchase the Series 2008 Bonds at an underwriting discount of \$\_\_\_\_\_ from the offering prices shown on the cover page. The Underwriters have agreed to purchase all of the Series 2008 Bonds, if any of the Series 2008 Bonds are purchased. The obligation of the Underwriters is subject to certain conditions as described in the Bond Purchase Agreement.

The prices and other terms on which the Series 2008 Bonds are offered may be changed from time to time by the Underwriters. The Series 2008 Bonds may be offered and sold at prices other than the initial offering prices, including sales to dealers who may sell the Series 2008 Bonds into investment accounts.

## **CONTINUING DISCLOSURE OF INFORMATION**

In the Resolutions, the Authority has made the following agreement for the benefit of the holders and beneficial owners of the Series 2008 Bonds. The Authority is required to observe the agreement for so long as it remains obligated to advance funds to pay the Series 2008 Bonds. Under the agreement, the Authority will be obligated to provide certain updated financial information and operating data annually, and timely notice of specified material events, to certain information vendors. This information will be available to securities brokers and others who subscribe to receive the information from the vendors.

### **Annual Reports**

The Authority will provide certain updated financial information and operating data to certain information vendors annually. The information to be updated includes all quantitative financial information and operating data with respect to the Authority of the general type included in this Official Statement in the tables under "INVESTMENTS" and "FINANCIAL DATA." The Authority will update and provide this information within six months after the end of each fiscal year ending on or after December 31, 2008. The Authority will provide the updated information to each nationally recognized municipal securities information repository ("*NRMSIR*") and to any state information depository ("*SID*") that is designated by the State and approved by the staff of the Commission.

The Authority may provide updated information in full text or in such other form consistent with the agreement, or may incorporate by reference certain other publicly available documents, as permitted by SEC Rule 15c2-12 (the "*Rule*"). The updated information will include audited financial statements, if the Authority commissions an audit and it is completed by the required time. If audited financial statements are not provided by that time, the Authority will provide audited financial statements when and if they become available and will provide such financial statements on an unaudited basis within the required time. Any such financial statements will be prepared in accordance with the accounting principles described in Appendix A or such other accounting principles as the Authority may be required to employ from time to time pursuant to state law or regulation.

The Authority's current fiscal year end is December 31. Accordingly, it must provide updated information by June 30 in each year, unless the Authority changes its fiscal year. If the Authority changes its fiscal year, it will notify each NRMSIR and any SID of the change.

## **Material Event Notices**

The Authority will also provide timely notices of certain events to certain information vendors. The Authority will provide notice of any of the following events with respect to the Series 2008 Bonds, if such event is material to a decision to purchase or sell Series 2008 Bonds: (i) principal and interest payment delinquencies; (ii) non-payment related defaults; (iii) unscheduled draws on debt service reserves reflecting financial difficulties; (iv) unscheduled draws on credit enhancements reflecting financial difficulties; (v) substitution of credit or liquidity providers, or their failure to perform; (vi) adverse tax opinions or events affecting the tax-exempt status of the Series 2008 Bonds; (vii) modifications to rights of holders of the Series 2008 Bonds; (viii) Series 2008 Bond calls; (ix) defeasances; (x) release, substitution, or sale of property securing repayment of the Series 2008 Bonds; and (xi) rating changes. In addition, the Authority will provide timely notice of any failure by the Authority to provide information, data, or financial statements in accordance with its agreement described above under "Annual Reports." The Authority will provide each notice described in this paragraph to any SID and to either each NRMSIR or the Municipal Securities Rulemaking Board.

## **Availability of Information**

The Authority has agreed to provide the foregoing information only to NRMSIRs and any SID. The information will be available to holders of Series 2008 Bonds only if the holders comply with the procedures and pay the charges established by such information vendors or obtain the information through securities brokers who do so.

The Municipal Advisory Council of Texas has been designated by the State as a SID and the Commission has determined that it is a qualified SID. The address of the Municipal Advisory Council is 600 West 8th Street, Austin, Texas 78701 or P.O. Box 2177, Austin, Texas 78768-2177, and its telephone number is (512) 476-6947.

At the option of the Authority, any filing under this agreement may be made solely by transmitting such filing to the Texas Municipal Advisory Council (the "MAC") as provided at <http://www.disclosureusa.org> unless the United States Securities and Exchange Commission has withdrawn the interpretive advice in its letter to the MAC dated September 7, 2004 or the MAC ceases to operate as described in the application for the advice.

## **Limitations and Amendments**

The Authority has agreed to update information and to provide notices of material events only as described above. The Authority has not agreed to provide other information that may be relevant or material to a complete presentation of its financial results of operations, condition or prospects or agreed to update any information that is provided, except as described above. The Authority makes no representation or warranty concerning such information or concerning its usefulness to a decision to invest in or sell Series 2008 Bonds at any future date. The Authority disclaims any contractual or tort liability for damages resulting in whole or in part from any breach of its continuing disclosure agreement or from any statement made pursuant to its agreement, although holders of Series 2008 Bonds may seek a writ of mandamus to compel the Authority to comply with its agreement.

The Authority may amend its continuing disclosure agreement to adapt to changed circumstances that arise from a change in legal requirements, a change in law, or a change in the identity, nature, status or type of operations of the Authority, if the agreement, as amended, would have permitted an underwriter to purchase or sell Series 2008 Bonds in the offering made hereby in compliance with the Rule and either the holders of a majority in aggregate principal amount of the outstanding Series 2008 Bonds consent or nationally recognized bond counsel determines that the amendment will not materially impair the interests of the beneficial owners of the Series 2008 Bonds. If the Authority amends its agreement, it must include with the next financial information and operating data provided in accordance with its agreement described above under "Annual Reports" an explanation, in narrative form, of the reasons for the amendment and of the impact of any change in the type of information and data provided.

### **Compliance with Prior Undertakings**

During the last five years, the Authority has complied in all material respects with all continuing disclosure agreements made by it in accordance with the Rule, except possibly for one late report of water pumpage data, which has since been corrected.

### **MISCELLANEOUS**

The descriptions herein do not purport to be complete and all such descriptions or references are qualified in their entirety by reference to the complete form of the Resolutions or other documents or source they summarize. Statements made herein involving estimates or projections, whether or not expressly identified as such, should not be construed to be statements of fact or as representations that such estimates or projections will ever be attained or will approximate actual results. Any summaries or excerpts of constitutional provisions, statutes, Indenture, GRP or other documents do not purport to be complete statements of same and are made subject to all of the provisions thereof. Reference should be made to such original sources in all respects.

This document was approved by the Board of Directors of the Authority.

**APPENDIX A**

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY,  
FINANCIAL STATEMENTS FOR THE FISCAL YEAR  
ENDED DECEMBER 31, 2007**

**NORTH HARRIS COUNTY REGIONAL  
WATER AUTHORITY**

**FINANCIAL STATEMENTS**

**December 31, 2007 and 2006**



**Null-Lairson**

CERTIFIED PUBLIC ACCOUNTANTS

PROFESSIONAL CORPORATION

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Houston, Texas 77046  
Phone (713) 621-1515  
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**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY  
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## **Independent Auditors' Report**

Board of Directors  
North Harris County Regional Water Authority

We have audited the accompanying statements of net assets of the business type activities of North Harris County Regional Water Authority, as of December 31, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended, as listed in the table of contents. These financial statements are the responsibility of North Harris County Regional Water Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall basic financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the business type activities of North Harris County Regional Water Authority, as of December 31, 2007 and 2006, and the changes in financial position and cash flows thereof for the years ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis information listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the North Harris County Regional Water Authority's basic financial statements. The information beginning on page 42 appears as supplementary information. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However we did not audit the information and express no opinion on it.

*Null-Lairson, A.C.*

Houston, Texas  
May 5, 2008

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MEMBERS: AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS,  
CPA ASSOCIATES INTERNATIONAL, INC. WITH ASSOCIATED OFFICES IN PRINCIPAL U.S. AND INTERNATIONAL CITIES

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## **Management's Discussion and Analysis**

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## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Management's Discussion and Analysis*

*December 31, 2007*

#### **Using this Annual Report**

Within this section of the financial report of the North Harris County Regional Water Authority (the "Authority"), the Authority's Management provides narrative discussion and analysis of the financial activities of the Authority, for the fiscal year ended December 31, 2007. This analysis should be read in conjunction with the basic financial statements that follow this section.

In addition to this discussion and analysis, this annual report consists of:

- The Authority's basic financial statements;
- Notes to the basic financial statements; and
- Additional supplementary information

#### **Overview of the Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements, which are comprised of the following: 1) statement of net assets, 2) statement of revenues, expenses and changes in net assets, 3) statement of cash flows and 4) notes to the financial statements. This report also contains supplementary information in addition to the basic financial statements themselves.

The statement of net assets presents information on all of the Authority's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of changes in the financial position of the Authority.

The statement of revenues, expenses and changes in net assets presents information showing how the Authority's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

#### **Notes to the Financial Statements**

The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements.

#### **Financial Analysis of the Authority**

On the Statements of Net Assets, the difference between assets and liabilities is called net assets. The Authority's net assets at December 31, 2007, were \$13,194,490. Net assets are categorized based on their availability to provide financial resources for the Authority. Net assets that are "Invested in capital assets, net of related debt" represent the Authority's investments in capital assets, less any debt used to acquire those assets that is still outstanding. Resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. "Restricted" net assets represent amounts that are restricted for future debt service requirements. "Unrestricted" net assets represent amounts available to meet the Authority's future obligations.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Management's Discussion and Analysis**  
**December 31, 2007**

**Financial Analysis of the Authority (continued)**

The Authority's overall financial position at December 31, 2007 as compared to the two prior years is summarized as follows, based on information contained in the statement of net assets:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current and other assets	\$ 106,620,907	\$ 118,779,859	\$ 128,902,722
Capital assets	<u>184,042,781</u>	<u>164,970,204</u>	<u>154,923,008</u>
<b>Total assets</b>	<b>290,663,688</b>	<b>283,750,063</b>	<b>283,825,730</b>
Current liabilities	1,052,110	762,305	491,314
Long term liabilities	<u>276,417,088</u>	<u>274,657,948</u>	<u>278,305,864</u>
<b>Total liabilities</b>	<b>277,469,198</b>	<b>275,420,253</b>	<b>278,797,178</b>
Net Assets			
Invested in capital assets, net of related debt	(37,978,292)	(33,476,343)	(34,256,626)
Restricted for debt service	5,190,910	7,825,401	14,418,661
Unrestricted	<u>45,981,872</u>	<u>33,980,752</u>	<u>24,866,517</u>
<b>Total net assets</b>	<b><u>\$ 13,194,490</u></b>	<b><u>\$ 8,329,810</u></b>	<b><u>\$ 5,028,552</u></b>

The Authority's net operating income for the year ended December 31, 2007 was \$12,246,230 with net non-operating expenses of \$7,381,550 resulted in an increase in net assets of \$4,864,680. Non-operating revenues and non-operating expenses represented interest income from the Authority's investments and interest expense from the Authority's debt. The increase in net assets was primarily the result of the increase in the pumpage fee, which was effective October 1, 2006. The rate increase is consistent with the Authority's financial planning and budgeting, and is used to satisfy bond covenants and debt service requirements.

A summarized comparison of the Authority's operations for the year ended December 31, 2007 with the previous two years is as follows, based on information in the statement of activities:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Operating revenues	\$ 20,748,512	\$ 17,713,495	\$ 13,623,099
Operating expenses	<u>(8,502,282)</u>	<u>(7,142,128)</u>	<u>(4,551,144)</u>
Net operating income	12,246,230	10,571,367	9,071,955
Net non-operating revenue (expense)	<u>(7,381,550)</u>	<u>(7,270,109)</u>	<u>(6,959,040)</u>
Change in net assets	4,864,680	3,301,258	2,112,915
Net assets, beginning of year	<u>8,329,810</u>	<u>5,028,552</u>	<u>2,915,637</u>
Net assets, end of year	<b><u>\$ 13,194,490</u></b>	<b><u>\$ 8,329,810</u></b>	<b><u>\$ 5,028,552</u></b>

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Management's Discussion and Analysis**  
**December 31, 2007**

**Capital Assets**

As of December 31, 2007, the Authority had invested \$184,042,781 (net of accumulated depreciation) in capital assets. These capital assets primarily consist of land, construction in progress, infrastructure and the Authority's interest in treated water facilities and water transmission facilities.

The Authority's capital assets at December 31, 2007, as compared to the two previous years are summarized as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Capital assets not being depreciated:</b>			
Land and ROW acquisition	\$ 13,539,105	\$ 9,810,939	\$ 8,104,474
Construction in progress	<u>23,636,984</u>	<u>3,932,596</u>	<u>58,028,461</u>
Total capital assets not being depreciated	37,176,089	13,743,535	66,132,935
<b>Capital assets being depreciated or amortized:</b>			
Interest in treated water facilities	52,454,277	52,454,277	52,454,277
Interest in transmission facilities	26,064,086	29,187,152	29,187,152
Infrastructure	77,978,492	75,682,444	10,451,304
Furniture, computers & equipment	<u>141,361</u>	<u>141,361</u>	<u>134,693</u>
	156,638,216	157,465,234	92,227,426
Less accumulated depreciation and amortization	<u>(9,771,524)</u>	<u>(6,238,565)</u>	<u>(3,437,353)</u>
Total capital assets being depreciated or amortized	<u>146,866,692</u>	<u>151,226,669</u>	<u>88,790,073</u>
Total capital assets	<u>\$ 184,042,781</u>	<u>\$ 164,970,204</u>	<u>\$ 154,923,008</u>

During the current year, \$26,922,790 additional capital assets were added to the Authority. The additional capital assets consisted primarily of land, the completion of the Supervisory Control and Data Acquisition System (SCADA) and construction in progress.

Construction has been completed on several projects related to the Groundwater Reduction Plan. Completed projects in the current period include the Supervision Control and Data Acquisition (SCADA) System (project 101A). The approximate cost for this completed project is \$1.4 million.

Capital assets include construction in progress on the following projects:

- Spears Road Regional Pump Station (Project 2)
- TC Jester Distribution Line (Project 10)
- TC Jester / Ella Distribution Line (Project 11)
- Cypresswood Distribution Line (Project 14)
- Bourgeois Distribution Line (Project 15)
- Cutten Distribution Line – Phase II (Project 16)
- 2010 Transmission Line (Project 17)
- GTP System Improvements (Project 100)
- Geographical Information System (GIS) (Project 200)

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Management's Discussion and Analysis**  
**December 31, 2007**

**Capital Assets (continued)**

The projects that are not complete as of fiscal year end, along with related engineering fees, have been recorded as construction in progress in the statement of net assets. Engineering fees related to various other projects that are in the preliminary phases have also been recorded as construction in progress in the statement of net assets. No depreciation has been recorded for construction in progress.

**Long-Term Obligations**

The Authority's total long term obligation at December 31, 2007, as compared to the previous two years is as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Capital contributions			
2003	\$ 32,573,177	\$ 32,573,177	\$ 32,573,177
2005	<u>14,675,978</u>	<u>14,675,978</u>	<u>14,675,978</u>
	47,249,155	47,249,155	47,249,155
Revenue bonds			
Series 2003	124,685,000	124,685,000	124,685,000
Series 2005	93,875,000	93,875,000	93,875,000
Unamortized bond premium	8,065,916	8,358,911	8,654,906
Unamortized bond discount	<u>(1,660,560)</u>	<u>(1,723,307)</u>	<u>(1,786,054)</u>
	224,965,356	225,195,604	225,428,852
Accrued compensated absences	<u>133,564</u>	<u>134,861</u>	<u>92,190</u>
	<u>\$ 272,348,075</u>	<u>\$ 272,579,620</u>	<u>\$ 272,770,197</u>

During 2007, the Authority has continued to comply with all its bond covenants. See Note 5 for additional information.

During the year, the Authority transferred the net amount of \$9,000,000 from the Operating Fund to the Coverage Fund, in order to minimize the increase in pumpage fees necessary to satisfy the additional bond and rate covenants.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Management's Discussion and Analysis**  
**December 31, 2007**

**Next Year's Budget**

The Authority's 2008 budget as compared to actual results for 2007 is as follows:

	<u>2007 Actual</u>	<u>2008 Budget</u>
Operating revenues	\$ 20,748,512	\$ 24,549,200
Operating expenses	<u>(8,502,282)</u>	<u>(4,451,042)</u>
Net operating income	12,246,230	20,098,158
Interest revenues	5,795,884	2,000,000
Interest expense	<u>(13,177,434)</u>	<u>(13,407,682)</u>
Net non-operating expense	(7,381,550)	(11,407,682)
Change in net assets	4,864,680	8,690,476
Beginning net assets	<u>8,329,810</u>	<u>13,194,490</u>
Ending net assets	<u>\$ 13,194,490</u>	<u>\$ 21,884,966</u>

The Authority budgeted more revenues due to the increase in pumpage fees from \$0.84 to \$0.99, effective October 1, 2007, and less operating expenses for professional fees.

**Economic Factors**

The Harris-Galveston Subsidence District (HGSD) groundwater reduction requirements mandate that construction will begin on the infrastructure required to meet the 2010 conversion target of thirty percent reduction in groundwater use, along with requirements for higher conversion target thresholds which will take effect through the year 2030. The Authority's approved Groundwater Reduction Plan (GRP) defines how it will comply with this requirement.

In October 2003, the Authority adopted its first Capital Improvement Plan (the 2004-2005 "CIP"). The primary focus of the first CIP was the definition and construction of the infrastructure necessary to allow implementation of the Groundwater Transfer Program (the "GTP").

As the GRP was being developed, it became apparent that some water districts within the Authority were experiencing difficulty with either water quality or water quantity to meet accelerating demand. The dilemma facing these districts was to decide whether or not to drill a new well that may be minimally used once they are converted to surface water in 2010. In response, the Authority implemented a program to share the existing groundwater capacity by connecting the districts that had surplus capacity in their wells to districts that needed additional water capacity now. The GTP involved constructing portions of the 2010 distribution lines earlier than originally planned. The initial components of the GTP were completed and the GTP was placed in operation in January 2006.

The first two CIP's primary focus was the definition and construction of the infrastructure necessary to allow implementation of the GTP. The next two current CIPs outlined and initiated the implementation of a broad-based program to provide the remainder of the infrastructure necessary to allow the conversion to surface water in 2010. The 2008-2009 CIP continues and completes that program and quantifies the funding needed to allow construction of the required infrastructure to enable the timely conversion to surface water in 2010.

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Management's Discussion and Analysis*

*December 31, 2007*

#### **Economic Factors (continued)**

The 2008-2009 Capital Improvement Plan (the "Plan") continues the systematic planning and development process begun when the Authority's Board adopted the first CIP in 2003. The primary focus of the Plan is to provide for: (1) the remaining components of the system needed to provide surface water to districts in 2010 and (2) the procurement of sites/easements for several of the key infrastructure components which will be needed to continue implementation of the GRP in 2020.

Some of the more significant activities provided for in the Plan are:

- Complete definition of the alignment, secure necessary easements, complete design and construct the remaining 2010 distribution lines and district connections
- Secure necessary easements, complete design and construct the 2010 Transmission Line from the Greens Road water line to the Authority's distribution system (Project 1A)
- Complete design and construct the Spears Road Regional Pump Station
- Complete design and construct the Louetta Regional Pump Station
- Complete the evaluation of the need and as need is defined, locate, design and construct and/or purchase regional water wells
- Define, design and construct Supervisory Control and Data Acquisition (SCADA) System to enable efficient operation of the 2010 system
- Provide infrastructure to areas adjacent to the original service area thereby allowing a practical expansion of the area which will receive surface water in 2010
- Finalize the alignment of the portion of the 2020 transmission line generally north of Beltway 8 from just west of US Highway 59 to State Highway 249 and secure the necessary easements
- Pay the final component of the capital cost for the 31 MGD allocation of water from the City of Houston and funds to increase the Authority's allocation up to 36 MGD
- Identify and purchase the site for each of the three 2020 regional water plants and two 2020 regional pump stations
- Reuse program participation
- Provide professional services to perform the wide variety of activities required to implement the CIP

The Plan has been developed using the best information currently known about the scope of each project and cost information from a variety of sources including cost experience from the Authority's projects completed to date. While the Authority does have some history in terms of cost experience, its cost base is still evolving in several areas. As such, the following points are offered so that the implementation of this CIP may be kept in perspective:

- Inasmuch as a large portion of the system is currently under design, there is the possibility that conditions could be uncovered which impact the costs of the project(s)
- Real estate and construction costs can be and are influenced by variables over which the Authority has no control
- It is common to experience unexpected costs during the implementation of large public works projects; provision of contingency amounts is the most practical way to attempt to address this issue and such contingencies have been provided for in the Plan

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Management's Discussion and Analysis*

*December 31, 2007*

**Economic Factors (continued)**

While the 2004-2005 CIP used the best cost estimation available at the time, it did not have the benefit of actual prior Authority project experience on which to build. Additionally, the costing was based on the general project definition presented in the GRP. As the actual design of the projects proceeded and the criteria within which the Authority needed to develop its projects became clearer, the definition of the projects was sharpened. As a result, the ability to estimate project costs has improved. The estimated costs included in the Plan have been updated and /or based, where practical, on experience gained thus far on actual Authority projects.

As seen in the following table, the estimated cost to implement the Plan is approximately \$233.6 million. Approximately \$29.6 million will be funded by the proceeds from the sale of the Authority's 2003 and 2005 Senior Lien Revenue Bonds, capital contributions and interest earned (collectively called "Revenue Bonds"). It is currently anticipated that the remaining \$204 million will be funded with a future bond sale in 2008.

Through September 2007, approximately 85% of the Revenue Bonds earmarked for the implementation of the CIP have been authorized. The remainder of those funds is scheduled to be authorized in early 2008.

Capital Improvement Plan Summary 2008-2009

Category	Authorizations		Fiscal Year		Project Total
			Planned Authorizations		
	1/1/03-9/30/07	10/1/07-12/31/07	2008	2009	
Acquisition	\$ 13,733,000	\$ 2,975,000	\$ 13,871,000	\$	\$ 30,579,000
Design	26,813,000	8,877,000	6,966,000	2,700,000	45,356,000
Construction	91,066,000	5,533,000	148,358,000		244,957,000
Equipment					
Other	31,360,000	400,000	6,209,000	37,716,000	75,685,000
Total Authorizations	<u>\$ 162,972,000</u>	<u>\$ 17,785,000</u>	<u>\$ 175,404,000</u>	<u>\$ 40,416,000</u>	<u>\$ 396,577,000</u>
<b>Source of Funds</b>					
Revenue Bonds	\$ 162,972,000	\$ 17,785,000	\$ 10,662,000	\$ 1,100,000	\$ 192,519,000
Future BANS/Bonds			164,742,000	39,316,000	204,058,000
Total Funds	<u>\$ 162,972,000</u>	<u>\$ 17,785,000</u>	<u>\$ 175,404,000</u>	<u>\$ 40,416,000</u>	<u>\$ 396,577,000</u>

**Request for Information**

This financial report is designed to provide a general overview of the Authority's finances. Questions concerning any information provided in this report or requests for additional information should be addressed to the Financial Assistant, North Harris County Regional Water Authority, 3648 FM 1960 West, Suite 110, Houston, Texas 77068.

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## **Basic Financial Statements**

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Statements of Net Assets**  
**December 31, 2007 and 2006**

	<u>2007</u>	<u>2006</u>
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 186,489	\$ 34,339
Investments	43,205,986	34,171,840
Due from the City of Houston (see Note 13)	3,123,067	
Accounts receivable other	160,690	180,425
Total current assets	<u>46,676,232</u>	<u>34,386,604</u>
<b>Noncurrent assets</b>		
Restricted cash and investments	56,305,896	80,619,353
Unamortized bond issuance costs, net	3,638,779	3,773,902
Capital assets not being depreciated	37,176,089	13,743,535
Capital assets net of accumulated depreciation	146,866,692	151,226,669
Total noncurrent assets	<u>243,987,456</u>	<u>249,363,459</u>
<b>Total assets</b>	<u>290,663,688</u>	<u>283,750,063</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable	556,549	246,966
Other payables	4,247	24,025
Interest payable on bonds	491,314	491,314
Total current liabilities	<u>1,052,110</u>	<u>762,305</u>
<b>Noncurrent liabilities</b>		
Accounts payable from restricted assets	3,360,273	2,032,159
Retainage payable from restricted assets	708,740	46,169
Accrued compensated absences	133,564	134,861
Capital contributions due in more than one year	47,249,155	47,249,155
Bonds payable due in more than one year (net of unamortized bond premium and discount)	224,965,356	225,195,604
Total noncurrent liabilities	<u>276,417,088</u>	<u>274,657,948</u>
<b>Total liabilities</b>	<u>277,469,198</u>	<u>275,420,253</u>
<b>Net assets</b>		
Invested in capital assets, net of related debt	(37,978,292)	(33,476,343)
Restricted for debt service	5,190,910	7,825,401
Unrestricted	45,981,872	33,980,752
<b>Total net assets</b>	<u>\$ 13,194,490</u>	<u>\$ 8,329,810</u>

See Notes to Financial Statements.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**  
**Statements of Revenues, Expenses and Changes in Net Assets**  
**For the Years Ended December 31, 2007 and 2006**

	<u>2007</u>	<u>2006</u>
<b>Operating revenues</b>		
Charges for services		
Pumpage fees	\$ 19,680,186	\$ 16,784,075
Water sales	1,055,286	928,314
Other	13,040	1,106
<b>Total operating revenues</b>	<u>20,748,512</u>	<u>17,713,495</u>
<b>Operating expenses</b>		
Personnel	1,133,978	1,106,957
Professional fees	1,494,284	1,556,567
Purchased water	960,666	725,625
Contracted services	534,713	213,135
Occupancy and office	439,071	339,591
Other	270,489	262,918
Depreciation and amortization	3,669,081	2,937,335
<b>Total operating expenses</b>	<u>8,502,282</u>	<u>7,142,128</u>
<b>Net operating income</b>	12,246,230	10,571,367
<b>Non-operating revenues (expenses)</b>		
Interest and fiscal charges expense	(13,177,434)	(13,171,672)
Interest income	5,795,884	5,901,563
<b>Net non-operating revenues (expenses)</b>	<u>(7,381,550)</u>	<u>(7,270,109)</u>
<b>Change in net assets</b>	4,864,680	3,301,258
<b>Total net assets - beginning</b>	<u>8,329,810</u>	<u>5,028,552</u>
<b>Total net assets - ending</b>	<u>\$ 13,194,490</u>	<u>\$ 8,329,810</u>

See Notes to Financial Statements.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Statements of Cash Flows*

*For the Years Ended December 31, 2007 and 2006*

	<u>2007</u>	<u>2006</u>
<b>Cash flows from operating activities</b>		
Receipts from customers	\$ 20,768,247	\$ 18,452,149
Payments for personnel costs	(1,135,275)	(1,064,286)
Payments to contractors and vendors	(3,409,418)	(2,826,845)
Net cash provided by operating activities	<u>16,223,554</u>	<u>14,561,018</u>
<b>Cash flows from capital and related financing activities</b>		
Interest paid	(13,408,681)	(13,406,420)
Acquisition and construction of capital assets	(23,737,918)	(16,305,747)
Net cash provided (used) by capital and related financing activities	<u>(37,146,599)</u>	<u>(29,712,167)</u>
<b>Cash flows from investing activities</b>		
Interest received	5,795,884	5,901,563
Net cash provided by investing activities	<u>5,795,884</u>	<u>5,901,563</u>
Net decrease in cash and cash equivalents	(15,127,161)	(9,249,586)
<b>Balances -beginning of the year</b>	<u>114,825,532</u>	<u>124,075,118</u>
<b>Balances - end of the year</b>	<u>\$ 99,698,371</u>	<u>\$ 114,825,532</u>
<b>Reconciliation of operating income to net cash provided by operating activities:</b>		
Operating income	\$ 12,246,230	\$ 10,571,367
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization expense	3,669,081	2,937,335
Change in assets and liabilities:		
Increase in accounts receivable	19,735	738,654
Increase in accounts payable	289,805	270,991
Decrease in compensated absences	(1,297)	42,671
Total adjustments	<u>3,977,324</u>	<u>3,989,651</u>
Net cash provided by operating activities	<u>\$ 16,223,554</u>	<u>\$ 14,561,018</u>
<b>Cash and cash equivalents per balance sheet:</b>		
Cash	\$ 186,489	\$ 34,339
Investments	43,205,986	34,171,840
Restricted cash and investments	56,305,896	80,619,353
	<u>\$ 99,698,371</u>	<u>\$ 114,825,532</u>

See Notes to Financial Statements.

# **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

## *Notes to Financial Statements*

*December 31, 2007*

### **Note 1- Summary of Significant Accounting Policies**

The North Harris County Regional Water Authority (the “Authority”) was created in 1999 under Article 16, Section 59 of the Texas Constitution by House Bill 2965, as passed by the 75th Texas Legislature and as amended (the “Act”). The Authority began operations in October 1999. The Act empowers the Authority to provide for the conservation, preservation, protection, recharge and prevention of waste of groundwater and for the reduction of groundwater withdrawals.

The Authority may charge a fee, based on the amount of water pumped from the well, to the owner of wells located in the Authority’s boundaries, unless exempted. The fees established by the Board of Directors must be sufficient to: (1) achieve water conservation, prevent waste of water, serve as a disincentive to pumping groundwater and make available alternative water supplies; and (2) enable the Authority to meet operation and maintenance expenses and pay the principal and interest on any debt issued by the Authority.

The accompanying financial statements of the Authority have been prepared in conformity with accounting principles generally accepted in the United States of America. The following is a summary of the most significant policies:

#### **Reporting Entity**

The Authority is a political subdivision of the State of Texas governed by an elected five member board. As required by generally accepted accounting principles, these financial statements have been prepared based on considerations regarding the potential for inclusion of other entities, organizations or functions as part of the Authority’s financial reporting entity. No other entities, organizations or functions have been included in the Authority’s financial reporting entity. Additionally, as the Authority is considered a primary government for financial reporting purposes, its activities are not considered a part of any other governmental or other type of reporting entity.

Considerations regarding the potential for inclusion of other entities, organizations or functions in the Authority’s financial reporting entity are based on criteria prescribed by generally accepted accounting principles. These same criteria are evaluated in considering whether the Authority is a part of any other governmental or other type of reporting entity. The overriding elements associated with prescribed criteria considered in determining that the Authority’s financial reporting entity status is that of a primary government are: that it has a separate governing body; it is legally separate; and it is fiscally independent of other state and local governments. Additional prescribed criteria under generally accepted accounting principles include; considerations pertaining to organizations for which the primary government is financially accountable; and considerations pertaining to other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete.

#### **Basic Financial Statements**

The basic financial statements include the statement of net assets, the statement of revenues, expenses and changes in net assets and the statement of cash flows. These statements focus on the sustainability of the Authority as an entity and the change in aggregate financial position resulting from these activities for the fiscal year.

# **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

## *Notes to Financial Statements*

*December 31, 2007*

### **Note 1- Summary of Significant Accounting Policies (continued)**

#### **Measurement Focus and Basis of Accounting**

The Authority follows proprietary fund accounting and reporting requirements, which utilize the economic resources measurement focus and the accrual basis of accounting. The Authority follows generally accepted accounting principles prescribed by the Governmental Accounting Standards Board (GASB) and all Financial Accounting Standard Board's (FASB) standards issued prior to November 30, 1989. The Authority has elected not to apply FASB pronouncements issued after that date.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues are charges to customers for pumpage fees. Operating expenses include the cost of services, administrative expenses and depreciation and amortization on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Net assets are classified into the following three components:

- Invested in capital assets, net of related debt – this component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, notes, capital contribution credits or other borrowings.
- Restricted – this component of net assets consists of constraints placed on net assets used through external constraints imposed by creditors, grantors, contributors or laws or regulations of other governments or through contractual provisions or enabling legislation.
- Unrestricted – this component of net assets consists of net assets that do not meet the definition of the previous two categories.

#### **Cash and Investments**

The Authority's cash and investments consist of cash on hand, demand deposits and balances in TexPool, TexPool Prime and TexSTAR accounts, which are public funds investment pools. Amounts in these pools are stated at amortized cost, rather than market value. For the purposes of the statement of cash flows, the Authority considers investments in investment pools to be cash equivalents.

#### **Receivables**

All receivables are reported at their gross value and, where appropriate, are reduced by an allowance for amounts considered uncollectible. At December 31, 2007 and 2006 an allowance of \$34,365 was provided for possible uncollectible accounts.

#### **Restricted Assets**

Proceeds of bonds or other resources set aside for specific purposes are classified as restricted assets on the balance sheet because their use is limited by applicable bond covenants or contractual agreements.

#### **Capital Assets**

The Authority defines capital assets as assets with an individual cost of \$5,000 or more and an estimated useful life in excess of one year. Capital assets, which include land, right of way acquisition costs, infrastructure and interest in infrastructure assets constructed by the City of Houston, are reported at historical cost. Donated assets are recorded at their estimated fair value at the date of donation.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 1- Summary of Significant Accounting Policies (continued)**

**Capital Assets (continued)**

The costs of normal maintenance and repairs that do not add to the value of assets or materially extend asset lives are not capitalized. Capital assets are depreciated using the straight-line method over the following estimated useful lives:

<u>Asset</u>	<u>Years</u>
Computer and software	3
Furniture and equipment	5-7
Infrastructure	20-45

**Long Term Obligations**

Long term debt and other long term obligations are reported as liabilities on the Authority's statement of net assets. Bonds payable are reported net of any applicable discount or premium. Bond issuance costs are reported as a deferred charge (i.e., a non-current asset) and are amortized over the life of the bonds to which they relate using the straight line method, which approximates the interest method.

**Compensated Employee Absences**

Compensated employee absences, which include vacation, compensatory time and sick leave, are accumulated during employment and are accrued when earned. The rate at which an employee earns benefits will vary depending upon their employment status, years employed and position with the Authority. Full-time employees are eligible for vacation time after six months employment and earn between 10 and 25 days vacation per year. At December 31, up to 40 hours of vacation leave is automatically converted to compensatory time. Employees who work at least 32 hours per week earn sick leave at the rate of 3-5 hours per pay period, not to exceed 480 hours. Upon termination, employees are paid for accumulated vacation and compensatory time. The General Manager is also entitled to receive compensation for accrued sick leave.

**Use of Estimates**

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual amounts could differ from those estimates.

**Note 2 – Cash and Investments**

**Deposit Custodial Credit Risk**

Custodial credit risk as it applies to deposits (i.e. cash) is the risk that, in the event of the failure of the depository institution, a government will not be able to recover its deposits or will not be able to recover collateral securities. The *Public Funds Collateral Act* (Chapter 2257, Texas Government Code) requires that all of the Authority's deposits with financial institutions be covered by federal depository insurance and, if necessary, pledged collateral held by a third party custodian. The act further specifies the types of securities that can be used as collateral. The Authority's written investment policy establishes additional requirements for collateralization of deposits. As of December 31, 2007, all of the Authority's deposits are insured or fully collateralized.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 2 – Cash and Investments (continued)**

**Restricted Cash**

Cash and investments were restricted for the following purposes at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Bond reserves	\$ 5,682,224	\$ 8,316,715
Capital improvements	<u>50,623,672</u>	<u>72,302,638</u>
	<u>\$ 56,305,896</u>	<u>\$ 80,619,353</u>

**Investments**

The Authority is authorized by the *Public Funds Investment Act* (Chapter 2256, Texas Government Code) to invest in the following: (1) obligations of the United States or its agencies and instrumentalities, (2) direct obligations of the State of Texas or its agencies and instrumentalities, (3) certain collateralized mortgage obligations, (4) other obligations, which are unconditionally guaranteed or insured by the State of Texas or the United States or its agencies or instrumentalities, (5) certain A rated or higher obligations of states and political subdivisions of any state, (6) bonds issued, assumed or guaranteed by the State of Israel, (7) insured or collateralized certificates of deposit, (8) certain fully collateralized repurchase agreements, (9) bankers' acceptances with limitations, (10) commercial paper rated A-1 or P-1 or higher and a maturity of 270 days or less, (11) no-load money market mutual funds and no-load mutual funds, with limitations, (12) certain guaranteed investment contracts, (13) certain qualified governmental investment pools and (14) a qualified securities lending program.

The Authority has adopted a written investment policy to establish the principles by which the Authority's investment program should be managed. This policy further restricts the types of investments in which the Authority may invest.

As of December 31, 2007 and 2006, the Authority's investments consist of the following:

Type	<u>2007</u>		<u>2006</u>	
	Carrying Value	Percentage of Total	Carrying Value	Percentage of Total
TexPool	\$ 16,099,020	16%	27,082,612	24%
TexPool Prime	36,894,808	37%	48,416,559	42%
TexSTAR	<u>46,411,379</u>	<u>47%</u>	<u>39,018,691</u>	<u>34%</u>
<b>Total</b>	<u>\$ 99,405,207</u>	<u>100%</u>	<u>\$ 114,517,862</u>	<u>100%</u>

  

	<u>Rating</u>	<u>Rating</u>
TexPool	AAA	AAA
TexPool Prime	AAA	AAA
TexSTAR	AAA	AAA

  

	<u>Weighted Average Maturity</u>	<u>Weighted Average Maturity</u>
TexPool	79 days	50 days
TexPool Prime	27 days	34 days
TexSTAR	Less than 90 days	Less than 90 days

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 2 – Cash and Investments (continued)**

**Investment Pools**

The Authority participates in TexPool, the Texas Local Government Investment Pool. The State Comptroller of Public Accounts exercises oversight responsibility of TexPool, which includes (1) the ability to significantly influence operations, (2) designation of management and (3) accountability for fiscal matters. Additionally, the State Comptroller has established an advisory board composed of both participants in TexPool and other persons who do not have a business relationship with TexPool. The Advisory Board members review the investment policy and management fee structure. Although TexPool is not registered with the SEC as an investment company, it operates in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. As permitted by GAAP, TexPool uses amortized cost (which excludes unrealized gains and losses) rather than market value to compute share price. Accordingly, the fair value of the Authority's position in TexPool is the same as the value of TexPool shares.

The Authority also participates in TexSTAR, which also operates as 2a-7 like investment pool. TexSTAR is managed by First Southwest Asset Management and JP Morgan Chase. As with TexPool, the Authority's position in the pool is the same as the value of the Authority's share in that pool.

**Investment Credit and Interest Rate Risk**

Investment credit risk is the risk that the investor may not recover the value of an investment from the issuer, while interest rate risk is the risk that the value of an investment will be adversely affected by changes in interest rates. The Authority's investment policies do not address investment credit and interest rate risk beyond the rating and maturity restrictions established by state statutes.

**Note 3 – Capital Assets**

A summary of changes in capital assets during the year ended December 31, 2007, follows:

	Beginning Balance	Additions	Retirements/ Adjustments	Ending Balance
<b>Capital assets not being depreciated:</b>				
Land and ROW acquisition	\$ 9,810,939	\$ 3,728,166	\$	\$ 13,539,105
Construction in progress	3,932,596	20,898,576	(1,194,188)	23,636,984
Total capital assets not being depreciated	13,743,535	24,626,742	(1,194,188)	37,176,089
<b>Capital assets being depreciated or amortized:</b>				
Interest in treated water facilities	52,454,277			52,454,277
Interest in transmission facilities Infrastructure	29,187,152		(3,123,066)	26,064,086
Furniture, computers & equipment	75,682,444	2,296,048		77,978,492
Less accumulated depreciation and amortization	141,361			141,361
	(6,238,565)	(3,602,360)	69,401	(9,771,524)
Total capital assets being depreciated or amortized	151,226,669	(1,306,312)	(3,053,665)	146,866,692
Total capital assets	\$ 164,970,204	\$ 23,320,430	\$ (4,247,853)	\$ 184,042,781

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 3 – Capital Assets (continued)**

The Authority had the following contractual commitments for construction projects at December 31, 2007:

<u>Contract</u>	<u>Contractual Commitment</u>	<u>Construction in Progress</u>	<u>Remaining Commitment</u>
Construction of 16" and 30" water transmission line to serve Harris County Municipal Utility District No. 367 and Harris County Municipal Utility District No. 368 - Project 6A-1	\$ 3,883,276	\$	\$ 3,883,276
Construction of 48" / 42" water line along T.C. Jester Boulevard from Bammel North Houston Drive to Ivy Falls Drive and construction of 12" water line connections to the Northwest Harris County Municipal Utility District No. 20 and Harris County Municipal Utility District No. 44 water plants - Project 10A	7,187,464	6,295,908	891,556
Construction of 42" Water line along T.C. Jester Boulevard, Cypresswood Drive and Spring Gully from Ivy Falls Drive to Theiss Gully and a 20" water line along Cypresswood Drive from Spring Gully to Cypress-Klien Utility District Water Plant - Project 10B	4,588,436	3,485,723	1,102,713
Construction of 36" water line along Louetta Road from the Burlington Northern Santa Fe Railroad tracks to Squyres Road - Project 15A	8,563,220	4,811,806	3,751,414
Total	<u>\$ 24,222,396</u>	<u>\$ 14,593,437</u>	<u>\$ 9,628,959</u>

The Authority has recorded an additional \$8,331,729 for engineering fees, \$708,740 for retainage and \$3,078 for electrical costs in construction in progress.

**Note 4 - Leases**

In 2000, the Authority entered into a lease for office space. The term of the lease was for five years. The lease was amended effective November 1, 2005 and will terminate on January 31, 2011. The Authority may terminate the lease anytime after thirty-six months, by giving twelve months written notice and by paying a lease termination penalty of \$19,500. The Authority has also entered into various leases for office equipment. The Authority paid \$100,970 under these leases during the current period. The annual commitments for leases are as follows:

<u>Year Ending</u>	<u>Amount</u>
2008	\$ 103,439
2009	100,972
2010	106,844
2011	8,895
Total	<u>\$ 320,150</u>

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 5 – Long -Term Obligations**

The Authority’s long term obligations consist of revenue bonds, capital contributions (see Note 6) and compensated absences.

**Senior Lien Revenue Bonds**

The Authority issues Senior Lien Revenue Bonds (Senior Bonds) primarily to finance the design, acquisition and construction of regional water production, transmission, pumping, storage and distribution systems. The principal and interest on the Authority’s bonds will be repaid from net revenues.

Long-term debt, as reported on the financial statements for years ending 2007 and 2006 is comprised of the following:

	<u>2007</u>	<u>2006</u>
Bonds Payable	\$ 218,560,000	\$ 218,560,000
Unamortized premiums	8,065,916	8,358,911
Unamortized discounts	<u>(1,660,560)</u>	<u>(1,723,307)</u>
Total	<u>\$ 224,965,356</u>	<u>\$ 225,195,604</u>
Due within one year	<u>\$ 0</u>	<u>\$ 0</u>

Bonds payable at December 31, 2007 are comprised of the following issues:

<u>Series</u>	<u>Amounts Outstanding</u>	<u>Original Issue Amount</u>	<u>Interest Rates</u>	<u>Maturity Date, Serially, Beginning /Ending</u>	<u>Interest Payment Dates</u>	<u>Callable Date</u>
2003	\$ 124,685,000	\$ 124,685,000	5.00% - 5.25%	December 15, 2010/2033	June 15 / December 15	December 15, 2013
2005	93,875,000	93,875,000	3.50% - 5.25%	December 15, 2010/2033	June 15 / December 15	December 15, 2014
	<u>\$ 218,560,000</u>					

There were no changes in the principal amount of long term bonds during the year.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 5 – Long -Term Obligations (continued)**

The Senior Bonds are secured by a lien on and pledge of the net revenues of the Authority. As additional security, the bond resolutions required the establishment of an Interest and Sinking Fund, a Reserve Fund and a Coverage Fund. A description of each fund follows:

- Interest and Sinking Fund - Used to accumulate the funds required to make the scheduled payments of debt service on the Senior Bonds. Money in the Interest and Sinking Fund shall be used solely for the purpose of paying principal, interest and any bank charges and other costs associated with payments of debt service on the Senior Bonds. Investments restricted for this fund as of December 31, 2007 were \$5,190,910.
- The Reserve Fund –Used (to the extent that amounts on deposit in the Interest and Sinking Fund and the Coverage Fund are insufficient) to pay the principal and interest on the Senior Bonds as it becomes payable. An insurance surety bond is on hand to secure performance and satisfy bond covenants.
- The Coverage Fund – Used to accumulate funds equal to 25% of the maximum annual debt service requirements for outstanding debt in any fiscal year. As of December 31, 2007, investments restricted by bond covenants for this fund were \$3,916,529, with an additional \$42,076,658 designated by the Authority (see Note 7).
- Operation and Maintenance Reserve Fund – Funds from gross revenues of the Authority will be deposited on or before the last business day of the month into this account. Investments restricted for this fund were \$825,000 as of December 31, 2007.

The Authority was in compliance with the bond covenants as of December 31, 2007. See Note 16 concerning a material subsequent event related to the Reserve Fund.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 5 – Long -Term Obligations (continued)**

As of December 31, 2007, the debt service requirements on the Senior Bonds outstanding are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Totals</u>
2008	\$	\$ 11,054,556	\$ 11,054,556
2009		11,054,556	11,054,556
2010	4,605,000	11,054,556	15,659,556
2011	4,810,000	10,851,981	15,661,981
2012	5,025,000	10,635,356	15,660,356
2013	5,275,000	10,384,106	15,659,106
2014	5,545,000	10,115,156	15,660,156
2015	5,835,000	9,824,044	15,659,044
2016	6,145,000	9,517,706	15,662,706
2017	6,470,000	9,195,094	15,665,094
2018	6,810,000	8,855,418	15,665,418
2019	7,165,000	8,497,893	15,662,893
2020	7,540,000	8,121,731	15,661,731
2021	7,935,000	7,725,881	15,660,881
2022	8,355,000	7,309,293	15,664,293
2023	8,775,000	6,883,293	15,658,293
2024	9,225,000	6,435,868	15,660,868
2025	9,685,000	5,974,618	15,659,618
2026	10,175,000	5,490,368	15,665,368
2027	10,680,000	4,981,618	15,661,618
2028	11,215,000	4,447,618	15,662,618
2029	11,775,000	3,886,868	15,661,868
2030	12,360,000	3,298,118	15,658,118
2031	12,980,000	2,680,118	15,660,118
2032	13,635,000	2,031,118	15,666,118
2033	14,315,000	1,349,368	15,664,368
2034	5,960,000	626,531	6,586,531
2035	6,265,000	321,081	6,586,081
Totals	<u>\$ 218,560,000</u>	<u>\$ 192,603,912</u>	<u>\$ 411,163,912</u>

Principal and interest payments on the Senior Bonds will be provided through the payment of pumpage fees by utility districts and non-exempt well owners.

**Compensated Absences**

The Authority’s liability for compensated absences changed as follows:

	<u>2007</u>	<u>2006</u>
Balance at beginning of year	\$ 134,861	\$ 92,190
Increase in liability	133,564	134,861
Decrease in liability	<u>(134,861)</u>	<u>(92,190)</u>
Balance at end of year	<u>\$ 133,564</u>	<u>\$ 134,861</u>

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 6 – Capital Contributions**

In 2003, the Authority entered into contracts with twenty-four Municipal Utility Districts (MUDs) to provide funds to pay capital expenditures of the Authority’s system. Each MUD has paid a Capital Contribution based on a percentage of its pro-rata share of the total groundwater production for all water utilities during the calendar year 2002. Capital contributions of \$32,573,177 were made to the Authority in the 2003 fiscal year. The participating MUDs began receiving contribution credits against their individual pumpage fees distributed over the life of the Series 2003 Senior Bonds beginning with the 2003 third quarter pumpage fees. Any amounts remaining plus accrued interest at the end of the capital contribution expiration date will be credited against any amounts owed to the Authority by the MUDs or paid to the MUDs by the Authority.

In 2005, the Authority entered into agreements with nineteen MUDs. Capital contributions of \$14,675,978 were made to the Authority in the 2005 fiscal year. The participating MUDs began receiving contribution credits against their individual pumpage fees distributed over the life of the Series 2005 Senior Bonds beginning with the 2005 third quarter pumpage fees. As with the 2003 contribution credits, any amounts remaining plus accrued interest at the end of the capital contribution date will be credited against any amounts owed to the Authority by the MUDs or paid to the MUDs by the Authority.

Future contribution credits including interest at the effective interest rate of the 2003 Senior Bonds as of December 31, 2007 are as follows:

<u>Year</u>	<u>Contribution Credits</u>	<u>Year</u>	<u>Contribution Credits</u>
2008	\$ 1,647,402	2021	\$ 2,373,821
2009	1,647,402	2022	2,373,821
2010	2,373,821	2023	2,373,821
2011	2,373,821	2024	2,373,821
2012	2,373,821	2025	2,373,821
2013	2,373,821	2026	2,373,821
2014	2,373,821	2027	2,373,821
2015	2,373,821	2028	2,373,821
2016	2,373,821	2029	2,373,821
2017	2,373,821	2030	2,373,821
2018	2,373,821	2031	2,373,821
2019	2,373,821	2032	2,373,821
2020	2,373,821	2033	2,373,821
		Totals	<u>\$ 60,266,508</u>

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 6 – Capital Contributions (continued)**

Future contribution credits including interest at the effective interest rate of the 2005 Senior Bonds as of December 31, 2007 are as follows:

<u>Year</u>	<u>Contribution Credits</u>	<u>Year</u>	<u>Contribution Credits</u>
2008	\$ 705,724	2022	\$ 1,000,879
2009	705,724	2023	1,000,879
2010	1,000,879	2024	1,000,879
2011	1,000,879	2025	1,000,879
2012	1,000,879	2026	1,000,879
2013	1,000,879	2027	1,000,879
2014	1,000,879	2028	1,000,879
2015	1,000,879	2029	1,000,879
2016	1,000,879	2030	1,000,879
2017	1,000,879	2031	1,000,879
2018	1,000,879	2032	1,000,879
2019	1,000,879	2033	1,000,879
2020	1,000,879	2034	1,000,879
2021	1,000,879	2035	1,000,879
		Totals	<u>\$ 27,434,302</u>

**Note 7 – Unrestricted Net Assets**

Included in the Authority's unrestricted net assets of \$45,981,872, is \$42,076,658 which the Authority has designated as additional bond reserves. These funds have been deposited in the Coverage Fund discussed in Note 5.

**Note 8 – Risk Management**

The Authority is exposed to various risks related to torts: theft of, damage to and destruction of assets; errors and omissions; and natural disasters. The Authority's risk management program encompasses various means of protecting the Authority against loss by obtaining property, casualty and liability coverage through commercial insurance carriers. There have been no significant reductions in insurance coverage. Settlement amounts have not exceeded insurance coverage for the current year or the three prior years.

**Note 9 – Deferred Compensation Plans**

The Authority offers its employees a deferred compensation plan created in accordance with Internal Revenue Code, Section 457. The plan is available and permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. The plan is administered by the International City Management Association - Retirement Corporation (ICMA-RC).

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Notes to Financial Statements*

*December 31, 2007*

#### **Note 10 – Pension Plan**

The Authority has established the North Harris County Regional Water Authority Qualified Pension Plan 401(a) (the “Plan”). The Plan covers all employees. Under the terms of the Plan, active participants become 100% vested on the fifth anniversary of employment. Participants are eligible for payment of benefits upon reaching age 65, becoming disabled or separating from service for any other reason. Benefits are distributed in accordance with the instructions of the participants. The Board of Directors appointed ICMA-RC to serve as Plan administrator and trustee. The Plan provides for a minimum Authority contribution of 7% of total current covered payroll. At December 31, 2007, all of the Authority’s employees were members of the Plan. Non-vested contributions are immaterial to total contributions at December 31, 2007. Vested contributions are solely the possession of participating employees. Total current payroll was \$958,479 for the year ended December 31, 2007, of which \$933,429 was covered under the Plan. Employer contributions to the Plan for the year ended December 31, 2007 were \$130,163.

In 2003, the Authority established an additional 401(a) plan for management employees only. It is identical to the above Plan with the following exceptions: 1) management employees are fully vested on the second anniversary of employment and 2) the Plan provides for a minimum Authority contribution of 25% for the current year annual covered payroll of the General Manager. The total payroll and employer contributions for this plan are included in the totals above.

#### **Note 11 – Water Supply Contracts**

In December 2002, the Authority entered into a forty year contract with the City of Houston (Houston) for the purchase of capacity in certain untreated water facilities and treated water facilities, including transmission facilities, of Houston. Under the terms of the contract, Houston will provide surface water to the Authority at a point of delivery to be located near Highway 59 and Beltway 8.

The contract stipulates that the Authority will purchase capacity, in phases, in Houston’s surface water system. Houston will be responsible for the design, construction, ownership, maintenance and operation of both treated and untreated water facilities prior to a mutually agreeable delivery point(s). The Authority will be responsible for the design, construction, ownership, maintenance and operation of all facilities located beyond the point of delivery.

During 2003, the Authority made its first payment of \$51,492,844 to Houston for the purchase of capacity in Houston’s treated water facilities and transmission facilities constructed prior to the effective date of the contract.

The Authority will pay Houston, on a monthly basis, its pro-rata share of operating and maintenance costs of the treated and untreated water facilities and transmission lines based on an annual operating budget once it begins receiving water. Such monthly payments will include an amount adequate to establish an operating reserve. The contract also provides the Authority with the option to purchase additional capacity in the future.

In March 2003, the Authority entered into an Interim Treated Water Supply Contract with Houston. Subject to the terms of this contract, the Authority entered into an agreement with Emerald Forest Utility District (the “District”) for water supply. In the 2003 fiscal year, the Authority reimbursed the District \$36,694 for the cost of constructing a water line to Houston’s line. During the current year, the Authority paid Houston \$52,101 on behalf of the District for purchased water.

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Notes to Financial Statements*

*December 31, 2007*

#### **Note 12 – Agreement for Joint Financing of Facilities**

In November 2003, the Authority entered into an Agreement for Joint Financing, Design, Construction, Operation and Maintenance of Surface Water Transmission Facilities (Joint Financing Agreement) with Harris County Municipal Utility District No. 33 (No. 33) for the Central Harris County Water Users Consortium, now Central Harris County Regional Water Authority (CHCRWA), a consortium of conservation and reclamation districts established and operating pursuant to the Central Harris County Water Users Consortium Agreement, dated December 13, 2002. Under the terms of the Joint Financing Agreement, the Authority will construct a sixty-inch water transmission line that is currently planned to commence at the point of delivery, as defined in the Authority's Water Supply Contract with Houston (see Note 11) to enable the Authority and the CHCRWA to receive surface water from the Northeast Water Purification Plant. The joint use facilities shall be completed no later than December 31, 2009.

The CHCRWA requires a means to receive surface water from Houston for delivery to the Member Districts and desires to participate in the financing, design, construction, operation and maintenance of the proposed water transmission line. The Authority will hold title to the joint use facilities and the CHCRWA will pay a pro-rata share of the costs of right-of-way acquisition, design and construction costs for the joint use facilities. The CHCRWA will escrow funds with the Authority for each phase of the construction and design. When each phase is complete, a summary of costs will be compiled and any excess or deficiency will be settled at that time. The CHCRWA will also be responsible for its pro-rata share of operation and maintenance costs of the facilities and will be required to establish an operation and maintenance cost reserve with the Authority, based on operation and maintenance budgets to be prepared annually. The estimated cost of the transmission line was \$63,681,140, with the Authority's share being 90.38% and the CHCRWA share being 9.62% of such costs.

#### **Note 13 – Interlocal Agreements**

**Greens Road Water Line.** The Authority entered into an interlocal agreement with the City of Houston (Houston), effective March 11, 2005, for the term of forty years, for the design and construction of the Greens Road water line that will provide the water transmission capacity necessary to serve the needs of Houston and the Authority. Houston has provided estimates to the Authority for real estate costs, engineering costs and contingencies for the project as well as the manner of calculation of such costs and the parties pro rata share of such costs. In the 2005 fiscal year, the Authority paid Houston its pro rata share of estimated construction costs and contingencies in the amount of \$29,187,152. Subsequent to year end, Houston performed a final accounting on the project which resulted in a refund to the Authority in the amount of \$3,123,067, which is recorded as a reduction in the cost of the asset and as receivable from the City of Houston in the Statement of Net Assets. Houston shall hold legal title to the Greens Road Project, however, Houston and the Authority shall each have an undivided equitable interest in, and use and benefit of capacity in the Greens Road water line, in accordance with their pro rata shares of capacity. The estimated capacity of the water line is 76.8 MGD, of which the Authority requires capacity of 44 MGD at the point of delivery in order to have adequate supply of treated surface water for distribution to the Authority's customers to comply with the Harris-Galveston Coastal Subsidence District's 1999 Regulatory Plan, as amended. Houston shall maintain and operate the Greens Road water line. The Authority will be billed for operation and maintenance costs based on their pro rata share of capacity and based on the budget approved by Houston and the Authority.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 13 – Interlocal Agreements (continued)**

**Louetta Regional Water Plant.** On February 16, 2005, the Authority entered into an interlocal agreement with Charterwood Municipal Utility District (Charterwood) and V&W Partners, Ltd. (V&W), for the term of forty years. The purpose of this agreement is to enable the Authority to construct a regional water plant in the area of Charterwood to be known as the Louetta Regional Water Plant (the “Louetta Plant”), enable Charterwood to obtain a supply of water for domestic use to supplement the water supply of Charterwood and to satisfy the needs of V&W for water service from Charterwood for 98 acres for commercial and residential development, which has been annexed into Charterwood. Under the terms of the agreement, the Authority will purchase a 30 foot wide water line easement from V&W to be used for the placement of two large diameter water lines from the plant site. Upon execution of the agreement, the Authority drilled a test hole for a well on the plant site to determine the feasibility and viability of the proposed wells. The drilling of the test hole was completed in the 2005 fiscal year at the cost of \$260,210, which includes construction costs and engineering. Under the terms of the agreement, the Authority proceeded with the construction of the production wells. Upon determination that there is at least one feasible production well, the Authority proceeded with the design and construction of a water line from the plant site to Charterwood’s Water Plant No. 2. The water line is used by the Authority to convey water from the Authority’s production wells to Charterwood’s Water Plant No. 2 in order for Charterwood to provide a supply of water to its customers. Upon completion of the two water lines, the Authority will own, operate and maintain the lines. Charterwood shall proceed with the construction of additional facilities, including pumps, chlorination equipment, storage tanks and other related equipment that are necessary to treat and distribute the water delivered to Charterwood’s Water Plant No. 2 by the Authority. The Authority shall pay Charterwood its pro rata share of the capital costs of the additional facilities. In the 2005 fiscal year, the Authority paid \$961,433 for its estimated share of the cost of the additional facilities.

The facilities were completed in the current fiscal year, a final accounting of construction costs has been made and is in review and the Authority anticipates that they will receive a small refund from Charterwood. In addition, the Authority shall pay Charterwood its pro rata share of the direct costs to repair and maintain the additional facilities. The Authority agrees to deliver water to Charterwood’s Water Plant No. 2, at the point of delivery, in an amount mutually agreed upon by Charterwood and the Authority. Charterwood agrees to purchase water from the Authority to provide a supply of water to its customers. All water delivered by the Authority to and used by Charterwood will be billed to Charterwood and, in turn, water delivered to the Authority by Charterwood will be billed to the Authority. In addition, Charterwood will be able to receive a non-depreciated asset credit for Charterwood’s existing water supply facilities based on the date each facility was constructed, not to exceed \$0.80 per 1,000 gallons of water purchased from the Authority.

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Notes to Financial Statements*

*December 31, 2007*

#### **Note 14 – Buy / Sell Agreements**

In fiscal years 2005 and 2006 the Authority entered into Buy/Sell agreements for implementation of the Groundwater Transfer Program (GTP) with eighteen utility districts for the purpose of encouraging the maximum utilization of existing water production facilities to provide water to districts that are currently in need of water from districts with a surplus of water. The first priority of the GTP is to supply water to districts with water quality issues such as arsenic, secondly to districts needing additional water for growth and finally to districts needing additional water for peaking purposes. The primary purpose of the GTP is to limit construction of new water wells and related water production facilities that will have limited use after the conversion to surface water in 2010. During a delivery period, a seller shall sell, and the Authority may purchase a volume of water equal to an amount determined by the Authority to be required from a seller to meet demand and create a minimum flow within the Authority's system. The Authority shall sell, and a buyer shall purchase, a volume of water equal to at least the minimum water demand allocation, if any, and not to exceed the maximum water demand allocation by up to ten percent. A buyer shall pay the Authority for water it receives from the Authority for the purchase price of \$1.70 per 1,000 gallons less applicable depreciation credit times the volume of water delivered by the Authority to the buyer. The depreciation credit shall be limited to a maximum of \$0.80 per 1,000 gallons of water purchased. The Authority shall pay the seller the sale price of \$0.91 per 1,000 gallons plus an amount equal to the pumpage fee times the volume of water delivered to the Authority by a seller. The GTP program was implemented in January 2006. During the current year, the Authority recorded \$1,026,988 in revenue and \$908,565 in expenditures for water exchanged for this program.

#### **Note 15 – Water Well Agreement**

On March 28, 2006, the Authority entered into a Water Well Agreement (the "Agreement") with V&W Partners, Ltd. (V&W), for itself and on behalf of the to be created Harris County Municipal Utility District No. 468 (MUD). Under the terms of the agreement, the Authority agreed to acquire a water well from V&W for a price of \$567,306. The Authority also purchased easements from V&W which will were used for the placement of two water lines which were purchased by the Authority. The Authority is delivering water, in the amount stated in the agreement, from the water well to the MUD water plant in order to serve customers of the MUD. In addition to the amounts specified in the agreement, the MUD shall be entitled to obtain up to 100,000 GPD to provide water supply service to the Hewlett Packard Data Center (HP Data Center). The MUD has interconnect agreements with Charterwood Municipal Utility District and Harris County Municipal Utility District No. 286 and will be required to provide water to these districts in emergency situations. The Authority can also utilize the water well to supplement its water supply facilities located north of Louetta Road and may utilize the water to serve customers of the Authority.

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### ***Notes to Financial Statements***

***December 31, 2007***

#### **Note 15 – Water Well Agreement (continued)**

Any amount pumped by the Authority and delivered to the MUD shall be treated by the MUD and delivered to the Authority's point of measurement is subject to treatment charges as described in the agreement. The requirements for delivery and treatment of water shall apply until such time as the Authority delivers surface water to the MUD in accordance with the Authority's GRP. Upon delivery of surface water to the MUD, any water pumped from the water well will be sent to the Authority's water plant north of Louetta Road and the Authority will not be authorized to transmit water directly to the MUD water plant. The MUD agrees to treat water delivered from the Authority's water well to the MUD water plant and the Authority agrees to pay the MUD for the treatment of the water based upon the MUDs then current cost to treat water. The initial charge for the treatment of water will be \$0.84 per 1,000 gallons of water delivered to the Authority's point of measurement and shall be adjusted on an annual basis beginning October 1, 2007. The MUD will bill the Authority on a monthly basis for the treated water delivered through the Authority point of measurement. In turn, the Authority will bill the MUD on a monthly basis for the water delivered to the MUD in the amount of \$1.40 per 1,000 gallons of water, which will be increased from time to time as stipulated in the agreement. The MUD will not be required to pay a pumpage fee for such water. At such time the MUD takes surface water from the Authority, the MUD will only be required to pay the amount established by the Authority for the purchase of surface water. Until such time as the HP Data Center takes water from the MUD, the MUD will be required to pay a reservation fee of \$0.40 per 1,000 gallons for the 100,000 GPD reserved for the HP Data Center. If the HP Data Center obtains water from the MUD then the reserved amount and the corresponding reservation charge will be reduced according to the amount of water obtained. The term of this agreement is forty years with options to renew for successive five year periods, unless terminated by mutual agreement of the parties. As of December 31, 2007, the Authority had paid \$1,211,944 to V&W partners for the well and line improvements, water line easement and water well acquisition in accordance with the Agreement.

#### **Note 16- Subsequent Event**

As referred to in Note 5 the Authority has issued approximately \$218,560,000 of Senior Bonds in two separate series. In connection with the issuance of the Senior Bonds, the master resolution authorizing the issuance of the Senior Bonds (the "Master Resolution") required the Authority to provide for a debt service reserve fund (the "Reserve Fund").

The purpose of the Reserve Fund is to provide for ready access to funds on short notice to pay the Senior Bonds in the event that the Authority is ever unable to make debt service payments in a timely manner. Typically, a debt service reserve fund must contain cash and authorized investments in a required minimum amount (the "Reserve Fund Requirement") equal to a percentage of the of the average annual or maximum annual debt service payments on the related bonds. In the case of the Senior Bonds, the current Reserve Fund Requirement is \$15,666,118, which is equal to the maximum annual debt service payment on the Senior Bonds. (\$9,079,000 of this amount is in respect of the Series 2003 Senior Bonds, and \$6,587,118 of this amount is in respect of the Series 2005 Senior Bonds.)

The Reserve Fund may be funded from Senior Bond proceeds at the time of issuance of each series of Senior Bonds or from other lawfully available funds. In the alternative, the Reserve Fund Requirement may be satisfied with either: (i) a surety bond or insurance policy, if the insurer strength rating of the issuer of the surety bond or insurance policy is rated "AAA" or the equivalent; or (ii) an unconditional irrevocable letter of credit issued by a bank rated "AA" or the equivalent.

## **NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

### *Notes to Financial Statements*

*December 31, 2007*

#### **Note 16- Subsequent Event (continued)**

The Authority elected to satisfy the Reserve Fund Requirement for the Senior Bonds through the purchase of surety bonds. Financial Guaranty Insurance Company (FGIC) provided the surety bond in connection with the Series 2003 Senior Bonds, and MBIA, Inc. (MBIA) provided the surety bond in connection with the Series 2005 Senior Bonds. At the times of the issuance of the Senior Bonds, both FGIC and MBIA held insurer strength ratings of “AAA,” as rated by two national recognized statistical rating organizations, Standard & Poor’s Rating Services (S&P) and Moody’s Investors Service (Moody’s).

Subsequent to year end, FGIC’s “AAA” insurer strength rating was downgraded several times by both S&P and Moody’s. As of April 15, 2008, FGIC’s insurer strength was rated “BB” by S&P and “Baa3” by Moody’s. As of April 15, 2008, S&P and Moody’s continue to rate the insurer strength of MBIA “AAA”.

The Master Resolution provides that, in the event the insurer strength rating of the provider of a surety bond satisfying the Reserve Fund Requirements falls below “AAA” (but not below “A”), the Authority must take one of the following steps:

- i. deposit into the Reserve Fund cash sufficient to cause money in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the ensuing five years in equal installments at least semi-annually, or
- ii. replace the surety bond with another surety bond, insurance policy or letter of credit issued by an adequately rated provider within six months of such downgrade.

The Master Resolution further provides that in the event the insurer strength rating of the provider of a surety bond satisfying the Reserve Fund Requirement falls below “A”, the Authority must take one of the following steps:

- i. deposit into the Reserve Fund cash sufficient to cause the money in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the ensuing year in equal installments on at least a monthly basis, or
- ii. replace such instrument with a surety bond, insurance policy or letter of credit issued by an adequately rated provider within six months of such occurrence.

#### **Series 2003 Senior Bonds**

As a result of the FGIC downgrades, the FGIC surety policy currently held for the Reserve Fund does not satisfy the requirements of the Master Resolution. The Authority’s Financial Advisors and Bond Counsel are in the process of evaluating appropriate options to either (i) satisfy that portion of the Reserve Fund Requirement applicable to the Series 2003 Senior Bonds with another surety bond, insurance policy, or letter of credit, or (ii) fund that portion of the Reserve Fund Requirement applicable to the Series 2003 Senior Bonds with cash (to be provided from one of several financing options under review).

If either (A) it is determined that it is impractical or impossible to satisfy the Reserve Fund Requirement with another surety bond, insurance policy, or letter of credit, or (B) such surety bond, insurance policy, or letter of credit cannot be obtained within six months of the initial insurer strength rating downgrades described above, the Authority must fund the Reserve Fund with cash. This obligation to fund the Reserve Fund with cash will begin upon the earlier to occur of either (A) or (B) above. With respect to the Series 2003 Senior Bonds insured by FGIC, such cash deposits to the Reserve Fund must be paid in equal monthly installments in an amount sufficient to fully fund that portion of the Reserve Fund applicable to the Series 2003 Senior Bonds over the ensuing twelve months.

**NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY**

*Notes to Financial Statements*

*December 31, 2007*

**Note 16- Subsequent Event (continued)**

**Series 2005 Senior Bonds**

As noted above, as of April 15, 2008, the insurer strength rating of MBIA, the provider of the surety bond for that portion of the Reserve Fund Requirement applicable to the Series 2005 Senior Bonds, is “AAA” by both S&P and Moody’s. Fitch Ratings, Inc. (Fitch) has recently downgraded MBIA’s insurer strength rating from “AAA” to “AA”. However, the Master Resolution does not establish Fitch as a “Rating Agency” with respect to the Series 2005 Senior Bonds. Accordingly, a rating action by Fitch does not affect the Authority or the Reserve Fund Requirements at this time. Nevertheless, both S&P and Moody’s, while currently maintaining the “AAA” insurer strength rating of MBIA, assign MBIA’s insurer strength rating a “Negative Outlook.” If either S&P or Moody’s downgrade the insurer strength rating of MBIA in the future, the Authority will need to take additional actions to replace the surety bond for that portion of the Reserve Fund Requirement applicable to the Series 2005 Senior Bonds.

## APPENDIX B

### LIST OF RETAIL UTILITIES THAT OWN WATER WELLS

Albury Manor Utility Co.	Harris Co. M.U.D. 286	Northwest Freeway M.U.D.
Amberwood Utility Co.	Harris Co. M.U.D. 358	Northwest Water Systems, Inc.
Aquasource Utility Inc.	Harris Co. M.U.D. 360	Northwest Harris Co. M.U.D. 10
Bammel Forrest Utility Company	Harris Co. M.U.D. 364/365	Northwest Harris Co. M.U.D. 15
Bammel U.D.	Harris Co. M.U.D. 367/383	Northwest Harris Co. M.U.D. 19
Bayer Water System	Harris Co. M.U.D. 368	Northwest Harris Co. M.U.D. 20
Bilma P.U.D.	Harris Co. M.U.D. 387	Northwest Harris Co. M.U.D. 21
Bridgestone M.U.D.	Harris Co. M.U.D. 389	Northwest Harris Co. M.U.D. 23
C & P Utilities, Inc.	Harris Co. M.U.D. 391	Northwest Harris Co. M.U.D. 24
Charterwood M.U.D.	Harris Co. M.U.D. 401	Northwest Harris Co. M.U.D. 29
Chasewood Utilities, Inc.	Harris Co. M.U.D. 43	Northwest Harris Co. M.U.D. 30
CMH Parks	Harris Co. M.U.D. 44	Northwest Harris Co. M.U.D. 32
CNP Utility District	Harris Co. M.U.D. 468	Northwest Harris Co. M.U.D. 36
Consumers Water Corporation	Harris Co. M.U.D. 69	Northwest Harris Co. M.U.D. 5
Cy-Champ P.U.D.	Harris Co. M.U.D. 82	Northwest Harris Co. M.U.D. 6
Cy-Forest Service Association	Harris Co. M.U.D. 86	Northwest Harris Co. M.U.D. 9
Cypress Creek U.D.	Harris Co. W.C. & I.D. 109	Oak Hill Estates Water Company
Cypress Forest P.U.D.	Harris Co. W.C. & I.D. 110	Pitcairn Water Supply
Cypress Hill M.U.D. 1	Harris Co. W.C. & I.D. 113	Ponderosa Forest U.D.
Cypress-Klein U.D.	Harris Co. W.C. & I.D. 114	Post Wood M.U.D.
Dowdell P.U.D.	Harris Co. W.C. & I.D. 116	Prestonwood Forest U.D.
Emerald Forest U.D.	Harris Co. W.C. & I.D. 119	Provence Water System
Encanto Real U.D.	Harris Co. W.C. & I.D. 132	Reid Road M.U.D. 1
Enchanted Valley Water Supply	Harris Co. W.C. & I.D. 136	Reid Road M.U.D. 2
Faulkey Gully M.U.D.	Harris Co. W.C. & I.D. 91	Richey Road M.U.D.
Fountainhead M.U.D.	Harris Co. W.C. & I.D. 92	S C Utilities, Inc.
Grant Road P.U.D.	Harris Co. W.C. & I.D. 99	Shasia P.U.D.
Greens Road MHP	Harris County	Spring Creek Forest P.U.D.
Harris Co. F.W.S.D. 52	Heatherloch M.U.D.	Spring Cypress Water Supply Corp.
Harris Co. F.W.S.D. 61	HMW Special Utility District	Spring West M.U.D.
Harris Co. M.U.D. 1	HOE Water Supply Corporation	Suburban Utility Company
Harris Co. M.U.D. 104	Hometown Utilities LP	Tall Pines Utility
Harris Co. M.U.D. 109	Hunters Glen M.U.D.	Tattor Road M.U.D.
Harris Co. M.U.D. 16	Inverness Forest I.D.	Terranova West M.U.D.
Harris Co. M.U.D. 168	Jersey Village, City Of	Timberlake I.D.
Harris Co. M.U.D. 170	Johnston Utilities, Inc.	Timberlane U.D.
Harris Co. M.U.D. 18	Klein P.U.D.	Tomball, City Of
Harris Co. M.U.D. 191	Kleinwood M.U.D.	Tower Oak Bend Water Supply
Harris Co. M.U.D. 202	Lake Forest U.D.	Utilities Investment Co. Inc.
Harris Co. M.U.D. 222	Louetta North P.U.D.	West Harris Co. M.U.D. 9
Harris Co. M.U.D. 230	Louetta Road U.D.	West Harris Co. M.U.D. 10
Harris Co. M.U.D. 233	Malcomson Road U.D.	West Harris Co. M.U.D. 11
Harris Co. M.U.D. 24	Meadowhill Regional M.U.D.	West Harris Co. M.U.D. 21
Harris Co. M.U.D. 249	Memorial Hills U.D.	Westador M.U.D.
Harris Co. M.U.D. 25	Mills Road M.U.D.	Westside Water LLC
Harris Co. M.U.D. 26	North Park P.U.D.	White Oak Bend M.U.D.
Harris Co. M.U.D. 275	Northampton M.U.D.	White Oak Manor Mobile Home Park
Harris Co. M.U.D. 280/281/282/283	Northgate Crossing M.U.D. 2	Woodmark Water LC

The foregoing list does not include Retail Utilities that purchase their water requirements from other Retail Utilities.

**APPENDIX C**  
**EXCERPTS OF CERTAIN PROVISIONS**  
**OF THE MASTER RESOLUTION**

This Appendix sets forth selected provisions of the Master Resolution. These excerpted provisions should be qualified by reference to the other portions of the Master Resolution referred to elsewhere in this Official Statement. All references and summaries pertaining to the Master Resolution in this Official Statement are qualified by reference to the exact terms of the Master Resolution, a copy of which may be obtained from the Authority. Any references to articles and sections listed below are to the articles and sections of the Master Resolution unless otherwise provided.

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**Section 2.1**     **Definitions.** The words and terms used in this Master Resolution and the recitals hereto shall have the following meanings, unless the context or use clearly indicates another or different meaning or intent, and such definitions shall be equally applicable to both the singular and plural forms of the terms and words therein defined.

“*Act*” shall mean Chapter 1029, Acts of the 76th Texas Legislature 1999 (Regular Session), as amended by Chapter 1296, Acts of the 77th Texas Legislature 2001 (Regular Session), and as the Act may be further amended from time to time.

“*Adjusted Net Revenues*” shall mean the sum of (i) Net Revenues and (ii) the balance in the Coverage Fund and the Improvement Fund on the last day of the Fiscal Year.

“*Annual Debt Service Requirements*” shall mean, for any Fiscal Year, the principal of, interest on, and other payments due from the Authority under, all Senior Lien Obligations coming due (or that could come due on demand of the owner thereof other than by acceleration or other demand conditioned upon default by the Authority on such Senior Lien Obligations, or be payable in respect of any required purchase of such Senior Lien Obligations by the Authority) in such Fiscal Year (including any costs and amounts due and owing under any Credit Agreements), except to the extent that any such principal, interest or other payments are to be paid from amounts (including investment earnings thereon) held in the Interest and Sinking Fund, the Reserve Fund, or any other Fund into which amounts have been set aside for the purpose of providing for the payment of such principal, interest or other payments; and, for such purposes, any one or more of the following rules shall apply at the election of the Authority:

- (a)     Committed Take Out. If the Authority has entered into a Credit Agreement constituting a binding commitment within normal commercial practice to discharge any of its Funded Debt at its stated maturity (or, if due on demand, at any date on which demand may be made) or to purchase any of its Funded Debt at any date on which such Parity Bonds are subject to required purchase, all under arrangements whereby the Authority’s obligation to repay the amounts advanced for such discharge or purchase constitutes Funded Debt, then the portion of the Funded Debt committed to be discharged or purchased shall be excluded from such calculation and the principal of and interest on the Funded Debt incurred for such discharging or purchase that would be due in the Fiscal Year for which the calculation is being made, if incurred at the stated maturity or purchase date of the Funded Debt to be discharged or purchased, shall be added;
  
- (b)     Balloon Debt. If, as of the Issue Date and as of the date of any calculation of Annual Debt Service Requirements, any portion of the maturing principal (including the accretion of interest resulting from original issue discount or compounding of interest) of any series or issue of Funded Debt (or any amount payable in respect of any required purchase of such Funded Debt by the Authority) is expected to be paid from a source other than Net Revenues (such principal or purchase price being referred to herein as “Balloon Debt”), such expectation being evidenced by a certificate of an Authorized Representative, the amount of principal of such Balloon Debt taken into account during any Fiscal Year shall be equal to the debt service calculated using the principal amount of such Balloon Debt amortized over the Term of Issue on a substantially level debt service basis at an assumed interest rate equal to the rate borne by such Balloon Debt on the date of calculation;
  
- (c)     Consent Sinking Fund. In the case of Balloon Debt (as defined in clause (b) above), if an Authorized Representative shall deliver to the Authority a certificate providing for the retirement of (and the instrument

creating such Balloon Debt shall permit the retirement of), or for the accumulation of a sinking fund for (and the instrument creating such Balloon Debt shall permit the accumulation of a sinking fund for), such Balloon Debt according to a fixed schedule stated in such certificate ending on or before the Fiscal Year in which such principal (and premium, if any) is due, then the principal of (and, in the case of retirement, or to the extent provided for by the sinking fund accumulation, the premium, if any, and interest and other debt service charges on) such Balloon Debt shall be computed as if the same were due in accordance with such schedule, provided that this clause (c) shall apply only to Balloon Debt for which the installments previously scheduled have been paid or deposited to the sinking fund established with respect to such Senior Lien Obligations on or before the times required by such schedule; and provided further that this clause (c) shall not apply where the Board has elected to apply the rule set forth in clause (b) above;

(d) Prepaid Senior Lien Obligations. Principal of and interest on Senior Lien Obligations, or portions thereof, shall not be included in the computation of the Annual Debt Service Requirements for any Fiscal Year for which such principal or interest are payable from funds on deposit or set aside in trust for the payment thereof at the time of such calculations (including without limitation capitalized interest and accrued interest so deposited or set aside in trust) with a financial institution acting as fiduciary with respect to the payment of such Senior Lien Obligations;

(e) Variable Rate. As to any Senior Lien Obligation that bears interest at a variable interest rate that cannot be ascertained at the time of calculation of the Annual Debt Service Requirement then, at the option of an Authorized Representative, either (i) an interest rate equal to the average rate borne by such Senior Lien Obligation(s) (or by comparable debt in the event that such Senior Lien Obligation(s) have not been outstanding during the preceding twelve (12) months) for any twelve (12) month period ending within thirty (30) days prior to the date of calculation or (ii) an interest rate equal to the BMA (Bond Market Association) Index as most recently published in The Bond Buyer (or a comparable index if such index is no longer published in The Bond Buyer), shall be presumed to apply for all future dates;

(f) Commercial Paper. With respect to any Senior Lien Obligations issued in the form of commercial paper with maturities not exceeding 270 days, the interest on such Senior Lien Obligations shall be calculated in the manner provided in clause (e) of this definition and (to the extent that the principal of such Senior Lien Obligations is expected to be paid from a source other than Net Revenues, such expectation being evidenced by a certificate of an Authorized Representative) the maturity schedule shall be calculated in the manner provided in clause (b) of this definition; and

(g) Credit Agreement Payments. If the Authority has entered into a Credit Agreement in connection with an issue of Senior Lien Obligations, payments due under the Credit Agreement (other than payments for fees and expenses) by either the Authority or the other party to such Credit Agreement shall be included in such calculation, except to the extent that (i) the payments are already taken into account under clause (a) through (f) above, (ii) the payments are accounted for by the Authority as Gross Revenues or (iii) payments under the Credit Agreement are payable by a party that has a long term credit rating (in a generic rating category, without regard to modifiers within a rating category) that is lower than the long term credit rating of the Authority; and any payments otherwise included above under clause (a) through (f) that are to be replaced by payments under a Credit Agreement (pursuant to this clause (g)), from either the Authority or the other party to such Credit Agreement, shall be excluded from such calculation.

With respect to any calculation of historic data, only those payments actually made in the subject period shall be taken into account in making such calculation and, with respect to prospective calculations, only those payments reasonably expected to be made in the subject period shall be taken into account in making the calculation.

“*Bond Insurance Policy*” shall mean a Credit Agreement issued as an insurance policy by a Bond Insurer insuring or guaranteeing the payment of principal of and interest on any Senior Lien Obligations.

“*Bond Insurer*” shall mean an entity that insures or guarantees the payment of principal of and interest on any of the Senior Lien Obligations.

“*Budgeted Operation and Maintenance Expenses*” means, in each Fiscal Year, an amount equal to the aggregate amount of the Operation and Maintenance Expenses of the System for the Fiscal Year as fixed by the then current budget for that year.

“*Capital Contribution*” shall mean the amount paid or credited in respect of a contribution or prepayment received from any source by the Authority in payment of a person’s share of the cost of financing the acquisition, construction and equipment of the System as determined by the Authority pursuant to an agreement entered into with the Authority providing for such Capital Contribution.

“*Capital Contribution Credit*” shall mean, for any period, the amount calculated by the Authority as the amortized portion of a Capital Contribution for such period.

“*Capital Expenses and Major Repair and Replacement Costs*” shall mean capitalized expenditures that are amortized in accordance with generally accepted accounting principles or such other accounting principles as the Authority may be required to utilize from time to time pursuant to state law or regulation over a period of not less than two (2) years.

“*Code*” shall mean the Internal Revenue Code of 1986, as amended from time to time.

“*Coverage Fund*” shall mean the special fund created pursuant to Section 4.1 hereof.

“*Coverage Fund Requirement*” shall mean 25% of the maximum Annual Debt Service Requirements for the Outstanding Senior Lien Obligations.

“*Coverage Requirement*” shall mean an amount equal to 120% of the maximum Annual Debt Service Requirements for Covered Debt in any Fiscal Year.

“*Covered Debt*” shall mean all Outstanding Senior Lien Obligations.

“*Credit Agreement*” shall mean any agreement (including any loan agreement, revolving credit agreement, agreement establishing a line of credit, letter of credit, reimbursement agreement, insurance contract, commitment to purchase an obligation, purchase or sale agreement, interest rate swap agreement, cap or floor agreement, interest rate lock agreement, currency swap agreement, or other commitment or agreement) entered into by the Board with any other Person in connection with the authorization, issuance, sale, resale, security, exchange, payment, purchase, remarketing, redemption, refinancing, defeasance, hedging or administration of any bonds or other obligations (or the interest on such bonds or other obligations, or both), as authorized by the Act, Chapter 1371, or other applicable law.

“*Credit Agreement Provider*” shall mean the Person, if any, that is then obligated to the Authority under any Credit Agreement.

“*Defeasance Obligations*” shall mean any investment that is authorized for the purpose of defeasing an obligation of the Authority pursuant to Chapter 1207, Texas Government Code.

“*Eligible Investments*” shall mean any investment authorized by the Act or the Public Funds Investment Act (Chapter 2256, Texas Government Code, as amended from time to time).

“*Engineer*” shall mean any registered or licensed professional engineer having a favorable reputation for skill and experience in the field of designing, preparing plans and specifications for and supervising construction of water utility systems and related facilities who is entitled to practice and practicing as such under the laws of the State.

“*Fiscal Agents*” shall mean any fiscal agent, issuing agent, paying agent, remarketing agent, auction agent, market agent, broker-dealer, trustee or other similar agent appointed pursuant to a Supplemental Resolution and serving in one or more of such or similar capacities in accordance with such Supplemental Resolution.

“*Fiscal Year*” shall mean the Authority’s fiscal year, which currently runs from January 1 to December 31 of each year, but which may be changed from time to time by the Authority.

“*Fund*” shall mean any fund created and established by this Master Resolution.

“*Funded Debt*” shall mean all Senior Lien Obligations that mature by their terms (in the absence of the exercise of any earlier right of demand), or are renewable at the option of the Board to a date, more than one year after the original creation, assumption, or guarantee of such Senior Lien Obligations. Funded Debt shall include Senior Lien Obligations issued pursuant to a commercial paper or similar financing program that (i) provides for the periodic refinancing of such Senior Lien Obligations through the issuance of other Senior Lien Obligations and (ii) that expires or terminates by its terms more than one year after the original creation or establishment of such commercial paper or similar financing program.

“*Gross Revenues*” shall mean all revenues, income and receipts of every nature (including any investments purchased with such revenues, income or receipts) derived or received by the Authority from (a) the operation and ownership of the System; (b) the collection of the Pumpage Fees; (c) the investment or deposit of money in the Revenue Fund, the Interest and Sinking Fund, the Reserve Fund, the Coverage Fund, the Operation and Maintenance Reserve Fund and the Improvement Fund; and (d) any other revenues hereafter pledged to the payment of all Senior Lien Obligations. Gross Revenues shall not include any of (i) grants from, or payments by, any federal, state or local governmental agency or authority or any other entity or person, the use of which is restricted by law or by the terms of the grant or payment to capital expenditures of the System (including Capital Contributions), (ii) receipts of capital assets, interest and sinking funds or debt service reserve funds of conservation and reclamation districts or other public or private water or sewer systems annexed, acquired or otherwise assumed by the Authority or (iii) any interest earned on items (i) or (ii) above.

“*Groundwater Reduction Plan*” shall mean the plan developed, implemented, participated in and enforced by the Authority pursuant to the Act (as such plan may be revised from time to time) to supply water, reduce reliance on groundwater, regulate groundwater pumping and water usage and require and allocate water usage among Persons in order to comply with the requirements imposed by the Subsidence District, including any applicable groundwater reduction requirements.

“*Improvement Fund*” shall mean the special fund created pursuant to Section 4.1 hereof.

“*Independent Rate Consultant*” shall mean a nationally recognized independent firm, person or corporation having a widely known and favorable reputation for special skill, knowledge and expertise in methods of development, operation, financing and management of water utility systems of approximately the same size as the System.

“*Insurance Agreement*” shall mean an agreement between the Authority and the Bond Insurer respecting a municipal bond debt service reserve insurance policy constituting a Reserve Fund Obligation.

“*Interest and Sinking Fund*” shall mean the special fund created pursuant to Section 4.1 hereof to secure payment of the Senior Lien Obligations.

“*Issue Date*” shall mean, for any series or installment of Parity Bonds or Parity Obligations, the date on which such series or installment of Parity Bonds or Parity Obligations is delivered to the purchaser or purchasers thereof upon original issuance or execution thereof and, for any Parity Credit Agreement, the date of execution thereof.

“*Junior Lien Obligations*” shall mean any bonds, notes or other obligations or evidences of indebtedness secured by a pledge of and lien on the Net Revenues (in accordance with the provisions of Section 4.2 hereof) that is expressly (i) junior and subordinate to the pledge of and lien on such security in favor of all Senior Lien Obligations theretofore or thereafter issued and (ii) senior and prior to the pledge of and lien on such security in favor of any Subordinate Lien Obligations theretofore or thereafter issued.

“*Net Revenues*” shall mean all Gross Revenues remaining after deducting the Operation and Maintenance Expenses.

“*Operation and Maintenance Expenses*” shall mean the reasonable and necessary expenses of operation and maintenance of the Authority and the System, including (a) all services, salaries, labor, materials, repairs and extensions necessary to accomplish the purposes of the Act and to render efficient service (but only such repairs and extensions as, in

the judgment of the Board, are necessary to accomplish the purposes of the Authority, keep the System in operation and render adequate service to the customers of the Authority and the inhabitants thereof) and (b) all payments (including payments of amounts equal to all or a part of the debt service on bonds issued by other political subdivisions and authorities of the State of Texas) under contracts for the impoundment, conveyance or treatment of water which are (i) entered into by the Authority in order to render efficient service throughout the territory of the Authority and to customers of the System or (ii) now or hereafter defined as operating expenses by the Legislature of Texas, and the treatment of such payments as Operation and Maintenance Expenses shall not be affected in any way if, subsequent to the entering into such contracts, the Authority acquires as a part of the System title to any properties or facilities used to impound, convey or treat water under such contracts, or if the Authority contracts to acquire title to such properties or facilities as a part of the System until the final payment of debt service on the bonds issued to finance such properties or facilities. Neither (i) allowances for depreciation or amortization (including Capital Contribution Credits) nor (ii) Capital Expenses and Major Repair and Replacement Costs shall be considered as an Operation and Maintenance Expense.

*“Operation and Maintenance Reserve Fund”* shall mean the special fund created pursuant to Section 4.1 hereof.

*“Operation and Maintenance Reserve Requirement”* means at any time in each Fiscal Year an amount at least equal to one-sixth (1/6) (or such greater fraction as shall be determined by the Authority) of the aggregate amount of the Operation and Maintenance Expenses of the System for the Fiscal Year as fixed by the then current budget for that year, which amount shall be deposited, accumulated or reaccumulated, and maintained in the Operation and Maintenance Reserve Fund pursuant to Section 4.6 hereof.

*“Outstanding,”* when used with reference to the Parity Bonds and Parity Obligations shall mean, as of a particular date, all such bonds and obligations theretofore delivered except: (a) any such bond or obligation canceled by or on behalf of the Authority at or before said date; (b) any such bond or obligation defeased pursuant to the defeasance provisions of the order or resolution authorizing its issuance, or otherwise defeased as permitted by applicable law; and (c) any such bond or obligation in lieu of or in substitution for which another bond or obligation shall have been delivered pursuant to the order or resolution authorizing the issuance of such bond or obligation.

*“Owner,”* or any similar term, when used in conjunction with any Senior Lien Obligation, means the registered owner of any Senior Lien Obligation which is registered for payment.

*“Parity Bond”* or *“Parity Bonds”* shall mean bonds authorized to be issued in series and installments from time to time under and secured by the lien established in favor of Senior Lien Obligations pursuant to this Master Resolution.

*“Parity Credit Agreement”* shall mean any Credit Agreement authorized by the Board in connection with or relating to any series or installment of Parity Bonds or Parity Obligations or other Parity Credit Agreement which is secured by the pledge of and lien on the Gross Revenues established in favor of Senior Lien Obligations pursuant to this Master Resolution. To the extent permitted by law, the Board may approve one or more Parity Credit Agreements subsequent to the authorization and issuance of any Parity Bonds or Parity Obligations benefiting from such Parity Credit Agreement(s).

*“Parity Obligation”* shall mean any note or other obligation or evidence of indebtedness (other than Parity Bonds) authorized to be issued or incurred from time to time under and secured by the lien established in favor of Senior Lien Obligations pursuant to this Master Resolution.

*“Person”* (or words importing persons) shall mean any individual, corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.

*“Pro-Forma Coverage Requirement”* shall mean an amount equal to 130% of the maximum Annual Debt Service Requirements for Covered Debt in any Fiscal Year.

*“Pro-forma Net Revenues”* shall mean the Adjusted Net Revenues adjusted to give effect to (a) any increase in rates, fees or other charges of the Authority or the System or (b) the addition of territory to the Authority that was placed into effect or consummated prior to the adoption of the Supplemental Resolution authorizing the Senior Lien Obligations then being issued (as if such increase or addition had been in effect or consummated throughout the period being considered), as certified by an Independent Rate Consultant.

“*Pumpage Fee*” shall mean the fee charged by the Authority (as established by the Board from time to time) on water (i) pumped from wells located in the Authority’s boundaries (except for any wells that are exempt from payment of such fee by law or rules of the Authority or the Subsidence District) or (ii) produced outside of the Authority’s boundaries and transported into the Authority’s boundaries.

“*Rate Coverage Requirement*” shall mean (a) when measured against Net Revenues, an amount equal to 110% of the Annual Debt Service Requirements for Covered Debt for the Fiscal Year or (b) when measured against Adjusted Net Revenues, an amount equal to 120% of the Annual Debt Service Requirements for Covered Debt for the Fiscal Year.

“*Rating Agency*” shall mean any nationally recognized statistical rating organization designated by an Authorized Representative. The designation of a Rating Agency other than Moody’s Investors’ Service, Inc. or Standard & Poor’s, a division of The McGraw-Hill Companies, Inc. (or their respective successors) shall be subject to the approval of the Bond Insurer(s), if any.

“*Rebate Fund*” shall mean the special fund which the Authority may create pursuant to Section 4.8 hereof.

“*Regulations*” means any applicable Internal Revenue Service Regulations promulgated in proposed, temporary or final form. Proposed regulations are “applicable” only if, in the event they are adopted in final form, such regulations would apply to the Senior Lien Obligations.

“*Reserve Fund*” shall mean the special fund created pursuant to Section 4.4 hereof to secure payment of the Senior Lien Obligations.

“*Reserve Fund Obligation*” shall mean a Parity Credit Agreement satisfying the requirements of Section 4.4 which is deposited in the Reserve Fund to meet all or part of the Reserve Fund Requirement.

“*Reserve Fund Requirement*” shall mean an amount (which may consist of money, authorized investments, one or more Reserve Fund Obligations, or any combination thereof) equal to the least of (a) 10% of the original principal amount of the Outstanding Senior Lien Obligations, (b) 125% of the average Annual Debt Service Requirement on the Outstanding Senior Lien Obligations, (c) 100% of the maximum Annual Debt Service Requirement on the Outstanding Senior Lien Obligations, or (d) an amount which, when added to the existing Reserve Fund Requirement for Outstanding Senior Lien Obligations, will not cause the total Reserve Fund Requirement to exceed the maximum Annual Debt Service Requirement on the Outstanding Senior Lien Obligations; provided the Reserve Fund Requirement for the Outstanding Senior Lien Obligations may be revised to a lesser amount in accordance with requirements of Regulations specifying the maximum amount in a reserve fund permitted to be invested without regard to investment yield.

“*Revenue Fund*” shall mean the Authority’s fund established and maintained to collect and receive Gross Revenues in accordance with Article IV of this Master Resolution.

“*Senior Lien Obligation*” shall mean (i) all Outstanding Parity Bonds and Parity Obligations and (ii) any Parity Credit Agreement to the extent that it is secured by a senior lien on and pledge of the Net Revenues in accordance with the requirements of Article III.

“*Special Project*” shall mean, to the extent permitted by law, any of the Authority’s network of pipelines, conduits, canals, pumping stations, force mains, treatment plants, and any other construction, device, or related appurtenance used to treat or transport water (including ground water or surface water) or wastewater, declared by the Authority not to be part of the System, for which the costs of acquisition, construction, and installation are paid from proceeds of a financing transaction other than the issuance of bonds payable from Gross Revenues and for which all maintenance and operation expenses are payable from sources other than Gross Revenues, but only to the extent that and for so long as all or any part of the revenues or proceeds of which are or will be pledged to secure the payment or repayment of such costs of acquisition, construction, and installation under such financing transaction.

“*State*” shall mean the State of Texas.

“*Subordinate Lien Obligations*” shall mean any notes, bonds, other obligations or evidences of indebtedness secured by a pledge of lien on the Net Revenues (in accordance with the provisions of Section 4.2 hereof) that is expressly junior and subordinate to the pledge of and lien on such security in favor of all Senior Lien Obligations and Junior Lien Obligations.

“*Supplemental Resolution*” means any resolution adopted by the Board (together with any supplements or amendments thereto) specifying the designation and aggregate principal amount for any series or installment of Parity Bonds or Parity Obligations and/or approving one or more Parity Credit Agreements; it being acknowledged that if a Parity Credit Agreement is provided to secure or pay a series or installment of Parity Bonds or Parity Obligations, such Parity Credit Agreement must secure all of the Parity Bonds or Parity Obligations of such series or installment, but that different Parity Credit Agreements may secure different issues or series of Parity Bonds or Parity Obligations.

“*System*” shall mean all works, plants, properties, facilities, improvements, equipment, interests, appliances, rights and powers constituting the Authority’s network of pipelines, conduits, canals, pumping stations, force mains, treatment plants, and any other construction, device, or related appurtenance used to treat or transport water (including ground water or surface water) or wastewater, and all future extensions, replacements, betterments, additions, improvements, enlargements, acquisitions, purchases and repairs to the System, including, all those heretofore or hereafter acquired as a result of the annexation and dissolution or merger of conservation and reclamation districts with the Authority or the acquisition of the properties or assets of any other public, private or non-profit entities. The Authority’s rights under the Water Supply Contract Between the City of Houston, Texas and the North Harris County Regional Water Authority, dated as of December 16, 2002, and any similar water supply contracts shall constitute part of the System. The System shall not include any Special Project.

“*Term of Issue*” means with respect to any Balloon Debt, including, without limitation, commercial paper, a period of time equal to the greater of (i) the period of time commencing on the date of issuance of such Balloon Debt and ending on the final maturity date of such Balloon Debt or the maximum maturity date in the case of commercial paper or (ii) thirty (30) years.

**Section 3.1**     **Establishment of Financing Program.** Pursuant to authority conferred by and in accordance with the provisions of the Constitution and laws of the State, particularly the Act and Chapter 1371, the Board hereby establishes a financing program to (a) to carry out the powers and authority conferred by the Act; (b) fund any reserve or other fund established in connection with the issuance of Senior Lien Obligations; (c) refund and refinance Outstanding Senior Lien Obligations and other bonds, notes, obligations and evidences of indebtedness incurred by the Authority; (d) pay the cost of issuance of Senior Lien Obligations; and (e) provide funds for any other lawful purpose.

Each separate series or installment of Senior Lien Obligations shall be issued pursuant to the terms and conditions contained in a Supplemental Resolution and may be issued in one or more installments; provided that each Senior Lien Obligation shall be designated in a manner that includes in its title a reference to the issuer of the Senior Lien Obligations and (in the case of Parity Bonds or Parity Obligations) a series or installment designation therefor, together with any other identifying or descriptive words deemed appropriate by the Board or an Authorized Representative.

Each Supplemental Resolution shall provide for the authorization, issuance, sale, delivery, form, characteristics, interest rate(s) (which may be fixed, variable, adjustable or computed by any other method), provisions for payment and redemption and any other matters related to the Senior Lien Obligations of such series or installment (including, without limitation, matters related to the delegation of the sale of any such Senior Lien Obligations to an Authorized Representative and the execution and delivery of Parity Credit Agreements, if any). A Supplemental Resolution may provide for different or additional terms for the Senior Lien Obligations of each series or installment.

Except as provided in Section 3.4(b), no limit is imposed as to the principal amount of Senior Lien Obligations that may be issued under the provisions of this Master Resolution.

**Section 3.2**     **Security for Senior Lien Obligations.**

(a)     The Senior Lien Obligations shall constitute special obligations of the Authority secured by and payable solely from the sources herein provided. To secure the payment of (i) principal of, premium, if any, and interest on Parity

Bonds and Parity Obligations and (ii) all costs and amounts due and owing under any Parity Credit Agreements (including any Reserve Fund Obligations), except as therein provided, the Authority hereby pledges and grants a first and prior lien on all Gross Revenues as collected and received by the Authority, subject only to the prior use of Gross Revenues to pay Operation and Maintenance Expenses in accordance with Section 4.2 hereof. All Senior Lien Obligations shall be additionally secured by and payable from amounts in the Interest and Sinking Fund and the Reserve Fund. If the Board provides a Parity Credit Agreement as additional security for any Parity Bonds or Parity Obligations, such Parity Bonds or Parity Obligations shall be further secured by and payable from such Parity Credit Agreement to the extent provided therein; provided, that the Parity Credit Agreement may provide that payment of costs and amounts due and owing under such Parity Credit Agreement shall be paid and payable only after payment of any Parity Bonds or Parity Obligations supported by such Parity Credit Agreement.

The Owners of the Senior Lien Obligations shall never have the right to demand payment of either the principal of, interest on or any premium on the Parity Bonds or Parity Obligations or any costs and amounts owing under any Parity Credit Agreement out of any funds raised or to be raised by taxation.

**Section 3.3     Senior Lien Obligations Ratably Secured.** All Senior Lien Obligations issued or incurred hereunder are, and are to be, to the extent provided in this Master Resolution, equally and ratably secured by the security pledged under this Master Resolution without preference, priority or distinction on account of the series or installment, or the actual time or times of the execution, authentication, delivery or maturity of such Senior Lien Obligations so that all such Senior Lien Obligations at any time Outstanding hereunder shall have the same right, lien and preference under and by virtue of this Master Resolution and shall be equally and ratably secured hereby with like effect as if they were of the same series or installment and they had all been executed, authenticated and delivered simultaneously on the date hereof, whether the same, or any of them, shall actually be disposed of at such date, or whether they, or any of them, shall be disposed of at some future date; provided that no series or installment of Parity Bonds or Parity Obligations shall have any right, lien or claim to the security of or payment from any Credit Agreement unless such Credit Agreement is provided to secure or pay Parity Bonds or Parity Obligations of such series or installment.

**Section 3.4     Issuance of Senior Lien Obligations; Additional Senior Lien Obligations.**

(a) The Authority reserves and shall have the right and power to issue Parity Bonds and Parity Obligations and to execute and deliver Parity Credit Agreements for any purpose authorized by law pursuant to the provisions of this Master Resolution and any Supplemental Resolution hereto. Senior Lien Obligations, if and when authorized, issued and delivered in accordance with this Master Resolution, shall be secured by and made payable equally and ratably on a parity with all Outstanding Senior Lien Obligations from an irrevocable lien on and pledge of the Net Revenues.

(b) The Parity Bonds or Parity Obligations of each series or installment and any Parity Credit Agreement(s) shall be delivered in accordance with terms to be set forth in the Supplemental Resolution authorizing such series, installment or agreement.

Each Supplemental Resolution under which Senior Lien Obligations are issued shall specify or provide for (i) the authorized principal amount and designation of Senior Lien Obligations issued as Parity Bonds or Parity Obligations; (ii) the purpose or purposes for which the Senior Lien Obligations are being issued; (iii) the maturity date or dates of the Senior Lien Obligations; (iv) the interest rate(s) of the Senior Lien Obligations (which may be fixed, variable or otherwise) and the manner of determining such rate(s) and the interest payment date(s) therefor; (v) the authorized denomination(s) of and the manner of dating, numbering and lettering Senior Lien Obligations issued as Parity Bonds or Parity Obligations; (vi) the redemption or prepayment price(s), if any, and the redemption or prepayment terms for the Senior Lien Obligations; (vii) the increased or changed Reserve Fund Requirement as of the issuance of the Senior Lien Obligations and the manner in which any increase or change in the Reserve Fund Requirement will be funded, including any special provisions for a Reserve Fund Obligation; (viii) the form(s) of Senior Lien Obligations issued as Parity Bonds or Parity Obligations; (ix) the appointment of any fiscal agent(s) or other agents, if any, for such Senior Lien Obligations; and (x) any other provisions deemed advisable by the Authority and not in conflict with the provisions of this Master Resolution.

In addition, following the first issuance of Senior Lien Obligations hereunder and prior to the delivery of any additional series or installment Parity Bonds or Parity Obligations or any Parity Credit Agreement constituting a Senior

Lien Obligation, an Authorized Representative shall provide a written certificate attesting to the matters in each of clauses (i) and (ii) and to the matters in either clause (iii), (iv) or (v):

- (i) All action on the part of the Authority necessary for the valid issuance of the Parity Bonds or Parity Obligations then to be issued (or any Parity Credit Agreement then to be delivered) has been taken; that all provisions of State and federal law necessary for the valid issuance of such Parity Bonds or Parity Obligations (or the delivery of any Parity Credit Agreement) have been complied with; and that such Parity Bonds or Parity Obligations (or any Parity Credit Agreement) will be valid and enforceable special obligations of the Authority according to their terms, subject to the exercise of judicial discretion in accordance with general principles of equity and bankruptcy, insolvency, reorganization, moratorium and other similar laws affecting creditors' rights heretofore or hereafter enacted to the extent constitutionally applicable.
- (ii) No Event of Default under this Master Resolution or any Supplemental Resolution has occurred and is continuing as of the date of such certificate, and the Authority is not in default as to any covenant, condition or obligation in connection with its Outstanding Senior Lien Obligations and the resolutions authorizing same.
- (iii) The Adjusted Net Revenues for the most recently completed Fiscal Year, or any consecutive twelve (12) month period out of the eighteen (18) month period immediately preceding the Issue Date for such Parity Bonds or Parity Obligations (or the date of delivery of such Parity Credit Agreement), were at least equal to the Coverage Requirement (which shall include debt service on the proposed series or installment of Senior Lien Obligations then being issued) for the current Fiscal Year.
- (iv) The Pro-forma Net Revenues for the most recently completed Fiscal Year, or any consecutive twelve (12) month period out of the eighteen (18) month period immediately preceding the Issue Date for such Parity Bonds or Parity Obligations (or the date of delivery of such Parity Credit Agreement), were at least equal to the Pro-Forma Coverage Requirement (which shall include debt service on the proposed series or installment of Senior Lien Obligations then being issued) for the current Fiscal Year.
- (v) The Senior Lien Obligations are being issued for the purpose of refunding previously issued Senior Lien Obligations and the issuance of such Senior Lien Obligations will result in a reduction in the maximum Annual Debt Service Requirements of the Senior Lien Obligations to be Outstanding following the issuance of such Senior Lien Obligations.

(c) Any Parity Credit Agreement (i) providing for the payment of or security for Parity Bonds or Parity Obligations that are Outstanding at the time such Parity Credit Agreement is executed and delivered and (ii) that is not described in or contemplated by the Supplemental Resolution that authorized the related series or installment of Parity Bonds or Parity Obligations, may be executed and delivered pursuant to a Supplemental Resolution, subject to compliance with this Section 3.4 (including delivery of the certifications required by Subsection (b)). Any Parity Credit Agreement executed and delivered in accordance with this subsection 3.4(c) shall be equally and ratably secured in accordance with subsection 3.4(a).

**Section 3.5** **Junior Lien Obligations and Subordinate Lien Obligations.** The Authority reserves the right to issue, for any lawful purpose, Junior Lien Obligations and Subordinate Lien Obligations in such amounts, on such dates and having such terms as the Board may determine; provided, that the Junior Lien Obligations and the Subordinate Lien Obligations shall not be secured by, or payable from any moneys drawn under, any Parity Credit Agreement that provides for the payment of or security for Parity Bonds or Parity Obligations. Such Junior Lien Obligations and Subordinate Lien Obligations may be further secured by any other source of payment lawfully available for such purpose.

**Section 3.6** **Special Project Bonds.** The Authority reserves the right to issue revenue bonds secured by liens on and pledges of revenues and proceeds derived from Special Projects.

**Section 4.1** **Special Funds.** The Authority hereby covenants and agrees that Gross Revenues, as collected and received by the Authority, shall be deposited and paid into the special funds hereinafter established, and shall be applied in

the manner hereinafter set forth, in order to provide for (a) the payment of all Operation and Maintenance Expenses, (b) the payment of principal of, interest on and any premium on the Parity Bonds and Parity Obligations and all expenses of paying same, (c) payment of all costs and amounts due and owing under any Parity Credit Agreements and (d) the disposition of the remaining Net Revenues.

The following special Funds shall be established, maintained and accounted for as hereinafter provided so long as any of the Parity Bonds or Parity Obligations remain Outstanding (or any costs or amounts owed under a Parity Credit Agreement remain unpaid):

- (a) North Harris County Regional Water Authority Revenue Fund (the “*Revenue Fund*”);
- (b) North Harris County Regional Water Authority Senior Lien Interest and Sinking Fund (the “*Interest and Sinking Fund*”);
- (c) North Harris County Regional Water Authority Senior Lien Reserve Fund (the “*Reserve Fund*”);
- (d) North Harris County Regional Water Authority Senior Lien Obligation Coverage Fund (the “*Coverage Fund*”);
- (e) North Harris County Regional Water Authority Operation and Maintenance Reserve Fund (the “*Operation and Maintenance Reserve Fund*”); and
- (f) North Harris County Regional Water Authority Improvement Fund (the “*Improvement Fund*”).

All of such Funds shall be held by a depository of the Authority and maintained as separate accounts on the books of the Authority. The Interest and Sinking Fund, the Reserve Fund and the Coverage Fund shall constitute trust funds which shall be held in trust for the Owners of the Senior Lien Obligations and the proceeds of which shall be pledged to the payment of the Senior Lien Obligations. All of the Funds named above shall be used solely as herein provided so long as any Parity Bond or Parity Obligation remains Outstanding (or any costs or amounts owed under a Parity Credit Agreement remain unpaid).

**Section 4.2** **Flow of Funds.** The Gross Revenues of the System shall be deposited as collected into the Revenue Fund. In addition, amounts transferred from the Coverage Fund pursuant to Section 4.5(b) shall be deposited to the credit of the Revenue Fund.

On or before the last Business Day of each month, moneys from time to time on deposit to the credit of the Revenue Fund shall be applied in the following manner and in the following order of priority:

- (a) First, to pay Operation and Maintenance Expenses;
- (b) Second, to make all deposits into the Interest and Sinking Fund required by Section 4.3;
- (c) Third, to make all deposits into the Reserve Fund required by Section 4.4;
- (d) Fourth, to make all deposits into the Coverage Fund required by Section 4.5;
- (e) Fifth, to make all deposits and transfers (including any required reserves therefor) as may be required by any order or resolution of the Authority authorizing the issuance of Junior Lien Obligations in order to provide for the payment of and security for such Junior Lien Obligations; and
- (f) Sixth, to make all deposits into the Operation and Maintenance Reserve Fund required by Section 4.6;
- (g) Seventh, to make all deposits and transfers (including any required reserves therefor) as may be required by any order or resolution of the Authority authorizing the issuance of Subordinate Lien Obligations in order to provide for the payment of and security for such Subordinate Lien Obligations; and

(h) Eighth, all remaining Net Revenues shall be deposited into the Improvement Fund in accordance with Section 4.7.

**Section 4.3** **Interest and Sinking Fund.** An Authorized Representative shall provide for the deposit into the Interest and Sinking Fund of any amounts determined to be accrued or capitalized interest received from the sale of Senior Lien Obligations.

On or before the last Business Day of each month (and at such other times as shall be set forth in any Supplemental Indenture) so long as any Senior Lien Obligations remain Outstanding, after making all required payments and provision for payment of Operation and Maintenance Expenses, there shall be transferred into the Interest and Sinking Fund from the Revenue Fund the following amounts:

(a) such amounts (in approximately equal monthly installments and taking into account (i) any amounts then on deposit in the Interest and Sinking Fund and available for such purpose and (ii) the number of monthly installments to occur between the date such installment is deposited and the next interest payment date) as will be sufficient to accumulate, during the six-month period immediately preceding the next succeeding interest payment date for Senior Lien Obligations, the amount required to pay the interest scheduled to become due on the Senior Lien Obligations (other than Reserve Fund Obligations) on the next interest payment date therefor;

(b) such amounts (in approximately equal monthly installments and taking into account (i) any amounts then on deposit in the Interest and Sinking Fund and available for such purpose and (ii) the number of monthly installments to occur between the date such installment is deposited and the next principal payment date) as will be sufficient to accumulate, during the twelve-month period immediately preceding the next succeeding principal payment date for Senior Lien Obligations, the amount required to pay the next maturing principal of the Senior Lien Obligations (other than Reserve Fund Obligations), including the principal of, and any premium on, any Senior Lien Obligations payable as a result of the operation or exercise of any mandatory or optional redemption provision contained in any Supplemental Resolution;

(c) to the extent not included in the amounts transferred pursuant to subsection (a) and (b), such amounts (in approximately equal monthly installments and taking into account (i) any amounts then on deposit in the Interest and Sinking Fund and available for such purpose and (ii) the number of monthly installments to occur between the date such installment is deposited and the next payment date therefor) as will be sufficient to pay the costs and amounts due and owing in the current Fiscal Year under any Parity Credit Agreements (other than costs and amounts paid with respect to a Reserve Fund Obligation pursuant to Section 4.4) as such costs and amounts become due and owing; and

(d) such amounts (in approximately equal monthly installments and taking into account (i) any amounts then on deposit in the Interest and Sinking Fund and available for such purpose and (ii) the number of monthly installments to occur between the date such installment is deposited and the next payment date therefor) as will be sufficient to pay any bank charges or other costs and expenses incurred in the current Fiscal Year and related to the disbursement of payments from and the administration of amounts on deposit in the Interest and Sinking Fund.

Whenever the total amounts on deposit to the credit of the Interest and Sinking Fund and the Reserve Fund shall be equivalent to the sum of the aggregate principal amount of all Outstanding Senior Lien Obligations plus the aggregate amount of all interest accrued and to accrue thereon and all costs and amounts owed and to be owed under any Parity Credit Agreements, no further payments need be made into the Interest and Sinking Fund or the Reserve Fund, and such Senior Lien Obligations shall not be regarded as being outstanding except for the purpose of being paid with the moneys on deposit in such Funds.

Moneys deposited to the credit of the Interest and Sinking Fund shall be used solely for the purpose of paying principal (whether at maturity, upon prior redemption or upon the purchase of Senior Lien Obligations in the open market, at a price that does not exceed the redemption price therefor, to be credited against mandatory redemption requirements), interest and premium on the Parity Bonds and Parity Obligations and the costs and amounts due and owing under any Parity Credit Agreements, plus all bank charges and other costs and expenses relating to such payment.

On or before (a) each principal and/or an interest payment date for Parity Bonds or Parity Obligations and (b) each date that any cost or amount becomes due and owing under any Parity Credit Agreement, the Authority shall transfer from

the Interest and Sinking Fund to the paying agent (or the obligee, as applicable) for the Senior Lien Obligations an amount equal to the principal of, interest on, any premium and any costs or other amounts payable on the Senior Lien Obligations on such date, together with an amount equal to all bank charges and other costs and expenses relating to such payment. The paying agent shall totally destroy all paid Senior Lien Obligations and shall provide the Authority with an appropriate certificate of destruction.

**Section 4.4      Reserve Fund.**

(a) There shall be deposited from the proceeds of the sale of Senior Lien Obligations or other lawfully available funds, to the credit of the Reserve Fund, an amount of money which (together with any Reserve Fund Obligation which the Authorized Representative may secure for the Reserve Fund) equals the Reserve Fund Requirement. No further deposits shall be made into the Reserve Fund as long as the money and investments (together with any Reserve Fund Obligation) in the Reserve Fund are at least equal in market value to the Reserve Fund Requirement; but if and whenever the market value of money and investments (together with any Reserve Fund Obligation) in the Reserve Fund is reduced below such Reserve Fund Requirement because of a decrease in market value of investments, then the Authority shall deposit Net Revenues into the Reserve Fund in an amount sufficient to restore the Reserve Fund to the Reserve Fund Requirement; and in the event the Reserve Fund is used to pay the principal of or interest on the Senior Lien Obligations because of insufficient amounts being available in the Interest and Sinking Fund, then the Authority shall deposit Net Revenues into the Reserve Fund in an amount sufficient to restore the Reserve Fund to the Reserve Fund Requirement by depositing into the Reserve Fund an amount in equal payments, required on or before the last Business Day of each month (beginning with the first month following the occurrence of a deficiency), to restore any deficiency in the Reserve Fund Requirement in not more than twelve (12) months (or such shorter period as may be established by any Supplemental Resolution). For purposes of calculating the amount on hand in the Reserve Fund, an amount equal to the maximum available amount which may be drawn under any Reserve Fund Obligation, as described in (d) below, will be deemed on deposit in the Reserve Fund. During any period in which the money and the market value of investments credited to the Reserve Fund (taking into account any Reserve Fund Obligation) are equal to or exceed the Reserve Fund Requirement then during such period all investment earnings and income from the Reserve Fund shall be deposited upon receipt to the credit of the Interest and Sinking Fund.

(b) The Reserve Fund shall secure and (to the extent that amounts on deposit in the Interest and Sinking Fund and the Coverage Fund are insufficient therefor) be used to pay the principal of and interest on Senior Lien Obligations as such principal and interest becomes due and payable; provided that any Parity Credit Agreement may provide that payment of costs and amounts due and owing thereunder shall be paid and payable only after payment of any Parity Bonds or Parity Obligations supported by such Parity Credit Agreement. However, each Supplemental Resolution shall provide and require that (i) the aggregate amount to be accumulated and maintained in the Reserve Fund shall be increased (if and to the extent necessary) to the Reserve Fund Requirement required after the issuance of such Senior Lien Obligations; and (ii) the required additional amount, if any, shall be so accumulated by the deposit in the Reserve Fund of all of such required additional amount in cash or a Reserve Fund Obligation immediately after the delivery of the then proposed Senior Lien Obligations.

(c) Notwithstanding any other provision of this Master Resolution, an equivalent Reserve Fund Obligation may be substituted by the Authority at any time and from time to time in lieu of all or any part of the money and/or investments held for (or required to be held for) the credit of the Reserve Fund, and such money and/or investments may be withdrawn and used for any lawful purpose. If a Reserve Fund Obligation is used as provided above, any reimbursements required thereunder to be paid to a Credit Agreement Provider as a result of a draw or demand thereunder and any interest thereon and expenses payable thereunder shall be made, as provided in the Reserve Fund Obligation, from moneys deposited into the Reserve Fund until fully paid.

(d) A Reserve Fund Obligation permitted under (c), above, must be a Credit Agreement in the form of a surety bond, insurance policy or letter of credit meeting the requirements described below.

(1) A surety bond or insurance policy issued to the entity serving as trustee or paying agent (the “*Fiduciary*”), as agent of the Owners, by a company licensed to issue an insurance policy guaranteeing the timely payment of debt service on the Senior Lien Obligations (a “municipal bond insurer”) if the claims paying ability of the issuer thereof shall be rated “AAA” or the equivalent by at least two Rating Agencies.

(2) A surety bond or insurance policy issued to the Fiduciary, as agent of the Owners, by an entity other than a municipal bond insurer, if (A) the claims paying ability of the provider of such surety bond or insurance policy shall be rated by a Rating Agency not lower than the lowest rating applicable to any Outstanding Senior Lien Obligations and the form and substance of such instrument and the issuer thereof shall be approved in writing by each Bond Insurer of record or (B) all Outstanding Parity Bonds and Parity Obligations are insured by a Bond Insurance Policy and the form and substance of such instrument and the issuer thereof shall be approved in writing by each Bond Insurer of record.

(3) An unconditional irrevocable letter of credit issued to the Fiduciary, as agent of the Owners, by a bank if the issuer thereof is rated "AA" or the equivalent by at least two Rating Agencies. The letter of credit shall be payable in one or more draws upon presentation by the beneficiary of a sight draft accompanied by its certificate that it then holds insufficient funds to make a required payment of principal or interest on the Senior Lien Obligations. The draws shall be payable within two (2) days of presentation of the sight draft. The letter of credit shall be for a term of not less than three (3) years and shall be subject to an "evergreening" feature so as to provide the Authority with at least thirty (30) days notice of termination. The issuer of the letter of credit shall be required to notify the Authority and the Fiduciary not later than thirty (30) days prior to the stated expiration date of the letter of credit, as to whether such expiration date shall be extended, and if so, shall indicate the new expiration date. If such notice indicates that the expiration date shall not be extended, the Authority shall deposit in the Reserve Fund, in accordance with this section, an amount sufficient to cause the money or investments on deposit in the Reserve Fund (together with any other qualifying Reserve Fund Obligations) to accumulate to the Reserve Fund Requirement, unless the expired Reserve Fund Obligation is replaced by a Reserve Fund Obligation meeting the requirements in clause (1) or (2), above, or in this clause (3). The letter of credit shall permit a draw in full not less than fourteen (14) days prior to the expiration or termination of such letter of credit if the letter of credit has not been replaced or renewed. The Fiduciary shall draw upon the letter of credit prior to its expiration or termination unless an acceptable replacement is in place or the Reserve Fund is otherwise fully funded to the Reserve Fund Requirement at the time of such expiration or termination.

(4) The obligation to reimburse the issuer of a Reserve Fund Obligation for any expenses, claims or draws upon such Reserve Fund Obligation, including interest thereon, shall be made from the deposits made to the Reserve Fund as provided in this Section (and subordinate to the payment of debt service on other Senior Lien Obligations). Any reimbursement obligation shall be repaid from amounts deposited into the Reserve Fund in approximately equal monthly installments over a period of not less than twelve (12) months (beginning with the month that follows the month in which the reimbursement obligation arises) and, to the extent not inconsistent with such payment schedule, in accordance with the provisions of the Reserve Fund Obligation. The Reserve Fund Obligation shall provide for a revolving feature under which the amount available thereunder will be reinstated to the extent of any reimbursement of draws or claims paid. If the revolving feature is suspended or terminated for any reason, the right of the issuer of the Reserve Fund Obligation to reimbursement will be subordinated to the cash replenishment of the Reserve Fund to an amount equal to the difference between the full original amount available under the Reserve Fund Obligation and the amount then available for further draws or claims. In the event (A) the issuer of a Reserve Fund Obligation becomes insolvent, or (B) the issuer of a Reserve Fund Obligation defaults in its payment obligations thereunder, or (C) the claims paying ability of the issuer of the insurance policy or surety bond falls below "AAA" or the equivalent by a Rating Agency, or (D) the rating of the issuer of the letter of credit falls below "AA" or the equivalent by a Rating Agency, the obligation to reimburse the issuer of the Reserve Fund Obligation shall be subordinate to the cash replenishment of the Reserve fund.

(5) In the event (A) the revolving reinstatement feature described in the preceding paragraph is suspended or terminated, or (B) the rating of the claims paying ability of the issuer of the surety bond or insurance policy falls below "AAA" or the equivalent by a Rating Agency, or (C) the rating of the issuer of the letter of credit falls below "AA" or the equivalent by a Rating Agency, the Authority shall either (i) deposit into the Reserve Fund an amount sufficient to cause the money or permitted investments on deposit in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the ensuing five years in equal installments at least semi-annually, or (ii) replace such instrument with a surety bond, insurance policy, or letter of credit meeting the requirements in any of clauses (1) through (3) above within six (6) months of such occurrence. In the event (A) the rating of the claims paying ability of the issuer of the surety bond or insurance policy falls below "A" or the equivalent by a Rating Agency, or (B) the rating of the issuer of the letter of credit falls below "A" or the equivalent by a Rating Agency, or (C) the issuer of the Reserve Fund Obligation defaults in its payment obligations hereunder, or (D) the

issuer of the Reserve Fund Obligation becomes insolvent, the Authority shall either (i) deposit into the Reserve Fund an amount sufficient to cause the money or permitted investments on deposit in the Reserve Fund to accumulate to the Reserve Fund Requirement, such amount to be paid over the ensuing year in equal installments on at least a monthly basis, or (ii) replace such instrument with a surety bond, insurance policy, or letter of credit meeting the requirements in any of clauses (1) through (3) above within six (6) months of such occurrence.

(6) Where applicable, the amount available for draws or claims under a Reserve Fund Obligation may be reduced by the amount of money or permitted investments deposited in the Reserve Fund pursuant to clause (i) of the preceding clause (5).

(7) The Fiduciary shall ascertain the necessity for a claim or draw upon any Reserve Fund Obligation and provide notice to the Authority and the issuer of the Reserve Fund Obligation in accordance with its terms not later than three (3) days prior to each interest or principal payment date (or such appropriate time period as will, when combined with the timing of required payment under the Reserve Fund Obligation, ensure payment under the Reserve Fund Obligation on or before the interest or principal payment date).

(8) Cash on deposit in the Reserve Fund may be used (or investments purchased with such cash shall be liquidated and the proceeds applied as required) prior to any drawing on any Reserve Fund Obligation. If and to the extent that more than one Reserve Fund Obligation is deposited in the Reserve Fund, drawings thereunder and repayments of costs associated therewith shall be made on a pro rata basis, calculated by reference to the maximum amounts available thereunder.

(9) Any Reserve Fund Obligation (A) shall be subject to receipt of such opinion(s) of counsel as may be required by any Supplemental Resolution authorizing the issuance or incurrence of Senior Lien Obligations and (B) must, to the extent required by law, be submitted to and approved by the Office of the Attorney General of the State of Texas.

#### **Section 4.5      Coverage Fund.**

(a) On or before the last Business Day of the month in which the Issue Date for any series or installment of Senior Lien Obligations occurs, after making all prior transfers from the Revenue Fund, there shall be transferred from the Revenue Fund to the Coverage Fund (i) to the extent funds are available in the Revenue Fund, an amount equal to the Coverage Fund Requirement and (ii) if required, in each succeeding month, an amount equal to one-twelfth (1/12) of the Coverage Fund Requirement until (A) the Coverage Fund Requirement has been established in the Coverage Fund or (B) the transfer of funds provided in subsection (b) occurs.

(b) On the first Business Day of each calendar year, there shall be transferred to the Revenue Fund from the Coverage Fund an amount equal to the Coverage Fund Requirement (or so much thereof as shall be on deposit in the Coverage Fund).

(c) On or before the last Business Day of each month, after making all prior transfers from the Revenue Fund, there shall be transferred from the Revenue Fund to the Coverage Fund, (i) in the first month of each calendar year to the extent available in the Revenue Fund, an amount equal to the Coverage Fund Requirement and (ii) if required, in each succeeding month, an amount equal one-twelfth (1/12) of the Coverage Fund Requirement until the Coverage Fund Requirement has been reestablished in the Coverage Fund.

(d) If funds on deposit in the Interest and Sinking Fund are insufficient to pay the principal of and interest on Senior Lien Obligations as such principal and interest becomes due and payable, amounts in the Coverage Fund shall be transferred to the Interest and Sinking Fund to the extent required for such purpose. During any period in which the money and or the market value of investments credited to the Coverage Fund are equal to or exceed the Coverage Fund Requirement, all investment earnings and income from the Coverage Fund shall be deposited upon receipt to the credit of the Revenue Fund.

#### **Section 4.6      Operation and Maintenance Reserve Fund.** Commencing on the Issue Date of any Senior Lien Obligations, there shall be transferred from the Revenue Fund to the Operation and Maintenance Reserve Fund, an amount

sufficient to accumulate the Operation and Maintenance Reserve Requirement. In any Fiscal Year, the amount of the Operation and Maintenance Reserve Requirement shall be determined based on that Fiscal Year's budget.

If the money and the market value of investments in the Operation and Maintenance Reserve Fund is less than the Operation and Maintenance Reserve Requirement for the Fiscal Year, as stated in the budget therefor, on or before the last Business Day of each month, there shall be credited to the Operation and Maintenance Reserve Fund, (i) an amount sufficient to re-establish the Operation and Maintenance Reserve Requirement or (ii) if such deficiency results from a requisition for funds as provided in the next paragraph of this Section, an amount equal to 1/6th of the deficiency caused by such requisition until the amount on deposit in the Operation and Maintenance Reserve Fund equals the Operation and Maintenance Reserve Requirement. No payment need be made into the Operation and Maintenance Reserve Fund so long as the moneys and investments therein shall then equal not less than the Operation and Maintenance Reserve Requirement.

The moneys and investments in the Operation and Maintenance Reserve Fund shall be maintained as a continuing reserve to be used only to prevent deficiencies in the payment of Operation and Maintenance Expenses resulting from a deficiency of Gross Revenues sufficient to pay such expenses as the same accrue and become due. If at any time the Gross Revenues are not sufficient to pay Operation and Maintenance Expenses, the Authority acting by and through an Authorized Representative may requisition the additional moneys needed therefor, and thereupon such money shall be withdrawn from the Operation and Maintenance Reserve Fund and applied for the payment of Operation and Maintenance Expenses. Any moneys accounted for in the Operation and Maintenance Reserve Fund and exceeding the Operation and Maintenance Reserve Requirement for the then current Fiscal Year may be transferred to and deposited in the Revenue Fund.

**Section 4.7**      **Improvement Fund.**

(a) Any money remaining in the Revenue Fund after all prior transfers have been satisfied shall be transferred to the Improvement Fund on or before the last day of each Fiscal Year. Moneys deposited into the Improvement Fund may be used by the Authority for any lawful purpose.

(b) In the event that the amount on deposit in the Interest and Sinking Fund is ever insufficient to pay the principal of or the interest on any Senior Lien Obligations as such principal and interest become due and payable, amounts in the Improvement Fund shall be transferred to the Interest and Sinking Fund to the extent required to pay such principal and interest when due and payable. In addition, in the event that the Coverage Fund Requirement is not established in the Coverage Fund on the last Business Day of the penultimate month of each Fiscal Year, after all transfers required by Section 4.2 have been made, the Authority shall transfer amounts from the Improvement Fund to the Coverage Fund as necessary to re-establish the Coverage Fund Requirement prior to the last Business Day of such Fiscal Year. Except as otherwise provided by this subsection (b), investment earnings and income from amounts on deposit in the Improvement Fund shall be deposited upon receipt to the credit of the Revenue Fund.

**Section 4.8**      **Rebate Fund.** The Authority may establish a Rebate Fund and deposit therein such amounts as are required to be paid to the United States of America under the Code and the Regulations. Moneys in the Rebate Fund shall be used to make payments to the United States of America to the extent required pursuant to the requirements of the Code, the Regulations, and the federal tax covenants of any Supplemental Resolution. For purposes of satisfying such requirements, amounts in any Fund established in this Indenture may be transferred to the Rebate Fund.

**Section 4.11**      **Investment of Funds; Transfer of Investment Income.** Moneys in any Fund established by this Master Resolution may, at the option of the Authority, be invested in Eligible Investments, provided that all such deposits and investments shall have a market value exclusive of accrued interest at all times at least equal to the amount of money credited to such Funds, and shall be made in such manner that the money required to be expended from any Fund will be available at the proper time or times. Moneys in the Reserve Fund shall be invested in Eligible Investments maturing not later than the final maturity of the Senior Lien Obligations. Such investments shall be valued in terms of current market value as of the last day of each year or Fiscal Year, except that direct obligations of the United States in book-entry form shall be continuously valued at their par or face principal amount. Such investments shall be sold promptly when necessary to prevent any default in connection with the Senior Lien Obligations.

**Section 4.12**     **Security for Uninvested Funds.** So long as any Senior Lien Obligation remains Outstanding, all uninvested moneys on deposit in, or credited to, any Fund shall be secured by the pledge of security as provided by law for governmental entities and political subdivisions of the State of Texas.

**Section 5.1**     **General Covenants.** The Authority covenants and agrees that in accordance with and to the extent required or permitted by law, and for as long as any of the Senior Lien Obligations is Outstanding:

(a)     **Performance.** It will faithfully perform at all times any and all covenants, undertakings, stipulations and provisions contained in this Master Resolution; it will promptly pay or cause to be paid the principal of and interest on every Senior Lien Obligation, on the dates and in the places and manner prescribed herein and in any Supplemental Resolutions; it will, at the times and in the manner prescribed, deposit or cause to be deposited the amounts required to be deposited into the Funds, and any Owner of a Senior Lien Obligation may require the Authority, its officials and employees to carry out, respect or enforce the covenants and obligations of this Master Resolution, by all legal and equitable means, including specifically, but without limitation, the use and filing of mandamus proceedings, in any court of competent jurisdiction, against the Authority, its officials and employees.

(b)     **Title.** It has or will obtain lawful title to the lands, buildings, structures, storage capacities and other facilities constituting the System, that it warrants that it will defend the title to all the aforesaid lands, buildings, structures and facilities, and every part thereof, for the benefit of the Owners of the Senior Lien Obligations, against the claims and demands of all persons whomsoever, and it is lawfully qualified to pledge the Net Revenues to the payment of the Senior Lien Obligations in the manner prescribed herein, and has lawfully exercised such rights.

(c)     **Liens.** It will from time to time and before the same become delinquent pay and discharge all taxes, assessments and governmental charges, if any, which shall be lawfully imposed upon it, or the System; it will pay all lawful claims for rents, royalties, labor, materials, and supplies which if unpaid might by law become a lien or charge thereon, the lien of which would be prior to or interfere with the liens hereof, so that the priority of the liens granted hereunder shall be fully preserved in the manner provided herein, and it will not create or suffer to be created any mechanic's, laborer's, materialman's or other lien or charge which might or could be prior to the liens hereof, or do or suffer any matter or thing whereby the liens hereof might or could be impaired; provided, however, that no such tax, assessment or charge, and that no such claims which might be used as the basis of a mechanic's, laborer's, materialman's or other lien or charge, shall be required to be paid so long as the validity of the same shall be contested in good faith by the Authority.

(d)     **Operations of System.** It will continuously and efficiently operate the System, and shall maintain the System in good condition, repair and working order, all at reasonable cost and in the same manner as comparable public authorities engaged in similar activities.

(e)     **Further Encumbrance.** It will not additionally encumber the Gross Revenues or the Net Revenues (or any part thereof) in any manner, except as permitted in this Master Resolution in connection with Senior Lien Obligations (heretofore or hereafter issued), unless such encumbrance is made junior and subordinate in all respects to the liens, pledges, covenants and agreements of this Master Resolution; but the right of the Authority to issue revenue bonds or other obligations, payable from a subordinate lien on the Net Revenues is specifically recognized and retained.

(f)     **Sale of Property.** It will not sell or encumber the System, or any significant or substantial part thereof; provided that whenever the Authority deems it necessary to dispose of any property, machinery, fixtures or equipment which is a part of the System, it may sell or otherwise dispose of such property, machinery, fixtures or equipment when it has made arrangements to replace the same or provide substitutes therefor, unless it is determined that no such replacement or substitute is necessary to the efficient operation of the System.

(g)     **Insurance.**

(1)     It will cause to be insured such parts of the System as would usually be insured by corporations operating like properties, with a responsible insurance company or companies, against risks, accidents or casualties against which and to the extent insurance is usually carried by corporations operating like properties, including, to the extent reasonably obtainable, fire and extended coverage insurance, insurance against damage by floods, and use and occupancy insurance. Public liability and property damage insurance shall also be carried unless the

Authority's attorney gives a written opinion to the effect that the Authority is not liable for claims which would be protected by such insurance. At any time while any contractor engaged in construction work shall be fully responsible therefor, the Authority shall not be required to carry insurance on the work being constructed if the contractor is required to carry appropriate insurance. All such policies shall be open to the inspection of the owners of Senior Lien Obligations and their representatives at all reasonable times. Upon the happening of any loss or damage covered by insurance from one or more of said causes, the Authority shall make due proof of loss and shall do all things necessary or desirable to cause the insuring companies to make payment in full directly to the Authority. The proceeds of insurance covering such property, together with any other funds necessary and available for such purpose, shall be used forthwith by the Authority for repairing the property damaged or replacing the property destroyed; provided, however, that if said insurance proceeds and other funds are insufficient for such purpose, then such insurance proceeds pertaining to the System shall be used promptly as follows:

- (A) for the redemption prior to maturity of the Senior Lien Obligations, ratably in the proportion that the Outstanding principal of each series or installment of Senior Lien Obligations bears to the total Outstanding principal of all Senior Lien Obligations, provided that if on any such occasion the principal of any such series or installment is not subject to redemption, it shall not be regarded as Outstanding in making the foregoing computation; or
- (B) if none of the Outstanding Senior Lien Obligations is subject to redemption, then for the purchase on the open market and retirement of said Senior Lien Obligations in the same proportion as prescribed in the foregoing clause (A), to the extent practicable; provided that the purchase price for any Senior Lien Obligations shall not exceed the redemption price of such Senior Lien Obligations on the first date upon which it becomes subject to redemption; or
- (C) to the extent that the foregoing clauses (A) and (B) cannot be complied with at the time, the insurance proceeds, or the remainder thereof, shall be deposited in a special and separate trust fund, at a depository of the Authority, to be designated the "*Insurance Account.*" The Insurance Account shall be held until such time as the foregoing clauses (A) and/or (B) can be complied with, or until other funds become available which, together with the Insurance Account, will be sufficient to make the repairs or replacements originally required, whichever of said events occurs first.

(2) The foregoing provisions of (1) above notwithstanding, the Authority shall have authority to enter into coinsurance or similar plans where risk of loss is shared in whole or in part by the Authority; provided that the portion of the risk of loss that is coinsured shall not exceed the portion as would reasonably and customarily be coinsured by similar entities operating like properties.

(3) The annual audit hereinafter required shall contain a section commenting on whether or not the Authority has complied with the requirements of this Section with respect to the maintenance of insurance, and listing all policies carried, and whether or not all insurance premiums upon the insurance policies to which reference is hereinbefore made have been paid.

(h) Records. It will keep proper books of record and account in which full, true and correct entries will be made of all dealings, activities and transactions relating to the System, the Gross Revenues and the Net Revenues and the Funds created pursuant to this Master Resolution, and all books, documents and vouchers relating thereto shall at all reasonable times be made available for inspection upon request of an owner of Senior Lien Obligations.

(i) Audits. After the close of each Fiscal Year while any of the Senior Lien Obligations are Outstanding, it will cause an audit to be made of the books and accounts relating to the Authority, including the System and the Net Revenues by an independent certified public accountant or an independent firm of certified public accountants as soon as practicable after the close of each such Fiscal Year.

(j) Franchises, Permits and Authorizations. It will comply with all of the terms and conditions of any and all franchises, permits and authorizations that are applicable to or necessary with respect to the System and that have been obtained from any governmental agency; and the Authority has or will use its best efforts to obtain and keep in full force

and effect all franchises, permits, authorization and other requirements applicable to or necessary with respect to the acquisition, construction, equipment, operation and maintenance of the System.

(k) No Free Service. It will not grant or permit any free service from the System, except for public buildings and institutions operated by the Authority. In addition, the Authority will not grant or permit any free service from the System permitted by the previous sentence if to do so would violate any condition or covenant to which the Authority is bound in connection with any federal grant agreement or otherwise.

(l) Subsidence District Rules and Regulations. It will comply with all applicable rules and regulations of the Subsidence District and all other governmental agencies and regulatory bodies that exercise lawful jurisdiction in regard to the regulation of the Authority's operations and affairs.

(m) Power to Own and Operate System; Ratemaking Power. It will establish, fix, increase, impose and collect rates, fees and charges (in the amounts required to comply with the covenants and provisions contained herein) for the use and services of the System and for the pumping or other extraction of water from wells located within the territory of the Authority. In addition, to the greatest extent permitted by law, the Authority will maintain and impose fees upon the importation of water into the territory of the Authority from sources located outside the territory of the Authority.

Such rates, fees and charges shall be established, fixed, increased, imposed and collected in amounts sufficient (a) to achieve water conservation, prevent waste of water, serve as a disincentive to pumping ground water, and accomplish the purposes of the Act and (b) when combined with all other Gross Revenues, to enable the Authority to pay all Maintenance and Operation Expenses, debt service on Senior Lien Obligations, and all other obligations of the Authority payable from Gross Revenues or any portion thereof.

(n) To Monitor Water Volumes. It will establish, administer and enforce an audit program to monitor and to ensure the accuracy of the reporting of volumes of water pumped and extracted by owners of wells located within the territory of the Authority.

(o) To Inspection of Facilities. Not less frequently than once every three (3) years, it will engage an independent Engineer to inspect and provide a written report identifying the Authority's facilities (including the System) and describing the condition thereof.

**Section 5.2 Rate Covenant.**

(a) After taking into consideration any Capital Contribution Credits and other credits that the Authority may grant from time to time, the Authority shall fix, establish, maintain and collect Gross Revenues sufficient:

- (1) to pay all current Operation and Maintenance Expenses;
- (2) to produce either (A) Net Revenues or (B) Adjusted Net Revenues for each Fiscal Year at least equal to the Rate Coverage Requirement;
- (3) to produce Adjusted Net Revenues for each Fiscal Year in an amount sufficient to pay all debt service on Senior Lien Obligations actually coming due during such Fiscal Year; and
- (4) to pay all other obligations of the System reasonably expected to be paid from Net Revenues.

To the extent that any agency of the United States of America or the State of Texas shall exercise any lawful jurisdiction in regard to the fixing of any such rates, charges and fees, the Authority within lawful limits shall contest such to the extent the exercise of such jurisdiction should make ineffective or reduce the effectiveness of the establishment by the Authority of such rates, charges and fees in accordance with this paragraph.

(b) Compliance with the Rate Coverage Requirement set forth in clause (a)(2) of this Section shall be measured and determined each year using a schedule which shall be prepared by the Authority in accordance with the provisions of this Master Resolution and attached to the Authority's audited financial statements. Not later than the sixtieth

(60th) day following the receipt by the Board of the Authority's audited financial statements for a Fiscal Year in which the Authority has failed to satisfy the Rate Coverage Requirement, the Authority shall appoint an Independent Rate Consultant to make recommendations to ensure compliance with the Rate Coverage Requirement and the rate covenant. As long as the Independent Rate Consultant's recommendations are implemented and administered by the Authority, no default shall result solely from a failure by the Authority to satisfy the Rate Coverage Requirement or the rate covenant set forth herein.

**Section 5.3 Owners' Rights and Remedies.** This Master Resolution shall constitute a contract between the Authority and the Owners of the Senior Lien Obligations from time to time Outstanding and this Master Resolution shall be and remain irrevocable until all Outstanding Senior Lien Obligations shall be fully paid or discharged or provision therefor shall have been made as provided herein. In the event of a default in the payment of the principal of or interest on any of the Senior Lien Obligations or a default in the performance of any duty or covenant provided by law or in this Master Resolution, the Owners of any of the Senior Lien Obligations may pursue all legal remedies afforded by the Constitution and laws of the State of Texas to compel the Authority to remedy such default and to prevent further default or defaults. Without in any way limiting the generality of the foregoing, it is expressly provided that any Owner of any of the Senior Lien Obligations may (at law or in equity), by suit, action, mandamus, or other proceedings, enforce and compel performance of all duties required to be performed by the Authority under this Master Resolution, including (a) the assessment and collection of reasonable and sufficient Pumpage Fees and rates, fees and charges for the use and services of the System, (b) the deposit of the revenues thereof into the special funds herein provided, and (c) the application of such revenues in the manner required in this Master Resolution.

So long as a Bond Insurer shall not have defaulted in its payment obligations under its Bond Insurance Policy insuring a portion of the Senior Lien Obligations, any such Bond Insurer shall have all the rights granted to the Owners of such Senior Lien Obligations in this Master Resolution (and no consent of the Owner shall be required in the exercise by the Bond Insurer of such rights).

**Section 6.1 Amendments to Master Resolution Not Requiring Consent of Owners.** The Authority, without the consent of or notice to any Owner, may adopt amendments to this Master Resolution (or any Supplemental Resolution) which do not materially adversely affect the interests of the Owners for one or more of the following purposes:

(a) To grant to or confer upon the Owners any additional rights, remedies, powers or authority that may lawfully be granted to or conferred upon the Owners;

(b) To grant or pledge to the Owners any additional security other than that granted or pledged under this Master Resolution;

(c) To amend this Master Resolution or any resolution amendatory hereto in such manner as to permit the qualification thereof under the Trust Indenture Act of 1939 or any similar federal statute then in effect or to permit the qualification of the Senior Lien Obligations for sale under the securities laws of any of the states of the United States;

(d) To amend this Master Resolution for the purpose of obtaining or retaining a rating on the Senior Lien Obligations from a Rating Agency;

(e) To amend this Master Resolution as may be necessary or convenient in connection with the book-entry system for payments, transfers and other matters relating to the Senior Lien Obligations;

(f) To cure any ambiguity, supply any omission, or to correct or supplement any provision contained herein or in any amendatory resolution which may be defective or inconsistent with any provision contained herein or in any amendatory resolution;

(g) To make such changes or insert such provisions to clarify matters or questions arising under this Master Resolution as are necessary or desirable and are not contrary to or inconsistent with this Master Resolution as theretofore in effect;

(h) To make any change therein necessary, in the opinion of Bond Counsel, to maintain the exclusion from gross income for federal income tax purposes of the interest on any Outstanding Senior Lien Obligations;

(i) To make any change or modification in the terms and conditions of any series or installment established pursuant to a Supplemental Resolution to the extent that such change or modification (A) is not inconsistent with the terms and conditions of this Master Resolution, (B) affects only Senior Lien Obligations of such series or installment that have not been issued and delivered to the initial purchasers thereof on the effective date of such change or modification and (C) does not adversely affect the interests of the Senior Lien Obligations that were Outstanding immediately before the effective date of such change or modification; and

(j) To modify any of the provisions of this Master Resolution in any other respect whatever, provided that such modification shall be, and be expressed to be, effective only after all Senior Lien Obligations Outstanding at the date of the adoption of such modification shall cease to be Outstanding.

Prior to the effective date of any such amendment, a copy of such amendment shall be promptly furnished to the Fiscal Agents and Credit Agreement Providers of any Parity Credit Agreements then in effect.

## **Section 6.2 Amendments to Master Resolution Requiring Consent of Owners.**

(a) Exclusive of amendments covered by Section 6.1, the Owners of not less than a majority of the aggregate principal amount of the then Outstanding Parity Bonds or Parity Obligations, with the consent of the Credit Agreement Providers of any Parity Credit Agreements then in effect, shall have the right, from time to time, anything contained in this Master Resolution to the contrary notwithstanding, to consent to such other amendments hereto (including amendments to any Supplemental Resolution) as shall be consented to by the Board in its sole discretion for the purpose of modifying, altering, amending, adding to or rescinding any of the terms or provisions contained in this Master Resolution (or any Supplemental Resolution) or in any amendatory resolution; provided, however, that nothing in this Section shall permit, or be construed as permitting, without the consent of each affected Owner, (i) an extension of the maturity of the principal of, or the mandatory redemption date of, or interest payment date on, any Parity Bond or Parity Obligation, (ii) a reduction in the principal of, or the premium or the rate of interest on, any Parity Bond or Parity Obligation, (iii) a preference or priority of any Parity Bond or Parity Obligation or Parity Bonds or Parity Obligations over any other Parity Bond or Parity Obligation or Parity Bonds or Parity Obligations, (iv) the creation of a lien prior to the lien of this Master Resolution or (v) a reduction in the aggregate principal amount of the Parity Bonds or Parity Obligations required for any consent to any amendment. The giving of notice to and consent of the Owners to any such proposed amendment shall be obtained pursuant to Section 6.4 hereof.

(b) With regard to any series or installment of Parity Bonds or Parity Obligations that are insured (or for which the payment of principal and interest has been guaranteed) such that they bear the highest generic rating of each Rating Agency then rating such series or installment of Parity Bonds or Parity Obligations, the Bond Insurer that issued the Bond Insurance Policy for such series or installment of Parity Bonds or Parity Obligations shall be authorized to exercise the rights of Owners of Parity Bonds or Parity Obligations that it insures or guarantees for purposes of consenting to any amendment hereto except for the matters detailed in clauses (i), (ii), (iii) and (v) of Section 6.2(a).

**Section 6.3 Amendments, Changes and Modifications to Parity Credit Agreements.** No Parity Credit Agreement may be effectively amended, changed or modified without the prior written consent of the Authority and the related Credit Agreement Provider. The Authority may, without the consent of the owners of the Parity Bonds or Parity Obligations, consent to any amendment of a Parity Credit Agreement which, in the Board's or an Authorized Representative's judgment, does not prejudice in any material respect the interests of the Owners. The foregoing shall not limit the Fiscal Agent's obligation to send notice to a Credit Agreement Provider to reduce amounts available under its currently effective Parity Credit Agreement, under the circumstances set forth therein.

Copies of any such amendments, changes or modifications shall be filed with the Fiscal Agents.

**Section 6.4 Notice to and Consent of Owners.** If consent of the Owners is required under the terms of this Master Resolution for the amendment of this Master Resolution or a Parity Credit Agreement or for any other similar purpose, the Authority shall cause notice of the proposed amendment to be given by first-class mail to the last known holders of the Outstanding Parity Bonds or Parity Obligations (whose consent is so required) then shown on the registration books for the Parity Bonds or Parity Obligations. Such notice shall briefly set forth the nature of the proposed amendment or other action and shall state that copies of any such amendment or other document are on file at the office of the Authority and the principal office of the Fiscal Agent for inspection by all Owners. If, within sixty (60) days or such longer period as shall be

prescribed by the Authority following the mailing of such notice, the holders of the requisite principal amount of the Parity Bonds or Parity Obligations Outstanding by instruments filed with the Authority shall have consented to the amendment or other proposed action, then the Authority may adopt or execute, as appropriate, such amendment or other document or take such proposed action and the consent of the Owners shall thereby be conclusively presumed.

**Section 6.5**      **Supplemental Resolutions.** Notwithstanding any provision of this Master Resolution to the contrary, the Authority, without notice to or consent of the Owners or the Credit Agreement Providers of any Parity Credit Agreements then in effect, may adopt Supplemental Resolutions not inconsistent with the provisions of this Master Resolution (i) authorizing the issuance and specifying the designation, and aggregate principal amount, of any series or installment of Parity Bonds or Parity Obligations, (ii) authorizing one or more Parity Credit Agreements, (iii) appointing one or more Fiscal Agents (and specifying their respective duties and responsibilities) for such Parity Bonds or Parity Obligations and (iv) taking other appropriate action relating to the issuance of Parity Bonds or Parity Obligations hereunder.

**Section 7.1**      **Discharge of Lien and Security Interest.** Upon payment in full of all of the Parity Bonds or Parity Obligations and of all amounts owing under all Parity Credit Agreements (including Reserve Fund Obligations), the pledge and lien on the Net Revenues arising under this Master Resolution shall cease, terminate and be void; provided, however, that such discharge of this Master Resolution shall not terminate the powers and rights granted to, or the obligation of the Authority to secure the services of, a Fiscal Agent with respect to the payment, transfer and exchange of the Parity Bonds or Parity Obligations .

**Section 7.2**      **Provision for Payment of Senior Lien Obligations.** Senior Lien Obligations (or any portion of the Senior Lien Obligations) shall be deemed to have been paid, retired and no longer Outstanding within the meaning of Section 7.1 if:

(a)            there shall have been irrevocably deposited in a special escrow fund established for such purpose either (i) sufficient money or (ii) Defeasance Obligations of such maturities and interest payment dates and bearing such interest as will, without further investment or reinvestment of either the principal amount thereof or the interest earnings thereon (said earnings also to be held in trust), be sufficient (as confirmed by a report of an independent certified public accountant or firm of certified public accountants) together with any money referred to in Section 7.2(a)(i) above, for the payment at their respective maturities or redemption dates prior to maturity of the principal thereof and the premium (if any) and interest to accrue thereon at such maturity or redemption dates, as the case may be;

(b)            there shall have been paid (or provision shall have been duly made for the payment of) all fees and expenses of any Fiscal Agent for such Senior Lien Obligations due or to become due; and

(c)            if any such Senior Lien Obligations are to be redeemed on any date prior to their maturity, the Fiscal Agent shall have received in form satisfactory to it irrevocable instructions from an Authorized Representative to redeem such Senior Lien Obligations on such date and irrevocable power authorizing the Fiscal Agent to give such redemption notices.

Limitations elsewhere specified herein regarding the investment of money held by the Fiscal Agent in the Interest and Sinking Fund shall not be construed to prevent the depositing and holding of moneys and investments in the special escrow fund described in the preceding subparagraph (a)(ii) for the purpose of defeasing the lien of this Master Resolution as to Senior Lien Obligations which have not yet become due and payable. In addition, all money so deposited with the Fiscal Agent as provided in this Section 7.2 may also be invested and reinvested, at the direction of an Authorized Representative, in Defeasance Obligations, maturing in the amounts and times as hereinbefore set forth, and all income from all Defeasance Obligations in the hands of the Fiscal Agent pursuant to this Section 7.2 which is not required for the payment of the Senior Lien Obligations and interest and premium, if any, thereon with respect to which such money shall have been so deposited shall be deposited in the Interest and Sinking Fund as and when realized and collected for use and application as are other moneys deposited in the Interest and Sinking Fund.

Senior Lien Obligations issued as variable rate obligations shall be deemed to be paid and discharged only if the amount held under 7.2(a)(i) or (ii) above shall be sufficient to provide for the payment of such Senior Lien Obligations assuming the highest possible interest rate on such Senior Lien Obligations (as established in accordance with the proceedings authorizing the issuance of such Senior Lien Obligations) to the earlier of the first tender date on which such

Senior Lien Obligations will be tendered on the redemption date on which such Senior Lien Obligations have been called for redemption.

In the proceedings providing for the payment of Senior Lien Obligations at their stated maturity or maturities in accordance with this Section 7.2, any determination not to redeem such Senior Lien Obligations may be made revocable by the Authority and the Authority may reserve the right to redeem such Senior Lien Obligations on any date that such Senior Lien Obligations would have been subject to redemption at the option of the Authority in accordance with the proceedings that authorized the issuance of such Senior Lien Obligations.

In addition to or in lieu of the provisions for payment set forth in this Section 7.2, Senior Lien Obligations of any series or installment may be defeased in any manner provided in the Supplemental Resolution authorizing the issuance of such series or installment of Senior Lien Obligations.

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**APPENDIX D**  
**SPECIMEN MUNICIPAL BOND INSURANCE POLICY**

[See “*BOND INSURANCE*” herein.]

**APPENDIX E**  
**FORM OF CO-BOND COUNSEL OPINION**

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\_\_\_\_\_, 2008

WE HAVE ACTED as Co-Bond Counsel for the North Harris County Regional Water Authority (the "Authority") in connection with an issue of bonds (the "Bonds") described as follows:

NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY SENIOR LIEN REVENUE BONDS, SERIES 2008, dated as of August 15, 2008, in the aggregate principal amount of \$241,160,000 maturing on December 15 in each year from 2013 through 2038, inclusive. The Bonds are issuable in fully registered form only, in denominations of \$5,000 or integral multiples thereof, bear interest, are subject to redemption prior to maturity and may be transferred and exchanged as set out in the Bonds and in the Second Supplemental Resolution to the Master Resolution, as amended (collectively, the "Resolutions"), adopted by the Board of Directors of the Authority (the "Board") authorizing their issuance.

WE HAVE ACTED as Co-Bond Counsel for the sole purpose of rendering an opinion with respect to the legality and validity of the Bonds under the Constitution and laws of the State of Texas and with respect to the exclusion of interest on the Bonds from gross income under federal income tax law. In such capacity we have examined the Constitution and laws of the State of Texas, federal income tax law and a transcript of certain certified proceedings pertaining to the issuance of the Bonds. The transcript contains certified copies of certain proceedings of the Authority, certain certifications and representations and other material facts within the knowledge and control of the Authority, upon which we rely, and certain other customary documents and instruments authorizing and relating to the issuance of the Bonds. We have also examined executed Bond No. R-1 of this issue.

WE HAVE NOT BEEN REQUESTED to examine, and have not investigated or verified, any original proceedings, records, data or other material, but have relied upon the transcript of certified proceedings. We have not assumed any responsibility with respect to the financial condition or capabilities of the Authority or the disclosure thereof in connection with the sale of the Bonds. Our role in connection with the Authority's Official Statement prepared for use in connection with the sale of the Bonds has been limited as described therein.

BASED ON SUCH EXAMINATION, it is our opinion as follows:

- (1) The transcript of certified proceedings evidences complete legal authority for the issuance of the Bonds in full compliance with the Constitution and laws of the State of Texas presently in effect; the Bonds constitute valid and legally binding limited obligations of the Authority enforceable in accordance with the terms and conditions thereof; and the Bonds have been authorized and delivered in accordance with law;
- (2) The Bonds, together with any prior and future additional Senior Lien Obligations issued under the Master Resolution, are secured by and payable solely from the Net Revenues and the special funds of the Authority described in the Resolutions; and
- (3) The Authority is authorized to impose and collect Pumpage Fees and, after the System is operational, System revenues in the amounts imposed and required by the Resolutions.

THE RIGHTS AND REMEDIES OF THE OWNERS of the Bonds are subject to, and may be limited by, laws heretofore or hereafter enacted relating to bankruptcy, insolvency, reorganization, moratorium or other similar laws affecting the rights of creditors of political subdivisions and the exercise of judicial discretion in appropriate cases. The Bonds are secured solely by a lien on and pledge of the Net Revenues and do not constitute a general obligation of the Authority. The Authority may not impose an ad valorem tax, and the owners of the Bonds shall never have the right to demand payment of the principal of or interest on the Bonds out of any funds raised or to be raised by ad valorem taxation.

THE AUTHORITY HAS RESERVED THE RIGHT in the Resolutions, and the Resolutions permit the Authority, to issue from time to time additional Senior Lien Obligations which are equally and ratably secured on parity with the Bonds by a pledge of and lien on the Net Revenues. The Authority has also reserved the right to issue other obligations secured by a lien on the Net Revenues that is junior and subordinate to the lien on the Net Revenues with respect to the Bonds and any additional Senior Lien Obligations.

ALSO BASED ON OUR EXAMINATION AS DESCRIBED ABOVE, it is our further opinion that, subject to the restrictions hereinafter described, interest on the Bonds is excludable from gross income of the owners thereof for federal income tax purposes under existing law and is not subject to the alternative minimum tax on individuals or, except as hereinafter described, corporations. The opinion set forth in the first sentence of this paragraph is subject to the condition that the Authority comply with all requirements of the Internal Revenue Code of 1986, as amended (the "Code"), that must be satisfied subsequent to the issuance of the Bonds in order that interest thereon be, or continue to be, excluded from gross income for federal income tax purposes. The Authority has covenanted in the Resolutions to comply with each such requirement. Failure to comply with certain of such requirements may cause the inclusion of interest on the Bonds in gross income for federal income tax purposes to be retroactive to the date of issuance of the Bonds. The Code and the existing regulations, rulings and court decisions thereunder, upon which the foregoing opinions of Co-Bond Counsel are based, are subject to change, which could prospectively or retroactively result in the inclusion of the interest on the Bonds in gross income of the owners thereof for federal income tax purposes.

INTEREST ON all tax-exempt obligations, including the Bonds, owned by a corporation (other than an S corporation, a regulated investment company, a real estate investment trust (REIT), a real estate mortgage investment conduit (REMIC) or a financial asset securitization investment trust (FASIT)) will be included in such corporation's adjusted current earnings for purposes of calculating such corporation's alternative minimum taxable income. A corporation's alternative minimum taxable income is the basis on which the alternative minimum tax imposed by the Code is computed. Purchasers of Bonds are directed to the discussion entitled "TAX EXEMPTION" set forth in the Official Statement.

EXCEPT AS DESCRIBED ABOVE, we express no opinion as to any federal, state or local tax consequences under present law, or future legislation, resulting from the ownership of, receipt or accrual of interest on, or the acquisition or disposition of, the Bonds. Prospective purchasers of the Bonds should be aware that the ownership of tax-exempt obligations, such as the Bonds, may result in collateral federal income tax consequences to, among others, financial institutions, life insurance companies, property and casualty insurance companies, certain foreign corporations doing business in the United States, certain S corporations with Subchapter C earnings and profits, individual recipients of Social Security or Railroad Retirement benefits, taxpayers who are deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations, taxpayers owning an interest in a FASIT that holds tax-exempt obligations, and individuals otherwise qualified for the earned income credit. For the foregoing reasons, prospective purchasers should consult their own tax advisors as to the consequences of investing in the Bonds.

OUR OPINIONS ARE BASED ON EXISTING LAW, which is subject to change. Such opinions are further based on our knowledge of facts as of the date hereof. We assume no duty to update or supplement our opinions to reflect any facts or circumstances that may thereafter come to our attention or to reflect any changes in any law that may thereafter occur or become effective. Moreover, our opinions are not a guarantee of result and are not binding on the Internal Revenue Service; rather, such opinions represent our legal judgment based upon our review of existing law that we deem relevant to such opinions and in reliance upon the representations and covenants referenced above.

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**APPENDIX F**  
**MAP OF AUTHORITY**

