MANAGEMENT'S DISCUSSION AND ANALYSIS

September 30, 2006

(Dollar amounts expressed in thousands)

This Management's Discussion and Analysis (MD&A) provides a narrative overview and analysis of the financial activities of the District of Columbia (the District) for the fiscal year ended September 30, 2006. This discussion and analysis should be read in conjunction with the basic financial statements and the related note disclosures, which follow this discussion on pages 37 through 98. In addition, it is important to also read the Transmittal Letter, which begins on page 1, in conjunction with the MD&A.

OVERVIEW OF THE FINANCIAL STATEMENTS

The District's basic financial statements are comprised of three components:

(1) *Government-Wide Financial Statements* - Exhibit 1-a, *Statement of Net Assets,* and Exhibit 1-b, *Statement of Activities* on pages 38 and 39 respectively, present information about the financial activities of the District as a whole. These two statements provide an overall view of the District's finances.

(2) *Governmental Fund Financial Statements* - Exhibit 2-a, *Balance Sheet – Governmental Funds,* Exhibit 2-b, *Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds,* Exhibit 2-c, *Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances of Governmental Funds to the Statement of Activities*, and Exhibit 2-d, *Budgetary Comparison Statement* on pages 40, 41, 42, and 43, respectively, show the District's financial position at the end of the fiscal year and how governmental activities were financed during the current year.

The fund financial statements focus on the most significant District funds and present operations in more detail. The fiduciary funds report activities for which the District acts exclusively as a trustee or agent for the benefit of entities or individuals external to the government.

(3) *Notes To The Basic Financial Statements* - Present additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements, and can be found on pages 51 through 98.

FINANCIAL HIGHLIGHTS

- In the government-wide analysis, assets exceeded liabilities, resulting in total net assets of $2,508,355. The total net assets consisted of *net assets invested in capital assets, net of related debt* of $975,988; *restricted net assets* of $1,335,588; and *unrestricted net assets* of $196,779. The total government-wide net assets included $2,114,026 generated by governmental activities and $394,329 generated by business-type activities.

- There was an increase of $383,647 over the previous year in the government-wide total net assets. This increase is attributable to a $1,576,519 increase in total assets, which was offset by an increase in total liabilities of $1,192,872. The increased collection of taxes and other revenues accounted for the majority of this increase. (See Table 1, *Net Assets as of September 30, 2006* on page 22.)

- The governmental funds reported a combined fund balance of $2,489,622 which was an increase of $880,659 over the previous year. The fund balance of the general fund was $1,435,142 or 57.6% of the combined fund balances, and represented a decrease of $(149,541) over the previous year. This reduction was due to management's decision to use $528.4 million to finance various projects such as: $252.7 million in capital improvements; $138.0 million for other post employment benefits and $75.2 million for advancement in health care, education, and the arts and humanities.

- $1,045,560 of the general fund's fund balance is reserved for specific purposes: $293,649 is legally set aside for emergencies and contingencies, $262,640 for bond escrow, and $87,987 for PAYGO capital, with $401,284 reserved for other purposes. Of the $389,582 unreserved general fund's fund balance, $41,473 is designated for other post employment benefits, $73,784 for school modernization, and $136,320 for other special purposes, with $138,005 remaining undesignated and available for use.

- Total long-term debt related to notes and bonds increased by $929,191, or 21.9%. There was a net increase of $141,665 in general obligation debt, a new issuance of Ballpark Bonds in the amount of $534,800 and an increase of $252,726 in other debt. (Table 4, *Outstanding Bonds and Notes at September 30, 2006*, page 30).

NEW GASB PRONOUNCEMENTS

GASB Statement No. 45

In July 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related assets and liabilities, note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers.

GASB Statement No. 45 does not become effective for the District until FY2008. The District plans to implement this Statement on or before the effective date.

GASB Statement No. 46

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation.* This Statement requires that limitations on the use of net assets, imposed by enabling legislation, be reported as restricted net assets. Statement No. 46 clarifies that a legally enforceable enabling legislation restriction is one that a party external to the government – such as citizens, public interest groups, or the judiciary – can compel a government to honor. The Statement requires that the legal enforceability of an enabling legislation be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation, or if the government has other cause for consideration.

The District implemented the requirements of this Statement in fiscal year 2002, prior to its effective date. GASB Statement No. 46 became effective for the District in FY2006.

GASB Statement No. 47

In June 2005, GASB issued Statement No 47, *Accounting for Termination Benefits.* This Statement requires that in the period in which an employer becomes obligated for termination benefits, and in any additional period in which employees are required to render future service in order to receive involuntary termination benefits, the employer should disclose the following: 1) a description of the termination benefit arrangements, 2) the cost of the termination benefits, 3) a disclosure of whether termination benefits are measured at the discounted present value, and, 4) if the expected benefits are not estimable, the employer should disclose that fact. The provisions of this Statement need not be applied to immaterial items.

GASB Statement No. 47 became effective for the District in FY2006. The District has implemented this Statement.

GASB Statement No. 48

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.* Governments sometimes exchange an interest in their expected cash flows from specific receivables or specific revenues, for immediate cash payments – generally, a single lump sum. This Statement establishes criteria that governments will use to ascertain whether the proceeds should be reported as revenue or as a liability. This Statement also includes guidance to be used for recognizing other assets and liabilities arising from a sale of specific receivables or future revenue, including residual interests and recourse provisions. The requirements in this Statement improve financial reporting by establishing measurement, recognition, and disclosure requirements that apply to both governmental and business-type activities.

GASB Statement No. 48 does not become effective for the District until FY2008. The District has begun the implementation of this Statement.

THE DISTRICT'S FINANCIAL CONDITION

The District government's level of financial responsibility and performance can be measured in various ways. Below are some of the indicators of the District's improved financial position:

- The total expenditures for the District were again within budget.
- The general fund ended the year with a budgetary surplus of $325,162. After deducting the use of fund balance released from restrictions and other adjustments required by generally accepted accounting principles (GAAP), the non-budgetary or GAAP deficit was $(149,541).
- The accumulated general fund fund balance at September 30, 2006 was $1,435,142.
- The required legal debt limitation allows the District to use up to 17.0% of its total revenues for debt service in FY2006. However, the District's debt service cost was only 7.4% of total revenues, or about 43.8% of the legal limit.
- The District continues to allocate large amounts of funds for infrastructure assets.

Reporting the District as a Whole (Government-Wide Financial Statements)

The District, as a whole, reports all assets and liabilities using the *accrual basis of accounting*. This method of reporting is similar to the accounting method used by most private-sector companies. Under this basis of accounting, all of the current year's financial activities are taken into account regardless of when cash is received or paid. The governmental activities and business-type activities are presented in two separate columns and combined to show totals for the primary government. The *Statement of Net Assets* and the *Statement of Activities* are two statements that present information and activities that help the reader determine the overall financial condition of the District.

The District's current financial resources (short-term disposable resources) are reported along with capital assets and long-term obligations in the *Statement of Net Assets*. The *Statement of Net Assets* presents information on all of the District's assets and liabilities, with the difference between the two reported as *net assets*. This statement distinguishes between governmental activities, business-type activities and component units' activities.

The total net assets is the sum of three components: 1) *net assets invested in capital assets, net of related debt, 2) restricted net assets,* and *3) unrestricted net assets.* Over time and accounting periods, changes in the District's net assets are an indicator of its financial health. However, changes in population, property tax base, infrastructure condition and other non-financial factors must also be considered in assessing the overall financial health of the District.

The *Statement of Activities* presents information showing how the government's net assets changed from the last 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 reported in this statement also include items that will only result in cash flows in future fiscal periods, (for example, uncollected taxes and earned but unused vacation leave).

The *Statement of Activities* summarizes both the gross and net cost of the governmental activities and business-type activities. Governmental activities show the District's basic functional services while business-type activities reflect enterprise operations where fees for services are expected to cover all or most of the costs of operations, including depreciation. Program/functional expenses are reduced by program specific earned revenues, and by grants, that reduce net expenses for governmental and business-type activities. The District's general revenues (property, sales, income and franchise taxes) offset remaining costs, resulting in an increase or decrease in net assets.

Financial Analysis of the Government as a Whole (Government-Wide Financial Statements)

In fiscal year 2006, the combined total net assets increased by $383,647. This increase is the combination of a governmental activities increase of $363,362 and a business-type activities increase of $20,285. See Table 2, Change in Net Assets as of

September 30, 2006, on page 23. The increased collection of taxes and other revenues accounted for the majority of this outcome. More efficient use of resources, including better expenditure management, also contributed to this positive result.

Restricted net assets are assets that are subject to use-constraints that are either: (a) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or, (b) imposed by law through constitutional provisions or by enabling legislation. In FY2006, total restricted net assets increased by $82,674, or 6.60%, consisting of an increase of $57,629, or 6.20%, from governmental activities, and an increase of $25,045, or 7.76% from business-type activities.

The Lottery and Charitable Games Control Board, an enterprise fund of the primary government, transfers substantially all of its net income to the District at the end of each fiscal year. In fiscal year 2006, the transfer was $73,800, which was a $2,350 increase from last year's amount. Please see Exhibit 3-b, *Statement of Revenues, Expenses and Changes in Fund Net Assets – Proprietary Funds*, on page 45.

Fund balances in the governmental fund financial statements will generally differ from net assets in the governmental activities of the government-wide financial statements due to the measurement focus and basis of accounting used in the respective financial statements.

- Fund financial statements focus primarily on the sources, uses, and balances of current financial resources and use the modified accrual basis of accounting.
- The government-wide financial statements focus on all of the District's economic resources and use the full accrual basis of accounting.

The positive unrestricted net assets of $167,779 in FY2006 represents a change of $416,867 from the FY2005 deficit of $(249,088). This change is the result of an increase in total net assets of $363,362 and a net decrease of $(53,505) in other restrictions and net assets invested in capital assets. The net decrease of $(53,505) was composed primarily of a decrease of $(111,134) in invested in capital assets, net of related debt; and an increase of $57,629 for other restricted net assets. The increase in net assets was due mainly to a significant increase in property taxes of $122.0 million, an increase of income and franchise taxes of $119.0 million, and an increase of $120.0 million for miscellaneous revenues.

Restricted net assets are assets whose uses are *not* subject to the District's discretion. This category includes resources subject to *externally imposed* restrictions by creditors, grantors, contributors, laws/regulations of other governments, and constitutional provisions.

Table 1 - Net Assets as of September 30, 2006

	Governmental activities		Business-type activities		Totals	
	2006	2005	2006	2005	2006	2005
Current and other assets	$ 3,811,134	$ 2,783,666	$ 473,582	$ 453,541	$ 4,284,716	$ 3,237,207
Capital assets	5,546,741	5,018,939	17,391	16,183	5,564,132	5,035,122
Total assets	9,357,875	7,802,605	490,973	469,724	9,848,848	8,272,329
Long-term liabilities	5,984,643	4,862,030	52,584	59,449	6,037,227	4,921,479
Other liabilities	1,259,206	1,189,911	44,060	36,231	1,303,266	1,226,142
Total Liabilities	7,243,849	6,051,941	96,644	95,680	7,340,493	6,147,621
Net assets:						
Invested in capital assets, net of related debt	958,597	1,069,731	17,391	16,183	975,988	1,085,914
Restricted	987,650	930,021	347,938	322,893	1,335,588	1,252,914
Unrestricted	167,779	(249,088)	29,000	34,968	196,779	(214,120)
Total net assets	**$ 2,114,026**	**$ 1,750,664**	**$ 394,329**	**$ 374,044**	**$ 2,508,355**	**$ 2,124,708**

Table 2 - Change in Net Assets as of September 30, 2006

	Governmental activities		Business-type activities		Total		
	2006	2005	2006	2005	2006	2005	Variance
Revenues:							
Program revenues:							
Charges for services	$ 325,413	$ 327,162	$ 295,545	$ 267,115	$ 620,958	$ 594,277	$ 26,681
Operating grants and contributions	2,155,035	2,098,723	14,825	16,707	2,169,860	2,115,430	54,430
Capital grants and contributions	119,715	112,704	-	-	119,715	112,704	7,011
General revenues:							-
Property taxes	1,272,998	1,150,672	-	-	1,272,998	1,150,672	122,326
Income and franchise taxes	1,591,483	1,472,432			1,591,483	1,472,432	119,051
Sales and use taxes	1,004,471	957,394	-	-	1,004,471	957,394	47,077
Other taxes	668,995	673,032	95,888	92,985	764,883	766,017	(1,134)
Non tax revenues	504,389	351,473	20,031	19,567	524,420	371,040	153,380
Total revenues	**7,642,499**	**7,143,592**	**426,289**	**396,374**	**8,068,788**	**7,539,966**	**528,822**
Expenditures:							
Governmental direction and support	574,097	641,964	-	-	574,097	641,964	(67,867)
Economic development and regulation	391,203	283,186	-	-	391,203	283,186	108,017
Public safety and justice	1,124,896	1,036,120	-	-	1,124,896	1,036,120	88,776
Public education system	1,486,112	1,374,538	-	-	1,486,112	1,374,538	111,574
Human support services	2,967,372	2,663,556	-	-	2,967,372	2,663,556	303,816
Public works	351,917	307,247	-	-	351,917	307,247	44,670
Public transportation	187,615	167,783	-	-	187,615	167,783	19,832
Interest on long-term debt	269,725	201,882	-	-	269,725	201,882	67,843
Lottery and games	-	-	193,907	164,066	193,907	164,066	29,841
Unemployment compensation	-	-	102,749	92,728	102,749	92,728	10,021
Nursing home services	-	-	35,548	35,066	35,548	35,066	482
Total expenses	**7,352,937**	**6,676,276**	**332,204**	**291,860**	**7,685,141**	**6,968,136**	**717,005**
Increase in net assets before transfers	**289,562**	**467,316**	**94,085**	**104,514**	**383,647**	**571,830**	**(188,183)**
Transfer from lottery and games	73,800	71,450	(73,800)	(71,450)	-	-	-
Increase in net assets	363,362	538,766	20,285	33,064	383,647	571,830	(188,183)
Net assets - Oct 1	1,750,664	1,211,898	374,044	340,980	2,124,708	1,552,878	571,830
Net assets - Sept 30	**$ 2,114,026**	**$ 1,750,664**	**$ 394,329**	**$ 374,044**	**$ 2,508,355**	**$ 2,124,708**	**$ 383,647**

Please refer to Note 1.V – *Reconciliation of Government-Wide and Fund Financial Statements*, on page 63, for additional information on the differences between the two bases of accounting that the District uses in this Report.

Chart 1 shows various sources of revenues. This chart is a visual presentation of the numbers that were presented in Table 2, *Change in Net Assets* as of September 30, 2006 on page 23.

Chart 1 – Revenues by Source – Governmental Activities

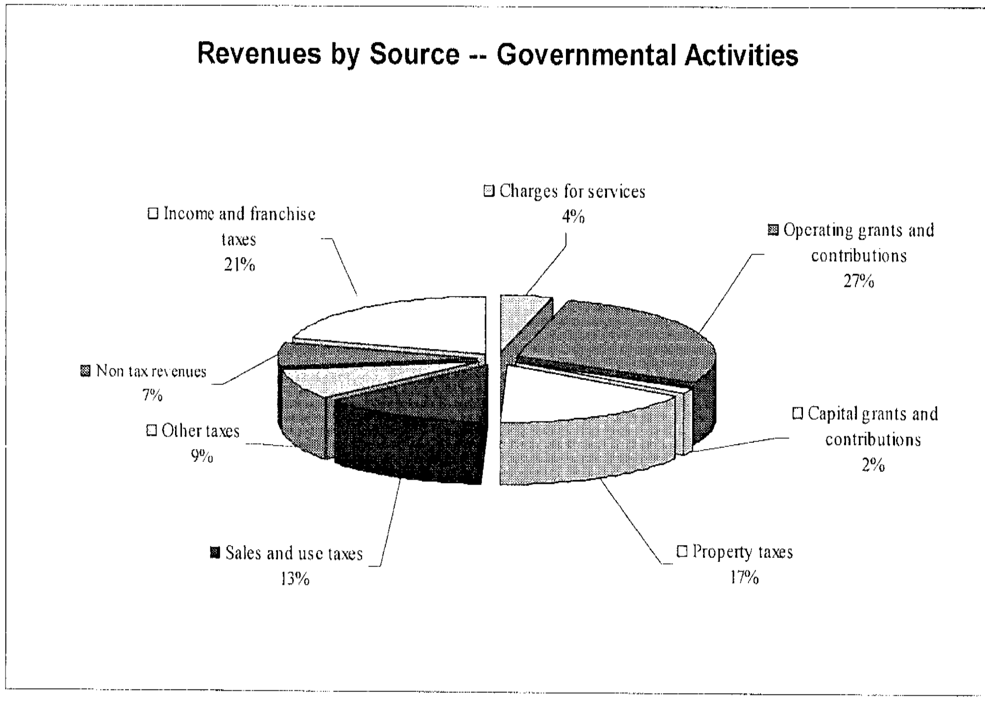
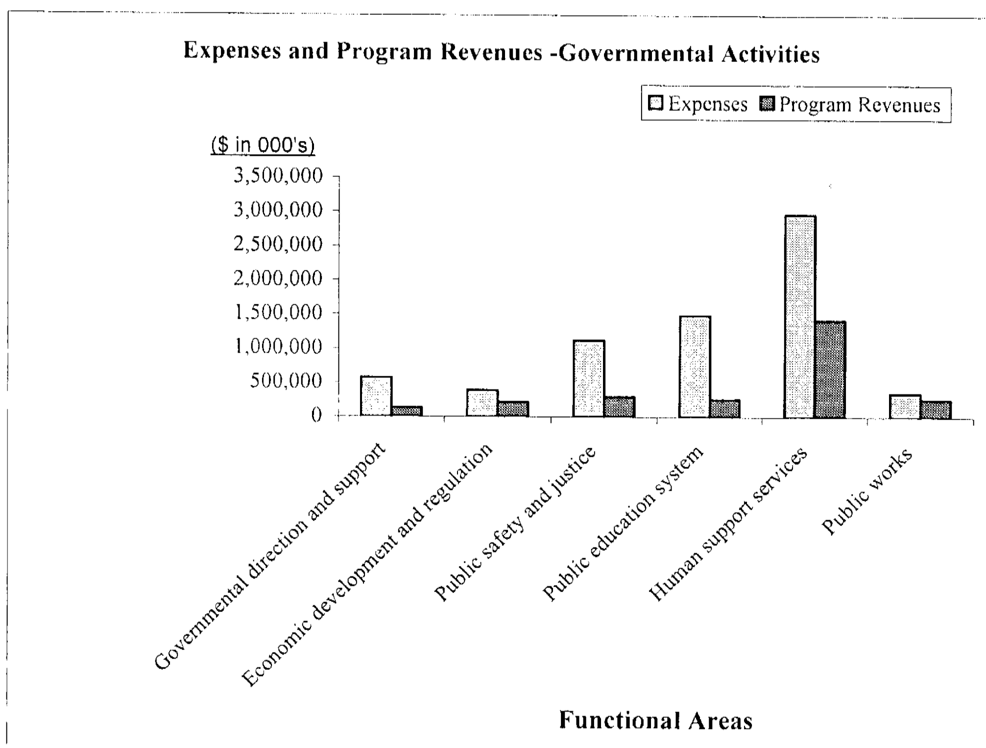


Chart 2 - Expenses and Program Revenues – Governmental Activities

Chart 2 displays both expenses and program revenues of selected governmental activities for the fiscal year. The governmental activities that are shown are: governmental direction and support, economic development and regulation, public safety and justice, public education system, human support services and public works.



Reporting on the District's Most Significant Funds

A fund is a fiscal and accounting entity with a self-balancing set of accounts that the District uses to keep track of specific sources of funding and spending for a particular purpose. In accordance with District law, bond covenants, and other legal stipulations, funds are established for specific purposes and to report on the activities related to the goods and services that the District provides to the general public. The District's funds are presented in three categories or groups: governmental, enterprise, and fiduciary.

The focus of the fund financial statements' presentation is on major funds, and not on fund types. Major funds, as required by GAAP, are presented individually; with non-major governmental funds combined in a single column. Detailed information for individual non-major governmental funds can be found in 'Other Supplementary Information', Exhibits B-1, *Combining Balance Sheet* and B-2, *Combining Statement of Revenues and Expenditures and Changes in Fund Balances*, pages 110 and 111.

Governmental Funds

The District's governmental funds provide information on near-term inflows, outflows, and balances of spendable resources. This information is useful in assessing the District'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. The governmental fund financial statements relate to the governmental activities column in the government-wide statements. The focus is on a shorter-term basis and measures how money flows into and out of these funds and determines the balances left at year-end for future spending.

Most basic services are found in this fund category, which are reported as General, Federal and Private Resources, General Capital Improvements, Baseball Capital Project, and Non-major Governmental Funds. These funds are reported using the *modified accrual basis of accounting*, which measures cash and other financial assets that can be readily converted into cash. Please refer to Exhibit 2-a, *Balance Sheet – Governmental Funds* and Exhibit 2-b, *Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds*, pages 40 and 41, for more detailed information about these funds.

- **Fund Balances:** The governmental funds reported a combined fund balance of $2,489,622, an increase of $880,659 over the previous year. The components of this combined fund balance are as follows:

  - General Fund - $ 1,435,142, a decrease of $(149,541) over the previous year.
  - Federal and private resources - $161,310, an increase of $43,363 over the previous year.
  - General capital improvements - $396,820, an increase of $643,182 over the previous year.
  - Baseball capital project - $328,581. In FY2005, the activity of this fund did not result in a fund balance.
  - Nonmajor governmental funds - $167,769, an increase of $15,074 over the previous year.

- **Revenues:** The collection of taxes and other revenues increased in FY2006 due to the continued strength of the Washington, D.C. economy. Revenues of the governmental funds increased by $494,118. Property taxes, income and franchise taxes, and sales and use taxes continued to show steady increases. Commercial retail and office space growth continued, and commercial vacancy rates remained amongst the lowest in the nation.

  On the residential side, longer commuting times, for non-resident employees, has made Washington, D.C. a more attractive place to live. The growth in the wages and salaries of residents contributed to the increase in individual income tax revenue. The increase in the sales and use tax was due to increased retail and hospitality sales, a result of increased individual income and the growth in the number of conventions and visitors.

  The primary sources of the increases in general fund revenues are:

  - Property taxes increased by $93,149.
  - Income and franchise taxes increased by $119,051.
  - Miscellaneous revenues increased by $177,494.

  The increase in real property tax revenue in FY2006 reflects the strength of the D.C. real estate market two-years prior, since there is a two-year lag between when real property value is assessed and when the revenue from the increased assessment is realized. As the demand for residential and commercial real estate has soared in the last several years, prices have climbed steeply and the result has been higher assessments and increased tax revenue, despite several rounds of tax relief to the residential sector.

The rise in individual income tax revenue, despite another round of tax cuts from the phased implementation of Tax Parity, reflects the strong growth in income of D.C.'s top earners. The largest source of growth was from the non-withholding portion of the income – the portion that is tied closely to stock market returns. This suggests that the strong growth in returns from the financial markets in the previous year was the main driver of the continued growth in the individual income tax.

The growth in miscellaneous revenues was the result of fluctuations in unclaimed property and end of year adjustments resulting from a change in estimates relating to expenditure accruals. Please see Exhibit 2-b, *Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds*, page 41, for more detailed information.

Dedicated Revenues

Every year, some portion of various District revenue streams are dedicated to certain purposes. The dedicated portion of the tax revenues is transferred out of the local fund, and is thus not available for general budgeting. In FY2006, the District transferred a total of $271.7 million in tax revenues out of the local fund budget.

Table 3 – Dedicated Local Tax Revenues ($ in 000's)

Tax Revenue		Dedicated Purpose (Transfer to)								
Source	Gross Collection	TIF	Neighborhood Investment Fund	DDOT	Convention Center	Ballpark Fund	Highway Trust Fund	Nursing Facility Quality of Care Fund	HPTF	Net Collection
Real Property	$ 1,153,795	(1,652)								1,152,143
Personal Property	65,514		(9,966)							55,548
Public Space Rental	22,206			(22,206)						-
General Sales	908,884	(11,562)		(33,586)	(79,706)	(8,664)				775,366
Motor Fuel Tax	24,960						(24,960)			-
Public Utility	155,157					(10,356)				144,801
Toll Telecommunications	56,611					(2,055)				54,556
Healthcare Provider Tax	9,107							(9,107)		-
Baseball Gross Receipts	15,952					(15,952)				-
Deed Recordation	197,528								(28,504)	169,024
Deed Transfer	132,615								(19,106)	113,509
TOTAL	$ 2,742,329	(13,214)	(9,966)	(55,792)	(79,706)	(37,027)	(24,960)	(9,107)	(47,610)	2,464,947

- **Expenditures:** The District's expenditures increased in most of its program/functional areas in the total amount of $977,053 over the previous year. The program/functional areas were led by an increase in governmental direction and support of $21,276, human support services of $294,789, the public education system of $98,743, public safety and justice of $99,344, economic development and regulation of $80,756, and capital outlays of $286,115.

The largest individual expenditure increase at agency level was the $54.8 million cost in personal services for the Metropolitan Police Department (MPD). This was attributed to a 4% pay increase for the 3,800 sworn members of the MPD, and a $12.7 million settlement related to the Public Employee's Relations Board (PERB) award. The PERB award was a retroactive settlement agreement with the Fraternal Order of Police for overtime and compensatory time earned from FY2001 to FY2003. An additional $1.6 million was for new hires in FY2006. Also, in FY2006, the Chief of Police declared a crime emergency which increased overtime by $10.6 million.

The District spent $652,198 on general capital improvements which exceeded the general capital improvements revenues of $212,112 by $(440,086) resulting in the deficiency shown in the capital projects fund. The District investments in capital improvements is based on need rather than available current year revenues, before considering current year bond proceeds. This deficiency is subsequently financed through the use of bond proceeds, after other financing sources of $1,083,268 were applied. The net change in the general capital improvements fund balance was an increase of $643,182.

The District is rapidly investing in infrastructure and other improvements to encourage residents and businesses to stay in the District and to attract new residents and businesses. Please see Exhibit 2-b, *Statement of Revenues, Expenditures and Changes in Fund Balances*, page 41, for more detailed information.

Listed below are the seven major infrastructure projects undertaken in FY2006, by costs incurred:

1) Street Repair/Pavement Restoration, Citywide - $10,561
2) 9th Street Bridge Design Build - $10,049
3) Theodore Roosevelt Bridge - $7,447
4) Curb/Sidewalks/Alley Replacement/Improvements, Wards 7 & 8- $7,115
5) Traffic Signal Maintenance/Improvements, Citywide - $7,011
6) Road/Resurface/Reconstruction/Upgrades, Ward 5 - $6,572
7) Pavement Restoration Wards 1 & 8 - $5,333

It is the District's financial policy to issue general obligation bonds to support the expenditures associated with its Capital Improvements Program. In order to minimize the cost of carrying debt, the District has instituted the practice of issuing bonds based on actual expenditures as opposed to an estimated amount budgeted on an annual basis. In practice, agencies are authorized to spend their annual appropriated capital budget in advance of financing. The general fund advances the amount of the funding, and is repaid with the proceeds from the bonds when issued.

This allows the District to determine when it will enter the market to issue bonds based upon cash flow needs, favorable market rates and the number of municipal debt financing and the types of credits that are available. This flexibility helps to minimize borrowing costs and maximizes the pool of potential investors for the District's debt issuances.

Proprietary Funds

Proprietary funds account for activities of District entities that charge customers a fee for services provided, whether to outside customers or to other entities of the District. Proprietary funds are reported in the same way that all activities are reported in the Statement of Net Assets and the Statement of Activities. The District currently has two major Proprietary Funds: the D.C. Lottery & Charitable Games Board (Lottery), and the Unemployment Compensation Fund (Unemployment). There is one non-major proprietary fund, Nursing Home Services, which includes the operations of the Washington Center for Aging Services, the Washington Center for Aging Services Center Care, and the JB Johnson Nursing Center. See *Chart 3, Expense and Program Revenues – Business-Type Activities* and *Chart 4, Revenues by Source – Business-Type Activities*, both on page 28, which give a visual comparative presentation of the revenues and expenses of the three funds.

The total assets for Lottery decreased by $(4,138), or -5.6%, over the previous year due to scheduled disbursements to long-term prize winners. The total assets for Unemployment increased by $19,177, or 5.2%, due to higher tax collections from employers. The net cash provided by (used in) operating activities for Lottery, Unemployment and non-major proprietary funds (Nursing Services) were $75,610, $3,310, and $(2,393) respectively. See Exhibit 3-a, *Statement of Net Assets – Proprietary Funds*, Exhibit 3-b, *Statement of Revenues, Expenses and Changes in Fund Net Assets – Proprietary Funds*, and Exhibit 3-c, *Statement of Cash Flows – Proprietary Funds*, on pages 44, 45 and 46 respectively for more detailed information.

Proprietary funds provide goods and services to the general public and use the *full accrual accounting* method for reporting purposes.

The graphic comparisons in Charts 3 and 4 are based on financial information in *Table 2, Change in Net Assets as of September 30, 2006*, page 23.

Chart 3 – Expenses and Program Revenues – Business-type Activities

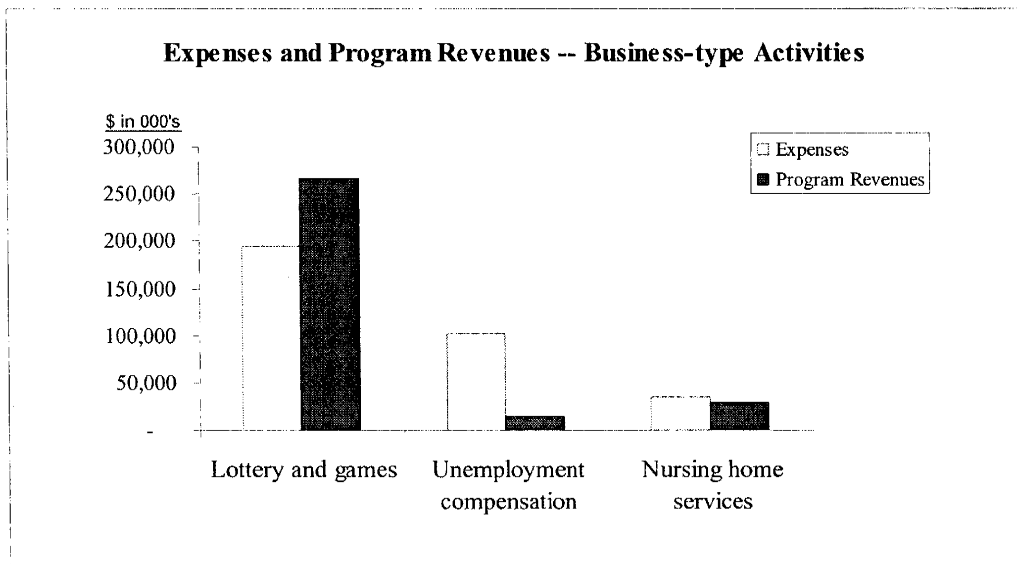
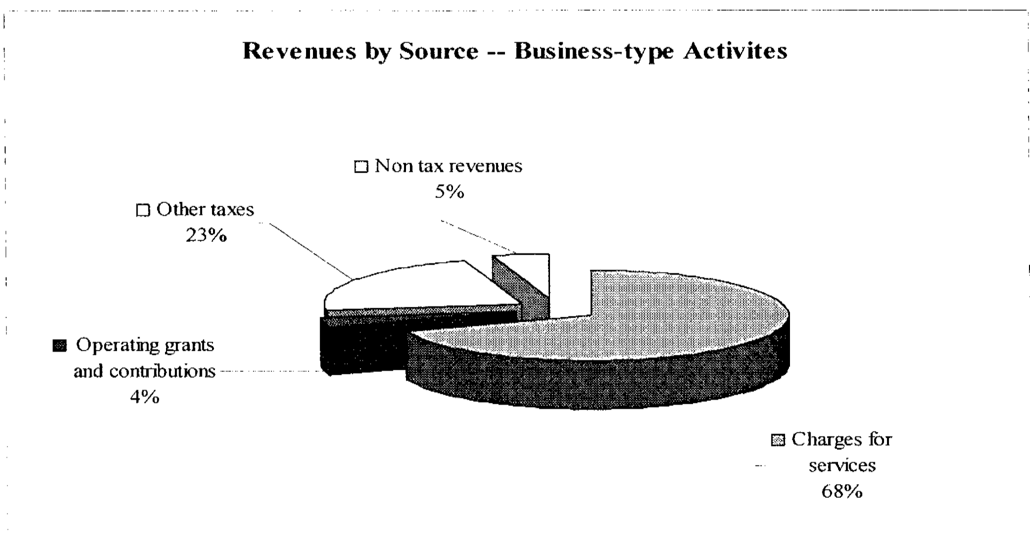


Chart 4 – Revenues by Source – Business-type Activities



Fiduciary Funds

The *Trust and Agency Funds* are used to account for assets held by the District as trustee for individuals, private organizations, or other governments. The District is the *trustee* or *fiduciary* for its employees' pension plans. All fiduciary activities are reported in Exhibit 4-a, *Statement of Fiduciary Fund Net Assets* and Exhibit 4-b, *Statement of Changes in Fiduciary Fund Net Assets* on pages 47 and 48, respectively. Please also refer to Exhibit C-1, *Pension Trust Funds – Combining Statement of Fiduciary Net Assets*, Exhibit C-2, *Pension Trust Funds – Combining Statement of Changes in Fiduciary Net Assets* on pages 114 and 115 respectively, for more details. These activities are excluded from the District's financial statements because these resources are restricted and are not available to support the District's operations.

Private-purpose trust funds are used to report any trust arrangement not reported in pension funds or investment trust funds "under which principal and income benefit individuals, private organizations, or other governments." The District offers a tax-advantaged 529 College Savings Investment Plan (named after Section 529 of the Internal Revenue Code). The Plan is designed to help families save for the higher education expenses of designated beneficiaries which is available to D.C. residents and non-residents. This plan is reported in the Private-purpose trust fund, and was established during FY2003. Please see Note 1-E, *Fiduciary Funds – Private Purpose Trust Funds* on page 55.

The net assets of the pension trust fund increased by $473,737. Net investment income is the primary source of the increases as both entities continue to benefit from the improved U.S. equity and non-U.S. equity markets, and from prudent investment management.

The Component Units

The District currently has six component units: 1) Water and Sewer Authority (WASA), 2) Washington Convention Center Authority (WCCA), 3) Sports and Entertainment Commission (SEC), 4) Housing Finance Agency (HFA), 5) University of the District of Columbia (UDC) and 6) Anacostia Waterfront Corporation (AWC). Component units are legally separate organizations for which the District is financially accountable. Accountability exists because the Mayor, with the consent of the Council, appoints the governing bodies of all of the component units. In addition, the District has an obligation to provide financial support to the Convention Center, and the University of the District of Columbia. Certain tax revenues are dedicated to each of these organizations. The financial data of the component units are reported separately from the financial data of the primary government.

Each of the component units prepares its own independently audited financial statements, which are accompanied by their respective MD&A. Please see Exhibit 5a, *Discretely Presented Component Units - Combining Statement of Net Assets,* page 49, and Exhibit 5b, *Discretely Presented Component Units - Combining Statement of Activities,* page 50, for more detailed financial information on the component units.

Short-Term Debt

The District issues short-term debt primarily to finance seasonal cash flow needs. This need occurs due to the timing variance between receipts of taxes, grants and other revenues and the outflow of funds for governmental operations and required disbursements. The District issued $250,000 in General Obligation Tax Revenue Anticipation Notes (TRANs) on December 14, 2005, at an interest rate of 3.28%, which has been repaid. By law, the District must repay any short-term debt in its entirety by September 30 of the fiscal year in which the debt was incurred. The FY2005 TRANs were repaid on September 29, 2006.

Long-Term Debt and Bond Ratings

On December 15, 2005, the District issued its Series 2005A General Obligation Bonds in the aggregate principal amount of $331,210. The proceeds of these bonds will be used to finance capital project expenditures in the District's fiscal year 2006 capital improvements program, and to pay cost and expenses of issuing and delivering the bonds. The 2005A Bonds were issued as fixed-rate bonds at a weighted average interest rate yield of 4.60%. Like all District general obligation bonds, the 2005A bonds are secured by the District's full faith and credit, and are further secured by a security interest and lien on the funds derived from a Special Property Tax levied annually by the District. Interest payments began in FY2006, and principal payments will begin in 2007, with payments being made on June 1 and December 1. The 2005A Bonds will be paid off on June 1, 2030.

On December 15, 2005, the District issued its Series 2005B General Obligation Refunding Bonds in the aggregate principal amount of $116,475. The proceeds of these bonds were used to redeem, or defease, a portion of the District's outstanding general obligation bonds at a savings to the District and to pay the costs and expenses of issuing and delivering the bonds. The 2005B Bonds were issued as fixed-rate bonds at a weighted average interest rate yield of 4.48%. Like all District general obligation bonds, the 2005B bonds are secured by the District's full faith and credit, and are further secured by a security interest and lien on the funds derived from a Special Property Tax levied annually by the District. Interest payments began in FY2006, and principal payments will begin in 2009, with interest payments being made on June 1 and December 1, and principal payments being made on June 1. The 2005B Bonds will be paid off on June 1, 2027. The refunding bonds, which refinanced existing bonds at lower interest rates, will provide the District with $4.12 million in present value savings over the next several years.

In November 2005, Moody's Investors Service upgraded the District's general obligation bond rating to "A2 (Positive Outlook)" from "A2". Also in November 2005, Standard & Poor's upgraded the District's general obligation bond rating to "A+" from "A", based on its stable economic outlook. In June 2005, Fitch Ratings upgraded the District's bond rating from "A- (Positive Outlook)" to "A (Positive Outlook)." Each time the District issues new debt, the current debt rating is reviewed for the new issuance. At that time, the bond rating agencies assess the District's financial condition, and underlying credit worthiness, and change their rating as warranted. Bond rating agencies will also periodically review the District's overall financial condition for possible adjustments to its bond rating or outlook.

The significantly improved bond ratings allow the District to either refinance outstanding debt, or issue new debt, at more favorable rates. In the past, the District's financial and operational difficulties required it to pay substantially higher interest rates on its debt. The District's financial advisors estimate that the effect of the upgrades on the District's recent general obligation bond sale was a savings of approximately 5 basis points, or $200,000 per year. A basis point is one-percent of a percentage point of interest, or 0.01%. Lower interest rates translate into reduced debt service payments, resulting in a greater percentage of the District's budget being available for the services and operations needed for its citizens.

At September 30, 2006 the District had a total of $5,180,470 in general obligation bonds, TIF Bonds and Notes, Qualified Zone Academy Bonds (QZAB), and Tobacco Bonds outstanding. Please refer to Table 3, *Outstanding Bonds and Notes at September 30, 2006.* This is an increase of $929,191 over last year's figure of $4,251,279. General obligation bonds represent 72.8% of the District's outstanding long-term debt. TIF bonds and notes and QZAB represent 2.5% and Tobacco Bonds Outstanding represent 14.3% of its outstanding long-term debt. In FY2006, the District issued $534,800 in Ballpark Bonds to finance the new baseball stadium. The District's borrowing has been increasing over the past few years because of the demand for improvements in infrastructure, such as roads, streets, and bridges. (Please see *Note 8. Long-Term Liabilities*, pages 78-88 for a more detailed discussion).

The general obligation debt per capita (D.C. resident) as of September 30, 2006 was $6,490. This is an increase of $250, or 1.6% over the revised amount of $6,240 per capita on September 30, 2005. The increase is due to the District's issuance of additional general obligation debt. The debt per capita figure that was given in last year's CAFR may not correspond to the figure given in this year's CAFR because of adjustments in census estimates. Please refer to Exhibit S-3B, *Ratios of General Bonded Debt Outstanding – Last Ten Years* on page 142.

Table 4 – Outstanding Bonds and Notes at September 30, 2006

Long-Term Debt
($ in thousands)

	2006	2005	Variance
General Obligation Bonds	$ 3,773,863	$ 3,632,198	$ 141,665
Ballpark Bonds	534,800	-	534,800
TIF Bonds and Notes	124,302	117,526	6,776
Qualified Zone Academy Bonds	5,221	2,815	2,406
Tobacco Bonds	742,284	498,740	243,544
Total	**$ 5,180,470**	**$ 4,251,279**	**$ 929,191**

Capital Assets

Net capital assets of the governmental activities totaled $5,546,741, while the net capital assets in business-type activities totaled $17,391, for a total of $5,564,132 net capital assets at September 30, 2006. These capital assets include, but are not limited to, land, buildings, police and fire equipment, office equipment, park facilities, roads and bridges. The governmental activities depreciation charges for the current fiscal year totaled $225,809 compared to last year's $220,981. The general capital improvements fund is used to account for the purchase or construction of capital assets financed by transfers, capital grants, and or debt. Please see Table 5, *Net Capital Assets*, below for more details.

Total capital assets increased by $529,010 or 10.5%, over capital assets reported on September 30, 2005. This increase was made up of an increase in governmental activities capital assets of $ 527,802 or 10.5% and an increase in capital assets from business-type activities of $1,208, or 7.5%. Total capital assets are increasing because the District is investing more resources in new and existing rehabilitated infrastructure, such as roads, streets, and bridges. The cost of these assets is being funded primarily by the increase in District revenues, the issuance of debt, and the use of general fund fund balance. Please see Note 5. - *Capital Assets* for a more complete discussion of the District's capital assets, on pages 72-76.

Table 5 – Net Capital Assets as of September 30, 2006

Asset Category	Governmental activities		Business-type activities		Total	
	2006	2005	2006	2005	2006	2005
Land	$ 219,938	$ 220,004	$ 1,264	$ 1,264	$ 221,202	$ 221,268
Buildings	1,701,162	1,609,435	14,464	14,133	1,715,626	1,623,568
Infrastructure	1,792,926	1,653,759	-	-	1,792,926	1,653,759
Equipment	512,232	409,132	1,663	786	513,895	409,918
Construction in progress	1,320,483	1,126,609	-	-	1,320,483	1,126,609
Total net capital assets	**$ 5,546,741**	**$ 5,018,939**	**$ 17,391**	**$ 16,183**	**$ 5,564,132**	**$ 5,035,122**

REPORTING THE DISTRICT'S BUDGET

The District's budget is subject to revision and/or veto by the United States Congress and the President of the United States. As the budget moves through the federal budgetary process, there may be changes in both the amounts and the purposes. In addition, when the District's CFO prepares revised revenue estimates, the budget submission must be adjusted to conform to those revisions. During the Congressional review of the FY2006 budget, the CFO's revised estimates caused the District to revise its budget submission, before the budget was finally approved. Both federal and District laws require that the District present a balanced budget.

General Fund Budget

The original formulation of the general fund budget estimated total revenues and other sources at $5,397,860 and total expenditures and other uses at $5,396,587. The revised general fund budget resulted in estimated total revenues and other sources of $5,534,946 and total expenditures and other uses of $5,499,997, representing a projected budgetary surplus of $34,949. See Table 6, *Fiscal Year 2006 – General Fund Budgetary Highlights* on page 32 for more details.

Table 6 - Fiscal Year 2006 General Fund Budgetary Highlights

	Budget Original	Budget Revised	Actual	Variance Over(under)
Revenues and Other Sources:				
Property taxes	$ 1,222,165	$ 1,163,667	$ 1,207,691	$ 44,024
Other taxes	2,834,729	2,993,207	3,031,259	38,052
Charges for services	313,820	315,226	361,951	46,725
Other sources (O type)	268,009	422,414	375,389	(47,025)
All other sources	759,137	640,432	612,726	(27,706)
Total revenues and other sources	5,397,860	5,534,946	5,589,016	54,070
Expenditures and Other Uses:				
Governmental direction and support	340,858	350,238	333,547	(16,691)
Economic development and regulation	328,158	361,724	251,762	(109,962)
Public safety and justice	827,036	903,046	894,748	(8,298)
Public education system	1,189,303	1,120,488	1,101,639	(18,849)
AY07 public education expenditures	-	69,064	69,064	-
Human support services	1,307,530	1,413,855	1,389,575	(24,280)
Public works	366,101	374,077	363,798	(10,279)
Other	1,037,601	907,505	859,721	(47,784)
Total expenditures and other uses	5,396,587	5,499,997	5,263,854	(236,143)
Excess (deficit) -- budgetary basis	$ 1,273	$ 34,949	$ 325,162	$ 290,213

General Fund Budgetary Highlights – Original to Revised Budget

The adjustments necessary to bring the expenditure budget into agreement with the revised revenue budget account for the differences between the proposed General Fund budget and the final amended budget. Total estimated revenues were increased by $137,086 and total estimated expenditures were increased by $103,410. The projected General Fund budgetary basis surplus was increased from $1,273 to $34,949, as a result of the revisions. The major changes in the budget are summarized as follows:

<u>Revenues</u>
- Property taxes were decreased by $(58,498).
- Other taxes were increased by $158,478.
- Other sources (O Type) were increased by $154,405.
- All other sources were decreased by $(118,705).

<u>Expenditures</u>
- The advance of Appropriation Year 2007 budget in the amount of $69,064 of public education expenditures, to ready the public schools for the new school year which began prior to the District's fiscal year.
- Human support services expenditures were increased by $106,325.
- Public safety and justice expenditures were increased by $76,010**.**
- Public education expenditures were decreased by $(68,815).
- Other, which represents various nonfunctional expenditures on a budgetary basis decreased by $(130,096).

The decrease of $ (58,498) for property taxes was largely the result of real property tax relief measures that were enacted in FY2006. Two of the largest of these were the increase in the homestead exemption from $38 to $60, and the lowering of the tax rate from $0.96 per $100.00 of assessed value to $0.92 per $100.00 of assessed valued. There were also many smaller, more targeted tax relief measures that were enacted between the time that the original and revised estimates were made.

The estimate for the individual income tax was revised upwards by $127.0 million because of higher than expected growth in the non-withholding portion of individual income tax which was driven by performance of the stock market.

Corporation franchise and unincorporated business tax were both revised upward by about $24.0 million as the national economy remained strong and business profitability soared. After the previous two-years of double digit growth in the business taxes, the original estimate assumed slower growth going forward. However, at the time of the revised estimate, the business tax growth remained strong and was revised upward.

The deed recordation tax was revised downward by about $20 million because, by the time of the revised estimate, it was clear that the D.C. real estate market was slowing after several years of double digit growth. Although the volume of sales for single-family housing was falling, at the time of the original estimates, single-family prices were still growing at double digit rates; and both the volume of sales and prices for condominiums were still growing at the same pace. By the time of the revised estimate, the volume of sales for both single-family housing and condominiums were falling and prices were beginning to level off.

The estimate for interest income was revised upward by $26 million to reflect the unexpected strong growth of that revenue source. At the time of the original revenue estimate, the expectation of the financial community was that the Federal Reserve would stop raising short-term interest rates after a year of rate hikes. Instead, the Federal Reserve continued rate hikes deep into 2006 that resulted in better than expected growth in interest income.

The $69,064 AY 2007 Advance for Public Education represents the expenditure of the appropriations for AY 2007 in FY2006. The FY2006 D.C. Appropriations Act requires that the advance appropriations be provided on July 1, 2006, based on 10% and 25% of the FY2007 Proposed Budgets for the D.C. Public Schools and the D.C. Public Charter Schools, respectively. When Congress approves the District's budget for the current fiscal year, it does not know the proposed funding level for the next fiscal year. As such, the advance appropriations are not included in the District's Original Budget. The advance appropriations are not known until July 1, and are then made a part of the District's Revised Budget.

The $106,325 increase for Human Support Services (HSS) was caused primarily by five items: 1) the Department of Human Services (DHS) was increased by $37,336; 2) the Department of Health was increased by $27,636; 3) Child and Family Services was increased by $13,682; 4) the Department of mental Health was increased by $17,031, and 5) the Department of Youth Rehabilitative Services was increased by $9,301.

The largest increase for HSS was the result of increases for DHS for reprogramming for Mental Retardation and Developmental Disabilities Administration (MRDDA) program of $10,000, funding for various programs based on additional certified local revenue of $8,100, a FY2007 Operating Cash Reserve allocation for the MRDDA program of $7,900, the Fixed Commodity reallocation from other agencies of $2,000, and an allocation for Workforce Investment for pay raises of $1,450.

The $76,010 increase for Public Safety and Justice was made up almost entirely by the $66,173 increase for the Metropolitan Police Department. The increase reflects local Workforce Investment allocations to cover pay raises of $37,800, contingency cash reserve allocations to fund the District's Crime Initiative of $13,200, Section 103 payments to cover Public Employee Relation's Board arbitration awards of $12,800, and Operating Cash Reserve allocation to cover fleet fuel, and an O Type increase of $1,200 primarily representing a reprogramming from the Office of Unified Communications.

The $(68,815) decrease for Public Education was composed primarily of five items: 1) an increase of $22,101 for the D.C. Public Schools; 2) a decrease of $(72,209) for Public Charter Schools; 3) an increase of $66,120 for the AY 2007 Public Charter School Advance; 4) a reduction of $(21,000) for the District of Columbia Education Investment Fund, and; 5) a reduction of $(12,200) for the Schools Modernization Fund.

Of the $(72,209) decrease for Public Charter Schools, the net decrease reflects reprogramming $(16,900) and the FY2006 budget advanced and expended in FY2005 $(58,400). Partly offsetting these decreases is an allocation from the Public Charter School Educational Investment fund of $3,110. The advance appropriations for the AY 2007 Public Charter Schools were not included in the June budget submission to the U.S. Congress. The proposed budget for FY2007, upon which the advance appropriations is based, was not developed at the time of the current fiscal budget submission to Congress.

The $(130,096) decrease for "Other" was made up of three major items; 1) a decrease of $(47,731) for the Cash Reserve; 2) a decrease of $(51,548) for Workforce Investments, and; 3) a decrease for Non-Department of $(33,020). These three items total $(132,299), which was offset by net $2,203 increase in other items were included under "Other". The change in the Cash Reserve was a result of the increase in allocation by the D.C. Council to various agencies to fund spending pressures and/or policy initiatives. The decrease in the budget for workforce investments reflects $(53,600) in allocations to various agencies to cover pay raises.

Budget to Actual Revenue Variances

Real property assessments are usually known at the time of the estimate for the current fiscal year. Therefore, the variance of the actual from the expected for FY2006 was generally due to differences between estimated adjustments to tax assessments from appeals and the actual results of actual appeals. The positive variance of $44.0 million is due primarily to the appeals being much lower than expected. The number of appeals was lower than normal because of the large number of real property tax relief programs that were implemented in FY2006. This suggests that FY2007 will see increased tax assessment appeals as residential property owners become used to the effects of the FY2006 tax relief programs.

The economic interest tax is paid when owners of real estate assets sell their ownership *interests* in that asset rather than the property itself. Revenue from the economic interest tax fluctuates from year to year because most of the revenue from this tax is generated from activity in the real estate investment trusts (REITs) market which, like financial markets, are inherently difficult to predict. The $22.3 million increase was likely due to higher than usual activity in the REIT market as the underlying real estate market changes.

The "Other" revenue category has a positive variance of $29.4 million over the budgeted amount. The growth in miscellaneous revenues was the result of fluctuations in unclaimed property and end of year adjustments resulting from a change in estimates relating to expenditure accruals, and had a positive variance of $12.0 million. However, the largest source of variance in this category is an $18 million end of the year adjustment to account for changes in prior period expenditure accrual.

Budget to Actual Expenditure Variances

The District had a negative variance of $(236,143) for FY2006. Whenever the District spends less money than was projected in the budget, it shows up in the budget as a negative, but, in reality it means that the District has more money at the end of the fiscal year than it would have if it had actually spent everything that was budgeted. If the District collects more money in revenues than it budgeted, then that money could become part of an operating budget surplus, as long as it is larger than any actual overspending in the budget. Over the past few years, including FY2006, the District has, in fact, collected both more revenues and spent less than projected in the revised budget. As a result, the District has ended with an operating budget surplus for the past ten-years. The largest expenditure variance was for economic development and regulation of $(109,962).

Within economic development and regulation, $(74,000) was caused by the Department of Housing and Community Development (DHCD), and $(12,300) was caused by Business Services and Economic Development (BSED). DHCD's FY2005 to FY2006 variance of $(74,000) was caused primarily by the $(69,000) variance for the Housing Production Trust Fund (HPTF).

The variance for fiscal charges was due to $(30,804) bond issuance costs for the baseball stadium bonds that were expected to be paid out of this account, but were not. However, the baseball stadium bonds were redirected and paid for out of the baseball project special revenue fund, where the transaction was more properly classified, rather than being paid as a general fund expense.

SUBSEQUENT EVENTS

Short-Term Debt

The District issues short-term debt to finance seasonal cash flow needs. This need occurs due to the timing variance between receipts of taxes, grants and other revenues and the outflow of funds for governmental operations and other required disbursements. On December 21, 2006, the District issued fixed-rate Tax Revenue Anticipation Notes in the aggregate amount of $300,000. These Notes were issued at an interest rate of 4.25% and priced to yield 3.5%, and are to be paid off on September 28, 2007. By law, the District must repay any short-term debt in its entirety by September 30 of the fiscal year of issuance.

Long-Term Debt

The proposed FY2007 general obligation debt service budget totals $408.1 million, on total projected long-term debt of approximately $4 billion. This represents an increase of approximately $37.4 million over the approved FY2006 long-term debt service budget of $370.7 million. This increase is primarily attributable to debt service on new debt issued in FY2006 and on debt to be issued in FY2007 to finance capital project expenditures. The proposed FY2007 debt service budget includes debt service on presumed borrowing of approximately $714 million in the first quarter of FY2007. This amount will support the District's Capital Improvement Plan (CIP), which includes two major initiatives (Government Centers and Great Streets) that were actually approved in the FY2006 capital plan but will not be financed until FY2007, and also includes the next installment in the plan to reduce the capital fund deficit.

CONTACTING THE DISTRICT'S OFFICE OF THE CHIEF FINANCIAL OFFICER

This CAFR is designed to provide the District's citizens, taxpayers, customers, vendors, investors, and creditors with a general overview of the District's finances and to show the District's accountability for the money it receives. For additional information on the District's component units: the D.C. Water & Sewer Authority, the Washington Convention Center Authority, the Sports & Entertainment Commission, the Housing Finance Agency, the University of the District of Columbia, and the Anacostia Waterfront Corporation, please refer to page 53 of the notes to the basic financial statements for contact information. If you have any questions about the District's Fiscal Year 2006 CAFR, suggestions for improvement, or need additional financial information, please contact:

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