

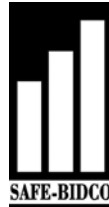
2005 Sonoma County Technology Sector Report



Prepared by the Economic Development Board
in Partnership with the Sonoma County
Workforce Investment Board

July 2005

With Acknowledgment and Appreciation to the Underwriters of the
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Sonoma County Economic Development Board Technology Sector Report 2005

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July 2005

The Sonoma County Economic Development Board, in partnership with the Workforce Investment Board, is pleased to bring you the 2005 annual technology report. In this report you will find the latest available economic data and industry trends for the technology sector in Sonoma County.

Key highlights of the trends that can be found in this report include:

- Increased demand in wireless technology is causing a rebound in demand for infrastructure equipment.
- Local biotech firms show a positive outlook, and Sonoma County will see growth in both research and employment for stent research.
- While tech employment has been cut in half since early 2001, employment has stabilized since last November. Despite the lack of employment growth, there has been an increase in productivity.
- Overall, profitability has rebounded thanks to rising sales and improved cost structures.
- Sonoma County's long-term strength in technology lies not as a producer of commodity products, but as a source of innovation.

As always, please feel free to contact the EDB Offices at (707) 565-7170, or by email at edb@sonoma-county.org.

Please note the following list of underwriters whose generous support make this research information possible. Thank you again for your interest in the Sonoma County economy.

Yours sincerely,



Ben Stone



North Bay Technology Roundtable

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Ben Stone
Executive Director, Economic
Development Board

Six years ago, the Sonoma County Board of Supervisors authorized the Economic Development Board to form the North Bay Technology Roundtable (NBTR). I am proud to report that since the NBTR's inception, the group has played a dynamic role in shaping a number of initiatives that benefit the technology industry, government, education, and community organizations.

While it is gratifying to see the accomplishments of the programs we have established, we continue to work towards improving the vitality of the NBTR. Under its vision to develop and sustain the region as a recognized center for technology-related industries, the NBTR has expanded its membership roster and chartered four new committees to address key concerns of the industry including an Economic Development Committee, Technology Community Committee, Education and Workforce Committee, and Human Resource Committee. In addition, the NBTR recently reached out to new sectors within the technology industry in an effort to expand its roster of companies. It has received endorsements from electronics, biotech, telecommunications, internet and software companies in the North Bay.

This year's initiatives were truly exciting. In April 2005, the NBTR and the Sonoma County Economic Office of Education (SCOE) sponsored the third annual Lego Robotics program to introduce middle school students to a new and fun way of learning more math, science, and engineering skills. Also in April, the NBTR initiated its inaugural Science Fair for Sonoma County middle school students in conjunction with SCOE. We continue to build math, science, and engineering skills for local university students by working with Sonoma State University and strongly supporting its Bachelors in Science and Engineering Program.

As you can see, the NBTR has played a powerful role in enhancing the technology sector in Sonoma County, and indeed the quality of life in our community. For more information about the North Bay Technology Roundtable, contact the Sonoma County Economic Development Board at 707-565-7170 or visit the NBTR website at NBTR.org. I look forward to the positive work that the NBTR will do in the years to come.

Sincerely,

Jerry Gladstone
Chair, NBTR

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Section I

Economy.com's 2005 Technology Sector Report

This report was prepared for the Sonoma County Economic Development Board.

Tech Industry - Sonoma County

Recent Trends. Sonoma County's high-technology industries are rebounding slowly. Demand for high-tech equipment and services remains healthy thanks to broad-based global growth, rising business capital spending, and strong consumer spending. However, the major components of Sonoma's high-tech manufacturing base—such as medical devices, test and measurement equipment, and telecommunications equipment—are experiencing mixed results.

While sales in the medical technology industry may be rising, employment is not. Locally, Medtronic Inc. plans to construct a \$5.5 million research laboratory for testing pharmaceutical compounds; the company also has sent hundreds of manufacturing jobs from Sonoma County production facilities to Mexico and Ireland, where many products are now made. Although this continual offshoring trend weighs on local manufacturing jobs, the county has grown accustomed to this production cycle and continues to experience a growing emphasis on research and development and innovation.

Some telecom component makers are shifting their focus to the testing market. That said, Sonoma's high-tech test and measurement equipment industry has surged over the last 15 months, drawing down the local talent pool and filling part of the vacuum left by the receding telecom equipment industry. Some of the activity can be attributed to former Agilent Technologies employees putting their electronics testing expertise to new uses. But makers of a broad range of weighing, sensing, and measuring equipment for the electronics, telecommunications, agricultural, manufacturing, and biotech industries are coming into the area and flourishing as a result, although here again, the employment impacts can be small. For example, the three-employee Virtual Measurement & Control in Sonoma County leased a warehouse to hold a greatly expanded line of digital programmable scales made in its new Chinese plant.

Anecdotal evidence points to improvements in Sonoma's telecommunications industry. With the integration of ATG into Eschelon, the Minneapolis-based phone company plans to launch a major rebranding campaign in July to leverage the original infrastructure—advance switches, fiber ring, and DSL networks. Consolidation among telecom service providers has thus far been a mixed blessing for the national telecom equipment industry. Companies are again spending heavily to upgrade their networks, including laying

more fiber. However, the large telecom service providers now have more power to dictate prices. While this trend is not new in the wireless segment, as service providers often demand certain features on phones they will support, this phenomenon will increasingly be a facet of more high-technology products. This could limit already tight margins for the domestic telecom manufacturing industry.

Venture capital investment also buoys high-tech start-ups in Sonoma County, although the growth of VC placements has been slow.

Macro Drivers. The U.S. economy's steady expansion continues to benefit high-tech companies who are enjoying strengthening consumer spending and double-digit annualized increases in spending on capital equipment. The one exception is telecom equipment, which has yet to see strong renewed demand for telecommunications equipment nationally. Factory shipments for communications equipment grew by 9.2% in 2004, a slower pace than the double-digit increases in spending on all capital equipment.

Still-strong corporate profitability is generating ample cash flow to fund investment, and external financing conditions remain favorable. The healthy global economy, replacement demand, and high profits support healthy IT demand. On the consumer side, over the long term stronger growth in employment and personal income will support spending on telecom services and equipment.

Demographic trends and rising household income remain the fundamental drivers of medical supplies sales. In this regard, the industry is assured of steady demand for drugs and medical instruments that fight degenerative diseases in innovative ways—such as new stent grafts—thanks to aging baby boomers and the rising life expectancy of Americans. In addition, the growing prevalence of cardiac and other conditions related to obesity likely will support demand for several categories of medical devices. Sonoma County is reaping the benefits of this demand; Medtronic has leased a building in the county for the world headquarters of its endovascular division. The base of operations for the vascular division will remain at its complex in northeast Santa Rosa.

The weak U.S. dollar also benefits domestic manufacturers. As the dollar slips in value against other currencies, U.S.-made goods become more price-competitive both at home and abroad, boosting demand. In recent months, the dollar has maintained a steady trade-weighted level, weighing on California tech exports which had been climbing

significantly in previous quarters. However, the downward trend of the dollar should resume, particularly versus currencies in the fast-growing Asian economies.

Industry Drivers. Recent regulatory decisions of the FCC will have a far-reaching impact on Sonoma County's communications equipment industry. Indeed, the wave of recent consolidation in the services industry was in part due to the agency revisiting leasing rate regulations. The FCC's move was a major victory for the Baby Bells, spurring greater investment by increasing the rate of return on investment in new network infrastructure.

The high-tech testing industry follows the trajectory of high-tech manufacturing, and the past few years have seen a lot of consolidation among wireline telecommunications and semiconductor test equipment makers. That area of test and measurement is not a bright spot right now. Yet in general, the semiconductor industry is a large consumer of testing equipment, especially machine vision to inspect circuit boards and wafers. Traditionally, machine vision equipment makers turned out huge, expensive turnkey systems. But the price of components is dropping, and manufacturers are putting them together themselves. The most active sector of the testing industry is wireless telecommunications. Anything to do with testing cellular phones, WiFi, hot spots, and wireless services is attractive, especially for startups, who could never afford to break into semiconductor test equipment.

The impact that regulatory changes at the FDA has on the medical devices and equipment industry cannot be overstated. The FDA's Critical Path to New Medical Products initiative seeks to address a recent slowdown of innovative medical processes. The initiative envisages closer communication between reviewers and applicants, which will reduce the need for multiple-cycle reviews and consequently make product development less costly and more predictable. The program is still only in its initial stages and has just finished accepting proposals from the medical industry and related groups.

Pricing. Pricing power among producers of high-tech products remains weak. According to PPI data, telecom equipment prices continue to edge down as they have for most of the past six years. Deflation has eased somewhat since 2002, thanks to improving demand, but ongoing excess capacity persists.

Telecom manufacturers will not experience relief any time soon. Chinese manufacturers have moved into the global telecom equipment

market, using low prices to garner market share and thus accelerating the commoditization of some industry segments. While still a small player in the overall market, Chinese network equipment and cell phone manufacturers are experiencing robust growth in Asian and South American markets, and will only see their influence on global prices expand.

Greater scrutiny of pricing practices by medical device makers will lead to more competitive pricing in the industry, while emerging technologies in the medical devices industry will improve industry pricing power. Medical device manufacturers obtain over 30% of total revenue from a product in the first two years following its release when companies enjoy the least competition and the greatest pricing power.

Operating Expenses. Technology companies have managed to cut costs considerably over the last couple of years. Firms in Sonoma County have reduced operating expenses largely through layoffs and offshoring. For example, in recent news, JDS Uniphase announced it would cut 350 manufacturing jobs by the end of the year as it phased out production of some of its projection TV equipment. The company acknowledged production was better suited to other companies in Japan, though JDS would still make high-tech components in Santa Rosa. Indeed, although sizable job losses in high-tech have stalled, there is no indication of a substantial net hiring expected in the near term.

Among the county's smaller tech firms, high R&D spending will remain a large burden and, thus, many will continue to rely on venture capital investments to keep them afloat. Although VC funding remains a fraction of what it was during the tech boom, California companies have experienced solid growth in VC financing over the last year, with biotech and medical instrument companies leading the way.

Profitability. Profits in Sonoma's high-tech industries are on the upswing. Thanks to stabilizing demand and aggressive cost cutting over the past few years, telecommunications profitability has improved significantly. On the medical supplies front, increasing unit sales and the introduction of new technologies remain the primary drivers of profitability.

Going forward, the current cyclical upturn in telecom equipment spending should prop up demand from businesses, despite a slowdown in aggregate profit growth and the end of investment tax incentives. However, ongoing unit price depreciation as well as elevated production costs will weigh

on industry bottom lines over the forecast horizon. The medical devices industry will benefit from increased utilization of products due to demographic changes and a loosening of managed care restrictions. Profitability will also improve as a result of greater capitalization of new technologies in the medical device industry.

Specifically, Agilent Technologies Inc. reported a dip in revenues over last year because of weak sales in its automated test and semiconductor businesses, but its locally based operations had gains. Agilent's test and measurement group, which includes the company's Sonoma County wireless division, was a bright spot. Revenues for the group were up 7% over last year and the prior quarter. Intense competition and a weak market in the automated test sector, which saw revenues fall by \$85 million, are mostly to blame. But sales jumped \$48 million for the test and measurement group. In addition to a stabilized market for wireless handset testing equipment, Agilent saw growing demand for wireline test gear, oscilloscopes, and logic analyzers.

Long-Term Outlook. High-tech industries will have a harder time competing with lower-cost regions of the world. Although this trend is not unique to Sonoma County, the region's higher costs make manufacturing all the more difficult, confirming that Sonoma County's long-term advantage lies in innovation. Though the U.S. still has a formidable lead in engineering talent in the world, other countries are fast closing the gap. China is graduating five times the number of engineers as the U.S. New companies are continually starting up in the economy, but once growth reaches a state where the manufacturing or service can be performed in a more cost-effective way elsewhere, the jobs will likely leave and the cycle of investment and innovation will start again. For example, although Ireland will eventually surpass Sonoma County as Medtronic's producer of stents used in heart repair, research and development of drug-related stents and other future medical devices will remain in the U.S.

Going forward, technological advances, easing of regulatory barriers and demands for data, internet and wireless services all bolster the long-term outlook for communications equipment companies. Telecom investment will eventually return to more sustainable levels, with growth tied more closely to carriers' cash flows. In the meantime, some segments of telecom equipment have stronger prospects, namely broadband, IP technologies, metropolitan networks and wireless.

Sonoma County will continue to experience a high level of M&A activity. For example, medical device-maker TriVascular Inc. was sold to giant Boston Scientific. The 220-employee, 7-year-old TriVascular started in the shadow of another medical device company, Arterial Vascular Engineering, which later became part of Medtronic. TriVascular has developed a promising device to treat life-threatening aneurysms in the aorta which is expected to be on the market by 2008. Developments such as these and Boston Scientific's plan to grow the organization will support Sonoma's economy going forward.

Growth in healthcare spending for medical supplies will be stable in the U.S., but faces some downside risk due to concerns about the high level of healthcare expenditures relative to total consumer spending. This will place sustained pressure on medical device manufacturers to prove the efficacy of their costly products.

Upside Risks. Widespread recognition of WiMax, the newest wireless format, would certainly be a boon for the telecom industry, but not as much as Wi-Fi has been. WiMax has the ability to send signals over miles, not the feet that currently limit Wi-Fi access. This means that the industry would sell may fewer units, although it would certainly try to compensate by charging a higher price.

Tech-based curricula, through Sonoma State University's master's program in computer and engineering science, generate further upside potential to provide personnel needed for local tech industries. Its BS program in engineering science will commence this year, adding to local workforce quality and completing the stream of tech-based curricula that is also available at the junior college and high school level.

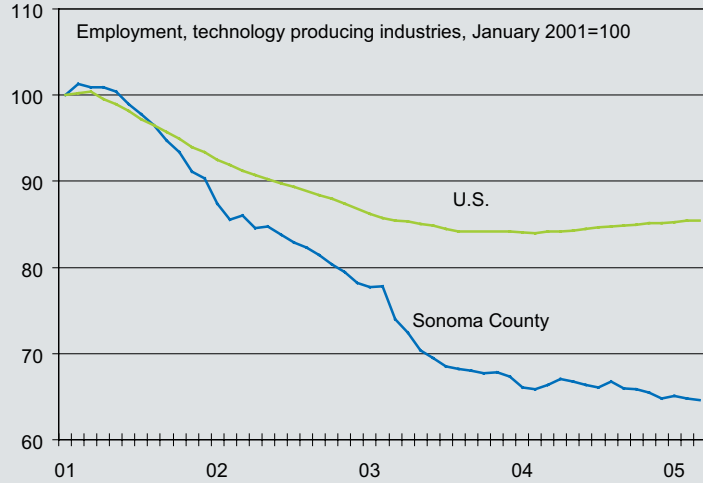
Downside Risks. The stretched U.S. consumer is a stark downside risk for the high-tech industry. Fundamental drivers of consumer spending are currently mixed. While job gains are improving, high energy prices, lackluster wage growth, high levels of consumer debt, and a low saving rate all bode ill for sustained retail growth this year. A sharp downward correction could cripple some of the weaker players in the telecommunications industry.

Consolidation among service providers presents further downside risk. If only a handful of telecom services firms are purchasing equipment, they would enjoy more bargaining power over prices.

*Kasie Blanchette
July 2005*

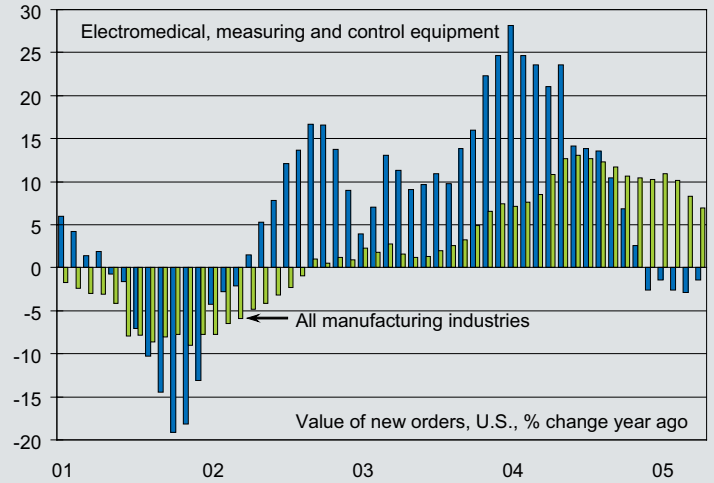
Tech Industry - Sonoma County

Increased Productivity and Offshoring Hurt Local Jobs



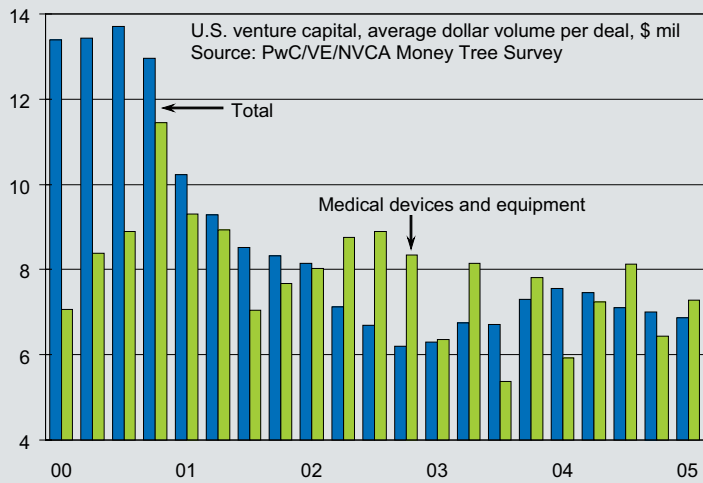
Nationwide employment in high-tech industries has been pinched by increased worker productivity and offshoring but Sonoma County's economy has been hit even harder by the downturn in tech employment. Peaking in 2001, the share of high-tech jobs in Sonoma County has dropped from nearly 10% to just over 6% of total employment. Nationwide the decline in share was less than one percentage point to about 4.5%. Indeed, consolidation and offshoring of manufacturing has caused a number of local operations to close or rapidly shrink, concentrating only R&D operations among local workers.

Falling Orders Bode Ill for Medical Equipment Makers



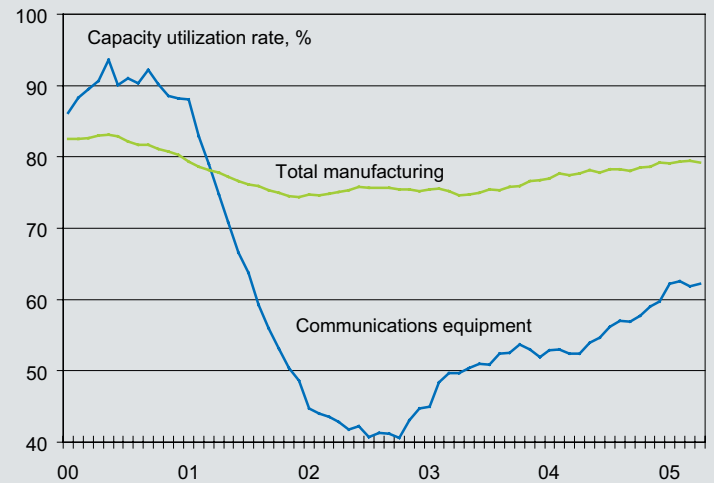
Steep accumulation of medical equipment in the past few years has led to decelerating orders for the industry. Indeed there has been some backlash against expensive equipment purchases as hospitals have had to absorb more of the cost of healthcare. Increasingly, hospitals are tightening oversight of purchasing decisions and ceding less leeway to doctors who normally make purchasing decisions. However, growing momentum for the modernization of medical records will drive a new cycle of equipment accumulation by hospitals. In addition, the perennial demand for consumer devices will offer support to the industry.

Venture Capital Flows Reviving for Medical Devices



Venture capital flows are returning and the medical supplies and devices industry is enjoying an above-average dollar volume. Such funding is of critical importance to the industry because small firms and start-ups rely heavily on such outside sources to fund hefty research and development costs. Furthermore, the federal deficit may restrain public funding for R&D. Small firms generate a high share of innovation in the industry and often are eventually taken over by larger firms when their research proves successful.

Telecom Price Pressures Remain at Bay, for Now



The capacity utilization rate is increasing more rapidly in the communications equipment manufacturing segment than in manufacturing as a whole, with a more than 22 percentage point increase since the end of 2002. This is not altogether surprising given the pronounced drop in utilization rates in 2001—from near 90% to well below 50%—due to the sharp decline in new orders. If the rebound continues at the current pace, telecom manufacturing utilization rates will approach 75% by next year, nearing the rate at which capacity strain results more capital investment and hiring of workers.

Section II

Sonoma County Economic Development Board's Quantitative Report

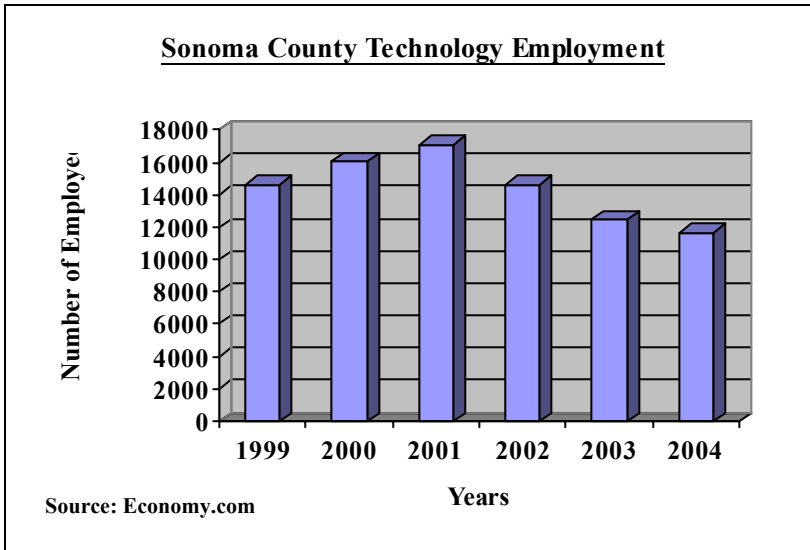
A. Background

The quantitative section of this report updates the information that was previously presented by the EDB in its 2000-2004 annual technology reports. As such, the first series of graphs depicts comparisons between the number of tech employees in Sonoma County and the percent growth or decline between years.

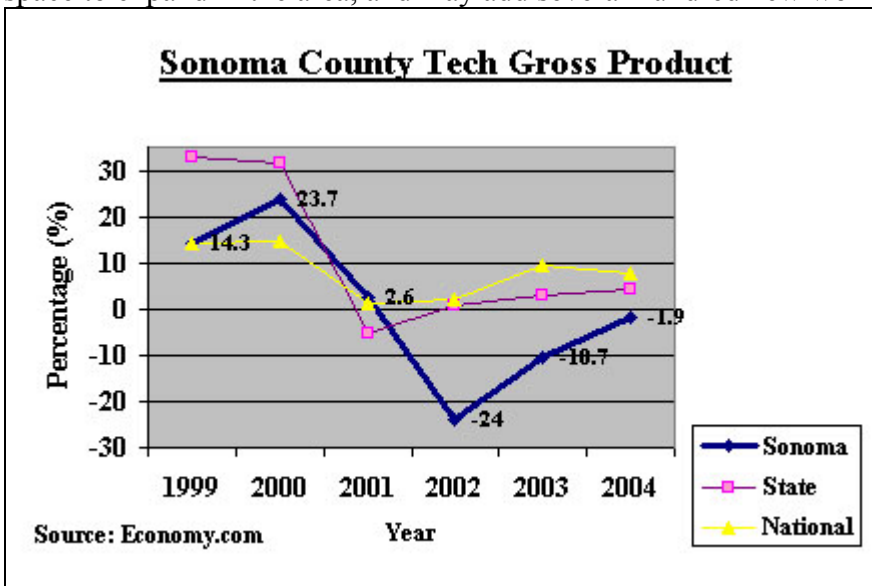
Graphs showing state and national tech employment, patent trends, national SAT math scores are also included. This will allow readers to compare the trends in Sonoma County to those occurring at the state and national level. In most cases the graphs include yearly figures over a six-year time span, between 1999 and 2004, representing the most current available annual data. However, in some circumstances, the 2004 data has not been compiled or released; this report provides the most recent statistics that are available.

Set out below are graphs that will assist in reviewing the updated statistics from the 2000-2004 annual technology reports, within the high tech employment, gross product, output, innovation, education, housing, and traffic areas.

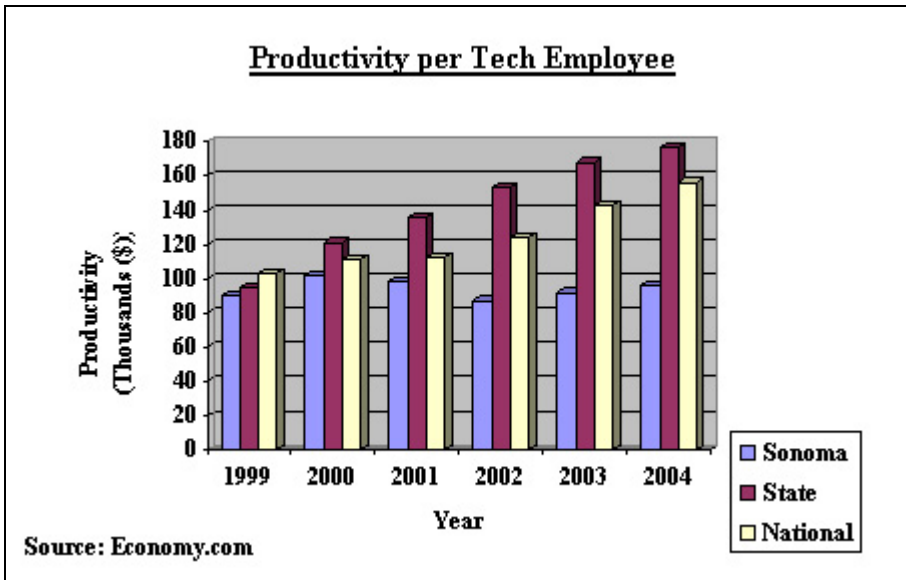
B. High Tech Employment, Gross Product, and Output



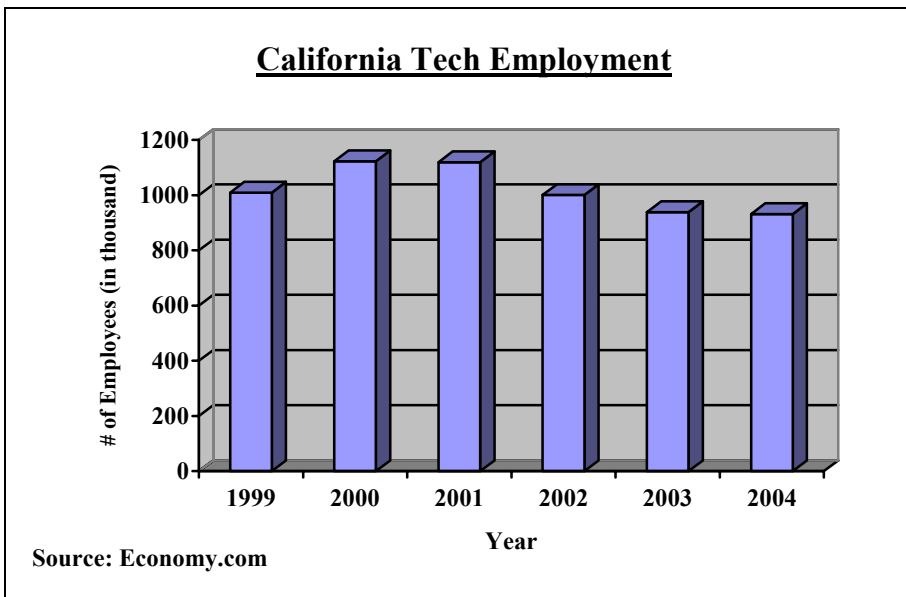
Sonoma County tech employment is down 6.6% from 12,460 employees in 2003 to 11,640 in 2004. Current local employment, similarly, shows mixed results. According to the Economic Development Board's Spring Local Economic Report produced by Economy.com for the EDB, the optical components manufacturer JDS Uniphase is planning to cut employment back by 350 positions locally by the end of 2005. At the same time, medical device maker, TriVascular Engineering is currently searching for space to expand in the area, and may add several hundred new workers to their payroll.



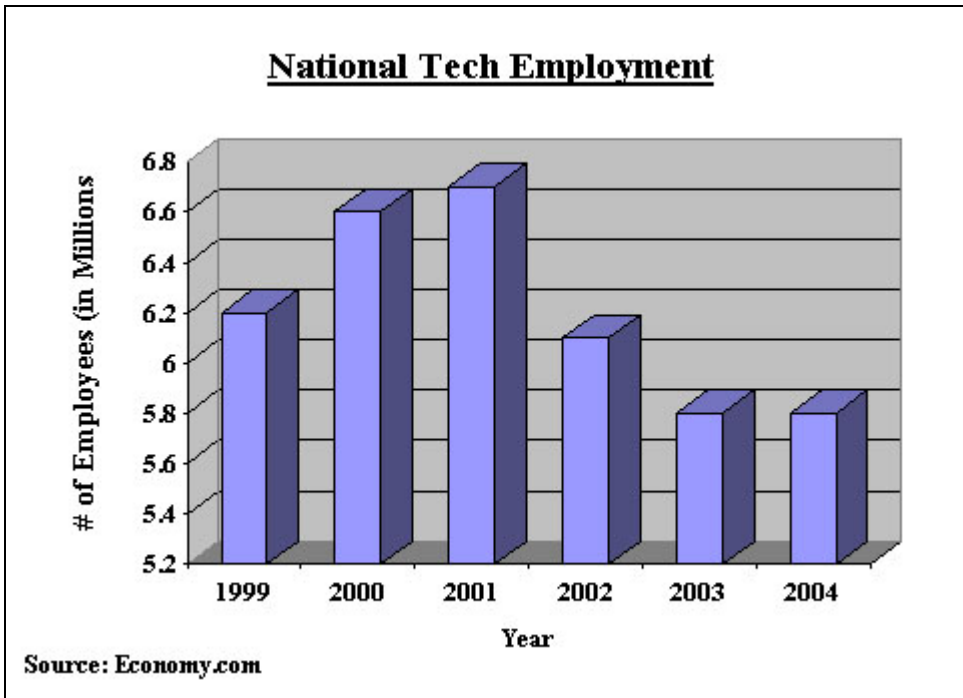
The tech industry in Sonoma County has seen an increase in gross product since 2002. Nevertheless, it is still experiencing negative growth, reporting 10% and 2% losses in 2003 and 2004 respectively.



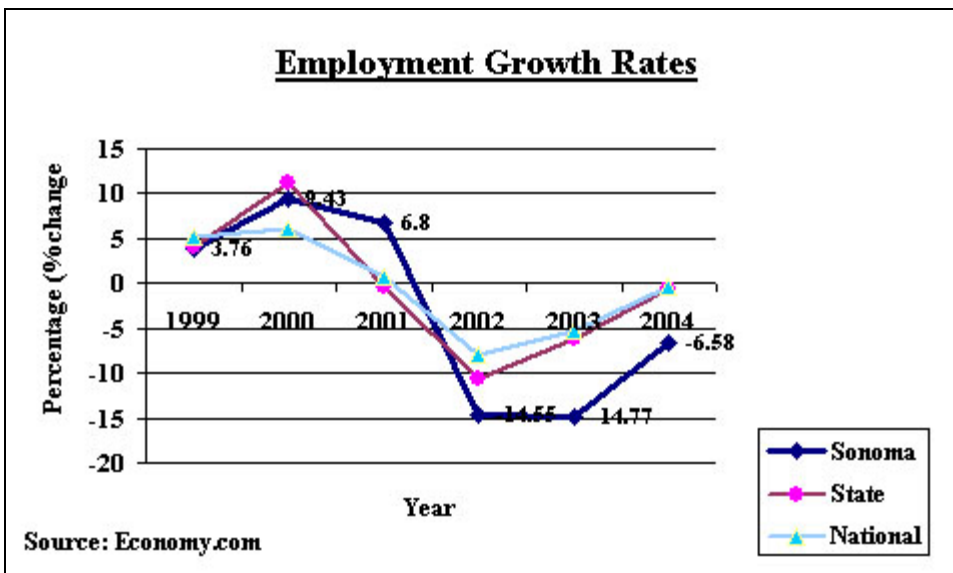
Productivity levels have remained steady since the dip in 2002, and are slowly edging up to higher “pre-dot.com bust” levels. However, local productivity is still behind the state and national levels.



Although California companies were beneficiaries of a large part of the tech boom, they have also felt a greater effect of the tech bubble. Since the height of the boom in 2000-2001, statewide tech employment has been steadily decreasing, leaving off in 2004 at 931 employees, a 0.7% decrease from 2003.

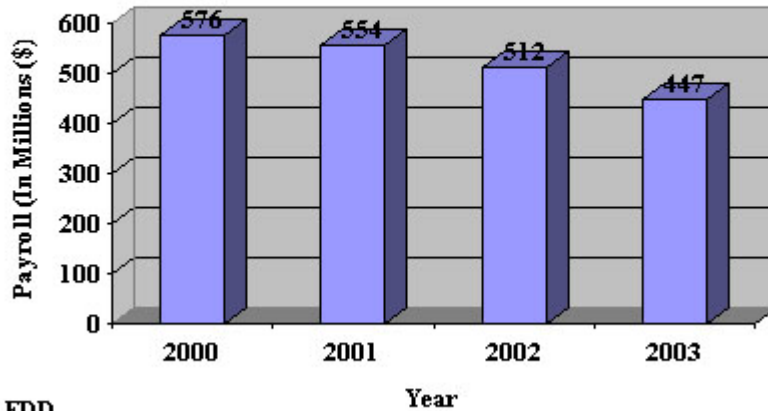


Similar to California, national tech employment growth declined dramatically in 2002, dropping again in 2003 by 5% to 5.8 million, and leveling off in 2004 at 5.8 million employees.



Similar to national and statewide trends, local employment growth in the tech sector is still negative but gaining positive upward momentum, improving from -14.77% growth in 2003 to -6.58% in 2004.

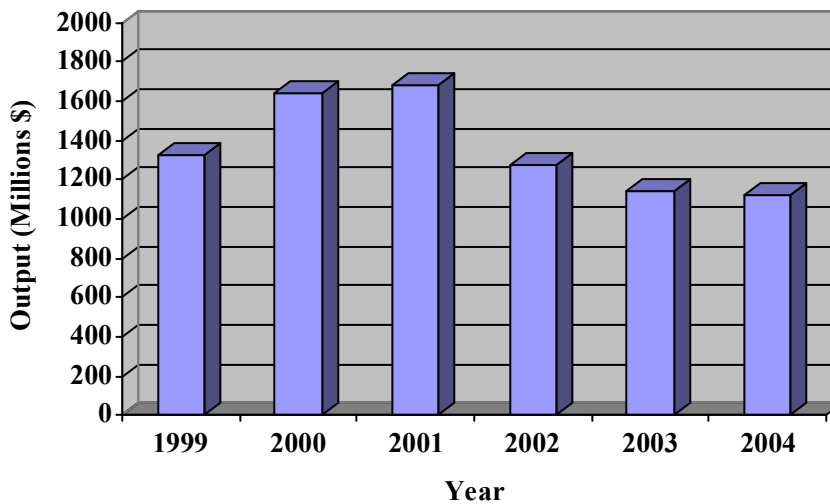
Sonoma County High-Tech Industry Average Annual Payroll



Source: EDD

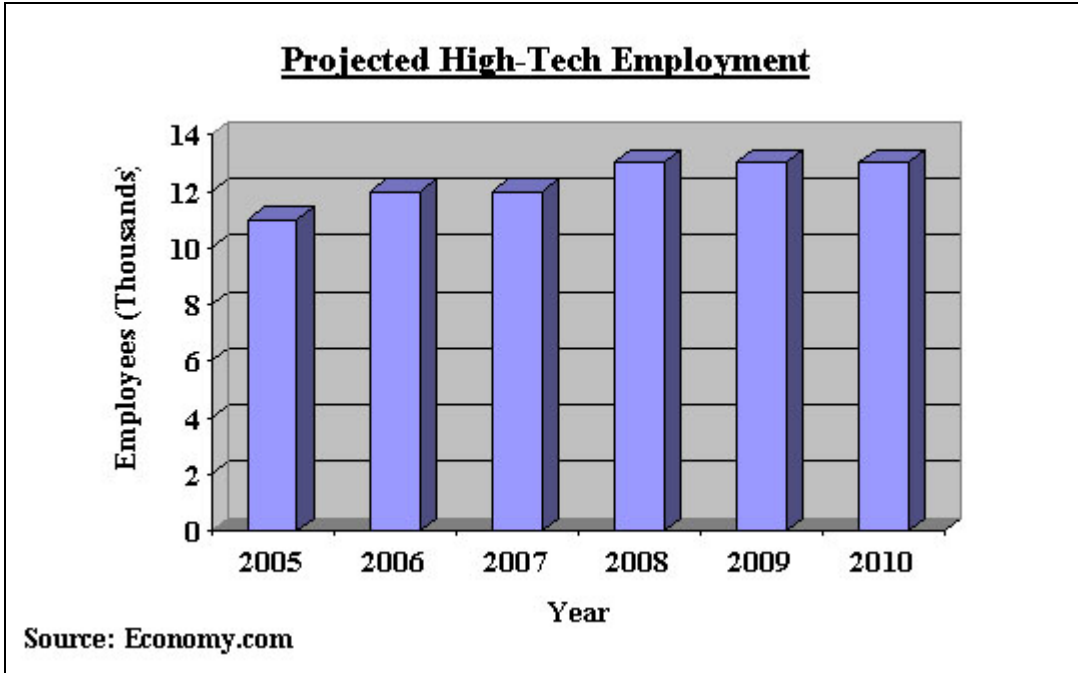
In addition, the Sonoma County tech sector continues to experience a steady decline in the average annual payroll, decreasing 12.7% in 2003 from 2002.

High-Tech Real Output

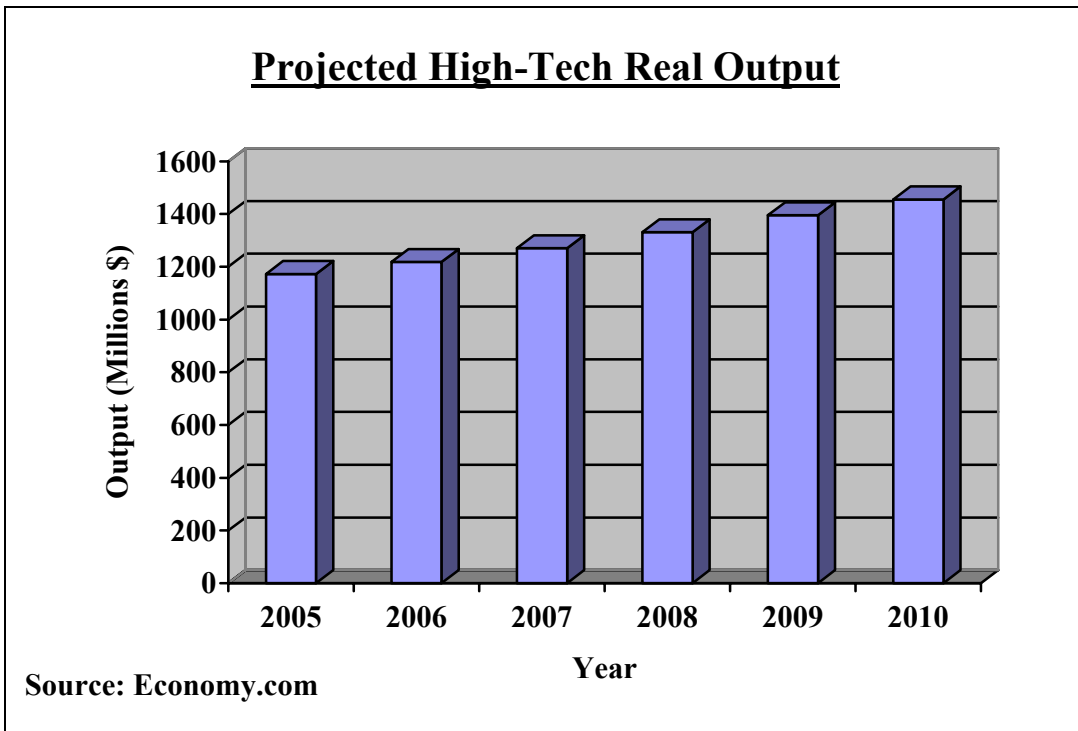


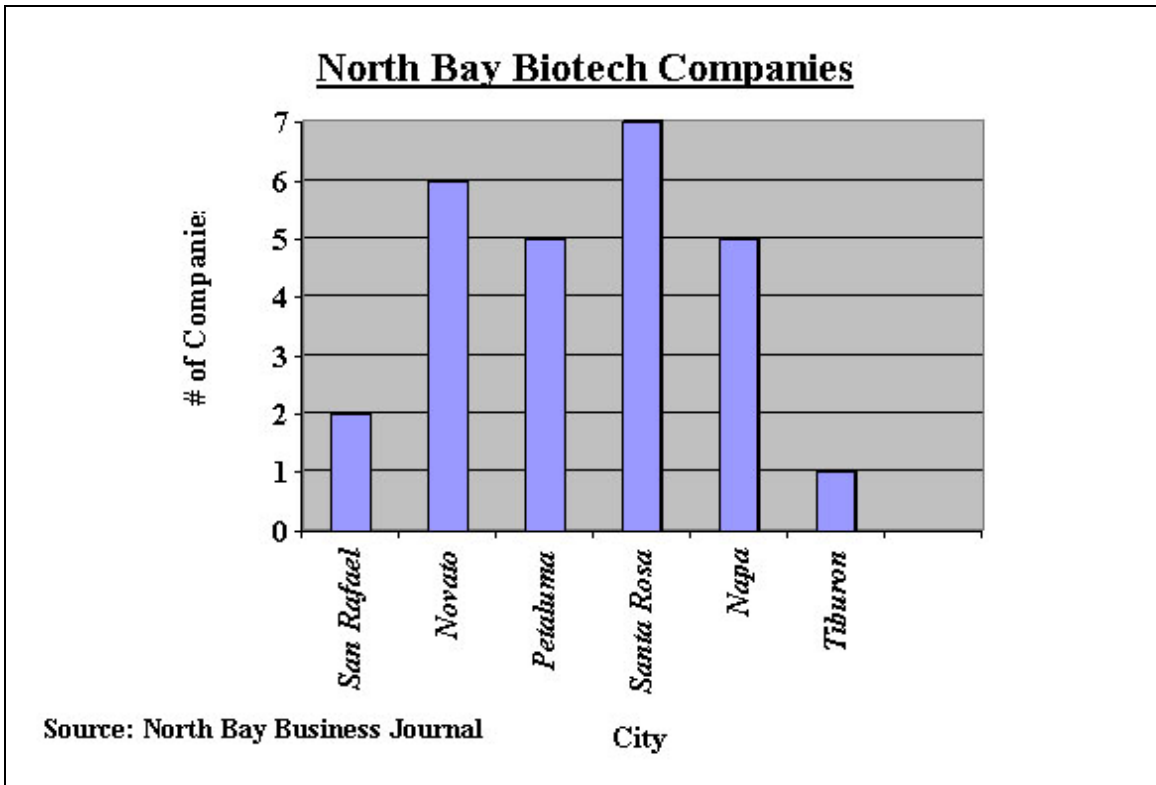
Source: Economy.com

High-tech output has also followed the path of decline after the tech bust dropping 24% from 2001 to 2002. However, output has held relatively steady since 2003, losing only 2% in 2004.



As both projection graphs depict, estimated high-tech employment and output is predicted to improve over the next five years.

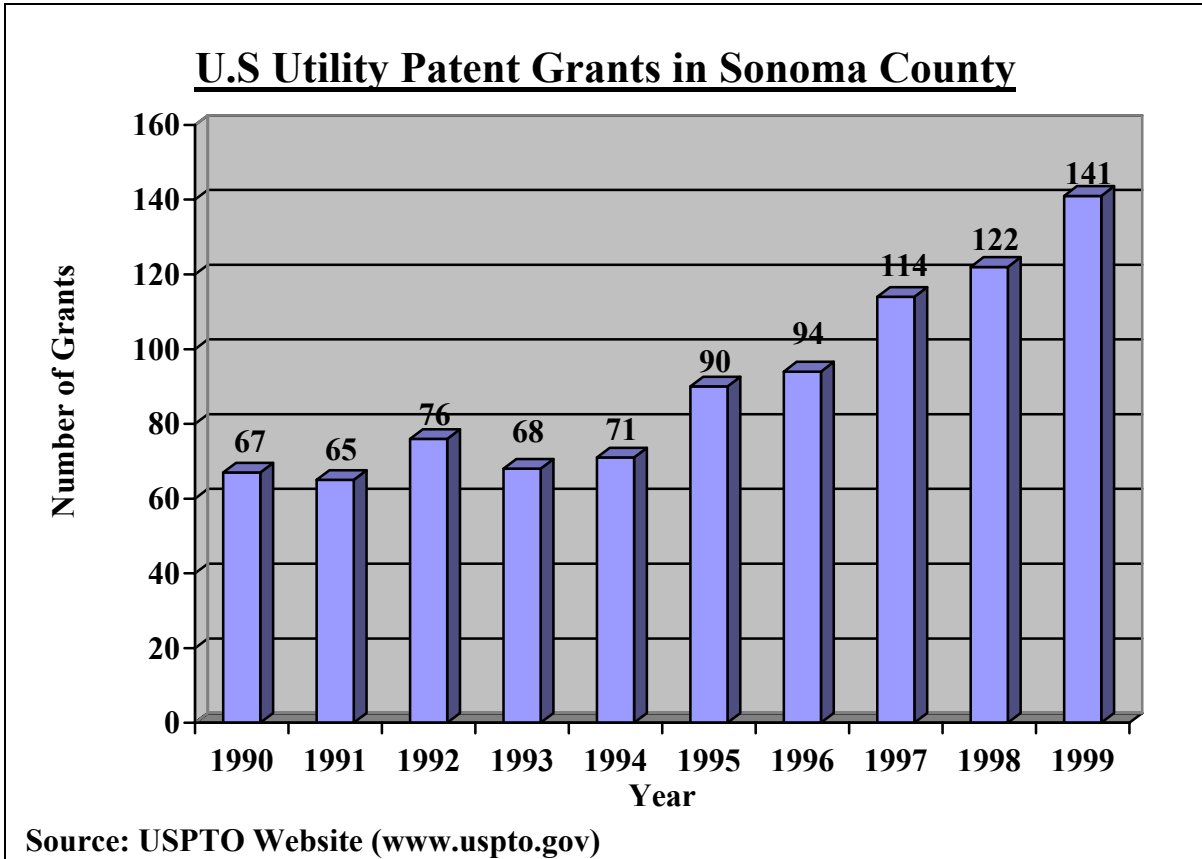




The North Bay is home to upwards of 30 biotechnology companies. Comparative data shown in the chart indicates that a significant number of North Bay biotech companies choose to operate in Sonoma County.

C. Innovation

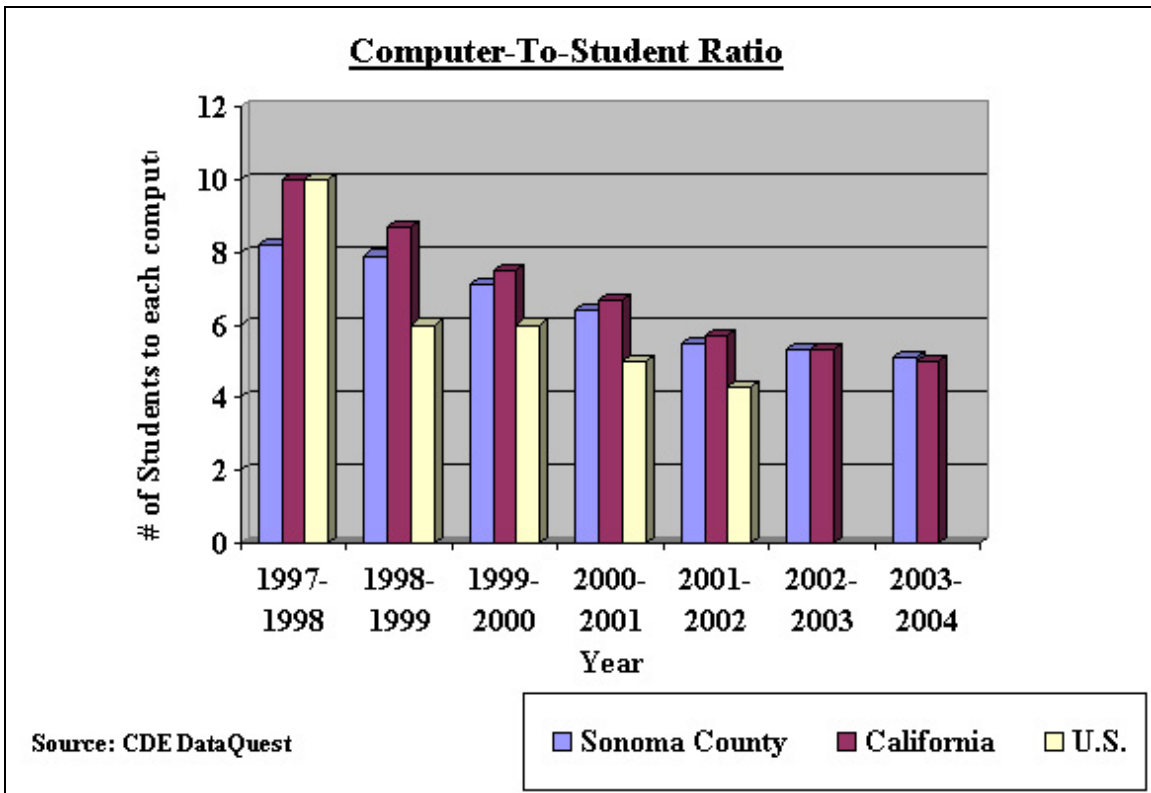
The increase in patent grants shows that the North Bay’s potential for growth and innovation is on the rise. The North Bay area’s “entrepreneurial spirit and open mindedness to cross disciplinary lines for new approaches, adopting new tools and looking for outcomes that can be practically realized,” (North Bay Biz Magazine) allow for its exceeding potential.



The existing data that is available for Utility Patents in the Santa Rosa MSA running through the year 1999. The U.S Patent Office has not published an updated report to show the numbers of companies or individuals receiving utility patents in the Santa Rosa MSA. According to the United States Patent and Trademark Office (USPTO) 1999, 141 utility patents were successfully registered Sonoma County’s residents, a 16% increase from the previous year.

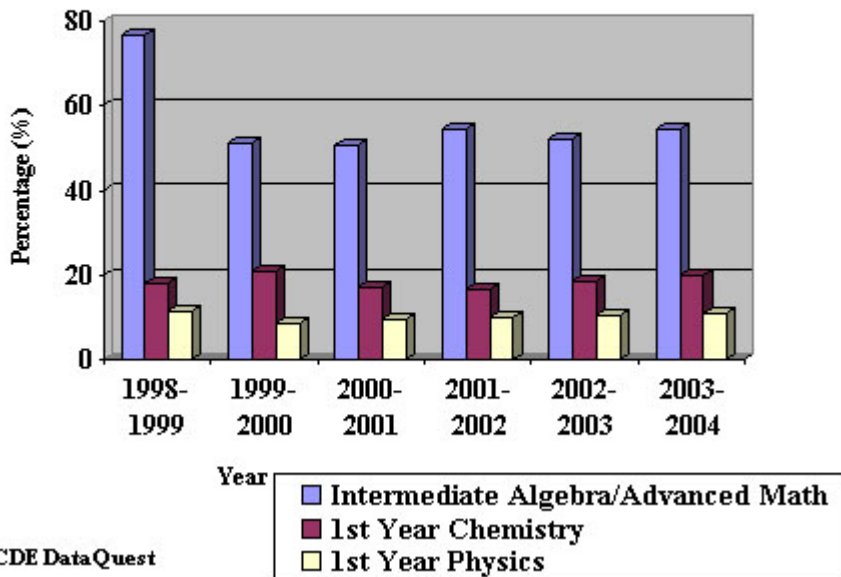
D. Education

Education remains one of many companies' primary concerns in order to affirm Sonoma County as a successful environment for the technology industry. Education also remains a key-qualifying component in deciding on new technology sector hires. The following series of diagrams provide insight into the current condition of the tech-related education offered by Sonoma County schools.



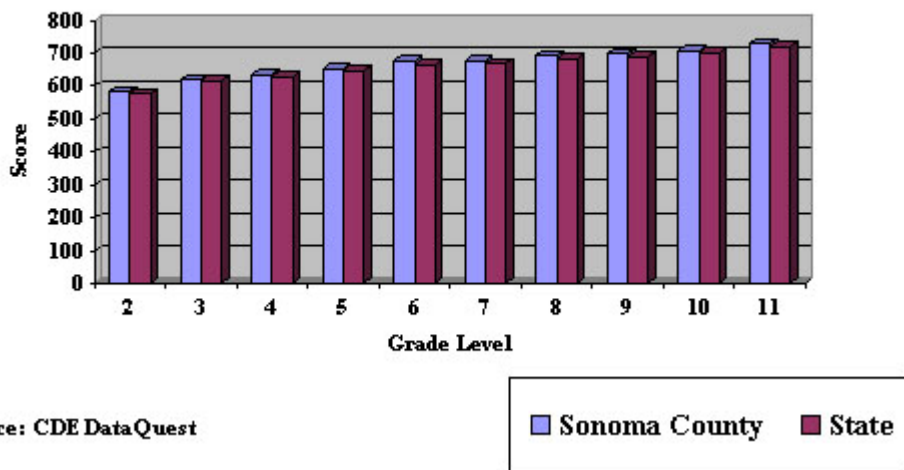
Over the years, the gap for computer advantage between Sonoma County and the state has been narrowing significantly. In 2002-2003, the ratio of local students per computer compared to statewide is almost equal. Currently, Sonoma County students have the competitive advantage, as the local ratio of students per computer is better than the statewide ratio.

**Percentage of 11th and 12th Grade Students
Enrolled in Tech-Related Courses**

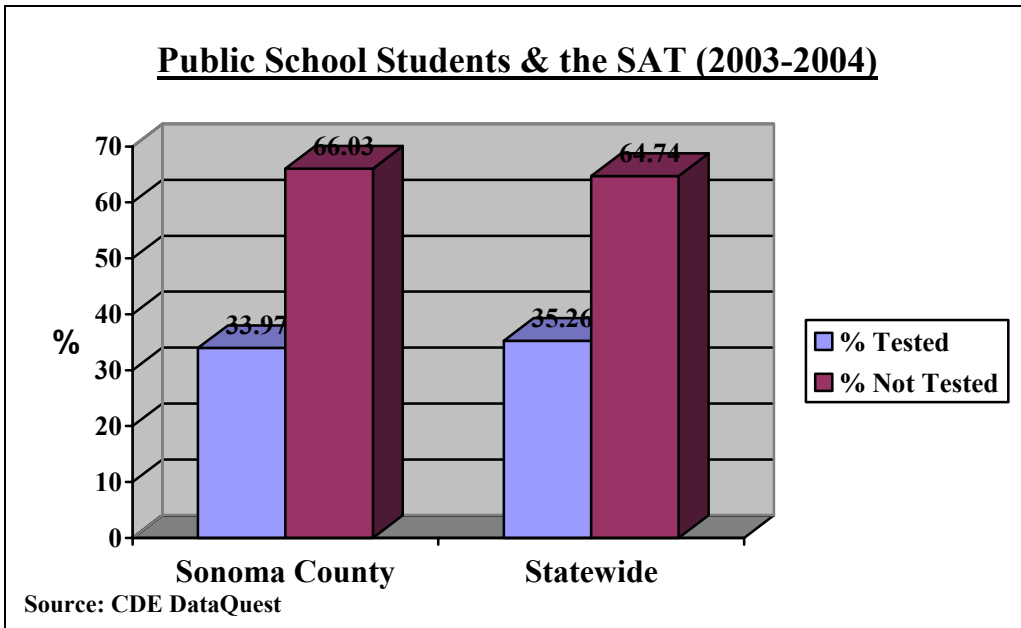


The 11th and 12th grade students' enrollment in Intermediate Algebra/Advanced Math decreased in 1999 and has remained relatively steady for the past five years, increasing 4.2% in 2003-2004. Moreover, only a low percentage of 11th and 12th graders take basic Chemistry and Physics courses.

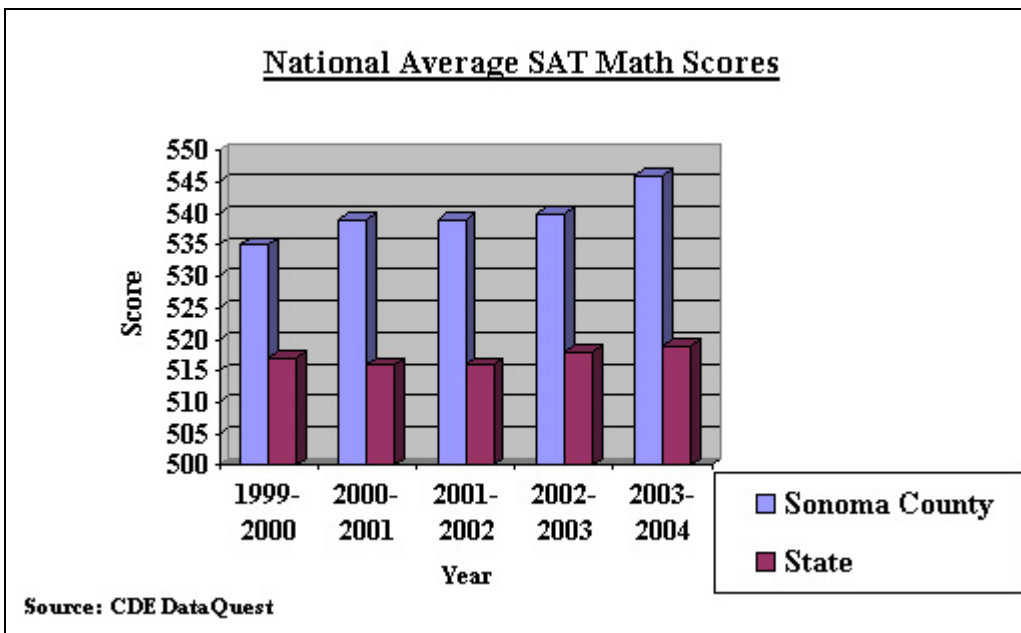
California STAR Math Scores 2003-2004



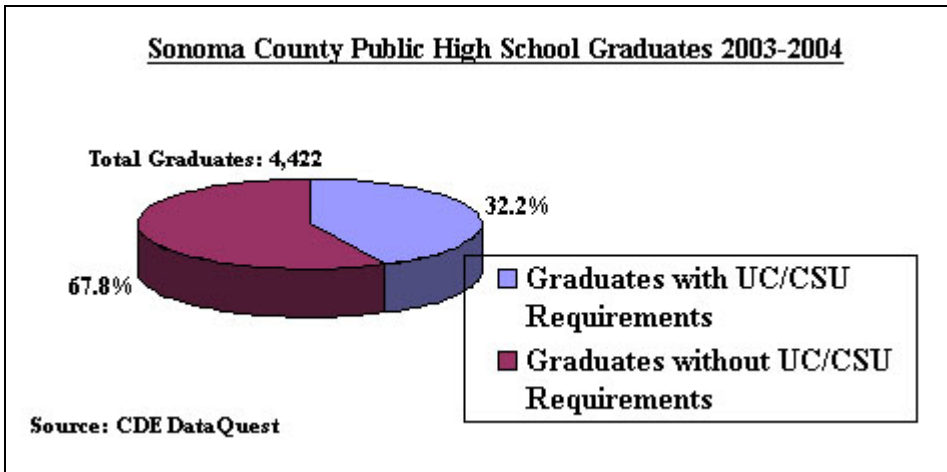
The objective of the Standardized Testing and Reporting (STAR) program is to measure the progress of California students in varying areas of study. The graph illustrates that Sonoma County students' scores are slightly higher than statewide trends.



The data extracted from the Sonoma County Office of Education indicated that 34% of public school students took the SAT test. The percentage is slightly lower than statewide results.

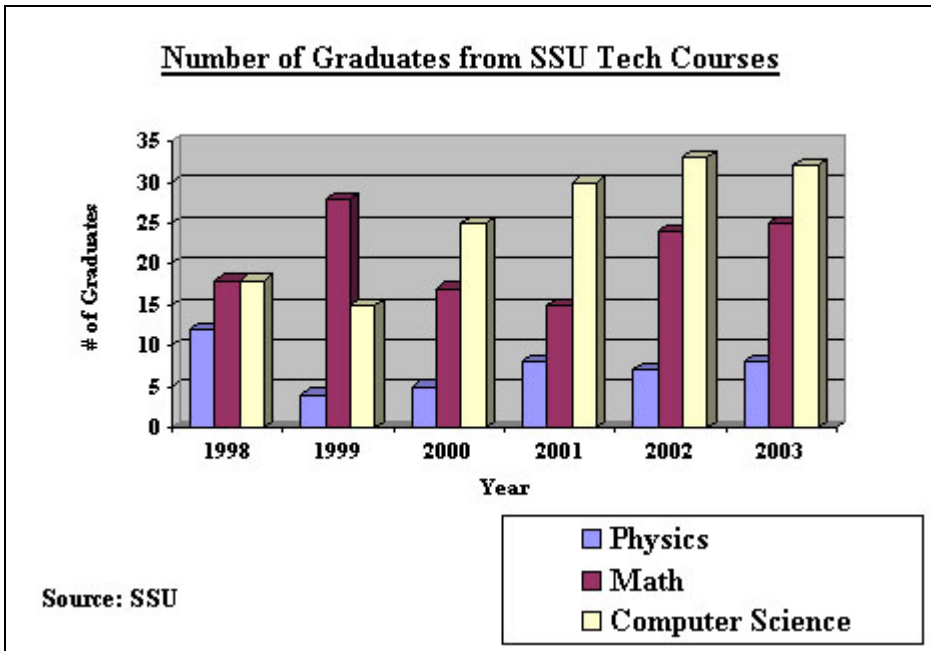


Sonoma County students score considerably higher on the math section of the SAT than the average student in the State.



The percentage of Sonoma County students eligible for UC/CSU admission dropped from 45% in 1997 to 32% in 2003. The decline in admissions is a concern as students are thus unlikely to acquire a four-year college education. Although there has been a decline, it is possible that many Sonoma County public high school graduates may attend SRJC before transferring to UC/CSU, and these students do not have to meet UC/CSU requirements at the time of high school graduation.

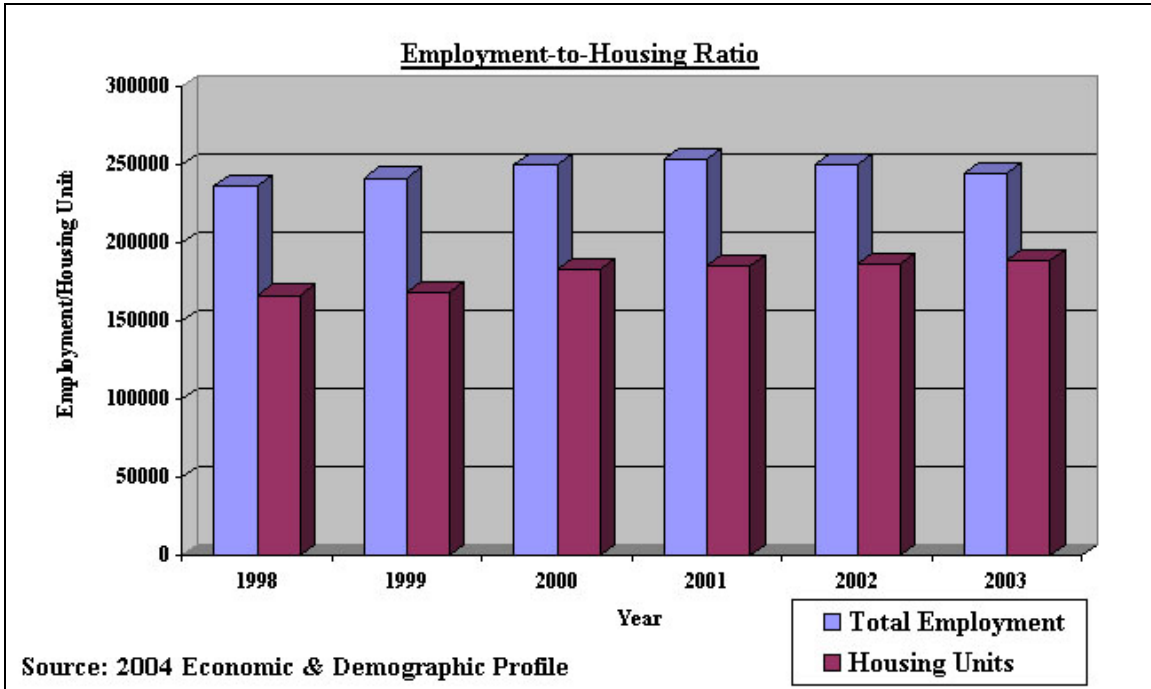
The graphs illustrate that there are more Computer Science graduates than Physics or Math at SSU since 2000.



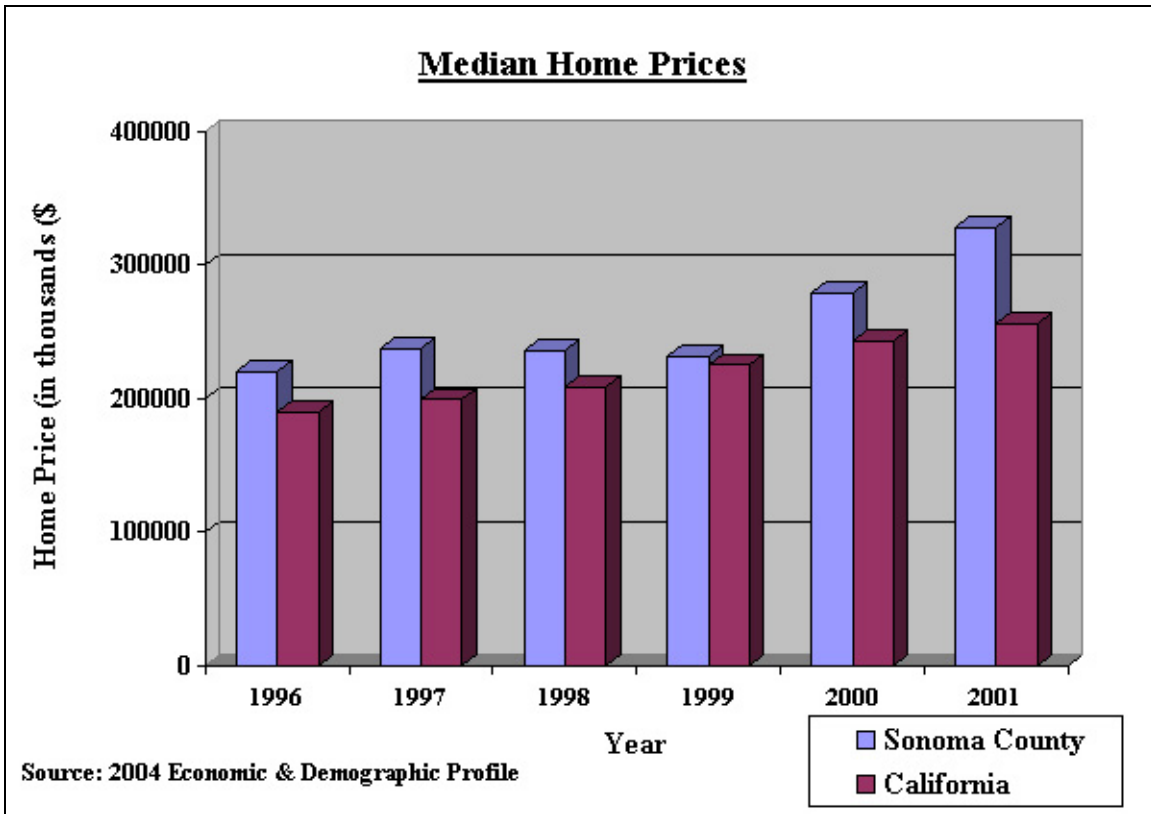
Overall, the number of Sonoma State University (SSU) students that have graduated in tech-related fields has gradually increased. The addition of the new Bachelor in Engineering program at SSU in Fall 2005 will enhance the existing tech programs offered.

E. Housing

Despite the high-tech industry's substantial downsizing, housing costs have continued to skyrocket for the last seven years. This has been a concern for many technology executives.



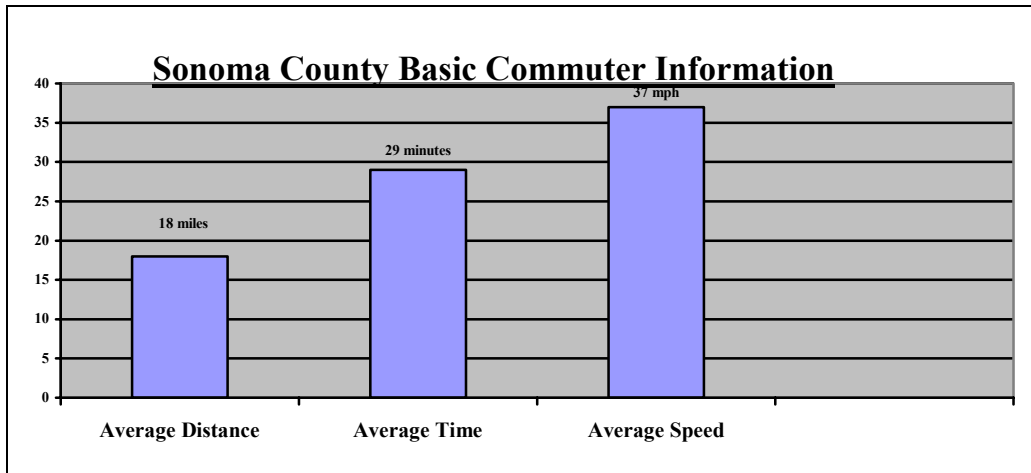
As depicted in the graph above, the disparity between the number of employees working in Sonoma County and the number of housing units continues to expand; the demand for housing continues to outpace the supply.



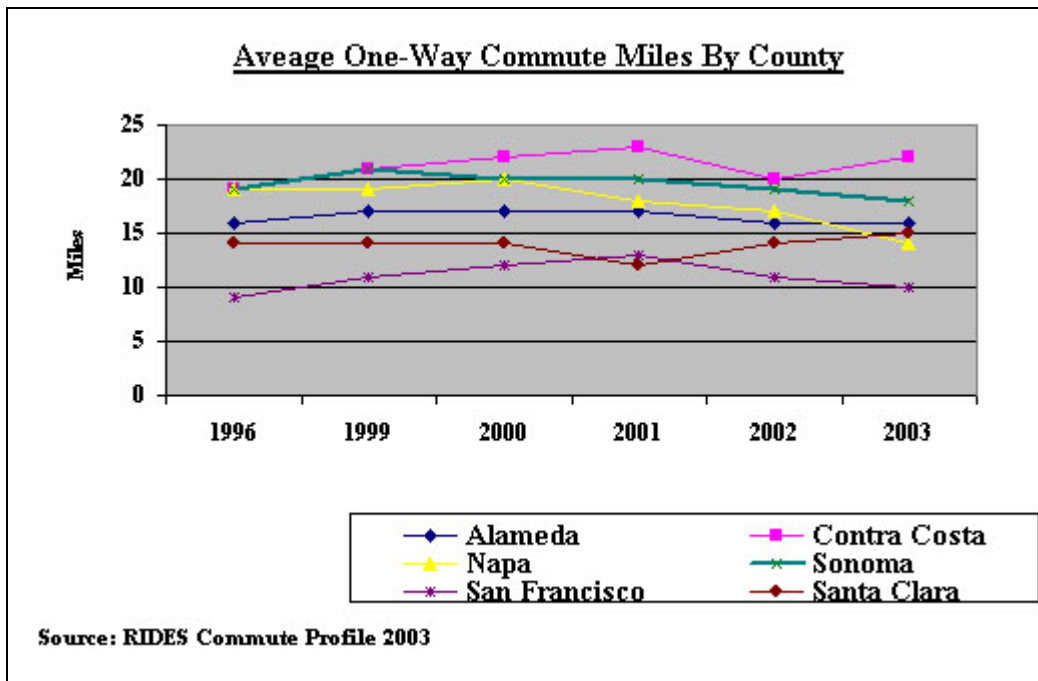
The data shows that median home prices in Sonoma County have risen drastically over the years. With the median sales price for a single family home rising in November to more than \$500,000, affordability is nearly at an all-time low.

F. Traffic

To most technology executives, traffic is seen as a drawback in doing business in Sonoma County. However, this concern is being addressed by the November 2004 ballot approval of Measure M, which increases sales tax to support the widening of Highway 101 and other transportation improvements.



Most Sonoma County residents spend more than an hour of their day in the car, traveling close to 38 miles a day.



The average commute for a Sonoma County resident is comparable to the time spent by other Bay Area county residents, and in some cases even shorter. As shown in the graph, the average commute time by Sonoma County residents has declined in the past two years.

Acknowledgements

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This report was finalized by Nicole Knecht, Collin Keyser and Will Cathcart, Project Coordinators for the Sonoma County Economic Development Board.



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