

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, 2007. 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.

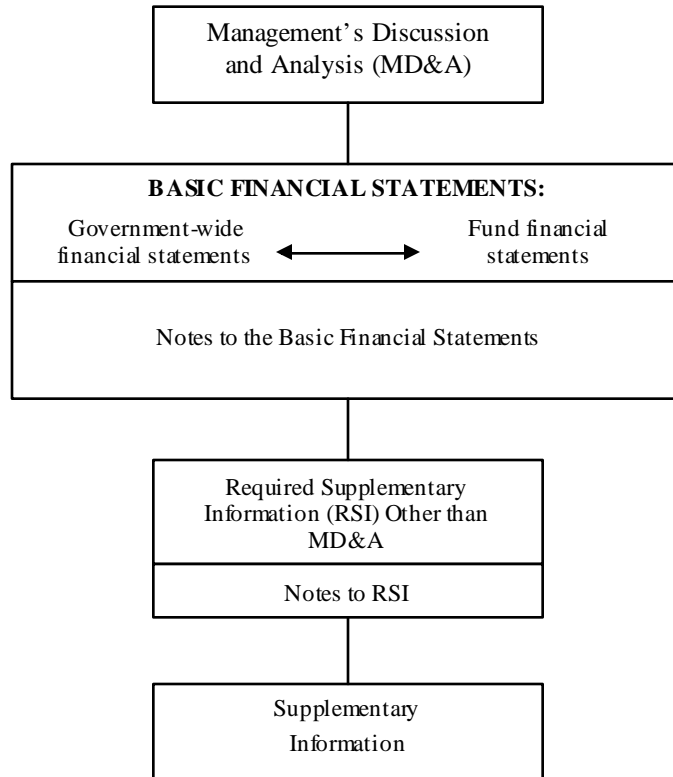
FINANCIAL HIGHLIGHTS

- ❖ The City's net assets totaled \$357 million at June 30, 2007, increasing \$11 million over June 30, 2006.
- ❖ The City's unrestricted net assets totaled \$58 million, which are comprised of \$32 million resulting from governmental activities and \$26 million resulting from business-type activities.
- ❖ Government-wide current assets totaled \$168 million, of which \$110 million was attributable to governmental activities and \$58 million was attributable to business-type activities; while current liabilities totaled \$51 million, with \$41 million from governmental activities and \$10 million from business-type activities. The ratio of current assets to current liabilities was 3.3% overall – 2.7% for governmental activities and 5.8% for business-type activities.
- ❖ The City's long-term indebtedness at June 30, 2007 (including the portions due in fiscal year 2008) totaled \$391 million, for an increase of \$24 million from the prior year. The long-term indebtedness includes landfill closure and postclosure care of \$5 million and compensated absences of \$8 million.
- ❖ The City's general revenues and transfers of \$153 million were \$12 million more than expenses, net of program revenues, of \$142 million. 94% percent of general revenues and transfers were funded through taxes.
- ❖ The General Fund undesignated fund balance decreased less than 1% during the current year to \$35 million from \$36 million in the prior year.
- ❖ Total net assets for the Public Utility Fund rose 8% from \$117 million at June 30, 2006 to \$126 million at June 30, 2007. This \$9 million increase resulted from net income before transfers and capital contributions of \$17 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 statement 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:

Table 1

Summary of Statements of Net Assets

As of June 30, 2007 and 2006 (in millions)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
Current and other assets	\$ 112	97	59	45	171	142
Capital assets	393	392	202	193	595	585
Total assets	\$ 505	489	261	238	766	727
Current and other liabilities	\$ 41	41	10	9	51	50
Long-term liabilities	243	230	115	101	358	331
Total liabilities	284	271	125	110	409	381
Net assets:						
Invested in capital assets, net of related debt	178	173	108	105	286	278
Restricted	11	15	2	-	13	15
Unrestricted	32	30	26	23	58	53
Total net assets	221	218	136	128	357	346
Total liabilities and net assets	\$ 505	489	261	238	766	727

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 \$357 million at June 30, 2007. 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 (\$58 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 \$3 million from \$218 million to \$221 million, as reflected in the Statement of Activities.

The net assets of the City's business-type activities increased by \$8 million from \$128 million to \$136 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	
	2007	2006	2007	2006	2007	2006
Revenues						
Program revenues:						
Charges for services	\$ 17	19	45	42	62	61
Operating grants and contributions	75	73	1	-	76	73
Capital grants and contributions	4	3	-	1	4	4
General revenues:						
Taxes	144	129	-	-	144	129
Other	6	10	4	1	10	11
Total revenues	246	234	50	44	296	278
Expenses						
General government	31	21	-	-	31	21
Judicial	18	17	-	-	18	17
Public safety	54	49	-	-	54	49
Public works	29	29	-	-	29	29
Health and welfare	39	36	-	-	39	36
Parks, recreational, and cultural	13	11	-	-	13	11
Community development	13	10	-	-	13	10
Education	45	39	-	-	45	39
Public utility	-	-	18	17	18	17
Golf	-	-	2	2	2	2
Parking Authority	-	-	2	1	2	1
Waste management	-	-	10	9	10	9
Interest on long-term debt	11	11	-	-	11	11
Total expenses	253	223	32	29	285	252
Excess (deficiency) before transfers and special item	(7)	11	18	15	11	26
Transfers	10	8	(10)	(8)	-	-
Special item	-	(2)	-	-	-	(2)
Change in net assets	3	17	8	7	11	24
Net as sets, beginning of year, as restated	218	201	128	121	346	322
Net as sets, end of year	\$ 221	218	136	128	357	346

Governmental Activities

The City's total revenues from governmental activities were \$246 million for the fiscal year ended June 30, 2007. The largest source of revenue is taxes, which represents 59% of the total and is comprised of property taxes, other

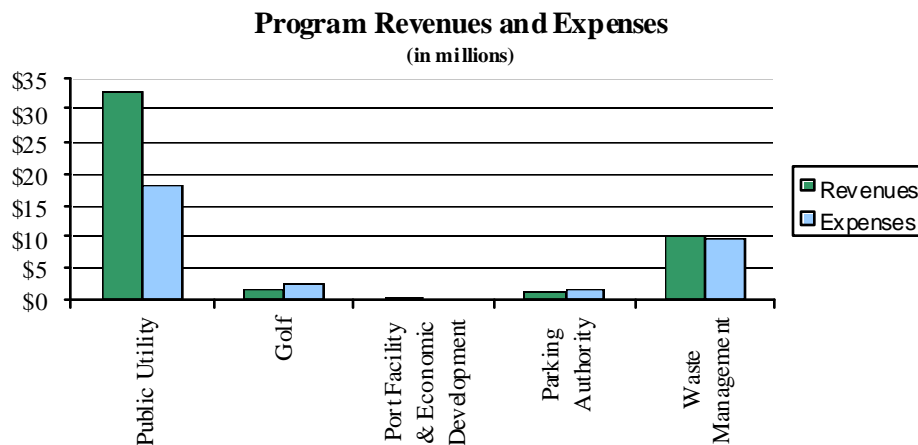
local taxes, and utility taxes. The City's assessed real property value increased 25% from the prior year due in part to new commercial and residential construction, as well as the rising real estate market.

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 \$96 million. The largest component of program revenues for governmental activities is operating grants and contributions totaling \$75 million, representing 78% of total program revenues for governmental activities.

For the fiscal year ended June 30, 2007, expenses for the City's governmental activities totaled \$253 million. The City's expenses cover a wide range of services, with 21% related to public safety, 18% related to education, and 15% 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 \$9 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 90% 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, 2007, the governmental funds reflected a combined fund balance of \$84 million. The General Fund's fund balance totaled \$41 million at June 30, 2007, a decrease of \$2 million over the prior year. The General Fund's undesignated fund balance totaled \$35 million at June 30, 2007, which decreased by \$1 million from the prior year's undesignated fund balance of \$36 million. The decrease in the General Fund's fund balance is due primarily to actual expenditures being less than budgeted expenditures of \$1 million and collected revenue being under budgeted revenues by \$3 million, including \$2 million in taxes and \$1 million in charges for services.

The City spent \$27 million in the Capital Improvements Fund to fund major projects, including Victory Boulevard, Downtown Crawford Roundabout, drainage facility repairs, Simonsdale Street Improvements, and Victory Elementary School. The Capital Improvements Fund has a \$35 million fund balance at June 30, 2007, all of which is reserved or designated for future capital project costs.

General Fund Budgetary Highlights

General Fund Budgetary Highlights			
General Fund			
Fiscal Year Ended June 30, 2007 (in millions)			
	Original Budget	Final Budget	Actual
Revenues and Transfers			
Taxes	\$ 139	145	142
Intergovernmental	36	36	37
Other financing sources	1	1	44
Transfer	9	9	9
Other	14	16	16
Total	\$ 199	207	248
Expenditures, transfers, and other financing uses			
Expenditures	\$ 190	195	194
Other financing uses	-	-	44
Transfers	9	13	12
Total	\$ 199	208	250

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 \$1 million.

Actual General Fund revenues and transfers from other funds were above the final budgeted revenues by \$41 million during fiscal year 2007. This increase is primarily a result of bonds issued of \$44 million that are not budgeted. Actual General Fund expenditures were \$1 million less than the final budget. Other financing uses totaling \$44 million that are not budgeted are included in the total actual expenditures, transfers, and other financing sources and uses totaling \$250 million.

During fiscal year 2007, City Council approved supplemental appropriation ordinances, amending the original budget, for the following purposes:

- To appropriate \$5 million for personnel related costs.
- To appropriate \$1 million for risk management charges related to Harbor Center and to fund educational capital projects.
- To appropriate \$1 million transfer to the Comprehensive Services Fund for the City's local share of services.
- To appropriate \$2 million transfer to the Social Services Fund for the City's local share of services.

Proprietary Funds

Total net assets of the Public Utility Fund increased \$9 million during fiscal year 2007 from \$117 million to \$126 million. Of the total net assets, \$95 million is invested in capital assets, net of related debt. Unrestricted net assets totaled \$29 million, an increase of \$4 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 \$17 million.

Total net assets of the Parking Authority, a blended component unit, at June 30, 2007 increased \$15 thousand during fiscal year 2007 to \$720 thousand. Of the total net assets, \$1 million is invested in capital assets, net of related debt, and there is an unrestricted net assets deficit of \$355 thousand.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of fiscal year 2007, the City had invested \$595 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, 2007 (in millions)			
	Governmental Activities	Business-Type Activities	Total Primary Government
Land	\$ 17	15	32
Site improvements	1	-	1
Infrastructure	154	-	154
Buildings	125	13	138
Improvements other than buildings	-	88	88
Machinery, furniture, and equipment	17	10	27
Construction in progress	79	76	155
Total	\$ 393	202	595

Major capital asset activity for the fiscal year ended June 30, 2007 included:

- Capital asset additions for governmental activities totaled \$39 million, including \$23 million for construction in progress and \$2 million from capital lease proceeds.
- Capital asset additions for business-type activities totaled \$18 million, including \$10 million for construction in progress.
- Depreciation expense totaled \$20 million and \$5 million for governmental and business-type activities, respectively.
- Construction in progress totaled \$79 million for governmental activities at June 30, 2007 (including certain school projects under construction).
- Construction in progress totaled \$76 million for business-type activities at June 30, 2007.

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

The City's fiscal year 2008 capital budget estimates spending another \$46 million for capital projects. The major projects include \$6 million for schools, \$17 million for water and sewer improvements, \$6 million for drainage and street improvement, \$10 million for industrial and economic development, and \$6 million for municipal facilities.

Long-term Debt

At year-end, the City had \$361 million in outstanding debt, excluding landfill closure and post closure care costs, and compensated absences. General obligation and revenue bonds outstanding represented \$330 million of this total, as reflected in the following schedule:

	Outstanding Debt					
	As of June 30, 2007 and 2006 (in millions)					
	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
General obligation and revenue bonds	\$ 218	171	112	98	330	269
General obligation notes payable	7	8	-	-	7	8
Obligations under capital leases	19	19	2	1	21	20
Obligations under cooperation agreements	-	35	-	-	-	35
Literary loans	3	4	-	-	3	4
Total	\$ 247	237	114	99	361	336

On August 24, 2006, the City issued \$63,540,000 of General Obligation and Refunding Bonds, Series 2006A with a net discount of \$6,640. The proceeds of the Series 2006A bonds were used to pay \$10,500,000 of public improvement bonds, \$17,325,000 of public utility bonds, and to advance refund \$34,725,000 of the Series 1999 revenue bonds of the Economic Development Authority of the City of Portsmouth in advance of their stated maturities. The refunded Economic Development Authority bonds had been an obligation of the City under a cooperation agreement.

Of the total amount of refunding payments made, \$36,133,012 was used to purchase U.S. Treasury Securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for those bonds has been removed from general long term debt.

The advance refunding of the Series 1999 Revenue Bonds resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$1,408,012. This difference, reported in the accompanying government-wide financial statements as a deduction from bonds payable, is being amortized over the life of the new debt. The City completed the advance refunding to reduce its total debt service payments over the next 22 years by \$3,576,142 and to obtain an economic gain (difference between the present values of the debt service payments on the old and new debt) of \$1,029,695.

On August 24, 2006, the City issued \$8,095,000 of Taxable General Obligation Refunding Bonds, Series 2006B with a premium of \$101,862. The proceeds of the 2006B Bonds were used to refund \$2,530,000 of the outstanding balance of the City's General Obligation Note, Series 2004, and \$5,450,000 of the outstanding balance of the City's General Obligation Note, Series 2003. The City completed the current refunding in order to convert the interim financing (general obligation notes) to general obligation bonds, a more permanent form of financing. The refunding resulted in an increase in debt service over the next 10 years of \$2,694,198 and an economic loss (the difference between the present value of the debt service payments on the old and new debt) of \$107,123.

On August 24, 2006, the City issued \$6,800,000 of General Obligation Notes, Series 2006C with a discount of \$5,780. The proceeds of the Series 2006C Notes will be used to pay the costs of various capital improvements, including but not limited to a new courts complex, the existing courts building, and the costs related to the temporary relocation of the courts.

On November 9, 2006, the City issued \$6,009,753 of General Obligation Bonds Series 2006B from the Virginia Public School Authority with a premium of \$165,520. The proceeds will be used to pay capital costs for Parkview Elementary School.

On December 12, 2006, the City amended the Master Lease agreement with Banc of America Public Capital Corp to increase the funding capacity for fiscal year 2007 by an additional \$500,000. In addition, the master lease agreement was extended through fiscal year 2009 for a total four-year spending cap of \$24,000,000.

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 \$574 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 Note 5 to the basic financial statements.

ECONOMIC FACTORS

The City's unemployment rate for June 2007 was 4.3%, which compares to the national unemployment rate of 5.4% for June 2007. Per capita income as of December 31, 2005 was \$27,799, an increase of 2% over the previous year.

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.