



City of Palo Alto, California

2003-2004

Comprehensive
Annual Financial Report

Fiscal Year Ended June 30, 2004

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*City of Palo Alto
California*

Comprehensive
Annual Financial
Report

For the fiscal year ended
June 30, 2004



Prepared by: Administrative Services Department

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Introduction

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City of Palo Alto
Office of the City Manager

Transmittal Letter.....

December 14, 2004

THE HONORABLE CITY COUNCIL
Palo Alto, California

Attention: Finance Committee

COMPREHENSIVE ANNUAL FINANCIAL REPORT

YEAR ENDED JUNE 30, 2004

Members of the Council and Citizens of Palo Alto:

Transmittal: The Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2004, is submitted for Council review in accordance with Article IV, Section 13 of the City of Palo Alto Charter and published as a matter of public record for interested citizens. This transmittal letter provides information regarding the economy and the governing structure in Palo Alto. An overview of the City’s financial activities for the fiscal year is discussed in detail in the Management’s Discussion and Analysis section of the CAFR. While the independent auditor has expressed an opinion on the financial statements contained in this report, management takes sole responsibility for the contents of the CAFR. To the best of its knowledge, staff believes the CAFR information is accurate in all material respects.

INDEPENDENT AUDIT

The City of Palo Alto’s financial statements have been audited by Maze and Associates, a firm of licensed certified public accountants. The goal of the audit is to obtain reasonable assurance that the financial statements are free of material misstatement. Maze and Associates concluded, based on the audit, that there was a reasonable basis for rendering an unqualified opinion for the fiscal year ended June 30, 2004, and that the financial statements are fairly presented in conformity with generally accepted accounting principals (GAAP). The independent auditor’s report is presented as the first component of the financial section of this report.

In addition, Maze and Associates also conducts the federally mandated “Single Audit” designed to meet the special needs of federal grantor agencies. The standards governing the Single Audit require the independent auditor to report on the fair presentation of the financial statements, government’s internal controls and compliance with legal requirements. These reports are available in the Single Audit section of the CAFR.



THE PALO ALTO ECONOMY

Local Trends: The City of Palo Alto, population 60,246, is a largely “built-out” community in the heart of Silicon Valley and the greater San Francisco and San Jose areas. The adjacent Stanford University, one of the premier institutions of higher education in the nation, has produced much of the talent that founded many successful high-tech companies in Palo Alto and Silicon Valley. With varied and relatively stable employers such as Stanford University, the Stanford Medical Center, the Palo Alto Medical Foundation, the Palo Alto Unified School District, and businesses such as the Stanford Shopping Center, Hewlett-Packard/Compaq, and Roche Pharmaceuticals; Palo Alto has enjoyed a diverse employment and revenue base. The City, however, was not immune from the pervasive economic downturn that began in January 2001.

This downturn, manifested by layoffs in the technology sector, lack of capital investment, curtailed venture capital activity, and weaker consumer spending persisted into 2003-04. While unemployment rates soared in Santa Clara County and in Palo Alto, economically sensitive revenue sources such as sales and transient occupancy tax revenues declined. Since January 2001, the City has engaged in a series of “Strengthening the Bottom Line” efforts whereby expenses were brought into alignment with available revenues. Because of its budget discipline, the City is fortunate to report that it has not relied on General Fund reserves to meet its commitments.

Toward the latter part of 2003-04, the economic downturn appears to have abated somewhat. Sales and transient occupancy tax revenues appeared to have stopped declining and county and local unemployment levels decreased. While these are positive signs, they do not provide evidence of a resurgent local economy. In fact, State financial difficulties causing local revenue “take-backs,” strong competition from neighboring City retail outlets, high commercial vacancy rates, rising employee benefit costs, and higher oil prices make it unlikely the Palo Alto economy will improve dramatically in the near future. As a consequence of continued pressure on revenue sources, the City anticipates taking additional measures to control expenditures in the next year.

Employment Trends: Palo Alto is home to a strong mix of large, medium and small firms. The number of jobs in Palo Alto total around 100,000. With a local workforce somewhat over 35,000, commuters hold almost two-thirds of Palo Alto jobs. Palo Alto employment opportunities are much sought after and include: education at Stanford University, high technology at the Stanford Research Park, and health care at two medical facilities of national stature. Numerous institutions that have more than 1,000 employees include: the University, the Veterans Affairs Palo Health Care facility, the Medical Foundation, Agilent Technologies, Hewlett Packard/Compaq, and the City of Palo Alto.

Even with this employment base, Palo Alto’s unemployment rate increased from 2.3 percent in 2000 to 4.4 percent in July 2003. During the same period, the Santa Clara County unemployment rate went from 2.0 percent to 8.4 percent. Layoffs occurred at technology firms such as Agilent, Apple, Sun Microsystems, Oracle, Hewlett Packard/Compaq and other businesses. The trend of outsourcing high-paying technology jobs to India and China is also of growing concern. Being a regional destination point because of its vibrant downtown and state of the art Shopping Center, Palo Alto’s economy and revenues were adversely affected by lost jobs. Some improvement in the employment picture was seen in late 2003-04 as unemployment rates in the City and County fell to 3.2 percent and 6.3 percent, respectively.

Real Estate Market: Assessed property valuation in Santa Clara County experienced an anemic growth rate of 2.28 percent in 2003-04. This was the slowest rate of growth in the last decade. A significant decline in real estate values occurred in office buildings, industrial property, and research and development campuses. Residential property remained relatively stable. In Palo Alto actual secured property receipts came in 2.5 percent over 2002-03 levels, but unsecured receipts (based on machinery, equipment and computers) fell by 13.2 percent. Secured valuations in Palo Alto for 2004-



05 will improve, primarily as a consequence of a long-term lease transaction for the Stanford Shopping Center.

Cash and Investments: The City of Palo Alto invests funds prudently and has adopted an investment policy as prescribed by State law that restricts the City to investments emphasizing , in the following priority order: safety, liquidity and yield. Staff provides a quarterly report of investments for Council and Finance Committee review. The City’s investment practice is to buy securities and hold them to maturity to avoid potential losses from a sale. During 2003-04, staff complied with all aspects of the investment policy.

THE PALO ALTO GOVERNMENT

As a charter city delivering a full range of municipal services and public utilities under the council-manager form of government, Palo Alto offers an outstanding quality of life for its residents. The independent Palo Alto Unified School District (PAUSD) has achieved state and national recognition for the excellence of its programs. The City has dedicated 4,000 acres of open space to parks and wildlife preserves. Public facilities include five libraries, four community centers, a cultural arts center, adult and children’s theater, a junior museum and zoo, and a golf course. The City provides a diversity of human services for seniors and youths, an extensive continuing education program, concerts, exhibits, team sports and special events.

City Council: The Council consists of nine members elected at-large for four-year, staggered terms. At the first meeting of each calendar year, the Council elects a Mayor and Vice-Mayor from its membership, with the Mayor having the duty of presiding over Council meetings. The Council is the appointing authority for the City Manager and three other officials, the City Attorney, City Clerk, and City Auditor, who all report directly to it.

Finance Committee: While retaining the authority to approve all actions, the City Council has established a subcommittee to review financial matters. Staff provides the CAFR, the results of external and internal audits, periodic budget-versus-actual, investment and performance measure reports to the Finance Committee and Council to assist in their evaluation of the City’s financial performance.

City Manager: The City Manager directs administrative services, human resources, public works, planning and community environment, public safety, community services departments and also the municipal electric, water, gas, wastewater collection, wastewater treatment, storm drainage, and refuse utilities (the utilities represent almost two-thirds of the City’s revenues).



SUMMARY

Awards: During the past year, the City received two awards for the prior fiscal year CAFR, one from the Government Finance Officers Association (GFOA) for “excellence in financial reporting” and one from the California Society of Municipal Finance Officers (CSMFO) for “outstanding financial reporting”. This is the tenth consecutive year the City has received both of these awards and the current certificates appear immediately after the end of this transmittal letter. The 2003-04 CAFR also has been submitted to the GFOA and CSMFO award programs and management believes that, once again, it will meet the criteria for these distinguished financial reporting awards.

Acknowledgment: This CAFR reflects the hard work, talent and commitment of the staff members of the Administrative Services Department. This document could not have been accomplished without their efforts and each contributor deserves sincere appreciation. Management wishes to acknowledge the support of Trudy Eikenberry, Accounting Manager, and the Senior Accountants, Staff Accountants, and Accounting Specialists for the high level of professionalism and dedication they bring to the City of Palo Alto. Management would also like to express its appreciation to Maze & Associates, the City’s independent auditors, who assisted and contributed to the preparation of this Comprehensive Annual Financial Report.

Special acknowledgment must be given to the City Council Finance Committee for its support and interest in directing the financial affairs of the City in a responsible, professional and progressive manner.

Respectfully submitted,

CARL YEATS,
Administrative Services Director

FRANK BENEST,
City Manager



City of Palo Alto City Officials

City Council

Bern Beecham, *Mayor*

Jim Burch, *Vice-Mayor*

Victor Ojakian	Dena Mossar
Hillary Freeman	Judy Kleinberg
Yoriko Kishimoto	LaDoris Cordell
Jack Morton	

Finance Committee

Judy Kleinberg, *Chair*

Hillary Freeman

Dena Mossar

Vic Ojakian

Policy and Services Committee

Yoriko Kishimoto, *Chair*

Jim Burch

LaDoris Cordell

Jack Morton

Council-Appointed Officers

City Manager

Frank Benest

City Attorney

Gary Baum

City Clerk

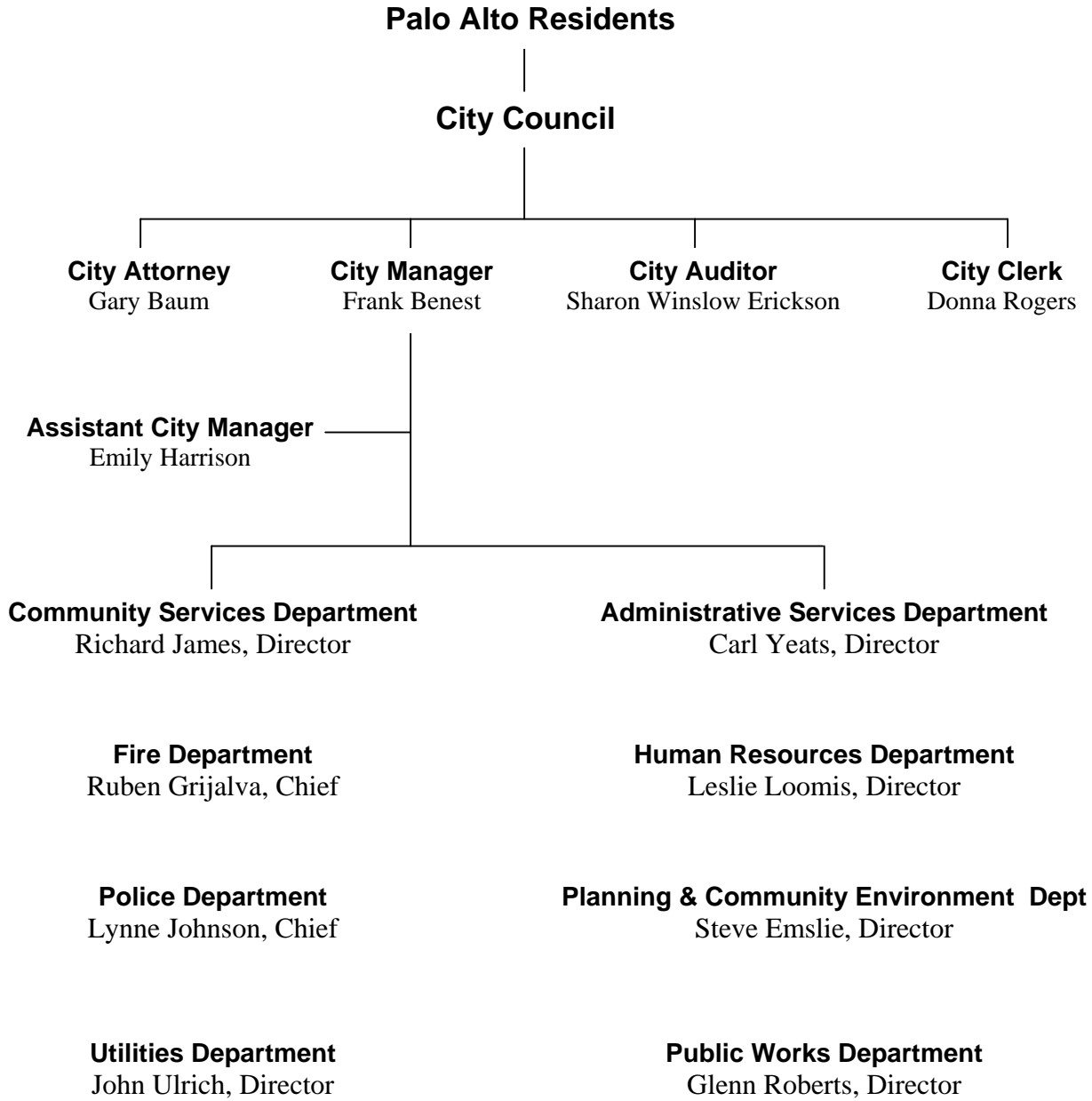
Donna Rogers

City Auditor

Sharon Winslow Erickson



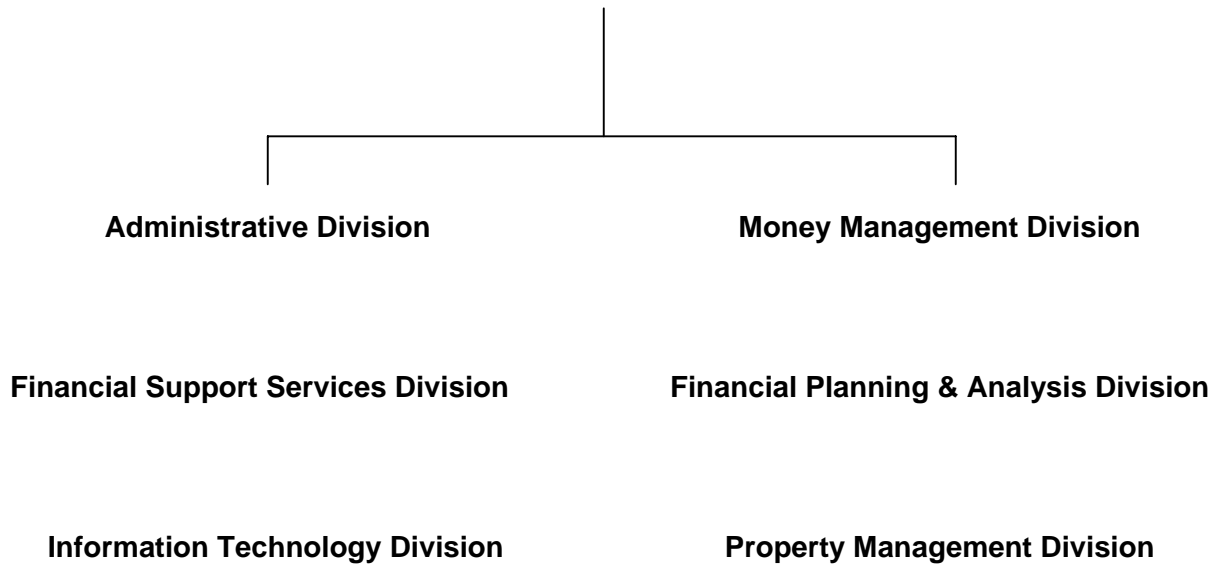
City of Palo Alto Organization





Administrative Services Organization

Administrative Services Department



Mission Statement

To provide proactive administrative and technical support to City departments and decision makers, and to safeguard and facilitate the optimal use of City resources.

Government Finance Officers Association of the United States and Canada - Award

Certificate of Achievement for Excellence in Financial Reporting

Presented to

City of Palo Alto,
California

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director



California Society of Municipal Finance Officers – Award





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Financial Section

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**INDEPENDENT AUDITOR'S REPORT
ON BASIC FINANCIAL STATEMENTS**

ACCOUNTANCY CORPORATION
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Walnut Creek, California 94596
(925) 930-0902 • FAX (925) 930-0135
E-Mail: maze@mazeassociates.com
Website: www.mazeassociates.com

Honorable Mayor and City Council
City of Palo Alto, California

We have audited the basic financial statements of the governmental activities, business-type activities, each major fund and the aggregate remaining fund information of the City of Palo Alto, California as of and for the year ended June 30, 2004, which collectively comprise the City's basic financial statements as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Palo Alto, California as of June 30, 2004 and the respective changes in the financial position and cash flows, where applicable thereof and the respective budgetary comparisons listed as part of the basic financial statements for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued reports dated October 19, 2004 on our consideration of the City of Palo Alto's internal control structure and on its compliance with laws and regulations.

Management's Discussion and Analysis 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 this information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the basic financial statements. The supplemental section listed in the Table of Contents is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The Introductory and Statistical Sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly we express no opinion on them.

Maze & Associates

October 19, 2004

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Management's Discussion & Analysis

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Management's Discussion and Analysis

With the 2003-04 Comprehensive Annual Financial Report (CAFR), the City will have implemented the provisions of Government Accounting Standards Board Statement 34 (GASB 34), "Basic Financial Statements – and Management's Discussion & Analysis – for State and Local Governments" for three consecutive years. GASB 34 required municipalities to make fundamental changes in accounting and reporting in an effort to make government financial performance clearer and more understandable to readers. GASB 34 has required the City to make substantial changes to its financial statement format. Moreover, the City must provide more detailed discussion and analysis of its financial activities, particularly in comparing results to the prior fiscal year and to the 2003-04 fiscal year budget. Other required changes will be described in the financial statements below. To obtain a complete picture of the City's financial condition, this document should be read in conjunction with the accompanying Transmittal Letter and Basic Financial Statements.

OVERVIEW OF THE COMPREHENSIVE ANNUAL FINANCIAL REPORT

The CAFR is presented in six sections:

- An introductory section which includes the Transmittal Letter and general information;
- Management's Discussion and Analysis;
- The Basic Financial Statements which include the Citywide and Fund Financial Statements, along with the Notes to these statements;
- Supplemental Information;
- Statistical information; and
- Single Audit

Basic Financial Statements

The Basic Financial Statements contain the Citywide Financial Statements and the Fund Financial Statements. These statements provide long and short-term views of the City's financial activities and financial position.

The Citywide Financial Statements provide a longer-term view of the City's activities as a whole. They include the Statement of Net Assets and the Statement of Activities. The Statement of Net Assets includes the City's capital assets and long-term liabilities on a full accrual basis of accounting similar to that used by private-sector companies. The Statement of Activities provides information about the City's revenues and expenses on a full accrual basis, with an emphasis on measuring net revenues or expenses for each of the City's programs. The Statement of Activities explains in detail the change in net assets for the year. The amounts in the Statement of Net Assets and the Statement of Activities are separated into Governmental and Business-type Activities in order to provide a summary of these activities for the City.



The Fund Financial Statements display the City's operations in more detail than the Citywide statements. They focus primarily on the short-term activities of the City's General Fund and other major funds such as the Capital Projects Fund, Housing In-Lieu Fund, Water Services Fund, Electric Services Fund, Gas Services Fund, Wastewater Collection Fund, Wastewater Treatment Fund, Refuse Services Fund, Storm Drainage Services Fund and External Services Fund.

For certain entities and funds, the City acts solely as a depository agent. For example, the City has several Assessment Districts for which it provides fiduciary statements showing the cash balances and activities of these districts. These statements are separate from, and their balances are excluded from, the City's financial statements.

Together, all these statements are called Basic Financial Statements.

Citywide Financial Statements

Governmental Activities - All of the City's basic services are considered to be governmental activities. These include the City Council, City Manager, City Attorney, City Clerk, City Auditor, Administrative Services, Human Resources, Public Works, Planning and Community Development, Police, Fire, Community Services, and non-departmental services. These services are supported by general City revenues such as taxes and by specific program revenues such as fees.

The City's governmental activities include the activities of the Palo Alto Public Improvement Corporation and Redevelopment Agency, separate legal entities financially accountable to the City.

Business-Type Activities - All of the City's enterprise activities are reported here, including Water, Electric, Gas, Wastewater Collection, Wastewater Treatment, Refuse, Storm Drainage, and External services. Unlike governmental services, these services are supported by charges paid by users based on services used.

Citywide Financial Statements are prepared on the accrual basis of accounting, which means they measure the flow of all economic resources of the City as a whole.

Fund Financial Statements

The Fund Financial Statements provide detailed information about each of the City's most significant funds, called Major Funds. The concept of Major Funds, and the determination of which are Major Funds, was established by GASB 34 and replaces the concept of combining like funds and presenting them in total. Instead, each Major Fund is presented individually, with all Non-major Funds combined in a single column on each fund statement. Subordinate schedules present the detail of these Non-major Funds. Major Funds present the major activities of the City for the year. The General Fund is always a Major Fund, but other funds may change from year to year as a result of changes in the pattern of City activities.

Fund Financial Statements include Governmental, Enterprise and Internal Service Funds.

Governmental Fund financial statements are prepared on the modified accrual basis of accounting, which means they measure only current financial resources and uses. Capital assets and other long-lived assets, along with long-term liabilities, are presented only in the Citywide Financial

Statements. In 2003-04, the City has three Major Governmental Funds, the General Fund, Housing In-Lieu Fund and the Capital Projects Fund.

Enterprise and Internal Service Fund financial statements are prepared on the full accrual basis of accounting, as in the past, and include all their assets and liabilities, current and long-term.

Since the City's Internal Service Funds provide goods and services only to the City's Governmental and Business-type activities, their activities are reported only in total at the Fund level. Internal Service Funds, such as Printing and Mailing services, may not be considered Major Funds because their revenues are derived from other City Funds. These revenues are eliminated in the Citywide Financial Statements and any related profits or losses are returned to the activities that created them, along with any residual net assets of the Internal Service Funds.

Comparisons of Budget and Actual financial information are presented only for the General Fund and any Major Special Revenue Funds.

Fiduciary Statements

The City is the agent for certain assessment districts, holding amounts collected from property owners which await transfer to these Districts' bond trustees. The City's fiduciary activities are reported in the separate Statements of Fiduciary Net Assets and the Agency Funds Statement of Changes in Assets and Liabilities. These activities are excluded from the City's other financial statements because the City cannot use these assets to finance its own operations.

FINANCIAL HIGHLIGHTS

Economic Background

The significant decline in the local and State economy experienced in the past three years appeared to have abated somewhat toward the end of 2003-04. Unemployment levels have decreased slightly. At the beginning of 2003-04, the unemployment rates were 4.2 percent and 6.7 percent for the City and State, respectively. At the end of 2003-04, these rates were 3.2 percent and 6.4 percent, respectively. In the latter months of 2003-04, economically sensitive revenue sources such as sales and transient occupancy taxes stopped declining and appeared to plateau at their recent lows. Mirroring the national and state economies, there is evidence, however, that an expected economic "turnaround" is running into resistance.

Local job and economic growth has been slow to materialize as technology firms have been reluctant to hire new employees and appear to prefer outsourcing highly skilled and high paying jobs. Corporate demand for new technology such as computers, servers, and telecommunications equipment has slowed causing major regional businesses such as Intel and Cisco to lower profit forecasts. These outcomes have led, in turn, to lower City revenues. The State's financial dilemmas have compounded pressures on the City's resources as the State reduced vehicle license fee revenue in 2003-04 by \$1.1 million to solve its budget problems. Over the next two years, the State will take away another \$3.1 million in City revenues.



Other pressures on the City's budget include:

- Competition from surrounding city "big-box" stores and upscale malls reducing sales tax revenues.
- The potential departure of major revenue generating businesses such as auto dealerships.
- Weakening property tax revenues due to commercial and office vacancies
- Rising employee benefit costs such as health and retirement expenses.
- These pressures, along with the tentative economy and State fiscal woes, will compel the City to maintain its "Strengthening The Bottom Line" balanced budget program into 2004-05 and beyond.

The comparisons in the discussion and analysis below are between 2003-04 and 2002-03. All increases and decreases are expressed relative to 2002-03 results. Fiscal year 2003-04 financial highlights include the following:

Citywide

- The City's total net assets increased to \$973.5 million, a \$16.7 million increase.
- The City's total capital assets, net of related debt, increased to \$591.3 million, a \$32.1 million increase.
- The City's total restricted net assets decreased to \$32.2 million, a \$6.6 million drop.
- The City's total unrestricted net assets decreased to \$350.0 million, a \$8.7 million decrease.
- Citywide revenues totaled \$291.5 million, a decrease of \$17.5 from the prior year. This total consists of \$227.6 million in program revenues and \$63.9 million in general revenues. Program revenues increased by \$9.4 million while general revenues decreased by \$26.9 million.
- Total Citywide expenses were \$268.9 million, a \$7.3 million increase.
- Citywide total assets increased to \$1,083.4 million, a \$23.3 million increase.
- Citywide capital assets, net of depreciation, increased by \$30.9 million to \$639.1 million.
- Citywide other assets decreased \$7.6 million to \$444.3 million.
- Citywide total liabilities were \$109.9 million, an increase of \$6.6 million.
- Citywide long-term debt decreased \$2.0 million to \$57.5 million.
- Citywide other liabilities were \$52.4 million, an increase of \$8.6 million.

Fund Level – Governmental Funds

- Governmental Fund balances decreased to \$109.9, a \$15.7 million change.
- Governmental Fund revenues decreased to \$93.6 million, a \$10.3 million drop.
- Governmental Fund expenditures were \$118.8, a \$14.1 million decrease.

- General Fund revenues came in at \$86.2 million, a drop of \$10.1 million over prior year levels.
- General Fund expenditures are \$94.4 million, a drop of \$4.5 million.
- The General Fund balance of \$66.8 million at June 30, 2004 was an increase of \$0.5 million from the prior year.

Fund Level - Enterprise Funds

- Enterprise Fund net assets increased to \$522.7 million, a \$12.6 million increase.
- Enterprise Fund revenues increased to \$191.5 million, a \$3.8 million increase over prior year revenues.
- Enterprise Fund expenses increased to \$158.2 million, a \$6.7 million decrease.

FINANCIAL PERFORMANCE

Citywide Financial Statements – Governmental Activities

The following analysis focuses on the net assets and changes in net assets of the City’s Governmental Activities, presented in the Citywide Statement of Net Assets and Statement of Activities.

GOVERNMENTAL ACTIVITIES			
<i>Net Assets at June 30</i>			
(in Millions)			
	<u>2004</u>	<u>2003</u>	<u>Increase/ (Decrease) from 2003</u>
Cash and investments	\$157.6	\$173.7	(\$16.1)
Other assets	26.8	23.5	3.3
Capital assets	<u>310.0</u>	<u>293.0</u>	<u>17.0</u>
Total Assets	<u>494.4</u>	<u>490.2</u>	<u>4.2</u>
Long-term debt outstanding	12.7	13.4	(0.7)
Other liabilities	<u>30.4</u>	<u>29.9</u>	<u>0.5</u>
Total Liabilities	<u>43.1</u>	<u>43.3</u>	<u>(0.2)</u>
Net Assets:			
Invested in capital assets, net of debt	297.1	279.3	17.8
Restricted	30.4	37.2	(6.8)
Unrestricted	123.8	130.4	(6.6)
Total Net Assets	<u>\$451.3</u>	<u>\$446.9</u>	<u>\$4.4</u>

The City’s governmental net assets increased \$4.4 million to \$451.3 million in 2003-04. This change results from the following:

- Cash and investments decreased by \$16.1 million. This consists of cash outlays from fiscal agent cash of \$11.4 million to complete construction of two new parking garages and cash outlays of \$5.7 million to continue other capital projects such as streets and sidewalks and Homer Avenue Under-Crossing project.
- Capital assets increased \$17.0 million net of depreciation. \$8.6 million is a result of garage construction in the University Avenue Parking Assessment District.
- Net assets invested in capital assets net of related debt increased \$17.8 million as the City completed two parking garages and other General Fund infrastructure assets as discussed under the Capital Assets sections below.
- Restricted net assets decreased \$6.8 million, primarily due to the completion of the parking garages.

- Unrestricted net assets of \$123.8 million, a decrease of \$6.6 million, represent current net assets available to finance subsequent year operations and other expenditures approved by City Council.

GOVERNMENTAL ACTIVITIES			
<i>Revenues for the Year ended June 30</i>			
(in Millions)			
Revenues by Source	2004	2003	Increase/ (Decrease) from 2003
Program Revenues:			
Charges for services	\$24.0	\$25.4	(\$1.4)
Operating contributions & grants	4.2	4.5	(0.3)
Capital contributions & grants	2.0	0.6	1.4
Total Program Revenues	30.2	30.5	(0.3)
General Revenues:			
Property Taxes	13.7	13.9	(0.2)
Sales Taxes	18.2	18.0	0.2
Utility User's Taxes	7.2	7.1	0.1
Transient Occupancy Tax	5.5	5.3	0.2
Other Taxes and Fines	8.5	7.3	1.2
Investment Earnings	0.1	10.2	(10.1)
Rents and Miscellaneous	10.2	15.3	(5.1)
Transfers	15.0	14.7	0.3
Total General Revenues	78.4	91.8	(13.4)
Total Revenues	\$108.6	\$122.3	(\$13.7)

Governmental Activities – Revenues

The table above shows that governmental revenues totaled \$114.5 million in 2003-04, a decrease of \$7.8 million compared to prior year revenues of \$122.3 million. The change primarily results from a \$10.1 million decrease in investments earnings. This decrease is a result of the year-end adjustment to carrying value for investments. Prior year adjustment to carrying value was a gain, whereas this year's adjustment is a loss. The adjustment to carrying value is netted against actual investment income.

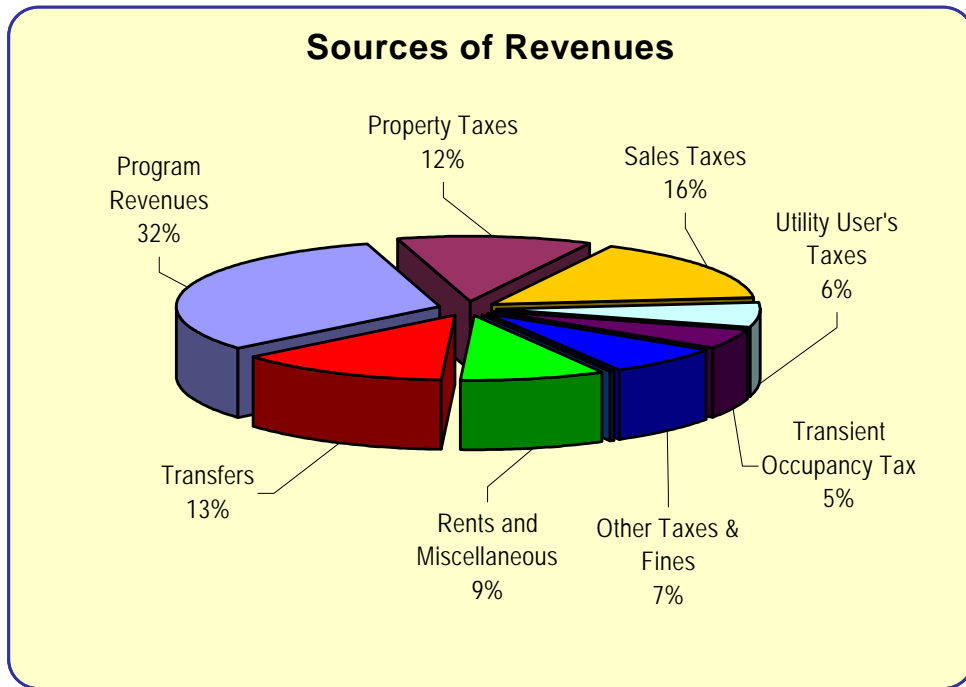
Generally Accepted Accounting Principals (GAAP) require adjustments of investments to market value at year-end. In FY 03-04 the Federal Reserve Board began raising interest rates in an effort to stimulate the economy. As overall market interest rates increase the market value of investments with fixed interest rates decreases. This decrease represents an unrealized loss in market value.



It is the City's policy to hold investments to maturity. As an investment approaches its maturity date the investment loss decreases to zero. For a detailed discussion of investments, please refer to Note 3.

Rents and miscellaneous had a decrease of \$5.1 million from prior year due to a decrease of \$1.7 million in facilities rent charged to Enterprise Funds and a decrease of \$3.2 million of technology support charges, a result of moving the IT division of ASD to the Technology Fund.

Program revenues such as charges for services; operating grants and contributions; and capital grants and contributions are generated from or restricted to each activity. Program revenues include contributions from the University Avenue Off-Street Parking Assessment District as well as recurring resources.



General revenues are composed of taxes and other revenues not specifically generated by or restricted to individual activities. All tax revenues, investment earnings, rents for governmental facilities, and fees for services are included in general revenues.

Governmental Activities - Expenses

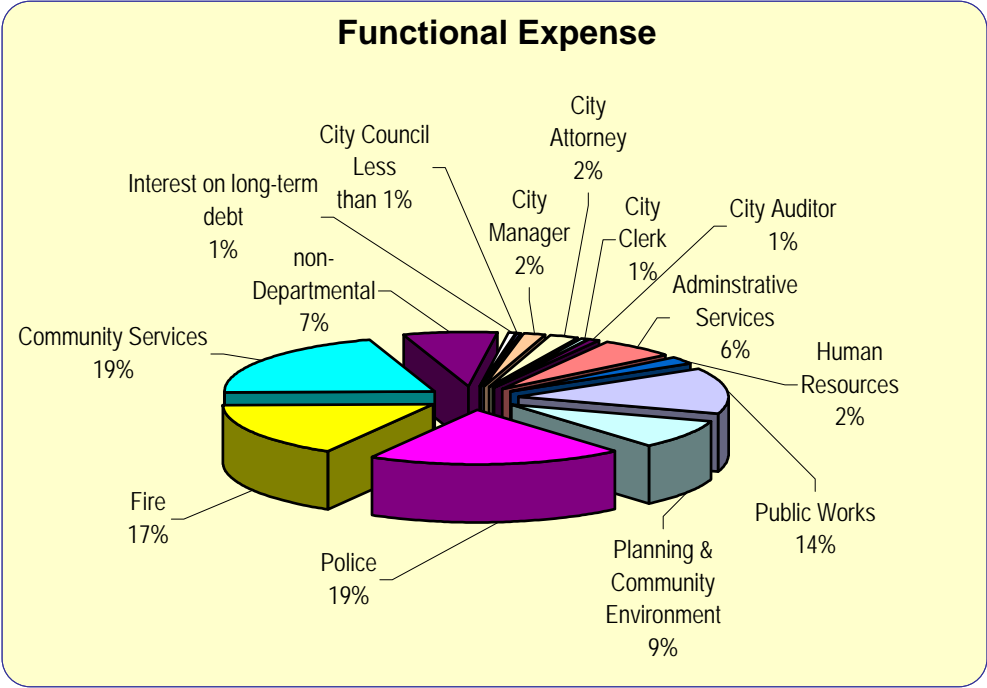
The table below presents a comparison of 2003-04 and 2002-03 expenses (does not include encumbrances and reappropriations) by Governmental Activities and interest on long-term debt. Total Governmental Activities expense was \$104.2 million in 2003-04, an increase of \$2.6 million.

GOVERNMENTAL ACTIVITIES			
<i>Expenses for the Year ended June 30</i>			
(in Millions)			
Activities	2004	2003	Increase/ (Decrease) from 2003
City Council	\$0.2	\$0.2	
City Manager	1.7	1.5	\$0.2
City Attorney	2.3	2.0	0.3
City Clerk	0.8	0.6	0.2
City Auditor	0.7	0.6	0.1
Administrative Services	6.3	9.7	(3.4)
Human Resources	2.1	1.7	0.4
Public Works	14.4	13.7	0.7
Planning and Community Environment	8.9	7.5	1.4
Police	20.4	19.3	1.1
Fire	17.3	16.9	0.4
Community Services	20.9	19.7	1.2
non-Departmental	7.6	7.5	0.1
Interest on long-term debt	0.6	0.7	(0.1)
Total Revenues	\$104.2	\$101.6	\$2.6



Management Discussion and Analysis

The Functional Expenses Chart below includes only current year expenses. It does not include capital outlays, which are now added to the City’s capital assets. In 2003-04, the City added \$17.0 million in capital assets. The composition of 2003-04 additions is shown in detail in the Capital Asset section of the Management’s Discussion and Analysis



Citywide Financial Statements – Business-Type Activities

The following analysis focuses on the net assets and changes in net assets of the City’s Business-Type Activities presented in the Citywide Statement of Net Assets and Statement of Activities.

BUSINESS-TYPE ACTIVITIES			
<i>Net Assets at June 30</i>			
(in Millions)			
	2004	2003	Increase/ (Decrease) from 2003
Cash and investments	\$238.2	\$233.5	\$4.7
Other assets	21.7	21.2	0.5
Capital assets	329.1	315.2	13.9
Total Assets	589.0	569.9	19.1
Long-term debt outstanding	44.9	46.1	(1.2)
Other liabilities	21.9	13.9	8.0
Total Liabilities	66.8	60.0	6.8
Net assets:			
Invested in capital assets, net of debt	294.2	279.9	14.3
Restricted	1.8	1.7	0.1
Unrestricted	226.2	228.3	(2.1)
Total Net Assets	\$522.2	\$509.9	\$12.3

The City’s Business-type net assets increased \$12.3 million to \$522.2 million in 2003-04.

- Cash and investments increased \$4.7 million as a result of operations. Other assets increased \$0.5 million to \$21.7 million as a result of Wastewater Treatment Fund accounts receivable increase of \$1.7 million.
- Capital assets increased \$13.9 million to \$329.1 million in 2003-04. This increase is primarily a result of electric and gas infrastructure improvements totaling \$10.1 million.
- Repayments reduced long-term debt \$1.2 million to \$44.9 million. No debt was issued in 2003-04.
- Net assets invested in capital assets net of related debt increased \$14.3 million to \$294.2 million. \$5.0 million of improvements in the Electric Fund and \$5.1 million in Gas Fund improvements caused this rise in assets.
- Unrestricted net assets of \$226.2 million, a decrease of \$2.1 million over the prior year, represent liquid assets available to finance day-to-day operations and other expenditures approved by the City Council. This amount includes such Council

designated reserves as rate stabilization reserves of \$99.6 million, the Calaveras reserve for stranded costs of \$70.4 million and the emergency plant replacement reserve of \$6.7 million.

BUSINESS-TYPE ACTIVITIES

For the Year Ended June 30
(in Millions)

	Net (Expense) Revenue From Services		
	2004	2003	Increase/ (Decrease) from 2003
Water	\$5.9	\$4.4	\$1.5
Electric	19.1	17.9	1.2
Gas	1.8	7.4	(5.6)
Wastewater Collection	3.4	2.0	1.4
Wastewater Treatment	(0.1)	(0.8)	0.7
Refuse	(2.3)	(2.9)	0.6
Storm Drainage	(0.8)	(0.3)	(0.5)
External Services	(0.1)	0.0	0
Totals	\$26.9	\$27.7	(\$0.8)

The table above presents the net cost of each of the City’s Business-type Activities or Enterprise Funds. The City operates the Water, Electric, Gas, Wastewater Collection, Wastewater Treatment, Refuse, Storm Drainage and External Services Enterprise Funds, which are major funds and are presented in the Basic Financial Statements. Net cost is defined as total program cost less the revenues generated by those specific activities.

Business-type Activities showing a total decrease of \$0.8 million from 2002-03 were significantly affected by the following events:

- Net revenues in the Water activity increased by \$1.5 million. This resulted from a rate increase to consumers for water service and an increase of wholesale water purchases.
- Net revenues in the Gas activity decreased by \$5.6 million in 2003-04 primarily due to a 15 percent rate decrease beginning July 1, 2003.

FUND FINANCIAL STATEMENTS

Performance of Governmental Funds

At June 30, 2004, the City's Governmental Funds reported combined fund balances of \$109.9 million, a decrease of \$15.7 million or 12.5 percent compared with the prior year

Governmental Fund revenues and other financing sources decreased \$13.5 million for a total of \$122.2 million. Revenues and other financing sources in the General Fund decreased \$8.3 million; Capital Project Fund decreased \$2.4 million as a result of a decrease of operating transfers from the General Fund of \$3.9 million. Non-major Fund revenues and other financing sources decreased by \$2.3 million.

Governmental Fund expenditures and other uses decreased \$11.6 million this year to \$137.9 million. General Fund expenditures decreased \$5.9 million. Capital Projects Fund expenditures decreased by \$5.0 million; and non-major fund expenditures and other uses dropped by \$0.7 million.

General Fund – The General Fund ended the year with a \$0.5 million addition to fund balance, compared to \$2.9 million in the prior year. The \$0.5 million excess of revenues over expense is due mainly to the \$0.8 million Utilities payment to an Equity Transfer Stabilization Reserve. During this period of slow economic recovery, the City has continued to closely monitor its expenditures.

Palo Alto's General Fund revenues and other financing sources reached \$104.1 million in 2003-04, a decline of \$8.3 million.

Sales tax, the City's largest revenue source, totaled \$18.2 million in 2003-04 compared to \$18.0 million in 2002-03. After controlling for prior year one-time adjustments in both years, actual revenues were \$17.6 and \$17.4 million, respectively. From an economic perspective, this data appears to indicate a more stable local economy compared to the past three years. From a structural perspective, however, there are challenges to this revenues source from competition from new malls and big box stores, and the potential exodus of additional auto dealerships. Compared to the adopted budget, which was based on an economic rebound in 2003-04, sales tax revenue growth did not materialize. This caused a downward adjustment in budget at midyear from \$19.3 million to \$17.4 million. Sales tax at year-end came in \$0.7 million or 4.3 percent above the adjusted budget. The increase is attributable to one-time payment in the electronics sector. The City saw modest growth in sectors such as general consumer goods and restaurants. This growth was somewhat offset by declines in auto sales and leases and from office equipment.

Documentary transfer tax revenues performed well in 2003-04, increasing by \$2.1 million or 59.4 percent from 2002-03. The City received a sizeable, one-time transfer tax from a transaction whereby Stanford University entered into a long-term lease with a private party to manage the Stanford Shopping Center. In addition, a moderation in home prices and a low interest rate environment boosted residential sales.

Another indication of a slightly more stable economy in late 2003-04, was the performance of transient occupancy tax. It increased by \$0.2 million or 2.9 percent compared to 2002-03. The City was forced, however, to adjust its \$6.3 million budget downward by \$0.75 million due to a sluggish



hotel market. With a modest occupancy rate increase toward the end of 2003-04, revenues totaled a \$5.5 million, a modest \$0.06 million or 1.1 percent below the adjusted budget. Average vacancy rates increased from 54.2 percent in 2002-03 to 56.8 percent in 2003-04. More significantly, average daily rates fell from \$122 to \$114 during the same period.

Motor vehicle in-lieu license fees (VLF) came in \$0.4 million or 16.7 percent above the adjusted budget. This positive variance was primarily due to consumers postponing car purchases until the Governor indicated he would not raise VLF fees. It is important to note that the adjusted budget included a \$1.1 million downward adjustment due to a state take away. Without the \$1.1 million State reduction, VLF revenues would have exceeded prior year receipts.

Offsetting the positive variances described above were declines in property taxes and interest income. Due to a high volume of appeals and assessed value reductions, property taxes fell well below budget in 2003-04. These adjustments primarily came from commercial properties that sought to adjust their secured and unsecured (personal) property values downward. The high level of commercial vacancy rates had a negative influence on commercial values. Revenues were \$0.36 million or 2.5 percent under budget and were \$0.01 million or 0.7 percent below the prior year.

Interest Income was \$0.1 million or 3.7 percent below the adjusted budget and \$0.5 million or 11.4 percent below the prior year. The decline is primarily due to reinvestment of older, maturing securities in a low interest rate environment.

At June 30, 2004, the General Fund Balance totaled \$66.8 million. This represents 70.8 percent of direct General Fund expenditures, providing a buffer against unexpected financial events. Of this, \$6.7 million is reserved and \$60.1 is unreserved. A substantial portion of the unreserved amount is designated by the Council for budget stabilization, \$21.5 million at year-end; and infrastructure improvements, \$35.9 million at year-end. The equity transfer stabilization designation, established in 2001-02, totaled \$2.3 million at year-end. This reserve would be used in the event that the Electric or Gas Fund was unable to make its required equity transfer to the General Fund.

The City has continued to closely monitor revenues and expenditures, making adjustments as needed to maintain a balanced budget. In addition, the City has continued to make efforts to reduce expenditures without impacting services to the public. This proactive approach was established with the ongoing "Strengthening the Bottom Line" (SBL) efforts established in 2001-02. Continued maintenance of these service levels will be jeopardized if the economy continues to have a slow recovery, State financial problems continue, and employee benefit costs rise significantly. The City continues to maintain a strong position of liquidity or cash flow to cover expenditures.

General Fund expenditures and other uses totaled \$103.6 million, a decrease of \$5.9 million from prior year. This decline was primarily from the \$4.1 million decrease in ASD (due to reclassification of Information Technology division to the Technology Fund) and a decrease in Public Works expenditures of \$1.9 million. Nearly all City departments had savings compared to the adjusted budget, Community Services (\$1.4 million primarily from contract expenditures), Police (\$1.7 million primarily from salary expenditures), Public Works (\$1.1 million primarily from salaries and expenditures being recognized in the Capital Fund).

Housing In-Lieu Fund - The Housing In-Lieu Fund met the criteria for a major fund in 2003-04 primarily due to the loan of \$5.874 million and \$1.96 million to Palo Alto Housing Corporation for the purchase of land and construction of the Oak Court Apartments (for details refer to Note 5).

Housing In-Lieu revenues were \$0.4 million, a decline of \$0.7 from prior year. Expenditures were \$0.3 an increase of \$0.1 from prior year. Housing In-Lieu Fund balance totaled \$10.9 million, an increase of \$0.1 million from the prior year.

Capital Projects Fund – Capital Projects Fund expenditures and other uses were \$28.2 million in 2003-04, which is a decrease of \$5.0 million from the prior year. This level of expenditure is consistent with the City’s effort to rehabilitate and maintain its existing infrastructure and to complete the construction of two new downtown parking structures. Capital expenditures include \$8.6 million on the garages, \$4.3 million on streets and sidewalks, and \$2.5 million on the Homer Avenue Under-Crossing project. Other important expenditures include, for example, park and facility improvements, library master planning efforts, traffic calming and bike lane improvements.

Non-major Funds -These funds are not presented separately in the Basic Financial statements, but are individually presented as Supplemental Information.

Performance of Enterprise Funds

At June 30, 2004, the City’s Enterprise Funds reported total net assets of \$522.7 million, an increase of \$12.6 million or 2.5 percent compared with last year. The Electric and Gas Funds contributed net assets of \$291.4 million and \$60.8, respectively, to total net assets. These assets constitute 67.4 percent of the Enterprise Funds’ total net assets. Unrestricted net assets for these two funds total \$173.5 million, a \$0.6 million or .3 percent decrease over 2002-03.

Water Fund – Revenue increased by \$4.3 million in 2003-04. The Water Fund ended the year with net income of \$3.2 million, compared to \$3.0 million in the prior year, a \$.2 million or 5.8 percent increase. The rise in net income is primarily due to a 15 percent rate increase effective July 1, 2003. There will be a series of rate increases to consumers in coming years as commodity costs rise to pay for major capital improvements related to the Hetch-Hetchy distribution system

Electric Fund – Operating revenues increased to \$92.6 million, a \$1.0 million rise from 2002-03. This slight increase resulted from relatively flat price and volume as compared to 2002-03. A \$2.0 million increase in excess capacity (surplus energy) sales due to market price increases offset a \$1.5 million decrease in other operating revenue. Central Valley Project loan repayments and a one-time only legal settlement affected other operating revenue in the prior year.

Operating expenses increased from \$67.1 million in 2002-03 to \$68.7 in 2003-04, an increase of \$1.6 million. The retail purchase of utilities increased \$4.2 million; this was mainly due to an \$8.5 million accrual for SCS Tariff charge backs to be paid in 2004-05. Due to lower legal expenses in 2003-04, resource management expenses declined by \$2.1 million.

The Electric Fund ended the year with a net gain of \$10.9 million compared to a net gain of \$18.4 million in 2002-03.

Gas Fund – A 15 percent rate decrease for 2003-04 caused revenues to decrease by \$4.9 million compared to the prior year. In June 2001, Gas Fund rates increased 67 percent to cover dramatically increased commodity prices; the 2003-04-rate decrease is the second phase of rate adjustments that began in 2002-03 as commodity prices fell. Natural gas prices were higher than expected in 2003-04



and commodity expenditure increased \$.6 million. Year-end results show net loss of \$1.4 million in 2003-04 compared to net income of \$5.4 million in 2002-03.

Wastewater Collection Fund - In 2003-04 collection rates increased by 15 percent. Compared to the prior year, revenues rose by \$2.0 million or 18.5 percent. Operating costs rose by \$.6 million due to higher utility costs. Utility costs in this Fund increased by \$.4 million or 7.9 percent. Net income increased to \$3.3 million, a rise of \$.8 million over 2002-03.

Wastewater Treatment Fund - Revenues increased by \$1.2 million in 2003-04, while operating expenses increased by \$0.2 million. This increase was due to higher salary and benefit increases. The Fund ended the year with net income of \$0.1 million, compared to a net loss of \$0.2 million in the prior year. Total net assets at year-end totaled a solid \$33.7 million.

Refuse Fund - Refuse operating revenues increased \$.2 million in 2003-04. Greenwaste charges to the General Fund were restored in 2003-04. Operating and maintenance expenses rose by \$.8 million due to \$1.0 million transfer to the General Fund for interest on deferred rent. Rent decreased by \$1.0 million because of a payment for deferred rent made in the prior year. The fund ended the year with a net loss of \$3.0 million, compared to a \$1.9 million loss in the prior year. Total net assets at year-end totaled \$13.7 million.

Storm Drainage Fund - The Storm Drainage Fund continues to experience a net loss before transfers due to insufficient revenue from existing fees. Supplemental funding from the General Fund is required in order to maintain the current level of service. In 2003-04, operating revenues remained stable at \$2.2 million. The Fund required a transfer of \$.3 million from the General Fund to continue basic services and maintain water quality standards.

External Services Fund - Created in 2001-02, this Fund provides information technology and training services to neighboring municipalities and other community organizations. As part of the City's effort to enhance revenues, the Fund added three outside contracts in 2003-04. The Fund had an operating loss of \$.1 million in 2003-04 as it positions itself to expand services.

CAPITAL ASSETS

GASB 34 requires the City to record all its capital assets including infrastructure. Infrastructure includes roads, bridges, signals and similar assets used by the entire population. Although GASB 34 allowed the City four years to record all its infrastructure assets in its financial statements, as of June 30, 2002 all assets were included in the financial statements. The table below shows capital assets and the amount of accumulated depreciation for these assets for Governmental and Business-type Activities (further detail may be found in Note 6 to the financial statements).

CAPITAL ASSETS AT JUNE 30			
(in Millions)			
	<u>2004</u>	<u>2003</u>	<u>Increase/ (Decrease) from 2003</u>
Governmental Activities			
<i>Capital Assets</i>			
Land and improvements	\$67.8	\$67.8	
Street trees	15.7	15.8	(\$0.1)
Construction in progress	46.3	33.2	13.1
Buildings and improvements	54.3	54.0	0.3
Equipment	8.1	7.9	0.2
Roadway network	220.3	216.9	3.4
Recreation & open space network	8.8	7.8	1.0
Less accumulated depreciation	(127.3)	(120.8)	(6.5)
<i>Internal Service Fund Assets</i>			
Construction in progress	1.9	0.7	1.2
Equipment	31.0	26.0	5.0
Less accumulated depreciation	(16.9)	(16.3)	(0.6)
Total Governmental	<u>\$310.0</u>	<u>\$293.0</u>	<u>\$17.0</u>
Business-type Activities			
Land	\$1.5	\$1.5	
Construction in progress	72.1	57.9	\$14.2
Buildings and improvements	16.9	16.6	0.3
Transmission, Distribution & Treatment Systems	416.4	406.1	10.3
Less accumulated depreciation	(177.8)	(166.9)	(10.9)
Total Business-type	<u>\$329.1</u>	<u>\$315.2</u>	<u>\$13.9</u>



Governmental Activities capital assets net of depreciation, increased by \$17.0 million compared to 2002-03. Significant increases occurred in construction in progress (\$13.1 million) and in the roadway network (\$3.4 million). Construction activity is due to the two new downtown parking structures and roadway improvements as a consequence of the City's enhanced infrastructure efforts and additional State funding. Total Business-type activities capital assets net of depreciation, increased by \$13.9 million. Areas of increase included construction in progress and equipment. The increase of \$14.2 million in construction in progress mainly consisted of \$3.2 million in the Water Enterprise Fund, \$2.9 million in the Electric Enterprise Fund, \$4.8 million in the Gas Enterprise Fund and \$2.7 million in the Wastewater Enterprise Collection Fund. The change in transmission, distribution and treatment systems of \$10.3 million is comprised mostly of \$7.4 million in the Electric Enterprise Fund, \$0.8 million in the Wastewater Treatment Enterprise Fund and \$0.8 million in the Gas Enterprise Fund.

During 2003-04, Palo Alto's capital improvement projects focused on the completion of the downtown parking structures as well as continued work on the rehabilitation and replacement of the City's General Fund infrastructure. Work on the City's infrastructure is a continuation of the ten-year plan, costing \$100 million, developed to address the needs of the City's aging infrastructure. The ten-year plan included an assessment and prioritization of work needed on buildings, facilities, streets, sidewalks, medians, bikeways, parks and open space. Key infrastructure projects include improvements to streets and sidewalks, refurbishing of park playgrounds and irrigation systems, upgrading athletic fields, open space and trail improvements, and facility renovations.

The City depreciates all its capital assets over their estimated useful lives, as required by GASB 34. The purpose of depreciation is to spread the cost of a capital asset over the years of its useful life so that an allocable portion of the cost of the asset is borne by all users. Additional information on capital assets and depreciable lives may be found in Note 6.

DEBT ADMINISTRATION

Each of the City's debt issues is discussed in detail in Notes 7 and 8 to the financial statements. At June 30, 2004, the City's debt comprised:

LONG-TERM DEBT AT JUNE 30			
(in Millions)			
	2004	2003	Increase/ (Decrease) from 2003
Governmental Activity Debt:			
General Long Term Obligations:			
1998 Golf Course Certificates of Participation	\$6.0	\$6.2	(\$0.2)
2002A Civic Center Refinancing Certificates of Participation	2.9	3.2	(0.3)
2002B Downtown Parking Improvements Certificates of Participation	3.3	3.4	(0.1)
Special Assessment Debt with City Commitment			
1978 California Avenue Parking Bonds	0.4	0.5	(0.1)
Sub-Total	12.6	13.3	(0.7)
Internal Service Long-Term Obligations:			
Information Systems Capital Lease Obligations	0.0	0.1	(\$0.1)
Total Governmental Activity Debt	\$12.6	\$13.4	(\$0.8)
Business-Type Activity Debt:			
Enterprise Long Term Obligations:			
Utility Revenue Bonds			
1995 Series A	\$6.8	\$7.1	(\$0.3)
1999 Refunding	16.0	16.3	(0.3)
2002 Series A	23.3	24.0	(0.7)
Less: unamortized discount/issuance cost	(1.2)	(1.3)	0.1
Total Business-type Activity	\$44.9	\$46.1	(\$1.2)

The City did not issue new debt in 2003-04. Although there are discussions about long-term projects that may require debt financing, there are no immediate plans or needs to issue debt. As stated in the Statistical Section of the CAFR, the combined direct debt ratio to assessed valuation for the General Fund is a low 0.1 percent compared to the allowable, legal debt margin of 15 percent.



In 2001-02, Standard & Poors (S&P) reaffirmed the City's overall AAA rating (a rating based on issuing General Obligation bond debt), the highest general city credit rating possible. The City also received an AA+ rating from S&P Investor Services for its 2002 COPs. The AA+ rating, one notch below the highest possible AAA rating is considered "high-quality grade" and works to lower interest rate and other debt issuance costs. Finally, S&P and Moody's have given an AA- and Aa3 rating, respectively, to the City's 2002 Utility Revenue bonds. While at the lower end of the "high-quality grade" rating, the rating received is excellent given the volatile utility markets. The rating agencies are recognizing the City's strong reserves, solid revenues, and sound management in the light of significant upheaval in the commodity markets.

Although the past two years have brought significant revenue challenges to the City's General Fund, it has made the necessary alignments in its cost structures to maintain solid reserves and sound financial management of its resources.

SPECIAL ASSESSMENT DISTRICT DEBT

Special assessment districts in different parts of the City have also issued debt to finance infrastructure and facilities construction entirely in those districts. At June 30, 2004, a total of \$0.4 million in special assessment district debt was outstanding, issued by the California Avenue Parking Special Assessment District. The City is contingently obligated for this debt and it has been included in the City's governmental long-term debt.

Throughout this analysis, references have been made to two new parking garages funded by University Avenue Off-Street Parking Assessment District Improvement Bonds. These bonds were issued in 2000-01 and in 2001-02 and the resulting debt is secured only by special assessments on the real property in the district issuing the debt. The debt is not the City's responsibility, although the City does act as these Districts' agent in the collection and remittance of assessments and manages the two parking garages that were opened in 2003.

ECONOMIC OUTLOOK

The economy of the City is discussed in the accompanying Transmittal Letter and in this Discussion and Analysis.

CONTACTING THE CITY'S FINANCIAL MANAGEMENT

The CAFR is intended to provide citizens, taxpayers, investors, and creditors with a general overview of the City's finances. Questions about this report should be directed to the Administrative Services Department, at 250 Hamilton Avenue, 4th Floor, Palo Alto, California. This report and other financial reports can be viewed on the City of Palo website at: www.cityofpaloalto.org. On the home page, under "Browse by Topic" select City Departments, select Administrative Services. Within Administrative Services there are reports under "Finance" and there are links to reports by division (such as Purchasing or Budget).

Financial Statements

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Citywide Statement of Net Assets and Statement of Activities.....

The Citywide Statement of Net Assets and the Statement of Activities purpose is to summarize the entire City’s financial activities and financial position. They are prepared on the same basis as is used by most businesses, which means they include all the City’s assets and all its liabilities, as well as all its revenues and expenses. This is known as the full accrual basis—the effect of all the City’s transactions is taken into account, regardless of whether or when cash changes hands. All material internal transactions between City funds have been eliminated.

The Statement of Net Assets reports the difference between the City’s total assets and the City’s total liabilities, including all the City’s capital assets and all its long-term debt. The Statement of Net Assets focuses the reader on the composition of the City’s net assets, by subtracting total liabilities from total assets.

The Statement of Net Assets summarizes the financial position of all the City’s Governmental Activities in a single column, and the financial position of all the City’s Business-type Activities in a single column; these columns are followed by a Total column that presents the financial position of the entire City.

The City’s Governmental and Business-type Activities include the activities of its General Fund, along with all its Special Revenue, Capital Projects, Debt Service Funds, and Enterprise Funds. Since the City’s Internal Service Funds service these Funds, their activities are consolidated with Governmental and Business-type Activities, after eliminating inter-fund transactions and balances.

The Statement of Activities reports increases and decreases in the City’s net assets. It is also prepared on the full accrual basis, which means it includes all the City’s revenues and all its expenses, regardless of when cash changes hands. This differs from the “modified accrual” basis used in the Fund financial statements, which reflect only current assets, current liabilities, available revenues and measurable expenditures.

The format of the Statement of Activities presents the City’s expenses first, listed by program, and follows these with the expenses of its Business-type Activities. Program revenues—that is, revenues which are generated directly by these programs—are then deducted from program expenses to arrive at the net expense of each governmental and Business-type program. The City’s general revenues are then listed in the Governmental Activities or Business-type Activities column, as appropriate, and the Change in Net Assets is computed and reconciled with the Statement of Net Assets.

Both these Statements include the financial activities of the City and the Public Improvement Corporation, which is a legally separate component unit of the City because it is controlled by the City, which is financially accountable for its activities.

These financial statements along with the fund financial statements and footnotes are called *Basic Financial Statements*.



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City of Palo Alto - Statement of Net Assets

June 30, 2004

(In thousands of dollars)

	<u>Governmental</u> <u>Activities</u>	<u>Business-type</u> <u>Activities</u>	<u>Totals</u>
ASSETS			
Cash and investments (Note 3)	\$150,155	\$226,451	\$376,606
Cash and investments with fiscal agents (Note 3)	7,447	11,758	19,205
Receivables:			
Accounts and intergovernmental	7,947	19,659	27,606
Interest receivable	2,067	2,796	4,863
Loans receivable (Note 5)	13,235		13,235
Internal balances (Note 4)	705	(705)	
Inventory of materials and supplies	2,809		2,809
Capital assets, net of depreciation (Note 6)	<u>310,016</u>	<u>329,099</u>	<u>639,115</u>
Total assets	<u>494,381</u>	<u>589,058</u>	<u>1,083,439</u>
LIABILITIES			
Accounts payable and accrued liabilities	3,729	14,010	17,739
Accrued salaries and benefits	4,136	1,358	5,494
Accrued compensated absences	12,004		12,004
Claims payable (Note 14)	10,548		10,548
Accrued landfill closure liability (Note 9)		6,555	6,555
Long-term debt (Notes 7 and 8)			
Due in one year	840	1,367	2,207
Due in more than one year	<u>11,820</u>	<u>43,495</u>	<u>55,315</u>
Total liabilities	<u>43,077</u>	<u>66,785</u>	<u>109,862</u>
NET ASSETS (Note 10)			
Invested in capital assets, net of related debt	<u>297,125</u>	<u>294,197</u>	<u>591,322</u>
Restricted for:			
Special revenue programs	17,854		17,854
Capital projects:			
Downtown parking structure	1,300		1,300
Other capital projects	9,315		9,315
Debt service	<u>1,948</u>	<u>1,798</u>	<u>3,746</u>
Restricted	<u>30,417</u>	<u>1,798</u>	<u>32,215</u>
Unrestricted net assets	<u>123,762</u>	<u>226,278</u>	<u>350,040</u>
Total net assets	<u>\$451,304</u>	<u>\$522,273</u>	<u>\$973,577</u>

See accompanying notes to financial statements

City of Palo Alto - Statement of Activities

For the Year Ended June 30, 2004

(In thousands of dollars)

Functions/Programs	Total Expenses	Program Revenues			Net (Expense) Revenue and Change in Net Assets		Total
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	
Governmental Activities:							
City Council	\$269				(\$269)		(\$269)
City Manager	1,663				(1,663)		(1,663)
City Attorney	2,300	\$64			(2,236)		(2,236)
City Clerk	808	1			(807)		(807)
City Auditor	668				(668)		(668)
Administrative Services	6,271	815			(5,456)		(5,456)
Human Resources	2,078				(2,078)		(2,078)
Public Works	14,460	260	\$2,273	\$1,947	(9,980)		(9,980)
Planning and Community Environment	8,898	3,074	1,035	15	(4,774)		(4,774)
Police	20,414	4,415	315		(15,684)		(15,684)
Fire	17,308	7,565	7		(9,736)		(9,736)
Community Services	20,864	7,846	583	28	(12,407)		(12,407)
Non-Departmental	7,618				(7,618)		(7,618)
Interest on long-term debt	635				(635)		(635)
Total Governmental Activities	104,254	24,040	4,213	1,990	(74,011)		(74,011)
Business-type Activities:							
Water	16,047	21,993				\$5,946	5,946
Electric	73,545	92,617				19,072	19,072
Gas	22,994	24,839				1,845	1,845
Wastewater Collection	9,203	12,647				3,444	3,444
Wastewater Treatment	14,868	14,744				(124)	(124)
Refuse	24,282	21,923				(2,359)	(2,359)
Storm Drainage	2,975	2,170				(805)	(805)
External Services	688	585				(103)	(103)
Total Business-type Activities	164,602	191,518				26,916	26,916
Total	\$268,856	\$215,558	\$4,213	\$1,990	(74,011)	26,916	(47,095)
General revenues:							
Taxes:							
Property taxes					13,707		13,707
Sales taxes					18,151		18,151
Utility user's taxes					7,152		7,152
Transient occupancy tax					5,489		5,489
Other taxes and fines					8,493		8,493
Investment earnings					326	387	713
Rents and miscellaneous					10,165		10,165
Transfers					14,951	(14,951)	
Total general revenues and transfers					78,434	(14,564)	63,870
Change in Net Assets					4,423	12,352	16,775
Net Assets-Beginning					446,881	509,921	956,802
Net Assets-Ending					\$451,304	\$522,273	\$973,577

See accompanying notes to financial statements



Fund Financial Statements.....

Introduction

GASB 34 revises the format of the Fund Financial Statements so that only individual major funds are presented, while non-major funds are combined in a single column. Major funds are defined generally as having significant activities or balances in the current year. The practice of combining like funds and presenting their totals in separate columns (Combined Financial Statements) has been discontinued, along with the use of the General Fixed Assets and General Long-term Debt Groups of Accounts.

Major Governmental Funds

The funds described below were determined to be Major Funds by the City in fiscal year 2003-04. Individual non-major funds may be found in the Supplemental section.

General Fund

The General Fund is used for all the general revenues of the City not specifically levied or collected for other City funds, and related expenditures.

Housing In-Lieu Special Revenue Fund

The Housing In-Lieu Special Revenue Fund is used to account for revenues from commercial and residential developers to provide housing under the City's Below Market Rate program.

Capital Projects Fund

The Capital Projects Fund is utilized to account for resources used for the acquisition and construction of capital facilities by the City, with the exception of those assets financed by proprietary funds.



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City of Palo Alto - Governmental Funds

Balance Sheet - June 30, 2004

(In thousands of dollars)

	General	Housing In-Lieu Fund	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
ASSETS					
Cash and investments (Note 3):					
Available for operations	\$59,779	\$3,719	\$15,299	\$5,024	\$83,821
Cash and investments with fiscal agent			6,034	1,413	7,447
Receivables					
Accounts and intergovernmental	6,848		243	428	7,519
Special Assessment				420	420
Interest receivable	1,239	46	4	71	1,360
Notes receivable (Note 5)	1,256	7,312		4,667	13,235
Interfund receivables and advances (Note 4)	439				439
Inventory of materials and supplies	2,506				2,506
	<u>\$72,067</u>	<u>\$11,077</u>	<u>\$21,580</u>	<u>\$12,023</u>	<u>\$116,747</u>
Total Assets					
LIABILITIES					
Accounts payable and accrued liabilities	\$1,990	\$156	\$478	\$162	\$2,786
Accrued salaries and benefits	3,086		69		3,155
Deferred revenue	137			420	557
Interfund payable and advances (Note 4)	32			311	343
	<u>5,245</u>	<u>156</u>	<u>547</u>	<u>893</u>	<u>6,841</u>
Total Liabilities					
FUND BALANCES					
Reserved for: (Note 10):					
Encumbrances	2,973	940	9,314	796	14,023
Downtown parking structure			1,300		1,300
Notes	1,256	7,312		4,667	13,235
Inventory of materials and supplies	2,506				2,506
Debt service				1,461	1,461
Debt proceeds					
Unreserved, designated for:					
Special revenue projects		2,625		4,080	6,705
Equity transfer stabilization	2,338				2,338
Reappropriations	401	44	10,419		10,864
Budget stabilization	21,467				21,467
Infrastructure	35,881				35,881
Unreserved undesignated, reported in Special Revenue Funds				126	126
	<u>66,822</u>	<u>10,921</u>	<u>21,033</u>	<u>11,130</u>	<u>109,906</u>
Total Fund Balances					
Total Liabilities and Fund Balances	<u>\$72,067</u>	<u>\$11,077</u>	<u>\$21,580</u>	<u>\$12,023</u>	<u>\$116,747</u>

See accompanying notes to financial statements



City of Palo Alto - Governmental Funds
Reconciliation of Fund Balances to Governmental Activities Net Assets
June 30, 2004

(In thousands of dollars)

Governmental fund balances from prior page \$109,906

Amounts reported for governmental activities in the statement of net assets are different because:

Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds (Note 6) 310,016

Internal service funds are used by management to charge the costs of certain activities, such as insurance and central services and maintenance, to individual funds. The assets and liabilities of the internal service funds are included in governmental activities in the statement of net assets. 43,802
(Excludes capital assets reported above and debt reported below)

Accrual adjustment to remove deferred revenue from the balance sheet 420

Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds (Notes 7 & 8) (12,840)

Net assets of governmental activities \$451,304

See accompanying notes to financial statements



City of Palo Alto - Governmental Funds
Statement of Revenues, Expenditures and
Changes in Fund Balance - For the Year Ended June 30, 2004
(In thousands of dollars)

	General	Housing In-Lieu Fund	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
REVENUES					
Property taxes	\$13,707				\$13,707
Special assessments				\$196	196
Sales taxes	18,151				18,151
Utility users' tax	7,152				7,152
Transient occupancy tax	5,489				5,489
Other taxes and fines	11,328			1,146	12,474
Charges for services	16,018				16,018
From other agencies	444		\$3,389	828	4,661
Permits and licenses	2,563				2,563
Investment earnings	(120)	\$40	80	8	8
Rental income	11,472	8			11,480
Other revenue	(23)	381	24	1,291	1,673
Total Revenues	86,181	429	3,493	3,469	93,572
EXPENDITURES					
Current operations:					
City Council	269				269
City Manager	1,643				1,643
City Attorney	2,291				2,291
City Clerk	819				819
City Auditor	668				668
Administrative Services	6,059				6,059
Human Resources	2,113				2,113
Public Works	8,031				8,031
Planning and Community Environment	8,037	175		581	8,793
Police	19,856			106	19,962
Fire	16,891				16,891
Community Services	19,934				19,934
Non-Departmental	7,573	84		(59)	7,598
Capital outlay	181		22,108		22,289
Debt service:					
Principal payments				780	780
Interest and fiscal fees				639	639
Total Expenditures	94,365	259	22,108	2,047	118,779
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(8,184)	170	(18,615)	1,422	(25,207)
OTHER FINANCING SOURCES (USES)					
Transfers in (Note 4)	17,888		9,670	1,074	28,632
Transfers (out) (Note 4)	(9,189)		(6,101)	(3,843)	(19,133)
Total Other Financing Sources (Uses)	8,699		3,569	(2,769)	9,499
Net change in fund balances	515	170	(15,046)	(1,347)	(15,708)
Fund balances at beginning of year	66,307	10,751	36,079	12,477	125,614
Fund balances at end of year	\$66,822	\$10,921	\$21,033	\$11,130	\$109,906

See accompanying notes to financial statements



City of Palo Alto - Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances of Governmental Funds to the Statement of Activities For the Year Ended June 30, 2004 (In thousands of dollars)

Net change in fund balances-total governmental funds (\$15,708)

Amounts reported for Governmental Activities in the Statement of Activities are different because:

Governmental Funds report capital outlays as expenditures. However, in the Statement of Activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. The capital outlay expenditures are therefore added back to fund balance

The capital outlay, net of retirements, are therefore deducted from fund balance 18,057

Depreciation expense is deducted from fund balance (Depreciation expense is net of Internal Service Fund depreciation \$2,234 which has already been allocated to serviced funds.) (6,575)

Bond proceeds provide current financial resources to Governmental Funds, but issuing debt increases long-term liabilities in the Statement of Net Assets. Repayment of bond principal is an expenditure in the Governmental Funds, but in the Statement of Net Assets the repayment reduces long-term liabilities.

Fund balance is increased by the amount of debt repayment 780

Some amounts reported in the Statement of Activities do not require the use of current financial resources and therefore are not reported as expenditures in Governmental Funds. 10

Deferred revenue (165)

Internal Service Funds are used by management to charge the costs of certain activities, such as equipment acquisition, maintenance, and insurance to individual funds. The net revenue (expense) of all Internal Service Funds is reported with Governmental Activities. 8,024

Change in net assets of Governmental Activities \$4,423

See accompanying notes to financial statements



City of Palo Alto - General Fund
Statement of Revenues, Expenditures and Changes in Fund Balance
Budget and Actual - For the Year Ended June 30, 2004

(In thousands of dollars)

	<u>Budgeted Amount</u>		<u>Actual Amount</u> Budgetary Basis	Variance from
	<u>Adopted</u>	<u>Adjusted</u>		Final Budget Positive (Negative)
REVENUES				
Property taxes	\$13,556	\$14,100	\$13,740	(\$360)
Sales taxes	19,335	17,400	18,151	751
Utility users' tax	7,498	7,300	7,152	(148)
Transient occupancy tax	6,300	5,549	5,489	(60)
Other taxes, fines & penalties	6,724	9,305	11,295	1,990
Charges for services	17,678	17,755	16,018	(1,737)
Permits and licenses	4,721	3,403	2,560	(843)
Charges to other funds	8,816	9,396	9,309	(87)
Rental income	11,658	11,658	11,472	(186)
Other revenues	10,462	6,967	2,225	(4,742)
Transfers in	14,476	14,383	17,888	3,505
Prior year encumbrance and reappropriations		4,279	4,279	
Total Revenues	121,224	121,495	119,578	(1,917)
EXPENDITURES				
Current operations:				
Administrative Departments	14,738	16,595	15,902	693
Community Services	24,946	25,660	24,273	1,387
Fire	18,917	19,054	18,979	75
Planning and Community Environment	8,946	10,309	9,313	996
Police	23,609	23,999	22,282	1,717
Public Works	11,348	11,634	10,517	1,117
Non-Departmental	6,459	6,242	7,677	(1,435)
Transfers out	11,747	7,403	9,180	1,777
Total Use of Funds	120,710	120,896	118,123	6,327
EXCESS OF REVENUES - BUDGETARY BASIS	\$514	\$599	1,455	\$856
Adjustments to Budgetary Basis:				
Current year encumbrance/reappropriations			3,244	
Prior year encumbrance/reappropriations			(4,289)	
Current year stores adjustment, net			(14)	
Prior year stores adjustment			119	
EXCESS OF REVENUES - GAAP BASIS			515	
Fund balances at beginning of year			66,307	
Fund balances at end of year, GAAP basis			<u>\$66,822</u>	

See accompanying notes to financial statements

**City of Palo Alto - Housing In-Lieu Special Revenue Fund
Statement of Revenues, Expenditures and Changes in Fund Balance
Budget and Actual - For the Year Ended June 30, 2004**

(In thousands of dollars)

	Budgeted Amount		Actual Amount Budgetary Basis	Variance from Final Budget
	Adopted	Adjusted		Positive (Negative)
REVENUES				
Return on investment	\$224	\$224	\$40	\$184
Rental income	9	9	8	1
Other revenues				
Housing In-Lieu - residential	200	200	284	(84)
Housing In-Lieu - commercial	50	50	61	(11)
Other fees			36	(36)
Transfers in		150		150
Total Revenues	483	633	429	204
EXPENDITURES				
Current operations:				
Planning and Community Environment	99	368	175	193
Non-Departmental	241	13	84	(71)
Transfers out		150		(150)
Total Use of Funds	340	531	259	(28)
EXCESS OF REVENUES	\$143	\$102	170	\$68
Fund balances at beginning of year			10,751	
Fund balances at end of year, GAAP basis			\$10,921	

See accompanying notes to financial statements



Proprietary Funds.....

Introduction

Proprietary Funds account for City operations financed and operated in a manner similar to a private business enterprise. The intent of the City is that the cost of providing goods and services be financed primarily through user charges.

The concept of Major Funds established by GASB Statement 34 extends to Enterprise Funds. The City has elected to treat all of its Enterprise Funds as Major Funds in fiscal year 2003-04.

GASB 34 does not provide for the disclosure of budget versus actual comparisons for the Proprietary Funds.

Water Services Fund

This fund accounts for all financial transactions relating to the City’s Water service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Electric Services Fund

This fund accounts for all financial transactions relating to the City’s Electric service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Gas Services Fund

This fund accounts for all financial transactions relating to the City’s Gas service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Wastewater Collection Fund

This fund accounts for all financial transactions relating to the City’s Wastewater Collection service. Collections are on a user charge basis to residents and business owners located in Palo Alto.

Wastewater Treatment Fund

This fund accounts for all financial transactions relating to the City’s Wastewater Treatment. Services are on a user charge basis to residents and business owners located in Palo Alto.

Refuse Services Fund

This fund accounts for all financial transactions relating to the City’s Refuse service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Storm Drainage Services Fund

This fund accounts for all financial transactions relating to the City’s Storm Drain service. Services are on a user charge basis to residents and business owners located in Palo Alto.

External Service Fund

This fund accounts for all financial transactions relating to the City’s External Services provided to surrounding communities. Service charges are established on a case-by-case basis.

City of Palo Alto - Proprietary Funds

Statement of Net Assets - June 30, 2004

(In thousands of dollars)

	Business-type Activities-Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
ASSETS				
Current Assets:				
Cash and investments (Note 3):				
Available for operations	\$16,827	\$158,325	\$14,525	\$12,643
Cash and investments with fiscal agent	5,782		5,812	
Accounts receivable, net	3,185	8,983	1,708	1,435
Interest receivable	207	1,959	188	146
Inventory of materials and supplies				
Total Current Assets	26,001	169,267	22,233	14,224
Noncurrent Assets:				
Interfund receivable (Note 4)				
Capital assets (Note 6)	43,603	132,949	52,592	47,596
Total Noncurrent Assets	43,603	132,949	52,592	47,596
Total Assets	69,604	302,216	74,825	61,820
LIABILITIES				
Current Liabilities:				
Accounts payable and accrued liabilities	1,647	10,305	1,160	490
Accrued salaries and benefits	172	516	191	83
Interfund payable (Note 4)				
Current portion of revenue bonds (Note 7)	313		382	49
Current portion of capital lease (Note 7)				
Accrued claims payable - current (Note 14)				
Total Current Liabilities	2,132	10,821	1,733	622
Noncurrent liabilities:				
Accrued compensated absences - noncurrent (Note 1)				
Accrued claims payable - noncurrent (Note 14)				
Landfill closure and postclosure care (Note 9)				
Utility revenue bonds, net of unamortized issuance costs and discounts	10,034		12,242	1,476
Total Noncurrent Liabilities	10,034		12,242	1,476
Total Liabilities	12,166	10,821	13,975	2,098
NET ASSETS				
Invested in capital assets, net of related debt	38,261	132,949	44,831	46,071
Restricted for debt service (Note 10)	777		949	
Unrestricted (Note 10)	18,400	158,446	15,070	13,651
Total Net Assets	\$57,438	\$291,395	\$60,850	\$59,722

Some amounts reported for *Business-type Activities* in the Statement of Net Assets are different because certain Internal Service Fund assets and liabilities are included with Business-type Activities

Net Business-type Activities

See accompanying notes to financial statements



Business-type Activities-Enterprise Funds					Governmental
Wastewater	Refuse	Storm	External	TOTALS	Activities -
Treatment		Drainage	Service		Internal Service
					Funds
\$10,230	\$13,103	\$775	\$23	\$226,451	\$66,334
164				11,758	
1,705	2,148	260	235	19,659	8
134	161	5	(4)	2,796	707
					303
<u>12,233</u>	<u>15,412</u>	<u>1,040</u>	<u>254</u>	<u>260,664</u>	<u>67,352</u>
					132
<u>31,523</u>	<u>5,200</u>	<u>15,636</u>		<u>329,099</u>	<u>15,870</u>
<u>31,523</u>	<u>5,200</u>	<u>15,636</u>		<u>329,099</u>	<u>16,002</u>
<u>43,756</u>	<u>20,612</u>	<u>16,676</u>	<u>254</u>	<u>589,763</u>	<u>83,354</u>
98	233	77		14,010	601
218	116	39	23	1,358	981
			228	228	
318		305		1,367	
					25
					3,143
<u>634</u>	<u>349</u>	<u>421</u>	<u>251</u>	<u>16,963</u>	<u>4,750</u>
					12,004
					7,405
	6,555			6,555	
<u>9,405</u>		<u>10,338</u>		<u>43,495</u>	
<u>9,405</u>	<u>6,555</u>	<u>10,338</u>		<u>50,050</u>	<u>19,409</u>
<u>10,039</u>	<u>6,904</u>	<u>10,759</u>	<u>251</u>	<u>67,013</u>	<u>24,159</u>
21,892	5,200	4,993		294,197	15,845
72				1,798	
<u>11,753</u>	<u>8,508</u>	<u>924</u>	<u>3</u>	<u>226,755</u>	<u>43,350</u>
<u>\$33,717</u>	<u>\$13,708</u>	<u>\$5,917</u>	<u>\$3</u>	<u>522,750</u>	<u>\$59,195</u>
				(477)	
				<u>\$522,273</u>	

City of Palo Alto - Proprietary Funds

Statements of Revenues, Expenses and Changes in Net Assets
For the Year Ended June 30, 2004
(In thousands of dollars)

	Business-type Activities-Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
OPERATING REVENUES				
Sales of utilities:				
Customers	\$20,345	\$66,739	\$23,294	\$11,984
City departments	1,040	2,048	868	204
Wholesale		4,424		
Excess capacity		11,114		
Wastewater treatment				
Service connection charges and miscellaneous	179	558	347	37
Charges for services				
Other operating revenues	429	7,734	330	422
Total Operating Revenues	21,993	92,617	24,839	12,647
OPERATING EXPENSES				
Purchase of utilities				
Retail	7,453	34,299	15,878	5,304
Excess Capacity		7,022		
Administration and general	2,627	5,008	2,421	1,027
Engineering (operating)	335	882	148	124
Resource management and energy efficiency programs	261	5,046	1,128	
Operations and maintenance	3,184	8,168	2,140	1,537
Rent	1,257	3,025	138	73
Depreciation and amortization	919	5,230	1,156	1,076
Claims payments and changes in estimated self-insurance liability				
Compensated absences and other benefits				
Total Operating Expenses	16,036	68,680	23,009	9,141
Operating Income	5,957	23,937	1,830	3,506
NONOPERATING REVENUES (EXPENSES)				
Return on investment	23	252	181	30
Interest (expense)	(2)		(3)	(81)
Joint venture debt service (Note 15)		(4,744)		
Gain (loss) on disposal of fixed assets	(2)	(66)	(5)	
Other				
Net Nonoperating Revenues (Expenses)	19	(4,558)	173	(51)
Income (Loss) Before Contributions and Transfers	5,976	19,379	2,003	3,455
Contribution of assets				
Transfers in (Note 4)	19	1,020	172	1
Transfers (out) (Note 4)	(2,811)	(9,521)	(3,534)	(135)
Change in Net Assets	3,184	10,878	(1,359)	3,321
Total net assets at beginning of year	54,254	280,517	62,209	56,401
Total net assets at end of year	\$57,438	\$291,395	\$60,850	\$59,722

Some amounts reported for *Business-type Activities* in the Statement of Net Assets are different because certain Internal Service Fund assets and liabilities are included with Business-type Activities

Change in Net Assets of Business-type Activities

See accompanying notes to financial statements



Business-type Activities-Enterprise Funds					Governmental
Wastewater	Refuse	Storm	External	TOTALS	Activities -
Treatment		Drainage	Service		Internal Service
					Funds
	\$17,923	\$2,033		\$142,318	
\$5,363	846	121		10,490	
				4,424	
				11,114	
9,114				9,114	
				1,121	
					\$47,382
267	3,154	16	\$585	12,937	
<u>14,744</u>	<u>21,923</u>	<u>2,170</u>	<u>585</u>	<u>191,518</u>	<u>47,382</u>
	8,356			71,290	
				7,022	
1,733	1,468	513		14,797	10,191
924	473	512		3,398	
		89		6,524	
9,113	9,289	617	657	34,705	2,676
	4,289			8,782	
2,515	226	555		11,677	2,234
					6,951
					27,113
<u>14,285</u>	<u>24,101</u>	<u>2,286</u>	<u>657</u>	<u>158,195</u>	<u>49,165</u>
<u>459</u>	<u>(2,178)</u>	<u>(116)</u>	<u>(72)</u>	<u>33,323</u>	<u>(1,783)</u>
(16)	(83)	1	(1)	387	318
(196)	(386)	(657)		(1,325)	(6)
				(4,744)	
				(73)	114
					165
<u>(212)</u>	<u>(469)</u>	<u>(656)</u>	<u>(1)</u>	<u>(5,755)</u>	<u>591</u>
<u>247</u>	<u>(2,647)</u>	<u>(772)</u>	<u>(73)</u>	<u>27,568</u>	<u>(1,192)</u>
					3,498
1	91	311	45	1,660	5,553
(120)	(449)	(41)		(16,611)	(101)
<u>128</u>	<u>(3,005)</u>	<u>(502)</u>	<u>(28)</u>	<u>12,617</u>	<u>7,758</u>
<u>33,589</u>	<u>16,713</u>	<u>6,419</u>	<u>31</u>		<u>51,437</u>
<u>\$33,717</u>	<u>\$13,708</u>	<u>\$5,917</u>	<u>\$3</u>		<u>\$59,195</u>
				(265)	
				<u>\$12,352</u>	

City of Palo Alto - Proprietary Funds
Statement of Cash Flows -
For the Year Ended June 30, 2004
(In thousands of dollars)

	Business-type Activities-Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
CASH FLOWS FROM OPERATING ACTIVITIES:				
Receipts from customers	\$19,918	\$90,604	\$24,589	\$11,961
Payments to suppliers	(12,044)	(52,272)	(19,639)	(6,922)
Payments to employees	(2,455)	(4,492)	(2,230)	(944)
Internal activity - receipts from other funds	1,040	2,048	868	204
Claims paid				
Other receipts (payments)	429		330	422
Net Cash From Operating Activities	<u>6,888</u>	<u>35,888</u>	<u>3,918</u>	<u>4,721</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:				
Interfund receipts (payments)				
Transfers in	19	1,020	172	1
Transfers (out)	(2,811)	(9,521)	(3,534)	(135)
Net Cash From Noncapital Financing Activities	<u>(2,792)</u>	<u>(8,501)</u>	<u>(3,362)</u>	<u>(134)</u>
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES:				
Acquisition and construction of fixed assets	(4,076)	(10,327)	(6,264)	(3,248)
Proceeds from sale of capital assets				
Principal paid on long-term debt	(296)		(360)	(33)
Interest paid on long-term debt	(2)	(4,744)	(3)	(81)
Cash Flows From Capital Financing Activities	<u>(4,374)</u>	<u>(15,071)</u>	<u>(6,627)</u>	<u>(3,362)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:				
Interest on investments	37	218	258	23
Net Cash Flows	(241)	12,534	(5,813)	1,248
Cash and cash equivalents at beginning of year	22,850	145,791	26,150	11,395
Cash and cash equivalents at end of year	<u>\$22,609</u>	<u>\$158,325</u>	<u>\$20,337</u>	<u>\$12,643</u>
FINANCIAL STATEMENT PRESENTATION:				
Cash and investments available for operations	\$16,827	\$158,325	\$14,525	\$12,643
Cash and investments with fiscal agent	5,782		5,812	
Cash and cash equivalents at end of year	<u>\$22,609</u>	<u>\$158,325</u>	<u>\$20,337</u>	<u>\$12,643</u>
Reconciliation of operating income (loss) to Cash Flows from Operating Activities				
Operating income (loss)	\$5,957	\$23,937	\$1,830	\$3,506
Adjustments to reconcile operating income (loss) to cash flows from operating activities:				
Depreciation and amortization	919	5,230	1,156	1,076
Other				
Changes in assets and liabilities:				
Accounts receivable	(606)	35	948	(60)
Inventory of materials and supplies				
Accounts and other payables	618	6,686	(16)	199
Accrued claims payable and other liabilities				
Net Cash From Operating Activities	<u>\$6,888</u>	<u>\$35,888</u>	<u>\$3,918</u>	<u>\$4,721</u>

Capital Asset contributions

See accompanying notes to financial statements



Business-type Activities-Enterprise Funds					Governmental
Wastewater Treatment	Refuse	Storm Drainage	External Service	TOTALS	Activities - Internal Service Funds
\$7,409	\$18,051	\$2,074	(\$89)	\$174,517	\$47,380
(10,098)	(22,290)	(1,218)	(657)	(125,140)	(2,120)
(1,515)	(1,352)	(474)	23	(13,439)	(38,068)
5,363	846	121		10,490	
					(5,656)
267	3,263	16	585	5,312	165
1,426	(1,482)	519	(138)	51,740	1,701
			113	113	123
1	91	311	45	1,660	5,553
(120)	(449)	(41)		(16,611)	(101)
(119)	(358)	270	158	(14,838)	5,575
(1,602)	(40)	(105)		(25,662)	(4,219)
					114
(260)		(258)		(1,207)	(32)
(196)	(386)	(657)		(6,069)	(6)
(2,058)	(426)	(1,020)		(32,938)	(4,143)
3	(43)	9	3	508	357
(748)	(2,309)	(222)	23	4,472	3,490
11,142	15,412	997		233,737	62,844
\$10,394	\$13,103	\$775	\$23	\$238,209	\$66,334
\$10,230	\$13,103	\$775	\$23	\$226,451	\$66,334
164				11,758	
\$10,394	\$13,103	\$775	\$23	\$238,209	\$66,334
\$459	(\$2,178)	(\$116)	(\$72)	\$33,323	(\$1,783)
2,515	226	555		11,677	2,234
					165
(1,705)	128	41	(89)	(1,308)	(2)
					61
157	233	39	23	7,939	(269)
	109			109	1,295
\$1,426	(\$1,482)	\$519	(\$138)	\$51,740	\$1,701
					\$3,498



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Fiduciary Funds

Introduction

These funds account for assets held by the City in trust or as an agent for various assessment and community facilities districts. The financial activities of these funds are excluded from the Citywide financial statements, but are presented in separate Fiduciary Fund financial statements.



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City of Palo Alto - Fiduciary Funds

Statement of Fiduciary Net Assets - June 30, 2004

(In thousands of dollars)

	<u>Agency Funds</u>
ASSETS	
Cash and investments available for operations (Note 3)	\$1,334
Cash and investments with fiscal agents (Note 3)	5,604
Interest receivable	<u>72</u>
Total Assets	<u><u>\$7,010</u></u>
LIABILITIES	
Due to bondholders	\$5,970
Due to other governments	<u>1,040</u>
Total Liabilities	<u><u>\$7,010</u></u>

See accompanying notes to financial statements



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Notes

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Notes are essential to present fairly the information contained in the overview level of basic financial statements. Narrative explanations are intended to communicate information that is not readily apparent or cannot be included in the statements and schedules themselves, and to provide additional disclosures as required by the Governmental Accounting Standards Board.



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Note 1.....

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The City of Palo Alto was incorporated in 1894 and operates as a charter city, having had its first charter granted by the State of California in 1909. The City operates under the Council-Manager form of government and provides the following services: public safety (police and fire), public works, electric, water, gas, wastewater, storm drain, refuse, golf course, planning and zoning, general administration services, library, open space and science, recreational and human services.

Reporting Entity

The City is governed by a nine-member council, elected by City residents. The City is legally separate and fiscally independent which means it can issue debt, set and modify budgets and fees and sue or be sued. The accompanying Basic Financial Statements present the financial activity of the City, which is the primary government presented, along with the financial activities of its component units, which are entities for which the City is financially accountable. Although they are separate legal entities, *blended* component units are in substance part of the City's operations and are reported as an integral part of the City's financial statements. This City's component units, which are described below are blended.

The Palo Alto Public Improvement Corporation provides financing of public capital improvements for the City through the issuance of Certificates of Participation (COPs), a form of debt, which allows investors to participate in a stream of future lease payments. Proceeds from the COPs are used to construct projects which are leased to the City. The lease payments are sufficient in timing and amount to meet the debt service requirements of the COPs. The Corporation is controlled by the City, which performs all accounting and administrative functions for the Corporation. The financial activities of the Corporation are included in the Golf Course and Civic Center Debt Service Funds and the Capital Projects Fund.

The Palo Alto Redevelopment Agency is a separate government entity whose purpose is to prepare and implement plans for improvement, rehabilitation, and development of certain areas within the City. The City Council and the Redevelopment Agency Board are composed of the same individuals. Certain administrative and accounting functions are performed by City staff. The financial activities of the Agency have been included in these financial statements in the Redevelopment Agency Special Revenue Fund.

Financial statements for the Palo Alto Public Improvement Corporation and Redevelopment Agency may be obtained from the City of Palo Alto, Administrative Services Department, 250 Hamilton Avenue, Palo Alto, CA 94301.

Basis of Presentation

The City's Basic Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America. The Government Accounting Standards Board is the acknowledged standard setting body for establishing accounting and financial reporting standards followed by governmental entities in the United States.

The accompanying financial statements are presented on the basis set forth in GASB Statements No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, No. 36, *Recipient Reporting for Certain Non-exchange Revenues, an Amendment of GASB Statement No. 33*, No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments; Omnibus*, and No. 38, *Certain Financial Statement Note Disclosures*.

These Statements require that the financial statements described below be presented.

Citywide Statements: The Statement of Net Assets and the Statement of Activities display information about the primary government (the City) and its component units. These statements include the financial activities of the overall City government, except for fiduciary activities. Eliminations have been made to minimize the double counting of internal activities. These statements distinguish between the *Governmental* and *Business-type Activities* of the City. Governmental Activities generally are financed through taxes, intergovernmental revenues, and other non-exchange transactions. Business-type Activities are financed in whole or in part by fees charged to external parties.

The Statement of Activities presents a comparison between direct expenses and program revenues for each segment of the Business-type Activities of the City and for each function of the City's Governmental Activities. Direct expenses are those that are specifically associated with a program or function and, therefore, are clearly identifiable to a particular function. Program revenues include (a) charges paid by the recipients of goods or services offered by the programs, (b) grants and contributions that are restricted to meeting the operational needs of a particular program and (c) fees, grants and contributions that are restricted to financing the acquisition or construction of capital assets. Revenues that are not classified as program revenues, including all taxes, are presented as general revenues.

Fund Financial Statements: The Fund financial statements provide information about the City's funds, including fiduciary funds and blended component units. Separate statements for each fund category—*governmental*, *proprietary*, and *fiduciary*—are presented. The emphasis of Fund financial statements is on major individual governmental and enterprise funds, each of which is displayed in a separate column. All remaining governmental and enterprise funds are aggregated and reported as non-major funds.

Proprietary Fund *operating* revenues, such as charges for services, result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. *Non-operating* revenues, such as subsidies and investment earnings, result from non-exchange transactions or ancillary activities.

Major Funds

GASB Statement 34 defines Major Funds and requires that the City's Major Governmental and Business-type Funds be identified and presented separately in the Fund financial statements. All other funds, called Non-major Funds, are combined and reported in a single column, regardless of their fund-type.

Major Funds are defined as funds that have either assets, liabilities, revenues or expenditures/expenses equal to ten percent of their fund-type total and five percent of the grand total. The General Fund is always a Major Fund. The City may also select other funds it believes should be presented as Major Funds.

The City reported the following Major Governmental Funds in the accompanying financial statements:

General Fund - This is the City's primary operating fund. It accounts for all financial resources of the general government, except those required to be accounted for in another fund.

Housing In-Lieu Fund - This fund accounts for revenues from commercial and residential developers to provide housing under the City's Below Market Rate program.

Capital Projects Fund – This fund accounts for resources used for the acquisition and construction of capital facilities by the City, with the exception of those assets financed by Proprietary Funds.

The City reported all its Enterprise Funds as Major Funds in the accompanying financial statements:

Water Services Fund- This fund accounts for all financial transactions relating to the City’s Water service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Electric Services Fund- This fund accounts for all financial transactions relating to the City’s Electric service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Gas Services Fund- This fund accounts for all financial transactions relating to the City’s Gas service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Wastewater Collection Services Fund- This fund accounts for all financial transactions relating to the City’s Wastewater Collection. Collections are on a user charge basis to residents and business owners located in Palo Alto.

Wastewater Treatment Services Fund- This fund accounts for all financial transactions relating to the City’s Wastewater Treatment. Services are on a user charge basis to residents and business owners located in Palo Alto.

Refuse Services Fund- This fund accounts for all financial transactions relating to the City’s Refuse service. Services are on a user charge basis to residents and business owners located in Palo Alto.

Storm Drainage Services Fund- This fund accounts for all financial transactions relating to the City’s Storm Drain service. Services are on a user charge basis to residents and business owners located in Palo Alto.

External Services Fund This fund accounts for all financial transactions relating to the City’s External services provided to surrounding communities.

The City also reports the following fund types:

Internal Service Funds - These funds account for fleet replacement and maintenance, technology, central duplicating, printing and mailing services, administration of compensated absences and health benefits, and the City’s self-insured workers’ compensation and general liability programs, all of which are provided to other departments on a cost-reimbursement basis. Also included is the Retiree Health Benefits Internal Service Fund which accounts for benefits when the amount of actual benefits exceed one and one-half percent of the City’s gross payroll cost in any fiscal period.

Fiduciary Funds- These funds account for assets held by the City in trust or as an agent for various assessment and community facilities districts. The financial activities of these funds are excluded from the Citywide financial statements, but are presented in separate Fiduciary Fund financial statements.

Agency Funds - These funds are custodial in nature and do not involve measurement of results of operations. The City maintains four agency funds.

Basis of Accounting

The Citywide and Proprietary fund financial statements are reported using the *economic resources measurement focus* and the full *accrual basis* of accounting. Revenues are recorded when *earned* and expenses are recorded at the time liabilities are *incurred*, regardless of when the related cash flows take place.

Governmental Funds are reported using the *current financial resources* measurement focus and the *modified accrual* basis of accounting. Under this method, revenues are recognized when *measurable and available*. The City considers all revenues reported in the Governmental Funds to be available if the revenues are collected within ninety days after year-end. Expenditures are recorded when the related fund liability is incurred, except for principal and interest on general long-term debt, claims and judgments, and compensated absences, which are recognized as expenditures to the extent they have matured. General capital asset acquisitions are reported as *expenditures* in Governmental Funds. Proceeds of general long-term debt and acquisitions under capital leases are reported as *other financing sources*.

Those revenues susceptible to accrual include taxes, intergovernmental revenues, interest and charges for services.

Grant revenues are recognized in the fiscal year in which all eligibility requirements are met. Under the terms of grant agreements, the City may fund certain programs with a combination of cost-reimbursement grants, categorical block grants, and general revenues. Thus, both restricted and unrestricted net assets may be available to finance program expenditures. The City's policy is to first apply restricted grant resources to such programs, followed by general revenues if necessary.

Certain indirect costs are included in program expenses reported for individual functions and activities.

The City follows those Financial Accounting Standard Board Statements issued before November 30, 1989, which do not conflict with Governmental Accounting Standards Board Statements.

Inventory of Materials and Supplies

Materials and supplies are held for consumption and are valued at average cost. The consumption method is used to account for inventories. Under the consumption method, inventories are recorded as an expenditure at the time inventory items are used, rather than purchased.

Compensated Absences

The liability for compensated absences includes the vested portions of vacation, sick leave, and overtime compensation pay. The City's liability for accrued compensated absences is recorded in the General Benefits and Insurance Internal Service Fund. The Fund is reimbursed through payroll charges to all other funds. Earned but unpaid vacation and overtime compensation pay is recognized as an expense or expenditure in the Proprietary and Governmental Fund types when earned because the City has provided financial resources for the full amount through its budgetary process. Vested accumulated sick pay is paid in the event of termination due to disability and under certain conditions specified in employment agreements primarily restricted to individuals with fifteen or more years of continuous service. The City had accumulated vacation and overtime compensation pay of \$8.547 million, and vested accumulated sick pay of \$3.457 million as of June 30, 2004.



Property Tax

Santa Clara County assesses properties and bills, collects, and distributes property taxes to the City. The County remits the entire amount levied and handles all delinquencies, retaining interest and penalties. Secured and unsecured property taxes are levied on January 1 of the preceding fiscal year.

Secured property tax is due in two installments, on November 1 and February 1, and becomes a lien on those dates. It becomes delinquent on December 10 and April 10, respectively. Unsecured property tax is due on July 1, and becomes delinquent on August 31. Collection of delinquent accounts is the responsibility of the County, which retains all penalties.

The term “unsecured” refers to taxes on personal property other than real estate, land and buildings. These taxes are secured by liens on the property being taxed. Property tax revenues are recognized by the City in the fiscal year they are assessed, provided they become available as defined above.

New Funds

Downtown Business Improvement District Fund was established to account for the activities of the Palo Alto Downtown Business Improvement District, which was established to enhance the viability of the downtown business district.

Rounding

All amounts included on the basic financial statements, combining statements, fiduciary statements, footnotes and schedules are presented to the nearest thousands in accordance with the City’s policy.

Note 2.....

BUDGETS AND BUDGETARY ACCOUNTING

1. The City Manager submits to the City Council a proposed operating budget for the fiscal year commencing the following July 1. The operating budget includes proposed expenditures and the means of financing them.
2. Public hearings are conducted to obtain public comments.
3. The Adopted budget is legally enacted through passage of a budget ordinance for all funds except for Agency Funds.
4. The City Manager is authorized to reallocate funds from a contingent account maintained in the General Fund in conformance with the adopted policies set by the City Council. Additional appropriations to departments in the General Fund, or to total appropriations for all other budgeted funds, or transfers of appropriations between funds, require approval by the City Council. These amendments are added to the Adopted budget and the resulting totals are reflected as Adjusted budget amounts.
5. Expenditures may not legally exceed budgeted appropriations at the department level for the General Fund, and at the fund level for Special Revenue and Debt Service Funds.
6. Formal budgetary integration is employed as a management control device during the year in all funds except Agency Funds and the Civic Center Refinancing and Downtown Parking Improvement Debt Service Funds.
7. Budgets for governmental funds are adopted on a basis consistent with generally accepted accounting principles (GAAP) for all funds, except that General Fund encumbrances are treated as budgetary expenditures when incurred and stores (materials, parts and supplies) transactions included in the General Fund are not budgeted.
8. Expenditures for the Capital Projects Fund are budgeted and managed on a project length basis and budget to actual comparisons for these expenditures have been excluded from the accompanying financial statements.

Excess of Expenditures over Appropriations

The funds below incurred expenditures and operating transfers in excess of their budgets in the amounts indicated as the result of unanticipated expenses. Sufficient resources were available within each fund to finance these excesses.

The Street Improvement Special Revenue Fund, Golf Course Debt Service Fund, Civic Center Refinancing Debt Service Fund and Parking COP Debt Service Fund actual expenditures and operating transfers out exceeded budget in the amounts of \$1 million, \$14 thousand, \$2 thousand and \$4 thousand, respectively.



Note 3.....

CASH AND INVESTMENTS

The City pools cash from all sources and all funds except Restricted Cash and Investments with Fiscal Agents so that it can be invested at the maximum yield, consistent with safety and liquidity, while individual funds can make expenditures at any time.

Investment income is allocated among funds on the basis of average month-end cash and investment balances in these funds.

Categorization of Credit Risk of Securities Instruments

The City invests in individual investments and in investment pools. Individual investments are evidenced by specific identifiable pieces of paper called securities instruments, or by an electronic entry registering the owner in the records of the institution issuing the security, called the *book* entry system. In order to maximize security, the City employs the Trust Department of a bank as the custodian of all its investments, regardless of their form.

The City categorizes its individual securities instruments in ascending order to reflect the relative risk of loss of these instruments. This risk is called Credit Risk, the lower the number, the lower the risk.

The three levels of risk prescribed by generally accepted accounting principles are described below:

Category 1 - The City is the registered owner of securities held in book entry form by the bank's Trust Department. Securities instruments in this category are in the City's name and are in the possession of the Trust Department of the bank employed by the City solely for this purpose.

Category 2 - Securities instruments and book entry form securities in this category are in the bank's name but are held by the Bank's Trust Department in a separate account in the City's name.

Category 3 - None of the City's investments are in this category, which would include only City-owned securities instruments or book entry form securities, which were not in the City's name and not held by the bank's Trust Department.

Pooled Investments - Pooled investments are not categorized because of their pooled rather than individual nature.

Investments are carried at fair value, which is the same as fair market value and are categorized as follows at June 30, 2004 (in thousands):

	Cash and Investments		Total
	Available for Operations	With Fiscal Agents	
Category 1 Investments:			
U.S. Treasury and Agency Obligations	\$354,167	\$6,485	\$360,652
Pooled Investments (non Categorized):			
Local Agency Investment Fund	23,618		23,618
California Asset Management Program		16,447	16,447
Mutual funds (government securities)	766	1,877	2,643
Total Investments	378,551	24,809	403,360
Cash in banks (overdraft) and on hand	(611)		(611)
Total Cash and Investments	<u>\$377,940</u>	<u>\$24,809</u>	<u>\$402,749</u>

The City must maintain required amounts of cash and investments with trustees under the terms of certain debt issues. These funds are unexpended bond proceeds or are pledged as reserves to be used if the City fails to meet its obligations under these debt issues. The California Government Code requires these funds to be invested in accordance with City ordinance, bond indentures or State statute. All these funds have been invested as permitted under the Code.

Cash and investments maturing in three months or less at the time of purchase are considered to be liquid assets for purposes of measuring cash flows.

Classification

Cash and investments are classified in the financial statements as shown below, based on whether or not their use is restricted under the terms of City debt instruments or Agency agreements (in thousands):

Cash and investments available for operations	\$376,606
Cash and investments with fiscal agents	19,205
City cash and investments	<u>395,811</u>
Cash and investments available for operations in	
Fiduciary Funds (separate Statement)	1,334
Cash and investments with fiscal agents	
Fiduciary Funds (separate Statement)	5,604
Total cash and investments	<u>\$402,749</u>

Cash Deposits

California Law requires banks and savings and loan institutions to pledge government securities with a market value of 110% of the City’s cash on deposit or first trust deed mortgage notes with a value of 150% of the deposit as collateral for these deposits. Under California Law this collateral is held in the City’s name and places the City ahead of general creditors of the institution. The City has waived collateral requirements for the portion of deposits covered by federal deposit insurance.

Cash in banks is entirely insured (Category 1) or collateralized by the institution holding the deposit (Category 2), as discussed above.

Bank balances before reconciling items were \$1.849 million, of which \$100 thousand was insured (Category 1) and \$1.749 million was collateralized as discussed above (Category 2) at June 30, 2004.

Market Risk and Investment Maturities

Market risk is the risk that investments will decline in market value. The City limits market risk by limiting the types and maturities of its investments and by not borrowing against its investments. Investment yield is ranked after safety and liquidity in making investment decisions. All investments are held to maturity and maturities are matched to the City's projected cash flow needs. Investments managed by the City mature as follows at June 30, 2004 (in thousands):

Type of Investment	Fair Value
Local Agency Investment Fund	\$23,618
Mutual funds (government securities)	766
U.S. Treasury and Agency Obligations:	
Maturities of less than 1 year	52,069
Maturities of 1 to 3 years	178,713
Maturities of 3 to 5 years	97,201
Maturities of 5 to 10 years	26,125
Mortgage Backed Securities, Maturing in 15 Years	<u>59</u>
 Total Investments Available for Operations	 <u><u>\$378,551</u></u>

Authorized City Investments

Investment instruments authorized for purchase include:

- Securities of the U.S. Government or its agencies. The maximum stated final maturity of individual securities in the portfolio shall not exceed ten years. No limit on purchase of these securities, except for Callable and Multi-step-up agency securities, limited to no more than twenty percent of the City's portfolio, provided that:
 - the potential call dates are known at the time of purchase;
 - the interest rates at which they "step-up" are known at the time of purchase; and
 - the entire face value of the security is redeemed at the call date.
- Certificates of Deposit (or Time Deposits) with federally insured institutions. No more than twenty percent of the City's portfolio may be invested in CD's. Rollovers are not permitted without specific instruction from authorized City staff.
- Bankers Acceptance Notes. Purchases from any one bank may not exceed \$5 million, and total bankers acceptance notes may not exceed thirty percent of the City's investment portfolio.
- Short-term Commercial Paper. Purchases of commercial paper may not exceed 180 days maturity or more than fifteen percent of the City's investment portfolio, and purchases from any one institution may not exceed \$3 million.
- State of California Local Agency Investment Fund.
- Short-term Repurchase Agreements (REPO). Agreement shall not exceed one year and market value of securities that underlay a repurchase agreement shall be valued at 102 percent or greater of the funds borrowed against those securities.

7. City of Palo Alto Bonds.
8. California Asset Management Program.
9. Money Market Deposit Accounts.
10. Mutual Funds which are limited essentially to the above investments, registered with the Federal Securities and Exchange Commission (SEC), and which are rated in the highest rating category by a nationally recognized rating service. No more than twenty percent of the City's portfolio may be invested in mutual funds, and no more than ten percent of the portfolio may be in any one Mutual Fund.
11. Medium-Term Corporate Notes. No more than ten percent of the City's investment portfolio may be invested in Medium-Term Corporate Notes, and purchases may not exceed \$5 million invested in any single issuer, other than the U.S. Government, its agencies and instrumentality.

The City is a voluntary participant in the Local Agency Investment Fund (LAIF) that is regulated by California Government Code Section 16429 under the oversight of the Treasurer of the State of California. LAIF management calculates the fair value and cost of the entire LAIF pool. The City adjusts its cost basis invested in LAIF to fair value based on this ratio. The balance available for withdrawal is based on the accounting records maintained by LAIF, which are recorded on an amortized cost basis. Included in LAIF's investment portfolio are collateralized mortgage obligation, mortgage-backed securities, other asset-backed securities, loans to certain state funds, and floating rate securities issued by Federal agencies, government-sponsored enterprises, and corporations.

Investments Carrying Value

The City adjusts the carrying value of its investments to reflect their fair value at each fiscal year end, and it includes the effects of these adjustments in income for that fiscal year.



Note 4.....

INTERFUND TRANSACTIONS

Transfers Between Funds

With Council approval, resources may be transferred from one City fund to another. The purpose of the majority of transfers is to reimburse a fund, which has made an expenditure on behalf of another fund. Less often, a transfer may be made to open or close a fund.

Transfers between City funds during fiscal year 2003-04 were as follows (in thousands):

Fund Receiving Transfer	Fund Making Transfer	Amount Transferred
General Fund	Special Districts Special Revenue Fund	\$460
	Transportation Mitigation Special Revenue Fund	150
	Law Enforcement Block Grant Special Revenue Fund	19
	Downtown Planned Community Special Revenue Fund	25
	Redevelopment Agency Special Revenue Fund	9
	Capital Projects Fund	3,157
	Golf Course Improvement Debt Service Fund	14
	Civic Center Refinancing Debt Service Fund	2
	Downtown Parking Improvement Debt Service Fund	3
	Water Enterprise Fund	2,306 A
	Electric Enterprise Fund	8,611 A
	Gas Enterprise Fund	2,914 A
	Wastewater Collection Enterprise Fund	4 A
	Refuse Enterprise Fund	166 A
	Technology Internal Service Fund	48 A
Local Law Enforcement Special Revenue Fund	General Fund	2
Redevelopment Agency Special Revenue Fund	General Fund	9
Debt Service Funds:		
Parking COP	General Fund	318
Civic Center Financing	General Fund	341
	Special Districts Special Revenue Fund	80
Golf Course Improvements	General Fund	324
Capital Projects Fund	General Fund	6,551 C
	Street Improvement Special Revenue Fund	2,791 B
	Special Districts Special Revenue Fund	111
	Local Law Enforcement Special Revenue Fund	89
	Electric Enterprise Fund	128

Enterprise Fund

Water Fund	Water Enterprise Fund	1	
	Gas Enterprise Fund	9	
	Wastewater Collection Enterprise Fund	9	
Electric	General Fund	276	
	Water Enterprise Fund	215	
	Gas Enterprise Fund	358	
	Wastewater Collection Enterprise Fund	50	
	Refuse Enterprise Fund	102	
	Storm Drainage Enterprise Fund	17	
	Technology Internal Service Fund	2	
Gas	Water Enterprise Fund	170	
	Technology Internal Service Fund	2	
Wastewater Treatment	Technology Internal Service Fund	1	
Wastewater Collection	Technology Internal Service Fund	1	
Refuse	Special Districts Special Revenue Fund	91	
Storm Drainage	General Fund	310	
	Technology Internal Service Fund	1	
External Service	Technology Internal Service Fund	45	
Internal Service Funds:			
Computer Equipment	General Fund	1,038	D
	Capital Projects Fund	2,426	D
	Water Enterprise Fund	120	
	Electric Enterprise Fund	783	
	Gas Enterprise Fund	252	
	Wastewater Collection Enterprise Fund	72	
	Wastewater Treatment Enterprise Fund	120	
	Refuse Enterprise Fund	171	
	Storm Drainage Enterprise Fund	24	
Vehicle Replacement	General Fund	20	
	Capital Projects Fund	517	
	Refuse Enterprise Fund	10	
		<u>35,845</u>	

The reasons for these transfers are set forth below:

- (A) Transfer to reimburse the General Fund for costs incurred for the benefit of funds making the transfer.
- (B) Transfer to return unspent construction funds.
- (C) Allocation of funds to construct capital assets.
- (D) Allocation of funds for costs incurred for improving network infrastructure.

Current Interfund Balance

Current interfund balances arise in the normal course of business and are expected to be repaid shortly after the end of the fiscal year. At June 30, 2004, the Federal Revenue Special Revenue Fund, the Local Law Enforcement Special Revenue Fund, the Downtown Planned Community Special Revenue Fund and the External Services Business-type Fund owed the General Fund \$282 thousand, \$25 thousand, \$4 thousand, and \$128 thousand, respectively.

Long-Term Interfund Advances

The City has a long-term interfund advance which the General Fund owes the Vehicle Replacement and Maintenance Internal Service Fund \$32 thousand. The amount is expected to be repaid over two fiscal years commencing with 2003-2004 from General Fund Community Services Department resources.

The City also has a long-term interfund advance which the External Services Enterprise Fund owes the Technology Internal Service Fund \$100 thousand. The amount is expected to be repaid over four fiscal years commencing in 2004-05 from External Service Fund resources.



Interfund Commitment

During fiscal year 2001-02, the City established the Palo Alto Redevelopment Agency. The Agency and the City have an agreement whereby the City will advance funds to the Agency in support of start up and formation costs. However, the interfund advances have no specific repayment date. Generally accepted accounting principals require that such amounts be treated as transfers in the year made. Advances without specified repayment terms total \$338 thousand as of June 30, 2004.

Internal Balances

Internal balances represent the net interfund receivables and payables remaining after the elimination of all such balances within Governmental and Business-type Activities.

Note 5.....

Notes and Loans Receivable

At June 30, 2004, the City's notes and loans receivable totaled (in thousands):

Palo Alto Housing Corporation:	
Oak Manor Townhouse	\$1,204
Emerson Street Project	375
Alma Single Room Occupancy Development	2,222
Barker Hotel	1,400
Sheridan Apartments	2,248
Mid-Peninsula Housing Coalition:	
Palo Alto Gardens Apartments	1,000
Oak Court Apartments, L.P.	1,960
Community Working Group, Inc	1,280
Home Rehabilitation Loans	141
Executive Relocation Assistance Loans	1,256
Below Market Rate Assessment Loans	54
Adolescent Counseling	56
Palo Alto Senior Housing	28
Clara-Mateo Alliance	11
Total	\$13,235

Housing Loans

The City engages in programs designed to encourage construction or improvement in low-to-moderate income housing or other projects. Under these programs, grants or loans are provided under favorable terms to homeowners or developers who agree to spend these funds in accordance with the City's terms. These loans have been offset by reserved fund balances, as they are not expected to be repaid immediately.

Oak Manor Townhouse

On January 7, 1991, the City loaned \$2.1 million to assist in the acquisition of an apartment complex to be used to provide rental housing for low and very low income households. This loan bears interest at three percent, is due in annual installments until 2011 and is collateralized by a subordinated deed of trust. Under the terms of the loan agreement, loan payments are forgiven if the Corporation meets the objective of this project. During the year ended June 30, 2004 the obligation was not met. The annual loan payment was not forgiven.

Emerson Street Project

On November 8, 1994 the City loaned \$375 thousand for expenses necessary to acquire an apartment complex for the preservation of rental housing for low and very low-income households in the City. This loan is collateralized by a second deed of trust. The loan bears no interest until 2009 after which the loan bears interest at three percent per year. The principal balance is due in 2034.



Alma Single Room Occupancy Development

On December 13, 1996 the City loaned \$2.695 million to the Alma Place Association for the development of a 107 unit single room occupancy development. This loan bears interest at three percent and is collateralized by a subordinated deed of trust. Loan payments are deferred until 2014. The principal balance is due in 2041.

Barker Hotel

On April 12, 1994 the City loaned a total of \$2.07 million for the preservation, rehabilitation and expansion of a low income, single room occupancy hotel. This loan was funded by three sources: \$400 thousand from the Housing In-Lieu Special Revenue Fund, \$1 million from HOME Investment Partnership Program Funds, and \$670 thousand from Community Development Block Grant Funds. All three notes bear no interest and are collateralized by a deed of trust, which is subordinated to private financing. Loan repayments are deferred until 2035. The City does not expect to collect the entire loan balance and has therefore recorded an allowance for doubtful accounts amounting to \$670 thousand to reduce the carrying value of the loans to \$1.4 million.

Sheridan Apartments

On December 8, 1998 the City loaned \$2.45 million to the Palo Alto Housing Corporation for the purchase and rehabilitation of a 57 unit apartment complex to be used for senior and low income housing. The loan is funded by \$1.625 million in Community Development Block Grant Funds, and \$825 thousand in Housing In-Lieu funds. The note bears interest at nine percent when available surplus cash from the project equals or exceeds twenty-five percent of interest calculated using nine percent. When available surplus cash falls below this level the note bears interest at three percent. The note is collateralized by a second deed of trust and an Affordability Reserve Account held by the Corporation. Annual loan payments are deferred until the Corporation accumulates \$1 million in an Affordability Reserve Account. The principal balance is due in 2033.

Oak Court Apartments

On August 18, 2003, in connection with the loan to Oak Court Apartments L.P. discussed below, the City loaned \$5.874 million to the Palo Alto Housing Corporation for the purchase of land on which Oak Court Apartments, L.P. will construct a 53-unit rental apartment complex for low and very low-income households with children. The note bears interest of five percent and is secured by a deed of trust. Annually accrued interest is added to the principal balance and note payments are due annually after 55 years, or beginning in 2058, unless the Corporation elects to extend the note until 2102, as define in the regulatory agreement. The city does not expect to collect the loan balance and has therefore recorded an allowance for doubtful account amounting to \$5.874 million.

Palo Alto Gardens Apartments

On April 22, 1999 the City loaned \$1 million to the Mid-Peninsula Housing Coalition for the purchase and rehabilitation of a 155 unit complex for the continuation of low income housing. This loan is funded by \$659 thousand in Community Development Block Grant funds and \$341 thousand in Housing In-Lieu funds. There are two notes that bear interest at three percent and are secured by second deeds of trust and a City Affordability Reserve Account held by the Coalition. Annual loan payments are deferred until certain criteria defined in the notes are reached. The principal balance is due in 2039.

Oak Court Apartments, L.P.

On August 18, 2003 the City loaned \$1.960 million to Oak Court Apartments, L.P. for the construction of a 53-unit rental apartment complex for low and very low-income households with children. The note bears no interest until certain criteria defined in the note are satisfied, at which time the note will bear an interest rate not to exceed three percent. The note is secured by a subordinate deed of trust. The principal balance is due in 2058.

Community Working Group, Inc

On May 13, 2002 the City loaned \$1.280 million to the Community Working Group, Inc for the predevelopment, relocation and acquisition of a 95 unit complex for the continuation of very low-income households. The loan is funded by \$1.280 million dollars of Community Development Block Grant funds. The note bears no interest and is secured by a first deed of trust. No repayment of the \$1.280 million will be required, provided that compliance with the City’s agreement is maintained. After 89 years of compliance with the regulatory agreement, the City’s loan would convert to a grant and its deed of trust would be reconveyed.

Home Rehabilitation

The City administers a closed housing rehabilitation loan program initially funded with Community Development Block Grant funds. Under this program, individuals with incomes below a certain level are eligible to receive low interest loans, for rehabilitation work on their homes. These loans are secured by deeds of trusts, which may be subordinated to subsequent encumbrances upon said real property with the prior written consent of the City. The loan repayments may be amortized over the life of the loans, deferred or a combination of both.

Executive Relocation Assistance Loans

The City Council may authorize a mortgage loan as part of a relocation assistance package to executive staff. The loans are secured by first deeds of trust and interest is adjusted annually based on the rate of return of the invested funds of the City for the year ending June 30 plus one quarter of 1 percent. Principal and interest payments are due bi-weekly. Employees must pay off any outstanding balance of their loans within a certain period after ending employment with the City. As of June 30, 2004, the City had two outstanding employee home loans due in 2030 and 2031 respectively.

Below Market Rate Assessment Loans

In December 2002 the City loaned \$53 thousand to Below Market Rate home owners with low incomes and /or very limited assets for capital repairs and improvements of their property. The loan bears interest at three percent and is secured by a deed of trust on the property. Loan payments are deferred until 2032. In 2004, the City did not accrue interest.

Adolescent Counseling Services Loans

In October 2003 the City agreed to loan up to \$111 thousand to Adolescent Counseling Services for rehabilitation expenses in connection with a rental housing facility for teenage girls. The loan is funded entirely by Community Development Block Grant funds, bears interest at three percent and is secured by a deed of trust on the property.



Palo Alto Senior Housing Project Loans

In July 2003 the City agreed to loan up to \$45.2 thousand to Palo Alto Senior Housing Project for home improvements in the independent living facility for low-income seniors. The loan is funded entirely by Community Development Block Grant funds, bears interest at six percent and is secured by a deed of trust on the property. Principal and interest payments are deferred until 2009. Principal and interest on the loan shall be forgiven if the borrower satisfactorily complies with all the terms set forth in the July 2003 agreement.

Clara-Mateo Alliance Loans

In July 2003 the City agreed to loan up to \$200 thousand to Clara-Mateo Alliance for rehabilitation of the kitchen and the Elsa Segovia Center to provide services for the homeless. The loan is funded entirely by Community Development Block Grant funds, bears interest at six percent and is secured by a deed of trust on the property. Principal and interest payments are deferred until 2009. Principal and interest on the loan shall be forgiven if the borrower satisfactorily complies with all the terms and conditions set forth in the July 2003 agreement.

Note 6.....

CAPITAL ASSETS

Valuation

All capital assets are valued at historical cost or estimated historical cost if actual historical cost is not available. Contributed capital assets are valued at their estimated fair market value on the date contributed. The City’s policy is to capitalize all assets when costs are equal to/or exceed \$5,000 and the useful life exceeds three years. Infrastructure assets are capitalized when costs are equal to/or exceed \$100,000.

Proprietary Fund capital assets are recorded at cost including significant interest costs incurred under restricted tax-exempt borrowings, which finance the construction of capital assets. These interest costs, net of interest earned on investment of the proceeds of such borrowings are capitalized and added to the cost of capital assets during the construction period. Maintenance and repairs are expensed as incurred.

GASB 34 Changes

With the implementation of GASB Statement 34 last year, the City has recorded all its public domain (infrastructure) capital assets, which consists of the following networks: Roadway, Recreation and Open Space in its Citywide financial statements. Capital assets formerly reported in the General Fixed Assets Account Group are now reported in the Citywide financial statements.

GASB Statement 34 requires that all capital assets with limited useful lives be depreciated over their estimated useful lives. Alternatively, the “modified approach” may be used for certain capital assets. Depreciation is not provided under this approach, but all expenditures on these assets are expensed, unless they are additions or improvements. The City has elected to use the depreciation method for its capital assets.

The purpose of depreciation is to spread the cost of capital assets equitably among all users over the life of these assets. The amount charged to depreciation expense each year represents that year’s pro rata share of the cost of capital assets.

Depreciation has been provided on capital assets. Depreciation of all capital assets is charged as an expense against operations each year and the total amount of depreciation taken over the years, called accumulated depreciation, is reported on the balance sheet as a reduction in the book value of capital assets.

Depreciation is provided using the straight line method which means the cost of the asset is divided by its expected useful life in years and the result is charged to expense each year until the asset is fully depreciated. The City has assigned the useful lives listed below to capital assets.



	Years
GOVERNMENTAL ACTIVITIES	
Buildings & structures	10-30
Equipment:	
Computer equipment	4
Office machinery & equipment	5
Machinery & equipment	10
Roadway network includes pavement, striping & legends, curbs, gutters & sidewalks, parking lots, traffic signage and bridges	5-40
Recreation and open space network includes major park facilities, park trails, bike paths and median	25-40
 BUSINESS-TYPE ACTIVITIES	
Buildings and structures	25-60
Vehicles and heavy equipment	3-10
Machinery and equipment	10-50
Transmission and distribution systems	10-100

General Capital Assets

Changes in the City’s general capital assets during the year ended June 30, 2004 were (in thousands):

	Balance June 30, 2003	Additions	Retirements	Transfers	Balance June 30, 2004
Governmental activities					
Capital assets not being depreciated:					
Land and improvements	\$67,847				\$67,847
Street trees	15,846	\$149	(\$274)		15,721
Construction in progress	33,950	24,211		(\$9,911)	48,250
Total capital assets not being depreciated	<u>117,643</u>	<u>24,360</u>	<u>(274)</u>	<u>(9,911)</u>	<u>131,818</u>
Capital assets being depreciated					
Buildings and improvements	54,016			299	54,315
Equipment	33,865	1,978	(1,924)	5,115	39,034
Roadway network	216,899			3,459	220,358
Recreation & open space network	7,793			1,038	8,831
Total capital assets being depreciated	<u>312,573</u>	<u>1,978</u>	<u>(1,924)</u>	<u>9,911</u>	<u>322,538</u>
Less accumulated depreciation					
Buildings and improvements	(50,016)	(305)			(50,321)
Equipment	(22,568)	(2,596)	1,634		(23,530)
Roadway network	(60,889)	(5,704)		58	(66,535)
Recreation & open space network	(3,692)	(204)		(58)	(3,954)
Net capital assets being depreciated	<u>(137,165)</u>	<u>(8,809)</u>	<u>1,634</u>		<u>(144,340)</u>
Total depreciable assets	<u>175,408</u>	<u>(6,831)</u>	<u>(290)</u>	<u>9,911</u>	<u>178,198</u>
Governmental activity capital assets, net	<u>\$293,051</u>	<u>\$17,529</u>	<u>(\$564)</u>		<u>\$310,016</u>



Business-type Capital Assets

Changes in the City's Enterprise Fund capital assets during the year ended June 30, 2004 were (in thousands):

	Balance June 30, 2003	Additions	Retirements	Transfers	Balance June 30, 2004
Business-type activities					
Capital assets not being depreciated:					
Land and improvements	\$1,541				\$1,541
Construction in progress	57,926	\$25,011		(\$10,789)	72,148
Total capital assets not being depreciated	59,467	25,011		(10,789)	73,689
Capital assets being depreciated:					
Buildings and structures	16,625	136			16,761
Transmission, distribution, and treatment systems	406,030	265	(\$634)	10,789	416,450
Total capital assets being depreciated	422,655	401	(634)	10,789	433,211
Less accumulated depreciation					
Buildings and structures	(4,183)	(365)			(4,548)
Transmission, distribution, and treatment systems	(162,752)	(11,063)	562		(173,253)
Net capital assets being depreciated	(166,935)	(11,428)	562		(177,801)
Total depreciable assets	255,720	(11,027)	(72)	10,789	255,410
Business-type activity capital assets, net	\$315,187	\$13,984	(\$72)		\$329,099

Capital Asset Contributions

Some capital assets may be acquired using Federal and State grant funds, or they may be contributed by developers or other governments. Generally accepted accounting principles require that these contributions be accounted for as revenues at the time the capital assets are contributed.

Depreciation Allocation

Depreciation expense was charged to functions and programs based on their usage of the related assets. The amounts allocated to each function or program were as follows (in thousands):

<i>Governmental Activities</i>		<i>Business-Type Activities</i>	
City Manager	\$11	Water	\$911
Administrative Services	76	Electric	5,230
Community Services	408	Gas	1,145
Fire	70	Wastewater Collection	1,065
Police	84	Wastewater Treatment	2,481
Public Works	5,908	Refuse	226
Planning	7	Storm Drainage	370
Non departmental (Common Use Assets)	11		<u>\$11,428</u>
Internal Service Funds	2,234		
	<u>\$8,809</u>		

Construction in Progress and Completed Projects

Construction in progress in fiscal year 2003-04 comprise (in thousands):

	<u>Expended to June 30, 2004</u>
Governmental Funds:	
Children's Theater System	\$202
Community Services Lighting Enhancements	132
Open Space Trails & Amenities	521
Open Space Parking Improvement	452
Public Safety Mobile Data Computer	133
Fire Portable Radio Replacement	131
Fire Communication Computer System	201
Homer Avenue Undercrossing	3,178
Library Master Plan Project	974
Roth Building Wings	1,307
Arastradero Preserve Gateway	207
Embarcadero Pedestrian/bike bridge	1,420
Downtown Parking Structure	32,327
Police Building Project	598
San Mateo Drive Bridges	108
Civic Center Infrastructure	548
Fire Station Improvements	155
Interior Finishes Construction	122
Park Facilities Improvement	1,411
Park Backflow Replacement & Irrigation	518
San Antonio/101 Sign	234
Sidewalk Repairs	172
Vehicle Replacement Fund	599
Computer Equipment Replacement Fund	1,329
Other construction in progress	<u>1,271</u>
 Total governmental construction in progress	 <u><u>\$48,250</u></u>
Enterprise Funds:	
Storm drainage structural and water quality improvements	\$206
Gas system extension replacements and improvements	1,417
Water system extension replacements and improvements	1,542
Electric distribution system improvements	1,587
Other electrical improvement projects	8,820
Water quality control plant equipment replacement and lab facilities	284
Sewer system rehabilitation and extensions	8,761
Other construction in progress	<u>49,531</u>
 Total enterprise construction in progress	 <u><u>\$72,148</u></u>

Allocations of Enterprise Fund administration and general expenses of \$3.18 million have been capitalized and included in amounts expended to June 30, 2004.

Note 7.....

GENERAL LONG-TERM OBLIGATIONS

The City's Long -Term Obligations

Bond discounts and issuance costs of long-term debt issues are amortized over the life of the related debt. Gains or losses between the net book value of debt and funds placed in escrow to defease that debt are amortized over the remaining life of either the refunded debt or the refunding debt, whichever is shorter.

The City's long-term debt issues and transactions, other than Special Assessment debt discussed in Note 8, were as follows (in thousands):

	Original Issue Amount	Balance June 30, 2003	Retirements	Balance June 30, 2004	Current Portion
Governmental Activity Debt:					
<i>General Long Term Obligations:</i>					
1998 Golf Course Certificates of Participation, 4.00-5.00%, due 09/01/2018	\$7,750	\$6,235	\$270	\$5,965	\$285
2002A Civic Center Refinancing Certificates of Participation, 2.00-4.00%, due 03/01/2012	3,500	3,200	315	2,885	325
2002B Downtown Parking Improvements Certificates of Participation 4.55-6.00%, due 03/01/2022	3,555	3,470	105	3,365	110
	<u>14,805</u>	<u>12,905</u>	<u>690</u>	<u>12,215</u>	<u>720</u>
<i>Internal Service Long Term Obligations:</i>					
Information Systems Capital Lease Obligations, 10.46%, due 8/2/2004	128	57	32	25	25
Total Governmental Activity Debt	<u>\$14,933</u>	<u>\$12,962</u>	<u>\$722</u>	<u>\$12,240</u>	<u>\$745</u>
Business-type Activity Debt:					
<i>Enterprise Long Term Obligations:</i>					
Utility Revenue Bonds,					
1995 Series A, 5.0-6.25%, due 06/01/2020	\$8,640	\$7,055	\$250	\$6,805	\$265
1999 Refunding, 3.25-5.25%, due 06/01/24	17,735	16,320	385	15,935	406
2002 Series A, 3.00-5.00%, due 06/01/23	26,055	24,035	675	23,360	696
Less: unamortized discount/ issuance cost		(1,341)	(103)	(1,238)	
	<u>\$52,430</u>	<u>\$46,069</u>	<u>\$1,207</u>	<u>\$44,862</u>	<u>\$1,367</u>

Description of the City's Long-Term Debt Issues

1998 Golf Course COPS- In August 1998, the City's Public Improvement Corporation issued Golf Course Improvement COPS, Series 1998 in the amount of \$7.75 million to retire the 1978 Golf Course Lease Revenue Bonds, and to finance various improvements at the Palo Alto Public Golf Course, including upgrading five fairways and various traps, trees and greens, constructing new storm drain facilities, replacing the existing irrigation system, upgrading the driving range, and installing new cart paths. The 1998 COPS are secured by lease revenues received by the Public Improvement Corporation from golf course revenues or other unrestricted revenues of the City. Principal and interest are payable semi-annually each March 1 and September 1.

2002A Civic Center Refinancing COPS - On January 16, 2002 the City issued \$3.5 million of COPS to refund the City's 1992 COPS which were subsequently retired. Principal payments for the 2002A COPS are due annually on March 1 and interest payments semi-annually on March 1 and September 1 and are payable from lease revenues received by the Palo Alto Public Improvement Corporation from the City from available funds.

2002B Downtown Parking Improvement Project COPS - On January 16, 2002 the City issued \$3.555 million of COPS to finance the construction of certain improvements to the non-parking area contained in the City's Bryant /Florence Garage complex. Principal payments are due annually on March 1 and interest payments semi-annually on March 1 and September 1 from 4.55% - 6.5%, and are payable from lease revenues received by the Palo Alto Public Improvement Corporation from the City from available funds.

Information Systems Capital Lease - In fiscal year 2000-01, the City signed a lease to finance the acquisitions of certain information systems hardware and software. Debt service is repayable from the Technology Internal Service Fund revenues.

1995 Utility Revenue Bonds, Series A - The City issued Utility Revenue Bonds on February 1, 1995 to finance certain extensions and improvements to the City's Storm Drainage and Surface Water System. The Bonds are special obligations of the City payable solely from and secured by a pledge of and lien upon the revenues derived by the City from the funds, services and facilities of all Enterprise Funds except the Refuse Fund. Principal payments are payable annually on June 1 and interest payments semi-annually on June 1 and December 1. A \$2.86 million 6.25% term bond is due June 1, 2020. In lieu of a reserve fund, the Bonds are secured by a Surety Bond issued by AMBAC Indemnity Corporation.

1999 Utility Revenue and Refunding Bonds, Series A - The City issued Utility Revenue Bonds on June 1, 1999 to refund the 1990 Utility Revenue Refunding Bonds, Series A and the 1992 Utility Revenue Bonds, Series A, and to finance rehabilitation of the Wastewater Treatment System's two sludge incinerators. The 1990 Utility Revenue Refunding Bonds, Series A and the 1992 Utility Revenue Bonds, Series A, were subsequently retired.

The 1999 Bonds are special obligations of the City payable solely from and secured by a pledge of and lien upon certain net revenues derived by the City’s Sewer System and its storm and surface water system (the “Storm Drain System”). As of June 30, 2001, the 1999 Bonds had been allocated to and were repayable from net revenues of the following enterprise funds: Wastewater Collection (10.2%), Wastewater Treatment (64.6%) and Storm Drain (25.2%). Principal payments are payable annually on June 1 and interest payments semi-annually on June 1 and December 1. A \$3.125 million 5.25% term bond, and a \$5.12 million 5.25% term bond are due June 1, 2021 and 2024, respectively. In lieu of a reserve fund, the Bonds are secured by a Surety Bond issued by AMBAC Indemnity Corporation.

2002 Utility Revenue Bonds, Series A – On January 24, 2002 the City issued Utility Revenue Bonds to finance certain improvements to the City’s water utility system, and the City’s natural gas utility system. Principal payments are due annually on June 1 and interest payments are due semi-annually on June 1 and December 1 from 3% to 5%. The 2002 Revenue Bonds are secured by net revenues generated by the Water Services and Gas Services Funds.

Debt Service Requirements (in thousands):

Debt service and capitalized lease requirements are shown below for all long-term debt.

For the Year Ending June 30	Governmental Activities		Business-Type Activities	
	Principal	Interest	Principal	Interest
2005	\$745	\$580	\$1,367	\$2,256
2006	740	555	1,410	2,203
2007	770	528	1,465	2,147
2008	805	497	1,525	2,088
2009	835	464	1,590	2,025
2010-2014	3,920	1,741	9,095	8,968
2015-2019	3,580	823	11,564	6,493
2020-2024	845	113	14,884	3,174
2025-2026			3,200	242
Total	<u>\$12,240</u>	<u>\$5,301</u>	46,100	<u>\$29,596</u>

Reconciliation of long-term debt

Less unamortized original issue discount	<u>(1,238)</u>
Net long-term debt	<u>\$44,862</u>

Debt Call Provisions

Long-term debt as of June 30, 2004 is callable on the following terms and conditions:

	<u>Initial Call Date</u>
<i>Governmental Activities Long-Term</i>	
1998 Certificates of Participation	09/01/2008 (3)
2002B Certificates of Participation	03/01/2011 (2)
<i>Business-Type Activities Long-Term</i>	
Utility Revenue Bonds -	
1995 Series A	06/01/2004 (1)
1999 Refunding	06/01/2009 (1)
2002 Series A	06/01/2012 (1)

- (1) Callable in inverse numerical order of maturity at par plus a premium of 2% beginning on the initial call date. The call price declines subsequent to the initial date.
- (2) Callable in any order specified by the City at par plus a premium of 1% beginning on the initial call date. The call price declines subsequent to the initial date.
- (3) Callable in any order specified by the Trustee at par plus a premium of 1% beginning on the initial call date. The call price declines subsequent to the initial date.

Leasing Arrangements

COPS and Capital Leases are issued for the purpose of financing the construction or acquisition of projects defined in each leasing arrangement. Projects are leased to the City for lease payments which, together with unspent proceeds of the leasing arrangement, will be sufficient to meet the debt service obligations of the leasing arrangement. At the termination of the leasing arrangement title to the project will pass to the City.

Leasing arrangements are similar to debt; they allow investors to participate in a share of guaranteed payments which are made by the City. Because they are similar to debt, the present value of the total of the payments to be made by the City is recorded as long-term debt. The City’s leasing arrangements are included in long-term obligations discussed above.

Conduit Financing

On December 15, 1996, the City acted as a financial intermediary in order to assist Lytton Gardens Health Care Center in issuing Insured Revenue Refunding Bonds. The Bonds are payable solely from revenues collected by Lytton Gardens Health Care Center. The City has not included these Bonds in its basic financial statements since it is not legally or morally obligated for the repayment of the Bonds. At June 30, 2004 the amount of Bonds outstanding was \$10.455 million.

Note 8.....

SPECIAL ASSESSMENT DEBT

Special Assessment Debt with City Commitment

Special assessment districts exist in the City to provide improvements to properties located in those districts. Properties are assessed for the cost of improvements; these assessments are payable over the term of the debt issued to finance the improvements. The total amount of the assessment is recorded as a receivable and deferred revenue at the time the related debt is issued, and reduced as assessments are collected. The City is obligated to be the purchaser of last resort or to advance available City funds to repay this debt in the event of default by any of these districts. At June 30, 2004 the district was in compliance with the repayment and other requirements of its respective debt issue. The City accounts for resources available to pay special assessment debt in a Debt Service Fund. The special assessment debt is included in the City's Governmental Activities long-term debt.

Special assessment debt with City commitment comprises the following issues (in thousands):

	Original Issue Amount	Balance June 30, 2003	Retirements	Balance June 30, 2004	Current Portion
Governmental Activity Debt					
1987 California Avenue Parking, 6.70-9.25%, due 09/02/2007	\$1,325	\$510	\$90	\$420	\$95

Special assessment debt service requirements, including principal and interest, are as follows (in thousands):

For the Year Ending June 30	Governmental Activities	
	Principal	Interest
2005	\$95	\$28
2006	100	21
2007	110	13
2008	115	5
Total	\$420	\$67

Description of Special Assessment Debt with City’s Commitment

1987 California Avenue Parking Assessment District Assessment Bonds – The City issued Special Assessment Bonds on April 13, 1987 to finance the acquisition of land and related improvements for the purpose of providing public parking in the City. Principal payments are payable annually on September 2 and interest payments semi-annually on March 2 and September 2.

Special Assessment Debt with no City Commitment

The California Avenue Parking Assessment District No. 92-13 issued Assessment Bonds of 1993, but the City has no legal or moral liability with respect to the payment of this debt, which is secured only by assessments on the properties in this District. Therefore, this debt is not included in Governmental Activities long-term debt of the City. At June 30, 2004, the District’s outstanding debt amounted to \$1.465 million.

The University Avenue Area Off-Street Parking Assessment District issued Assessment Bonds of Series 2001-A, but the City has no legal or moral liability with respect to the payment of this debt, which is secured only by assessments on the properties in the District. Therefore, this debt is not included in Governmental Activities long-term debt of the City. At June 30, 2004, the District’s outstanding debt amounted to \$9.120 million. A portion of the proceeds from the 2001 Bonds amounting to \$3.2 million was used to defease the 1977 University Avenue Area Off-Street Parking Assessment District Bonds and the 1989 University Avenue Area Off-street Parking Assessment District Refunding and Improvement Bonds.

The University Avenue Area Off-Street Parking Assessment District issued Assessment Bonds of Series 2002-A, but the City has no legal or moral liability with respect to the payment of this debt, which is secured only by assessments on the properties in the District. Therefore, this debt is not included in Governmental Activities long-term debt of the City. At June 30, 2004, the District’s outstanding debt amounted to \$35.460 million.



Note 9.....

LANDFILL CLOSURE AND POST-CLOSURE CARE

State and Federal laws and regulations require the City to place a final cover on the remaining open areas of the Palo Alto Refuse Disposal Site when it stops accepting waste and to perform certain maintenance and monitoring functions at the site for thirty years after closure. Closure costs of \$1.561 million were reported in fiscal 1991-92, when a section of the refuse area was capped with a final cover and Byxbee Park was constructed on top of that section. A second section of the refuse area was capped with a final cover during fiscal year 1992-93, with closure costs of \$904 thousand. The remaining closure and post-closure care costs are expected to be paid only near and after the date that the refuse site stops accepting waste.

An updated cost estimate for the landfill closure and post-closure, based on landfill capacity, was performed during 2001. The estimates of these costs were based upon 2001 cost and are adjusted annually for inflation as mandated by the State of California. The 2004 amount is \$6.555 million. Currently, 90.1 percent of the landfill capacity has been used to date.

Total cost estimates are based on what it would cost to perform all currently mandated closure and post-closure care in 2001. The City expects to close the refuse area in the year 2013. Actual closure and post-closure care costs may be higher due to inflation variances, changes in technology, or changes in State or Federal regulations.

The City is required by State and federal laws and regulations to make annual funding contributions to finance closure and post-closure care. The City is in compliance with these requirements for the year ended June 30, 2004 with the establishment of the fully-funded liability for this purpose.

Note 10.....

NET ASSETS AND FUND BALANCES

Net Assets

Net assets are the excess of all the City’s assets over all its liabilities, regardless of fund. Net assets are divided into three categories under GASB Statement 34. These categories apply only to net assets, and are described below:

Invested in Capital Assets, net of related debt describes the portion of net assets which is represented by the current net book value of the City’s capital assets, less the outstanding balance of any debt issued to finance these assets.

Restricted describes the portion of net assets which is restricted as to use by the terms and conditions of agreements with outside parties, governmental regulations, laws, or other restrictions which the City cannot unilaterally alter. These principally include bond proceeds received for use on capital projects, debt service requirements, and special revenue programs subject to limitations defined regulations and laws underlying such programs.

Unrestricted describes the portion of net assets which is not restricted as to use.

Fund Balances, Reserves and Designations

In the Fund financial statements, fund balances represent the net current assets of each fund. Net current assets generally represent a fund’s cash and receivables, less its liabilities. Portions of a fund’s balance may be reserved or designated for future expenditure.

At June 30, 2004, Governmental Funds reservations and designations included (in thousands):

	Major Funds			Non-Major Funds
	General Fund	Housing In Lieu Fund	Capital Projects Fund	
Reserved for:				
Encumbrances	\$2,973	\$940	\$9,314	\$796
Downtown parking structure			1,300	
Notes	1,256	7,312		4,667
Inventory of materials and supplies	2,506			
Debt service				1,461
Total Reserved Fund Balance	\$6,735	\$8,252	\$10,614	\$6,924
Unreserved; designated for:				
Special revenue projects		2,625		4,080
Equity transfer stabilization	2,338			
Reappropriations	401	44	10,419	
Budget stabilization	21,467			
Infrastructure	35,881			
Total Unreserved/Designated Fund Balances	\$60,087	\$2,669	\$10,419	\$4,080



Reserve for **encumbrances** represents the portion of fund balance set aside for open purchase orders.

Reserve for **downtown parking structure** represents a portion of fund balance for the Downtown Parking Improvement Project. The project was funded with debt proceeds.

Reserves for **notes and inventory** are the portions of fund balance set aside to indicate these items do not represent available, spendable resources even though they are a component of assets.

Reserve for **debt service** is the portion of fund balance legally restricted for the payment of principal and interest on long-term liabilities.

Reserve for **debt proceeds** is the portion of fund balance legally restricted for the expenditure of bond proceeds on authorized project costs.

Designated for **unrealized gain on investments** is the portion of fund balance used to accumulate gains on the market values of investments.

Designated for **capital and special revenue projects** is the portion of fund balance for use on capital outlay projects.

Designated for **equity transfer stabilization** is the portion of fund balance to replace required equity transfer by Gas, or Electric Enterprise Funds in the event the fund was unable to make its required equity transfer.

Designated for **reappropriations** is the portion of fund balance set aside for subsequent years' appropriations.

Designated for **budget stabilization** is the portion of fund balance to be used to supplement the regular budget when unexpected events such as state government action, a downturn in the economy or a natural disaster reduces revenue or creates obligations that significantly impact the current year budget.

Designated for **infrastructure** is the portion of fund balance to be used for financing future capital improvements.

Internal Service Funds

At June 30, 2004, internal service fund net assets reservations and designations included (in thousands):

Reserved net assets-	
Commitments and reappropriations	\$2,433
Unreserved:	
Designated for:	
Future catastrophic losses	3,852
Retiree health care	18,178
Interfund advances/payables	132
Undesignated	18,755
	<hr/>
Net assets unrestricted	\$43,350
	<hr/> <hr/>

Reserve for **commitments and reappropriations** represents the portion of net assets set aside for open purchase orders.

Designated for **future catastrophic losses** is the portion of net assets to be used for unforeseen future losses.

Designated for **retiree health care** represents the portion of net assets set aside to defer future costs of retiree health care coverage.

Enterprise Funds

At June 30, 2004, Enterprise Fund net assets reservations included (in thousands):

	<u>Water</u>	<u>Electric</u>	<u>Gas</u>	<u>Wastewater Collection</u>	<u>Wastewater Treatment</u>	<u>Refuse</u>	<u>Storm Drainage</u>	<u>External Services</u>	<u>Total</u>
Reserved net assets:									
Rate stabilization									
Supply		\$58,562	\$6,822						\$65,384
Distribution		7,557	6,703						14,260
Operations	\$6,178			\$2,723	\$4,625	\$6,135	\$336		19,997
	6,178	66,119	13,525	2,723	4,625	6,135	336		99,641
Emergency plant replacement	1,129	2,451	896	555	1,719				6,750
Calaveras		70,464							70,464
Reappropriations	13,622	8,758	1,146	7,995	2,233	997	235		34,986
Commitments	2,163	7,698	3,946	2,329	2,951	786	46	\$1	19,920
Restricted bond proceeds					72				72
Conservation loan			34						34
Underground loan		664							664
Refuse Water Resources Board						590			590
Shasta rewind loan		64							64
Public benefit program		2,082							2,082
Central Valley Project		149							149
Debt Service	777		948						1,725
External Service - Information Technology								2	2
Total	\$23,869	\$158,449	\$20,495	\$13,602	\$11,600	\$8,508	\$617	\$3	\$237,143

The City Council has committed unreserved net assets for general contingencies, future capital and debt service expenditures including operating and capital contingencies for unusual or emergency expenditures.



Note 11.....

PENSION PLANS

CALPERS Safety and Miscellaneous Employees Plans

Substantially all permanent City employees are eligible to participate in pension plans offered by California Public Employees Retirement System (CALPERS) an agent multiple employer defined benefit pension plan which acts as a common investment and administrative agent for its participating member employers. CALPERS provides retirement and disability benefits, annual cost of living adjustments and death benefits to plan members, who must be public employees and beneficiaries. The City’s employees participate in the separate Safety (police and fire) and Miscellaneous (all other) Employee Plans. Benefit provisions under both Plans are established by State statute and City resolution. Benefits are based on years of credited service, equal to one year of full time employment. Funding contributions for both Plans are determined annually on an actuarial basis as of June 30 by CALPERS. The City contributes these amounts and has no pension benefit obligation.

The Plans’ provisions and benefits in effect at June 30, 2004, are summarized as follows:

	Safety		Miscellaneous
	Police	Fire	
Benefit vesting schedule	5 years service	5 years service	5 years service
Benefit payments	monthly for life	monthly for life	monthly for life
Retirement age	50	50	50
Monthly benefits, as a % of annual salary	3%	3%	1.426-2.418%
Required employee contribution rates	9%	9%	7%
Required employer contribution rates	21.312%	7.775%	0%

The City’s labor contracts require it to pay employee contributions as well as its own.

CALPERS determines contribution requirements using a modification of the Entry Age Normal Method. Under this method, the City’s total normal benefit cost for each employee from date of hire to date of retirement is expressed as a level percentage of the related total payroll cost. Normal benefit cost under this Method is the level amount the employer must pay annually to fund an employee’s projected retirement benefit. This level percentage of payroll method is used to amortize any unfunded actuarial liabilities. The actuarial assumptions used to compute contribution requirements are also used to compute the actuarial accrued liability. The City does not have a net pension obligation since it pays these actuarially required contributions monthly.

CALPERS uses the market related value method of valuing the Plan’s assets. An investment rate of return of 8.25 percent is assumed, including inflation at 3.5 percent. Annual salary increases are assumed to vary by duration of service. Changes in liability due to plan amendments, changes in actuarial assumptions, or changes in actuarial methods are amortized as a level percentage of payroll on a closed basis over twenty years. Investment gains and losses are accumulated as they are realized and ten percent of the net balance is amortized annually.

The Plans’ actuarial value (which differs from market value) and funding progress over the most recently available three years is set forth below at their actuarial valuation date of June 30, 2002 (in thousands):

Safety Police Plan:

Actuarial						
Valuation Date	Entry Age Accrued Liability	Value of Assets	Unfunded (Overfunded) Liability	Funded Ratio	Annual Covered Payroll	Unfunded (Overfunded) Liability as a % of Payroll
2000	\$70,289	\$69,998	\$291	99.6%	\$6,858	4.2%
2001	74,102	72,195	1,907	97.4%	7,007	27.2%
2002	79,375	68,767	10,608	86.6%	7,426	142.8%

Safety Fire Plan:

Actuarial						
Valuation Date	Entry Age Accrued Liability	Value of Assets	Unfunded (Overfunded) Liability	Funded Ratio	Annual Covered Payroll	Unfunded (Overfunded) Liability as a % of Payroll
2000	\$87,651	\$104,220	(\$16,569)	118.9%	\$8,805	(188.2%)
2001	95,116	106,757	(11,641)	112.2%	10,426	(111.7%)
2002	103,493	101,355	2,138	97.9%	10,871	19.7%

Miscellaneous Plan:

Actuarial						
Valuation Date	Entry Age Accrued Liability	Value of Assets	Unfunded (Overfunded) Liability	Funded Ratio	Annual Covered Payroll	Unfunded (Overfunded) Liability as a % of Payroll
2000	\$194,552	\$262,285	(\$67,733)	134.8%	\$47,866	(141.5%)
2001	211,510	272,025	(60,515)	128.6%	51,933	(116.5%)
2002	235,232	258,317	(23,085)	109.8%	57,445	(40.2%)

Audited annual financial statements and ten-year trend information are available from CALPERS at P.O. Box 942709, Sacramento, CA 94229-2709.

PERS has reported that the value of the net assets in the Plans held for Pension Benefits changed as follows during the year ended June 30, 2002 (in thousands):

	Safety		
	Police	Fire	Miscellaneous
Actuarial Value of Assets 6/30/01	\$72,195	\$106,757	\$272,025
Contributions received	1,439	2,051	4,300
Benefits and Refunds Paid	(3,162)	(4,519)	(8,916)
Transfers & Miscellaneous Adjustments	135	(22)	(2,498)
Expected Investment Earnings Credited	5,892	8,707	22,154
Expected Actuarial Value of Assets 6/30/02	<u>\$76,499</u>	<u>\$112,974</u>	<u>\$287,065</u>
Market Value of Assets 6/30/02	<u>\$62,516</u>	<u>\$92,141</u>	<u>\$234,833</u>
Actuarial Value of Assets 6/30/02	<u>\$68,767</u>	<u>\$101,355</u>	<u>\$258,317</u>

Additional disclosures will be included when made available by PERS.

Actuarially required contributions for all plans for fiscal years 2004, 2003, and 2002 were, \$7.887, \$3.587, and \$5.313, million, respectively. The City made these contributions as required, together with certain immaterial amounts required as the result of the payment of overtime and other additional employee compensation.

Note 12.....

RETIREE HEALTH BENEFITS

In addition to providing pension benefits, the City participates in the California Public Employees Medical and Health Care Act program to provide certain health care benefits for retired employees. Substantially all of the City’s employees may become eligible for those benefits if they reach normal retirement age while working for the City. The costs of retiree health care are recognized as expenditures when premiums are paid. For fiscal year 2003-04, expenditures for retiree health care for approximately 565 eligible retired employees totaled \$2.804 million, including administrative fees. The premium is based upon an average annual cost of coverage per retiree of \$5 thousand.

In the fiscal year ended June 30, 1993, the City received a \$6.1 million refund from the California Public Retirement System (“CALPERS”) through the passage of Assembly Bill (AB) 702. This amount was placed in a separate fund to defer future costs of retiree health care coverage. During the fiscal year ended June 30, 1995, the City established and transferred the amount to a separate fund which is now accounted for as an Internal Service Fund.

The City pays annual retiree medical premiums out of its operating budget. In 2001, Aon Consulting performed a valuation on the retiree medical benefit and determined an actuarial liability of \$93.5 million. Since the City has saved \$14.0 million towards that liability, the unfunded portion is \$79.5 million. However, Aon did not incorporate the value of the City’s continued savings toward that liability, which has ranged in the \$1.1 to \$2.0 million per year range. Assuming this rate of savings continues, the unfunded liability would be reduced to the \$60 million range. Staff is evaluating various options for both reducing the liability and saving the required funds to address it. Because of the magnitude of the liability, staff budgets retiree medical expenses through its benefit allocations. As a result, the interest earnings for the year totaled \$67 thousand, bringing the balance to \$18.178 million. This interest earnings is recorded in the Retiree Health Benefit Internal Service Fund.

The Retiree Fund’s net assets consist of the following for the fiscal year ended June 30, 2004 (in thousands):

Retiree Health Benefits	2004	2003
Net assets, beginning of year	\$18,111	\$16,448
Interest earnings	789	807
Unrealized gain (loss) on investments	(722)	256
Interdepartmental charges		600
Net assets, end of year	<u>\$18,178</u>	<u>\$18,111</u>



Note 13.....

DEFERRED COMPENSATION PLAN

City employees may defer a portion of their compensation under City sponsored Deferred Compensation Plans created in accordance with Internal Revenue Code Section 457. Under these Plans, participants are not taxed on the deferred portion of their compensation until distributed to them; distributions may be made only at termination, retirement, death or in an emergency as defined by the Plans.

The laws governing deferred compensation plan assets now require plan assets to be held by a Trust for the exclusive benefit of plan participants and their beneficiaries. Since the assets held under these plans are not the City’s property and are not subject to City control, they have been excluded from these financial statements.

Note 14.....

RISK MANAGEMENT

Coverage

The City provides dental coverage to employees through programs which are administered by a service agent. The City is self-insured for the dental coverage.

The City has a workers’ compensation insurance policy with coverage up to the statutory limit set by the State of California. The City retains the risk for the first \$750 thousand in losses for each accident and employee under this policy.

The City also has public employee dishonesty insurance with a \$5 thousand deductible and coverage up to \$1 million per loss. The City’s property and machinery insurance policy has various deductibles and various coverages based on the kind of machinery.

The City is a member of the Authority for California Cities Excess Liability (ACCEL) which provides general liability, including auto liability, insurance coverage up to \$22 million per occurrence. The City retains the risk for the first \$1 million in losses for each occurrence under this policy.

ACCEL was established for the purpose of creating a risk management pool for central California municipalities. ACCEL is governed by a Board of Directors consisting of representatives of its member cities. The board controls the operations of ACCEL, including selection of management and approval of the annual budget.

The City’s deposits with ACCEL equal the ratio of the City’s payroll to the total payrolls of all entities. Actual surpluses or losses are shared according to a formula developed from overall loss costs and spread to member entities on a percentage basis after a retrospective rating.

During the fiscal year ended June 30, 2004 the City contributed \$513 thousand to ACCEL for current year coverage.

Audited financial statements are available from ACCEL at 160 Spear Street, San Francisco, California 94105.

Claims Liability

The City provides for the uninsured portion of claims and judgments in the General Benefits and Insurance Internal Service Fund. Claims and judgments, including a provision for claims incurred but not reported, are recorded when a loss is deemed probable of assertion and the amount of the loss is reasonably determinable. As discussed, above, the City has a coverage for such claims, but it has retained the risk for the deductible, or uninsured portion of these claims.

The City’s liability for uninsured claims is limited to dental, general liability, and workers’ compensation claims, as discussed above, and was estimated by management based on prior years claims experience as follows as of June 30 (in thousands):

	Year Ended June 30	
	2004	2003
Beginning Balance	\$9,253	\$8,025
Liability for current and prior fiscal year claims and claims incurred but not reported (IBNR)	5,383	4,727
Claims paid	(4,088)	(3,499)
Ending Balance	<u>\$10,548</u>	<u>\$9,253</u>



Note 15.....

JOINT VENTURES

General

The City participates in joint ventures through Joint Powers Authorities (JPAs) established under the Joint Exercise of Powers Act of the State of California. As separate legal entities, these JPAs exercise full powers and authorities within the scope of the related Joint Powers Agreement, including the preparation of annual budgets, accountability for all funds, the power to make and execute contracts and the right to sue and be sued. Obligations and liabilities of the JPAs are not those of the City.

Each JPA is governed by a board consisting of representatives from each member agency. Each board controls the operations of its respective JPA, including selection of management and approval of operating budgets, independent of any influence by member agencies beyond their representation on the Board.

Northern California Power Agency

The City is a member of Northern California Power Agency (NCPA), a joint powers agency which operates under a joint powers agreement among fifteen public agencies. The purpose of NCPA is to use the combined strength of its members to purchase, generate, sell and interchange electric energy and capacity through the acquisition and use of electrical generation and transmission facilities. Each agency member has agreed to fund a pro rata share of certain assessments by NCPA and enter into take-or-pay power supply contracts with NCPA. While NCPA is governed by its members, none of its obligations are those of its members unless expressly assumed by them.

During the year ended June 30, 2004, the City incurred expenses totaling \$14.727 million for purchased power and assessments earned by NCPA.

The City's interest in NCPA projects and reserves, as computed by NCPA, was \$3.082 million at June 30, 2004. This amount represents the City's portion of funds which resulted from the settlement with third parties of issues with financial consequences and reconciliations of several prior years' budgets for programs. It is recognized that all the funds credited to the City are linked to the collection of revenue from the City's ratepayers, or to the settlement of disputes relating to electric power supply and that the money was collected from the City's ratepayers to pay power bills. Additionally, the NCPA Commission identified and approved the funding of specific reserves for working capital, accumulated employees post-retirement medical benefits, and billed property taxes for the geothermal project. The Commission also identified a number of contingent liabilities that may or may not be realized, the cost of which in most cases is difficult to estimate at this time. One such contingent liability is the steam field depletion which will require funding to cover debt service and operational costs in excess of the expected value of the electric power. The General Operating Reserve is intended to minimize the number and amount of individual reserves needed for each project, protect NCPA's financial condition and maintain its credit worthiness. These funds are available on demand, but the City has left them with NCPA as a reserve against these contingencies identified by NCPA.

Members of NCPA may participate in an individual project of NCPA without obligation for any other project. Member assessments collected for one project may not be used to finance other projects of NCPA without the member's permission.

Geothermal Projects

A purchased power agreement with NCPA obligated the City for 6.158% and 6.158%, respectively, of the operating costs and debt service of the two NCPA 110-megawatt geothermal steam powered generating plants, Project Number 2 and Project Number 3.

The City's participation in the Geothermal Project was sold to Turlock Irrigation District in October 1984. Accordingly, the City is liable for payment of outstanding geothermal related debt only in the event that Turlock fails to make specified payments. Total outstanding debt of the NCPA Geothermal Project at June 30, 2004 is \$261.349 million. The City's participation in this project was 6.158%, or \$16.094 million.

NCPA's Geothermal Project has experienced a greater than originally anticipated decline in steam production from geothermal wells on its leasehold property. Results of the continuing well analysis program indicate that the potential productive capacity of the geothermal steam reservoir is less than originally estimated. Therefore, NCPA has modified the operations of the Geothermal Project to reduce the average annual output from past levels. As a result, the per unit cost of energy generated by the projects will be higher than anticipated.

NCPA will continue to monitor the wells while pursuing alternatives for improving and extending reservoir performance, including supplemental water re-injection, plant equipment modifications, and changes in operating methodology. NCPA, along with other steam field operators, has observed a substantial increase in steam production in the vicinity of re-injection wells and is attempting to increase water re-injection at strategic locations. NCPA, other steam developers, and the Lake County Sanitation District are constructing a wastewater pipeline project that will greatly increase the amount of water available for re-injection.

Calaveras Hydroelectric Project

In July 1981, NCPA agreed with Calaveras County Water District to purchase the output of the North Fork Stanislaus River Hydroelectric Development Project and to finance its construction. Debt service payments to NCPA began in February 1990 when the project was declared substantially complete and power was delivered to the participants. Under its power purchase agreement with NCPA, the City is obligated to pay 22.92% of this Project's debt service and operating costs. At June 30, 2004, the book value of this Project's plant, equipment and other assets was \$517.398 million, while its long-term debt totaled \$514.127 million and other liabilities totaled \$978 thousand. The City's share of the Project's long term-debt amounted to \$117.838 million at that date.

In April 1991, the City signed an agreement with the City of Roseville to sell a 6.52% portion of its capacity share of NCPA's Calaveras hydroelectric plant for a period of 14 years. Under the terms of the sale agreement, Roseville pays all the operation and maintenance costs associated with 6.52% of the plant. In addition, Roseville will also pay the City a portion of the net debt service obligations of the current long-term debt associated with the



Hydroelectric Project No. 1. However, if Roseville defaults, the City is secondarily liable for the outstanding debt service obligations.

Geothermal Public Power Line

In 1983, NCPA, Sacramento Municipal Utility District, the City of Santa Clara and the Modesto Irrigation District (joint owners) initiated studies for a Geothermal Public Power Line (GPPL) which would carry power generated at several existing and planned geothermal plants in the Geysers area to a location where the joint owners could receive it for transmission to their load centers. NCPA has an 18.5% share of this Project and the City has an 11.0736% participation in NCPA's share. In 1989, the development of the proposed Geothermal Public Power Line was discontinued because NCPA was able to contract for sufficient transmission capacity to meet its needs in the Geysers. However, because the project financing provided funding for an ownership interest in a PG&E transmission line, a central dispatch facility and a performance bond pursuant to the Interconnection Agreement with PG&E, as well as an ownership interest in the proposed GPPL, NCPA issued \$16 million in long-term, fixed-rate revenue bonds in November 1989 to defease the remaining variable rate refunding bonds used to refinance this project. The City is obligated to pay its 11.0736% share of the related debt service, but debt service costs are covered through NCPA billing mechanisms that allocate the costs to members based on use of the facilities and services.

At June 30, 2004, the book value of this Project's plant, equipment and other assets was \$5.533 million, while its long term debt totaled \$4.759 million. The City's share of the Project's long-term debt amounted to \$527 thousand at that date.

Northwest Power Purchase Contract

The City's participation with other NCPA members in a long-term contract for purchase of power from the Washington Water Power Company was approved in 1993. At that date the City did not have a share of the Project's long-term debt. On February 1, 1997, the NCPA issued \$18.310 million in Northwest Resource Revenue Bonds. The proceeds were used to finance a portion of a payment made under the Northwest Power Purchase Contract and costs of issuance of the debt. Under the NCPA Agreement for Financing Electric Capacity, the City was obligated to pay 13.61% of this debt service. At June 30, 2004 the book value of this Project's plant, equipment and other assets was \$9.955 million, while its long-term debt was retired.

NCPA Financial Information

NCPA's financial statements can be obtained from NCPA, 180 Cirby Way, Roseville, CA 95678.

Transmission Agency of Northern California (TANC)

The City is a member of a joint powers agreement with 14 other entities in the Transmission Agency of Northern California (TANC). TANC's purpose is to provide electrical transmission or other facilities for the use of its members. While governed by its members, none of TANC's obligations are those of its members unless expressly assumed by them. The City is obligated to pay 4% of TANC's debt-service and operating costs.

According to the 1985 Project Agreement with TANC for the development of the California-Oregon Transmission Project (COTP) and subsequent related project agreements, the City is obligated to pay its share of the project's costs, including debt service and is entitled to the use of a percentage of the project's transmission or transfer capacity. TANC has issued four series of Revenue Bonds and Commercial Paper Notes totaling \$440.112 million as of June 30, 2004. The City's share of this debt is \$17.604 million.

Construction of the COTP was complete as of June 30, 1993. The transmission line was energized March 24, 1993. Because funding of certain project participants' shares in the project was needed pending approval of their applications for participation, TANC issued \$93.781 million of Commercial Paper debt backed by a Letter of Credit. The City's share of the Commercial Paper was \$1.295 million at June 30, 2004, which is included in the share of debt discussed above. Shares and obligations of the existing participants could increase pending final project subscription.

TANC Financial Information

TANC's financial statements can be obtained from TANC, P.O. Box 15129, Sacramento, CA 95851.

Note 16.....

COMMITMENTS AND CONTINGENCIES

Palo Alto Unified School District – The City leases the former Cubberley School site and eleven extended day care sites from the Palo Alto Unified School District (PAUSD). The lease is part of a larger agreement which includes a covenant not to develop certain properties owned by the PAUSD. The lease term expires in December 2004 with an option for an additional ten year term. The City’s rent for the facilities is \$4.963 million per year plus insurance, repairs and maintenance work to be completed, which are not to exceed \$250 thousand per year. This lease is cancelable upon 90 days’ written notice in the event funds are not appropriated by the City. In addition, the lease is contingent upon authorization by the Palo Alto electorate if it exceeds the City’s Proposition 4 (Gann) appropriations limitation in any fiscal year. Lease expenditures for the year ended June 30, 2004 amounted to \$5.820 million.

Future minimum annual lease and covenant payments are as follows (in thousands):

<u>Year ending June 30:</u>	<u>Payments</u>
2005	\$5,966
2006	6,116
2007	6,299
2008	6,488
2009	6,680
2010-2015	44,498
	<u>\$76,047</u>

Palo Alto Sanitation Company – In 1999 the City, under the provisions of a new agreement, contracted with the Palo Alto Sanitation Company (PASCO) for services related to residential and commercial refuse collection, curbside recycling, and other operation special programs. The new agreement has a term of seven years and ten months from the effective date of September 1, 1999. The new contract revised the method by which compensation is paid to PASCO to be more in-line with the industry standard. The method establishes compensation based on the relationship between costs and profits and includes periodic performance reviews. In 2003-04 this resulted in payments to PASCO of \$8.356 million.

City of Palo Alto Regional Water Quality Control Plant – The cities of Palo Alto, Mountain View and Los Altos (the Partners) participate jointly in the cost of maintaining and operating the City of Palo Alto Regional Water Quality Control Plant and related system (the Plant). The City is the owner and administrator of the Plant which provides the transmission, treatment and disposal of sewage for the Partners. The cities of Mountain View and Los Altos are entitled to use a portion of the capacity of the Plant for a specified period of time. Each partner has the right to rent unused capacity from/to the other partners. The expenses of operations and maintenance are paid quarterly by each partner based on its pro rata share of treatment costs. Additionally, joint system revenues are shared by the partners in the same ratio as expenses are paid. The amended agreement has a term of fifty years beginning from the original signing in October 1968, but may be terminated by any partner upon ten years’ notice to the other partners. All sewage treatment property, plant and equipment are included in the Wastewater Treatment Enterprise Fund’s capital assets balance at June 30, 2004. If the City initiates the termination of the contracts, it is required to pay the other partners their unamortized contribution towards the capital assets.

Solid Waste Materials Recovery and Transfer Station (SMaRT Station) – On June 9, 1992, the City, along with the City of Mountain View, signed a Memorandum of Understanding (MOU) with the City of Sunnyvale (Sunnyvale) to participate in the construction and operation of the SMaRT station which recovers recyclable materials from the municipal solid waste delivered from participating cities. Per the MOU, the City has capacity share of 21.27 percent of this facility and reimburses its proportionate capacity share of design, construction, and operation costs to Sunnyvale.

On December 1, 1992, the Sunnyvale Financing Authority issued \$24.6 million in revenue bonds to finance the design and construction costs of the SMaRT Station. During the fiscal year ending June 30, 2003 the 1992 bonds were refunded by issuing the 2003 Solid Waste Revenue Bonds in the amount of \$20.575 million. Even though these bonds are payable from and secured by the net revenues of Sunnyvale's Utilities Enterprise, the City is obligated to reimburse Sunnyvale 21.27 percent of total debt service payments related to these bonds. The City's portion of remaining principal balance for SMaRT revenue bonds as of June 30, 2004 is \$4.158 million. During the year ended June 30, 2004, the City paid \$413 thousand as its portion of current debt service.

UTILITIES ENERGY RESOURCE MANAGEMENT

The Energy Markets in the United States and California

Electric and gas energy prices that have stabilized since the energy crisis during 2000-01, showed an uptick since January 2003. For example, the NYMEX natural gas futures price for January 2005 deliveries rose from \$4.50 in January 2003 to \$5.50 in January 2004, and to \$6.50/MMBtu in September 2004. This increase is closely tied to the rise in world crude oil prices. Rising natural gas prices have also triggered the doubling of coal prices in the U.S over the past 18 months, the primary fuel for electricity production in the U.S. The increase in national coal and natural gas prices has caused higher electricity prices, with forward prices of electricity in Northern California for the year 2005 rising from approximately 4.2¢/kWh in January 2003 to 5.1¢/kWh in September 2004.

The California Independent System Operator (CAISO) - the state's electric transmission grid operator, the California Public Utilities Commission (CPUC), and the Federal Energy Regulatory Commission (FERC) continue to forge ahead in their efforts to reform electricity markets to ensure reliability and spur economic growth. Ensuring that adequate generation and transmission resources are built competitively; mandating investor owned utilities to contract for supplies in the forward markets and reducing over-reliance on the spot energy market; and increasing transparency in transmission and energy markets are different facets of this reform. Though all stakeholders agree on the need for reform to ensure stable markets and avoid re-occurrence of the 2000-01 energy crisis, the CAISO is facing considerable resistance to the implementation of Locational Marginal Pricing (LMP) as a tool to achieve such reform.

Governor Schwarzenegger also has developed an energy plan. In his January 2004 State of the State speech, the Governor pinpointed the need for regulatory reform; reform of the wholesale power market to attract new energy investment; reform of the retail power market so large customers can get competitive prices; renegotiation of the high-priced electricity contracts that were locked in at the market's peak; and promotion of the State's commitment to the environment. The CPUC has acted on the Governor's request to accelerate resource adequacy requirements, and the Governor has also requested that the CPUC implement existing legislation (AB 57) that mandates a procurement process for investor owned utilities.

In spite of the emergence of Pacific Gas and Electric Company (PG&E) from bankruptcy protection on April 12, 2004 and the Governor's plan and various CPUC/CAISO initiatives for the re-establishment of a robust and healthy energy market in California, there still remains a lack of a cohesive energy policy. A failure to act quickly could result in another 2000-01 like energy crisis with rolling blackouts by 2006,

particularly since the nascent economic recovery has resulted in higher electric and natural gas loads in California. California electric loads in 2003-04 have increased by 2% compared to the prior year and has increased 5% since 2001-02. The electric loads at present are 2% above the all time highs experienced in year 2000.

Future Outlook

Electric

The City has entered into a number of new long-term electricity supply commitments to meet anticipated energy deficits caused by reduced energy availability from the Western Area Power Administration (Western) in January 2005. The Palo Alto City Council approved the Long-Term Electric Acquisition Plan ("LEAP") in October 2002 and the LEAP Implementation Plan in August 2003. LEAP is designed to meet the City's objectives of continuing to provide low and stable electric rates to retail customers. As part of LEAP, the City has negotiated a number of energy contracts with suppliers and has obtained a number of supply commitments. The City expects to meet 10% of its electricity needs from new renewable resources such as wind and landfill gas generation by 2008, with the target rising to 20% by 2015.

In conformance with LEAP Guidelines, the City is investigating the potential of setting local generation within City limits. A public outreach effort to gauge local support for such an initiative is underway. Depending upon the findings of the outreach efforts, the City Council is expected to make a decision in 2005 on whether to proceed with a detailed setting feasibility study.

The expiration of the current Western contract in December 2004 will result in higher energy costs. These higher costs have been incorporated into the City's long-term electric rate projections. Electric rates are projected to increase starting in January 2005. The City's electric rates, however, are projected to continue to be substantially lower than PG&E rates.

The Utility Department's energy procurement efforts conform to Council approved Energy Risk Management Policies. These include a formal oversight role (middle office) within the Administrative Services Department. A quarterly energy risk management report is provided to the Council as part of this oversight role. As of September 21, 2004, 19 of the 24 risk management program recommendations made by the City Auditor in her July 2002 audit report have been implemented.

As stated earlier, California's grid operator (CAISO) is in the process of implementing a number of initiatives with the goals of efficient operation of the transmission grid and creation of incentives for transmission grid investment. The initiative, formally known as Market Design 2002 (MD02), has recently been renamed Market Redesign and Technology Update (MRTU). The latest estimate for full implementation of MRTU is February 2007. An underlying component of MRTU is the use of LMP or location specific prices for the scheduling of energy transactions, which could lead to significant cost increases for transmission services for entities located in relatively transmission-congested areas such as the Bay Area. The City is actively participating in efforts to ensure fair market design and fair treatment of costs allocated to Bay Area municipal loads by the CAISO and regulatory agencies. The City also is working with the cities of Santa Clara and Alameda to advocate for higher electric transmission reliability standards and building additional transmission into the Bay Area.

Natural Gas

Declining production in the U.S. and Canada is barely being replaced by new drilling and as a result, gas prices in the range of \$6 per MMBtu are likely for the next few years. While liquefied natural gas (LNG) imports are expected to relieve prices somewhat, the impact of those imports will not be realized until 2007 at the earliest. Market price volatility has increased and is expected to remain high in the short term.

Staff completed and Council approved a Gas Utility Long-Term Plan (GULP). In the final report, staff made six recommendations that included: 1) Pursue any low-cost, high-value prospects to acquire supply-related resources that may arise from time to time, and (2) Develop comprehensive demand-side management goals and an implementation plan. (3) Do not contract for natural gas storage capacity at this time, (4) Do not acquire additional natural gas pipeline capacity at this time, (5) Undertake initial steps related to gas reserve acquisition, (6) Do not participate in a gas prepay deal at this time. As part of the GULP process, staff reviewed the gas commodity laddering strategy and implemented some revisions to the purchase plan.

Water

The outlook for water supply costs indicates an upward trend as the San Francisco Public Utilities Commission (SFPUC) embarks on a much delayed, but essential, upgrade to its wholesale facilities. In the November 2002 elections, the San Francisco electorate voted in favor of a bond measure to pay for San Francisco's one-third share of the approximately \$3 billion cost of a capital improvement program. A new state water agency, the Bay Area Water Supply and Conservation Agency (BAWSCA), and a Regional Financing Authority were created in 2003 to provide the funding for the two-thirds share of the CIP costs allocated to the agencies that purchase water from the SFPUC. Estimates for these increased costs have been factored into Palo Alto's long-term rate projections. As of September 2004, however, the SFPUC has indicated that the costs could be even higher after new estimates for the cost to fix the regional water system emerged. In addition, the wholesale agencies (including Palo Alto) may be asked to make an up-front capital commitment, rather than pay for their share of the improvements over time through increased SFPUC wholesale water rates.

Contingent Liabilities

There are a number of major uncertainties facing City utility operations. These uncertainties are periodically evaluated by staff and have been considered in developing the Reserve Guidelines approved by Council in October 2003. These uncertainties are discussed below.

The FERC's inquiry into the events and actions that may have caused or contributed to high market prices during the 2000-01 energy crisis has yet to be completed. It is possible that Palo Alto may have to refund some of the revenues from the surplus sales generated by the Northern California Power Agency (NCPA), the City's resource scheduler and operator. These surplus sales were recognized and the contingencies were noted in the City's financial statements since 2000-01.

The long standing dispute between PG&E and NCPA regarding PG&E's rights to pass-through CAISO charges (related to Scheduling Coordinator Services (SCS) under the PG&E-NCPA Transmission Interconnection Agreement) has not been settled. PG&E claims that it incurred, approximately \$21.3 million in SCS Tariff charges plus accrued interest (methodology is in dispute) on behalf of NCPA pool loads between April 1998 and August 2002. Of this amount, approximately \$8.5 million is estimated by NCPA to be Palo Alto's share. This amount and PG&E's contractual rights to pass various SCS Tariff charges are being disputed by NCPA along with other entities that had similar interconnection agreements with PG&E. Proceedings are now underway before the FERC to resolve the dispute. Additional claims related to the period September 2003 to December 2004 are unknown at this point in time. Palo Alto's share of \$8.5 million for the period prior to September 2002 has been deposited into an escrow account with NCPA and has been recognized and reflected in the financial statements this year.

The Western Area Power Administration and PG&E have a dispute regarding PG&E's ability to pass through higher transmission costs to Western customers such as Palo Alto. This dispute has continued since 2001, but FERC has consistently ruled in favor of Western. A recent Court ruling, however, in response to PG&E's appeal, has asked FERC to reconsider its past decision. There is some risk that if

PG&E prevails, transmission rates to deliver Western energy to Palo Alto may be increased by approximately \$2.5 million per year for all or part of the period prior to January 2005.

During 2001, Enron North America (“ENA”) supplied natural gas and provided gas acquisition and transportation services to the City pursuant to three contracts, and Enron Power Marketing, Inc. (“EPMI”) provided power to the City pursuant to one contract (the “Power Agreement”). The purchase represented approximately 20 percent of the City’s projected need for power during the specified contract period.

In inducing the City to enter into the several agreements, Enron Corporation and its affiliates, ENA and EPMI, each made representations about their net worth, financial strength and other material matters and in audited financial statements. Enron Corporation has publicly admitted and acknowledged a number of financial irregularities and conflicts of interest, and has made representations which are apparently false and misleading. The Enron entities have also failed to disclose information concerning certain off-balance sheet limited partnerships.

At the end of November 2001, the City gave notice of defaults to EPMI and ENA in connection with the electric and gas contracts with the City. In early December 2001, Enron Corporation, ENA, and EPMI filed for protection under Chapter 11 of the United States Bankruptcy Code. Those cases, and the bankruptcy cases of other Enron affiliates, are pending in the United States Bankruptcy Court for the Southern District of New York.

Contemporaneously with the receipt of notices of default and filing their Chapter 11 petitions, the Enron affiliates ceased to perform their obligations under the agreements. The City has arranged for alternative sources of supply. Service disruptions to the City’s utility customers have not occurred and are not expected. The agreements for the supply of gas and power provide for early termination payments under certain circumstances. The amounts of such payments would be based on the present value of the difference between the contract price and market prices. The Enron affiliates could contend that the City is obligated to pay early termination payments under the terms of the agreements upon termination. The City denies any and all liability to the Enron affiliates under the agreements, including any liability for early termination payments. The City asserts that those agreements are void, unenforceable and subject to rescission, and any obligations that it may have had have been excused. In the event of litigation, which is unfavorable to the City, a resolution of the termination of the agreements is not expected to have a material adverse impact on the City’s electric or gas retail rates and charges or electric utility or gas utility operations.

Litigation – The City is subject to litigation arising in the normal course of business. In the opinion of the City Attorney there is no pending litigation which is likely to have a material adverse effect on the financial position of the City.

Sales Tax Adjustment – On April 14, 1999 the State Board of Equalization informed the City that it had been allocated and paid \$594 thousand in sales and use taxes in error and that the City was obligated to refund these taxes from future sales tax revenues. The City is in the process of challenging the Board’s finding. However, as of June 30, 2004, the issue had not been settled and the refund had not been returned.

Grant Programs – The City participates in Federal and State grant programs. These programs have been audited by the City’s independent accountants in accordance with the provisions of the Federal Single Audit Act amendments of 1996 and applicable State requirements. No cost disallowances were proposed as a result of these audits; however, these programs are still subject to further examination by the grantors and the amount, if any, of expenditures which may be disallowed by the granting agencies cannot be determined at this time. The City expects such amounts, if any, to be immaterial.



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Supplemental

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Non-major Governmental Funds.....

STREET IMPROVEMENT

This fund accounts for revenues received from state gas tax, allocations must be spent on the construction and maintenance of the road network system of the City.

FEDERAL REVENUE

This fund accounts for grant funds received under the Community Development Act of 1974 and HOME Investment Grant Programs, for activities approved and subject to federal regulations.

SPECIAL DISTRICTS

This fund accounts for revenues from parking permits and for maintenance of various parking lots within the City's parking districts.

TRANSPORTATION MITIGATION

This fund accounts for revenues from fees or contributions required for transportation mitigation issues encountered as a result of City development.

LOCAL LAW ENFORCEMENT

This fund accounts for revenues received in support of City's law enforcement program.

DOWNTOWN PLANNED COMMUNITY

This fund accounts for revenues received from contributions and fees that will be used to implement downtown improvements.

ASSETS SEIZURE

This fund accounts for seized property and funds associated with drug trafficking. Under California Assembly Bill No. 4162, the monies are released to the City for specific expenditures related to law enforcement activities.

DEVELOPER'S IMPACT FEE

This fund accounts for fees imposed on new developments for parks, community centers and libraries.

DOWNTOWN BUSINESS IMPROVEMENT DISTRICT

The Downtown Business Improvement District Fund was established to account for the activities of the Palo Alto Downtown Business Improvement District, which was established to enhance the viability of the downtown business district.

REDEVELOPMENT AGENCY ADMINISTRATION

This fund accounts for the activities of administrating the Redevelopment Agency.

GOLF COURSE

This fund accounts for revenues received from the General Fund to provide payment of principal and interest associated with general obligation debt issued for the City's golf course.



CIVIC CENTER REFINANCING

This fund accounts for revenues received from the General Fund to provide payment of principal and interest associated with the 2002A Civic Center Refinancing Certificates of Participation as they become due.

DOWNTOWN PARKING IMPROVEMENT

This fund accounts for revenues received from the General Fund to provide payment of principal and interest associated with the 2002B Downtown Parking Improvement Certificate of Participation as they become due.

SPECIAL ASSESSMENT DEBT

This fund accumulate monies for payments of special assessment improvement bonds which are financed by assessments placed on property owners within the University Avenue and California Avenue Parking district.



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City of Palo Alto - Non-Major Governmental Funds
Combining Balance Sheets- June 30, 2004
(In thousands of dollars)

	<u>SPECIAL REVENUE FUNDS</u>				
	<u>Street</u>	<u>Federal</u>	<u>Special</u>	<u>Transportation</u>	<u>Local Law</u>
	<u>Improvement</u>	<u>Revenue</u>	<u>Districts</u>	<u>Mitigation</u>	<u>Enforcement</u>
ASSETS					
Cash and investments					
Available for operations	\$30	\$55	\$1,402	\$2,578	\$108
Cash and investments with fiscal agent					
Receivables:					
Accounts	110	308			
Special assessments					
Interest			18	31	1
Notes		4,667			
<u>Total Assets</u>	<u>\$140</u>	<u>\$5,030</u>	<u>\$1,420</u>	<u>\$2,609</u>	<u>\$109</u>
LIABILITIES					
Accounts payable		\$162			
Deferred revenue					
Interfund payable and advances		282			\$25
<u>Total Liabilities</u>		<u>444</u>			<u>25</u>
FUND EQUITY					
Reserved for:					
Encumbrances	\$329	\$434			\$33
Notes receivable		4,667			
Debt service					
Unreserved, designated for:					
Special revenue projects			\$1,420	\$2,609	51
Reappropriations					
Unreserved, undesignated	(189)	(515)			
<u>140</u>	<u>4,586</u>	<u>1,420</u>	<u>2,609</u>	<u>84</u>	
<u>\$140</u>	<u>\$5,030</u>	<u>\$1,420</u>	<u>\$2,609</u>	<u>\$109</u>	



<u>SPECIAL REVENUE FUNDS</u>				<u>DEBT SERVICE FUNDS</u>		
<u>Downtown Planned Community</u>	<u>Assets Seizure</u>	<u>Developer's Impact Fee</u>	<u>Redevelopment Agency</u>	<u>Downtown Business Improvement District</u>	<u>Golf Course</u>	<u>Civic Center Refinancing</u>
	\$16	\$673		\$58	\$740	\$351
				10		
		9		1	11	
	<u>\$16</u>	<u>\$682</u>		<u>\$69</u>	<u>\$751</u>	<u>\$351</u>
\$4						
4						
					\$751	\$351
(4)	\$16	\$682		\$69		
(4)	16	682		69	751	351
	<u>\$16</u>	<u>\$682</u>		<u>\$69</u>	<u>\$751</u>	<u>\$351</u>

(Continued)

**City of Palo Alto - Non-Major Governmental Funds ...
Combining Balance Sheets- June 30, 2004**

(In thousands of dollars)

(Continued)

	<u>DEBT SERVICE FUNDS</u>		Total
	Downtown Parking Improvement	Special Assessment Debt	Non-major Governmental Funds
ASSETS			
Cash and investments			
Available for operations		\$104	\$5,024
Cash and investments with fiscal agent	\$322		1,413
Receivables:			
Accounts			428
Special assessments		420	420
Interest			71
Notes			4,667
Total Assets	\$322	\$524	\$12,023
LIABILITIES			
Accounts payable			\$162
Deferred revenue		\$420	420
Interfund payable and advances			311
Total Liabilities		420	893
FUND EQUITY			
Reserved for:			
Encumbrances			796
Notes receivable			4,667
Debt service	\$324	35	1,461
Unreserved, designated for:			
Special revenue projects			4,080
Reappropriations			
Unreserved, undesignated	(2)	69	126
	322	104	11,130
	\$322	\$524	\$12,023



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City of Palo Alto - Non-Major Governmental Funds

**Combining Statements of Revenues, Expenditures and
Changes in Fund Balances -
For the Year Ended June 30, 2004
(In thousands of dollars)**

	<u>SPECIAL REVENUE FUNDS</u>			
	<u>Street Improvement</u>	<u>Federal Revenue</u>	<u>Special Districts</u>	<u>Transportation Mitigation</u>
REVENUES				
Special assessments				
Other taxes and fines	\$1,146			
From other agencies:				
Community Development Block Grant		\$643		
Local Law Enforcement Block Grant				
State of California	41			
Other revenue from other agencies		32		
Return on investment	(55)	18	\$10	\$9
Other:				
Housing In-Lieu - residential				
Housing In-Lieu - commercial				
University Avenue Parking			651	42
California Avenue Parking			105	
Other fees				
Total Revenues	<u>1,132</u>	<u>693</u>	<u>766</u>	<u>51</u>
EXPENDITURES				
Current:				
Planning and Community Environment		581		
Public Safety - Police				
Non Departmental		(59)		
Capital outlay				
Debt service:				
Principal retirement				
Interest and fiscal charges				
Total Expenditures		<u>522</u>		
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>1,132</u>	<u>171</u>	<u>766</u>	<u>51</u>
OTHER FINANCING SOURCES (USES)				
Transfers in				
Transfers (out)	(2,791)		(741)	(150)
Total Other Financing Sources (Uses)	<u>(2,791)</u>		<u>(741)</u>	<u>(150)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	(1,659)	171	25	(99)
Fund balances at the beginning of year	<u>1,799</u>	<u>4,415</u>	<u>1,395</u>	<u>2,708</u>
Fund balances at end of year	<u><u>\$140</u></u>	<u><u>\$4,586</u></u>	<u><u>\$1,420</u></u>	<u><u>\$2,609</u></u>



SPECIAL REVENUE FUNDS					DEBT SERVICE FUNDS		
Local Law Enforcement	Downtown Planned Community	Assets Seizure	Developer's Impact Fee	Redevelopment Agency	Downtown Business Improvement District	Golf Course	Civic Center Refinancing
					\$68		
\$12							
100							
(9)	(\$1)	(\$1)	\$11		1	\$21	\$2
			493				
103	(1)	(1)	504		69	21	2
106							
						270	315
						284	106
106						554	421
(3)	(1)	(1)	504		69	(533)	(419)
2					\$9	324	421
(108)	(25)				(9)	(14)	(2)
(106)	(25)					310	419
(109)	(26)	(1)	504		69	(223)	
193	22	17	178			974	351
\$84	(\$4)	\$16	\$682		\$69	\$751	\$351

(Continued)

City of Palo Alto - Non-Major Governmental Funds

**Combining Statements of Revenues, Expenditures and
Changes in Fund Balances -**

For the Year Ended June 30, 2004

(In thousands of dollars)

(Continued)

	<u>DEBT SERVICE FUNDS</u>		Total Non-major Governmental Funds
	<u>Downtown Parking Improvement</u>	<u>Special Assessment District</u>	
REVENUES			
Special assessments		\$128	\$196
Other taxes and fines			1,146
From other agencies:			
Community Development Block Grant			643
Local Law Enforcement Block Grant			12
State of California			141
Other revenue from other agencies			32
Return on investment	\$2		8
Other:			
Housing In-Lieu - residential			
Housing In-Lieu - commercial			
University Avenue Parking			693
California Avenue Parking			105
Other fees			493
Total Revenues	<u>2</u>	<u>128</u>	<u>3,469</u>
EXPENDITURES			
Current:			
Planning and Community Environment			581
Public Safety - Police			106
Non Departmental			(59)
Capital outlay			
Debt service:			
Principal retirement	105	90	780
Interest and fiscal charges	214	35	639
Total Expenditures	<u>319</u>	<u>125</u>	<u>2,047</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(317)</u>	<u>3</u>	<u>1,422</u>
OTHER FINANCING SOURCES (USES)			
Transfers in	318		1,074
Transfers (out)	(3)		(3,843)
Total Other Financing Sources (Uses)	<u>315</u>		<u>(2,769)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(2)</u>	<u>3</u>	<u>(1,347)</u>
Fund balances at the beginning of year	<u>324</u>	<u>101</u>	<u>12,477</u>
Fund balances at end of year	<u><u>\$322</u></u>	<u><u>\$104</u></u>	<u><u>\$11,130</u></u>



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City of Palo Alto - Non-major Governmental Funds
Combining Schedule of Revenues, Expenditures and
Changes in Fund Balances -Budget and Actual
For the Year Ended June 30, 2004
(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	Street Improvement			Federal Revenue		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES						
Property taxes						
Special assessments						
Other taxes and fines	\$1,126	\$1,146	\$20			
From other agencies:						
Community Development Block Grant				\$791	\$643	(\$148)
County Measure A/B						
Local Law Enforcement Block Grant						
State of California	34	41	7			
Other revenue from other agencies				10	32	22
Return on investment	137	(55)	(192)	5	18	13
Other:						
Great Western Bank - loan payoff						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees				7		(7)
Total Revenues	<u>1,297</u>	<u>1,132</u>	<u>(165)</u>	<u>813</u>	<u>693</u>	<u>(120)</u>
EXPENDITURES						
Current operations:						
Planning and Community Environment				373	581	(208)
Public Safety - Police						
Non Departmental				1,052	(59)	1,111
Capital outlay						
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures	<u> </u>	<u> </u>	<u> </u>	<u>1,425</u>	<u>522</u>	<u>903</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>1,297</u>	<u>1,132</u>	<u>(165)</u>	<u>(612)</u>	<u>171</u>	<u>783</u>
OTHER FINANCING SOURCES (USES)						
Transfers in	218		(218)	15		(15)
Transfers (out)	(1,761)	(2,791)	(1,030)	(34)		34
Total Other Financing Sources (Uses)	<u>(1,543)</u>	<u>(2,791)</u>	<u>(1,248)</u>	<u>(19)</u>	<u> </u>	<u>19</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(\$246)</u>	<u>(1,659)</u>	<u>(\$1,413)</u>	<u>(\$631)</u>	<u>171</u>	<u>\$802</u>
Fund balances at the beginning of year		<u>1,799</u>			<u>4,415</u>	
Fund balances at end of year		<u>\$140</u>			<u>\$4,586</u>	



.....

SPECIAL REVENUE FUNDS					
Special Districts			Transportation Mitigation		
Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
\$61	\$10	(\$51)	\$108	\$9	(\$99)
759	651	(108)	480	42	(438)
84	105	21			
<u>904</u>	<u>766</u>	<u>(138)</u>	<u>588</u>	<u>51</u>	<u>(537)</u>
(45)		(45)	50		50
<u>(45)</u>		<u>(45)</u>	<u>50</u>		<u>50</u>
<u>949</u>	<u>766</u>	<u>(183)</u>	<u>538</u>	<u>51</u>	<u>(487)</u>
<u>(981)</u>	<u>(741)</u>	<u>240</u>	<u>(368)</u>	<u>(150)</u>	<u>218</u>
<u>(981)</u>	<u>(741)</u>	<u>240</u>	<u>(368)</u>	<u>(150)</u>	<u>218</u>
<u>(\$32)</u>	25	<u>\$57</u>	<u>\$170</u>	(99)	<u>(\$269)</u>
	<u>1,395</u>			<u>2,708</u>	
	<u>\$1,420</u>			<u>\$2,609</u>	

(Continued)

City of Palo Alto - Non-major Governmental Funds
Combining Schedule of Revenues, Expenditures and
Changes in Fund Balances -Budget and Actual
For the Year Ended June 30, 2004

(In thousands of dollars)
(Continued)

	SPECIAL REVENUE FUNDS					
	Local Law Enforcement			Downtown Planned Community		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES						
Property taxes						
Special assessments						
Other taxes and fines						
From other agencies:						
Community Development Block Grant						
County Measure A/B						
Local Law Enforcement Block Grant	\$12	\$12				
State of California	100	100				
Other revenue from other agencies						
Return on investment	12	(9)	(\$21)		(\$1)	(\$1)
Other:						
Great Western Bank - loan payoff						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees						
Total Revenues	<u>124</u>	<u>103</u>	<u>(21)</u>		<u>(1)</u>	<u>(1)</u>
EXPENDITURES						
Current operations:						
Planning and Community Environment						
Public Safety - Police	223	106	117			
Non Departmental						
Capital outlay						
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures	<u>223</u>	<u>106</u>	<u>117</u>			
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(99)</u>	<u>(3)</u>	<u>96</u>		<u>(1)</u>	<u>(1)</u>
OTHER FINANCING SOURCES (USES)						
Transfers in	1	2	1			
Transfers (out)	(89)	(108)	(19)	(25)	(25)	
Total Other Financing Sources (Uses)	<u>(88)</u>	<u>(106)</u>	<u>(18)</u>	<u>(25)</u>	<u>(25)</u>	
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(\$187)</u>	<u>(109)</u>	<u>\$78</u>	<u>(\$25)</u>	<u>(26)</u>	<u>(\$1)</u>
Fund balances at the beginning of year		<u>193</u>			<u>22</u>	
Fund balances at end of year		<u>\$84</u>			<u>(\$4)</u>	



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SPECIAL REVENUE FUNDS

Assets Seizure			Developer's Impact Fee			Redevelopment Agency		
<u>Budget</u>	<u>Actual</u>	<u>Variance Positive (Negative)</u>	<u>Budget</u>	<u>Actual</u>	<u>Variance Positive (Negative)</u>	<u>Budget</u>	<u>Actual</u>	<u>Variance Positive (Negative)</u>
	(\$1)	(\$1)	\$2	\$11	\$9			
			553	493	(60)			
	(1)	(1)	555	504	(51)			
							\$9	\$9
						9		9
	(1)	(1)	555	504	(51)	(9)		9
						9	\$9 (9)	(9)
						9		(9)
	(1)	(\$1)	555	504	(\$51)			
	17			178				
	\$16			\$682				

(Continued)

City of Palo Alto - Non-major Governmental Funds

**Combining Schedule of Revenues, Expenditures and
Changes in Fund Balances -Budget and Actual
For the Year Ended June 30, 2004**

(In thousands of dollars)
(Continued)

	SPECIAL REVENUE FUNDS			DEBT SERVICE FUNDS					
	Downtown Business Improvement District			Golf Course			Civic Center Refinance		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES									
Property taxes									
Special assessments	\$77	\$68	(\$9)						
Other taxes and fines									
From other agencies:									
Community Development Block Grant									
County Measure A/B									
Local Law Enforcement Block Grant									
State of California									
Other revenue from other agencies									
Return on investment		1	1	\$38	\$21	(\$17)	\$2	\$2	
Other:									
Great Western Bank - loan payoff									
Housing In-Lieu - residential									
Housing In-Lieu - commercial									
University Avenue Parking									
California Avenue Parking									
Other fees									
Total Revenues	<u>77</u>	<u>69</u>	<u>(8)</u>	<u>38</u>	<u>21</u>	<u>(17)</u>	<u>2</u>	<u>2</u>	<u>2</u>
EXPENDITURES									
Current operations:									
Planning and Community Environment									
Public Safety - Police									
Non Departmental	77		77						
Capital outlay									
Debt service:									
Principal retirement				270	270		315	315	
Interest and fiscal charges				284	284		106	106	
Total Expenditures	<u>77</u>		<u>77</u>	<u>554</u>	<u>554</u>		<u>421</u>	<u>421</u>	
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES		<u>69</u>	<u>69</u>	<u>(516)</u>	<u>(533)</u>	<u>(17)</u>	<u>(421)</u>	<u>(419)</u>	<u>2</u>
OTHER FINANCING SOURCES (USES)									
Transfers in				516	324	(192)	421	421	
Transfers (out)					(14)	(14)		(2)	(2)
Total Other Financing Sources (Uses)				<u>516</u>	<u>310</u>	<u>(206)</u>	<u>421</u>	<u>419</u>	<u>(2)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES		<u>69</u>	<u>\$69</u>		<u>(223)</u>	<u>(\$223)</u>			
Fund balances at the beginning of year					<u>974</u>			<u>351</u>	
Fund balances at end of year		<u>\$69</u>			<u>\$751</u>			<u>\$351</u>	



DEBT SERVICE FUNDS						TOTAL		
Downtown Parking Improvement			Special Assessment District			Non-major Governmental Funds		
Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
			\$125	\$128	\$3	\$202	\$196	(\$6)
						1,126	1,146	20
						791	643	(148)
						12	12	
						134	141	7
						10	32	22
	\$2	\$2				363	8	(355)
						1,239	693	(546)
						84	105	21
						560	493	(67)
	2	2	125	128	3	4,521	3,469	(1,052)
						373	581	(208)
						223	106	117
						1,143	(59)	1,202
105	105		90	90		780	780	
213	214	(1)	35	35		638	639	(1)
318	319	(1)	125	125		3,157	2,047	1,110
(318)	(317)	1		3	3	1,364	1,422	58
318	318					1,498	1,074	(424)
	(3)	(3)				(3,258)	(3,843)	(585)
318	315	(3)				(1,760)	(2,769)	(1,009)
	(2)	(\$2)		3	\$3	(\$396)	(1,347)	(\$951)
	324			101			12,477	
	\$322			\$104			\$11,130	



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Internal Service Funds

Introduction

Internal Service Funds are used to finance and account for special activities and services performed by a designated department for other departments in the City on a cost reimbursement basis.

The concept of Major Funds introduced by GASB Statement 34 does not extend to Internal Service Funds because they do not do business with outside parties. GASB Statement 34 requires that for the Statement of Activities, the net revenues or expenses of each Internal Service Fund be eliminated by netting them against the operations of the other City departments which generated them. The remaining balance sheet items are consolidated with these same funds in the Statement of Net Assets.

However, Internal Service Funds are still presented separately in the Fund financial statements, including the funds below.

VEHICLE REPLACEMENT AND MAINTENANCE

This fund accounts for the maintenance and replacement of vehicles and equipment used by all City departments. The source of revenue is an accumulation of resources.

TECHNOLOGY

This fund accounts for replacement and upgrade of technology, and covers four primary areas used by all City departments: desktop, infrastructure, applications, and technology research and development. The source of revenue is an accumulation of resources.

PRINTING AND MAILING SERVICES

This fund accounts for central duplicating, printing and mailing services provided to all City departments. Source of revenue for this fund is on reimbursement of costs for services and supplies purchased by other departments.

GENERAL BENEFITS AND INSURANCE

This fund accounts for the administration of compensated absences and health benefits, and the City's self-insured workers' compensation and general liability programs.

RETIREE HEALTH BENEFITS

This fund accounts for the retiree health benefits when the amount of actual benefits exceed one and one-half percent of the City's gross payroll costs in any fiscal period.



City of Palo Alto - Internal Service Funds
Combining Statements of Net Assets - June 30, 2004
(In thousands of dollars)

	<u>Vehicle Replacement and Maintenance</u>	<u>Technology</u>	<u>Printing and Mailing Services</u>	<u>General Benefits and Insurance</u>	<u>Retiree Health Benefit</u>	<u>Total</u>
ASSETS						
Current Assets						
Cash and investments available for operations	\$4,774	\$16,013	\$689	\$26,903	\$17,955	\$66,334
Accounts receivable, net				8		8
Interest receivable	59	141	8	276	223	707
Inventory of materials and supplies	303					303
Total Current Assets	5,136	16,154	697	27,187	18,178	67,352
Noncurrent Assets:						
Interfund receivables	32	100				132
Capital assets, net of depreciation	10,342	5,528				15,870
Total Noncurrent Assets	10,374	5,628				16,002
Total Assets	15,510	21,782	697	27,187	18,178	83,354
LIABILITIES						
Current Liabilities						
Accounts payable and accrued liabilities	534	49		18		601
Accrued salaries and benefits	46	159	11	765		981
Accrued claims payable - current				3,143		3,143
Capital lease obligation - current		25				25
Total Current Liabilities	580	233	11	3,926		4,750
Long-term Liabilities						
Accrued compensated absences				12,004		12,004
Accrued claims payable				7,405		7,405
Total Long-term Liabilities				19,409		19,409
Total Liabilities	580	233	11	23,335		24,159
NET ASSETS						
Investment in capital assets, net of related debt	10,342	5,503				15,845
Unrestricted	4,588	16,046	686	3,852	18,178	43,350
Total Net Assets	\$14,930	\$21,549	\$686	\$3,852	\$18,178	\$59,195



City of Palo Alto - Internal Service Funds

**Combining Statements of Revenues, Expenses and
Changes in Net Assets - For the Year Ended June 30, 2004**
(In thousands of dollars)

	Vehicle Replacement and Maintenance	Technology	Printing and Mailing Services	General Benefits and Insurance	Retiree Health Benefit	Total
OPERATING REVENUES						
Charges for services	\$5,265	\$8,849	\$976	\$32,292		\$47,382
OPERATING EXPENSES						
Administration and general	902	7,016	938	1,335		10,191
Operations and maintenance	2,676					2,676
Depreciation and amortization	2,070	164				2,234
Claim payments and change in estimated self-insured liability				6,951		6,951
Compensated absences and other benefits				27,113		27,113
Total Operating Expenses	5,648	7,180	938	35,399		49,165
Total Operating Income (Loss)	(383)	1,669	38	(3,107)		(1,783)
NONOPERATING REVENUES (EXPENSES)						
Return on investment	19	104	2	126	\$67	318
Interest (expense)		(6)				(6)
Gain (loss) on disposal of fixed assets	114					114
Other nonoperating revenues	171			(6)		165
Total Nonoperating Revenues	304	98	2	120	67	591
Income (Loss) Before Contributions and Transfers	(79)	1,767	40	(2,987)	67	(1,192)
Contribution of assets		3,498				3,498
Transfers in	547	5,006				5,553
Transfers (out)		(101)				(101)
Change in Net Assets	468	10,170	40	(2,987)	67	7,758
Net assets at beginning of year	14,462	11,379	646	6,839	18,111	51,437
Net assets at end of year	\$14,930	\$21,549	\$686	\$3,852	\$18,178	\$59,195



City of Palo Alto - Internal Service Funds

Combining Statements of Cash Flows - For the Year Ended June 30, 2004

(In thousands of dollars)

	Vehicle Replacement and Maintenance	Technology	Printing and Mailing Services	General Benefits and Insurance	Retiree Health Benefit	Total
CASH FLOW FROM OPERATING ACTIVITIES						
Receipts from customers	\$5,266	\$8,849	\$976	\$32,289		\$47,380
Payments to suppliers	(2,092)	(28)				(2,120)
Payments to employees	(856)	(6,857)	(927)	(29,428)		(38,068)
Claims paid				(5,656)		(5,656)
Other receipts	171			(6)		165
Net cash provided by operating activities	<u>2,489</u>	<u>1,964</u>	<u>49</u>	<u>(2,801)</u>		<u>1,701</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES						
Interfund payments	123					123
Transfers in	547	5,006				5,553
Transfers (out)		(101)				(101)
Cash flows from noncapital financing activities	<u>670</u>	<u>4,905</u>				<u>5,575</u>
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES						
Acquisition and construction of fixed assets	(2,211)	(2,008)				(4,219)
Proceeds from sale of capital assets	114					114
Principal paid on long term obligation		(32)				(32)
Interest paid on long term obligation		(6)				(6)
Cash flows from capital financing activities	<u>(2,097)</u>	<u>(2,046)</u>				<u>(4,143)</u>
CASH FLOWS FROM INVESTING ACTIVITIES						
Interest and dividends on pooled investments	9	110	2	165	\$71	357
Net Cash Flows	<u>1,071</u>	<u>4,933</u>	<u>51</u>	<u>(2,636)</u>	<u>71</u>	<u>3,490</u>
Cash and investments at beginning of year	<u>3,703</u>	<u>11,080</u>	<u>638</u>	<u>29,539</u>	<u>17,884</u>	<u>62,844</u>
Cash and investments at end of year	<u><u>\$4,774</u></u>	<u><u>\$16,013</u></u>	<u><u>\$689</u></u>	<u><u>\$26,903</u></u>	<u><u>\$17,955</u></u>	<u><u>\$66,334</u></u>
CASH FLOWS FROM OPERATING ACTIVITIES						
Operating income (loss)	(\$383)	\$1,669	\$38	(\$3,107)		(\$1,783)
Adjustments to reconcile operating income (loss) to cash flows from operating activities:						
Depreciation and amortization	2,070	164				2,234
Other	171			(6)		165
Changes in assets and liabilities:						
Accounts receivable	1			(3)		(2)
Inventory of materials and supplies	61					61
Accounts and other payables	569	131	11	(980)		(269)
Accrued claims payable				1,295		1,295
Net cash provided by operating activities	<u>\$2,489</u>	<u>\$1,964</u>	<u>\$49</u>	<u>(\$2,801)</u>		<u>\$1,701</u>
Capital Asset contributions		<u>\$3,498</u>				<u>\$3,498</u>



Fiduciary Funds.....

Introduction

Fiduciary Funds are used to account for assets held by the City acting in a fiduciary capacity for other entities and individuals. The funds are operated to carry out the specific actions required by the trust agreements, ordinances and other governing regulations.

GASB Statement 34 requires that the Fiduciary Funds the City has, be presented separately from the Citywide and Fund financial statements.

Agency Funds are custodial in nature and do not involve measurement of results of operations. The City maintains four agency funds, as follows:

CALIFORNIA AVENUE PARKING ASSESSMENT DISTRICT

This fund accounts for receipts and disbursements associated with the 1993 Parking District No. 92-13 Assessment Bonds.

CABLE JOINT POWERS AUTHORITY

The fund was established to account for the activities of the cable television system on behalf of the members.

UNIVERSITY AVENUE AREA PARKING ASSESSMENT DISTRICT

The fund accounts for the receipts and disbursements associated with the Series 2001-A University Avenue Are Off-Street Parking Assessments Bonds.

City of Palo Alto - Agency Funds

Statement of Changes in Assets and Liabilities -
For the Year Ended June 30, 2004
(In thousands of dollars)

	Balance June 30, 2003	Additions	Reductions	Balance June 30, 2004
<u>California Avenue Parking Assessment District</u>				
ASSETS				
Cash and investments available for operations	\$323	\$144	\$160	\$307
LIABILITIES				
Due to bondholders	\$323	\$144	\$160	\$307
<u>Cable Joint Powers Authority</u>				
ASSETS				
Cash and investments available for operations	\$742	\$298	\$13	\$1,027
Interest receivable	10	13	10	13
Total assets	\$752	\$311	\$23	\$1,040
LIABILITIES				
Due to other governments	\$752	\$311	\$23	\$1,040
<u>University Avenue Area Parking Assessment District</u>				
ASSETS				
Cash and investments with fiscal agents	\$5,299	\$2,733	\$2,428	\$5,604
Interest receivable	52	59	52	59
Total assets	\$5,351	\$2,792	\$2,480	\$5,663
LIABILITIES				
Due to bondholders	\$5,351	\$2,792	\$2,480	\$5,663
<u>Total Agency Funds</u>				
ASSETS				
Cash and investments available for operations	\$1,065	\$442	\$173	\$1,334
Cash and investments with fiscal agents	5,299	2,733	2,428	5,604
Interest receivable	62	72	62	72
Total assets	\$6,426	\$3,247	\$2,663	\$7,010
LIABILITIES				
Due to bondholders	\$5,674	\$2,936	\$2,640	\$5,970
Due to other governments	752	311	23	1,040
Total liabilities	\$6,426	\$3,247	\$2,663	\$7,010

Statistical

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Statistical Section.....

The statistical section contains comprehensive statistical data which relates to physical, economic, social and political characteristics of the City. It is intended to provide users with a broader and more complete understanding of the City and its financial affairs than is possible from the financial statements and supporting schedules included in the financial section.

In this section, readers will find comparative information related to the City's revenue sources, expenditures, property tax valuations, levies and collections, general obligation bonded debt, utility revenue debt service, demographics and pension plan funding. Where available, the comparative information is presented for the last ten fiscal years.

In addition, this section presents information related to the City's legal debt margin computation, principal taxpayers, notary and security bond coverages, and other miscellaneous statistics pertaining to services provided by the City.

In contrast to the financial section, the statistical section information is not usually subject to independent audit.



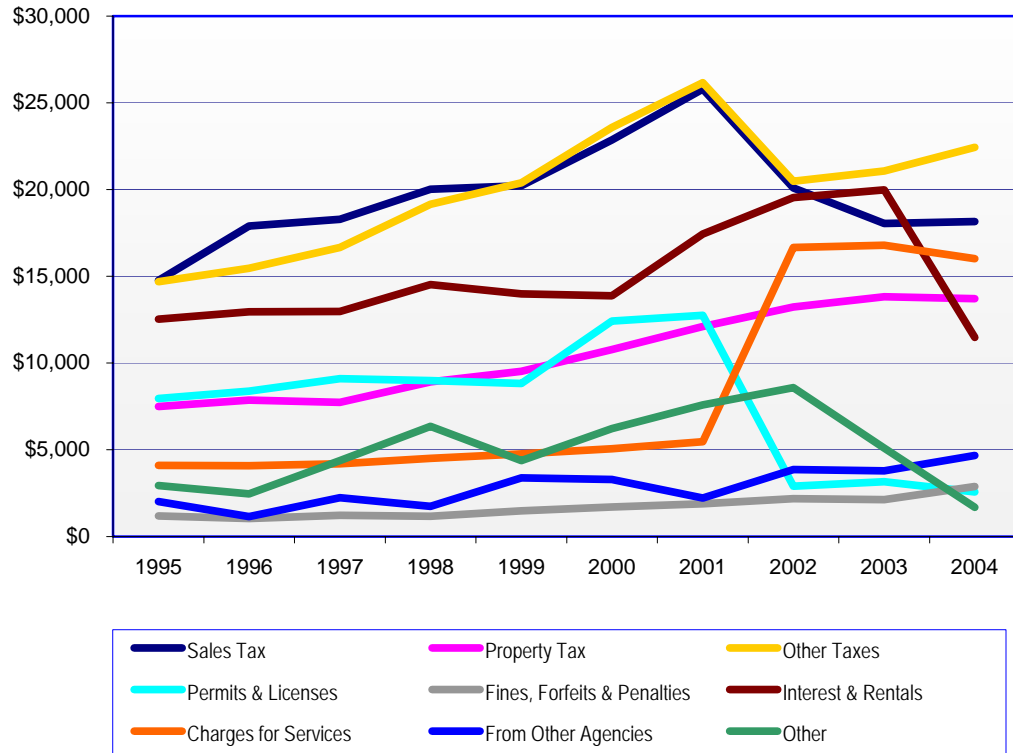
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City of Palo Alto - General Governmental Revenues by Source

All Governmental Fund Types

Last Ten Fiscal Years (\$000s)



Fiscal Year	Sales Tax	Property Tax	Other Taxes	Permits & Licenses	Fines, Forfeits & Penalties	Interest & Rentals	Charges for Services	From Other Agencies	Other	Total
1995	\$14,765	\$7,485	\$14,682	\$7,955	\$1,179	\$12,528	\$4,097	\$2,007	\$2,938	\$67,636
1996	17,895	7,854	15,469	8,380	1,032	12,953	4,073	1,144	2,445	71,245
1997	18,277	7,735	16,654	9,087	1,219	12,966	4,193	2,239	4,380	76,750
1998	20,011	8,903	19,150	8,984	1,161	14,525	4,507	1,732	6,354	85,327
1999	20,225	9,521	20,393	8,810	1,475	13,992	4,751	3,374	4,376	86,917
2000	22,867	10,770	23,582	12,408	1,703	13,874	5,053	3,282	6,213	99,752
2001	25,786	12,110	26,160	12,743	1,873	17,432	5,466	2,208	7,590	111,368
2002	20,085	13,231	20,485	2,901	2,181	19,547	16,667	3,860	8,580	107,537
** 2003	18,041	13,821	21,070	3,161	2,124	19,981	16,798	3,776	5,095	103,867
2004	18,151	13,707	22,427	2,563	2,884	11,480	16,018	4,661	1,681	93,572

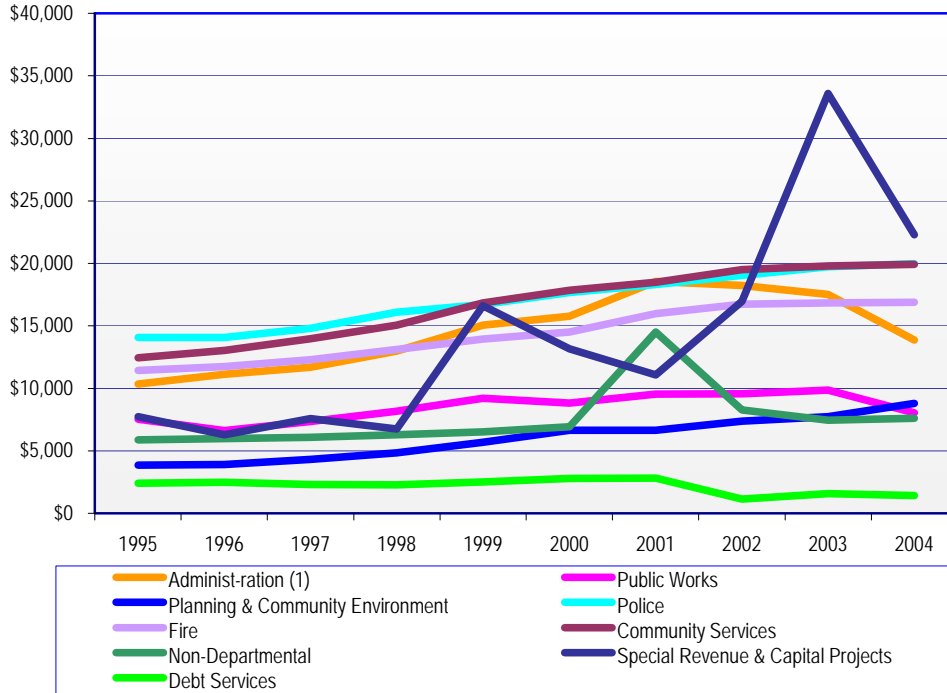
** Revenue categories were changed to align with budget classifications in 2002

Source: Annual Financial Statements

City of Palo Alto - General Governmental Expenditures by Function.....

All Governmental Fund Types

Last Ten Fiscal Years (\$000s)



Fiscal Year	Administ-ration (1)	Public Works	Planning & Community Environment	Police	Fire	Community Services	Non-Departmental	Special Revenue & Capital Projects	Debt Services	Total
(2) 1995	\$10,340	\$7,517	\$3,842	\$14,058	\$11,437	\$12,435	\$5,884	\$7,722	\$2,415	\$75,650
1996	11,133	6,614	3,901	14,066	11,739	13,019	5,992	6,296	2,490	75,250
1997	11,689	7,339	4,320	14,804	12,292	13,972	6,086	7,581	2,319	80,402
1998	12,987	8,172	4,832	16,093	13,100	15,050	6,298	6,749	2,293	85,574
1999	15,066	9,202	5,674	16,705	13,949	16,820	6,520	16,605	2,509	103,050
2000	15,772	8,827	6,639	17,666	14,512	17,858	6,927	13,151	2,801	104,153
2001	18,557	9,522	6,652	18,306	15,973	18,469	14,487	11,089	2,817	115,872
2002	18,235	9,549	7,378	19,047	16,722	19,499	8,259	16,960	1,151	116,800
2003	17,521	9,858	7,721	19,719	16,841	19,793	7,442	33,584	1,571	134,050
2004	13,862	8,031	8,793	19,962	16,891	19,934	7,598	22,289	1,419	118,779

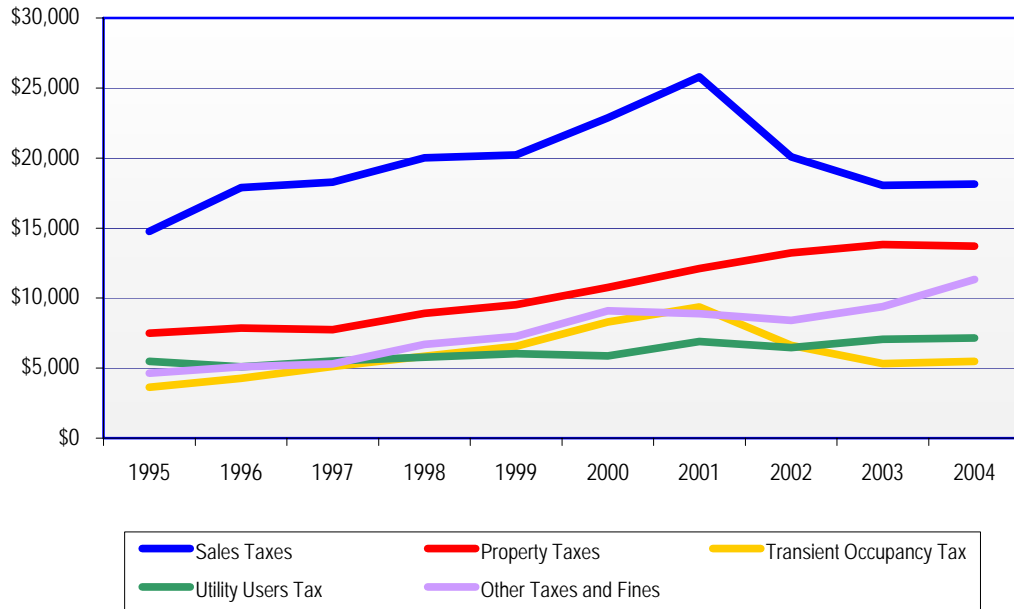
Source: Annual Financial Statements

NOTE (1) Comprised of the following departments: City Council, City Manager, City Attorney, City Clerk, City Auditor, Administrative Services and Human Resources

(2) During fiscal year 1993-94 the City implemented GASB Statement No.14. The Reporting Entity, and as a result, the Palo Alto Centennial 1994, Inc., was included in the beginning of this year. Data prior to 1993-94 has not been restated.



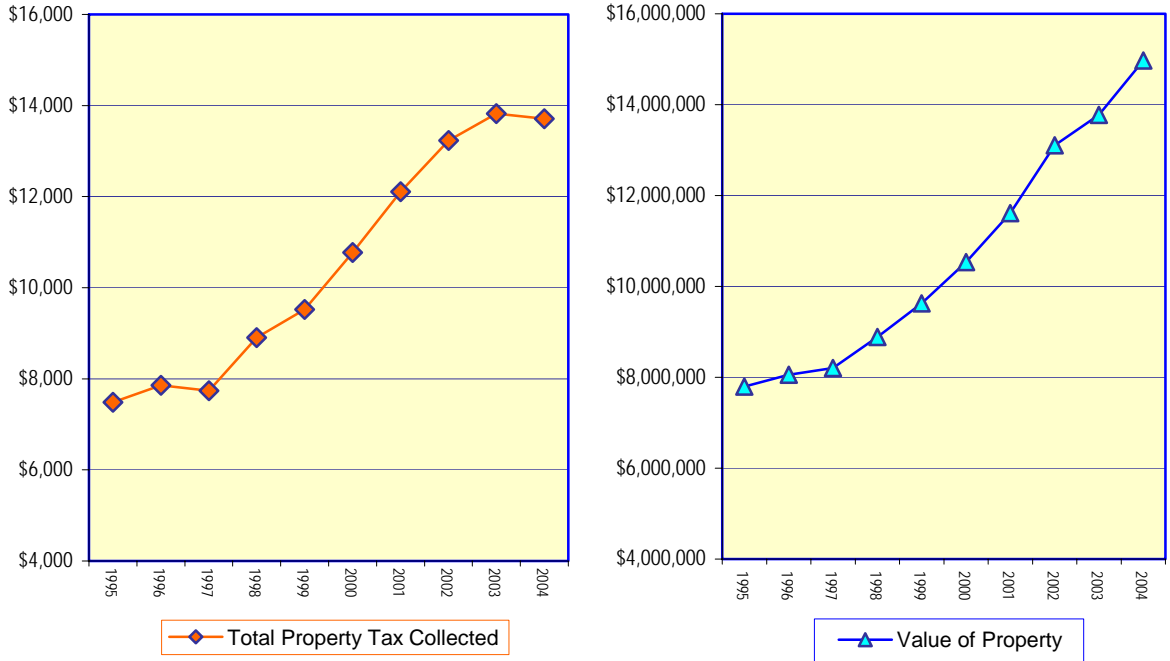
City of Palo Alto - General Fund Tax Revenues by Source.....
Last Ten Fiscal Years (\$000)



Fiscal Year	Sales Taxes	Property Taxes	Transient Occupancy Tax	Utility Users Tax	Other Taxes and Fines	Total
1995	\$14,765	\$7,485	\$3,643	\$5,482	\$4,633	\$36,008
1996	17,895	7,854	4,279	5,098	5,092	40,218
1997	18,277	7,735	5,107	5,509	5,299	41,927
1998	20,011	8,903	5,846	5,780	6,694	47,234
1999	20,225	9,521	6,551	6,039	7,255	49,591
2000	22,867	10,770	8,293	5,861	9,096	56,887
2001	25,786	12,110	9,359	6,895	8,887	63,037
2002	20,085	13,231	6,615	6,457	8,407	54,795
2003	18,041	13,821	5,333	7,067	9,398	53,660
2004	18,151	13,707	5,489	7,152	11,328	55,827

SOURCE: City of Palo Alto: Administrative Services Department, Comprehensive Annual Financial Reports

City of Palo Alto - Property Tax Levies and Collections.....
Last Ten Fiscal Years (\$ Billions)



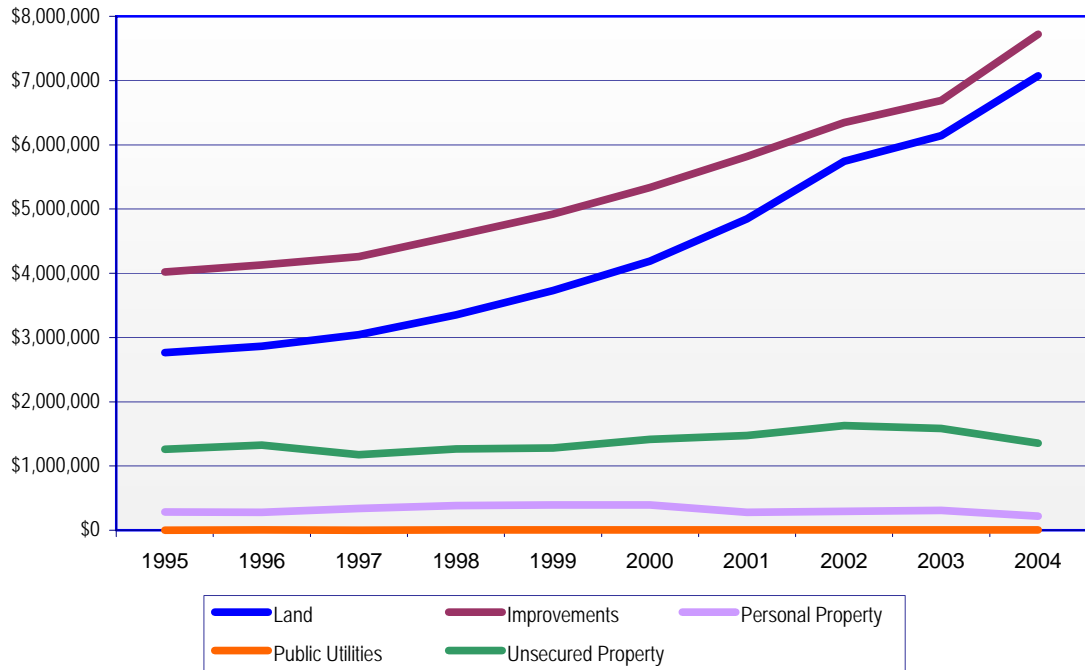
Fiscal Year	Total Tax Levy	Current Tax Collections	Delinquent Tax Collections	Total Property Tax Collected	Value of Property Subject to Basic County Wide Tax Rate (\$000s)
1995	\$7,485	\$7,485	\$427	\$7,485	\$7,795,396
1996	7,854	7,854	A	7,854	8,058,927
1997	7,735	7,735	A	7,735	8,206,532
1998	7,660	8,903	A	8,903	8,885,623
1999	9,521	9,521	A	9,521	9,623,868
2000	10,770	10,770	A	10,770	10,533,778
2001	12,110	12,110	A	12,110	11,609,915
2002	13,231	13,231	A	13,231	13,102,696
2003	13,821	13,821	A	13,821	13,776,406
2004	13,707	13,707	A	13,707	14,974,966

Source: County of Santa Clara Assessor's Office

Note: (A) Effective with the fiscal year 1993-94, the City is on the Teeter Plan, under which the County of Santa Clara Pays the full tax levy due. All prior delinquent taxes were also received in this fiscal year. Assessed value of property is considered to be an estimate of full market value.



**City of Palo Alto - Assessed Value of Taxable Property.....
Last Ten Fiscal Years (\$000)**



Fiscal Year	Net Local Secured Roll			Subtotal			Less		Total Assessed Value
	Land	Improvements	Personal Property	Net Local Secured Roll	Public Utilities	Unsecured Property	Exemptions Net of State Aid		
1995	\$2,764,558	\$4,018,251	\$281,479	\$7,064,288	\$1,508	\$1,262,254	\$532,654	\$7,795,396	
1996	2,865,710	4,129,805	277,037	7,272,552	2,508	1,325,835	541,968	8,058,927	
1997	3,045,477	4,259,209	340,073	7,644,759	2,410	1,173,563	614,200	8,206,532	
1998	3,353,027	4,585,725	381,091	8,319,843	2,652	1,265,100	701,972	8,885,623	
1999	3,729,475	4,920,111	394,610	9,044,196	2,842	1,279,315	702,485	9,623,868	
2000	4,187,357	5,335,026	394,198	9,916,581	3,362	1,415,999	802,164	10,533,778	
2001	4,849,233	5,816,633	280,958	10,946,824	3,309	1,473,678	813,896	11,609,915	
2002	5,744,675	6,347,719	292,812	12,385,206	3,371	1,627,594	913,475	13,102,696	
2003	6,140,438	6,692,162	309,386	13,141,986	3,859	1,582,368	951,807	13,776,406	
2004	7,075,300	7,722,660	220,585	15,018,545	4,150	1,354,310	1,402,039	14,974,966	

SOURCE: County of Santa Clara Assessor's Office

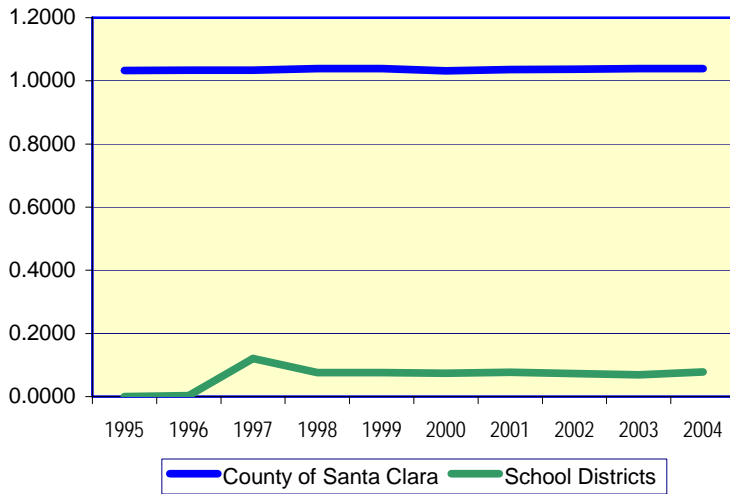
NOTE: Beginning in fiscal year 1988-89, Chapter 921 of the Statutes of 1987 requires the establishment of a single county-wide tax rate area for the assignment of the assessed value of certain types of state-assessed utility property and sets forth formulas for the determination of county-wide tax rates for this particular type of property.

The State Constitution requires property to be assessed at one hundred percent of the most recent purchase price, plus an increment of no more than two percent annually, plus any local over-rides. These values are considered to be full market values.

City of Palo Alto - Property Tax Rates.....

All Overlapping Governments

Per \$100 of Assessed Value - Last Ten Years



Fiscal Year	County of Santa Clara	School Districts	Total
1995	1.0330	0.0000	1.0330
1996	1.0340	0.0030	1.0370
1997	1.0340	0.1210	1.1550
1998	1.0388	0.0764	1.1152
1999	1.0388	0.0757	1.1145
2000	1.0319	0.0740	1.1059
2001	1.0356	0.0771	1.1127
2002	1.0364	0.0727	1.1091
2003	1.0388	0.0694	1.1082
2004	1.0388	0.0776	1.1164

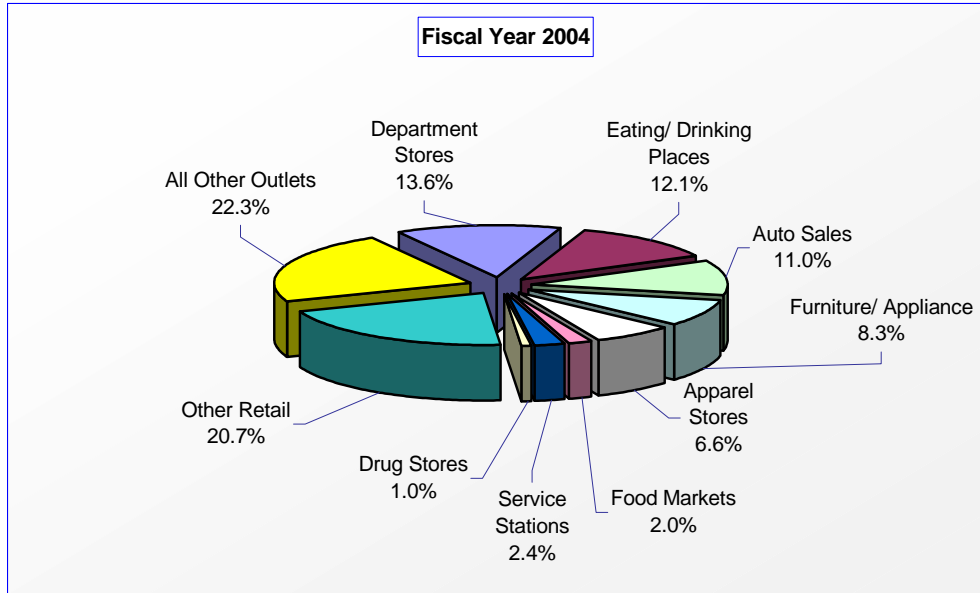
Source: County of Santa Clara, Tax Rates and Information



City of Palo Alto- Taxable Transactions by Type of Business.....

Taxable Transactions by Type of Business

Last Ten Fiscal Years (\$millions)



RETAIL STORES

Fiscal Year	Department Stores	Eating/ Drinking Places	Auto Sales	Furniture/ Appliance	Apparel Stores	Food Markets	Service Stations	Drug Stores	Other Retail	Retail Stores Total	All Other Outlets	Total
1995	\$2,090	\$1,532	\$1,024	\$975	\$1,019	\$266	\$281	\$113	\$3,678	\$10,978	\$3,967	\$14,945
1996	2,436	1,727	1,374	1,145	921	285	292	108	3,155	11,443	4,711	16,154
1997	2,656	1,839	1,595	1,238	1,031	297	327	119	3,740	12,842	4,518	17,360
1998	2,925	2,032	2,112	1,388	1,033	325	318	131	4,177	14,441	5,026	19,467
1999	2,740	2,077	2,265	1,485	1,116	344	269	143	4,079	14,518	5,128	19,646
2000	3,011	2,379	2,724	1,845	1,226	347	323	173	4,169	16,197	6,386	22,583
2001	3,112	2,551	3,118	1,824	1,343	351	417	186	4,706	17,608	7,270	24,878
2002	2,646	2,321	2,533	1,593	1,171	371	379	180	3,674	14,868	5,009	19,877
2003	2,316	2,172	2,094	1,455	1,114	375	388	171	2,811	12,896	4,834	17,730
2004	2,425	2,168	1,958	1,479	1,186	351	437	168	3,698	13,870	3,997	17,867

Source: California State Board of Equalization compiled by The HDL Companies

NOTE: All amounts have been restated in Fiscal Year totals. Prior CAFR amounts were reported as Calendar Year totals.

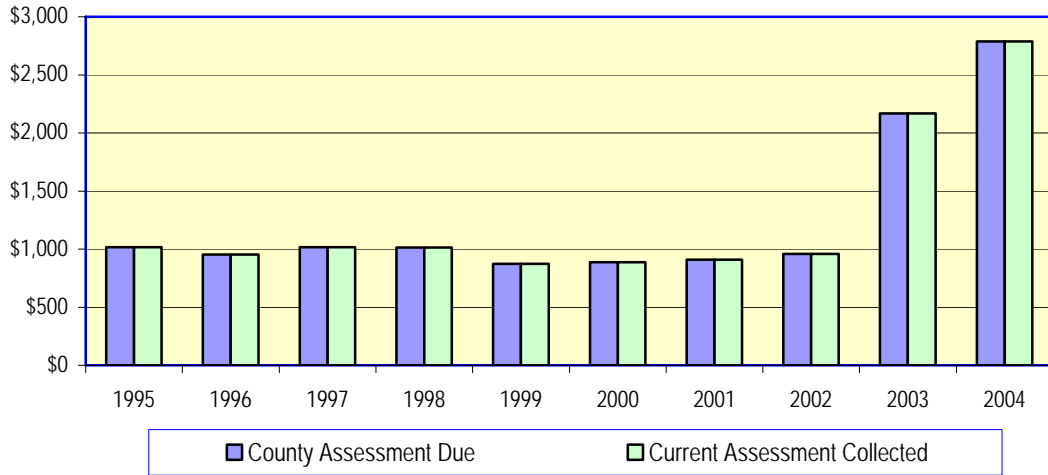
SALES TAX RATES FOR THE FISCAL YEAR ENDED JUNE 30, 2004

State Funds	6.00%
County Transportation Fund (Transportation Development Act)	0.25%
County Transportation Fund	1.00%
City	1.00%
<hr/>	
	8.25%

Source: California State Board of Equalization

City of Palo Alto - Special Assessment Billings and Collections.....

Last Ten Fiscal Years (\$000)



Fiscal Year	County Assessment Due	Current Assessment Collected	Delinquent & Penalties Collected	Special Assessment Billings and Collections
1995	\$1,016	\$1,016	14	\$1,016
1996	952	952	(A)	952
1997	1,016	1,016	(A)	1,016
1998	1,015	1,015	(A)	1,015
1999	874	874	(A)	874
2000	887	887	(A)	887
2001	910	910	(A)	910
2002	958	958	(A)	958
2003	2,169	2,169	(A)	2,169
2004	2,787	2,787	(A)	2,787

Source: County of Santa Clara Assessor's Office

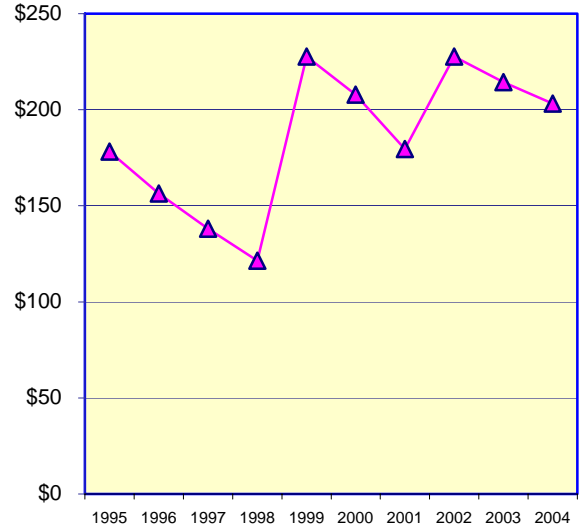
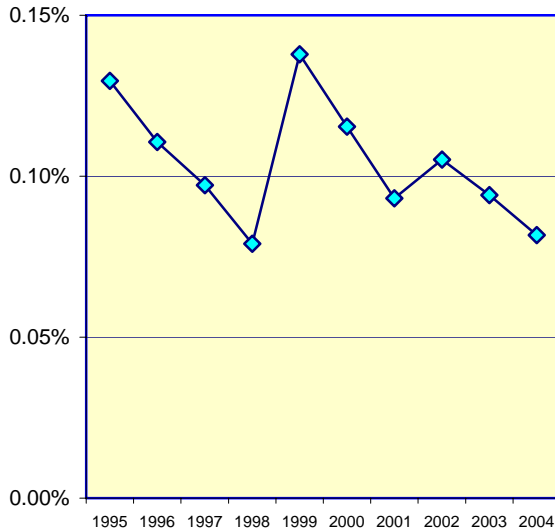
Notes: (A) Effective with the fiscal year 1993-94, the City is on the Teeter Plan, under which the County of Santa Clara pays the full tax levy due. Payment for all prior delinquencies was also received in this fiscal year.



City of Palo Alto - Ratio of Net Certificates of Participation Bonded Debt to Assessed Value and Net Certificates of Participation

Bonded Debt per Capita

Last Ten Fiscal Years



—◆— Net Bonded Debt to Assessed Valuations

—▲— Net Bonded Debt Per Capita

Fiscal Year	Population	Assessed Value (in Thousands)	Bonded Debt (in Thousands)	Net Bonded Debt to Assessed Valuations	Net Bonded Debt Per Capita
1995	56,700	\$7,795,396	\$10,103	0.130%	\$178.18
1996	57,000	8,058,927	8,916	0.111%	156.42
1997	57,800	8,206,532	7,981	0.097%	138.08
1998	57,900	8,885,623	7,026	0.079%	121.35
1999	58,300	9,623,868	13,271	0.138%	227.63
2000	58,500	10,533,778	12,162	0.115%	207.90
2001	60,200	11,609,915	10,813	0.093%	179.62
2002	60,500	13,102,696	13,778	0.105%	227.74
2003	60,465	13,776,406	12,962	0.094%	214.37
2004	60,246	14,974,966	12,240	0.082%	203.17

Source: Annual Financial Statements

City of Palo Alto - Computation of Legal Debt Margin
June 30, 2004
(in thousands of dollars)

2003-2004 Assessed Valuation	<u>\$14,974,966</u>
Debt limit - 15% of assessed value	2,246,245
Amount of debt applicable to debt limit:	
Certificates of participation	12,215
Capital lease obligations	25
Special assessment debt with governmental commitment	<u>420</u>
Total	12,660
Less amount of debt not applicable to debt limit	<u>0</u>
Total amount of debt applicable to debt limit	<u>12,660</u>
Legal debt margin	<u><u>\$2,233,585</u></u>

Source: Annual Financial Statements

- Note** (1) The above does not include debt recorded in the Enterprise Funds because such debt is not subject to legal debt margin
- (2) Special assessments debt excludes Cambridge Ave. parking (aka: 1993 California Avenue Parking) debt because there is no government commitment (\$1,465)



City of Palo Alto - Computation of Direct and Overlapping Bonded Debt

June 30, 2004 (\$000)

2003-2004 Assessed Valuation \$14,974,966

	Percentage Applicable To City of Palo Alto	June 30, 2004 Bonded Debt
Direct and Overlapping Bonded Debt		
OVERLAPPING TAX AND ASSESSMENT DEBT:		
Santa Clara Valley Water District, Zone W-1	0.48%	\$28,008
Foothill-De Anza Community College District	22.21%	42,081,113
Palo Alto Unified School District	89.19%	107,680,294
Fremont Union High School District	0.01%	10,713
Mountain View-Los Altos Union High School District	1.04%	484,076
Cupertino Union School District	0.01%	7,338
Los Altos School District	0.99%	909,565
Whisman School District	4.05%	1,108,118
City of Palo Alto Special Assessment Bonds	100.00%	46,465,000
Santa Clara Valley Water District Benefit Assessment District	7.40%	14,586,140
Total Overlapping tax and assessment debt		213,360,365
DIRECT AND OVERLAPPING GENERAL FUND OBLIGATION DEBT:		
Santa Clara County General Fund Obligations	7.40%	46,622,960
Santa Clara County Board of Education Certificates of Participation	7.40%	1,369,740
Foothill-DeAnza Community College District Certificates of Participation	22.21%	5,416,884
Mountain View-Los Altos Union High School District Certificates of Participation	1.04%	89,177
Cupertino Union School District Certificates of Participation	0.01%	388
City of Palo Alto General Fund Obligations	100.00%	12,215,000
Midpeninsula Regional Open Space Park District General Fund Obligations	12.94%	15,119,390
Santa Clara Valley Water District Certificates of Participation		
El Camino Hospital District Authority	0.09%	756
Total gross direct and overlapping General Fund obligation debt		80,834,295
Less: El Camino Hospital Authority (100% self-supporting)		756
Total net direct and overlapping General Fund obligation debt		80,833,539
GROSS COMBINED TOTAL DEBT		294,194,660⁽¹⁾
NET COMBINED TOTAL DEBT		\$294,193,904

(1) Excludes tax and revenue anticipation notes, revenue, mortgage revenue and tax allocation bonds and non-bonded capital lease obligations.

Ratios to Assessed Valuation:

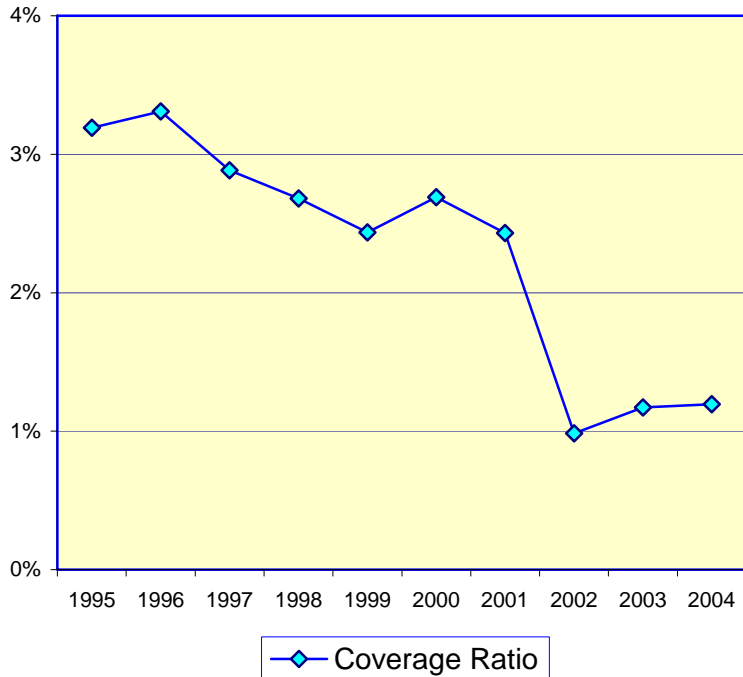
Combined Direct Debt (\$12,215,000)	0.09%
Total Overlapping Tax and Assessment Debt	1.51%
Gross Combined Total Debt	2.08%
Net Combined Total Debt	2.08%

STATE SCHOOL BUILDING AID REPAYABLE AS OF 6/30/04: \$0

SOURCE: California Municipal Statistics, Inc.

City of Palo Alto - Ratio of Annual Debt Service Expenditures for General Bonded Debt to Total General Expenditures.....

Last Ten Fiscal Years (\$000)



Fiscal Year	Total General Expenditures (1)	Debt Service			Coverage Ratio
		Principal	Interest	Total	
1995	\$75,650	\$1,245	\$1,170	\$2,415	3.19%
1996	75,250	1,365	1,125	2,490	3.31%
1997	80,402	1,355	964	2,319	2.88%
1998	85,574	1,405	888	2,293	2.68%
1999	103,050	1,553	956	2,509	2.43%
2000	104,153	1,775	1,026	2,801	2.69%
2001	115,872	1,895	922	2,817	2.43%
2002	116,800	465	686	1,151	0.99%
2003	134,050	875	696	1,571	1.17%
2004	118,779	780	639	1,419	1.19%

Note: (1) Includes general, special revenue, debt services and capital project funds

Source: **Governmental Funds:**
Statement of Revenues, Expenditures, and Changes in Fund Balance

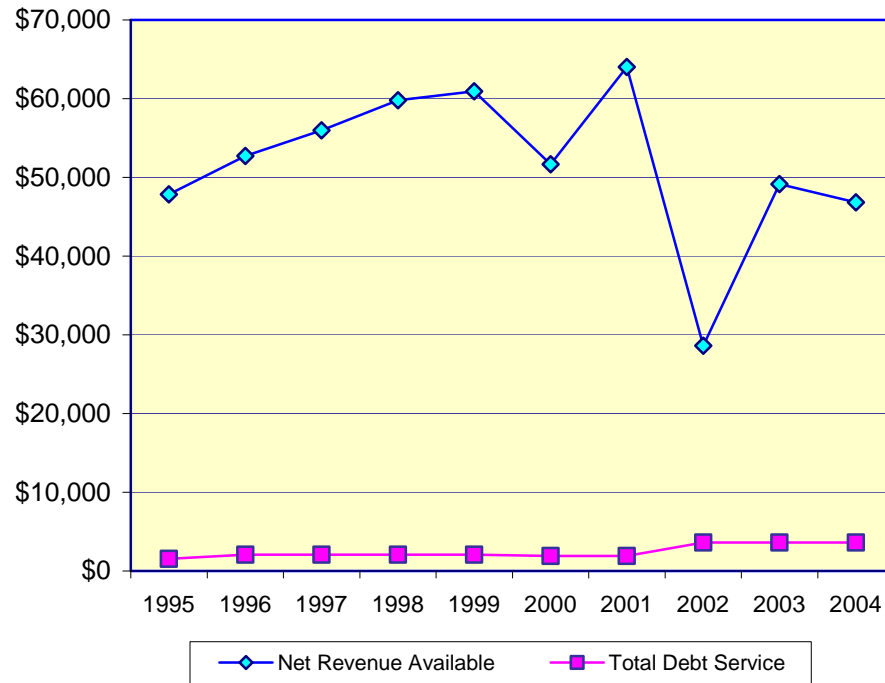


City of Palo Alto -Revenue Bond Coverage.....

Water, Electric, Gas, Wastewater Collection

Wastewater Treatment, Storm Drainage Funds and External Service Funds

Last Ten Fiscal Years (\$000)



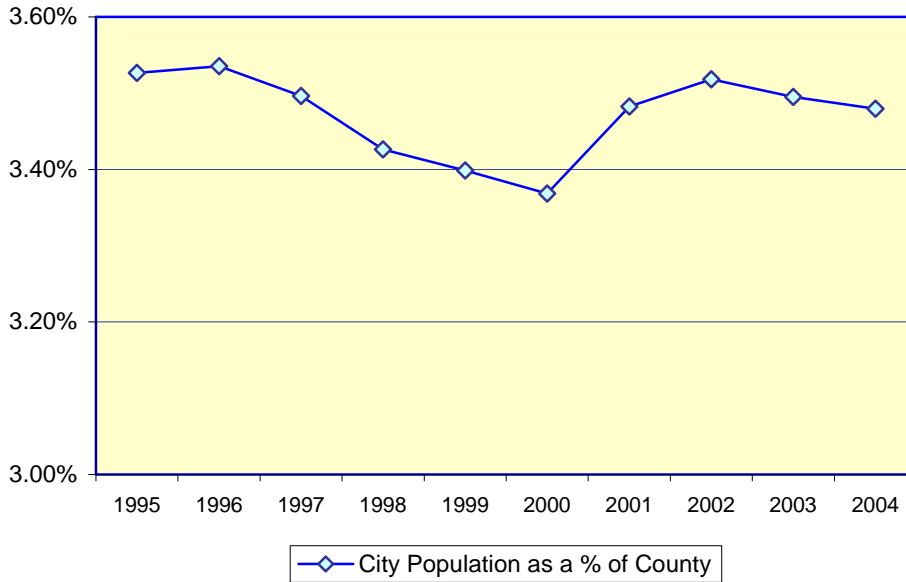
Fiscal Year	Gross Revenue	Direct Operating Expenditures	Net Revenue Available for Debt Services (1)	Debt Service			Coverage
				Principal	Interest	Total	
1995	\$124,537	\$76,693	\$47,844	\$555	\$997	\$1,552	\$30.83
1996	120,828	68,096	52,732	755	1,308	2,063	25.56
1997	133,081	77,107	55,974	801	1,263	2,064	27.12
1998	144,195	84,415	59,780	840	1,214	2,054	29.10
1999	141,696	80,748	60,948	895	1,163	2,058	29.62
2000	130,550	78,880	51,670	545	1,363	1,908	27.08
2001	197,022	133,012	64,010	555	1,342	1,897	33.74
2002	177,327	148,694	28,633	1,955	1,660	3,615	7.92
2003	166,019	116,869	49,150	1,255	2,354	3,609	13.62
2004	169,551	122,716	46,835	1,310	2,307	3,617	12.95

Source: Annual Financial Statements

Notes: (1) Excludes depreciation and amortization expense.

City of Palo Alto - Demographic Statistics.....

Last Ten Fiscal Years (\$000)



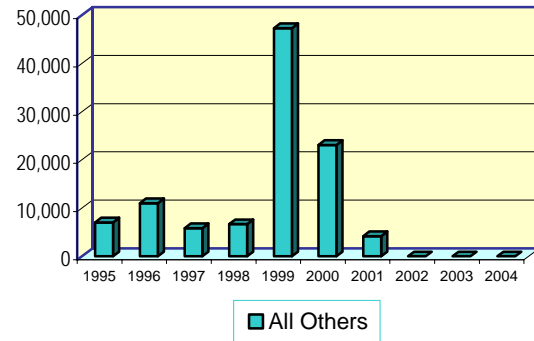
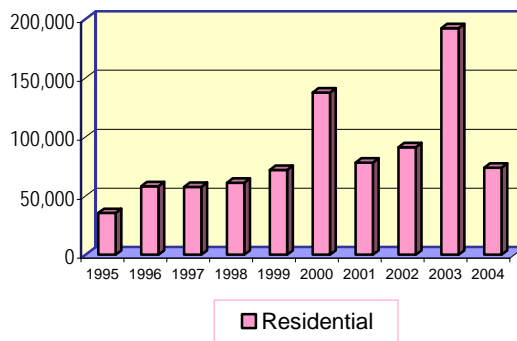
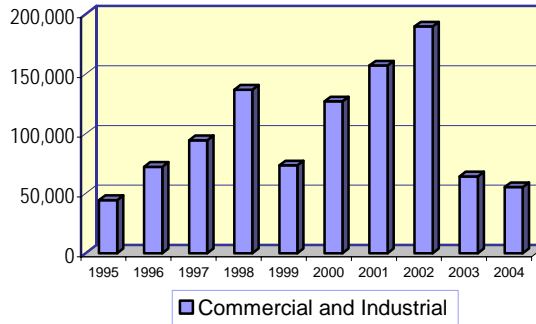
Fiscal Year	City Size Square Miles	Street Miles	City Population	(1) County Population	City Population % of County	(2) School Population	(3) Unemployment Rate
1995	25.98	193.12	56,700	1,607,700	3.53%	8,419	2.80%
1996	25.98	193.12	57,000	1,612,300	3.54%	9,122	1.90%
1997	25.98	193.12	57,800	1,653,100	3.50%	9,407	1.50%
1998	25.98	193.12	57,900	1,689,900	3.43%	9,719	1.50%
1999	25.98	193.12	58,300	1,715,400	3.40%	9,946	1.70%
2000	25.98	193.12	58,500	1,736,700	3.37%	9,881	1.50%
2001	25.98	193.12	60,200	1,728,680	3.48%	10,031	2.40%
2002	25.98	193.12	60,500	1,719,565	3.52%	9,952	3.70%
2003	25.98	193.12	60,465	1,729,917	3.50%	10,151	4.10%
2004	25.98	193.12	60,246	1,731,422	3.48%	10,341	3.20%

Sources: (1) State Department of Finance
 (2) Palo Alto Unified School District.
 (3) State Employment Development Office



City of Palo Alto - Construction Activity.....

Last Ten Fiscal Years (\$000)



Fiscal Year	Commercial & Industrial			Residential		All Other	
	Property Values	Number of Permits	Valuation	Number of Permits	Valuation	Number of Permits	Valuation
1995	\$7,795,396	384	\$44,471	1,032	\$35,563	72	\$7,055
1996	8,058,927	410	72,271	1,194	58,262	89	11,052
1997	8,206,532	377	94,485	1,095	57,617	106	5,874
1998	8,885,623	374	136,761	1,154	61,316	80	6,704
1999	9,623,898	330	73,462	1,167	71,989	106	47,325
2000	10,533,778	428	127,107	1,113	137,674	371	23,113
2001	11,609,915	820	157,088	2,599	78,345	25	4,200
2002	13,102,696	690	189,698	2,498	91,416	1	8
2003	13,776,406	725	64,219	2,275	192,359	54	0
2004	14,974,966	755	55,227	2,465	73,963	16	0

Sources: City of Palo Alto: Planning and Community Environment Department

City of Palo Alto - Insurance Coverage.....

June 30, 2004 (\$000)

TYPE	COVERAGE (Deductible)	LIMITS	COMPANY	EXPIRATION DATE
PROPERTY LOSS				
Blanket	All real & personal property (\$25,000 deductible), Fine Arts (\$2,500 deductible)	\$259,667,545	CA Public Entity Property Program	07/01/05
Boiler & Machinery	All real & personal property (\$50,000 deductible)	\$500,000 combined limit excluding power generation facilities \$100,000 combined business interruption	CA Public Entity Property Program	07/01/05
Flood Insurance	All real property 1305 Middlefield Road (\$1,000 deductible)	\$500,000	Hartford Fire Insurance Company	04/07/05
FINANCIAL LOSS				
Employee Dishonesty	Position bond-faithful performance per loss (\$5,000 deductible)	\$1,000,000 / \$4,000,000 x \$1,000,000 per occurrence for City Mgr. & Director of ASD	Fidelity & Deposit Co.	03/22/05
UMBRELLA EXCESS LIABILITY	City is a member of an insurance pool participating with a number of other California cities (\$1,000,000 self-insured retention)	\$33,000,000 annual aggregate	Insurance Company of Pennsylvania	07/01/05
Trustees Errors and Omissions	Bodily injury and property damage liability Errors and omissions liability			
SPECIAL LIABILITY				
Volunteers Accident	Medical - Each person / (\$25 deductible)	\$20,000	Pan-American Life Insurance Company	01/01/05
Special Events	Bodily injury	\$1,000,000 per occurrence	Axis Surplus Insurance Company	01/01/05
AUTOMOBILE LIABILITY	Physical Damage	\$1,000,000	Progressive Com.	04/11/05
City Manager Vehicle Only	(\$1,000 deductible comp. collision)		Auto Insurance	
EMPLOYEE BENEFIT				
Travel Accident	Indemnity, based on salary	\$1,500,000 per accident	Life Insurance Co. of North America	06/01/06
EMPLOYEE HEALTH PLAN	The City participates in the California Public Employees' Medical and Health Care Act (PEMHCA) program to provide medical benefits to employees and retirees			
WORKERS' COMPENSATION	City is self-insured for first \$750,000 liability	\$750,000 per occurrence		07/01/05
EXCESS WORKERS' COMPENSATION	Pooled Retention	\$50,000,000 limit per occurrence - Workers Comp and Employers Liability	CA. Public Entity Ins Authority	07/01/05
	Reinsured Layer	\$45,000,000 workers comp per occurrence, excess of pooled retention limit, includes \$5,000,000 employers liability excess of \$5,000,000 pooled retention, \$10,000,000 sublimit for terrorism	American Reinsurance Company	07/01/05

SOURCE: Sandra Blanch, Human Resources Dept, City of Palo Alto



City of Palo Alto - Top Ten Property Taxpayers.....

June 30, 2004 (\$000)

Taxpayer	Type of Business	Assessed Valuation	Percent of Total Assessed Valuation
Leland Stanford Jr. University	University and Ancillary	\$1,948,912	12.98%
Space Systems/Loral, Inc.	Research and Development	178,725	1.19%
Harbor Investment Partners	Offices, Banks and Clinics	60,370	0.40%
Cowper-Hamilton Associates	Offices, Banks and Clinics	41,991	0.28%
EOP-Embaracadero Place LLC	Offices, Banks and Clinics	36,000	0.24%
California Pacific Commercial Corp.	Offices, Banks and Clinics	33,926	0.23%
Campus For Jewish Life	Offices, Banks and Clinics	32,640	0.22%
Thoits Bros Inc	Offices, Banks and Clinics	27,515	0.18%
Hyatt Equities LLC	Offices, Banks and Clinics	25,469	0.17%
Seabiscuit LLC	Offices, Banks and Clinics	24,919	0.17%
Totals		<u>\$2,410,467</u>	<u>16.05%</u>
2003/2004 Local Secured Assessed Valuation:		<u>\$15,018,545</u>	

SOURCE: County of Santa Clara compiled by Hunt Consulting, LLC

City of Palo Alto - Miscellaneous Statistics

June 30, 2004

YEAR CITY DISCOVERED	1769	NUMBER OF HOUSING UNITS	27,019
DATE OF INCORPORATION	April 16, 1894	COMMERCIAL AND INDUSTRIAL SPACE	27.3 Million Square Feet
INCORPORATED AS CHARTER CITY	July 1, 1909	LAND AREA	25.98 Square Miles
FORM OF GOVERNMENT	Council-Manager	CITY MAINTAINED TREES	35,440
POPULATION	60,246		

POLICE PROTECTION

Number of Stations	1
Number of Full-time Positions	171
Number of Police Patrol Vehicles	30

FIRE PROTECTION

Number of Stations	8
Number of Full-time Positions	129
Number of Fire Apparatus	23
Number of Fire Hydrants	2,653

COMMUNITY SERVICES

Acres - Downtown Parks	170
Acres - Open Space	3,731
Parks	34
Golf Course	1
Tennis Courts	52
Athletic Center	1
Community Centers	4
Theatres	3
Cultural Centre	1
Junior Museum - Zoo	1
Swimming Pools	1
Nature Centers	2
Libraries	5

MUNICIPAL UTILITY PLANTS:

WATER

Millions of CCF Sold	6.0
Accounts	19,557
Miles of Water Mains	226

WASTEWATER

Millions of Gallons Processed	8,238
Accounts	21,830
Miles of Sanitary Sewer Lines	202

ELECTRIC

Millions of kWh Sold	958
Accounts	28,482
Pole Miles of Overhead Lines	227
Trench Miles of Underground Lines	186

GAS

Millions of Therms Sold	31.5
Accounts	23,216
Miles of Gas Mains	207

Single Audit

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Single Audit Index.....

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Single Audit Section.....

This section provides an overview of grant awards received from the Federal government. The Single Audit Act Amendments of 1996 require local governments to report and audit Federal funds separately from their Basic Financial Statements.



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SUMMARY OF FINDINGS AND QUESTIONED COSTS

Honorable Mayor and Members of the
City Council of the City of Palo Alto, California

We have audited the basic financial statements of the City of Palo Alto, California, for the year ended June 30, 2004 and have issued our unqualified report thereon dated October 19, 2004. These basic financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America; *Government Auditing Standards*, issued by the Comptroller General of the United States and the Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non profit Organizations*. We performed a Single Audit as requested by the City to comply with the provisions of the Single Audit Act Amendments of 1996 and OMB A-133 and are required to present the following summary:

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Audit of Basic Financial Statements

Our audit did not disclose any reportable conditions, or material weaknesses or instances of noncompliance material to the basic financial statements. However we did communicate matters to the City Council in our separate Memorandum on Internal Controls dated October 18, 2004.

Audit of Major Programs

Our audit did not disclose any reportable conditions or material weaknesses in internal controls over major programs. We have issued an unqualified opinion on compliance with the requirements applicable to major programs.

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)

Identification of Major Programs

The Department of Housing and Urban Development Community Development Block Grant (CFDA #14.218) and the Department of Housing and Urban Development Home Investment Partnerships Program (CFDA #14.239) were major programs.

Dollar Threshold Used to Distinguish Between Type A and Type B Programs

The threshold for Type A programs was \$300,000.

Organizational Risk Evaluation

The City was assessed as a low risk auditee based on prior years reporting results, our overall knowledge of the City and other criteria specified by the Office of Management and Budget.

FINDINGS RELATED TO FINANCIAL STATEMENTS

There were no findings required to be reported under Generally Accepted Government Auditing Standards.

FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS

There were no findings or questioned costs required to be reportable under OMB Circular A-133 section .510(a)

SUMMARY OF PRIOR YEAR FINDINGS

There were no findings in the prior year.

October 19, 2004

Mage + Associates



CITY OF PALO ALTO
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Program Name	Grantor/ Pass-Through Entity Grant Number	Catalog of Federal Domestic Assistance Number	Program Expenditures
Department of Housing and Urban Development			
Community Development Block Grant Program			
Program Expenditures	B-03-MC-06-0020	14.218	\$98,060
Subgrants:			
Emergency Housing Consortium			7,650
Catholic Charities Ombudsman Program			5,550
Avenidas HVAC			127,579
Stevenson Hs Emergency Cal			1,976
Saint Vincent dePaul			9,500
Clara Mateo Alliance Shelter			25,000
New Housing Development			3,344
Clara Mateo Alliance Family Shelter			20,900
InnVision			17,750
Shelter Network Haven Housing			19,000
Economic and Social Opportunities, Inc.			60,000
Project Sentinel - Fair Housing			26,800
Ventura Community Center			75,000
Palo Alto Housing Corporation:			
Barker Counseling			22,300
Loans Receivable			<u>4,195,547</u>
Total CDBG Expenditures		14.218	<u>4,715,956</u>
HOME Investment Partnership Program Grant			
Loan Receivable		14.239	<u>1,000,000</u>
U.S. Department of Transportation,			
Highway Planning and Construction Grant			
(Passed through California Department of Transportation)	CML-5100	20.205	1,148,580
Governor's Office of Emergency Services	FEMA-3033110-DR-CA,		
(Passed through California Department of Transportation)	OES ID #085-55282	20.703	<u>3,254</u>
Total Department of Transportation Expenditures			<u>1,151,834</u>
U.S. Department of Justice			
Local Law Enforcement Block Grant		16.592	<u>24,634</u>
TOTAL FEDERAL FINANCIAL AWARDS			<u><u>\$6,892,424</u></u>

See Notes to Schedule of Expenditures of Federal Awards



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NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Note 1

Reporting Entity

The financial statements of the City of Palo Alto and the Schedule of Expenditure of Federal Awards include the financial activities of the City as well the separate legal entities described below, since they are governed by the City Council sitting in a separate capacity or they provide services exclusively to the City.

The City's Basic Financial Statements include the financial activities of the City, the Palo Alto Regional Quality Control Plant, the Palo Alto Golf Course Corporation, and the Palo Alto Public Improvement Corporation, all of which are controlled by and dependent on the City. While these are separate legal entities, City Council serves in separate session as their governing body and their financial activities are integral to those of the City. Their financial activities have been aggregated and merged (termed "blended") with those of the City in the accompanying financial statements.

Financial statements for the above component units can be obtained from the City of Palo Alto, 250 Hamilton Avenue, Palo Alto, CA 94301.

The financial statements exclude the Palo Alto Cable Cooperative Franchise, as it is administered by a board separate from and independent of the City.

Note 2

Basis of Accounting

Basis of accounting refers to *when* revenues and expenditures or expenses are recognized in the accounts and reported in the financial statements, regardless of the measurement focus applied. All governmental funds and agency funds are accounted for using the modified accrual basis of accounting.

Expenditures of Federal Awards reported on the Schedule are recognized when incurred. An exception to this rule is expenditures of federal awards for loan programs. The City operates the Community Development Block Grant and HOME Investment Partnership loan programs under which it must insure participants maintain compliance with program requirements on an ongoing basis. OMB Circular A-133 section .205(b) requires that expenditures for the above programs include the balance of loans outstanding plus cash received from the program.

Note 3

Direct and Pass-Through Federal Awards

Federal awards may be granted directly to the City by the Federal granting agency or may be granted to other government agencies which pass-through federal awards to the City. The Schedule includes both of these types Federal award programs.



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**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Honorable Mayor and City Council
City of Palo Alto, California

We have audited the basic financial statements of City of Palo Alto as of and for the year ended June 30, 2004, and have issued our report thereon dated October 19, 2004. We conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However we did communicate other matters to City Council in our separate Memorandum on Internal Controls dated October 19, 2004.

This report is intended for the information of the City Council, management and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.

Maze + Associates

October 19, 2004

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REPORT ON COMPLIANCE AND INTERNAL CONTROL OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM

Honorable Mayor and City Council
City of Palo Alto, California

Compliance

We have audited the compliance of the City of Palo Alto with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004. The City's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the City's management. Our responsibility is to express an opinion on the City's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the City's compliance with those requirements.

In our opinion, the City of Palo Alto complied in all material respects with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004.

Internal Control Over Compliance

City management is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the City's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Report on Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of City of Palo Alto as of and for the year ended June 30, 2004, and have issued our report thereon dated October 18, 2004. Our audit was made for the purpose of forming an opinion on the basic financial statements of the City of Palo Alto taken as a whole. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. The information in that schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and in our opinion is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

This report is intended for the information of the City Council, management and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.

Mage + Associates

October 19, 2004



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The City of Palo Alto is located in northern Santa Clara County, approximately 35 miles south of the City of San Francisco and 12 miles north of the City of San Jose. Spanish explorers named the area for the tall, twin-trunked redwood tree they camped beneath in 1769. Palo Alto incorporated in 1894 and the State of California granted its first charter in 1909.

AMERICANS WITH DISABILITIES ACT STATEMENT

In compliance with Americans with Disabilities Act (ADA) of 1990, this document may be provided in other accessible formats.

For information contact:

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250 Hamilton Avenue
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(650) 328-1199 (TDD)

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