

Water Services
Department of Water and Power
City of Los Angeles

Report and Financial Statements

June 30, 2001

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 and retained income reinvested in the business, and of cash flows present fairly, in all material respects, the financial position of the Water System (Water 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.

PricewaterhouseCoopers LLP

September 24, 2001

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

	June 30,	
	<u>2001</u>	<u>2000</u>
Assets		
Utility Plant		
Source of water supply	\$ 348,947	\$ 363,004
Pumping	189,235	169,565
Purification	229,955	221,270
Distribution	2,354,977	2,211,820
General	311,146	308,066
	<u>3,434,260</u>	<u>3,273,725</u>
Accumulated depreciation	1,242,737	1,155,735
	<u>2,191,523</u>	<u>2,117,990</u>
Construction work in progress	263,137	196,710
	<u>2,454,660</u>	<u>2,314,700</u>
Restricted investments	107,383	308,186
Current Assets		
Cash and cash equivalents	300,403	106,876
Cash collateral received from securities lending transactions	63,953	25,216
Customer and other accounts receivable, net of \$3,500 allowance for losses	76,686	68,508
Underrecovered costs	19,487	-
Due from Energy Services	7,340	1,344
Accrued unbilled revenue	48,569	42,447
Materials and supplies, at average cost	17,671	15,753
Prepayments and other current assets	15,017	12,273
	<u>549,126</u>	<u>272,417</u>
Net pension asset	52,822	45,513
	<u>\$ 3,163,991</u>	<u>\$ 2,940,816</u>
Capitalization and Liabilities		
Retained income reinvested in the business	\$ 1,730,697	\$ 1,655,160
Long-term debt	1,043,733	709,498
Advance refunding bonds	80,603	315,968
	<u>2,855,033</u>	<u>2,680,626</u>
Current Liabilities		
Debt due within one year	10,185	19,700
Accounts payable and accrued expenses	76,510	72,250
Accrued interest	11,018	14,726
Accrued employee expenses	23,856	20,162
Obligations under securities lending transactions	63,953	25,216
Overrecovered costs	-	183
Customer deposits	40,546	38,766
	<u>226,068</u>	<u>191,003</u>
Accrued postretirement liability	82,890	69,187
Commitments and contingencies (Note 9)	-	-
	<u>\$ 3,163,991</u>	<u>\$ 2,940,816</u>

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

Los Angeles Department of Water and Power
Water Services Statements of Income and
Retained Income Reinvested in the Business, as restated
(Amounts in thousands)

	Year Ended June 30,		
	2001	2000	1999
Operating Revenues			
Residential	\$ 217,029	\$ 207,873	\$ 173,812
Multiple dwelling units	167,309	153,356	139,217
Commercial and industrial	126,927	118,311	104,927
Other	33,675	30,663	25,456
	<u>544,940</u>	<u>510,203</u>	<u>443,412</u>
Operating Expenses			
Purchased water	134,480	91,275	37,192
Maintenance and other operating expense	194,030	186,963	198,398
Depreciation and amortization	80,910	75,339	72,788
	<u>409,420</u>	<u>353,577</u>	<u>308,378</u>
Operating Income	<u>135,520</u>	<u>156,626</u>	<u>135,034</u>
Other Income and Expense			
Investment income (loss)	27,350	9,475	(3,907)
Loss on asset impairment and abandoned projects	(35,601)	-	-
Other, net	1,285	565	5,371
	<u>(6,966)</u>	<u>10,040</u>	<u>1,464</u>
Debt Expenses			
Interest on debt	46,234	47,958	44,987
Allowance for funds used during construction	(2,023)	(1,246)	(2,610)
	<u>44,211</u>	<u>46,712</u>	<u>42,377</u>
Contributions in aid of construction and grants	19,790	12,718	26,383
Income before transfer to the City and extraordinary item	104,133	132,672	120,504
Transfer to the reserve fund of the City of Los Angeles	25,500	22,200	16,252
Income before extraordinary item	78,633	110,472	104,252
Extraordinary loss on extinguishment of long-term debt	<u>(3,096)</u>	<u>-</u>	<u>-</u>
Net income	75,537	110,472	104,252
Retained income reinvested in the business:			
Beginning of year	1,655,160	1,544,688	1,440,436
End of year	<u>\$ 1,730,697</u>	<u>\$ 1,655,160</u>	<u>\$ 1,544,688</u>

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

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

	Year Ended June 30,		
	2001	2000	1999
Cash Flows from Operating Activities:			
Operating income	\$ 135,520	\$ 156,626	\$ 135,034
Adjustments to reconcile operating income to net cash provided by operating activities			
Depreciation and amortization	80,910	75,339	72,788
Provision for losses on customer and other receivables	3,945	2,478	2,172
Loss on asset impairment and abandoned projects	(35,601)	-	-
Extraordinary loss on extinguishment of long-term debt	(3,096)	-	-
Changes in assets and liabilities:			
Customer and other accounts receivable	(12,087)	7,976	(18,967)
Net pension asset	(7,309)	2,332	(12,079)
Accounts payable and accrued expenses	4,260	12,290	(4,315)
Underrecovered/Overrecovered costs	(19,670)	(36,757)	(6,548)
Accrued postretirement liability	13,703	12,127	11,324
Other assets and liabilities	(10,083)	(11,656)	6,773
	<u>150,492</u>	<u>220,755</u>	<u>186,182</u>
Cash Flows from Noncapital Financing Activities:			
Payments to the reserve fund of the City of Los Angeles	<u>(25,500)</u>	<u>(22,200)</u>	<u>(21,252)</u>
Cash Flows from Capital and Related Financing Activities:			
Additions to plant and equipment, net	(218,847)	(211,251)	(160,069)
Contributions in aid of construction and grants	19,790	12,718	26,383
Gain on sale of land	-	-	5,524
Proceeds from escrow investment maturities	307,632	13,555	65,968
Purchases of escrow investments	(103,927)	(9,613)	(235,069)
Sale of revenue bonds and refunding bonds, net	730,482	99,132	233,395
Principal payments and maturities of long-term debt	(643,185)	(18,720)	(77,881)
Debt interest payments	<u>(56,745)</u>	<u>(59,333)</u>	<u>(56,365)</u>
	<u>35,200</u>	<u>(173,512)</u>	<u>(198,114)</u>
Cash Flows from Investing Activities:			
Investment income	<u>33,335</u>	<u>19,267</u>	<u>12,565</u>
Cash and Cash Equivalents			
Net increase (decrease)	193,527	44,310	(20,619)
Beginning of year	<u>106,876</u>	<u>62,566</u>	<u>83,185</u>
	<u>\$ 300,403</u>	<u>\$ 106,876</u>	<u>\$ 62,566</u>

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

**Los Angeles Department of Water and Power
Water Services**

Notes to 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 Water System (Water Services) is responsible for the procurement, quality and distribution of water for sale in the City.

Method of accounting

The accounting records of Water 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, Water Services records various regulatory assets and liabilities to reflect the regulator’s actions. Management believes that Water 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.

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.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

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. Estimated service lives range from 5 to 70 years. Depreciation expense as a percentage of average depreciable utility plant in service was 2.6% for each of the fiscal years 2001, 2000 and 1999. Amortization expense for computer software is computed using the straight-line method over 5 years.

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 \$19 million of internally-designated balances relating to bond redemption and interest funds and a self-insurance fund. In addition, at June 30, 2001, the cash and cash equivalents balance includes \$255 million 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.

Los Angeles Department of Water and Power
Water Services

Notes to Financial Statements (continued)

NOTE 1: (continued)

Restricted Investments

Water Services' restricted investments consist of escrow investments held to call specified revenue bonds at scheduled maturity dates. Such investments include United States Government and governmental agency securities. 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.

Revenues

Water Services' rates are established by a rate ordinance, which is approved by the City Council. Water Services sells water to other City departments at rates provided in the ordinance. Water Services recognizes water costs in the period incurred and accrues for estimated water sold but not yet billed.

Revenues consist of billings to customers for water consumption at rates specified in the water rate ordinance. These rates include a cost adjustment factor that provides Water Services with full recovery of purchased water costs. Water Services is also authorized to collect approved demand-side management, water reclamation and water quality improvement expenditures. Management estimates these costs to establish the cost recovery component of customer billings and any difference between billed and actual costs is adjusted in subsequent billings. This difference is reflected as under or over recovered costs on the balance sheet.

The rate ordinance limits Water Services' recovery of combined expenditures for demand-side management, water reclamation and water quality improvement. During fiscal year 2001, Water Services incurred expenditures of \$27 million in excess of these limits, which is being funded through funds received from the issuance of debt. These expenditures were not recovered during fiscal year 2001; however, Water Services' rate ordinance permits future recovery of principal and interest payments related to debt used to fund approved expenditures over the life of the related debt issues.

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.

Los Angeles Department of Water and Power
Water Services

Notes to Financial Statements (continued)

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. 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.

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 5.8%, 6.3% and 6.4% for fiscal years 2001, 2000 and 1999, respectively.

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.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 2: Accounting Changes

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 income statement. 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 \$550 million increase to retained income reinvested in the business effective July 1, 1998.

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

	Year Ended June 30,	
	<u>2000</u>	<u>1999</u>
Net income, as previously reported	\$ 120	\$ 94
- Contributions in aid of construction	13	26
- Transfers to the reserve fund of the City of Los Angeles	<u>(22)</u>	<u>(16)</u>
Net income, as restated	111	104
Retained income reinvested in the business		
Beginning of year, as restated	<u>1,544</u>	<u>1,440</u>
End of year, as restated	<u>\$ 1,655</u>	<u>\$ 1,544</u>

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 3: 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 Department's eligible assets 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. 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 the year.

As of June 30, 2001 and 2000, Water Services had securities lending obligations related to corporate fixed income securities with a fair value of \$7 and \$5 million, respectively. These securities were lent for cash collateral of \$7 and \$5 million, respectively.

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. Water Services' attributed share of cash collateral and the related obligation from the City's program was \$57 and \$20 million as of June 30, 2001 and 2000, 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.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 4: 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):

<u>Bond Issues</u>	<u>Date of Issue</u>	<u>Effective Interest Rate</u>	<u>Fiscal Year of Last Scheduled Maturity</u>	<u>Principal Outstanding</u>
Second Issue of 1991	11/01/91	6.623%	2032	\$ 95
Refunding Issue of 1993	04/15/93	5.880%	2024	80
Second Refunding Issue of 1993	12/01/93	5.297%	2030	126
Refunding Issue of 1998	10/15/98	4.689%	2035	236
Issue of 2001, Series A	02/01/01	5.202%	2042	315
Issue of 2001, Series B	02/28/01	Variable	2036	<u>325</u>
Total principal amount				1,177
Unamortized debt-related costs (including net loss on refundings)				(43)
Long-term debt due within one year				<u>(10)</u>
				<u>\$ 1,124</u>

The revenue bonds generally are callable ten years after issuance. The Department has agreed to certain covenants with respect to its bonded indebtedness. Significant covenants include the requirement that Water 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. The revenue bonds and refunding revenue bonds are secured by future revenues of Water Services.

New issuances

In February 2001, the Department issued \$315 and \$325 million of Water Services fixed and variable rate bonds, respectively. The net proceeds from these issuances were used as follows (amounts in millions):

Deposits to construction funds	\$ 312
Defeasance of selected revenue bonds	<u>318</u>
	<u>\$ 630</u>

Los Angeles Department of Water and Power
Water Services

Notes to Financial Statements (continued)

NOTE 4: (continued)

A portion of the proceeds was used to defease bonds with par amounts of \$305 million. Based on an assumed interest cost of 5.1% for the variable rate bonds, the defeasance is expected to increase total debt payments over the life of the new issues by approximately \$30 million and is expected to result in present value savings of approximately \$17 million. The actual savings will vary depending on future interest rates. An increase in the average rate of the variable bonds to 5.8% would change the total increase in net debt service by \$47 million and the present value savings to \$8 million. These transactions resulted in a net loss for accounting purposes of \$12 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 November 2000, the Department issued \$100 million of short term revenue certificates. These certificates were among the long-term debt issues defeased upon the issuance of the \$325 million in variable rate bonds described above.

Cash tender and defeasance

In February 2001, the Department transferred \$16 and \$56 million from the Water Revenue Fund to tender for and to defease bonds with par values of \$16 and \$53 million, respectively. In addition, the Department transferred \$23 million for the purpose of making future interest payments on revenue bonds issued prior to 1995 for which principal is being paid from existing escrow accounts. As a result of these additional cash transfers, the Department completed additional defeasances of bonds with par amounts of \$161 million. These transactions resulted in a net loss for accounting purposes of \$15 million. Of this loss, \$12 million was deferred and will be amortized over the shorter of the life of the bonds retired or the life of the new bonds. The remaining \$3 million loss has been recognized in fiscal year 2001 as an extraordinary item.

Escrow investments

In February 2001, the Department deposited \$14 million into a trust established for the purpose of making future debt service payments on specified revenue bonds with a par value of \$13 million. The final maturity of the related revenue bonds is 2031.

Variable rate bonds

The variable rate bonds currently bear interest at a weekly rate (2.5% 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 \$325 million to provide liquidity for these bonds. The initial Standby Agreements expire in November 2001 and February 2004. 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

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 4: (continued)

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.

Advance refunding bonds

In prior years, Water Services established irrevocable escrow trusts with the proceeds from issuance of refunding bonds. Escrow investments of \$107 million (stated at fair value as of June 30, 2001) will be used to pay interest on certain refunding revenue bonds and to pay bonds presently included in long-term debt at scheduled redemption dates as follows (amounts in millions):

<u>Bond Issue</u>	<u>Redemption Date</u>	<u>Principal Amount to be Redeemed</u>
Second Issue of 1991	11/1/2001	\$ <u>81</u>

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 on 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 fiscal years following June 30, 2001 are \$10, \$12, \$13, \$12 and \$12 million, respectively, and \$1.12 billion thereafter. These scheduled maturities exclude the impact of mandatory redemptions with escrow investments.

Fair value

The fair value of long-term debt and advance refunding bonds is \$1.08 and \$1.02 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 advance refunding bonds, discounted using current interest rates obtainable by the Department for debt of similar quality and maturities.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 5: 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 Water Services and Energy 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.

Los Angeles Department of Water and Power
Water Services

Notes to Financial Statements (continued)

NOTE 5: (continued)

Water 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	2000
Annual required contribution	\$ -	\$ -
Interest on net pension asset	(3)	(3)
Adjustment to annual required contribution	<u>5</u>	<u>11</u>
APC (including \$1 and \$3 million of amounts capitalized in fiscal 2001 and 2000, respectively)	2	8
Department contributions	(9)	(8)
Shared operating expenses (see Note 7)	<u>-</u>	<u>2</u>
Change in NPO	(7)	2
NPO (asset) at beginning of year	<u>(46)</u>	<u>(48)</u>
NPO (asset) at end of year	<u>\$ (53)</u>	<u>\$ (46)</u>

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:

Actuarial Valuation Date	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.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 5: (continued)

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

Year ended June 30,	NPO	Percentage of APC Contributed	APC
2001	\$ (53)	413%	\$ 2
2000	\$ (46)	71%	\$ 8
1999	\$ (48)	285%	\$ 5

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

Water Services' allocated share of disability and death benefit plan costs and administrative expenses totaled \$3, \$4 and \$4 million for each of the fiscal years 2001, 2000, and 1999 respectively.

Los Angeles Department of Water and Power
Water Services

Notes to Financial Statements (continued)

NOTE 6: 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 Water Services of providing such benefits amounted to \$33, \$25, and \$22 million for fiscal years 2001, 2000 and 1999, respectively. Of these costs, \$12, \$9, and \$7 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.

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

	Year ended June 30,		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Service cost	\$ 4	\$ 2	\$ 2
Interest cost	16	9	7
Expected return on plan assets	(1)	(1)	(1)
Amortization of transition obligation	5	4	4
Amortization of prior service costs	3	2	-
Special termination benefits	-	-	2
	<u>\$ 27</u>	<u>\$ 16</u>	<u>\$ 14</u>

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 6: (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	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	<u>803</u>	<u>636</u>
Change in fair value of plan assets:		
Fair value of plan assets at beginning of year	71	69
Actual return on plan assets	<u>7</u>	<u>2</u>
Fair value of plan assets at end of year	<u>78</u>	<u>71</u>
Funded status	(725)	(565)
Unrecognized net loss	201	63
Unrecognized transition obligation	183	197
Unrecognized prior service cost	<u>55</u>	<u>62</u>
Accrued benefit cost	<u>\$ (286)</u>	<u>\$ (243)</u>
 Water Services' allocated share of accrued benefit cost	 <u>\$ (83)</u>	 <u>\$ (69)</u>

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

	June 30,		
	2001	2000	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 benefit to be provided under this plan.

**Los Angeles Department of Water and Power
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Notes to Financial Statements (continued)

NOTE 6: (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. Water Services' allocated \$11 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 \$4 and \$2 million respectively, was allocated to Water Services.

NOTE 7: Shared Operating Expenses

Water Services shares certain administrative functions with the Department's Energy Services. Generally, the costs of these functions are allocated on the basis of the benefits provided. Operating expenses shared with Energy Services were \$455, \$466, and \$430 million for fiscal years 2001, 2000 and 1999, respectively, of which \$154, \$150, and \$146 million were allocated to Water Services.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 8: Loss On Asset Impairment And Abandoned Projects

During fiscal year 2001, management approved the sale of one of its administrative facilities and Water Services reported its portion of the loss on asset impairment of \$12 million. The completion of the sale is expected to occur within the next 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 certain projects and Water Services reported its portion of the loss on abandonment of \$24 million. Projects abandoned included a customer information system, and studies and research related to construction projects.

NOTE 9: Commitments and Contingencies

Transfers to the reserve fund of the City of Los Angeles

Under the provisions of the City Charter, Water 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 \$26, \$22 and \$16 million in fiscal years 2001, 2000 and 1999, respectively, from Water Services to the reserve fund of the City. The Department expects to make a transfer declaration from Water Services of approximately \$27 million during fiscal year 2002.

Environmental matters

Surface Water Treatment Rule

The Department is subject to the State of California Surface Water Treatment Rule (SWTR), which increases filtration requirements at open distribution reservoirs. The Department has four major reservoirs subject to the SWTR: Upper and Lower Hollywood, Lower Stone Canyon and Encino. Under the terms of an agreement with the State Department of Health Services, all four reservoirs are scheduled to be in compliance with the SWTR requirements by the end of 2004. The Department plans to comply with the SWTR by removing these reservoirs from regular service through construction of larger pipelines and storage facilities. These changes will improve water quality while maintaining flexibility in the water system.

As of June 30, 2001, the Department has incurred capital costs of approximately \$214 million associated with SWTR compliance. These costs relate to engineering studies and construction activities at the four reservoirs and for the addition of key pipelines in the San Fernando Valley. As of June 30, 2001, management estimates that the total cost of compliance with the SWTR will be approximately \$325 million.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 9: (continued)

Owens Valley

During July 1997, the Great Basin Unified Air Pollution Control District (the "District") adopted an initial State Implementation Plan and an implementing order requiring the Department to initiate pollution control measures to control particulate matters emitting from the Owens Dry Lake bed. The Department disputed the remediation measures imposed by the original order; however, in July 1998, the Board of the District and the City Council approved a Memorandum of Agreement (MOA) resolving the level of control measures required.

Under the MOA, the City committed to providing control measures on the lakebed in a phased manner until the lakebed emissions are reduced to a level that complies with the requirements of the Federal Clean Air Act. In addition, the District agreed to adopt a revised State Implementation Plan (SIP) that extends the period for the City to complete the installation of control measures until 2006, which is the deadline currently required by the Clean Air Act. In November 1998, the District approved the revised SIP, which incorporated the provisions of the MOA. The SIP was subsequently approved by the California Air Resources Board and ultimately by the United States Environmental Protection Agency in August 1999. The SIP anticipates that the City will have control measures in place over a minimum of 22.5 square miles of the lakebed by 2006. It is estimated that about 40,000 acre-feet of water will be required on an annual basis to operate the pollution control facilities. The current plan assumes that a portion of this water will be obtained from the local sub-potable groundwater basin; however, the actual quantity available will not be known until additional studies are completed.

As of June 30, 2001, the Department has incurred capital costs of approximately \$58 million associated with the Owens Dry Lake. Based on the current plan, management estimates that the total capital related costs of implementing the pollution control measures through 2006 will be approximately \$225 million; however, the cost estimate may change as additional information becomes available. The SIP also provides that the District shall develop a new SIP in 2003 to incorporate actual experience and to revise the schedule and plan as necessary to meet the air quality standards.

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 Water Services' financial position, results of operations or cash flows as of June 30, 2001.

**Los Angeles Department of Water and Power
Water Services**

Notes to Financial Statements (continued)

NOTE 9: (continued)

Risk management

Water 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 Water Services. For other significant business risks, however, Water Services has elected to self-insure. It is management's belief that exposure to loss arising out of self-insured business risks will not materially impact Water 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 accounts receivable from retail customers. The Department's 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 deposits from certain customers and through procedures designed to identify and monitor credit risk.