



City of Palo Alto, California

2004-2005

Comprehensive Annual Financial Report

Fiscal Year Ended June 30, 2005





*City of Palo Alto
California*

**Comprehensive
Annual Financial
Report**

**For the fiscal year ended
June 30, 2005**



Prepared by: Administrative Services Department

This page is intentionally left blank.



Table of Contents.....

INTRODUCTION

Letter of Transmittal	v
City Officials	ix
Organizational Structure	x
Administrative Services Department Organization	xi
GFOA Certificate of Achievement for Excellence in Financial Reporting	xii
CSMFO Certificate of Award for Outstanding Financial Reporting	xiii

FINANCIAL SECTION

Independent Auditor’s Report on Basic Financial Statement.....	xv
--	----

M D & A

Management’s Discussion and Analysis.....	1
---	---

BASIC FINANCIAL STATEMENTS

Citywide Financial Statements

Statement of Net Assets	25
Statement of Activities	26

Fund Financial Statements

Major Governmental Funds:

Balance Sheet	29
Reconciliation of Fund Balances to Governmental Activities Net Assets.....	30
Statement of Revenues, Expenditures, and Changes in Fund Balance	31
Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances of Governmental Funds to the Statement of Activities.....	32
Statement of Revenues, Expenditures, and Changes in Fund Balances – Budget and Actual:	33



BASIC FINANCIAL STATEMENTS (Continued)

Major Proprietary Funds:

Statement of Net Assets	36
Statements of Revenues, Expenses and Changes in Net Assets	38
Statement of Cash Flows.....	40

Fiduciary Funds:

Statement of Fiduciary Net Assets	45
---	----

Notes to Financial Statements

Index to the Notes to the Basic Financial Statements	47
Notes to Basic Financial Statements	49

SUPPLEMENTAL INFORMATION

Non-major Governmental Funds

Combining Balance Sheets	102
Combining Statements of Revenues, Expenditures, and Changes in Fund Balances.....	106
Combining Schedule of Revenues, Expenditures, and Changes in Fund Balance—Budget and Actual.....	110

Internal Service Funds

Combining Statements of Net Assets	118
Combining Statements of Revenues, Expenses and Changes in Net Assets.....	119
Combining Statements of Cash Flows.....	120

Fiduciary Funds

Statement of Changes in Assets and Liabilities - All Agency Funds.....	122
--	-----



STATISTICAL SECTION

General Governmental Revenues by Source - Last Ten Fiscal Years..... 125

General Governmental Expenditures by Function - Last Ten Fiscal Years 126

General Fund Tax Revenues by Source - Last Ten Fiscal Years 127

Property Tax Levies and Collections - Last Ten Fiscal Years 128

Assessed Value of Taxable Property - Last Ten Fiscal Years 129

Property Tax Rates - All Overlapping Governments
-Last Ten Fiscal Years 130

Taxable Transactions by Type of Business - Last Ten Fiscal Years
and Sales Tax Rates..... 131

Special Assessment Billings and Collections - Last Ten Fiscal Years..... 132

Ratio of Net Certificates of Participation Bonded Debt to Assessed Value and
Net Certificates of Participation Bonded Debt per Capita -
Last Ten Fiscal Years..... 133

Computation of Legal Debt Margin 134

Computation of Direct and Overlapping Bonded Debt 135

Ratio of Annual Debt Service Expenditures for General Bonded
Debt to Total General Expenditures - Last Ten Fiscal Years..... 136

Revenue Bond Coverage - Water, Electric, Gas, Wastewater Collection,
Wastewater Treatment, Storm Drainage Funds and External Service Funds -
Last Ten Fiscal Years..... 137

Demographic Statistics - Last Ten Fiscal Years 138

Construction Activity - Last Ten Fiscal Years 139

Insurance Coverage..... 140

Top Ten Property Taxpayers..... 141

Miscellaneous Statistics..... 142



SINGLE AUDIT SECTION

Summary of Audit Results..... 147

Schedule of Expenditures of Federal Awards..... 149

Notes to the Schedule of Expenditures of Federal Awards..... 151

Report on Internal Control Over Financial
Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements Performed
in Accordance with Government Auditing Standards..... 153

Report on Compliance with Requirements Applicable
to Each Major Program and on Internal Control Over
Compliance in Accordance with OMB Circular A-133..... 154

City of Palo Alto
Office of the City Manager

Transmittal Letter.....

December 13, 2005

THE HONORABLE CITY COUNCIL
Palo Alto, California

Attention: Finance Committee

COMPREHENSIVE ANNUAL FINANCIAL REPORT

YEAR ENDED JUNE 30, 2005

Members of the Council and Citizens of Palo Alto:

Transmittal: The Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005, 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, 2005, 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 61,674, 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. In 2004-05, the Silicon Valley economy finally saw signs of a longer-term recovery. Unemployment rates in the last year declined from 3.4 percent to 2.7 percent in Palo Alto and from 6.8 percent to 5.5 percent in Santa Clara County. Economically sensitive revenue sources such as sales and transient occupancy tax revenues began to rebound slowly after years of declines. 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, and therefore has not had to rely on General Fund reserves to meet its commitments.

The City continues to face fiscal challenges, including rising employee benefit costs, strong competition from neighboring City retail outlets, high commercial vacancy rates, and the closing of several revenue generators – a hotel and automobile dealership. These factors make it unlikely the City’s fiscal condition will improve dramatically in the near future, and the City will vigilantly monitor expenditures in the next year. For example, as part of the 2005-06 budget, the City enacted a layoff of 14.5 FTEs, for a savings of about \$1.5 million needed to balance the budget.

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 79,250 (jurisdictional boundary). With a local workforce around 33,000, commuters hold over 60 percent 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 Palo Alto Medical Foundation, Agilent Technologies, Hewlett Packard/Compaq, and the City of Palo Alto.

However, over the last few years, a number of local and regional technology companies have implemented layoffs, including Agilent, Apple, Sun Microsystems, Oracle, Hewlett Packard/Compaq and other businesses. Consequently, Palo Alto’s unemployment rate rose 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. More recently, as the economy has slowly rebounded, so have unemployment rates. By July 2004 unemployment rates in the City and County fell to 3.2 percent and 6.3 percent, respectively. In July of 2005, Palo Alto unemployment had fallen to 2.7 percent; County unemployment was at 5.5 percent.



Real Estate Market: Assessed property valuation in Santa Clara County experienced an anemic growth rate of 2.23 percent in 2004-05. This was the slowest rate of growth in the last decade. This is due to a continued trend of declining commercial and industrial property values, while residential values remain fairly stable. According to the County Assessor, “the collapse of [the] commercial and industrial market has been unprecedented.” Furthermore, business personal property (computers, machinery, equipment and fixtures) experienced a significant reduction.

In Palo Alto assessed valuation increased by 5.74 percent, compared to a 2.61 percent increase from 2002-03 to 2003-04. This is due to the fact that a greater percentage of Palo Alto’s assessment roll is residential, compared to other cities like Sunnyvale, Milpitas, and Santa Clara. Secured property (property subject to a lien) values were 8.2 percent higher in 2004-05 than in 2003-04, but unsecured property values fell by 13.6 percent.

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 2004-05, 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, libraries, 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 eleventh consecutive year the City has received both of these awards and the current certificates appear immediately after the end of this transmittal letter. The 2004-05 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, Payroll Analysts 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

Jim Burch, *Mayor*

Judy Kleinberg, *Vice-Mayor*

Victor Ojakian Dena Mossar

Hillary Freeman Bern Beecham

Yoriko Kishimoto LaDoris Cordell

Jack Morton

Finance Committee

Victor Ojakian, *Chair*

Yoriko Kishimoto

Jack Morton

Dena Mossar

Policy and Services Committee

Hillary Freeman, *Chair*

Bern Beecham

LaDoris Cordell

Judy Kleinberg

Council-Appointed Officers

City Manager

Frank Benest

City Attorney

Gary Baum

City Clerk

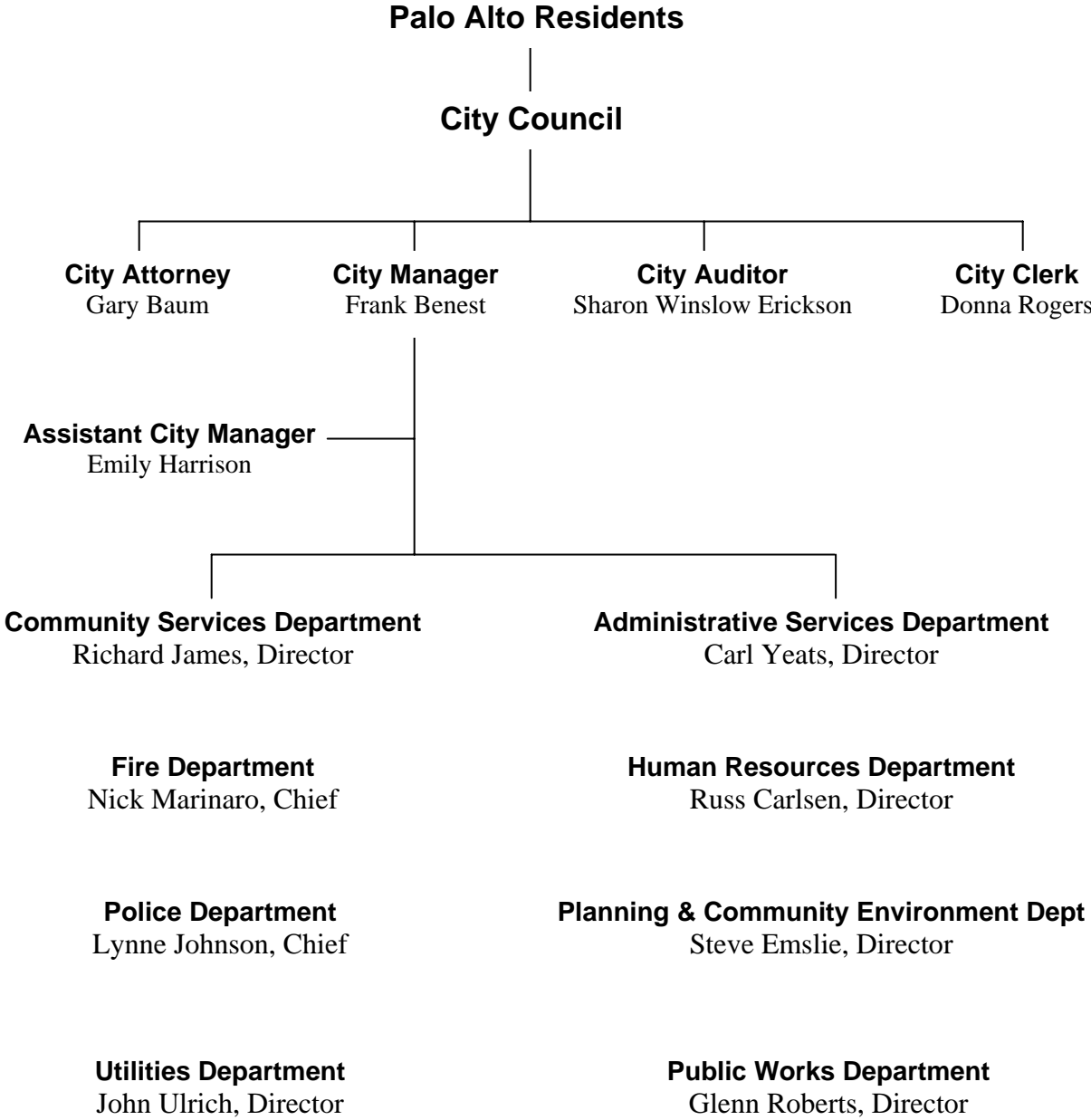
Donna Rogers

City Auditor

Sharon Winslow Erickson



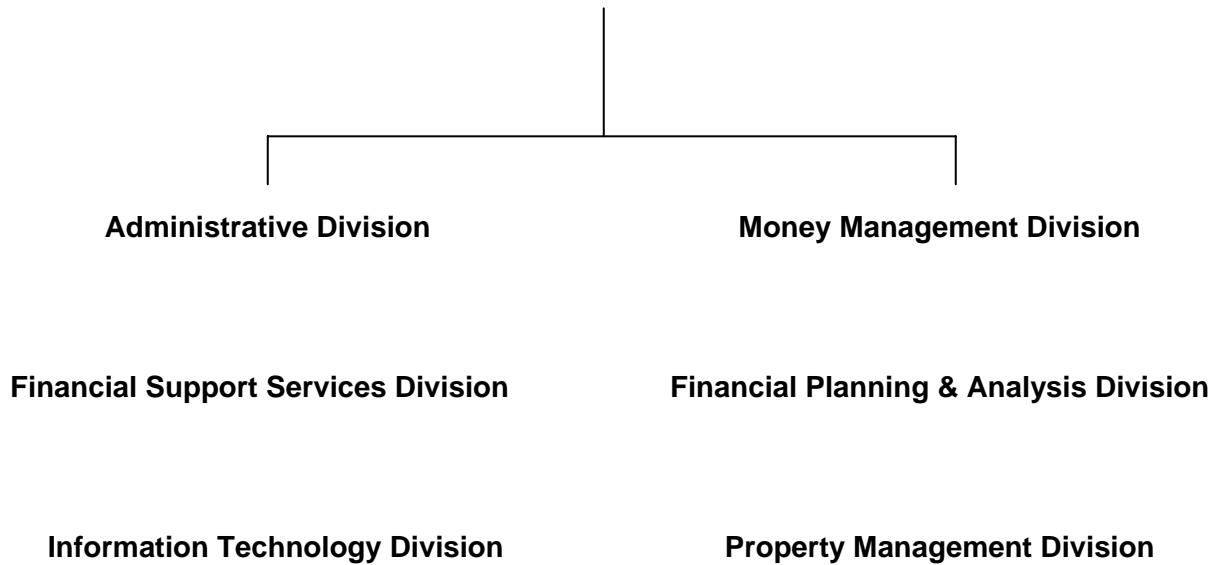
City of Palo Alto Organization





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, 2004

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.



Nancy L. Zjelle

President

Jeffrey R. Emer

Executive Director

California Society of Municipal Finance Officers – Award





This page is intentionally left blank.

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

ACCOUNTANCY CORPORATION
1931 San Miguel Drive - Suite 100
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, 2005, 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.

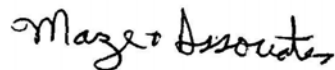
In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Palo Alto, California as of June 30, 2005 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 7, 2005 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.



October 7, 2005

This page is intentionally left blank.



Management’s Discussion and Analysis

With the 2004-05 Comprehensive Annual Financial Report (CAFR), the City will have complied with 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 four 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 2004-05 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



Management Discussion and Analysis

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, 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, Libraries 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 2004-05, the City has two Major Governmental Funds, the General 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 economic downturn that began in Spring 2000 and persisted into 2004 showed signs of stabilizing and reversal in the latter half of fiscal year 2004-05. Adverse events and trends in the downturn such as layoffs in the technology sector, lack of capital investment, curtailed venture capital activity, and weaker consumer spending began to turn around in the Silicon Valley economy toward the end of 2004-05. Unemployment rates over the last year declined from 3.4 percent to 2.7 percent in Palo Alto and from 6.8 percent to 5.5 percent in Santa Clara County. Statistics on job growth on the Peninsula indicated growth of a little over 1 percent over the prior year - a modest, but welcomed trend. Nationally, firms that had reduced computer purchases began to reinvest in technology and boosted the bottom line of Silicon Valley companies. Economically sensitive revenue sources such as sales and transient occupancy tax revenues began to rebound slowly after years of declines. This movement indicated that consumers and businesses felt confident to spend more money on goods and services which reinvigorated City resources.

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. This effort continued into 2004-05 resulting in a modest General Fund surplus at year-end. To achieve this, and to balance its budgets, the City engaged in significant and difficult cost reduction measures. These included reducing the workforce by 70 positions since the beginning of the recession. An important consequence of the expense reduction program was that the City did not draw down reserves to solve the numerous financial tests it faced.

The City does face expense and revenue challenges in the future. These include: funding rising employee benefit costs and existing and new infrastructure needs; warding off strong competition from neighboring City retail outlets for sales tax dollars; and preventing the potential exodus of automobile dealerships generating high sales tax receipts. To counter these challenges the City has initiated changes in health benefit plans, launched new efforts to maintain and attract businesses, and to explore new revenue sources. Based on its efforts to date, the City is well positioned to meet future economic challenges.

The comparisons in the discussion and analysis below are between 2004-05 and 2003-04. All increases and decreases are expressed relative to 2003-04 results. Fiscal year 2004-05 financial highlights include the following:

Citywide

- The City’s total net assets decreased to \$970.2 million, a \$3.3 million decrease.
- The City’s total capital assets, net of related debt, increased to \$608.7 million, a \$17.4 million increase.
- The City’s total restricted net assets decreased to \$29.0 million, a \$3.2 million reduction.
- The City’s total unrestricted net assets decreased to \$332.4 million, a \$17.6 million decrease.
- Citywide revenues totaled \$284.5 million, a decrease of \$1.1 million from the prior year. This total consists of \$225.4 million in program revenues and \$59.1 million in general revenues. Program revenues increased by \$3.7 million while general revenues decreased by \$4.8 million.
- Total Citywide expenses were \$287.9 million, a \$19.0 million increase.
- Citywide total assets decreased to \$1,080.3 million, a \$3.1 million decrease.
- Citywide capital assets, increased by \$26.3 million to \$665.4 million.
- Citywide other assets decreased \$29.4 million to \$414.9 million.
- Citywide total liabilities were \$110.2 million, an increase of \$0.3 million.
- Citywide long-term debt decreased \$3.0 million to \$54.5 million.
- Citywide other liabilities were \$55.7 million, an increase of \$3.3 million.



Fund Level – Governmental Funds

- Governmental Fund balances decreased to \$98.2 million, an \$11.7 million change.
- Governmental Fund revenues increased to \$100.3 million, a \$6.7 million increase.
- Governmental Fund expenditures were \$124.8 million, a \$6.0 million increase.
- General Fund revenues came in at \$92.9 million, an increase of \$6.7 million over prior year levels.
- General Fund expenditures are \$100.7 million, an increase of \$6.3 million.
- The General Fund balance of \$31.8 million at June 30, 2005 was a decrease of \$35.0 million from the prior year (refer to Performance of Governmental Funds – General Fund, Page #14).

Fund Level – Enterprise Funds

- Enterprise Fund net assets decreased to \$521.8 million, a \$0.9 million decrease.
- Enterprise Fund revenues increased to \$195.6 million, a \$4.1 million increase over prior year revenues.
- Enterprise Fund expenses increased to \$162.5 million, a \$4.3 million increase.

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>2005</u>	<u>2004</u>	<u>Increase/ (Decrease) from 2004</u>
Cash and investments	\$149.8	\$157.6	(\$7.8)
Other assets	27.6	26.8	0.8
Capital assets	318.5	310.0	8.5
Total Assets	<u>495.9</u>	<u>494.4</u>	<u>1.5</u>
Long-term debt outstanding	11.0	12.7	(1.7)
Other liabilities	35.1	30.4	4.7
Total Liabilities	<u>46.1</u>	<u>43.1</u>	<u>3.0</u>
Net Assets:			
Invested in capital assets, net of debt	305.2	297.1	8.1
Restricted	27.3	30.4	(3.1)
Unrestricted	117.3	123.8	(6.5)
Total Net Assets	<u>\$449.8</u>	<u>\$451.3</u>	<u>(\$1.5)</u>

The City’s governmental net assets decreased \$1.5 million to \$449.8 million in 2004-05. This change results from the following:

- Cash and investments decreased by \$7.8 million. This consists of cash outlays from fiscal agent for bond defeasance.
- Capital assets increased \$8.5 million net of depreciation; \$ 4.8 million is a result of roadway network and \$ 2.4 million of recreation and open space network capital improvement projects.
- Other liabilities increased by \$4.7 million, primarily from a \$3.4 million increase in claims payable.

- Net assets invested in capital assets net of related debt increased \$8.1 as the City added General Fund infrastructure assets as discussed in the Capital Assets section.
- Unrestricted net assets decreased \$6.5 million for a total of \$117.3 million; this represents current net assets available to finance subsequent year operations and other expenditures approved by City Council.

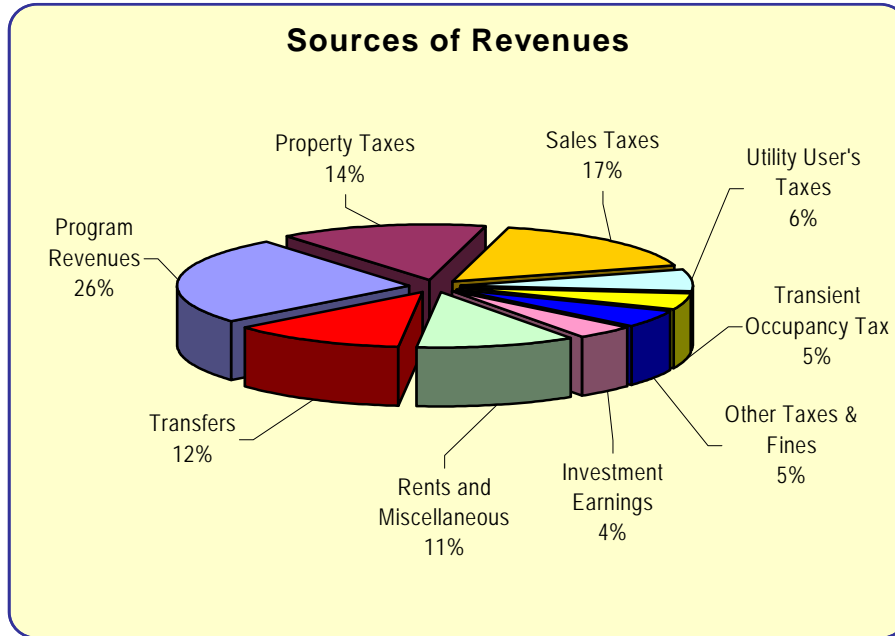
GOVERNMENTAL ACTIVITIES			
<i>Revenues for the Year ended June 30</i>			
(in Millions)			
Revenues by Source	2005	2004	Increase/ (Decrease) from 2004
Program Revenues:			
Charges for services	\$25.2	\$24.0	\$1.2
Operating contributions & grants	3.7	4.2	(0.5)
Capital contributions & grants	0.8	2.0	(1.2)
Total Program Revenues	29.7	30.2	(0.5)
General Revenues:			
Property Taxes	16.7	13.7	3.0
Sales Taxes	19.3	18.2	1.1
Utility User's Taxes	7.3	7.2	0.1
Transient Occupancy Tax	5.7	5.5	0.2
Other Taxes and Fines	5.6	8.5	(2.9)
Investment Earnings	5.0	0.1	4.9
Rents and Miscellaneous	13.0	10.2	2.8
Transfers	14.1	15.0	(0.9)
Total General Revenues	86.7	78.4	8.3
Total Revenues	\$116.4	\$108.6	\$7.8

Governmental Activities – Revenues

The table above shows that governmental revenues totaled \$116.4 million in 2004-05, an increase of \$7.8 million compared to prior year revenues of \$108.6 million.

Property Taxes had an increase of \$3.0 million, other taxes and fines decreased by \$2.9 million. These variances are primarily due to State mandated payment changes designed to solve its budget problems. Vehicle License Fees (VLF) were paid through a shift or increase in property taxes to the City and the VLF payments were consequently reduced. The net effect is that the changes in these two revenues offset one another. Investment earnings increased by \$4.9 million. The increase is a result of the year-end adjustment to carrying value for investments and reflects the year to year change in carrying value.

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 2004-05 and 2003-04 expenses (does not include encumbrances and reappropriations) by Governmental Activities and interest on long-term debt. Total Governmental Activities expense was \$117.8 million in 2004-05, an increase of \$13.6 million.

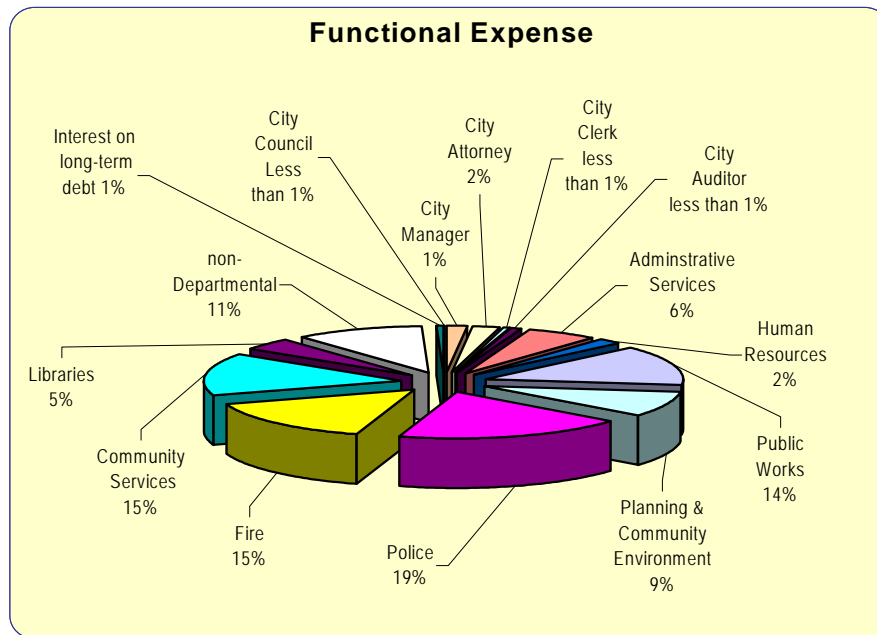
GOVERNMENTAL ACTIVITIES			
<i>Expenses for the Year ended June 30</i>			
(in Millions)			
Activities	2005	2004	Increase/ (Decrease) from 2004
City Council	\$0.1	\$0.2	(\$0.1)
City Manager	1.7	1.7	0.0
City Attorney	2.7	2.3	0.4
City Clerk	0.8	0.8	0.0
City Auditor	0.8	0.7	0.1
Administrative Services	7.0	6.3	0.7
Human Resources	2.4	2.1	0.3
Public Works	16.4	14.4	2.0
Planning and Community Environment	10.2	8.9	1.3
Police	22.4	20.4	2.0
Fire	18.1	17.3	0.8
Community Services	17.2	20.9	(3.7)
* Libraries	4.8	0.0	4.8
Non-Departmental	12.5	7.6	4.9
Interest on long-term debt	0.7	0.6	0.1
Total Functional Expense	\$117.8	\$104.2	\$13.6
Transfers in	\$14.1	\$15.0	(\$0.9)
Change in Net Assets	(\$1.5)	\$4.4	(\$5.9)
Net Assets-Beginning	451.3	446.9	4.4
Net Assets-Ending	\$449.8	\$451.3	(\$1.5)

* Libraries were part of Community Services in 2004



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 2004-05, the City added \$8.5 million in capital assets. The composition of 2004-05 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)			
	2005	2004	Increase/ (Decrease) from 2004
Cash and investments	\$209.7	\$238.2	(\$28.5)
Other assets	27.8	21.7	6.1
Capital assets	346.9	329.1	17.8
Total Assets	584.4	589.0	(4.6)
Long-term debt outstanding	43.6	44.9	(1.3)
Other liabilities	20.4	21.9	(1.5)
Total Liabilities	64.0	66.8	(2.8)
Net assets:			
Invested in capital assets, net of debt	303.5	294.2	9.3
Restricted	1.8	1.8	(0.1)
Unrestricted	215.1	226.2	(11.1)
Total Net Assets	\$520.4	\$522.2	(\$1.8)

The City’s Business-type net assets decreased \$1.8 million to \$520.4 million in 2004-05.

- Cash and investments decreased \$28.5 million as a result of operations. Other assets increased \$6.1 million to \$27.8 million as a result of Electric Fund accounts receivable increase of \$7.4 million.
- Capital assets increased \$17.8 million to \$346.9 million in 2004-05. This increase is primarily a result of water, electric and gas infrastructure improvements totaling \$15.5 million.
- Repayments reduced long-term debt \$1.3 million to \$43.6 million. No debt was issued in 2004-05.
- Net assets invested in capital assets net of related debt increased \$9.3 million to \$303.5 million. The increase was due to \$4.8 million of improvements in the Electric Fund, \$1.0

million in the Gas Fund improvements and \$3.4 million in the Wastewater Collection Fund.

- Unrestricted net assets of \$215.1 million, a decrease of \$11.1 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 \$81.7 million, the Calaveras reserve for stranded costs of \$72.9 million and the emergency plant replacement reserve of \$7.0 million.

BUSINESS-TYPE ACTIVITIES

*Revenues for the Year ended June 30
(in Millions)*

Revenues by Source	2005	2004	Increase/ (Decrease) from 2004
Program Revenues:			
Water	\$21.0	\$22.0	(\$1.0)
Electric	88.7	92.6	(3.9)
Gas	31.2	24.8	6.4
Wastewater Collection	12.0	12.6	(0.6)
Wastewater Treatment	16.0	14.7	1.3
Refuse	23.4	21.9	1.5
Storm Drainage	2.5	2.2	0.3
External Services	0.8	0.6	0.2
Total Program Revenues	195.6	191.4	4.2
General Revenues:			
Investment Earnings	8.1	0.4	7.7
Total General Revenues	8.1	0.4	7.7
Total Revenues	\$203.7	\$191.8	\$11.9

The table above presents the revenues for 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.

Business-type Activity revenues totaled \$203.7 million, an increase of \$11.9 million from prior year. Revenues were significantly affected by the following events:

- Program Revenues for the Electric fund decreased \$3.9 million primarily due to the termination of excess capacity revenue contracts.

- Program Revenues for the Gas fund increased \$6.4 million primarily due to two rate increases during the year; 9.9 percent effective July 2004 and 15 percent effective January 2005.
- Investment earnings increased \$7.7 million due to the year-end adjustment to the carrying value for investments.

BUSINESS-TYPE ACTIVITIES

Expenses for the Year ended June 30
(in Millions)

Activities	2005	2004	Increase/ (Decrease) from 2004
Water	\$15.0	\$16.0	(\$1.0)
Electric	73.1	73.5	(0.4)
Gas	26.7	23.0	3.7
Wastewater Collection	8.9	9.2	(0.3)
Wastewater Treatment	17.5	14.9	2.6
Refuse	25.0	24.3	0.7
Storm Drainage	3.3	3.0	0.3
External Services	0.8	0.7	0.1
Transfers/Special Items			
Special Item	21.5	0.0	21.5
Transfers out	14.1	15.0	(0.9)
Total Expense	\$205.7	\$179.6	\$26.1
Change in Net Assets	(\$1.9)	\$12.4	(\$14.3)
Net Assets-Beginning	522.3	509.9	12.4
Net Assets-Ending	\$520.4	\$522.3	(\$1.9)

The table above presents a comparison of the 2004-05 and 2003-04 expenses for the City’s Business-type Activities. Encumbrances and reappropriations are not included.

Business-type Activity expenses increased \$26.1 million for a total of \$205.7 million. Changes to expenses were significantly affected by the following events:

- Commodity expenses increased \$2.9 million in the Gas Fund.
- Operation and Maintenance expenses increased \$1.6 million in the Wastewater Treatment Fund. The increase was primarily due to increased costs for salary, benefits and supplies.
- The \$21.5 million increase in Special Items is due to a legal settlement with Enron Corporation.



FUND FINANCIAL STATEMENTS

Performance of Governmental Funds

At June 30, 2005, the City's Governmental Funds reported combined fund balances of \$98.2 million, a decrease of \$11.7 million or 10.6 percent compared with the prior year

Governmental Fund revenues and other financing sources increased \$38.6 million for a total of \$160.8 million. Revenues and other financing sources in the General Fund increased \$4.2 million; Capital Project Fund increased \$ 32.4 million as a result of an increase of operating transfers from the General Fund of \$ 33.1 million. Non-major Fund revenues and other financing sources increased by \$2.0 million.

Governmental Fund expenditures and other uses increased \$34.6 million this year to \$172.5 million. General Fund expenditures increased \$39.7 million, Capital Projects Fund expenditures decreased by \$ 5.6 million; and non-major fund expenditures and other uses increased by \$0.5 million.

General Fund – The General Fund ended the year with a \$35.0 million decrease to fund balance, compared to \$0.5 million increase in the prior year. The \$35.0 million decrease is due mainly to the \$35.9 million operating transfer to move the infrastructure reserve to the Capital fund. The City Auditor recommended a simplification of infrastructure funding by: (1) moving the Infrastructure Reserve from the General Fund to the Capital Projects fund; and (2) retaining unspent project funds in the Capital Projects Fund. The City Council approved this recommendation with the adoption of the 2004-05 budget. This operating transfer complies with City Council direction. During this period of slow economic recovery, the City has continued to closely monitor its expenditures.

Palo Alto's General Fund revenues totaled \$92.9 million in 2004-05. This represents an increase of \$6.7 million or 7.8 percent compared to the prior year. Since economically sensitive revenue sources such as sales and transient occupancy taxes began their steep decline in 2000-02, it appears that these revenues have begun to stabilize in 2004-05. In fact, there is preliminary evidence that receipts from these sources are slowly and gradually turning upward. There are, however, numerous issues that could derail this emerging trend. These include: little employment growth in Silicon Valley, the impacts of high oil prices on consumer spending, and a potential housing bubble that could severely affect consumer confidence and the local economy.

Sales tax, the City's largest revenue source, totaled \$19.3 million in 2004-05 rising \$1.1 million above budgeted and prior year revenues. This increase, along with other revenue data, supports the perspective of a measured turnaround. Economic segments contributing to the positive results include: department and apparel stores, service stations, and miscellaneous retail. Those segments turning in lackluster performances include: automobile, food market, and business service sales. Although retail sales tax receipts have risen, the City is facing stiff competition from nearby big box stores and surrounding malls, and the potential exodus of automobile dealers. Currently, the City is in the process of identifying suitable off-freeway sites to maintain its dealerships.

Further indication of improvement in revenue streams comes from Transient Occupancy Tax (TOT) performance. TOT revenues rose to \$5.7 million in 2004-05, a 4.0 percent or \$0.2 million improvement over the prior year. Although revenues were a slight \$0.2 million under budget, underlying performance statistics are showing some strength. Average occupancy rates increased



from 56.8 percent in 2003-04 to 61.1 percent in 2004-05. The rise in occupancy rates was accompanied by a slight 1.7 percent increase in average daily rates that went from \$117.03 in the prior year to \$119.22 in 2004-05. On the downside, the loss of significant Hyatt Rickey's revenue in 2005-06 and competition from new hotels in neighboring cities will present challenges in 2005-06.

As in 2003-04, documentary transfer tax revenues (reported as part of Other Taxes and Fines) performed well in 2004-05, totaling \$5.1 million. These revenues were \$0.5 million below those in 2003-04 (due to a sizeable transaction in prior year), but \$1.4 million above budget. This positive variance results from significant appreciation in residential home values and a low interest rate environment that has fueled sales. As the residential housing market cools, it is anticipated this revenue source will revert to historical revenue levels.

Because of State takeaways (ERAF III) of local revenues in 2004-05, property taxes came in \$0.3 million below prior year levels. Controlling for the ERAF takeaway, which will be restored in 2006-07, property taxes performed nicely in 2004-05 at \$14.9 million. This represents an increase of \$1.5 million in the City's revenue base. A thriving residential market and a rebound in the purchase of fixed and moveable equipment by businesses are responsible for higher property taxes. It is important to note that if a housing bubble does emerge and residential values decline, positive movement in this revenue source will be undermined.

Planning and Building fees were below expectations by \$0.5 million due to a recent slump in commercial Planning and Building applications. In 2005-06, we are projecting a resurgence of commercial building activity, and fee revenue is increased accordingly. Paramedic revenues were below forecast by \$0.4 million due to delays in implementation of the Basic Life Support program and inter-facility transports. Green fees also fell below expectations by \$0.2 million due to a heavy rainy season. Finally, street cut fees were \$0.7 million below forecast due to lower than anticipated street cut activities. In 2005-06, we will review the forecast for street cut fees and update it accordingly.

At June 30, 2005, the General Fund Balance totaled \$31.8 million. This represents 31.6 percent of direct General Fund expenditures, providing a buffer against unexpected financial events. Of this, \$7.3 million is reserved and \$24.5 million is unreserved. A substantial portion of the unreserved amount is designated by the Council for budget stabilization, \$21.1 million at year-end. The equity transfer stabilization designation, established in 2001-02, totaled \$3.2 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.

General Fund expenditures and other uses totaled \$143.3 million, an increase of \$39.7 million from prior year. This increase was primarily from the \$35.9 million operating transfer to move the infrastructure reserve to the Capital fund. The increase without the operating transfer totals \$3.8 million.

Capital Projects Fund – Capital Projects Fund expenditures and other uses were \$22.5 million in 2004-05, which is a decrease of \$5.6 million from the prior year. This level of expenditure is consistent with the City's effort to rehabilitate and maintain its existing infrastructure. Capital expenditures include \$4.8 million on streets and sidewalks, \$1.9 million on Homer Avenue under-crossing project and \$1.2 million on fire station improvements project.



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, 2005, the City's Enterprise Funds reported total net assets of \$521.8 million, a decrease of \$0.9 million or .2 percent compared with last year. The Electric and Gas Funds contributed net assets of \$285.8 million and \$59.2 million, respectively, to total net assets. These assets constitute 66.1 percent of the Enterprise Funds' total net assets. Unrestricted net assets for these two funds total \$160.3 million, a \$13.2 million or 7.6 percent decrease over 2003-04.

Water Fund - Revenues decreased by \$1.0 million in 2004-05. This decrease is mainly the result of reduced sales due to weather conditions. The Water Fund ended the year with net income of \$3.7 million, compared to \$3.2 million in the prior year, a \$0.5 million or 15.6 percent increase. The rise in net income is primarily due to a decrease in commodity purchases of \$0.7 million and an increase in investment income of \$0.7 million.

Electric Fund - Operating revenues decreased to \$88.7 million, a \$3.9 million decrease from 2003-04. This decrease is primarily due to the cancellation of excess capacity revenue contracts mid-year. Operating expenses decreased from \$68.7 million in 2003-04 to \$68.0 million in 2004-05, a decrease of \$0.7 million. The Electric Fund ended the year with a net loss of \$5.6 million compared to a net gain of \$10.9 million in 2003-04. The decrease in net income was mainly the result of legal settlement of \$19.0 million.

Gas Fund - A 9.9 percent rate increase effective July 2004 and a 15 percent rate increase effective January 2005 increased revenue \$6.4 million over 2003-04. Operating expenses increased to \$26.7 million in 2004-05 as compared to \$23.0 million in 2003-04. An increase of \$3.7 million or 16.0 percent increase. The Gas Fund ended the year with a net loss of \$1.7 million, compared to a \$1.4 million net loss in 2003-04.

Wastewater Collection Fund - Operating revenues decreased to \$12.0 million, a \$0.6 million decrease from 2003-04. A decrease in contributed capital and installation service contributed to the reduction. Operating expenses decreased to \$8.9 million, a \$0.3 million decrease from 2003-04. The Wastewater Collection Fund ended the year with a net income of \$3.4 million, an increase of \$0.1 million over 2003-04.

Wastewater Treatment Fund - Revenues increased in 2004-05 by \$1.2 million, while operating expenses increased by \$1.8 million. Expense increases were primarily due to increases in salary, benefit and supply costs. The Wastewater Treatment Fund ended the year with a net income of \$0.7 million, compared to a net income of \$0.1 million in 2003-04.

Refuse Fund - Refuse Fund revenues increased to \$23.4 million in 2004-05, an increase of \$1.5 million or 6.8 percent from 2003-04. A 10 percent rate increase effective July 2004 contributed to the rise in revenue. Operating expenses increased \$0.4 million to \$24.5 million in 2004-05. The Refuse Fund ended the year with a net loss of \$1.2 million, compared to a \$3.0 million net loss in 2003-04. The decrease in net loss is primarily due to the increase in revenue and return on investments.



Storm Drainage Fund - A voter approved ballot measure passed in 2004-05 raised Storm Drainage fees from \$4.25 to \$10.00 per residential unit. This increase was effective June 2005, and affected operating revenues as they increased \$0.3 million in 2004-05. Operating expenses increased \$0.2 million and the supplemental funding from the General Fund increased \$0.1 million. The supplement funding from the General Fund may not be needed in future years due to the voter approved fee increase. The Storm Drainage Fund ended the year with a net loss of \$0.2 million, as compared to a net loss of \$0.5 million in 2003-04.

External Services Fund - Created in 2001-02, this Fund provides information technology and training services to neighboring municipalities and other community organizations. Revenues increased to \$0.8 million in 2004-05 from \$0.6 million in 2003-04. This increase is primarily due to one additional outside contract and increased fees for four existing contracts. The External Services Fund ended the year with a net income of \$0.1 million as compared to a net loss of \$0.1 million in 2003-04.

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)

	2005	2004	Increase/ (Decrease) from 2004
Governmental Activities			
<i>Capital Assets</i>			
Land and improvements	\$67.8	\$67.8	\$0.0
Street trees	15.4	15.7	(0.3)
Construction in progress	55.5	46.3	9.2
Buildings and improvements	54.6	54.3	0.3
Equipment	8.2	8.1	0.1
Roadway network	225.1	220.3	4.8
Recreation & open space network	11.2	8.8	2.4
Less accumulated depreciation	(133.8)	(127.3)	(6.5)
<i>Internal Service Fund Assets</i>			
Construction in progress	2.1	1.9	0.2
Equipment	31.8	31.0	0.8
Less accumulated depreciation	(19.4)	(16.9)	(2.5)
Total Governmental	\$318.5	\$310.0	\$8.5
Business-type Activities			
Land	\$2.0	\$1.5	\$0.5
Construction in progress	91.4	72.1	19.3
Buildings and improvements	16.9	16.9	0.0
Transmission, Distribution & Treatment Systems	425.4	416.4	9.0
Less accumulated depreciation	(188.7)	(177.8)	(10.9)
Total Business-type	\$346.9	\$329.1	\$17.8



Governmental Activities capital assets net of depreciation, increased by \$8.5 million compared to 2003-04. Significant increases occurred in the roadway network, \$4.8 million and recreation and open space network, \$2.4 million.

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, 2005, the City's debt comprised:

LONG-TERM DEBT AT JUNE 30			
(in Millions)			
	<u>2005</u>	<u>2004</u>	<u>Increase/ (Decrease) from 2004</u>
Governmental Activity Debt:			
General Long Term Obligations:			
1998 Golf Course Certificates of Participation	\$5.7	\$6.0	(\$0.3)
2002A Civic Center Refinancing Certificates of Participation	2.6	2.9	(0.3)
2002B Downtown Parking Improvements Certificates of Participation	2.4	3.3	(0.9)
Special Assessment Debt with City Commitment			
1987 California Avenue Parking Bonds	0.3	0.4	(0.1)
Sub-Total	<u>11.0</u>	<u>12.6</u>	<u>(1.6)</u>
Internal Service Long-Term Obligations:			
Information Systems Capital Lease Obligations	0.0	0.0	\$0.0
Total Governmental Activity Debt	<u>\$11.0</u>	<u>\$12.6</u>	<u>(\$1.6)</u>
Business-Type Activity Debt:			
Enterprise Long Term Obligations:			
Utility Revenue Bonds			
1995 Series A	\$6.5	\$6.8	(\$0.3)
1999 Refunding	15.5	16.0	(0.5)
2002 Series A	22.7	23.3	(0.6)
Less: unamortized discount/issuance cost	(1.1)	(1.2)	0.1
Total Business-type Activity	<u>\$43.6</u>	<u>\$44.9</u>	<u>(\$1.3)</u>

The City did not issue new debt in 2004-05. A partial redemption was done by placing excess construction and debt service reserve funds into an escrow account to defease \$0.9 million of 2002B Downtown Parking Improvements Certification of Participation. 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.



Although the past three 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, 2005, a total of \$0.3 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.

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).



This page is intentionally left blank.



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.

These Statements include the financial activities of the City Public Improvement Corporation and Redevelopment Agency, which are legally separate component units of the City because they are 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*.

This page is intentionally left blank.

City of Palo Alto - Statement of Net Assets

June 30, 2005

(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)	\$147,039	\$207,844	\$354,883
Cash and investments with fiscal agents (Note 3)	2,781	1,890	4,671
Receivables:			
Accounts and intergovernmental	6,903	26,975	33,878
Interest receivable	1,856	2,447	4,303
Notes and loans receivable (Note 5)	14,011		14,011
Internal balances (Note 4)	1,864	(1,864)	
Prepaid items		203	203
Inventory of materials and supplies	2,931		2,931
Capital assets, nondepreciable (Note 6)	140,895	93,329	234,224
Capital assets, net of depreciation (Note 6)	<u>177,614</u>	<u>253,602</u>	<u>431,216</u>
Total assets	<u>495,894</u>	<u>584,426</u>	<u>1,080,320</u>
LIABILITIES			
Accounts payable and accrued liabilities	4,585	12,093	16,678
Accrued salaries and benefits	4,893	1,692	6,585
Accrued compensated absences			
Due within one year	11,784		11,784
Claims payable (Note 14)			
Due within one year	4,084		4,084
Due in more than one year	9,799		9,799
Accrued landfill closure liability (Note 9)		6,692	6,692
Long-term debt (Notes 7 and 8)			
Due within one year	810	1,411	2,221
Due in more than one year	<u>10,140</u>	<u>42,187</u>	<u>52,327</u>
Total liabilities	<u>46,095</u>	<u>64,075</u>	<u>110,170</u>
NET ASSETS (Note 10)			
Invested in capital assets, net of related debt	<u>305,225</u>	<u>303,473</u>	<u>608,698</u>
Restricted for:			
Special revenue programs	20,822		20,822
Capital projects:			
Downtown parking structure	130		130
Other capital projects	4,535		4,535
Debt service	<u>1,786</u>	<u>1,750</u>	<u>3,536</u>
Total Restricted	<u>27,273</u>	<u>1,750</u>	<u>29,023</u>
Unrestricted net assets	<u>117,301</u>	<u>215,128</u>	<u>332,429</u>
Total net assets	<u>\$449,799</u>	<u>\$520,351</u>	<u>\$970,150</u>

See accompanying notes to financial statements

City of Palo Alto - Statement of Activities

For the Year Ended June 30, 2005

(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	
Governmental Activities:						
City Council	\$130				(\$130)	(\$130)
City Manager	1,725				(1,725)	(1,725)
City Attorney	2,653	\$22			(2,631)	(2,631)
City Clerk	770				(770)	(770)
City Auditor	764				(764)	(764)
Administrative Services	6,982	480			(6,502)	(6,502)
Human Resources	2,410				(2,410)	(2,410)
Public Works	16,400	573	\$1,907	\$625	(13,295)	(13,295)
Planning and Community Environment	10,162	4,090	1,377		(4,695)	(4,695)
Police	22,416	3,801	353		(18,262)	(18,262)
Fire	18,127	8,555	9		(9,563)	(9,563)
Community Services	17,240	7,592		179	(9,469)	(9,469)
Library	4,835	133	31		(4,671)	(4,671)
Non-Departmental	12,474				(12,474)	(12,474)
Interest on long-term debt	693				(693)	(693)
Total Governmental Activities	117,781	25,246	3,677	804	(88,054)	(88,054)
Business-type Activities:						
Water	14,969	21,041			\$6,072	6,072
Electric	73,051	88,737			15,686	15,686
Gas	26,656	31,206			4,550	4,550
Wastewater Collection	8,907	12,041			3,134	3,134
Wastewater Treatment	17,457	15,982			(1,475)	(1,475)
Refuse	24,959	23,387			(1,572)	(1,572)
Storm Drainage	3,336	2,484			(852)	(852)
External Services	760	766			6	6
Total Business-type Activities	170,095	195,644			25,549	25,549
Total	\$287,876	\$220,890	\$3,677	\$804	(88,054)	(62,505)
General revenues:						
Taxes:						
Property taxes					16,657	16,657
Sales taxes					19,308	19,308
Utility user's taxes					7,269	7,269
Transient occupancy tax					5,686	5,686
Other taxes					5,580	5,580
Investment earnings					4,988	8,093
Rents and miscellaneous					12,997	12,997
Special item (Note 16)						(21,500)
Transfers					14,064	(14,064)
Total general revenues, special item and transfers					86,549	(27,471)
Change in Net Assets					(1,505)	(1,922)
Net Assets-Beginning					451,304	522,273
Net Assets-Ending					\$449,799	\$520,351

See accompanying notes to financial statements



Fund Financial Statements.....

Introduction

The Fund Financial Statements are presented by individual major funds, 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.

Major Governmental Funds

The funds described below were determined to be Major Funds by the City in fiscal year 2004-05. 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.

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.

This page is intentionally left blank.

City of Palo Alto - Governmental Funds

Balance Sheet - June 30, 2005

(In thousands of dollars)

	General	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
ASSETS				
Cash and investments (Note 3):				
Available for operations	\$26,035	\$43,362	\$8,178	\$77,575
Cash and investments with fiscal agent		1,441	1,340	2,781
Receivables				
Accounts and intergovernmental	6,026	148	323	6,497
Special assessment			325	325
Interest receivable	965	4	117	1,086
Notes and loans receivable (Note 5)	1,234		12,777	14,011
Interfund receivables and advances (Note 4)	491			491
Inventory of materials and supplies	2,697			2,697
	<u>\$37,448</u>	<u>\$44,955</u>	<u>\$23,060</u>	<u>\$105,463</u>
LIABILITIES				
Accounts payable and accrued liabilities	\$2,071	\$763	\$256	\$3,090
Accrued salaries and benefits	3,429	96		3,525
Deferred revenue	118		325	443
Interfund payable and advances (Note 4)			196	196
	<u>5,618</u>	<u>859</u>	<u>777</u>	<u>7,254</u>
FUND BALANCES				
Reserved for: (Note 10):				
Encumbrances	3,401	4,535	471	8,407
Downtown parking structure		130		130
Notes and loans	1,234		12,777	14,011
Inventory of materials and supplies	2,697			2,697
Debt service			1,392	1,392
Unreserved, designated for:				
Special revenue projects			6,405	6,405
Equity transfer stabilization	3,165			3,165
Reappropriations	267	14,265	122	14,654
Budget stabilization	21,066			21,066
Infrastructure		25,166		25,166
Undesignated, reported in Special Revenue Funds			1,116	1,116
	<u>31,830</u>	<u>44,096</u>	<u>22,283</u>	<u>98,209</u>
Total Liabilities and Fund Balances	<u>\$37,448</u>	<u>\$44,955</u>	<u>\$23,060</u>	<u>\$105,463</u>

See accompanying notes to financial statements

City of Palo Alto - Governmental Funds
Reconciliation of Fund Balances to Governmental Activities Net Assets
June 30, 2005

(In thousands of dollars)

Governmental Fund fund balances from prior page \$98,209

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) 318,509

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. (Excludes capital assets reported above and debt reported below) 43,883

Accrual adjustment to remove deferred revenue from the balance sheet 325

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) (11,127)

Net assets of governmental activities \$449,799

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, 2005

(In thousands of dollars)

	General	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
REVENUES				
Property taxes	\$16,657			\$16,657
Special assessments			\$260	260
Sales taxes	19,308			19,308
Utility users' tax	7,269			7,269
Transient occupancy tax	5,686			5,686
Other taxes and fines	7,678		1,144	8,822
Charges for services	17,159			17,159
From other agencies	465	\$1,552	740	2,757
Permits and licenses	3,183			3,183
Investment earnings	1,625	1,023	371	3,019
Rental income	11,943		6	11,949
Other revenue	1,948	226	2,095	4,269
Total Revenues	92,921	2,801	4,616	100,338
EXPENDITURES				
Current operations:				
City Council	130			130
City Manager	1,668			1,668
City Attorney	2,571			2,571
City Clerk	743			743
City Auditor	764			764
Administrative Services	6,342			6,342
Human Resources	2,291			2,291
Public Works	9,060			9,060
Planning and Community Environment	8,769		923	9,692
Police	21,059		58	21,117
Fire	17,615			17,615
Community Services	16,298			16,298
Library	4,800			4,800
Non-Departmental	8,603		425	9,028
Capital outlay		21,317		21,317
Debt service:				
Principal payments			785	785
Interest and fiscal fees			583	583
Total Expenditures	100,713	21,317	2,774	124,804
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(7,792)	(18,516)	1,842	(24,466)
OTHER FINANCING SOURCES (USES)				
Payment to bond escrow agent (Note 7)			(1,038)	(1,038)
Transfers in (Note 4)	15,384	42,756	2,289	60,429
Transfers (out) (Note 4)	(42,584)	(1,177)	(2,861)	(46,622)
Total Other Financing Sources (Uses)	(27,200)	41,579	(1,610)	12,769
Net change in fund balances	(34,992)	23,063	232	(11,697)
Fund balances at beginning of year	66,822	21,033	22,051	109,906
Fund balances at end of year	<u>\$31,830</u>	<u>\$44,096</u>	<u>\$22,283</u>	<u>\$98,209</u>

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, 2005
(In thousands of dollars)**

Net change in fund balances-total governmental funds (\$11,697)

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 16,264

Depreciation expense is deducted from fund balance
(Depreciation expense is net of Internal Service Fund depreciation
\$3,093 which has already been allocated to serviced funds.) (6,410)

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 785
Principal on defeasance of 2002B Downtown Parking Improvements 900
Issuance cost on defeasance of 2002B Downtown Parking Improvements 138

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.

Interest payable (110)
Deferred revenue (95)

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. (1,280)

Change in net assets of Governmental Activities (\$1,505)

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, 2005

(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	\$13,600	\$16,093	\$16,700	\$607
Sales taxes	18,335	18,100	19,308	1,208
Utility users' tax	7,392	7,226	7,270	44
Transient occupancy tax	5,800	6,000	5,686	(314)
Other taxes, fines & penalties	9,526	6,382	7,634	1,252
Charges for services	18,296	18,324	17,154	(1,170)
Permits and licenses	4,397	3,137	3,179	42
Charges to other funds	9,309	10,054	10,105	51
Rental income	11,776	11,845	12,016	171
Other revenues	3,742	3,938	3,069	(869)
Transfers in	14,619	14,682	15,425	743
Prior year encumbrance and reappropriations		3,244	3,244	
	<u>116,792</u>	<u>119,025</u>	<u>120,790</u>	<u>1,765</u>
Total Revenues				
EXPENDITURES				
Current operations:				
Administrative Departments	15,222	16,803	16,344	459
Community Services	19,618	20,167	19,807	360
Fire	18,837	19,278	19,264	14
Library	5,251	5,229	5,218	11
Planning and Community Environment	8,839	10,101	10,056	45
Police	22,421	22,821	22,706	115
Public Works	11,262	11,526	11,417	109
Non-Departmental	8,063	6,520	8,677	(2,157)
Transfers out	42,383	42,809	42,584	225
	<u>151,896</u>	<u>155,254</u>	<u>156,073</u>	<u>(819)</u>
Total Use of Funds				
EXCESS OF REVENUES OR EXPENDITURES	<u>(\$35,104)</u>	<u>(\$36,229)</u>	<u>(35,283)</u>	<u>\$946</u>
BUDGETARY BASIS				
Adjustments to Budgetary Basis:				
Current year encumbrance/reappropriations			3,569	
Prior year encumbrance/reappropriations			(3,244)	
Current year stores adjustment, net			(48)	
Prior year stores adjustment			14	
			<u>14</u>	
EXCESS OF REVENUES OVER				
EXPENDITURES - GAAP BASIS			(34,992)	
Fund balances at beginning of year			<u>66,822</u>	
Fund balances at end of year, GAAP basis			<u>\$31,830</u>	

See accompanying notes to financial statements

This page is intentionally left blank.



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 City has elected to treat all of its Enterprise Funds as Major Funds in fiscal year 2004-05.

Proprietary Funds do not provide for the disclosure of budget versus actual comparisons.

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, 2005
(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	\$20,080	\$137,613	\$12,969	\$12,249
Cash and investments with fiscal agent	788		962	
Accounts receivable, net	3,112	16,357	2,184	1,504
Interest receivable	239	1,623	152	143
Prepaid items		203		
Inventory of materials and supplies				
Total Current Assets	24,219	155,796	16,267	13,896
Noncurrent Assets:				
Interfund receivable (Note 4)				
Capital assets, nondepreciable (Note 6)	16,006	22,112	24,996	26,092
Capital assets, depreciable (Note 6)	32,679	115,719	33,156	24,866
Total Noncurrent Assets	48,685	137,831	58,152	50,958
Current Total Assets	72,904	293,627	74,419	64,854
LIABILITIES				
Current Liabilities:				
Accounts payable and accrued liabilities	1,540	7,194	2,753	111
Accrued salaries and benefits	207	596	242	112
Interfund payable (Note 4)				
Current portion of revenue bonds (Note 7)	320		391	52
Accrued claims payable - current (Note 14)				
Total Current Liabilities	2,067	7,790	3,386	275
Noncurrent liabilities:				
Interfund payable (Note 4)				
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 (Note 7)	9,723		11,861	1,437
Total Noncurrent Liabilities	9,723		11,861	1,437
Total Liabilities	11,790	7,790	15,247	1,712
NET ASSETS				
Invested in capital assets, net of related debt	38,642	137,831	45,900	49,469
Restricted for debt service	788		962	
Unrestricted	21,684	148,006	12,310	13,673
Total Net Assets	\$61,114	\$285,837	\$59,172	\$63,142

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
\$12,916	\$11,609	\$408		\$207,844	\$69,464
140				1,890	
197	2,513	675	\$433	26,975	81
153	137			2,447	770
				203	
					234
<u>13,406</u>	<u>14,259</u>	<u>1,083</u>	<u>433</u>	<u>239,359</u>	<u>70,549</u>
					75
1,861	2,254	8		93,329	2,157
29,020	3,009	15,153		253,602	12,352
<u>30,881</u>	<u>5,263</u>	<u>15,161</u>		<u>346,931</u>	<u>14,584</u>
<u>44,287</u>	<u>19,522</u>	<u>16,244</u>	<u>433</u>	<u>586,290</u>	<u>85,133</u>
160	194	141		12,093	1,200
310	147	45	33	1,692	1,368
			295	295	
323		325		1,411	
					4,084
<u>793</u>	<u>341</u>	<u>511</u>	<u>328</u>	<u>15,491</u>	<u>6,652</u>
			75	75	
					11,784
					9,799
	6,692			6,692	
<u>9,122</u>		<u>10,044</u>		<u>42,187</u>	
<u>9,122</u>	<u>6,692</u>	<u>10,044</u>	<u>75</u>	<u>48,954</u>	<u>21,583</u>
<u>9,915</u>	<u>7,033</u>	<u>10,555</u>	<u>403</u>	<u>64,445</u>	<u>28,235</u>
21,576	5,263	4,792		303,473	12,352
				1,750	
12,796	7,226	897	30	216,622	44,546
<u>\$34,372</u>	<u>\$12,489</u>	<u>\$5,689</u>	<u>\$30</u>	<u>521,845</u>	<u>\$56,898</u>
				(1,494)	
				<u>\$520,351</u>	

City of Palo Alto - Proprietary Funds
Statements of Revenues, Expenses and Changes in Net Assets
For the Year Ended June 30, 2005
(In thousands of dollars)

	Business-type Activities - Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
OPERATING REVENUES				
Sales of utilities:				
Customers	\$19,630	\$70,070	\$28,910	\$11,524
City departments	1,017	2,222	980	225
Wholesale		3,320		
Excess capacity		4,894		
Wastewater treatment				
Service connection charges and miscellaneous	154	1,692	450	35
Charges for services				
Other operating revenues	240	6,539	866	257
Total Operating Revenues	21,041	88,737	31,206	12,041
OPERATING EXPENSES				
Purchase of utilities				
Retail	6,719	36,593	18,783	5,906
Excess capacity		4,417		
Administration and general	2,362	5,076	2,920	350
Engineering (operating)	189	932	228	157
Resource management and energy efficiency programs	372	5,039	1,192	
Operations and maintenance	3,080	7,480	2,324	1,308
Rent	1,368	3,123	128	66
Depreciation and amortization	916	5,409	1,160	1,096
Claims payments and changes in estimated self-insurance liability				
Compensated absences and other benefits				
Total Operating Expenses	15,006	68,069	26,735	8,883
Operating Income	6,035	20,668	4,471	3,158
NONOPERATING REVENUES (EXPENSES)				
Return on investment	740	5,475	543	423
Interest (expense)	(2)		(2)	(79)
Joint venture debt service (Note 15)		(4,928)		
Gain (loss) on disposal of fixed assets	(15)	(250)	(6)	
Other				
Net Nonoperating Revenues (Expenses)	723	297	535	344
Income (Loss) Before Transfers and Special Item	6,758	20,965	5,006	3,502
Transfers in (Note 4)	29	692	55	5
Transfers (out) (Note 4)	(3,111)	(9,155)	(3,299)	(87)
Special item (Note 16)		(18,060)	(3,440)	
Change in Net Assets	3,676	(5,558)	(1,678)	3,420
Total net assets at beginning of year	57,438	291,395	60,850	59,722
Total net assets at end of year	\$61,114	\$285,837	\$59,172	\$63,142

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	Storm	External			Activities -
Treatment	Refuse	Drainage	Service	TOTALS	Internal Service
					Funds
	\$18,950	\$2,336		\$151,420	
\$5,957	955	126		11,482	
				3,320	
				4,894	
9,866				9,866	
				2,331	
					\$48,362
159	3,482	22	\$766	12,331	
<u>15,982</u>	<u>23,387</u>	<u>2,484</u>	<u>766</u>	<u>195,644</u>	<u>48,362</u>
	7,941			75,942	
				4,417	
1,737	1,564	563		14,572	11,712
1,064	367	578		3,515	
		78		6,681	
10,708	10,148	791	726	36,565	2,570
	4,289			8,974	
2,567	234	520		11,902	3,093
					7,564
					28,040
<u>16,076</u>	<u>24,543</u>	<u>2,530</u>	<u>726</u>	<u>162,568</u>	<u>52,979</u>
<u>(94)</u>	<u>(1,156)</u>	<u>(46)</u>	<u>40</u>	<u>33,076</u>	<u>(4,617)</u>
473	437	15	(13)	8,093	1,969
(192)	(395)	(641)		(1,311)	
				(4,928)	
				(271)	45
					49
<u>281</u>	<u>42</u>	<u>(626)</u>	<u>(13)</u>	<u>1,583</u>	<u>2,063</u>
<u>187</u>	<u>(1,114)</u>	<u>(672)</u>	<u>27</u>	<u>34,659</u>	<u>(2,554)</u>
505	154	457		1,897	587
(37)	(259)	(13)		(15,961)	(330)
				(21,500)	
655	(1,219)	(228)	27	(905)	(2,297)
<u>33,717</u>	<u>13,708</u>	<u>5,917</u>	<u>3</u>		<u>59,195</u>
<u>\$34,372</u>	<u>\$12,489</u>	<u>\$5,689</u>	<u>\$30</u>		<u>\$56,898</u>
				(1,017)	
				<u>(\$1,922)</u>	

City of Palo Alto - Proprietary Funds
Statement of Cash Flows -
For the Year Ended June 30, 2005
(In thousands of dollars)

	Business-type Activities - Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
CASH FLOWS FROM OPERATING ACTIVITIES:				
Receipts from customers	\$19,857	\$79,141	\$28,884	\$11,490
Payments to suppliers	(11,835)	(60,898)	(21,062)	(7,816)
Payments to employees	(2,327)	(4,996)	(2,869)	(321)
Internal activity - receipts from other funds	1,017	2,222	980	225
Claims paid				
Other receipts	240		866	257
Net Cash From Operating Activities	<u>6,952</u>	<u>15,469</u>	<u>6,799</u>	<u>3,835</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:				
Interfund receipts				
Special item		(18,060)	(3,440)	
Transfers in	29	692	55	5
Transfers (out)	(3,111)	(9,155)	(3,299)	(87)
Net Cash From Noncapital Financing Activities	<u>(3,082)</u>	<u>(26,523)</u>	<u>(6,684)</u>	<u>(82)</u>
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES:				
Acquisition and construction of fixed assets	(6,013)	(10,541)	(6,726)	(4,458)
Proceeds from sale of capital assets				
Principal paid on long-term debt	(304)		(372)	(36)
Interest paid on long-term debt	(2)	(4,928)	(2)	(79)
Cash Flows From Capital Financing Activities	<u>(6,319)</u>	<u>(15,469)</u>	<u>(7,100)</u>	<u>(4,573)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:				
Interest on investments	708	5,811	579	426
Net Cash Flows	(1,741)	(20,712)	(6,406)	(394)
Cash and cash equivalents at beginning of year	22,609	158,325	20,337	12,643
Cash and cash equivalents at end of year	<u>\$20,868</u>	<u>\$137,613</u>	<u>\$13,931</u>	<u>\$12,249</u>
FINANCIAL STATEMENT PRESENTATION:				
Cash and investments available for operations	\$20,080	\$137,613	\$12,969	\$12,249
Cash and investments with fiscal agent	788		962	
Cash and cash equivalents at end of year	<u>\$20,868</u>	<u>\$137,613</u>	<u>\$13,931</u>	<u>\$12,249</u>
Reconciliation of operating income (loss) to Cash Flows from Operating Activities				
Operating income (loss)	\$6,035	\$20,668	\$4,471	\$3,158
Adjustments to reconcile operating income (loss) to cash flows from operating activities:				
Depreciation and amortization	916	5,409	1,160	1,096
Other				
Changes in assets and liabilities:				
Accounts receivable	73	(7,374)	(476)	(69)
Prepaid items		(203)		
Inventory of materials and supplies				
Accounts and other payables	(72)	(3,031)	1,644	(350)
Accrued claims payable and other liabilities				
Net Cash From Operating Activities	<u>\$6,952</u>	<u>\$15,469</u>	<u>\$6,799</u>	<u>\$3,835</u>

See accompanying notes to financial statements



Business-type Activities - Enterprise Funds					Governmental
Wastewater		Storm	External		Activities -
Treatment	Refuse	Drainage	Service	TOTALS	Internal Service
					Funds
\$11,374	\$18,585	\$1,921		\$171,252	\$48,289
(11,710)	(22,784)	(1,383)		(137,488)	(3,015)
(1,645)	(1,533)	(557)	(\$716)	(14,964)	(38,472)
5,957	955	126		11,482	
					(4,229)
159	3,619	22	568	5,731	49
4,135	(1,158)	129	(148)	36,013	2,622
			142	142	57
				(21,500)	
505	154	457		1,897	587
(37)	(259)	(13)		(15,961)	(330)
468	(105)	444	142	(35,422)	314
(1,925)	(297)	(45)		(30,005)	(1,732)
					45
(278)		(274)		(1,264)	(25)
(192)	(395)	(641)		(6,239)	
(2,395)	(692)	(960)		(37,508)	(1,712)
454	461	20	(17)	8,442	1,906
2,662	(1,494)	(367)	(23)	(28,475)	3,130
10,394	13,103	775	23	238,209	66,334
\$13,056	\$11,609	\$408		\$209,734	\$69,464
\$12,916	\$11,609	\$408		\$207,844	\$69,464
140				1,890	
\$13,056	\$11,609	\$408		\$209,734	\$69,464
(\$94)	(\$1,156)	(\$46)	\$40	\$33,076	(\$4,617)
2,567	234	520		11,902	3,093
					49
1,508	(365)	(415)	(198)	(7,316)	(73)
				(203)	
					69
154	(8)	70	10	(1,583)	766
	137			137	3,335
\$4,135	(\$1,158)	\$129	(\$148)	\$36,013	\$2,622

This page is intentionally left blank.



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.

This page is intentionally left blank.



City of Palo Alto - Fiduciary Funds

Statement of Fiduciary Net Assets - June 30, 2005

(In thousands of dollars)

	<u>Agency Funds</u>
ASSETS	
Cash and investments available for operations (Note 3)	\$1,561
Cash and investments with fiscal agents (Note 3)	6,213
Interest receivable	<u>79</u>
Total Assets	<u><u>\$7,853</u></u>
LIABILITIES	
Due to bondholders	\$6,570
Due to other governments	<u>1,283</u>
Total Liabilities	<u><u>\$7,853</u></u>

See accompanying notes to financial statements

This page is intentionally left blank.



Index.....

	Page
1. Summary of Significant Accounting Policies	49
2. Budgets and Budgetary Accounting	54
3. Cash and Investments	55
4. Interfund Transactions	60
5. Notes and Loans Receivable	63
6. Capital Assets	67
7. General Long-Term Obligations	73
8. Special Assessment Debt	77
9. Landfill Closure and Post-closure Care	79
10. Net Assets and Fund Balances	80
11. Pension Plans	83
12. Retiree Health Benefits	86
13. Deferred Compensation Plan	87
14. Risk Management	87
15. Joint Ventures	89
16. Commitments and Contingencies	93

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.



This page is intentionally left blank.

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.



These Standards 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

The City's Major Governmental and Business-type Funds need to 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.



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 Service 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 to retirees.

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 three 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 \$8.166 million, and vested accumulated sick pay of \$3.618 million as of June 30, 2005. During fiscal 2004-05, the City paid \$3.823 million against these liabilities and recorded additional accruals of \$3.603 million.

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 within 60 days after year end.

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.



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.

Policies

The City invests in individual investments and in investment pools. Individual investments are evidenced by specific identifiable *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 increase security, the City employs the Trust Department of a bank as the custodian of certain City managed investments, regardless of their form.

The City's investments are carried at fair value, as required by generally accepted accounting principles. 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.

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	\$354,883
Cash and investments with fiscal agents	4,671
City cash and investments	<u>359,554</u>
Cash and investments available for operations in	
Fiduciary Funds (separate Statement)	1,561
Cash and investments with fiscal agents	
Fiduciary Funds (separate Statement)	<u>6,213</u>
Total cash and investments	<u><u>\$367,328</u></u>

Investments Authorized by the City’s Investment Policy & Debt Agreements

The table below identifies the investment types that are authorized by the City’s Investment Policy. The table also identifies certain provisions of the City’s Investment Policy that address interest rate risk, credit risk and concentration of credit risk. The table addresses investments of debt proceeds held by bond trustee that are governed by the provisions of debt agreements of the City, rather than the general provisions of the City’s investment policy.

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment In One Issuer
U.S. Government Securities	10 years	N/A	No Limit	No Limit
U.S. Government Agency Securities	10 years	N/A	No Limit (A)	No Limit
Certificates of Deposit	10 years	N/A	20%	10% of the par value of portfolio
Bankers Acceptances	180 days (D)	N/A (D)	30%	\$5 million
Commercial Paper	270 days	AAA	15%	\$3 million (B)
Local Agency Investment Fund	N/A	N/A	No Limit	\$40 million per account
Short-Term Repurchase Agreements	1 year	N/A	No Limit	No Limit
City of Palo Alto Bonds	N/A	N/A	No Limit	No Limit
Money Market Deposit Accounts	N/A	N/A (E)	No Limit	10%
Mutual Funds (F)	N/A	N/A	20%	10%
Negotiable Certificates of Deposit	10 years	N/A	10%	\$5 million
Medium Term Corporate Notes	5 years	AA	10%	\$5 million
Obligations of States (C)	N/A	A2/A	No Limit	No Limit

(A) Callable and multi-step securities are limited to no more than twenty percent of the par value of the portfolio, provided that:

- 1) the potential call dates are known at the time of purchase.
- 2) the interest rates at which they "step-up" are known at the time of purchase.
- 3) the entire face value of the security is redeemed at the call date.

(B) The lesser of \$3 million or 10% of outstanding commercial paper of any one institution.

(C) Utility Revenue Bonds 2002 Series A and 1999 Series A allow General Obligations of states with a Minimum Credit Quantity Rating of A-2/A by Moody’s and S&P.

(D) Utility Revenue Bonds 2002 Series A and 1999 Series A require a Minimum Credit Quality Rating of A-1/P-1 by Moody’s and S&P and maturing no more than 360 days.

Utility Revenue Bonds 1995 limit the maximum maturity to 365 days.

(E) Utility Revenue Bonds 2002 Series A and 1999 Series A require a Minimum Credit Quality Rating of AAAM or AAAM-G by S&P.

(F) Utility Revenue Bonds 2002 Series A , Golf PIC COP 1998, University Avenue Parking Bond 2001 and University Avenue Parking Bond 2002 are allowed to invest in the California Asset Management Program.

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.



Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Normally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates.

Information about the sensitivity of the fair values of the City's investments (including investments held by bond trustees) to market interest rate fluctuations is provided by the following table that shows the distribution to the City's investments by maturity or earliest call date (in thousands):

Type of Investments	Less Than One Year	One to Three Years	Three to Five years	More than Five years	Total
U.S. Treasury Notes	\$1,560	\$3,571			\$5,131
U.S. Federal Agency Securities	84,382	108,290	\$105,593	\$42,695	340,960
U.S. Federal Agency Mortgage Backed Securities	7				7
Mutual funds (government securities)	1,013				1,013
California Asset Management Program	2,023				2,023
Local Agency Investment Fund	15,413				15,413
Total Investments	\$104,398	\$111,861	\$105,593	\$42,695	364,547
<i>Cash in banks and on hand</i>					2,781
Total Cash and Investments					\$367,328

Local Agency Investment Fund

The City is a 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 on demand, and 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. At June 30, 2005, these investments matured in an average of 151 days.

Mutual funds are available for withdrawal on demand and at June 30, 2005 matured in an average of 1 day.

Investments with Fair Values Highly Sensitive to Interest Rate Fluctuations

The City's investments (including investments held by bond trustees) include the following investments that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided above):

Highly Sensitive Investments

US Federal Agency Mortgage Backed Securities. These securities are subject to early payment in a period of declining interest rates. The resultant reduction in expected total cash flows affects the fair value of these securities and makes the values of these securities highly sensitive to changes in interest rates.

Fair Value at Year End

\$7,560

Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. Presented below is the actual rating as provided by Standard & Poor’s investment rating system as of June 30, 2005 for each investment type (in thousands):

Investment Type	AAA	Total
U.S. Federal Agency Securities	\$340,960	\$340,960
U.S. Federal Agency Mortgage Backed Securities	7	7
Mutual funds (government securities)	1,013	1,013
Total	\$341,980	341,980
Not Rated:		
California Asset Management Program		2,023
Local Agency Investment Fund		15,413
Exempt from Credit Rating Disclosure:		
U.S. Treasury Notes		5,131
<i>Cash in banks and on hand</i>		2,781
Total Cash and Investments		\$367,328



Concentration of Credit Risk

Investments in any one issuer, other than U.S. Treasury securities, mutual funds, and external investment pools, that represent 5% or more of total City portfolio Entity-wide investments, are as follows at June 30, 2005 (in thousands):

Investment	Reporting	Investment
Federal Farm Credit	U.S. Federal Agency Securities	\$25,024
Federal Home Loan Mortgage Corp	U.S. Federal Agency Securities	51,449
Federal National Mortgage	U.S. Federal Agency Securities	79,476
Federal Home Loan Bank	U.S. Federal Agency Securities	161,989

Only the Fiduciary Funds debt service proceeds have investments in the securities that represent 5% or more of total investments at June 30, 2005 (in thousands):

Investment	Issue	Investment
Federal National Mortgage Association	U.S. Federal Agency Securities	\$2,950
Federal Home Loan Mortgage	U.S. Federal Agency Securities	537

Custodial Risk

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.

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty (e.g. broker-dealer) to a transaction, the City will not be able to recover the value of its investment or collateral securities that are in the possession of another party. The City's Investment Policy limits its exposure to custodial credit risk by requiring that all security transactions entered into by the City, be conducted on a delivery-versus-payment basis. Securities are to be held by a third party custodian.

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 2004-05 were as follows (in thousands):

Fund Receiving Transfer	Fund Making Transfer	Amount Transferred
General Fund	Special Districts Special Revenue Fund	\$705
	Redevelopment Agency Special Revenue Fund	9
	Capital Projects Fund	185
	Civic Center Refinancing Debt Service Fund	3
	Water Enterprise Fund	2,374 A
	Electric Enterprise Fund	8,885 A
	Gas Enterprise Fund	3,003 A
	Wastewater Collection Enterprise Fund	4 A
	Refuse Enterprise Fund	166 A
	Technology Internal Service Fund	50 A
Special Revenue Funds:		
Redevelopment Agency	General Fund	9
Debt Service Funds:		
Golf Course Improvements	General Fund	537
Civic Center Financing	General Fund	345
	Special Districts Special Revenue Fund	80
Downtown Parking Improvement	General Fund	326
	Capital Projects Fund	992
Capital Projects Fund	General Fund	40,639 B
	Street Improvement Special Revenue Fund	1,175 C
	Transportation Mitigation Special Revenue Fund	600
	Developer's Impact Fee Special Revenue Fund	37
	Downtown Parking Improvement Debt Service Fund	105
	Technology Internal Service Fund	200

Fund Receiving Transfer	Fund Making Transfer	Amount Transferred
Enterprise Funds:		
Water Fund	Gas Enterprise Fund	\$10
	Technology Internal Service Fund	9
Electric	Wastewater Collection Enterprise Fund	10
	General Fund	260
	Water Enterprise Fund	156
	Gas Enterprise Fund	181
	Wastewater Collection Enterprise Fund	20
	Refuse Enterprise Fund	34
	Storm Drainage Enterprise Fund	6
Gas	Technology Internal Service Fund	35
	Electric Enterprise Fund	38
	Technology Internal Service Fund	17
Wastewater Collection	Technology Internal Service Fund	5
Wastewater Treatment	Water Enterprise Fund	500
	Technology Internal Service Fund	5
Refuse	Special Districts Special Revenue Fund	147
	Technology Internal Service Fund	7
Storm Drainage	General Fund	455
	Technology Internal Service Fund	2
Internal Service Funds:		
Vehicle Replacement and Maintenance	General Fund	13
Technology	Water Enterprise Fund	81
	Electric Enterprise Fund	232
	Gas Enterprise Fund	105
	Wastewater Collection Enterprise Fund	53
	Wastewater Treatment Enterprise Fund	37
	Refuse Enterprise Fund	59
	Storm Drainage Enterprise Fund	7
		\$62,913

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) Allocation of funds to construct capital assets.
- (C) Transfer to return unspent construction funds.

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, 2005, the Federal Revenue Special Revenue Fund, the Downtown Planned Community Special Revenue Fund and the External Service Business-type Fund owed the General Fund \$192 thousand, \$4 thousand, and \$295 thousand, respectively.

Long-Term Interfund Advances

The City also has a long-term interfund advance which the External Service Enterprise Fund owes the Technology Internal Service Fund \$75 thousand at June 30, 2005. 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 \$347 thousand as of June 30, 2005.

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, 2005, 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	1,404
Sheridan Apartments	2,247
Oak Court Apartments, L.P.	1,960
Mid-Peninsula Housing Coalition:	
Palo Alto Gardens Apartments	1,000
Community Working Group, Inc	1,280
Opportunity Center Associates, L.P.	750
Home Rehabilitation Loans	136
Executive Relocation Assistance Loans	1,234
Below Market Rate Assessment Loans	53
Stevenson Housing - Hot Water	50
Adolescent Counseling	57
Palo Alto Senior Housing Project	28
Clara-Mateo Alliance	11
Total	<u><u>\$14,011</u></u>

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, 2005 the objective 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.

In July 2004 the City agreed to loan up to \$41 thousand to Palo Alto Housing Corporation to rehabilitate the interior of the Barker Hotel. The loan is funded entirely by Community Development Block Grant funds and is collateralized by a deed of trust on the property. Annual loan payments are deferred until certain criteria defined in the loan agreement are reached. The loan shall be forgiven if the borrower satisfactorily complies with all the terms and conditions of the loan agreement.

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. constructed 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 accounts amounting to \$5.874 million.

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 which was completed in April 2005. 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.



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.

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.

Opportunity Center Associates L.P.

On July 19, 2004 the City loaned \$750 thousand to the Opportunity Center Associates L.P. for construction of 89 units of rental housing for extremely low-income and very low-income households. The loan is funded by \$750 thousand of Residential Housing Funds. The note bears 3% interest and is secured by a deed of trust. The principal balance is due September 1, 2007 but can be extended an additional 55 years if certain conditions in the loan agreement are met.

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, 2005, 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 2005, 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.

Stevenson Housing Hot Water Loans

In July 2004 the City agreed to loan up \$38 thousand to Palo Alto Senior Housing Project, Inc to refurbish the hot water piping system at the Stevenson House Senior Housing facility. In April 2005, the City agreed to increase the loan by \$45 thousand, bringing the total loan to \$83 thousand. The loan is funded entirely by Community Development Block Grant funds, and bears simple interest of six percent. Principle and interest payments are deferred until July 1, 2010, as long as the borrower continues to comply with all terms and conditions of the 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.

The City has recorded all its public domain (infrastructure) capital assets, which consists of Roadway, Recreation and Open Space, in its Citywide financial statements.

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.



Notes to Basic Financial Statements – Note 6

	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, 2005 were (in thousands):

	Balance June 30, 2004	Additions	Retirements	Transfers	Balance June 30, 2005
<i>Governmental activities</i>					
Capital assets not being depreciated					
Land and improvements	\$67,847				\$67,847
Street trees	15,721		(\$289)		15,432
Construction in progress	48,250	\$16,631		(\$7,265)	57,616
	<u>131,818</u>	<u>16,631</u>	<u>(289)</u>	<u>(7,265)</u>	<u>140,895</u>
Total capital assets not being depreciated					
Capital assets being depreciated					
Buildings and improvements	54,315	103		152	54,570
Equipment	39,034	975	(760)	657	39,906
Roadway network	220,358	677		4,047	225,082
Recreation & open space network	8,831			2,409	11,240
	<u>322,538</u>	<u>1,755</u>	<u>(760)</u>	<u>7,265</u>	<u>330,798</u>
Total capital assets being depreciated					
Less accumulated depreciation					
Buildings and improvements	(50,321)	(293)			(50,614)
Equipment	(23,530)	(3,320)	659		(26,191)
Roadway network	(66,535)	(5,676)			(72,211)
Recreation & open space network	(3,954)	(214)			(4,168)
	<u>(144,340)</u>	<u>(9,503)</u>	<u>659</u>		<u>(153,184)</u>
Net capital assets being depreciated					
Total depreciable assets	<u>178,198</u>	<u>(7,748)</u>	<u>(101)</u>	<u>7,265</u>	<u>177,614</u>
<i>Governmental activity capital assets, net</i>	<u><u>\$310,016</u></u>	<u><u>\$8,883</u></u>	<u><u>(\$390)</u></u>		<u><u>\$318,509</u></u>

Business-type Capital Assets

Changes in the City’s Enterprise Fund capital assets during the year ended June 30, 2005 were (in thousands):

	Balance June 30, 2004	Additions	Retirements	Transfers	Balance June 30, 2005
<i>Business-type activities</i>					
Capital assets not being depreciated					
Land and improvements	\$1,541			\$412	\$1,953
Construction in progress	72,148	\$28,570		(9,342)	91,376
Total capital assets not being depreciated	73,689	28,570		(8,930)	93,329
Capital assets being depreciated					
Buildings and structures	16,761			157	16,918
Transmission, distribution, and treatment systems	416,450	1,372	(\$1,209)	8,773	425,386
Total capital assets being depreciated	433,211	1,372	(1,209)	8,930	442,304
Less accumulated depreciation					
Buildings and structures	(4,548)	(337)			(4,885)
Transmission, distribution, and treatment systems	(173,253)	(11,318)	754		(183,817)
Net capital assets being depreciated	(177,801)	(11,655)	754		(188,702)
Total depreciable assets	255,410	(10,283)	(455)	8,930	253,602
<i>Business-type activity capital assets, net</i>	<u>\$329,099</u>	<u>\$18,287</u>	<u>(\$455)</u>		<u>\$346,931</u>

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	\$909
Administrative Services	23	Electric	5,409
Community Services	372	Gas	1,150
Fire	27	Wastewater Collection	1,085
Police	33	Wastewater Treatment	2,533
Public Works	5,889	Refuse	234
Planning	9	Storm Drainage	335
Non departmental (Common Use Assets)	11		<u>\$11,655</u>
Library Dept	35		
Internal Service Funds	3,093		
	<u>\$9,503</u>		



Construction in Progress and Completed Projects

Construction in progress in fiscal year 2004-05 comprise (in thousands):

	Expended to June 30, 2005
Governmental Activities:	
Open Space Trails & Amenities	\$705
Open Space Parking Improvement	455
Park Facilities Improvement	1,507
Park Backflow Replacement & Irrigation	519
Civic Center Infrastructure Improvements	1,469
Fire Station Improvement	1,404
Lucie Stern Community Center Improvements	102
Community Services Lighting Enhancements	138
Homer Avenue Undercrossing	5,091
Library Master Plan Project	974
Children's Theater System Upgrade	202
Roth Building Wings Demo	1,335
Fire Communication Computer System	224
Civic Center Plaza Waterproofing	164
Lot S/L Garage (Downtown Parking Structure)	32,582
Police Building Project	632
San Mateo Drive Bridges	110
Arts in Public Places	114
Library Automation Service	326
Public Safety Mobile Data	164
Fire Portable Radio Replacement	131
Sand Hill Road Bridge	170
Children's Library Improvement	371
Mitchell Park Library & Community Center	115
Fire Stations 3 & 4 Feasibility Study	188
Animal Shelter Expansion & Renovation	272
Arastradero Preserve Gateway	479
Street Maintenance	279
Building Systems Improvements	114
Cubberley Mechanical & Electrical Upgrades	358
Cubberley Building I Air Conditioning	172
American w/ Disabilities Act Compliance	513
School Site Irrigation	142
Mitchell Park Facilities Improvements	991
San Antonio/101 Signal	234
Sidewalk Repairs	677
Interior Finishes Construction	165
Safe Routes to School	160
Photovoltaic Design & Installations	129
Embarcadero Road Median Improvements	122
Baylands Field-Lighting & Fencing	582
Vehicle Replacement Fund	535
Technology Fund	1,622
Other construction in progress	878
Total Governmental construction in progress	\$57,616



Notes to Basic Financial Statements – Note 6

Enterprise Funds:

Gas system extension replacements and improvements	\$1,694
Water system extension replacements and improvements	1,796
Electric distribution system improvements	5,145
Other electrical improvement projects	11,113
Water quality control plant equipment replacement and	1,316
Sewer system rehabilitation and extensions	9,214
Other construction in progress	<u>61,098</u>
 Total enterprise construction in progress	 <u><u>\$91,376</u></u>

Allocations of Enterprise Fund administration and general expenses of \$5.23 million have been capitalized and included in amounts expended to June 30, 2005.

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, 2004	Retirements	Balance June 30, 2005	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	\$5,965	\$285	\$5,680	\$295
2002A Civic Center Refinancing Certificates of Participation, 2.00-4.00%, due 03/01/2012	3,500	2,885	325	2,560	330
2002B Downtown Parking Improvements Certificates of Participation 4.55-6.00%, due 03/01/2022	3,555	3,365	980	2,385	85
	<u>14,805</u>	<u>12,215</u>	<u>1,590</u>	<u>10,625</u>	<u>710</u>
<i>Internal Service Long Term Obligations:</i>					
Information Systems Capital Lease Obligations, 10.46%, repaid 8/2/2004	128	25	25		
Total Governmental Activity Debt	<u>\$14,933</u>	<u>\$12,240</u>	<u>\$1,615</u>	<u>\$10,625</u>	<u>\$710</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	\$6,805	\$265	\$6,540	\$281
1999 Refunding, 3.25-5.25%, due 06/01/24	17,735	15,935	405	15,530	420
2002 Series A, 3.00-5.00%, due 06/01/26	26,055	23,360	695	22,665	710
Less: unamortized discount/ issuance cost		(1,238)	(101)	(1,137)	
	<u>\$52,430</u>	<u>\$44,862</u>	<u>\$1,264</u>	<u>\$43,598</u>	<u>\$1,411</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.

On January 25, 2005 the City defeased \$900 thousand of the 2002B Downtown Parking Improvements Certificates of Participation. The City placed \$1.038 million in surplus cash from the Civic Center Refinancing and Downtown Parking Improvement Project Construction account in an irrevocable trust to provide for future debt payments. Accordingly, the trust account assets and the liability for the defeased Bonds are not included on the financial statements. The outstanding amount of the defeased debt at June 30, 2005 is \$870 thousand. The defeasance resulted in an overall debt service savings of \$1,511 thousand and an economic gain of \$462 thousand.

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 was 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
2006	\$710	\$501	\$1,411	\$2,203
2007	740	475	1,465	2,147
2008	770	446	1,525	2,088
2009	800	415	1,590	2,025
2010	840	381	1,655	1,955
2011-2015	3,450	1,354	9,530	8,534
2016-2020	2,890	523	12,155	5,899
2021-2025	425	42	13,764	2,407
2026			1,640	82
Total	\$10,625	\$4,137	44,735	\$27,340

Reconciliation of long-term debt

Less unamortized original issue discount	(1,137)
Net long-term debt	\$43,598



Debt Call Provisions

Long-term debt as of June 30, 2005 is callable on the following terms and conditions:

	<u>Initial Call Date</u>
 <i>Governmental Activities Long Term Debt</i>	
1998 Certificates of Participation	09/01/2008 (3)
2002B Certificates of Participation	03/01/2011 (2)
 <i>Business-Type Activities Long Term Debt</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, 2005 the amount of Bonds outstanding was \$9.925 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, 2005 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, 2004	Retirements	Balance June 30, 2005	Current Portion
<i>Governmental Activity Debt</i>					
1987 California Avenue Parking					
6.70-9.25%, due 09/02/2007	\$1,325	\$420	\$95	\$325	\$100

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

For the Year Ending June 30	Governmental Activities	
	Principal	Interest
2006	\$100	\$21
2007	110	13
2008	115	5
Total	\$325	\$39

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, 2005, the District’s outstanding debt amounted to \$1.380 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, 2005, the District’s outstanding debt amounted to \$8.940 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. As of June 30, 2005, \$3.75 million of the bonds were called and the remaining outstanding debt amounted to \$31.055 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 (\$137 thousand in fiscal 2004-05) as mandated by the State of California. The 2005 amount is \$6.692 million. Currently, 90.6 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, 2005 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 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, 2005, Governmental Funds reservations and designations included (in thousands):

	Major Funds		
	General Fund	Capital Projects Fund	Non-Major Funds
Reserved for:			
Encumbrances	\$3,401	\$4,535	\$471
Downtown parking structure		130	
Notes and loans	1,234		12,777
Inventory of materials and supplies	2,697		
Debt service			1,392
Total Reserved Fund Balance	<u>\$7,332</u>	<u>\$4,665</u>	<u>\$14,640</u>
Unreserved, designated for:			
Special revenue projects			\$6,405
Equity transfer stabilization	\$3,165		
Reappropriations	267	\$14,265	122
Budget stabilization	21,066		
Infrastructure		25,166	
Total Unreserved/Designated Fund Balances	<u>\$24,498</u>	<u>\$39,431</u>	<u>\$6,527</u>



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, loans and inventory of materials and supplies** 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.

Designated for **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.

Deficit Fund Balance:

As of June 30, 2005 the Downtown Planned Community Special Revenue Fund had a deficit balance of \$4 thousand. The Downtown Planned Community Fund had received an advance from the General Fund of \$4 thousand. This advance is expected to be repaid shortly after the end of the fiscal year.

Internal Service Funds

At June 30, 2005, internal service fund net assets reservations and designations included (in thousands):

Reserved net assets-	
Commitments and reappropriations	\$2,366
Unreserved:	
Designated for:	
Future catastrophic losses	3,737
Retiree health care	18,265
Interfund advances/payables	75
Undesignated	<u>20,103</u>
Net assets unrestricted	<u><u>\$44,456</u></u>

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

Notes to Basic Financial Statements – Note 10

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.

Designated for **interfund advances/payables** represents the portion of net assets set aside to indicate these items do not represent available, spendable resources even though they are a component of assets.

Enterprise Funds

At June 30, 2005, Enterprise Fund net assets reservations included (in thousands):

	Water	Electric	Gas	Wastewater Collection	Wastewater Treatment	Refuse	Storm Drainage	External Services	Total
Rate stabilization									
Supply		\$44,199	\$3,821						\$48,020
Distribution		13,519	4,023						17,542
Operations	\$5,217			\$4,917	\$1,882	\$3,842	\$330		16,188
	5,217	57,718	7,844	4,917	1,882	3,842	330		81,750
Emergency plant replacement	1,204	2,509	934	595	1,807				7,049
Calaveras		72,963							72,963
Reappropriations	9,446	8,557	1,857	5,627	3,532	19	216		29,254
Commitments	5,507	3,221	1,295	2,340	5,390	2,775	27		20,555
Restricted bond proceeds					3				3
Underground loan		668							668
Refuse Water Resources Board						590			590
Shasta rewind loan									
Public benefit program		2,224							2,224
Central Valley Project		145							145
Debt Service	780		952						1,732
External Service - Information Technology								\$30	30
Total	\$22,154	\$148,005	\$12,882	\$13,479	\$12,614	\$7,226	\$573	\$30	\$216,963

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 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.

Effective July 1, 2004, the separate Police and Fire Plans were combined into one Safety Plan. Prior actuarial valuation information for Safety is not available, since the plan was combined.

The Plans' provisions and benefits in effect at June 30, 2005, are summarized as follows:

	Safety	Miscellaneous
Benefit vesting schedule	5 years service	5 years service
Benefit payments	monthly for life	monthly for life
Retirement age	50	50
Monthly benefits, as a % of annual salary	3%	1.426-2.418%
Required employee contribution rates	9%	7%
Required employer contribution rates	21.164%	6.446%

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.

Notes to Basic Financial Statements – Note 11

CALPERS uses the market related value method of valuing the Plan’s assets. An investment rate of return of 7.75 percent is assumed, including inflation at 3 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, 2003 (in thousands):

Safety 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
2001	N/A	N/A	N/A	N/A	N/A	N/A
2002	N/A	N/A	N/A	N/A	N/A	N/A
2003	\$193,154	\$170,471	\$22,683	88.3%	\$18,855	120.3%

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
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%)
2003	272,422	257,123	15,299	94.4%	60,498	25.3%

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, 2003 (in thousands):

	<u>Safety</u>	<u>Miscellaneous</u>
Actuarial Value of Assets 6/30/02	\$101,355	\$258,316
Contributions received	3,398	4,578
Benefits and Refunds Paid	(8,272)	(9,664)
Transfers & Miscellaneous Adjustments	36	(4,268)
Expected Investment Earnings Credited	8,166	20,933
	<u>\$104,683</u>	<u>\$269,895</u>
Expected Actuarial Value of Assets 6/30/03	<u>\$104,683</u>	<u>\$269,895</u>
Market Value of Assets 6/30/03	<u>\$154,974</u>	<u>\$233,753</u>
Actuarial Value of Assets 6/30/03	<u>\$170,471</u>	<u>\$257,123</u>

Additional disclosures will be included when made available by PERS.

Actuarially required contributions for all plans for fiscal years 2005, 2004, and 2003 were \$15.840, \$7.887, and \$3.587, 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 2004-05, expenditures for retiree health care for approximately 590 eligible retired employees totaled \$3.199 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 million towards that liability, the unfunded portion is \$79.5 million. However, Aon did not incorporate the value of the City’s reserves toward the liability. 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 \$585 thousand, bringing the balance to \$18.265 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, 2005 (in thousands):

Retiree Health Benefits	2005	2004
Net assets, beginning of year	\$18,178	\$18,111
Interest earnings	703	789
Unrealized gain (loss) on investments	(118)	(722)
Interdepartmental charges	2,701	
Compensated benefits	(3,199)	
Net Assets, end of year	\$18,265	\$18,178



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 \$23 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, 2005 the City contributed \$582 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	
	2005	2004
Beginning Balance	\$10,548	\$9,253
Liability for current and prior fiscal year claims and claims incurred but not reported (IBNR)	7,508	5,383
Claims paid	(4,173)	(4,088)
Ending Balance	<u>\$13,883</u>	<u>\$10,548</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, 2005, the City incurred expenses totaling \$21.489 million for purchased power and assessments earned by NCPA.

The City's interest in NCPA projects and reserves, as computed by NCPA, was \$2.806 million at June 30, 2005. 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, 2005 is \$212.377 million. The City's participation in this project was 6.158%, or \$13.078 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, 2005, the book value of this Project's plant, equipment and other assets was \$514.080 million, while its long-term debt totaled \$505.815 million and other liabilities totaled \$6.099 million. The City's share of the Project's long term-debt amounted to \$117.330 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, 2005, the book value of this Project's plant, equipment and other assets was \$4.833 million, while its long term debt totaled \$ 4.045 million. The City's share of the Project's long-term debt amounted to \$448 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, 2005 the book value of this Project's plant, equipment and other assets was \$38.687 million, while its long-term debt had been 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 \$433.495 million as of June 30, 2005. The City's share of this debt is \$17.340 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



Notes to Basic Financial Statements – Note 15

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 \$1.384 million at June 30, 2005, 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 a portion of 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 expired in December 2004, with an option for an additional ten-year term. The City renewed the lease for 10 years in 2005. 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, 2005 amounted to \$5.916 million.

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

Year ending June 30:	Payments
2006	\$6,072
2007	6,253
2008	6,440
2009	6,633
2010	6,832
2011-2015	37,347
	\$69,577

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 2004-05 this resulted in payments to PASCO of \$7.942 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, 2005. 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, 2005 is \$3.932 million. During the year ended June 30, 2005, the City paid \$414 thousand as its portion of current debt service.

UTILITIES ENERGY RESOURCE MANAGEMENT

Energy Markets in the United States and California

U.S. and California electric and gas energy prices have increased considerably in the past year, mirroring the increase in worldwide crude oil prices. Between July 2004 and June 2005, forward electric and gas commodity prices for a rolling 12-month period increased by approximately 20% in Northern California. Due to City's commodity purchase strategy, whereby purchases are made on a 3-year forward basis in a laddered fashion, most of the supplies for fiscal year 2004-05 were purchases at lower cost ahead of time. This 3-year laddered purchase resulted in City's electric and gas utility customers enjoying lower retail rates in fiscal year 2004-05 compared to what they would have paid if exposed to market prices during the year. The City's retail rates were also lower than neighboring utilities. City's average electric commodity cost during the year was approximately 3.9 cents/kWh when spot market prices were close to 5.1 cents/kWh; the corresponding average gas commodity costs were \$5.47/MMBtu compared to a spot market price of \$6.25/MMBtu respectively. With most of the supply needs for fiscal year 2005-06 purchased ahead of time, City's supply cost advantage compared to market prices is expected to increase in fiscal year 2005-06 as natural gas and electric market prices escalate further after Hurricane Katrina.

City's electric commodity purchase costs increased considerably in January 2005 when the City's 40-year low-cost Western Area Power Administration (Western) contract expired in December 2004. This transition also resulted in City's long-term electric portfolio moving from an overall surplus energy position to a long-term deficit position. However, additional resources were procured under the Utilities Long Term Electric Acquisition Plan (LEAP) established by the City Council in the 2001-02 period to make up the energy shortfall. Starting in January 2005, approximately 50% of City's annual energy needs will be met from large hydroelectric plants, and 6% from new wind resources. The new renewable resource share of City's supply portfolio is expected to rise from the 6% in 2005 to 20% by 2008. The remainder of the energy needs are met through short and medium term market purchases. These purchases are made with City's approved suppliers and in accordance with City's laddered purchasing strategy.

The table below outlines the forward electric and natural gas commodity supply commitments made by the City with each supplier as of June 30, 2005. Monthly payments are made to suppliers upon delivery of supplies for the month.

Forward Natural Gas Commodity Supply Commitments as of June 30, 2005

Supplier	FY05/06	FY06/07	FY07/08	Total
Coral Energy	\$ 1,679,176	\$ 1,507,604	\$ 552,000	\$ 3,738,780
Sempra	\$ 3,128,858	\$ 4,862,490	\$ 666,045	\$ 8,657,393
BP	\$ 6,905,960	-	-	\$ 6,905,960
ConocoPhillips	\$ 628,135	-	-	\$ 628,135
	\$ 12,342,129	\$ 6,370,094	\$ 1,218,045	\$ 19,930,268

Forward Electricity Commodity Supply Commitments as of June 30, 2005

Supplier	FY05/06	FY06/07	FY07/08	FY08/09	FY09/10	Total
BP	\$ 3,465,000	\$ 1,993,120	-	-	-	\$ 5,458,120
Duke	2,698,100	-	-	-	-	\$ 2,698,100
Sempra	4,242,051	4,501,364	1,571,409	-	-	\$ 10,314,824
Coral Power	13,882,587	5,830,135	4,019,594	3,997,635	2,021,235	\$ 29,751,186
	\$ 24,287,738	\$ 12,324,619	\$ 5,591,003	\$ 3,997,635	\$ 2,021,235	\$ 48,222,230

The California Independent System Operator (CASIO), 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 attempting to ensure reliability and efficient use of the transmission grid. The goal of this reform program includes: 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.

During the year, City's natural gas transportation contract with Pacific Gas and Electric Company (PG&E) was extended for an additional 3-year term starting January 2005. This extension, commonly known as Gas Accord III between PG&E and its transportation customers, provides City's retail customers stable transportation costs. Terms of the new contract are similar to the prior contract.

Future Outlook

Electric

The City has entered into new long-term electricity supply commitments to meet anticipated energy deficits caused by reduced Western energy deliveries in January 2005. The City Council approved the LEAP objectives and guidelines in 2001 and 2002 and the LEAP Implementation Plan in 2003. LEAP is designed to meet City's objectives of continuing to provide low and stable electric rates to retail customers. As part of LEAP, the City has negotiated energy contracts with suppliers and has obtained a number of supply commitments.

The LEAP target is to achieve 10% new renewable supplies by 2008, rising to 20% by 2015. In addition supplies are needed to meet demand for Palo Alto Green, the City's voluntary 100% renewable energy retail rate program. During 2004-05, the City contracted for supplies from new renewable energy resources such as wind and landfill gas sufficient to meet 9-12% of its long-term electricity needs.

Additional new renewable resource contracts to meet 20% of the City's electricity needs by 2008 are expected in the coming fiscal year. The wind and landfill gas resources are competitive with conventional resources, allowing the City to accelerate its renewable energy goals meeting Council's approved target ahead of schedule.

In conformance with LEAP Guidelines, the City is investigating the potential for meeting a portion of its electric supply needs with local generation within City limits. Public outreach to gauge local support for such an initiative is underway. Depending upon the findings of the outreach efforts, City Council is expected to decide in 2006 whether to proceed with a detailed siting feasibility study.

The expiration of the current Western contract (December 2004) will result in higher energy costs. These higher costs have been incorporated into City's long-term electric rate projections. Electric retail rates increased by 8.5% and 11.5% in January and July 2005, respectively, and are expected to increase further in July 2006. However, City's electric rates are projected to continue to be lower than PG&E retail rates. City retail gas rates in fiscal year 2004-05 were lower than those paid by PG&E customers, and the trend is expected to continue in the coming year.

The Utilities Department's energy procurement efforts conform to the 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 August 2005, all except one of the risk management program recommendations made by the City Auditor in her July 2002 audit report have been implemented. Further segregation of back-office settlement duties from the front and middle office commodity procurement and management duties is in the process of being implemented. With guidance from the City Auditor, the Utilities Department and Administrative Services Department are expected to complete implementation in the coming year.

The CAISO is in the process of implementing a number of initiatives with the stated goals of reliable and efficient operation of the transmission grid. Implementation of these initiatives, or the Market Redesign and Technology Update (MRTU) formerly known as Market Design 2002 (MD02), is anticipated to occur in February 2007. An underlying component of MRTU is the use of location specific prices for the scheduling of energy transactions, which could lead to significant cost increases for transmission services for load-serving entities, such as the City which is located in the Bay Area transmission-congested area.

Another component of MRTU is the resource adequacy requirements, whereby load-serving entities must show that they have sufficient generation capacity to meet their peak load, including requirements for local area transmission reliability. To date, the resource adequacy proceedings have resided primarily with the CPUC. However, it is possible that the CAISO will enforce the CPUC determined requirements on all load serving entities, including municipal utilities, which could again lead to significant cost increases for load serving entities in transmission-congested areas. 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 other regulatory agencies. The City also is working with the cities of Santa Clara and Alameda to advocate for higher electric transmission reliability standards and the building of additional transmission infrastructure into the Greater Bay Area.

Governor Schwarzenegger has introduced a reorganization plan to consolidate the state energy related agencies. This plan calls for the creation of a cabinet-level energy department headed by an energy secretary who would also be the head of the California Energy Commission (CEC). The proposed legislation (AB 1165) contemplates folding the CEC and the Office of Energy Market Oversight into the department. The bill would also transfer jurisdiction over the issuance of certificates of public convenience and necessity for certain electric facilities from the Public Utilities Commission to the Department of Energy or the CEC.



Natural Gas

Prior to Hurricane Katrina, declining production in the U.S. and Canada was barely being replaced by new drilling. This phenomenon, coupled with Katrina-related long-term damage to gas production in the Gulf of Mexico and to gas processing facilities along the Gulf Coast, will likely keep an upward pressure on natural gas prices for at least a year. For the next 12 months, prices are expected to reside in the \$8 per MMBtu to \$10 per MMBtu range. Projected increase in Liquefied natural gas (LNG) imports is expected to make up the declining production in the U.S and Canada in the long term, and is expected to lower prices by 2008-09. Market price volatility has increased and is expected to remain high in the short term.

The 3-year ladder strategy for purchasing gas commodity for the City's residential and small commercial customers continues to be implemented. Staff will analyze and make appropriate recommendations related to extending the time horizon for possible purchases from three to ten years in order to better manage market price risk to the City's ratepayers.

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 water and power facilities. In the November 2002 elections, the San Francisco electorate approved a bond measure to pay for San Francisco's one-third share of the cost of the Water System Improvement Program (WSIP) that was estimated to be about \$3 billion at the time. Costs for the WSIP are now expected to be about \$4 billion. The Bay Area Water Supply and Conservation Agency (BAWSCA) and the San Francisco Bay Area Regional Financing Authority were created in 2003 to provide funding for the two-thirds share of the WSIP costs allocated to the agencies that purchase water from the SFPUC, including Palo Alto. Estimates for these increased costs have been factored into City's long-term water rate projections. However, the wholesale agencies (including the City) 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

Two major uncertainties that the City's utility operation has faced were resolved in fiscal year 2004-05. A long-standing dispute with Enron Corporation was settled when the City agreed to pay Enron \$21.5 million to settle pending litigation. The payment was treated as a special item in 2004-05. The Northern California Power Agency (NCPA) resolved another long disputed FERC case with PG&E. This final settlement amount was lower than the liability recognized by the City in its 2003-04 financial statements. The City had previously recognized the full PG&E claim of \$8.5 million, but the ultimate settlement payment was \$4.3 million. The difference between the full claim and the actual payment was treated as a reduction of expense in 2004-05.

A number of uncertainties remain. Western and PG&E have a pending dispute regarding PG&E's ability to pass through higher transmission related costs to Western customers such as Palo Alto. This dispute commenced in 2001 and is being litigated in multiple phases. In one phase, the dispute is in litigation at the FERC with a hearing before an Administrative Law Judge scheduled for Fall 2005. In another phase of this case, Western intends to appeal a FERC ruling favorable to PG&E. In this proceeding, PG&E has invoiced Western the higher transmission wheeling costs and Western has passed those costs to its customers. If Western is successful in the ongoing appeals process, it may recover amounts paid. The City paid close to \$1.6 million of these costs in fiscal year 2004-05.

Another uncertainty the Utilities Department faces is related to the yet-to-be resolved efforts to recover funds identified in NCPA's proof of claim in the PG&E Bankruptcy case. These funds are related to the pre-2001 Interconnected Transmission Agreement services and energy services provided by NCPA during the energy crisis. City's share of these claims is estimated at \$2.3 million. PG&E and the CAISO



have made certain counter claims against NCPA related to the California refund case. A final resolution is expected in 2006.

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 process of challenging the Board’s finding. However, as of June 30, 2005, 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.



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.

HOUSING IN-LIEU

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

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.

REDEVELOPMENT AGENCY ADMINISTRATION

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

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.

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.



Non-major Governmental Funds

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.



This page is intentionally left blank.



City of Palo Alto - Non-Major Governmental Funds

Combining Balance Sheets- June 30, 2005

(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	<u>Street Improvement</u>	<u>Federal Revenue</u>	<u>Housing In-Lieu</u>	<u>Special Districts</u>	<u>Transportation Mitigation</u>	<u>Local Law Enforcement</u>
ASSETS						
Cash and investments						
Available for operations	\$4	\$25	\$3,210	\$1,396	\$2,073	\$127
Cash and investments with fiscal agent						
Receivables:						
Accounts	106	188				
Special assessments						
Interest	6		39	18	23	1
Notes		4,715	8,062			
Total Assets	<u>\$116</u>	<u>\$4,928</u>	<u>\$11,311</u>	<u>\$1,414</u>	<u>\$2,096</u>	<u>\$128</u>
LIABILITIES						
Accounts payable		\$100	\$156			
Deferred revenue						
Interfund payable and advances		192				
Total Liabilities		<u>292</u>	<u>156</u>			
FUND EQUITY						
Reserved for:						
Encumbrances	\$88	147	232			
Notes receivable		4,715	8,062			
Debt service						
Unreserved, designated for:						
Special revenue projects			2,767	\$1,414	\$2,096	\$128
Reappropriations	28		94			
Unreserved, undesignated		(226)				
	<u>116</u>	<u>4,636</u>	<u>11,155</u>	<u>1,414</u>	<u>2,096</u>	<u>128</u>
	<u>\$116</u>	<u>\$4,928</u>	<u>\$11,311</u>	<u>\$1,414</u>	<u>\$2,096</u>	<u>\$128</u>



SPECIAL REVENUE FUNDS				DEBT SERVICE FUNDS		
<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>
	\$17	\$1,143		\$77	\$751	\$352
				29		
		14		1	11	
	<u>\$17</u>	<u>\$1,157</u>		<u>\$107</u>	<u>\$762</u>	<u>\$352</u>
\$4						
4						
				\$4		
					\$762	\$351
(4)	\$17	\$1,157		103		1
(4)	17	1,157		107	762	352
	<u>\$17</u>	<u>\$1,157</u>		<u>\$107</u>	<u>\$762</u>	<u>\$352</u>

(Continued)



City of Palo Alto - Non-Major Governmental Funds ..

Combining Balance Sheets- June 30, 2005

(In thousands of dollars)

	<u>DEBT SERVICE FUNDS</u>		Total
	<u>Downtown Parking Improvement</u>	<u>Special Assessment Debt</u>	<u>Non-major Governmental Funds</u>
ASSETS			
Cash and investments			
Available for operations		\$106	\$8,178
Cash and investments with fiscal agent	\$237		1,340
Receivables:			
Accounts			323
Special assessments		325	325
Interest	4		117
Notes			12,777
Total Assets	\$241	\$431	\$23,060
LIABILITIES			
Accounts payable			\$256
Deferred revenue		\$325	325
Interfund payable and advances			196
Total Liabilities		325	777
FUND EQUITY			
Reserved for:			
Encumbrances			471
Notes receivable			12,777
Debt service	\$241	38	1,392
Unreserved, designated for:			
Special revenue projects			6,405
Reappropriations			122
Unreserved, undesignated		68	1,116
	241	106	22,283
	\$241	\$431	\$23,060



This page is intentionally left blank.



City of Palo Alto - Non-Major Governmental Funds
Combining Statements of Revenues, Expenditures and
Changes in Fund Balances -
For the Year Ended June 30, 2005
(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	Street Improvement	Federal Revenue	Housing In-Lieu	Special Districts	Transportation Mitigation	Local Law Enforcement
REVENUES						
Special assessments						
Other taxes and fines	\$1,144					
From other agencies:						
Community Development Block Grant State of California		\$566				\$100
Other revenue from other agencies		74				
Return on investment	7	18	\$121	\$54	\$87	2
Rental income			6			
Other:						
Housing In-Lieu - residential			10			
Housing In-Lieu - commercial			647			
University Avenue Parking				759		
California Avenue Parking				113		
Other fees		25	63			
Total Revenues	1,151	683	847	926	87	102
EXPENDITURES						
Current:						
Planning and Community Environment		633	290			
Public Safety - Police						58
Non Departmental			323			
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures		633	613			58
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	1,151	50	234	926	87	44
OTHER FINANCING SOURCES (USES)						
Payment to bond escrow agent						
Transfers in						
Transfers (out)	(1,175)			(932)	(600)	
Total Other Financing Sources (Uses)	(1,175)			(932)	(600)	
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	(24)	50	234	(6)	(513)	44
Fund balances at the beginning of year	140	4,586	10,921	1,420	2,609	84
Fund balances at end of year	\$116	\$4,636	\$11,155	\$1,414	\$2,096	\$128



SPECIAL REVENUE FUNDS				DEBT SERVICE FUNDS		
Downtown Planned Community	Assets Seizure	Developer's Impact Fee	Redevelopment Agency	Downtown Business Improvement District	Golf Course	Civic Center Refinancing
				\$135		
	\$1	\$34		5	\$32	\$4
		478				
	1	512		140	32	4
				102		
					285	325
					273	100
				102	558	425
	1	512		38	(526)	(421)
			\$9		537	425
		(37)	(9)			(3)
		(37)			537	422
	1	475		38	11	1
(\$4)	16	682		69	751	351
(\$4)	\$17	\$1,157		\$107	\$762	\$352

(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, 2005
(In thousands of dollars)

	<u>DEBT SERVICE FUNDS</u>		Total Non-major Governmental Funds
	<u>Downtown Parking Improvement</u>	<u>Special Assessment District</u>	
REVENUES			
Special assessments		\$125	\$260
Other taxes and fines			1,144
From other agencies:			
Community Development Block Grant			566
State of California			100
Other revenue from other agencies			74
Return on investment	\$6		371
Rental income			6
Other:			
Housing In-Lieu - residential			10
Housing In-Lieu - commercial			647
University Avenue Parking			759
California Avenue Parking			113
Other fees			566
Total Revenues	<u>6</u>	<u>125</u>	<u>4,616</u>
EXPENDITURES			
Current:			
Planning and Community Environment			923
Public Safety - Police			58
Non Departmental			425
Debt service:			
Principal retirement	80	95	785
Interest and fiscal charges	182	28	583
Total Expenditures	<u>262</u>	<u>123</u>	<u>2,774</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(256)</u>	<u>2</u>	<u>1,842</u>
OTHER FINANCING SOURCES (USES)			
Payment to bond escrow agent	(1,038)		(1,038)
Transfers in	1,318		2,289
Transfers (out)	(105)		(2,861)
Total Other Financing Sources (Uses)	<u>175</u>		<u>(1,610)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(81)</u>	<u>2</u>	<u>232</u>
Fund balances at the beginning of year	<u>322</u>	<u>104</u>	<u>22,051</u>
Fund balances at end of year	<u>\$241</u>	<u>\$106</u>	<u>\$22,283</u>



This page is intentionally left blank.



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, 2005
(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	\$1,144	\$18			
From other agencies:						
Community Development Block Grant				\$816	\$566	(\$250)
State of California				10	74	64
Other revenue from other agencies				5	18	13
Return on investment	49	7	(42)			
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees				7	25	18
Total Revenues	<u>1,175</u>	<u>1,151</u>	<u>(24)</u>	<u>838</u>	<u>683</u>	<u>(155)</u>
EXPENDITURES						
Current operations:						
Planning and Community Environment				832	633	199
Public Safety - Police						
Non Departmental						
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures				<u>832</u>	<u>633</u>	<u>199</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>1,175</u>	<u>1,151</u>	<u>(24)</u>	<u>6</u>	<u>50</u>	<u>44</u>
OTHER FINANCING SOURCES (USES)						
Payment to bond escrow agent						
Transfers in				34		(34)
Transfers (out)	<u>(2,017)</u>	<u>(1,175)</u>	<u>842</u>	<u>(41)</u>		<u>41</u>
Total Other Financing Sources (Uses)	<u>(2,017)</u>	<u>(1,175)</u>	<u>842</u>	<u>(7)</u>		<u>7</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u><u>(\$842)</u></u>	<u><u>(24)</u></u>	<u><u>\$818</u></u>	<u><u>(\$1)</u></u>	<u><u>50</u></u>	<u><u>\$51</u></u>
Fund balances at the beginning of year		<u>140</u>			<u>4,586</u>	
Fund balances at end of year		<u><u>\$116</u></u>			<u><u>\$4,636</u></u>	



.....

SPECIAL REVENUE FUNDS

Housing In-Lieu			Special Districts			Transportation Mitigation		
Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
\$1679	\$1216	(\$46)(3)	\$63	\$54	(\$9)	\$121	\$87	(\$34)
200200	10647	(190)447						
			75984	759113	29	480		(480)
	63	63						
576	847	271	906	926	20	601	87	(514)
1,078	290	788						
453	323	130	39		39			
1,531	613	918	39		39			
(955)	234	1,189	867	926	59	601	87	(514)
			(867)	(932)	(65)	(600)	(600)	
			(867)	(932)	(65)	(600)	(600)	
<u>(\$955)</u>	234	<u>\$1,189</u>		(6)	<u>(\$6)</u>	<u>\$1</u>	(513)	<u>(\$514)</u>
	<u>10,921</u>			<u>1,420</u>			<u>2,609</u>	
	<u>\$11,155</u>			<u>\$1,414</u>			<u>\$2,096</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, 2005
(In thousands of dollars)

	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						
State of California	\$100	\$100				
Other revenue from other agencies						
Return on investment	8	2	(\$6)	\$1		(\$1)
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees						
Total Revenues	108	102	(6)	1		(1)
EXPENDITURES						
Current operations:						
Planning and Community Environment						
Public Safety - Police	108	58	50			
Non Departmental				1		1
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures	108	58	50	1		1
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES		44	44			
OTHER FINANCING SOURCES (USES)						
Payment to bond escrow agent						
Transfers in						
Transfers (out)						
Total Other Financing Sources (Uses)						
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES		44	\$44			
Fund balances at the beginning of year		84				(\$4)
Fund balances at end of year		\$128				(\$4)



SPECIAL REVENUE FUNDS											
Asset Seizure			Developer's Impact Fee			Redevelopment Agency			Downtown Business Improvement District		
Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
									\$154	\$135	(\$19)
	\$1	\$1	\$7	\$34	\$27					5	5
			553	478	(75)						
	1	1	560	512	(48)				154	140	(14)
							\$9	\$9	154	102	52
							9	9	154	102	52
	1	1	560	512	(48)	(9)		9		38	38
			(37)	(37)		9	\$9	(9)			
			(37)	(37)		9		(9)			
	1	\$1	\$523	475	(\$48)					38	\$38
	\$16			682						69	
	\$17			\$1,157						\$107	

(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, 2005
(In thousands of dollars)

	DEBT SERVICE FUNDS					
	Golf Course			Civic Center Refinance		
	Budget	Actual	Variance	Budget	Actual	Variance
			Positive (Negative)			Positive (Negative)
REVENUES						
Property taxes						
Special assessments						
Other taxes and fines						
From other agencies:						
Community Development Block Grant						
State of California						
Other revenue from other agencies						
Return on investment	\$38	\$32	(\$6)	\$4	\$4	
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees						
Total Revenues	<u>38</u>	<u>32</u>	<u>(6)</u>	<u>4</u>	<u>4</u>	
EXPENDITURES						
Current operations:						
Planning and Community Environment						
Public Safety - Police						
Non Departmental						
Debt service:						
Principal retirement	285	285		\$325	325	
Interest and fiscal charges	273	273		100	100	
Total Expenditures	<u>558</u>	<u>558</u>		<u>425</u>	<u>425</u>	
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(520)</u>	<u>(526)</u>	<u>(6)</u>	<u>(425)</u>	<u>(421)</u>	<u>4</u>
OTHER FINANCING SOURCES (USES)						
Payment to bond escrow agent						
Transfers in	520	537	17	425	425	
Transfers (out)					(3)	(3)
Total Other Financing Sources (Uses)	<u>520</u>	<u>537</u>	<u>17</u>	<u>425</u>	<u>422</u>	<u>(3)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>11</u>	<u>\$11</u>		<u>1</u>	<u>\$1</u>	
Fund balances at the beginning of year		<u>751</u>			<u>351</u>	
Fund balances at end of year		<u>\$762</u>			<u>\$352</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)
			\$123	\$125	\$2	\$277	\$260	(\$17)
						1,126	1,144	18
						816	566	(250)
						100	100	
						10	74	64
	\$6	\$6				459	371	(88)
						9	6	(3)
						200	10	(190)
						200	647	447
						1,239	759	(480)
						84	113	29
						560	566	6
	6	6	123	125	2	5,080	4,616	(464)
						1,910	923	987
						108	58	50
						656	425	231
\$99	80	19	95	95		804	785	19
203	182	21	28	28		604	583	21
302	262	40	123	123		4,082	2,774	1,308
(302)	(256)	46		2	2	998	1,842	844
	(1,038)	(1,038)					(1,038)	(1,038)
302	1,318	1,016				1,290	2,289	999
	(105)	(105)				(3,562)	(2,861)	701
302	175	(127)				(2,272)	(1,610)	662
	(81)	(\$81)		2	\$2	(\$1,274)	232	\$1,506
	322			104			22,051	
	\$241			\$106			\$22,283	



Non-major Governmental Funds

This page is intentionally left blank.



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.

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 BENEFIT

This fund accounts for the retiree health benefits.



City of Palo Alto - Internal Service Funds

Combining Statements of Net Assets - June 30, 2005

(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	\$5,453	\$14,583	\$690	\$30,688	\$18,050	\$69,464
Accounts receivable, net	71			9	1	81
Interest receivable	64	172	8	311	215	770
Inventory of materials and supplies	234					234
Total Current Assets	<u>5,822</u>	<u>14,755</u>	<u>698</u>	<u>31,008</u>	<u>18,266</u>	<u>70,549</u>
Noncurrent Assets:						
Interfund receivables		75				75
Capital assets, nondepreciable	535	1,622				2,157
Capital assets, net of depreciation	9,103	3,219	30			12,352
Total Noncurrent Assets	<u>9,638</u>	<u>4,916</u>	<u>30</u>	<u></u>	<u></u>	<u>14,584</u>
Total Assets	<u>15,460</u>	<u>19,671</u>	<u>728</u>	<u>31,008</u>	<u>18,266</u>	<u>85,133</u>
LIABILITIES						
Current Liabilities						
Accounts payable and accrued liabilities	20	623	4	552	1	1,200
Accrued salaries and benefits	60	240	16	1,052		1,368
Accrued claims payable - current				4,084		4,084
Total Current Liabilities	<u>80</u>	<u>863</u>	<u>20</u>	<u>5,688</u>	<u>1</u>	<u>6,652</u>
Long-term Liabilities						
Accrued compensated absences				11,784		11,784
Accrued claims payable				9,799		9,799
Total Long-term Liabilities	<u></u>	<u></u>	<u></u>	<u>21,583</u>	<u></u>	<u>21,583</u>
Total Liabilities	<u>80</u>	<u>863</u>	<u>20</u>	<u>27,271</u>	<u>1</u>	<u>28,235</u>
NET ASSETS						
Investment in capital assets	9,103	3,219	30			12,352
Unrestricted	6,277	15,589	678	3,737	18,265	44,546
Total Net Assets	<u>\$15,380</u>	<u>\$18,808</u>	<u>\$708</u>	<u>\$3,737</u>	<u>\$18,265</u>	<u>\$56,898</u>



City of Palo Alto - Internal Service Funds

Combining Statements of Revenues, Expenses and

Changes in Net Assets - For the Year Ended June 30, 2005

(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	\$5,344	\$6,004	\$1,180	\$33,133	\$2,701	\$48,362
OPERATING EXPENSES						
Administration and general	619	8,356	1,184	1,538	15	11,712
Operations and maintenance	2,570					2,570
Depreciation and amortization	1,967	1,125	1			3,093
Claim payments and change in estimated self-insured liability				7,564		7,564
Compensated absences and other benefits	25			24,831	3,184	28,040
Total Operating Expenses	5,181	9,481	1,185	33,933	3,199	52,979
Total Operating Income (Loss)	163	(3,477)	(5)	(800)	(498)	(4,617)
NONOPERATING REVENUES (EXPENSES)						
Return on investment	182	492	25	685	585	1,969
Gain (loss) on disposal of fixed assets	45					45
Other nonoperating revenues	47		2			49
Total Nonoperating Revenues	274	492	27	685	585	2,063
Income (Loss) Before Transfers	437	(2,985)	22	(115)	87	(2,554)
Transfers in	13	574				587
Transfers (out)		(330)				(330)
Change in Net Assets	450	(2,741)	22	(115)	87	(2,297)
Net assets at beginning of year	14,930	21,549	686	3,852	18,178	59,195
Net assets at end of year	\$15,380	\$18,808	\$708	\$3,737	\$18,265	\$56,898



City of Palo Alto - Internal Service Funds

Combining Statements of Cash Flows - For the Fiscal Year Ended June 30, 2005

(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	\$5,273	\$6,004	\$1,180	\$33,132	\$2,700	\$48,289
Payments to suppliers	(3,015)					(3,015)
Payments to employees	(630)	(7,701)	(1,175)	(25,768)	(3,198)	(38,472)
Claims paid				(4,229)		(4,229)
Other receipts	47		2			49
Net cash provided by operating activities	1,675	(1,697)	7	3,135	(498)	2,622
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES						
Interfund payments	32	25				57
Transfers in	13	574				587
Transfers (out)		(330)				(330)
Cash flows from noncapital financing activities	45	269				314
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES						
Acquisition and construction of fixed assets	(1,263)	(438)	(31)			(1,732)
Proceeds from sale of capital assets	45					45
Principal paid on long term obligation		(25)				(25)
Cash flows from capital financing activities	(1,218)	(463)	(31)			(1,712)
CASH FLOWS FROM INVESTING ACTIVITIES						
Interest and dividends on pooled investments	177	461	25	650	\$593	1,906
Net Cash Flows	679	(1,430)	1	3,785	95	3,130
Cash and investments at beginning of year	4,774	16,013	689	26,903	17,955	66,334
Cash and investments at end of year	\$5,453	\$14,583	\$690	\$30,688	\$18,050	\$69,464
CASH FLOWS FROM OPERATING ACTIVITIES						
Operating income (loss)	\$163	(\$3,477)	(\$5)	(\$800)	(\$498)	(\$4,617)
Adjustments to reconcile operating income (loss) to cash flows from operating activities:						
Depreciation and amortization	1,967	1,125	1			3,093
Other	47		2			49
Changes in assets and liabilities:						
Accounts receivable	(71)			(1)	(1)	(73)
Inventory of materials and supplies	69					69
Accounts and other payables	(500)	655	9	601	1	766
Accrued claims payable				3,335		3,335
Net cash provided by operating activities	\$1,675	(\$1,697)	\$7	\$3,135	(\$498)	\$2,622



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.

Fiduciary Funds are 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 three 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 Fiscal Year Ended June 30, 2005

(In thousands of dollars)

	Balance <u>June 30, 2004</u>	<u>Additions</u>	<u>Reductions</u>	Balance <u>June 30, 2005</u>
<u>California Avenue Parking Assessment District</u>				
ASSETS				
Cash and investments available for operations	\$307	\$147	\$161	\$293
LIABILITIES				
Due to bondholders	\$307	\$147	\$161	\$293
<u>Cable Joint Powers Authority</u>				
ASSETS				
Cash and investments available for operations	\$1,027	\$256	\$15	\$1,268
Interest receivable	13	15	13	15
Total assets	<u>\$1,040</u>	<u>\$271</u>	<u>\$28</u>	<u>\$1,283</u>
LIABILITIES				
Due to other governments	<u>\$1,040</u>	<u>\$271</u>	<u>\$28</u>	<u>\$1,283</u>
<u>University Avenue Area Parking Assessment District</u>				
ASSETS				
Cash and investments with fiscal agents	\$5,604	\$3,432	\$2,823	\$6,213
Interest receivable	59	64	59	64
Total assets	<u>\$5,663</u>	<u>\$3,496</u>	<u>\$2,882</u>	<u>\$6,277</u>
LIABILITIES				
Due to bondholders	<u>\$5,663</u>	<u>\$3,496</u>	<u>\$2,882</u>	<u>\$6,277</u>
<u>Total Agency Funds</u>				
ASSETS				
Cash and investments available for operations	\$1,334	\$403	\$176	\$1,561
Cash and investments with fiscal agents	5,604	3,432	2,823	6,213
Interest receivable	72	79	72	79
Total assets	<u>\$7,010</u>	<u>\$3,914</u>	<u>\$3,071</u>	<u>\$7,853</u>
LIABILITIES				
Due to bondholders	\$5,970	\$3,643	\$3,043	\$6,570
Due to other governments	1,040	271	28	1,283
Total liabilities	<u>\$7,010</u>	<u>\$3,914</u>	<u>\$3,071</u>	<u>\$7,853</u>



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.



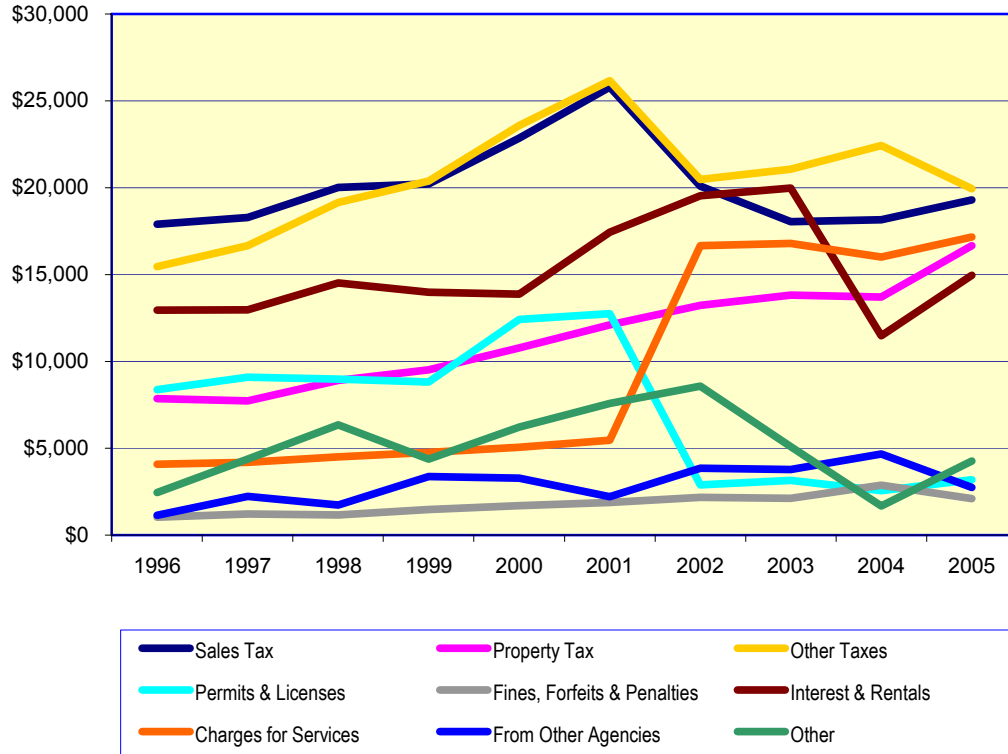
This page is intentionally left blank.



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
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
2005	19,308	16,657	19,941	3,183	2,096	14,968	17,159	2,757	4,269	100,338

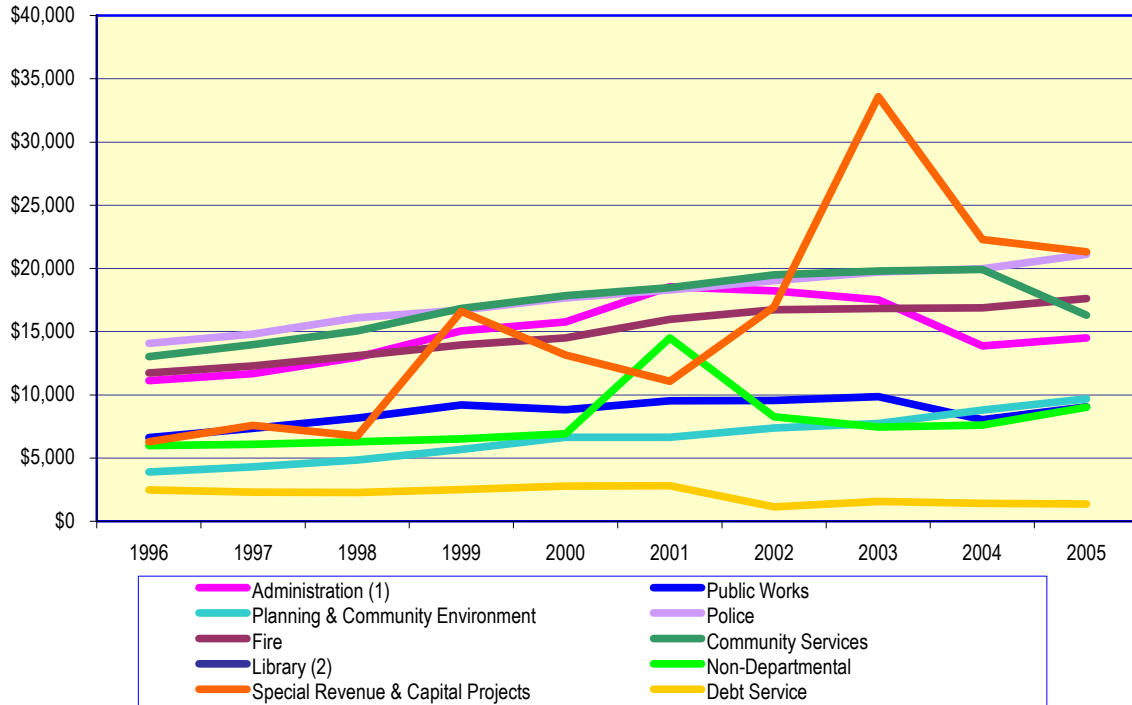
** Revenue categories were changed to align with budget classifications in 2002

Source: Annual Financial Statements

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

All Governmental Fund Types

Last Ten Fiscal Years (\$000s)



Fiscal Year	Administration (1)	Public Works	Planning & Community Environment	Police	Fire	Community Services	Library (2)	Non-Departmental	Special Revenue & Capital Projects	Debt Service	Total
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
2005	14,509	9,060	9,692	21,117	17,615	16,298	\$4,800	9,028	21,317	1,368	124,804

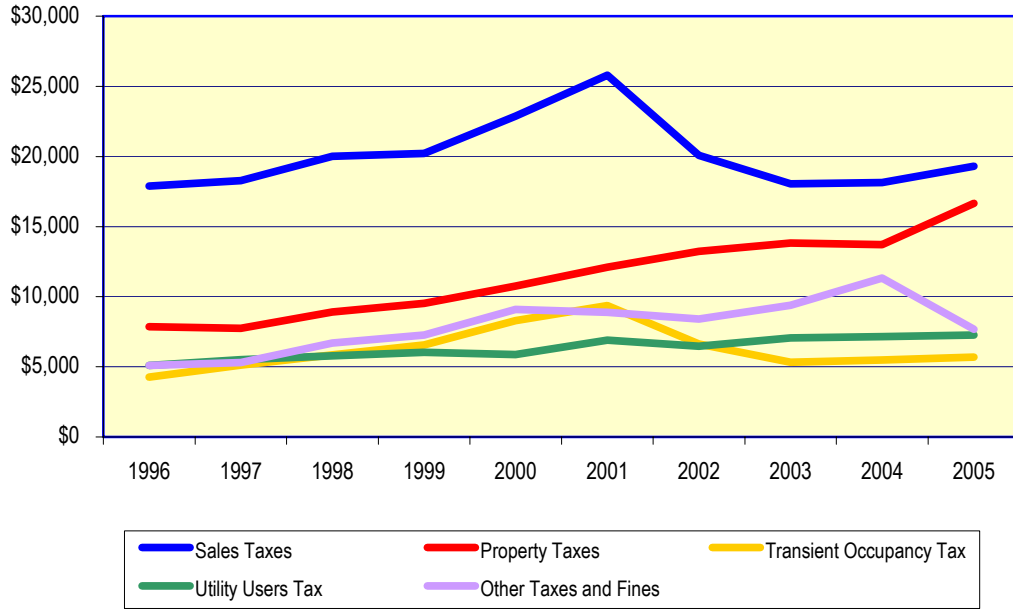
Source: Annual Financial Statements

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

(2) Prior to 2005, Library was included in Community Services.



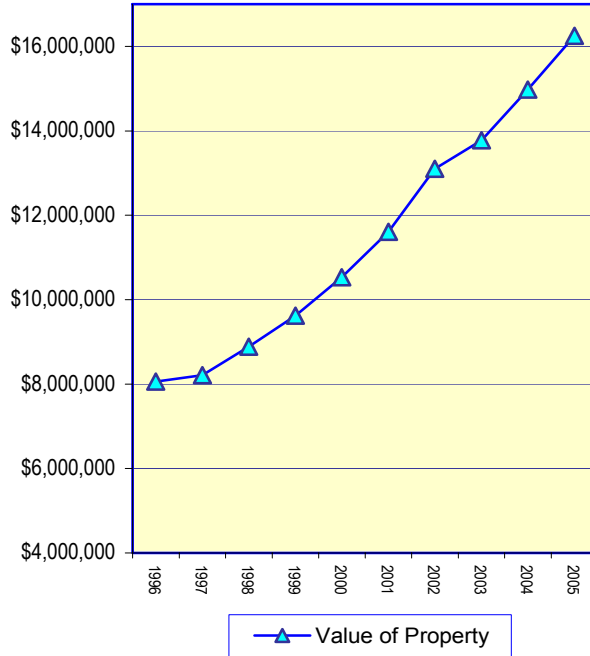
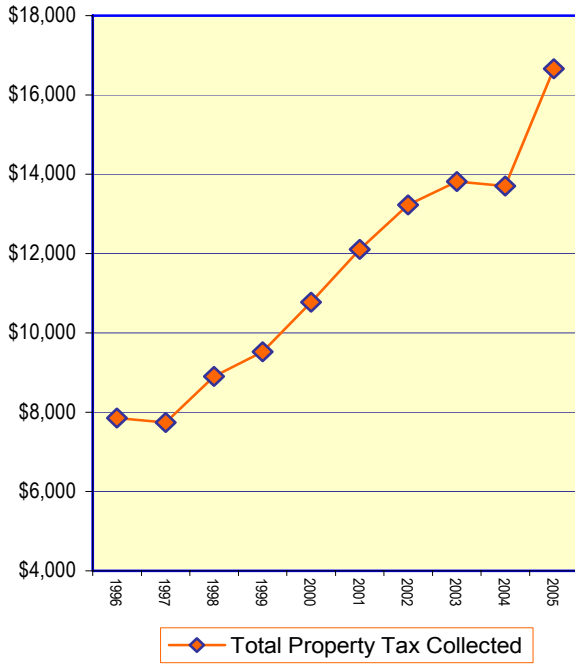
City of Palo Alto - General Fund Tax Revenues by Source.....
Last Ten Fiscal Years (\$000)



Fiscal Year	Sales Taxes	Property Taxes	Transient Occupancy Tax	Utility Users Tax	Other Taxes and Fines	Total
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
2005	19,308	16,657	5,686	7,269	7,678	56,598

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 (\$000)**



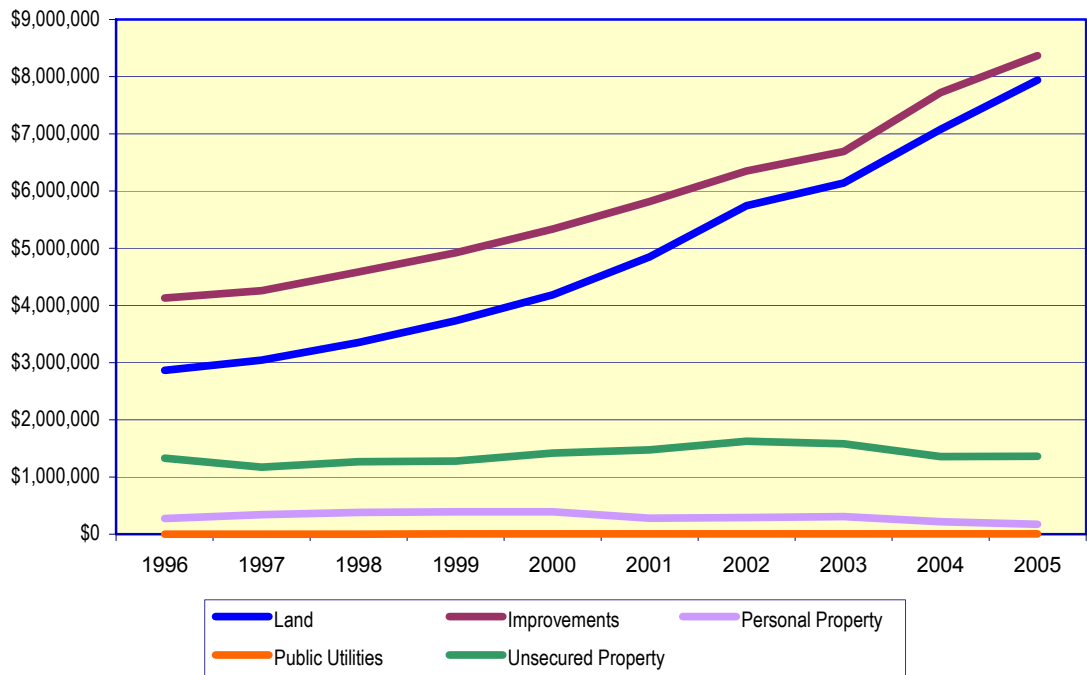
Fiscal Year	Total Tax Levy	Current Tax Collections	Delinquent Tax Collections	Total Property Tax Collected	Value of Property Subject to Basic County Wide Tax Rate (\$000s)
1996	\$7,854	\$7,854	A	\$7,854	\$8,058,927
1997	7,735	7,735	A	7,735	8,206,532
1998	7,660	8,903	A	8,903	8,885,623
1999	9,521	9,521	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
2005	16,657	16,657	A	16,657	16,250,066

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		
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	
2005	7,941,482	8,364,668	174,666	16,480,816	4,084	1,361,117	1,595,951	16,250,066	

SOURCE: County of Santa Clara Assessor's Office

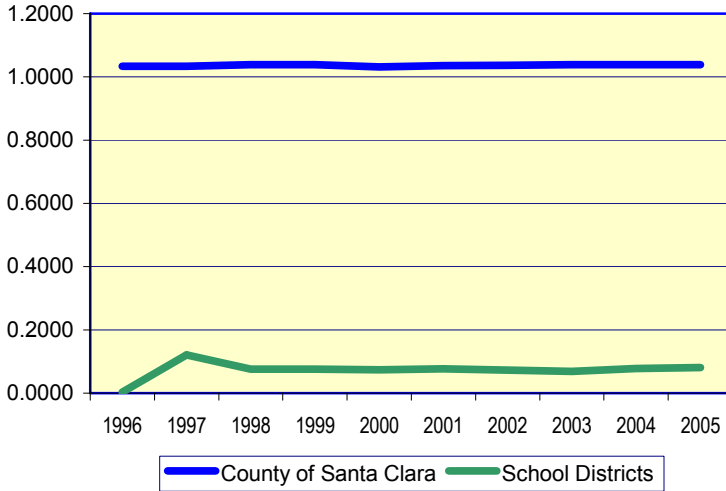
NOTE: Beginning in fiscal year 1988-89, Chapter 921 of the Statutes of 1987 requires the establishment of a single county-wide tax rate area for the assignment of the assessed value of certain types of state-assessed utility property and sets forth formulas for the determination of county-wide tax rates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

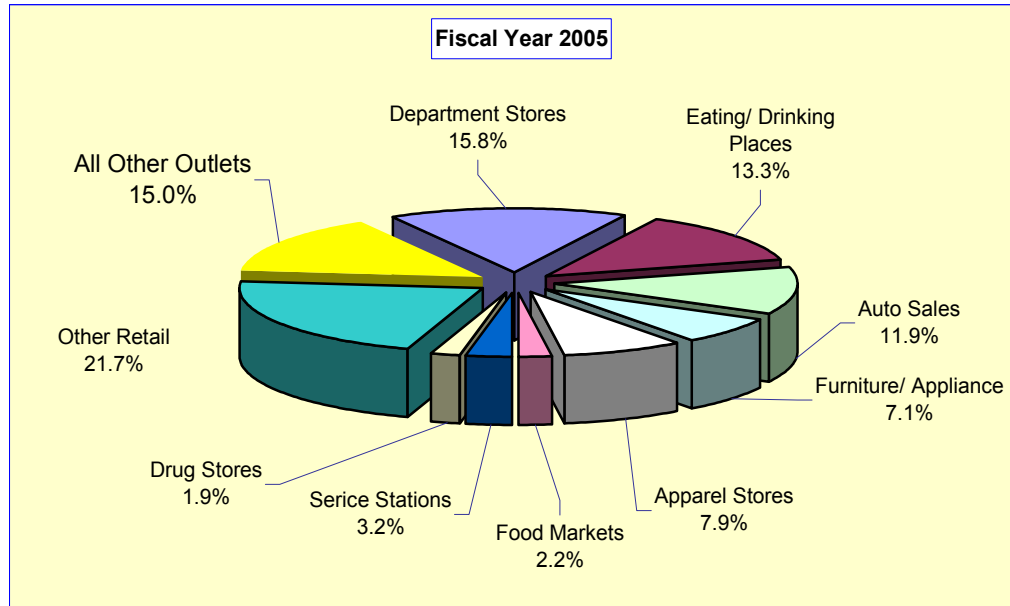


Fiscal Year	County of Santa Clara	School Districts	Total
1996	1.0340	0.0030	1.0370
1997	1.0340	0.1210	1.1550
1998	1.0388	0.0764	1.1152
1999	1.0388	0.0757	1.1145
2000	1.0319	0.0740	1.1059
2001	1.0356	0.0771	1.1127
2002	1.0364	0.0727	1.1091
2003	1.0388	0.0694	1.1082
2004	1.0388	0.0776	1.1164
2005	1.0388	0.0809	1.1197

Source: County of Santa Clara, Tax Rates and Information



City of Palo Alto- Taxable Transactions by Type of Business.....
Last Ten Fiscal Years (\$000)



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
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
2005	2,621	2,206	1,966	1,176	1,310	356	533	317	3,590	14,075	2,476	16,551

Source: California State Board of Equalization compiled by MBIA Muniservices Company

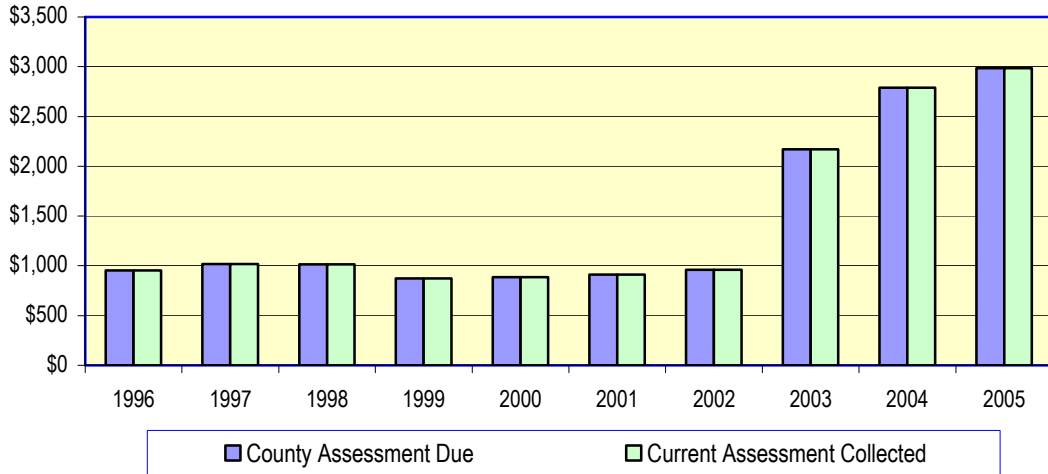
**SALES TAX RATES FOR THE
 FISCAL YEAR ENDED JUNE 30, 2005**

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
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
2005	2,984	2,984	(A)	2,984

Source: County of Santa Clara Assessor's Office

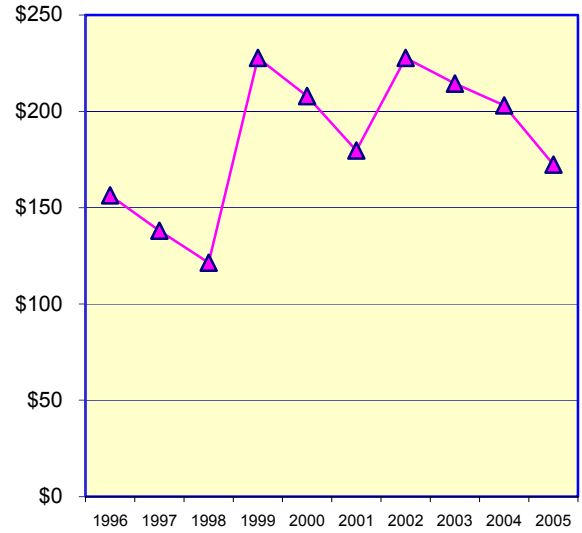
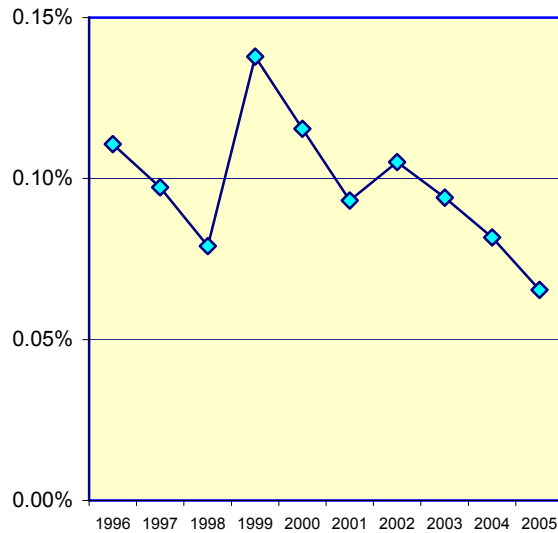
Notes: (A) Effective with the fiscal year 1993-94, the City is on the Teeter Plan, under which the County of Santa Clara pays the full tax levy due. Payment for all prior delinquencies was also received in this fiscal year.



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
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
2005	61,674	16,250,066	10,625	0.065%	172.28

Source: Annual Financial Statements

City of Palo Alto - Computation of Legal Debt Margin
June 30, 2005
(in thousands of dollars)

<hr/>	
2004-2005 Assessed Valuation	<u>\$16,250,066</u>
Debt limit - 15% of assessed value	\$2,437,510
Amount of debt applicable to debt limit:	
Certificates of participation	10,625
Capital lease obligations	0
Special assessment debt with governmental commitment	<u>325</u>
Total	10,950
Less amount of debt not applicable to debt limit	<u>0</u>
Total amount of debt applicable to debt limit	<u>10,950</u>
Legal debt margin	<u><u>\$2,426,560</u></u>
<hr/>	

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 assessment debt excludes debt where there is no government commitment

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

June 30, 2005

2004-2005 Assessed Valuation

\$16,250,066,000

Direct and Overlapping Bonded Debt	Percentage Applicable To City of Palo Alto	June 30, 2005 Bonded Debt
OVERLAPPING TAX AND ASSESSMENT DEBT:		
Santa Clara Valley Water District, Zone W-1	0.47%	\$17,785
Foothill-De Anza Community College District	22.89%	42,424,622
Palo Alto Unified School District	88.77%	103,265,192
Fremont Union High School District	0.01%	10,038
Mountain View-Los Altos Union High School District	1.00%	458,113
Cupertino Union School District	0.01%	8,836
Los Altos School District	0.98%	887,172
Whisman School District	3.67%	964,646
City of Palo Alto Special Assessment Bonds	100.00%	41,695,000
Santa Clara Valley Water District Benefit Assessment District	7.55%	14,396,737
Total Overlapping tax and assessment debt		<u>204,128,141</u>
DIRECT AND OVERLAPPING GENERAL FUND OBLIGATION DEBT:		
Santa Clara County General Fund Obligations	7.55%	60,802,917
Santa Clara County Board of Education Certificates of Participation	7.55%	1,358,047
Foothill-DeAnza Community College District Certificates of Participation	22.89%	5,138,109
Mountain View-Los Altos Union High School District Certificates of Participation	1.00%	82,319
Cupertino Union School District Certificates of Participation	0.01%	386
City of Palo Alto General Fund Obligations	100.00%	11,495,000
Midpeninsula Regional Open Space Park District General Fund Obligations	13.16%	15,049,629
El Camino Hospital District Authority	0.08%	352
Total gross direct and overlapping General Fund obligation debt		<u>93,926,759</u>
Less: El Camino Hospital Authority (100% self-supporting)		352
Total net direct and overlapping General Fund obligation debt		<u>93,926,407</u>
GROSS COMBINED TOTAL DEBT		<u>298,054,900</u> ⁽¹⁾
NET COMBINED TOTAL DEBT		<u>\$298,054,548</u>

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

Ratios to Assessed Valuation:

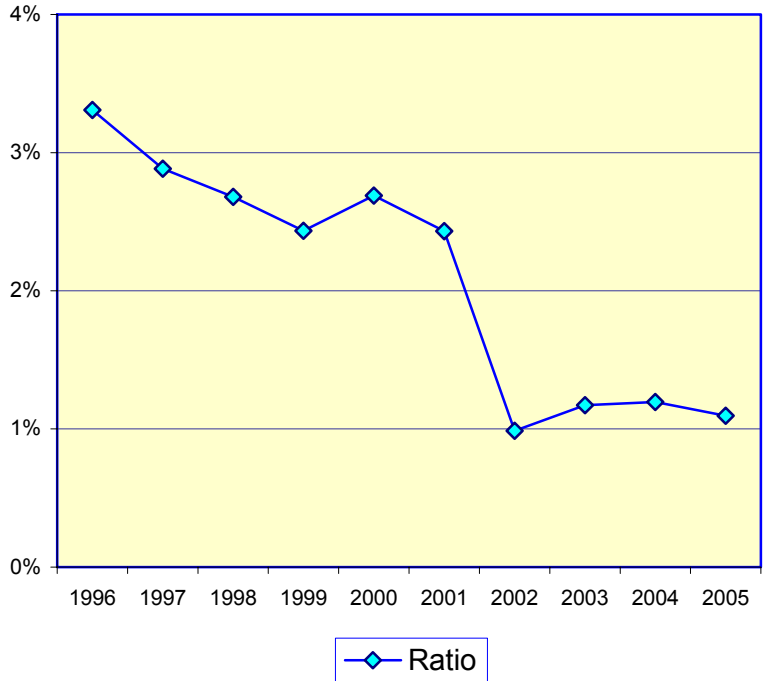
Combined Direct Debt (\$11,495,000)	0.08%
Total Overlapping Tax and Assessment Debt	1.36%
Gross Combined Total Debt	1.99%
Net Combined Total Debt	1.99%

STATE SCHOOL BUILDING AID REPAYABLE AS OF 6/30/05: \$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 (2)			Ratio
		Principal	Interest	Total	
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%
2005	124,804	785	583	1,368	1.10%

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

Note: (2) Excludes debt defeased in 2005

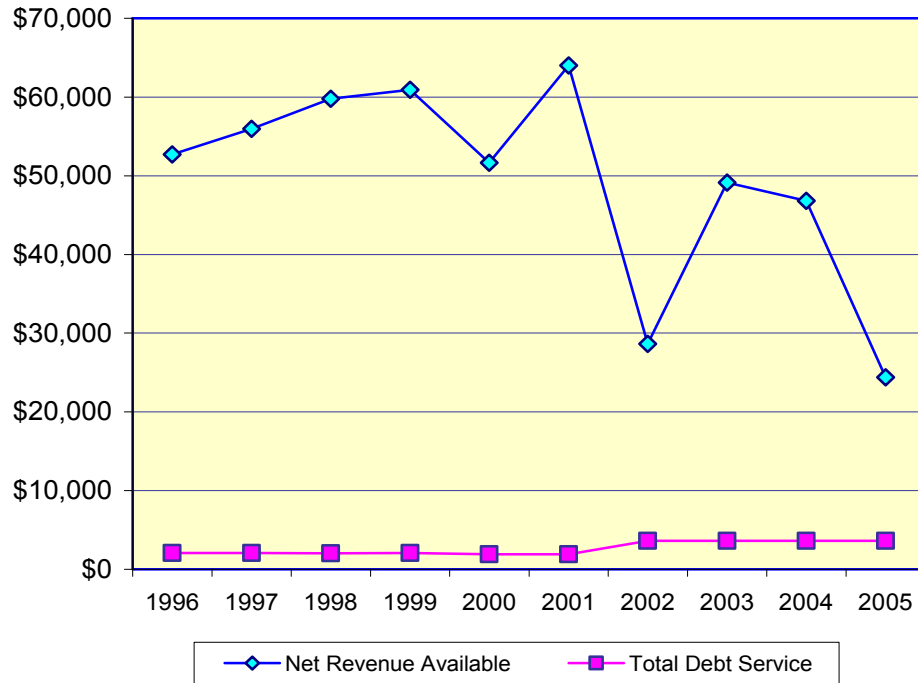
Source: Governmental Funds:
Statement of Revenues, Expenditures, and Changes in Fund Balance



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)



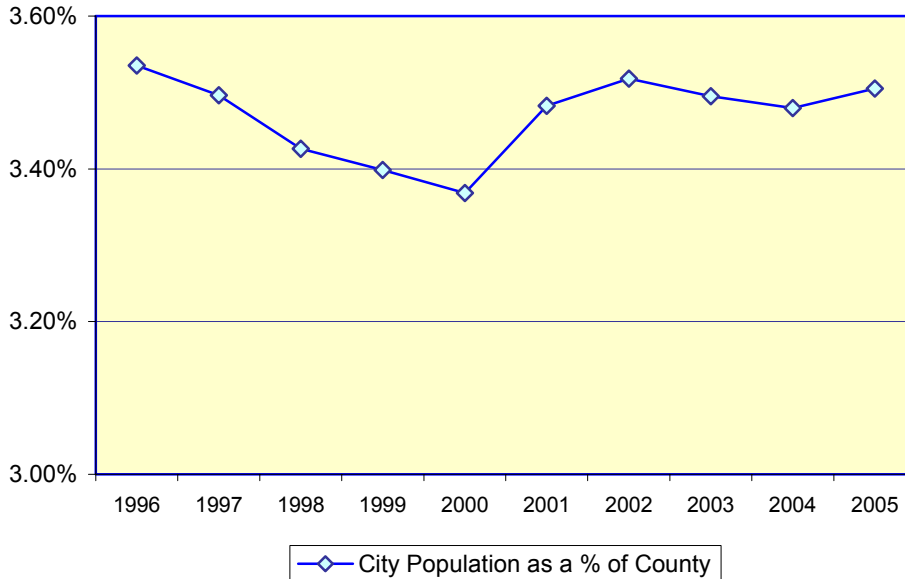
Fiscal Year	Gross Revenue	Direct Operating Expenditures	Net Revenue Available for Debt Services (1)	Debt Service			Coverage
				Principal	Interest	Total	
1996	\$120,828	\$68,096	\$52,732	\$755	\$1,308	\$2,063	25.56
1997	133,081	77,107	55,974	801	1,263	2,064	27.12
1998	144,195	84,415	59,780	840	1,214	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
2005	172,257	147,847	24,410	1,365	2,257	3,622	6.74

Source: Annual Financial Statements

Notes: (1) Excludes depreciation and amortization expense.

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

Last Ten Fiscal Years



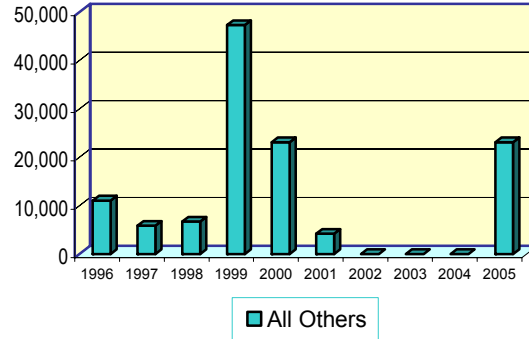
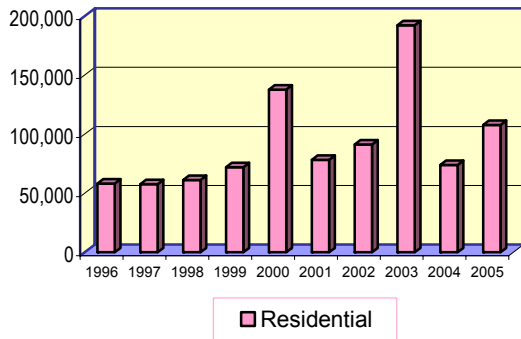
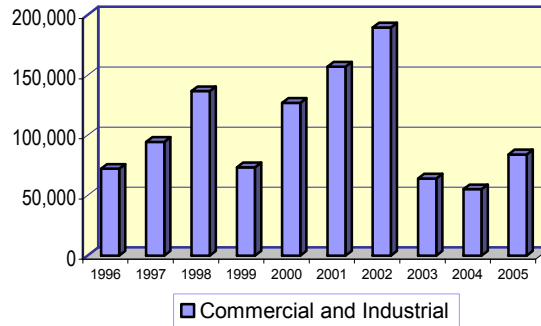
Fiscal Year	City Size Square Miles	Street Miles	City Population	(1) County Population	City Population % of County	(2) School Population	(3) Unemployment Rate
1996	25.98	193.12	57,000	1,612,300	3.54%	9,122	1.90%
1997	25.98	193.12	57,800	1,653,100	3.50%	9,407	1.50%
1998	25.98	193.12	57,900	1,689,900	3.43%	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%
2005	25.98	193.12	61,674	1,759,585	3.51%	10,527	2.80%

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
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
2005	16,250,066	687	84,163	2,324	107,961	71	23,125

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

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

June 30, 2005

TYPE	COVERAGE (Deductible)	LIMITS	COMPANY	EXPIRATION DATE
PROPERTY LOSS				
Blanket	All real & personal property (\$25,000 deductible), Fine Arts (\$2,500 deductible)	\$298,503,727	CA Public Entity Property Program	07/01/06
Boiler & Machinery	All real & personal property (\$50,000 deductible)	\$1,000,000 maximum all risk per occurrence limit \$1,000,000 minimum contingent business interruption	CA Public Entity Property Program	07/01/06
Flood Insurance	All real property 1305 Middlefield Road (\$1,000 deductible)	\$500,000	Hartford Fire Insurance Company	04/07/06
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.	03/22/06
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)	\$34,000,000 annual aggregate	Insurance Company of Pennsylvania	07/01/06
Trustees Errors and Omissions	Bodily injury and property damage liability Errors and omissions liability			
SPECIAL LIABILITY				
Volunteers Accident	Medical - Each person / (\$100 deductible)	\$20,000	Life Insurance Co. of North America	01/03/06
Special Events	Bodily injury	\$1,000,000 per occurrence	Axis Surplus Insurance Company	01/01/06
AUTOMOBILE LIABILITY				
City Manager Vehicle Only	Physical Damage (\$1,000 deductible comp. collision)	\$1,000,000	Progressive Com. Auto Insurance	04/11/06
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		07/01/06
EXCESS WORKERS' COMPENSATION				
	Pooled Retention	\$5,000,000 limit per occurrence - Workers Comp and Employers Liability	CA. Public Entity Ins Authority	07/01/06
	Reinsured Layer	\$145,000,000 workers comp per occurrence, excess of pooled retention limit, includes \$5,000,000 employers liability excess of \$5,000,000 pooled retention, \$25,000,000 sublimit for terrorism	Renaissance Reinsurance LTD, Montpelier Reinsurance LTD, Axis Reinsurance Company	07/01/06

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



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

June 30, 2005 (\$000)

Taxpayer	Type of Business	Assessed Valuation	Percent of Total Assessed Valuation
Leland Stanford Jr. University	University and Ancillary	\$2,508,150	15.43%
Space Systems/Loral, Inc.	Research and Development	196,954	1.21%
Agilent Technologies	Communication and Life Science	70,688	0.44%
Harbor Investment Partners	Offices, Banks and Clinics	61,997	0.38%
Hamilton Associates	Offices, Banks and Clinics	37,335	0.23%
505 Hamilton Avenue Partners	Offices, Banks and Clinics	36,358	0.22%
California Pacific Commercial Corp.	Offices, Banks and Clinics	34,492	0.21%
Thoits Bros Inc	Offices, Banks and Clinics	28,596	0.18%
Hyatt Equities LLC	Offices, Banks and Clinics	25,944	0.16%
Inspire Real Estate Holdings	Offices, Banks and Clinics	22,500	0.14%
Totals		\$3,023,014	18.60%
2004/2005 Local Secured Assessed Valuation:		\$16,250,066	

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

City of Palo Alto - Miscellaneous Statistics

June 30, 2005

YEAR CITY DISCOVERED	1769	NUMBER OF HOUSING UNITS	27,522
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	35,096
POPULATION	61,674		

POLICE PROTECTION

Number of Stations	1
Number of Full-time Positions	168
Number of Police Patrol Vehicles	30

FIRE PROTECTION

Number of Stations	8
Number of Full-time Positions	126
Number of Fire Apparatus	25
Number of Fire Hydrants	2,653

COMMUNITY SERVICES

Acres - Downtown Parks	170
Acres - Open Space	3,731
Parks	35
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	5.3
Accounts	19,605
Miles of Water Mains	226

WASTEWATER

Millions of Gallons Processed	8,395
Accounts	21,825
Miles of Sanitary Sewer Lines	202

ELECTRIC

Millions of kWh Sold	959
Accounts	28,539
Pole Miles of Overhead Lines	225
Trench Miles of Underground Lines	188

GAS

Millions of Therms Sold	32.0
Accounts	23,300
Miles of Gas Mains	207



Single Audit Index.....

Summary of Audit Results	147
Schedule of Expenditures of Federal Awards	149
Notes to Schedule of Expenditures of Federal Awards.....	151
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards	153
Report on Compliance with Requirements Applicable to Each Major and On Internal Control over Compliance in Accordance with OMB Circular A-133.....	154



This page is intentionally left blank.



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.



This page is intentionally left blank.

SUMMARY OF AUDIT RESULTS

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

We are required by the Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-profit Organizations*, to present an overview of the Single Audit which is described below.

Audit of Basic Financial Statements

We have audited the basic financial statements of the City of Palo Alto, California, for the year ended June 30, 2005 and have issued our unqualified report thereon dated October 7, 2005. 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 as amended in 1996 and OMB A-133.

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 other matters to City Council in our separate Memorandum on Internal Controls dated October 7, 2005.

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.

SUMMARY OF AUDIT RESULTS (Continued)

Identification of Major Programs

The following Programs were determined to be major programs:

- Department of Housing and Urban Development Community Development Block Grant (CFDA# 14.218)

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

Our audit did not disclose any findings required to be disclosed by OMB Circular A-133, Subpart E.510.

SUMMARY OF PRIOR YEAR FINDINGS

There were no unresolved prior year findings.

Maze + Associates

October 7, 2005



CITY OF PALO ALTO
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

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	\$145,200
Subgrants:			
Emergency Housing Consortium			7,650
Catholic Charities Ombudsman Program			5,550
Saint Vincent de Paul			2,160
Clara Mateo Alliance Shelter			25,000
New Housing Development			102,208
Clara Mateo Alliance Family Shelter			20,900
InnVision			19,100
Shelter Network Haven Housing			19,000
Economic and Social Opportunities, Inc.			60,000
Project Sentinel - Fair Housing			26,800
Adolescent Counseling			47,574
Palo Alto Senior Housing Project - Stevenson House			16,784
Saint Joseph the Worker			7,340
Palo Alto Housing Corporation:			
Barker Counseling			22,300
Oak Manor Townhouse			106,958
Loans Receivable			<u>4,249,028</u>
Total CDBG Expenditures		14.218	<u>4,883,552</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	CML-5100	20.205	
(Passed through California Department of Transportation)			
Embarcadero Road Bike & Pedestrian Path			625,274
Various locations in Palo Alto			<u>265,315</u>
Total Highway Planning and Construction Grant		20.205	<u>890,589</u>
Governor's Office of Emergency Services	FEMA-3033110-DR-CA,		
(Passed through California Department of Transportation)	OES ID #085-55282	20.703	<u>18,471</u>
Department of Energy	DE-FG36-03GO13066	81.122	<u>68,186</u>
Department of Homeland Security		91.005	<u>45,685</u>
TOTAL FEDERAL FINANCIAL AWARDS			<u><u>\$6,906,483</u></u>

See Notes to Schedule of Expenditures of Federal Awards



This page is intentionally left blank.



NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Note 1.....

Reporting Entity

The Schedule of Expenditure of Federal Awards (the Schedule) includes expenditures of federal awards for the City and its component units as disclosed in the notes to the Basic Financial Statements.

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. All proprietary funds are accounted for using the accrual basis of accounting. Expenditures of Federal Awards reported on the Schedule are recognized when incurred.

OMB Circular A-133 requires that certain adjustments be made to expenditures recognized when incurred. The adjustments applicable to the City are summarized below:

Loan Program with continuing Compliance Requirements - The City operates a loan program under which it must insure participants maintain compliance with program requirements on an on going basis. OMB Circular A-133 section .205(b) requires that expenditures for the above program include the balance of loans outstanding at the beginning of the year plus cash received from the program.

Note 3.....

Direct and Pass-Through Federal Awards

Federal awards may be granted directly to the City by a 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 when they occur.





This page is intentionally left blank.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE
AND OTHER MATTERS 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, 2005, and have issued our report thereon dated October 7, 2005. 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.

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 an opinion 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 caused by error or fraud 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.

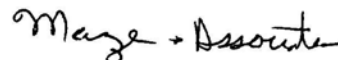
However we did communicate other matters to City Council in our separate Memorandum on Internal Controls dated October 7, 2005.

Compliance and Other Matters

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 grant agreements, 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*.

This report is intended for the information of the City Council, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than the above parties.

October 7, 2005



A Professional Corporation

ACCOUNTANCY CORPORATION
1931 San Miguel Drive - Suite 100
Walnut Creek, California 94596
(925) 930-0902 • FAX (925) 930-0135
E-Mail: maze@mazeassociates.com
Website: www.mazeassociates.com

**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO
EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE IN
ACCORDANCE WITH OMB CIRCULAR A-133**

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, 2005. The City's major federal programs are identified in the summary of auditor's results section of this report. 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, 2005.

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.

A Professional Corporation

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 caused by error or fraud 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.

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, 2005, and have issued our report thereon dated October 7, 2005. 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 and is not intended to be and should not be used by anyone other than the above parties.

Maze + Associates

October 7, 2005

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:

Fred Herman
City of Palo Alto
250 Hamilton Avenue
(650) 329-2550
(650) 328-1199 (TDD)