MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of King County's (the County) Comprehensive Annual Financial Report (CAFR) presents a narrative overview and analysis of the financial activities of the County for the year ended December 31, 2006. We encourage readers to consider this information in conjunction with the additional information that is furnished in the letter of transmittal, which can be found preceding this narrative, and with the County's financial statements and notes to the financial statements, which follow.

FINANCIAL HIGHLIGHTS – PRIMARY GOVERNMENT

- As of December 31, 2006, the assets of the County exceeded its liabilities by $3,730.0 million (net assets). Because all of the County's net assets are either invested in capital assets or restricted as to use, the combined unrestricted net assets showed a $244.5 million deficit at the end of the year.
- In 2006 the County's total net assets increased by 8.6 percent or $296.1 million. The governmental net assets increased by 13.9 percent or $209.5 million, and the business-type net assets increased by 4.5 percent or $86.6 million.
- As of December 31, 2006, the County's governmental funds reported combined ending fund balances of $420.4 million. Approximately 68.5 percent or $287.9 million is unreserved fund balance available for spending at the government's discretion within the purposes specified for the County's funds.
- At the end of 2006 the unreserved, undesignated fund balance for the General Fund was $96.3 million, amounting to 18.1 percent of total General Fund expenditures for 2006. Total fund balance for the General Fund decreased 0.2 percent or $227 thousand for the year.
- The County's total bonded debt increased by 3.7 percent or $111.2 million in 2006 due primarily to issuance of $250.0 million of sewer revenue bonds offset by $122.2 million of debt service principal payments made during the year.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the County's basic financial statements which include three components: (1) government-wide financial statements; (2) fund financial statements; and (3) notes to the financial statements. This report also contains required supplementary information and other supplementary information in addition to the basic financial statements.

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 statements provide short-term and long-term information about the County's financial position, which assists in assessing the County's financial condition at the end of the fiscal year. These statements are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This means they follow methods that are similar to those used by most businesses, taking into account all revenues and expenses connected with the fiscal year, even if cash involved has not been received or paid. The government-wide financial statements include two statements:

The **statement of net assets** presents all of the County's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in the County's net assets may serve as a useful indicator of whether 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. As a result, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods, such as revenues pertaining to uncollected taxes and expenses pertaining to earned but unused vacation and sick leave.

Both of the government-wide financial statements have separate sections for three different types of County programs or activities:

Governmental activities. The activities in this section are principally supported by taxes and intergovernmental revenues. Most of the County's basic services fall into this category, including general government; law, safety and justice; physical environment; transportation; economic environment; mental and physical health; culture and recreation; and debt service. Also included within the governmental activities are the operations of the County's four flood control zone districts, of which only one is currently active. Although legally separate from the County, these component units are blended with the primary government (King County) because of their governance relationship with the County.

Business-type activities. These functions are intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. These business-type activities include the operation of the County's public transportation system, wastewater treatment facilities, solid waste disposal facilities, airport, and other services.

Discretely presented component units. The government-wide financial statements include not only King County itself as the primary government, but also four legally separate entities for which the County is financially accountable: the Harborview Medical Center (HMC), the Washington State Major League Baseball Stadium Public Facilities District (PFD), the Cultural Development Authority (CDA) of King County, doing business as 4Culture, and Flood Control Zone Districts. Financial information for the first three of these component units is reported separately from the financial information presented for the primary government itself in a single, aggregated presentation in the government-wide financial statements. Individual financial statements for the HMC, the PFD, and the CDA can be found immediately following the fiduciary funds financial statements in the Basic Statements section of this report.

Fund Financial Statements

The fund financial statements are designed to report information about groupings of related accounts that 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.

Governmental funds. Most of the basic services provided by the County are financed through governmental funds. Governmental funds are used to account for essentially the same functions that are reported as governmental activities in the government-wide financial statements. Unlike the government-wide financial statements, however, the governmental funds financial statements focus on how cash and other financial assets can readily be converted to available resources, and the balances left at year-end that are available for

future spending. Such information may be useful in determining whether there will be adequate financial resources available to meet the current needs of the County.

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 a general fund and several other individual governmental funds organized according to their type (special revenue, debt service, and capital projects). Two governmental funds, the General Fund and the Public Health Fund, are considered to be major funds for financial reporting purposes. Each of the major funds is presented in a separate column in the governmental funds balance sheet and the governmental funds statement of revenues, expenditures, and changes in fund balances. Data from the other governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor funds is provided in the form of combining and subcombining statements in the Governmental Funds section of this report, following the Basic Statements section.

The County adopts an annual budget appropriated at the department/division level for the General Fund and at the fund level for the Public Health Fund. A budgetary comparison statement has been provided for each of the two major governmental funds.

The basic governmental funds financial statements can be found immediately following the government-wide statements.

Proprietary funds. Proprietary funds are generally used to account for services for which the County charges customers a fee. Proprietary funds provide the same type of information as shown in the government-wide financial statements, only in more detail. Like the government-wide financial statements, proprietary funds financial statements use the accrual basis of accounting. The basic proprietary funds financial statements can be found immediately following the governmental funds financial statements.

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 proprietary funds financial statements provide separate information for the Water Quality Enterprise and the Public Transportation Enterprise, both considered to be major funds of the County for financial reporting purposes. All other enterprise funds are aggregated into a single presentation within the proprietary funds financial statements.

Internal service funds are used to report activities that provide services to the County's other programs and activities on a cost reimbursement basis. The County uses internal service funds to account for its motor pool, information and telecommunications services, facilities management, risk management, employee benefits, and financial and various other administrative services. These services predominantly benefit governmental rather than business-type functions and have been included within governmental activities in the government-wide financial statements. One internal service fund that provides equipment and fleet maintenance and procurement for the Water Quality Enterprise is included within the business-type activities in the government-wide financial statements but is combined

with all other internal service funds into a single aggregated presentation in the proprietary funds financial statements.

Fiduciary funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds include the investment trust funds, used to report investment activity conducted by the County on behalf of legally separate entities, such as special districts and public authorities that are not part of the County's reporting entity, and the agency funds. Since the resources of these funds are not available to support the County's own programs, they are not reflected in the government-wide financial statements. The accounting used for fiduciary funds is much like that used for proprietary funds. The basic fiduciary funds financial statements can be found immediately following the proprietary funds financial statements.

Notes to the financial statements

The notes provide additional information essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found immediately following the individual component unit financial statements in the Basic Statements section of this report.

Other information

Required supplementary information. In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information on infrastructure assets reported using the modified approach. The required supplementary information immediately follows the notes to the financial statements in the Basic Statements section of this report.

Combining Statements. The combining and subcombining statements, referred to earlier, are presented in separate sections immediately following the required supplementary information.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

Analysis of Net Assets

Net assets may serve over time as a useful indicator of a government's financial position. As indicated in the condensed financial information on the following page, which was derived from the government-wide Statement of Net Assets, the County's combined net assets (governmental and business-type activities) were $3,730.0 million at the end of 2006. This is an increase of 8.6 percent or $296.1 million over the net assets of the previous year, as restated.

Governmental activities. Although net assets of the County's governmental activities increased 13.9 percent to $1,712.8 million, all of the net assets are either subject to external restrictions as to how they may be used, or are invested in capital assets (e.g., land, buildings, infrastructure, right-of-way, equipment, and work in progress) less any related outstanding debt used to acquire those assets. Consequently, unrestricted net assets for governmental activities showed a $366.2 million deficit at the end of 2006. This is a 10.4 percent or $42.6 million decrease in the deficit in unrestricted net assets from that of fiscal year-end 2005.

Net Assets
(in thousands)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Assets						
Current and other assets	$ 899,582	$ 886,077	$ 822,909	$ 825,539	$ 1,722,491	$ 1,711,616
Capital assets	2,307,564	2,208,545	3,805,845	3,569,735	6,113,409	5,778,280
Total Assets	3,207,146	3,094,622	4,628,754	4,395,274	7,835,900	7,489,896
Liabilities						
Long-term liabilities	1,217,133	1,310,429	2,382,170	2,144,772	3,599,303	3,455,201
Other liabilities	277,216	280,961	229,335	319,834	506,551	600,795
Total Liabilities	1,494,349	1,591,390	2,611,505	2,464,606	4,105,854	4,055,996
Net Assets						
Invested in capital assets, net of related debt	1,754,320	1,622,170	1,566,302	1,524,744	3,320,622	3,146,914
Restricted	324,716	289,894	329,262	311,665	653,978	601,559
Unrestricted	(366,239)	(408,832)	121,685	94,259	(244,554)	(314,573)
Total net assets	$ 1,712,797	$ 1,503,232	$ 2,017,249	$ 1,930,668	$ 3,730,046	$ 3,433,900

This deficit does not mean that the County's governmental activities do not have resources available to pay their obligations in the coming year. The increase in net assets for governmental activities in 2006 reflects the County's ability, on an annual basis, to meet its current obligations in those activities including the related debt service requirements. The deficit in unrestricted net assets is the result of the governmental activities having long-term commitments that are greater than currently available resources. Specifically, the County's governmental activities include general obligation debt of $523.2 million, $42.2 million less than at the end of 2005, for which no corresponding assets are recorded but for which future revenues are obligated.

Of the amount of debt with no corresponding assets, 72.2 percent or $378.0 million is related to assets that are recorded on the books of two of the County's three discretely presented component units: the Washington State Major League Baseball Stadium PFD ($169.6 million), and the Harborview Medical Center ($208.4 million). As discretely presented component units, these entities are not part of the primary government or incorporated into this analysis. The remainder of the debt, for which there are no corresponding assets, consists of $106.4 million associated with the Kingdome facility, which was demolished to make room for the Seahawks (Qwest) Football Stadium, and $38.7 million used to finance assets that have been contributed by the County to other programs and services that benefit the citizens of the County.

Business-type activities. There was an increase of 4.5 percent to $2,017.2 million in the net assets of business-type activities. Of the total net assets for business-type activities, 77.7 percent or $1,566.3 million is invested in capital assets (e.g., land, buildings, vehicles, plant assets, equipment, and work in progress), net of related debt. The business-type activities use these capital assets to provide services to their customers; consequently, these assets are not available for future spending. The resources needed to repay the debt incurred to acquire these assets must be provided from other sources since the capital assets themselves cannot be liquidated for these liabilities. Another 16.3 percent of the total net assets of business-type

activities is restricted as to use for capital construction ($285.2 million), debt service ($39.4 million), and other purposes ($4.7 million). The remaining 6.0 percent or $121.7 million is unrestricted net assets that may be used to finance the continuing operations of the County's business-type activities. Any balance in the unrestricted net assets for business-type activities cannot be used to reduce the unrestricted net asset deficit in governmental activities.

The combination of the $366.2 million deficit in the governmental activities unrestricted net assets and the $121.7 million positive balance in the business-type activities unrestricted net assets resulted in the deficit of $244.5 million in total unrestricted net assets for the County as a whole.

Analysis of Changes in Net Assets

The increase in the County's total net assets in 2006 resulted from revenues exceeding related expenses and reflects the County's ability to meet its ongoing obligations including its debt service requirements. Approximately 42.3 percent of the County's total revenues came from taxes, primarily Property taxes and the Retail sales and use taxes. Charges for various goods and services provided 39.3 percent of the total revenues, while 15.4 percent was derived from operating and capital grants and contributions (including state and federal assistance). The County's expenses cover a range of services, the largest of which were for law, safety and justice; mental and physical health; public transportation; and water quality.

The condensed financial information on the following page is derived from the government-wide Statement of Activities and reflects how the County's net assets changed during the 2006 fiscal year.

Governmental activities. Governmental activities accounted for 70.8 percent of the total growth in net assets of the County, resulting in an increase in the County's governmental activities net assets of $209.5 million. Program revenues for governmental activities total $776.9 million and include the amount paid by those who directly benefited from the programs ($484.3 million), and by other governments and organizations that subsidized certain programs with operating grants and contributions ($183.6 million), and capital grants and contributions ($109.0 million). In 2006 the cost of all governmental activities was $1,301.0 million. The County paid for the $524.1 million remaining "public benefit" portion of governmental activities with $468.7 million in property taxes, $150.1 million in retail sales and use taxes, and $117.3 million in other revenues, including other taxes and interest earnings. As discussed earlier, all of the increase in governmental activities net assets was either restricted as to use or used to acquire capital assets to provide services to the County's citizens.

Changes in Net Assets
(in thousands)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenues						
Program revenues						
Charges for services	$ 484,298	$ 455,768	$ 500,165	$ 464,344	$ 984,463	$ 920,112
Operating grants and contributions	183,563	193,299	56,400	14,141	239,963	207,440
Capital grants and contributions	109,043	156,613	37,366	83,987	146,409	240,600
General revenues						
Property taxes	468,740	447,041	-	-	468,740	447,041
Retail sales and use taxes	150,111	138,572	367,264	341,149	517,375	479,721
Other taxes	72,123	67,617	-	-	72,123	67,617
Unrestricted interest earnings	45,206	28,352	28,833	16,397	74,039	44,749
Total revenues	1,513,084	1,487,262	990,028	920,018	2,503,112	2,407,280
Expenses [a]						
General government [b]	86,785	85,516	-	-	86,785	85,516
Law, safety and justice	509,225	476,101	-	-	509,225	476,101
Physical environment	57,132	51,897	-	-	57,132	51,897
Transportation	97,601	90,803	-	-	97,601	90,803
Economic environment	92,459	87,420	-	-	92,459	87,420
Mental and physical health	364,600	346,672	-	-	364,600	346,672
Culture and recreation	41,042	36,902	-	-	41,042	36,902
Interest and other debt service costs	52,144	54,538	-	-	52,144	54,538
Airport	-	-	15,392	15,537	15,392	15,537
Public transportation	-	-	536,954	529,679	536,954	529,679
Solid waste	-	-	102,703	95,457	102,703	95,457
Water quality	-	-	244,243	228,438	244,243	228,438
Other enterprises activity	-	-	6,686	5,788	6,686	5,788
Total expenses	1,300,988	1,229,849	905,978	874,899	2,206,966	2,104,748
Increase in net assets before transfers	212,096	257,413	84,050	45,119	296,146	302,532
Transfers	(2,531)	992	2,531	(992)	-	-
Increase in net assets	209,565	258,405	86,581	44,127	296,146	302,532
Net assets, beginning of year (restated) [c]	1,503,232	1,244,827	1,930,668	1,886,541	3,433,900	3,131,368
Net assets, end of year	$ 1,712,797	$ 1,503,232	$ 2,017,249	$ 1,930,668	$ 3,730,046	$ 3,433,900

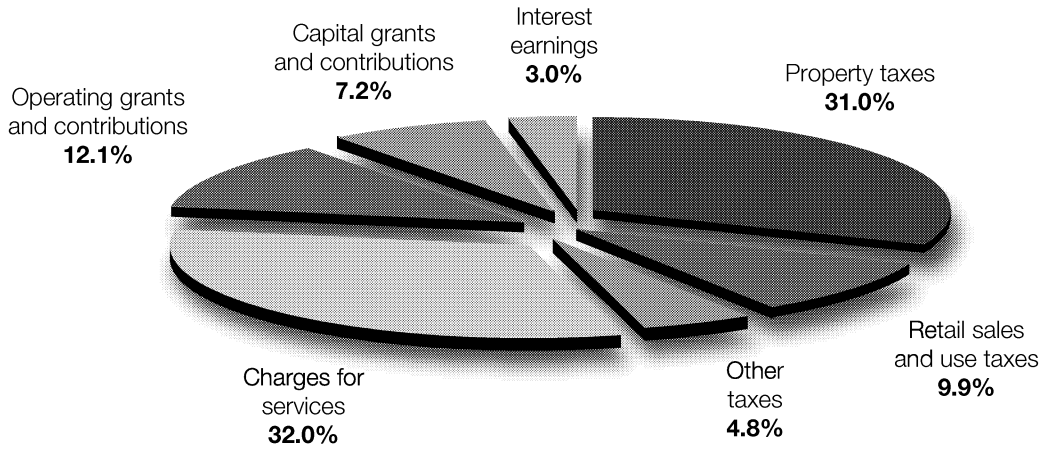
(a) Expenses for all functions include the allocation of indirect expenses from the general government function. The amount of indirect general government expenses allocated to each function is shown in a separate column on the County's government-wide Statement of Activities alongside the column that reflects the direct operating expenses incurred by each function. As a result of this allocation, the $86.8 million in General government expense above consists of $126.8 million in direct program expenses and loss on disposal (transfer) of capital assets of $22.3 million reduced by a net allocation of $62.3 million to other County functions.

(b) General government expenses includes loss on sale/disposal of capital assets of $22.3 million and $26.9 million in 2006 and 2005, respectively. The 2005 loss on sale of capital assets includes the write-off of $15.2 million of costs from the Financial System Replacement Project.

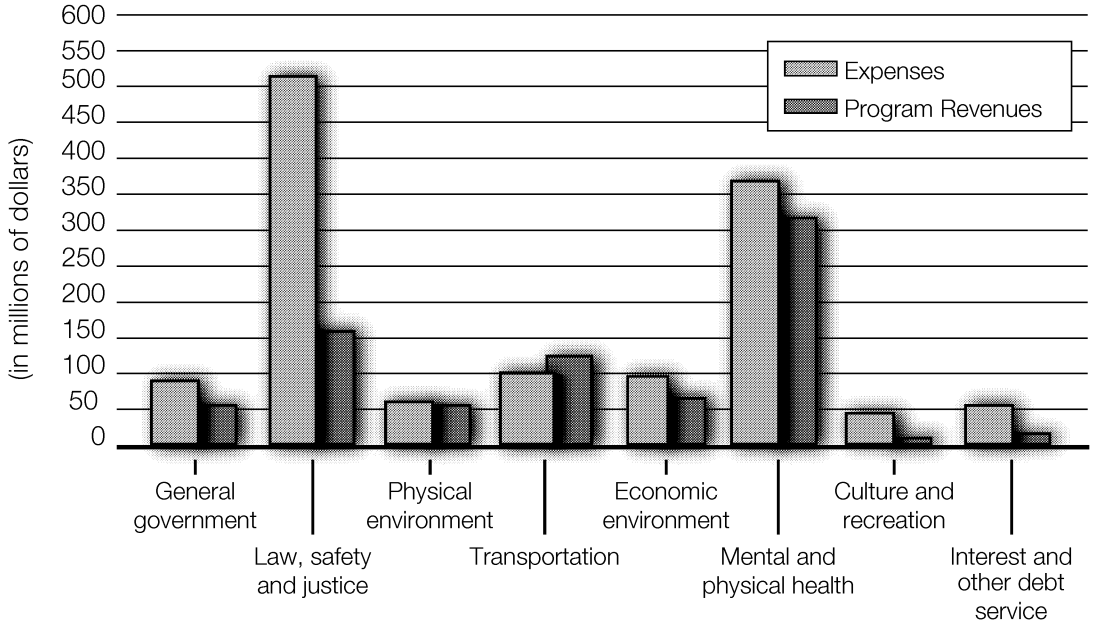
(c) Net assets, beginning of year has been restated, see Note 15, "Restrictions, Reserves, Designations, and Changes in Equity" – Restatements of Beginning Balances.

The charts below illustrate the County's revenues by source and its expenses and program revenues by function for its governmental activities:

Revenue by Source – Governmental Activites
2006



Expenses and Program Revenues – Governmental Activites
2006



Charges for services provided 32.0 percent, and property taxes 31.0 percent, of total revenues for governmental activities. One of the most significant expense amounts is for Law, safety and justice, a function that requires the greatest usage of general government revenues. The primary revenue sources for Mental and physical health are charges for services and operating grants and contributions, which paid for 85.6 percent of the activities for that function. In 2006 Transportation received $75.8 million in infrastructure and right-of-way capital assets from developers, which enabled program revenues to exceed expenses. These capital contributions accounted for over one-third of the 2006 increase in governmental activities net assets.

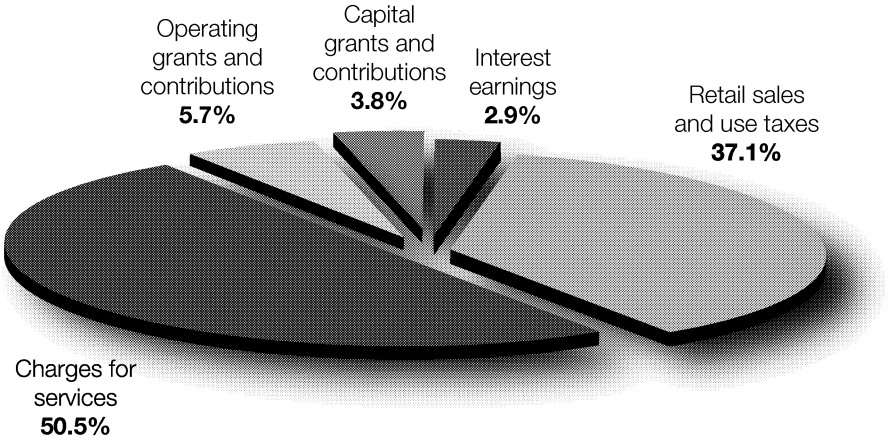
A comparison of the cost of services by function for the County's governmental activities is shown below, along with the revenues used to cover the net expenses of the governmental activities (in thousands):

(Expenses) Net of Program Revenues	
General government	$ (33,801)
Law, safety and justice	(353,991)
Physical environment	(4,526)
Transportation	23,067
Economic environment	(29,682)
Mental and physical health	(51,739)
Culture and recreation	(34,161)
Interest and other debt service costs	(39,251)
Total expenses	(524,084)
General revenues	
Property taxes	468,740
Retail sales and use taxes	150,111
Other taxes	72,123
Unrestricted interest earnings	45,206
Other	(2,531)
Increase in net assets	$ 209,565

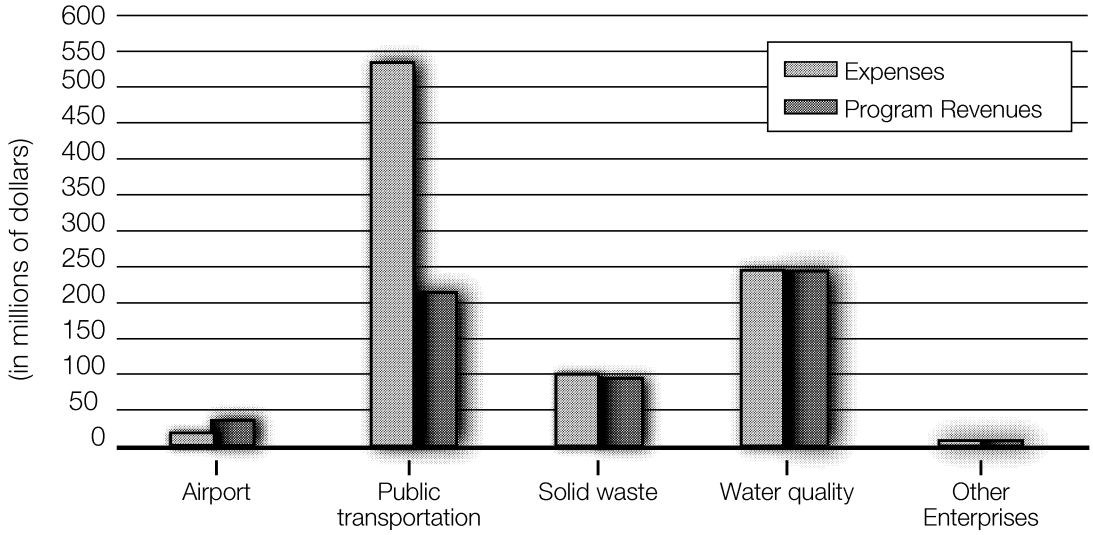
Business-type activities. Business-type activities increased the County's net assets by $86.6 million in 2006, accounting for 29.2 percent of the total growth in net assets of the County. Total revenues for business-type activities were $990.1 million. The cost of all business-type activities for 2006 was $906.0 million. Of that amount, 65.5 percent or $594.0 million was funded from program revenues, including $500.2 million in charges for services, $56.4 million from other governments and organizations that subsidized certain programs with operating grants, and $37.4 million in capital grants and contributions. The Public Transportation program operations are subsidized with retail sales and use tax revenues, which amounted to $367.3 million in 2006. In addition, business-type activities received $28.8 million in unrestricted interest earnings and other rental income.

The charts on the following page illustrate the County's business-type revenues by source and business-type expenses and program revenues by function:

Revenue by Source – Business-type Activites
2006



Expenses and Program Revenues – Business-type Activites
2006



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.

Governmental Funds

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

As of December 31, 2006, the County's governmental funds reported combined ending fund balances of $420.4 million, an increase of $3.4 million in comparison with the prior year. Approximately 68.5 percent ($287.9 million) constitutes unreserved fund balance which is available for spending in the coming year at the County's discretion. The remainder of fund balance is reserved to indicate that it is not available for new spending because it has already been committed to the liquidation of outstanding contracts and purchase orders of the prior fiscal year ($93.8 million), to pay debt service ($16.7 million), for prepayments ($4.9 million), and for a variety of other restricted purposes ($17.1 million).

Overall governmental fund revenues totaled approximately $1,482.6 million for 2006, which represents an increase of 6.5 percent, or $90.0 million, over the fiscal year ended December 31, 2005. The increase was primarily due to strong growth in Property taxes (up $21.6 million), Retail sales and use taxes (up $11.5 million), Intergovernmental revenues (up $24.7 million), and Interest earnings (up $13.8 million). In 2006, expenditures for governmental funds totaled $1,489.4 million, an increase of 7.1 percent or $98.8 million from the previous fiscal year. Current expenditures were up 6.4 percent or $74.6 million from the previous fiscal year, Debt service expenditures (excluding the payment to escrow agent) were up $3.4 million (2.5 percent), and Capital outlay expenditures were up $2.8 million (3.3 percent). Total expenditures for governmental funds exceeded revenues by $6.8 million in 2006 compared to revenues exceeding expenditures by $2.0 million for the 2005 fiscal year.

The **General Fund** is the chief operating fund for the County. At the end of the fiscal year, total fund balance for the General Fund equaled $143.8 million. Unreserved fund balance, the amount considered available to spend, totaled $119.5 million. Of that amount, $23.2 million has been designated for working capital purposes and contingencies and is not considered available to spend. As a measure of the General Fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents 22.5 percent of total General Fund expenditures, a decrease from the 25.9 percent of a year ago. Total fund balance represents 27.1 percent of total General Fund expenditures, a decrease from the 29.7 percent of a year ago.

The fund balance of the County's General Fund decreased by a modest $227 thousand during 2006, which was a major decline from the $22.0 million increase in 2005. While revenues were up $34.5 million (6.1 percent) in 2006, expenditures were up $46.2 million (9.5 percent) and Other Uses were up $10.6 million. As a result, Revenues and Other Sources closely matched Expenditures and Other Uses in 2006. The $34.5 million increase in revenues includes an increase of $14.3 million in Taxes, $7.7 million in Interest earnings, $6.3 million in Intergovernmental revenues, and $5.2 million in charges for service. The total $56.8 million (10.5 percent) increase in expenditures and other financing uses, reflecting increased support for programs and services, resulted in the $22.3 million decline in change in fund balance in the 2006 fiscal year from the change in fund balance in the 2005 fiscal year. Over $31 million of the $46.2 million

increase in expenditures was in the Law, Safety, and Justice function, including increased expenditures of $9.1 million for Adult and Juvenile Detention, $8.4 million in the Sheriff's Office, $4.1 million in the Office of the Prosecuting Attorney, and $6.6 million in increased expenditures for the courts. Other significant increases in current expenditure functions in 2006 include $7.7 million in general government and $4.9 million in economic environment. The 2006 increase of $10.6 million in transfers out included $6 million of General Fund support for the Pandemic Influenza Response Plan.

The **Public Health Fund**, a special revenue fund, is used to finance health service centers located throughout the County and other public health programs to promote health and prevent disease to King County residents. At the end of 2006 it had a total fund balance of $7.7 million (down from $9.7 million at the end of 2005), of which $4.7 million was unreserved and available for spending. The $3.1 million increase in revenues from the 2005 level is due to a $4.9 million increase in Intergovernmental revenues and a decline in Charges for services of $3.0 million. Other revenues were up $1.2 million. In 2006, expenditures increased by $5.1 million.

Proprietary Funds

The County's proprietary funds provide the same type of information found in the government-wide financial statements for business-type activities. This information is presented on the same basis of accounting, but provides more detail.

As previously discussed in the business-type activities, the County's net assets increased by $86.6 million as a result of operations in the proprietary funds adjusted to reflect the consolidation of internal service fund activities related to the enterprise funds. Of the two major proprietary funds, the Public Transportation Enterprise provided $48.6 million of this increase while the net assets of the Water Quality Enterprise increased by $10.4 million.

The **Public Transportation Enterprise** accounts for the operations, maintenance, capital improvements, and expansion of public transportation and related facilities in the County. At the end of 2006 the Public Transportation Enterprise had total net assets of $1,289.3 million of which 77.2 percent or $995.3 million was invested in capital assets, net of related debt; 18.0 percent or $232.0 million was restricted as to use for capital purposes and bond reserves; and 4.8 percent or $62.0 million was unrestricted and available for spending. Net assets increased by $48.6 million in 2006, up from the 2005 change in net assets of $36.9 million. In 2006 operating revenues increased by $12.8 million (9.8 percent) and operating expenses increased by $14.5 million (2.8 percent). These changes were influenced by a number of factors, including increased diesel prices in 2006 resulting in additional expenditures of $4.7 million; and a decrease in depreciation expenses in 2006 of $20.0 million, primarily because depreciation was suspended while the Downtown Seattle Transit Tunnel and Waterfront Streetcar are not in operation.

The **Water Quality Enterprise** accounts for the operations, maintenance, capital improvements, and expansion of the County's water pollution control facilities. Total net assets in the Water Quality Enterprise were $509.5 million at the end of 2006 of which 75.5 percent or $384.9 million was invested in capital assets, net of related debt; 16.7 percent or $85.0 million was restricted as to use for construction projects, debt service, and litigation; and the remaining 7.8 percent or $39.6 million was unrestricted and available for spending. The monthly sewer rate remained at $25.60 in 2006 and the associated Residential Customer Equivalents (RCE) customer base grew from 689,817 to 690,934. Total operating revenues increased to $241.3 million reflecting an overall 9.1 percent increase or a 2.4 percent increase in revenues if the 2005 contribution to the Rate Stabilization Reserve is excluded. Other operating revenues increased $5.7 million in 2006 or 24.1 percent following a decrease of $0.8 million or 4.3 percent in 2005. The majority of these changes were related to capacity charge revenues. The capacity charge rate for new

connections was $34.05 in both 2005 and 2006 with new capacity charge connections of 10,896 and 9,628 respectively. Construction continued on the new Brightwater treatment plant located in southern Snohomish County and the associated conveyance system. Total cost estimates for the Brightwater project currently are $1.8 billion. In 2006, actual expenditures were $170.3 million, and cumulatively are $434.0 million life-to-date.

General Fund Budgetary Highlights

The County's final General Fund budget differs from the original budget in that it reflects an increase in appropriations of $42.3 million during the year. However, actual budgetary basis expenditures were only $24.3 million more than the original budget. This resulted in an underutilization of the total final appropriation authority by $18.0 million, including $5.6 million underexpenditures in General governmental services; $4.9 million in Law, safety and justice; and $4.6 million in Transfers out. During the year total revenues exceeded budgetary estimates by $25.4 million and total expenditures were less than budgetary estimates by $18.0 million, eliminating the need to draw upon the existing fund balance.

CAPITAL ASSETS, INFRASTRUCTURE, AND DEBT ADMINISTRATION

Capital assets

The King County primary government's investment in capital assets for its governmental and business-type activities as of December 31, 2006, amounts to $6.1 billion (net of accumulated depreciation). Capital assets include land, right-of-way, conservation easements and development rights, buildings, improvements other than buildings, roads and bridges infrastructure, vehicles, furniture, machinery and equipment, and construction work-in-progress. The total increase in the investment in capital assets over the previous year was 5.8 percent (4.5 percent increase for governmental activities and 6.6 percent increase for business-type activities). Notably, construction activity picked up in 2006 as evidenced by an increase in work-in-progress by 48.3 percent in governmental activities and 37.5 percent in business-type activities.

Major capital asset events during 2006 included the following:

- Construction of the Brightwater regional wastewater treatment plant began in 2006. Major acquisitions of real property and conveyances were made and site preparations have begun at the portal sites and at the main treatment plant area. Mitigation projects to lessen environmental impacts were also ongoing. As a result land and work-in-progress for Water Quality increased dramatically.

- Significant construction activity is also noted in the Public Transportation, King County International Airport, and Solid Waste enterprises. Public Transportation undertook improvements and remodels of bus bases and parking facilities, improvements and additions to transit centers and park-and-ride lots, and continued planning and construction for the bus tunnel joint project. At the King County International Airport, there is an ongoing runway improvement project, part of the implementation of the Airport Development Plan intended to bring the airport's main runway up to Federal Aviation Administration safety standards. For the Solid Waste enterprise, construction began on the replacement of the 1st NE Transfer Station in accordance with the facility master plan.

- For governmental activities, significant construction activity came from additions and upgrades to parks facilities, development and improvements to the trail system, building renovations and upgrades to the King County Courthouse and other county buildings, systems and security improvements to the King County Correctional Facility, and technology related projects to automate various agency operations.

A summary of the 2006 capital assets activity is shown below. The restatements of the indicated prior year amounts are due to changes in the Water Quality enterprise related to a reclassification of items between capital asset classes, and an adjustment to accumulated depreciation due to a change in estimated useful lives of certain plant assets. More detailed information on the County's capital assets can be found in Note 6 – Capital Assets.

King County's Capital Assets
(in millions)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Land	$ 731.3	$ 686.2	$ 324.8	$ 282.8	$ 1,056.1	$ 969.0
Buildings*	452.3	461.8	691.8	688.0 **	1,144.1	1,149.8
Improvements other than buildings*	17.7	24.9	1,296.7	1,273.6 **	1,314.4	1,298.5
Infrastructure	953.2	910.5	-	-	953.2	910.5
Equipment*	75.8	73.0	536.5	629.8 **	612.3	702.8
Construction in progress	77.2	52.1	956.1	695.5	1,033.3	747.6
Total	$ 2,307.5	$ 2,208.5	$ 3,805.9	$ 3,569.7	$ 6,113.4	$ 5,778.2

* Net of depreciation
** Restated

Infrastructure

The County has elected to use the modified approach in reporting roads and bridges. Under the modified approach, asset condition is reported rather than recording depreciation. The rating scales for pavements (roads) and bridges are further explained in the required supplementary information which follows the notes to the basic financial statements.

The County performs condition assessments on its network of roads through the King County Pavement Management System, which generates a Pavement Condition Index (PCI) for each segment of arterial and local access road in the network. The PCI is a numerical index on a 100-point scale that represents the pavement's functional condition based on the quantity, severity, and type of visual distress. Condition assessments are undertaken every three years.

It is the policy of the King County Road Services Division to maintain at least 80 percent of the road system at a PCI of 40 or better. In the most recent condition assessments, 86.2 percent of the arterial roads in the County and 87.0 percent of the local access roads in the County had a PCI rating at 40 and above. The majority of roads that fall below the established rating are local access roads that are situated in rural areas. The amount budgeted in 2006 for road maintenance was $26.6 million. The amount actually expended was $16.7 million. Underspending of the budgeted amount is a result of the removal of roads from the project list because of conflicts with anticipated utility work, cost efficiencies related to a relatively few roads to be resurfaced in remote locations, and weather-related work reductions or stoppages.

The County currently maintains 187 bridges. Physical inspections to uncover deficiencies are carried out at least every two years and documented. There is also an annual evaluation to determine which bridges are candidates for replacement or rehabilitation using a 10-point priority scale based on various factors of bridge condition. A key element in the priority scale is the sufficiency rating, which is a numerical rating (on a 100-point scale) of a bridge based on its structural adequacy and safety, essentiality for public use, and its serviceability and

functional obsolescence. The policy of the King County Road Services Division is to maintain bridges in such a manner that no more than 12 (6.4 percent) will have a sufficiency rating of 20 or less. The current assessment showed 6 bridges are at or below this threshold. The amount budgeted in 2006 to maintain and preserve bridges was $16.6 million. Actual amounts expended were $11.2 million. Underspending of the budgeted amount is due to the construction schedule of certain projects extending beyond the budget year.

More detailed information on the County's capital assets can be found in Note 6 – Capital Assets.

Debt Administration

At the end of 2006, King County primary government has total bonded debt outstanding of $3,148.2 million for its governmental activities and business-type activities. Of this amount, $1,649.1 million is comprised of debt backed by the full faith and credit of the County. The $1,499.1 million remainder of the County's bonded debt represents bonds secured solely by specified revenue sources (revenue bonds).

King County's Outstanding Debt
General Obligation and Revenue Bonds
(in millions)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
General obligation bonds	$ 870.4	$ 966.3	$ 642.4	$ 741.1	$ 1,512.8	$ 1,707.4
General obligation lease revenue bonds	136.3	139.8	-	-	136.3	139.8
Revenue bonds	-	-	1,499.1	1,189.8	1,499.1	1,189.8
Total	$ 1,006.7	$ 1,106.1	$ 2,141.5	$ 1,930.9	$ 3,148.2	$ 3,037.0

The total bonded debt increased by 3.7 percent over 2005 or $111.2 million (9.0 percent or $99.4 million decrease for governmental activities and 10.9 percent or $210.6 million increase for business-type activities). The decrease of bonded debt outstanding in the governmental activities was primarily due to the $82.3 million of debt service payments in 2006. The business-type activities' bonded debt was increased due to the issuance of $250.0 million of sewer revenue bonds to finance the capital needs of the Water Quality Enterprise.

During 2006 the County refinanced some of its existing debt through advance refunding to take advantage of the favorable interest rates:

- The County refinanced $46.6 million of general obligation bonds that is expected to decrease future aggregate debt service payments by $4.4 million over the life of the bonds.
- The County also refinanced $85.1 million of sewer revenue bonds and $85.3 million of previously outstanding general obligation bonds payable from sewer revenues. The result is expected to decrease future aggregate debt service payments by $22.6 million over the life of the bonds.
- Using excess proceeds from special taxes and revenues, the County completed two partial defeasances of general obligation (baseball stadium) bonds that are expected to decrease debt service payments by $23.5 million.

The County maintains a rating of "Aa1" from Moody's, a rating of "AAA" from Standard & Poor's, and a rating of "AA+" from Fitch for its limited tax general obligation debt. For its unlimited tax general obligation debt, the County has a rating of "Aaa" from Moody's, a rating of "AAA" from Standard & Poor's, and a rating of "AAA" from Fitch. The ratings for its Water Quality Enterprise's revenue debt are "A1" from Moody's and "AA" from Standard & Poor's.

State statutes limit the amount of general obligation debt that the County may issue to 2 ½ percent of its total assessed valuation for both general county purposes and metropolitan functions. The current debt limitation of total general obligations is $7,468.9 million for both general county purposes and metropolitan functions, which is significantly higher than the County's outstanding general obligation debt of $1,129.5 million for general county purposes and $676.5 million for metropolitan functions.

Additional information on King County's long-term debt can be found in Note 13 – Debt.

ECONOMIC OUTLOOK AND NEXT YEAR'S BUDGET

Economic factors have a direct impact on the County's revenues and the demand for services. The County's revenue sources include taxes, charges for services, and intergovernmental revenues. The largest single source is taxes, which comprise approximately forty percent of total revenues and consist primarily of taxes on real property. Property taxes tend to be stable because levy rates are calculated months in advance and King County establishes assessed value from the preceding four years of real estate sales. Other tax sources, such as retail sales and use tax, are more volatile and directly influenced by economic conditions in the region.

Property assessed valuation increased by 10.5 percent and 8.5 percent in 2006 and 2005, respectively. Property tax collections grew by 2.5 percent in 2006 compared with 0.8 percent growth in 2005. Total regional employment growth is expected to be 3.6 percent, and regional population growth is expected to be 1.5 percent. Unemployment in King County was 4.2 percent in 2006 compared with 4.7 percent in 2005. Personal income has grown by 5.9 percent on average between 2003 and 2006. These and other factors were considered in the budget enacted for 2007. By law, the County is required to adopt a balanced budget. The entire 2007 budget for the County, adopted by the County Council in November 2006, totals $4,050.5 million. Of this amount, $649.7 million is appropriated for the General Fund; $889.1 million for enterprise funds (including public transportation, solid waste and water quality); and $789.4 million for special revenue funds (including public health, emergency medical services, human services, and road funds). The budget also includes $1,133.3 million committed to capital improvements for water quality, public transportation, roads, parks and other major public facilities. The general fund budget maintained a six percent budgetary undesignated fund balance as a percentage of revenues.

Other considerations

King County will continue to face numerous challenges including volatile energy prices, rising employee and programmatic healthcare costs and the need to raise sufficient revenues to support utility, public transportation and general government activities.

Property tax is the largest revenue source in the County's general fund at 40 percent of total general fund revenues. The Council-approved property tax levy is limited to one percent growth each year plus the property tax on new construction.

The County is in the fourth year of an annexation initiative and will face operational and budgetary adjustments as annexations are completed. Ten major urban unincorporated areas are identified that by County Planning Policies should be incorporated into or annexed into cities by 2012. Incorporation or annexation is also encouraged by the Washington State Growth Management Act. Major annexation areas are in various stages of the annexation process, but the completion dates of major annexations are not currently known. In 2006, there were no large annexations or incorporations. The fiscal impacts of incorporation and annexation depend upon the revenue generating capacity of an area compared to its service demands. The 2007 adopted budget made a policy reserve of $10 million for annexation incentives.

In early 2006 the Washington State Legislature enacted a credit against the state sales tax for cities that annex areas with over ten thousand residents. The annexing city is eligible for the credit, which is effectively a sales tax rate of 0.1 percent, applied to the newly annexed area and within the prior city. If the annexed area population exceeds twenty thousand, the applicable credit is 0.2 percent. Annexing cities must complete annexations by January 1, 2010 to be eligible for the credit.

In 2006, voters approved an expansion of transit services by approving a 0.1 percent sales tax increase in King County. The tax is to support increases in King County Metro Transit service in the Public Transportation Enterprise.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of the County's financial activities 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 Chief Accountant/Manager, Financial Management Section, Room 653, Administration Building, 500 Fourth Ave., Seattle, WA 98104.