

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

This section of the County of Santa Cruz (the "County") comprehensive annual financial report presents a discussion and analysis of the County's financial performance during the fiscal year ended June 30, 2004. Please read it in conjunction with the transmittal letter at the front of this report and the County's basic financial statements following this section.

FINANCIAL HIGHLIGHTS

- The assets of the County exceeded liabilities at the close of the 2003-2004 fiscal year by \$101,424,933 (*net assets*). Of this amount, \$16,558,212 (*unrestricted net assets*) may be used to meet ongoing obligations to citizens and creditors, \$16,499,604 is restricted for specific purpose (*restricted net assets*), and \$68,367,117 is invested in capital assets, net of related debt.
- The government's total net assets decreased by \$27,529,680 (exclusive of prior period adjustment). This decrease is mostly attributable to the increased labor costs associated with the new agreements, the completion of major road pavement projects from the use of one-time funding sources, and a weak economy.
- As of June 30, 2004, the County's governmental funds reported combined ending fund balances of \$153,247,427, a decrease of \$11,402,736 (exclusive of prior period adjustment and change in reserve for inventories) in comparison with the prior year. Approximately 68% of the combined fund balances, \$103,740,322 is available to meet the County's current and future needs (*unreserved fund balance*).
- At the end of the fiscal year, unreserved fund balance for the general fund was \$19,137,624 or 7% of total general fund expenditures. This amount is budgeted to be spent in the next fiscal year, except for \$5,707,268, a designation for working capital to provide the State with a budget bridge loan of \$4 million to be repaid on or before August 15, 2006.
- The County's total long-term liabilities increased by \$19,485,625 in comparison with the prior year (excluding compensated absence, estimated claims, and postclosure liability). The increase resulted primarily from the scheduled principal payments and the new settlement bonds issued to pay the plaintiffs of the 1995 Pajaro River Flood an amount of \$22 million. The County Government Center was used as collateral for the financing over 20 years.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the County's basic financial statements. The County's basic financial statements are comprised of three components: (1) **Government-wide** financial statements, (2) **Fund** financial statements, and (3) **Notes** to the basic financial statements. Required Supplementary Information is included in addition to the basic financial statements.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Government-wide Financial Statements

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

The *statement of net assets* presents information on all County assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether or not the financial position of the County is improving or deteriorating.

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

Both of these government-wide financial statements distinguish functions of the County that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the County include general government, public protection, health and sanitation, public assistance, education, recreation and culture, and public ways and facilities. The business-type activities of the County include the County Disposal Sites CSA 9, and the following Board of Supervisor Governed Districts - Boulder Creek CSA 7, Rolling Woods CSA 10, Septic Tank Maintenance CSA 12, Freedom County Sanitation District, Davenport Sanitation District, Place de Mer CSA 2, Sand Dollar Beach CSA 5, Trestle Beach CSA 20, Summit West CSA 54, and Graham Hill CSA 57 operations.

Component units are included in our basic financial statements and consist of legally separate entities for which the County is financially accountable and that have substantially the same board as the County or provide services entirely to the County. The Santa Cruz County Sanitation District is reported as a discretely presented component unit of the County. The District is managed by the County Department of Public Works and provides sanitation services to the unincorporated areas of the County.

Fund Financial Statements

The fund financial statements are designed to report information about groupings of related accounts which are used to maintain control over resources that have been segregated for specific activities or objectives. The County, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the County can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements—i.e. most of the County's basic services are reported in governmental funds. These statements, however, focus on (1) how cash and other financial assets can readily be converted to available resources and (2) the balances left at year-end that are available for spending. Such information may be useful in determining what financial resources are available in the near future to finance the County's programs.

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

The County maintains several individual governmental funds organized according to their type (general, special revenue, debt service, and capital projects). Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures, and changes in fund balances for the general fund and the Redevelopment Agency, which are considered to be major funds. Data from the remaining governmental funds are combined into a single, aggregated presentation. Individual fund data for each of the non-major governmental funds is provided in the form of combining statements elsewhere in this report.

The County adopts an annual appropriated budget. The budget is a compilation of operating budgets from individual functional units within the General Fund, Special Revenue Funds, Capital Projects Funds, and Proprietary Funds (operating plans). Budgets are adopted for all funds except for Debt Service Funds and certain special revenue funds, namely, Public Finance Authority, General Assessments, and Health Realignment Funds. A budgetary comparison schedule has been provided for the General Fund and Special Revenue-Redevelopment Agency to demonstrate compliance with these budgets.

Proprietary funds are generally used to account for services for which the County charges customers—either outside customers, or internal units or departments of the County. Proprietary funds provide the same type of information as shown in the government-wide financial statements, only in more detail. The County maintains the following two types of proprietary funds:

- **Enterprise funds** are used to report the same functions presented as business-type activities in the government-wide financial statements. The County uses enterprise funds to account for the operations of the County include the County Disposal Sites CSA 9, and the following Board of Supervisor Governed Districts -Boulder Creek CSA 7, Rolling Woods CSA 10, Septic Tank Maintenance CSA 12, Freedom County Sanitation District, Davenport Sanitation District, Place de Mer CSA 2, Sand Dollar Beach CSA 5, Trestle Beach CSA 20, Summit West CSA 54, and Graham Hill CSA 57 operations.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

- **Internal Service funds** are an accounting device used to accumulate and allocate costs internally among the County's various functions. The County uses internal service funds to account for its central duplicating, information services, public works, service center, and self-insurance (risk management, dental and health, liability and property, workers' compensation, employee benefit staffing, and state unemployment insurance) functions. Because these services predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements. The internal service funds are combined into a single, aggregated presentation in the proprietary fund financial statements. Individual fund data for the internal service funds is provided in the form of combining statements elsewhere in this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the County. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the County's own programs. The fiduciary funds the County maintains are agency funds. Since agency funds are custodial in nature (i.e., assets equal liabilities), they do not involve the measurement of results of operations.

Notes to the Basic Financial Statements

The notes to the basic financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Required Supplementary Information (other than MD&A)

In addition to the basic financial statements and accompanying notes, this report presents certain required supplementary information concerning the County's general fund budgetary comparison schedule and progress in funding its obligation to provide pension benefits to its employees.

Combining Statements and Schedules

The combining and individual fund statements and schedules referred to earlier in connection with non-major governmental funds, enterprise and internal service funds, and fiduciary funds are presented immediately following the required supplementary information.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

GOVERNMENT-WIDE FINANCIAL ANALYSIS

Net Assets

	<u>Governmental Activities</u>		<u>Business-type Activities</u>		<u>Total</u>		<u>Variance (%)</u>
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	
Assets:							
Current and other assets	\$256,681,497	\$254,297,579	\$19,033,914	\$23,763,717	\$275,715,411	\$278,061,296	(0.84)
Capital assets	<u>131,336,916</u>	<u>97,331,950</u>	<u>23,798,416</u>	<u>22,342,521</u>	<u>155,135,332</u>	<u>119,674,471</u>	29.63
Total assets	<u>388,018,413</u>	<u>351,629,529</u>	<u>42,832,330</u>	<u>46,106,238</u>	<u>430,850,743</u>	<u>397,735,767</u>	8.33
Liabilities:							
Current and other liabilities	125,623,053	113,760,969	1,756,605	1,817,410	127,379,658	115,578,379	10.21
Long-term liabilities	<u>196,716,222</u>	<u>174,174,014</u>	<u>5,329,930</u>	<u>4,678,669</u>	<u>202,046,152</u>	<u>178,852,683</u>	12.97
Total liabilities	<u>322,339,275</u>	<u>287,934,983</u>	<u>7,086,535</u>	<u>6,496,079</u>	<u>329,425,810</u>	<u>294,431,062</u>	11.89
Net assets:							
Invested in capital assets, net of related debt	46,942,253	43,068,978	21,424,864	20,301,446	68,367,117	63,370,424	7.88
Restricted net assets	16,191,546	19,585,321	308,058	277,013	16,499,604	19,862,334	(16.93)
Unrestricted net assets	<u>2,545,339</u>	<u>1,040,247</u>	<u>14,012,873</u>	<u>19,031,700</u>	<u>16,558,212</u>	<u>20,071,947</u>	(17.51)
Total net assets	<u>\$ 65,679,138</u>	<u>\$ 63,694,546</u>	<u>\$35,745,795</u>	<u>\$39,610,159</u>	<u>\$101,424,933</u>	<u>\$103,304,705</u>	(1.82)

Analysis of Net Assets

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. For the County, assets exceeded liabilities by \$101,424,933 at the close of the current fiscal year.

The largest portion of the County's net assets \$68,367,117 (67.4%) reflects its investment in capital assets (e.g. land, building and structures, and equipment), less any related debt used to acquire those assets that is still outstanding. The County uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the County's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the County's net assets, \$16,499,604 (16.3%) represents resources that are subject to external restrictions on how they may be used.

The remaining (16.3%) represents the unrestricted net assets, \$16,558,212 which may be used to meet the government's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the County reported positive balances in all three categories of net assets, both for the County as a whole, as well as for its separate governmental activities.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Changes in Net Assets

	Governmental Activities		Business-type Activities		Total		
	2004	2003	2004	2003	2004	2003	Variance (%)
Revenues:							
Program revenues:							
Charges for services	\$ 63,997,734	\$ 57,282,985	\$12,184,964	\$10,923,487	\$ 76,182,698	\$ 68,206,472	11.69
Operating grants and contri.	184,463,919	188,238,700	320,418	389,260	184,784,337	188,627,960	(2.04)
Capital grants and contri.	-	-	1,619	9,224	1,619	9,224	(82.45)
General revenues:							
Property taxes	64,880,739	58,190,576	-	-	64,880,739	58,190,576	11.50
Other taxes	14,211,827	13,069,921	-	-	14,211,827	13,069,921	8.74
Interest and investment income	3,672,892	5,423,752	293,205	517,153	3,966,097	5,940,905	(33.24)
Miscellaneous	10,953,731	9,775,877	642,167	512,796	11,595,898	10,288,673	12.71
Total revenues	<u>342,180,842</u>	<u>331,981,811</u>	<u>13,442,373</u>	<u>12,351,920</u>	<u>355,623,215</u>	<u>344,333,731</u>	3.28
Expenses:							
General government	25,065,854	23,334,622	-	-	25,065,854	23,334,622	7.42
Public protection	115,996,350	106,222,864	-	-	115,996,350	106,222,864	9.20
Health and sanitation	81,903,397	75,039,192	-	-	81,903,397	75,039,192	9.15
Public assistance	83,909,463	86,609,599	-	-	83,909,463	86,609,599	(3.12)
Education	3,926,053	3,469,990	-	-	3,926,053	3,469,990	13.14
Recreation and culture	7,948,990	8,125,177	-	-	7,948,990	8,125,177	(2.17)
Public ways and facilities	41,229,761	31,029,943	-	-	41,229,761	31,029,943	32.87
Interest on long-term debt	8,453,032	8,742,496	-	-	8,453,032	8,742,496	(3.31)
County Disposal Sites CSA	-	-	12,381,318	12,260,297	12,381,318	12,260,297	0.99
Boulder Creek CSA	-	-	326,541	396,283	326,541	396,283	(17.60)
Rolling Woods CSA	-	-	46,093	62,643	46,093	62,643	(26.42)
Septic Tank Maintenance CSA	-	-	793,196	718,478	793,196	718,478	10.40
Freedom County Sanitation Distr.	-	-	551,016	530,424	551,016	530,424	3.88
Davenport Sanitation District	-	-	401,144	378,715	401,144	378,715	5.92
Place de Mer CSA	-	-	35,668	64,456	35,668	64,456	(44.66)
Sand Dollar Beach CSA	-	-	148,206	211,602	148,206	211,602	(29.96)
Trestle Beach CSA	-	-	25,734	33,280	25,734	33,280	(22.67)
Summit West CSA	-	-	3,937	3,541	3,937	3,541	11.18
Graham Hill CSA	-	-	7,142	7,481	7,142	7,481	(4.53)
Total expenses	<u>368,432,900</u>	<u>342,573,883</u>	<u>14,719,995</u>	<u>14,667,200</u>	<u>383,152,895</u>	<u>357,241,083</u>	7.25
Change in net assets	(26,252,058)	(10,592,072)	(1,277,622)	(2,315,280)	(27,529,680)	(12,907,352)	(113.29)
Restated net assets, beginning	63,694,546	73,605,387	39,610,159	41,925,439	103,304,705	115,530,826	(10.58)
Prior period adjustment	<u>28,236,650</u>	<u>681,231</u>	(2,586,742)	-	<u>25,649,908</u>	<u>681,231</u>	3,665.23
Net assets, ending	<u>\$ 65,679,138</u>	<u>\$ 63,694,546</u>	<u>\$35,745,795</u>	<u>\$39,610,159</u>	<u>\$101,424,933</u>	<u>\$103,304,705</u>	(1.82)

Analysis of Changes in Net Assets

The County's net assets decreased by \$27,529,680 (exclusive of prior period adjustment) during the current fiscal year. These decreases are explained in the government and business-type activities discussion below.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Governmental activities. Governmental activities decreased the County's net assets by \$26,252,058, thereby accounting for 95% of the total decrease in net assets of the County. Key elements of this decrease are as follows:

- Interest and investment income – the result of historically low returns on short-term investments coupled with the expenditure of one-time funds on capital infrastructure projects and the Vehicle In Lieu Tax Loan to the State of California (\$4 million).
- Miscellaneous income – mostly attributed to reimbursements from the In Home Support Services Authority for payroll.
- General government expenditures – the result of increased election and communication expenses.
- Education expenditures – the result of a prior period adjustment providing additional tax revenues that were appropriated and expended.
- Public ways and facilities expenditures – the result of completion of several major capital infrastructure projects in the prior fiscal year.
- Interest on long-term debt – the result of refunding the Redevelopment Agency Tax Allocation bonds, 1993 Series A and B, for lower interest rates.

Business-type activities. Business-type activities decreased the County's net assets by \$1,277,622. Key elements of this decrease are as follows:

- Boulder Creek CSA – the result of decreased labor costs and plant improvements in prior year.
- Septic Tank Maintenance CSA – the result of increased labor and technology costs, and disposal fees.
- Place de Mer CSA – the result of a decrease in the service level.
- Sand Dollar CSA – the result of a decrease in the service level.

FINANCIAL ANALYSIS OF THE COUNTY'S FUNDS

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

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Governmental Funds

The focus of the County's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the County's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year. Types of governmental funds reported by the County include the General Fund, Special Revenue Funds, Debt Service Funds, and Capital Project Funds.

At June 30, 2004, the County's governmental funds reported combined ending fund balances of \$153,247,427, a decrease of \$11,402,736 (exclusive of change in reserve for inventories) in comparison with the prior year. Approximately 68% or \$103,740,322 of the combined ending fund balances constitutes unreserved fund balance, which is available to meet the County's current and future needs, of which \$22,403,352 is available to the County's General Fund. The remainder of fund balance is reserved to indicate that it is not available for new spending because it has been committed: (1) to pay debt service \$9,930,109; (2) to fund fixed asset acquisition \$10,086,716; (3) to liquidate contractual commitments of the period \$21,759,953; (4) for a variety of other purposes \$7,730,327.

Revenues for governmental functions totaled \$342,816,068 in fiscal year 2003-2004, which represents an increase of \$11,510,670 or 3.47% from fiscal year 2002-2003. Expenditures for governmental functions, totaling \$357,008,532 increased by \$9,788,408 or 2.82% from the fiscal year 2002-2003. In the fiscal year 2003-2004, expenditures for governmental functions exceeded revenues by \$14,192,464.

The general fund is the primary operating fund of the County. At June 30, 2004, unreserved fund balance of the general fund was \$19,137,624 while its total fund balance was \$22,403,352. The undesignated portion plus encumbrances totaled \$14,610,203 and were used to finance the 2004-05 budget. As a measure of the general fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved general fund balance represents 7% of total general fund expenditures of \$282,216,435, while its total fund balance represents 8% of that same amount. The unreserved portion of the general fund balance reflects budget savings, without which would necessitate further budgetary reductions.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

The following table presents the amount of revenues from various sources as well as increases or decreases from the prior year.

Revenues Classified by Source
Governmental Funds

<u>Revenues by Source</u>	<u>FY 2004</u>		<u>FY 2003</u>		<u>Increase/(Decrease)</u>	
	<u>Amount</u>	<u>% of Total</u>	<u>Amount</u>	<u>% of Total</u>	<u>Amount</u>	<u>% of Change</u>
Taxes	\$ 79,092,566	23.07	\$ 71,260,497	21.51	\$ 7,832,069	10.99
Licenses	9,013,130	2.63	7,776,634	2.35	1,236,496	15.90
Fines, forfeitures and penalties	5,198,755	1.52	4,312,197	1.30	886,558	20.56
Use of money and property	3,672,892	1.07	5,423,752	1.64	(1,750,860)	(32.28)
Aid from other governmental agencies	184,744,588	53.89	187,134,942	56.48	(2,390,354)	(1.28)
Charges for current services	49,785,849	14.52	45,194,154	13.64	4,591,695	10.16
Other revenues	<u>11,308,288</u>	<u>3.30</u>	<u>10,203,222</u>	<u>3.08</u>	<u>1,105,066</u>	<u>10.83</u>
Totals	<u>\$342,816,068</u>	<u>100.00</u>	<u>\$331,305,398</u>	<u>100.00</u>	<u>\$11,510,670</u>	<u>3.47</u>

The following provides an explanation of revenues by source that changed significantly from the prior year.

- Taxes – the result of growth in secured property taxes, defaulted redemption penalties, and deed transfer taxes.
- Licenses – the result of an increase in construction permit activity.
- Fines, forfeitures and penalties – the result of an audit adjustment to realign distributions among participating agencies.
- Use of money and property – a major decline in the reinvestment rates earned on the Treasurer's Pooled Investments. Rates dropped from 6.276% to 3.279% during 2001-02, a decrease of 2.997%. In 2002-2003 the rates decreased by 1.291% from the prior year down to 1.988%. For fiscal year 2003-2004, the rate was 1.299%, reflecting a continuing decline of 0.689%.
- Charges for current services – the result of a general increase in fees due to the loss of the utility tax, including street improvement fees of \$1 million, recordation fees and jail booking fees.
- Other revenues – the result of contributions from other funds for the mold removal project at the new health services facility on the Emeline Avenue campus.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

The following table presents expenditures by function compared to prior year amounts.

Expenditures Classified by Function
Governmental Funds

<u>Expenditures by Function</u>	<u>FY 2004</u>		<u>FY 2003</u>		<u>Increase/(Decrease)</u>	
	<u>Amount</u>	<u>% of Total</u>	<u>Amount</u>	<u>% of Total</u>	<u>Amount</u>	<u>% of Change</u>
General government	\$ 23,638,513	6.62	\$ 20,886,273	6.01	\$2,752,240	13.18
Public protection	105,349,946	29.51	101,844,827	29.33	3,505,119	3.44
Health and sanitation	83,237,724	23.31	73,562,270	21.19	9,675,454	13.15
Public assistance	85,584,648	23.97	85,112,340	24.51	472,308	0.55
Education	4,016,639	1.13	3,421,184	0.99	595,455	17.40
Recreation and culture	7,917,550	2.22	7,916,680	2.28	870	0.01
Public ways and facilities	26,519,216	7.43	28,944,355	8.34	(2,425,139)	(8.38)
Capital outlay	5,417,219	1.52	10,681,308	3.08	(5,264,089)	(49.28)
Debt service-bond redemption	4,512,403	1.26	5,329,686	1.53	(817,283)	(15.33)
Debt service-issue cost	2,117,335	0.59	267,107	0.08	1,850,228	692.69
Debt service-interest and fiscal charges	<u>8,697,339</u>	<u>2.44</u>	<u>9,254,094</u>	<u>2.66</u>	<u>(556,755)</u>	<u>(6.02)</u>
Totals	<u>\$357,008,532</u>	<u>100.00</u>	<u>\$347,220,124</u>	<u>100.00</u>	<u>\$9,788,408</u>	<u>2.82</u>

The following provides an explanation of expenditures by function that changed significantly from the prior year.

- General government – increase due to purchase of the Animal Authority Services building and various equipment financed through the Public Financing Authority.
- Health and sanitation – the result of increased labor costs due to contract and retirement rate increases, increased outside medical services, and increased overhead charges.
- Public ways and facilities – the result of completion of several major infrastructure capital projects in the prior year.
- Capital outlay – the decrease reflects the reduction of expenditures for the road pavement improvement program.
- Debt Service bond redemption – the decrease is due to the refunding of the Redevelopment Agency 1993 Revenue Bonds (Tax Allocation), Series A and Series B (refunded by the 2003 Tax Allocation Refunding Bonds), and decreased debt service payments.
- Debt Service bond issue cost – the increase reflects bond issue costs related to the 2004 Certificates of Participation, and the Redevelopment Agency 2003 Tax Allocation Refunding Bonds.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Other financing sources and uses are presented below to illustrate changes from the prior year:

Other Financing Sources (Uses)
Governmental Funds

	FY 2004		FY 2003		Increase/(Decrease)	
	Amount	% of Total	Amount	% of Total	Amount	% of Change
Sale of capital assets	\$ 4,790	0.17	\$ 3,408	0.12	\$ 1,382	40.55
Proceeds from long-term debt	23,000,000	824.45	-	-	23,000,000	-
Premium on long-term debt	27,378	0.98	192,196	6.75	(164,818)	(85.76)
Discount on long-term debt	(194,382)	(6.97)	-	-	(194,382)	-
Proceeds from refunding bonds	48,435,000	1,736.19	8,377,728	294.26	40,057,272	478.14
Payments to bond refunding escrow agent	(46,392,100)	(1,662.96)	(5,726,315)	(201.13)	(40,665,785)	(710.16)
Transfers in	37,818,604	1,355.64	42,696,585	1,499.70	(4,877,981)	(11.42)
Transfers out	(60,018,604)	(2,151.41)	(42,696,585)	(1,499.70)	(17,322,019)	(40.57)
Inception of lease purchase agreement	<u>109,042</u>	<u>3.91</u>	<u>-</u>	<u>-</u>	<u>109,042</u>	<u>-</u>
Totals	<u>\$ 2,789,728</u>	<u>100.00</u>	<u>\$ 2,847,017</u>	<u>100.00</u>	<u>(\$ 57,289)</u>	<u>(2.01)</u>

The current year excess of revenues and other financing sources over expenditures and other financing uses is presented below:

Statement of Revenues, Expenditures, and Changes in Fund Balances
Governmental Funds

	Major Funds		Nonmajor Funds			Total
	General Fund	Redevelopment Agency	Special Revenue Fund	Debt Service Fund	Capital Projects Funds	
Revenues	\$278,655,091	\$17,284,353	\$43,596,320	\$ 322,010	\$ 2,958,294	\$342,816,068
Expenditures	(282,216,435)	(9,191,442)	(52,143,899)	(8,039,537)	(5,417,219)	(357,008,532)
Net other financing Sources (uses)	(<u>5,733,506</u>)	(<u>5,101,449</u>)	<u>6,644,992</u>	<u>6,949,967</u>	<u>29,724</u>	<u>2,789,728</u>
Net change in fund balances	(9,294,850)	2,991,462	(1,902,587)	(767,560)	(2,429,201)	(11,402,736)
Fund balances, beginning	31,693,524	71,297,235	41,732,152	6,872,390	13,050,184	164,645,485
Change in fund balances reserved for inventories	<u>4,678</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,678</u>
Fund balances, ending	<u>\$ 22,403,352</u>	<u>\$74,288,697</u>	<u>\$39,829,565</u>	<u>\$6,104,830</u>	<u>\$10,620,983</u>	<u>\$153,247,427</u>

The decrease in the County's general fund balance of \$9,294,850 (excluding change in reserve for inventories) during the fiscal year was explained above under the caption Analysis of Changes in Net Assets which shows the use of the Federally Qualified Health Facilities reserve of \$475,000, and the loss of both the Utility User Tax and \$4,000,000 Motor Vehicle In-Lieu tax loan to the State.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Proprietary Funds

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

The County Disposal Sites CSA had total net assets of \$27,651,906 at June 30, 2004 of which \$11,576,079 is unrestricted. The \$828,559 (excluding prior period adjustment) total decrease in net assets for the County Disposal Sites CSA is discussed below.

The following table shows the Enterprise Funds' actual revenues, expenses and results of operations for the current fiscal year:

	<u>Major Fund</u> County Disposal Sites CSA	Nonmajor Funds	<u>Total</u>
Operating revenues	\$10,544,333	\$2,235,106	\$12,779,439
Operating expenses	(<u>11,506,347</u>)	(<u>2,229,671</u>)	(<u>13,736,018</u>)
Operating loss	(962,014)	5,435	(956,579)
Net non-operating revenues (expenses)	<u>133,455</u>	<u>93,402</u>	<u>226,857</u>
Net income (loss) before contributions	(828,559)	98,837	(729,722)
Capital contributions	<u>-</u>	<u>1,619</u>	<u>1,619</u>
Change in net assets	(\$ <u>828,559</u>)	\$ <u>100,456</u>	(\$ <u>728,103</u>)

The net loss before contributions of the enterprise funds of \$729,722 is primarily attributable to the County Disposal Sites CSA. The negative change in net assets for the County Disposal Sites CSA, reflects reduced gate fees due to the waste diversion program, purchase of capital equipment, and increased operating expenditures.

The internal service funds' activities attributable to the enterprise funds amounts to a decrease in net assets of \$2,231,977.

GENERAL FUND BUDGETARY HIGHLIGHTS

After the adoption of the final budget, the budget was increased due to additional financial resources made available from State and Federal Agencies, totaling about \$12.5 million. While the budget was amended, the actual expenditures were \$8.2 million less than the original budget, excluding appropriations for general contingencies. The 2003-04 total expenditures were \$11.7 million (excluding operating transfers applicable to the Extended Police Protection-CSA 38) greater than the prior fiscal year or 4%. The increase was mostly attributed to the increased cost of labor agreements with non-management and law enforcement employees. These increased expenditures were financed with a budget reduction of 152 budgeted positions from the prior fiscal year, cutting all new spending on capital projects, focusing on revenue maximization, and hiring controls through out the fiscal year.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

The original budget estimates for revenues were \$7.7 million under budget but this resulted in a favorable outcome of about \$.5 million. During the prior period, reserves decreased by \$8.2 million and the undesignated fund balance decreased by \$644,939. The decrease in the designated reserves reflected the \$4 million loan to the State of California to offset the gap in revenue from the motor vehicle in lieu taxes. The decline in the undesignated fund balance reflected largely on lower salary savings and the recession. Designations and Undesignated Reserve balances reflect a total decline of \$8.9 million.

For additional information, readers should refer to the letter of transmittal.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The County's capital assets for its governmental and business-type activities as of June 30, 2004, totaled \$155,135,332 (net of accumulated depreciation). This investment in capital assets includes land, construction in progress, infrastructure, buildings and structures, and equipment. The increase in the County's restated investment in capital assets for the current period was \$16,899,335 or 7%.

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

- Infrastructure increased by \$9,715,390, mostly due to governmental activities for Public Works projects.
- Buildings and structures increased by \$6,984,540, due to business-type activities of \$4,740,942 for the recycling center at the refuse site and \$2,243,598 of governmental activities for various buildings and the jail facilities.

For government-wide financial statement presentation, all depreciable capital assets were depreciated from acquisition date to the end of the current fiscal year. Fund financial statements record capital asset purchases as expenditures.

Capital assets for the governmental and business-type activities are presented below to illustrate changes from the prior year:

	<u>Governmental Activities</u>		<u>Business-type Activities</u>		<u>Total</u>		<u>Increase/ (Decrease) % of Change</u>
	<u>2004</u>	<u>Restated 2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>Restated 2003</u>	
Land	\$ 31,780,653	\$ 31,780,653	\$ 1,858,849	\$ 1,858,849	\$ 33,639,502	\$ 33,639,502	- .
Construction in progress	870,501	- .	- .	- .	870,501	- .	- .
Infrastructure	41,157,813	31,442,423	- .	- .	41,157,813	31,442,423	30.90
Buildings and structures	94,046,031	91,802,433	28,643,462	23,902,520	122,689,493	115,704,953	6.04
Equipment	<u>46,709,528</u>	<u>47,546,612</u>	<u>8,646,820</u>	<u>8,480,832</u>	<u>55,356,348</u>	<u>56,027,444</u>	(1.20)
Total	<u>\$214,564,526</u>	<u>\$202,572,121</u>	<u>\$39,149,131</u>	<u>\$34,242,201</u>	<u>\$253,713,657</u>	<u>\$236,814,322</u>	7.14

Additional information on the County's capital assets can be found in Note 5 on pages 64-65 of this report.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

Long-term debt

The County's long-term debt for governmental and business-type activities are presented below to illustrate changes from the prior year:

	<u>Governmental Activities</u>		<u>Business-type Activities</u>		<u>Total</u>		<u>Increase/ (Decrease) % of Change</u>
	Restated		Restated		Restated		
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	
Tax allocation bonds	\$110,815,618	\$109,050,000	\$ -	\$ -	\$110,815,618	\$109,050,000	1.62
Refunding certificates of participation	27,177,022	28,286,230	-	-	27,177,022	28,286,230	(3.92)
Lease revenue bonds	10,595,000	11,300,000	-	-	10,595,000	11,300,000	(6.24)
Lease revenue refunding bonds	15,064,406	16,459,008	-	-	15,064,406	16,459,008	(8.47)
Certificates of participation	23,027,378	-	-	-	23,027,378	-	100.00
Revenue bonds	3,565,000	3,870,000	-	-	3,565,000	3,870,000	(7.88)
CA Health Facility	1,382,106	1,521,732	-	-	1,382,106	1,521,732	(9.18)
Loans payable	2,887,106	3,672,748	2,373,552	2,949,832	5,260,658	6,622,580	(20.56)
Capital leases	670,861	927,874	-	-	670,861	927,874	(27.70)
Local assessment bonds	<u>40,000</u>	<u>75,000</u>	<u>-</u>	<u>-</u>	<u>40,000</u>	<u>75,000</u>	(46.67)
Totals	<u>\$195,224,497</u>	<u>\$175,162,592</u>	<u>\$2,373,552</u>	<u>\$2,949,832</u>	<u>\$197,598,049</u>	<u>\$178,112,424</u>	10.94

For the governmental activities, the County had total long-term debt outstanding of \$195,224,497 as compared to \$173,481,480 (as restated) in the prior year (excluding compensated absence and estimated claims). This amount was comprised of \$110,815,618 of Redevelopment Agency Tax Allocation Bonds, \$27,177,022 of refunding certificates of participation, \$10,595,000 of lease revenue bonds, \$15,064,406 of lease revenue refunding bonds, \$23,027,378 of certificates of participation, \$3,565,000 of revenue bonds, \$1,382,106 of California Health facilities financing authority debt, \$2,887,106 of loans payable, \$670,861 of capital leases, and \$40,000 of local assessment bonds. During the year, retirement of debt amounted to \$51,315,133, and new debt issuance amounted to \$71,377,038.

For the business-type activities, the County had total long-term debt outstanding of \$2,373,552 as compared to \$2,949,832 (as restated) in the prior year (excluding postclosure liability). This amount was all loans payable. During the year, retirement of debt amounted to \$576,280. There were no additions to long-term debt for business-type activities.

The component unit, Santa Cruz County Sanitation District, had total long-term debt outstanding of \$30,392,736 as compared to \$31,788,687 in the prior year. This amount was comprised of \$4,005,000 of Revenue Bonds, \$1,125,000 of Limited Obligation Improvement Bonds, \$5,905,000 of Certificates of Participation, \$19,430,498 of loans payable less \$72,762 of unamortized discount. During the year, retirement of debt amounted to \$1,395,951. There were no additions to long-term debt for the component unit.

COUNTY OF SANTA CRUZ, CALIFORNIA
Management's Discussion and Analysis
Year Ended June 30, 2004

The County's total debt increased by \$19,485,625 (or 11%) during the current fiscal year (excluding compensated absence, estimated claims, and postclosure liability). The key factor in this increase resulted primarily from the scheduled principal payments and the new settlement bonds issued to pay the plaintiffs of the 1998 Pajaro River Flood an amount of \$22 million. The County Government Center was used as collateral for the financing over 20 years.

Additional information on the County's long-term debt can be found in Note 9 on pages 68-79 of this report.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET AND RATES

- The County financial position is presently in line with the budgetary parameters set by the Board of Supervisors and as amended for the 2003-2004 fiscal year. However, the General Fund's ending undesignated year end fund balance is estimated to be less than the prior year due to fewer vacant positions and the salary and employee benefit increases approved by the Board of Supervisors for the County's General Representation Group of Employees and Public Safety Employees.
- Real property assessment at January 1, 2004 showed an average increase of 6.95% over the prior year, and property tax growth is expected to continue in the new fiscal year.
- Sales tax revenue is expected to increase slightly due to continued consumer confidence as the economy continues to recover. However, our budget estimates were held flat for 2003-04 and we anticipate achieving that estimate for the fiscal year.
- The financial deficits of the State of California have shifted financial responsibilities to local agencies. The State has failed to reimburse counties for state mandated programs for the prior and current fiscal years without any promise of when or if these owed monies will ever be repaid. To track monies owed to the county by the State, accounts receivables have been established with offsetting reserves in the event that the State fails to carry out its obligations. At year end \$2.3 million was designated.
- Substantial State budget cuts are now known for fiscal year 2004-05. The County made significant budget cuts resulting in the elimination of 118 positions.
- During fiscal year 2003-04, unreserved fund balance in the general fund decreased to \$19,137,624. The County has appropriated the full amount for spending in the 2004-05 fiscal year budget and is expected to end the fiscal year with a \$22 million balance remaining.
- On October 5, the County adopted the final budget for the 2004-2005 fiscal year. Due to slow economic growth in revenues and projected increased labor costs, departments submitted budgets that reflect minor increases or no increase in the net cost to the county and provided for no new capital fixed asset acquisitions.
- For further discussion, please see the accompanying transmittal letter.

REQUESTS FOR INFORMATION

This financial report is designed to provide a general overview of the County's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Auditor-Controller's Office, County of Santa Cruz, 701 Ocean Street, Room 100, Santa Cruz, CA 95060.