

MANAGEMENT'S DISCUSSION AND ANALYSIS

As management of the City of Eureka, we offer readers of the City of Eureka's financial statements this narrative overview and analysis of the financial activities of the City of Eureka for the fiscal year ended June 30, 2006. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal found in the introductory section of this annual report.

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to the City of Eureka's basic financial statements. The City of Eureka's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

Government-wide financial statements. The government-wide financial statements are designed to provide readers with a broad overview of the City of Eureka's finances, in a manner similar to private-sector business.

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

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

Both of the government-wide financial statements distinguish functions of the City of Eureka that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities of the City of Eureka include general government, public safety, community development, community services, culture-recreation, highways and street, public works, and interest on long-term debt. The business-type activities of the City of Eureka include water, wastewater, transit, harbor, building, and golf operations.

The government-wide financial statements include not only the City of Eureka itself (known as the primary government), but also a legally separate redevelopment agency for which the City of Eureka is financially accountable. The redevelopment agency, although legally separate, functions for all practical purposes as a department of the City of Eureka, and therefore has been included as an integral part of the primary government.

The government-wide financial statements can be found beginning on page 13 of this report.

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City of Eureka, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City of Eureka can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on short-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's short-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's short-term financing decisions. Both the governmental funds balance sheet and the governmental funds statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The City of Eureka maintains fourteen individual governmental funds. Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures, and changes in fund balances for the general fund, housing and the redevelopment funds, which are considered to be major funds. Data from the other nine governmental funds are combined into a single, aggregated presentation. Individual fund data for these nonmajor governmental funds is provided in the form of combining statements found in the supplemental statements and schedules section of this report.

The City of Eureka adopts an annual appropriated budget for its general fund. A budgetary comparison schedule has been provided for the general fund to demonstrate compliance with this budget and is found on page 77 in the basic financial statements section of this report. The basic governmental fund financial statements can be found on pages 16-23 of this report.

Proprietary funds. The City of Eureka maintains two different types of proprietary funds. Enterprise funds are used to report the same functions presented as business-type activities in the government-wide financial statements. The City of Eureka uses enterprise funds to account for its water, wastewater, transit, harbor, building, and golf operations. Internal service funds are an accounting device used to accumulate and allocate costs internally among the City of Eureka's various functions. The City of Eureka uses internal service funds to account for its equipment operation, risk management, information technology, and redevelopment administration. Because these services predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary funds financial statements provide separate information for the water, wastewater, transit, harbor, building, and golf operations, all of which are considered to be major funds of the City of Eureka. Conversely, all internal service funds are combined into a single, aggregated presentation in the proprietary fund financial statements. Individual fund data for the internal service funds is provided in the form of combining statements found in the supplemental statements and schedules section of this report.

The basic proprietary fund financial statements can be found on pages 24-33 of this report.

Fiduciary funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City of Eureka's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds.

The basic fiduciary fund financial statements can be found on pages 34-35 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 37-76 of this report.

Other information. In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information concerning the City of Eureka's progress in funding its obligation to provide pension benefits to its employees. Required supplementary information can be found on pages 77-82 of this report.

The combining statements and schedules referred to earlier in connection with nonmajor governmental funds and internal service funds are presented immediately following the required supplementary information. Combining and individual fund statements and schedules can be found on pages 90-109 of this report.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City of Eureka, assets exceeded liabilities by \$149,368,173 at the close of the most recent fiscal year.

A large portion of the City of Eureka's net assets (79 percent) reflects its investment in capital assets (e.g., land, easements, buildings, machinery, and infrastructure); less any related debt used to acquire those assets that is still outstanding. The City of Eureka uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the City of Eureka's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

City of Eureka
Net Assets

	Governmental		Business-type		Total	
	Activities		Activities			
	2006	2005	2006	2005	2006	2005
Current and other assets	\$19,942,401	\$25,219,249	\$23,344,017	\$18,675,993	\$43,286,418	\$43,895,242
Capital assets	75,812,947	73,130,650	72,030,979	70,515,774	147,843,926	143,646,424
Total assets	<u>95,755,348</u>	<u>98,349,899</u>	<u>95,374,996</u>	<u>89,191,767</u>	<u>191,130,344</u>	<u>187,541,666</u>
Non-current liabilities	17,958,228	17,735,028	20,563,843	17,736,175	38,522,071	35,471,203
Other liabilities	2,051,297	4,232,268	1,188,803	2,116,413	3,240,100	6,348,681
Total liabilities	<u>20,009,525</u>	<u>21,967,296</u>	<u>21,752,646</u>	<u>19,852,588</u>	<u>41,762,171</u>	<u>41,819,884</u>
Net assets:						
Invested in capital assets, net of related debt	60,629,251	60,192,828	56,739,394	56,367,517	117,368,645	116,560,345
Restricted	13,746,334	14,440,769	4,467,734	4,714,780	18,214,068	19,155,549
Unrestricted	1,370,238	1,749,006	12,415,222	8,256,882	13,785,460	10,005,888
Total Net Assets	<u><u>\$75,745,823</u></u>	<u><u>\$76,382,603</u></u>	<u><u>\$73,622,350</u></u>	<u><u>\$69,339,179</u></u>	<u><u>\$149,368,173</u></u>	<u><u>\$145,721,782</u></u>

An additional portion of the City of Eureka's net assets (12 percent) represents resources that are subject to external restrictions on how they may be used. The remaining balance of unrestricted net assets (\$13,785,460) may be used to meet the government's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the City of Eureka is able to report positive balances in all three categories of net assets, both for the government as a whole, as well as for its separate governmental and business-type activities. The same situation held true for the prior fiscal year. Overall, total net assets increased by \$3,646,391 the majority of which is a result of an increase in construction in progress and an increase in unrestricted net assets.

Changes in net assets. The statement of net assets provides a snapshot at a given point in time of the assets and liabilities of the City. The other government-wide statement provided is the Statement of Activities. This statement provides the reader with information regarding the revenues, expenses, and changes in net assets over the fiscal year. Generally, all changes to the City's net assets from one fiscal year to the next flows through the statement of activities.

The City of Eureka's net assets increased by \$3,646,391, (which includes a prior period adjustment in the amount of \$468,473 which represents adjustments to capital assets and infrastructure, increases in construction in progress, and improvements within current assets such as cash and receivables). The change in net assets as a result of governmental activities is a decrease of \$636,780 while the change in net assets as a result of business-type activities increased by \$4,283,171.

Details of the City's changes in net assets are as follows:

City of Eureka
Changes in Net Assets

	Governmental		Business-type		Total	
	Activities		Activities			
	2006	2005	2006	2005	2006	2005
Revenues:						
Program Revenues:						
Charges for services	\$ 2,642,484	\$ 2,565,212	\$ 12,299,680	\$ 10,733,264	\$ 14,942,164	\$ 13,298,476
Operating grants and contributions	1,845,142	5,519,557	-	-	1,845,142	5,519,557
Capital grants and contributions	1,798,449	4,171,641	272,728	729,167	2,071,177	4,900,808
General Revenues:	-	-	-	-	-	-
Taxes:	-	-	-	-	-	-
Property taxes	5,135,206	4,551,056	-	-	5,135,206	4,551,056
Sales taxes	9,278,077	9,612,899	**	-	9,278,077	9,612,899
Other taxes	3,973,219	2,658,362	-	-	3,973,219	2,658,362
Investment income	1,561,018	1,582,007	742,297	696,148	2,303,315	2,278,155
Other	2,177,091	1,239,211	-	-	2,177,091	1,239,211
Total revenues	28,410,686	31,899,945	13,314,705	12,158,579	41,725,391	44,058,524
Expenses:						
General government	3,530,892	3,509,992	-	-	3,530,892	3,509,992
Public safety	11,715,731	10,688,693	-	-	11,715,731	10,688,693
Community development	3,198,428	3,614,988	-	-	3,198,428	3,614,988
Community services *	-	67,087	-	-	-	67,087
Culture - recreation	1,997,492	1,852,558	-	-	1,997,492	1,852,558
Public works	2,631,869	2,580,587	-	-	2,631,869	2,580,587
Interest on long-term debt	1,998,632	1,088,993	-	-	1,998,632	1,088,993
Unallocated depreciation	1,789,798	1,728,090	-	-	1,789,798	1,728,090
Water	-	-	3,643,896	3,562,419	3,643,896	3,562,419
Wastewater	-	-	4,755,559	4,847,871	4,755,559	4,847,871
Transit	-	-	1,692,494	1,433,596	1,692,494	1,433,596
Harbor	-	-	1,103,056	1,157,822	1,103,056	1,157,822
Building	-	-	472,560	461,251	472,560	461,251
Golf	-	-	17,066	38,597	17,066	38,597
Total expenses	26,862,842	25,130,988	11,684,631	11,501,556	38,547,473	36,632,544
Change in net assets before transfers	1,547,844	6,768,957	1,630,074	657,023	3,177,918	7,425,980
Transfers	(2,602,206)	(317,010)	2,602,206	317,010	-	-
Change in net assets	(1,054,362)	6,451,947	4,232,280	974,033	3,177,918	7,425,980
Net assets - beginning	76,382,603	55,668,719	69,339,179	68,365,146	145,721,782	124,033,865
Prior period adjustments	417,582	14,261,937	50,891	-	468,473	14,261,937
Net assets (restated)	76,800,185	69,930,656	69,390,070	68,365,146	146,190,255	138,295,802
Net assets - ending	\$ 75,745,823	\$ 76,382,603	\$ 73,622,350	\$ 69,339,179	\$ 149,368,173	\$ 145,721,782

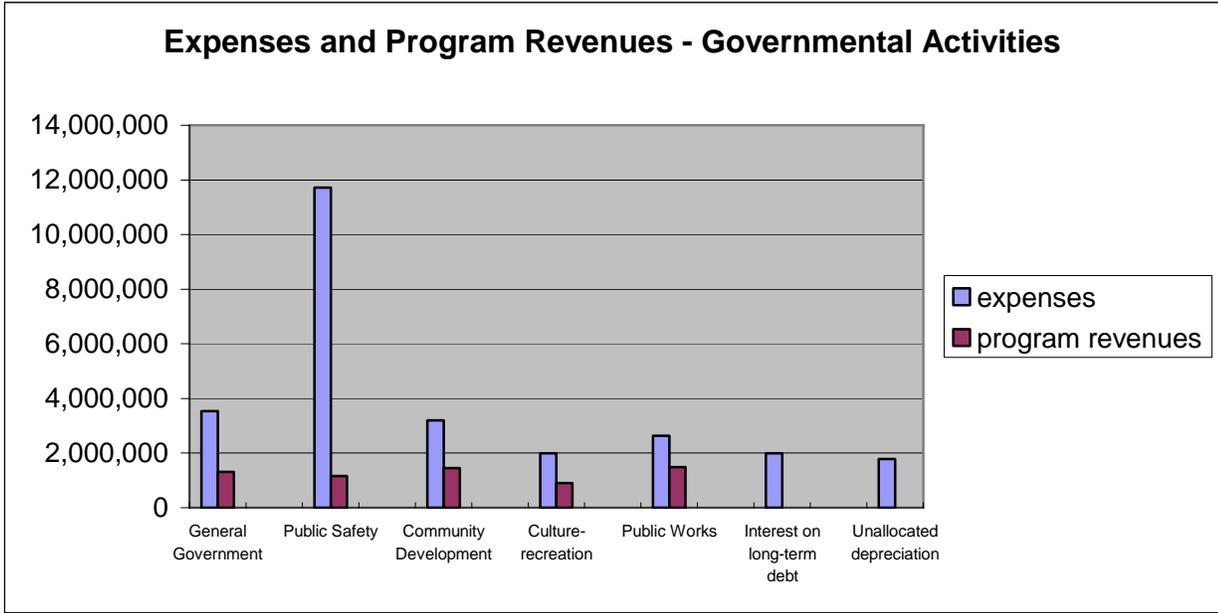
* In 2006, Community services is included in Public works.

** This total is affected by a (\$439,500) prior period adjustment making the year to year change an increase of \$104,678.

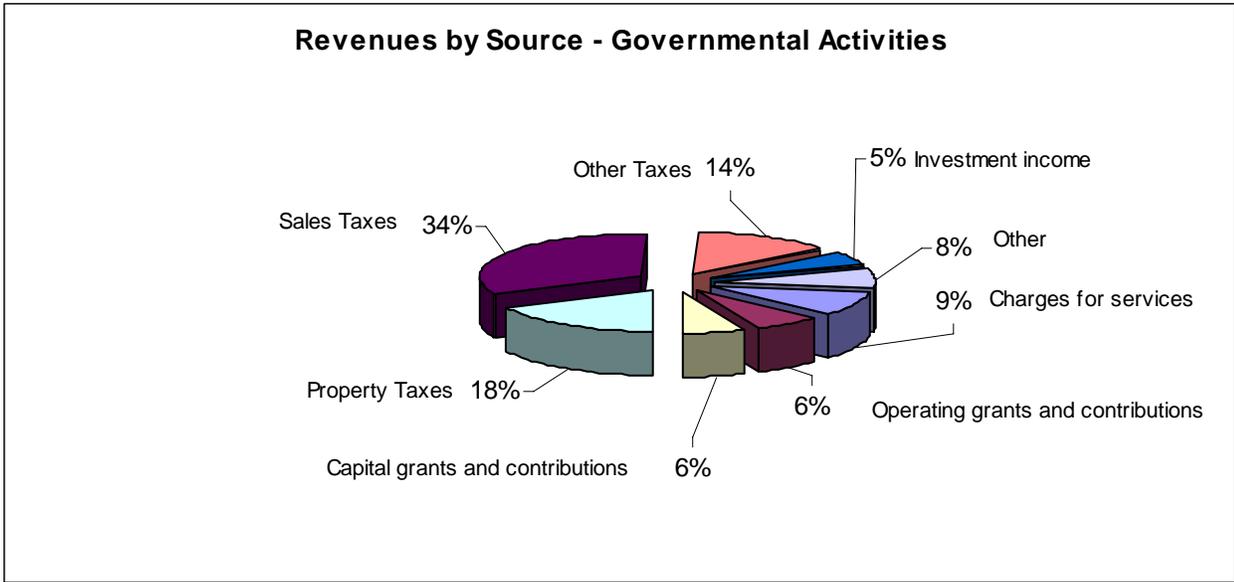
The City's largest governmental revenue source, sales tax, accounts for 33% of total revenues. Property tax is the next largest governmental revenue source making up 18% of total revenues and showing an increase of nearly 13% over the prior year.

Operating grants for governmental activities furnished resources to support five of the City of Eureka's functions: general government, public safety, redevelopment, community development, and community services.

Expenses and Program Revenues - Governmental Activities



Revenues by Source - Governmental Activities



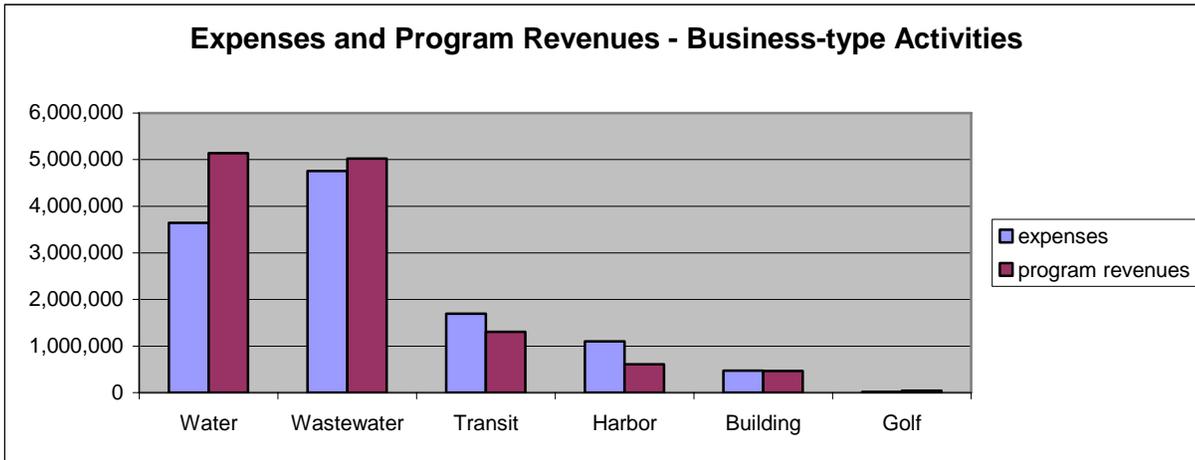
Public safety expenses account for 44% of total governmental activity expenses, and increased by 10% over the prior fiscal year. Of this increase, 65% can be attributed to employee costs.

Business-type activities. Business-type activities increased the City of Eureka’s net assets by \$4,283,171 (3% of total net assets). Increased water and wastewater rates along with interfund transfers account for the largest share of the increase..

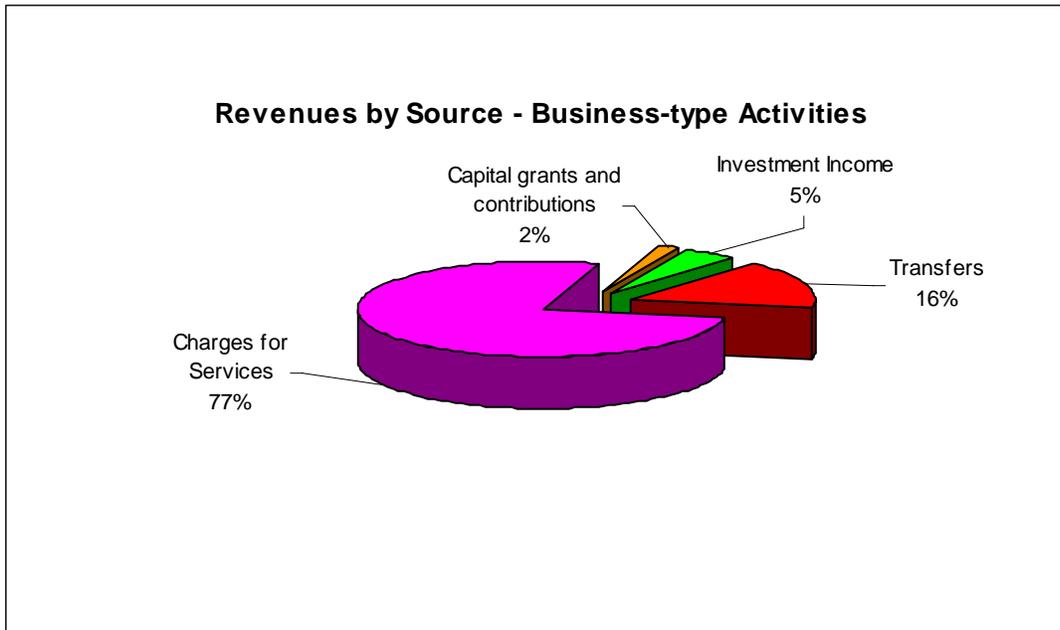
Key elements of this increase are as follows.

- Charges for services for business-type activities account for 92% of total revenues, with the water and wastewater funds accounting for a significant portion of this total. Water and wastewater fees increased over the prior year due to the approval of a 12% water rate increase and a 3% wastewater rate increase. The increases were needed primarily to provide additional resources to meet debt service requirements.
- Investment earnings totaled \$742,297 for business-type activities. This 6.6% increase over the prior year is attributable to interest rates which rose throughout the fiscal year.

Expenses and Program Revenues - Business-type Activities



Revenues by Source - Business-type Activities



Financial Analysis of the Government's Funds

As noted earlier, the City of Eureka uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds. The focus of the City of Eureka's governmental funds is to provide information on short-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the City of Eureka's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the City of Eureka's governmental funds reported combined ending fund balances of \$13,073,668, a decrease of \$3,405,719 in comparison with the prior year. The majority of this fund balance is reserved to indicate that it is not available for new spending because it has already been committed for the following purposes: 1) to account for payments due on notes receivable (\$6,162,818); 2) for advances to other funds (\$4,843,695); and 3) for land held for resale (\$4,613,178).

The general fund is the chief operating fund of the City of Eureka. At the end of the current fiscal year, unreserved fund balance of the general fund was \$2,130,331 a decrease of \$235,205 in comparison with the prior year. As a measure of the general fund's liquidity, it may be useful

to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance at the end of the fiscal year represented 10% of total general fund expenditures, a decrease of 3% over the prior year, while total fund balance represents 33% of the same amount.

The fund balance of the City of Eureka's general fund decreased by \$2,001,311 during the current fiscal year, of which \$1,673,674 is from transfers out to proprietary and internal service funds.

The redevelopment and housing funds have a total fund balance of \$4,504,403, all of which will be used for specific redevelopment and housing activities.

Proprietary funds. The City of Eureka's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

Unrestricted net assets of the water and wastewater funds at the end of the year amounted to \$12,890,928 and those for other proprietary funds total \$(475,706). This negative net assets is a result of the activities within the City's harbor fund.

General Fund Budgetary Highlights

Differences between the original budget and the final amended budget were \$904,188, an 8% increase, which is comprised of a decrease of (\$107,725) in revenue and an increase of \$796,463 in expenditures, which can be briefly summarized as follows:

- \$28,260 decrease in investment income due to lower interest rates
- \$113,644 decrease in intergovernmental revenues due to fewer grants
- \$34,180 increase in other revenues from miscellaneous sources
- \$796,463 increase in general government, public safety and public works as a result of changes to salary agreements with employees

Differences between the final budget and actual budgetary expenditures and transfers were six percent more than appropriated (\$1,349,404 more than \$20,970,038) and include:

- \$1,494,115 over expenditures as transfers to other funds for construction projects
- \$24,500 unexpected expenses for promotion of community activities, such as fourth of July fireworks
- \$40,000 increase in liability insurance expenses

Capital Asset and Debt Administration

Capital assets. The capital assets of the City are those assets that are used in the performance of the City's functions, including infrastructure. At June 30, 2006, the City of Eureka's net capital assets for its governmental and business-type activities amounts to \$147,843,926 (net of accumulated depreciation). The investment in capital assets includes land, easements, buildings, improvements other than buildings, machinery and equipment, infrastructure, artwork, and construction in progress. Net additions to capital assets of the City over the prior year totaled \$4,256,106.

Major capital asset events during the current fiscal year included the following:

- Construction in progress such as the Martin Slough Lift Station, City Hall Improvements and Water Transmission Line Replacement accounting for an increase of \$699,406 as of the close of the fiscal year.
- A variety of street construction projects added \$831,490 to total construction in progress at the close of the fiscal year (mainly the Waterfront Drive improvements).
- Construction in progress for the City's Fishermen's Terminal Project added \$2,725,210 during this fiscal year.

City of Eureka
Capital Assets (net of depreciation)

	Governmental		Business-type		Total	
	Activities		Activities			
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Land	\$4,143,599	\$4,042,899	\$11,026,586	\$8,835,741	\$15,170,185	\$12,878,640
Easements	23,922,864	23,922,864			23,922,864	23,922,864
Buildings	9,569,042	4,858,184	6,485,056	6,146,853	16,054,098	11,005,037
Improvements other than buildings	7,757,769	8,585,326	19,035,364	19,726,396	26,793,133	28,311,722
Machinery and equipment	3,611,515	4,623,214	20,415,703	19,226,209	24,027,218	23,849,423
Infrastructure	18,307,951	16,029,251	4,871,853	4,851,524	23,179,804	20,880,775
Artwork	86,795				86,795	
Construction in progress	8,413,412	11,068,912	10,196,417	11,670,447	18,609,829	22,739,359
Total capital assets	\$75,812,947	\$73,130,650	\$72,030,979	\$70,457,170	\$147,843,926	\$143,587,820

Additional information on the City of Eureka's capital assets can be found in note 7 on pages 58-59 of this report.

Long-term debt. At the end of the current fiscal year, the City of Eureka had total bonded debt outstanding of \$33,208,718. Of this amount, \$13,463,718 comprises debt backed by revenues within the water fund, another \$3,730,000 comprises debt backed by revenues within the wastewater fund, \$765,000 comprises debt backed by revenues within the harbor fund and \$15,250,000 in tax allocation bonds backed by incremental tax revenues from the redevelopment project areas.

City of Eureka
Outstanding Debt

	Governmental		Business-type		Total	
	Activities		Activities			
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenue bonds payable, net	\$15,250,000	\$15,250,000	\$17,958,718	\$16,129,754	\$33,208,718	\$31,379,754
Capital leases	743,961	493,652			743,961	493,652
Loans payable			2,465,705	2,526,304	2,465,705	2,526,304
Net pension obligation	1,145,707	1,810,012			1,145,707	1,810,012
Compensated absences	818,560	824,000	139,420	103,118	957,980	927,118
	<u>\$17,958,228</u>	<u>\$18,377,664</u>	<u>\$20,563,843</u>	<u>\$18,759,176</u>	<u>\$38,522,071</u>	<u>\$37,136,840</u>

The City of Eureka Redevelopment Agency and its water and wastewater funds all maintain a "AAA" rating from Standard & Poor's.

Changes to the City's long-term debt included net increases to the liability for compensated absences of \$30,862, increases to bonds and capital leases payable of \$2,079,273, and reductions to loans payable and pension obligations of \$724,904.

State statutes limit the amount of general obligation debt a governmental entity may issue to 3.75 percent of its total assessed valuation. The current debt limitation for the City of Eureka is \$65,128,081 which is significantly in excess of the City of Eureka's outstanding general obligation debt, which is currently zero.

Additional information on the City of Eureka's long-term debt can be found in note 9 on pages 61-67 of this report.

Economic Factors and Next Year's Budgets and Rates

- The unemployment rate for the City of Eureka is currently 6.4 percent, which is a decrease from a rate of 6.75 percent a year ago. This does not compare favorably to the state's average unemployment rate of 5.1 percent and the national average rate of 4.3 percent.
- The occupancy rate of the City's main street area has improved to 98 percent over the last ten years.
- Inflationary trends in the region compare favorably to national indices.

All of these factors were considered in preparing the City of Eureka's budget for the 2006-07 fiscal year.

During the current fiscal year, the unreserved fund balance in the general fund decreased to \$2,130,331 which is available in the 2006-07 fiscal year for appropriation. Of this amount the City of Eureka has appropriated \$762,520 for spending in the 2006-07 fiscal year budget. It is intended that this use of available fund balance will avoid the need to reduce services during the 2006-07 fiscal year.

Water fund rates were increased for the 2006-07 budget year. The water rates were increased by an average of 12% for all customers. These rate increases were necessary to finance debt service on the debt issued during the 2002-03 and 2005-06 fiscal years within the water fund. Rate increases for the wastewater fund were increased by 3% in the 2006-07 budget year for all customers with the exception of the senior citizen rate to finance debt issued during the 2002-03 fiscal year within the wastewater fund.

Requests for Information

This financial report is designed to provide a general overview of the City of Eureka's finances for all those with an interest in the government's finances, and to demonstrate the City's accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of the Finance Director, City of Eureka, 531 K Street, Eureka, California, 95501.

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