

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the City of Portsmouth's (City's) Comprehensive Annual Financial Report (CAFR) presents Management's Discussion and Analysis (MD&A) of the City's financial performance during the fiscal year ended June 30, 2006. The MD&A should be read in conjunction with the transmittal letter found in the Introductory Section of this report and the City's Financial Statements that follow this section.

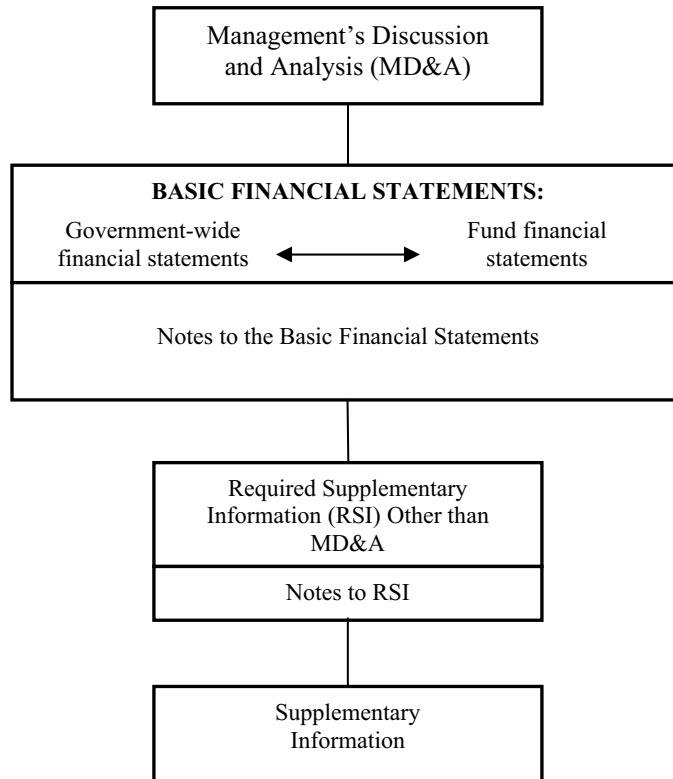
FINANCIAL HIGHLIGHTS

- ❖ The City's net assets totaled \$341 million at June 30, 2006, increasing \$29 million over June 30, 2005.
- ❖ The City's unrestricted net assets totaled \$53 million, which are comprised of \$30 million resulting from governmental activities and \$23 million resulting from business-type activities.
- ❖ Government-wide current assets totaled \$139 million, of which \$95 million was attributable to governmental activities and \$44 million was attributable to business-type activities; while current liabilities totaled \$51 million, with \$42 million from governmental activities and \$9 million from business-type activities. The ratio of current assets to current liabilities was 2.73% overall – 2.26% for governmental activities and 4.89% for business-type activities.
- ❖ The City's long-term indebtedness at June 30, 2006 (including landfill closure and postclosure care of \$5 million and compensated absences of \$8 million) totaled \$349 million, for an increase of \$48 million from the prior year.
- ❖ The City's general revenues and transfers of \$138 million were \$24 million more than expenses net of program revenues of \$114 million. 93% percent of general revenues and transfers were funded through taxes.
- ❖ The General Fund undesignated fund balance increased 41% during the current year to \$36 million from \$25 million in the prior year.
- ❖ Total net assets for the Public Utility Fund rose 6.8% from \$110 million at June 30, 2005 to \$117 million at June 30, 2006. This \$7 million increase resulted from net income before transfers and capital contributions of \$15 million.

FINANCIAL SECTION OF THE COMPREHENSIVE ANNUAL FINANCIAL REPORT

This Comprehensive Annual Financial Report consists of four sections: introductory, financial, statistical, and compliance. As the following chart shows, the financial section of this report has four components - *management's discussion and analysis* (this section), the *basic financial statements*, the *required supplementary information* and the *supplementary information*. The basic financial statements have three components – *government-wide financial statements*, *fund financial statements*, and *notes to the basic financial statements*.

Components of the Financial Section



The City's financial statements present two kinds of statements each with a different snapshot of the City's finances. The government-wide financial statements provide both long-term and short-term information about the City's overall financial status. The fund financial statements focus on the individual parts of the City government, reporting the City's operations in more detail than the government-wide statements. Both perspectives (government-wide and fund) allow the user to address relevant questions, broaden the basis of comparison and enhance the City's accountability.

Government-wide Financial Statements

The government-wide statements report information about the City as a whole using accounting methods similar to those used by private-sector companies. One of the most important questions asked about the City's finances is, "Is the City, as a whole, better off or worse off as a result of the year's activities?" The Statement of Net Assets and the Statement of Activities, which are the government-wide statements, report information about the City as a whole and about its activities in a manner that provides an answer to this question. These statements include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the City's net assets and changes in net assets. The City's net assets, which is the difference between assets and liabilities, is one way to measure the City's overall financial health and its current financial position. Over time, increases or decreases in the City's net assets are one indicator of whether its financial condition is improving or deteriorating. Other non-financial factors will need to be considered, however, such as changes in the City's property tax base and the condition of the City's roads, to assess the overall health of the City.

In the Statement of Net Assets and the Statement of Activities, the City is divided into the following:

Governmental activities - The City's basic municipal services, such as public safety (police and fire), public works, parks and recreation, and general administration, are reported herein. Property taxes, other local taxes, and state and federal grants finance most of these activities.

Business-type activities - The City charges fees to cover the full cost of services provided to customers. The City's water and sewer system, port facility and economic development fund, waste management services and golf courses are reported herein. The Parking Authority, a blended component unit, accounts for parking services provided to citizens and customers.

Component units - The City includes 3 other separate legal entities in its report - the School Board, the EDA, and the PPIC, all discretely presented. Although legally separate, these "component units" are important in that the City is financially accountable for providing operating and capital funding to them.

Fund Financial Statements

The focus of the fund financial statement presentation is on the City's most significant funds. The fund financial statements provide more information about the City's most significant funds - not the City as a whole. Funds are accounting units that the City uses to keep track of specific sources of funding and spending for particular purposes. Some funds are required by State law and by bond covenants. Other funds are established to control and manage money for particular purposes or to demonstrate certain tax and grant revenues are properly used.

The City has three types of funds:

Governmental funds - Most of the City's basic services are included in governmental funds, which focus on (1) the inflows and outflows of cash and other financial assets that can readily be converted into cash and (2) the balances remaining at year end that are available for future spending. Consequently, the governmental funds financial statements provide a detailed short-term view that helps the reader determine whether there are more or fewer financial resources that can be spent in the near future to finance the City's programs. Because this information does not encompass the additional long-term focus of the government-wide financial statements, additional information is provided on the subsequent page of the governmental funds financial statements that explains the relationship (or differences) between these statements. The City has two major governmental funds, the General Fund and the Capital Improvements Fund.

Proprietary funds - Services for which the City charges customers a fee are generally reported in proprietary funds. Proprietary funds, like the government-wide financial statements, provide both long- and short-term financial information.

In fact, the City's enterprise funds (one type of proprietary fund) are the same as business-type activities, but the fund financial statements provide more detailed and additional information, such as cash flows. The City has 2 major enterprise funds: the Public Utility Fund and the Parking Authority, a blended component unit.

The City uses internal service funds (another type of proprietary fund) to report activities that provide supplies and services for other City programs and activities, such as the City Garage Fund and the Information Technology Fund.

Fiduciary funds - The City is the trustee, or fiduciary, for its employees' pension plans and is responsible for the plans' assets, which can be used only to benefit the trust beneficiaries as part of a trust arrangement. The City is responsible for ensuring that the assets reported in these funds are used for their intended purposes. All of the City's fiduciary activities are reported in a separate statement of fiduciary net assets and a statement of changes in fiduciary net assets. The City excludes these activities from the City's government-wide financial statements in that the City cannot use these assets to finance its operations.

FINANCIAL ANALYSIS OF THE CITY ENTITY

Statements of Net Assets

The following table reflects the condensed Statements of Net Assets:

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
Current and other assets	\$ 97	62	45	27	142	89
Capital assets	387	388	193	175	580	563
Total assets	\$ 484	450	238	202	722	652
Current and other liabilities	\$ 41	49	9	15	50	64
Long-term liabilities	230	209	101	67	331	276
Total liabilities	271	258	110	82	381	340
Net assets:						
Invested in capital assets, net of related debt	168	176	105	105	273	281
Restricted	15	6	-	-	15	6
Unrestricted	30	10	23	15	53	25
Total net assets	213	192	128	120	341	312
Total liabilities and net assets	\$ 484	450	238	202	722	652

Net assets (assets in excess of liabilities) may serve over time as a useful indicator of a government's financial position. In the case of the City of Portsmouth, assets exceeded liabilities by \$341 million at June 30, 2006. By far, the largest portion of the City's net assets, 80%, reflects its investment in capital assets (land, buildings, infrastructure, etc.) net of accumulated depreciation and related debt used to acquire those assets. The City uses these assets to provide services to its citizens and, consequently, these assets are not available for future spending. The resources needed to repay the debt related to these capital assets must be provided from other sources. Approximately 4% of the City's net assets are currently subject to various external restrictions. The remaining balance of unrestricted net assets (\$53 million or 16%) may be used to meet the City's ongoing obligations to citizens and creditors.

The net assets of the City's governmental activities increased by \$21 million from \$192 million to \$213 million, as reflected in the Statement of Activities.

The net assets of the City's business-type activities increased by \$8 million from \$120 million to \$128 million, as reflected in the Statement of Activities.

Statements of Activities

The following table shows the revenues and expenses of the governmental and business-type activities:

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
Revenues						
<u>Program revenues:</u>						
Charges for services	\$ 19	16	42	39	61	55
Operating grants and contributions	73	68	-	1	73	69
Capital grants and contributions	3	2	1	-	4	2
<u>General revenues:</u>						
Taxes	129	117	-	-	129	117
Other	10	4	1	1	11	5
Total revenues	234	207	44	41	278	248
Expenses						
General government	21	19	-	-	21	19
Judicial	17	16	-	-	17	16
Public safety	49	47	-	-	49	47
Public works	29	28	-	-	29	28
Health and welfare	36	32	-	-	36	32
Parks, recreational & cultural	11	12	-	-	11	12
Community development	10	11	-	-	10	11
Education	39	33	-	-	39	33
Public utility	-	-	17	16	17	16
Golf	-	-	2	2	2	2
Parking Authority	-	-	1	-	1	-
Waste management	-	-	9	9	9	9
Interest on long-term debt	11	9	-	-	11	9
Total expenses	223	207	29	27	252	234
Excess (deficiency) before transfers and special item	11	-	15	14	26	14
Transfers	8	9	(8)	(9)	-	-
Special item	(2)	-	-	-	(2)	-
Change in net assets	17	9	7	5	24	14
Net assets, beginning of year, as	196	183	121	115	317	298

Governmental Activities

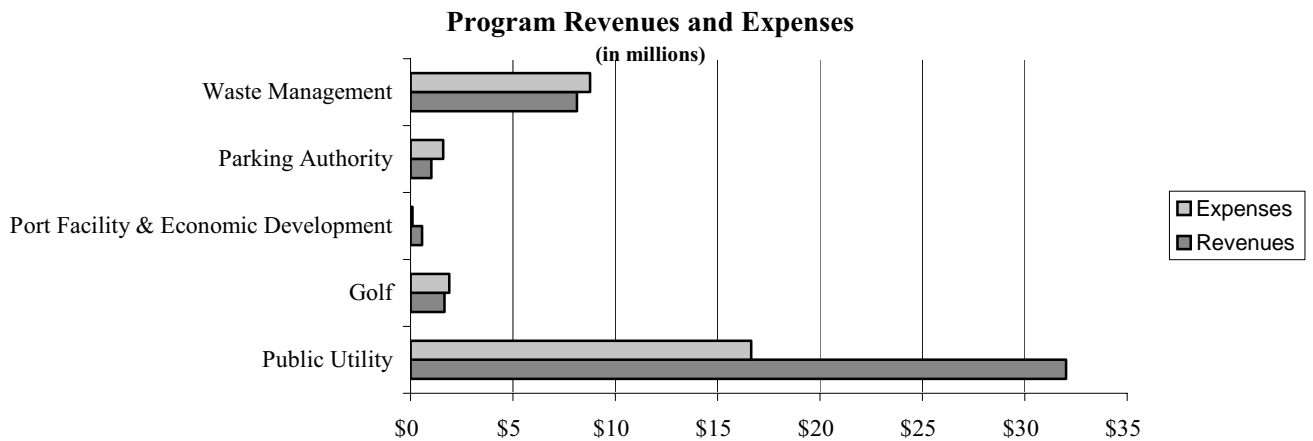
The City's total revenues from governmental activities were \$234 million for the fiscal year ended June 30, 2006. The largest source of revenue is taxes, which represents 55% of the total and is comprised of property taxes, other local taxes, and utility taxes. The City's assessed real property value increased 13.4% from the prior year due in part to new commercial and residential construction, as well as the rising real estate market.

Program revenues are derived from the program itself and reduce the cost of the function to the City. Total program revenues for governmental activities were \$95 million. The largest component of program revenues for governmental activities is operating grants and contributions totaling \$73 million, representing 31% of total revenues for governmental activities.

For the fiscal year ended June 30, 2006, expenses for the City's governmental activities totaled \$223 million. The City's expenses cover a wide range of services, with 22% related to public safety, 17% related to education, and 16% related to health and welfare.

Business-Type Activities

The total net assets for business-type activities increased by \$8 million, which is due primarily to the \$7 million increase in net assets for public utility activities. Charges for services, including water and sewer utility fees, waste management fees, parking fees, and golf fees, represent 95% of total revenues for business-type activities. The following graph compares the program revenues and expenses of the business-type activities.



FINANCIAL ANALYSIS OF THE CITY FUNDS

Governmental Funds

The focus of the City's governmental funds is to provide information on current inflows, outflows, and balances of available resources. Such information is useful in assessing the City's financing requirements. For the fiscal year ended June 30, 2006, the governmental funds reflected a combined fund balance of \$74 million. The General Fund's fund balance totaled \$43 million at June 30, 2006, an increase of \$13 million over the prior year. The General Fund's undesignated fund balance totaled \$36 million at June 30, 2006, an increase of \$11 million over the prior year's undesignated fund balance of \$25 million. The increase in the General Fund's fund balance is due primarily to actual expenditures being less than budgeted expenditures of \$2 million and excess revenue collected of \$7 million, including excess general property taxes of \$2 million and excess legal and administrative fees collected of \$2 million.

The City spent \$13 million in the Capital Improvements Fund to fund major projects, including Parkview Elementary School, London Boulevard Bridge substructure repainting, drainage facility repairs, and the Midtown Corridor redevelopment project. The Capital Improvements Fund has a \$25.1 million fund balance at June 30, 2006, all of which is reserved or designated for future capital project costs.

General Fund Budgetary Highlights

General Fund

Fiscal Year Ended June 30, 2006 (in millions)

	Original Budget	Final Budget	Actual
Revenues and Transfers			
Taxes	\$ 126	126	129
Intergovernmental	35	36	37
Other financing sources	-	1	42
Transfer	8	8	8
Other	14	16	19
Total	183	187	235
Expenditures, transfers, and other financing uses			
Expenditures	176	179	177
Other financing uses	-	-	38
Transfers	7	10	10
Special item	-	-	2
Total	\$ 183	189	227

Actual expenditures in the above chart are shown on the budgetary basis, which differs from the generally accepted accounting principle basis (see Schedule I-3). The final amended budget included an estimated use of fund balance of \$2 million.

Actual General Fund revenues and transfers from other funds were above the final budgeted revenues by \$48 million during fiscal year 2006. This increase is primarily a result of bonds issued of \$42 million that are not budgeted. Actual General Fund expenditures were \$2 million less than the final budget. Other financing uses and a special item totaling \$40 million that are not budgeted are included in the total actual expenditures, transfers and other financing sources and uses totaling \$227 million.

During fiscal year 2006, City Council approved supplemental appropriation ordinances, amending the original budget, for the following purposes:

- To appropriate \$1 million for legal settlement and attorney costs.
- To appropriate \$1 million for cost of issuance related to bond refunding and issuance of new debt.
- To appropriate \$3 million transfer to the Capital Projects Fund for the joint financial and human resources management system and environmental abatement and relocation of the existing Courts Complex.

Proprietary Funds

Total net assets of the Public Utility Fund increased \$7 million during fiscal year 2006 from \$110 million to \$117 million. Of the total net assets, \$92 million is invested in capital assets, net of related debt. Unrestricted net assets totaled \$26 million, an increase of \$9 million from the prior year. The increase in net assets is due primarily to the fund's net income before transfers and capital contributions of \$15 million.

Total net assets of the Parking Authority, a blended component unit, at June 30, 2006 increased \$40 thousand during fiscal year 2006 to \$757 thousand. Of the total net assets, \$931 thousand is invested in capital assets, net of related debt, and there is an unrestricted net assets deficit of \$174 thousand.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of fiscal year 2006, the City had invested \$580 million in a broad range of capital assets, including vehicles and equipment, buildings, park and golf facilities, roads, bridges, and water and sewer lines, as reflected in the following schedule:

Capital Assets (net of depreciation)			
As of June 30, 2006 (in millions)			
	Governmental Activities	Business-Type Activities	Total Primary Government
Land	\$ 24	15	39
Site improvements	1	-	1
Infrastructure	157	-	157
Buildings	127	13	140
Improvements other than buildings	-	90	90
Machinery, furniture and equipment	16	5	21
Construction in progress	62	70	132
Total	\$ 387	193	580

Major capital asset activity for the fiscal year ended June 30, 2006 included:

- Capital asset additions for governmental activities totaled \$18 million, including \$12 million for construction in progress and \$4 million from capital lease proceeds.
- Capital asset additions for business-type activities totaled \$10 million, including \$8 million for construction in progress.
- Depreciation expense totaled \$18 million and \$3 million for governmental and business-type activities, respectively.
- Construction in progress totaled \$62 million for governmental activities at June 30, 2006 (including certain school projects under construction).
- Construction in progress totaled \$70 million for business-type activities at June 30, 2006.

More detailed information about the City's capital assets is presented in Note 4 to the basic financial statements.

The City's fiscal year 2007 capital budget estimates spending another \$66 million for capital projects. The major projects include \$15 million for schools, \$17 million for water and sewer improvements, \$16 for drainage and street improvement, \$3 million for industrial and economic development, and \$12 million for municipal facilities. The City issued additional debt in the fall of 2006 to finance these capital projects.

Long-term Debt

At year-end, the City had \$336 million in outstanding debt, excluding landfill closure and post closure care costs, and compensated absences. General obligation and revenue bonds outstanding represented \$269 million of this total, as reflected in the following schedule:

	Governmental		Business-Type		Total Primary	
	Activities		Activities		Government	
	2006	2005	2006	2005	2006	2005
General obligation and revenue bonds	\$ 171	122	98	65	269	185
General obligation notes payable	8	8	-	-	8	8
Obligations under capital leases	19	23	1	1	20	24
Obligations under cooperation agreements	35	51	-	-	35	51
Bond anticipation note	-	12	-	6	-	18
Literary loans	4	4	-	-	4	4
Total	\$ 237	220	99	72	336	290

On August 25, 2005, the City issued a \$3,600,000 General Obligation Bond Anticipation Note to provide interim financing for public utility water and sewer capital projects.

On October 18, 2005, the City issued \$81,630,000 of General Obligation and Refunding Bonds, Series 2005A with a premium of \$2,524,306. The proceeds were used to fund public improvement and public utility capital improvement projects, and to refund certain General Obligation Public Improvement and Revenue Bonds, and to pay off Public Improvement and Public Utility Bond Anticipation Notes.

On October 18, 2005, the City issued \$17,390,000 of General Obligation Public Utility Refunding Bonds, Series 2005B with a premium of \$139,495, to refund the outstanding 1996 General Obligation 1996 Series Bonds, and outstanding 2001B Series Bonds.

On October 18, 2005, the City issued \$21,090,000 of Taxable General Obligation Refunding Bonds, Series 2005C, with a discount of \$67,183, to advance refund the Series 2001 Performing Arts Center General Obligation Taxable Variable Rate Public Facility Revenue Bonds, and to pay off the Series 2002 General Obligation Taxable Public Improvement Bond Anticipation Note. The Series 1997A Fairwood Homes – Taxable EDA Variable Rate Demand Revenue Bonds and the Series 1997B Port Centre I- Taxable EDA Variable Rate Demand Revenue Bonds, both debt of the EDA, a component unit of the City, were paid in full.

The state limits the amount of general obligation debt the City can legally issue to ten percent of the assessed value of real property within the City. The City's outstanding debt, not all of which is applicable to the state limits, is significantly below this limit - which is currently \$449.2 million.

The City maintains bond ratings on general obligation debt of "A1", "AA-", and "AA-", from Moody's Investors Service, Standard & Poor's Public Finance Ratings and Fitch, Inc., respectively.

More detailed information about the City's long-term liabilities is presented in Notes 5 and 19 to the basic financial statements.

ECONOMIC FACTORS

The City's unemployment rate for July 2006 was 5.2%, which compares to the national unemployment rate of 5.0% for July 2006. Per capita income as of December 31, 2004 was \$27,265, an increase of 8% over the previous year.

The fiscal year 2007 capital budget includes the new Tidewater Community College campus, Churchland Library, neighborhood improvement related to the new APM Terminals port development, the Midtown corridor, downtown developments including the North Pier and Desk Inc. sites and the Crawford roundabout, McLean Street and Cavalier Boulevard infrastructure related to the New Port housing development, Seawall reinforcements and the closure of ditches in the Cavalier Manor neighborhood. In addition, \$5 million has been approved in FY 07 for design of a new court complex totaling \$64 million.

FINANCIAL INQUIRIES

This financial report is designed to provide our citizens, taxpayers, customers, investors and creditors with a general overview of the City's finances and to demonstrate the City's accountability for the money it receives. Questions concerning this report or requests for additional financial information should be directed to the Chief Financial Officer, 801 Crawford Street, Portsmouth, VA 23704.