Energy Services
Department of Water and Power
City of Los Angeles

Report and Financial Statements

June 30, 2001

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Report of Independent Accountants

To the Board of Water and Power Commissioners
Department of Water and Power
City of Los Angeles

In our opinion, the accompanying balance sheets and the related statements of income, changes in equity and cash flows present fairly, in all material respects, the financial position of the Power System (Energy Services) of the Department of Water and Power of the City of Los Angeles at June 30, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2001 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Department's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, on July 1, 2000 the Department changed its method of accounting for contributions in aid of construction and for transfers to the reserve fund of the City of Los Angeles, and has restated all prior years presented. In addition, on July 1, 2000 the Department adopted Statement of Financial Accounting Standards No. 133 and changed its method of accounting for derivative instruments.

PricewaterhouseCoopers LLP

September 24, 2001

Los Angeles Department of Water and Power
Energy Services Balance Sheets, as restated
(Amounts in thousands)

	June 30, 2001	June 30, 2000
Assets		
Utility Plant		
Generation	$ 2,449,908	$ 2,434,930
Transmission	794,023	788,701
Distribution	3,553,306	3,469,367
General	832,586	814,281
	7,629,823	7,507,279
Accumulated depreciation	3,634,060	3,358,196
	3,995,763	4,149,083
Construction work in progress	362,789	80,224
Nuclear fuel, at amortized cost	14,003	12,274
	4,372,555	4,241,581
Restricted and other investments	987,100	1,385,349
Current Assets		
Cash and cash equivalents	392,586	439,923
Cash collateral received from securities lending transactions	139,156	228,414
Customer and other accounts receivable, net of $11,000 allowance for losses	254,549	296,196
Current portion of long-term notes receivable	35,610	-
Accrued unbilled revenue	124,477	130,600
Materials and fuel	104,980	91,222
Prepayments and other current assets	62,532	43,598
	1,113,890	1,229,953
Long-term California wholesale energy receivable	183,243	-
Long-term notes receivable	1,280,037	1,118,617
Net pension asset	112,262	100,166
	$ 8,049,087	$ 8,075,666
Capitalization and Liabilities		
Equity		
Retained income reinvested in the business	$ 3,379,184	$ 3,058,823
Accumulated other comprehensive loss	(5,218)	-
	3,373,966	3,058,823
Long-term debt	3,326,292	3,390,214
Advance refunding bonds	244,474	557,954
	6,944,732	7,006,991
Current Liabilities		
Debt due within one year	120,290	136,165
Accounts payable and accrued expenses	189,175	149,418
Accrued interest	46,995	56,223
Accrued employee expenses	47,370	43,671
Due to Water Services	7,340	1,344
Obligations under securities lending transactions	139,156	228,414
	550,326	615,235
Deferred credits	350,894	279,172
Accrued postretirement liability	203,135	174,268
Commitments and contingencies (Note 13)	-	-
	$ 8,049,087	$ 8,075,666

The accompanying notes are an integral part of these financial statements.

Los Angeles Department of Water and Power
Energy Services Statements of Income, as restated
(Amounts in thousands)

	Year Ended June 30,		
	2001	2000	1999
Operating Revenues			
Residential	$ 655,847	$ 641,196	$ 633,633
Commercial and industrial	1,423,730	1,404,912	1,333,868
Sales for resale	956,185	297,845	184,667
Other	47,301	52,184	51,196
	3,083,063	2,396,137	2,203,364
Operating Expenses			
Fuel for generation	876,187	326,008	213,030
Purchased power	893,864	707,333	797,743
Maintenance and other operating expenses	557,246	532,581	509,800
Depreciation and amortization	280,010	279,853	268,418
	2,607,307	1,845,775	1,788,991
Operating Income	475,756	550,362	414,373
Other Income and Expense			
Investment income	180,553	100,213	46,197
Loss on asset impairment and abandoned projects	(43,519)	-	-
Loss on terminated power contract	-	(77,462)	-
Other, net	693	2,846	11,401
	137,727	25,597	57,598
Debt Expenses			
Interest on debt	185,378	175,711	162,644
Allowance for funds used during construction	(1,123)	(1,830)	(2,761)
	184,255	173,881	159,883
Contributions in aid of construction and grants	16,730	14,465	18,138
Income before transfers to the City and cumulative effect	445,958	416,543	330,226
Transfers to the reserve fund of the City of Los Angeles	119,800	112,000	108,146
Income before cumulative effect of change in accounting	326,158	304,543	222,080
Cumulative effect of change in accounting for energy purchases and sales	(5,797)	-	-
Net income	$ 320,361	$ 304,543	$ 222,080

The accompanying notes are an integral part of these financial statements.

Los Angeles Department of Water and Power
Energy Services Statements of Changes in Equity, as restated
(Amounts in thousands)

	Retained Income Reinvested in the Business	Accumulated Other Comprehensive Loss	Total
Balances at June 30, 1998	$ 2,532,200	$ -	$ 2,532,200
Net income	222,080	-	222,080
Balances at June 30, 1999	2,754,280	-	2,754,280
Net income	304,543	-	304,543
Balances at June 30, 2000	3,058,823	-	3,058,823
Comprehensive income:			
Net income	320,361		320,361
Other comprehensive income:			
- Cumulative effect of adoption	-	(42,366)	(42,366)
- Reclassifications included in net income	-	42,366	42,366
- Unrealized losses on energy purchases and sales	-	(5,218)	(5,218)
Total comprehensive income			315,143
Balance at June 30, 2001	$ 3,379,184	$ (5,218)	$ 3,373,966

The accompanying notes are an integral part of these financial statements.

Los Angeles Department of Water and Power
Energy Services Statements of Cash Flows
(Amounts in thousands)

	Year Ended June 30, 2001	2000	1999
Cash Flows from Operating Activities:			
Operating income	$ 475,756	$ 550,362	$ 414,373
Adjustments to reconcile operating income to net cash provided by operating activities			
Depreciation and amortization	280,010	279,853	268,418
Provision for losses on customer and other accounts receivable	11,872	10,778	16,763
Loss on asset impairment and abandoned projects	(43,519)	-	-
Loss on terminated power contract	-	(77,462)	-
Cumulative effect of change in accounting	(5,797)	-	-
Changes in assets and liabilities:			
Customer and other accounts receivable	(161,120)	(75,697)	(47,379)
Accrued unbilled revenue	6,123	(33,693)	5,769
Net pension asset	(12,096)	7,504	(24,758)
Accounts payable and accrued expenses	34,539	27,590	(44,791)
Deferred credits	71,722	68,342	85,972
Accrued postretirement liability	28,867	25,748	25,259
Other	(22,304)	(8,110)	(15,540)
	664,053	775,215	684,086
Cash Flows from Noncapital Financing Activities:			
Payments to the reserve fund of the City of Los Angeles	(119,800)	(112,000)	(108,146)
Issuance of noncapital revenue bonds, net	-	564,876	-
Interest paid on noncapital revenue bonds	(18,132)	(7,405)	-
	(137,932)	445,471	(108,146)
Cash Flows from Capital and Related Financing Activities:			
Additions to plant and equipment, net	(409,861)	(163,960)	(156,828)
Contributions in aid of construction and grants	16,730	14,465	18,138
Purchases of escrow investments	(176,843)	(49,651)	-
Proceeds from escrow investment maturities	528,770	330,182	117,019
Principal payments and maturities on long-term debt, net	(1,672,236)	(505,196)	(154,416)
Issuance of bonds and revenue certificates, net	1,275,939	387,777	178,585
Debt interest payments	(193,189)	(199,710)	(207,630)
	(630,690)	(186,093)	(205,132)
Cash Flows from Investing Activities:			
Purchases of investment securities	(1,214,808)	(221,211)	(1,855,227)
Proceeds from maturities of investment securities	1,298,544	342,897	1,436,115
Purchase of long-term notes receivable, net	(186,435)	(1,114,520)	-
Investment income	159,931	109,975	80,236
	57,232	(882,859)	(338,876)
Cash and Cash Equivalents:			
Net (decrease) increase	(47,337)	151,734	31,932
Beginning of year	439,923	288,189	256,257
	$ 392,586	$ 439,923	$ 288,189

The accompanying notes are an integral part of these financial statements.

NOTE 1: Summary of Significant Accounting Policies

The Department of Water and Power of the City of Los Angeles (the "Department") exists as a separate proprietary agency of the City of Los Angeles (the "City") under and by virtue of the City Charter enacted in 1925 and as revised effective July 2000. The Department's Power System (Energy Services) is responsible for the generation, transmission and distribution of electric power for sale in the City.

Method of accounting

The accounting records of Energy Services are maintained in accordance with accounting principles generally accepted in the United States of America. As a government-owned utility, the Department applies all statements issued by the Governmental Accounting Standards Board (GASB) and all statements and interpretations issued by the Financial Accounting Standards Board (FASB), which are not in conflict with statements issued by the GASB.

The Department's rates are determined by the Board of Water and Power Commissioners (the "Board") and are subject to review and approval by the City Council. As a regulated enterprise, the Department's financial statements are prepared in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "*Accounting for the Effects of Certain Types of Regulation*", which requires that the effects of the ratemaking process be recorded in the financial statements. Such effects primarily concern the time at which various items enter into the determination of net income in order to follow the principle of matching costs and revenues. Accordingly, Energy Services records various regulatory assets and liabilities to reflect the regulator's actions. Management believes that Energy Services meets the criteria for continued application of SFAS No. 71, but will continue to evaluate its applicability based on changes in the regulatory and competitive environment (see Note 3).

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 1: (continued)

Utility plant

The costs of additions to utility plant and replacements of retired units of property are capitalized. Costs include labor, materials, an allowance for funds used during construction (AFUDC), and allocated indirect charges such as engineering, supervision, transportation and construction equipment, retirement plan contributions, health care costs, and certain administrative and general expenses. The costs of maintenance, repairs and minor replacements are charged to the appropriate operations and maintenance expense accounts. The original cost of property retired, net of removal and salvage costs, is charged to accumulated depreciation.

Depreciation and amortization

Depreciation expense is computed using the straight-line method based on service lives for all projects completed after July 1, 1973, and for all office and shop structures, related furniture and equipment, and transportation and construction equipment. Depreciation for facilities completed prior to July 1, 1973 is computed using the 5% sinking fund method based on estimated service lives. Estimated service lives range from 5 to 75 years. Depreciation expense as a percentage of average depreciable utility plant in service was 3.9%, 3.9% and 3.8% for fiscal years 2001, 2000 and 1999, respectively. Amortization expense for computer software is computed using the straight-line method over 5 years.

Nuclear decommissioning

The Department owns a 5.7% direct ownership interest in the Palo Verde Nuclear Generating Station (PVNGS). In addition, through its participation in the Southern California Public Power Authority (SCPPA), the Department is party to a contract for an additional 3.95% of the output of PVNGS. Nuclear decommissioning costs associated with the Department's output entitlement are included in purchased power expense (see Note 5). The Department recognizes an increase in accumulated depreciation equivalent to its contributions and investment earnings from the nuclear decommissioning trust funds.

Decommissioning of PVNGS is expected to commence subsequent to the year 2024. The total cost to decommission the Department's direct ownership interest in PVNGS is estimated to be $101 million in 1998 dollars. This estimate is based on an updated site specific study prepared by an independent consultant in 1998. Prior to December 1999, the Department contributed to external trusts established in accordance with the PVNGS participation agreement and Nuclear Regulatory Commission requirements. In fiscal year 1999, the Department contributed $11 million to these trusts in order to fund its direct share of estimated decommissioning costs. The contributions were charged to depreciation expense.

NOTE 1: (continued)

During fiscal year 2000, the Department suspended contributing additional amounts to the trust funds, as management believes that contributions to date, combined with reinvested earnings, will be sufficient to fully fund the Department's share of decommissioning costs. The Department will continue to reinvest its investment income. The Department reinvested $8 and $6 million in fiscal years 2001 and 2000, respectively, and recognized an offsetting expense. As of June 30, 2001, decommissioning funds totaled $80 million.

Nuclear fuel

Nuclear fuel is amortized and charged to fuel for generation on the basis of actual thermal energy produced relative to total thermal energy expected to be produced over the life of the fuel. Under the provisions of the Nuclear Waste Policy Act of 1982, the federal government assesses each utility with nuclear operations, including the Department, $1 per megawatt hour of nuclear generation. The Department includes this charge as a current year expense. See Note 13 for discussion of spent nuclear fuel disposal.

Cash and cash equivalents

As provided for by the California Government Code, the Department's cash is deposited with the City Treasurer in the City's general investment pool for the purpose of maximizing interest earnings through pooled investment activities. Cash and cash equivalents in the City's general investment pool are reported at fair value and changes in unrealized gains and losses are recorded in the Statement of Income. Interest earned on such pooled investments is allocated to the participating funds based on each fund's average daily cash balance during the allocation period. The City Treasurer invests available funds of the City and its independent operating departments on a combined basis. At June 30, 2001 and 2000, cash and cash equivalents includes $61 and $35 million of internally-designated balances relating to bond redemption and interest funds and a self-insurance fund, respectively. In addition, at June 30, 2001 and 2000, the cash and cash equivalents balance includes $113 and $253 million, respectively, of funds restricted by bond indenture for use in construction. The Department considers all unrestricted investments with an original maturity of three months or less to be cash equivalents.

Restricted and other investments

Restricted and other investments include primarily commercial paper, United States Government and governmental agency securities, and corporate bonds. Investments are reported at fair value and changes in unrealized gains and losses are recorded in the Statement of Income. Gains and losses realized on the sale of investments are generally determined using the specific identification method. The stated fair value of investments is generally based on published market prices or quotations from major investment dealers.

NOTE 1: (continued)

Debt expenses

Debt premium, discount and issue expenses are deferred and amortized to expense over the lives of the related debt issues. Gains and losses on refundings related to bonds redeemed by proceeds from the issuance of new bonds are amortized over the shorter of the life of the new bonds or the remaining term of the bonds refunded.

Revenues

Energy Services' rates are established by a rate ordinance, which is approved by the City Council. Energy Services sells energy to other City departments at rates provided in the ordinance. Energy Services recognizes energy costs in the period incurred and accrues for estimated energy sold but not yet billed. The Department's current rates include amounts designated for the pre-collection of out-of-market future purchase power costs. These amounts are included in deferred credits. At the discretion of the Department, these amounts will be recognized as revenue when the related purchase power expense is incurred. At June 30, 2001 and 2000, deferred credits include $327 and $256 million, respectively, related to pre-collected purchased power costs.

Non-operating revenues

Contributions in aid of construction and other grants received by the Department for constructing utility plant and other activities are recognized as non-operating revenues when all applicable eligibility requirements, including time requirements, are met.

Allowance for funds used during construction

Allowance for funds used during construction represents the cost of borrowed funds used for the construction of utility plant. Capitalized AFUDC is included as part of the cost of utility plant and as a reduction of debt expenses. The average AFUDC rate was 5.4%, 5.4% and 6.0% for fiscal years 2001, 2000 and 1999, respectively.

NOTE 1: (continued)

Recent Accounting Pronouncements

During 1999, the GASB issued Statement No. 34, *"Basic Financial Statements – MD&A for Local and State Governments"*. Under the new Statement, certain modifications to the Department's financial statements will be required including name and presentation changes. In addition, this Statement establishes new required disclosures, including basic financial statements, management's discussion and analysis and other required supplementary information. The Department has adopted the new Statement effective July 1, 2001.

In August 2001, the FASB issued Statement No. 143, *"Accounting for Asset Retirement Obligations"*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement will be effective for financial statements issued for fiscal years beginning after June 15, 2002. The Department has not yet determined the financial statement impact of adopting the new Statement.

Reclassification

Certain financial statement items for prior years have been reclassified to conform to the current year presentation. The reclassifications did not impact net income, total assets or net equity.

NOTE 2: Accounting Changes

GASB Statement No. 33

On July 1, 2000, the Department adopted GASB Statement No. 33 (GASBS 33), *"Accounting and Financial Reporting for Nonexchange Transactions"*. This statement establishes accounting and financial reporting standards over the recording of nonexchange transactions involving cash and financial and capital resources. As a result of the adoption of GASBS 33, contributions in aid of construction and the voluntary transfer to the City of Los Angeles are included as non-operating revenues and expenses, respectively, in the Statement of Income. Prior to the adoption of GASBS 33, contributions in aid of construction and the voluntary transfer were reported as equity transactions.

The Department restated prior year financial statements to retroactively apply GASBS 33. The adoption of GASBS 33 as of July 1, 1998 resulted in the combination of two equity accounts, contributions in aid of construction and retained income reinvested in the business. The cumulative effect of adoption of GASBS 33 resulted in a $263 million increase to retained income reinvested in the business effective July 1, 1998.

NOTE 2: (continued)

The adoption of GASBS 33 resulted in a restatement of prior year net income as follows (amounts in millions):

	Year Ended June 30, 2000	Year Ended June 30, 1999
Net income, as previously reported	$ 402	$ 312
- Contributions in aid of construction	15	18
- Transfers to the reserve fund of the City of Los Angeles	(112)	(108)
Net income, as restated	305	222
Retained income reinvested in the business		
Beginning of year, as restated	2,754	2,532
End of year, as restated	$ 3,059	$ 2,754

FASB Statement No. 133

In June 1998, the FASB issued SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*". SFAS No. 133 requires companies to record derivatives on the balance sheet as assets and liabilities, and measure those instruments at fair value. This Statement, as amended, became effective for Energy Services' financial statements at the beginning of fiscal year 2001.

The Department is party to contracts that qualify as derivative instruments under the Statement when it buys and sells electricity and fuel that is scheduled for delivery in future periods. Certain of these contracts qualify as an exception provided under the Statement for activities that are considered normal purchases and normal sales. These contracts are reflected in the income statement at the time of contract settlement.

For certain contracts which qualify as derivatives but do not qualify as a normal purchase or sale, the Department has designated the contract as a cash flow hedge of a future transaction. A contract that is treated as a cash flow hedge is recorded at fair value in the balance sheet; however, the offsetting entry is recorded as other comprehensive income, an equity account within the balance sheet. When the contract settles, the amount recorded as other comprehensive income is reclassified as a gain or loss to the income statement.

NOTE 2: (continued)

On July 1, 2000, Energy Services adopted SFAS No. 133 and recorded the cumulative effect of the change in accounting principle by recording its short-term energy purchases and sales at fair value in the financial statements. This resulted in a cumulative effect of $6 million to net income for trading activities and $42 million to other comprehensive income for cash flow hedges.

As of June 30, 2001, the Department recorded the following amounts related to derivative instruments (in millions):

Balance Sheet:	
Contract commitments (included in current assets and current liabilities)	$ 1
Accumulated other comprehensive loss	$ 5
Income Statement:	
Unrealized gain on derivative instruments (included in sales for resale)	$ (6)

The Department will release all of the balance included in accumulated other comprehensive loss during fiscal year 2002 as the associated contracts are settled.

In June 2001, the FASB cleared Implementation Issue No. C15 (“C15”). C15 expands the normal purchase and normal sales exception to include electricity contracts entered into by a utility company when certain criteria are met. Energy Services implemented C15 as of July 1, 2001 and expects that a majority of its short-term purchases and sales will qualify as normal purchases and normal sales under the interpretation. C15 will be implemented on a prospective basis. Contracts reported as derivatives as of June 30, 2001 that qualify as normal purchases and sales under C15, will continue to be reported on the balance sheet at their fair values as of June 30, 2001. At the time the contracts are settled, the recorded fair value and any associated amounts included in accumulated other comprehensive income (loss) will be reversed with an offsetting entry to the income statement.

NOTE 3: Regulatory Matters

Effective April 1, 1998, customers of California's investor-owned utilities (IOU) became eligible for direct access. The introduction of direct access resulted in significant structural changes to the electric power industry, including plant divestitures and management of IOU transmission assets through the California Independent System Operator (CISO). In 2001, legislation was enacted to suspend direct access to retail customers in California.

As a government-owned utility, the Department was not compelled to participate in direct access or to divest its generation assets. Management continues to evaluate the Department's alternatives in response to deregulation, including potential rate decreases, the introduction of direct access and participation in the CISO. In addition, management has implemented debt and cost reduction programs and restructured certain purchase power commitments in response to the changes in the electric utility market. Furthermore, in August 2000, the City Council approved a $1.7 billion, ten-year plan to upgrade the Department's local power plants and to implement a program that includes demand side management, alternative energy sources and distributed generation.

No definitive plan for allowing direct access to customers in the Department's service area has been adopted; however, if the Department implements direct access in the future, it is likely that its generation business will no longer qualify for accounting under SFAS No. 71. SFAS No. 71 requires that the effects of the ratemaking process be recorded in the financial statements. Based on current and projected market prices, management does not believe that market issues or the introduction of direct access will negatively impact the Department's financial position.

Federal Energy Regulatory Commission Price Mitigation Plan

In June 2001, the Federal Energy Regulatory Commission (FERC) issued a price mitigation plan on spot market sales in the Western System Coordinating Council (WSCC). The plan imposes price limits on the sale of electricity in WSCC based on a calculation that estimates the cost of production of the least efficient gas-fired generation plant in California and a fixed factor to account for other variable costs. The calculation is based on factors existing at the then most current California Stage 1 Emergency. Sellers and other marketers have the opportunity to justify prices above the limit to the FERC. Energy Services' purchases and sales of electricity occur entirely within the WSCC. Management has not determined the effect, if any, that the price mitigation plan will have on future purchases and sales of electricity.

NOTE 3: (continued)

California Receivables

During fiscal year 2001, the Department made sales to two California agencies that were formed by Assembly Bill 1890 to facilitate the purchase and sale of energy and ancillary services in the State of California. These agencies, the CISO and the California Power Exchange (CPX), have not made payments on amounts outstanding to counterparties for energy consumed in fiscal year 2001, including Energy Services, since April of 2001. Two utilities with significant amounts due to these agencies, Southern California Edison Company and Pacific Gas & Electric, have stated in public disclosure documents that they may not be able to pay for all the power they consumed in 2001. In addition, Pacific Gas & Electric has filed for protection under Chapter 11 of the Federal Bankruptcy Statute.

A total of $183 million is due Energy Services from the CISO and CPX. In addition, during fiscal years 2000 and 2001 the FERC has questioned whether amounts charged for energy sold to the CISO and the CPX represent “unlawful profits” that should be subject to refund. The FERC has considered various options for determination of a refund amount but has not issued definitive guidance on what represents unlawful profits for sales during the period. If the FERC issues an order requiring a refund under defined conditions, the Department may be liable to refund a portion of amounts recorded as sales. However, it has not been established that the FERC has any jurisdiction over municipal utilities, including the Department.

Energy Services has not recorded a reserve for potential losses on its California receivables as management believes that it is entitled to all amounts due from sales to counterparties in California, including those named above. In addition, management does not believe that Energy Services’ exposure to losses with respect to these receivable balances is currently estimable. If final settlement of these receivables results in an amount less than the recorded balance, the Department will be required to record a loss in the Statement of Income.

Public benefits

In accordance with Assembly Bill 1890, a percentage of the Department’s retail revenue is designated for use for qualifying public benefits programs. Qualifying programs include cost-effective demand side management services to promote energy-efficiency and energy conservation, new investment in renewable energy resources and technologies, development and demonstration programs to advance science and technology, and services provided for low-income electricity customers. During fiscal years 2001, 2000 and 1999, the Department spent $64, $61, and $45 million, respectively, on public benefits programs including investments in electric buses and vehicles, photovoltaic power and other alternative energy sources, and support for low-income customers. The Department defers public benefits collections from customers in excess of costs incurred under qualifying programs. As of June 30, 2001 and 2000, the deferred credits balance includes public benefits deferrals of $3 and $10 million, respectively.

NOTE 4: Jointly-Owned Utility Plant

Energy Services has direct interests in several electric generating stations and transmission systems, which are jointly-owned with other utilities. As of June 30, 2001, utility plant includes the following amounts related to Energy Services' ownership interest in each jointly-owned utility plant (amounts in millions, except as indicated):

			Plant in Service	
	Ownership Interest	Share of Capacity (MW)	Cost	Accumulated Depreciation
Palo Verde Nuclear Generating Station	5.7%	217	$ 512	$ 206
Navajo Generating Station	21.2%	477	207	167
Mohave Generating Station	20.0%	316	124	72
Pacific Intertie DC Transmission Line	40.0%	1240	183	47
Other transmission systems	Various		76	36
			$ 1,102	$ 528

Energy Services will incur certain minimum operating costs related to the jointly-owned facilities, regardless of the amount or its ability to take delivery of its share of energy generated. Energy Services' proportionate share of the operating costs of the joint plants is included in the corresponding categories of operating expenses.

On September 18, 2001, the Board approved the sale of 50% of the Department's 20% ownership interest in the Mohave Generating Station (Mohave) to the Salt River Project Agricultural Improvement and Power District (SRP). SRP took the place of the original purchaser, AES Corporation (AES), under the terms of the Mohave Project Plant Site Conveyance and Co-Tenancy Agreement. SRP will pay approximately $95 million for the 10% interest. The sale is expected to result in an accounting gain of approximately $73 million. This transaction is pending approval by the Los Angeles City Council.

NOTE 5: Purchase Power Commitments

The Department has entered into a number of energy and transmission service contracts, which involve substantial commitments as follows (amounts in millions, except as indicated):

			Department's Interest in Agency's Share		
	Agency	Agency Share	Interest	Capacity MW	Outstanding Principal
Intermountain Power Project	IPA	100.0%	66.8%	1,068	$ 1,895
Palo Verde Nuclear Generating Station	SCPPA	5.9%	67.0%	151	$ 572
Mead-Adelanto Project	SCPPA	67.9%	35.7%	291	$ 83
Mead-Phoenix Project	SCPPA	17.8% - 22.4%	24.8%	148	$ 18
Southern Transmission System	SCPPA	100.0%	59.5%	1,142	$ 636

IPA: The Intermountain Power Agency is an agency of the State of Utah established to own, acquire, construct, operate, maintain, and repair the Intermountain Power Project (IPP). Energy Services serves as the Project Manager and Operating Agent of IPP.

SCPPA: The Southern California Public Power Authority, a California Joint Powers Agency. Note: SCPPA's interest in the Mead-Phoenix Project includes three components.

The above agreements require Energy Services to make certain minimum payments, which are based mainly upon debt service requirements. In addition to average annual fixed charges of approximately $314 million during each of the next five years, the Department is required to pay for operating and maintenance costs related to actual deliveries of energy under these agreements (averaging approximately $219 million annually during each of the next five years). The Department made total payments under these agreements of approximately $532, $550, and $610 million in fiscal years 2001, 2000 and 1999, respectively. These agreements are scheduled to expire from 2027 to 2030.

Long-term notes receivable

Under the terms of its purchase power agreement with IPA, the Department is charged for its output entitlements based on its share of IPA's costs, including debt service. During fiscal year 2000, the Department restructured a portion of this obligation by transferring $1.12 billion to IPA in exchange for long-term notes receivable. The funds transferred were obtained from the debt reduction trust funds and through the issuance of new variable rate debentures (see Notes 6 and 8). IPA used the proceeds from these transactions to defease and to tender for bonds with par values of approximately $615 and $611 million, respectively. The net discount of $114 million is being amortized using the effective interest method over the lives of the bonds through 2023.

NOTE 5: (continued)

On September 7, 2000, the Department transferred $187 million to IPA in exchange for additional long-term notes receivable. IPA used the proceeds to defease bonds with a face value of $198 million. The net discount of $9 million is being amortized using the effective interest method over the life of the bonds through 2017.

The Department's future payments to IPA will be partially offset by interest payments and principal maturities from the subordinated notes receivable.

Termination of power contract

During fiscal year 2000, the Department terminated a power contract with the Montana Power Company under which the Department was required to take approximately 750,000 megawatt hours annually through 2010. The Department recorded a net loss of approximately $77 million on this transaction in fiscal year 2000.

Energy entitlement

The Department has a contract through 2017 with the U.S. Department of Energy for the purchase of available energy generated at the Hoover Power Plant. The Department's share of capacity at Hoover is approximately 500 megawatts. The cost of power purchased under this contract was $11, $11, and $12 million in fiscal years 2001, 2000 and 1999, respectively.

NOTE 6: Restricted and Other Investments

A summary of Energy Services' restricted and other investments is as follows (amounts in millions):

	June 30, 2001	June 30, 2000
Escrow investments	$ 283	$ 612
Debt reduction trust funds	446	679
Nuclear decommissioning trust funds	80	73
Other investments	178	21
	$ 987	$ 1,385
Postretirement health care benefit trust fund	$ 60	$ 54

All restricted and other investments are held in trust accounts to be used for a designated purpose as follows:

Escrow investments

Escrow investments are held to call specified revenue bonds at scheduled maturity dates.

Debt reduction trust funds

The debt reduction trust funds were established during fiscal year 1997 to provide for the payment of principal and interest on long-term debt obligations and purchased power obligations arising from the Department's participation in the Intermountain Power Project and the Southern California Public Power Authority (SCPPA) (see Note 5). The Department has transferred funds from purchased power pre-collections into these trust funds. Funds from operations may also be transferred by management as funds become available.

Nuclear decommissioning trust funds

Nuclear decommissioning trust funds will be used to pay the Department's share of decommissioning the Palo Verde Nuclear Generating Station at the end of its useful life (see Note 1).

Postretirement health care benefit trust fund

The postretirement health care benefit trust fund was established to provide for the payment of the Department's postretirement health benefits. The trust fund is recorded net of the accrued postretirement liability (see Note 10).

NOTE 6: (continued)

Other investments

Other investments consist of funds held by SCPPA on behalf of the Department. Certain of these investments are currently being used by the Department to provide for the payment of principal and interest on long-term debt obligations and purchased power obligations arising from the Department's participation in SCPPA. However, there are no restrictions imposed on the Department regarding the use of these investments.

Restricted and other investments held by the Department are categorized separately below to give an indication of the level of custodial credit risk assumed by the Department at June 30, 2001. Specifically, identifiable investments are classified as to credit risk by three categories and summarized below as follows: Category 1 includes investments that are insured or registered or for which securities are held by the Department or its agent in the Department's name; Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the Department's name; and Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent, but not in the Department's name. At June 30, 2001, Energy Services' restricted and other investments are categorized as follows (amounts in millions):

	Category			
Type of Investments	1	2	3	Total
Investments – Categorized				
U.S. Government Securities	$ 651	$ -	$ -	$ 651
Bonds	135	-	-	135
Banker's Acceptances	22	-	-	22
Commercial Paper	75	-	-	75
Repurchase Agreements	-	67	-	67
Negotiable Certificates of Deposits	100	-	-	100
Total Categorized Restricted Investments	$ 983	$ 67	$ -	1,050
Investments – Not Categorized				
Investments Held by Broker-Dealers:				
U.S. Government Securities				64
Total				$ 1,114

Repurchase agreements relate to the Department's securities lending program (see Note 7).

NOTE 7: Securities Lending Transactions

In December 1999, the Department initiated a securities lending program managed by its custodial bank. The bank lends up to 20% of the investments held in the debt reduction trust funds, decommissioning trust funds, and plan assets held in the postretirement benefits trust fund for securities, cash collateral or letters of credit equal to 102% of the market value of the loaned securities and interest, if any. The Department can sell collateral securities only in the event of borrower default.

A summary of Energy Services' securities lending transactions as of June 30, 2001 and 2000 is as follows (amounts in millions):

	June 30, 2001		June 30, 2000	
Securities lent for cash collateral	Fair value of underlying securities	Collateral value	Fair value of underlying securities	Collateral value
US Government and agency securities	$ 65	$ 67	$ 3	$ 3
Corporate fixed income securities	-	-	137	142
	$ 65	$ 67	$ 140	$ 145

The lending agent provides indemnification for borrower default. There were no violations of legal or contractual provisions and no borrower or lending agent default losses during fiscal years 2001 and 2000.

General Investment Pool Program

The Department also participates in the City's securities lending program through the pooled investment fund. The City's program has substantially the same terms as the Department's direct securities lending program. The Department recognizes its proportionate share of the cash collateral received for securities loaned and the related obligation for the general investment pool. As of June 30, 2001 and 2000, Energy Services' attributed share of cash collateral and the related obligation from the City's program was $72 and $83 million, respectively.

Management believes that participation in these securities lending programs results in no credit risk exposure to the Department because the amounts owed to the borrowers exceed the amounts the borrowers owe to the Department and the Pool.

NOTE 8: Long-term Debt and Advance Refunding Bonds

Long-term debt outstanding as of June 30, 2001 consists of revenue bonds and refunding revenue bonds due serially in varying annual amounts as follows (amounts in millions):

Bond Issues	Date of Issue	Effective Interest Rate	Fiscal Year of Last Scheduled Maturity	Principal Outstanding
Third Issue of 1991	10/01/91	6.684%	2032	$ 124
Refunding Issue of 1992	02/01/92	6.398%	2028	107
Issue of 1992	04/01/92	6.687%	2032	121
Refunding Issue of 1993	04/15/93	5.824%	2031	515
Second Refunding Issue of 1993	11/15/93	5.424%	2032	526
Issue of 2000	03/02/00	5.878%	2030	87
Second Issue of 2000	03/02/00	Variable	2010	621
Issue of 2001, Series A1	03/20/01	4.869%	2025	1,141
Issue of 2001, Series A3	04/01/01	5.043%	2025	116
	Total principal amount			3,358
	Revenue certificates			389
	Unamortized debt-related costs (including net loss on refundings)			(56)
	Debt due within one year (including current portion of revenue certificates)			(120)
				$ 3,571

Revenue bonds generally are callable ten years after issuance. The Department has agreed to certain covenants with respect to bonded indebtedness. Significant covenants include the requirement that Energy Services' net income, as defined, will be sufficient to pay certain amounts of future annual bond interest and of future annual aggregate bond interest and principal maturities. Revenue bonds and refunding bonds are collateralized by the future revenues of Energy Services.

NOTE 8: (continued)

New issuances

Fiscal Year 2001

In March 2001, the Department issued $1.3 billion of Energy Services fixed rate bonds. The net proceeds from these issuances were used to defease bonds with par amounts of $1.2 billion. The defeasance is expected to reduce total debt payments over the life of the new issues by $67 million and is expected to result in present value savings of approximately $49 million. This transaction resulted in a net loss for accounting purposes of $44 million, which was deferred and will be amortized over the shorter of the life of the bonds retired or the life of the new bonds.

In June 2001, the Department issued $621 million of Energy Services variable rate bonds for the purpose of defeasing the Second Issue of 2000 bonds in August 2001. The net proceeds from the issuance were deposited into a trust and were used to secure the new bonds until August 2001 at which time the Second Issue of 2000 bonds were defeased.

Fiscal Year 2000

In March 2000, the Department issued $337 and $621 million of fixed and variable rate bonds, respectively. The net proceeds from these issuances were used as follows (amounts in millions):

Deposits to construction funds	$	248
Defeasance of selected revenue bonds		86
Purchase of long-term notes receivable		565
Tender for selected revenue bonds		54
	$	953

A portion of the proceeds was used to tender for and to defease bonds with par amounts of $58 and $92 million, respectively. Based on an assumed cost of 4.0% for the variable rate bonds, the tender and defeasance are expected to reduce total debt payments over the life of the new issues by $99 million and are expected to result in present value savings of approximately $6 million. The actual savings will vary depending on future interest rates. An increase in the average rate of the variable bonds to 4.5% would change total net debt service savings to $97 million and the present value savings to $4 million. These transactions resulted in a net gain for accounting purposes of $7 million, which was deferred and will be amortized over the shorter of the life of the bonds retired or the life of the new bonds.

NOTE 8: (continued)

Cash defeasance

In February 2000, the Department transferred $51 million from the debt reduction trust funds to trusts established for the purpose of making future debt service payments on specific revenue bonds with a par value of $54 million. As a result of the completion of certain defeasances upon the new issuances in fiscal year 2001 discussed above, the Department further defeased bonds with par amounts of $50 million. This transaction resulted in a net loss for accounting purposes of $1 million, which has been recognized in fiscal 2001 as part of debt expenses. The final maturity of the remaining $4 million in revenue bonds not defeased, is 2006.

Escrow Investments

In July 2000, the Department deposited $32 million into a trust established for the purpose of making future debt service payments on specified revenue bonds with a par value of $35 million. The final maturity of the related revenue bonds is 2031.

Forward purchase agreement

On March 6, 2001, the Department entered into a forward delivery contract with a group of underwriters under which the Department will sell and deliver $109 million principal amount of fixed rate bonds on November 6, 2001. The net proceeds of the issuance will be used to defease bonds with a par value of $107 million.

Variable rate bonds

The variable rate bonds currently bear interest at a weekly rate (ranging from 2.50% to 2.65% as of June 30, 2001). The Department can elect to change the interest rate period of the bonds, with certain limitations. The bondholders have the right to tender the bonds to the tender agent on any business day with seven days prior notice. The Department has entered into Standby Agreements with a syndicate of commercial banks in an initial amount of $621 million to provide liquidity for these bonds. The initial Standby Agreements expire on February 27, 2002. Bonds purchased under the agreements will bear interest that is payable quarterly at the greater of the Federal Funds Rate plus .50% or the bank's announced base rate, as defined. The unpaid principal of bonds purchased is payable in ten equal semi-annual installments, commencing after the termination of the agreement. At its discretion, the Department has the ability to convert the outstanding bonds to fixed rate obligations, which cannot be tendered by the bondholders. The Department has the ability to refinance the outstanding variable rate bonds upon tender and, therefore has included the balance outstanding in long-term debt as of June 30, 2001.

NOTE 8: (continued)

Advance refunding bonds

In prior years, Energy Services established irrevocable escrow trusts with proceeds from the issuance of refunding bonds. During fiscal year 2001, bonds with a par value of $308 million were refunded using proceeds from the balance in the restricted escrow investments. Escrow investments of $246 million (stated at fair value as of June 30, 2001) will be used to refund bonds presently included in long-term debt at scheduled redemption dates as follows (amounts in millions):

Bond Issues	Redemption Date	Principal Amount to be Redeemed
Third Issue of 1991	10/01/01	$ 122
Issue of 1992	04/01/02	118
		$ 240

The related advance refunding bonds will be reclassified to long-term debt from advance refunding bonds at the time that the bonds to be refunded are called. Interest expense from refunding bonds and interest income earned on related escrow investments are included in investment income.

Scheduled principal maturities

Scheduled annual principal maturities during the five years following June 30, 2001 are $40, $34, $152, $165 and $158 million, respectively, and $3.2 billion thereafter. These scheduled maturities exclude the impact of mandatory redemptions with escrow investments.

Revenue certificates

As of June 30, 2001, the Department has outstanding commercial paper of $389 million bearing interest at an average rate of 2.74%. The commercial paper matures not more than 162 days from the date of issuance. The Department intends and has the ability to refinance $309 million of the outstanding revenue certificates upon their maturity and, therefore, has included this portion of the balance outstanding in long-term debt at June 30, 2001. The commercial paper is an unsecured obligation of the Department.

NOTE 8: (continued)

Effective September 1, 1999, the Department entered into a letter of credit and reimbursement agreement (the "Agreement") with a commercial banking syndicate in the amount of $400 million to provide liquidity and credit support for the Department's commercial paper program. The Agreement secures the payment when due of the principal and interest on commercial paper issued on or subsequent to September 1, 1999. Drawings on the Agreement will represent advances to the Department and will bear interest that is payable monthly at the Federal Funds Rate plus 0.5% or an adjusted rate based on the London Interbank Offered Rate (LIBOR), as defined. The unpaid principal of each advance is payable in ten equal semi-annual installments, commencing on the date six months after the advance. The Agreement terminates on August 31, 2002, unless extended.

Fair value

The fair value of long-term debt and refunding bonds is $3.3 and $3.7 billion at June 30, 2001 and 2000, respectively. Management has estimated fair value based on the present value of interest and principal payments on the long-term debt and refunding bonds, discounted using current interest rates obtainable by the Department for debt of similar quality and maturities.

The carrying amount of revenue certificates of $389 million at June 30, 2001 and 2000 approximates fair value due to the short maturities of these instruments.

NOTE 9: Retirement, Disability and Death Benefit Insurance Plan

The Department has a funded contributory retirement, disability and death benefit insurance plan covering substantially all of its employees. The Water and Power Employees' Retirement, Disability and Death Benefit Insurance Plan (the "Plan") operates as a single-employer benefit plan to provide pension benefits to eligible Department employees and to provide disability and death benefits from the respective insurance funds. Plan benefits are generally based on years of service, age at retirement and the employee's highest 12 consecutive months of salary before retirement. Active participants who joined the Plan on or after June 1, 1984 are required to contribute 6% of their annual covered payroll. Participants who joined the Plan prior to June 1, 1984 contribute an amount based upon an entry-age percentage rate. The Department contributes $1.10 for each $1.00 contributed by participants plus an actuarially determined annual required contribution as determined by the Plan's independent actuary. The contributions are allocated between Energy Services and Water Services based on the current year labor costs.

The Retirement Board of Administration (the "Retirement Board") is the administrator of the Plan. The Plan is subject to provisions of the Charter of the City of Los Angeles and the regulations and instructions of the Board of Water and Power Commissioners (the "Board of Commissioners"). The Plan is an independent pension trust fund of the Department.

Plan amendments must be approved by both the Retirement Board and the Board of Commissioners. During March 1998, two amendments were made to the Plan. The amendments change the retirement age required to receive unreduced benefits with thirty years of service from 55 to 50 years of age for employees retiring before October 1, 2002, and provide participants with the option of purchasing other governmental service for purposes of enhancing benefits and eligibility for retirement. These amendments are considered in the actuarial determination of annual required contributions.

NOTE 9: (continued)

Energy Services' allocated share of annual pension cost (APC) and net pension obligation (NPO) consists of the following (amounts in millions):

	Year Ended June 30, 2001	Year Ended June 30, 2000
Annual required contribution	$ -	$ -
Interest on net pension asset	(8)	(8)
Adjustment to annual required contribution	12	34
APC (including $1 and $5 million of amounts capitalized in fiscal 2001 and 2000, respectively)	4	26
Department contributions	(16)	(16)
Shared operating expenses (see Note 11)	-	(2)
Change in NPO	(12)	8
NPO (asset) at beginning of year	(100)	(108)
NPO (asset) at end of year	$ (112)	$ (100)

Annual required contributions are determined through actuarial valuations using the entry age normal actuarial cost method. The actuarial value of assets in excess of the Department's actuarial accrued liability (AAL) was being amortized by level contribution offsets over the period ending June 30, 2003. As a result of an April 2000 amendment to the Plan, the amortization period was changed to rolling fifteen-year periods effective July 1, 2000.

In accordance with actuarial valuations, the Department's required contribution rates are as follows:

Acturial Valuation Date June 30	Normal Cost	Surplus Amortization	Contribution Rate
2000	10.59%	-14.52%	0.00%
1999	10.57%	-26.72%	0.00%
1998	9.64%	-13.39%	0.00%

The significant actuarial assumptions include an investment rate of return of 8%, projected inflation-adjusted salary increases of 5.5%, and postretirement benefit increases of 3%. The actuarial value of assets is determined using techniques that smooth the effects of short-term volatility in the market value of investments over a four-year period. Plan assets consist primarily of corporate and government bonds, common stocks, mortgage-backed securities and short-term investments.

NOTE 9: (continued)

Trend information for the current and two preceding fiscal years for Energy Services are as follows (amounts in millions):

Year ended June 30,	NPO	Percentage of APC Contributed	APC
2001	$ (112)	413%	$ 4
2000	$ (100)	71%	$ 26
1999	$ (108)	285%	$ 15

The following schedule provides information about the Department's overall progress made in accumulating sufficient assets to pay benefits when due, prior to allocations to Water Services and Energy Services (amounts in millions):

Actuarial Valuation Date June 30,	Actuarial Value of Assets	AAL	Actuarial Assets Over AAL	Funded Ratio	Covered Payroll	Overfunding as a % of Covered Payroll
2000	$ 5,606	$ 5,083	$ 523	110%	$ 370	142%
1999	$ 5,254	$ 4,911	$ 343	107%	$ 355	97%
1998	$ 4,514	$ 4,340	$ 174	104%	$ 431	40%

The Department's measurement, recognition and disclosure of pension information are in accordance with GASB Statement No. 27, "*Accounting for Pensions by State and Local Governmental Employers*".

Disability and death benefits

Energy Services' allocated share of disability and death benefit plan costs and administrative expenses totaled $7, $9, and $9 million for each of the fiscal years 2001, 2000, and 1999, respectively.

NOTE 10: Health Care Costs

The Department provides certain health care benefits to active and retired employees and their dependents. The total number of active and retired Department participants entitled to receive benefits was approximately 15,500 at June 30, 2001. The allocated cost to Energy Services of providing such benefits amounted to $89, $78, and $73 million for fiscal years 2001, 2000 and 1999, respectively. Of these costs, $20, $15, and $15 million were capitalized and the remainder was charged to expense for fiscal years 2001, 2000 and 1999, respectively.

Postretirement benefits

The Department accounts for postretirement benefits in accordance with SFAS No. 106, "*Employers' Accounting for Postretirement Benefits Other Than Pensions*", which requires that the cost of postretirement benefits be recognized as expense over employees' service periods.

Energy Services' allocated share of postretirement benefit costs is summarized as follows (amounts in millions):

	Year Ended June 30,		
	2001	2000	1999
Service cost	$ 8	$ 8	$ 6
Interest cost	32	30	23
Expected return on plan assets	(3)	(3)	(3)
Amortization of transition obligation	10	12	12
Amortization of prior service costs	5	5	2
Special termination benefits	-	-	7
	$ 52	$ 52	$ 47

NOTE 10: (continued)

The funded status and the accrued benefit cost related to postretirement benefits for the Department, prior to allocations to Water Services and Energy Services, are summarized as follows (amounts in millions):

	June 30, 2001	June 30, 2000
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 636	$ 513
Service cost	13	10
Interest cost	48	39
Actuarial losses	139	58
Plan amendment	-	46
Benefits paid	(33)	(30)
Benefit obligation at end of year	803	636
Change in fair value of plan assets:		
Fair value of plan assets at beginning of year	71	69
Actual return on plan assets	7	2
Fair value of plan assets at end of year	78	71
Funded status	(725)	(565)
Unrecognized net loss	201	63
Unrecognized transition obligation	183	197
Unrecognized prior service cost	55	62
Accrued benefit cost	$ (286)	$ (243)
Energy Services' allocated share of accrued benefit cost	$ (203)	$ (174)

Weighted average actuarial assumptions used in determining postretirement benefit costs are as follows:

	June 30, 2001	June 30, 2000	June 30, 1999
Discount rate	7.25%	7.75%	7.25%
Expected return on plan assets	6.50%	7.00%	7.00%

Plan assets consist primarily of commercial paper, United States Government and governmental agency securities, and corporate bonds. No funding policy has been established for the future benefits to be provided under this plan.

NOTE 10: (continued)

For measurement purposes, a 10.0% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2001; the rate was assumed to decrease gradually to 5.50% in 2011 and remain at that level thereafter. For the dental plan, an 8.5% annual rate of increase in the per capita cost was assumed for 2001, the rate was assumed to decrease gradually to 5.50% in 2008 and remain at that level thereafter. The effect of a 1% change in these assumed health care cost trend rates would increase or decrease the Department's total benefit obligation by approximately $104 or $88 million, respectively. In addition, such a 1% change would increase or decrease the aggregate service and interest cost components of net periodic benefit cost by approximately $11 or $9 million, respectively.

During fiscal year 2000, the Department began contributing toward dental coverage for retirees enrolled in a Department-sponsored plan. This amendment resulted in a $46 million increase in the Department's accumulated postretirement benefit obligation at June 30, 2000. Energy Services' allocated $35 million share of this increase is being amortized through 2008, the remaining average service period. This change also resulted in an $11 and $8 million increase in postretirement benefit costs for fiscal years 2001 and 2000, respectively, of which $7 and $6 million, respectively, was allocated to Energy Services.

NOTE 11: Shared Operating Expenses

Energy Services shares certain administrative functions with the Department's Water Services. Generally, the costs of these functions are allocated on the basis of the benefits provided. Operating expenses shared with Water Services were $455, $466, and $430 million for fiscal years 2001, 2000 and 1999, respectively, of which $301, $316 and $284 million were allocated to Energy Services.

NOTE 12: Loss on Asset Impairment and Abandoned Project

During fiscal year 2001, management approved the sale of one of its administrative facilities and Energy Services reported its portion of the loss on asset impairment of $28 million. The completion of the sale is expected to occur within 12 to 24 months for a total purchase price of $50 million, which is below the total asset carrying value. In addition, management formally abandoned one of its customer information system projects and Energy Services reported its portion of the loss on abandonment of $15 million.

NOTE 13: Commitments and Contingencies

Transfers to the reserve fund of the City of Los Angeles

Under the provisions of the City Charter, Energy Services transfers funds at its discretion to the reserve fund of the City. Pursuant to covenants contained in the bond indentures, the transfers may not be in excess of net income of the prior fiscal year. Such payments are not in lieu of taxes and are recorded as a reduction of income in accordance with GASBS 33 (See Note 2).

The Department made payments of $120, $112 and $108 million in fiscal years 2001, 2000 and 1999, respectively, from Energy Services to the reserve fund of the City. The Department expects to make a transfer declaration from Energy Services of approximately $154 million during fiscal year 2002.

Palo Verde Nuclear Generating Station (PVNGS)

As a joint project participant in PVNGS, the Department has certain commitments with respect to nuclear spent fuel and waste disposal. Under the Nuclear Policy Act, the Department of Energy (DOE) was to develop the facilities necessary for the storage and disposal of spent fuel and to have the first such facility in operation by 1998; however, the DOE has announced that such a repository cannot be completed before 2010. There is ongoing litigation with respect to the DOE's ability to accept spent nuclear fuel; however, no permanent resolution has been reached.

Arizona Public Service (APS), PVNGS' operating agent, has capacity in existing fuel storage pools at PVNGS which, with certain modifications, could accommodate all fuel expected to be discharged from normal operation of PVNGS through 2002. In addition, APS believes it could augment that wet storage with new facilities for on-site storage of spent fuel for an indeterminate period of operation beyond 2002, subject to obtaining required government approvals. The Department currently estimates that it will incur $23 million (in 1998 dollars) over the life of PVNGS for its direct share of the costs related to the on-site interim storage of spent nuclear fuel. During fiscal 1999, the Department expensed approximately $7 million for its direct share of on-site interim nuclear fuel storage costs related to nuclear fuel burned prior to fiscal 1999. In addition, the Department began accruing for current nuclear fuel storage costs as a component of fuel expense as the fuel is burned. The Department's share of spent nuclear fuel costs related to its indirect interest in PVNGS is included in purchased power expense. APS currently believes that spent fuel storage or disposal methods will be available for use by PVNGS to allow its continued operation beyond 2002.

NOTE 13: (continued)

The Price-Anderson Act (the "Act") requires that all utilities with nuclear generating facilities share in payment for claims resulting from a nuclear incident. The Act limits liability from third-party claims to $9 billion per incident. Participants in PVNGS currently insure potential claims and liability through commercial insurance with a $200 million limit; the remainder of the potential liability is covered by the industry-wide retrospective assessment program provided under the Act. This program limits assessments to $79 million for each licensee for each nuclear incident occurring at any nuclear reactor in the United States; payments under the program are limited to $10 million per incident, per year. Based on the Department's 5.7% direct interest and its 3.95% indirect investment interest through SCPPA, the Department would be responsible for a maximum assessment of $8 million per incident, limited to payments of $1 million per incident annually.

Environmental matters

Numerous environmental laws and regulations affect Energy Services' facilities and operations. The Department monitors its compliance with laws and regulations and reviews its remediation obligations on an ongoing basis.

The Department is subject to the Regional Clean Air Incentives Market (RECLAIM) emission reduction program adopted by the South Coast Air Quality Management District (SCAQMD). In accordance with this program, an emissions cap is established for each company that controls emissions. Companies that exceed the required limit may buy emissions credits from other companies that have emissions below the maximum threshold. The Department has established a program of installing emission controls and purchasing RECLAIM trading credits to meet the emissions requirements.

Based on the Department's significant increase in sales for resale during the spring and the early summer of 2000, the Department anticipated a potential shortfall in nitrogen oxide emission (NOx) credits to provide for both its native load and the demands of the California grid during the remaining months of calendar year 2000. As a result, during August 2000, the Department entered into a Settlement Agreement (Agreement) with the SCAQMD. The Agreement released the Department from any and all claims or penalties arising from the incidents which gave rise to the RECLAIM violations at its local facilities through December 31, 2000. The Agreement also provides for a civil penalty of not less than $14 million. The civil penalty must be spent within a three-year period on supplemental environmental projects agreed to by the SCAQMD and the Department.

NOTE 13: (continued)

Although the Department did not have a shortfall of RECLAIM trading credits at the end of calendar year 2000, the Department has continued its partnership with SCAQMD in the Department's funding of environmental projects. The Department and SCAQMD have agreed to projects in the areas of micro-turbine development and commercialization, natural gas fueling station infrastructure, tree plantings at schools, advanced fuel cell demonstration, and hybrid-electric midsize school buses.

In May 2001, SCAQMD adopted amendments to RECLAIM with the intent of lowering and stabilizing RECLAIM trading credit prices. One key element of the amendments is that existing power plants are bifurcated from the rest of the RECLAIM market and are required to install Best Available Retrofit Control Technology (BARCT) through compliance plans. The Department submitted its compliance plans for SCAQMD approval in August 2001 that demonstrate that the Department has sufficient RECLAIM trading credits to meet its needs for the next five years; operates its generating units using "environmental dispatch"; and has installed BARCT or better on all sources of NOx emissions, or will do so by January 2003.

Litigation

A number of claims and suits are pending against the Department for alleged damages to persons and property and for other alleged liabilities arising out of its operations. In the opinion of management, any ultimate liability, which may arise from these actions, are not expected to materially impact Energy Services' financial position, results of operations or cash flows as of June 30, 2001.

Risk management

Energy Services is subject to certain business risks common to the utility industry. The majority of these risks are mitigated by external insurance coverage obtained by Energy Services. For other significant business risks, however, Energy Services has elected to self-insure. Management believes that exposure to loss arising out of self-insured business risks will not materially impact Energy Services' financial position, results of operations or cash flows as of June 30, 2001.

Credit risk

Financial instruments, which potentially expose the Department to concentrations of credit risk, consist primarily of retail and wholesale receivables. The Department's retail customer base is concentrated among commercial, industrial, residential and governmental customers located within the City. Although the Department is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 2001, except as provided in the allowance for losses. The Department manages its credit exposure by requiring credit enhancements from certain customers and through procedures designed to identify and monitor credit risk.

NOTE 13: (continued)

Energy Services also enters into forward purchase and sale commitments for the physical delivery of energy with utility companies and energy marketers. Energy Services is exposed to credit risk related to nonperformance by its wholesale counterparties under the terms of these contractual agreements. In order to limit the risk of counterparty default, the Department has implemented a Wholesale Marketing Counterparty Evaluation Policy (the "Policy"). The Policy includes provisions to limit risk including: the assignment of internal credit ratings to all Department counterparties based on counterparty and/or debt ratings; the requirement for credit enhancements (including irrevocable letters of credit, escrow trust accounts and parent company guarantees) for counterparties that do not meet an acceptable level of risk; and the use of standardized agreements which allow for the netting of positive and negative exposures associated with a single counterparty. As discussed in Note 3, during fiscal year 2001, Energy Services experienced nonperformance and material counterparty default with the CISO and the CPX. Energy Services does not anticipate nonperformance by any other of its counterparties and has no reserves related to nonperformance at June 30, 2001 and 2000, respectively. Apart from the events discussed in Note 3, Energy Services did not experience any material counterparty default during fiscal years 2001, 2000 or 1999.