

OFFICIAL NOTICE OF SALE

\$33,000,000*
CITY OF PALO ALTO
(SANTA CLARA COUNTY, CALIFORNIA)
WATER REVENUE BONDS
TAX-EXEMPT 2009 SERIES A
AND/OR
TAXABLE 2009 SERIES B
(DIRECT PAYMENT BUILD AMERICA BONDS)

NOTICE IS HEREBY GIVEN by the City of Palo Alto (the "City") that bids will be received by the City for the purchase of \$33,000,000* City of Palo Alto Water Revenue Bonds, Tax-Exempt 2009 Series A and/or Taxable 2009 Series B (Direct Payment Build America Bonds) (together, the "Bonds"). Only facsimile bids will be accepted. The bids will be received in the manner and up to the time and date specified below:

DATE AND TIME: 10:00 A.M. Pacific Daylight Time on Tuesday, October 6, 2009 (subject to postponement or cancellation in accordance with this Official Notice of Sale).

FACSIMILE BIDS: Bid proposals may only be submitted via facsimile on the Official Bid Form (attached hereto), as provided below.

The City may postpone the date or change the time of the sale to any subsequent date or any other time by providing notification *via* Bloomberg Financial Markets or Thomson Municipal Market Monitor (www.tm3.com) at least 24 hours prior to the scheduled date and time of sale. The actual principal amount of the Bonds may vary, higher or lower, as a function of how the actual interest rates affect the amount of costs of issuance and the size of the reserve fund and as a function of the actual discount taken by the successful bidder. The definitive principal amount will be determined on the date of sale, after adjustment, as provided herein. Bidders should refer to the preliminary Official Statement for definitions of terms and credit information regarding the Bonds.

TERMS OF THE BONDS

ISSUE. The Bonds will be issued under an Indenture of Trust, dated as of November 1, 2009, between U.S. Bank National Association (the "Trustee") and the City (the "Indenture"), in the aggregate principal amount of approximately \$33,000,000* designated "City of Palo Alto Water Revenue Bonds, Tax-Exempt 2009 Series A (the "Series A Bonds") and/or Taxable 2009 Series B (Direct Payment Build America Bonds) (the "Series B Bonds")," consisting of fully-registered bonds, without coupons, executed and delivered in book-entry only form and

* Preliminary, subject to change, as provided herein.

registered in the name of Cede & Co., as nominee for The Depository Trust Company ("DTC"), in the denomination of five thousand dollars (\$5,000) each or any integral multiple thereof.

The City is offering the Bonds as: tax-exempt Series A Bonds and/or or as taxable Series B Bonds (which the City will elect to designate as Qualified Direct Payment Build America Bonds). A bidder may bid on all of the Bonds as Series A Bonds, or all of the Bonds as Series B Bonds, or a combination of Series A Bonds and Series B Bonds. All of the Bonds of each maturity will be designated as either Series A Bonds or Series B Bonds. A bidder must submit a bid for all of the Bonds.

If the Bonds are issued as Series B Bonds, the City will elect to receive direct subsidy payments from the U.S. Department of Treasury. The owners of, and owners of beneficial interests in, the Series B Bonds will not receive any tax credit with respect to such Bonds.

DATE, MATURITIES AND AMOUNTS. The Bonds will be dated their date of delivery, with interest from such date at the rate or rates fixed upon the sale thereof and will mature serially or be paid as Mandatory Sinking Fund Installments on June 1 in each year as set forth in the following table: The principal amount in each maturity is subject to change as provided herein and will not change by more than 15% in each maturity. Each maturity may be bid as Series A Bonds or Series B Bonds by indicating such an election in the bid form.

Maturity Date (June 1)	Principal Amount *	Maturity Date (June 1)	Principal Amount *
2011	\$ 785,000	2024	\$1,285,000
2012	800,000	2025	1,350,000
2013	820,000	2026	1,420,000
2014	845,000	2027	1,490,000
2015	870,000	2028	1,565,000
2016	905,000	2029	1,640,000
2017	940,000	2030	1,725,000
2018	980,000	2031	1,810,000
2019	1,020,000	2032	1,900,000
2020	1,060,000	2033	1,995,000
2021	1,110,000	2034	2,095,000
2022	1,165,000	2035	2,200,000
2023	1,225,000		

ADJUSTMENT OF PRINCIPAL AMOUNTS. The City reserves the right to increase or decrease the principal amount of any maturity of the Bonds as the City deems advisable in order to accomplish the optimal sizing of the Bond issue, however, the total principal amount will not exceed \$35,500,000 for Bonds designated as Series A Bonds and \$37,500,000 for Bonds designated as Series B Bonds. The principal amount of each maturity (set forth above) will not change by more than fifteen per cent. Notice of such increase or decrease shall be given to the successful bidder within 24 hours of bid opening. No such adjustment will have the effect of

* Preliminary, subject to change, as provided herein.

altering the basis upon which the best bid is determined; *provided, however*, that any such increase or decrease shall result in a *pro rata* increase or decrease, as the case may be, in the amount of discount or premium on the purchase of the Bonds. In the event of any such adjustment, no re-bidding or re-calculation of the bids submitted will be required or permitted, and the successful bid or bids may not be withdrawn, and the successful bidder will not be permitted to change the interest rate(s) in its bid for the Bonds.

The purchaser may elect to combine any number of consecutive maturities of Bonds for which an identical interest rate has been specified to comprise term bonds by indicating such an election on the bid form. The election to create term bonds in such manner will require the creation of a mandatory sinking fund so that the sinking fund redemption payments shall equal the corresponding serial bond amounts.

PRIOR REDEMPTION.

(a) Optional Redemption. The Bonds maturing on or before June 1, 2019 are not subject to optional redemption prior to maturity. The Bonds maturing on or after June 1, 2020 are subject to redemption prior to their respective maturity dates, at the option of the City, pro rata among maturities, and by lot within a maturity, in whole or in part, on any date occurring on or after June 1, 2019, from any source of available funds, at a redemption price equal to the principal amount of the Bonds to be redeemed, plus accrued interest thereon to the date of redemption, without premium.

(b) Optional Redemption at Make-Whole Redemption Price. The Series B Bonds are subject to optional redemption prior to their stated maturity, at the option of the City, in whole or in part on any date occurring on or before June 1, 2019, but only upon the occurrence of a Federal Subsidy Termination Event, at a redemption price equal to the greater of:

(1) 100% of the principal amount of the Series B Bonds to be redeemed; or

(2) the sum of the present values of the remaining scheduled payments of principal and interest on the Series B Bonds to be redeemed (exclusive of interest accrued to the date fixed for redemption) discounted to the date of redemption on a semiannual basis (assuming a 360-day year consisting of twelve 30-days months) at the Treasury Rate (defined below) plus 100 basis points;

plus in each case, accrued and unpaid interest on the Series B Bonds being redeemed to the date fixed for redemption.

For purposes of this subsection (b), the following terms have the following respective meanings:

“Comparable Treasury Issue” means the United States Treasury security or securities selected by the Designated Investment Banker which has an actual or interpolated maturity comparable to the remaining average life of

the Series B Bonds to be redeemed, and that would be utilized in accordance with customary financial practice in pricing new issues of debt securities of comparable maturity to the remaining average life of such Series B Bonds.

“Comparable Treasury Price” means with respect to any redemption date, (i) if the Designated Investment Banker receives at least four Reference Treasury Dealer Quotations, the average of the Reference Treasury Dealer Quotations for such redemption date, after excluding the highest and lowest Reference Treasury Deal Quotations, or (ii) if the Designated Investment Banker obtains fewer than four such Reference Treasury Dealer Quotations, the average of all such quotations.

“Designated Investment Banker” means one of the Reference Treasury Dealers appointed by the City as the Designated Investment Banker for the Series B Bonds.

“Federal Subsidy Termination Event” will have occurred if the City determines that either: (i) Section 54AA or 6431 of the Internal Revenue Code of 1986, as amended (the “Code”) (as such Sections were added by Section 1531 of the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”), pertaining to “Build America Bonds”) has been amended in a material way; or (ii) there is any guidance published by the Internal Revenue Service or the United States Treasury with respect to such Sections; or (iii) any other determination by the Internal Revenue Service or the United States Treasury, which determination is not the result of any act or omission by the City to satisfy the requirements to qualify to receive the 35% cash subsidy payment from the United States Treasury - any of which results in the City’s right to receive the 35% cash subsidy payment from the United States Treasury with respect to debt service due on the Series B Bonds under the Recovery Act being reduced or eliminated.

“Reference Treasury Dealer” means each of the four firms specified by the City from time to time, that are primary U.S. Government securities dealers in the City of New York (each a “Primary Treasury Dealer”); *provided, however*, that if any of them ceases to be a Primary Treasury Dealer, the City will substitute another Primary Treasury Dealer.

“Reference Treasury Dealer Quotations” means, with respect to each Reference Treasury Dealer and any redemption date, the average as determined by the Designated Investment Banker, of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) quoted in writing to the Designated Investment Banker by such Reference Treasury Dealer at 3:30 p.m., New York City time, on the third Business Day preceding such redemption date.

“Treasury Rate” means, with respect to any redemption date, the rate per annum equal to the semiannual equivalent yield to maturity or interpolated

maturity of the Comparable Treasury Issue, assuming that the Comparable Treasury Issue is purchased on the redemption date for a price equal to the Comparable Treasury Price as calculated by the Designated Investment Banker.

(c) Special Mandatory Redemption From Insurance or Condemnation Proceeds. The Bonds are also subject to redemption as a whole or in part on any date prior to maturity, in inverse order of maturity and by lot within a maturity, to the extent of the net proceeds of hazard insurance not used to repair or rebuild the Water System (as herein defined) or the net proceeds of condemnation awards received with respect to the Water System (as herein defined) to be used for such purpose, at a redemption price equal to the principal amount of the Bonds plus interest accrued thereon to the date fixed for redemption, without premium.

(d) Mandatory Sinking Fund Redemption. The Bonds which mature in the years which are checked in the Bid Form as being Term Bonds are also subject to mandatory redemption in part by lot, on June 1 in each of the years checked under the heading "Term Bonds" in the Bid Form, from Mandatory Sinking Fund Installments, at a Redemption Price equal to the principal amount thereof to be redeemed, without premium, in the aggregate respective principal amounts and in the respective years as set forth in the Bid Form (as adjusted according to the provisions of "ADJUSTMENT OF PRINCIPAL AMOUNTS" above).

PAYMENT. Interest on the Bonds is payable semiannually on each June 1 and December 1 (each, and "Interest Payment Date" or "Payment Date"), commencing June 1, 2010. So long as Cede & Co. is the registered holder of the Bonds, principal of and premium, if any, and interest evidenced and represented by the Bonds will be paid by the Trustee at its principal corporate trust office directly to DTC, which will in turn remit such principal, premium, if any, and interest to its participants for subsequent disbursement to the beneficial owners of the Bonds.

PURPOSE OF ISSUE. The Bonds are to be issued by the City and are authorized pursuant to the charter of the City and the provisions of Chapter 12.28 (commencing with Section 12.28.010), of the Palo Alto Municipal Code, to (i) finance certain improvements to the City's water system (the "Water System"), (ii) establish a debt service reserve fund for the Bonds and (iii) pay certain costs of issuing the Bonds.

SECURITY. The City has transferred, placed a charge upon, assigned and set over to the Trustee, for the benefit of the Owners, the Net Revenues of the Water System of the City, as more particularly provided for in the Indenture, which is necessary to pay the principal or redemption price of and interest on the Bonds in any Fiscal Year, together with all moneys on deposit in the Debt Service Fund, and such Net Revenues has been irrevocably pledged to the punctual payment of the principal or redemption price of and interest on the Bonds. Such Net Revenues cannot be used for any other purpose while any of the Bonds remain Outstanding, except that out of Net Revenues there may be apportioned and paid such sums for such purposes, as are expressly permitted by the Indenture. Said pledge constitutes a direct charge and lien on such Net Revenues for the payment of the principal or redemption price of and interest on the Bonds and any bonds outstanding or issued on a parity therewith, including the City's Utility Revenue Bonds, 2002 Series A, issued on February 7, 2002 in the principal amount of \$26,055,000, of which \$19,690,000 are presently outstanding and a portion of which are

secured by a pledge the Net Revenues of the Water System (and certain other revenues), all in accordance with the terms thereof. However, the City's Utility Revenue Bonds, 1995 Series A (the "1995 Bonds") are currently outstanding in the principal amount of \$5,320,000, and are secured by a lien on Net Revenues of the City's entire enterprise system, which collectively consists of the Sewer System, the Storm Drain System, the Gas System, the Electric System and the Water System. The lien of the 1995 Bonds on the Net Revenues of the Water System is senior to the lien on those Net Revenues securing the Bonds.

The Net Revenues constitute a trust fund for the security and payment of the principal or redemption price of and interest on the Bonds. The general fund of the City is not liable and the credit or taxing power of the City is not pledged for the payment of the principal or redemption price of and interest on the Bonds. The owners of the Bonds cannot compel the exercise of the taxing power by the City or the forfeiture of its property. The principal or redemption price of and interest on the Bonds are not a debt of the City, nor a legal or equitable pledge, charge, lien or encumbrance, upon any of its property, or upon any of its income, receipts, or revenues except the Net Revenues of the Water System.

Neither the faith and credit nor the taxing power of the City, the State of California, or any political subdivision thereof is pledged to the payment of the Bonds. The Bonds are not general obligations of the City, but are limited obligations payable solely from certain funds held pursuant to the Indenture. Neither the City of Palo Alto nor the State of California shall be obligated to pay the principal of the Bonds, or the interest thereon and neither the faith and credit nor the taxing power of the City of Palo Alto, the State of California or any of its political subdivisions thereof is pledged to the payment of the principal of or the interest on the Bonds.

TAX-EXEMPT STATUS. In the opinion of Jones Hall, A Professional Law Corporation, San Francisco, California, Bond Counsel, subject, however to certain qualifications, under existing law, the interest on the Series A Bonds is excluded from gross income for federal income tax purposes, and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations.

In the event that, prior to the delivery of the Series A Bonds (a) the interest on other obligations of the same type and character shall be declared to be subject to taxation (either at the time of such declaration or at any future date) under any federal income tax laws, either by the terms of such laws or by ruling of a federal income tax authority or official which is followed by the Internal Revenue Service, or by decision of any federal court, or (b) any federal income tax law is enacted which will have a substantial adverse effect upon the owners of the Series A Bonds as such, the successful bidder may, at its option, prior to the tender of the Series A Bonds, be relieved of its obligation to purchase the Series A Bonds, and in such case the deposit accompanying its bid will be returned.

EXEMPTION FROM CALIFORNIA INCOME TAX. In the opinion of Bond Counsel, interest on both the Series A Bonds and the Series B Bonds is exempt from California personal income taxes.

LEGAL OPINION. The legal opinion of Jones Hall, A Professional Law Corporation, San Francisco, California, Bond Counsel, approving the validity of the Bonds and regarding "TAX-EXEMPT STATUS" above will be furnished to the successful bidder without cost.

FURTHER INFORMATION. A copy of the Preliminary Official Statement describing the Bonds will be furnished upon request to the financial advisor to the City: Stone & Youngberg LLC, One Ferry Building, Suite 275, San Francisco, California 94111, telephone: (415) 445-2300 (the "Financial Advisor"). Facsimile: (415) 445-2395.

RATING. The City has applied for and received ratings from Moody's Investor's Service and Standard & Poor's Ratings Services. Information on such ratings may be obtained from the Financial Advisor. The City will pay the fees for such ratings. Any additional ratings desired by the purchaser of the Bonds, as well as any fees associated with such additional ratings, will be the sole responsibility of the purchaser.

TERMS OF SALE

SUBMISSION OF BIDS: All bids must be for not less than all of the Bonds hereby offered for sale. Bidders may submit only one bid, via facsimile. All bids must comply with the requirement for a good faith deposit. See "GOOD FAITH DEPOSIT" herein.

Bids will be received in accordance with this Official Notice of Sale until 10:00 a.m. Pacific Daylight Time on the sale date, but no bid will be received after the time specified for receiving bids. Bid proposals may only be submitted via facsimile on the Official Bid Form (attached hereto). Facsimile: (415) 445-2395.

THE CITY RETAINS ABSOLUTE DISCRETION TO DETERMINE WHETHER ANY BID IS TIMELY, LEGIBLE AND COMPLETE. THE CITY TAKES NO RESPONSIBILITY FOR INFORMING ANY BIDDER PRIOR TO THE TIME FOR RECEIVING BIDS THAT ITS BID IS INCOMPLETE, ILLEGIBLE OR NOT RECEIVED.

THE CITY, THE FINANCIAL ADVISOR AND BOND COUNSEL ASSUME NO RESPONSIBILITY FOR ANY ERROR CONTAINED IN ANY BID SUBMITTED OR FOR FAILURE OF ANY BID TO BE TRANSMITTED, RECEIVED OR OPENED AT THE OFFICIAL TIME FOR RECEIPT OF BIDS. THE OFFICIAL TIME FOR RECEIPT OF BIDS WILL BE DETERMINED BY THE CITY AT THE PLACE OF BID OPENING.

FORM OF BID; MINIMUM PURCHASE PRICE: Each proposal must be for not less than all of the Bonds hereby offered for sale. The purchase price to be paid for the Bonds may not be less than 98.5% of the par value thereof. Each bid must be delivered as set forth above, and must be received not later than the date and time of sale set forth above. If the City receives multiple bids from a single bidder by any means or combination of means, the City will accept the best of such bids, and each bidder agrees by submitting any bid to be bound by its best bid.

In order to comply with the provisions of the Recovery Act governing the issuance of Build America Bonds, all Series B Bonds of each maturity must be offered to the ultimate purchasers thereof (not including bond houses, brokers or similar persons or organizations acting in the capacity of underwriters or wholesalers) at the price of par, and at least ten percent (10%) of the first Series B Bonds sold in each maturity of the issue will be actually sold at a price

not in excess of the par amount thereof $\times .0025 \times$ the number of complete years to maturity from the date of issue of the Series B Bonds to the date of said maturity.

DESIGNATION OF INTEREST RATES: Each bidder must specify the rate or rates of interest which the Bonds will bear. Interest on each Bond will be computed from the date of original delivery to its stated maturity at the interest rate specified in the proposal, payable on the Interest Payment Dates as set forth above. A bidder will be permitted to bid different rates of interest for each maturity of Bonds; but:

- Each interest rate specified must be in a multiple of 1/20% or 1/8%.
- The maximum rate bid on any maturity may not exceed 9% per annum.
- All Bonds maturing at any one time must bear the same rate of interest.
- The rate of interest bid on any maturity of Bonds may not exceed the rate of interest bid on any other maturity of Bonds by more than 8% per annum.
- The interest rate bid on any successive maturity of Bonds may not be less than the interest rate on the immediately prior maturity.

DETERMINATION OF BEST BID: The Bonds will be awarded to the responsible bidder whose bid produces the lowest true interest rate on the Bonds. The true interest rate specified in any bid will be that rate which, when used in computing the present worth of all payments of principal and interest to be paid on all Bonds from an assumed closing date of October 28, 2009, to their respective maturity dates or mandatory sinking fund redemption dates, produces an amount equal to the purchase price specified in such bid. For the Series A Bonds, such interest to be paid on the Series A Bonds will be based on the stated rate, and for Series B Bonds, such interest will be based on the stated rate, multiplied by 0.65. If two or more bidders offer bids at the same lowest true interest rate, the City will determine by lot which bidder will be awarded the Bonds. For purposes of computing the true interest rate represented by any proposal, the purchase price specified in such proposal will be equal to the par amount of the Bonds, plus any premium or less any discount specified in such proposal, and the true interest rate will be calculated by the use of a semiannual interval of compounding interest based on the Interest Payment Dates for the Bonds.

RIGHT OF REJECTION: The City reserves the right, in its discretion, to reject any and all bids and to the extent not prohibited by law to waive any irregularity or informality in any bid.

PROMPT AWARD: The City Council of the City has authorized one of its officers to accept the best responsible bid for the purchase of the Bonds and to accept such bid, for and in the name of the City, by notice to the successful bidder. The Bonds will be awarded, or all bids will be rejected, not later than 24 hours after the expiration of the time prescribed for the receipt of proposals, unless such time of award is waived by the successful bidder; provided, that the award may be made after the expiration of the specified time if the bidder has not notified the City in writing of the withdrawal of such proposal.

PLACE OF DELIVERY; CANCELLATION FOR LATE DELIVERY: It is expected that the Bonds will be delivered to DTC for the account of the successful bidder on October 28, 2009. The successful bidder has the right, at its option, to cancel the contract of purchase if the Bonds are not tendered for delivery within 60 days from the date of the sale thereof, and in such event the successful bidder will be entitled to the return of the deposit accompanying its bid.

GOOD FAITH DEPOSIT: A good faith deposit (the "Deposit") in the form of a certified or cashier's check or a Financial Surety Bond in the amount of \$50,000 payable to the order of the City, is required for each bid to be considered. If a check is used, it must be drawn on a California bank and must accompany the bid. If a Financial Surety Bond is used, it must be from an insurance company licensed to issue such a bond in the State of California, and such bond must be submitted to Stone & Youngberg LLC as financial advisor to the City prior to the opening of the bids. The Financial Surety Bond must identify each bidder whose Deposit is guaranteed by such Financial Surety Bond. If the Bonds are awarded to a bidder utilizing a Financial Surety Bond, then such bidder must submit its Deposit to the City in the form of a cashier's check (or wire transfer such amount as instructed by the financial advisor) not later than 12:00 p.m. (noon) California time on the next business day following the award. If such Deposit is not received by that time, the Financial Surety Bond may be drawn by the City to satisfy the Deposit requirement. No interest on the Deposit will accrue to the purchaser. The amount of the Deposit will be applied as a credit towards the payment of the purchase price by the successful bidder. If after the award of the Bonds, the successful bidder fails to complete its purchase on the terms stated in its proposal, the full amount of the good faith deposit will be retained by the City.

PAYMENT OF PURCHASE PRICE: The successful bidder is required to pay the purchase price of the Bonds, reduced by the good faith deposit made pursuant to the preceding paragraph, in funds which are immediately available to the City, or at the direction of the City, the Trustee. Such payment must be made on the date of original delivery of the Bonds by the City to DTC.

STATEMENT OF TRUE INTEREST RATE: Each bidder is requested, but not required, to state in its proposal the percentage true interest rate represented by its proposal, determined as described above, which will be considered as informative only and not binding on either the bidder or the City.

CERTIFICATION OF REOFFERING PRICE. The successful bidder will, as of the date the Bonds are sold pursuant to this Notice of Sale, certify to the City the prices at which it reasonably expects to initially offer each maturity of the Bonds to the general public (the "Initial Offering Prices"). For this purpose, the general public does not include bond houses, brokers or similar persons or organizations acting in the capacity of underwriters or wholesalers.

The successful bidder agrees that, on or prior to the Closing Date, it will actually offer 100% of each maturity of the Bonds to the general public in a bona fide public offering for prices equal to or less than the Initial Offering Prices.

The successful bidder agrees that, prior to the Closing Date, it will deliver a certificate dated as of the Closing Date in form and substance attached as Exhibit A and satisfactory to Bond Counsel.

NO LITIGATION: There is no litigation pending concerning the validity of the Bonds, the corporate existence of the City or the entitlement of the officers thereof to their respective offices, and the purchaser will be furnished a no-litigation certificate certifying to the foregoing as of and at the time of delivery of the Bonds.

CUSIP NUMBERS AND OTHER FEES: It is anticipated that CUSIP numbers will be printed on the Bonds, but neither the failure to print such numbers on any Bonds nor any error with respect thereto will constitute cause for a failure or refusal by the purchaser to accept delivery of and pay for the Bonds in accordance with the terms hereof. All expenses in relation to the printing of CUSIP numbers on the Bonds will be paid for by the City; *provided, however*, that the CUSIP Service Bureau charge for the assignment of said numbers will be the responsibility of and will be paid for by the purchaser. The successful bidder will also be required to pay all fees required by the Depository Trust Company, Securities Industry and Financial Markets Association, Municipal Securities Rulemaking Board, and other similar entity imposing a fee in connection with the issuance of the Bonds (including the California Debt and Investment Advisory Commission as described below).

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION FEES: All fees payable to the California Debt and Investment Advisory Commission in connection with the issuance of the Bonds will be the responsibility of the purchaser of the Bonds.

OFFICIAL STATEMENT: The City has approved a preliminary Official Statement relating to the Bonds. Copies of such preliminary Official Statement will be distributed to any ☐ bidder, upon request, prior to the sale in a form "deemed final" by the City for purposes of Rule 15c2-12 under the Securities Exchange Act of 1934 (the "Rule"). Within seven business days from the sale date, the City will deliver to the purchaser copies of the final Official Statement, executed by an authorized representative of the City and dated the date of delivery thereof to the purchaser, in sufficient number to allow the purchaser to comply with paragraph (b)(4) of the Rule and to satisfy the Municipal Securities Rulemaking Board (the "MSRB") Rule G-32 or any other rules adopted by the MSRB, including information permitted to be omitted by paragraph (b)(1) of the Rule and such other amendments or supplements as are approved by the City (the "Final Official Statement"). The purchaser agrees that it will not confirm the sale of any Bonds unless the confirmation of sale is accompanied or preceded by the delivery of a copy of the Final Official Statement. The City will furnish to the successful bidder, at no charge, not in excess of 100 copies of the Official Statement for use in connection with any resale of the Bonds.

CERTIFICATE REGARDING OFFICIAL STATEMENT: A responsible officer of the City will certify to the original purchaser of the Bonds, as a condition of closing, that based on such officer's participation in the preparation of the Official Statement, nothing has come to his or her attention to lead him or her to believe that the Official Statement (except for certain financial statements, statistical data and other information) contains any untrue statement of a material fact or omits to state any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading.

CONTINUING DISCLOSURE. In order to assist bidders in complying with S.E.C. Rule 15c2-12(b)(5), the City has committed to undertake, pursuant to the Resolution and a Continuing Disclosure Certificate, to provide certain annual financial information and notices of

the occurrence of certain events, if material. A description of this undertaking is set forth in the preliminary Official Statement and will also be set forth in the final Official Statement. Such Continuing Disclosure Certificate will be a document required to be delivered at closing by the City, and the failure by the City to deliver such document in form and substance acceptable to Bond Counsel and the successful bidder will relieve the successful bidder of its obligation to purchase the Bonds

GIVEN pursuant to resolution of the Council of the City of Palo Alto adopted July 27, 2009.

Dated: September 24, 2009

By: /s/ Lalo Perez
Administrative Services Director
City of Palo Alto

EXHIBIT A
Reoffering Price Certificate

\$ _____
CITY OF PALO ALTO
WATER REVENUE BONDS, TAX-EXEMPT SERIES A

CERTIFICATE OF PURCHASER

The undersigned, on behalf of _____, as underwriter (the "Underwriter") of the above-captioned bonds (the "Bonds"), hereby confirms our advice that:

- (i) Based upon reasonable expectations and actual facts which existed on _____, 2009, being the date upon which the City of Palo Alto (the "Issuer") sold the Bonds to the Underwriter (the "Sale Date"), the Underwriter reasonably expected to sell a substantial amount of each maturity of the Bonds (being at least 10% of each maturity) to the general public (for purposes of this Certificate, "general public" excludes bond houses, brokers or similar persons or organizations acting in the capacity of underwriters or wholesalers) in a bona fide public offering at the prices, or in the case of obligations sold on a yield basis, at the respective yields (together the "Initial Offering Prices") set forth in the Exhibit attached hereto and by this reference incorporated herein (these prices are also shown on the cover of the Official Statement).
- (ii) The aggregate of the Initial Offering Prices is \$_____.
- (iii) As of the date hereof, 100% of the Bonds of each maturity were actually offered to the general public in a bona fide public offering for the Initial Offering Prices.
- (iv) As of the Sale Date, the Underwriter, taking into account market conditions, had no reason to believe any of the Bonds would be initially sold to the general public at prices greater than the Initial Offering Prices.
- (v) As of the Sale Date, other than the _____, _____ and _____ maturities of the Bonds, at least 10% of each maturity of the Bonds was initially sold to the general public for the respective Initial Offering Prices.
- (vi) In our opinion, the Initial Offering Prices do not exceed the fair market value of said maturities of the Bonds to the general public as of the Sale Date.

Capitalized terms used herein and not otherwise defined shall have the meanings ascribed thereto in that certain Indenture of Trust, dated as of November 1, 2009, by and between the Issuer and _____, as trustee, authorizing the issuance of the Bonds.

Dated: _____, 2009

as Underwriter

By _____
Name,
Title

OFFICIAL BID FORM

PROPOSAL FOR THE PURCHASE OF

\$33,000,000*

CITY OF PALO ALTO
(SANTA CLARA COUNTY, CALIFORNIA)
WATER REVENUE BONDS
TAX EXEMPT 2009 SERIES A
AND/OR
TAXABLE 2009 SERIES B
(DIRECT PAYMENT BUILD AMERICA BONDS)

City of Palo Alto
c/o Stone & Youngberg
One Ferry Building, Suite 275
San Francisco, CA 94111
FAX: 415/445-2395

Name of Firm Submitting Bid:

Ladies and Gentlemen:

We offer to purchase the \$33,000,000* City of Palo Alto Water Revenue Bonds, Tax-Exempt 2009 Series A and/or Taxable 2009 Series B (Direct Payment Build America Bonds) in the principal amounts*, in such denominations, dated their date of delivery, maturing on June 1 in the years and bearing interest as set forth below.

NOTES:

*** Principal amounts are preliminary, and are subject to change and adjustment as set forth in the Official Notice of Sale.**

**** A check in this column indicates the particular maturity is to be treated as part of a Term Bond.**

***** Check box in Column A to indicate this maturity is to be purchased as Tax-Exempt 2009 Series A Bonds, OR, check box in Column B to indicate this maturity is to be purchased as Taxable 2009 Series B (Direct Payment Build America Bonds). Do not check boxes in both columns for the same maturity.**

Maturity Date (<u>June 1</u>)	Principal <u>Amount*</u>	Term Bond (**)	Interest <u>Rate %</u>	COLUMN A Tax Exempt 2009 Series A*** CHECK THIS BOX	OR	COLUMN B Taxable 2009 Series B (Direct Payment Build America Bond)*** CHECK THIS BOX
2011	\$785,000					
2012	800,000					
2013	820,000					
2014	845,000					
2015	870,000					

Maturity Date (June 1)	Principal Amount*	Term Bond (**)	Interest Rate %	COLUMN A Tax Exempt 2009 Series A*** CHECK THIS BOX	OR	COLUMN B Taxable 2009 Series B (Direct Payment Build America Bond)*** CHECK THIS BOX
2016	905,000					
2017	940,000					
2018	980,000					
2019	1,020,000					
2020	1,060,000					
2021	1,110,000					
2022	1,165,000					
2023	1,225,000					
2024	1,285,000					
2025	1,350,000					
2026	1,420,000					
2027	1,490,000					
2028	1,565,000					
2029	1,640,000					
2030	1,725,000					
2031	1,810,000					
2032	1,900,000					
2033	1,995,000					
2034	2,095,000					
2035	2,200,000					

We offer to pay therefor the principal amount thereof, plus a premium of \$_____ (or minus a discount of \$_____), making an aggregate sum of \$_____.

This proposal is made subject to all the terms and conditions of the Official Notice of Sale of such Bonds dated September 24, 2009, all of which terms and conditions are made a part hereof as fully as though set forth in full in this proposal.

This proposal is subject to acceptance, in whole or in part, within 24 hours after the expiration of the time for the receipt of proposals, as specified in said Official Notice of Sale; we agree that it may not be withdrawn prior to the expiration of said time.

There is enclosed herewith a [] certified or cashier's check or [] surety bond for \$50,000 payable to the order of the City of Palo Alto.

The following is our computation made as provided in the Official Notice of Sale, but not constituting any part of the foregoing, of the true interest cost under the foregoing proposal is \$_____ and the true interest rate determined thereby is ____%.

If this is the purchasing bid, we hereby request that ____ printed copies of the Official Statement pertaining to the Bonds be furnished to us in accordance with the terms of said Official Notice of Sale.

Following is a list of the members of our account on whose behalf this bid is made.

_____	_____
_____	_____

Respectfully submitted,

Name of firm: _____

Account Manager: _____

By: _____

Address: _____

Name, address and phone number of Bidder's representative to be contacted regarding closing procedures:

Name: _____

Address: _____

Phone: _____

PRELIMINARY OFFICIAL STATEMENT DATED SEPTEMBER 24, 2009

NEW ISSUE—BOOK-ENTRY ONLY

RATINGS:
Moody's: "____"
S&P: "AAA" (Stable)
See "RATINGS" herein.

In the opinion of Jones Hall, A Professional Law Corporation, San Francisco, California, Bond Counsel, subject, however to certain qualifications described herein, under existing law, the interest on the 2009 Bonds issued as Tax-Exempt Bonds is excluded from gross income for federal income tax purposes and such interest is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations. In the opinion of Bond Counsel, subject, however to certain qualifications described herein, under existing law, the interest on the 2009 Bonds issued as Build America Bonds is not excluded from gross income for federal income tax purposes. In the further opinion of Bond Counsel, interest on the 2009 Bonds, whether issued as Tax-Exempt Bonds or as Build America Bonds, is exempt from California personal income taxes. See "LEGAL MATTERS—Tax Matters" herein.



\$33,000,000* **CITY OF PALO ALTO** **(Santa Clara County, California)** **Water Revenue Bonds, 2009 Series A**

Dated: Date of Delivery

Due: June 1, as shown on the inside cover

The City of Palo Alto, a chartered city and municipal corporation (the "City"), is issuing its Water Revenue Bonds, 2009 Series A (the "2009 Bonds"), pursuant to an Indenture of Trust, dated as of October 1, 2009 (the "Indenture"), by and between the City and U.S. Bank National Association, as trustee (the "Trustee"), the Charter of the City and Chapter 12.28 of the Palo Alto Municipal Code.

It is expected that the 2009 Bonds will be issued as (i) bonds the interest on which is excluded from gross income for purposes of federal income taxation ("Tax-Exempt Bonds"), (ii) bonds designated as "Direct Payment Build America Bonds" under the provisions of the American Recovery and Reinvestment Act of 2009 ("Build America Bonds"), the interest on which is not excluded from gross income for purposes of federal income taxation, or (iii) a combination of Tax-Exempt Bonds and Build America Bonds, determined at the time of sale of the 2009 Bonds. See "TAX MATTERS" herein. If issued as Build America Bonds, the City expects to receive a cash subsidy payment from the United States Treasury equal to 35% of the interest payable on such 2009 Bonds. See "THE 2009 BONDS—Designation of 2009 Bonds as Build America Bonds."

The 2009 Bonds are being issued to (i) finance certain improvements to the City's water utility system (the "Water System"), (ii) establish a debt service reserve fund for the 2009 Bonds, (iii) fund capitalized interest for the 2009 Bonds through June 1, 2010, and (iv) pay certain costs of issuing the 2009 Bonds. See "FINANCING PLAN."

The 2009 Bonds are special obligations of the City and are secured by amounts held from time to time in the Debt Service Fund established under the Indenture and, subject to certain restrictions set forth in the Indenture, a pledge of and lien on certain net revenues generated by the Water System (the "Net Revenues"). The 2009 Bonds are secured by Net Revenues on a parity, as to payment and security, with the portion of the City's outstanding Utility Revenue Bonds, 2002 Series A (the "2002 Bonds"), issued to finance certain improvements to the Water System. The 2002 Bonds are also secured by certain net revenues derived from the City's gas system (the "Gas System"), which are not pledged for the payment of the 2009 Bonds. The City has also agreed to advance moneys from certain rate stabilization reserve funds (the "Available Reserves"), if necessary, to pay debt service on the 2009 Bonds. The 2002 Bonds and the City's Utility Revenue and Refunding Bonds, 1999 Series A, constitute additional claims on the Available Reserves as well as certain other rate stabilization reserve funds. See "SECURITY FOR THE 2009 BONDS" herein.

The 2009 Bonds will be issued in fully registered form only and, when executed and delivered, will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). DTC will act as securities depository for the 2009 Bonds. Beneficial ownership interests in the 2009 Bonds may be purchased in book-entry form only. Payments of principal and interest (and premium, if any) will be paid by the Trustee to DTC for subsequent disbursements to DTC Participants who will remit such payments to the beneficial owners of the 2009 Bonds. See "THE 2009 BONDS—Book-Entry Only System" herein. The 2009 Bonds will be issued as fully registered bonds in denominations of \$5,000 or any integral multiple of \$5,000. Interest is payable on each June 1 and December 1, commencing June 1, 2010.

The 2009 Bonds are subject to optional and mandatory redemption prior to maturity. The redemption provisions relating to 2009 Bonds issued as Tax-Exempt Bonds and 2009 Bonds issued as Build America Bonds will differ. See "THE 2009 BONDS—Redemption" herein.

The City's Utility Revenue Bonds, 1995 Series A (the "1995 Bonds"), are currently outstanding in the principal amount of \$5,320,000 and are secured by a lien on net revenues of the City's entire "Enterprise," which consists of the Water System, the Gas System, the City's storm and surface water drainage system (the "Storm Drain System"), the City's sanitary sewer system (the "Sewer System"), and the City's electric utility (the "Electric System"). *The lien of the 1995 Bonds on the Net Revenues is senior to the lien on Net Revenues securing the 2009 Bonds and the 2002 Bonds.* The 1995 Bonds are also secured by certain net revenues derived from the Storm Drain System, the Sewer System and the Electric System which are not pledged for the payment of the 2009 Bonds or the 2002 Bonds.

Additional bonds and other indebtedness payable from Net Revenues may be issued on a parity with the 2009 Bonds and of the portion of the 2002 Bonds payable from Net Revenues (and subordinate to the 1995 Bonds), subject to the conditions contained in the Indenture. See "SECURITY FOR THE 2009 BONDS—Limitations on Net Revenue Pledge" herein.

NEITHER THE GENERAL FUND, THE FULL FAITH AND CREDIT NOR THE TAXING POWER OF THE CITY, THE STATE OF CALIFORNIA OR ANY OF ITS POLITICAL SUBDIVISIONS IS PLEDGED FOR THE PAYMENT OF THE 2009 BONDS.

MATURITY SCHEDULE

SEE INSIDE COVER

Bids for the purchase of the 2009 Bonds will be received by the City on Tuesday, October 6, 2009, until 10:00 A.M., Pacific time, as provided in the Official Notice of Sale. The 2009 Bonds will be sold pursuant to the terms of sale set forth in the Official Notice of Sale, dated September 24, 2009. Each bidder will specify if its bid is for Tax-Exempt Bonds, Build America Bonds or a combination of both.

This cover page contains information for general reference only. It is not a summary of this issue. Potential purchasers of the 2009 Bonds are advised to read the entire Official Statement to obtain information essential to making an informed investment decision.

The 2009 Bonds will be offered when, as and if issued and received by the Underwriter subject to the approval of legality by Jones Hall, A Professional Law Corporation, San Francisco, California, Bond Counsel. Certain disclosure matters will be passed upon for the City by Quint & Thimmig LLP, San Francisco, California, Disclosure Counsel. Certain matters will be passed upon for the City by Gary M. Baum, Esq., the City Attorney. It is expected that the 2009 Bonds, in book-entry form, will be available for delivery on or about October 28, 2009.

Dated: October __, 2009

*Preliminary, subject to change.



\$33,000,000*
CITY OF PALO ALTO
(Santa Clara County, California)
Water Revenue Bonds, 2009 Series A

MATURITY SCHEDULE*

CUSIP Prefix: _____†

<u>Maturity</u> <u>Date</u> <u>(June 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Price or</u> <u>Yield</u>	<u>CUSIP</u> <u>Suffix†</u>	<u>Maturity</u> <u>Date</u> <u>(June 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Price or</u> <u>Yield</u>	<u>CUSIP</u> <u>Suffix†</u>
2011					2024				
2012					2025				
2013					2026				
2014					2027				
2015					2028				
2016					2029				
2017					2030				
2018					2031				
2019					2032				
2020					2033				
2021					2034				
2022					2035				
2023									

*Preliminary, subject to change.

† Copyright 2009, American Bankers Association. CUSIP® is a registered trademark of the American Bankers Association. CUSIP data herein is provided by the CUSIP Service Bureau, operated by Standard & Poor's, a division of The McGraw-Hill Companies, Inc. This data is not intended to create a database and does not serve in any way as a substitute for the CUSIP Services Bureau. CUSIP numbers have been assigned by an independent company not affiliated with the City and are included solely for the convenience of the registered owners of the 2009 Bonds. The City is not responsible for the selection or uses of these CUSIP numbers, and no representation is made as to their correctness on the 2009 Bonds or as included herein. The CUSIP number for a specific maturity is subject to being changed after the issuance of the 2009 Bonds as a result of various subsequent actions including, but not limited to, a refunding in whole or in part or as a result of the procurement of secondary market portfolio insurance or other similar enhancement by investors that is applicable to all or a portion of certain maturities of the 2009 Bonds.

No dealer, broker, salesperson or any other person has been authorized to give any information or make any representation with respect to the 2009 Bonds, other than as contained in this Official Statement, and, if given or made, any such information or representation must not be relied upon as having been authorized by the City.

This Official Statement does not constitute an offer of any securities other than those described on the cover page or an offer to sell or a solicitation of an offer to buy, nor may there be any sale of the 2009 Bonds by any person in any jurisdiction in which it is unlawful to make such offer, solicitation or sale. This Official Statement is not to be construed as a contract with the purchasers of the 2009 Bonds.

The information set forth in this Official Statement has been furnished by the City and other sources which are believed to be reliable, but it is not guaranteed as to accuracy or completeness. The information and expressions of opinion in this Official Statement are subject to change without notice and neither the delivery of this Official Statement nor any sale of the 2009 Bonds will, under any circumstances, create any implication that there has been no change in the affairs of the City since the date of this Official Statement.

Summaries and references to statutes and documents in this Official Statement do not purport to be comprehensive or definitive and are qualified in their entirety by reference to each such statute or document.

This Official Statement is submitted in connection with the sale of the 2009 Bonds and may not be reproduced or be used, as a whole or in part, for any other purpose.

In connection with the offering of the 2009 Bonds, the Underwriter may over-allot or effect transactions which stabilize or maintain the market price of the 2009 Bonds at a level above that which might otherwise prevail in the open market. Such stabilizing, if commenced, may be discontinued at any time. The Underwriter may offer and sell the 2009 Bonds to certain dealers and dealer banks and banks acting as agent and others at prices lower than the public offering prices stated on the cover page of this Official Statement, and those public offering prices may be changed from time to time by the Underwriter.

The 2009 Bonds have not been registered under the Securities Act of 1933, as amended, in reliance upon an exemption contained in that act. The 2009 Bonds have not been registered or qualified under the securities laws of any state.

Certain statements included or incorporated by reference in this Official Statement constitute "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995, Section 21E of the United States Securities Exchange Act of 1934, as amended, and Section 27A of the United States Securities Act of 1933, as amended. Such statements are generally identifiable by the terminology used such as "plan," "expect," "estimate," "project," "budget" or other similar words. Such forward-looking statements include, but are not limited to, certain statements contained in the information under the caption "THE WATER SYSTEM." The achievement of certain results or other expectations contained in such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The City does not plan to issue any updates or revisions to the forward-looking statements set forth in this Official Statement.

CITY OF PALO ALTO

CITY COUNCIL MEMBERS

Peter Drekmeier, *Mayor*
Jack Morton, *Vice Mayor*
John Barton, *Council Member*
Patrick Burt, *Council Member*
Sid Espinosa, *Council Member*
Yoriko Kishimoto, *Council Member*
Larry Klein, *Council Member*
Greg Schmid, *Council Member*
Ylaway Yeh, *Council Member*

CITY STAFF

James Keene, *City Manager*
Steve Emslie, *Assistant City Manager*
Lalo Perez, *Director of Administrative Services*
Joe Saccio, *Deputy Director of Administrative Services*
Tarun Narayan, *Senior Financial Analyst, Administrative Services*
Gary M. Baum, *City Attorney*
Donna G. Rogers, *City Clerk*

Utilities Department

Valerie Fong, *Director of Utilities*
Tom Auzenne, *Assistant Director of Utilities, Customer Support Services*
Tomm Marshall, *Assistant Director of Utilities, Engineering*
Jane Ratchye, *Assistant Director of Utilities, Resource Management*
Dean Batchelor, *Assistant Director of Utilities, Operations*

SPECIAL SERVICES

Bond Counsel

Jones Hall
A Professional Law Corporation
San Francisco, California

Disclosure Counsel

Quint & Thimmig LLP
San Francisco, California

Financial Advisor

Stone & Youngberg LLC
San Francisco, California

Trustee

U.S. Bank National Association
San Francisco, California



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\$33,000,000*
CITY OF PALO ALTO
Water Revenue Bonds
2009 Series A

INTRODUCTION

The purpose of this Official Statement, which includes the cover page and appendices hereto, is to set forth certain information in connection with the sale by the City of Palo Alto (the "City") of its \$33,000,000* Water Revenue Bonds, 2009 Series A (the "2009 Bonds").

It is expected that the 2009 Bonds will be issued as (i) bonds the interest on which is excluded from gross income for purposes of federal income taxation ("Tax-Exempt Bonds"), (ii) bonds designated as "Direct Payment Build America Bonds" under the provisions of the American Recovery and Reinvestment Act of 2009 ("Build America Bonds"), the interest on which is not excluded from gross income for purposes of federal income taxation, or (iii) a combination of Tax-Exempt Bonds and Build America Bonds, determined at the time of sale of the 2009 Bonds. See "TAX MATTERS" herein. If issued as Build America Bonds, the City expects to receive a cash subsidy payment from the United States Treasury equal to 35% of the interest payable on such 2009 Bonds. See "THE 2009 BONDS—Designation of 2009 Bonds as Build America Bonds."

Certain capitalized terms used in this Official Statement and not otherwise defined have the meanings set forth under "SECURITY FOR THE 2009 BONDS—Definitions" and APPENDIX A—"SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE OF TRUST." All references to and summaries of provisions of the Indenture are qualified in their entirety by reference to the full Indenture, copies of which are available for inspection at the offices of the City.

Authority for Issuance. The 2009 Bonds are being issued pursuant to (a) the charter of the City and the provisions of Chapter 12.28 (commencing with Section 12.28.010), of the Palo Alto Municipal Code, all as in effect on the Closing Date (the "Bond Law"), (b) the terms and conditions of an Indenture of Trust, dated as of October 1, 2009 (the "Indenture"), by and between the City and U.S. Bank National Association, as trustee (the "Trustee"), and (c) a resolution of the City Council, adopted on July 27, 2009, authorizing the issuance of the 2009 Bonds.

Payments of Principal and Interest. Principal of the 2009 Bonds is payable on each June 1 in the years set forth on the cover of this Official Statement. Interest on the 2009 Bonds is payable on each June 1 and December 1 each year, beginning on June 1, 2010. See "THE 2009 BONDS—Bond Terms."

Purposes. The 2009 Bonds are being issued to (a) finance certain improvements (the "Project") to the City's water utility system (the "Water System"), (b) establish a debt service reserve fund for the 2009 Bonds, (c) fund capitalized interest for the Bonds through June 1, 2010, and (d) pay certain costs of issuing the 2009 Bonds. See "THE FINANCING PLAN."

Pledge of Net Revenues. The 2009 Bonds are special obligations of the City and are secured by amounts held from time to time in the Debt Service Fund established under the Indenture and, subject to certain restrictions set forth in the Indenture, a pledge of and lien on

* Preliminary, subject to change.

the “Net Revenues” generated by the Water System. See “SECURITY FOR THE 2009 BONDS—Pledge of Net Revenues” and “—Limitations on Net Revenue Pledge.” Such pledge is on a parity as to payment and security with that portion of the City’s Utility Revenue Bonds, 2002 Series A (the “2002 Bonds”), secured by a pledge of the Net Revenues of the Water System. The 2002 Bonds are currently outstanding in the principal amount of \$19,690,000, approximately 45% of which is secured by the Net Revenues of the Water System, and are subordinate to a portion of the City’s Utility Revenue Bonds, 1995 Series A (the “1995 Bonds”), which are currently outstanding in the principal amount of \$5,320,000.

Covenant to Maintain and Advance From Available Reserves. The City has established utility rate stabilization reserve funds (collectively, the “Available Reserves”) for certain of its utility systems, including the Water System, listed below (collectively, the “Systems”). As additional security for the 2009 Bonds, the City will, if necessary, advance funds to pay debt service on the 2009 Bonds from the Available Reserves, which the City will maintain in an aggregate amount at least equal to five times maximum annual debt service on all outstanding bonded indebtedness secured by net revenues of any of the Systems:

- (i) Rate Stabilization Reserve for the Water System,
- (ii) Distribution Rate Stabilization Reserve for the City’s electric utility (the “Electric System”),
- (iii) Distribution Rate Stabilization Reserve for the Gas System (the “Gas System”),
- (iv) Supply Rate Stabilization Reserve for the Electric System,
- (v) Supply Rate Stabilization Reserve for the Gas System, and
- (vi) the Electric System’s Calaveras-Stranded Costs Reserve (the “Calaveras Reserve”).

See “SECURITY FOR THE 2009 BONDS—Available Reserves” and “AVAILABLE RESERVES.”

Other Claims on Available Reserves. The City has also covenanted to advance funds, if necessary, from the Available Reserves, as well as rate stabilization reserve funds established by the City for its wastewater collection system, its wastewater treatment system and its refuse utility, to pay debt service on the City’s Utility Revenue and Refunding Bonds, 1999 Series A (the “1999 Bonds”), which are currently outstanding in the principal amount of \$13,735,000. The 1999 Bonds are primarily secured by a lien on net revenues of the Wastewater Collection System, the Wastewater Treatment System and the City’s storm and surface water system (the “the Storm Drain System”).

The City has also covenanted to advance funds, if necessary, from the Available Reserves, as well as rate stabilization reserve funds established by the City for its wastewater collection system, its wastewater treatment system and its refuse utility, to pay debt service on the 2002 Bonds. The 2002 Bonds are secured by a lien on net revenues of the Water System and the Gas System. See “SECURITY FOR THE 2009 BONDS—Other Claims on Available Reserves.”

Limitations on Net Revenue Pledge. The debt service on the 2009 Bonds is payable from Net Revenues generated by the Water System and from moneys advanced from the Available Reserves. See “SECURITY FOR THE 2009 BONDS—Limitations on Net Revenue Pledge.”

Neither the general fund, the full faith and credit, nor the taxing power of the City, the State of California (the “State”) or any other political subdivision thereof is pledged to the payment of the 2009 Bonds. The 2009 Bonds are not secured by a legal or equitable pledge of or charge, lien or encumbrance upon any property of the City or any of its income or receipts except the Net Revenues.

Senior Obligations. The 1995 Bonds are secured by a lien on net revenues of all systems. The lien of the 1995 Bonds on the Net Revenues is senior to the lien on Net Revenues securing the 2002 Bonds and the 2009 Bonds. See “SECURITY FOR THE 2009 BONDS—Limitations on Net Revenue Pledge.”

Parity Bonds. The lien of the 2002 Bonds on the Net Revenues is on a parity with the lien on Net Revenues securing the 2009 Bonds. Additional bonds and other indebtedness payable from Net Revenues may be issued on a parity with the 2009 Bonds and the portion of the 2002 Bonds secured by Net Revenues (and subordinate to the portion of the 1995 Bonds secured by Net Revenues) subject to the conditions of the Indenture. See “SECURITY FOR THE 2009 BONDS—Parity and Subordinate Bonds.”

Rate Covenant. The City covenants in the Indenture that it will fix, prescribe, revise and collect Charges for the Water System in each Fiscal Year which are:

(i) sufficient (along with moneys transferred from the Available Reserve for the Water System) to pay 100% of debt service on all outstanding 2009 Bonds, the portion of the 2002 Bonds payable from Net Revenues and all Parity Bonds payable from Net Revenues, and

(ii) equal, when added to the balance then on hand in the Available Reserve for the Water System, to 125% of principal of and interest payable in that Fiscal Year on all outstanding bonds payable from Net Revenues.

See “SECURITY FOR THE 2009 BONDS—Rate Covenant.”

Reserve Account. To further secure the payment of the principal of and interest on the 2009 Bonds, the Indenture establishes the Reserve Account to be held by the Trustee. The Indenture defines the Reserve Requirement to be equal to the lesser of (i) Maximum Annual Debt Service on the 2009 Bonds, (ii) 10% of the principal amount of the 2009 Bonds, and (iii) 125% of Average Annual Debt Service on the 2009 Bonds. See “APPENDIX A—SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE OF TRUST” and “SECURITY FOR THE 2009 BONDS—Reserve Account.”

THE 2009 BONDS

Bond Terms

General. The 2009 Bonds will be dated their date of delivery and are to be issued in the aggregate principal amount, bear interest at the rate per annum and mature on the dates set forth on the cover page of this Official Statement. Interest on the 2009 Bonds is payable on each June 1 and December 1, commencing June 1, 2010.

Registered Form. The 2009 Bonds are deliverable in fully registered form in the denomination of \$5,000 each or any integral multiple of \$5,000, and when issued will be registered in the name of Cede & Co. as nominee of The Depository Trust Company, New York, New York (“DTC”). Beneficial owners of the 2009 Bonds will not receive physical certificates representing the 2009 Bonds purchased, but will receive a credit balance on the books of the nominees of such beneficial owners. So long as Cede & Co. is the registered holder of the 2009 Bonds, principal of and premium, if any, and interest evidenced and represented by the 2009 Bonds will be paid the Trustee directly to DTC, which will in turn remit such principal, premium, if any, and interest to its participants for subsequent disbursement to the beneficial owners of the 2009 Bonds. See “THE 2009 BONDS—Book-Entry-Only System.”

Principal of and premium, if any, on the 2009 Bonds will be payable at maturity or prepayment upon surrender thereof at the principal corporate trust office of the Trustee.

Manner of Payment. Interest on the 2009 Bonds is payable on each Interest Payment Date to the person whose name appears on the Bond Registration Books as of the Record Date immediately preceding the applicable Interest Payment Date, such interest to be paid by check or draft of the Trustee mailed by first class mail to the Owner or, at the option of any Owner of at least \$1,000,000 aggregate principal amount of the 2009 Bonds with respect to which written instructions have been filed with the Trustee prior to the Record Date, by wire transfer, at the address of the owner as it appears on the Bond Registration Books. Principal of and premium (if any) on any 2009 Bond will be paid upon presentation and surrender thereof at the corporate trust office of the Trustee in San Francisco, California. Both the principal of and interest and premium (if any) on the 2009 Bonds will be payable in lawful money of the United States of America.

So long as Cede & Co., is the registered holder of the 2009 Bonds, references to the holders or owners or registered holders or owners of the 2009 Bonds means Cede & Co. and not the beneficial owners of the 2009 Bonds.

Transfer and Exchange

Any 2009 Bond may, in accordance with its terms, be transferred upon the Bond Registration Books by the person in whose name it is registered, in person or by his duly authorized attorney, upon surrender of the 2009 Bond for cancellation, accompanied by delivery of a written instrument of transfer in a form approved by the Trustee, duly executed. Whenever any 2009 Bond is so surrendered for transfer, the City will execute and the Trustee will authenticate and deliver to the transferee a new 2009 Bond or 2009 Bonds of like tenor, maturity and aggregate principal amount. If a notice of redemption of any 2009 Bonds has been mailed pursuant to the redemption provisions of the Indenture, those 2009 Bonds will not be subject to transfer.

The 2009 Bonds may be exchanged at the Trust Office of the Trustee, for 2009 Bonds of the same tenor and maturity and of other authorized denominations.

2009 Bonds Mutilated, Destroyed, Stolen or Lost

If any 2009 Bond becomes mutilated, the City, at the expense of the Owner of that 2009 Bond, will execute, and the Trustee will authenticate and deliver, a new 2009 Bond of like maturity and principal amount in exchange and substitution for the 2009 Bonds so mutilated, but only upon surrender to the Trustee of the 2009 Bond so mutilated. The Trustee will cancel every mutilated 2009 Bond so surrendered, and will deliver those canceled 2009 Bonds to, or upon the order of, the City.

If any 2009 Bond is lost, destroyed or stolen, evidence of such loss, destruction or theft may be submitted to the City and the Trustee. If such evidence is satisfactory to them, and indemnity satisfactory to them is given, the City, at the expense of the Owner, will execute, and the Trustee will authenticate and deliver, a new 2009 Bond of like maturity and principal amount in lieu of and in substitution for the 2009 Bond so lost, destroyed or stolen. (If any such 2009 Bond matures or is called for redemption, instead of issuing a substitute 2009 Bond the Trustee may pay the same without surrender thereof upon receipt of indemnity satisfactory to the Trustee).

The City may require payment of a reasonable fee for each new 2009 Bond issued and the reimbursement of any expenses incurred by the City or the Trustee. Any 2009 Bond issued in lieu of any 2009 Bond alleged to be lost, destroyed or stolen will constitute an original contractual obligation on the part of the City whether or not the 2009 Bond alleged to be lost, destroyed or stolen is at any time enforceable by anyone, and will be equally and proportionately entitled to the benefits of the Indenture with all other 2009 Bonds secured by the Indenture.

Designation of 2009 Bonds as Build America Bonds

If any 2009 Bonds are issued as “Direct Payment Build America Bonds” for purposes of the American Recovery and Reinvestment Act of 2009, signed into law on February 17, 2009 (the “Recovery Act”), the City expects to receive a cash subsidy payment from the United States Treasury pursuant to the Recovery Act equal to 35% of the interest payable on such 2009 Bonds on or about each Interest Payment Date. The cash payment does not constitute a full faith and credit guarantee of the United States, but is required to be paid by the Treasury under the Recovery Act. Any cash subsidy payments received by the City will constitute a portion of the Gross Revenues. The City is obligated to make all payments of principal of and interest on the 2009 Bonds whether or not it receives cash subsidy payments pursuant to the Recovery Act.

Redemption

*If the 2009 Bonds are issued as **Tax-Exempt Bonds**, the following redemption provisions will apply to such 2009 Bonds:*

Optional Redemption. The 2009 Bonds maturing on or before June 1, 2019, are not subject to optional redemption prior to maturity. The 2009 Bonds maturing on or after June 1, 2020, are subject to redemption prior to their respective maturity dates, at the option of the City, as a whole, or in part pro rata among maturities and by lot within a maturity, from any source of available funds, on any Interest Payment Date on or after June 1, 2019, at a Redemption Price equal to the principal amount of the 2009 Bonds to be redeemed, plus accrued interest thereon to the date of redemption, without premium.

[To be applicable if the successful bidder of the 2009 Bonds designates certain maturities as term bonds] *Sinking Fund Redemption.* The 2009 Bonds maturing on June 1, ____ (the “Term Bonds”) are subject to mandatory redemption in part from sinking fund payments to be made by the City on June 1, ____, and on each June 1 thereafter up to and including June 1, ____, at a redemption price equal to 100% of the principal amount thereof plus accrued interest, if any, to the redemption date without premium, as follows:

<u>June 1</u>	<u>Principal Amount</u>
---------------	-------------------------

†Maturity

If the 2009 Bonds are issued as **Build America Bonds**, the following redemption provisions will apply to such 2009 Bonds:

Optional Redemption. The 2009 Bonds maturing on or before June 1, 2019, are not subject to optional redemption prior to maturity. The 2009 Bonds maturing on or after June 1, 2020, are subject to redemption prior to their respective maturity dates, at the option of the City, as a whole, or in part pro rata among maturities and by lot within a maturity, from any source of available funds, on any Interest Payment Date on or after June 1, 2019, at a redemption price equal to the principal amount of the 2009 Bonds to be redeemed, plus accrued interest thereon to the date of redemption, without premium.

[To be applicable if the successful bidder of the 2009 Bonds designates certain maturities as term bonds] *Sinking Fund Redemption.* The 2009 Bonds maturing on June 1, ____ (the "Term Bonds") are subject to mandatory redemption in part from sinking fund payments to be made by the City on June 1, ____, and on each June 1 thereafter up to and including June 1, ____, at a redemption price equal to 100% of the principal amount thereof plus accrued interest, if any, to the redemption date without premium, as follows:

<u>June 1</u>	<u>Principal Amount</u>
---------------	-------------------------

†Maturity

Special Optional Redemption upon the Occurrence of a Federal Subsidy Termination Event. Before June 1, 2019, the 2009 Bonds will be subject to redemption prior to their maturity at the option of the City, as a whole or in part, upon the occurrence of a Federal Subsidy Termination Event, at a redemption price (the "Federal Subsidy Termination Optional Redemption Price") equal to the greater of (1) 100% of the principal amount of the 2009 Bonds to be redeemed; or (2) the sum of the present value of the remaining scheduled payments of principal of and interest on the 2009 Bonds to be redeemed, not including any portion of those payments of interest accrued and unpaid as of the date on which the 2009 Bonds are to be redeemed, discounted to the date on which the 2009 Bonds are to be redeemed on a semi-annual basis, assuming a 360-day year consisting of twelve 30-day months, at the Treasury Rate (as defined below), plus 100 basis points; plus, in each case, accrued interest on the 2009 Bonds to be redeemed to the redemption date.

A "Federal Subsidy Termination" will have occurred if the City determines that either: (i) Section 54AA or 6431 of the Internal Revenue Code of 1986, as amended (the "Code") (as such Sections were added by Section 1531 of the American Recovery and Reinvestment Act of 2009 (the "Recovery Act")), pertaining to "Build America Bonds" has been amended in a material way; or (ii) there is any guidance published by the Internal Revenue Service or the United States Treasury with respect to such Sections; or (iii) any other determination by the Internal Revenue Service or the United States Treasury, which determination is not the result of any act or omission by the City to satisfy the requirements to qualify to receive the 35% cash subsidy payment from the United States Treasury - any of which results in the City's right to receive the 35% cash subsidy payment from the United States Treasury with respect to debt service due on the 2009 Bonds under the Recovery Act being reduced or eliminated..

For purposes of determining the Federal Subsidy Termination Optional Redemption Price, the following meanings apply:

"Treasury Rate" means, with respect to any redemption date for a particular 2009 Bond, the rate per annum, expressed as a percentage of the principal amount, equal to the semiannual equivalent yield to maturity of the Comparable Treasury Issue, assuming that the Comparable Treasury Issue is purchased on the redemption date for a price equal to the Comparable Treasury Price, as calculated by the Designated Investment Banker.

"Comparable Treasury Issue" means, with respect to any redemption date for a particular 2009 Bond, the United States Treasury security or securities selected by the Designated Investment Banker which has an actual or interpolated maturity comparable to the remaining average life of the 2009 Bond to be redeemed, and that would be utilized in accordance with customary financial practice in pricing new issues of debt securities of comparable maturity to the remaining average life of the 2009 Bonds to be redeemed.

"Comparable Treasury Price" means, with respect to any redemption date for a particular 2009 Bond, (1) if the Designated Investment Banker receives at least four Reference Treasury Dealer Quotations, the average of such quotations for such redemption date, after excluding the highest and lowest Reference Treasury Dealer Quotations, or (2) if the Designated Investment Banker obtains fewer than four Reference Treasury Dealer Quotations, the average of all such quotations.

"Designated Investment Banker" means one of the Reference Treasury Dealers appointed by the City.

"Reference Treasury Dealer" means each of the four firms, specified by the City from time to time, that are primary United States Government securities dealers in the City of New York (each a "Primary Treasury Dealer"); *provided, however*, that if any of them ceases to be a Primary Treasury Dealer, the City will substitute another Primary Treasury Dealer.

"Reference Treasury Dealer Quotations" means, with respect to each Reference Treasury Dealer and any redemption date for a particular 2009 Bond, the average, as determined by the Designated Investment Banker, of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) quoted in writing to the Designated Investment Banker by such Reference Treasury Dealer at 3:30 P.M., New York City time, on the third Business Day preceding such redemption date.

*Regardless if the 2009 Bonds are issued as **Tax-Exempt Bonds** or **Build America Bonds**, the following redemption provisions will apply to the 2009 Bonds:*

Special Mandatory Redemption from Insurance or Condemnation Proceeds. The 2009 Bonds are subject to redemption as a whole or in part on any date, in inverse order of maturity and by lot within a maturity, to the extent of the Net Proceeds of hazard insurance not used to repair or rebuild the Water System or the Net Proceeds of condemnation awards received with respect to the Water System to be used for such purpose, at a Redemption Price equal to the principal amount of the 2009 Bonds plus interest accrued thereon to the date fixed for redemption, without premium.

Notice of Redemption. Unless waived by any Owner of 2009 Bonds to be redeemed, notice of any redemption of Bonds will be given, at the expense of the City, by the Trustee by mailing a copy of a redemption notice by first class mail at least 30 days and not more than 60 days prior to the date fixed for redemption to the Owner of the 2009 Bond or 2009 Bonds to be redeemed at the address shown on the Bond Registration Books; provided, that neither the failure to receive such notice nor any immaterial defect in any notice will affect the sufficiency of the proceedings for the redemption of the 2009 Bonds.

All notices of redemption must be dated and state the following:

- (i) the redemption date,
- (ii) the Redemption Price,
- (iii) if fewer than all Outstanding 2009 Bonds are to be redeemed, the identification (and, in the case of partial redemption, the respective principal amounts) of the 2009 Bonds to be redeemed,
- (iv) that on the redemption date the Redemption Price will become due and payable with respect to each such 2009 Bond or portion thereof called for redemption, and that interest with respect thereto will cease to accrue from and after the redemption date, and
- (v) the place or places where such 2009 Bonds are to be surrendered for payment of the Redemption Price, which places of payment may include the corporate trust office of the Trustee.

At least 45 days prior to any redemption date, the City must deposit with the Trustee an amount of money sufficient to pay the Redemption Price of all the 2009 Bonds or portions of 2009 Bonds which are to be redeemed on that date.

So long as the 2009 Bonds are held only in the book-entry system of DTC, notice of redemption will be sent to Cede & Co., as nominee for DTC, and will not be sent to the beneficial owners of the 2009 Bonds.

Purchase in Lieu of Optional Redemption. In lieu of optional redemption, amounts in the Redemption Account of the Debt Service Fund may be used for the purchase of 2009 Bonds at public or private sale as and when and at such prices (including brokerage and other charges, but excluding accrued interest, which is payable from the Debt Service Fund) as the City may determine, but not to exceed the principal amount of such 2009 Bonds plus the redemption premium applicable on the next ensuing optional redemption date.

Book-Entry-Only System

While the 2009 Bonds are subject to the book-entry system, the principal, interest and any redemption premium with respect to a 2009 Bond will be paid by the Trustee to The Depository Trust Company, New York, New York ("DTC"), which in turn is obligated to remit such payment to its DTC Participants for subsequent disbursement to Beneficial Owners of the 2009 Bonds, as described in APPENDIX F—"DTC AND THE BOOK-ENTRY ONLY SYSTEM."

FINANCING PLAN

Purposes of the Bonds

The 2009 Bonds are being issued to (a) finance the Project, which will consist of improvements to the Water System, (b) establish a debt service reserve fund for the 2009 Bonds, (c) fund capitalized interest for the Bonds through June 1, 2010, and (d) pay certain costs of issuing the 2009 Bonds.

See “THE WATER SYSTEM—Capital Improvement Program Summary” for a description of the water utility facilities to be financed with the proceeds of the 2009 Bonds.

Estimated Sources and Uses of Funds

The following table sets forth the estimated sources and uses of funds for the 2009 Bonds:

Sources of Funds:

Principal Amount of 2009 Bonds
[Plus: Original Issue Premium]
[Less: Original Issue Discount]
Less: Underwriter’s Discount
Total Sources

Uses of Funds:

Deposit to Project Fund
Deposit to Reserve Account
Deposit to Debt Service Fund (1)
Deposit to Costs of Issuance Fund (2)
Total Uses

(1) Represents capitalized interest for the Bonds through June 1, 2010.

(2) Represents amounts to pay fees of rating agencies, the Trustee, bond counsel, disclosure counsel, the financial advisor, printing and other miscellaneous costs of issuing the 2009 Bonds.

Annual Debt Service

Set forth below is the annual debt service on the 2009 Bonds based on the interest rates and maturity schedule set forth on the cover of this Official Statement (assuming no optional redemption).

Bond Year Ending June 1	Principal	Interest	Total Debt Service
2010			
2011			
2012			
2013			
2014			
2015			
2016			
2017			
2018			
2019			
2020			
2021			
2022			
2023			
2024			
2025			
2026			
2027			
2028			
2029			
2030			
2031			
2032			
2033			
2034			
2035			

Set forth below is the combined annual debt service on the 2009 Bonds and the portion (approximately 45%) of the 2002 Bonds secured by Net Revenues (assuming no optional redemption).

Bond Year Ending June 1	2002 Bonds	2009 Bonds	Total
2010	\$774,586		
2011	774,501		
2012	775,597		
2013	775,687		
2014	774,638		
2015	774,660		
2016	775,617		
2017	775,110		
2018	775,341		
2019	774,153		
2020	773,894		
2021	774,434		
2022	775,350		
2023	776,475		
2024	776,025		
2025	774,000		
2026	774,900		
2027	—		
2028	—		
2029	—		
2030	—		
2031	—		
2032	—		
2033	—		
2034	—		
2035	—		

SECURITY FOR THE 2009 BONDS

Pledge of Net Revenues

General. The 2009 Bonds are special obligations of the City and, pursuant to the Indenture, there is pledged, for the benefit of the Owners of the 2009 Bonds, the Net Revenues on a parity with a lien on the Net Revenues securing the 2002 Bonds.

“Net Revenues” are defined in the Indenture to mean, for any period of computation, the amount of the Gross Revenues during such period, less the amount of Maintenance and Operation Costs becoming payable during that period.

“Gross Revenues” are defined in the Indenture as, for any period of computation, all gross charges received for, and all other gross income and revenues derived by the City from, the ownership or operation of the Water System or otherwise arising from the Water System during that period, including but not limited to (a) all Charges received by the City for use of the Water System, (b) all receipts derived from the investment of funds held by the Director of Administrative Services or the Trustee under the Indenture, (c) transfers from any related stabilization reserve fund into the Revenue Fund, and (d) all moneys received by the City from other public entities whose inhabitants are served pursuant to contracts with the City.

“Maintenance and Operation Costs” are defined in the Indenture as the reasonable and necessary costs spent or incurred by the City for maintaining and operating the Water System, calculated in accordance with sound accounting principles. Maintenance and Operation Costs include the cost of supply of water, gas and electric energy under contracts or otherwise, the funding of reasonable operating reserves, and all reasonable and necessary expenses of management and repair and other expenses to maintain and preserve the Water System in good repair and working order. Maintenance and Operation Costs further include all reasonable and necessary administrative costs of the City attributable to the Water System and the 2009 Bonds, such as salaries and wages and the necessary contribution to retirement of employees, overhead, insurance, taxes (if any), expenses, compensation and indemnification of the Trustee, and fees of auditors, accountants, attorneys or engineers, and all other reasonable and necessary costs of the City or charges required to be paid by it to comply with the terms of the 2009 Bonds or the Indenture. Maintenance and Operation Costs do not include depreciation, replacement and obsolescence charges or reserves therefor and amortization of intangibles or other bookkeeping entries of a similar nature.

“Charges” is defined in the Indenture as fees, tolls, assessments, rates and rentals prescribed under the Bond Law or any other law of the State by the City Council for the services and facilities of the Water System furnished by the City.

Flow of Funds. The City covenants and agrees in the Indenture that all Gross Revenues will be received and held by the City in trust and will be deposited by the City in the Revenue Fund which exists in the City Treasury.

All Gross Revenues will be transferred, disbursed, allocated and applied solely to the uses and purposes set forth in the Indenture, and will be accounted for separately and apart from all other money, funds, accounts or other resources of the City.

Limitations on Net Revenue Pledge

Limited Obligations of the City. The general fund of the City is not liable and the credit or taxing power of the City is not pledged for the payment of the principal or redemption price of and interest on the 2009 Bonds. The owners of the 2009 Bonds cannot compel the exercise of the taxing power by the City or the forfeiture of its property. The principal or redemption price of and interest on the 2009 Bonds are not a debt of the City, nor a legal or equitable pledge, charge, lien or encumbrance, upon any of its property, or upon any of its income, receipts, or revenues except the Net Revenues.

Senior Lien of 1995 Bonds. The pledge of Net Revenues to the 2009 Bonds and to the portion of the 2002 Bonds which financed improvements to the Water System is subordinate to the lien of the 1995 Bonds, which are secured by a lien on net revenues of all Systems. Therefore, the lien of the 1995 Bonds on the Net Revenues is senior to the lien on the Net Revenues securing the 2009 Bonds and to the portion of the 2002 Bonds (approximately 45%) which financed improvements to the Water System. It should be noted, however, that unlike the 2009 Bonds, the 1995 Bonds are also secured by net revenues of the Sewer System, the Storm Drain System and the Electric System and the 2002 Bonds are also payable from net revenues of the Gas System and unlike the 2009 Bonds, the 2002 Bonds are also secured by net revenues of the Gas System.

The 1995 Bonds mature by their terms on June 1, 2020. The Indenture provides that no additional bonds can be secured by a pledge of Net Revenues that is prior to the lien securing the 2009 Bonds and the portion of the 2002 Bonds which financed improvements to the Water System.

Rate Covenant

The City has covenanted in the Indenture to fix, prescribe, revise and collect Charges for the Water System during each Fiscal Year which (together with other funds transferred from the stabilization reserve fund for the Water System and which are lawfully available to the City for payment of any of the following amounts during such Fiscal Year) are at least sufficient, after making allowances for contingencies and error in the estimates, to pay the following amounts in the following order:

(a) all Maintenance and Operation Costs with respect to the Water System estimated by the City to become due and payable in that Fiscal Year;

(b) the principal of and interest on the Outstanding Bonds payable from the Net Revenues becoming due and payable during that Fiscal Year, including the redemption price of Term Bonds subject to sinking fund redemption during such Fiscal Year;

(c) all other payments required for compliance with the Indenture and the instruments pursuant to which any Parity Bonds that are issued with respect to the Water System ("Parity Bonds" are defined below under "Parity and Subordinate Bonds"); and

(d) all payments required to meet any other obligations of the City which are charges, liens, encumbrances upon or payable from the Gross Revenues or the Net Revenues.

In addition, the City has covenanted in the Indenture to fix, prescribe, revise and collect Charges for the Water System during each Fiscal Year which, when added to the balance then on hand in Available Reserve for the Water System, are sufficient to yield Net Revenues at least equal to 125% of the principal of and interest on the Outstanding Bonds payable from the Net Revenues becoming due and payable during such Fiscal Year, including the redemption price of Term Bonds subject to sinking fund redemption during such Fiscal Year.

See "Available Reserves" below for a discussion of limitations on the treatment of appropriation of funds from or into a System's related Available Reserve for purposes of satisfying the rate covenant.

Available Reserves

Covenant to Maintain Aggregate Available Reserves. The City has covenanted in the Indenture to maintain the funds on hand in Available Reserves in an aggregate amount at least equal to five times maximum annual debt service on all outstanding bonded indebtedness secured by net revenues of any of the Systems.

Transfers. In addition, the City has covenanted to advance from Available Reserves to the Water System, as needed, amounts sufficient to enable the City to pay all Maintenance and Operation Costs and all Debt Service payable with respect to the Water System, when and as the same become due and payable. See "AVAILABLE RESERVES" below for information about the Available Reserves.

The Indenture further provides that the City will transfer from Available Reserves, to the Water System, as needed, amounts sufficient to enable the City to pay all Maintenance and Operation Costs and all debt service on obligations issued to finance improvements to the Water System, when and as the same become due and payable.

Other Claims on Available Reserves. The City has also covenanted to advance funds, if necessary, from the Available Reserves to pay debt service on the 1999 Bonds. The 1999 Bonds are secured by a lien on net revenues of the Wastewater Collection System, the Wastewater Treatment System and the Storm Drain System. The City has also covenanted to advance funds, if necessary, from the Available Reserves to pay debt service on the 2002 Bonds. The 2002 Bonds are secured by a lien on Net Revenues and by a lien on net revenues of the Gas System.

Parity and Subordinate Bonds

In addition to the 2009 Bonds, the City may issue or incur other loans, advances or indebtedness payable from Net Revenues in a principal amount determined by the City.

Parity Bonds. The City may issue or incur any such Parity Bonds subject to the following specific conditions, which are hereby made conditions precedent to the issuance and delivery of such Parity Bonds:

(a) The City shall be in compliance with all covenants set forth in the Indenture.

(b) (i) The Net Revenues, calculated on sound accounting principles, as shown by the books of the City for the latest Fiscal Year or any more recent twelve (12) month period selected by the City ending not more than sixty (60) days prior to the adoption of the Parity Bonds Instrument pursuant to which such Parity Bonds are issued, as shown by the books of the City, less withdrawals, if any, from the Water System's rate stabilization fund, plus, at the option of the City, the Additional Allowance, shall at least equal one hundred percent (100%) of Maximum Annual Debt Service, with Maximum Annual Debt Service calculated on all Bonds to be Outstanding immediately subsequent to the issuance of such Parity Bonds which have a lien on Net Revenues of the Water System; and

(ii) The Net Revenues of the Water System, calculated on sound accounting principles, as shown by the books of the City for the latest Fiscal Year or any more recent twelve (12) month period selected by the City ending not more than sixty (60) days prior to the adoption of the Parity Bonds Instrument pursuant to which such Parity Bonds are issued, as shown by the books of the City, plus, at the option of the City, any or all of the items hereinafter in this paragraph designated (i), (ii) and (iii), shall at least equal one hundred twenty-five percent (125%) of Maximum Annual Debt Service, with Maximum Annual Debt Service calculated on all Bonds to be Outstanding immediately subsequent to the issuance of such Parity Bonds which have a lien on Net Revenues of the Water System. The items any or all of which may be added to such Net Revenues for the purpose of issuing or incurring Parity Bonds hereunder are the following:

(A) An allowance for Net Revenues from any additions to or improvements or extensions of the Water System, and also for Net Revenues from any such additions, improvements or extensions which have been made from moneys from any source but in any case which, during all or any part of such Fiscal Year or such twelve (12) month period, were not in service, all in an amount equal to ninety percent (90%) of the estimated additional average annual Net Revenues to be derived from such additions, improvements and extensions for the first thirty-six (36) month period in which each addition, improvement or extension is respectively to be in operation, all as shown in the written report of an Independent Consultant engaged by the City;

(B) The Additional Allowance; and

(C) Funds then on hand in Available Reserves for the Water System.

(c) The Parity Bonds Instrument providing for the issuance of such Parity Bonds shall provide that:

(i) The proceeds of such Parity Bonds shall be applied to the acquisition, construction, improvement, financing or refinancing of additional facilities, improvements or extensions of existing facilities within the Water System, or otherwise for facilities, improvements or property which the City determines are of benefit to the Water System, or for the purpose of refunding any Bonds in whole or in part, including all costs (including costs of issuing such Parity Bonds and including capitalized interest on such Parity Bonds during any period which the City deems necessary or advisable) relating thereto;

(ii) Interest on such Parity Bonds shall be payable on an Interest Payment Date;

(iii) The principal of such Parity Bonds shall be payable on June 1 in any year in which principal is payable; and

(iv) Money shall be deposited in a reserve account for such Parity Bonds from the proceeds of the sale of such Parity Bonds or otherwise equal to the Reserve Requirement.

Subordinate Bonds. The Indenture authorizes the City to issue Bonds secured by Net Revenues of the Water System on a basis subordinate to the pledge of Net Revenues to the 2009 Bonds.

Reserve Account

General. The Indenture provides for establishment of a Reserve Account. On the date of issuance of the 2009 Bonds, the City intends to satisfy the Reserve Requirement with a cash deposit made from a portion of the proceeds of the 2009 Bonds.

Use of the Reserve Account. If at any time there are insufficient amounts in the Debt Service Fund to pay principal and redemption price of or interest on the 2009 Bonds, the Trustee will withdraw from the Reserve Account the amount of the deficiency. Any amounts in the Reserve Account in excess of the Reserve Requirement (whether derived from interest or gain on investments or otherwise) will, on June 2 of each year, be paid by the Trustee to the City for deposit in the Revenue Fund.

THE CITY AND CITY UTILITIES

The City

The City is located in northern Santa Clara County (the "County"), approximately 35 miles south of the City of San Francisco. The City has a current population of approximately 64,500. It is part of the San Francisco Bay metropolitan area. Partly due to the presence of Stanford University, which is adjacent to the City, the City is considered the birthplace of the high technology industry that has made the County famous worldwide as Silicon Valley. The 630-acre Stanford Research Park includes prestigious and innovative high-tech leaders such as Hewlett-Packard, SAP America, Varian Medical Systems, VMware, Tibco Software, Space Systems Loral, the Electric Power Research Institute and Communications and Power

Industries. The City is also a major employment center, including U.S. Department of Veteran Affairs' Palo Alto Health Care System, Stanford Hospitals and Clinics, Lockheed Martin Missiles and Space, Palo Alto Medical Foundation, Stanford Shopping Center, the law offices of Wilson Sonsini Goodrich and Rosati, and the Xerox Palo Alto Research Center.

The City was incorporated in 1894. Its first Charter was granted by the State of California in 1909, and the City continues to operate as a charter city. Municipal operations are conducted under the Council-Manager form of government. The nine City Council Members are elected at large for four-year, staggered terms. The Mayor and Vice Mayor are elected annually at the first City Council meeting in January. The Mayor presides over all City Council meetings. The City Manager is responsible for the operation of all municipal functions, except the offices of the City Attorney, City Clerk, and City Auditor. These officials are appointed by, and report directly to, the City Council. For general, economic and demographic information regarding the City, see APPENDIX B—"GENERAL AND ECONOMIC INFORMATION ABOUT THE CITY."

City Utilities

The City operates the following utility systems:

- the Sewer System,
- the Electric System,
- the Gas System,
- the Storm Drain System,
- the Refuse System,
- the Water System, and
- the Fiber Optics System.

The City's Utilities Department is in charge of the operation of the Electric System, the Fiber Optics System, the Gas System, the Water System and the Wastewater Collection System (which comprises a portion of the Sewer System) and the City's Public Works Department is in charge of the operation of the Storm Drain System, the Refuse System and the Wastewater Treatment System (which comprises the remaining portion of the Sewer System).

As described more completely above (see "SECURITY FOR THE 2009 BONDS"), in addition to Net Revenues, the City will, if Net Revenues are insufficient, advance funds from moneys on deposit from time to time in the Available Reserves to pay debt service on the 2009 Bonds, specifically:

- (i) Rate Stabilization Reserve for the Water System,
- (ii) Distribution Rate Stabilization Reserve for the Electric System,
- (iii) Distribution Rate Stabilization Reserve for the Gas System,
- (iv) Supply Rate Stabilization Reserve for the Electric System,
- (v) Supply Rate Stabilization Reserve for the Gas System, and
- (vi) the Electric System's Calaveras Reserve.

The City has covenanted to maintain the aggregate balance of the reserves at an amount at least equal to five times maximum annual debt service on all outstanding bonded indebtedness secured by Net Revenues of any of the Systems. See "THE AVAILABLE RESERVES" below for a discussion of each of the Available Reserves and the City's current policies with respect to each. However, Proposition 218 may require the City to replenish certain Available Reserves in the event of an advance from an Available Reserve for payment of

debt service on the 2009 Bonds. See “CONSTITUTIONAL LIMITATIONS ON TAXES AND WATER RATES AND CHARGES—Articles XIIIC and XIID.”

Management of the Utilities Department

The Utilities Department is responsible for the operation of five utility systems (the Electric System, the commercial Fiber Optics System, the Gas System, the Water System and the Wastewater Collection System) that serve the City. The City, through its Utilities Department, services customer accounts for all of the City’s utilities (including the Storm Drain System, the Refuse System and the Wastewater Treatment System).

The Utilities Department is currently staffed by the following individuals, among others:

Valerie Fong, Director of Utilities. On October 16, 2006, the City appointed Valerie Fong as Director of Utilities. Ms. Fong began her career with PG&E working on various gas and electric procurement and regulatory matters of increasing responsibility, including working with customers in the company’s field offices, testifying in regulatory proceedings, negotiating long-term procurement contracts, and overseeing the development and management of the company’s electric and gas core customer procurement portfolios. She was at PG&E for 22 years. Subsequently, she worked for the City of Alameda for over four years, where she was the Utility Services Manager, and later, the General Manager over the utility’s two business lines, the electric and the telecommunications businesses. Ms. Fong earned a Bachelor’s Degree in civil engineering from the University of California, Berkeley and is a registered professional engineer in the State of California

Tom Auzenne, Assistant Director of Utilities, Customer Support Services. Tom Auzenne has 19 years of utility experience with PG&E, and 14 years with the City’s Utilities Department. At PG&E he held positions in Gas and Electric Operations, Gas Transmission, Customer Services, Marketing, and Governmental Affairs. At the City, he has been the Utilities Marketing Manager and Assistant Director. The Customer Support Services Division comprises 35 full-time equivalent staff divided into: (a) marketing, which implements efficiency programs, sells fiber optic connectivity, and provides key account management services; (b) customer service, providing call center services, credit and collection activities, meter reading, and utilities billing; and, (c) utilities rates, which provides long-term financial forecasting, and establishes rates and reserve requirements for the City’s Utilities Department for the water, electricity, natural gas, fiber optic and wastewater collection business lines. Mr. Auzenne received a Bachelor’s degree from San Francisco State University.

Tomm Marshall, Assistant Director of Utilities, Engineering. Mr. Marshall graduated from Washington State University in 1976 with Bachelors of Science in Electrical Engineering. He began work in distribution engineering with Pacific Gas and Electric Company in 1980. At Pacific Gas and Electric he worked in the Electric Distribution Engineering, System Protection Engineering, Substation and Transmission Regional Operations, working primarily on capital project justification and implementation, and operational and maintenance issues with the electric system. In 1993, he started a job at the consultant firm of Enertech Consultants where he worked on research and operational projects related to Electromagnetic Fields. In 1995, he became the Electric Engineering Manager for the City where he was responsible for the planning design and implementation of the capital improvement projects. Currently, as Assistant Director of Engineering for the City, he is responsible for the planning design and implementation of the capital improvement projects for the Electric, Water, Gas and Wastewater Utilities.

Jane Ratchye, Assistant Director of Utilities, Resource Management. Ms. Ratchye first came to the City in 1985 as an account representative advising large customers on how to reduce peak electrical demand and save energy. She then worked on the design and evaluation of efficiency programs and in the supply side resource planning area for water, gas and electricity. She has worked on many areas of supply portfolio management, integration of demand- and supply-side resources, and the initiation of the City's gas and electric commodity risk management program. As Assistant Director for Resource Management, Ms. Ratchye is responsible for the management and contracting of the electric, gas, and water supplies for the City, legislative advocacy, representation in regulatory proceedings, coordination with joint action agencies, and rate setting and financial reserve management for the Utilities Department. Ms. Ratchye holds a Bachelor of Science degree in Mechanical Engineering and a Master of Science degree in Engineering-Economic Systems, both from Stanford University.

Dean Batchelor, Assistant Director of Utilities, Operations. Mr. Batchelor has 27 years of experience in utility operations and holds a Bachelors of Arts degree in Business from Long Beach State. He has extensive experience in telecommunications, gas and electrical operations. From 1982 to 1997, he worked for Pacific Gas and Electric in the Gas and Electric distribution systems. He joined TCI/AT&T in 1997 as the operations Manager where he oversaw the installation, construction, maintenance and engineering of many CATV-HSD plants. In 2002, he started with the City of Alameda as the CATV Operational Superintendent including coordinating the work of technicians engaged in construction, maintenance and operation of the plant, head-end and ensuring optimum customer service. In 2005, he became the Operations Manager where he was responsible for electric utility transmission, substations, distribution system and the CATV system. In October of 2008, he joined the City as the Assistant Director of Operations where he is in charge of administrative activities, operations and maintenance planning that include the water, gas, and electric receiving facilities, water transmission facilities, the water, gas and electric distribution systems and the wastewater collection system.

Enterprise Staffing and Technology

The City employs approximately 229 full-time equivalent employees to operate its utilities. All of these employees, excluding those in the management classification, are represented by Service Employees International Union ("SEIU") in all matters pertaining to wages, benefits and working conditions. The current two-year agreement with this union, which is in the form of a memorandum of understanding, expired on June 30, 2009. The City and SEIU are negotiating a new agreement. Management employees receive substantially the same fringe benefit package as the SEIU members. The City's wage and fringe benefits are generally comparable to those offered by other local public agencies.

The City covers all of its permanent employees under the Public Employees' Retirement System ("PERS"). Pension costs are co-funded by monthly contributions to PERS by the City and its employees. At June 30, 2006 (the most recent actuarial information available), the total pension benefit obligation for all City employees was \$593,960, net assets available for plan benefits were \$526,576 and the total pension benefit obligation exceeded the City's net assets available for plan benefits by \$67,384.

Enterprise Management Policy

Treated as enterprise funds, the Electric, Gas, Refuse, Water, Fiber Optics. Sewer and Storm Drain Systems are financed and operated in a manner comparable to private business enterprises. The City utilizes a Strategic Planning process in concert with its annual budget to

identify and record progress in meeting benchmark goals and objectives. In addition, business plans are developed on an annual basis for the Water, Gas, Electric and Wastewater Collection Systems. For the Gas and Electric Systems, separate business plans are developed for the supply and distribution business units.

The City uses the accrual basis of accounting with respect to the enterprise funds. Revenues are recognized when earned, and expenses are recognized when incurred. Utility revenues are used to pay operating costs, bond debt service, most capital expenditures, and reserve accumulations. In accordance with City policy, the cost of providing utility services to the general public continues to be funded predominately through user charges. Policies for cash reserves and Utilities Transfers to the City's General Fund (which are transferred from the Gas and Electric Systems only) are established by the City Council in a manner consistent with the voter-approved City Charter. Transfers to the General Fund are based on the approved rate of return for comparable public utilities.

The methodology used to calculate the transfers to the General Fund is a "Return on Rate Base" method which requires an annual calculation of the "rate base" for the Electric and Gas Funds. The "rate base" for the Electric and Gas Funds includes (1) the net asset value of the utility assets as of the latest audited fiscal year; (2) working capital for the supply purchases for the upcoming fiscal year; (3) working capital for non-energy supply operating costs for the upcoming fiscal year; (4) additional capital projects budgeted during the current fiscal year less customer-funded improvements; and (5) depreciation for the current fiscal year. The rate base is adjusted by an appropriate return on equity, equal to PG&E's approved return on equity adjusted downward by 30% to reflect the City's tax-exempt status, and adjusted again by a 15% "risk" adjustment based on the concept that an investment in a municipal utility is less risky than an investment in an investor-owned utility.

The Utilities and Public Works Departments are expected to continue meeting all of their financial obligations while charging retail rates to their customers that are comparable to those charged in neighboring cities. Careful budgeting and sound financial planning have been and will continue to be important factors in maintaining competitive rates. The Utilities Department recognizes the importance of minimizing wholesale commodity costs which is the largest expenditure category. Much time and effort are spent in dealing with the various commodity suppliers, regulatory agencies and commissions to help ensure reasonable and economical wholesale commodity costs.

Rates and Billing

The City Council has full discretion to set utility rates for each utility system. The City's rate-making objectives are "to price utilities competitively, consistent with sound financial planning, while promoting efficient resource utilization and customer satisfaction." To achieve an appropriate balance between these objectives, the City forecasts all financial obligations and funding sources over a five year planning horizon. In this manner, timely rate adjustments for all utilities are coordinated and alternated to assure adequate funding, minimize consumer impacts, and promote rate stability. To provide for rate stability and to insure funds are available to cover any unforeseen cost contingencies, Rate Stabilization Reserves are funded from surplus net sales revenues and withdrawn in subsequent periods to supplement retail sales revenue as needed.

The City collects utility charges by means of a single monthly bill to each customer, listing charges for each service provided. Uncollectible accounts for all utilities average approximately 0.16% of the amount billed. In 2007, the City Council approved a project to implement a new utilities customer information system using SAP. The system was successfully implemented in May 2009, and it allows for the billing of utilities customers. It

also provides customer service staff with secure online access to customer information and gives customers the choice to pay their bill online.

Reserve Policies

In 1993, 1998, 2001, 2003, 2007 and again in 2009, the City Council established new utility rate stabilization reserve policies and guideline levels. See “AVAILABLE RESERVES” below. On an annual basis, operating reserves are funded, withdrawn, or unchanged depending on the particular circumstances of that utility fund.

In 1996, the City Council adopted the Calaveras Reserve Policy, which established a reserve balance to recover potential stranded costs related to outstanding obligations for the Calaveras Hydroelectric Project and other assets whose costs were above market values such as the California Oregon Transmission Project and the Seattle City Light Energy Exchange Contract. This policy initially required an annual review of the stranded cost issue and an update of the underlying assumptions to calculate stranded costs. An updated cost calculation performed in 1999, which took into account a refinancing of the Calaveras Reserve by the Northern California Power Agency, resulted in a target balance of \$65 million to be achieved by December 31, 2001. This target was in fact achieved during Fiscal Year 2000-01. This reserve balance was planned to gradually decline through Fiscal Year 2031-32. Each year, the Calaveras Reserve accrues interest income which is added to the year-end reserve balance.

In May 2009, the City Council revised the Calaveras Reserve Policy. Under the new policy, the stranded costs are to be reviewed and recalculated annually during the budget process to set a minimum transfer from the Calaveras Reserve to the Electric Supply Operating Budget. The review also includes a recalculation of the stranded cost over the long-term (until 2032 when the Calaveras debt is paid off) of the electric supply portfolio to determine the sufficiency of the Calaveras Reserve balance to cover that amount. To the extent funds are available in excess of long-term stranded cost needs, the City Council may consider and approve projects funded by the Calaveras Reserves which will benefit electric ratepayers.

Following the electric deregulation in 1997, the City Council unbundled electric rates into the cost components of distribution, power supply, transition, cost recovery and public benefits. Because of the need to recover costs and capture revenues for specific business activities, the rate stabilization reserve for the Electric System was replaced with two separate reserves for distribution and supply services. Similarly, the City Council separated its single rate stabilization reserve for the Gas System into two separate reserves.

In 1998, 2001, 2003, 2007, and 2009, the City Council adopted various updated guidelines for the rate stabilization reserves. The 2009 rate stabilization reserve guidelines incorporate the following:

- * For the Electric Distribution and Gas Distribution Rate Stabilization Reserves, the minimum and maximum guideline levels are equal to 15% and 30% of the annual distribution sales revenues respectively;
- * For the Water and Wastewater collection Rate Stabilization Reserves, the minimum and maximum guideline levels equal 15% and 30% of annual budgeted sales revenues respectively;
- * For the Electric Supply Rate Stabilization Reserve, the minimum and maximum guideline levels equal 50% and 100% of supply purchase costs, respectively (unchanged from 2007);
- * For the Gas Supply Rate Stabilization Reserve, the minimum and maximum guideline levels equal 25% and 50% of supply purchase costs, respectively.

Annual Financial Statements and Significant Accounting Policies

The City's annual financial statements are audited by Maze & Associates, Accountancy Corporation, Walnut Creek, California, in accordance with generally accepted auditing standards and the standards for financial audits issued by the Comptroller General of the United States. The Maze & Associates audit report contains opinions that the financial statements present fairly the financial position of the various funds maintained by the City. The annual financial statements include certain notes which may not be fully described in this Official Statement, but which constitute an integral part of the audited financial statements.

The City's most recent annual financial statement is attached as APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008." Copies of prior reports are available on the City's website (http://www.cityofpaloalto.org/depts/asd/financial_reporting.asp) or upon request to the Administrative Services Department, City of Palo Alto, 250 Hamilton Avenue, Palo Alto, CA 94301.

Governmental accounting systems are organized and operated on a fund basis. A fund is defined as an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein. Funds are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations and restrictions.

As indicated above, the various Systems are accounted for as enterprise funds. Enterprise funds are used to account for operations (i) that are financed and operated in a manner similar to private business enterprises (where the intent of the governing body is that the costs and expenses, including depreciation, of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges), or (ii) where the governing body has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate for capital maintenance, public policy, management control, accountability or other purposes.

The City's enterprise funds are accounted for using the accrual basis of accounting. Each fund's revenues are recognized when they are earned, and their expenses are recognized when they are incurred, except for revenues from utility customers, which are recognized based on cycle billings. Revenues for services provided but not billed at the end of a fiscal period are not material and are not accrued.

The City has not requested nor did the City obtain permission from Maze & Associates to include the audited financial statements as an appendix to this Official Statement. Accordingly, Maze & Associates has not performed any post-audit review of the financial condition or operations of the City.

THE WATER SYSTEM

History

When the City was incorporated in 1894, the majority of its population was served by private water companies that drew their supply from relatively shallow wells. In 1896, a bond issue was approved for purchase by the City of these private water companies. In succeeding

years, additional purchases completed the acquisition of privately owned facilities. Deep wells provided water to the gradually increasing population until 1938, when the decline of the groundwater table necessitated the purchase of imported water. Thereafter, the City's growing demand was met with increasing water supplies from the Public Utilities Commission of the City and County of San Francisco (the "SFPUC"), through a 36-inch pipeline. In 1962, in order to provide a very high quality of water to its customers, the City began supplying 100% of its water from the SFPUC. Approximately 85% of the SFPUC supply is derived from snowfield run-off to the Hetch Hetchy Reservoir in Yosemite National Park, and the remaining 15% is derived from rainfall run-off stored in San Francisco's East Bay and Peninsula Reservoirs. Over the years, the City has added three additional SFPUC pipeline connections.

As the population grew in the 1930s, 1940s and 1950s, the City issued bonds to finance the necessary water distribution system expansions and improvements. This policy was changed in the 1960s to a "pay as you go" funding approach, whereby current revenues were raised to accommodate capital improvement projects.

Service Area

The City is the primary provider of water service within its incorporated limits and on other land owned or leased by the City. The City's service area encompasses approximately 26 square miles.

Water Storage and Distribution System

The City's water distribution system distributes potable water throughout the City to meet residential, commercial, industrial, irrigation and other water demands. The City operates five connections or turnouts from the SFPUC's Hetch-Hetchy system. Pursuant to the City's Rule and Regulation 3, the distribution system pressures vary between 30 and 125 pounds per square inch; an average of 50 pounds per square inch will be maintained, with the maximum and minimum pressures being experienced at the lower and higher elevations of the distribution system. The City's water system is presently comprised of 214 miles of mains ranging in pipe diameter sizes from 4" to 30" serving nine pressure zones spanning 26 square miles. The City also operates five turnouts with SFPUC, five booster pump stations and six storage reservoirs ranging from 1.0 MG to 4.0 MG (with a total storage capacity of 10.5 MG). City water is distributed to approximately 19,500 metered connections.

Sources of Water Supply

The City's current potable water supply consists entirely of purchased water from the SFPUC's Hetch Hetchy system. The City also maintains interconnections with four neighboring water distribution systems, as well as five deep wells, which are available on an emergency basis. The sources of supply are further described below.

SFPUC's Hetch Hetchy System. The SFPUC's water supply originates in the Hetch Hetchy reservoir and surrounding watersheds located in and around Yosemite National Park. Water flows by gravity across the California central valley to Sunol, where it is blended with water from local reservoirs, and is then pumped across the Hayward fault and through the Irvington Tunnel. There the SFPUC's Bay Division pipelines Number 1 and 2 carry water across the San Francisco Bay to Redwood City and to the Palo Alto Pipeline, which carries water south to three of the City's water turnouts at Sand Hill Road, Lytton Avenue and California Avenue. SFPUC Bay Division Pipelines Number 3 and 4 carry water around and below the southern end of San Francisco Bay to the City's other two connections to the SFPUC.

system at Arastradero Road and Page Mill Road. The resulting blend of water represents approximately 85% Hetch Hetchy water and 15% local reservoir water.

The City has two 25-year water delivery contracts with the SFPUC, both of which were executed in June 2009: (i) a “Water Supply Agreement,” which is a master agreement between the City and County of San Francisco and the 27 wholesale customers (the “Suburban Purchasers”), and (ii) an Individual “Water Sales Contract.” The contracts contain provisions for adjusting wholesale water rates to match changing wholesale revenue requirements of the SFPUC on a periodic basis.

The Water Supply Agreement guarantees a maximum supply of 184 million gallons per day (the “Maximum Supply Assurance”) collectively to all of the SFPUC’s wholesale customers. In 2009, the SFPUC and the wholesale customers agreed to maintain the existing allocation methodology that divides the Maximum Supply Assurance among the individual Suburban Purchasers. The City’s Maximum Supply Assurance share is 17.075 million gallons per day, or 8,333,000 hundred cubic feet (ccf) per year¹. In Fiscal Year 2007-08, the SFPUC delivered an average of approximately 12.72 million gallons per day to the City, or a total of approximately 6,205,790 hundred cubic feet.

The Water Supply Agreement provides that the amount of water made available to the Suburban Purchasers is subject to reductions due to water shortage, drought, earthquakes, other acts of God, or rehabilitation or malfunctioning of the SFPUC’s water delivery system.

On October 30, 2008, the SFPUC approved the Water System Improvement Program (WSIP), a long-range financial plan and capital improvement plan to address capital improvement needs and priorities for its water enterprise, which are intended to replace old systems or upgrade systems to improve reliability and meet future customer needs. The WSIP will be debt funded. The total estimated cost of the WSIP, which includes the SFPUC infrastructure to serve the City of San Francisco and the 27 wholesale customers, including inflation and contingencies, is approximately \$4.5 billion. The new contracts specify the repayment method and the amount that is to be borne by the wholesale customers (including the City).

The City’s cost of water purchased from the SFPUC has increased in recent years as a result of rising operations and maintenance costs of the aging water delivery systems that transport SFPUC water. It is anticipated that purchased water costs will continue to increase as the WSIP is implemented. SFPUC wholesale water rates for Fiscal Year 2007-08 were \$1.30 per hundred cubic feet. Recent SFPUC wholesale water rate projections indicate that wholesale rates are expected to increase to \$3.57 per hundred cubic feet by Fiscal Year 2015-16.

The SFPUC adopted a capital program to repair and upgrade the regional water system that serves the City and other Bay Area communities. The SFPUC’s Water System Improvement Program (WSIP) consists of projects that are designed to increase the reliability of the regional system, especially if subjected to a large earthquake. According to the SFPUC, the objectives of the WSIP include:

- Improve the system to provide high-quality water that reliably meets all current and foreseeable local, State, and Federal requirements.
- Reduce vulnerability of the water system to damage from earthquakes.

¹ 1 ccf equals 748 gallons

- Increase system reliability to deliver water by providing the redundancy needed to accommodate outages.
- Provide improvements related to water supply/drought protection.
- Enhance sustainability through improvements that optimize protection of the natural and human environment.

Prior to completion of the WSIP, the SFPUC's studies showed that the service area could be without water for up to 60-days after a major earthquake. The 50 WSIP projects for the regional system include replacement of some sections of pipeline, replacement of pump stations, upgrades to water treatment plants, new pipelines, dam and reservoir improvements, control system upgrades, large valve replacements, and fisheries enhancements.

Wholesale water prices have increased over the past five years as the SFPUC has started the planning, environmental review and design stage for many of the WSIP projects. The wholesale water rates for the past five years are as follows:

<u>Fiscal Year</u>	<u>Rate per CCF</u>
2005	\$1.13
2006	\$1.02
2007	\$1.22
2008	\$1.30
2009	\$1.43

The latest forecast of wholesale water prices from the SFPUC incorporate the expected cost and schedule for the WSIP. The price forecast is as follows:

<u>Fiscal Year</u>	<u>Rate per CCF</u>
2010	\$1.65
2011	\$1.95
2012	\$2.28
2013	\$2.76
2014	\$3.14
2015	\$3.41
2016	\$3.57
2017	\$3.55
2018	\$3.57
2019	\$3.59

Interconnections with Neighboring Systems. The City maintains interconnections with four neighboring water distribution systems: Mountain View, the Stanford University campus, Purissima Hills Water District, and East Palo Alto. These interconnections are available for use in cases of water distribution system emergencies.

Emergency Wells. The City maintains five existing deep wells, which could supply a portion of the service area's needs on an emergency basis. It is anticipated that these existing wells, plus the three new wells the City plans to build over the next five years, could provide a near-normal water supply during an extended SFPUC water supply interruption.

Water Wells, Regional Storage and Distribution System Study. Due to the critical need to ensure sufficient water supplies are provided under emergency conditions, in accordance with City Council Direction, the City is accelerating the implementation of the recommendations of the Water Wells, Regional Storage and Distribution System Study, completed in 1999, over the

next five fiscal years. This study identified system deficiencies and recommended capital improvements to improve the operation and reliability of the City's water distribution system, particularly during emergency situations. The City's five existing wells will be rehabilitated or rebuilt. Three new wells will also be constructed. A new reservoir and pump station at El Camino Park as well as an augmentation to an existing pump station at Mayfield will be constructed to allow the City to supply near-normal levels of water supply during SFPUC water supply interruptions. Five booster pump stations have been rehabilitated in the Foothills to improve water conveyance efficiency. These planned improvements are projected to maintain the City's water supply capacity at nearly normal usage levels on a continuous basis for the duration of many long-term emergency scenarios, some lasting 90 days or longer. In addition, the wells could be used as supplemental supplies in protracted drought conditions when conservation efforts and SFPUC supplies were not sufficient to meet demands.

Recycled Water Project

The City completed a Water Reclamation Master Plan (Master Plan) for the Palo Alto Regional Water Quality Control Plant (RWQCP) in 1992 and an accompanying Final Program Environmental Impact Report (PEIR) in 1995. The Master Plan and the PEIR evaluated the development of a regional water reuse system that could ultimately provide service to the entire RWQCP service area. Benefits of a regional water reuse system include reduced effluent discharge from the RWQCP into San Francisco Bay and reduced reliance on potable water deliveries from the Hetch Hetchy system. The Master Plan includes a phased approach to the expansion of treatment, distribution, storage and use of recycled water. Phase 1 of the regional recycled water system has been in operation since 1980. It currently serves the Palo Alto Golf Course, Greer Park, the Emily Renzel Marsh, the Duck Pond, and the RWQCP. Construction of Phase 2, the Mountain View Recycled Water project, is almost complete and the project is scheduled to be online in the next few months. The Palo Alto Recycled Water Project, which would expand the recycled water distribution system to serve additional customers in Palo Alto, is Phase 3 of the RWQCP's ongoing expansion of its regional recycled water system.

The City is currently investigating the feasibility of constructing the Phase 3 project. The City completed a market survey in June 2006 to update the cost estimate and potential users for the project. Subsequently, the City completed a Recycled Water Facility Plan in December 2008, which provided further detail regarding potential project cost and potential recycled water use. The project would primarily serve irrigation customers within the City, with an initial yield of approximately 900 acre feet per year of recycled water. The Facility Plan identified a target recycled water use area, the Stanford Research Park, and a pipeline alignment for the project that would connect to the Phase 2 project. The projected capital cost estimate for the Phase 3 project is \$33 million.

The City is preparing the project level environmental document for the project and has involved stakeholders from the community and the potential end use customers and landowners in the Stanford Research Park. One of the issues identified in the environmental review phase is the salinity of the recycled water, which may negatively impact vegetation that would be irrigated with the recycled water.

Another issue is the high cost of the project. The City is investigating many funding options for the project, including state and federal grant and loan programs. The City is currently seeking federal authorization for a grant award of \$8.25 million under the Bureau of Reclamation Wastewater and Groundwater Study and Facilities Act of 1992 (Title 16). The City is also applying for a low interest State Revolving Fund (SRF) loan from the State Water Resources Control Board for the project. Under this program, eligible projects can apply for loans with interest rates that are roughly half of the State general obligation bond rate. If the City is unsuccessful in obtaining an SRF loan, it is possible that the City could finance the

Project with a traditional debt issuance. If the City is successful in obtaining an SRF loan, it would be subordinate to the current bond issuance. At this time, the City Council has not decided to go forward with the Phase 3 Recycled Water Project. A decision to proceed could be made as soon as the fall of 2009, but many details regarding completion of the environmental document, potential state and federal funding, salinity management, and recycled water rate design remain to be determined.

If the project did proceed, potable water sales volumes would decrease and less potable water supplies would be purchased from the SFPUC. Since wholesale water costs are only a portion of the total water utility cost, the remaining water utility costs would be borne by fewer customers resulting in upward pressure on retail potable water rates. Recycled water retail rates have not been developed, but are typically set to an amount equal to about 75% of potable water retail rates. Providing a discount for recycled water users may result in a small upward impact on potable water rates, but this is not expected to be a large impact at this time.

Water Conservation Policies and Procedures

The City Council adopts an Urban Water Management Plan (UWMP) every five years. The latest UWMP was adopted in December 2005. The 2005 UWMP contains the Urban Water Shortage Contingency Plan, which describes what the City would do in case of a water supply shortage. The plan describes a set of activities that would need to be done to implement various stages of a water supply shortage. There are four water shortage stages culminating in Stage IV, a critical water shortage where water supplies are reduced by 35% to 50%. The actions taken to respond to the water shortage stages include outreach campaigns, water audit programs, stepped-up incentive programs for customers to install water efficient appliances, implementation of water use restrictions, modifications of water rate structures or rationing programs, and the use of groundwater as a supplemental supply. In a water shortage situation, the City would select the appropriate mix of actions to respond to the severity of the water shortage.

The City has had extensive experience implementing programs to reduce customer use of water in water shortage situations. In the last extended water shortage from 1988 through 1992, the City reduced water consumption by over 35% from pre-drought consumption levels. Water consumption has not returned to the levels that existed prior to that water shortage and the City believes that future water reductions are unlikely to be as dramatic in a future drought.

Historical Production and Deliveries

The following table sets forth a five-year history of water purchased from the SFPUC and delivered to customers in the Water System's service area.

Table 1
WATER PURCHASES AND SALES
(in hundreds of cubic feet)
Fiscal Years 2004-05 through 2008-09

	2004-05	2005-06	2006-07	2007-08	2008-09
Wholesale Water Purchases	5,896,965	5,802,911	6,361,100	6,205,790	6,207,836*
Retail Water Sales	5,331,324	5,208,903	5,480,603	5,526,644	5,533,352*

* Estimated

Source: City of Palo Alto, Utilities Department.

Environmental Issues Relating to the Water System

The Utilities Department reports that no environmental issues exist that are anticipated to materially affect the Water System.

Capital Improvement Program Summary

The City currently projects that it will undertake capital improvements to the Water System for the next ten fiscal years in the aggregate amount of approximately \$80 million. The City intends to use a portion of the proceeds of the 2009 Bonds to finance a portion of these projects through fiscal year 2012, together with certain engineering, design and related costs previously incurred with respect to Water System improvements, for a total of approximately \$30,965,000. See "FINANCING PLAN." The City currently intends to finance the remaining projects with available Water Fund revenues on a pay-as-you-go basis, and not through the issuance of additional bonds or other debt instruments. The following table displays these projects and highlights those that are intended to be financed from the proceeds of the 2009 Bonds.

Table 2
TEN YEAR CAPITAL IMPROVEMENT PROGRAM SUMMARY

<u>Project</u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>	<u>2018-19</u>	<u>Total</u>
El Camino Park Reservoir and Pump Station Reservoir, Pump Station, and Well Land Acquisition and El Camino Park Relocation	3,006,725	\$2,500,000 1,500,000	\$7,364,643	\$7,364,643	\$3,682,321							\$20,911,607 4,506,725
El Camino Park Well		400,000	490,191	490,191	245,096							1,625,478
Mayfield Pump Station		750,000	2,207,793	2,207,793	1,103,896							6,269,482
Eleanor Pardee Park Well	273,000	1,000,000										1,273,000
Community Garden Well	273,000	1,000,000										1,273,000
Existing Well Rehabilitation			1,716,283	1,716,283	858,142							4,290,708
Sub-total	\$3,552,725	\$7,150,000	\$11,778,910	\$11,778,910	\$5,889,455							40,150,000
Financed from (Pay-As-You-Go) Capital Improvement Project Funds												9,185,000
Amount to be Bond Financed												\$30,965,000
Arastradero Creek Access Road Paving Maintenance (annual, ongoing)	\$22,100	\$23,133	\$24,183	\$25,233	\$26,283	\$27,333	\$28,383	\$29,433	\$30,483	\$31,533	\$32,583	\$300,683
Water Regulation Station Improvements	40,000	320,000	710,000	70,000	80,000	90,000	100,000	110,000	120,000	130,000	140,000	1,030,000
WGWI Utility GIS Data		50,000	60,000						395,000	415,000	3,750,000	990,000
Water Main Replacements Phase 32								375,000	3,550,000	3,650,000		4,165,000
Water Main Replacements Phase 31								3,450,000				4,045,000
Water Main Replacements Phase 30												3,925,000
Water Main Replacements Phase 29												3,805,000
Water Main Replacements Phase 28												3,625,000
Water Main Replacements Phase 27					325,000	340,000	355,000	3,450,000				3,455,000
Water Main Replacements Phase 26				307,000	2,980,000	3,130,000	3,285,000					3,287,000
Water Main Replacements Phase 25			292,000	2,835,000							435,000	3,127,000
Water Main Replacements Phase 33												435,000
Water Main Replacements Phase 21	2,700,000											2,700,000
Water Main Replacements Phase 22	233,000	2,500,000										2,733,000
Water Main Replacements Phase 23	240,000	2,600,000										2,840,000
Water Main Replacements Phase 24		292,000										2,992,000
Seismic Water Tank Valve		250,000	550,000									800,000
Four Steel Reservoir Interior and Exterior Coating		250,000	1,800,000									2,050,000
Water System Portable Emergency Generators	134,000	136,000	138,000	140,000	142,000	144,000						834,000
Service and Hydrant Replacement	146,000	149,000	152,000	155,000	158,000	161,000	164,000	167,000	170,000	173,000	176,000	1,771,000
Water Meters	197,000	203,000	209,000	215,000	221,000	227,000	233,000	239,000	245,000	251,000	257,000	2,497,000
Sub-total	3,712,100	6,773,133	6,635,183	3,747,233	3,932,283	4,119,333	4,165,383	4,370,433	4,510,483	4,650,533	4,790,583	51,406,683
Distribution System - Customer Design and Connection Services												
Water System Extensions	343,000	353,000	364,000	373,800	384,000	394,200	404,400	414,600	424,800	435,000	445,200	4,336,000
Full Reimbursement by Customer (Revenues)	(843,000)	(853,000)	(864,000)	(873,800)	(884,000)	(894,200)	(904,400)	(914,600)	(924,800)	(935,000)	(945,200)	(9,836,000)
Sub-total Distribution System	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(5,500,000)
Total Water Projects (Net)	\$6,764,825	\$13,423,133	\$17,914,093	\$15,026,143	\$9,321,739	\$3,619,333	\$3,665,383	\$3,870,433	\$4,010,483	\$4,150,533	\$4,290,583	\$86,056,683

Source: City of Palo Alto Utilities Department

Water Rates, Fees and Charges

Rate Setting Process. Water rates are based entirely on the City's costs of purchased water and operating and maintaining the Water System. Purchased water costs comprise 26% of the Water System's budget. The City receives annual cost projections from its water wholesaler, SFPUC. To establish retail rates, these supply costs are added to other expense requirements related to operation of the water distribution system, including the payment of any outstanding debt and the funding of reserves.

Historical and Current Rate Increases. The City has historically adjusted water rates as necessary for each customer class. The most recent increase of 5% was adopted on June 15, 2009 for fiscal year 2010. The following table sets forth a five-year history of water rate increases.

Table 3
HISTORIC WATER RATE INCREASES FOR ALL CUSTOMER CLASSES

Year	Increase
2004-05	10.3%
2005-06	—
2006-07	7%
2007-08	10%
2008-09	8%
2009-10	5%

Source: City of Palo Alto, Utilities Department.

Water Rate Structure. Water rate schedules are established for residential and non-residential (commercial and industrial) users. Prior to Fiscal Year 2006-07, water rate structures consisted of only a variable (volumetric) water usage charge. Since Fiscal Year 2006-07, both customer classes have both a fixed monthly service charge and a variable water usage charge. The fixed charge is based on the size of the meter serving the customer. The volumetric component of the residential rate schedule consists of rate or usage blocks that ascend in price as consumption increases. The volumetric component of non-residential users (including public facilities) does not have usage blocks.

The following tables set forth the Water System rates for the past five fiscal years. Water Rate Structure (1) shows the volumetric component, and water rate structure (2) shows the Fixed Charge Component. Fiscal Year 2008-09's rate structure was approved on June 9, 2008. The rates shown below are per hundred cubic feet (ccf) of water usage.

Table 4
WATER RATE STRUCTURE (1)
Volumetric Component
Fiscal Years 2004-05 through 2008-09
(per ccf)

User type and Monthly Rate Block	2004-05	2005-06	2006-07	2007-08	2008-09
Residential:					
0-7 ccf	\$3.707/ccf	\$3.707/ccf	\$4.04/ccf	\$3.949/ccf	\$3.949/ccf
over 7 ccf	\$4.025/ccf	\$4.025/ccf	\$4.27/ccf	\$4.510/ccf	\$5.164/ccf
Industrial/Commercial:	\$4.025/ccf	\$4.025/ccf	\$4.25/ccf	\$4.341/ccf	\$4.697/ccf

Source: City of Palo Alto, Utilities Department.

Table 5
WATER RATE STRUCTURE (2)
Fixed Charge Component
In Effect Since Fiscal Year 2007-08
(per meter)

Meter Size	Monthly Customer Charge (\$)
5/8-inch meter	5.00
3/4 inch meter	5.00
1 inch meter	6.50
1 1/2 inch meter	12.27
2-inch meter	19.37
3-inch meter	77.65
4-inch meter	130.60
6-inch meter	260.43
8-inch meter	383.67
10-inch meter	383.67

Source: City of Palo Alto, Utilities Department.

Projected Rates. The City's water rates will increase by 5% in fiscal year 2009-10 and are projected to increase by 7%, 8%, 9% and 9% per year for each of the following 4 years, respectively. These projected rate increases could change depending on the future projections, and will largely depend on the future costs of purchased water.

Comparative Monthly Water Rates. The table below shows comparative monthly residential water bills for a usage rate of 14 hundred cubic feet by water suppliers serving neighboring communities for fiscal year 2008-09.

Table 6
COMPARATIVE RATES FOR AVERAGE MONTHLY RESIDENTIAL SERVICE
Fiscal Year 2008-09

Water Provider	Average Monthly Rate (1)
Mountain View	\$43.54
Redwood City	\$50.72
Menlo Park	\$54.28
Millbrae	\$67.10
Palo Alto	\$68.79
Burlingame	\$76.82
Average excluding Palo Alto	\$58.49

Source: City of Palo Alto, Utilities Department.

(1) Represents rate for typical residential users based on consumption of 14 ccf plus a service charge for a 5/8" meter.

Water Demand and Customer Base

On average, the City's water customers consume 11.3 million gallons of water per day. However, demand rises and falls depending on the season, with the summer months showing high consumption and the fall and winter months lower consumption. In fiscal year 2008-09, the Water System sold approximately 5,533,352 cubic feet of water to approximately 19,359

users. (This amount is lower than water purchased from the SFPUC due to water losses in the storage and transmission systems, billing period differences and unmetered water uses.)

The following table sets forth a five-year history of the number of accounts for the Water System.

Table 7
NUMBER OF ACCOUNTS
As of June 30, 2004-05 through 2008-09

Fiscal Year	Number of Accounts
2004-05	19,208
2005-06	19,347
2006-07	19,406
2007-08	19,336
2008-09 *	19,359

Source: City of Palo Alto, Utilities Department.

* Estimated

The following table shows billing amounts, water consumption in hundred cubic feet by customer type, and water consumption as a percentage of total consumption by type of customer for active water accounts during fiscal year 2008-09.

Table 8
SUMMARY OF WATER ACCOUNTS AND USAGE BY USER TYPE
Fiscal Year 2008-09*
(Dollars in Thousands)

User Type	Number of Accounts	Billings	Consumption (in ccf)	Consumption as Percent of Total
Single Family Residences	14,727	\$12,561	2,567,054	46.4%
Apartments	2,232	4,149	841,806	15.2%
Commercial/Industrial	2,005	7,863	1,614,605	29.2%
Other	395	2,451	509,887	9.2%
Total	19,359	\$27,024	5,533,352	100.0%

Source: City of Palo Alto, Utilities Department.

*Estimated

Largest Water Customers. For Fiscal Year 2007-08, total consumption was 5,526,644 ccf, and total operating revenues were \$26,510,000. The ten largest customers accounted for approximately 18.4% of total consumption and 18.1% of total operating revenue. The largest customer (other than the City) accounted for 3.2% of total consumption and 3.1% of total operating revenue.

The following tables lists the ten largest customers of the Water System for fiscal year 2007-08:

Table 9
TEN LARGEST CUSTOMERS
Fiscal Year 2007-08

Rank	Primary Business Activity	Billings	% of Total	Consumption (in ccf)	% of Total
1	Government	\$1,510,714	5.7%	316,766	5.7%
2	Medical	815,012	3.1	176,849	3.2
3	Recreation	461,530	1.7	100,489	1.8
4	Education	443,019	1.7	91,281	1.7
5	Medical	415,539	1.6	89,410	1.6
6	Retail	312,234	1.2	62,409	1.1
7	High Tech	235,503	0.9	49,450	0.9
8	High Tech	231,761	0.9	48,251	0.9
9	High Tech	194,127	0.7	42,070	0.8
10	High Tech	191,754	0.7	41,043	0.7
Total Top Ten		\$4,811,193	18.1%	1,018,018	18.4%
Total System		\$26,510,000		5,526,644	

Source: City of Palo Alto, Utilities Department.

Management Discussion of Operations

Utilities Strategic Plan. The City continues to focus on providing a high quality and reliable source of water for its residents and businesses. The four key objectives in the Updated Utilities Strategic Plan that the City Council approved in 2005 are: (1) Enhance customer satisfaction and utility infrastructure; (2) employ balanced environmental solutions; (3) provide fair and reasonable returns to the City and competitive rates to customers through municipal ownership, and (4) ensure a safe and engaged workforce. Based on these objectives, seven separate strategies provide a focus for the Utilities Department to meet these objectives while providing flexibility to succeed in a changing environment. The Utilities Strategic Plan is applicable to Water, Gas, Electric, Wastewater Collection, and Fiber Optics operations.

Water Supply. With regard to water supply, the City's wholesale supplier, the SFPUC, has provided rate projections indicating that the City's wholesale costs will steadily increase over the next six years. This is due to the construction of seismic upgrades to the SFPUC water delivery system. These costs will be borne by the City and County of San Francisco as well as the SFPUC's wholesale customers, including the City.

Sales Revenues. Water sales revenue during the past five years grew from \$20.6 million in fiscal year 2004-05 to \$26.9 million in fiscal year 2008-09. This represents a compound annual growth rate of 5.4% over this period. Water rates did not change in fiscal year 2005-06. In fiscal year 2009-10, water sales revenue is projected to increase 7.55% to recover rising wholesale purchase costs and distribution operating costs, including debt service on the 2009 Bonds. Between fiscal year 2009-10 and fiscal year 2013-14, water rates are projected to increase by 7%, 8%, 9% and 9% annually to offset rising wholesale water purchase costs.

Rate Stabilization Reserves. The Water Fund Rate Stabilization Reserve (W-RSR) balance is budgeted to be \$6.4 million in Fiscal Year 2009-10. See “AVAILABLE RESERVES” for a discussion of the minimum and maximum guideline levels established for each reserve fund.

Capital Improvements. To improve the operation and reliability of the City’s water distribution system, the City’s Capital Improvement Program will be accelerated over the next five years. See “THE WATER SYSTEM—Capital Improvement Program Summary” above.

The projects identified will ensure that water is available during emergencies and plays a vital role in development of the City’s emergency response plans. Emergency Planning was identified as one of the City Council’s top four priorities for 2006 and 2007. These projects also supports Comprehensive Plan Goal N-10, Protection of Life and Property from Natural Hazards, Including Earthquake, Landslide, Flooding and Fire.

Balance Sheet

The following table sets forth the balance sheets of the Water System for the last five fiscal years. These numbers are excerpted from the audited financial statements of the City which were prepared in accordance with generally accepted accounting principles.

Table 10
BALANCE SHEET
Fiscal Years Ended June 30, 2005 through 2009
(Dollars in Thousands)

	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>	(Unaudited) <u>2008-09</u>
<u>ASSETS</u>					
CURRENT ASSETS:					
Cash and Investments	\$20,868	\$18,092	\$20,201	\$24,424	\$24,832
Accounts Receivable (Net)	3,112	3,191	3,490	4,233	4,052
Interest Receivable	239	220	251	272	273
TOTAL CURRENT ASSETS	<u>24,219</u>	<u>21,503</u>	<u>23,942</u>	<u>28,929</u>	<u>29,157</u>
NON-CURRENT ASSETS:					
Property, Plant and Equipment: (net)	<u>48,685</u>	<u>52,960</u>	<u>56,636</u>	<u>59,426</u>	<u>64,276</u>
TOTAL ASSETS	<u>72,904</u>	<u>74,463</u>	<u>80,578</u>	<u>88,355</u>	<u>93,433</u>
<u>LIABILITIES</u>					
Accounts Payable and Accrued Liabilities	11,583	11,601	11,068	11,449	10,387
Accrued Salaries and Benefits	207	58	192	81	(14)
TOTAL LIABILITIES	<u>11,790</u>	<u>11,659</u>	<u>11,260</u>	<u>11,530</u>	<u>10,373</u>
<u>FUND EQUITY</u>					
Investment in capital assets, net of related debt	38,642	43,259	47,226	49,599	54,797
Restricted for Debt Service	788	780	780	780	780
Unrestricted	21,684	18,765	21,312	26,446	27,483
TOTAL FUND EQUITY	<u>61,114</u>	<u>62,804</u>	<u>69,318</u>	<u>76,825</u>	<u>83,060</u>
TOTAL LIABILITIES AND FUND EQUITY	<u>72,904</u>	<u>74,463</u>	<u>80,578</u>	<u>88,355</u>	<u>93,433</u>

Source: City of Palo Alto Audited Financial Statements, 2005-2008. Figures for 2009 are unaudited.

Historical Operating Results

The following table is a summary of operating results and debt service coverage of the Water System for the last five fiscal years. These results have been derived from the audited financial statements of the City for the four fiscal years ended June 30, 2008. The data for the fiscal year ended June 30, 2009, is unaudited. See APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008."

Table 11
SUMMARY STATEMENT OF HISTORICAL REVENUES, EXPENSES
AND CHANGES IN RETAINED EARNINGS
Fiscal Years 2004-05 through 2008-09
(Dollars in Thousands)

	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>	(Unaudited) <u>2008-09</u>
OPERATING REVENUES:					
Sales of Utilities:					
Customers	\$19,630	\$19,506	\$21,826	\$24,558	\$25,461
City Departments	1,017	924	1,088	1,298	1,468
Service Connection Charge & Miscellaneous	154	228	315	409	325
Other Operating Revenues	240	179	266	245	198
Total Operating Revenues	<u>21,041</u>	<u>20,837</u>	<u>23,495</u>	<u>26,510</u>	<u>27,452</u>
OPERATING EXPENSES:					
Purchase of Utilities	6,719	6,472	7,805	8,363	7,967
Administration and General	2,362	2,776	2,247	2,741	3,183
Engineering (Operating)	189	195	262	359	335
Resource Management	372	464	396	350	397
Operations and Maintenance	3,080	2,875	2,702	3,561	4,167
Rent	1,368	1,506	1,781	1,788	1,919
Depreciation and Amortization	916	995	1,132	1,134	786
Total Operating Expenses	<u>15,006</u>	<u>15,283</u>	<u>16,325</u>	<u>18,296</u>	<u>18,754</u>
Operating Income (Loss)	6,035	5,554	7,170	8,214	8,698
NON-OPERATING REVENUES (EXPENSES):					
Return on Investment	740	437	1,080	1,627	1,788
Interest Expense	(2)	(457)	(454)	(436)	(426)
Capacity Fees	—	271	542	951	523
Loss on Disposal of Fixed Assets	(15)	(148)	—	—	—
Net Non-operating Revenues (Expenses)	<u>723</u>	<u>103</u>	<u>1,168</u>	<u>2,142</u>	<u>1,885</u>
INCOME (LOSS) BEFORE OPERATING TRANSFERS	6,758	5,657	8,338	10,356	10,583
Operating Transfers In	29	20	1,153	200	43
Operating Transfers (Out)	(3,111)	(3,987)	(2,977)	(3,049)	(4,391)
Net Revenue	<u>3,676</u>	<u>1,690</u>	<u>6,514</u>	<u>7,507</u>	<u>6,235</u>
2002 Bonds (Water System Portion)	778	775	775	776	776
Net Revenues Available for Debt Service (1)	4,721	3,771	7,929	8,471	6,812
Debt Service Coverage	6.07x	4.87x	10.23x	10.92x	8.78x

Source: City of Palo Alto

(1) Depreciation, amortization and Interest Expense have been added back.

Projected Operating Results and Debt Service Coverage

The following table is a summary of the projected operating results of the Water System for the fiscal years ending June 30, 2010, through June 30, 2014. The financial forecast represents the City's estimate of projected financial results based upon its judgment of the most probable occurrence of certain important future events. Actual operating results achieved during the projection period may vary from those presented in the forecast and such variations may be material.

Table 12
SUMMARY STATEMENT OF REVENUES, EXPENSES AND FUND BALANCES
Fiscal Years 2007-08 through 2013-14
(Dollars in Thousands)

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
OPERATING REVENUES					
Sales of Water	\$28,948	\$30,972	\$33,460	\$36,483	\$39,794
Connection Fees	405	424	418	413	407
Other Operating Revenues (& Operating Transfers In)	334	338	341	344	348
Total Operating Revenues	<u>29,687</u>	<u>31,734</u>	<u>34,219</u>	<u>37,240</u>	<u>40,549</u>
NON-OPERATING REVENUES					
Interest / Return on Investment	1,223	1,241	1,266	1,294	1,333
Transfers from Rate Stabilization Fund	515	505	520	535	550
Total Non-operating Revenues	<u>1,738</u>	<u>1,746</u>	<u>1,786</u>	<u>1,829</u>	<u>1,883</u>
TOTAL GROSS REVENUES	<u>31,425</u>	<u>33,480</u>	<u>36,005</u>	<u>39,069</u>	<u>42,432</u>
OPERATING EXPENSES					
Purchase of Water	10,354	12,067	14,028	16,907	19,059
Admin & General / Engineering / Resource Mgmt / O&M	9,911	10,023	10,123	10,224	10,327
Rent	2,107	2,107	2,128	2,150	2,171
Depreciation and Amortization	1,000	1,000	1,000	1,000	1,000
Total Operating Expenses	<u>23,372</u>	<u>25,197</u>	<u>27,279</u>	<u>30,281</u>	<u>32,557</u>
NON-OPERATING EXPENSES					
Interest Expense	412	399	384	368	352
General Fund / Other Transfers	258	223	225	228	230
Total Non-Operating Expenses	<u>670</u>	<u>622</u>	<u>609</u>	<u>596</u>	<u>582</u>
TOTAL EXPENSES	<u>24,042</u>	<u>25,819</u>	<u>27,888</u>	<u>30,877</u>	<u>33,139</u>
NET REVENUES	<u>\$7,383</u>	<u>\$7,661</u>	<u>\$8,117</u>	<u>\$8,192</u>	<u>\$9,293</u>
NET REVENUES AVAILABLE FOR DEBT SERVICE (1)	<u>8,795</u>	<u>9,060</u>	<u>9,501</u>	<u>9,560</u>	<u>10,645</u>
2002 DEBT SERVICE	<u>775</u>	<u>775</u>	<u>776</u>	<u>776</u>	<u>775</u>
2009 DEBT SERVICE (2)	<u>952</u>	<u>2,376</u>	<u>2,372</u>	<u>2,374</u>	<u>2,375</u>
TOTAL DEBT SERVICE (2)	<u>1,727</u>	<u>3,151</u>	<u>3,148</u>	<u>3,150</u>	<u>3,150</u>
TOTAL DEBT SERVICE COVERAGE RATIO (2)	<u>5.09x</u>	<u>2.88x</u>	<u>3.02x</u>	<u>3.03x</u>	<u>3.38x</u>
NET REVENUES AFTER DEBT SERVICE	<u>7,068</u>	<u>5,909</u>	<u>6,353</u>	<u>6,410</u>	<u>7,495</u>
RESERVE BALANCE AS OF YEAR END					
Plant Replacement	\$1,000	\$1,000	\$1,000	\$1,000	\$ 1,000
Rate Stabilization	6,422	5,357	5,189	7,255	10,198
Total Reserve Balances	<u>\$7,422</u>	<u>\$6,357</u>	<u>\$6,189</u>	<u>\$8,255</u>	<u>\$11,198</u>

Source: City of Palo Alto

(1) Depreciation, amortization and Interest Expense have been added back.

(2) Estimate.

AVAILABLE RESERVES

Set forth below is information, including historical balances, policies and minimum, maximum and target guidelines with respect to each of the Available Reserves.

The City's Rate Stabilization Reserves For Its Enterprise Funds

Utility Reserve Policy. Based upon a comprehensive review of utility reserves, the City Council adopted a utility reserve policy in 1993 that defined the role of reserves, established a rate stabilization reserve for each utility fund, and identified reserve guidelines. Rate stabilization reserves were created to cover a number of contingencies, including the need to supplement rates to cover distribution expenses and commodity supply costs.

The 1993 reserve policy declared that reserves should be established to finance "extraordinary one-time contingencies." The policy further stated that reserves should not be used to solve long-term financial problems; rather, rates should finance current operating, capital and financial obligations which are of an ongoing nature. In addition, reserves should not be funded to cover major catastrophic disasters; the City maintains insurance for that purpose and other governmental resources can be made available in case of disaster. Finally, if current operating costs exceed current revenues, reserves should be used to cover increased operating costs in the short run, while allowing rates to gradually increase over a reasonable period to meet such cost levels. Thus, the underlying goal of the reserves is to provide rate stability.

Based upon a City Council-approved methodology, reserve level guidelines (minimum and maximum) are set annually to allow reserves to adjust up or down without unduly falling below the minimum or above the maximum. On occasion, reserves have exceeded the maximum level for a short time. Reserve levels are then adjusted in subsequent years, usually through rate changes. The decision to set aside more or less than the minimum or maximum is based upon an assessment of the uncertainties and financial risk facing the utilities. The City notes that reserve levels in excess of "maximum" levels are considered to be consistent with its reserve guidelines.

The City Council is notified in the Midyear Financial Report, as well as in the Fourth Quarter Financial Report, of any existing or potential issues known at that time with respect to the reserves. In the absence of direction from the City Council to immediately address disposition of a reserve surplus, the disposition will be addressed in the following year's budget cycle. Disposition may include a rate reduction, customer rebate, application of the surplus in satisfaction of a financial obligation or, if justified, maintenance of the reserve in its surplus position for a specific period of time. The City's policy is to require City Council action to use the reserve; as a result, utility management is held accountable for operating efficiently and the City Council makes the decisions regarding the use of reserves.

Since 1993, deregulation of the electric and gas industries has progressed rapidly. In 1997, the City Council approved several policies related to electric deregulation, including recovery of stranded costs and providing customer choice of supplier and marketing sales to customers residing outside the City's service territory. See "AVAILABLE RESERVES—Calaveras-Stranded Costs Reserve" below. In 1998, the City Council split the Gas and Electric Fund Rate Stabilization Reserves (RSRs) into Supply and Distribution RSRs when the retail rates in those funds were unbundled into supply and distribution components of the rate. In 1999, the City took similar action by approving a Direct Access Plan for the Gas System. In 2001, 2003, 2007, and in 2009, the City Council made various revisions to the guidelines for the Electric and Gas Supply and Distribution RSRs and Water and Wastewater RSRs.

Available Reserve Balances History. The table below sets forth a summary of the amounts on hand in the Available Reserves for the prior three fiscal years, debt service of the outstanding bonds with a claim on Available Reserves, and resulting debt service coverage ratios.

Table 13
AVAILABLE RESERVE BALANCES
Fiscal Years 2007-2009
(Dollars in Thousands)

Rate Stabilization Reserve Fund	2004-05	2005-06	2006-07	2007-08	2008-09
Water System	\$ 5,217	\$ 4,143	\$ 16,276	\$ 13,111	\$ 5,974
Electric System (Supply)	44,199	64,542	60,594	47,309	38,086
Electric System (Distribution)	13,519	12,281	7,787	8,109	9,377
Gas System (Supply)	3,821	2,801	6,668	7,399	10,407
Gas System (Distribution)	4,023	3,868	1,738	4,734	6,541
Calaveras Reserve (Electric)	72,963	73,163	71,810	70,397	64,535
Total:	<u>\$143,742</u>	<u>\$160,798</u>	<u>\$164,873</u>	<u>\$151,059</u>	<u>\$134,921</u>
Debt Service	3,622	3,613	3,612	3,713	3,715
Debt Service Coverage Ratio	39.69x	44.51x	45.65x	40.68x	36.32x

Source: City of Palo Alto.

Rate Stabilization Reserve for the Water System

The Water System rate stabilization reserve fund is maintained on the basis of the following guidelines:

Minimum Guideline Level: 15 percent of budgeted sales revenue for that year

Maximum Guideline Level: twice the minimum level

The table below sets forth actual sales revenue, policy guidelines and actual levels of the Water System rate stabilization reserve as of June 30 for the last five fiscal years:

Table 14
RATE STABILIZATION RESERVE FOR THE WATER SYSTEM
Fiscal Years 2005-2009
(Dollars in Thousands)

	2004-05	2005-06	2006-07	2007-08	2008-09
Actual Sales Revenue	\$20,647	\$20,430	\$22,914	\$25,856	\$26,929
Minimum Level	7,106	7,435	7,108	4,942	5,303
Maximum Level	14,211	14,869	14,215	12,356	13,258
Actual Reserve Level	5,217	4,143	16,276	13,111	5,974

Source: City of Palo Alto.

See also APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008."

Rate Stabilization Reserves for the Electric System

Beginning in 1993, the Electric System had a single Rate Stabilization Reserve that was funded from rate revenues. Following electric deregulation in 1997, the City Council unbundled electric rates into the four cost components of Distribution, Power Supply, Transition Cost Recovery and Public Benefits. The unbundling of rate charges addressed, among other things, a need for the Electric System to account for its distribution business separately from its supply business in a competitive environment. Because of this need to recover costs and capture revenues for specific business activities, the rate stabilization reserve for the Electric System was replaced with separate reserves for distribution services and supply services. The City Council also established a Public Benefits Reserve in the Electric Fund to reserve revenues collected but unspent for Public Benefit programs; however, the Public Benefits Reserve is not pledged as an Available Reserve pursuant to the Indenture.

At the time the City Council created the Electric Supply Rate Stabilization Reserves (E-SRSR) in 1998, the minimum reserve level guideline was set at 30 percent of the budgeted commodity sales revenue. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2001, the City Council revised the guidelines for the E-SRSR so that the minimum reserve level guideline was set at 40 percent of the budgeted supply purchase cost. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2003, the City Council revised the guidelines so that the maximum reserve level guideline was set at 103 percent of the supply purchases costs for Electric Supply. As before, the minimum guideline level was half the maximum guideline level. In 2007, the City Council again revised the guidelines so that the minimum reserve level guideline was set at 50 percent of the supply purchase cost for the E-SRSR. The maximum guideline level was twice the minimum guideline level.

Similarly for the Electric Distribution Rate Stabilization Reserves, (E-DRSR) the minimum reserve level guideline was set at 15 percent of the distribution sales revenue in 1998. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2003, the City Council revised the guidelines of the E-DRSR so that the minimum reserve level guideline was set at 19 percent of the distribution sales revenue. As before, the maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2007, the City Council again revised the guidelines for the E-DRSR setting the minimum guideline level to 20% of sales revenue and the maximum guideline level to 50% of sales revenue. And finally in 2009, in the City Council's most recent revision to the guidelines, E-DRSR minimum and maximum guidelines were set at 15% and 30% of sales respectively for Fiscal Year 2009-10 and beyond.

The current target guidelines for the Electric System Supply Rate Stabilization Reserve are set forth below:

<u>Minimum Guideline Level:</u>	50% of budgeted purchase costs
<u>Maximum Guideline Level:</u>	twice the minimum level

The current target guidelines for the Electric System Distribution Rate Stabilization Reserve are set forth below:

<u>Minimum Guideline Level:</u>	15% of budgeted distribution sales revenue
<u>Maximum Guideline Level:</u>	twice the minimum level

The table below sets forth actual sales revenue, policy guidelines and actual levels of the Electric System Distribution Rate Stabilization Reserve and Supply Rate Stabilization Reserve as of June 30 for the past five years:

Table 15
RATE STABILIZATION RESERVE FOR THE ELECTRIC FUND
Fiscal Years 2005-2009
(Dollars in Thousands)

	2004-05*	2005-06	2006-07	2007-08	2008-09
Actual Sales Revenue	\$74,822	\$84,961	\$85,417	\$90,833	\$105,864
Minimum Level	24,321	32,669	33,900	35,913	47,834
Maximum Level	48,641	65,338	67,799	75,147	99,292
Actual Reserve Level	57,718	75,866	68,381	55,418	40,988

Source: City of Palo Alto.

* 2004-05 figures include fiber optics. Subsequent years do not.

See also APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008."

Rate Stabilization Reserves for the Gas System

In 1998, the City Council separated its single rate stabilization reserve for the Gas System into two separate reserves as Supply and Distribution for the same deregulation-related reasons as it had done with the Electrical System.

At the time, the City Council created the Gas Supply Rate Stabilization Reserves (G-SRSR) in 1998, the minimum reserve level guideline was set at 20 percent of the budgeted commodity sales revenue. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2001, the City Council revised the guidelines for the G-SRSR so that the minimum reserve level guideline was set at 20 percent of the budgeted supply purchase cost. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2003, the City Council revised the guidelines so that the maximum reserve level guideline was set at 75 percent of the supply purchases costs for Gas Supply. As before, the minimum guideline level was half the maximum guideline level. In 2007, the City Council again revised the guidelines so that the minimum reserve level guideline was set at 35 percent of the supply purchase cost for the G-SRSR. The maximum guideline level was twice the minimum guideline level. And finally in 2009, in the City Council's most recent revision to the guidelines, G-SRSR minimum and maximum guidelines were set at 25 percent and 50 percent of gas supply purchase costs respectively.

Similarly for the Gas Distribution Rate Stabilization Reserves, (G-DRSR) the minimum reserve level guideline was set at 20 percent of the distribution sales revenue in 1998. The maximum guideline level was twice the minimum and the target was the midpoint between the minimum and maximum. In 2007, the City Council again revised the guidelines for the G-DRSR setting the minimum guideline level to 20 percent of sales revenue and the maximum guideline level to 50 percent of sales revenue. And finally in 2009, in the City Council's final revision to the guidelines, G-DRSR minimum and maximum guidelines were set at 15 percent and 30 percent of sales respectively.

The current (2009-10) target guidelines for the Gas System Supply Rate Stabilization Reserve are set forth below:

<u>Minimum Guideline Level:</u>	25% of budgeted purchase costs
<u>Maximum Guideline Level:</u>	twice the minimum level

The current target guidelines for the Gas System Distribution Rate Stabilization Reserve are set forth below:

<u>Minimum Guideline Level:</u>	15% of budgeted sales revenue
<u>Maximum Guideline Level:</u>	twice the minimum level

Based on the guidelines applicable in the previous fiscal years, the Gas System guidelines and actual reserve levels are set forth below:

Table 16
RATE STABILIZATION RESERVE FOR THE GAS SYSTEM
Fiscal Years 2005-2009
(Dollars in Thousands)

	2004-05	2005-06	2006-07	2007-08	2008-09
Actual Sales Revenue	\$29,890	\$36,433	\$41,457	\$48,100	\$47,692
Minimum Level	8,393	10,572	13,145	13,150	13,839
Maximum Level	16,786	21,145	26,289	29,606	31,111
Actual Reserve Level	7,844	6,669	8,406	12,133	13,175

Source: City of Palo Alto.

See also APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008."

Calaveras-Stranded Costs Reserve

In 1983, the City Council established the Calaveras Reserve in the Electric Fund to help defray a portion of the annual debt service costs associated with the Calaveras Hydroelectric Project, which was put in service at that time. As originally established, the Calaveras Reserve policy did not provide for a target balance and depletion of the reserve was anticipated by 2002.

California Assembly Bill 1890 was adopted in 1996, which provided for the deregulation of California's electric industry effective January 1, 1998. A key element of deregulation was the provision for Direct Access, which would allow electric customers to choose their electric commodity supplier. The City, along with other California utilities, were faced with the prospect of losing customers and load to Direct Access and being saddled with expensive generation assets purchased or built to serve these customers. In response to such risk, Pacific Gas and Electric Company and other investor- and municipally-owned utilities established stranded cost surcharges to collect funds from ratepayers to cover the amount that these uneconomic assets were projected to cost above their market value in the future (i.e., "stranded cost").

The City Council changed the purpose of the Calaveras Reserve in 1996 and authorized collections from electric ratepayers to cover the amount that certain electric assets' costs were projected to be higher than their market value in the future (i.e., stranded cost). In addition, the City Council approved a new Calaveras Reserve policy linking the reserve balance to an amount sufficient to cover potential stranded costs. The assets identified as stranded included the Seattle City Light Exchange contract, the Calaveras Hydroelectric Project, and the California-Oregon Transmission Project (COTP). In 1999, the City Council ceased collecting funds for these stranded costs and established the Calaveras Reserve Target and Guidelines with a schedule to draw down the funds and manage electric rates through the end of FY 2032-33.

In 1997, the City Council revised the reserve target level to cover above-market, or "stranded," costs to \$93 million by December 31, 2001 to be collected from a stranded cost surcharge imposed on electric rates. When the Calaveras Reserve balance reached \$71 million in 1999, stranded costs were deemed fully collected. At that time, the City Council authorized the cessation of the collection of the stranded cost surcharge and established the Calaveras Reserve Target and Guidelines with a schedule to drawdown the funds and manage electric rates through transfers from the Calaveras Reserve to the Electric Supply Rate Stabilization Reserve (E-SRSR) through the end of Fiscal Year (FY) 2032-33, when the Calaveras Reserve would be exhausted.

In 2001, the California electric industry faced an energy crisis triggering wholesale power price spikes and rolling blackouts throughout the state. The crisis was blamed on poor deregulation market design and market manipulation by energy suppliers. As a result, Direct Access was suspended in California for the investor-owned utilities and subsequently, the City suspended its Direct Access program. Further, as a result of changing market conditions and the assignment of certain electric assets, the estimate of the City's stranded cost is lower now than when stranded cost collections stopped in 1999. Since then, electric market prices have increased significantly, reducing the stranded cost associated with the Calaveras Hydroelectric Project.

On June 15, 2009, the City Council adopted new guidelines to manage the Calaveras Reserve through changes to the existing Calaveras Reserve Target and Guidelines as follows:

- Eliminate the existing Calaveras Reserve drawdown schedule;
- Require the calculation of the stranded costs for the electric supply portfolio during the annual budget process for the upcoming budget year(s) and set the minimum transfer from the Calaveras Reserve to the Electric Supply Operating Budget equal to this amount;
- Require the calculation of the stranded costs for the long-term (until 2032 when Calaveras debt is paid off) of the electric supply portfolio during the annual budget process and ensure that the Calaveras Reserve balance will be sufficient to cover this amount;
- Calculate stranded cost based on the above market cost of the Calaveras Hydroelectric Project and the California Oregon Transmission Project; and
- To the extent that there are funds available in excess of long-term stranded cost needs, staff will work with the UAC to identify and recommend projects for City Council consideration and approval. Such projects shall be to the benefit of electric ratepayers.

The approximate balance of the Calaveras Reserve for the last five fiscal years is set forth below:

Table 17
CALAVERAS-STRANDED COSTS RESERVE
Fiscal Years 2005-2009
(Dollars in Thousands)

	2004-05	2005-06	2006-07	2007-08	2008-09
Balance	\$72,963	\$73,163	\$71,180	\$70,397	\$64,535

Source: City of Palo Alto Audited Financial Statements.

See also APPENDIX C—"COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008."

CONSTITUTIONAL LIMITATIONS ON TAXES AND WATER RATES AND CHARGES

Article XIII A

Article XIII A of the State Constitution provides that the maximum *ad valorem* tax on real property cannot exceed 1% of the "full cash value," which is defined as "the county assessor's valuation of real property as shown on the 1975-76 tax bill under 'full cash value' or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment," subject to exceptions for certain circumstances of transfer or reconstruction and except with respect to certain voter approved debt. The "full cash value" is subject to annual adjustment to reflect increases, not to exceed 2% per year, or decreases in the consumer price index or comparable local data, or to reflect reduction in property value caused by damage, destruction or other factors.

Article XIII A requires a vote of two-thirds of the qualified electorate to impose special taxes, while generally precluding the imposition of any additional *ad valorem*, sales or transaction tax on real property. As amended, Article XIII A exempts from the 1% tax limitation any taxes above that level required to pay debt service on certain voter-approved general obligation bonds for the acquisition or improvement of real property. In addition, Article XIII A requires the approval of two-thirds of all members of the State Legislature to change any State laws resulting in increased tax revenues.

Under California law, any fee which exceeds the reasonable cost of providing the service for which the fee is charged is a "special tax," which under Article XIII A must be authorized by a two-thirds vote of the electorate. Accordingly, if a portion of the District's water or wastewater user rates or Capacity Fees were determined by a court to exceed the reasonable cost of providing service, the District would not be permitted to continue to collect that portion unless it were authorized to do so by a two-thirds majority of the votes cast in an election to authorize the collection of that portion of the rates or fees. The reasonable cost of providing wastewater services has been determined by the State Controller to include depreciation and allowance for the cost of capital improvements. In addition, the California courts have determined that fees such as capacity fees will not be special taxes if they approximate the reasonable cost of constructing the water or wastewater capital improvements contemplated by the local agency imposing the fee. See "THE WATER SYSTEM—Water Rates, Fees and Charges."

Article XIII B

Article XIII B of the California Constitution limits the annual appropriations of proceeds of taxes by State and local government entities to the amount of appropriations of the entity for the prior fiscal year, as adjusted for changes in the cost of living, changes in population and changes in services rendered by the entity. User fees and charges are considered proceeds of taxes only to the extent they exceed the reasonable costs incurred by a governmental entity in supplying the goods and services for which such fees and charges are imposed.

To the extent that assessments, fee and charges collected by the City are used to pay the costs of maintaining and operating the Water System and payments due on the 2009 Bonds (including the funding of the Reserve Account), the City believes that such moneys are not subject to the annual appropriations limit of Article XIII B.

Articles XIII C and XIII D

On November 5, 1996, the voters of the State approved Proposition 218, a constitutional initiative, entitled the "Right to Vote on Taxes Act" ("Proposition 218"). Proposition 218 added Articles XIII C and XIII D to the California Constitution and contained a number of interrelated provisions affecting the ability of local governments, including the City, to levy and collect both existing and future taxes, assessments, fees and charges.

Section 1 of Article XIII C requires majority voter approval for the imposition, extension or increase of general taxes and Section 2 thereof requires two thirds voter approval for the imposition, extension or increase of special taxes. These voter approval requirements of Article XIII C reduce the flexibility of the City to raise revenues by the levy of general or special taxes and, given such voter approval requirements, no assurance can be given that the City will be able to enact, impose, extend or increase any such taxes in the future to meet increased expenditure requirements.

Section 3 of Article XIII C expressly extends the initiative power to give voters the power to reduce or repeal local taxes, assessments, fees and charges, regardless of the date such taxes, assessments, fees or charges were imposed. Section 3 expands the initiative power to include reducing or repealing assessments, fees and charges, which had previously been considered administrative rather than legislative matters and therefore beyond the initiative power. This extension of the initiative power is not limited by the terms of Article XIII C to fees imposed after November 6, 1996, the effective date of Proposition 218, and absent other legal authority could result in the reduction in any existing taxes, assessments or fees and charges imposed prior to November 6, 1996.

"Fees" and "charges" are not expressly defined in Article XIII C or in SB 919, the Proposition 218 Omnibus Implementation Act enacted in 1997 to prescribe specific procedures and parameters for local jurisdictions in complying with Article XIII C and Article XIII D ("SB 919"). However, on July 24, 2006, the California Supreme Court ruled in *Bighorn-Desert View Water Agency v. Virgil (Kelley)* (the "*Bighorn Decision*") that charges for ongoing water delivery are property-related fees and charges within the meaning of Article XIII D and are also fees or charges within the meaning of Section 3 of Article XIII C. The California Supreme Court held that such water service charges may, therefore, be reduced or repealed through a local voter initiative pursuant to Section 3 of Article XIII C.

In the *Bighorn Decision*, the Supreme Court did state that nothing in Section 3 of Article XIII C authorizes initiative measures that impose voter-approval requirements for future

increases in fees or charges for water delivery. The Supreme Court stated that water providers may determine rates and charges upon proper action of the governing body and that the governing body may increase a charge which was not affected by a prior initiative or impose an entirely new charge.

The Supreme Court further stated in the *Bighorn Decision* that it was not holding that the initiative power is free of all limitations and was not determining whether the initiative power is subject to the statutory provision requiring that water service charges be set at a level that will pay debt service on bonded debt and operating expenses. Such initiative power could be subject to the limitations imposed on the impairment of contracts under the contract clause of the United States Constitution. Additionally, SB 919 provides that the initiative power provided for in Proposition 218 “shall not be construed to mean that any owner or beneficial owner of a municipal security, purchased before or after [the effective date of Proposition 218] assumes the risk of, or in any way consents to, any action by initiative measure that constitutes an impairment of contractual rights” protected by the United States Constitution. No assurance can be given that the voters of the City will not, in the future, approve initiatives which repeal, reduce or prohibit the future imposition or increase of assessments, fees or charges, including the City’s water service fees and charges, which are the source of Net Revenues pledged to the payment of debt service on the 2009 Bonds, the applicable portion of the 2002 or any additional Parity Bonds.

Notwithstanding the fact that water service charges may be subject to reduction or repeal by voter initiative undertaken pursuant to Section 3 of Article XIII C, the City has covenanted to levy and charge rates which meet the requirements of the Indenture in accordance with applicable law.

Article XIII D defines a “fee” or “charge” as any levy other than an *ad valorem* tax, special tax, or assessment imposed upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property-related service. A “property-related service” is defined as “a public service having a direct relationship to a property ownership.” In the *Bighorn Decision*, the California Supreme Court held that a public water agency’s charges for ongoing water delivery are fees and charges within the meaning of Article XIII D. Article XIII D requires that any agency imposing or increasing any property-related fee or charge must provide written notice thereof to the record owner of each identified parcel upon which such fee or charge is to be imposed and must conduct a public hearing with respect thereto. The proposed fee or charge may not be imposed or increased if a majority of owners of the identified parcels file written protests against it. As a result, the local government’s ability to increase such fee or charge may be limited by a majority protest.

The City’s water charge is a commodity charge based on the volume of water consumed. The City has ratified prior water rate measures and otherwise complied with the applicable notice and protest procedures of Article XIII D for its current water rates and charges. There has not been nor is there any pending challenge to any of the City’s water fees and charges approved since the effective date of Proposition 218. While the City Attorney is of the opinion, based upon the judicial precedent in place during the period of these rate increases, that a reviewing court could reasonably uphold the validity of those increases, neither the City nor the City Attorney can predict with certainty the outcome of a challenge to the increases in the City’s water rates and charges that were not approved in accordance with the notice and hearing requirements of Article XIII D if one were brought.

In addition, Article XIII D also includes a number of limitations applicable to existing fees and charges including provisions to the effect that (i) revenues derived from the fee or charge shall not exceed the funds required to provide the property-related service; (ii) such

revenues shall not be used for any purpose other than that for which the fee or charge was imposed; (iii) the amount of a fee or charge imposed upon any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel; and (iv) no such fee or charge may be imposed for a service unless that service is actually used by, or immediately available to, the owner of the property in question. Property-related fees or charges based on potential or future use of a service are not permitted.

Article XIIID establishes procedural requirements for the imposition of assessments, which are defined as any charge upon real property for a special benefit conferred upon the real property. Standby charges are classified as assessments. Procedural requirements for assessments under Article XIIID include conducting a public hearing and mailed protest procedure, with notice to the record owner of each parcel subject to the assessment. The assessment may not be imposed if a majority of the ballots returned oppose the assessment, with each ballot weighted according to the proportional financial obligation of the affected parcel. To provide guidance to City staff regarding the conduct of Proposition 218 “property-related fee” protest proceedings, the City Council adopted Resolution No. 4930 on January 16, 2007, establishing additional procedures for submitting protests against proposed increases to water rates, including the provision of notice of a proposed change in water fees to all owners of record on each identified parcel and all water customers of the City as reflected in the billing records of the City at the time the notice is given, and additional procedures for the tabulation of protests against proposed increases to water rates, including guidelines for determining when a valid protest has been submitted.

Existing, new or increased assessments are subject to the procedural provisions of Proposition 218. However, certain assessments existing on November 6, 1996, are classified as exempt from the procedures and approval process of Article XIIID. Expressly exempt assessments include (i) an assessment imposed exclusively to finance capital costs or maintenance and operation expenses for sewers, water, flood control and drainage systems, but subsequent increases are subject to the procedures and approval requirements; (ii) an assessment imposed pursuant to a petition signed by all affected landowners (but subsequent increases are subject to the procedural and approval requirements); (iii) assessments, the proceeds of which are used exclusively to pay bonded indebtedness, where failure to pay would violate the U.S. Constitution’s prohibition against the impairment of contracts; and (iv) any assessment which has previously received approval by a majority vote of the voters (but subsequent increases are subject to the procedural and approval requirements).

On July 14, 2008, the California Supreme Court ruled in *Silicon Valley Taxpayers Association, Inc. v. Santa Clara County Open Space Authority* (the “SCCOSA Decision”) that the Santa Clara County Open Space Authority’s county-wide assessment which was designed to fund the acquisition and maintenance of unspecified open-space lands in the County was invalid under Proposition 218. The Court held that deference should not be accorded to local agencies when Proposition 218 legislative acts are challenged. Under Proposition 218, courts must make an independent review of whether the assessment and formation of an assessment district meet the “special benefit” and proportionality requirements of Article XIIID. Further, while an assessment will not be invalidated because it confers a benefit upon the public at large, the “special benefit” must affect the assessed property in a distinct and particular manner not shared by other parcels and the public at large. Specifically, in the SCCOSA Decision the assessment did not meet the requirements of a “special benefit” and the assessment was not proportional to the special benefits conferred. Finally, the Court held that the Santa Clara Open Space Authority did not meet the proportionality requirement of Article XIIID because it did not specifically identify the improvements to be financed by the assessment and failed to sufficiently connect any costs of and benefits received from the open space assessment to the specific assessed parcels.

The City and the City Attorney are of the opinion that current water fees and charges that are subject to Proposition 218 comply with the provisions thereof and that the City will continue to comply with the rate covenant set forth in the Installment Purchase Agreement in conformity with the provisions of Article XIII D of the California State Constitution. The City and the City Attorney are also of the opinion that current water capacity fees are not subject to Proposition 218. Should it become necessary to increase the water fees and charges above current levels, the City would be required to comply with the requirements of Article XIII D in connection with such proposed increase. To date, there have been no legal challenges to water rate increases implemented by the City pursuant to Proposition 218 or otherwise. It is unclear whether under existing standards, rates and charges may be established at levels which would permit deposits to a Rate Stabilization Fund or maintenance of uncommitted cash reserves.

The interpretation and application of Proposition 218 will ultimately be determined by the courts or through implementing legislation with respect to a number of the matters described above, and it is not possible at this time to predict with certainty the outcome of such determination or the nature or scope of any such legislation.

RISK FACTORS RELATING TO THE 2009 BONDS

Payment of principal of and interest on the 2009 Bonds depends primarily upon the revenues derived from operation of the Water System and, if necessary, from moneys on deposit in the Available Reserves. Some of the events which could affect the revenues received by the Water System, as well as issues that could affect the availability of moneys in the Available Reserves, are set forth below. The following discussion of risks is not meant to be an exhaustive list of the risks associated with the purchase of the 2009 Bonds and the order in which the risks are discussed does not necessarily reflect the relative importance of the various risks.

Limited Obligations

The 2009 Bonds are limited obligations of the City and are not secured by a legal or equitable pledge or charge or lien upon any property of the City or any of its income or receipts, except the Net Revenues. The obligation of the City to pay debt service on the 2009 Bonds from Net Revenues does not constitute an obligation of the City to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation.

The City is obligated under the Indenture to make debt service payments solely from Net Revenues or from moneys on deposit in the Available Reserves. There is no assurance that the City can succeed in operating the Systems such that the Net Revenues in the future will be sufficient for that purpose. See also "Balance of the Available Reserves" and "Right to Vote on Taxes Act" below.

System Expenses

There can be no assurance that the City's expenses for the Systems will be consistent with the descriptions in this Official Statement. Changes in technology, changes in quality standards, loss of large customers, increased or decreased development, increases in the cost of operation, or other expenses could require increases in rates or charges in order to comply with the City's rate covenant in the Indenture.

Limited Recourse on Default

Failure by the City to pay debt service on the 2009 Bonds constitutes an event of default under the Indenture and the Trustee is permitted to pursue remedies at law or in equity to enforce the City's obligation to make such payments. Although the Trustee has the right to accelerate the total unpaid principal amount of the debt service on the 2009 Bonds, there is no assurance that the City would have sufficient funds to pay the accelerated amounts. See also "Proposition 218" below.

Limitations on Remedies

The ability of the City to comply with its covenants under the Indenture and to generate Net Revenues sufficient to pay principal of and interest with respect to the 2009 Bonds may be adversely affected by actions and events outside of the control of the City and may be adversely affected by actions taken (or not taken) by voters, property owners, taxpayers or persons obligated to pay assessments, fees and charges. See "Proposition 218" below. Furthermore, the remedies available to the owners of the 2009 Bonds upon the occurrence of an event of default under the Indenture are in many respects dependent upon judicial actions which are often subject to discretion and delay and could prove both expensive and time consuming to obtain.

In addition to the limitations on remedies contained in the Indenture, the rights and obligations under the Indenture may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases and to limitations on legal remedies against cities in the State of California. The opinion to be delivered by Bond Counsel concurrently with the issuance of the 2009 Bonds will be subject to such limitations and the various other legal opinions to be delivered concurrently with the issuance of the 2009 Bonds will be similarly qualified. See "APPENDIX D—Proposed Form of Bond Counsel Opinion." If the City fails to comply with its covenants in the Indenture or fails to pay principal of and interest due on the 2009 Bonds, there can be no assurance of the availability of remedies adequate to protect the interest of the holders of the 2009 Bonds.

Balance of the Available Reserves

Although the City has covenanted to maintain the Available Reserves at an aggregate balance equal to five times maximum annual debt service on all outstanding bonded indebtedness secured by Net Revenues of any of the Systems, each Available Reserve is primarily intended as a rate stabilization reserve for the applicable City utility System. As a result, extraordinary circumstances may arise that would cause the City to diminish Available Reserves below "minimum" guideline levels or, in the aggregate, below five times Maximum Annual Debt Service. Although the City has covenanted in the Indenture to replenish the Available Reserves to required levels, it will do so only from rates and charges paid by the customers of the various utility systems, which may adversely affect the City's ability to replenish the Available Reserves in a timely fashion.

In addition, certain provisions of the California Constitution may require the City to repay any advance from an Available Reserve that is not directly related to the System which the advance benefits. See "CONSTITUTIONAL LIMITATIONS ON TAXES AND WATER RATES AND CHARGES—Articles XIII C and XIII D."

Initiatives

In recent years several initiative measures have been proposed or adopted which affect the ability of local governments to increase taxes and rates. There is no assurance that the electorate or the State legislature will not at some future time approve additional limitations which could affect the ability of the City to implement rate increases which could reduce Net Revenues and adversely affect the security for the 2009 Bonds. See “Proposition 218” below.

Bankruptcy

The rights and remedies provided in the Indenture may be limited by and are subject to the provisions of federal bankruptcy laws, to other laws or equitable principles that may affect the enforcement of creditors’ rights, to the exercise of judicial discretion in appropriate cases and to limitations on legal remedies against public agencies in the State of California. The various opinions of counsel to be delivered with respect to the 2009 Bonds and the Indenture, including the opinion of Bond Counsel, will be similarly qualified. If the City were to file a petition under Chapter 9 of the Bankruptcy Code, the Owners of the 2009 Bonds and the City could be prohibited from taking any steps to enforce their rights under the Indenture.

Tax Exemption of the 2009 Bonds

The City has covenanted in the Indenture that it will take all actions necessary to assure the exclusion of interest with respect to the 2009 Bonds that are Tax-Exempt Bonds from the gross income of the Owners of the 2009 Bonds that are Tax-Exempt Bonds to the same extent as such interest is permitted to be excluded from gross income under the Internal Revenue Code of 1986. If the City fails to comply with the foregoing tax covenant, the interest component of the Installment Payments evidenced by the 2009 Bonds that are Tax-Exempt Bonds may be includable in the gross income of the Owners thereof for federal tax purposes. See “TAX MATTERS.”

Additional Obligations

The Indenture permits the issuance of Bonds secured by Net Revenues on a parity basis or a subordinate basis to the 2009 Bonds. Such additional Bonds would increase debt service payable from Net Revenues and could adversely affect debt service coverage with respect to the 2009 Bonds. In such event, however, the Rate Covenant will remain in effect. See “SECURITY FOR THE 2009 BONDS—Rate Covenant.”

Seismic Considerations

The City, like much of California, is subject to seismic activity that could result in interference with operation of the Systems. There are several major active fault zones transecting the County that could cause “strong ground motion” at the site of the various facilities constituting the Systems during their useful life. Those major fault zones, listed in order of proximity to the City, are the San Andreas, Hayward, Calaveras and San Gregorio faults. If there were to be an occurrence of severe seismic activity in the area of the City, there could be an interruption in the service provided by the Systems resulting in a temporary reduction in the amount of Net Revenues available to pay the principal of and interest on the 2009 Bonds when due.

Relevance to Available Reserves. Because Proposition 218 declares that revenues derived from a “fee” or “charge” may not exceed the funds required to provide the “property-related service” and may not be used for any purpose other than that for which the fee or charge was

imposed, the City may be required to repay any advance from an Available Reserve that is not directly related to the System which the advance benefits. For example, if the City requires an advance from the Rate Stabilization Reserve for the Sewer System to pay the portion of debt service on the 2009 Bonds attributable to the Water System, the City may be required to repay the Sewer System reserve. Proposition 218 expressly does not apply to revenues of the Electric System or the Gas System and, therefore, does not apply to their Available Reserves.

Investment of City Funds

Gross Revenues collected by the City will be held and invested by the City in accordance with the provisions of the Indenture. Otherwise, however, moneys held by the City, including Enterprise moneys, will be invested in accordance with the City's adopted investment policies. For more information about the City's investment policy as well as information about recent investment performance of the City's pooled investment funds, see APPENDIX B—"GENERAL AND ECONOMIC INFORMATION ABOUT THE CITY."

LEGAL MATTERS

Approval of Legal Proceedings

The legality of the sale, execution and delivery of the 2009 Bonds is subject to the approval of Jones Hall, A Professional Law Corporation, San Francisco, California, acting as Bond Counsel. A proposed form of such legal opinion is attached hereto as Appendix D. Quint & Thimmig LLP, San Francisco, California, is acting as disclosure counsel to the City in connection with the issuance of the 2009 Bonds.

Payment of the fees and expenses of Jones Hall and of Quint & Thimmig LLP are contingent upon issuance of the 2009 Bonds.

Absence of Litigation

At the time of delivery of and payment for the 2009 Bonds, the City will certify that there is no action, suit, proceeding, inquiry or investigation, at law or in equity, before or by any court, regulatory agency, public board or body, pending or, to the knowledge of the City, threatened against the City affecting the existence of the City or the titles of its officers to their respective offices or seeking to restrain or to enjoin the sale or delivery of the 2009 Bonds, the application of the proceeds thereof in accordance with the Indenture, or the collection or application of any Net Revenues provided for the payment of the 2009 Bonds, or in any way contesting or affecting the validity or enforceability of the 2009 Bonds, the Indenture, any action of the City contemplated by any of the said documents, or the collection or application of any revenues provided for the payment of the 2009 Bonds, or in any way contesting the completeness or accuracy of this Official Statement or any amendment or supplement thereto, or contesting the powers of the City or its authority with respect to the 2009 Bonds or any action of the City contemplated by any of those documents.

Tax Matters

2009 Bonds Issued as Tax-Exempt Bonds. In the opinion of Jones Hall, A Professional Law Corporation, San Francisco, California, Bond Counsel, subject, however to certain qualifications set forth below, under existing law, the interest on the 2009 Bonds is excluded from gross income for federal income tax purposes, and such interest is not an item of tax

preference for purposes of the federal alternative minimum tax imposed on individuals and corporations.

The opinions set forth in the preceding paragraph are subject to the condition that the City comply with all requirements of the Internal Revenue Code of 1986 (the "Code") that must be satisfied subsequent to the issuance of the 2009 Bonds in order that such interest be, or continue to be, excluded from gross income for federal income tax purposes. The City has covenanted to comply with each such requirement. Failure to comply with certain of such requirements may cause the inclusion of such interest in gross income for federal income tax purposes to be retroactive to the date of issuance of the 2009 Bonds.

If the initial offering price to the public (excluding bond houses and brokers) at which a 2009 Bond is sold is less than the amount payable at maturity thereof, then such difference constitutes "original issue discount" for purposes of federal income taxes and State of California personal income taxes. If the initial offering price to the public (excluding bond houses and brokers) at which each 2009 Bond is sold is greater than the amount payable at maturity thereof, then such difference constitutes "original issue premium" for purposes of federal income taxes and State of California personal income taxes. *De minimis* original issue discount and original issue premium is disregarded. Owners of 2009 Bonds with original issue discount or original issue premium, including purchasers who do not purchase in the original offering, should consult their own tax advisors with respect to federal income tax and State of California personal income tax consequences of owning such 2009 Bonds.

In the further opinion of Bond Counsel, interest on the 2009 Bonds is exempt from California personal income taxes.

Owners of the 2009 Bonds should also be aware that the ownership or disposition of, or the accrual or receipt of interest on, the 2009 Bonds may have federal or state tax consequences other than as described above. Bond Counsel expresses no opinion regarding any federal or state tax consequences arising with respect to the 2009 Bonds other than as expressly described above.

A copy of the proposed form of opinion of Bond Counsel is attached hereto APPENDIX D—"PROPOSED FORM OF BOND COUNSEL OPINION."

2009 Bonds Issued as Build America Bonds. In the opinion of Bond Counsel, subject, however to certain qualifications set forth below, under existing law, the interest on the 2009 Bonds issued as Direct Payment Build America Bonds is not excluded from gross income for federal income tax purposes.

In the further opinion of Bond Counsel, interest on the 2009 Bonds issued as Direct Payment Build America Bonds is exempt from California personal income taxes.

Owners of the 2009 Bonds should also be aware that the ownership or disposition of, or the accrual or receipt of interest on, the 2009 Bonds may have federal or state tax consequences other than as described above. Bond Counsel expresses no opinion regarding any federal or state tax consequences arising with respect to the 2009 Bonds other than as expressly described above.

A copy of the proposed form of opinion of Bond Counsel is attached hereto APPENDIX D—"PROPOSED FORM OF BOND COUNSEL OPINION."

CONTINUING DISCLOSURE

The City has covenanted for the benefit of the holders and beneficial owners of the 2009 Bonds to provide certain financial information and operating data relating to the City (the "Annual Report") by no later than each March 1 following the end of the City's fiscal year (which fiscal year currently ends on June 30), commencing March 1, 2010, with the Annual Report for the 2008-09 Fiscal Year, and to provide notices of the occurrence of certain enumerated events, if material. The City will file, or cause to be filed, the Annual Report with the Municipal Securities Rulemaking Board (the "MSRB") with a copy to the Underwriter. The City will file, or cause to be filed, the notices of material events with the MSRB, with a copy to the Underwriter. The specific nature of the information to be contained in the Annual Report or the notices of material events is set forth in APPENDIX E—"FORM OF CONTINUING DISCLOSURE CERTIFICATE." These covenants have been made in order to assist the Underwriter in complying with S.E.C. Rule 15c2-12(b)(5).

The City has never failed to comply, in all material respects, with an undertaking under the Rule.

RATINGS

Moody's Investors Service, Inc. ("Moody's") has assigned its municipal bond rating of "____" to the 2009 Bonds, and Standard & Poor's Ratings Services, A Division of the McGraw-Hill Companies ("Standard & Poor's"), has assigned its municipal bond rating of "AAA" to the 2009 Bonds.

Such ratings reflect only the views of such organizations and an explanation of the significance of such ratings may be obtained from Moody's and Standard & Poor's. There is no assurance that such ratings will continue for any given period of time or that such ratings will not be revised downward or withdrawn entirely by such organizations, if in their judgment circumstances so warrant. Any such downward revision or withdrawal of such ratings may have an adverse effect on the market price of the 2009 Bonds.

UNDERWRITING

The 2009 Bonds were sold pursuant to competitive sale held on October 6, 2009, and were awarded to _____ (the "Underwriter"). The 2009 Bonds are being purchased by the Underwriter at a purchase price of \$_____, which represents the aggregate principal amount of the 2009 Bonds (\$_____), [plus an original issue premium of \$_____] [less an original issue discount of \$_____] and less an Underwriter's discount of \$_____.

MISCELLANEOUS

Insofar as any statements made in this Official Statement involve matters of opinion or of estimates, whether or not expressly stated, they are set forth as such and not as representations of fact. No representation is made that any of the statements will be realized. Neither this Official Statement nor any statement which may have been made verbally or in writing is to be construed as a contract with the owners of the 2009 Bonds.

During the initial offering period for the 2009 Bonds, copies of the Indenture may be obtained, upon written request, from the City. After issuance of the 2009 Bonds, copies of such documents may be obtained from the Trustee.

The execution and delivery of this Official Statement have been duly authorized by the City Council of the City.

CITY OF PALO ALTO

By _____
Director of Administrative Services

APPENDIX A

SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE OF TRUST

Certain provisions of the Indenture are summarized below. This summary does not purport to be complete or definitive and is qualified in its entirety by reference to the full terms of the Indenture.

Definitions

“Additional Allowance” means an allowance for earnings arising from any increase in the Charges which has become effective prior to the incurring of such additional indebtedness but which, during all or any part of such Fiscal Year or such twelve (12) month period, was not in effect, in an amount equal to the amount by which the Net Revenues would have been increased if such increase in Charges had been in effect during the whole of such Fiscal Year or such twelve (12) month period, all as shown in the written report of an Independent Consultant engaged by the City.

“Authorized Investments” means any of the following, but only to the extent that the same are acquired at Fair Market Value, which at the time of investment are legal investments under the laws of the State of California and permitted under the City’s investment policy for the moneys proposed to be invested therein:

(a) Federal Securities;

(b) senior debt obligations rated “Aaa” by Moody’s and “AAA” by S&P issued by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, and obligations of the Resolution Funding Corporation (REFCORP);

(c) U.S. dollar denominated deposit accounts, federal funds and banker’s acceptances with domestic commercial banks (including the Trustee and its affiliates) which have a rating on their short term certificates of deposit on the date of purchase of “P-1” by Moody’s and “A-1” or “A-1+” by S&P and maturing no more than 360 days after the date of purchase, provided that ratings on holding companies are not considered as the rating of the bank;

(d) commercial paper which is rated at the time of purchase in the single highest classification, “P-1” by Moody’s and “A-1+” by S&P, and which matures not more than 270 days after the date of purchase;

(e) investments in a money market fund rated “AAAm” or “AAAm-G” or better by S&P, including any such money market fund from which the Trustee or its affiliates receive fees for services to such fund;

(f) pre-refunded municipal obligations defined as follows: Any bonds or other obligations of any state of the United States of America or of any agency, instrumentality or local governmental unit of any such state which are not callable at the option of the obligor prior to maturity or as to which irrevocable instructions have been given by the obligor to call on the date specified in the notice; and (i) which are rated, based upon an irrevocable escrow account or fund (the “escrow”), in the highest rating category of Moody’s and S&P or any successors thereto; or (ii)(A) which are fully secured as to principal and interest and redemption premium, if any, by an escrow consisting only of cash or obligations described in paragraph (a) above, which escrow may be applied only to the payment of such principal of and interest and redemption premium, if any, on such bonds or other obligations on the maturity date or dates thereof or the specified redemption date or dates pursuant to such irrevocable instructions, as appropriate, and (B) which escrow is sufficient, as verified by a nationally recognized independent certified public accountant, to pay principal of and interest and redemption premium, if any, on the bonds or other obligations described in this paragraph on the

maturity date or dates thereof or on the redemption date or dates specified in the irrevocable instructions referred to above, as appropriate;

(g) general obligations of states with a rating of at least "A2/A" or higher by both Moody's and S&P;

(h) investment agreements: (1) with financial institutions whose long term rating is at least "AA" or "Aa"; or (2) which are fully collateralized with securities described in paragraphs(a) of this definition;

(i) the Local Agency Investment Fund maintained by the State of California, to the extent any investments of moneys held by the Trustee may be made and withdrawn directly by, and in the name of, the Trustee; and

(j) the California Asset Management Program (CAMP).

"Available Reserves" means funds held in the City's:

- (i) Rate Stabilization Reserve for the Water System,
- (ii) Distribution Rate Stabilization Reserve for the Electric System,
- (iii) Distribution Rate Stabilization Reserve for the Gas System,
- (iv) Supply Rate Stabilization Reserve for the Electric System,
- (v) Supply Rate Stabilization Reserve for the Gas System, and
- (vi) the Electric System's Calaveras-Stranded Costs Reserve;

and includes the above numerated funds, even though given a different name by the City Council of the City, as well as newly created funds of the City which create reserves for the Systems listed above, and into which monies have been transferred from the above Funds.

"Average Annual Debt Service" means the total aggregate Debt Service for the entire period during which the Bonds are Outstanding divided by the number of Fiscal Years or portions thereof during which the Bonds are Outstanding.

"Bond Counsel" means any attorney at law or firm of attorneys, of nationally recognized standing in matters pertaining to the federal tax exemption of interest on bonds issued by states and political subdivisions, and duly admitted to practice law before the highest court of any state of the United States of America.

"Bond Law" means the charter of the City and the provisions of Chapter 12.28 (commencing with Section 12.28.010), of the Palo Alto Municipal Code, all as in effect on the Closing Date.

"Charges" means fees, tolls, assessments, rates and rentals prescribed under the Bond Law or any other law of the State by the Council for the water, gas, or electric energy, or the services and facilities of a particular System furnished by the City.

"Debt Service" means, during any period of computation, the amount obtained for such period by totaling the following amounts:

(a) The principal amount of all Outstanding Serial Bonds payable by their terms in such period;

(b) The principal amount of all Outstanding Term Bonds scheduled to be paid or redeemed by operation of mandatory Sinking Fund Installments in such period; and

(c) The interest which would be due during such period on the aggregate principal amount of Bonds which would be Outstanding in such period if the Bonds are paid or redeemed as scheduled.

"Defeasance Obligations" means (a) cash, (b) non-callable direct obligations of the United States of America ("Treasuries"), (c) evidences of ownership of proportionate interests in future interest and principal payments on Treasuries held by a bank or trust company as custodian, under which the owner of the investment is the real party in interest and has the right to proceed directly and individually against the obligor and the underlying Treasuries are not available to any person claiming through the custodian or to whom the custodian may be obligated or (d) pre-refunded municipal obligations rated "AAA" and "Aaa" by S&P and Moody's, respectively (or any combination thereof).

"Electric System" means the existing electrical system of the City, comprising all facilities for the transmission and distribution of electric energy.

"Event of Default" means any of the events described as "events of default" in the Indenture.

"Federal Securities" means any of the following which at the time of investment are legal investments under the laws of the State for the moneys proposed to be invested therein:

(a) direct general obligations of the United States of America (including obligations issued or held in book entry form on the books of the Department of the Treasury of the United States of America); and

(b) obligations of any department, agency or instrumentality of the United States of America the timely payment of principal of and interest on which are unconditionally and fully guaranteed by the United States of America.

"Federal Tax Credit Payments" means all payments received from the U.S. Department of Treasury of the tax credit for those Series A Bonds issued as Direct Payment Build America Bonds provided for in Sections 54AA(b) and 6431 of the Tax Code.

"Fiscal Year" means the period commencing on July 1 of each year and terminating on the next succeeding June 30.

"Gas System" means the existing gas system of the City, comprising all facilities for the production, storage, transmission and distribution of gas for public or private uses.

"Gross Revenues" means, for any period of computation, all gross charges received for, and all other gross income and revenues derived by the City from, the ownership or operation of the Water System or otherwise arising from the Water System during such period, including but not limited to (a) all Charges received by the City for use of the Water System, (b) all receipts derived from the investment of funds held by the City or the Trustee under the Indenture, (c) transfers from any stabilization reserve funds into the Water Revenue Fund, (d) all moneys received by the City from other public entities whose inhabitants are served pursuant to contracts with the City, and (e) Federal Tax Credit Payments.

"Improvement" means any addition, extension, improvement, equipment, machinery or other facilities to or for any System.

"Indenture" means the Indenture of Trust, as originally executed or as it may from time to time be supplemented, modified or amended by any Parity Bonds Instrument pursuant to the provisions hereof.

"Independent Certified Public Accountant" means any certified public accountant or firm of such accountants appointed and paid by the City, and who, or each of whom-

(a) is in fact independent and not under domination of the City;

(b) does not have any substantial identity of interest, direct or indirect, with the City; and

(c) is not and no member of which is connected with the City as an officer or employee of the City, but who may be regularly retained to make annual or other audits of the books of or reports to the City.

"Independent Consultant" means any financial or engineering consultant (including without limitation any Independent Certified Public Accountant) with an established reputation in the field of municipal finance or firm of such consultants appointed and paid by the City, and who, or each of whom-

(a) is in fact independent and not under domination of the City;

(b) does not have any substantial identity of interest, direct or indirect, with the City; and

(c) is not and no member of which is connected with the City as an officer or employee of the City, but who may be regularly retained to make annual or other audits of the books of or reports to the City.

"Information Services" means Financial Information, Inc.'s "Daily Called Bond Service", 30 Montgomery Street, 10th Floor, Jersey City, New Jersey 07302, Attention: Editor; Kenny Information Services' "Called Bond Service", 55 Broad Street, 28th Floor, New York, New York 10004; Moody's Investors Service "Municipal and Government," 99 Church Street, 8th Floor, New York, New York 10007, Attention: Municipal News Reports; Standard & Poor's Corporation "Called Bond Record," 25 Broadway, 3rd Floor, New York, New York 10004; and, in accordance with then current guidelines of the Securities and Exchange Commission, such other addresses and/or such other services providing information with respect to called bonds as the City may designate in a Request of the City delivered to the Trustee.

"Interest Requirement" means, as of any particular date of calculation, the amount equal to any unpaid interest then due and payable, plus an amount which will on the next succeeding Interest Payment Date be equal to the interest to become due and payable on the Bonds on such next succeeding Interest Payment Date.

"Maintenance and Operation Costs" means the reasonable and necessary costs spent or incurred by the City for maintaining and operating a System, calculated in accordance with sound accounting principles, including the cost of supply of water, gas and electric energy under contracts or otherwise, the funding of reasonable operating reserves, and all reasonable and necessary expenses of management and repair and other expenses to maintain and preserve such System in good repair and working order, and including all reasonable and necessary administrative costs of the City attributable to such System and the Bonds, such as salaries and wages and the necessary contribution to retirement of employees, overhead, insurance, taxes (if any), expenses, compensation and indemnification of the Trustee, and fees of auditors, accountants, attorneys or engineers, and including all other reasonable and necessary costs of the City or charges required to be paid by it to comply with the terms of the Bonds or of the 2002 Indenture, the Second Supplement to 2002 Indenture or the Indenture, but excluding depreciation, replacement and obsolescence charges or reserves therefor and amortization of intangibles or other bookkeeping entries of a similar nature.

"Maximum Annual Debt Service" means, as of the date of calculation, the maximum amount of Debt Service for the current or any future Fiscal Year.

"Net Revenues" means, with respect to the Water System, for any period of computation, the amount of the Gross Revenues received from the Water System during such period, less the amount of Maintenance and Operation Costs of the Water System becoming payable during such period.

"1990 Indenture" means that Indenture of Trust dated as of August 1, 1990, by and between the City and the Trustee.

"1995 Bonds" means the \$8,640,000 original principal amount of the City of Palo Alto Utility Revenue Bonds, 1995 Series A issued by the City pursuant to the Second Supplement to 1990 Indenture.

"Original Purchaser" means the first purchaser of the Series A Bonds from the City.

"Parity Bonds" means the 2002 Water Revenue Bonds, and all bonds, notes or other obligations (including without limitation long-term contracts, loans, sub-leases or other legal financing arrangements)

of the City payable from and secured by a pledge of and lien upon any of the Net Revenues, issued or incurred pursuant to the Indenture.

"Parity Bonds Instrument" means the resolution, trust indenture or installment sale agreement adopted, entered into or executed and delivered by the City, and under which Parity Bonds are issued.

"Principal Installment" means with respect to any particular Principal Installment Date, an amount equal to the sum of (i) the aggregate principal amount of Outstanding Serial Bonds payable on such Principal Installment Date as determined by the applicable Parity Bonds Instrument (but not including Sinking Fund Installments) and (ii) the aggregate of Sinking Fund Installments with respect to all Outstanding Term Bonds payable on such Principal Installment Date as determined by the applicable Parity Bonds Instrument.

"Redemption Price" means, with respect to any Bond, the principal amount thereof, plus the applicable premium, if any, payable upon redemption thereof pursuant to the Indenture and the Parity Bonds Instrument pursuant to which the same was issued.

"Request of the City" means a request in writing signed by the City Manager, Director of Administrative Services or Assistant City Manager of the City, or by any other officer of the City duly authorized by the Council for that purpose.

"Reserve Account" means the Account by that name established and held by the Trustee pursuant to the Indenture.

"Reserve Requirement" means an amount equal to the lesser of: (i) Maximum Annual Debt Service; (ii) ten percent (10%) of the principal amount of the Bonds; or (iii) 125% of Average Annual Debt Service, as may be set forth in a Parity Bonds Instrument pursuant to the Indenture.

"Revenue Fund" means the Fund by that name established and held by the City pursuant to the 1990 Indenture and referred to in the Indenture.

"Second Supplement to 1990 Indenture" means the Second Supplemental Indenture of Trust, between the City and the Trustee, as successor to Bank of America National Trust and Savings Association, dated as of February 1, 1995.

"State" means the State of California.

"System" means any of the Electric System, the Gas System, or the Water System.

"Trust Office" means the corporate trust office of the Trustee at One California Street, Suite 400, San Francisco, California 94111, or such other or additional offices as may be specified to the City by the Trustee in writing.

"2002 Water Revenue Bonds" means those 2002 Bonds issued to finance improvements to the Water System and secured by a pledge of Net Revenues Attributable to the Water System (as defined in the 2002 Indenture). On the Closing Date, 2002 Water Revenue Bonds were outstanding in the principal amount of \$8,860,500.

"Water System" means the existing water system of the City, comprising all facilities for the obtaining, conserving, treating, distributing, storing and supplying of water for domestic use, irrigation, sanitation, industrial use, fire protection, recreation, or any other public or private use.

Funds and Accounts

Reserve Account. On the Closing Date the Trustee shall satisfy the Reserve Requirement by delivering cash in the amount of the Reserve Requirement or a Qualified Surety Bond to the Trustee for the account of the Reserve Account. The Reserve Requirement for an issue of Parity Bonds may be increased by any Parity Bonds Instrument establishing any Parity Bonds pursuant to the Indenture.

2009 Water Project Fund. There is created in the Indenture a separate fund to be known as the “City of Palo Alto Utility Revenue 2009 Water Project Fund”, herein referred to as the “2009 Water Project Fund”, to be held in trust by the City.

The City shall disburse moneys in the 2009 Water Project Fund for the purpose of paying or reimbursing the payment of the costs of acquiring and constructing the 2009 Water Project, including but not limited to all costs incidental to or connected with such acquisition and construction; in either case upon receipt by the City from time to time of a Request of the City which: (a) identifies the total amount of such costs to be paid pursuant to such Request, including all items of cost in such detail as may be available to the City; (b) states with respect to such disbursement (i) the requisition number, (ii) the amount to be disbursed for payment of such costs, and (iii) that each item of cost identified therein has been properly incurred, and is a proper charge against the 2009 Water Project Fund and has not been the basis of any previous disbursement; and (c) is accompanied by an invoice, if any.

The City may apply any or all of the moneys on deposit in the 2009 Water Project Fund to the financing of any alternative project in place of any component of the 2009 Water Project on the condition that (i) such substitution will not have any adverse effect on the security for the 2002 Series A Bonds, and (ii) the alternative project identified will be of benefit to the Water System.

Any amounts remaining in the 2009 Water Project Fund after the date of completion of the 2009 Water Project shall be transferred by the City to the Debt Service Fund to be applied to the payment of Debt Service Attributable to the Water System, as the same becomes due and payable.

All interest earnings and profits or losses on the investment of amounts in the 2009 Water Project Fund shall be deposited in or charged to the 2009 Water Project Fund and applied to the purposes thereof.

Issuance of Parity Bonds. In addition to the Series A Bonds, the City may, by Parity Bonds Instrument, issue or incur other loans, advances or indebtedness payable from Net Revenues to be derived from the Water System, to provide financing for the Water System, in such principal amount as shall be determined by the City. The City may issue or incur any such Parity Bonds subject to the following specific conditions, which are hereby made conditions precedent to the issuance and delivery of such Parity Bonds:

(a) The City shall be in compliance with all covenants set forth in the Indenture.

(b) (i) The Net Revenues of the Water System, calculated on sound accounting principles, as shown by the books of the City for the latest Fiscal Year or any more recent twelve (12) month period selected by the City ending not more than sixty (60) days prior to the adoption of the Parity Bonds Instrument pursuant to which such Parity Bonds are issued, as shown by the books of the City, less withdrawals, if any, from the Water System’s rate stabilization fund, plus, at the option of the City, the Additional Allowance, shall at least equal One Hundred percent (100%) of Maximum Annual Debt Service, with Maximum Annual Debt Service calculated on all Bonds to be Outstanding immediately subsequent to the issuance of such Parity Bonds which have a lien on Net Revenues of the Water System; and

(ii) The Net Revenues of the Water System, calculated on sound accounting principles, as shown by the books of the City for the latest Fiscal Year or any more recent twelve (12) month period selected by the City ending not more than sixty (60) days prior to the adoption of the Parity Bonds Instrument pursuant to which such Parity Bonds are issued, as shown by the books of the City, plus, at the option of the City, any or all of the

items hereinafter in this paragraph designated (A), (B) and (C), shall at least equal One Hundred Twenty-Five percent (125%) of Maximum Annual Debt Service, with Maximum Annual Debt Service calculated on all Bonds to be Outstanding immediately subsequent to the issuance of such Parity Bonds which have a lien on Net Revenues of the Water System. The items any or all of which may be added to such Net Revenues for the purpose of issuing or incurring Parity Bonds hereunder are the following:

(A) An allowance for Net Revenues from any additions to or improvements or extensions of the Water System, and also for Net Revenues from any such additions, improvements or extensions which have been made from moneys from any source but in any case which, during all or any part of such Fiscal Year or such twelve (12) month period, were not in service, all in an amount equal to ninety percent (90%) of the estimated additional average annual Net Revenues to be derived from such additions, improvements and extensions for the first thirty-six (36) month period in which each addition, improvement or extension is respectively to be in operation, all as shown in the written report of an Independent Consultant engaged by the City;

(B) The Additional Allowance; and

(C) Funds then on hand in Available Reserves for the Water System.

(c) The Parity Bonds Instrument providing for the issuance of such Parity Bonds under the Indenture shall provide that:

(i) The proceeds of such Parity Bonds shall be applied to the acquisition, construction, improvement, financing or refinancing of additional facilities, improvements or extensions of existing facilities within the Water System, or otherwise for facilities, improvements or property which the City determines are of benefit to the Water System, or for the purpose of refunding any Bonds in whole or in part, including all costs (including costs of issuing such Parity Bonds and including capitalized interest on such Parity Bonds during any period which the City deems necessary or advisable) relating thereto;

(ii) Interest on such Parity Bonds shall be payable on an Interest Payment Date;

(iii) The principal of such Parity Bonds shall be payable on June 1 in any year in which principal is payable; and

(iv) Money shall be deposited in a reserve account for such Parity Bonds from the proceeds of the sale of such Parity Bonds or otherwise equal to the Reserve Requirement.

No Additional Prior Lien Bonds. No additional Bonds shall be issued pursuant to the 1990 Indenture.

Pledge of Net Revenues; Water Revenue Fund

The City has transferred, placed a charge upon, assigns and set over to the Trustee, for the benefit of the Owners, the Net Revenues of the Water System, on a parity with the 2002 Water Revenue Bonds. The Net Revenues of the Water System shall not be used for any other purpose while any of the Bonds remain Outstanding, except that out of Net Revenues of the Water System there may be apportioned and paid such sums for such purposes, as are expressly permitted by the Indenture. Said pledge shall constitute a first, direct and exclusive charge and lien on the Net Revenues of the Water System for the payment of the principal or Redemption Price of and interest on the Bonds in accordance with the terms thereof, subject only to the lien of the 1995 Bonds.

The City hereby transfers, places a charge upon, assigns and sets over to the Trustee, for the benefit of the Owners, the Net Revenues of the Water System, on a parity with the 2002 Water Revenue Bonds. The Net Revenues of the Water System shall not be used for any other purpose while any of the Bonds remain

Outstanding, except that out of Net Revenues of the Water System there may be apportioned and paid such sums for such purposes, as are expressly permitted by the Indenture. Said pledge shall constitute a first, direct and exclusive charge and lien on the Net Revenues of the Water System for the payment of the principal or Redemption Price of and interest on the Bonds in accordance with the terms thereof, subject only to the lien of the 1995 Bonds.

Receipt and Deposit of Revenues. The City covenants and agrees that all Gross Revenues, when and as received, will be received and held by the City in trust hereunder and will be deposited by the City in the Water Revenue Fund (which has heretofore been created and now exists in the City Treasury) and will be accounted for through and held in trust in the Water Revenue Fund, and the City shall only have such beneficial right or interest in any of such money as in the Indenture provided. All such Gross Revenues shall be transferred, disbursed, allocated and applied solely to the uses and purposes hereinafter in the Indenture set forth, and shall be accounted for separately and apart from all other money, funds, accounts or other resources of the City.

Establishment of Funds and Accounts and Allocation of Revenues Thereto. The Debt Service Fund, as a special Fund, and the Redemption Account and the Reserve Account, as special Accounts therein, have been created under the Indenture.

The Debt Service Fund and the Redemption Account and the Reserve Account therein shall be held and maintained by the Trustee.

All Gross Revenues shall be held in trust by the City in the Revenue Fund and shall be applied, transferred, used and withdrawn only for the purposes permitted in the Indenture.

(1) Operating Costs. The City shall first pay from the moneys in the Revenue Fund the budgeted Maintenance and Operation Costs as such Costs become due and payable.

(2) Debt Service Fund. On or before the third Business Day prior to each Interest Payment Date, beginning June 1, 2010 the City shall transfer from the Revenue Fund to the Trustee for deposit in the Debt Service Fund (i) an amount equal to the aggregate amount of interest to become due and payable on all Outstanding Series A Bonds on the next succeeding Interest Payment Date, plus (ii) beginning June 1, 2010 an amount equal to the aggregate amount of Principal Installments (including any Sinking Fund Installments) becoming due and payable on all Outstanding Series A Bonds on the next succeeding Principal Installment Date. All interest earnings and profits or losses on the investment of amounts in the Debt Service Fund shall be deposited in or charged to the Debt Service Fund and applied to the purposes thereof. No transfer and deposit need be made into the Debt Service Fund if the amount contained therein, taking into account investment earnings and profits, is at least equal to the Principal Installments or Principal Installments and interest to become due on the next Interest Payment Date or Principal Installment Date upon all Outstanding Series A Bonds.

(3) Reserve Account. After making the payments, allocations and transfers provided for in subsections (1) and (2) above, if the balance in the Reserve Account is less than the Reserve Requirement, the deficiency shall be restored by transfers from the first moneys which become available in the Revenue Fund to the Trustee for deposit in the Reserve Account, such transfers to be made no later than the times provided in the Indenture.

(4) Surplus. As long as all of the foregoing payments, allocations and transfers are made at the times and in the manner set forth above in subsections (1) to (3), inclusive, any moneys remaining in the Revenue Fund may at any time be treated as surplus and applied as provided in the Indenture.

Application of Debt Service Fund.

(a) The Trustee shall withdraw from the Debt Service Fund, prior to each Interest Payment Date, an amount equal to the Interest Requirement payable on such Interest Payment Date, and shall cause the same to be applied to the payment of said interest when due and is hereby authorized to apply the same to the payment of such interest by check or draft (or by wire transfer, as the case may be), as provided in the Indenture.

(b) The Trustee shall withdraw from the Debt Service Fund, prior to each Principal Installment Date, an amount equal to the principal amount of the Outstanding Serial Bonds, if any, maturing on said Principal Installment Date and any Sinking Fund Installments due and payable on said Principal Installment Date, and shall cause the same to be applied to the payment of the principal of said Bonds when due and is hereby authorized to apply the same to such payment upon presentation and surrender of the Bonds as they become due and payable, as provided in the Indenture.

(c) All withdrawals and transfers under the provisions of subsection (a) or subsection (b) above shall be made not earlier than one (1) day prior to the Interest Payment Date or Principal Installment Date to which they relate, and the amount so withdrawn or transferred shall, for the purposes of the Indenture, be deemed to remain in and be part of the appropriate Account until such Interest Payment Date or Principal Installment Date.

Application of Reserve Account.

If at any time there shall not be sufficient amounts in the Debt Service Fund to make payment of Principal Installments or Redemption Price of or interest on the Bonds, the Trustee shall provide notice of such fact to the City (by telephone, confirmed in writing, provided that no such notice shall be required to be given with respect to a withdrawal of amounts in excess of the Reserve Requirement or of withdrawals in connection with the refunding of the Bonds in whole or in part) and withdraw from the Reserve Account and pay into the appropriate Fund or Account the amount of the deficiency. Any amounts in the Reserve Account in excess of the Reserve Requirement (whether derived from interest or gain on investments or otherwise) shall, on June 2 of each year, be paid by the Trustee to the City for deposit in the Revenue Fund.

Application of Redemption Account. On or before the date which is at least forty-five (45) days prior to any Interest Payment Date on which Series A Bonds are subject to redemption pursuant to the Indenture or on which any Parity Bonds are subject to optional redemption pursuant to the provisions of the Parity Bonds Instrument authorizing such Parity Bonds, the City shall transfer from the Revenue Fund to the Trustee for deposit in the Redemption Account an amount at least equal to the Redemption Price (excluding accrued interest, which is payable from the Debt Service Fund) of such Bonds to be redeemed on such Interest Payment Date. In addition, the City shall transfer to the Trustee for deposit in the Redemption Account all amounts required to redeem any Series A Bonds which are subject to redemption pursuant to the Indenture and any Parity Bonds which are subject to redemption pursuant to any similar provision of the Parity Bonds Instrument authorizing such Parity Bonds, when and as such amounts become available. Amounts in the Redemption Account shall be applied by the Trustee solely for the purpose of paying the Redemption Price of Series A Bonds to be redeemed pursuant to the Indenture and to pay the purchase price in the same manner and subject to the same limitation as purchasers of Bonds under the Indenture or the Redemption Price of any Parity Bonds to be redeemed pursuant to similar provisions of the Parity Bonds Instrument authorizing such Parity Bonds. If after all of the Bonds have been paid or deemed to have been paid, there are moneys remaining in the Redemption Account, such moneys shall be transferred by the Trustee to the City for deposit in the Revenue Fund.

Surplus. Moneys remaining in the Revenue Fund after making the payments, allocations and transfers provided for in the Indenture shall be applied by the City as required by the city charter.

Investments. All moneys in the Revenue Fund may be invested by the City from time to time in any investments permitted under State law. All moneys in the Debt Service Fund and Cost of Issuance Fund shall be invested by the Trustee solely in Authorized Investments, as directed pursuant to a Request of the City. In the absence of any such Request of the City, the Trustee may (but shall not be required to)

invest any such moneys in money market funds described in paragraph (e) of the definition thereof. Obligations purchased as an investment of moneys in any Fund or Account shall be deemed to be part of such Fund or Account, and all interest or gain derived from the investment of amounts in any of the Funds or Accounts established under the Indenture shall be deposited in the Fund or Account from which such investment was made; and shall be accounted for and applied as provided in the Indenture (with respect to the Debt Service Fund) and the Indenture (with respect to the Reserve Account). For purposes of acquiring any investments under the Indenture, the Trustee may commingle funds held by it under the Indenture with the written approval of the City. The Trustee may act as principal or agent in the acquisition of any investment. The Trustee shall incur no liability for losses arising from any investments made pursuant to the Indenture.

Covenants of the City; Special Tax Covenants

Punctual Payment; Compliance With Documents. The City shall punctually pay or cause to be paid the interest and principal to become due with respect to all of the Bonds in strict conformity with the terms of the Bonds and of the Indenture, and will faithfully observe and perform all of the conditions, covenants and requirements of the Indenture and all Parity Bonds Instruments.

Against Encumbrances. The City will not mortgage or otherwise encumber, pledge or place any charge upon the Enterprise or any part thereof, or upon any of the Net Revenues, except as provided in the Indenture; provided, however, that nothing in the Indenture shall be construed to prevent the City from entering into long-term contracts to finance supplies of water, gas, or electric energy, payments under which are accounted for as Maintenance and Operation Costs.

Discharge of Claims. The City covenants that in order to fully preserve and protect the priority and security of the Bonds the City shall pay from the Net Revenues and discharge all lawful claims for labor, materials and supplies furnished for or in connection with the Enterprise which, if unpaid, may become a lien or charge upon the Net Revenues prior or superior to the lien of the Bonds and impair the security of the Bonds. The City shall also pay from the Net Revenues all taxes and assessments or other governmental charges lawfully levied or assessed upon or in respect of the Enterprise or upon any part thereof or upon any of the Net Revenues therefrom.

Acquisition, Construction or Financing of any Project and Improvements to the Enterprise. The City will acquire, construct, or finance any Project, as defined in a Parity Bonds Instrument, and Improvement to the Enterprise to be financed with the proceeds of any Parity Bonds with all practicable dispatch, and such Project and Improvement will be made in an expeditious manner and in conformity with laws so as to complete the same as soon as possible.

Maintenance and Operation of Water System in Efficient and Economical Manner. The City covenants and agrees to maintain and operate the Water System in an efficient and economical manner and to operate, maintain and preserve the Water System in good repair and working order.

Against Sale, Eminent Domain.

(a) The City will not sell, lease or otherwise dispose of the Water System or any part thereof essential to the proper operation of the Water System or to the maintenance of the Net Revenues except as herein expressly permitted. The City will not enter into any lease or agreement which impairs the operation of the Water System or any part thereof necessary to secure adequate Net Revenues for the payment of the interest on and principal or Redemption Price, if any, on the Series A Bonds, or which would otherwise impair the rights of the Holders with respect to the Net Revenues or the operation of the Water System. Any real or personal property which has become non-operative or which is not needed for the efficient and proper operation of the Water System, or any material or equipment which has worn out, may be sold at not less than the market value thereof without the consent of the Holders if such sale will not reduce Net Revenues and if all of the Net Proceeds of such sale are deposited in the Water Revenue Fund.

(b) If all or any part of the Water System shall be taken by eminent domain proceedings, the Net Proceeds realized by the City therefrom shall be deposited by the City with the Trustee in a special fund in trust, in an account to be established by the Trustee when deposits are required to be made therein, and

applied by the City to the cost of acquiring or constructing or financing Improvements to the Water System if (A) the City first secures and files with the Trustee a Certificate of the City showing (i) the estimated loss in annual Net Revenues, if any, suffered, or to be suffered, by the City by reason of such eminent domain proceedings, (ii) a general description of the Improvements to the Water System then proposed to be acquired or constructed by the City from such Net Proceeds, and (iii) an estimate of the additional Net Revenues to be derived from such Improvements; and (B) such Certificate of the City, shall state that such additional Net Revenues will sufficiently offset the loss of Net Revenues, resulting from such eminent domain proceedings so that the ability of the City to meet its obligations hereunder will not be substantially impaired, which determination shall be final and conclusive. If the foregoing conditions are met, the City shall then promptly proceed with the acquisition or construction or financing of such Improvements substantially in accordance with such Certificate of the City and payments therefor shall be made by the Trustee from such Net Proceeds and from other moneys of the City lawfully available therefor, and any balance of such Net Proceeds not required by the City for the purposes aforesaid shall be deposited in the Water Revenue Fund. If the foregoing conditions are not met, then such Net Proceeds shall be applied by the Trustee pro rata to the redemption or purchase of the Series A Bonds of each Series then Outstanding in the proportion which the principal amount of the Outstanding Bonds of each Series bears to the aggregate principal amount of all Series A Bonds then Outstanding. If the Trustee is unable to purchase or redeem Series A Bonds in amounts sufficient to exhaust the available moneys allocable to each such Series, the remainder of such moneys for each such Series shall be held in trust by the Trustee and applied to the payment of the Series A Bonds of such Series as the same become due by their terms, and, pending such application, such remaining moneys may be invested by the Trustee in the manner provided in the Indenture for the investment of moneys in the Reserve Account.

Insurance. The City covenants that it shall at all times maintain such insurance on the Water System as is customarily maintained with respect to works and properties of like character against accident to, loss of or damage to such works or properties. If any useful part of the Water System shall be damaged or destroyed, such part shall be restored to use. The Net Proceeds of insurance against accident to or destruction of the physical Water System shall be used for repairing or rebuilding the damaged or destroyed portions of the Water System, (to the extent that such repair or rebuilding is determined by the City to be useful or of continuing value to the Water System) and to the extent not so applied, shall be applied to the redemption of the Outstanding Bonds issued on a pro rata basis, and for such purpose shall be paid into the Redemption Account.

Any such insurance shall be in the form of policies or contracts for insurance with insurers of good standing and shall be payable to the City, or may be in the form of self-insurance by the City. The City shall establish such fund or funds or reserves as are necessary to provide for its share of any such self-insurance. The City shall file or cause to be filed with the Trustee, annually within one hundred twenty (120) days after the close of each Fiscal Year, a Certificate of the City (a) setting forth a description in reasonable detail of the insurance then in effect, including any self-insurance fund, maintained pursuant to the requirements of the Indenture, (b) stating that the City is then in compliance with the requirements of the Indenture, and (c) stating whether during the preceding Fiscal Year any loss has been incurred with respect to the Water System and, if so, the amount of Net Proceeds of insurance, including the Net Proceeds of any self-insurance fund, covering such loss and specifying the reasonable and necessary costs of repair, reconstruction or replacement thereof.

Records and Accounts. The City covenants that it shall keep proper books of record and accounts of the Water System, separate from all other records and accounts, in which complete and correct entries shall be made of all transactions relating to the Water System. Said books shall, upon reasonable request, be subject to the inspection of the Owners of not less than ten percent (10%) of the Outstanding Bonds or their representatives authorized in writing.

The City covenants that it will cause the books and accounts of the Water System to be audited annually by an Independent Certified Public Accountant and will make available for inspection by the Bond Owners, upon reasonable request, a copy of the report of such Independent Certified Public Accountant.

The City covenants that it will cause to be prepared annually, not more than one hundred eighty (180) days after the close of each Fiscal Year, as a part of its regular annual financial report, a summary

statement showing the amount of Gross Revenues and the amount of all other funds collected which are required to be pledged or otherwise made available as security for payment of principal of and interest on the Series A Bonds, the disbursements from the Gross Revenues and other funds in reasonable detail, and a general statement of the financial and physical condition of the Water System. The City shall furnish a copy of the statement to the Trustee, and upon written request, to any Bond Owner. The Trustee shall have no duty to review such statement.

Protection of Security and Rights of Owners. The City will preserve and protect the security of the Bonds and the rights of the Owners, and will warrant and defend their rights against all claims and demands of all persons. From and after the sale and delivery of any Parity Bonds by the City, such Parity Bonds shall be incontestable by the City.

Against Competitive Facilities. The City will not acquire, construct, operate or maintain any system or utility within the service area of the City that would be competitive with the Water System.

Payment of Taxes, Etc. The City will pay and discharge all taxes, assessments and other governmental charges which may hereafter be lawfully imposed upon the Water System or any part thereof or upon any Revenues when the same shall become due. The City will duly observe and conform with all valid requirements of any governmental authority relative to the Water System or any part thereof, and will comply with all requirements with respect to any state or federal grants received to assist in paying for the costs of the acquisition, construction or financing of any Improvements to the Water System.

Rates and Charges. a) The City shall fix, prescribe, revise and collect Charges for the Water System during each Fiscal Year which (together with other funds transferred from stabilization reserve funds for the Water System, and which are lawfully available to the City for payment of any of the following amounts during such Fiscal Year) are at least sufficient, after making allowances for contingencies and error in the estimates, to pay the following amounts in the following order:

(1) all Maintenance and Operation Costs of the Water System estimated by the City to become due and payable in such Fiscal Year;

(2) the Debt Service;

(3) all other payments required for compliance with the Indenture and the instruments pursuant to which any Parity Bonds relating to the Water System shall have been issued; and

(4) all payments required to meet any other obligations of the City which are charges, liens, encumbrances upon or payable from the Gross Revenues of the Water System or the Net Revenues of the Water System.

(b) In addition, the City shall fix, prescribe, revise and collect Charges for the Water System during each Fiscal Year which, when added to the balance then on hand in Available Reserves for the Water System, are sufficient to yield Net Revenues of the Water System at least equal to one hundred twenty-five percent (125%) of the amounts payable under the preceding clause (a)(2) in such Fiscal Year for Bonds which have a lien on such Net Revenues.

(c) To the extent that the City appropriates funds from Gross Revenues into a stabilization reserve fund for the Water System, a deduction shall be made from Gross Revenues of the Water System in the Fiscal Year during which said transfer occurred for purposes of calculations to be made under the Indenture. To the extent that the City appropriates funds from a stabilization reserve fund for the Water System into the Water Revenue Fund, the City may count the funds so transferred as Gross Revenues in the Fiscal Year in which said transfer occurs, for purposes of the Indenture.

Maintenance of Available Reserves; Transfers Therefrom. (A) The City shall maintain the funds on hand in Available Reserves in an aggregate amount at least equal to five (5.0) times maximum annual debt service on all outstanding bonded indebtedness secured by Net Revenues of any of the Systems.

(B) The City shall transfer from Available Reserves, to the Water Revenue Fund, as needed, amounts sufficient to enable the City to pay all maintenance and operation costs of the Water System, and all debt service on the Bonds, when and as the same become due and payable.

No Priority for Additional Obligations. The City has covenanted that no additional bonds or other obligations shall be issued or incurred having any priority in payment of principal or interest out of the Net Revenues over the Bonds. Nothing in the Indenture shall prohibit or impair the authority of the City to issue bonds or other obligations secured by a lien on Gross Revenues or Net Revenues which is subordinate to the lien established under the Indenture, upon such terms and in such principal amounts as the City may determine.

No Arbitrage. The City shall not take, nor permit nor suffer to be taken any action with respect to the proceeds of any of the Bonds which would cause any of the Bonds to be “arbitrage bonds” within the meaning of the Tax Code.

Information Report. The City is hereby directed to assure the filing of an information report for the Series A Bonds in compliance with Section 149 (e) of the Tax Code.

Private Business Use Limitation. Not more than ten percent (10%) of the Net Proceeds of the Series A Bonds shall be used in a manner which would cause the Series A Bonds to become “private activity bonds” under and within the meaning of Section 141 (a) of the Tax Code.

Private Loan Limitation. Not more than five percent (5%) of the Net Proceeds of the Series A Bonds shall be used, directly or indirectly, to make or finance a loan (other than loans constituting Nonpurpose Obligations or assessments) to persons other than state or local government units.

Federal Guarantee Prohibition. The City shall not take any action or permit or suffer any action to be taken if the result of the same would be to cause any of the Series A Bonds to be “federally guaranteed” within the meaning of section 149(b) of the Tax Code.

Further Assurances. The City will adopt, make, execute and deliver any and all such further resolutions, instruments and assurances as may be reasonably necessary or proper to carry out the intention or to facilitate the performance of the Indenture, and for the better assuring and confirming unto the Owners of the Bonds the rights and benefits provided in the Indenture.

Rebate Requirement. The City shall take any and all actions necessary to assure compliance with section 148(f) of the Tax Code, relating to the rebate of excess investment earnings, if any, to the federal government, to the extent that such section is applicable to the Bonds.

Maintenance of Tax-Exemption. The City shall take all actions necessary to assure the exclusion of interest on the Bonds from the gross income of the Owners of the Bonds to the same extent as such interest is permitted to be excluded from gross income under the Tax Code as in effect on the date of issuance of the Bonds.

Continuing Disclosure. The City will provide information on the financial condition of the relevant System to any Bond Owner or other interested person upon request and with payment of the City-prescribed handling costs thereof. Such information will be limited to financial statements and staff reports which have previously been distributed to the City Council. Additionally, the City will file annually with the Trustee a copy of its audited financial reports.

Modification and Amendment of the Indenture

Amendment by Consent of Bond Owners. The Indenture and the rights and obligations of the City and of the Owners of the Bonds may be modified or amended at any time by a Parity Bonds Instrument which shall become binding when the written consent of the Owners of a majority in aggregate principal amount of the Bonds then Outstanding exclusive of Bonds disqualified as provided in the Indenture, are filed with the Trustee. No such modification or amendment shall (a) extend the maturity of or reduce the interest rate on any Bond or otherwise alter or impair the obligation of the City to pay the principal, interest

or redemption premiums at the time and place and at the rate and in the currency provided therein of any Bond without the express written consent of the Owner of such Bond, (b) reduce the percentage of Bonds required for the written consent to any such amendment or modification, or (c) without its written consent thereto, modify any of the rights or obligations of the Trustee.

Amendment Without Consent of Bondholders. The Indenture and the rights and obligations of the City and of the Owners of the Bonds may also be modified or amended at any time by a Parity Bonds Instrument which shall become binding upon execution and delivery, without consent of any Bond Owners, but only to the extent permitted by law and only for any one or more of the following purposes-

(a) to add to the covenants and agreements of the City in the Indenture contained, other covenants and agreements thereafter to be observed, or to limit or surrender any rights or power herein reserved to or conferred upon the City; or

(b) to make such provisions for the purpose of curing any ambiguity, or of curing, correcting or supplementing any defective provision contained in the Indenture, or in any other respect whatsoever as the City may deem necessary or desirable, provided under any circumstances that such modifications or amendments shall not adversely affect the interests of the Owners of the Bonds;

(c) to provide for the issuance of any Parity Bonds, and to provide the terms and conditions under which such Parity Bonds may be issued, including but not limited to the establishment of special funds and accounts relating to such Parity Bonds and any other provisions relating solely to such Parity Bonds, subject to and in accordance with the provisions of the Indenture; or

(d) to make such additions, deletions or modifications as may be necessary or desirable to assure exemption from federal income taxation of interest on the Bonds.

Disqualified Bonds. Bonds owned or held by or for the account of the City (but excluding Bonds held in any employees' retirement fund) shall not be deemed Outstanding for the purpose of any consent or other action or any calculation of Outstanding Bonds in the Indenture provided for, and shall not be entitled to consent to, or take any other action in the Indenture provided for.

Endorsement or Replacement of Bonds After Amendment. After the effective date of any action taken as hereinabove provided, the City may determine that the Bonds shall bear a notation, by endorsement in form approved by the City, as to such action, and in that case upon demand of the Owner of any Bond Outstanding at such effective date and presentation of his Bond for that purpose at the Trust Office of the Trustee, a suitable notation as to such action shall be made on such Bond. If the City shall so determine, new Bonds so modified as, in the opinion of the City, shall be necessary to conform to such Bond Owners' action shall be prepared and executed, and in that case upon demand of the Owner of any Bond Outstanding at such effective date such new Bonds shall be exchanged at the Trust Office of the Trustee, without cost to each Bond Owner, for Bonds then Outstanding, upon surrender of such Outstanding Bonds.

Amendment by Mutual Consent. The provisions of the Indenture shall not prevent any Bond Owner from accepting any amendment as to the particular Bond held by him, provided that due notation thereof is made on such Bond.

Events of Default and Remedies of Bond Owners

Events of Default and Acceleration of Maturities. The following events shall be Events of Default under the Indenture:

(a) Default in the due and punctual payment of the principal of any Bond when and as the same shall become due and payable, whether at maturity as therein expressed, by proceedings for redemption, by declaration or otherwise;

(b) Default in the due and punctual payment of any installment of interest on any Bond when and as such interest installment shall become due and payable;

(c) Default by the City in the observance of any of the covenants, agreements or conditions on its part in the Indenture or in any Parity Bonds Instrument or in the Bonds contained, and such default shall have continued for a period of sixty (60) days after the City shall have been given notice in writing of such default by the Trustee; or

(d) The filing by the City of a petition or answer seeking reorganization or arrangement under the federal bankruptcy laws or any other applicable law of the United States of America, or if a court of competent jurisdiction shall approve a petition, filed with or without the consent of the City, seeking reorganization under the federal bankruptcy laws or any other applicable law of the United States of America, or if, under the provisions of any other law for the relief or aid of debtors, any court of competent jurisdiction shall assume custody or control of the City or of the whole or any substantial part of its property.

Upon the occurrence of an Event of Default, the Trustee may, and shall, at the direction of the owners of a majority of the principal amount of the Bonds, by written notice to the City, declare the principal of the Bonds to be immediately due and payable, whereupon that portion of the principal of the Bonds thereby coming due and there interest thereon accrued to the date of payment shall, without further action, become and be immediately due and payable, anything in the Indenture or in the Bonds to the contrary notwithstanding. This provision, however, is subject to the condition that if, at any time after the principal of the Bonds shall have been so declared due and payable and before any judgment or decree for the payment of the moneys due shall have been obtained or entered, the City shall deposit with the Trustee a sum sufficient to pay all of the principal of and interest on the Bonds having come due prior to such declaration, with interest on such overdue principal and interest calculated at the rate of interest per annum then borne by the Outstanding Bonds, and the reasonable fees and expenses of the Trustee and those of its attorneys, and any and all other defaults known to the Trustee (other than in the payment of the principal of and interest on the Bonds having come due and payable solely by reason of such declaration) shall have been made good or cured to the satisfaction of the Trustee or provision deemed by the Trustee to be adequate shall have been made therefor, then, and in every such case, the Owners of a majority in aggregate principal amount of the Bonds at the time Outstanding may, by written notice to the City and to the Trustee, on behalf of the Owners of all of the Outstanding Bonds, rescind and annul such declaration and its consequences. However, no such rescission and annulment shall extend to or shall affect any subsequent default, or shall impair or exhaust any right or power consequent thereon.

Application of Funds Upon Acceleration. All amounts received by the Trustee pursuant to any right given or action taken by the Trustee under the provisions of the Indenture shall be applied by the Trustee in the following order upon presentation of the several Bonds, and the stamping thereon of the amount of the payment if only partially paid, or upon the surrender thereof if fully paid -

First, to the payment of the costs and expenses of the Trustee and of Bond Owners in declaring such Event of Default, including reasonable compensation to their agents, attorneys and counsel, and to the payment of the costs and expenses of the Trustee, if any, in carrying out the provisions of the Indenture, including reasonable compensation to its agents, attorneys and counsel; and

Second, to the payment of the whole amount then owing and unpaid upon the Bonds for interest and principal, with interest on such overdue amounts to the extent permitted by law at the rate of interest then borne by the Outstanding Bonds, and in case such moneys shall be insufficient to pay in full the whole amount so owing and unpaid upon the Bonds, then to the payment of such interest, principal and interest on overdue amounts without preference or priority among such interest, principal and interest on overdue amounts ratably in proportion to the aggregate of such interest, principal and interest on overdue amounts.

Other Remedies; Rights of Bond Owners. Upon the occurrence of an Event of Default, the Trustee may pursue any available remedy, in addition to the remedy specified in the Indenture, at law or in equity to enforce the payment of the principal of, premium, if any, and interest on the Outstanding Bonds, and to enforce any rights of the Trustee under or with respect to the Indenture.

If an Event of Default shall have occurred and be continuing and if requested so to do by the Owners of at least twenty-five percent (25%) in aggregate principal amount of Outstanding Bonds and indemnified as provided in the Indenture, the Trustee shall be obligated to exercise such one or more of the rights and powers conferred by the Indenture, as the Trustee, being advised by counsel, shall deem most expedient in the interests of the Bond Owners.

No remedy by the terms of the Indenture conferred upon or reserved to the Trustee (or to the Bond Owners) is intended to be exclusive of any other remedy, but each and every such remedy shall be cumulative and shall be in addition to any other remedy given to the Trustee or to the Bond Owners under the Indenture or now or hereafter existing at law or in equity.

No delay or omission to exercise any right or power accruing upon any Event of Default shall impair any such right or power or shall be construed to be a waiver of any such Event of Default or acquiescence therein; such right or power may be exercised from time to time as often as may be deemed expedient.

Power of Trustee to Control Proceedings. In the event that the Trustee, upon the happening of an Event of Default, shall have taken any action, by judicial proceedings or otherwise, pursuant to its duties under the Indenture, whether upon its own discretion or upon the request of the Owners of a majority in principal amount of the Bonds then Outstanding, it shall have full power, in the exercise of its discretion for the best interests of the Owners of the Bonds, with respect to the continuance, discontinuance, withdrawal, compromise, settlement or other disposal of such action; provided, however, that the Trustee shall not, unless there no longer continues an Event of Default, discontinue, withdraw, compromise or settle, or otherwise dispose of any litigation pending at law or in equity, if at the time there has been filed with it a written request signed by the Owners of a majority in principal amount of the Outstanding Bonds under the Indenture opposing such discontinuance, withdrawal, compromise, settlement or other disposal of such litigation. Any suit, action or proceeding which any Owner of Bonds shall have the right to bring to enforce any right or remedy under the Indenture may be brought by the Trustee for the equal benefit and protection of all Owners of Bonds similarly situated and the Trustee is hereby appointed (and the successive respective Owners of the Bonds issued under the Indenture, by taking and holding the same, shall be conclusively deemed so to have appointed it) the true and lawful attorney-in-fact of the respective Owners of the Bonds for the purpose of bringing any such suit, action or proceeding and to do and perform any and all acts and things for and on behalf of the respective Owners of the Bonds as a class or classes, as may be necessary or advisable in the opinion of the Trustee as such attorney-in-fact.

Appointment of Receivers. Upon the occurrence of an Event of Default under the Indenture, and upon the filing of a suit or other commencement of judicial proceedings to enforce the rights of the Trustee and of the Bond Owners under the Indenture, the Trustee shall be entitled, as a matter of right, to the appointment of a receiver or receivers of the Net Revenues and other amounts pledged under the Indenture, pending such proceedings, with such powers as the court making such appointment shall confer.

Non-Waiver. Nothing in the Indenture, or in the Bonds, shall affect or impair the obligation of the City, which is absolute and unconditional, to pay the interest on and principal of the Bonds to the respective Owners of the Bonds at the respective dates of maturity, as herein provided, out of the Net Revenues and other moneys herein pledged for such payment.

A waiver of any default or breach of duty or contract by the Trustee or any Bond Owners shall not affect any subsequent default or breach of duty or contract, or impair any rights or remedies on any such subsequent default or breach. No delay or omission of the Trustee or any Owner of any of the Bonds to exercise any right or power accruing upon any default shall impair any such right or power or shall be construed to be a waiver of any such default or an acquiescence therein; and every power and remedy conferred upon the Trustee or Bond Owners by the Bond Law or by the Indenture may be enforced and exercised from time to time and as often as shall be deemed expedient by the Trustee or the Bond Owners, as the case may be.

If a suit, action or proceeding to enforce any right or exercise any remedy is abandoned or determined adversely to the Bond Owners, the City and the Bond Owners shall be restored to their former positions, rights and remedies as if such suit, action or proceeding had not been brought or taken.

Rights and Remedies of Bond Owners. No Owner of any Bond issued under the Indenture shall have the right to institute any suit, action or proceeding at law or in equity, for any remedy under or upon the Indenture, unless (a) such Owner shall have previously given to the Trustee written notice of the occurrence of an Event of Default; (b) the Owners of a majority in aggregate principal amount of all the Bonds then Outstanding shall have made written request upon the Trustee to exercise the powers hereinbefore granted or to institute such action, suit or proceeding in its own name; (c) said Owners shall have tendered to the Trustee indemnity reasonably acceptable to the Trustee against the costs, expenses and liabilities to be incurred in compliance with such request; and (d) the Trustee shall have refused or omitted to comply with such request for a period of sixty (60) days after such written request shall have been received by, and said tender of indemnity shall have been made to, the Trustee.

Such notification, request, tender of indemnity and refusal or omission are hereby declared, in every case, to be conditions precedent to the exercise by any Owner of Bonds of any remedy under the Indenture; it being understood and intended that no one or more Owners of Bonds shall have any right in any manner whatever by his or their action to enforce any right under the Indenture, except in the manner herein provided, and that all proceedings at law or in equity to enforce any provision of the Indenture shall be instituted, had and maintained in the manner herein provided and for the equal benefit of all Owners of the Outstanding Bonds.

The right of any Owner of any Bond to receive payment of the principal of and interest and premium (if any) on such Bond as herein provided or to institute suit for the enforcement of any such payment, shall not be impaired or affected without the written consent of such Owner, notwithstanding the foregoing provisions or any other provision of the Indenture.

Termination of Proceedings. In case the Trustee shall have proceeded to enforce any right under the Indenture by the appointment of a receiver or otherwise, and such proceedings shall have been discontinued or abandoned for any reason, or shall have been determined adversely, then and in every such case, the City, the Trustee and the Bond Owners shall be restored to their former positions and rights under the Indenture, respectively, with regard to the property subject to the Indenture, and all rights, remedies and powers of the Trustee shall continue as if no such proceedings had been taken.

Miscellaneous

Limited Liability of City. Notwithstanding anything in the Indenture contained, the City shall not be required to advance any moneys derived from any source of income other than the Net Revenues for the payment of the principal of or interest on the Bonds, or any premiums upon the redemption thereof, or for the performance of any covenants herein contained (except to the extent any such covenants are expressly payable under the Indenture from the Gross Revenues). The City may, however, advance funds for any such purpose, provided that such funds are derived from a source legally available for such purpose and may be used by the City for such purpose without incurring indebtedness.

Benefits of Indenture Limited to Parties. Nothing in the Indenture, expressed or implied, is intended to give to any person other than the City, the Trustee and the Owners of the Bonds, any right, remedy or claim under or by reason of the Indenture. Any covenants, stipulations, promises or agreements in the Indenture contained by and on behalf of the City shall be for the sole and exclusive benefit of the Trustee and the Owners of the Bonds.

Discharge of Indenture. If the City shall pay and discharge any or all of the Outstanding Bonds in any one or more of the following ways:

- (a) by well and truly paying or causing to be paid the principal of and interest and premium (if any) on such Bonds, as and when the same become due and payable;
- (b) by depositing with the Trustee, in trust, at or before maturity, money which, together with the available amounts then on deposit in the funds and accounts established pursuant to the Indenture, is fully sufficient to pay such Bonds, including all principal, interest and redemption premiums; or

(c) by depositing with a qualified escrow holder, in trust, Defeasance Obligations in such amount as the City (verified by an Independent Certified Public Accountant) shall determine will, together with the interest to accrue thereon and available moneys then on deposit in the Funds and Accounts established pursuant to the Indenture, be fully sufficient to pay and discharge the indebtedness on such Bonds (including all principal, interest and redemption premiums, if any) at or before their respective maturity dates;

and if such Bonds are to be redeemed prior to the maturity thereof notice of such redemption shall have been mailed pursuant to the Indenture or provision satisfactory to the Trustee shall have been made for the mailing of such notice, then, at the election of the City, and notwithstanding that any of such Bonds shall not have been surrendered for payment, the pledge of the Net Revenues and other funds provided for in the Indenture with respect to such Bonds, and all other pecuniary obligations of the City under the Indenture with respect to all such Bonds, shall cease and terminate, except only the obligation of the City to pay or cause to be paid to the Owners of such Bonds not so surrendered and paid all sums due thereon from amounts set aside for such purpose as aforesaid, and all expenses and costs of the Trustee. Notice of such election shall be filed with the Trustee.

Any funds thereafter held by the Trustee, which are not required for said purposes, shall be paid over to the City.

Refunding bonds may be issued at any time without regard to whether an Event of Default exists.

To accomplish defeasance the City shall cause to be delivered (i) a report of an Independent Certified Public Accountant verifying the sufficiency of the escrow established to pay the Bonds in full on the maturity or earlier redemption date ("Verification"), (ii) an escrow deposit agreement, and (iii) an opinion of nationally recognized bond counsel to the effect that the Bonds are no longer "Outstanding" under the Indenture; each Verification and defeasance opinion shall be acceptable in form and substance, and addressed, to the City and the Trustee.

APPENDIX B

GENERAL AND ECONOMIC INFORMATION ABOUT THE CITY

General

The City is located in northern Santa Clara County (the “County”), approximately 35 miles south of the City of San Francisco. The City has a current population of approximately 64,500. It is part of the San Francisco Bay metropolitan area. Partly due to the presence of Stanford University, which is adjacent to the City, the City is considered the birthplace of the high technology industry that has made the County famous worldwide as Silicon Valley. The 630-acre Stanford Research Park includes prestigious and innovative high-tech leaders such as Hewlett-Packard, SAP America, Varian Medical Systems, VMware, Tibco Software, Space Systems Loral, the Electric Power Research Institute and Communications and Power Industries. The City is also a major employment center, including U.S. Department of Veteran Affairs’ Palo Alto Health Care System, Stanford Hospitals and Clinics, Lockheed Martin Missiles and Space, Palo Alto Medical Foundation, Stanford Shopping Center, the law offices of Wilson Sonsini Goodrich and Rosati, and the Xerox Palo Alto Research Center.

The City was incorporated in 1894. Its first Charter was granted by the State of California in 1909, and the City continues to operate as a charter city. Municipal operations are conducted under the Council-Manager form of government. The nine City Council Members are elected at large for four-year, staggered terms. The Mayor and Vice Mayor are elected annually at the first City Council meeting in January. The Mayor presides over all City Council meetings. The City Manager is responsible for the operation of all municipal functions, except the offices of the City Attorney, City Clerk, and City Auditor. These officials are appointed by, and report directly to, the City Council.

Population

The following table shows a historical comparison of the respective populations of the City, the County and the State of California since 1970.

**CITY OF PALO ALTO, SANTA CLARA COUNTY,
AND STATE OF CALIFORNIA
Population Comparison**

Year	City of Palo Alto	Percent Change	Santa Clara County	Percent Change	State of California	Percent Change
1970	56,040	-	1,064,714	-	19,953,134	-
1980	55,225	-1.5%	1,295,071	2.2%	23,667,902	1.9%
1990	55,900	1.2	1,497,577	15.6	29,758,213	25.7
2000	58,598	4.8	1,682,585	12.4	33,873,086	13.8
2001	60,270	2.9	1,701,385	1.1	34,430,970	1.6
2002	60,326	0.1	1,715,329	0.8	35,063,959	1.8
2003	60,323	0.0	1,726,183	0.6	35,652,700	1.7
2004	60,487	0.3	1,738,654	0.7	36,199,342	1.5
2005	61,464	0.3	1,753,041	0.8	36,676,931	1.3
2006	62,108	1.0	1,771,610	1.1	37,086,191	1.1
2007	62,267	0.3	1,798,242	1.5	37,472,074	1.0
2008	63,098	1.3	1,829,480	1.7	37,883,992	1.1
2009	64,484	2.2	1,857,621	1.5	38,292,687	1.1

Sources: U.S. Department of Commerce, Bureau of the Census (1980, 1990 and 2000); State of California, Department of Finance, E-4 Population Estimates for Cities, Counties and the State, 2001–2009, with 2000 Benchmark. Sacramento, California, May 2009.

History

The earliest record of settlement in Palo Alto was dated 1769. The City is named for the tree by the banks of the San Francisquito Creek bordering Menlo Park. Many of the Spanish names in the Palo Alto area represent the local heritage and descriptive terms and former residents. In 1895, Leland Stanford came to the town of Mayfield (in what is now south Palo Alto), interested in founding his university there, and creating a train stop near his school. However, he had one condition: alcohol be banned from the town. Mayfield rejected his requests for reform. This prompted Stanford to drive the formation of Palo Alto in 1895. Stanford set up his university, Stanford University, and train stop. On July 2, 1925, Palo Alto voters approved the annexation of Mayfield and the two communities were officially consolidated on July 6, 1925.

Budgetary Policies and Processes

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. Public hearings are conducted to obtain public comments. The adopted budget is legally enacted through passage of a budget ordinance for all funds except for agency funds. 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. 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. Formal budgetary integration is employed as a management control device during the year in all funds except agency funds and certain debt service funds. Budgets for governmental funds are adopted on a basis consistent with generally accepted accounting principles 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. Expenditures for the City's 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.

Ad Valorem Property Taxes

Taxes are levied for each fiscal year on taxable real and personal property which is situated in the County of Santa Clara as of the preceding March 1. For assessment and collection purposes, property is classified either as "secured" or "unsecured," and is listed accordingly on separate parts of the assessment roll. The "secured roll" is that part of the assessment roll containing State-assessed property and property the taxes on which are a lien on real property sufficient, in the opinion of the County Assessor, to secure payment of the taxes. Other property is assessed on the "unsecured roll."

Assessed Valuations

The valuation of property in the City is established by the Santa Clara County Assessor. Assessed valuations are reported at 100% of the full value of the property, as defined in Article XIII A of the California Constitution. Prior to 1981-82, assessed valuations were reported at 25% of the full value of property.

The California State Legislature adopted two types of State-reimbursed exemptions beginning in the tax years 1969-1970. The first currently provides a credit of \$7,000 of the full value of an owner-occupied dwelling for which application has been made to the County Assessor. Revenue estimated to be lost to local taxing agencies due to the above exemptions has in the past been reimbursed from State sources. Reimbursement is based upon total taxes due upon such exemption values and therefore is not reduced by any estimated amount of actual delinquencies.

Pursuant to legislation adopted in 1979 (Statutes of 1979, Chapter 1150), business inventories are entirely exempt from taxation in fiscal year 1980-81, and each fiscal year thereafter. This law further provides a formula for reimbursement by the State to cities, counties, special districts and school districts for the amount of tax revenues lost by reason of such exemption, as adjusted for percentage changes in the population and the cost of living. Under prior State law, the State paid 50% of the taxes that were levied against business inventories. Under Chapter 1150, the State pays, as a subvention, an amount equal to 100%

of taxes that would otherwise be due (excluding taxes to pay for voter approved indebtedness) from business inventories commencing with the 1980-81 fiscal year. To compute amounts payable by the State, 1979-80 was established as the base year for business inventory subventions; thereafter, the subventions due are increased based upon increases in population and inflation rather than expanded business inventories.

In addition, certain classes of property such as churches, colleges, not-for-profit hospitals and charitable institutions are exempt from property taxation and do not appear on the tax rolls. No reimbursement is made by the State for such exemptions.

The following table provides a five-year record of assessed valuations for the City.

**CITY OF PALO ALTO
ASSESSED VALUATIONS OF TAXABLE PROPERTY
2002-03 through 2007-08
(In Thousands)**

Fiscal Year	Secured Valuation	Public Utility	Unsecured Valuation	Total Assessed Value
2002-03	\$13,141,986	\$3,859	\$1,612,179	\$13,806,217
2003-04	13,780,439	3,956	1,582,368	14,170,217
2004-05	15,018,545	4,150	1,354,310	14,974,966
2005-06	16,480,816	4,084	1,361,117	16,250,145
2006-07	17,854,262	3,923	1,391,284	17,609,613
2007-08	19,180,057	3,174	1,536,584	18,922,488

Source: City of Palo Alto, Certified Annual Financial Report 2007-08

The following two tables set out the amounts of property tax collected in the City and the ten largest property-taxpayers in the City, respectively.

**CITY OF PALO ALTO
PROPERTY TAX LEVIES AND COLLECTIONS
2001-02 through 2007-08
(In Thousands)**

Fiscal Year	Gross Tax Levy	Current Tax Collections	Percentage of Current Levy Collected	Delinquent Tax Collections	Total Collections
2001-02	\$13,231	\$13,231	100%	-	\$13,231
2002-03	13,821	13,821	100	-	13,821
2003-04	13,707	13,707	100	-	13,707
2004-05	16,657	16,657	100	-	16,657
2005-06	18,731	18,731	100	-	18,731
2006-07	21,466	21,466	100	-	21,466
2007-08	23,084	23,084	100	-	23,084

Source: County of Santa Clara Assessor's Office, as published in the City of Palo Alto, Certified Annual Financial Report 2007-08

CITY OF PALO ALTO
TEN LARGEST PROPERTY OWNERS
Fiscal Year ending June 30, 2008
(In Thousands)

<u>Company</u>	<u>Type of Business</u>	<u>Assessed Property Valuation</u>
Leland Stanford Jr. University	University and Ancillary	\$2,968,746
Space Systems/Loral Inc.	Satellite Design & Manufacturing	169,513
Whisman Ventures, LLC	Offices, Banks and Clinics	100,470
Harbor Investments Partners	Offices, Banks and Clinics	65,791
Western Pacific Housing Inc	Housing Development	60,033
EOP-Embarcadero Place, LLC	Offices, Banks and Clinics	45,000
505 Hamilton Avenue Partners L.P.	Offices, Banks and Clinics	38,583
Pacific Hotel Dev Venture L.P.	Offices, Banks and Clinics	38,143
Palo Alto Town & Country Village Inc	Mall, Shopping Center	37,031
California Pacific Comm. Corp.	Offices, Banks and Clinics	35,953

Source: City of Palo Alto, Certified Annual Financial Report 2007-08

Employment

The City is home to a strong mix of large, medium and small firms. The City employment opportunities are much sought after and include: education at Stanford University, high technology at the Stanford Research Park, and health care at two medical facilities of national stature. Numerous institutions that have more than 1,000 employees include: the University, the Veterans Affairs Palo Health Care facility, the Medical Foundation, Hewlett Packard/Compaq, the Palo Alto Unified School District, and the City.

The largest employers in the City of Palo Alto as of June 30, 2008 are as follows:

CITY OF PALO ALTO
TEN LARGEST EMPLOYERS
2007-08

<u>Employer</u>	<u>Number of Employees</u>
HP Labs	7,500
Veteran's Affairs Palo Alto Health Care System	3,500
VA Palo Alto Health Care	2,900
Hewlett-Packard Company	2,001
Palo Alto Medical Foundation	2,000
Space Systems Loral	1,700
Wilson Sonsini Goodrich Rosati	1,500
Packard Children's Hospital	1,300
City of Palo Alto	1,100
Roche Palo Alto	1,000

Source: www.ReferenceUSA.com & Palo Alto Weekly, as published in City of Palo Alto Certified Annual Financial Report 2007-08

Due to the nature of local industry, with its heavy emphasis on electronics, aerospace and research, Santa Clara has attracted many professional people and industrial workers possessing skills well above the average.

The Santa Clara Labor Market, as defined by the State Employment Development Department, includes all cities within Santa Clara County. This area is a highly developed industrial, research, and educational center of employment for a labor force that ranks well above the average in educational attainment and income. The following table presents the annual average wage and salary employment figures by industry classification for the San Jose-Sunnyvale-Santa Clara Metropolitan Statistical Area for the years 2004 through 2008.

According to the California Employment Development Department, the County's unemployment rate was 6.0% in 2008, up from 4.7% in 2007. The following table sets forth certain information regarding employment in the City from calendar year 2002 through 2008.

**SAN JOSE-SUNNYVALE-SANTA CLARA MSA
(San Benito and Santa Clara Counties)
Industry Employment & Labor Force - by Annual Average
March 2008 Benchmark**

	2004	2005	2006	2007	2008
Civilian Labor Force	850,100	844,500	854,300	876,500	905,200
Civilian Employment	794,500	798,600	815,300	834,800	850,100
Civilian Unemployment	55,600	45,900	38,900	41,700	55,100
Unemployment Rate	6.5%	5.4%	4.6%	4.8%	6.1%
Agricultural	6,700	6,300	6,200	6,700	6,100
Natural Resources and Mining	100	200	300	300	300
Construction	43,000	44,500	46,800	47,200	44,200
Manufacturing	167,200	164,900	163,700	166,700	168,000
Trade, Transportation and Utilities	130,900	132,800	137,100	139,700	138,500
Information	32,600	35,300	37,500	39,600	41,700
Financial Activities	35,400	36,300	37,100	37,200	34,800
Professional and Business Services	165,600	165,800	172,000	178,300	178,700
Educational and Health Services	95,000	96,800	100,400	103,200	107,500
Leisure and Hospitality	70,900	72,800	75,200	76,800	78,200
Other Services	25,000	24,600	24,800	25,100	25,300
Government	96,300	95,900	96,400	97,200	97,800
Total All Industries	868,700	876,300	897,400	917,900	921,200

Source: California Employment Development Department, Labor Market Information Division.

Note: Totals may not add due to independent rounding.

**CITY OF PALO ALTO
Average Annual Civilian Labor Force
Employment and Unemployment
Calendar Years 2002-2008**

Year	Labor Force	Unemployment Number	Rate
2002	32,000	1,400	3.7%
2003	30,500	1,400	4.5%
2004	29,900	1,000	3.4%
2005	29,900	800	2.8%
2006	30,400	700	2.3%
2007	31,200	800	2.5%
2008	32,000	1,000	3.2%

Source: California Employment Development Department

Construction Activity

"Single Family Housing," includes detached, semi-detached, rowhouse and townhouse units. Rowhouses and townhouses are included when each unit is separated from the adjacent unit by an unbroken ground-to-roof party or fire wall. Condominiums are included in single-family when they are of zero-lot-line or zero-property-line construction; when units are separated by an air space; or, when units are separated by an unbroken ground-to-roof party or fire wall. "Multi-Family Housing," includes duplexes, 3-

4-unit structures and apartment-type structures with five units or more. Multi-family housing also includes condominium units in structures of more than one living unit that do not meet the above single-family housing definition. "Residential Alterations and Additions," means alterations, additions, and conversions to residential structures, excluding special installation permits for electrical, plumbing, heating, air-conditioning, or similar mechanical work, or installation of fire escapes, elevators, signs, etc.

"New Commercial," includes new hotels and motels, office and bank buildings, stores and other mercantile buildings, parking garages, service stations, and amusement and recreational buildings. "New Industrial," includes manufacturing plants and affiliated buildings. "Other New Nonresidential," includes churches and religious buildings, hospitals and institutional buildings, schools and educational buildings, residential garages, public works and utilities buildings, and miscellaneous nonresidential structures. "Nonresidential Alterations and Additions," means alterations, additions, and conversions to nonresidential structures, excluding special installation permits for electrical, plumbing, heating, air conditioning, or similar mechanical work, or installation of fire escapes, elevators and signs, etc.

CITY OF PALO ALTO
Building Permits and Valuation
(Dollars in Thousands)

	2004	2005	2006	2007	2008
<u>Permit Valuation:</u>					
New Single-family	\$ 28,337	\$ 46,957	\$ 78,044	\$ 82,769	\$ 50,213
New Multi-family	22,125	13,911	28,338	81,679	27,827
Res. Alterations/Additions	32,993	36,943	30,770	34,756	33,897
Total Residential	83,455	97,811	137,152	199,204	111,937
Total Nonresidential	48,393	131,289	168,817	133,547	90,019
Total All Building	<u>\$131,848</u>	<u>\$229,101</u>	<u>\$303,969</u>	<u>\$332,751</u>	<u>\$201,956</u>
<u>New Dwelling Units:</u>					
Single Family	58	82	147	195	102
Multiple Family	149	83	117	294	125
Total	<u>207</u>	<u>165</u>	<u>264</u>	<u>489</u>	<u>227</u>

Sources: Construction Industry Research Board: "Building Permit Summary."

Note: Totals may not add due to independent rounding.

Income

The following table, based on data reported in the annual publication "Survey of Buying Power" published by Sales and Marketing Management, summarizes the median household effective buying income for the City, the County of Santa Clara, the State of California and the nation for the years 2004 through 2008.

**CITY, COUNTY, STATE AND UNITED STATES
Effective Buying Income**

Year	Area	Total Effective Buying Income (000's Omitted)	Median Household Effective Buying Income
2004	City of Palo Alto	\$ 2,877,945	\$73,411
	County of Santa Clara	474,763,338	62,614
	California	705,108,410	43,915
	United States	5,692,909,567	39,324
2005	City of Palo Alto	\$ 2,733,365	\$74,484
	County of Santa Clara	46,910,278	63,293
	California	720,798,106	44,681
	United States	5,894,663,364	40,529
2006	City of Palo Alto	\$ 2,839,023	\$77,184
	County of Santa Clara	49,261,000	65,458
	California	764,120,962	46,275
	United States	6,107,092,244	41,255
2007	City of Palo Alto	\$ 3,000,778	\$79,273
	County of Santa Clara	52,377,985	67,498
	California	814,894,438	48,203
	United States	6,300,794,040	41,792
2008	City of Palo Alto	\$ 3,088,305	\$80,515
	County of Santa Clara	53,987,635	68,929
	California	832,531,445	48,952
	United States	6,443,994,426	42,303

Source: "Survey of Buying Power," Sales and Marketing Management (2004); Claritas, Inc. (2005-2008).

* In 2005, Sales and Marketing Management ceased publishing the "Survey of Buying Power" report; however, subsequent years' data has been obtained from Claritas, Inc., who had previously prepared the data each year for the "Survey of Buying Power."

Commercial Activity

Taxable sales in the City of Palo Alto exceed \$1.9 billion annually. The County Planning Department reports that taxable sales per capita in Santa Clara are the highest of any city in Santa Clara County. The following summary shows the annual volume of taxable sales within the City since 2003. During 2007, retail sales totaled nearly \$1,300,000 and total taxable sales reached over \$1,900,000.

The following table shows annual sales tax revenues for the City for the last five years.

CITY OF PALO ALTO					
Taxable Transactions					
	2003	2004	2005	2006	2007 (1)
Apparel stores	115,793	121,820	127,235	129,903	134,920
General merchandise	250,904	276,625	284,186	289,288	301,192
Foods stores	34,571	34,120	33,726	33,495	31,781
Eating and drinking places	197,266	202,651	208,128	224,276	234,084
Home furnishings and appliances	58,394	59,936	64,308	68,273	75,510
Building materials	16,543	20,159	23,619	26,258	24,437
Automotive Group	201,196	196,341	203,998	202,441	187,342
Service stations	40,983	49,511	56,548	60,078	63,418
All other retail stores	227,027	239,684	248,882	250,153	224,463
Total Retail Outlets	1,142,677	1,200,847	1,250,630	128,465	1,277,147
All other outlets	380,460	419,867	458,491	551,068	629,859
Total All Outlets	1,523,137	1,620,714	1,709,121	1,835,233	1,907,006

Source: California State Board of Equalization, Taxable Sales in California Reports 2003-2007.

(1) Latest available full-year data.

Education

The Palo Alto Unified School District provides public schooling from kindergarten through high school. The Stanford University is the second largest university campus in the world. The University comprises the Schools of Engineering, Law, Medicine, Education, Business, Earth Sciences and Humanities and Science. Stanford University's teaching hospital and clinics are known for excellence.

Community Facilities

The City has some of the most outstanding healthcare facilities in California. Most prominent in the community is Stanford Hospital & Clinics, which is part of Stanford University Medical Center. With 611 beds for in-patient treatment, emergency care and major surgeries, Stanford Hospital is well known for its cancer treatment, oncology and transplant services.

Medical groups affiliated with Stanford Hospital & Clinics are Stanford Family Practice, Stanford Medical Group and Menlo Medical Clinic, and also includes the Stanford University School of Medicine and the Lucile Packard Children's Hospital.

The Veterans Affairs Palo Alto Health Care System provides the main campus in Palo Alto, a second campus in Menlo Park and a third campus in Livermore.

The Palo Alto Health Care System has 913 operating beds including three nursing homes and a 100-bed homeless domiciliary on the Menlo Park campus. The Health Care System is affiliated with the Stanford University School of Medicine.

The Palo Alto Medical Foundation is a full-service health-care clinic and research institute. Nearly 250 physicians provide a range of diagnostic and treatment services in primary care and most medical specialties.

The City's Parks and Recreation Department oversees 34 parks and playgrounds covering nearly one-third of its 26 square miles open space. The City's San Francisco Bay location and natural environment offer the opportunity to enjoy bird and aquatic life in a natural habitat. There is one golf course located in the City, a recently renovated 18-hole championship length course.

Transportation

The City is served by the Bayshore Freeway (U.S. Highway 101), which runs southeast from San Francisco to Los Angeles and is the major freeway connecting San Francisco and San Jose; Highway 84 - the Dumbarton Bridge and Highway 92, the Hayward-San Mateo Bridge; and Interstate 280, which runs north/south to San Francisco and State Highway 82. These freeways link the City to all parts of northern California.

Air transportation is available at both the San Francisco International Airport, approximately 40 miles to the north, and the San Jose Airport, approximately 20 miles to the south. Rail service is provided by Union Pacific Railroad, on a north/south track linking San Jose and San Francisco, and Cal Train commuter service to Gilroy and San Francisco.

Within the City, commuter rail transportation is conveniently located and the Palo Alto stop is one of the most used in the CalTrain system. Alternative transportation options include numerous bike paths throughout the City and an internal shuttle service is also available.

Utilities and Water Supply

The City is the only municipal utility in California that operates city-owned utility services that include electric, fiber optic, natural gas, water and wastewater services. Since 1896, the City has been providing quality services to the citizens and businesses of the City.

Agriculture

The City still supports a thriving agriculture industry, ranging from crops and wine to Leland Stanford's horse farm and training facilities, the Dixon Stables, Portola Valley Training Center, and Webb Ranch are just a few of the equestrian facilities that live up to the area's rich history. Just a few miles away off Highway 280, traditional ranches such as Hidden Villa continue to grow and distribute quality products. Organic grocery stores, such as Whole Foods Market, Piazza's Market and Trader Joe's share the market place with traditional grocery outlets and fresh fruit and vegetable stands.

Local greenhouses and florists provide a diverse selection to help residents and business beautify their yards and homes. The area also features a number of machinery and equipment outlets to make agriculture related job feasible.

Government and Services

The City was incorporated in 1894. Its first Charter was granted by the State of California in 1909, and the City continues to operate as a charter city. Municipal operations are conducted under the Council-Manager form of government. The nine City Council Members are elected at large for four-year, staggered terms. The Mayor and Vice Mayor are elected annually at the first City Council meeting in January. The Mayor presides over all City Council meetings. The City Manager is responsible for the operation of all municipal functions, except the offices of the City Attorney, City Clerk, and City Auditor. These officials are appointed by, and report directly to, the City Council.

The City provides a full range of municipal services and maintains municipal electric, water, gas, wastewater collection, wastewater treatment, storm drainage, and refuse utilities for the benefit of City residents and businesses. The City's parks, recreation and cultural facilities are numerous, and include 35 parks, a golf course, four community centers, a Cultural Center, a Community Theater, a Children's Theater, and a Junior Museum. The City offers a wide array of social, recreational and cultural events, including human services for seniors and youth, subsidized child care, classes, concerts, exhibits, team sports and special events. The City and the Palo Alto Unified School District have an agreement to jointly fund the costs of maintaining and rehabilitating school athletic fields, recognizing the significant recreational use of these facilities by the community. In addition, the City offers a high level of library and public safety services. The City has six libraries and eight fire stations providing services throughout the community.

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APPENDIX C

COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE CITY FOR THE FISCAL YEAR ENDED JUNE 30, 2008

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2007-08
Comprehensive
Annual Financial Report
Fiscal Year Ended June 30, 2008



**City of
Palo Alto
California**

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City of Palo Alto California

Comprehensive Annual Financial Report

For the fiscal year ended
June 30, 2008



Prepared by: Administrative Services Department

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City of Palo Alto

Office of the City Manager

Transmittal Letter.....

December 16, 2008

THE HONORABLE CITY COUNCIL
Palo Alto, California

Attention: Finance Committee

COMPREHENSIVE ANNUAL FINANCIAL REPORT
YEAR ENDED JUNE 30, 2008

Members of the Council and Citizens of Palo Alto:

Transmittal: The Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2008, is submitted for Council review in accordance with Article III, Section 16 and 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 completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control that it has established for this purpose. The objective of internal controls is to provide reasonable, rather than absolute, assurance that 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, 2008, and that the financial statements are fairly presented in conformity with generally accepted accounting principles (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 63,367, 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, the Stanford Shopping Center and businesses such as, Hewlett-Packard Company, Varian, Space Systems Loral, Palo Alto has enjoyed a diverse employment and revenue base.

Overall, revenues remained stable in 2007-08. Sales tax receipts, for example, increased by 1.9 percent over prior year levels. Transient occupancy taxes, after adjusting for a rate increase from 10 to 12 percent in January 2008, experienced organic growth of 7.6 percent over 2006-07. Similarly, property taxes rose by 7.5 percent. Somewhat shielded from the decline in the State’s economic woes, Silicon Valley held steady as technology sales and exports remained strong.

Preliminary data for 2008-09, however, is showing weakness in the economically sensitive revenue sources. Sales taxes from automobile and department stores are trending downward, hotel days are declining, and documentary transfer taxes from home and commercial sales are weakening. Credit tightening, falling stock prices, declines in corporate profits, and retrenchment in consumer spending appear to be taking a toll. The downward spiral of the national, State, and international economies are of serious concern.

As with the economic downturns in the early 1990s and 2000s, the City can be expected to take action to align expenses with its revenues. During the dot.com collapse the City closed a \$20 million structural deficit, primarily through expense reductions. On the revenue side, the City has been active in maintaining and attracting businesses that generate tax revenues. Examples include efforts to relocate a key auto dealership, participation in a regional effort to attract hotel traffic, and discussions on expanding the well regarded Stanford Shopping Center.

Employment Trends: Palo Alto is home to a strong mix of small, medium, and large firms. Employment opportunities within the City 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 Alto Health Care facility, the Medical Foundation, Hewlett Packard, the Palo Alto Unified School District, and the City of Palo Alto. A recent study states that “Palo Alto is home to over 98,000 workers and 6,000 businesses including a mix of high technology, private equity, and investment and venture capital firms.” Currently, Palo Alto’s unemployment rate is 3.5 percent; 4.1 percent and 2.6 percent under the State’s and national rate, respectively. The Bay Area’s ties and exports to the stronger Asian economies are expected to soften impacts on employment from the State and national economic malaise

Real Estate Market: In its most recent annual report, the Santa Clara County Assessor’s Office noted that the countywide annual rate of growth in residential and commercial assessed value has declined over the past 3 years. In 2005-06 the rate of growth was 9.6 percent; in 2006-07 it was 8.3 percent in 2007-08 it was 7.0 percent; and in 2008-09 it is expected to trend lower. The City of Palo Alto’s assessed value increased by 7.5 percent in 2007-08. These figures indicate a relatively healthy local real estate market, but recent documentary or property transfer tax revenues are softening. This may indicate a future slowdown in Palo Alto’s assessment roll growth. According to the Assessor’s Office in 2007-08 “the number of transactions recorded declined 15 percent over the prior year. In addition, the number of residential properties in which market values declined below the factored base year value, more than doubled to 41,000.” The Assessor went on to say that “just as major parts of



the residential market have cooled during the last three years, the commercial and industrial market has experienced a modest resurgence. Companies like Adobe, Facebook, Oracle, Google, e-Bay and Apple are expanding, while other companies like Sun, Yahoo, and HP are consolidating their facilities.”

Overall, demand for housing in Palo Alto remained relatively strong. In past recessions, such as in the early 1990s, Palo Alto home prices either reached a plateau or dipped slightly. With its highly regarded school district, well-educated and high income population, cultural amenities, and the presence of Stanford University, the City’s real estate values have been shielded from major price swings. With the current economic downturn, this phenomenon is likely to repeat itself.

Long Range Financial Forecast: The City of Palo Alto produces a 10 year Long Range Financial Forecast (LRFF) annually. This comprehensive report analyzes, for example, local, state, and federal economic conditions; short and long-term revenue and expense trends; expense challenges such as funding retiree medical benefits; revenue opportunities such as instituting an occupancy tax increase; and infrastructure needs. The forecast is designed to highlight finance issues which the City can address proactively. Moreover, it is a tool that allows policymakers an opportunity to prioritize funding needs over time.

Delivered to Council in December, this forecast sets the tone and themes for the annual budget process that begins in January. The forecast is one of the many tools and reports the City uses for financial planning. These include, for example: quarterly revenue and expense analyses, midyear budget adjustments, a five year capital improvement plan, quarterly sales tax reports, and actuarial reports to ascertain long-term retiree liabilities. Basically, the City is conscientious and pro-active in financial planning. It is worthwhile to note that during the last two economic downturns, the City has balanced its annual budget via expenditure reductions or revenue enhancements and has not drawn down reserves, as a consequence of revenue shortfalls.

Cash and Investments: The City of Palo Alto invests its excess cash prudently and has adopted an investment policy as prescribed by State law. The policy states that investments are to be made in the following priority order: safety, liquidity, and yield. As of June 30, 2008, the City had \$371.8 million (par value) in its portfolio. Its principal investments were in agency securities, treasuries, and a State of California investment pool. The City’s investment practice is to buy securities and hold them to maturity to avoid principal loss. Staff provides a quarterly report of investments for Council review. During 2007-08, staff complied with all requirements of the City’s 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, an 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 which the City Manager and three other officials, the City Attorney, City Clerk, and City Auditor, report directly to.



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, and 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 an award for the prior fiscal year CAFR, from the Government Finance Officers Association (GFOA) for "excellence in financial reporting". The 2007-08 CAFR has been submitted to the GFOA award program and management believes that, once again, it will meet the criteria for this distinguished financial reporting award.

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,

LALO PEREZ,
Administrative Services Director

JAMES KEENE,
City Manager



City of Palo Alto City Officials

City Council

Larry Klein, *Mayor*

Peter Drekmeier, *Vice-Mayor*

John Barton

Patrick Burt

Sid Espinosa

Yoriko Kishimoto

Jack Morton

Greg Schmid

Yiaway Yeh

Finance Committee

Jack Morton, *Chair*

Patrick Burt

Greg Schmid

Yiaway Yeh

Policy and Services Committee

Yoriko Kishimoto, *Chair*

John Burton

Peter Drekmeier

Sid Espinosa

Council-Appointed Officers

City Manager
Frank Benest

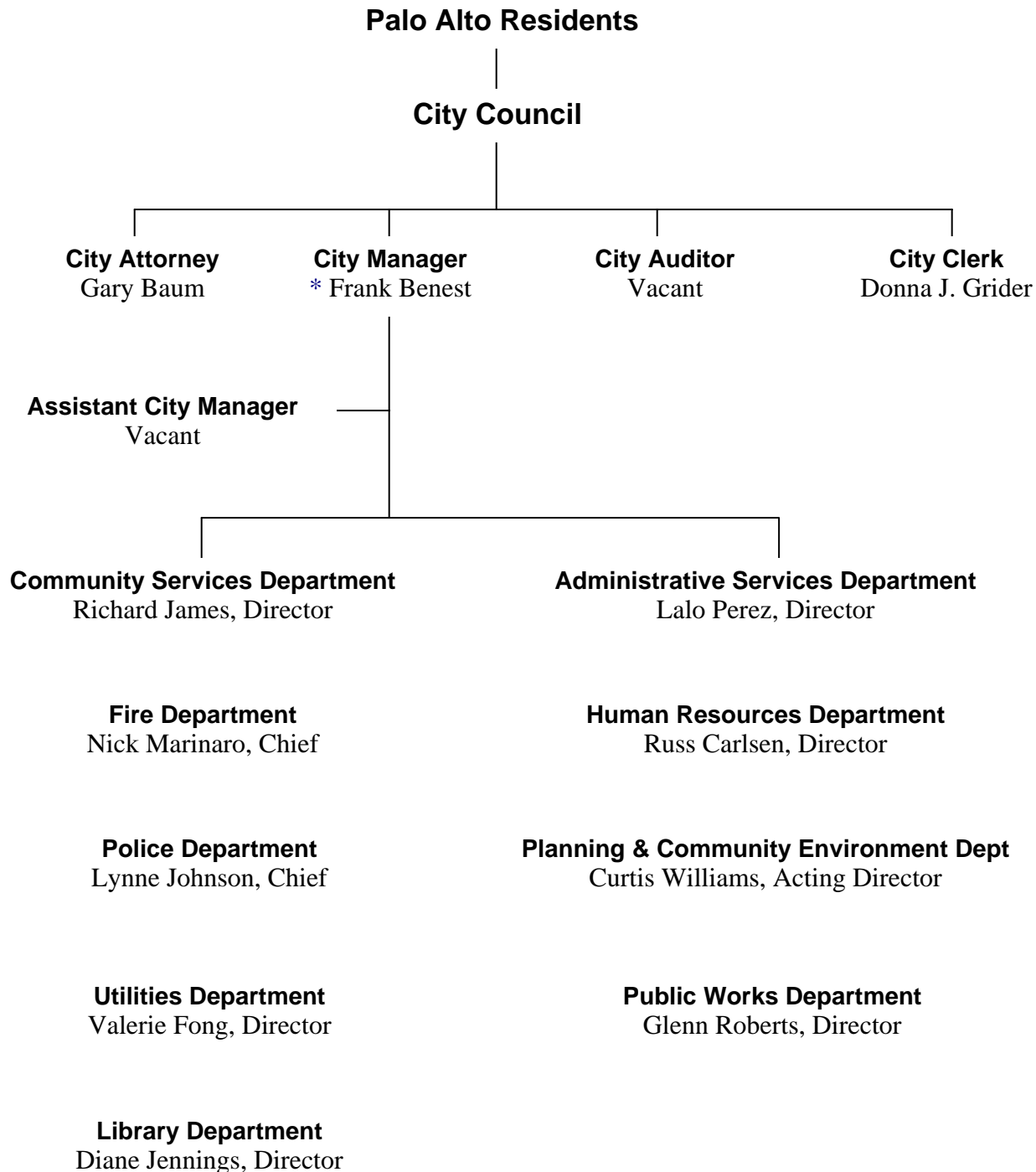
City Attorney
Gary Baum

City Clerk
Donna Grider

City Auditor
Vacant



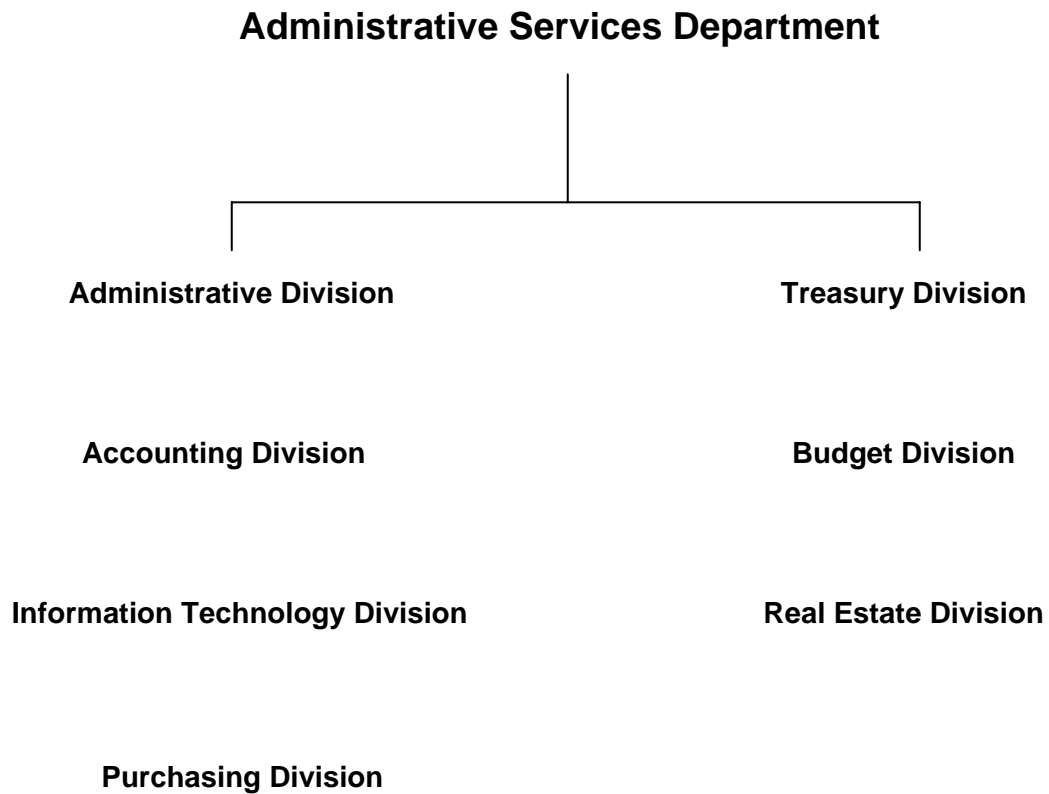
City of Palo Alto Organization



*through August 29, 2008. James Keene, effective September 2, 2008



Administrative Services Organization



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, 2007

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.



Charles S. Cox

President

Jeffrey R. Emery

Executive Director

Independent Auditor's Report.....

MAZE & ASSOCIATES

INDEPENDENT AUDITOR'S REPORT ON BASIC FINANCIAL STATEMENTS

ACCOUNTANCY CORPORATION
3478 Buskirk Ave. - Suite 215
Pleasant Hill, California 94523
(925) 930-0902 • FAX (925) 930-0135
maze@mazeassociates.com
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, 2008, 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, 2008 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.

As described in Notes 7 and 12, the City implemented the provisions of Governmental Accounting Standards Board Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* and GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

In accordance with Government Auditing Standards, we have also issued our report dated October 24, 2008 on our consideration of the City of Palo Alto's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit this information and express no opinion on it.

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

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

Maze + Associates

October 24, 2008

A Professional Corporation



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Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) provides an overview of the City of Palo Alto's financial performance for the 2007-08 fiscal year ended June 30, 2008. To obtain a complete understanding of the City's financial condition, this document should be read in conjunction with the accompanying Transmittal Letter and Basic Financial Statements.

OVERVIEW OF THE COMPREHENSIVE ANNUAL FINANCIAL REPORT

The CAFR is presented in six sections:

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

Basic Financial Statements

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

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

The Fund Financial Statements display the City's operations in more detail than the Citywide statements. Their focus is 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 produces fiduciary statements detailing the cash balances and activities of these districts. These statements are independent, and their balances are excluded from the City's financial statements.

Together, all these statements are called the Basic Financial Statements.

Citywide Financial Statements

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

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

Business-type Activities - All of the City's enterprise activities are reported as Business-type Activities, 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 customers 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 for 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. Therefore, each Major Fund is presented individually, with all Non-major Funds combined in a single column on each fund statement. Subordinate schedules display these Non-major Funds in more detail. Major Funds present the major activities of the City for the year. The General Fund is always considered 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 2007-08, the City had 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, similar to that used by private-sector companies. These statements, as in the past include all their assets and liabilities, current and long-term.

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

Budget vs. Actual financial comparisons information are presented only for the General Fund and all Major Special Revenue Funds.

Fiduciary Statements

The City is the fiduciary 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 utilize these assets to finance its own operations.

FINANCIAL HIGHLIGHTS

Economic Background

The U.S. has and continues to deal with its worst financial crisis since the Great Depression. The economy is faced with a tight credit market, growing unemployment, imploding banks, and a severe housing downturn. The State of California continues to face budget and revenue shortfalls that have led to a request for cash flow from the federal government. Through 2007-08 the local, Silicon Valley economy turned in a steady performance and was somewhat immune from factors affecting the larger economy. The technology sector and exports, particularly to Asian markets, lessened the adverse economic impacts suffered by the rest of California and the nation.

Evidence is beginning to emerge in 2008-09, however, that consumer and business confidence is eroding and that it will lead to declines in economically sensitive revenue sources such as sales and transient occupancy taxes. Sales taxes in the City of Palo Alto and surrounding cities have weakened in recent quarters; hotel days are moving downward slowly; and growth in assessed property values has slowed. Based on these trends, 2008-09 will likely present financial challenges.

As in the past, the City continues to face and address a number of expense and revenue challenges. These include: funding existing and new infrastructure needs; warding off strong competition from neighboring city retail outlets for sales tax dollars; preventing the potential exodus of key sales tax generators; and evaluating benefit costs such as rising medical premiums.

The City is proactive in dealing with these challenges. Currently, it is working with Stanford Shopping Center to expand its retail space and to build a new hotel on its premises. In January 2008, the City increased its transient occupancy tax from 10 to 12 percent to enhance its revenue base. In addition, the City is investigating a Business License Tax since it is one of a very few California cities without one. With an underlying triple A credit rating from Standard and Poor's, the City intends to maintain its sound financial and budget practices during this period of economic distress.

Citywide

- The City's total net assets increased to \$1,100.0 million, a \$38.3 million increase.
- The City's total capital assets, net of related debt, increased to \$713.8 million, a \$44.5 million increase.
- The City's total restricted net assets decreased to \$29.2 million, a \$5.1 million decrease.
- The City's total unrestricted net assets decreased to \$357.0 million, a \$1.1 million decrease.
- Citywide revenues totaled \$402.0 million, an increase of \$30.8 million from the prior year. This total consists of \$291.1 million in program revenues and \$110.9 million in general revenues. Program revenues increased by \$20.2 million and general revenues increased by \$10.5 million.
- Total Citywide expenses were \$363.7 million, a \$40.7 million increase.
- Citywide total assets increased to \$1,223.4 million, a \$54.1 million increase.
- Citywide capital assets, increased by \$49.0 million to \$768.5 million.
- Citywide other assets increased \$5.1 million to \$454.9 million.
- Citywide total liabilities were \$123.4 million, an increase of \$15.8 million.
- Citywide long-term debt increased \$4.5 million to \$54.7 million.
- Citywide other liabilities were \$68.7 million, an increase of \$11.3 million.

Fund Level – Governmental Funds

- Governmental Fund balances decreased to \$103.9 million, a \$1.6 million decrease.
- Governmental Fund revenues increased to \$127.0 million, a \$3.8 million increase.
- Governmental Fund expenditures were \$145.2 million, a \$14.5 million increase.
- General Fund revenues came in at \$115.0 million, an increase of \$4.2 million over the prior year.
- General Fund expenditures are \$115.5 million, an increase of \$7.2 million.
- The General Fund balance of \$42.4 million at June 30, 2008 was an increase of \$3.0 million from the prior year (refer to Performance of Governmental Funds – General Fund, Page #14).



Fund Level – Enterprise Funds

- Enterprise Fund net assets increased to \$600.1 million, a \$24.1 million increase.
- Enterprise Fund operating revenues increased to \$251.7 million, a \$20.1 million increase from prior year revenues.
- Enterprise Fund operating expenses increased to \$215.8 million, a \$25.5 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)			
	2008	2007	Increase/ (Decrease) from 2007
Cash and investments	\$149.9	\$173.0	(\$23.1)
Other assets	53.0	29.3	23.7
Capital assets	351.9	335.7	16.2
Total Assets	554.8	538.0	16.8
Long-term debt outstanding	8.4	9.3	(0.9)
Other liabilities	45.0	42.5	2.5
Total Liabilities	53.4	51.8	1.6
Net Assets:			
Invested in capital assets, net of debt	343.5	326.4	17.1
Restricted	27.4	32.6	(5.2)
Unrestricted	130.5	127.2	3.3
Total Net Assets	\$501.4	\$486.2	\$15.2

The City's governmental total net assets increased \$15.2 million to \$501.4 million in 2007-08. This change results from the following:

- Cash and investments decreased by \$23.1 million primarily from the transfer of \$33.8 million to California Employers Retirees Benefit Trust (CERBT). The irrevocable trust provides a funding mechanism for retiree post-employment benefits. The offset to the decreased cash is the increase of other assets of \$23.8 million. (please refer to Note 12 for details of Retiree Health Benefits and implementation of GASB 45).

- Capital assets increased \$16.2 million net of depreciation; \$6.2 million for buildings and improvements, \$4.5 million is a result of roadway network and \$1.7 million for land and improvements.
- Other liabilities increased by \$2.5 million, primarily from a \$2.4 million increase in claims payable.
- Net assets invested in capital assets, net of related debt increased \$17.1 million as the City added General Fund infrastructure assets as discussed in the Capital Assets section.
- Unrestricted net assets increased \$3.3 million for a total of \$130.5 million; this represents current net assets available to finance subsequent year operations and other expenditures approved by City Council.

GOVERNMENTAL ACTIVITIES

Revenues for the Year ended June 30

(in Millions)

Revenues by Source	2008	2007	Increase/ (Decrease) from 2007
Program Revenues:			
Charges for services	\$31.9	\$31.1	\$0.8
Operating contributions & grants	4.0	5.6	(1.6)
Capital contributions & grants	1.9	1.8	0.1
Total Program Revenues	37.8	38.5	(0.7)
General Revenues:			
Property Taxes	23.1	21.5	1.6
Sales Taxes	22.6	22.2	0.4
Utility User's Taxes	10.3	9.4	0.9
Transient Occupancy Tax	8.0	6.7	1.3
Other Taxes and Fines	6.3	6.3	0.0
Investment Earnings	12.3	8.7	3.6
Rents and Miscellaneous	11.9	13.7	(1.8)
Total General Revenues	94.5	88.5	6.0
Total Revenues	\$132.3	\$127.0	\$5.3



Governmental Activities – Revenues

The table above shows that governmental revenues totaled \$132.3 million in 2007-08, an increase of \$5.3 million compared to prior year revenues of \$127.0 million.

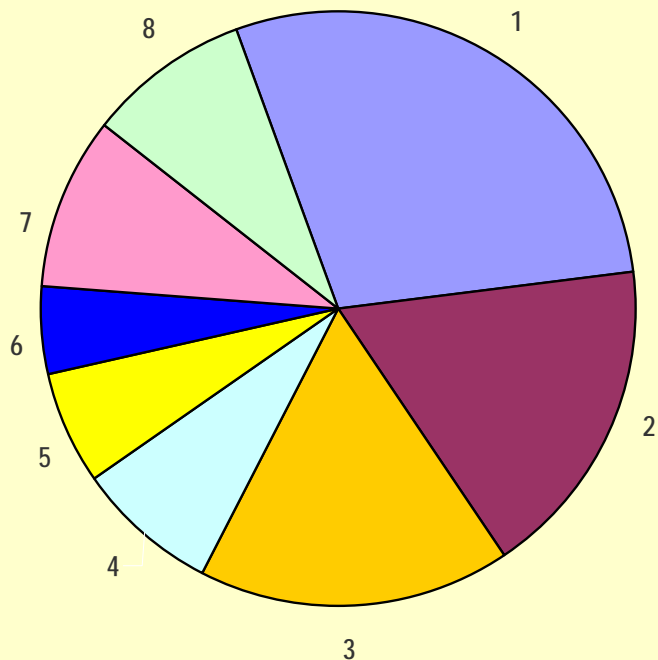
Property taxes had an increase of \$1.6 million, sales taxes increased by \$0.4 million, the utility user's tax rose by \$0.9 million, and transient occupancy taxes by \$1.3 million. Investment earnings increased by \$3.6 million. This is a result of the year-end adjustment to carrying value for investments and reflects the year to year change in carrying value. This mark to market value is a requirement of GASB 31.

Miscellaneous revenues had a decrease of \$1.8 million from the prior year. The prior year included an accounting reclassification of inter-department revenues and charges.

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 other recurring resources.

Sources of Revenues

- 1- Program Revenues - 29%
- 2- Property Taxes - 18%
- 3- Sales Taxes - 17%
- 4- Utility User's Taxes - 8%
- 5- Transient Occupancy Tax - 6%
- 6- Other Taxes & Fines - 5%
- 7- Investment Earnings - 9%
- 8- Rents and Miscellaneous - 8%



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 2007-08 and 2006-07 expenses (does not include encumbrances and reappropriations) by Governmental Activities and interest on long-term debt. Total Governmental Activities functional expense was \$135.7 million in 2007-08, an increase of \$14.1 million.

GOVERNMENTAL ACTIVITIES <i>Expenses for the Year ended June 30</i> (in Millions)			
Activities	2008	2007	Increase/ (Decrease) from 2007
City Council	\$0.3	\$0.2	\$0.1
City Manager	2.3	1.8	0.5
City Attorney	2.7	2.4	0.3
City Clerk	1.2	0.9	0.3
City Auditor	1.4	0.8	0.6
Administrative Services **	15.5	6.4	9.1
Human Resources	2.8	2.5	0.3
Public Works	18.6	16.6	2.0
Planning and Community Environment	16.4	12.9	3.5
Police	27.7	23.9	3.8
Fire	22.4	19.5	2.9
Community Services	17.7	15.7	2.0
Library	6.3	5.4	0.9
Non-Departmental **	0.0	12.1	(12.1)
Interest on long-term debt	0.4	0.5	(0.1)
Total Functional Expense	\$135.7	\$121.6	\$14.1
Increase/(Decrease) in Net Assets before Transfers	(3.5)	5.3	(8.8)
Transfers in	\$18.7	\$15.8	\$2.9
Change in Net Assets	\$15.2	\$21.1	(\$5.9)
Net Assets-Beginning	486.2	465.1	21.1
Net Assets-Ending	\$501.4	\$486.2	\$15.2

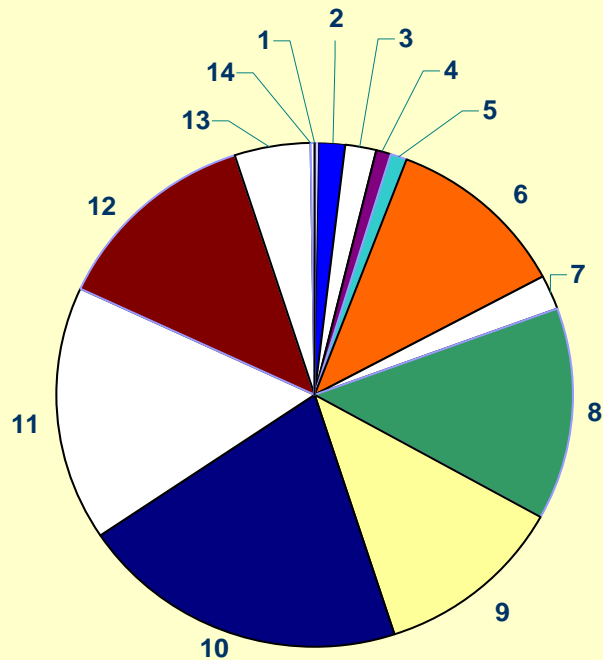
** FY 07-08 includes expenditures classified as Non-Departmental in prior years (GFOA recommendation).



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 2007-08, the City added \$16.2 million in capital assets. The composition of 2007-08 additions is shown in detail in the Capital Asset section of the Management's Discussion and Analysis.

Functional Expense

- 1- City Council - less than 1%
- 2- City Manager 2%
- 3- City Attorney 2%
- 4- City Clerk 1%
- 5- City Auditor 1%
- 6- Administrative Services 11%
- 7- Human Resources 2%
- 8- Public Works 14%
- 9- Planning & Community Environment 12%
- 10- Police 21%
- 11- Fire 17%
- 12- Community Services 13%
- 13- Library 5%
- 14- Interest on long-term debt < 1 %



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

Net Assets at June 30

(in Millions)

	2008	2007	Increase/ (Decrease) from 2007
Cash and investments	\$218.6	\$222.5	(\$3.9)
Other assets	33.3	25.0	8.3
Capital assets	416.6	383.8	32.8
Total Assets	668.5	631.3	37.2
Long-term debt outstanding	46.4	40.9	5.5
Other liabilities	23.6	14.9	8.7
Total Liabilities	70.0	55.8	14.2
Net assets:			
Invested in capital assets, net of debt	370.3	342.9	27.4
Restricted	1.7	1.7	0.0
Unrestricted	226.5	230.9	(4.4)
Total Net Assets	\$598.5	\$575.5	\$23.0

The City's Business-type total net assets increased \$23.0 million to \$598.5 million in 2007-08.

- Cash and investments decreased \$3.9 million as a result of capital financing operations.
- Other assets increased \$8.3 million to \$33.3 million primarily as the result of an increase of \$11.0 million in Accounts Receivable.
- Capital assets increased \$32.8 million to \$416.6 million in 2007-08. This increase is primarily a result of water, electric and gas infrastructure improvements totaling \$21.0 million and wastewater treatment infrastructure additions totaling \$10.9 million.
- Net assets invested in capital assets net of related debt increased \$27.4 million to \$370.3 million. The increase was mostly due to \$4.4 million of improvements in the Gas Fund, \$6.6 million in Electric Fund improvements, \$3.9 million in Storm Drain Fund improvements and \$7.7 million in Wastewater Treatment Fund improvements.
- Unrestricted net assets of \$226.5 million, a decrease of \$4.4 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 Council designated reserves such as the rate stabilization reserves of \$87.7 million, the Calaveras reserve for stranded costs of \$70.4 million and the emergency plant replacement reserve of \$9.4 million.

BUSINESS-TYPE ACTIVITIES

Revenues for the Year ended June 30

(in Millions)

Revenues by Source	2008	2007	Increase/ (Decrease) from 2007
Program Revenues:			
Water	\$27.5	\$24.0	\$3.5
Electric	103.8	102.6	1.2
Gas	49.0	42.2	6.8
Wastewater Collection	15.7	15.1	0.6
Wastewater Treatment	22.9	17.0	5.9
Refuse	28.8	25.5	3.3
Storm Drainage	5.5	5.2	0.3
External Services	0.1	0.8	(0.7)
Total Program Revenues	253.3	232.4	20.9
General Revenues:			
Investment Earnings	16.4	11.9	4.5
Total General Revenues	16.4	11.9	4.5
Total Revenues	\$269.7	\$244.3	\$25.4

The table above presents the revenues for 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 \$269.7 million, an increase of \$25.4 million from the prior year. Revenues were significantly affected by the following events:

- Program Revenue for the Water Fund increased \$3.5 million primarily due to a 10 percent rate increase effective July 1, 2007.
- Program Revenue for the Gas Fund increased \$6.8 million primarily due to a 9.5 percent rate increase effective July 1, 2007.
- Program Revenue for the Wastewater Treatment Fund increased \$5.9 million primarily due to a \$2.9 million grant for the Water Reclamation Project and \$2.1 million due to increased revenue from the member partners.
- Program Revenue for the Refuse Fund increased \$3.3 million primarily due to a 13 percent rate increase effective July 1, 2007.
- Investment earnings increased \$4.5 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	2008	2007	Increase/ (Decrease) from 2007
Water	\$18.9	\$16.8	\$2.1
Electric	108.0	99.2	8.8
Gas	37.2	30.7	6.5
Wastewater Collection	12.0	10.0	2.0
Wastewater Treatment	18.9	15.9	3.0
Refuse	28.8	25.4	3.4
Storm Drainage	3.2	2.6	0.6
External Services	1.0	0.8	0.2
Total Functional Expense	\$228.0	\$201.4	\$26.6
Increase in Net Assets before Transfers/Special Items	41.7	42.8	(1.1)
Transfers/Special Items			
Special Item	0.0	0.0	0.0
Transfers out	18.7	15.8	2.9
Total Transfers/Special Items	\$18.7	\$15.8	\$2.9
Change in Net Assets	\$23.0	\$27.0	(\$4.0)
Net Assets-Beginning	575.5	548.5	27.0
Net Assets-Ending	\$598.5	\$575.5	\$23.0

The table above presents a comparison of the 2007-08 and 2006-07 expenses for the City's Business-type Activities. Encumbrances and reappropriations are not included.

Business-type Activity expenses, transfers and special items increased \$29.5 million for a total of \$246.7 million. Changes to expenses were significantly affected by the following events:

- Functional Expense for the Electric Fund increased \$8.8 million primarily due to the net of a \$12.0 million increase in the retail purchase of utilities and a \$3.4 million decrease in Surplus Energy costs. Both costs are associated with the decrease in Surplus Energy revenue due to unfavorable weather conditions. (Further detail may be found in Note 16 to the financial statements).
- Functional Expense for the Gas Fund increased \$6.5 million, primarily due to \$5.0 million increase in commodity costs associated with declining production and increasing demand. (Further detail may be found in Note 16 to the financial statements).



- Functional Expense for the Wastewater Treatment Fund increased \$3.0 million primarily due to operational and maintenance charges which increased \$1.1 million.
- Functional Expense for the Refuse Fund increased \$3.4 million primarily due to a \$1.5 million increase from Palo Alto Sanitation Company (PASCO) charges.

FUND FINANCIAL STATEMENTS

Performance of Governmental Funds

At June 30, 2008, the City's Governmental Funds reported combined fund balances of \$103.9 million, a decrease of \$1.6 million or 1.5 percent compared with the prior year.

Governmental Fund revenues and other financing sources increased \$9.5 million for a total of \$160.4 million. Revenues and other financing sources in the General Fund increased \$5.8 million; Capital Project Fund increased \$5.2 million and Non-major Fund revenues and other financing sources decreased by \$1.5 million.

Governmental Fund expenditures and other uses increased \$15.5 million this year to \$162.1 million. General Fund expenditures and other uses increased \$8.0 million, Capital Projects Fund expenditures increased by \$4.6 million; and Non-major Fund expenditures and other uses increased by \$2.9 million.

General Fund – The General Fund ended the year with a \$3.0 million increase for a total of \$42.4 million fund balance, compared to \$5.2 million increase in the prior year.

Palo Alto's General Fund revenues totaled \$115.0 million in 2007-08. This represents an increase of \$4.2 million or 3.8 percent compared to the prior year.

Property Taxes increased by \$1.6 million or 7.5 percent from 2006-07 to 2007-08. Although Palo Alto's assessed values remains healthy for 2008-09, preliminary data indicates the growth in assessed values will be moderating. The Santa Clara Assessor recently said that the "assessment roll contains clear evidence that Silicon Valley is not immune to the national recession and economic meltdown in the residential real estate market."

Sales taxes rose by \$0.4 million or 1.9 percent over 2006-07 levels. Apparel stores, furniture and appliance, service stations, and office equipment turned in a strong performance. Department stores, automobile dealerships, electronic equipment, business services, and light industry had weak results.

The City's Utility Users Tax (UUT), which is 5 percent, is levied on telephone, water, electricity, and gas usage. This revenue source rose by \$0.9 million or 9.9 percent over the prior year. Actual revenue exceeded the budget by \$0.7 million or by 7.5 percent. Utility rates increased considerably over the prior year due to commodity costs and the building of reserve levels.

Transient Occupancy Tax (TOT) receipts rose to \$8.0 million in 2007-08, a \$1.3 million or 18.9 percent increase over the prior year. However, 59 percent or \$760 thousand of the \$1.3 million



increase is attributable to the TOT rate increasing from 10 percent to 12 percent in January 2008. Average occupancy and room rates increased over the prior year from 72.4 percent to 75.5 percent and from \$140 to \$149, respectively. This economically sensitive revenue source is anticipated to soften in 2008-09 due to the economic downturn.

Other Taxes, Fines & Penalties totaled \$7.8 million in 2007-08, a decrease of \$0.9 million from the prior year. After two years of solid results, The Documentary Transfer Tax came in at \$5.4 million, a decline of 7.8 percent from the prior year. Actual revenue results were in alignment with the 2007-08 budget. This revenue source is highly dependent on sales volume and the mix of commercial and residential sales. As with property tax projections, a softening in this sector is anticipated. Parking violations decreased by \$0.4 million from the prior year.

Charges for Services were \$19.3 million in 2007-08, a decrease of \$0.5 million from the prior year and a decrease of \$1.1 million from the adopted budget. This decrease is primarily due to decreases in plan check fees of \$0.6 million from the prior year and architect review board fees, which fell short of the prior year by \$0.3 million. Zoning plan check fees decreased by \$0.2 million from the prior year.

Permits and Licenses were \$4.8 million in 2007-08, an increase of \$0.3 million from the prior year and a decrease of \$1.2 million from the adjusted budget. The decrease is mainly due to decreases in new construction building permits and lower street cut fees.

Other Revenues totaled \$7.9 million in 2007-08, an increase of \$2.0 million from the prior year and an increase of \$3.4 million from the adjusted budget. This increase is primarily due to a \$1.5 million increase in the year-end adjustment to the carrying value of investments, partially offset by a \$0.6 million decrease in state revenues. A \$0.7 million increase was due to the sale of the Eyerly condominium property.

At June 30, 2008, the General Fund Balance totaled \$42.4 million. This represents 36.7 percent of direct General Fund expenditures providing a buffer against unexpected financial events. Of this, \$11.1 million is reserved and \$31.3 million is unreserved. Included in the reserved amount is \$2.0 million for the prepayment of Storm Drain rate increases over a three year period. A substantial portion of the unreserved balance amount is designated by the Council for budget stabilization, \$26.1 million at year-end. The designation for equity transfer stabilization designation, established in 2001-02, amounted to \$3.5 million at year-end. This reserve would be utilized in the event that the Electric or Gas Funds were not in a position to make their required equity transfer to the General Fund.

General Fund expenditures and other uses totaled \$129.1 million, an increase of \$8.0 million from the prior year. Transfers out increased by \$0.8 million from the prior year to \$13.7 million due to the transfer of the Eyerly Family Trust to a Permanent Fund for reporting purposes.

The Planning department had an increase in expenditures and encumbrances of \$0.4 million from the prior year for a total of \$10.1 million. This increase was primarily due to an increase in salaries and benefits.

Administrative departments had an increase of \$1.8 million to the adopted budget for a final budget of \$19.1 million. This increase was due to increases in legal fees of \$0.8 million, contract



expense of \$0.4 million, audit fees of \$0.1 million and salaries and benefits of \$0.6 million. Administrative departments had an increase in expenditures and encumbrances of \$2.0 million from the prior year. This increase was due to salaries and benefits of \$1.5 million and contract services expenditures of \$0.5 million.

Community Services department expenditures and encumbrances were \$0.9 million greater than the prior year. This was primarily due to an increase in salaries and benefits of \$0.7 million.

The Police department had an increase of \$1.8 million to the adopted budget for a final budget of \$29.8 million. This increase was primarily due to an increase of \$1.7 million in salary and benefits of which \$0.7 was the PAPOA contract settlement. The Police department expenditures and encumbrances were \$3.7 million greater than prior year primarily due to an increase in salaries and benefits of \$3.7 million.

The Fire department had an increase of \$1.4 million to the adopted budget for a final budget of \$24.3 million. This increase was due to increases in salaries and benefits of \$1.0 million and indirect charges of \$0.3 million. Fire department had an increase of \$2.4 million from prior year for expenditures and encumbrances mainly due to an increase in salaries and benefits of \$2.3 million.

The Library department expenditures and encumbrances were \$0.9 million greater than prior year due to salaries and benefits of \$0.6 million and supplies and materials of \$0.3 million.

Transfers out had an increase of \$4.9 million to the adopted budget for a final budget of \$15.6 million. This increase was due to a \$3.1 million increase in the transfer for infrastructure reserve to the Capital Projects Fund and a \$1.7 million increase in the transfer to the Storm Drain Fund for the water pump station.

Capital Projects Fund – Capital Projects Fund expenditures and other uses were \$21.7 million in 2007-08, which is an increase of \$4.6 million from the prior year. This increase is mainly the result of increase expenditures of capital projects of \$4.7 million and a decrease of \$0.2 million in other financing uses. This level of expenditure is consistent with the City’s effort to rehabilitate and maintain its existing infrastructure.

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, 2008, the City's Enterprise Funds reported total net assets of \$600.1 million, an increase of \$24.1 million or 4.2 percent compared with the prior year. The Water and Gas Funds net assets increased \$7.5 million and \$9.3 million, respectively. The Electric Fund net assets decreased \$4.6 million. These assets constitute 76.6 percent of the Enterprise Funds' total net assets. Unrestricted net assets for these three funds totaled \$193.6 million, a 0.6 percent decrease from 2006-07.

Water Fund – The Water Fund ended the year with net income of \$7.5 million, compared to \$6.5 million in the prior year, a \$1.0 million increase. The increase in net income is primarily due to an increase in operating revenues of \$3.0 million the result of a 10 percent rate increase effective July 1, 2007 and an increase in interest income of \$0.5 million.

Electric Fund – Operating revenues increased to \$103.8 million in 2007-08, a \$1.2 million increase from the prior year. The Electric Fund ended the year with a net loss of \$4.5 million compared to a net income of \$1.8 million in 2006-07. The net loss is due to an \$8.6 million increase in the purchase of utilities caused by the unfavorable weather conditions.

Gas Fund – A 9.5 percent rate increase effective July 1, 2007 increased revenue \$6.8 million over 2006-07. The Gas Fund ended the year with a net income of \$9.3 million, compared to a \$9.0 million in 2006-07, an increase of \$0.3 million.

Wastewater Collection Fund - Operating revenues increased to \$15.1 million, a \$0.2 million increase from 2006-07. Operating expenses decreased to \$10.0 million, a \$0.7 million decrease from 2006-07, and interest income and transfers increased to \$11.7 million, a \$1.7 million increase from 2006-07. This is due to the purchase of utilities increasing \$1.0 million. The Wastewater Collection Fund ended the year with a net income of \$4.3 million, a decrease of \$1.2 million from 2006-07.

Wastewater Treatment Fund – Revenues increased in 2007-08 by \$5.9 million due to \$2.9 million in grant funds for the Water Reclamation Project and \$2.1 million increased revenues from member partners. The Wastewater Treatment Fund ended with the year with a net income of \$5.0 million, compared to a net income of \$0.2 million in 2006-07.

Refuse Fund – Refuse Fund revenues increased to \$28.8 million in 2007-08, compared to \$25.5 million in 2006-07. Operating expenses increased \$3.5 million to \$28.6 million in 2007-08. The Refuse Fund ended the year with a net loss of \$0.2 million, compared to a \$0.6 million net income in 2006-07.

Storm Drainage Fund – The Storm Drainage Fund ended the year with a net income of \$2.7 million, the same net income as 2006-07.

External Services Fund - Created in 2001-02, this Fund provides information technology and training services to neighboring municipalities and other community organizations. The External Services Fund ended the year with a net loss of \$9.0 thousand, the same net loss in 2006-07. The Fund was discontinued in fiscal year 2007-08.

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)

	2008	2007	Increase/ (Decrease) from 2007
Governmental Activities			
<i>Capital Assets</i>			
Land and improvements	\$73.1	\$71.4	\$1.7
Street trees	15.1	15.0	0.1
Construction in progress	37.3	29.9	7.4
Buildings and improvements	99.7	93.5	6.2
Equipment	7.8	8.2	(0.4)
Roadway network	243.7	239.2	4.5
Recreation & open space network	13.9	13.5	0.4
Less accumulated depreciation	(156.5)	(149.4)	(7.1)
<i>Internal Service Fund Assets</i>			
Construction in progress	7.2	4.4	2.8
Equipment	35.3	32.0	3.3
Less accumulated depreciation	(24.7)	(22.0)	(2.7)
Total Governmental	\$351.9	\$335.7	\$16.2
Business-type Activities			
Land	\$2.0	\$1.9	\$0.1
Construction in progress	130.0	89.0	41.0
Buildings and improvements	19.6	18.9	0.7
Transmission, Distribution & Treatment Systems	481.4	480.1	1.3
Less accumulated depreciation	(216.4)	(206.1)	(10.3)
Total Business-type	\$416.6	\$383.8	\$32.8



Governmental Activities capital assets net of depreciation, increased by \$16.2 million compared to 2006-07. This increase was primarily due to a \$6.2 million increase for building and improvements, \$4.5 million for roadway network and \$1.7 million for land and improvements.

Work on the City's infrastructure is a continuation of a ten-year plan, totaling \$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. Current 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, 2008, the City's debt was comprised of the following:

LONG-TERM DEBT AT JUNE 30

(in Millions)

	2008	2007	Increase/ (Decrease) from 2007
Governmental Activity Debt:			
General Long Term Obligations:			
1998 Golf Course Certificates of Participation	\$4.8	\$5.1	(\$0.3)
2002A Civic Center Refinancing Certificates of Participation	1.5	1.9	(0.4)
2002B Downtown Parking Improvements Certificates of Participation	2.1	2.2	(0.1)
Special Assessment Debt with City Commitment			
1987 California Avenue Parking Bonds	0.0	0.1	(0.1)
Total Governmental Activity Debt	\$8.4	\$9.3	(\$0.9)
Business-type Activity Debt:			
Enterprise Long Term Obligations:			
Utility Revenue Bonds			
1995 Series A	\$5.6	\$6.0	(\$0.4)
1999 Refunding	14.2	14.7	(0.5)
2002 Series A	20.5	21.2	(0.7)
Energy Tax Credit Bonds			
2007 Series A	1.4	0.0	1.4
State Water Resources Loan			
2007	5.6	0.0	5.6
Less: unamortized discount/issuance cost	(1.0)	(1.0)	0.0
Total Business-type Activity	\$46.3	\$40.9	\$5.4

The City issued Energy Tax Credit Bonds and a State Water Resources Loan in fiscal year 2007-08. As stated in the Statistical Section of the CAFR, the combined direct debt ratio to assessed valuation for the General Fund is a low 0.04 percent compared to the allowable, legal debt margin of 15 percent.



SPECIAL ASSESSMENT DISTRICT DEBT

Special assessment districts throughout different parts of the City have also issued debt to finance infrastructure and facilities construction exclusively in their districts. At June 30, 2008, the City had no special assessment district debt with City commitment outstanding. The final payment of \$0.1 million for the California Avenue Parking Special Assessment District was made in September 2007.

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 Alto website at: www.cityofpaloalto.org. On the home page, select City Departments, select Administrative Services, and select Financial Reporting. Within Financial Reporting there are links to reports by title and reporting date.



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

The Citywide Statement of Net Assets and the Statement of Activities summarize all of the 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*.



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City of Palo Alto - Statement of Net Assets

June 30, 2008

(In thousands of dollars)

	Governmental Activities	Business Type Activities	Totals
ASSETS			
Cash and investments (Note 3):			
Available for operations	\$147,940	\$216,729	\$364,669
Cash and investments with fiscal agent	1,924	1,908	3,832
Receivables:			
Accounts and intergovernmental	7,018	33,201	40,219
Interest receivable	2,005	2,772	4,777
Notes and loans receivable (Note 5)	6,611		6,611
Internal balances (Note 4)	2,627	(2,627)	
Assets in excess of OPEB obligation (Note 12)	29,177		29,177
Inventory of materials and supplies and prepaids	5,563		5,563
Capital assets (Note 6):			
Nondepreciable	132,846	131,997	264,843
Depreciable, net of depreciation	219,096	284,616	503,712
Total assets	554,807	668,596	1,223,403
LIABILITIES			
Accounts payable and accrued liabilities	8,496	15,208	23,704
Accrued salaries and benefits	1,634	597	2,231
Unearned revenue	898		898
Accrued compensated absences (Note 1):			
Due within one year	3,604		3,604
Due in more than one year	6,819		6,819
Claims payable (Note 14):			
Due within one year	7,356		7,356
Due in more than one year	16,170		16,170
Accrued landfill closure liability (Note 9):			
Due in more than one year		7,907	7,907
Long-term debt (Notes 7 and 8):			
Due within one year	800	1,690	2,490
Due in more than one year	7,605	44,620	52,225
Total liabilities	53,382	70,022	123,404
NET ASSETS (Note 10)			
Invested in capital assets, net of related debt	343,537	370,303	713,840
Restricted for:			
Special revenue programs	21,691		21,691
Capital projects			
Other capital projects	4,331		4,331
Debt service	1,406	1,732	3,138
Total Restricted	27,428	1,732	29,160
Unrestricted net assets	130,460	226,539	356,999
Total net assets	\$501,425	\$598,574	\$1,099,999

See accompanying notes to financial statements

City of Palo Alto - Statement of Activities

For the Year Ended June 30, 2008

(In thousands of dollars)

Functions/Programs	Total Expenses	Program Revenues			Net (Expense) Revenue and Change in Net Assets		Total
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	
Governmental Activities:							
City Council	\$323				(\$323)		(\$323)
City Manager	2,273				(2,273)		(2,273)
City Attorney	2,653	\$16			(2,637)		(2,637)
City Clerk	1,241				(1,241)		(1,241)
City Auditor	1,379				(1,379)		(1,379)
Administrative Services	15,477	870			(14,607)		(14,607)
Human Resources	2,806				(2,806)		(2,806)
Public Works	18,565	1,310	\$2,340	\$1,903	(13,012)		(13,012)
Planning and Community Environment	16,388	5,498	980	27	(9,883)		(9,883)
Police	27,740	4,274	285		(23,181)		(23,181)
Fire	22,386	9,418	1		(12,967)		(12,967)
Community Services	17,736	10,314	302		(7,120)		(7,120)
Library	6,321	176	121		(6,024)		(6,024)
Interest on long-term debt	438				(438)		(438)
Total Governmental Activities	135,726	31,876	4,029	1,930	(97,891)		(97,891)
Business-type Activities:							
Water	18,842	26,510		951		\$8,619	8,619
Electric	108,032	103,833				(4,199)	(4,199)
Gas	37,211	49,021				11,810	11,810
Wastewater Collection	12,023	15,102		643		3,722	3,722
Wastewater Treatment	18,902	22,889				3,987	3,987
Refuse	28,827	28,805				(22)	(22)
Storm Drainage	3,202	5,450				2,248	2,248
External Services	984	112				(872)	(872)
Total Business-type Activities	228,023	251,722		1,594		25,293	25,293
Total	\$363,749	\$283,598	\$4,029	\$3,524	(97,891)	25,293	(72,598)
General revenues:							
Taxes:							
Property taxes					23,084		23,084
Sales taxes					22,623		22,623
Utility user's taxes					10,285		10,285
Transient occupancy tax					7,976		7,976
Transfer and other taxes					6,261		6,261
Investment earnings					12,313	16,416	28,729
Miscellaneous					11,896		11,896
Transfers (Note 4)					18,701	(18,701)	
Total general revenues and transfers					113,139	(2,285)	110,854
Change in Net Assets					15,248	23,008	38,256
Net Assets-Beginning					486,177	575,566	1,061,743
Net Assets-Ending					\$501,425	\$598,574	\$1,099,999

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 2007-08. 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.



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City of Palo Alto - Governmental Funds

Balance Sheet - June 30, 2008

(In thousands of dollars)

	General	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
ASSETS				
Cash and investments (Note 3):				
Available for operations	\$34,726	\$38,306	\$15,970	\$89,002
Cash and investments with fiscal agent		582	1,342	1,924
Receivables:				
Accounts and intergovernmental	6,071	151	464	6,686
Interest receivable	980		176	1,156
Notes and loans receivable (Note 5)	1,155		5,456	6,611
Interfund receivables and advances (Note 4)	1,100			1,100
Prepaid items	2,032			2,032
Inventory of materials and supplies	2,999			2,999
Total Assets	\$49,063	\$39,039	\$23,408	\$111,510
LIABILITIES				
Accounts payable and accrued liabilities	\$4,504	\$726	\$226	\$5,456
Accrued salaries and benefits	1,246	35		1,281
Deferred revenue	898			898
Total Liabilities	6,648	761	226	7,635
FUND BALANCES				
Reserved for (Note 10):				
Encumbrances	3,816	4,331	210	8,357
Downtown parking structure				
Notes and loans	1,155		5,456	6,611
Interfund advances	1,100			1,100
Prepaid items	2,032			2,032
Inventory of materials and supplies	2,999			2,999
Debt service			1,406	1,406
Unreserved, designated for:				
General Fund				
Unrealized gain on investment	1,035		172	1,207
Equity transfer stabilization	3,528			3,528
Reappropriations	648			648
Budget stabilization	26,102			26,102
Capital Project Fund				
Reappropriations		16,053		16,053
Infrastructure		17,894		17,894
Unreserved, undesignated, reported in:				
Special Revenue Funds			15,207	15,207
Permanent Fund			731	731
Total Fund Balances	42,415	38,278	23,182	103,875
Total Liabilities and Fund Balances	\$49,063	\$39,039	\$23,408	\$111,510

See accompanying notes to financial statements



City of Palo Alto - Governmental Funds

Reconciliation of Fund Balances to Governmental Activities Net Assets

June 30, 2008

(In thousands of dollars)

Governmental Fund fund balances from prior page	\$103,875
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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)	351,942
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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)	54,154
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Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds	
Interest payable	(141)
Long Term debt (Note 7)	<u>(8,405)</u>

Net assets of governmental activities	<u><u>\$501,425</u></u>
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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, 2008

(In thousands of dollars)

	General	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
REVENUES				
Property taxes	\$23,084			\$23,084
Special assessments			\$136	136
Sales taxes	22,623			22,623
Utility users' tax	10,285			10,285
Transient occupancy tax	7,976			7,976
Other taxes and fines	7,871		1,117	8,988
Charges for services	19,294		316	19,610
From other agencies	370	\$3,266	664	4,300
Permits and licenses	4,581		180	4,761
Investment earnings	4,563	1,028	1,318	6,909
Rental income	13,592		6	13,598
Other revenue	761	245	3,707	4,713
Total Revenues	115,000	4,539	7,444	126,983
EXPENDITURES				
Current operations:				
City Council	234			234
City Manager	2,149			2,149
City Attorney	2,570			2,570
City Clerk	1,239			1,239
City Auditor	828			828
Administrative Services	6,728			6,728
Human Resources	2,502			2,502
Public Works	10,072			10,072
Planning and Community Environment	8,953		6,399	15,352
Police	26,835		171	27,006
Fire	21,644			21,644
Community Services	17,138			17,138
Library	6,219			6,219
Non-Departmental	8,360		238	8,598
Capital outlay		21,626		21,626
Debt service:				
Principal payments			885	885
Interest and fiscal fees			451	451
Total Expenditures	115,471	21,626	8,144	145,241
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(471)	(17,087)	(700)	(18,258)
OTHER FINANCING SOURCES (USES)				
Transfers in (Note 4)	17,133	14,409	1,895	33,437
Transfers (out) (Note 4)	(13,655)	(118)	(3,046)	(16,819)
Total Other Financing Sources (Uses)	3,478	14,291	(1,151)	16,618
Net change in fund balances	3,007	(2,796)	(1,851)	(1,640)
Fund balances at beginning of year	39,408	41,074	25,033	105,515
Fund balances at end of year	\$42,415	\$38,278	\$23,182	\$103,875

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, 2008

(In thousands of dollars)

Net change in fund balances-total governmental funds (\$1,640)

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. 21,509

Depreciation expense is deducted from fund balance (Depreciation expense is net of Internal Service Fund depreciation \$3,083 million which has already been allocated to serviced funds.) (8,597)

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. 885

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 13
Deferred revenue (115)

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.

3,193

Change in net assets of Governmental Activities \$15,248

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, 2008

(In thousands of dollars)

	Budgeted Amount		Actual Amount Budgetary Basis	Variance from Final Budget Positive (Negative)
	Adopted	Adjusted		
REVENUES				
Property taxes	\$22,034	\$22,735	\$23,107	\$372
Sales taxes	22,045	22,400	22,621	221
Utility users' tax	9,402	9,793	10,285	492
Transient occupancy tax	6,985	7,700	7,976	276
Other taxes, fines & penalties	8,181	8,437	7,847	(590)
Charges for services	20,383	20,383	19,311	(1,072)
Permits and licenses	6,044	6,074	4,831	(1,243)
Charges to other funds	10,650	10,650	10,913	263
Rental income	13,037	13,037	13,591	554
Other revenues	3,742	4,452	7,872	3,420
Transfers in	17,207	17,786	17,133	(653)
Prior year encumbrance and reappropriations		3,558	3,558	
Total Revenues	139,710	147,005	149,045	2,040
EXPENDITURES				
Current operations:				
Administrative Departments	17,342	19,108	19,098	10
Community Services	21,212	21,872	21,866	6
Fire	22,868	24,279	24,279	
Library	6,484	7,035	7,033	2
Planning and Community Environment	10,137	10,148	10,145	3
Police	27,981	29,787	29,784	3
Public Works	13,225	13,254	13,243	11
Non-Departmental	9,229	7,903	7,899	4
Transfers out	10,707	15,570	13,654	1,916
Total Use of Funds	139,185	148,956	147,001	1,955
EXCESS OF REVENUES OR EXPENDITURES	\$525	(\$1,951)	2,044	\$3,995
BUDGETARY BASIS				
Adjustments to Budgetary Basis:				
Current year encumbrance/reappropriations			4,460	
Prior year encumbrance/reappropriations			(3,558)	
Current year stores adjustment, net			(37)	
Prior year stores adjustment			98	
EXCESS OF REVENUES OVER				
EXPENDITURES - GAAP BASIS			3,007	
Fund balances at beginning of year			39,408	
Fund balances at end of year, GAAP basis			\$42,415	

See accompanying notes to financial statements



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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 2007-08.

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. This fund was discontinued in fiscal year 2007-08.

City of Palo Alto - Proprietary Funds

Statement of Net Assets - June 30, 2008

(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	\$23,576	\$130,276	\$20,500	\$11,704
Cash and investments with fiscal agent	848		1,034	
Accounts receivable, net	4,233	14,584	3,714	2,076
Interest receivable	272	1,736	231	139
Inventory of materials and supplies				
Prepaid items				
Total Current Assets	28,929	146,596	25,479	13,919
Noncurrent Assets:				
Capital assets, nondepreciable (Note 6)	18,054	43,984	18,846	24,666
Capital assets, depreciable (Note 6)	41,372	113,284	50,679	38,510
Total Noncurrent Assets	59,426	157,268	69,525	63,176
Total Assets	88,355	303,864	95,004	77,095
LIABILITIES				
Current Liabilities:				
Accounts payable and accrued liabilities	1,622	1,077	2,616	118
Accrued salaries and benefits	81	210	79	48
Accrued compensated absences (Note 1)				
Current portion of revenue bonds (Note 7)	351	100	429	58
Accrued claims payable (Note 14)				
Total Current Liabilities	2,054	1,387	3,124	224
Noncurrent liabilities:				
Accrued compensated absences (Note 1)				
Accrued claims payable (Note 14)				
Interfund payable (Note 4)				
Landfill closure and postclosure care (Note 9)				
Utility revenue bonds, net of unamortized issuance costs and discounts (Note 7)	9,476	1,157	10,647	1,287
Total Noncurrent Liabilities	9,476	1,157	10,647	1,287
Total Liabilities	11,530	2,544	13,771	1,511
NET ASSETS (Note 10)				
Invested in capital assets, net of related debt	49,599	156,011	58,449	61,831
Restricted for debt service	780		952	
Unrestricted	26,446	145,309	21,832	13,753
Total Net Assets	\$76,825	\$301,320	\$81,233	\$75,584

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 Activities - Internal Service Funds
Wastewater Treatment	Refuse	Storm Drainage	External Service	TOTALS	Funds
\$12,223	\$11,825	\$6,616	\$9	\$216,729	\$58,938
26				1,908	
5,226	2,666	702		33,201	332
176	143	75		2,772	849
					532
					29,177
17,651	14,634	7,393	9	254,610	89,828
19,629	1,962	4,856		131,997	7,151
23,580	1,908	15,283		284,616	10,550
43,209	3,870	20,139		416,613	17,701
60,860	18,504	27,532	9	671,223	107,529
6,458	332	2,976	9	15,208	2,899
110	54	15		597	353
					3,604
367		385		1,690	
					7,356
6,935	386	3,376	9	17,495	14,212
					6,819
					16,170
		1,100		1,100	
	7,907			7,907	
13,000		9,053		44,620	
13,000	7,907	10,153		53,627	22,989
19,935	8,293	13,529	9	71,122	37,201
29,842	3,870	10,701		370,303	17,701
				1,732	
11,083	6,341	3,302		228,066	52,627
\$40,925	\$10,211	\$14,003		600,101	\$70,328
				(1,527)	
				\$598,574	

City of Palo Alto - Proprietary Funds

Statements of Revenues, Expenses and Changes in Net Assets

For the Year Ended June 30, 2008

(In thousands of dollars)

	Business-type Activities - Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
OPERATING REVENUES				
Sales of utilities:				
Customers	\$24,558	\$88,989	\$46,710	\$13,686
City departments	1,298	3,335	1,393	311
Surplus energy		1,454		
Wastewater treatment				
Service connection charges and miscellaneous	409	1,237	817	747
Charges for services				
Other operating revenues	245	8,818	101	358
Total Operating Revenues	26,510	103,833	49,021	15,102
OPERATING EXPENSES				
Purchase of utilities:				
Retail	8,363	70,302	27,220	7,056
Surplus energy		762		
Administration and general	2,741	4,909	3,309	774
Engineering (operating)	359	983	341	317
Resource management and energy efficiency programs	350	4,053	839	
Operations and maintenance	3,561	8,922	3,097	2,096
Rent	1,788	3,438	161	86
Depreciation and amortization	1,134	5,623	1,636	1,412
Claims payments and changes in estimated self-insurance liability				
Compensated absences and other benefits				
Total Operating Expenses	18,296	98,992	36,603	11,741
Operating Income	8,214	4,841	12,418	3,361
NONOPERATING REVENUES (EXPENSES)				
Return on investment	1,628	10,398	1,342	819
Interest (expense)	(437)		(535)	(74)
Joint venture debt service (Note 15)		(8,554)		
Gain (loss) on disposal of capital assets		(109)		
Capacity fees	951			643
Other				
Net Nonoperating Revenues (Expenses)	2,142	1,735	807	1,388
Income (Loss) Before Transfers and Special Item	10,356	6,576	13,225	4,749
Transfers in (Note 4)	200	33		64
Transfers (out) (Note 4)	(3,049)	(11,151)	(3,883)	(482)
Change in Net Assets	7,507	(4,542)	9,342	4,331
Total net assets at beginning of year	69,318	305,862	71,891	71,253
Total net assets at end of year	\$76,825	\$301,320	\$81,233	\$75,584

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 Activities - Internal Service Funds
Wastewater Treatment	Refuse	Storm Drainage	External Service	TOTALS	
	\$22,795	\$5,099		\$201,837	
\$7,128	1,301	306		15,072	
				1,454	
11,858				11,858	
				3,210	
					\$61,166
3,903	4,709	45	\$112	18,291	282
22,889	28,805	5,450	112	251,722	61,448
	9,276			122,217	
				762	
	1,521	888	26	14,168	13,539
2,179	401	298		4,878	
		189		5,431	
13,687	12,449	640	891	45,343	2,171
	4,289			9,762	
2,238	636	534		13,213	3,083
					7,029
					41,133
18,104	28,572	2,549	917	215,774	66,955
4,785	233	2,901	(805)	35,948	(5,507)
1,015	824	425	(35)	16,416	5,404
(461)	(398)	(585)		(2,490)	
				(8,554)	
				(109)	62
				1,594	
					55
554	426	(160)	(35)	6,857	5,521
5,339	659	2,741	(840)	42,805	14
	222		842	1,361	3,087
(363)	(1,053)	(70)	(11)	(20,062)	(1,004)
4,976	(172)	2,671	(9)	24,104	2,097
35,949	10,383	11,332	9		68,231
\$40,925	\$10,211	\$14,003			\$70,328
				(1,096)	
				\$23,008	

City of Palo Alto - Proprietary Funds

Statement of Cash Flows -

For the Year Ended June 30, 2008

(In thousands of dollars)

	Business-type Activities - Enterprise Funds			
	Water	Electric	Gas	Wastewater Collection
CASH FLOWS FROM OPERATING ACTIVITIES:				
Receipts from customers	\$24,224	\$94,648	\$46,597	\$14,238
Payments to suppliers	(14,457)	(86,460)	(30,371)	(9,952)
Payments to - or on behalf of employees	(2,852)	(4,891)	(3,306)	(766)
Internal activity - receipts from other funds	1,298	3,335	1,393	311
Claims paid				
Interfund receipts				
Interfund payment				
Other receipts	245		101	358
Net Cash From Operating Activities	<u>8,458</u>	<u>6,632</u>	<u>14,414</u>	<u>4,189</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:				
Transfers in	200	33		64
Transfers (out)	(3,049)	(11,151)	(3,883)	(482)
Net Cash From Noncapital Financing Activities	<u>(2,849)</u>	<u>(11,118)</u>	<u>(3,883)</u>	<u>(418)</u>
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES:				
Acquisition and construction of capital assets	(3,924)	(13,562)	(5,690)	(4,373)
Proceeds from sale of capital assets				
Proceeds from debt issuance	750	1,500		
Cost of issuance paid		(143)		
Capacity fees	951			643
Principal paid on long-term debt	(333)	(100)	(405)	(54)
Interest paid on long-term debt	(437)	(8,554)	(535)	(74)
Cash Flows From Capital Financing Activities	<u>(2,993)</u>	<u>(20,859)</u>	<u>(6,630)</u>	<u>(3,858)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:				
Interest on investments	1,607	10,550	1,296	833
Net Cash Flows	4,223	(14,795)	5,197	746
Cash and cash equivalents at beginning of year	20,201	145,071	16,337	10,958
Cash and cash equivalents at end of year	<u>\$24,424</u>	<u>\$130,276</u>	<u>\$21,534</u>	<u>\$11,704</u>
FINANCIAL STATEMENT PRESENTATION:				
Cash and investments available for operations	\$23,576	\$130,276	\$20,500	\$11,704
Cash and investments with fiscal agent	848		1,034	
Cash and cash equivalents at end of year	<u>\$24,424</u>	<u>\$130,276</u>	<u>\$21,534</u>	<u>\$11,704</u>
Reconciliation of operating income (loss) to Cash Flows from Operating				
Operating income (loss)	\$8,214	\$4,841	\$12,418	\$3,361
Adjustments to reconcile operating income (loss) to cash flows				
Depreciation and amortization	1,134	5,623	1,636	1,412
Other				
Changes in assets and liabilities:				
Accounts receivable	(743)	(4,396)	(930)	(195)
Inventory of materials and supplies				
Prepaid items				
Accounts and other payables	(147)	564	1,290	(389)
Interfund receipts				
Interfund payable				
Accrued compensated absences				
Accrued claims payable and other liabilities				
Net Cash From Operating Activities	<u>\$8,458</u>	<u>\$6,632</u>	<u>\$14,414</u>	<u>\$4,189</u>

See accompanying notes to financial statements

Business-type Activities - Enterprise Funds					Governmental Activities - Internal Service Funds
Wastewater Treatment	Refuse	Storm Drainage	External Service	TOTALS	
\$7,775	\$22,686	\$5,000	\$405	\$215,573	\$60,896
(10,807)	(26,372)	469	9	(177,941)	(31,330)
(15)	(1,529)	(889)	(925)	(15,173)	(56,486)
7,128	1,301	306		15,072	(4,633)
			(281)	(281)	25
		1,100		1,100	
3,903	5,536	45		10,188	337
7,984	1,622	6,031	(792)	48,538	(31,191)
	222		842	1,361	3,087
(363)	(1,053)	(70)	(11)	(20,062)	(1,004)
(363)	(831)	(70)	831	(18,701)	2,083
(14,511)	(10)	(4,056)		(46,126)	(6,412)
4,879				7,129	62
				(143)	
				1,594	
(342)		(329)		(1,563)	
(461)	(398)	(585)		(11,044)	
(10,435)	(408)	(4,970)		(50,153)	(6,350)
1,038	817	404	(39)	16,506	5,472
(1,776)	1,200	1,395		(3,810)	(29,986)
14,025	10,625	5,221	9	222,447	88,924
\$12,249	\$11,825	\$6,616	\$9	\$218,637	\$58,938
\$12,223	\$11,825	\$6,616	\$9	\$216,729	\$58,938
26				1,908	
\$12,249	\$11,825	\$6,616	\$9	\$218,637	\$58,938
\$4,785	\$233	\$2,901	(\$805)	\$35,948	(\$5,507)
2,238	636	534		13,213	3,083
					55
(4,083)	(109)	(99)	293	(10,262)	(270)
					(28)
					(29,177)
5,044	35	1,595	1	7,993	(1,784)
			(281)	(281)	25
		1,100		1,100	
					16
	827			827	2,396
\$7,984	\$1,622	\$6,031	(\$792)	\$48,538	(\$31,191)



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Fiduciary Funds.....

Introduction

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



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**City of Palo Alto - Fiduciary Funds****Statement of Fiduciary Net Assets - June 30, 2008***(In thousands of dollars)*

	<u>Agency Funds</u>
ASSETS	
Cash and investments available for operations (Note 3)	\$1,067
Cash and investments with fiscal agents (Note 3)	6,099
Interest receivable	<u>45</u>
Total Assets	<u><u>\$7,211</u></u>
LIABILITIES	
Due to bondholders	\$6,388
Due to other governments	<u>823</u>
Total Liabilities	<u><u>\$7,211</u></u>

See accompanying notes to financial statements



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



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Note 1

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Reporting Entity

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

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

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

Financial statements for the Palo Alto Public Improvement Corporation and Redevelopment Agency may be obtained from the City of Palo Alto, Administrative Services Department, 4th Floor, 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. However, interfund goods and services transactions have not been eliminated in the consolidation process. 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.

Operating expenses for enterprise funds and internal service funds include the cost of sales and services, administrative expenses, and depreciation on capital assets. All expenses not meeting this definition are reported as nonoperating expenses.

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 10 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.

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.

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 account for assets held by the City, an agent for assessment districts and the members of the Cable Joint Powers Authority. These funds are custodial in nature and do not involve measurement of results of operations. The City maintains three agency funds. The financial activities of these funds are excluded from the Government-wide financial statements, but are presented in separate Fiduciary Fund financial statements. Agency funds apply the accrual basis of accounting but do not have a measurement focus.

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

University Avenue Area Parking Assessment District – This fund accounts for the receipts and disbursements associated with the Series 2001-A University Avenue Area Off-Street Parking Assessments Bonds.

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 revenues susceptible to accrual reported in the Governmental Funds to be available if the revenues are collected within ninety days after year-end, except for property taxes. 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. Transactions representing the exchange of interfund goods and services have also been included.

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. Amounts expected to be "permanently liquidated", such as what is due to be paid because of a realized employment action, are recorded as fund liabilities 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.

During fiscal year ended June 30, 2008, changes to the compensated absences were as follows:

Beginning Balance	\$11,500
Additions	3,741
Payments	<u>(4,818)</u>
Ending Balance	<u><u>\$10,423</u></u>
Current Portion	<u><u>\$3,604</u></u>

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.

Estimates

The accompanying basic financial statements have been prepared on the modified accrual and/or accrual basis of accounting in accordance with generally accepted accounting principles. This requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenditures/expenses during the reporting period. Actual results could differ from those estimates.

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. 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	\$364,669
Cash and investments with fiscal agents	<u>3,832</u>
City cash and investments	368,501
Cash and investments available for operations in	
Fiduciary Funds (separate Statement)	1,067
Cash and investments with fiscal agents	
Fiduciary Funds (separate Statement)	<u>6,099</u>
Total cash and investments	<u><u>\$375,667</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 (C)	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

(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.

Debt Agreements:

(C) Utility Revenue Bonds 2002 Series A and 1999 Series A allow General Obligations of states with a Minimum Credit Quality Rating of A2/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 and may 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	Over Five Years	Total
U.S. Federal Agency Securities	\$53,704	\$119,068	\$57,355	\$110,471	\$340,598
Money Market Mutual Funds (government securities)	1,645				1,645
Certificates of Deposit	196	373	176		745
California Asset Management Program	3,900				3,900
Local Agency Investment Fund	26,133				26,133
Total Investments	<u>\$85,578</u>	<u>\$119,441</u>	<u>\$57,531</u>	<u>\$110,471</u>	373,021
Cash in banks and on hand					<u>2,646</u>
Total Cash and Investments					<u>\$375,667</u>

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 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, 2008, these investments matured in an average of 212 days.

California Asset Management Program

The City is a voluntary participant in the California Asset Management Program (CAMP). CAMP is an investment pool offered by the California Asset Management Trust (the Trust). The Trust is a joint powers authority and public agency created by the Declaration of Trust and established under the provisions of the California Joint Exercise of Powers Act (California Government Code Sections 6500 et seq., or the "Act") for the purpose of exercising the common power of its Participants to invest certain proceeds of debt issues and surplus funds. The Pool's investments are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code. The City reports its investments in CAMP at the fair value amounts provided by CAMP, which is the same as the value of the pool share. At June 30, 2008 the fair value approximated is the City's cost. At June 30, 2008, these investments have an average maturity of 49 days.

Money Market Mutual Funds are available for withdrawal on demand and at June 30, 2008 matured in an average of 17 days.



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

Fair Value at Year End
(in thousands)

US Federal Agency Callable Securities. These securities are subject to early redemption 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.

\$57,333

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, 2008 for each investment type (in thousands):

Investment Type	AAA	Total
U.S. Federal Agency Securities	\$340,598	\$340,598
Money Market Mutual Funds (government securities)	1,645	1,645
California Asset Management Program	3,900	3,900
Total	<u>\$346,143</u>	<u>346,143</u>
Not Rated:		
Certificates of Deposit		745
Local Agency Investment Fund		26,133
Cash in banks and on hand		<u>2,646</u>
Total Cash and Investments		<u>\$375,667</u>

Concentration of Credit Risk

Investments in any one issuer, other than U.S. Treasury securities, mutual funds, and external investment pools, that represent 5 percent or more of total City portfolio Entity-wide investments, are as follows at June 30, 2008 (in thousands):

Investments	Reporting Type	Investment Amount
Federal Agriculture Mortgage Corp.	U.S. Federal Agency Securities	\$25,920
Federal Farm Credit Bank	U.S. Federal Agency Securities	104,009
Federal Home Loan Bank	U.S. Federal Agency Securities	126,961
Federal Home Loan Mortgage Corp.	U.S. Federal Agency Securities	22,488
Federal National Mortgage Assoc.	U.S. Federal Agency Securities	40,758

Custodial Risk

California Law requires banks and savings and loan institutions to pledge government securities with a market value of 110 percent of the City's cash on deposit or first trust deed mortgage notes with a value of 150 percent 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 subsidize a fund. Less often, a transfer may be made to open or close a fund.

Transfers between City funds during fiscal year 2007-08 were as follows (in thousands):

Fund Receiving Transfer	Fund Making Transfer	Amount Transferred	
General Fund	Street Improvement Special Revenue Fund	\$292	
	Special Districts Special Revenue Fund	794	
	Redevelopment Agency Special Revenue Fund	6	
	Capital Projects Fund	118	
	Water Enterprise Fund	2,694	A
	Electric Enterprise Fund	9,412	A
	Gas Enterprise Fund	3,208	A
	Wastewater Collection Enterprise Fund	68	A
	Refuse Enterprise Fund	271	A
	Wastewater Treatment Enterprise Fund	134	
	Storm Drainage Enterprise Fund	27	
	External Services Enterprise Fund	11	
	Vehicle Replacement and Maintenance Internal Service Fund	27	
	Technology Fund Internal Service Fund	63	
	Printing and Mailing Services Internal Service Fund	8	
Special Revenue Funds:			
Redevelopment Agency	General Fund	6	
Debt Service Funds:			
Golf Course	General Fund	528	
Civic Center Refinancing	General Fund	329	
	Special Districts Special Revenue Fund	80	
Downtown Parking Improvement	General Fund	226	
Capital Projects Fund:	General Fund	11,807	B
	Street Improvement Special Revenue Fund	756	
	Developer's Impact Fee Special Revenue Fund	620	
	Transportation Mitigation Special Revenue Fund	82	
	Special Districts Special Revenue Fund	94	
	Local Law Enforcement Special Revenue Fund	100	
	Electric Enterprise Fund	270	
	Gas Enterprise Fund	40	
	Water Enterprise Fund	100	
	Refuse Enterprise Fund	390	
	Wastewater Collection Enterprise Fund	150	
Permanent Fund:			
Eyerly Trust	General Fund	726	

<u>Fund Receiving Transfer</u>	<u>Fund Making Transfer</u>	<u>Amount Transferred</u>
Enterprise Funds:		
Water	Gas Enterprise Fund	\$100
	Wastewater Collection Enterprise Fund	100
Electric	General Fund	33
Refuse	Special Districts Special Revenue Fund	222
Wastewater Collection Enterprise Fund	Retiree Health Benefit Internal Service Fund	64
External Services	Technology Fund Internal Service Fund	842
Internal Service Funds:		
Technology	Water Enterprise Fund	255
	Electric Enterprise Fund	1,469
	Gas Enterprise Fund	535
	Wastewater Collection Enterprise Fund	164
	Wastewater Treatment Enterprise Fund	229
	Refuse Enterprise Fund	392
	Storm Drainage Enterprise Fund	43
		<u>\$37,885</u>

The reasons for these transfers are set forth below:

(A) Transfer to reimburse the General Fund for costs incurred for the benefit of funds making the transfer.

(B) Allocation of funds to construct capital assets

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 \$368 thousand as of June 30, 2008.

Long-Term Interfund advances

On August 6, 2007, the City authorized a loan in the amount up to \$1.7 million from the General Fund Budget Stabilization Reserve to the Storm Drainage Fund for Capital Improvement Program project San Francisquito Creek Storm Water Pump Station. The General Fund Budget Stabilization Reserve will be paid back in three years after receipt of the last payment, together with interest at an interest rate commensurate with the Reserve's annual rate of return during the time period of the loan. The Storm Drain Fund will be charged interest on the principal borrowed (loan) from the General Fund. The interest rate will be equal to the average yield on the City's portfolio from the time the loan is issued through the time of repayment. The loan will be repaid over a 3 year period. There shall be no pre-payment penalty. At June 30, 2008 the balance of the advance including principal and accrued interest was \$1.1 million.

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, 2008, the City's notes and loans receivable totaled (in thousands):

Palo Alto Housing Corporation:	
Oak Manor Townhouse	\$1,045
Emerson Street Project	375
Alma Single Room Occupancy Development	2,222
Barker Hotel	2,111
Sheridan Apartments	2,247
Oak Court Apartments, L.P.	7,834
Mid-Peninsula Housing Coalition:	
Palo Alto Gardens Apartments	574
Community Working Group, Inc	1,280
Opportunity Center Associates, L.P.	750
Home Rehabilitation Loans	96
Executive Relocation Assistance Loans	1,155
Below Market Rate Assessment Loans	74
Stevenson Housing:	
Hot Water	81
Fire Alarm	48
Oak Manor Townhouse Water System	114
Palo Alto Senior Housing Project	28
Clara-Mateo Alliance	11
Lytton Gardens Assisted Living	101
Emergency Housing Consortium	75
Alma Gardens Apartment	<u>1,150</u>
 Total Loans and Notes	 <u>21,371</u>
 Less: valuation allowance	 <u>(14,760)</u>
 Net Carrying Value	 <u><u>\$6,611</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.

Some of these loans contain forgiveness clauses which provide for the amount loaned to be forgiven if the third party maintain compliance with the terms of the loan and associated regulatory agreements. Since some of these loans are secured by trust deeds which are subordinated to other debt on the associated projects or are only repayable from residual cash receipts on the projects, collectibility of some of the outstanding balances may be not be realized. As a result of the forgiveness clauses and nature of these housing projects and associated cash flows, a portion of the outstanding balances of the loans has been offset by a valuation allowance.

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 3 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, 2008 the objective was met. The annual loan payment was forgiven for the calendar year ending December 31, 2007.

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 \$2.7 million to the Alma Place Associates, L.P. for the development of a 107 unit single room occupancy development. This loan bears interest at 3 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 \$2.1 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, \$1.0 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.



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 \$2.5 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 \$1.6 million in Community Development Block Grant Funds, and \$825 thousand in Housing In-Lieu funds. The note bears interest at 9 percent when available surplus cash from the project equals or exceeds 25 percent of interest calculated using 9 percent. When available surplus cash falls below this level the note bears interest at 3 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 \$1.0 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 \$5.9 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.

Oak Court Apartments, L.P.

On August 18, 2003, the City loaned \$2.0 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 \$1.0 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 3 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. Principal and interest payments began in FY 2007-08. The principal balance is due in 2039.

Community Working Group, Inc.

On May 13, 2002, the City loaned \$1.3 million to the Community Working Group, Inc. for predevelopment, relocation and acquisition of land for development of an 89 unit complex and homeless service center for very low-income households. The loan is funded by \$1.3 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 \$1.3 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 for 55-year term 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 percent interest and is secured by a deed of trust.

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, 2008, 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, special assessments and improvements of their properties. The loans bear interest at 3 percent and are secured by a deed of trust on each property. Loan payments are deferred until 2032. In 2008, the City did not accrue interest.

Stevenson Housing Hot Water Loans

In July 2004, the City agreed to loan up to \$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 6 percent. Principal 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.

Adolescent Counseling Services Loans (Caravan House)

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 3 percent and is secured by a deed of trust on the property. Adolescent Counseling Services sold the property and paid the City in fiscal year 2007-08.



Palo Alto Senior Housing Project Loans

In July 2003, the City agreed to loan up to \$45 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 6 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.

In April 2008, the City provided \$47.6 thousand for the purpose of repairing and upgrading the fire alarm system at the Senior Housing facility.

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 6 percent and is secured by a deed of trust on the property. Repayment of the loan will not be required unless the property is sold or the program terminated; or changed to a use prior to July 1, 2009 that has not been approved by the City. 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.

Lytton Gardens Assisted Living

In June 2005, the City agreed to loan up to \$109 thousand to Community Housing, Inc. to upgrade and modernize the existing kitchens at the senior residential facility known as Lytton Gardens Assisted Living. The loan is funded entirely by Community Development Block Grant funds, and bears simple interest of 3 percent. Principal and interest payments are deferred until July 1, 2035, as long as the borrower continues to comply with all terms and conditions of the agreement.

Emergency Housing Consortium

In November 2005, the City agreed to loan up to \$75 thousand to Emergency Housing Consortium, to cover architectural expenses that will be incurred in rehabilitating and expanding the property. The loan is funded entirely by Community Development Block Grant funds, and bears simple interest of 3 percent. Principal and interest payments are deferred until July 1, 2035, as long as the borrower continues to comply with all terms and conditions of the agreement.

Alma Gardens Apartment

In March 2006, the City agreed to loan up to \$1.2 million to Community Working Group, Inc., to acquire a 10-unit multi-family housing complex known as Alma Garden Apartment. The loan is funded entirely by Community Development Block Grant funds. Principal and interest payments will be made as provided in the note until July 1, 2061, as long as the borrower continues to comply with all terms and conditions of the agreement.

Eden Housing

In September 2006, the City agreed to loan \$980 thousand to the Community Housing Alliance (CHA) to acquire two parcels of land for the development of a 53 unit housing complex to provide rental housing for extremely low-income residents. On September 30, 2006, the City deposited in an escrow account \$980 thousand to be used towards the purchase of the land. Of this amount, \$480 thousand was repaid back to the City.



In August 2008, the City agreed to the conveyance of the Alma Substation parcel to Eden Housing and the CHA and a loan of \$3.0 million for acquisition of adjacent Ole’s Automotive Repair Shop. The City’s total loan amount for the project is \$3.5 million.



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

GOVERNMENTAL ACTIVITIES	Years
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, 2008 were (in thousands):

	Balance June 30, 2007	Additions	Retirements	Transfers	Balance June 30, 2008
Governmental activities					
Capital assets not being depreciated					
Land and improvements	\$71,407			\$1,772	\$73,179
Street trees	15,042	\$222	(\$117)		15,147
Construction in progress	29,895	20,570		(13,096)	37,369
Total capital assets not being depreciated	116,344	20,792	(117)	(11,324)	125,695
Capital assets being depreciated					
Buildings and improvements	93,542			6,154	99,696
Equipment	8,188	329	(1,070)	344	7,791
Roadway network	239,179			4,502	243,681
Recreation & open space network	13,532			324	13,856
Total capital assets being depreciated	354,441	329	(1,070)	11,324	365,024
Less accumulated depreciation					
Buildings and improvements	(55,117)	(1,631)			(56,748)
Equipment	(6,182)	(320)	1,070		(5,432)
Roadway network	(83,396)	(5,778)			(89,174)
Recreation & open space network	(4,761)	(363)			(5,124)
Total accumulated depreciation	(149,456)	(8,092)	1,070		(156,478)
Net governmental fund program					
Capital assets being depreciated	204,985	(7,763)		11,324	208,546
Internal service fund capital assets					
Construction in progress	4,414	5,326		(2,589)	7,151
Equipment	31,967	1,163	(469)	2,589	35,250
Accumulated depreciation	(22,009)	(3,084)	393		(24,700)
Net internal service capital assets	14,372	3,405	(76)		17,701
Governmental activity capital assets, net	\$335,701	\$16,434	(\$193)		\$351,942

Business-type Capital Assets

Changes in the City's Enterprise Fund capital assets during the year ended June 30, 2008 were (in thousands):

	Balance June 30, 2007	Additions	Retirements	Transfers	Balance June 30, 2008
<i>Business-type activities</i>					
Capital assets not being depreciated					
Land and improvements	\$1,953				\$1,953
Construction in progress	88,969	\$43,204		(\$2,129)	130,044
Total capital assets not being depreciated	90,922	43,204		(2,129)	131,997
Capital assets being depreciated					
Buildings and structures	18,915			676	19,591
Transmission, distribution, and treatment systems	480,143	2,431	(\$2,581)	1,453	481,446
Total capital assets being depreciated	499,058	2,431	(2,581)	2,129	501,037
Less accumulated depreciation					
Buildings and structures	(5,647)	(469)			(6,116)
Transmission, distribution, and treatment systems	(200,524)	(12,253)	2,472		(210,305)
Net capital assets being depreciated	(206,171)	(12,722)	2,472		(216,421)
Total depreciable assets	292,887	(10,291)	(109)	2,129	284,616
<i>Business-type activity capital assets, net</i>	\$383,809	\$32,913	(\$109)		\$416,613

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	\$1,065
Community Services	598	Electric	5,616
Fire	102	Gas	1,552
Police	25	Wastewater Collection	1,412
Public Works	7,191	Wastewater Treatment	2,093
Planning	52	Refuse	636
Non departmental (Common Use Assets)	11	Storm Drainage	348
Library Dept	102		\$12,722
Internal Service Funds	3,084		
	\$11,176		



Construction in Progress and Completed Projects

Construction in progress in fiscal year 2007-08 comprise (in thousands):

	Expended to June 30, 2008
Governmental Activities:	
Open Space Trails & Amenities	\$1,112
Open Space Parking Improvement	622
Park Facilities Improvement	1,518
Park Backflow Replacement & Irrigation	260
Civic Center Infrastructure	2,000
Fire Station Improvement	258
Lucie Stern Community Center Improvements	111
Community Services Lighting Enhancements	207
Library Master Plan Project	974
Children's Theater System	207
Roth Building Wings Demolition	225
Fire Communication Computer Systems	227
Park Backflow Replacement & Irrigation	259
Lot S/L Garage (Downtown Parking Structure)	497
Public Safety Building	2,555
San Mateo Drive Bridges	110
Art in Public Places	134
Police Mounted Video	196
Library Automation Service	209
Open Space Lakes/Ponds	147
Public Safety Mobile Data	164
Fire Portable Radio Replacement	245
Sand Hill Road Bridge	173
Mitchell Park Library	1,384
Fire Stations 3 & 4 Feasibility Study	188
Animal Shelter Expansion & Renovation	818
Street Maintenance	3,045
Roofing Replacement	318
Building Systems Improvement	173
Cubberley Mechanical & Electrical Upgrades	166
Stanford/Palo Alto Playing Fields	855
School Site Irrigation	270
Mitchell Park Facilities Improvements	1,132
ECR/Ventura Signal	110
San Antonio/101 Signal	234
Sidewalk Repairs	3,121
Traffic Calming Project	306
Interior Finishes Construction	288
Security Systems Improvements	203
College Terrace Library Improvement	324
Sixteen ALS Monitor/Defibrillator	133
Municipal Service Center Improvements	164
Cubberley Community Center Campus Fire Alarm System	674
Photovoltaic Designs & Installations	3,175
College Terrace Traffic Calming	143
Charleston/Arastradero Corridor Plan	781
Traffic Signal Upgrades	148
Street Lights Improvements	137
Buildings Study	175
San Antonio Road Median Improvements	340
College Terrace Parks Improvements	150
Mitchell Park Facilities Improvements	503
Tennis & Basketball Court Resurfacing	186

Governmental Activities(continue):

Benches, Signage, Fencing, Walkways	\$183
Ramos Park Improvements	496
Roth Building Maintenance	159
Hoover Park Improvements	716
Library Service Model Analysis	267
Foothills Intrpt Ctr & Maint Yard Parking Lot	284
Heritage Park Playground Public/Private Partnership	158
Baylands Athletic Center Fencing Dugout	242
Peers Park Improvement	251
American with Disability	699
Foothills Park Road	225
Vehicle Replacement Fund	2,754
Technology Fund	4,397
Other construction in progress	1,635

Total governmental construction in progress	\$44,520
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Enterprise Funds:

Storm drainage structural and water quality improvements	\$4,847
Gas system extension replacements and improvements	15,832
Water system extension replacements and improvements	13,513
Electric distribution system improvements	11,473
Water quality control plant equipment replacement and lab facilities	17,201
Sewer system rehabilitation and extensions	3,685
Other construction in progress	63,493

Total enterprise construction in progress	\$130,044
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Allocations of Enterprise Fund administration and general expenses of \$5.78 million have been capitalized and included in amounts expended to June 30, 2008.

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, 2007	Additions	Retirements	Balance June 30, 2008	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	\$5,075		\$325	\$4,750	\$335
2002A Civic Center Refinancing						
Certificates of Participation,						
2.00-4.00%, due 03/01/2012	3,500	1,890		350	1,540	365
2002B Downtown Parking Improvements						
Certificates of Participation						
4.55-6.00%, due 03/01/2022	3,555	2,210		95	2,115	100
Total Governmental Activity Debt	\$14,805	\$9,175		\$770	\$8,405	\$800
Business-type Activity Debt:						
<i>Enterprise Long Term Obligations:</i>						
Utility Revenue Bonds,						
1995 Series A, 5.00-6.25%, due 06/01/2020	\$8,640	\$5,964		\$315	\$5,649	\$330
1999 Refunding, 3.25-5.25%, due 06/01/2024	17,735	14,670		455	14,215	480
2002 Series A, 3.00-5.00%, due 06/01/2026	26,055	21,225		755	20,470	780
Energy Tax Credit Bonds,						
2007 Series A, 0%, due 12/15/2021	1,500		1,500	100	1,400	100
State Water Resources Loan,						
2007, 0%, due 6/30/2029	9,000		5,629		5,629	
Less: unamortized discount/ issuance cost		(972)	(143)	(62)	(1,053)	
	\$62,930	\$40,887	\$6,986	\$1,563	\$46,310	\$1,690

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 \$7.8 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 \$3.6 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 4.6 percent to 6.5 percent, 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. Surplus cash from the Civic Center Refinancing and Downtown Parking Improvement Project Construction account were placed 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, 2008 is \$775 thousand. The defeasance resulted in an overall debt service savings of \$1.5 million and an economic gain of \$462 thousand.

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 and External Services Fund. Principal payments are payable annually on June 1 and interest payments semi-annually on June 1 and December 1. A \$2.9 million 6.3 percent 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.

The pledge of future Net Revenues for the above funds ends upon repayment of the \$5.649 million in remaining debt service on the bonds which is scheduled to occur in 2020. For fiscal year 2008, Net Revenues including operating revenues and non-operating interest earnings amounted to \$240.026 million and operating costs include operating expenses, but not interest, depreciation or amortization and amounted to \$186.287 million. Net Revenues available for debt service amounted to \$53.739 million which represented coverage of 78.57 times over the \$684 thousand in debt service.



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 percent), Wastewater Treatment (64.6 percent) and Storm Drain (25.2 percent). Principal payments are payable annually on June 1 and interest payments semi-annually on June 1 and December 1. A \$3.1 million 5.3 percent term bond, and a \$5.1 million 5.3 percent 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.

The pledge of future Net Revenues for the above funds ends upon repayment of the \$14.215 million in remaining debt service on the bonds which is scheduled to occur in 2024. For fiscal year 2008, Net Revenues including operating revenues and non-operating interest earnings amounted to \$18.612 million and operating costs include operating expenses, but not interest, depreciation or amortization amounted to \$11.811 million. Net Revenues available for debt service amounted to \$6.801 million which represents coverage of 5.64 times over the \$1.205 million in debt service.

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 3.0 percent to 5.0 percent. The 2002 Revenue Bonds are secured by net revenues generated by the Water Services and Gas Services Funds.

The pledge of future Net Revenues for the above funds ends upon repayment of the \$20.47 million in remaining debt service on the bonds which is scheduled to occur in 2026. For fiscal year 2008, Net Revenues including operating revenues and non-operating interest earnings amounted to \$79.452 million and operating costs include operating expenses, but not interest, depreciation or amortization amounted to \$52.767 million. Net Revenues available for debt service amounted to \$26.685 million which represented coverage of 15.48 times over the \$1.724 million in debt service.

2007 Electric System Clean Renewable Energy Tax Credit Bonds, Series A – In October 2007, the City issued \$1.5 million of Electric Utility Clean Renewable Energy Tax Credit Bonds (CREBs), 2007 Series A, to finance the City’s photovoltaic solar panel project. The Bonds do not bear interest. In lieu of receiving periodic interest payments, bondholders are allowed annual federal income tax credits in an amount equal to a credit rate for such CREBs multiplied by the outstanding principal amount of the CREBs owned by the bondholders. The Bonds are payable solely from and secured solely by a pledge of the Net Revenues of the Electric system and the other funds pledged therefore under the Indenture.

The pledge of future Electric Fund Net Revenues ends upon repayment of the \$1.5 million in remaining debt service on the bonds which is scheduled to occur in 2021. For fiscal year 2008, Net Revenues including operating revenues and non-operating interest earnings amounted to \$114.231 million and operating costs include operating expenses, but not interest, depreciation or amortization amounted to \$93.369 million. Net Revenues available for debt service amounted to \$20.862 million which represented coverage of 208.62 times over the \$0.1 million in debt service.

State Water Resources Loan – In October 2007, the City approved the \$9.0 million loan agreement with State Water Resources Control Board (SWRCB) to finance the City’s Mountain View/Moffett Area reclaimed water pipeline project. Under the terms of the contract, the City has agreed to repay \$9.0 million to the State in exchange for receiving \$7.5 million in proceeds to be used to fund the Project. The difference between the

repayment obligation and proceeds amounts to \$1.5 million and represents in-substance interest on the outstanding balance. Loan proceeds are drawn down as the project progresses and debt service payments commence on June 30, 2010. As of June 30, 2008, the City received a total loan amount of \$5.6 million.

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	Total	Principal	Interest	Total
2009	\$800	\$415	\$1,215	\$1,690	\$2,025	\$3,715
2010	840	381	1,221	2,205	1,955	4,160
2011	870	345	1,215	2,280	1,880	4,160
2012	905	305	1,210	2,365	1,800	4,165
2013	530	264	794	2,455	1,713	4,168
2014-2018	3,110	857	3,967	13,754	7,052	20,806
2019-2023	1,350	148	1,498	16,800	3,906	20,706
2024-2028				8,735	571	9,306
2029				450		450
Total	\$8,405	\$2,715	\$11,120	50,734	\$20,902	\$71,636

Reconciliation of long-term debt

Residual SWRCB loan not yet received as of FY08	(3,371)
Less unamortized original issue discount	(1,053)
Net long-term debt	<u><u>\$46,310</u></u>



Debt Call Provisions

Long-term debt as of June 30, 2008 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 -		
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 2.0 percent 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 1.0 percent 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 1.0 percent 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, 2008 the amount of Bonds outstanding was \$8.1 million.



Long-term Debt without City Commitment

On July 23, 2007, the City approved the issuance of two variable rate demand Tax-Exempt Revenue Bonds by the ABAG Finance Authority in the amounts of \$160 million and \$180 million for the construction of Albert L. Schultz Jewish Community Center and a new continuing care retirement community, respectively. The Debt is payable by the borrowers, Albert L. Schultz Jewish Community Center and 899 Charleston, LLC, the City has no legal or moral liability with respect to the payment of these debts.

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 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, 2008, 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, 2007	Retirements	Balance June 30, 2008
<i>Governmental Activity Debt</i>				
1987 California Avenue Parking,				
6.70-9.25%, repaid				
09/02/2007	<u>\$1,325</u>	<u>\$115</u>	<u>\$115</u>	<u>\$0</u>

The final debt service payment for the principal \$115 thousand was made in September 2007.

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, 2008, the District's outstanding debt amounted to \$1.1 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, 2008, the District's outstanding debt amounted to \$8.35 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, 2008, \$3.75 million of the bonds were called and the remaining outstanding debt amounted to \$29 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 \$1.6 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 (\$191 thousand in fiscal 2007-08) as mandated by the State of California. Landfill closure and post-closure liability for fiscal years 2008 and 2007 were \$7.9 million and \$7.1 million, respectively. Currently, 91.8 percent of the landfill capacity has been used to date. Based on this percentage, \$7.3 million is expected to be recorded as future landfill closure and post-closure liability.

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 2011. 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, 2008 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, 2008, Governmental Funds reservations and designations included (in thousands):

	Major Funds		Non-Major Funds
	General Fund	Capital Projects Fund	
Reserved for:			
Encumbrances	\$3,816	\$4,331	\$210
Notes and loans	1,155		5,456
Interfund advances	1,100		
Inventory of materials and supplies	2,999		
Prepaid items	2,032		
Debt service			1,406
Total Reserved Fund Balance	<u>\$11,102</u>	<u>\$4,331</u>	<u>\$7,072</u>
Unreserved, designated for:			
Unrealized gain on investments	\$1,035		\$172
Equity transfer stabilization	3,528		
Reappropriations	648	\$16,053	
Budget stabilization	26,102		
Infrastructure		17,894	
Total Unreserved/Designated Fund Balances	<u>\$31,313</u>	<u>\$33,947</u>	<u>\$172</u>



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

Reserves for **notes, loans, interfund advances, inventory of materials and supplies, and prepaid items** 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 for legally restricted for the payment of principal and interest on long-term liabilities.

Designated for **unrealized gain on investment** is the portion of fund balance set aside for unrealized gains on investment.

Designated for **infrastructure** is the portion of fund balance set aside for use on infrastructure.

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.

Internal Service Funds

At June 30, 2008, internal service fund net assets designations included (in thousands):

Reserved net assets-	
Commitments and reappropriations	\$6,771
Unreserved:	
Designated for:	
Future catastrophic losses	3,285
Retiree health care	29,756
Undesignated	<u>12,815</u>
Net assets unrestricted	<u><u>\$52,627</u></u>

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

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

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

Enterprise Funds

At June 30, 2008, Enterprise Fund net assets (in thousands):

	Water	Electric	Gas	Wastewater Collection	Wastewater Treatment	Refuse	Storm Drainage	Total
Unrestricted								
Rate stabilization								
Supply		\$47,309	\$7,399					\$54,708
Distribution		8109	4,734					12,843
Operations	<u>\$13,111</u>	<u>5,859</u>		<u>\$6,027</u>	<u>(\$7,285)</u>	<u>\$3,832</u>	<u>(\$1,384)</u>	<u>20,160</u>
	13,111	61,277	12,133	6,027	(7,285)	3,832	(1,384)	87,711
Emergency plant								
replacement	1,595	3,057	1,328	881	2,583			9,444
Calaveras		70,397						70,397
Reappropriations	10,306	4,731	6,755	6,082	2,647	990	996	32,507
Commitments	1,367	3,007	1,532	763	13,103	883	3,690	24,345
Restricted bond proceeds					9			9
Underground loan		709						709
Landfill								
Corrective Action						636		636
Public benefit program		2,109						2,109
Central Valley Project		22						22
Other/Unexpended debt portion	<u>67</u>		<u>84</u>		<u>26</u>			<u>177</u>
	<u>\$26,446</u>	<u>\$145,309</u>	<u>\$21,832</u>	<u>\$13,753</u>	<u>\$11,083</u>	<u>\$6,341</u>	<u>\$3,302</u>	<u>\$228,066</u>
Restricted for Debt Service	<u>\$780</u>		<u>\$952</u>					<u>\$1,732</u>

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 for multiple employer defined benefit pension plans 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 years 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 plans were combined.

The Plans' provisions and benefits in effect at June 30, 2008, 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%	8%
Required employer contribution rates	24.512%	17.005%

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

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

CALPERS uses the market related value method of valuing the Plan's assets. An investment rate of return of 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 tracked and amortized over 30 years.

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, 2006 (in thousands):

Safety Plan:

Actuarial					Unfunded	
Valuation	Entry Age	Value of	Unfunded	Funded	Annual	(Overfunded)
Date	Accrued	Assets	(Overfunded)	Ratio	Covered	Liability as a %
	Liability		Liability		Payroll	of Payroll
2004	\$201,972	\$175,239	\$26,733	86.8%	\$17,458	153.1%
2005	213,683	195,866	17,817	91.7%	18,953	94.0%
2006	230,186	215,471	14,715	93.6%	20,469	71.9%

Miscellaneous Plan:

Actuarial					Unfunded	
Valuation	Entry Age	Value of	Unfunded	Funded	Annual	(Overfunded)
Date	Accrued	Assets	(Overfunded)	Ratio	Covered	Liability as a %
	Liability		Liability		Payroll	of Payroll
2004	\$290,552	\$267,794	\$22,758	92.2%	\$60,316	37.7%
2005	339,641	287,139	52,502	84.5%	60,954	86.1%
2006	363,774	311,105	52,669	85.5%	61,265	86.0%

* On November 13, 2006, the City Council voted to increase the pension benefit for miscellaneous employees from 1.426-2.418 % to 2.0-2.7% effective the pay period inclusive of January 06, 2007. CALPERS revised the fiscal 2004-05 actuarial data for the impacts of this benefit enhancement.

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

Actuarially required contributions for all plans for fiscal years 2008, 2007 and 2006 were \$25.5, \$19.2 and \$15.8, 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. Employees who retire directly from the City are eligible for retiree health benefits if they retire on or after age 50 with 5 years of service and are receiving a monthly pension from CalPERS.

For employees hired before January 1, 2004, and all management employees, the City pays for the entire cost of retiree health benefits for retirees for their lifetimes. The City also pays a portion of medical costs for spouses of retirees equal to 70 percent of the premiums for 2007 and increasing 5 percent per year until the City's share reaches 100 percent of spouse premiums for 2013 and beyond.

For management employees, fire fighter and fire chief association members hired on or after January 1, 2004, and service employees hired on or after January 1, 2005, the City pays for the 50 percent of the above described benefits after 10 years of service, and the city's portion increases by 5 percent for each additional year of service up to 20 years.

During fiscal year 2008, the City implemented the provisions of Governmental Accounting Standards Board Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. This Statement establishes uniform financial reporting standards for employers providing postemployment benefits (OPEB). As part of the implementation, the City elected to participate in an irrevocable trust to provide a funding mechanism for the OPEB and applied the provisions of the statement on a prospective basis. The California Employers Retirees Benefit Trust, is administrated by CalPERS and managed by a separately appointed board which is not under the control of City Council. This Trust is not considered a component unit by the City.

Funding Policy and Actuarial Assumptions

The City's policy is to prefund these benefits by accumulating assets in the Trust Fund discussed above pursuant to City Council Resolution. The annual required contribution (ARC) was determined as part of a January 1, 2007 actuarial valuation using the entry age normal actuarial cost method. This is a projected benefit cost method, which takes into account those benefits that are expected to be earned in the future as well as those already accrued. The actuarial assumptions included (a) 7.75 percent investment rate of return, (b) 3.25 percent projected annual salary increase, and (c) 5 percent health inflation increases. The actuarial methods and assumptions used include techniques that smooth the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets. Actuarial calculations reflect a long-term perspective and actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future. Actuarially determined amounts are subject to revision at least biannually as results are compared to past expectations and new estimates are made about the future. The City's OPEB unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll using a 30 year amortization period.

Generally accepted accounting principles permit assets to be treated as OPEB assets and deducted from the Actuarial Accrued Liability when such assets are placed in an irrevocable trust or equivalent arrangement. During the fiscal year ended June 30, 2008, the City made contributions in excess of the ARC to prefund benefits. As a result, the City has calculated and recorded the Net OPEB Asset, representing the difference between the ARC, amortization and contributions, as presented below:

Annual required contribution	<u>\$9,313</u>
Annual OPEB cost	9,313
Contributions made:	
Funds Transferred CERBT	(33,844)
Premiums paid	<u>(4,646)</u>
(Decrease) increase in net OPEB obligations	(29,177)
Net OPEB obligation (asset) June 30, 2007	<u> </u>
Net OPEB obligation (asset) June 30, 2008	<u><u>(\$29,177)</u></u>

(A) The actuarial study was completed as of 1/29/2008 with a valuation date of January, 2007. After consideration of contributions made to CERBT, the study estimated a reduced ARC of \$7.686 million for future years.



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 Retiree Fund’s net assets consist of the following for the fiscal year ended June 30, 2008 (in thousands):

<u>Retiree Health Benefits</u>	<u>2008</u>	<u>2007</u>
Net assets, beginning of year	\$30,719	\$26,505
Interest earnings	970	1,202
Unrealized gain (loss) on investments	567	114
Interdepartmental charges	7,133	4,238
Compensated benefits	(9,569)	(4,240)
Transfers in		2,900
Transfers out	(64)	
	<u> </u>	<u> </u>
Net assets, end of year	<u>\$29,756</u>	<u>\$30,719</u>



Note 13.....

DEFERRED COMPENSATION PLAN

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

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

Note 14.....

RISK MANAGEMENT

Coverage

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

The City has a workers’ compensation insurance policy with coverage up to the statutory limit set by the State of California. The City retains the risk for the first \$500 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 \$1.0 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 \$49.0 million per occurrence. The City retains the risk for the first \$1.0 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, 2008, the City contributed \$714 thousand to ACCEL for current year coverage.

Audited financial statements are available from ACCEL at 160 Spear Street, San Francisco, California 94105-2709.

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	
	2008	2007
Beginning Balance	\$21,130	\$19,545
Liability for current and prior fiscal year claims and claims incurred but not reported (IBNR)	6,466	5,636
Claims paid	(4,070)	(4,051)
Ending Balance	<u>\$23,526</u>	<u>\$21,130</u>
Current Portion	<u>\$7,356</u>	<u>\$5,939</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, 2008, the City incurred expenses totaling \$72.6 million for purchased power and assessments earned by NCPA.

The City's interest in NCPA projects and reserves, as computed by NCPA, was \$3.8 million at June 30, 2008. 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 6.2 percent and 6.2 percent, 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, 2008 is \$117 million. The City's participation in this project was 6.2 percent, or \$7.3 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 22.9 percent of this Project's debt service and operating costs. At June 30, 2008, the book value of this Project's plant, equipment and other assets was \$505.1 million, while its long-term debt totaled \$495.2 million and other liabilities totaled \$4.1 million. The City's share of the Project's long term-debt amounted to \$114.2 million at that date.

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 percent share of this Project and the City has an 11.1 percent 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 \$16.0 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 11.1 percent 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, 2008, the book value of this Project's plant, equipment and other assets was \$2.6 million, while its long term debt totaled \$1.7 million. The City's share of the Project's long-term debt amounted to \$189 thousand at that date.

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 4.0 percent 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 \$443.6 million as of June 30, 2008. The City's share of this debt is \$15.9 million.

Construction of the COTP was complete as of June 30, 1993. The transmission line was energized March 24, 1993. Because funding of certain project participants' shares in the project was needed pending approval of their applications for participation, TANC issued \$93.8 million of Commercial Paper debt backed by a Letter of Credit. The City's share of the Commercial Paper was \$3 million at June 30, 2008, 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, with the lease expiring in 12/31/2014. The City's rent for the facilities is \$5.0 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, 2008 amounted to \$6.4 million.

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

<u>Year ending June 30:</u>	<u>Payments</u>
2009	\$6,654
2010	6,854
2011	7,060
2012	7,271
2013	7,490
2014-2017	40,952
	<u>\$76,281</u>

Palo Alto Sanitation Company – In 1999 the City, under the provisions of a new agreement, contracted with the Palo Alto Sanitation Company (PASCO) for services related to residential and commercial refuse collection, curbside recycling, and other operation special programs. The new agreement has a term of seven years and ten months from the effective date of September 1, 1999. The new contract revised the method by which compensation is paid to PASCO to be more in-line with the industry standard. The method establishes compensation based on the relationship between costs and profits and includes periodic performance reviews. In 2007-08 this resulted in payments to PASCO of \$9.3 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, 2008. 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 21.3 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 \$20.6 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 21.3 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, 2008 is \$3.2 million. During the year ended June 30, 2008, the City paid \$443.7 thousand as its portion of current debt service.

In fiscal 2007-08, the members agreed to finance an Equipment Replacement Project estimated to cost \$14.7 million. \$5.2 million of these costs are to be funded with existing reserves and the remaining \$9.5 million is to be funded by a proposed bond issue. The City's portion of the proposed bond issue is \$2.0 million.

UTILITIES ENERGY RESOURCE MANAGEMENT

Energy Markets in the United States and California

U.S. and California electric and gas prices continued to be volatile during the year. The City purchased electricity in fiscal year 2007-08 in conformance with the Council-approved Long-term Electric Acquisition Plan (LEAP) established in 2001 and modified in April 2007. Due to the City's commodity purchase strategy, whereby purchases are made on a 3-year forward basis in a ladder fashion, the City's electric and gas utility customers enjoyed stable rates in fiscal year 2007-08 compared to what they would have paid if exposed to volatile market prices during the year. The City's average wholesale electric commodity purchase cost during the fiscal year was approximately 6.4 ¢/kWh while the average spot market prices were close to 7.0 ¢/kWh. The primary reason the electric costs were lower than market prices is the availability of low-cost hydroelectric power. The average natural gas commodity cost for the gas pool customers was \$7.80/MMBtu compared to a spot market price of \$7.60 /MMBtu.

Hydro-electric production accounted for 36 percent of the City's electric supply. These hydroelectric supplies derive from two sources – from contract with the Western Area Power Administration and from the City's partial ownership of the Calaveras Hydroelectric Project. Wind and landfill gas resources accounted for 13 percent of the electric supply, with the balance purchased from the wholesale electric market. The city transacts with qualified suppliers for the market purchases and the Northern California Power Agency (NCPA), which provides scheduling services for the City, buys and sells electricity within the month as needed to meet the City's demands.

Due to the dry hydrologic conditions in 2007 and 2008, the hydroelectric supplies were at low levels during the year and resulted in the need for the City to purchase high-cost power during the year from the market. Incidental sales of surplus energy resulted in revenues of \$1.45 million during the year. (The inputted expense associated with the surplus energy sold from the overall electric supply portfolio was calculated at \$0.76 million during the year, and is shown separately on the Statement of Revenues, Expenses and Changes in Net Assets.)

The California Independent System Operation (CAISO) now has the authority to allocate to all electric load serving entities, including publicly owned utilities such as the City, the cost responsibility for the local

generation capacity required to maintain transmission reliability on the CAISO-controlled electric grid. This is expected to result in higher costs to Palo Alto's electric utility customers.

The City has executed Electric and Gas Master Agreements with suppliers to procure electricity and natural gas supplies. The table below outlines the electric and natural gas commodity supply commitments made by the City with these suppliers as of June 30, 2008. Monthly payments are made to suppliers upon delivery of supplies for the month. The City's procurement plans 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.

Forward Electricity Commodity Supply Commitments as of June 30, 2008

Supplier	FY08/09	FY09/10	FY10/11	Total
JP Morgan Chase	\$ 2,388,240		\$ -	\$ 2,388,240
Powerex	1,956,420			\$ 1,956,420
Sempra	2,849,610			\$ 2,849,610
SENA	13,394,411	5,879,730		\$ 19,274,141
	\$ 20,588,681	\$ 5,879,730	\$ -	\$ 26,468,411
Average Cost (cents/kWh)	6.58 ¢	5.37 ¢		6.26 ¢

Forward Natural Gas Commodity Supply Commitments as of June 30, 2008

Supplier	FY08/09	FY09/10	FY10/11	Total
BP	\$ 1,079,000	\$ 1,761,750	\$ 2,531,328	\$ 5,372,078
Powerex	\$ 1,347,260	\$ 3,425,610		\$ 4,772,870
Sempra	\$ 4,603,736	\$ 1,662,210	\$ 1,080,832	\$ 7,346,778
SENA	\$ 8,859,080	\$ 4,164,430	\$ 2,663,665	\$ 15,687,175
	\$ 15,889,076	\$ 11,014,000	\$ 6,275,825	\$ 33,178,901
Average Cost (\$/MMBtu)	\$8.26	\$8.16	\$8.75	\$8.32

The City's natural gas transportation contract entered into in 2005 with Pacific Gas and Electric Company (PG&E) was in place until the end of 2007. This contract, commonly known as Gas Accord III, between PG&E and its transportation customers provides the City's retail customers stable transportation costs. Gas Accord IV went into effect starting January 1, 2008 for three years. This contract is not substantially different from our current agreement.

Future Outlook

Electric

Market price for fossil fuel based electricity is expected to remain high at between 7 to 8¢/kWh. The price premium commanded by renewable energy projects has increased considerably in the last year and is expected to remain high in the foreseeable future. The higher prices will result in higher costs to meet the City's renewable energy supply targets.

The Council increased the renewable resource supply targets in March 2007. The new target is to meet 20 percent of the citywide load with renewable resource supplies by 2008, 30 percent by 2012 and 33 percent by 2015. Though the City has made considerable progress in securing renewable energy supplies, due to the



unavailability of short term renewable energy supplies, the delay in start date for projects for which commitments have already been made, and a large demand for renewable energy supplies in the Western U.S., the City expects to fall short of meeting the 20 percent target for 2008. Renewable supplies are expected to account for approximately 17 percent of supplies during calendar year 2008.

PaloAltoGreen, the City's volunteer green power program currently accounts for an additional 5 percent of the City's energy needs from renewable resources. The City is also in the process of implementing a program to encourage small-scale ultra-clean distributed generation and cogeneration applications within the city. The City is also in the process of reviewing all utility programs, including PaloAltoGreen, to ensure that programs are aligned to reduce greenhouse gas emissions associated with the City's energy supplies.

The California Independent System Operator (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), is anticipated to occur by February 2009. An underlying component of MRTU is the use of location-specific prices for the scheduling of energy transactions, which could lead to cost increases for transmission services for the City.

The following energy bills were signed into California law September 2008 (the second year of the two-year, 2007-2008, Session):

AB 1763 (Chaptered 9/28/2008): This bill requires investor-owned utilities (IOUs) to disclose specified information on usage and cost on residential customer's billing statements, and to make available online to residential customers specified information on usage and energy conservation measures. Publicly owned utilities, such as the City's, are not included under AB 1763.

AB 844 (Chaptered 9/30/2008), SB 447 (Chaptered 9/30/2008), and; SB 691 (Chaptered 9/30/2008): These three bills address the issue of metal theft by setting new regulations for junk dealers and recyclers.

The City continues to follow the development of laws and associated regulations related to implementation of AB 32 (California Global Warming Solutions Act of 2006, Chaptered 9/27/2006). In October 2008, the California Air Resources Board (CARB) will release a revised Scoping Plan, which is the primary guidance document for shaping how California will reduce its greenhouse gas (GHG) emissions to 1990 levels by 2020 as called for by AB 32. The Scoping Plan is due to be formally adopted by the CARB board by the end of November 2008. A key input to the Scoping Plan is the GHG policy decision released by the California Public Utilities Commission (CPUC) and the California Energy Commission (CEC) in proposal, about the need to protect consumers from flawed market designs, and highlighting problems regarding certain allowance distribution approaches.

The Emergency Economic Stabilization Act of 2008 (H.R. 1424), signed into law by President Bush in October, contained key tax extender provisions that the City have advocated for throughout the year. The \$17 billion energy tax provisions extend: the Production Tax Credit (PTC), a tax credit for the first 10 year of output from qualifying renewable projects such as wind, for one year; and the solar investment tax extension, commercial buildings for five years, and appliances for two years. In addition, the legislation also authorizes \$800 million for Clean Renewable Energy Bonds (CREBs) to be divided among state, local, and tribal governments, public power, and rural electric cooperatives.

Significant California state legislation that failed to pass this year included a number of bills that would have increased the statewide Renewable Portfolio Standard (RPS) to 33% and included publicly owned utilities in the regulations. Although these bills failed to pass the year they are expected to be back in some form in the next California legislative session of 2009. Also pending on the November California ballot this year is Proposition 7 (the Solar & Clean Energy Act of 2008), which calls for 40% RPS by 2020 and 50% by 2025.



Natural Gas

Long term market prices for natural gas remain at about \$0.80 per therm. Declining production in the U.S. and Canada and increasing U.S. and international demand will put pressure on the prices in the long-term. Market price volatility is expected to remain high in the short term due to the uncertainty in the financial markets. The City plans to continue implementing its 3-year laddering strategy using both fixed-price and capped-price products to hedge the gas utility supply portfolio. The City will also examine additional strategies to control commodity cost.

In February 2008, Council approved a new plan to implement a voluntary customer program similar to Palo Alto **Green** for non-fossil fuel gas supplies. The program may be supplied via biomethane sources or carbon offset credits. The cost of the new program has not yet been determined.

Water

The City's water use during fiscal year 2007-08 increased about 2.5 percent over the prior year. Usage is highly dependent on weather conditions, but has remained essentially flat for the past 10 years. Current water usage is only 70 percent of what it was in 1975. The slight drop in usage in FY 2007-08 may be attributed to customer response to the call for water conservation due to dry conditions that was issued in April 2008 by the San Francisco Public Utilities Commission (SFPUC). Water supply costs for fiscal year 2007-08 increased almost 3.8 percent from fiscal year 2006-07, consistent with a 6.6 percent increase in the wholesale water rate in fiscal year 2007-08.

Water supply costs are expected to trend upward as the SFPUC implements a much delayed, but essential, upgrade to the regional water system 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 \$3.0 billion at the time. Costs for the WSIP are now expected to be about \$4.4 billion. When other planned projects are factored in, the total cost to upgrade and improve the regional water system is about \$5.0 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 the City's long-term water rate projections.

The relationship between each of the BAWSCA agencies and the City and County of San Francisco is specified in a 25-year water service contract, which expires on June 30, 2009. Each agency, including Palo Alto, has given BAWSCA the authority to negotiate a new contract on its behalf. At this time, it is unknown whether the mechanism for cost allocation or wholesale rate structure will change from the current contract.

During fiscal year 2007-08, the City continued the planning phase for expanding the recycled water distribution system in Palo Alto by preparing a Recycled Water Facility Plan. The plan is expected to be complete in fiscal year 2008-09. This plan provides more detailed design information and includes the preparation of environmental documents for the project. Completion of the facility plan and environmental documents is necessary to compete for grant funding opportunities.



Contingent Liabilities

Many of the uncertainties faced by the Utilities Department as an aftermath of the 2000-01 energy crisis have been resolved, however, a number of uncertainties remain. The Ninth Circuit Court has determined that the Federal Energy Regulatory Commission (FERC) lacked authority under the Federal Power Act to grant refund relief against governmental agencies, and the United States Supreme Court declined to review that decision. Nonetheless a number of entities (“the California Parties”) have filed suit against the NCPA and other municipal utilities seeking refunds for sales made to the CAISO and Power Exchange during the energy crisis. The suit was filed in the Superior Court in Los Angeles in April 2007. Another dispute between the Western Area Power Administration and PG&E regarding PG&E’s claim to recover certain CAISO related costs has also not been resolved.

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, claims or assessments that are likely to have a material adverse effect on the City’s financial condition.

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 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 findings. However, as of June 30, 2008, 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.

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 to be used for parks, community centers and libraries.

REDEVELOPMENT AGENCY ADMINISTRATION

This fund accounts for the activities of administering 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 Certificates of Participation issued for the City's golf course.

CIVIC CENTER REFINANCING

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



Non-major Governmental Funds

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 accumulates 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.

EYERLY FAMILY

This fund accounts for the revenues received from assets donated by Mr. and Mrs. Fred Eyerly for the City and or its citizenry.



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City of Palo Alto - Non-Major Governmental Funds

Combining Balance Sheets- June 30, 2008

(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	Street Improvement	Federal Revenue	Housing In-Lieu	Special Districts	Transportation Mitigation	Local Law Enforcement
ASSETS						
Cash and investments :						
Available for operations	\$9	\$452	\$7,267	\$742	\$2,204	\$152
Cash and investments with fiscal agent						
Receivables:						
Accounts	371					
Interest	1		79	9	23	3
Notes		3,026	2,430			
Total Assets	<u>\$381</u>	<u>\$3,478</u>	<u>\$9,776</u>	<u>\$751</u>	<u>\$2,227</u>	<u>\$155</u>
LIABILITIES						
Accounts payable		38	176			9
Total Liabilities		<u>38</u>	<u>176</u>			<u>9</u>
FUND EQUITY						
Reserved for:						
Encumbrances		134	59			13
Notes receivable		3,026	2,430			
Debt service						
Unreserved, designated for:						
Special Revenue Funds						
Unrealized gain on investments	2		85	10	24	3
Special revenue projects			7,026	741	2,203	130
Special revenue reappropriations	2,502	682				
Unreserved, undesignated:						
Permanent Fund						
Special Revenue Funds	(2,123)	(402)				
Total Fund Balances	<u>381</u>	<u>3,440</u>	<u>9,600</u>	<u>751</u>	<u>2,227</u>	<u>146</u>
Total Liabilities and Fund Balances	<u>\$381</u>	<u>\$3,478</u>	<u>\$9,776</u>	<u>\$751</u>	<u>\$2,227</u>	<u>\$155</u>



SPECIAL REVENUE FUNDS				DEBT SERVICE FUNDS		
Assets Seizure	Developer's Impact Fee	Redevelopment Agency	Downtown Business Improvement District	Golf Course	Civic Center Refinancing	Downtown Parking Improvement
	\$4,344		\$19	\$17 749	\$22 353	\$13 240
			93			
	44			12		
	\$4,388		\$112	\$778	\$375	\$253
			4			
				778	375	253
	48					
	4,340		108			
	4,388		112	778	375	253
	\$4,388		\$112	\$778	\$375	\$253

(Continued)



City of Palo Alto - Non-Major Governmental Funds

Combining Balance Sheets- June 30, 2008

(In thousands of dollars)

	DEBT SERVICE FUND	PERMANENT FUND	Total Non-major Governmental Funds
	Special Assessment Debt	Eyerly Family	
ASSETS			
Cash and investments :			
Available for operations		\$729	\$15,970
Cash and investments with fiscal agent			1,342
Receivables:			
Accounts			464
Interest		5	176
Notes			5,456
Total Assets		\$734	\$23,408
LIABILITIES			
Accounts payable		3	226
Total Liabilities		3	226
FUND EQUITY			
Reserved for:			
Encumbrances			210
Notes receivable			5,456
Debt service			1,406
Unreserved, designated for:			
Special Revenue Funds			
Unrealized gain on investments			172
Special revenue projects			10,100
Special revenue reappropriations			3,184
Unreserved, undesignated:			
Permanent Fund		731	731
Special Revenue Funds			1,923
Total Fund Balances		731	23,182
Total Liabilities and Fund Balances		\$734	\$23,408



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City of Palo Alto - Non-Major Governmental Funds
Combining Statements of Revenues, Expenditures and
Changes in Fund Balances -
For the Year Ended June 30, 2008
(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	\$1,113				\$4	
Charges for services					316	
From other agencies:						
Community Development Block Grant		\$386				
State of California						\$122
Other revenue from other agencies		156				
Permit and licenses				\$180		
Return on investment	23	159	\$586	50	134	14
Rental income			6			
Other:						
Housing In-Lieu - residential			17			
Housing In-Lieu - commercial			421			
University Avenue Parking				902	53	
California Avenue Parking				98		
Other fees			146		25	
Total Revenues	1,136	701	1,176	1,230	532	136
EXPENDITURES						
Current:						
Planning and Community Environment		2,589	3,810			
Public Safety - Police						171
Non Departmental		(24)	156			
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures		2,565	3,966			171
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	1,136	(1,864)	(2,790)	1,230	532	(35)
OTHER FINANCING SOURCES (USES)						
Transfers in						
Transfers (out)	(1,048)			(1,190)	(82)	(100)
Total Other Financing Sources (Uses)	(1,048)			(1,190)	(82)	(100)
Net Change in Fund Balance	88	(1,864)	(2,790)	40	450	(135)
Fund balances at the beginning of year	293	5,304	12,390	711	1,777	281
Fund balances at end of year	\$381	\$3,440	\$9,600	\$751	\$2,227	\$146

SPECIAL REVENUE FUNDS				DEBT SERVICE FUNDS		
Assets Seizure	Developer's Impact Fee	Redevelopment Agency	Downtown Business Improvement District	Golf Course	Civic Center Refinancing	Downtown Parking Improvement
			\$135			
	\$250		3	\$69	\$14	\$11
	2,045					
	2,295		138	69	14	11
			106			
				325	350	95
				236	71	140
			106	561	421	235
	2,295		32	(492)	(407)	(224)
		\$6		528	409	226
	(620)	(6)				
	(620)			528	409	226
	1,675		32	36	2	2
	2,713		80	742	373	251
	\$4,388		\$112	\$778	\$375	\$253

(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, 2008

(In thousands of dollars)

	DEBT SERVICE FUND	PERMANENT FUND	Total
	Special Assessment District	Eyerly Family	Non-major Governmental Funds
REVENUES			
Special assessments	\$1		\$136
Other taxes and fines			1,117
Charges for services			316
From other agencies:			
Community Development Block Grant			386
State of California			122
Other revenue from other agencies			156
Permit and licenses			180
Return on investment		\$5	1,318
Rental income			6
Other:			
Housing In-Lieu - residential			17
Housing In-Lieu - commercial			421
University Avenue Parking			955
California Avenue Parking			98
Other fees			2,216
Total Revenues	1	5	7,444
EXPENDITURES			
Current:			
Planning and Community Environment			6,399
Public Safety - Police			171
Non Departmental			238
Debt service:			
Principal retirement	115		885
Interest and fiscal charges	4		451
Total Expenditures	119		8,144
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(118)	5	(700)
OTHER FINANCING SOURCES (USES)			
Transfers in		726	1,895
Transfers (out)			(3,046)
Total Other Financing Sources (Uses)		726	(1,151)
Net Change in Fund Balance	(118)	731	(1,851)
Fund balances at the beginning of year	118		25,033
Fund balances at end of year		\$731	\$23,182



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City of Palo Alto - Non-major Governmental Funds

**Combining Schedule of Revenues, Expenditures and
Changes in Fund Balances -Budget and Actual**

For the Year Ended June 30, 2008

(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	Street Improvement			Federal Revenue		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES						
Special assessments						
Other taxes and fines	\$1,136	\$1,113	(\$23)			
Charges for services						
From other agencies:						
Community Development Block Grant				\$712	\$386	(\$326)
State of California						
Other revenue from other agencies				40	156	116
Permit and licenses						
Return on investment	18	23	5		159	159
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees				7		(7)
Total Revenues	1,154	1,136	(18)	759	701	(58)
EXPENDITURES						
Current operations:						
Planning and Community Environment				2,074	653	1,421
Public Safety - Police						
Non Departmental					(24)	24
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures				2,074	629	1,445
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	1,154	1,136	(18)	(1,315)	72	1,387
OTHER FINANCING SOURCES (USES)						
Transfers in				5		(5)
Transfers (out)	(1,462)	(1,048)	414	(5)		5
Total Other Financing Sources (Uses)	(1,462)	(1,048)	414			
Net Change in Fund Balance - Budget Basis	(\$308)	88	\$396	(\$1,315)	72	\$1,387
Non budgeted transactions - Valuation Allowance					(1,936)	
Fund balances at the beginning of year - (GAAP Basis)		293			5,304	
Fund balances at end of year - (GAAP Basis)		\$381			\$3,440	



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)
						\$82	\$4 316	\$4 234
\$150 9	\$586 6	\$436 (3)	\$38	\$180 50	\$180 12	69	134	65
200 200	17 421	(183) 221						
			910 134	902 98	(8) (36)	480	53	(427)
375	146	(229)					25	25
934	1,176	242	1,082	1,230	148	631	532	(99)
395	255	140						
634	156	478						
1,029	411	618						
(95)	765	860	1,082	1,230	148	631	532	(99)
			(1,290)	(1,190)	100	(82)	(82)	
			(1,290)	(1,190)	100	(82)	(82)	
(\$95)	765	\$860	(\$208)	40	\$248	\$549	450	(\$99)
	(3,555)							
	12,390			711			1,777	
	\$9,600			\$751			\$2,227	

(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, 2008

(In thousands of dollars)

	SPECIAL REVENUE FUNDS					
	Local Law Enforcement			Asset Seizure		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES						
Special assessments						
Other taxes and fines						
Charges for services						
From other agencies:						
Community Development Block Grant						
State of California	\$150	\$122	(\$28)			
Other revenue from other agencies						
Permit and licenses						
Return on investment	14	14		\$1		(\$1)
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees						
Total Revenues	164	136	(28)	1		(1)
EXPENDITURES						
Current operations:						
Planning and Community Environment						
Public Safety - Police	198	171	27			
Non Departmental						
Debt service:						
Principal retirement						
Interest and fiscal charges						
Total Expenditures	198	171	27			
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(34)	(35)	(1)	1		(1)
OTHER FINANCING SOURCES (USES)						
Transfers in						
Transfers (out)	(100)	(100)				
Total Other Financing Sources (Uses)	(100)	(100)				
Net Change in Fund Balance - Budget Basis	(\$134)	(135)	(\$1)	\$1		(\$1)
Non budgeted transactions - Valuation Allowance						
Fund balances at the beginning of year - (GAAP Basis)		281				
Fund balances at end of year - (GAAP Basis)		\$146				



SPECIAL REVENUE FUNDS								
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)
						\$160	\$135	(\$25)
\$77	\$250	\$173				4	3	(1)
553	2,045	1,492						
630	2,295	1,665				164	138	(26)
						164	106	58
						164	106	58
630	2,295	1,665					32	32
(620)	(620)		\$9 (9)	\$6 (6)	(\$3) 3			
(620)	(620)							
\$10	1,675	\$1,665					32	\$32
	2,713						80	
	\$4,388						\$112	
								(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, 2008

(In thousands of dollars)

	DEBT SERVICE FUNDS					
	Golf Course			Civic Center Refinance		
	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
REVENUES						
Special assessments						
Other taxes and fines						
Charges for services						
From other agencies:						
Community Development Block Grant						
State of California						
Other revenue from other agencies						
Permit and licenses						
Return on investment	\$32	\$69	\$37	\$12	\$14	\$2
Rental income						
Other:						
Housing In-Lieu - residential						
Housing In-Lieu - commercial						
University Avenue Parking						
California Avenue Parking						
Other fees						
Total Revenues	32	69	37	12	14	2
EXPENDITURES						
Current operations:						
Planning and Community Environment						
Public Safety - Police						
Non Departmental						
Debt service:						
Principal retirement	325	325		350	350	
Interest and fiscal charges	235	236	(1)	71	71	
Total Expenditures	560	561	(1)	421	421	
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	(528)	(492)	36	(409)	(407)	2
OTHER FINANCING SOURCES (USES)						
Transfers in	528	528		409	409	
Transfers (out)						
Total Other Financing Sources (Uses)	528	528		409	409	
Net Change in Fund Balance - Budget Basis		36	\$36		2	\$2
Non budgeted transactions - Valuation Allowance						
Fund balances at the beginning of year - (GAAP Basis)		742			373	
Fund balances at end of year - (GAAP Basis)		\$778			\$375	

DEBT SERVICE FUNDS						PERMANENT FUND			TOTAL		
Downtown Parking Improvement			Special Assessment District			Eyerly Family			Non-major Governmental Funds		
Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)	Budget	Actual	Variance Positive (Negative)
			\$119	\$1	(\$118)				\$279	\$136	(\$143)
									1,136	1,117	(19)
									82	316	234
									712	386	(326)
									150	122	(28)
									40	156	116
										180	180
\$9	\$11	\$2				\$5			424	1,318	894
									9	6	(3)
									200	17	(183)
									200	421	221
									1,390	955	(435)
									134	98	(36)
									935	2,216	1,281
9	11	2	119	1	(118)		5		5,691	7,444	1,753
									2,469	908	1,561
									198	171	27
									798	238	560
95	95		115	115					885	885	
140	140		4	4					450	451	(1)
235	235		119	119					4,800	2,653	2,147
(226)	(224)	2		(118)	(118)		5		891	4,791	3,900
226	226						726	726	1,177	1,895	(8)
									(3,568)	(3,046)	522
226	226						726	726	(2,391)	(1,151)	514
	2	\$2		(118)	(\$118)		731	\$726	(\$1,500)	3,640	\$4,414
										(5,491)	
	251			118						25,033	
	\$253						\$731			\$23,182	



Non-major Governmental Funds

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Internal Service Funds

Introduction

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

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.



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City of Palo Alto - Internal Service Funds

Combining Statements of Net Assets - June 30, 2008

(In thousands of dollars)

	Vehicle Replacement and Maintenance	Technology	Printing and Mailing Services	General Benefits and Insurance	Retiree Health Benefit	Total
ASSETS						
Current Assets:						
Cash and investments available for operations	\$5,123	\$14,911	\$187	\$38,333	\$384	\$58,938
Accounts receivable, net	50	282				332
Interest receivable	61	187	3	403	195	849
Inventory of materials and supplies	587	(67)	(1)	13		532
Prepaid items					29,177	29,177
Total Current Assets	5,821	15,313	189	38,749	29,756	89,828
Noncurrent Assets:						
Capital assets, nondepreciable	2,754	4,397				7,151
Capital assets, net of depreciation	9,249	1,280	21			10,550
Total Noncurrent Assets	12,003	5,677	21			17,701
Total Assets	17,824	20,990	210	38,749	29,756	107,529
LIABILITIES						
Current Liabilities:						
Accounts payable and accrued liabilities	310	1,327		1,262		2,899
Accrued salaries and benefits	19	59	6	269		353
Accrued compensated absences	3	12	1	3,588		3,604
Accrued claims payable - current				7,356		7,356
Total Current Liabilities	332	1,398	7	12,475		14,212
Long-term Liabilities:						
Accrued compensated absences				6,819		6,819
Accrued claims payable				16,170		16,170
Total Long-term Liabilities				22,989		22,989
Total Liabilities	332	1,398	7	35,464		37,201
NET ASSETS						
Investment in capital assets	12,003	5,677	21			17,701
Unrestricted	5,489	13,915	182	3,285	29,756	52,627
Total Net Assets	\$17,492	\$19,592	\$203	\$3,285	\$29,756	\$70,328

City of Palo Alto - Internal Service Funds

Combining Statements of Revenues, Expenses and

Changes in Net Assets - For the Year Ended June 30, 2008

(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	\$6,383	\$9,193	\$1,250	\$37,207	\$7,133	\$61,166
Other operating revenues		282				282
Total Operating Revenues	6,383	9,475	1,250	37,207	7,133	61,448
OPERATING EXPENSES						
Administration and general	833	9,495	1,434	1,759	18	13,539
Operations and maintenance	2,171					2,171
Depreciation and amortization	1,920	1,160	3			3,083
Claim payments and change in estimated self-insured liability				7,029		7,029
Compensated absences and other benefits	74			31,508	9,551	41,133
Total Operating Expenses	4,998	10,655	1,437	40,296	9,569	66,955
Total Operating Income (Loss)	1,385	(1,180)	(187)	(3,089)	(2,436)	(5,507)
NONOPERATING REVENUES (EXPENSES)						
Return on investment	338	1,088	22	2,419	1,537	5,404
Gain (loss) on disposal of capital assets	62					62
Other nonoperating revenues (expense)		52	3			55
Total Nonoperating Revenues	400	1,140	25	2,419	1,537	5,521
Income (Loss) Before Transfers	1,785	(40)	(162)	(670)	(899)	14
Transfers in		3,087				3,087
Transfers (out)	(27)	(905)	(8)		(64)	(1,004)
Change in Net Assets	1,758	2,142	(170)	(670)	(963)	2,097
Net assets at beginning of year	15,734	17,450	373	3,955	30,719	68,231
Net assets at end of year	\$17,492	\$19,592	\$203	\$3,285	\$29,756	\$70,328

City of Palo Alto - Internal Service Funds

Combining Statements of Cash Flows - For the Fiscal Year Ended June 30, 2008

(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	\$6,383	\$8,911	\$1,250	\$37,219	\$7,133	\$60,896
Payments to suppliers	(2,152)				(29,178)	(31,330)
Payments to or on behalf of employees	(905)	(8,187)	(1,431)	(36,395)	(9,568)	(56,486)
Claims paid				(4,633)		(4,633)
Interfund payments		25				25
Other receipts		334	3			337
Net cash provided by operating activities	3,326	1,083	(178)	(3,809)	(31,613)	(31,191)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES						
Transfers in		3,087				3,087
Transfers (out)	(27)	(905)	(8)		(64)	(1,004)
Cash flows from noncapital financing activities	(27)	2,182	(8)		(64)	2,083
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES						
Acquisition and construction of capital assets	(3,030)	(3,382)				(6,412)
Proceeds from sale of capital assets	62					62
Cash flows from capital financing activities	(2,968)	(3,382)				(6,350)
CASH FLOWS FROM INVESTING ACTIVITIES						
Interest and dividends on pooled investments	340	1,077	25	2,389	1,641	5,472
Net Cash Flows	671	960	(161)	(1,420)	(30,036)	(29,986)
Cash and investments at beginning of year	4,452	13,951	348	39,753	30,420	88,924
Cash and investments at end of year	\$5,123	\$14,911	\$187	\$38,333	\$384	\$58,938
CASH FLOWS FROM OPERATING ACTIVITIES						
Operating income (loss)	\$1,385	(\$1,180)	(\$187)	(\$3,089)	(\$2,436)	(\$5,507)
Adjustments to reconcile operating income (loss) to cash flows from operating activities:						
Depreciation and amortization	1,920	1,160	3			3,083
Other		52	3			55
Changes in assets and liabilities:						
Accounts receivable		(282)		12		(270)
Inventory of materials and supplies	(83)	67	1	(13)		(28)
Prepaid items					(29,177)	(29,177)
Accounts and other payables	101	1,229	1	(3,115)		(1,784)
Accrued compensated absences	3	12	1			16
Interfund payment		25				25
Accrued claims payable				2,396		2,396
Net cash provided by operating activities	\$3,326	\$1,083	(\$178)	(\$3,809)	(\$31,613)	(\$31,191)



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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 Area 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, 2008

(In thousands of dollars)

	Balance June 30, 2007	Additions	Reductions	Balance June 30, 2008
<hr/> California Avenue Parking Assessment District <hr/>				
ASSETS				
Cash and investments available for operations	\$264		\$10	\$254
LIABILITIES				
Due to bondholders	\$264		\$10	\$254
<hr/> Cable Joint Powers Authority <hr/>				
ASSETS				
Cash and investments available for operations	\$769	\$44		\$813
Interest receivable	10			10
Total assets	\$779	\$44		\$823
LIABILITIES				
Due to other governments	\$779	\$44		\$823
<hr/> University Avenue Area Parking Assessment District <hr/>				
ASSETS				
Cash and investments with fiscal agents	\$6,097	\$3	\$1	\$6,099
Interest receivable	34	1		35
Total assets	\$6,131	\$4	\$1	\$6,134
LIABILITIES				
Due to bondholders	\$6,131	\$4	\$1	\$6,134
<hr/> Total Agency Funds <hr/>				
ASSETS				
Cash and investments available for operations	\$1,033	\$44	\$10	\$1,067
Cash and investments with fiscal agents	6,097	3	1	6,099
Interest receivable	44	1		45
Total assets	\$7,174	\$48	\$11	\$7,211
LIABILITIES				
Due to bondholders	\$6,395	\$4	\$11	\$6,388
Due to other governments	779	44		823
Total liabilities	\$7,174	\$48	\$11	\$7,211



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.

Financial Trends

These schedules contain trend information to help the reader understand how the City's financial performance and well being have changed over time:

1. Net Assets by Component
2. Changes in Net Assets
3. Fund Balances of Governmental Funds
4. Changes in Fund Balance of Governmental Funds

Revenue Capacity

These schedules contain information to help the reader assess the City's most significant local revenue sources, property tax and electric charges:

1. Electric Daily Loads and Top Customers by Usage
2. Electric Operating Revenue by Source
3. Assessed Value of Taxable Property
4. Property Tax Rates, All Overlapping Governments
5. Property Tax Levies and Collections
6. Principal Property Taxpayers

Debt Capacity

These schedules present information to help the reader assess the affordability of the City's current levels of outstanding debt and the City's ability to issue additional debt in the future:

1. Ratio of Outstanding Debt by Type
2. Computation of Direct and Overlapping Debt
3. Computation of Legal Bonded Debt Margin
4. Revenue Bond Coverage



Demographic and Economic Information

These schedules offer demographic and economic indicators to help the reader understand the environment within which the City's financial activities take place:

1. Taxable Transaction by Type of Business
2. Demographic and Economic Statistics
3. Principal Employers

Operating Information

These schedules contain service and infrastructure data to help the reader understand how the information in the City's financial report relates to the services the City provides and the activities it performs:

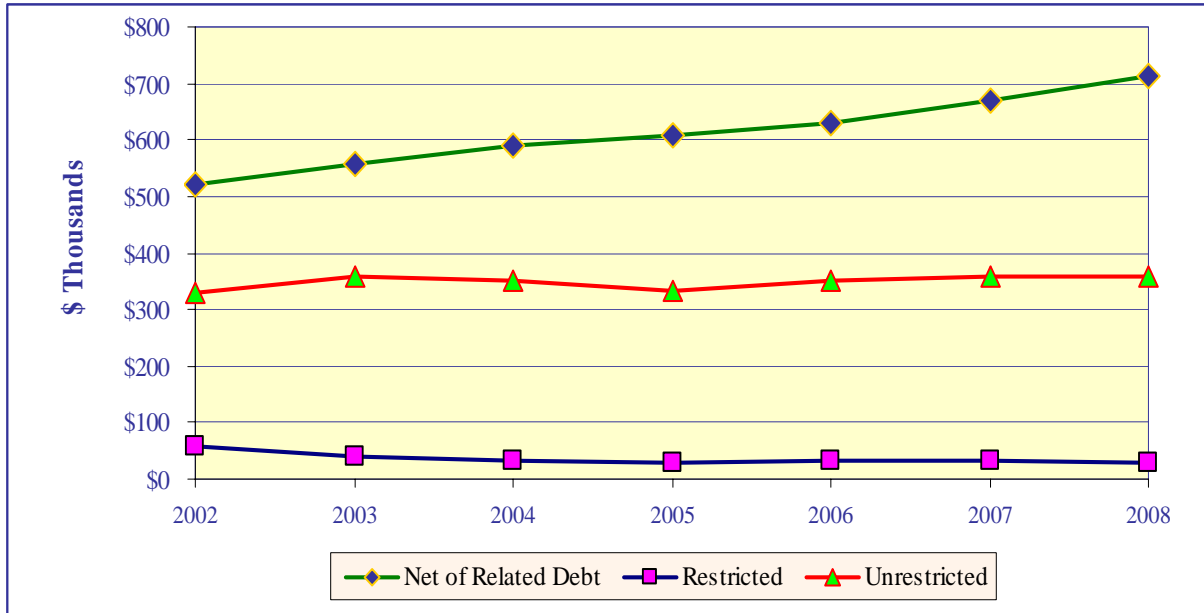
1. Full-Time Equivalent City Government Employees by Function
2. Operating Indicators by Function/Program
3. Capital Asset Statistics by Function/Program
4. Insurance Coverage

Sources

Unless otherwise noted, the information in these schedules is derived from the Comprehensive Annual Financial Reports for the relevant year. The City implemented GASB Statement 34 in 2002; schedules presenting government-wide information include information beginning in that year.

City of Palo Alto - Net Assets by Component

Last Seven Fiscal Years (\$000)
(Accrual Basis of Accounting)



	Fiscal Year Ended June 30,						
	2002	2003	2004	2005	2006	2007	2008
Governmental activities							
Invested in capital assets, net of related debt	\$252,183	\$279,306	\$297,125	\$305,225	\$311,335	\$326,411	\$343,537
Restricted	56,785	37,112	30,417	27,273	29,885	32,576	27,428
Unrestricted	117,113	130,463	123,762	117,301	123,823	127,190	130,460
Total governmental activities net assets	<u>\$426,081</u>	<u>\$446,881</u>	<u>\$451,304</u>	<u>\$449,799</u>	<u>\$465,043</u>	<u>\$486,177</u>	<u>\$501,425</u>
Business-type activities							
Invested in capital assets, net of related debt	\$270,622	\$279,885	\$294,197	\$303,473	\$318,738	\$342,922	\$370,303
Restricted	1,728	1,728	1,798	1,750	1,732	1,732	1,732
Unrestricted	210,990	228,308	226,278	215,128	228,032	230,912	226,539
Total business-type activities net assets	<u>\$483,340</u>	<u>\$509,921</u>	<u>\$522,273</u>	<u>\$520,351</u>	<u>\$548,502</u>	<u>\$575,566</u>	<u>\$598,574</u>
Primary government							
Invested in capital assets, net of related debt	\$522,805	\$559,191	\$591,322	\$608,698	\$630,073	\$669,333	\$713,840
Restricted	58,513	38,840	32,215	29,023	31,617	34,308	29,160
Unrestricted	328,103	358,771	350,040	332,429	351,855	358,102	356,999
Total primary government net assets	<u>\$909,421</u>	<u>\$956,802</u>	<u>\$973,577</u>	<u>\$970,150</u>	<u>\$1,013,545</u>	<u>\$1,061,743</u>	<u>\$1,099,999</u>

Source: Annual Financial Statements

Note: (a) The City implemented GASB Statement 34 in fiscal year 2002. Therefore this calculation is included only for fiscal years subsequent to that date.

City of Palo Alto - Changes in Net Assets

Last Seven Fiscal Years (\$000)

(Accrual Basis of Accounting)

	Fiscal Year Ended June 30,						
	2002	2003	2004	2005	2006	2007	2008
Expenses							
Governmental Activities:							
City Council	\$238	\$234	\$269	\$130	\$141	\$180	\$323
City Manager	1,765	1,565	1,663	1,725	1,563	1,760	2,273
City Attorney	2,410	2,028	2,300	2,653	2,598	2,390	2,653
City Clerk	633	598	808	770	945	900	1,241
City Auditor	583	646	668	764	843	838	1,379
Administrative Services **	10,138	9,723	6,271	6,982	6,972	6,419	15,477
Human Resources	2,166	1,728	2,078	2,410	2,546	2,472	2,806
Public Works	15,656	13,702	14,460	16,400	17,596	16,645	18,565
Planning and Community Environment	7,311	7,485	8,898	10,162	9,931	12,929	16,388
Police	19,049	19,273	20,414	22,416	23,411	23,861	27,740
Fire	16,870	16,859	17,308	18,127	18,747	19,530	22,386
Community Services	19,850	19,633	20,864	17,240	17,296	15,729	17,736
Library				4,835	5,323	5,347	6,321
Non-Departmental **	8,412	7,449	7,618	12,474	10,400	12,133	0
Interest on Long Term Debt	1,094	675	635	693	512	477	438
Total Governmental Activities Expenses	\$106,175	\$101,598	\$104,254	\$117,781	\$118,824	\$121,610	\$135,726
Business-Type Activities:							
Water	\$12,722	\$13,237	\$16,047	\$14,969	\$15,881	\$16,794	\$18,842
Electric	98,405	73,744	73,545	73,051	91,570	99,294	108,032
Gas	28,778	22,270	22,994	26,656	29,107	30,690	37,211
Wastewater Collection	8,489	8,712	9,203	8,907	11,005	10,085	12,023
Wastewater Treatment	13,287	14,312	14,868	17,457	16,747	15,901	18,902
Refuse	23,750	24,635	24,282	24,959	26,989	25,372	28,827
Storm Drainage	2,188	2,489	2,975	3,336	2,673	2,517	3,202
External Services	349	583	688	760	868	767	984
Total Business-Type Activities Expenses	187,968	159,982	164,602	170,095	194,840	201,420	228,023
Total Primary Government Expenses	\$294,143	\$261,580	\$268,856	\$287,876	\$313,664	\$323,030	\$363,749

Program Revenues

Governmental Activities

Charges for Services:

City Council							
City Manager							
City Attorney		\$92	\$64	\$22	\$22	\$13	\$16
City Clerk	1	1	1		2		
City Auditor		1					
Administrative Services	12	406	815	480	627	835	870
Human Resources						11	
Public Works	320	1,058	260	573	805	968	1,310
Planning and Community Environment	4,062	5,119	3,074	4,090	5,509	6,267	5,498
Police	3,966	3,396	4,415	3,801	4,178	4,179	4,274
Fire	7,976	7,811	7,565	8,555	9,078	9,610	9,418
Community Services	7,793	7,537	7,846	7,592	10,803	9,128	10,314
Library				133	129	146	176
Operating Grants and Contributions	5,568	4,468	4,213	3,677	3,976	5,642	4,029

** FY 07-08 includes expenditures classified as Non-departmental in prior years (GFOA recommendation)

City of Palo Alto - Changes in Net Assets

Last Seven Fiscal Years (\$000)

(Accrual Basis of Accounting)

	Fiscal Year Ended June 30,						
	2002	2003	2004	2005	2006	2007	2008
Capital Grants and Contributions	32,380	635	1,990	804	3,156	1,756	1,930
Total Government Activities Program Revenues	62,078	30,524	30,243	29,727	38,285	38,555	37,835
Business-Type Activities:							
Charges for Services:							
Water	16,034	17,654	21,993	21,041	21,108	23,495	26,510
Electric	93,755	91,622	92,617	88,737	119,418	102,549	103,833
Gas	41,658	29,714	24,839	31,206	36,977	42,221	49,021
Wastewater Collection	9,292	10,676	12,647	12,041	13,801	14,848	15,102
Wastewater Treatment	13,987	13,556	14,744	15,982	18,778	16,957	22,889
Refuse	21,777	21,691	21,923	23,387	24,795	25,532	28,805
Storm Drainage	2,221	2,192	2,170	2,484	5,174	5,181	5,450
External Services	380	605	585	766	854	789	112
Capital Grants and Contributions	185					756	1,594
Total Business-Type Activities Program Revenue	199,289	187,710	191,518	195,644	240,905	232,328	253,316
Total Primary Government Program Revenues	\$261,367	\$218,234	\$221,761	\$225,371	\$279,190	\$270,883	\$291,151
Net (Expense)/Revenue							
Governmental Activities	(\$44,097)	(\$71,074)	(\$74,011)	(\$88,054)	(\$80,539)	(\$83,055)	(\$97,891)
Business-Type Activities	11,321	27,728	26,916	25,549	46,065	30,908	25,293
Total Primary Government Net Expense	(\$32,776)	(\$43,346)	(\$47,095)	(\$62,505)	(\$34,474)	(\$52,147)	(\$72,598)
General Revenues and Other Changes in Net Assets							
Governmental Activities:							
Taxes:							
Property Taxes	\$13,270	\$13,882	\$13,707	\$16,657	\$18,731	\$21,466	\$23,084
Sales Taxes	20,085	18,041	18,151	19,308	20,315	22,194	22,623
Utilities Users Taxes	6,457	7,067	7,152	7,269	8,759	9,356	10,285
Transient Occupancy Tax	6,615	5,333	5,489	5,686	6,393	6,709	7,976
Other taxes	6,284	7,275	8,493	5,580	7,033	6,293	6,261
Investment Earnings	10,589	10,213	326	4,988	2,567	8,747	12,313
Rents and Miscellaneous	18,524	15,333	10,165	12,997	10,440	13,670	11,896
Transfers	13,334	14,730	14,951	14,064	21,545	15,754	18,701
Total Government Activities	95,158	91,874	78,434	86,549	95,783	104,189	113,139
Business-Type Activities:							
Investment Earnings	15,620	13,583	387	8,093	3,631	11,910	16,416
Special Item				(21,500)			
Transfers	(13,334)	(14,730)	(14,951)	(14,064)	(21,545)	(15,754)	(18,701)
Total Business-Type Activities	2,286	(1,147)	(14,564)	(27,471)	(17,914)	(3,844)	(2,285)
Total Primary Government	\$97,444	\$90,727	\$63,870	\$59,078	\$77,869	\$100,345	\$110,854
Change in Net Assets							
Governmental Activities	\$51,061	\$20,800	\$4,423	(\$1,505)	\$15,244	\$21,134	\$15,248
Business-Type Activities	13,607	26,581	12,352	(1,922)	28,151	27,064	23,008
Total Primary Government	\$64,668	\$47,381	\$16,775	(\$3,427)	\$43,395	\$48,198	\$38,256

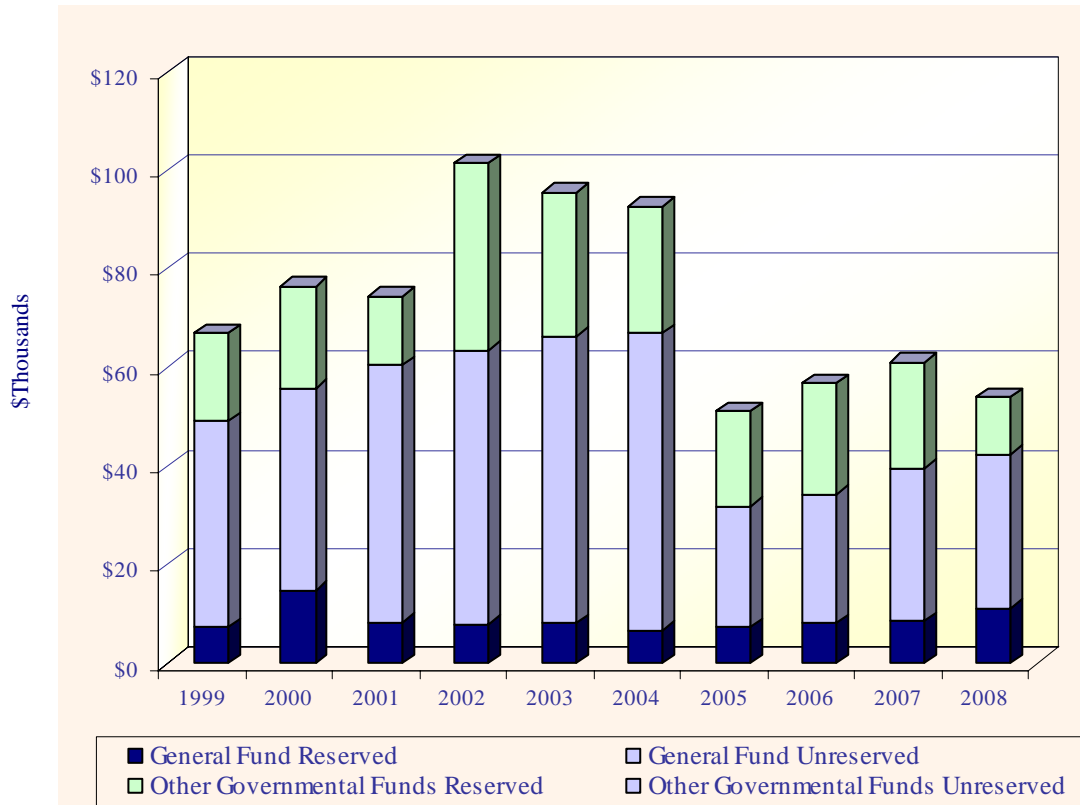
Source: Annual Financial Statements

Note: (a) The City implemented GASB Statement 34 in fiscal year 2002. Therefore this calculation is included only for fiscal years subsequent to that date.

City of Palo Alto - Fund Balances of Governmental Funds

Last Ten Fiscal Years (\$000)

(Modified Accrual Basis of Accounting)



	Fiscal Year Ended June 30,									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
General Fund										
Reserved	\$7,237	\$14,838	\$8,282	\$7,780	\$8,156	\$6,735	\$7,332	\$7,966	\$8,392	\$11,102
Unreserved	41,900	40,927	52,114	55,653	58,151	60,087	24,498	26,251	31,016	31,313
Total General Fund	\$49,137	\$55,765	\$60,396	\$63,433	\$66,307	\$66,822	\$31,830	\$34,217	\$39,408	\$42,415 (a)
All Other Governmental Funds										
Reserved	\$17,796	\$20,717	\$14,086	\$37,924	\$29,174	\$25,790	\$19,305	\$22,597	\$21,614	\$11,575
Unreserved, reported in:										
Special revenue & Permanent funds	5,273	4,908	7,466	18,263	7,428	6,875	7,643	7,063	10,847	33,947
Capital project funds	9,195	7,987	18,005	19,772	22,705	10,419	39,431	37,315	33,646	15,938
Total all other governmental funds	\$32,264	\$33,612	\$39,557	\$75,959	\$59,307	\$43,084	\$66,379	\$66,975	\$66,107	\$61,460

Source: Annual Financial Statements

Note: (a) The change in total fund balance for the General fund and other governmental funds is explained in Management's discussion and Analysis.



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City of Palo Alto - Changes in Fund Balance of Governmental Funds Last Ten Fiscal Years (\$000)

(Modified Accrual Basis of Accounting)

	Fiscal Year Ended June 30,				
	1999	2000	2001	2002	2003
<u>Revenues</u>					
Sales tax	\$20,225	\$22,867	\$25,786	\$20,085	\$18,041
Property tax	9,521	10,770	12,110	13,231	13,821
Other taxes	20,393	23,582	26,160	20,485	21,070
Permits and licenses	8,810	12,408	12,743	2,901	3,161
Fines, forfeits and penalties	1,475	1,703	1,873	2,181	2,124
Interest and rentals	13,992	13,874	17,432	19,547	19,981
From other agencies	3,374	3,282	2,208	3,860	3,776
Charges for services	4,751	5,053	5,466	16,667	16,798
Other	4,376	6,213	7,590	8,580	5,095
Total Revenues	86,917	99,752	111,368	107,537	103,867
<u>Expenditures</u>					
Administration (1)	15,066	15,772	18,557	18,235	17,521
Public works	9,202	8,827	9,522	9,549	9,858
Planning and community environment	5,674	6,639	6,652	7,378	7,721
Police	16,705	17,666	18,306	19,047	19,719
Fire	13,949	14,512	15,973	16,722	16,841
Community services	16,820	17,858	18,469	19,499	19,793
Library (2)					
Non-departmental	6,520	6,927	14,487	8,259	7,442
Special revenue and capital projects	16,605	13,151	11,089	16,960	33,584
Debt service - Principal payments	1,553	1,775	1,895	465	875
Debt Service - Interest and fiscal fees	956	1,026	922	686	696
Total Expenditures	103,050	104,153	115,872	116,800	134,050
Excess (deficiency) of revenues over (under) expenditures	(16,133)	(4,401)	(4,504)	(9,263)	(30,183)
<u>Other Financing Sources (Uses)</u>					
Transfers in	24,715	27,795	26,150	27,389	31,402
Transfers (out)	(649)	(15,418)	(14,487)	(14,444)	(16,603)
Contribution from assessment district			4,112	31,823	425
Proceeds from long term debt	7,750			7,055	
Payments to refunded bond escrow	(649)		(705)	(3,820)	
Total other financing sources (uses)	31,167	12,377	15,070	48,003	15,224
Net Change in fund balances	\$15,034	\$7,976	\$10,566	\$38,740	(\$14,959)
Debt service as a percentage of noncapital expenditures	(a)	(a)	(a)	1.1%	1.6%

Source: Annual Financial Statements

Note: (a) The City implemented GASB Statement 34 in fiscal year 2002. Therefore this calculation is included only for fiscal years subsequent to that date.

(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.



Fiscal Year Ended June 30,

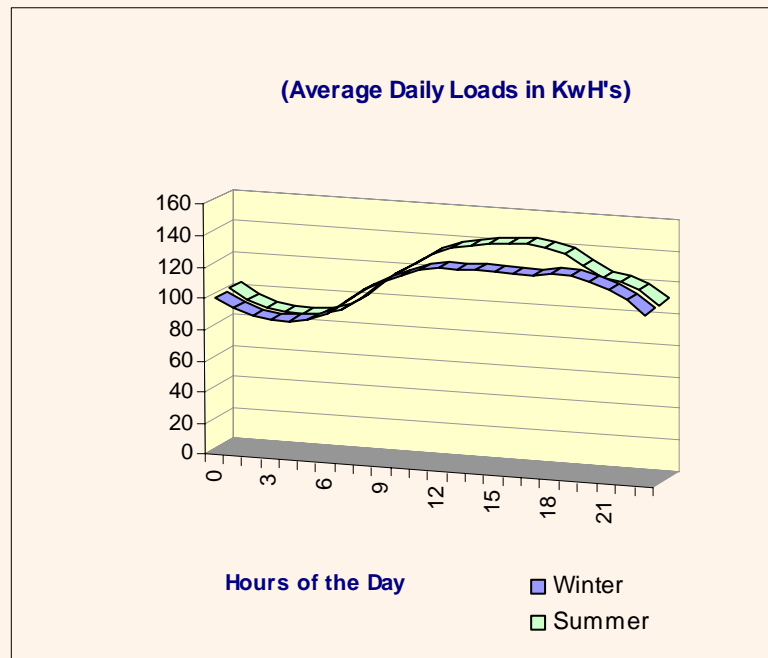
2004	2005	2006	2007	2008
\$18,151	\$19,308	\$20,315	\$22,194	\$22,623
13,707	16,657	18,731	21,466	23,084
22,427	19,941	23,712	23,698	25,202
2,563	3,183	4,305	4,711	4,761
2,884	2,096	2,128	2,517	2,183
11,480	14,968	13,776	17,750	20,507
4,661	2,757	5,931	3,448	4,300
16,018	17,159	18,672	19,929	19,610
1,681	4,269	4,058	7,503	4,713
<u>93,572</u>	<u>100,338</u>	<u>111,628</u>	<u>123,216</u>	<u>126,983</u>
13,862	14,509	14,299	14,399	16,250
8,031	9,060	9,036	9,256	10,072
8,793	9,692	9,292	11,874	9,861
19,962	21,117	22,279	23,305	27,006
16,891	17,615	18,114	19,146	21,644
19,934	16,298	19,740	16,533	17,138
	4,800	5,170	5,260	6,219
7,598	9,028	10,389	12,122	14,089
22,289	21,317	13,243	17,478	21,626
780	785	810	850	885
639	583	523	489	451
<u>118,779</u>	<u>124,804</u>	<u>122,895</u>	<u>130,712</u>	<u>145,241</u>
(25,207)	(24,466)	(11,267)	(7,496)	(18,258)
28,632	60,429	26,640	27,701	33,437
(19,133)	(46,622)	(12,390)	(15,882)	(16,819)
	(1,038)			
<u>9,499</u>	<u>12,769</u>	<u>14,250</u>	<u>11,819</u>	<u>16,618</u>
<u>(\$15,708)</u>	<u>(\$11,697)</u>	<u>\$2,983</u>	<u>\$4,323</u>	<u>(\$1,640)</u>
1.5%	1.3%	1.2%	1.2%	1.1%

City of Palo Alto - Electric Daily Loads and Top Customers by Usage

June 30, 2008

(in thousands of KWh)

Daily Hours	# Kilowatt Hours	
	(Oct-Mar) Winter	(Apr-Sep) Summer
0	103,128	103,496
1	97,059	97,157
2	93,139	93,225
3	91,909	91,508
4	91,495	90,823
5	92,562	91,698
6	97,011	95,830
7	106,586	104,078
8	115,415	113,076
9	120,913	120,351
10	125,664	126,552
11	129,417	131,883
12	131,324	135,021
13	131,926	136,543
14	132,031	137,518
15	131,652	137,847
16	130,838	137,396
17	130,400	136,502
18	132,858	136,189
19	132,210	132,559
20	128,757	127,843
21	125,328	125,264
22	119,571	120,136
23	111,357	111,782



Source: City of Palo Alto, Utilities Resource Management

Top Ten Electric Customers by Usage

Customer (alphabetical order)	Type of Business	Kw H's	% of System Total
City of Palo Alto	Municipal		%
CPI-David Morman	Research in Physical Science		
DPIX-BLDG 34	Municipal		
Hewlett Packard	Computer		
Space System Loral	Satellite & Satellite Systems		
Stanford Hines Interests	Property Management		
Stanford Hospital	Hospital		
Syntex/J Meek	Technology in Occupational Risk Mgmt		
Vet Admin Hosp	Hospital		
VMWare Inc.	Computer		
Total		330,385,588	33.77 %

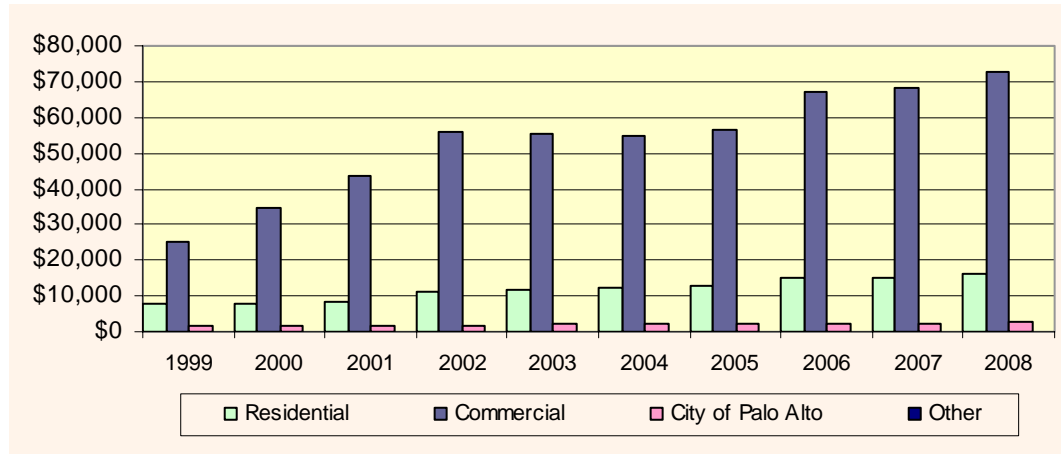
Source: City of Palo Alto, Utilities Department



City of Palo Alto - Electric Operating Revenue by Source

June 30, 2008

(in thousands of dollars)



Fiscal Year	Residential	Commercial	City of Palo Alto	Other	Total
1999	7,758	25,318	1,685	65	34,826
2000	7,987	34,826	1,415	29	44,256
2001	8,489	43,460	1,545	5	53,499
2002	11,377	56,214	1,925	6	69,521
2003	11,657	55,353	2,004	24	69,039
2004	12,245	54,881	2,047	66	69,240
2005	13,009	56,683	2,222	67	71,981
2006	14,973	67,389	2,395	97	84,854
2007	15,150	68,214	2,397	69	85,829
2008	16,109	72,632	2,571	0	91,312

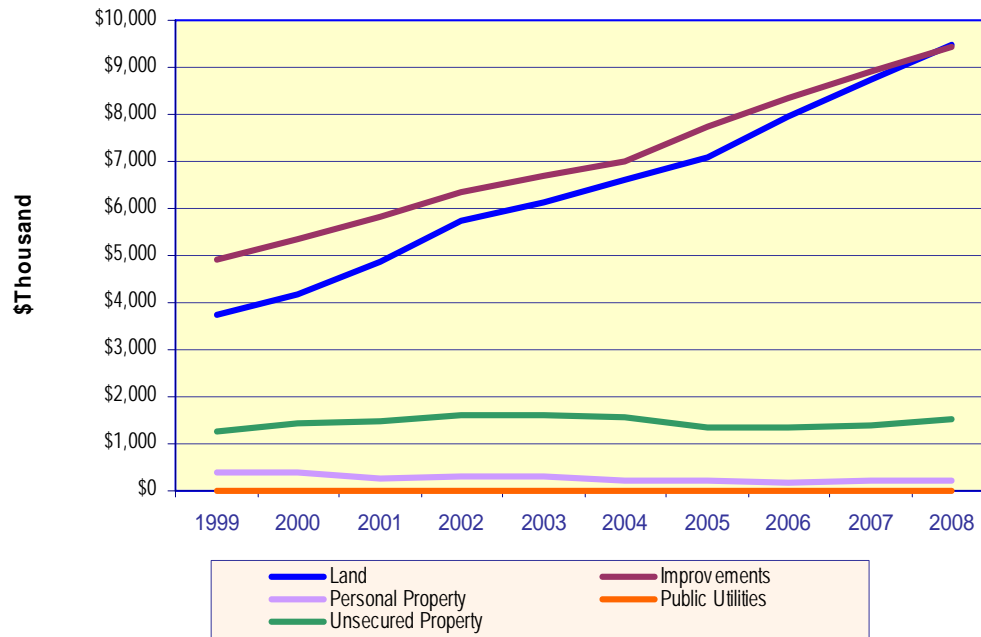
Top Ten Electric Revenue

Customer (alphabetical order)	Type of Business	Net Charges	% of System Total
City of Palo Alto	Municipal		
CPI-David Morman-MSB500	Research		
Hewlett Packard	Computer		
Palo Alto Schools	Education		
Space System Loral/MS-AC-1	Satellite System		
Stanford % Hines Interests	Property Mgmt		
Stanford Hospital	Hospital		
Syntex/J Meek-MS#SS-200	Technology		
Vet Admin Hospital	Hospital		
VMWare, Inc.	Computer		
Total		\$ 48,865,158	25.42%

Source: City of Palo Alto, Utilities Department

Note: Revenue includes all utilities (metered and non-metered), revenue adjustments, and Primary Voltage discount. Does not include CEC surcharge, UUT, Solar and Rap discounts, and deposits.

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



Net Local Secured Roll			Subtotal		Less			Total Assessed Value	Total Direct Tax Rate
Fiscal Year	Land	Improvements	Personal Property	Net Local Secured Roll	Public Utilities	Unsecured Property	Exemptions Net of State Aid		
1999	3,729,475	4,920,111	394,610	9,044,196	2,842	1,279,315	702,485	9,623,868	1%
2000	4,187,357	5,335,026	394,198	9,916,581	3,362	1,415,999	802,164	10,533,778	1%
2001	4,849,233	5,816,633	280,958	10,946,824	3,309	1,473,678	813,896	11,609,915	1%
2002	5,744,675	6,347,719	292,812	12,385,206	3,371	1,627,594	913,475	13,102,696	1%
2003	6,140,438	6,692,162	309,386	13,141,986	3,859	1,612,179	951,807	13,806,217	1%
2004	6,588,474	6,996,106	195,859	13,780,439	3,956	1,582,368	1,196,546	14,170,217	1%
2005	7,075,300	7,722,660	220,585	15,018,545	4,150	1,354,310	1,402,039	14,974,966	1%
2006	7,941,482	8,364,668	174,666	16,480,816	4,084	1,361,117	1,595,871	16,250,146	1%
2007	8,725,485	8,915,623	213,154	17,854,262	3,923	1,391,284	1,639,856	17,609,613	1%
2008	9,497,746	9,453,436	228,875	19,180,057	3,174	1,536,584	1,797,327	18,922,488	1%

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.

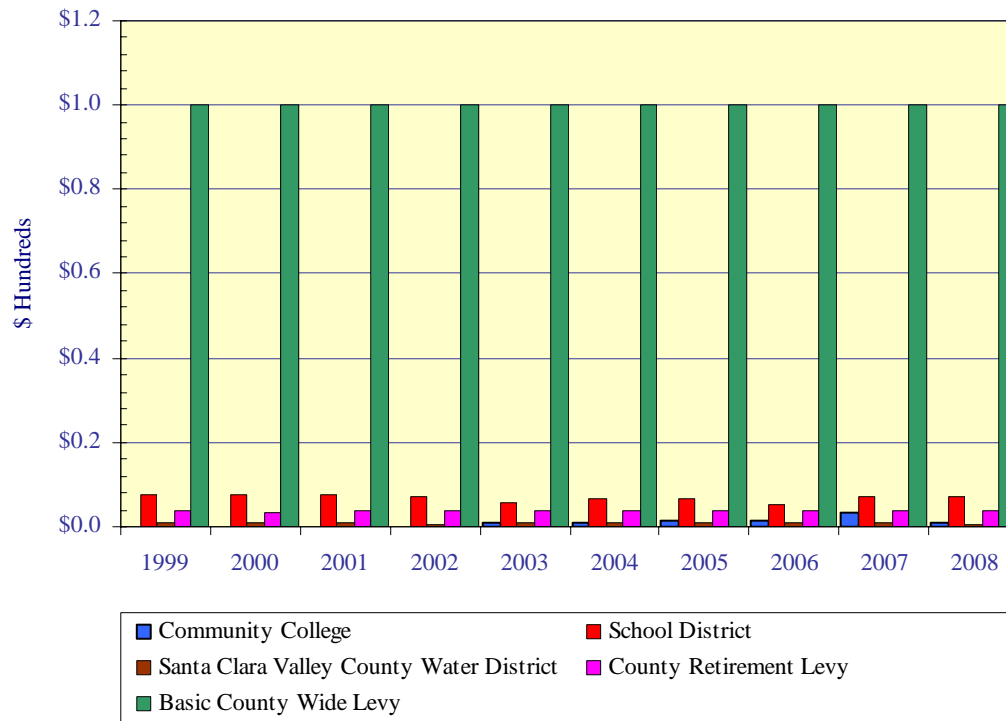
The State Constitution requires property to be assessed at one hundred percent of the most recent purchase price, plus an increment of no more than two percent annually, plus any local over-rides. These values are considered to be full market values.



City of Palo Alto - Property Tax Rates

All Overlapping Governments

Last Ten Fiscal Years



Fiscal Year	Basic County Wide Levy	County Retirement Levy	Santa Clara Valley Water District	School District	Community College	Total
1999	1.0000	0.0388	0.0082	0.0757	0.0000	1.1227
2000	1.0000	0.0319	0.0085	0.0740	0.0000	1.1144
2001	1.0000	0.0356	0.0075	0.0771	0.0000	1.1202
2002	1.0000	0.0364	0.0062	0.0727	0.0000	1.1153
2003	1.0000	0.0388	0.0072	0.0586	0.0108	1.1154
2004	1.0000	0.0388	0.0087	0.0666	0.0110	1.1251
2005	1.0000	0.0388	0.0092	0.0680	0.0129	1.1289
2006	1.0000	0.0388	0.0078	0.0526	0.0119	1.1111
2007	1.0000	0.0388	0.0072	0.0720	0.0346	1.1526
2008	1.0000	0.0388	0.0071	0.0702	0.0113	1.1274

Source: County of Santa Clara, Tax Rates and Information

City of Palo Alto - Property Tax Levies and Collections

Last Ten Fiscal Years (\$000)

Fiscal Year	Total Tax Levy (a)	Current Tax Collections	Percent of Levy Collected	Delinquent Tax Collections (b)	Total Tax Collections	Percent of Total Tax Collections to Tax Levy
1999	9,521	9,521	100%	-	9,521	100%
2000	10,770	10,770	100%	-	10,770	100%
2001	12,110	12,110	100%	-	12,110	100%
2002	13,231	13,231	100%	-	13,231	100%
2003	13,821	13,821	100%	-	13,821	100%
2004	13,707	13,707	100%	-	13,707	100%
2005	16,657	16,657	100%	-	16,657	100%
2006	18,731	18,731	100%	-	18,731	100%
2007	21,466	21,466	100%	-	21,466	100%
2008	23,084	23,084	100%	-	23,084	100%

Source: County of Santa Clara Assessor's Office

Note: Current tax collections beginning in 1993 have been reduced by a mandatory tax reallocation imposed by the State of California.

- (a) During fiscal year 1995, the County began providing the City 100% of its tax levy under an agreement which allows the County to keep all interest and delinquency charges collected.
- (b) 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 that fiscal year.



City of Palo Alto - Principal Property Tax Payers

Current Year and Nine Years Ago (\$'000)

Taxpayer	2007-08			1998-99		
	Taxable Assessed Value	Rank	Percentage of Total City Taxable Assessed Value	Taxable Assessed Value	Rank	Percentage of Total City Taxable Assessed Value
Leland Stanford Jr University	\$2,968,746	1	15.7%	\$1,631,031	1	16.9%
Space System /Loral Inc.	169,513	2	0.9%	193,128	2	2.0%
Sun Microsystems Inc.			0.0%	69,742	3	0.7%
Harbor Investments Partners	65,791	4	0.3%	53,705	4	0.6%
Digital Equipment Corporation			0.0%	44,422	5	0.5%
Embarcadero Place Corporation			0.0%	43,350	6	0.5%
Cowper-Hamilton Associates			0.0%	37,699	7	0.4%
Hyatt Equities, LLC			0.0%	23,101	8	0.2%
Stanford Square Limited Partners			0.0%	22,200	9	0.2%
University Ave. Partners and Associates			0.0%	21,180	10	0.2%
Whisman Ventures, LLC	100,470	3	0.5%			0.0%
Western Pacific Housing Inc	60,033	5	0.3%			0.0%
EOP-Embarcadero Place, LLC	45,000	6	0.2%			0.0%
505 Hamilton Avenue Partners L.P.	38,583	7	0.2%			0.0%
Pacific Hotel Dev Venture L P	38,143	8	0.2%			0.0%
Palo Alto Town & Country Village Inc	37,031	9	0.2%			0.0%
California Pacific Comm. Corp.	35,953	10	0.2%			0.0%
Subtotal	\$3,559,263		18.8%	\$2,139,558		22.2%

Total Net Assessed Valuation:

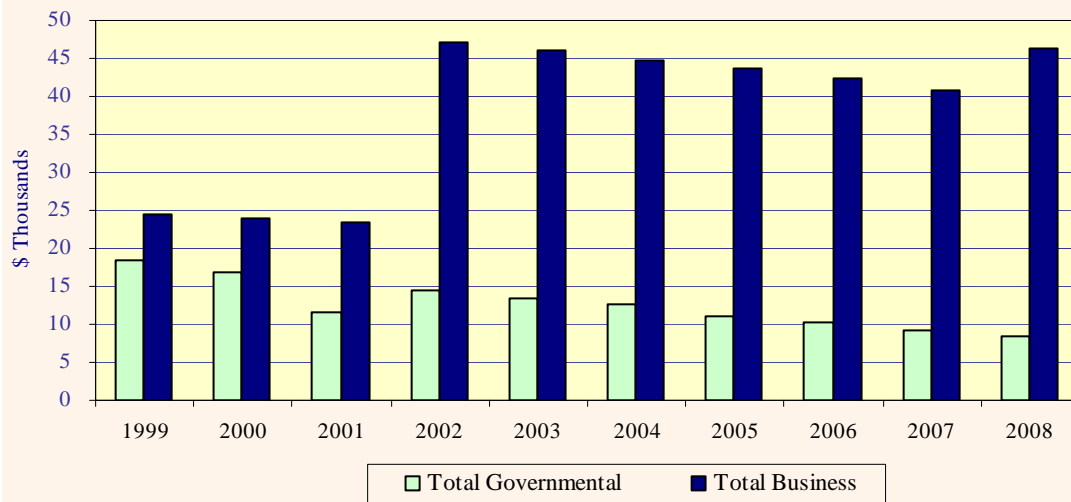
Fiscal Year 2007-2008 \$18,922,488

Fiscal Year 1998-1999 \$9,623,868

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

City of Palo Alto - Ratio of Outstanding Debt by Type

Last Ten Fiscal Years (\$000)



Governmental Activities

Fiscal Year	Certificates of Participation	Special Assessment Debt	Capital Lease Obligations	Total
1999	12,480	5,195	791	18,466
2000	11,625	4,670	537	16,832
2001	10,700	670	113	11,483
2002	13,695	595	84	14,374
2003	12,905	510	57	13,472
2004	12,215	420	25	12,660
2005	10,625	325		10,950
2006	9,915	225		10,140
2007	9,175	115		9,290
2008	8,405	0		8,405

Business-Type Activities

Fiscal Year	Utility Revenue Bonds	Total	Total Primary Government	Percentage of Assessed Value (a)	Per Capita (b)
1999	24,368	24,368	42,834	0.45 %	\$0.70
2000	23,935	23,935	40,767	0.39	0.66
2001	23,465	23,465	34,948	0.30	0.57
2002	47,210	47,210	61,584	0.47	1.02
2003	46,069	46,069	59,541	0.43	0.98
2004	44,862	44,862	57,522	0.38	0.95
2005	43,598	43,598	54,548	0.34	0.88
2006	42,288	42,288	52,428	0.32	0.84
2007	40,887	40,887	50,177	0.28	0.80
2008	46,310	46,310	54,715	0.29	0.86

Sources: City of Palo Alto

(a) County of Santa Clara (assessed value)

(b) State of California, Department of Finance (population)

Note: Debt amounts exclude any premiums, discounts, or other amortization amounts.

Details regarding the City's outstanding debt can be found in the notes to the financial statements.



City of Palo Alto - Computation of Direct and Overlapping Debt

June 30, 2008

2007-08 Assessed Valuation

\$18,922,488,000

	Total Debt Outstanding	Percentage Applicable To City of Palo Alto (a)	Amount Applicable To City of Palo Alto
OVERLAPPING TAX AND ASSESSMENT DEBT:			
Foothill-DeAnza Community College District	\$484,814,288	22.887%	\$110,959,446
Palo Alto Unified School District	100,660,000	88.994%	89,581,360
Fremont Union High School District	132,000,000	0.008%	10,560
Mountain View-Los Altos Union High School District	38,464,160	0.991%	381,180
Cupertino Union School District	128,129,883	0.004%	5,125
Los Altos School District	97,344,000	0.939%	914,060
Whisman School District	22,832,215	3.699%	844,564
El Camino Hospital District	146,365,000	0.101%	147,829
City of Palo Alto Special Assessment Bonds	37,520,000	100.000%	37,520,000
Santa Clara Valley Water District Benefit Assessment District	165,020,000	7.464%	12,317,093
TOTAL OVERLAPPING TAX AND ASSESSMENT DEBT	\$1,353,149,546		\$252,681,217

DIRECT AND OVERLAPPING GENERAL FUND DEBT:

Santa Clara County General Fund Obligations	\$895,655,000	7.464%	\$66,851,689
Santa Clara County Pension Obligations	389,484,822	7.464%	\$29,071,147
Santa Clara County Board of Education Certificates of Participation	15,445,000	7.464%	1,152,815
Foothill-DeAnza Community College District Certificates of Participation	27,685,000	22.887%	6,336,266
Mountain View-Los Altos Union High School District Certificates of Participation	7,245,000	0.991%	71,798
Cupertino Union School District Certificates of Participation	2,375,000	0.004%	95
City of Palo Alto General Fund Obligations	8,405,000	100.000%	8,405,000
Santa Clara County Vector Control District Certificates of Participation	4,275,000	7.464%	319,086
Midpeninsula Regional Open Space Park District General Fund Obligations	104,840,193	13.163%	13,800,115
TOTAL DIRECT AND OVERLAPPING GENERAL FUND DEBT	\$1,455,410,015		\$126,008,011

COMBINED TOTAL DEBT **\$2,808,559,561** **\$378,689,228** (b)

(a) Percentage of overlapping agency's assessed valuation located within boundaries of the city.

(b) 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 (\$8,405,000)	0.04%
Total Overlapping Tax and Assessment Debt	1.34%
Combined Total Debt	2.00%

STATE SCHOOL BUILDING AID REPAYABLE AS OF 06/30/08: \$0

Source: California Municipal Statistics, Inc.



City of Palo Alto - Computation of Legal Bonded Debt Margin

June 30, 2008

(in thousands of dollars)

Assessed Valuation:

Secured property assessed value, net of exempt real property	<u>\$18,922,488</u>
---	---------------------

Bonded debt limit 3.75% of assessed value (a)	<u>\$709,593</u>
--	------------------

Amount of debt subject to limit: (b)

Certificates of participation	8,405
Special assessment debt with government commitment	<u>0</u>
Total Debt	8,405
Less amount of debt not subject to limit	<u>8,405</u>
Amount of debt subject to limit	<u>0</u>

Legal bonded debt margin	<u><u>\$709,593</u></u>
---------------------------------	-------------------------

Fiscal Year	Debt Limit	Total Net Debt Applicable to Limit	Legal Debt Margin	Total net debt applicable to the limit as a percentage of debt limit
1999	360,895	0	360,895	0.00%
2000	395,017	0	395,017	0.00%
2001	435,372	0	435,372	0.00%
2002	491,351	0	491,351	0.00%
2003	516,615	0	516,615	0.00%
2004	561,561	0	561,561	0.00%
2005	609,378	0	609,378	0.00%
2006	609,377	0	609,377	0.00%
2007	660,360	0	660,360	0.00%
2008	709,593	0	709,593	0.00%

Source: Annual Financial Statements

Notes:

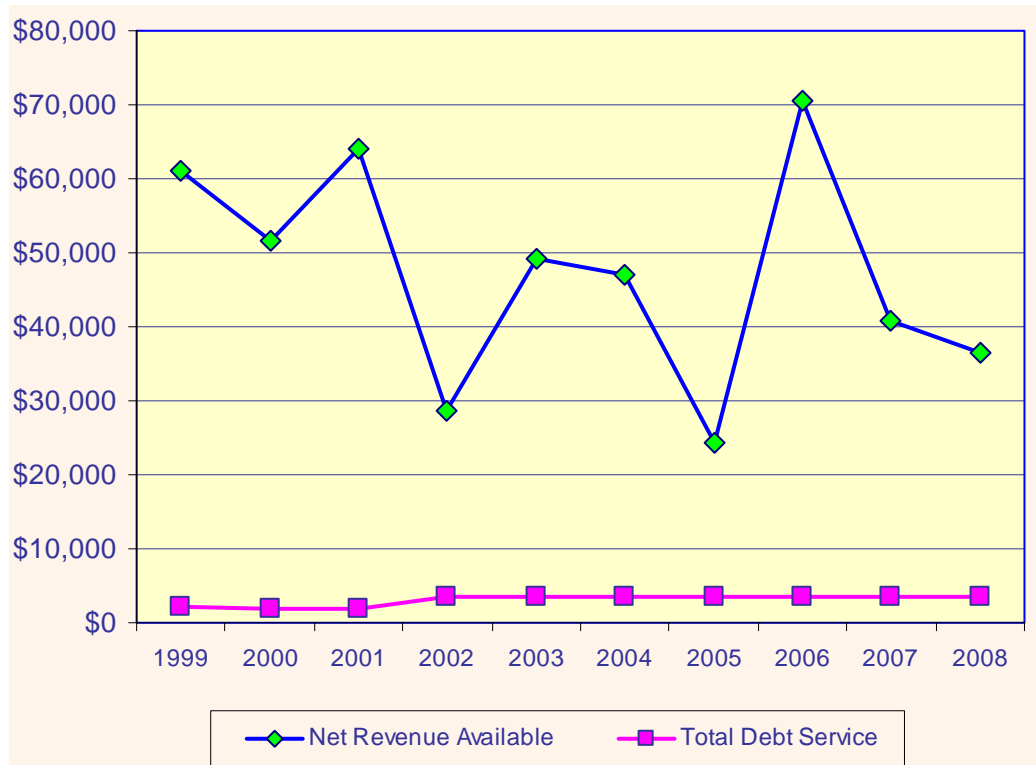
- (a) California Government Code, Section 43605 sets the debt limit at 15%. The Code section was enacted prior to the change in basing assessed value to full market value when it was previously 25% of market value. Thus, the limit shown as 3.75% is one-fourth the limit to account for the adjustment of showing assessed valuation at full cash value. Prior year limits have been adjusted to conform to the current year methodology.
- (b) In accordance with California Government Code Section 43605, only the City's general obligation bonds are subject to the legal debt limit of 15%. As of June 30, 2006, the City had no general obligation bonds outstanding. The above does not include debt recorded in the Enterprise Funds because such debt is not subject to legal debt margin.
- Special assessment debt excludes debt where there is no government commitment.



City of Palo Alto - Revenue Bond Coverage

Water, Electric, Gas, Wastewater Collection,
Wastewater Treatment and Storm Drainage Funds

Last Ten Fiscal Years (\$000)



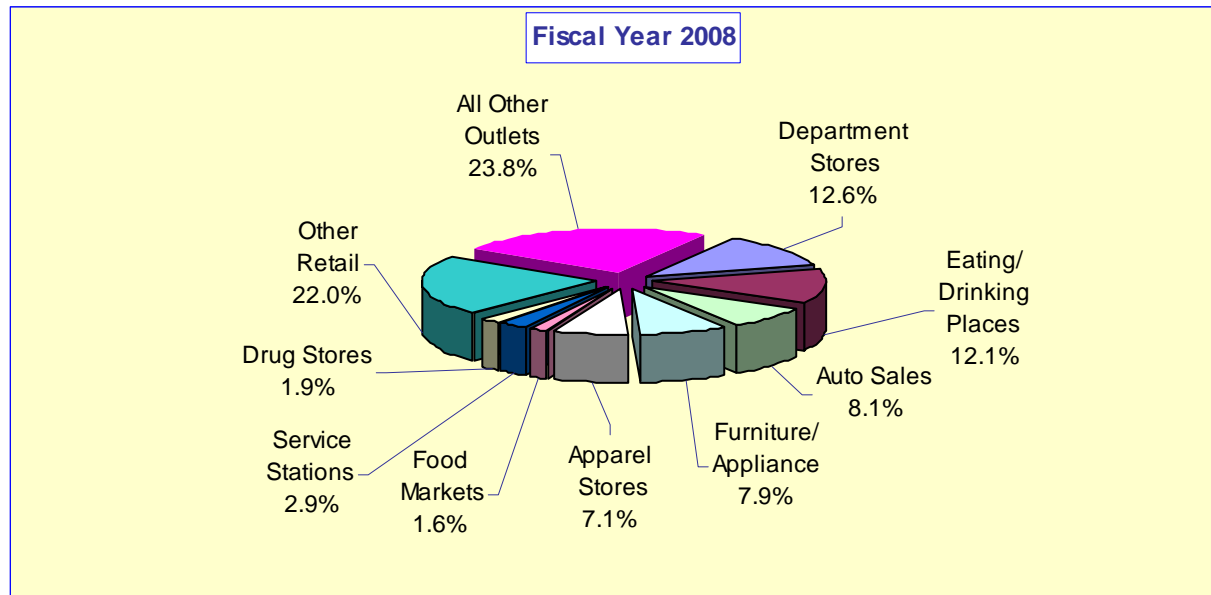
Fiscal Year	Gross Revenue	Direct Operating Expenditures	Net Revenue Available for Debt Services (a)	Debt Service			Coverage
				Principal	Interest	Total	
1999	141,696	80,748	60,948	896	1,163	2,059	29.60
2000	130,550	78,880	51,670	545	1,363	1,908	27.08
2001	197,022	133,012	64,010	555	1,342	1,897	33.74
2002	176,947	148,345	28,602	1,955	1,660	3,615	7.91
2003	165,414	116,268	49,146	1,255	2,354	3,609	13.62
2004	169,047	121,988	47,059	1,310	2,307	3,617	13.01
2005	171,493	147,123	24,370	1,365	2,257	3,622	6.73
2006	214,944	144,465	70,479	1,410	2,203	3,613	19.51
2007	205,258	164,340	40,918	1,465	2,147	3,612	11.33
2008	222,799	186,285	36,514	1,526	2,088	3,614	10.10

Source: Annual Financial Statements

Note: (a) Excludes depreciation and amortization expense.

Details regarding the City's outstanding debt can be found in the notes to the financial statements.

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
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	5,139	19,214
2006	2,664	2,306	2,062	1,168	1,346	370	595	392	4,244	15,147	5,042	20,189
2007	2,751	2,486	1,954	1,109	1,485	374	602	203	5,075	16,039	5,185	21,224
2008	2,685	2,566	1,731	1,685	1,497	349	622	405	4,682	16,222	5,066	21,288

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

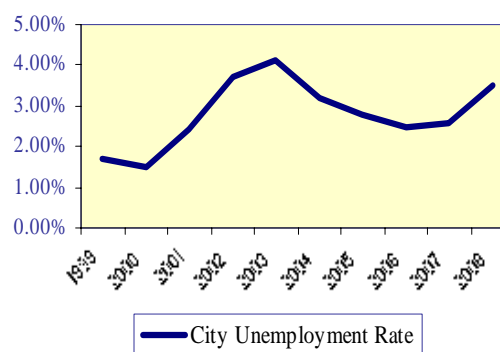
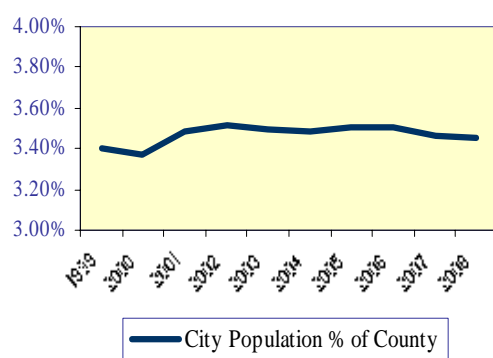
SALES TAX RATES FOR THE FISCAL YEAR ENDED JUNE 30, 2008

State Funds	6.00%
County Transportation Fund (Transportation Development Act)	0.25%
County Transportation Fund	1.00%
City	1.00%
	8.25%

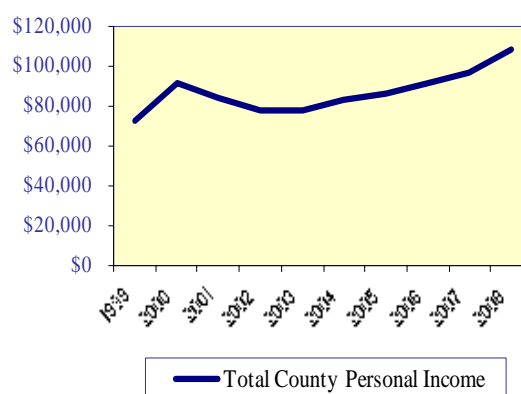
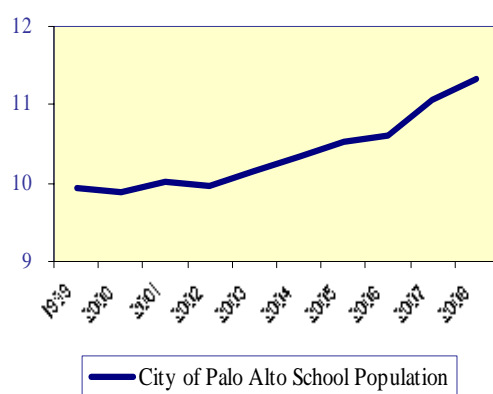
Source: California State Board of Equalization

City of Palo Alto - Demographic and Economic Statistics

Last Ten Fiscal Years



Thousands



Fiscal Year	City of Palo Alto Population	City of Palo Alto Unemployment Rate (%)	City of Palo Alto School Population	Santa Clara County Population	City Population % of County	Santa Clara Total County (\$000) Personal Income
1999	58,300	1.7%	9,946	1,715,400	3.40%	73,045,821
2000	58,500	1.5%	9,881	1,736,700	3.37%	91,386,181
2001	60,200	2.4%	10,031	1,728,680	3.48%	83,838,707
2002	60,500	3.7%	9,952	1,719,565	3.52%	77,548,912
2003	60,465	4.1%	10,151	1,729,917	3.50%	77,680,349
2004	60,246	3.2%	10,341	1,731,422	3.48%	82,638,917
2005	61,674	2.8%	10,527	1,759,585	3.51%	86,400,000 *
2006	62,148	2.5%	10,607	1,773,258	3.50%	91,600,000 *
2007	62,615	2.6%	11,056	1,808,056	3.46%	96,900,000 *
2008	63,367	3.5%	11,329	1,837,075	3.45%	107,900,000 *

Source: California State Department of Finance
 State Employment Development Office
 Palo Alto Unified School District

* California State Department of Transportation Forecasts



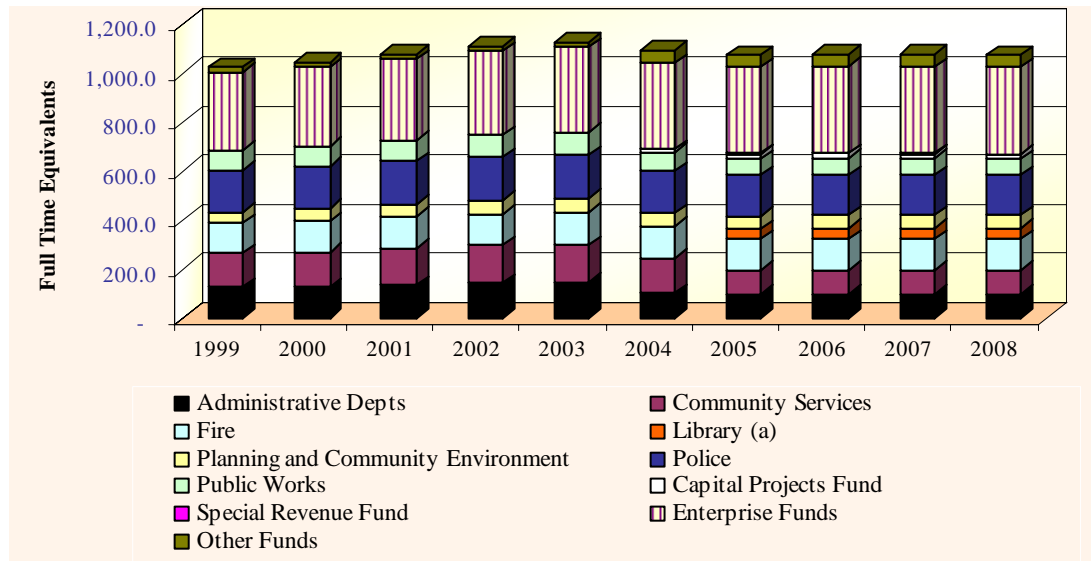
City of Palo Alto - Principal Employers

Current Year and Nine Years Ago

Employer	2007-08		1998-99	
	Number of Employees	Rank	Number of Employees	Rank
HP Labs	7,500	1		
Veteran's Affairs Palo Alto Health Care System	3,500	2	1,000 +	9
VA Palo Alto Health Care	2,900	3		
Hewlett-Packard Company	2,001	4	5000 +	2
Palo Alto Medical Foundation	2,000	5	1,500 +	6
Space Systems Loral	1,700	6	3,000 - 5,000	3
Wilson Sonsini Goodrich Rosati	1,500	7		
Packard Children's Hospital	1,300	8		
City of Palo Alto	1,100	9		
Roche Palo Alto	1,000	10		
Stanford University			5,000 +	1
Varian Associates			1,500 - 2,000	4
Palo Alto Unified School District			1,636	5
Alza Corporation			1,500 +	7
Roche Bioscience			1,000 - 1,500	8
Stanford University Medical Center/Hospital			750 - 1,000	10
Total City Day Population	63,367			

Source: www.ReferenceUSA.com & Palo Alto Weekly

City of Palo Alto - Full-Time Equivalent City Government Employees by Function Last Ten Fiscal Years



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Governmental Funds										
General Fund										
Administrative Depts	124.35	126.35	133.35	143.60	145.10	101.10	96.24	96.65	99.05	98.65
Community Services	139.25	142.25	152.00	153.00	153.00	144.75	98.25	99.25	97.25	96.25
Fire	124.00	128.00	129.00	129.00	132.50	128.50	126.00	127.00	127.00	127.00
Library (a)							44.00	44.25	43.75	43.75
Planning and Community Environment										
Public Works	46.00	51.00	52.00	56.50	59.00	54.80	53.30	53.30	53.30	53.30
Police	171.00	173.00	173.00	176.50	177.50	171.00	164.50	164.00	163.00	163.00
Public Works	82.42	83.42	85.98	87.05	93.05	76.20	67.90	67.90	67.90	67.90
Capital Projects Fund						12.70	20.20	20.20	20.00	20.00
Special Revenue Fund						1.20	1.20	1.20	1.20	1.20
Enterprise Funds										
Public Works Department (Refuse, Storm Drain, Wastewater Treatment)	106.58	107.58	109.52	110.45	110.45	111.35	112.65	112.65	112.65	112.65
Utilities Department (Administrative, Electric, Gas, Wastewater Collection, Water)	211.50	215.50	224.50	230.50	229.50	233.75	233.90	235.90	234.90	234.90
CPA External Services				4.00	7.00	5.70	6.00	6.00	5.80	5.80
Other Funds										
Printing and Mailing	5.15	5.15	5.15	4.15	4.15	4.15	4.70	4.60	4.65	4.05
Technology						33.15	29.56	29.60	29.80	29.80
Equipment Management	14.00	14.00	14.00	15.00	15.00	16.00	16.00	16.00	16.20	16.20
Total	1,024.25	1,046.25	1,078.50	1,109.75	1,126.25	1,094.35	1,074.40	1,078.50	1,076.45	1,074.45

Source: City of Palo Alto - Adopted Operating Budget

Notes: (a) Library became its own entity effective 2005, originally part of Community Services.



City of Palo Alto - Operating Indicators by Function/Program

Last Ten Fiscal Years

Function / Program	Fiscal Year		
	1999	2000	2001
Public Safety:			
Fire:			
Number of Fire Hydrants	1,699	1,708	1,729
Planning & Community Environment			
Number of Housing Units	25,708	25,732	26,048
Commercial & Industrial Space - Million Sq Ft	27.1	27.3	27.3
Electric Utility			
Number of Customer Accounts	27,674	27,533	28,097
Million of KWH Sold	1,124	1,134	1,057
Water Utility			
Number of Customer Accounts	19,322	18,921	19,335
Million CCF Sold	6.1	6.6	5.9
Gas Utility			
Number of Customer Accounts	23,322	23,154	23,101
Million Therms Sold	41.0	37.0	36.7
Waste Water			
Number of Customer Accounts	21,975	21,973	21,752
Millions of Gallons Processed	9,426	9,834	9,243

Source: City of Palo Alto
State of California, Dept of Finance (housing units)

Note: Fiscal Years 2004-2006 are restated due to change in source of data.



Fiscal Year						
2002	2003	2004	2005	2006	2007	2008
1,741	1,746	1,874	1,873	1,919	1,944	1,948
26,841	26,934	27,019	27,522	27,767	27,763	27,938
27.3	27.3	27.3	27.3	27.3	27.3	27.3
28,348	28,408	28,482	28,539	28,653	28,684	29,024
997	957	958	959	966	978	977
19,437	19,487	19,557	19,605	19,645	19,726	19,942
5.9	5.6	6.0	5.3	5.2	12.0	12.0
23,116	23,169	23,216	23,300	23,353	23,357	23,502
33.7	31.8	31.5	32.0	31.5	31.3	32.2
21,772	21,819	21,830	21,825	21,784	21,835	21,990
8,699	8,704	8,238	8,395	8,972	9,220	8,510



City of Palo Alto - Capital Asset Statistics by Function/Program

Last Ten Fiscal Years

Function/Program	Fiscal Year			
	1999	2000	2001	2002
Public Safety:				
Fire:				
Fire Stations	8	8	8	8
Fire Apparatus	24	23	24	25
Police:				
Police Stations	1	1	1	1
Police Patrol Vehicles	27	29	33	33
Community Services				
Acres - Downtown/Urban Parks	142	170	170	170
Acres - Open Space	3,997	3,731	3,731	3,731
Parks and Preserves	36	35	33	34
Golf Course	1	1	1	1
Tennis Courts	51	52	52	52
Athletic Center	1	1	1	1
Community Centers	4	4	4	4
Theatres	3	3	3	3
Cultural Center/Art Center	1	1	1	1
Junior Museum and Zoo	1	1	1	1
Swimming Pools	3	1	1	1
Nature Center	2	2	2	2
Libraries				
Libraries	6	6	6	6
Public Works				
Number of Trees Maintained	39,832	39,923	38,094	37,941
Electric Utility				
Overhead Pole Miles	183	228	227	227
Underground Trench Miles	202	209	220	186
Water Utility				
Miles of Water Mains	220	221	222	226
Gas Utility				
Miles of Gas Mains	169	170	201	207
Waste Water				
Miles of Sanitary Sewer Lines	219	219	218	202

Source: City of Palo Alto



Fiscal Year					
2003	2004	2005	2006	2007	2008
8	8	8	8	8	8
22	23	25	25	25	23
1	1	1	1	1	1
33	30	30	30	30	30
170	170	170	170	157	157
3,731	3,731	3,731	3,731	3,744	3,744
34	34	35	35	36	36
1	1	1	1	1	1
52	52	52	52	51	51
1	1	1	1	4	4
4	4	4	4	4	4
3	3	3	3	3	3
1	1	1	1	1	1
1	1	1	1	1	1
1	1	1	1	1	1
2	2	2	2	3	3
6	5	5	5	5	5
34,939	35,440	35,096	34,841	34,556	35,322
227	227	225	217	194	193
186	186	188	210	252	253
226	226	226	217	217	217
207	207	207	207	207	207
202	202	202	202	202	202

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

June 30, 2008

TYPE	COVERAGE (Deductible)	LIMITS	COMPANY	EXPIRATION DATE
PROPERTY LOSS				
Blanket	All real & personal property (\$25,000 deductible), Fine Arts (\$2,500 deductible)	\$350,460,922	CA Public Entity Property Program	07/01/09
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	07/01/09
Flood Insurance	All real property 1305 Middlefield Road (\$1,000 deductible)	\$500,000	Hartford Fire Insurance Co.	04/07/09
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.	03/22/09
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)	\$45,000,000 annual aggregate	Everest Ins. Co. Lexington Ins Co.	07/01/09
Trustees Errors and Omissions	Bodily injury and property damage liability Errors and omissions liability			
SPECIAL LIABILITY				
	Each occurrence			
Volunteers Accident	Medical - Each person / (\$100 deductible)	\$20,000	Life Insurance Co. of North America	02/02/09
Special Events	Bodily injury	\$1,000,000 per occurrence	Axis Surplus Insurance Company	01/01/09
EMPLOYEE BENEFIT				
Travel Accident	Indemnity, based on salary	\$1,500,000 per accident	Life Insurance Co. of North America	06/01/09
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 \$500,000 liability	\$500,000 per occurrence		07/01/09
EXCESS WORKERS' COMPENSATION				
	Pooled Retention	\$5,000,000 limit per occurrence - Workers Comp and Employers Liability	CA. Public Entity Insurance Authority	07/01/09
	Reinsured Layer	\$250,000,000 workers comp per occurrence, excess of pooled retention limit, includes \$5,000,000 employers liability excess of \$5,000,000 pooled retention	National Union Fire Insurance Co.	07/01/09

Source: Human Resources Dept, City of Palo Alto



Single Audit Index.....

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Single Audit Section.....

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



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Schedule of Findings.....

CITY OF PALO ALTO SCHEDULE OF FINDINGS AND QUESTIONED COSTS For The Year Ended June 30, 2008

SECTION I—SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued:	Unqualified		
Internal control over financial reporting:			
• Material weakness(es) identified?	_____ Yes	_____ X	No
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	_____ Yes	_____ X	None Reported
Noncompliance material to financial statements noted?	_____ Yes	_____ X	No

Federal Awards

Type of auditor's report issued on compliance for major programs:	Unqualified		
Internal control over major programs:			
• Material weakness(es) identified?	_____ Yes	_____ X	No
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	_____ Yes	_____ X	None Reported
Any audit findings disclosed that are required to be reported in accordance with section 510(a) of OMB Circular A-133?	_____ Yes	_____ X	No

Identification of major programs:

CFDA#(s)	Name of Federal Program or Cluster
66.458	State Water Resources Control Board Loan
81.087	Renewable Energy Research and Development

Dollar threshold used to distinguish between type A and type B programs: \$300,000

Auditee qualified as low-risk auditee? X Yes No



SECTION II – FINANCIAL STATEMENT FINDINGS

Our audit did not disclose any material weaknesses or instances of noncompliance material to the basic financial statements. We have also issued a separate Memorandum on Internal Control dated October 24, 2008 which is an integral part of our audits and should be read in conjunction with this report.

SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Our audit did not disclose any findings or questioned costs required to be reported in accordance with section 510(a) of OMB Circular A-133.

SECTION IV - STATUS OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS – Prepared by Management

Financial Statement Prior Year Findings

There were no prior year Financial Statement Findings reported.

Federal Award Prior Year Findings and Questioned Costs

There were no prior year Federal Award Findings and Questioned Costs reported.



CITY OF PALO ALTO

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2008

Program Name	Identifying Pass-Through Grant Number	Catalog of Federal Domestic Assistance Number	Program Expenditures
Department of Housing and Urban Development			
Community Development Block Grant Program	B-05-MC-06-0020		
Program Expenditures		14.218	124,536
Subgrants:			
Emergency Housing Consortium			7,500
OMBUDSMAN Program			7,500
Palo Alto Housing Corporation-Banker Counseling			25,000
New Housing Development			17,336
Clara Mateo Alliance Shelter			17,500
Clara Mateo Alliance Family Shelter			17,500
Shelter Network Haven Housing			8,500
InnVision			30,000
Project Sentinel - Fair Housing			26,800
Stevenson Housing - Fari Alarm Project			44,646
Stevenson Housing - Windows/Doors			257,952
EHC Off the Street			7,500
Lytton Gardens Nursing Facilities			86,571
Total CDBG Expenditures		14.218	678,841
Governor's Office of Emergency Services	FEMA-3033110-DR-CA		
(Passed through California Department of Transportation)			
Emergency Management Performance	OES ID #085-55282	20.703	8,533
(Passed through State of California through County)			
Urban Area Security (UAS)			1,150
OT/Backfill Terrorism Training			2,888
Total Expenditures from Governor's office			12,571
Department of Energy	DE-FG36-03GO13066	81.087	1,152,332
Office of Water, Environmental Protection Agency			
	Contract # 07-814-550-0		
(Passed through California State Water Resources Control Board)	Loan # C-06-4132-110	66.458	5,629,185
U.S. Fish & Wildlife Service-Baylands	81420-5-J225	15.631	24,000
U.S. Fish & Wildlife Service-Creek Restoration	81420-6-J145	15.631	4,003
TOTAL FEDERAL FINANCIAL AWARDS			\$7,500,932

See Notes to Schedule of Expenditures of Federal Awards



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NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Note 1.....

REPORTING ENTITY

The Schedule of Expenditure of Federal Awards (the Schedule) includes expenditures of federal awards for the City of Palo Alto, California 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.

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

Expenditure of Long-Term Debt Proceeds – In this fiscal year, the City received proceeds from long-term debt funded by the federal government passed through the California State Water Resources Control Board. In accordance with OMB Circular A-133, section .205(d) the City included current year expenditures of such proceeds on the Schedule of Expenditures of Federal Awards.

During fiscal 2007-08, the City expended \$5,629,185 in costs under the Office of Water, Environmental Protection Agency, Capitalization Grants For Clean Water State Revolving Funds Program (CFDA #66.458). As of June 30, 2008, the City had received \$2,784,823 in remittances from the State with another \$2,844,362 received subsequent to June 2008 as reimbursement of the above costs.

Note 3.....

DIRECT AND INDIRECT (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.



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**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
of the City of Palo Alto, California

We have audited the financial statements of the City of Palo Alto as of and for the year ended June 30, 2008, and have issued our report thereon dated October 24, 2008. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the City's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the City's financial statements that is more than inconsequential will not be prevented or detected by the City's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the City's internal control.

A Professional Corporation

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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 and other matters that are required to be reported under *Government Auditing Standards*.

Our audit did not disclose any material weaknesses or instances of noncompliance material to the basic financial statements. We have also issued a separate Memorandum on Internal Control dated October 24, 2008 which is an integral part of our audits and should be read in conjunction with this report.

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

Mage & Associates

October 24, 2008



MAZE & ASSOCIATES

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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
of the 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, 2008. The City's major federal programs are identified in Section I - Summary of Auditor's Results included in the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the City's management. Our responsibility is to express an opinion on the City's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted 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 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, 2008.

A Professional Corporation

Internal Control over Compliance

The management of the City is responsible for establishing and maintaining effective internal controls over compliance with the 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 the 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, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of City's internal control over compliance.

A *control deficiency* in a City's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the City's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the City's internal control.

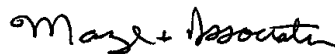
A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the City's internal control.

Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider material weaknesses, as defined above.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the City as of and for the year ended June 30, 2008, and have issued our report thereon dated October 24, 2008. Our audit was performed for the purpose of forming opinions on the financial statements. The accompanying schedule of expenditures of federal awards is presented for the purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

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



October 24, 2008

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:

ADA Coordinator
250 Hamilton Avenue
(650) 329-2550
ada@cityofpaloalto.org

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APPENDIX D

PROPOSED FORM OF BOND COUNSEL OPINION

(Tax-Exempt 2009 Series A)

[Letterhead of Jones Hall, A Professional Law Corporation]

[Closing Date]

City of Palo Alto
250 Hamilton Avenue
Palo Alto, California 94301

OPINION: \$_____ City of Palo Alto Water Revenue Bonds, 2009 Series A

Members of the City Council:

We have acted as bond counsel in connection with the issuance by the City of Palo Alto (the "City") of the \$_____ City of Palo Alto Water Revenue Bonds, Tax-Exempt 2009 Series A (the "Series A Bonds"), pursuant to the charter of the City and the provisions of Chapter 12.28 (commencing with Section 12.28.010) of the Palo Alto Municipal Code (the "Bond Law"), an Indenture of Trust, dated as of October 1, 2009, by and between the City and U.S. Bank National Association, as trustee (the "Indenture"), and a resolution of the City (the "Resolution") of the City Council of the City adopted on July 27, 2009. We have examined the law and such certified proceedings and other papers as we deem necessary to render this opinion.

As to questions of fact material to our opinion, we have relied upon representations of the City contained in the Indenture and in the certified proceedings and certifications of public officials and others furnished to us without undertaking to verify the same by independent investigation.

Based upon the foregoing, we are of the opinion, under existing law, as follows:

1. The City is duly created and validly existing as a municipal corporation and chartered city, with the power to enter into the Indenture, perform the agreements on its part contained therein, and issue the Series A Bonds.

2. The Indenture has been duly approved by the City, and constitutes a valid and binding obligation of the City, enforceable against the City in accordance with its terms.

3. Pursuant to the Bond Law, the Indenture creates a valid lien on the Net Revenues of the City's Water System (as defined in the Indenture) pledged by the Indenture for the security of the Series A Bonds, on a parity with that portion (approximately 45%) of the City's Utility Revenue Bonds, 2002 Series A, currently outstanding in the principal amount of \$19,690,000, the proceeds of which financed improvements to the Water System; subject only to a pledge of such Net Revenues (along with other net revenues of other City utilities not pledged for the security of the Series A Bonds) to payment of debt service on the City's outstanding Utility Revenue Bonds, 1995 Series A, currently outstanding in the amount of \$5,320,000, as described in the Indenture.

4. The Bonds have been duly authorized, executed and delivered by the City, and are valid and binding special obligations of the City, payable solely from the sources provided therefor in the Indenture.

5. The interest on the Series A Bonds is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations. The opinion set forth in the preceding sentence are subject to the condition

that the City comply with all requirements of the Internal Revenue Code of 1986 that must be satisfied subsequent to the issuance of the Series A Bonds in order that interest thereon be, or continue to be, excluded from gross income for federal income tax purposes. The City has covenanted to comply with each such requirement. Failure to comply with certain of such requirements may cause the inclusion of interest on the Series A Bonds in gross income for federal income tax purposes to be retroactive to the date of issuance of the Series A Bonds. We express no opinion regarding other federal tax consequences arising with respect to the Series A Bonds.

6. The interest on the Series A Bonds is exempt from personal income taxation imposed by the State of California.

The rights of the owners of the Series A Bonds and the enforceability of the Series A Bonds and the Indenture, may be subject to bankruptcy, insolvency, reorganization, moratorium and other similar laws affecting creditors' rights heretofore or hereafter enacted and may also be subject to the exercise of judicial discretion in appropriate cases.

Respectfully submitted,

A Professional Law Corporation

(Taxable 2009 Series B (Direct Payment Build America Bonds))

[Letterhead of Jones Hall, A Professional Law Corporation]

[Closing Date]

City of Palo Alto
250 Hamilton Avenue
Palo Alto, California 94301

OPINION: \$_____ City of Palo Alto Water Revenue Bonds, Taxable 2009 Series B
(Direct Payment Build America Bonds)

Members of the City Council:

We have acted as bond counsel in connection with the issuance by the City of Palo Alto (the "City") of the \$_____ City of Palo Alto Water Revenue Bonds, Taxable 2009 Series B (Direct Payment Build America Bonds) (the "Series B Bonds"), pursuant to the charter of the City and the provisions of Chapter 12.28 (commencing with Section 12.28.010) of the Palo Alto Municipal Code (the "Bond Law"), an Indenture of Trust, dated as of October 1, 2009, by and between the City and U.S. Bank National Association, as trustee (the "Indenture"), and a resolution of the City (the "Resolution") of the City Council of the City adopted on July 27, 2009. We have examined the law and such certified proceedings and other papers as we deem necessary to render this opinion.

As to questions of fact material to our opinion, we have relied upon representations of the City contained in the Indenture and in the certified proceedings and certifications of public officials and others furnished to us without undertaking to verify the same by independent investigation.

Based upon the foregoing, we are of the opinion, under existing law, as follows:

1. The City is duly created and validly existing as a municipal corporation and chartered city, with the power to enter into the Indenture, perform the agreements on its part contained therein, and issue the Series B Bonds.
2. The Indenture has been duly approved by the City, and constitutes a valid and binding obligation of the City, enforceable against the City in accordance with its terms.
3. Pursuant to the Bond Law, the Indenture creates a valid lien on the Net Revenues of the City's Water System (as defined in the Indenture) pledged by the Indenture for the security of the Series B Bonds, on a parity with that portion (approximately 45%) of the City's Utility Revenue Bonds, 2002 Series A, currently outstanding in the principal amount of \$19,690,000, the proceeds of which financed improvements to the Water System; subject only to a pledge of such Net Revenues (along with other net revenues of other City utilities not pledged for the security of the Series B Bonds) to payment of debt service on the City's outstanding Utility Revenue Bonds, 1995 Series A, currently outstanding in the amount of \$5,320,000, as described in the Indenture.
4. The Bonds have been duly authorized, executed and delivered by the City, and are valid and binding special obligations of the City, payable solely from the sources provided therefor in the Indenture.
5. The interest on the Series B Bonds is not excluded from gross income for federal income tax purposes.
6. The interest on the Series B Bonds is exempt from personal income taxation imposed by the State of California.

The rights of the owners of the Series B Bonds and the enforceability of the Series B Bonds and the Indenture, may be subject to bankruptcy, insolvency, reorganization, moratorium and other similar laws affecting creditors' rights heretofore or hereafter enacted and may also be subject to the exercise of judicial discretion in appropriate cases.

Respectfully submitted,

A Professional Law Corporation

APPENDIX E

FORM OF CONTINUING DISCLOSURE CERTIFICATE

This CONTINUING DISCLOSURE CERTIFICATE (the "Disclosure Certificate") is executed and delivered by the CITY OF PALO ALTO (the "City") in connection with the issuance by the City of its \$33,000,000* aggregate principal amount of City of Palo Alto Water Revenue Bonds, 2009 Series A (the "Bonds"). The Bonds are being issued pursuant to an indenture of trust, dated as of October 1, 2009 (the "Indenture"), by and between the City and U.S. Bank National Association, as trustee (the "Trustee"). The City covenants and agrees as follows:

Section 1. Purpose of the Disclosure Certificate. This Disclosure Certificate is being executed and delivered by the City for the benefit of the holders and beneficial owners of the Bonds and in order to assist the Participating Underwriter in complying with S.E.C. Rule 15c2-12(b)(5).

Section 2. Definitions. In addition to the definitions set forth in the Indenture, which apply to any capitalized term used in this Disclosure Certificate unless otherwise defined in this Section 2, the following capitalized terms shall have the following meanings:

"*Annual Report*" shall mean any Annual Report provided by the City pursuant to, and as described in, Sections 3 and 4 of this Disclosure Certificate.

"*Beneficial Owner*" shall mean any person which (a) has the power, directly or indirectly, to vote or consent with respect to, or to dispose of ownership of, any Bonds (including persons holding Bonds through nominees, depositories or other intermediaries), or (b) is treated as the owner of any Bonds for federal income tax purposes.

"*Dissemination Agent*" shall mean the City or any successor Dissemination Agent designated in writing by the City and which has filed with the City a written acceptance of such designation. In the absence of such a designation, the City shall act as the Dissemination Agent.

"*EMMA*" or "*Electronic Municipal Market Access*" means the centralized on-line repository for documents filed with the MSRB, such as official statements and disclosure information relating to municipal bonds, notes and other securities as issued by state and local governments.

"*Listed Events*" shall mean any of the events listed in Section 5(a) of this Disclosure Certificate.

"*MSRB*" means the Municipal Securities Rulemaking Board, which has been designated by the Securities and Exchange Commission as the sole repository of disclosure information for purposes of the Rule, or any other repository of disclosure information which may be designated by the Securities and Exchange Commission as such for purposes of the Rule in the future.

"*Participating Underwriter*" shall mean any of the original underwriters of the Bonds required to comply with the Rule in connection with offering of the Bonds.

"*Rule*" shall mean Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

Section 3. Provision of Annual Reports.

(a) *Delivery of Annual Report to MSRB.* The City shall, or shall cause the Dissemination Agent to, not later than eight months after the end of the City's fiscal year (which currently ends on June 30), commencing with the report for the 2008-2009 Fiscal Year, which is due not later than March 1, 2010, provide to the Participating Underwriter and to file with EMMA, in a readable pdf or other electronic format as prescribed

* Preliminary, subject to change.

by the MSRB, an Annual Report that is consistent with the requirements of Section 4 of this Disclosure Certificate. The Annual Report may be submitted as a single document or as separate documents comprising a package, and may cross-reference other information as provided in Section 4 of this Disclosure Certificate; provided that the audited financial statements of the City may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date.

(b) *Change of Fiscal Year.* If the City's fiscal year changes, it shall give notice of such change in the same manner as for a Listed Event under Section 5(d).

(c) *Delivery of Annual Report to Dissemination Agent.* Not later than fifteen (15) Business Days prior to the date specified in subsection (a) for providing the Annual Report to EMMA, the City shall provide the Annual Report to the Dissemination Agent (if other than the City). If by such date, the Dissemination Agent has not received a copy of the Annual Report, the Dissemination Agent shall notify the City.

(d) *Report of Non-Compliance.* If the City is unable to provide an Annual Report by the date required in subsection (a), the Dissemination Agent shall send a notice to EMMA in substantially the form attached as Exhibit A.

(e) *Annual Compliance Certification.* The Dissemination Agent shall, if the Dissemination Agent is other than the City, file a report with the City certifying that the Annual Report has been provided pursuant to this Disclosure Certificate, stating the date it was provided.

Section 4. Content of Annual Reports. The Annual Report shall contain or incorporate by reference the following:

(a) Audited financial statements of the City for the preceding fiscal year, prepared in accordance with the laws of the State and including all statements and information prescribed for inclusion therein by the Controller of the State. If the City's audited financial statements are not available by the time the Annual Report is required to be filed pursuant to Section 3(a), the Annual Report shall contain unaudited financial statements in a format similar to the financial statements contained in the final Official Statement, and the audited financial statements shall be filed in the same manner as the Annual Report when they become available.

(b) To the extent not included in the audited final statement of the City, the Annual Report shall also include operating data with respect to the City for preceding fiscal year, substantially similar to that provided in the corresponding tables and charts in the official statement for the Bonds, as follows:

- (i) Discussion of any changes in the rate and fee structure with respect to the Water System in the most recently completed fiscal year which could have a material affect on the Net Revenues of the Water System;
- (ii) Identification of any withdrawals by the City from the Available Reserves during the most recently completed fiscal year for the purpose of paying debt service on the Bonds;
- (iii) Identification with respect to each of the Available Reserves (A) the balance as of the end of the most recently completed fiscal year, and (B) any material changes in the applicable reserve policy;
- (iv) Description of any Parity Bonds or subordinate debt issued during the most recently completed fiscal year;
- (v) Total actual Gross Revenues and Net Revenues generated by the Water System in the most recently completed fiscal year, the total debt service on the Bonds for such fiscal year and the respective debt service coverage ratios; and
- (vi) Updated information on the collective total billings of the top ten customers of the Water System in the most recently completed fiscal year, and the percentage of the total Water System billings represented thereby.

(c) Any or all of the items listed above may be included by specific reference to other documents, including official statements of debt issues of the City or related public entities, which are available to the

public on the MSRB's Internet web site or filed with the Securities and Exchange Commission. The City shall clearly identify each such other document so included by reference.

If the document included by reference is a final official statement, it must be available from EMMA.

(d) In addition to any of the information expressly required to be provided under paragraph (b) of this Section 4, the City shall provide such further information, if any, as may be necessary to make the specifically required statements, in the light of the circumstances under which they are made, not misleading.

Section 5. Reporting of Significant Events.

(a) *Listed Events.* Pursuant to the provisions of this Section 5, the City shall give, or cause to be given, notice of the occurrence of any of the following events with respect to the Bonds, if material:

- (i) Principal and interest payment delinquencies.
- (ii) Non-payment related defaults.
- (iii) Unscheduled draws on debt service reserves reflecting financial difficulties.
- (iv) Unscheduled draws on credit enhancements reflecting financial difficulties.
- (v) Substitution of credit or liquidity providers, or their failure to perform.
- (vi) Adverse tax opinions or events affecting the tax-exempt status of the security.
- (vii) Modifications to rights of security holders.
- (viii) Contingent or unscheduled bond calls.
- (ix) Defeasances.
- (x) Release, substitution, or sale of property securing repayment of the securities.
- (xi) Rating changes.

(b) *Determination of Materiality of Listed Events.* Whenever the City obtains knowledge of the occurrence of a Listed Event, the City shall as soon as possible determine if such event would be material under applicable federal securities laws.

(c) *Notice to Dissemination Agent.* If the City has determined that knowledge of the occurrence of a Listed Event would be material under applicable federal securities laws, the City shall promptly notify the Dissemination Agent (if other than the City) in writing. Such notice shall instruct the Dissemination Agent to report the occurrence pursuant to subsection (d).

(d) *Notice of Listed Events.* The City shall file, or cause the Dissemination Agent to file, a notice of the occurrence of a Listed Event, if material, with EMMA, in a readable PDF or other electronic format as prescribed by EMMA, with a copy to the Participating Underwriter. Notwithstanding the foregoing, notice of Listed Events described in subsections (a)(viii) and (ix) (defeasances) need not be given under this subsection any earlier than the notice (if any) of the underlying event is given to Bondholders of affected Bonds.

Section 6. Identifying Information for Filings with EMMA. All documents provided to EMMA under this Disclosure Certificate shall be accompanied by identifying information as prescribed by the MSRB.

Section 7. Termination of Reporting Obligation. The City's obligations under this Disclosure Certificate shall terminate upon the defeasance, prior redemption or payment in full of all of the Bonds. If such termination occurs prior to the final maturity of the Bonds, the City shall give notice of such termination in the same manner as for a Listed Event under Section 5.

Section 8. Dissemination Agent.

(a) *Appointment of Dissemination Agent.* The City may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out its obligations under this Disclosure Certificate, and may discharge any such agent, with or without appointing a successor Dissemination Agent. If the Dissemination Agent is not the City, the Dissemination Agent shall not be responsible in any manner for

the content of any notice or report prepared by the City pursuant to this Disclosure Certificate. The initial Dissemination Agent shall be the City.

(b) *Compensation of Dissemination Agent.* The Dissemination Agent shall be paid compensation by the City for its services provided hereunder in accordance with its schedule of fees as agreed to between the Dissemination Agent and the City from time to time and all expenses, legal fees and advances made or incurred by the Dissemination Agent in the performance of its duties hereunder. The Dissemination Agent shall not be deemed to be acting in any fiduciary capacity for the City, Holders or Beneficial Owners, or any other party. The Dissemination Agent may rely and shall be protected in acting or refraining from acting upon any direction from the City or an opinion of nationally recognized bond counsel. The Dissemination Agent may at any time resign by giving written notice of such resignation to the City.

Section 9. Amendment; Waiver. Notwithstanding any other provision of this Disclosure Certificate, the City may amend this Disclosure Certificate (and the Dissemination Agent shall agree to any amendment so requested by the City that does not impose any greater duties or risk of liability on the Dissemination Agent), and any provision of this Disclosure Certificate may be waived, provided that the following conditions are satisfied:

(a) *Change in Circumstances.* If the amendment or waiver relates to the provisions of Sections 3(a), 4 or 5(a), it may only be made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature, or status of an obligated person with respect to the Bonds, or the type of business conducted;

(b) *Compliance as of Issue Date.* The undertaking, as amended or taking into account such waiver, would, in the opinion of a nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the original issuance of the Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) *Consent of Holders; Non-impairment Opinion.* The amendment or waiver either (i) is approved by the Bondholders in the same manner as provided in the Indenture for amendments to the Indenture with the consent of Bondholders, or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Bondholders or Beneficial Owners.

If this Disclosure Certificate is amended or any provision of this Disclosure Certificate is waived, the City shall describe such amendment or waiver in the next following Annual Report and shall include, as applicable, a narrative explanation of the reason for the amendment or waiver and its impact on the type (or in the case of a change of accounting principles, on the presentation) of financial information or operating data being presented by the City. In addition, if the amendment relates to the accounting principles to be followed in preparing financial statements, (i) notice of such change shall be given in the same manner as for a Listed Event under Section 5(d), and (ii) the Annual Report for the year in which the change is made should present a comparison (in narrative form and also, if feasible, in quantitative form) between the financial statements as prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles.

Section 10. Additional Information. Nothing in this Disclosure Certificate shall be deemed to prevent the City from disseminating any other information, using the means of dissemination set forth in this Disclosure Certificate or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by this Disclosure Certificate. If the City chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by this Disclosure Certificate, the City shall have no obligation under this Disclosure Certificate to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

Section 11. Default. In the event of a failure of the City to comply with any provision of this Disclosure Certificate, any Bondholder or Beneficial Owner may take such actions as may be necessary and appropriate, including seeking mandate or specific performance by court order, to cause the City to comply with its obligations under this Disclosure Certificate. The sole remedy under this Disclosure Certificate in

the event of any failure of the City to comply with this Disclosure Certificate shall be an action to compel performance.

Section 12. Duties, Immunities and Liabilities of Dissemination Agent. The Dissemination Agent shall have only such duties as are specifically set forth in this Disclosure Certificate, and the City agrees to indemnify and save the Dissemination Agent, its officers, directors, employees and agents, harmless against any loss, expense and liabilities which it may incur arising out of or in the exercise or performance of its powers and duties hereunder, including the costs and expenses (including attorneys fees) of defending against any claim of liability, but excluding liabilities due to the Dissemination Agent's negligence or willful misconduct. The obligations of the City under this Section shall survive resignation or removal of the Dissemination Agent and payment of the Bonds.

Section 13. Beneficiaries. This Disclosure Certificate shall inure solely to the benefit of the City, the Dissemination Agent, the Participating Underwriters and Holders and Beneficial Owners from time to time of the Bonds, and shall create no rights in any other person or entity.

Date: [Closing Date]

CITY OF PALO ALTO

By _____
Name _____
Title _____

EXHIBIT A

NOTICE TO MUNICIPAL SECURITIES RULEMAKING BOARD
OF FAILURE TO FILE ANNUAL REPORT

Name of Obligor: City of Palo Alto, California
Name of Issue: City of Palo Alto Water Revenue Bonds, 2009 Series A
Date of Issuance: [Closing Date]

NOTICE IS HEREBY GIVEN that the City of Palo Alto has not provided an Annual Report with respect to the above-named Bonds as required by the Continuing Disclosure Certificate dated October ____, 2009, furnished by the City in connection with the Bond Issue. The City anticipates that the Annual Report will be filed by _____.

Dated: _____

CITY OF PALO ALTO, CALIFORNIA, as
Dissemination Agent

By _____
Name _____
Title _____

cc: Trustee

APPENDIX F

DTC AND THE BOOK-ENTRY ONLY SYSTEM

The following description of the procedures and record keeping with respect to beneficial ownership interests in the 2009 Bonds, payment of principal, redemption premium, if any, and interest with respect to the 2009 Bonds to DTC, its Participants or Beneficial Owners, confirmation and transfers of beneficial ownership interests in the 2009 Bonds and other related transactions by and between DTC, its Participants and the Beneficial Owners is based solely on the understanding of the City of such procedures and record keeping from information provided by DTC. Accordingly, no representations can be made concerning these matters and neither DTC, its Participants nor the Beneficial Owners should rely on the foregoing information with respect to such matters, but should instead confirm the same with DTC or its Participants, as the case may be. The City, the Trustee and the Underwriter understand that the current "Rules" applicable to DTC are on file with the Securities and Exchange Commission and that the current "Procedures" of DTC to be followed in dealing with Participants are on file with DTC.

The Depository Trust Company ("DTC"), New York, NY, will act as securities depository for the Bonds. The Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond certificate will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com and www.dtc.org.

Purchases of the Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC's records. The ownership interest of each actual purchaser of each Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of the Bonds with DTC and their registration in the

name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of the Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Trust Agreement. For example, Beneficial Owners of the Bonds may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC, if less than all of the Bonds within a maturity are being redeemed. DTC's practice is to determine by lot the amount of the interest of each Direct Participant in each issue to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC's MMI Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Payments of principal of, premium, if any, and interest on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the City, the Authority or the Trustee, on payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustee, the City or the Authority, subject to any statutory or regulatory requirements as may be in effect from time to time. Payments of principal of, premium, if any, and interest on the Bonds by Cede & Co (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the City, the Authority or the Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as depository with respect to the Bonds at any time by giving reasonable notice to the City, the Authority or the Trustee. Under such circumstances, in the event that a successor depository is not obtained, Bond certificates are required to be printed and delivered.

The Authority may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Bond certificates will be printed and delivered.

The foregoing information concerning DTC and DTC's book-entry system has been provided by DTC, and neither the Authority nor the Trustee takes any responsibility for the accuracy thereof.

NEITHER THE AUTHORITY NOR THE TRUSTEE WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO DTC PARTICIPANTS, INDIRECT PARTICIPANTS OR BENEFICIAL OWNERS WITH RESPECT TO THE PAYMENTS OR THE PROVIDING OF NOTICE TO DTC PARTICIPANTS, INDIRECT PARTICIPANTS OR BENEFICIAL OWNERS OR THE SELECTION OF BONDS FOR REDEMPTION.

Neither the Authority nor the Trustee can give any assurances that DTC, DTC Participants, Indirect Participants or others will distribute payments of principal of, premium, if any, and interest on the Bonds

paid to DTC or its nominee, as the registered Owner, or any redemption or other notice, to the Beneficial Owners or that they will do so on a timely basis or that DTC will serve and act in a manner described in this Official Statement.

In the event that the book-entry system is discontinued as described above, the requirements of the Trust Agreement will apply.

The City, the Authority and the Trustee cannot and do not give any assurances that DTC, the Participants or others will distribute payments of principal, interest or premium, if any, evidenced by the Bonds paid to DTC or its nominee as the registered owner, or will distribute any redemption notices or other notices, to the Beneficial Owners, or that they will do so on a timely basis or will serve and act in the manner described in this Official Statement. Neither the Authority nor the Trustee are responsible or liable for the failure of DTC or any Participant to make any payment or give any notice to a Beneficial Owner with respect to the Bonds or an error or delay relating thereto.

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