# Energy Services
# Department of Water and Power
# City of Los Angeles

Report and Financial Statements and
Required Supplementary Information

**June 30, 2002**

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

**Management's Discussion and Analysis**

**June 30, 2002**

The following discussion and analysis of the financial performance of the City of Los Angeles' (the City) Department of Water and Power's (the Department), Power System Fund (Energy Services), provides an overview of the financial activities for the fiscal year ended June 30, 2002. Descriptions and other details pertaining to Energy Services are included in the notes to the financial statements. This discussion and analysis should be read in conjunction with the Energy Services' financial statements, which begin on page 16.

## Background and Creation of the Department

The Department is the largest municipal utility in the United States and is a separate proprietary agency of the City, controlling its own funds with full responsibility for meeting the electric and water requirements of its service area. The Department provides electric and water service almost entirely within the boundaries of the City, which encompasses some 465 square miles, to a population of approximately 3.7 million people. Certain factors, which affect the electric industry, generally apply to the Department's operation of Energy Services.

The Department was established under the City Charter adopted in January 1925 as amended effective July 2000. It had its beginning, however, in the early years of this century. The first Board of Water and Power Commissioners was established in 1902. The responsibilities for the provision of water as well as electricity were given to a new Los Angeles Department of Public Service organized in 1911. The Department of Public Service was superceded in 1925 when a new Charter was adopted creating the Department. Subsequently the Water Works and Electric Works came to be known as the Water System and the Power System. The operations and finances of the Water System are separate from those of the Power System.

## Charter Provisions

*Governance*

Pursuant to the Charter of the City, (the Charter), the five-member Board of Water and Power Commissioners, (the Board) is the governing body of the Department and the General Manager administers the affairs and operations of the Department as its chief administrative officer. The Board is granted the possession, management and control of Energy Services.

The provisions of the Charter relating to the Department are found in Article VI. Among other things, Article VI provides that all Energy Services revenue collected by the Department shall be deposited in the Power Revenue Fund, that the Board shall control the money in the Power Revenue Fund, and makes provisions for the issuance of Department bonds, notes and other evidences of indebtedness payable out of the Power Revenue Fund.

Section 245 of the Charter provides that actions of the Board shall become final at the expiration of the next five meeting days of the City Council (the Council), during which time the Council may bring the matter for review, or veto such action. If the Council votes to bring the matter for review, it has 21 days to review the matter, otherwise the Board's action on the matter will be final.

*Rates*

Pursuant to the Charter, the Board, subject to the approval of the Council by ordinance, fixes the rates for electric service provided by the Power System. The Charter provides that such rates shall be fixed by the Board from time to time as necessary. The Charter also provides that such rates shall, except as authorized by the Charter, be of uniform operation for customers of similar circumstances throughout the City, as near as may be, and shall be fair and reasonable, taking into consideration, among other things, the nature of the uses, the quantity supplied, and the value of the service, and the financial impact on the Power System resulting from such service.

A rate freeze for all Department electric customers was instituted effective April 1, 1998, which froze electric rates at the level in effect as of October 1997. This rate freeze remained in effect during fiscal year 2002.

*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 fund net assets in accordance with governmental accounting standards. Energy Services made a transfer of 5% of its fiscal 2001 operating revenues, plus an additional $25 million transfer, totaling $179 million, to the reserve fund of the City in fiscal 2002. Energy Services expects to transfer 7% of its fiscal 2002 revenues, or $156 million, to the reserve fund of the City in fiscal 2003.

*Competitive Abilities*

In 1996, certain amendments to the Charter were approved to enable the Department to compete more effectively in a deregulated electric market. These amendments are included in the amended Charter and include:

- Greater flexibility in debt structuring;
- The express authority to sell energy and related products and services outside the City;
- The ability to enter into contracts with retail customers for terms of up to ten years;
- The ability to invest moneys in the Power Revenue Fund in any investment authorized for City funds;
- The authority to finance the energy efficiency investments of the Department's retail customers.

## Critical Accounting Policies

*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.

Energy Services' rates are determined by the Board and are subject to review and approval by the 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. The primary impact of SFAS No. 71 is a deferral of a portion of revenues authorized for debt reduction. The Department deferred $69 million and $71 million in fiscal years 2002 and 2001, respectively.

*California Receivables*

The Department's policy is to reserve for known contingencies that can be estimated. The Department has recorded receivables due from two California agencies totaling $170 million. Energy Services has also recorded a $7 million liability representing the lower end of management's estimate of potential refunds pertaining to the above receivables. It is management's belief that the entire receivable represents a valid claim and should be paid with interest by the parties owing the Department, primarily the California Power Exchange (the CPX) and the California Independent Systems Operator. In January 2001, the CPX filed for bankruptcy and management has not yet determined how and when receivables will be paid from that organization. Two utilities with significant amounts due to these agencies, Southern California Edison Company and Pacific Gas & Electric, have previously stated in public disclosure documents that they may not be able to pay for all the power they consumed in 2001. Southern California Edison Company has paid all amounts due by it to the CPX, however the amounts remain in an escrow account pending the resolution of disbursement of the funds. Pacific Gas & Electric has filed for protection under Chapter 11 of the Federal Bankruptcy Statute and all amounts due from that entity are outstanding.

*Investment Policy and Controls*

The Department's cash, other than cash in certain trust funds, is deposited with the City Treasurer, who invests the funds in securities under the City Treasurer's pooled investment program, for the purpose of maximizing interest earnings. Under the program, available funds of the City and its independent operating departments are invested on a combined basis. The primary responsibilities of the City Treasurer are to protect the principal and asset holdings of the City's portfolio and to ensure adequate liquidity to provide for the prompt and efficient handling of City disbursements.

*Debt Management Program*

The debt restructuring element of the Debt Management Program includes the issuance of refunding bonds to achieve debt service savings and to accelerate the maturity of certain bonds while maintaining an appropriate overall annual debt service schedule for all of the Department's obligations in connection with the Power System. The Department has completed the major portion of its refunding program, including the issuance of several series of refunding bonds payable from the Power Revenue Fund under a Master Bond Resolution adopted by the Board on February 6, 2001. Pursuant to this refunding program, the Department issued $2.1 billion principal amount of refunding bonds to redeem, defease or purchase $1.5 billion principal amount of Department revenue bonds payable from the Power Revenue Fund and $0.6 billion principal amount of Intermountain Power Authority (IPA) bonds.

In addition, Energy Services has $808 million on deposit in trust funds restricted for the use of debt reduction as of June 30, 2002. The Debt Management Program is intended to bring Energy Services' cost structure to a competitive level.

## Using This Financial Report

This financial annual report consists of the financial statements and reflects the self-supporting activities of Energy Services that are funded primarily through the sale of energy, transmission and distribution services to the public it serves.

## Balance Sheets, Statements of Revenues, Expenses and Changes in Fund Net Assets, and Statements of Cash Flows

The financial statements provide an indication of Energy Services' financial health. The Balance Sheets include all of Energy Services' assets and liabilities, using the accrual basis of accounting, as well as an indication about which assets can be utilized for general purposes, and which assets are restricted as a result of bond covenants and other commitments. The Statements of Revenues, Expenses, and Changes in Fund Net Assets report all of the revenues and expenses during the time periods indicated. The Statements of Cash Flows report the cash provided and used by operating activities, as well as other cash sources such as investment income and cash payments for bond principal and capital additions and betterments.

The following table summarizes the financial condition and changes to fund net assets of Energy Services as of and for the fiscal years ending June 30, 2002 and 2001 (amounts in millions):

***Table 1 - Summary of financial condition and changes in fund net assets***

| | June 30, | |
|---|---|---|
| **Assets** | **2002** | **2001*** |
| Utility plant, net | $ 4,566 | $ 4,373 |
| Investments | 1,067 | 987 |
| Other long-term assets | 1,516 | 1,575 |
| Current assets | 1,063 | 1,114 |
| | $ 8,212 | $ 8,049 |
| **Liabilities and Fund Net Assets** | | |
| Long-term debt | $ 3,282 | $ 3,509 |
| Other long-term liabilities | 687 | 554 |
| Current liabilities | 612 | 612 |
| Fund net assets: | | |
| Invested in capital assets, net of related debt | 1,183 | 915 |
| Restricted | 1,048 | 992 |
| Unrestricted | 1,400 | 1,467 |
| Total fund net assets | 3,631 | 3,374 |
| | $ 8,212 | $ 8,049 |
| **Revenue, Expenses, and Changes in Fund Net Assets** | | |
| Operating revenues | $ 2,233 | $ 3,114 |
| Operating expenses | (1,865) | (2,601) |
| Operating income | 368 | 513 |
| Investment income | 130 | 180 |
| Other income and expenses, net | 91 | (26) |
| Debt expenses | (153) | (184) |
| Transfers to the reserve fund of the City | (179) | (120) |
| Cummulative effect of change in accounting principle | - | (48) |
| Increase in fund net assets | 257 | 315 |
| Beginning balance of fund net assets | 3,374 | 3,059 |
| Ending balance of fund net assets | $ 3,631 | $ 3,374 |

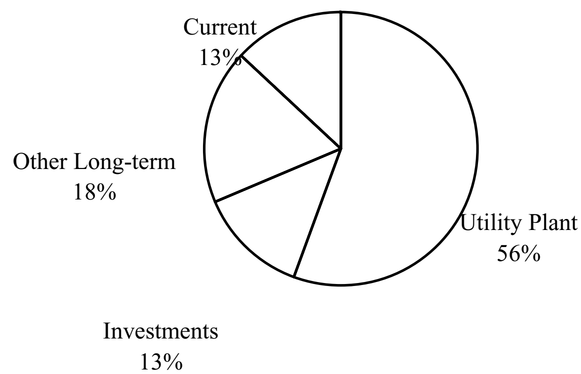
** As restated, for the adoption of GASBS 34, as amended.*

## Assets

*Utility Plant*

Utility plant is the first category of assets shown on the balance sheet. The utility industry is unique in this regard as most other industries list their long-term assets such as plant and equipment after current assets on the balance sheet. This difference is due to the capital-intensive nature of the utility industry with the most significant portion of that capital being invested in utility plant. As depicted in the chart below, utility plant, net of accumulated depreciation, makes up 56% of the total assets of Energy Services.

***Chart 1 - Total Assets by Type***




During fiscal year 2002, Energy Services capitalized $502 million of additions to utility plant. Of the $502 million, $283 million, or 56% related to generating utility plant assets. This was primarily due to new combustion turbines which were placed into service at Valley and Harbor generating stations in fiscal year 2002 to serve peak load. In addition, in November 2001, the Department sold 50% of its 20% interest in the Mohave Generating Station for approximately $95 million. The remaining $219 million of additions were incurred for normal capital activities to maintain and support load growth of the distribution and transmission systems.

The Department's strategy is to have generating utility plant assets that can produce energy from a variety of fuel types. This is referred to as a hedged power supply. This is important in that if the costs related to a particular fuel type rise substantially in a short period of time, the Department can utilize its mix of generating assets to meet customer demand and to minimize increases in fuel expense. The Department has implemented a $1.7 billion, ten-year plan to upgrade its local power plants and to implement a program that includes demand side management, alternative energy sources and distributed generation. Through June 30, 2002, the Department has incurred $552 million related to such upgrades.

The table below summarizes the generating resources available to the Department as of June 30, 2002. These resources include those owned by the Department (either solely or jointly with other utilities) as well as resources available through long-term purchase agreements. Generating station capacity is measured in megawatts. One megawatt is equal to 1,000 kilowatts.

***Table 2 - Generation resources***

| Type | Number of Units | Maximum Capacity (MWs) | | Net Dependable Capacity |
|---|---|---|---|---|
| Oil and gas | 22 | 3,397 | * | 3,169 |
| Coal | 7 | 1,743 | | 1,685 |
| Nuclear | 3 | 368 | | 366 |
| Hydro | 29 | 1,948 | | 1,832 |
| | 61 | 7,456 | | 7,052 |

* Includes the capacity of all the Valley Generating Station (558 MW). Due to the long-term lay-up of Units 1 and 2 (190 MW) the capacity has been reduced to 368 MW.

*Investments*

The Department sets aside funds to be used in future years for specified purposes. At June 30, 2002, a total of $1.1 billion in restricted and other investments was held by the Department, consisting primarily of U.S. government securities, bonds and repurchase agreements and other investments such as commercial paper and negotiable certificates of deposit. These investments are set aside for the following purposes:

- Refunding debt: the escrow investments are held to call specified revenue bonds at scheduled maturity dates.
- Debt reduction: 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).
- Nuclear decommissioning: 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.
- Post retirement benefits: the postretirement health care benefit trust fund was established to provide for the payment of the Department's postretirement health care benefits.
- Other: 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.

The Department has a securities lending program which allows it to lend up to 20% of its 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. In addition, Energy Services participates in the City's securities lending program and is allocated its share of the collateral received and the related liability, as well as earnings from the program. As of June 30, 2002 and 2001, the amount of collateral and liability pertaining to securities lending programs were $187 million and $139 million, respectively.

*Other Long-term Assets*

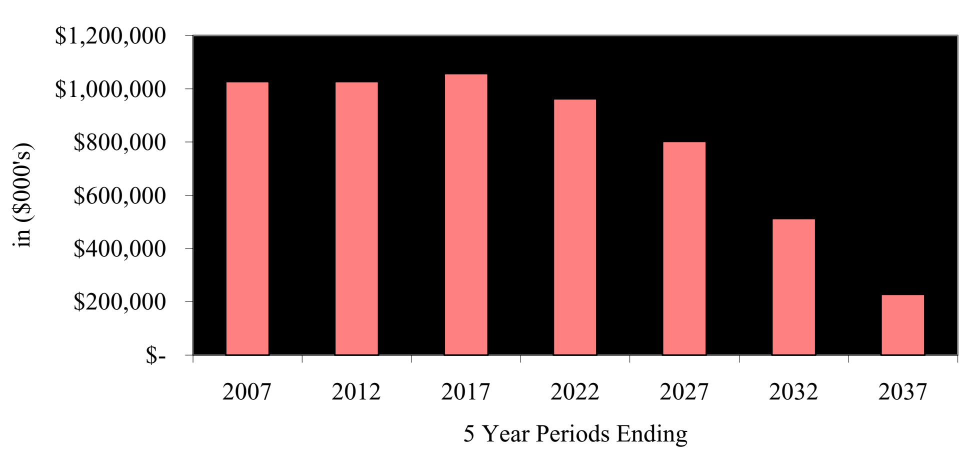
A significant portion of other long-term assets is Energy Services' long-term notes receivable. Prior to fiscal year 2002, the Department transferred $1.3 billion to IPA in exchange for long-term notes receivable. The funds transferred were obtained from the debt reduction trust fund and through the issuance of variable rate bonds. IPA used the proceeds to defease bonds with a face value of $1.4 billion. The Department's future payments to IPA, which are included in operating expenses in Table 1, will be partially offset by interest payments and principal maturities from the long-term notes receivable.

## Liabilities and Fund Net Assets

*Long-term Debt*

During fiscal year 2002, Energy Services' long-term debt was reduced from $3.5 billion to $3.3 billion. During fiscal year 2002, Energy Services completed $976 million in refundings of long-term debt by placing the proceeds of new debt or cash into irrevocable escrow trusts to pay future debt service on the refunded debt, and by calling certain debt issues. In addition, the Department implemented its Mini-Bond program, and issued $6 million of long-term debt to employees and retirees. Outstanding principal, plus scheduled interest as of June 30, 2002, is scheduled to mature as shown in the chart below:

*Chart 2: Debt Service Requirements*



As of June 30, 2002, $1.2 billion principal amount of long-term debt is considered defeased and remains outstanding.

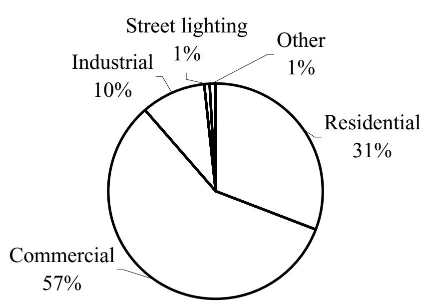
In August 2002 Energy Services' bond rating was upgraded from an A+ to a AA- by Standard & Poors and Fitch. Reasons for this upgrade include the following: Energy Services' strong financial position, debt reduction program, hedged power supply, experienced management team, and favorable customer/revenue mix.

## Changes in Fund Net Assets

*Revenues*

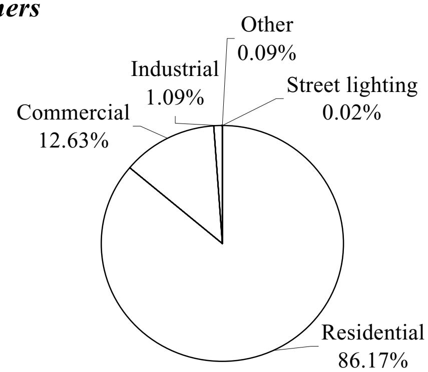
The operating revenues of Energy Services are generated from wholesale and retail customers. There are four major customer categories of retail revenue. These categories include residential, commercial, industrial, and other, which includes public street lighting. Chart 3 summarizes the percentage contribution of retail revenues from each customer segment.

***Chart 3: Revenues***



While commercial customers consume the most electricity, residential customers represent the largest customer-base. As of June 30, 2002, Energy Services had approximately 1.4 million customers. As shown in Chart 4, 1.2 million, or 86% of total customers were in the residential customer class.

***Chart 4: Number of Customers***




Operating revenues decreased from fiscal year 2001 levels due to the stabilization of the California energy market, the impact of the energy efficiency and conservation programs put in place, and weather conditions. Wholesale business was the primary element of change. Energy markets stabilized in the early summer period of fiscal year 2001 due to a substantial decline in natural gas prices, the impact of FERC price caps and the effects of conservation on demand. As a result, wholesale prices dropped substantially and revenues were impacted by a decrease in wholesale volumes sold, from 3.7 million MWH in fiscal year 2001 to 1.5 million MWH in fiscal year 2002, and a decline in the average price for energy from $228 per MWH in fiscal 2001 to $68 per MWH in fiscal year 2002. Retail volumes and sales also declined primarily due to the decline in the general economy which had a negative impact on commercial and industrial sales.

*Operating Expenses*

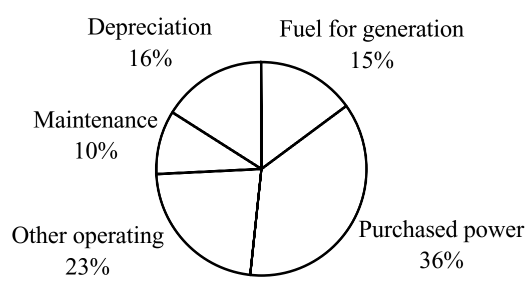
Fuel for generation expense and purchased power expense are two of the largest expenses that Energy Services incurs each fiscal year. Fuel for generation expense includes the cost of fuel that is used to generate energy. The majority of fuel costs include the cost of natural gas, coal, and nuclear fuel.

Purchased power expense includes the cost of buying power on the open market and paying the current portion of our purchase power contracts. Under these purchase power contracts, the Department has an entitlement to the energy that is produced at various generating stations, and an entitlement to the use of various transmission facilities. Most of these contracts require the Department to pay for these services regardless of whether the energy or transmission is used. These types of contracts are referred to as "take -or-pay" contracts.

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. Amortization expense for computer software is computed using the straight-line method over 5 years. Depreciation expense continues to increase as a result of Energy Services' substantial continuing investment in utility plant assets. In addition, the use of the 5% sinking fund method for assets placed in service prior to 1973 results in higher depreciation in the later years of the assets' lives.

The chart below summarizes Energy Services' operating expenses:

***Chart 5: Operating Expenses***




Fiscal year 2002 operating expenses were $735 million lower as compared to the prior year. This reduction was mostly due to a reduction in generation expenses and purchased power that corresponds with the decline in sales of surplus energy and transmission and generation capacity. In addition, the cost of natural gas to serve retail customers declined substantially during 2002 and further reduced the cost of generation.

*Non-Operating Revenue and Expenses*

The major non-operating activities of Energy Services for fiscal year 2002 included a $67 million gain on the sale of 50% of its 20% interest in the Mohave Generating Station; the transfer of $179 million to the City's General Fund; interest income earned on investments of $130 million; and paying $155 million in debt service expenses.

Interest on investments followed the general trend in interest rates and declined from an average yield of 5.30% in fiscal year 2001 to 3.44% in fiscal year 2002. Interest on debt service declined due to lower rates on variable rate debt and the effects of the debt restructuring program which lowered average interest rates on fixed rate debt.

## Risk Factors

Energy Services primary business is to provide its retail customers with reliable electricity service. Energy Services manages its overall cost of providing service by monitoring wholesale markets and purchasing electricity for customers when the market price is below the marginal cost of producing energy from Department resources. Energy Services sells its surplus generation to the market when the cost of excess resources is below the market price. The transactions are executed with external parties, primarily other utility companies and broker dealers which we refer to as counterparties.

The Department manages its counterparty risk by evaluating each of the entities that it transacts with and limiting its transaction volume based on an assessment of the entity's financial strength. In addition, the Department enters into master netting agreements with other Western System Coordinating Council participants.

Energy Services is subject to market risk in that the wholesale market price of energy impacts its cost of energy purchases in addition to its ability to market surplus power. The Department manages that risk by devoting its owned and contract resources to service retail customers. Only surplus resources are made available to wholesale markets. During fiscal 2002, the Department's peak load was 4,805 MWs. Net dependable capability from owned and contract resources totaled 7,052 MWs.

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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 revenue, expenses and changes in fund net assets and of 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, 2002 and 2001 and the changes in its fund net assets and its cash flows for the three years ended June 30, 2002 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, 2001 the Department adopted Governmental Accounting Standards No. 34, No. 37 and No. 38, and changed the presentation of the financial statements. On July 1, 2000 the Department adopted Statement of Financial Accounting Standards No. 133 and changed its method of accounting for derivative instruments.

The management's discussion and analysis included on pages 1 through 14 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

PricewaterhouseCoopers LLP

October 4, 2002

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

| | June 30, 2002 | June 30, 2001 |
|---|---|---|
| **Assets** | | |
| **Non-Current Assets** | | |
| Utility Plant | | |
| Generation | $ 2,614,229 | $ 2,449,908 |
| Transmission | 809,337 | 794,023 |
| Distribution | 3,716,333 | 3,553,306 |
| General | 857,244 | 832,586 |
| | 7,997,143 | 7,629,823 |
| Accumulated depreciation | 3,828,328 | 3,634,060 |
| | 4,168,815 | 3,995,763 |
| Construction work in progress | 379,970 | 362,789 |
| Nuclear fuel, at amortized cost | 16,943 | 14,003 |
| | 4,565,728 | 4,372,555 |
| Restricted and other investments | 1,066,982 | 987,100 |
| Long-term California wholesale energy receivable | 170,354 | 183,243 |
| Long-term notes receivable | 1,219,635 | 1,280,037 |
| Net pension asset | 125,655 | 112,262 |
| | 1,515,644 | 1,575,542 |
| **Current Assets** | | |
| Cash and cash equivalents - unrestricted | 166,760 | 218,584 |
| Cash and cash equivalents - restricted | 83,463 | 174,002 |
| Cash collateral received from securities lending transactions | 187,180 | 139,156 |
| Customer and other accounts receivable, net of $11,000 allowance for losses | 242,778 | 254,549 |
| Current portion of long-term notes receivable | 70,323 | 35,610 |
| Accrued unbilled revenue | 120,028 | 124,477 |
| Materials and fuel | 107,590 | 104,980 |
| Prepayments and other current assets | 85,540 | 62,532 |
| | 1,063,662 | 1,113,890 |
| | $ 8,212,016 | $ 8,049,087 |
| **Fund Net Assets and Liabilities** | | |
| **Fund Net Assets** | | |
| Invested in capital asset, net of related debt | $ 1,182,960 | $ 914,510 |
| Restricted fund net assets | 1,048,442 | 992,334 |
| Unrestricted fund net assets | 1,399,479 | 1,467,122 |
| | 3,630,881 | 3,373,966 |
| **Long-term Debt** | | |
| Long-term debt | 3,281,858 | 3,264,232 |
| Advance refunding bonds | - | 244,474 |
| | 3,281,858 | 3,508,706 |
| **Other Non-Current Liabilities** | | |
| Deferred credits | 421,832 | 350,894 |
| Accrued postretirement liability | 244,190 | 203,135 |
| Accrued workers' compensation claims | 21,300 | - |
| Commitments and contingencies (Notes 6 and 14) | - | - |
| | 687,322 | 554,029 |
| **Current Liabilities** | | |
| Current portion of long-term debt | 131,730 | 182,350 |
| Accounts payable and accrued expenses | 155,722 | 189,175 |
| Payable to the reserve fund of the City of LA | 25,000 | - |
| Accrued interest | 55,504 | 46,995 |
| Accrued employee expenses | 50,795 | 47,370 |
| Due to Water Services | 6,024 | 7,340 |
| Obligations under securities lending transactions | 187,180 | 139,156 |
| | 611,955 | 612,386 |
| | $ 8,212,016 | $ 8,049,087 |

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

**Los Angeles Department of Water and Power**
**Energy Services Statements of Revenue, Expenses, and Changes in Fund Net Assets, as restated**
*(Amounts in thousands)*

| | Year Ended June 30, | | |
|---|---|---|---|
| | 2002 | 2001 | 2000 |
| **Operating Revenues** | | | |
| Residential | $ 632,113 | $ 655,847 | $ 641,196 |
| Commercial and industrial | 1,377,135 | 1,423,730 | 1,404,912 |
| Sales for resale | 189,690 | 998,551 | 297,845 |
| Other | 34,743 | 35,429 | 44,906 |
| | 2,233,681 | 3,113,557 | 2,388,859 |
| **Operating Expenses** | | | |
| Fuel for generation | 280,474 | 876,187 | 326,008 |
| Purchased power | 683,572 | 899,082 | 707,333 |
| Maintenance and other operating expenses | 598,391 | 545,374 | 525,303 |
| Depreciation and amortization | 302,887 | 280,010 | 279,853 |
| | 1,865,324 | 2,600,653 | 1,838,497 |
| **Operating Income** | 368,357 | 512,904 | 550,362 |
| **Other Income and Expense** | | | |
| Investment income | 130,079 | 180,553 | 100,213 |
| Gain on sale of utility plant asset | 67,615 | - | - |
| Other non-operating income | 20,934 | 6,081 | 7,414 |
| | 218,628 | 186,634 | 107,627 |
| Other non-operating expenses | 19,724 | 5,388 | 4,568 |
| | 198,904 | 181,246 | 103,059 |
| Loss on asset impairment and abandoned projects | - | (43,519) | - |
| Loss on terminated power contract | - | - | (77,462) |
| | 198,904 | 137,727 | 25,597 |
| **Debt Expenses** | | | |
| Interest on debt | 154,600 | 185,378 | 175,711 |
| Allowance for funds used during construction | (1,393) | (1,123) | (1,830) |
| | 153,207 | 184,255 | 173,881 |
| **Contributions in aid of construction** | 22,014 | 16,730 | 14,465 |
| **Change in fund net assets before transfers to the City and cumulative effect of change in accounting principle** | 436,068 | 483,106 | 416,543 |
| **Transfers to the reserve fund of the City of Los Angeles** | 179,153 | 119,800 | 112,000 |
| **Increase in fund net assets before cumulative effect of change in accounting principle** | 256,915 | 363,306 | 304,543 |
| **Cumulative effect of change in accounting principle** | - | (48,163) | - |
| **Increase in fund net assets** | 256,915 | 315,143 | 304,543 |
| **Fund net assets** | | | |
| Beginning of period | 3,373,966 | 3,058,823 | 2,754,280 |
| End of period | $ 3,630,881 | $ 3,373,966 | $ 3,058,823 |

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

## Los Angeles Department of Water and Power
## Energy Services Statements of Cash Flows, as restated
*(Amounts in thousands)*

| | Year Ended June 30, 2002 | 2001 | 2000 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Cash Receipts | | | |
| Cash receipts from retail customers | $ 2,088,916 | $ 2,187,850 | $ 2,086,903 |
| Cash receipts from retail customers for other agency services | 273,361 | 305,018 | 250,257 |
| Cash receipts from wholesale customers | 266,489 | 747,601 | 209,282 |
| Cash receipts from interfund services provided | 256,774 | 259,453 | 315,573 |
| Cash Disbursements | | | |
| Cash payments to employees | (328,508) | (316,013) | (288,556) |
| Cash payments to suppliers | (1,241,118) | (1,948,551) | (1,233,365) |
| Cash payments for interfund services used | (254,213) | (249,747) | (210,012) |
| Cash payments on terminated power contracts | - | - | (77,462) |
| Cash payments to other agencies for fees collected | (276,419) | (284,116) | (262,235) |
| Other operating cash payments | (349) | (38,829) | (5,199) |
| | 784,933 | 662,666 | 785,186 |
| **Cash Flows from Noncapital Financing Activities:** | | | |
| Payments to the reserve fund of the City of Los Angeles | (154,153) | (119,800) | (112,000) |
| Cash received for state grant | 8,000 | 8,000 | - |
| Cash disbursed for state grant expenses | (14,753) | (1,247) | - |
| Issuance of noncapital revenue bonds, net | - | - | 564,876 |
| Interest paid on noncapital revenue bonds | (9,829) | (18,132) | (7,405) |
| | (170,735) | (131,179) | 445,471 |
| **Cash Flows from Capital and Related Financing Activities:** | | | |
| Additions to plant and equipment, net | (523,445) | (409,861) | (163,960) |
| Proceeds from sale of utility plant asset | 95,000 | - | - |
| Contributions in aid of construction | 11,060 | 11,364 | 4,494 |
| Purchases of escrow investments | - | (176,843) | (49,651) |
| Proceeds from escrow investment maturities | 250,315 | 528,770 | 330,182 |
| Principal payments and maturities on long-term debt, net | (392,699) | (1,672,236) | (505,196) |
| Issuance of bonds and revenue certificates, net | 112,837 | 1,275,939 | 387,777 |
| Debt interest payments | (136,517) | (193,189) | (199,710) |
| | (583,449) | (636,056) | (196,064) |
| **Cash Flows from Investing Activities:** | | | |
| Purchases of investment securities | (3,197,807) | (3,177,653) | (2,755,974) |
| Proceeds from sales maturities of investment securities | 2,857,321 | 3,261,389 | 2,877,660 |
| Purchase of long-term notes receivable, net | - | (186,435) | (1,114,520) |
| Maturities of long-term notes receivables | 36,002 | - | - |
| Investment income | 131,372 | 159,931 | 109,975 |
| | (173,112) | 57,232 | (882,859) |
| **Cash and Cash Equivalents:** | | | |
| Net (decrease) increase | (142,363) | (47,337) | 151,734 |
| Beginning of year | 392,586 | 439,923 | 288,189 |
| | $ 250,223 | $ 392,586 | $ 439,923 |

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 utilizes 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. Accordingly, Energy Services records various regulatory assets and liabilities to reflect the Board'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.

*Impairment of long-lived assets*

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to their fair value, which is normally determined through analysis of the future net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount that the carrying amount of the assets exceeds the fair value of the assets.

*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 and amortization expense as a percentage of average depreciable utility plant in service was 4.0%, 3.9% and 3.9% for fiscal years 2002, 2001 and 2000, 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 6).

**NOTE 1: (continued)**

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 $112 million in 2001 dollars. This estimate is based on an updated site-specific study prepared by an independent consultant in 2001. Prior to December 1999, the Department contributed to external trusts established in accordance with the PVNGS participation agreement and Nuclear Regulatory Commission requirements. 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 $6 million and $8 million of investment income in fiscal years 2002 and 2001, respectively and recognized an offsetting expense. Decommissioning funds, which are included in restricted investments, totaled $86 million and $80 million as of June 30, 2002 and 2001 (at fair value), respectively. The Department recognizes an increase in accumulated depreciation equivalent to its contributions to and realized and unrealized investment earnings from nuclear decommissioning trust funds.

*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 in fuel for generation. See Note 14 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 statements of revenues, expenses and changes in fund net assets. 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. The Department classifies all cash and cash equivalents that are restricted either by creditors, the Board, or by law, as restricted cash and cash equivalents on the balance sheet. The Department considers all unrestricted investments with an original maturity of three months or less to be cash equivalents.

**NOTE 1: (continued)**

At June 30, 2002 and 2001 restricted cash and cash equivalents includes the following (amounts in millions):

| | June 30, 2002 | June 30, 2001 |
|---|---|---|
| Bond redemption and interest funds | $ 54 | $ 38 |
| Construction funds | 1 | 113 |
| Self insurance fund | 27 | 22 |
| Other | 1 | 1 |
| | $ 83 | $ 174 |

*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 revenue, expenses and changes in fund net assets. 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.

*Accrued employee expenses*

Accrued employee expenses includes accrued payroll and an estimated liability for vacation leave, sick leave and compensatory time, which is accrued when the employees earn the rights to the benefits.

*Debt expenses*

Debt premium, discount and issue expenses are deferred and amortized to debt expense using the effective interest method 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 to debt expense using the effective interest method over the shorter of the life of the new bonds or the remaining term of the bonds refunded. Gains and losses on bond defeasances financed with cash are reported as a gain or loss on extinguishment of debt in the statements of revenues, expenses and changes in fund net assets.

**NOTE 1: (continued)**

*Gas and Electricity Option and Swap Agreements*

Gas and electricity option and location swap agreements are reported at fair value on the balance sheet. The Department does not enter into gas and option agreements for trading purposes. The Department is exposed to risk of nonperformance if the counterparties default or if the swap agreements are terminated.

*Accrued workers' compensation claims*

Liabilities for unpaid workers' compensation claims are recorded at their present value when they are probable of occurrence and the amount can be reasonably estimated. The liability is actuarially determined, based on an estimate of the present value of the claims outstanding and an amount for claim-events incurred but not reported based upon the Department's loss experience, less the amount of claims and settlements paid to date.

*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 in future periods as an offset to related purchased power expense. At June 30, 2002 and 2001, deferred credits include $396 and $327 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% for each of fiscal years 2002, 2001 and 2000.

**NOTE 1: (continued)**

*Recent Accounting Pronouncements*

In June 2001, the FASB issued SFAS 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 Energy Services beginning in fiscal 2003. The Department has not yet determined the financial statement impact of adopting the new Statement.

In August 2001, the FASB issued SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*," which supercedes SFAS No. 121, "*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*." This statement retains the fundamental provisions of SFAS No. 121 for the measurement and recognition of the impairment of long-lived assets to be held and used, as well as the measurement of long-lived assets to be disposed of by sale. SFAS No. 144 resolves significant implementation issues related to SFAS No. 121, and retains the amendments in SFAS No. 121 pertaining to regulatory assets under SFAS No. 71 and SFAS No. 90, "*Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs*." This Statement will be effective for Energy Services beginning in fiscal 2003. The Department does not expect the adoption of the Statement to have a material impact on Energy Services' financial statements.

In April 2002, the FASB issued SFAS No. 145, *"Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections."* SFAS No. 145 rescinds various pronouncements regarding early extinguishment of debt and allows extraordinary accounting treatment for early extinguishment only when the provisions of Accounting Principles Board Opinion No. 30, *"Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions"* have been met. SFAS No. 145 provisions regarding early extinguishment of debt are generally effective for the Department when it refunds debt using cash, and is effective beginning in fiscal 2003. When the Department refunds debt by issuing new debt, it accounts for these transactions in accordance with GASBS No. 7, "*Advance Refundings Resulting in Defeasance of Debt*" and GASBS No. 23, "*Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*." The Department does not expect that the adoption of SFAS No. 145 will have a material impact on Energy Services' financial statements.

*Reclassifications*

Certain financial statement items for prior years have been reclassified to conform to the current year presentation.

## NOTE 2: Accounting Changes

*GASB Statements Nos. 34, 37 and 38*

On July 1, 2001, the Department adopted GASB Statement No. 34 (GASBS 34), "*Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments,"* GASB Statement No. 37 (GASBS 37), "*Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus – an Amendment of GASB Statements No. 21 and No. 34"* and GASB Statement No. 38 "*Certain Financial Statement Note Disclosures*" (GASBS 38). GASBS 34, as amended, and GASBS 38 establish specific standards for external financial reporting for all state and local governments. As a result of adopting these Standards, the basic financial statement presentation was significantly changed, including adding management's discussion and analysis of operating, investing and financing activities. GASBS 34 also requires the classification of fund net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, net of accumulated depreciation reduced by the outstanding debt balances, net of unamortized debt expenses.
- Restricted – This component consists of net assets with constraints placed on their use, either externally or internally. Constraints include those imposed by creditors (such as through debt covenants), grants or laws and regulations of other governments, or by law through constitutional provisions or enabling legislation or by the Board.
- Unrestricted – This component of net assets consists of net assets that do not meet the definition of "restricted" or "invested in capital, net of related debt."

Under GASBS 34, the statements of equity and of other comprehensive income were eliminated, the statement of income was renamed the statement of revenues, expenses and changes in fund net assets, and the statement of cash flows is required to be presented using the direct method (including a reconciliation of operating cash flows to operating income).

SFAS No. 133 "*Accounting for Derivative Instruments and Hedging Activities*" allows private sector entities to elect to use cash flow hedge accounting treatment for derivative transactions that meet certain specific criteria. Entities that use cash flow hedge accounting are allowed to report the effective portion of qualifying hedge gains and losses in other comprehensive income, with a reclassification to earnings in the period in which the hedged item or transaction affects earnings. The requirements for reporting other comprehensive income items are established by SFAS No. 130, "*Reporting Comprehensive Income.*"

**NOTE 2: (continued)**

Because other comprehensive income ceases to exist once a governmental entity adopts GASBS 34, such entities are not permitted to use the cash flow hedging provisions of SFAS No. 133 once they have adopted the new GASB reporting model. Entities that had previously classified derivatives as cash flow hedging derivatives must discontinue cash flow hedge accounting upon adoption of GASBS 34, and thereafter report those derivatives as non-hedging derivatives. In comparative financial statements presented in the year of adoption of GASBS 34, amounts classified in other comprehensive income in the prior years must be reclassified and reported in the statement of revenues, expenses, and changes in fund net assets.

The Department restated its prior year financial statements to retroactively apply GASBS 34 as amended. In fiscal 2001, Energy Services reported certain energy contracts as cash flow hedges under SFAS No. 133. As a result, the market value of these contracts as of June 30, 2001 was reported as a liability and an offsetting entry was recorded as other comprehensive income. Upon adoption of GASBS 34 on July 1, 2001, Energy Services recorded the following amounts to discontinue the use of cash flow hedge accounting (amounts in millions):

| | As Previously Reported | Adjustments | As Restated |
|---|---|---|---|
| | June 30, 2001 | | |
| **Balance Sheets:** | | | |
| Other comprehensive loss | $ 5 | $ (5) | $ - |
| **Statements of Revenues, Expenses and Changes in Fund Net Assets** | | | |
| | Year ended June 30, 2001 | | |
| Sales for resale | $ 956 | $ 42 | $ 998 |
| Purchased power expense | $ 894 | $ 5 | $ 899 |
| Cummulative effect of change in accounting principle | $ (6) | $ (42) | $ (48) |

**NOTE 2: (continued)**

*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 are included as non-operating revenues and expenses, respectively, in the statement of revenues, expenses and changes in fund net assets. Prior to the adoption of GASBS 33, contributions in aid of construction and the voluntary transfer were reported as equity transactions.

The Department's adoption of GASBS 33 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.

The adoption of GASBS 33 resulted in a restatement of fiscal year 2000 financial statements and an increase in fund net assets as follows (amounts in millions):

| | Year ended June 30, 2000 |
|---|---|
| Increase in fund net assets, as previously reported | $ 402 |
| - Contributions in aid of construction | 15 |
| - Transfers to the reserve fund of the City of Los Angeles | (112) |
| Increase in fund net assets, as restated | 305 |
| Fund net assets | |
| Beginning of year, as restated | 2,754 |
| End of year, as restated | $ 3,059 |

*FASB Statement No. 133*

In June 1998, the FASB issued SFAS No. 133. 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.

**NOTE 2: (continued)**

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 statement of revenues, expenses and changes in fund net assets at the time of contract settlement.

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 (as restated for the adoption of GASBS 34) of $48 million in the statement of revenues, expenses and changes in fund net assets.

In December 2001, the FASB cleared Implementation Issue No. C16 ("C16"). C16 expands the scope of SFAS No. 133 to include certain natural gas contracts with options. The change in fair value of these contracts will be reported as an adjustment to fuel for generation expense. As these contracts are settled, the recorded fair value adjustment will be reversed.

In December 2001, the FASB cleared Implementation Issue No. C15. Under C15, the normal purchase and normal sales exception is expanded 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 a majority of its short-term purchases and sales qualified as normal purchases and normal sales under the interpretation. Contracts reported as derivatives as of June 30, 2001 that qualify as normal purchases and sales under C15 were designated as normal at that time.

**NOTE 2: (continued)**

As of June 30, 2002 and 2001, the Department recorded the following amounts related to derivative instruments (amounts in millions):

| | June 30, | |
|---|---|---|
| **Balance Sheet:** | **2002** | **2001** |
| Contract commitments (included in current assets and current liabilities) | $ 6 | $ 1 |
| **Statement of Revenues, Expenses and Changes in Fund Net Assets** | | |
| Unrealized gain on derivative instruments: | | |
| Sales for resale | $ 5 | $ (6) |
| Purchase power expense | $ - | $ 5 |
| Fuel for generation expense | $ (1) | $ - |

**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). 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. In 2001, legislation was enacted to suspend direct access to retail customers in California.

**NOTE 3: (continued)**

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. Through June 30, 2002, the Department has incurred $552 million related to such upgrades.

*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 Electric Coordinating Council (WECC). The plan imposes price limits on the sale of electricity in WECC 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. On July 17, 2002, FERC ordered effective October 1, 2002, among other things, a new price cap and certain automatic procedures in the WECC, designed to mitigate the effects of market power. Energy Services' purchases and sales of electricity occur entirely within the WECC. Management has not determined the effect, if any, that the price mitigation plan will have on future purchases and sales of electricity.

*California Receivables and FERC refund hearings*

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. Through June 30, 2002, these agencies, the CISO and the California Power Exchange (CPX), have made minimal payments since April 2001 on amounts outstanding to counterparties, including Energy Services, for certain energy purchases in fiscal years 2000 and 2001. The CPX filed for protection under Chapter 11 of the Federal Bankruptcy Statute in January of 2001. Two utilities with significant amounts due to these agencies, Southern California Edison Company and Pacific Gas & Electric, have previously stated in public disclosure documents that they may not be able to pay for all the power they consumed in 2001. Southern California Edison Company has paid all amounts due by it to the CPX, however the amounts remain in an escrow account pending the resolution of disbursement of the funds. Pacific Gas & Electric has filed for protection under Chapter 11 of the Federal Bankruptcy Statute and all amounts due from that entity are outstanding.

**NOTE 3: (continued)**

As of June 30, 2002 and 2001, a total of $170 million and $183 million, respectively, was due Energy Services from the CISO and the CPX. The FERC has questioned whether amounts charged for energy sold to the CISO and the CPX during 2000 and 2001 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 recorded a $7 million liability for potential refunds pertaining to its California receivables. This reserve was based on the Department's estimate of potential minimum amounts due under a potential refund formula recently disclosed by FERC. However, 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 any additional 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, net of the $7 million reserve, the Department will be required to record a loss in the statements of revenues, expenses and changes in fund net assets.

*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.

The Department defers public benefits collections from customers in excess of costs incurred under qualifying programs. During fiscal year 2002, Energy Services changed its public benefits deferral estimate. The change in estimate was the result of an updated interpretation of Assembly Bill 1890. As a result, the Department recorded an increase in its public benefits deferred credit balance of $26 million. During fiscal years 2002, 2001 and 2000, the Department spent $66, $64, and $61 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. As of June 30, 2002 and 2001, the deferred credits balance includes public benefits deferrals of $12 million and $3 million, respectively.

## NOTE 3: (continued)

*Accounting for the State Energy Efficiency Grant*

During fiscal year 2001, the Department was awarded a $16 million grant by the State of California for the purpose of reducing energy demand during the summer months. The Department received $8 million in fiscal year 2001 and the remaining $8 million in fiscal year 2002. Grant money received was initially recorded as a deferred credit on the balance sheet. As funds were disbursed on qualifying energy efficiency programs, Energy Services recognized the grant funds received as non-operating revenues, and recognized the expenditures as non-operating expenses. During fiscal years 2002 and 2001, the Department recognized $15 million and $1 million respectively of these grant funds as non-operating income. The entire grant was disbursed as of June 2002.

## NOTE 4: Utility Plant

Energy Services had the following activity in utility plant during fiscal year 2002 (amounts in millions):

| | Balance June 30, 2001 | Additions | Disposals | Transfers | Balance June 30, 2002 |
|---|---|---|---|---|---|
| **Nondepreciable utility plant** | | | | | |
| Land | $ 150 | $ 2 | $ - | $ - | $ 152 |
| Construction work in progress | 363 | 516 | - | (499) | 380 |
| Nuclear fuel* | 14 | 7 | (4) | - | 17 |
| Total nondepreciable utility plant | 527 | 525 | (4) | (499) | 549 |
| **Depreciable utility plant** | | | | | |
| Generation | 2,442 | - | (119) | 283 | 2,606 |
| Transmission | 716 | - | (2) | 17 | 731 |
| Distribution | 3,507 | - | (5) | 166 | 3,668 |
| General | 815 | - | (8) | 33 | 840 |
| Total depreciable utility plant | 7,480 | - | (134) | 499 | 7,845 |
| Less accumulated depreciation | (3,634) | (322) | 128 | - | (3,828) |
| **Total utility plant, net** | $ 4,373 | $ 203 | $ (10) | $ - | $ 4,566 |

* *Nuclear fuel disposals represent amortization.*

*Additions to accumulated depreciation include capitalized depreciation.*

## NOTE 5: 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, 2002, utility plant includes the following amounts related to Energy Services' ownership interest in each jointly-owned utility plant (amounts in millions, except as indicated):

| | Ownership Interest | Share of Capacity (MW) | Utility Plant in Service Cost | Utility Plant in Service Accumulated Depreciation |
|---|---|---|---|---|
| Palo Verde Nuclear Generating Station | 5.7% | 217 | $ 512 | $ 224 |
| Navajo Generating Station | 21.2% | 477 | 209 | 183 |
| Mohave Generating Station | 10.0% | 158 | 63 | 39 |
| Pacific Intertie DC Transmission Line | 40.0% | 1240 | 192 | 51 |
| Other transmission systems | Various | | 78 | 38 |
| | | | $ 1,054 | $ 535 |

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 November 27, 2001, the Los Angeles City Council approved the sale of fifty percent of the Department's twenty percent ownership interest in the Mohave Generating Station to the Salt River Project Agricultural Improvement and Power District (SRP). SRP took the place of the original purchaser, AES Corporation, under the terms of the Mohave Project Plant Site Conveyance and Co-Tenancy Agreement. SRP paid $95 million in cash for the 10% interest. The sale resulted in the recognition of a gain of $67 million, which is included in other income and expense on the statements of revenues, expenses and changes in fund net assets.

## NOTE 6: 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 | $ 1,776 |
| Palo Verde Nuclear Generating Station | SCPPA | 5.9% | 67.0% | 151 | $ 542 |
| Mead-Adelanto Project | SCPPA | 67.9% | 35.7% | 291 | $ 82 |
| Mead-Phoenix Project | SCPPA | 17.8% - 22.4% | 24.8% | 148 | $ 18 |
| Southern Transmission System | SCPPA | 100.0% | 59.5% | 1,142 | $ 604 |

**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 primarily upon debt service requirements. In addition to average annual fixed charges of approximately $295 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 $245 million annually during each of the next five years). The Department made total payments under these agreements of approximately $514, $532, and $550 million in fiscal years 2002, 2001 and 2000, respectively. These agreements are scheduled to expire from 2027 to 2030.

Energy Services earned fees under the IPP Project Manager and Operating agreements totaling $15, $14, and $12 million in fiscal years 2002, 2001 and 2000, respectively.

*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 5 and 9). 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 6: (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 IPA notes are subordinate to all of IPA's publicly held debt obligations. The Department's future payments to IPA will be partially offset by interest payments and principal maturities from the subordinated notes receivable. The net IPA notes receivable balance totaled $1.29 billion and $1.32 billion as of June 30, 2002 and 2001, respectively.

*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 million in each of fiscal years 2002, 2001 and 2000.

## NOTE 7: Restricted and Other Investments

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

| | June 30, 2002 | June 30, 2001 |
|---|---|---|
| Escrow investments | $ 34 | $ 283 |
| Debt reduction trust funds | 808 | 446 |
| Nuclear decommissioning trust funds | 86 | 80 |
| Other investments | 139 | 178 |
| | $ 1,067 | $ 987 |
| Cash collateral received from securities lending transactions (see Note 8) | $ 187 | $ 139 |
| Postretirement health care benefit trust fund | $ 63 | $ 60 |
| | $ 1,317 | $ 1,186 |

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 6). 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).

## NOTE 7: (continued)

*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. Accrued postretirement liabilities are recorded net of the trust fund (see Note 11).

*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. 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, 2002, 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 | | $ 642 | $ - | $ - | $ 642 |
| Bonds | | 249 | - | - | 249 |
| Commercial paper | | 42 | - | - | 42 |
| Repurchase agreements | - | - | 155 | - | 155 |
| Negotiable certificates of deposits | | 39 | - | - | 39 |
| Total categorized restricted and other investments | | $ 972 | $ 155 | $ - | $ 1,127 |
| Investments - not categorized | | | | | |
| Investments held by broker-dealers: | | | | | |
| U.S. government securities | | | | | 152 |
| Mutual funds | | | | | 6 |
| General pooled securities lending cash collateral | | | | | 32 |
| Total | | | | | $ 1,317 |

## NOTE 7: (continued)

At June 30, 2001, Energy Services' restricted and other investments are categorized as follows (amounts in millions):

| Type of Investments | | Category 1 | Category 2 | Category 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 and other investments | | $ 983 | $ 67 | $ - | $ 1,050 |
| Investments - not categorized | | | | | |
| Investments held by broker-dealers: | | | | | |
| U.S. government securities | | | | | 64 |
| General pooled securities lending cash collateral | | | | | 72 |
| Total | | | | | $ 1,186 |

Repurchase agreements relate to the Department's securities lending program (see Note 8).

## NOTE 8: 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. Both the investments purchased with the collateral received and the related liability to repay the collateral are reported on the balance sheets. A summary of Energy Services' securities lending transactions as of June 30, 2002 and 2001 is as follows (amounts in millions):

| | June 30, 2002 | | June 30, 2001 | |
|---|---|---|---|---|
| Securities lent for cash collateral | Fair value of underlying securities | Collateral value | Fair value of underlying securities | Collateral value |
| US Government and agency securities | $ 152 | $ 155 | $ 65 | $ 67 |

**NOTE 8: (continued)**

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 2002 and 2001.

*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, 2002 and 2001, Energy Services' attributed share of cash collateral and the related obligation from the City's program was \$32 and \$72 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 9: Long-term Debt and Advance Refunding Bonds

Long-term debt outstanding as of June 30, 2002 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 |
|---|---|---|---|---|
| Refunding Issue of 1993 | 04/15/93 | 5.824% | 2031 | $ 507 |
| Second Refunding Issue of 1993 | 11/15/93 | 5.424% | 2032 | 509 |
| Issue of 2000 | 03/02/00 | 5.878% | 2030 | 73 |
| Issue of 2001, Series A1 | 03/20/01 | 4.869% | 2025 | 1,141 |
| Issue of 2001, Series A2 | 11/06/01 | 4.479% | 2022 | 109 |
| Issue of 2001, Series A3 | 04/01/01 | 5.043% | 2026 | 116 |
| Issue of 2001, Series B | 06/05/01 | Variable | 2035 | 621 |
| Issue of 2001, Series C1 | 11/15/01 | 4.744% | 2017 | 6 |
| | Total principal amount | | | 3,082 |
| | Revenue certificates | | | 389 |
| | Unamortized debt-related costs (including net loss on refundings) | | | (57) |
| | Debt due within one year (including current portion of revenue certificates and variable rate debt | | | (132) |
| | | | | $ 3,282 |

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 9: (continued)

*Long term debt activity*

Energy Services had the following activity in long-term debt and advance refunding bonds during fiscal year 2002 (amounts in millions):

| | Balance at June 30, 2001 | Additions | Reductions | Reclassifications | Balance at June 30, 2002 | Current Portion |
|---|---|---|---|---|---|---|
| Long term debt, including revenue certificates | $ 3,264 | $ 785 | $ (1,011) | $ 244 | $ 3,282 | $ 132 |
| Advance refunding bonds | 244 | - | - | (244) | - | - |
| **Total long-term debt** | $ 3,508 | $ 785 | $ (1,011) | $ - | $ 3,282 | $ 132 |

*New issuances*

<u>*Fiscal Year 2002*</u>

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. The purpose of the defeasance was to bring the variable rate bonds under Energy Services' new Master Bond Resolution. The defeasance is not expected to reduce total debt payments over the life of the new issues nor to result in present value savings. This transaction resulted in a net gain for accounting purposes of $2 million, which was deferred and is being amortized through 2010.

In November 2001, the Department issued $109 million of Energy Services fixed rate bonds. The net proceeds were used to defease bonds with a par value of $107 million. The defeasance is expected to reduce total debt payments over the life of the new issues by $21 million and is expected to result in present value savings of approximately $8 million. This transaction resulted in a net loss for accounting purposes of $5 million, which was deferred and is being amortized through 2021.

In November 2001, the Department issued $6 million of Energy Services fixed rate bonds as part of the Mini Bond Program for employees and retirees. Energy Services' Mini-Bond Program allows for a maximum total issuance of $50 million. The net proceeds were deposited into the construction fund to be used for distribution system capital improvements.

**NOTE 9: (continued)**

*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 is being amortized over the shorter of the life of the bonds retired or the life of the new bonds.

*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 was recognized in fiscal 2001 as part of debt expenses. The final maturity of the remaining $4 million in revenue bonds not defeased is 2006.

**NOTE 9: (continued)**

*Outstanding debt defeased*

As discussed above, Energy Services defeased certain revenue bonds in prior years by placing cash or the proceeds of new revenue bonds in irrevocable trusts to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in Energy Services financial statements. At June 30, 2002, the following revenue bonds outstanding are considered defeased (amounts in millions):

| Bond Issues | Principal Outstanding |
|---|---|
| Third Issue of 1971 | $ 3 |
| Issue of 1972 | 2 |
| Third Issue of 1972 | 1 |
| Issue of 1973 | 1 |
| Second Issue of 1973 | 17 |
| Second Issue of 1977 | 26 |
| Third Issue of 1991 | 1 |
| Issue of 1992 | 3 |
| Second Issue of 1992 | 119 |
| Issue of 1993 | 190 |
| Second Issue of 1993 | 111 |
| Refunding Issue of 1993 | 59 |
| Second Refunding Issue of 1993 | 42 |
| Refunding Issue of 1994 | 127 |
| Issue of 1994 | 81 |
| Issue of 1999 | 180 |
| Issue of 2000 | 209 |
| | $ 1,172 |

*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.

**NOTE 9: (continued)**

*Variable rate bonds*

The variable rate bonds currently bear interest at daily and weekly rates (ranging from 1.15% to 1.85% as of June 30, 2002). 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 extended Standby Agreements expire on February 20, 2003 and February 27, 2003. Bonds purchased under the agreements will bear interest that is payable quarterly at the greater of the Federal Funds Rate plus 0.50% 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 that portion outstanding, which can be refinanced on a long-term basis, in long-term debt as of June 30, 2002. That portion which would be due in the next fiscal year in the event that the outstanding variable rate bonds were tendered and purchased by the commercial banks under the Standby Agreements, has been included in the current portion of long term debt and was $62 million as of June 30, 2002 and 2001.

*Advance refunding bonds*

In prior years, Energy Services established irrevocable escrow trusts with proceeds from the issuance of refunding bonds. During fiscal year 2002, bonds with a par value of $240 million were refunded using proceeds from the balance in the restricted escrow investments. Escrow investments of $34 million (stated at fair value as of June 30, 2002) will be used to pay debt service on bonds presently included in long-term debt. During fiscal 2002, all remaining advance refunding bonds were reclassified to long-term debt as the bonds to be refunded were called. Interest expense from refunding bonds and interest income earned on related escrow investments are included in investment income.

**NOTE 9: (continued)**

*Scheduled principal maturities and interest*

Scheduled annual principal maturities and interest are as follows (amounts in millions):

| | Principal | Interest and Amortization |
|---|---|---|
| Years ending June 30: | | |
| 2003 | $ 31 | $ 139 |
| 2004 | 61 | 135 |
| 2005 | 74 | 131 |
| 2006 | 67 | 127 |
| 2007 | 65 | 124 |
| 2008 - 2012 | 385 | 572 |
| 2013 - 2017 | 561 | 422 |
| 2018 - 2022 | 591 | 287 |
| 2023 - 2027 | 598 | 117 |
| 2028 - 2032 | 424 | 39 |
| 2033 - 2035 | 225 | 4 |
| Total Requirements | $ 3,082 | $ 2,097 |

These scheduled maturities exclude the impact of mandatory redemptions with escrow investments. Interest and amortization includes interest requirements for variable rate debt, using the average variable debt interest rate in effect at June 30, 2002, of 1.5%.

*Revenue certificates*

As of June 30, 2002, the Department had outstanding commercial paper of $389 million bearing interest at an average rate of 1.40%. The commercial paper matures not more than 162 days from the date of issuance. The commercial paper is an uncollateralized obligation of the Department.

**NOTE 9: (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 represent advances to the Department and would 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 terminated on August 31, 2002.

In August 2002, Energy Services issued $389 million in Power System Variable Rate Demand Revenue Bonds (2002 Series A). These revenue bonds were issued to refund the $389 million of commercial paper that was outstanding. Because the commercial paper has been refunded and replaced with long-term debt, the Department has included that portion of the commercial paper which was refinanced on a long-term basis, in long-term debt. Because the revenue certificates were refunded with Variable Rate Demand Revenue Bonds which may be tendered by the bondholders and are supported with a Standby Bond Purchase Agreement that expires in ten equal semi-annual installments from the date of purchase, a portion of the revenue certificates have been classified as long-term debt and a portion has been classified as current portion of long-term debt. The portion included in current portion of long term debt was $39 million and $80 million as of June 30, 2002 and 2001, respectively.

*Fair value*

The fair value of long-term debt and refunding bonds is $2.7 and $3.3 billion at June 30, 2002 and 2001, 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, 2002 and 2001 approximates fair value due to the short maturities of these instruments.

## NOTE 10: 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.

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, | |
|---|---|---|
| | 2002 | 2001 |
| Annual required contribution | $ - | $ - |
| Interest on net pension asset | (10) | (8) |
| Adjustment to annual required contribution | 14 | 12 |
| APC (including $1 of amounts capitalized in fiscal 2002 and 2001) | 4 | 4 |
| Department contributions | (18) | (16) |
| Shared operating expenses (see Note 12) | - | - |
| Change in NPO | (14) | (12) |
| NPO (asset) at beginning of year | (112) | (100) |
| NPO (asset) at end of year | $ (126) | $ (112) |

**NOTE 10: (continued)**

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 |
|---|---|---|---|
| 2001 | 10.64% | -13.65% | 0.00% |
| 2000 | 10.59% | -14.52% | 0.00% |
| 1999 | 10.57% | -26.72% | 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.

Trend information for fiscal years 2002, 2001 and 2000 for Energy Services is as follows (amounts in millions):

| Year ended June 30, | NPO | Percentage of APC Contributed | APC |
|---|---|---|---|
| 2002 | $ (126) | 400% | $ 4 |
| 2001 | $ (112) | 413% | $ 4 |
| 2000 | $ (100) | 71% | $ 26 |

**NOTE 10: (continued)**

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 |
|---|---|---|---|---|---|---|
| 2001 | $ 5,833 | $ 5,306 | $ 527 | 110% | $ 403 | 131% |
| 2000 | $ 5,606 | $ 5,083 | $ 523 | 110% | $ 370 | 142% |
| 1999 | $ 5,254 | $ 4,911 | $ 343 | 107% | $ 355 | 97% |

*Disability and death benefits*

Energy Services' allocated share of disability and death benefit plan costs and administrative expenses totaled $10, $7, and $9 million for each of the fiscal years 2002, 2001, and 2000, respectively.

**NOTE 11: 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 15,700 at June 30, 2002. The allocated cost to Energy Services of providing such benefits amounted to $109, $89, and $78 million for fiscal years 2002, 2001 and 2000, respectively. Of these costs, $26, $20, and $15 million were capitalized and the remainder was charged to expense for fiscal years 2002, 2001 and 2000, 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.

**NOTE 11: (continued)**

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

| | Year Ended June 30, 2002 | 2001 | 2000 |
|---|---|---|---|
| Service cost | $ 11 | $ 8 | $ 8 |
| Interest cost | 38 | 32 | 30 |
| Expected return on plan assets | (3) | (3) | (3) |
| Amortization of transition obligation | 10 | 10 | 12 |
| Amortization of prior service costs | 5 | 5 | 5 |
| Amortization of actuarial losses | 5 | - | - |
| | $ 66 | $ 52 | $ 52 |

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, 2002 | 2001 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $ 803 | $ 636 |
| Service cost | 16 | 13 |
| Interest cost | 57 | 48 |
| Actuarial losses | 102 | 139 |
| Plan amendment | - | - |
| Benefits paid | (36) | (33) |
| Benefit obligation at end of year | 942 | 803 |
| Change in fair value of plan assets: | | |
| Fair value of plan assets at beginning of year | 78 | 71 |
| Actual return on plan assets | 4 | 7 |
| Fair value of plan assets at end of year | 82 | 78 |
| Funded status | (860) | (725) |
| Unrecognized net loss | 295 | 201 |
| Unrecognized transition obligation | 168 | 183 |
| Unrecognized prior service cost | 47 | 55 |
| Accrued benefit cost | $ (350) | $ (286) |
| Energy Services' allocated share of accrued benefit cost | $ (244) | $ (203) |

## NOTE 11: (continued)

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

| | June 30, | | |
|---|---|---|---|
| | 2002 | 2001 | 2000 |
| Discount rate | 7.25% | 7.25% | 7.75% |
| Expected return on plan assets | 6.50% | 6.50% | 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.

For measurement purposes, a 10.0% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2002; the rate was assumed to decrease gradually to 5.5% in 2012 and remain at that level thereafter. For the dental plan, an 8.0% annual rate of increase in the per capita cost was assumed for 2002, the rate was assumed to decrease gradually to 5.5% 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 $121 or $105 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 $13 or $11 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 $12, $11 and $8 million increase in postretirement benefit costs for fiscal years 2002, 2001 and 2000, respectively, of which $8, $7 and $6 million, respectively, was allocated to Energy Services.

## NOTE 12: 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 $514, $455 and $466 million for fiscal years 2002, 2001 and 2000, respectively, of which $328, $301 and $316 million were allocated to Energy Services.

## NOTE 13: 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 was below the total asset carrying value. During fiscal year 2002, management became aware that the facility has mold in the structure. Management and the purchaser of the facility are each conducting a study to determine an estimated cost for mold cleanup. As of June 30, 2002, no estimate was available to record a clean-up liability.

During fiscal 2001, management formally abandoned one of its customer information system projects and Energy Services reported its portion of the loss on abandonment of $15 million. There were no abandonments during fiscal 2002.

## NOTE 14: 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 non-operating expense in the statement of revenues, expenses and changes in net assets in accordance with GASBS 33 (See Note 2).

The Department made payments of $154, $120 and $112 million in fiscal years 2002, 2001 and 2000, respectively, from Energy Services to the reserve fund of the City. In addition, the Department authorized a transfer of $25 million which is included as a liability as of June 30, 2002 and will be paid in fiscal year 2003. The Department expects to make an additional transfer declaration from Energy Services of approximately $156 million during fiscal year 2003.

*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 (the 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.

**NOTE 14: (continued)**

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. The Department accrues 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.

In July 2002, a measure was signed into law designating the Yucca Mountain in the State of Nevada, as the nation's high-level nuclear waste repository. This means the DOE can now file a construction and operation plan for Yucca Mountain with the Nuclear Regulatory Commission (the NRC). The DOE expects that the Yucca Mountain site would be open by 2010, a date which many believe is highly optimistic. The State of Nevada and its congressional delegation have vowed to prevent the launch of the project through the NRC process or through legal challenges.

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.

**NOTE 14: (continued)**

The Department's generating station facilities are subject to the Regional Clean Air Incentives Market (RECLAIM) nitrogen oxide (NOx) emission reduction program adopted by the South Coast Air Quality Management District (SCAQMD). In accordance with this program, SCAQMD established annual NOx allocations for NOx RECLAIM facilities based on historical emissions and type of emission sources operated. These allocations are in the form of RECLAIM trading emission credits (RTCs). Facilities that exceed their allocations may buy RTCs from other companies that have emissions below their allocations. The Department has a program of installing emission controls and purchasing RTCs, as necessary, to meet its emission 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 RTCs 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 (the 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.

Although the Department did not have a shortfall of RTCs 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 RTC 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 RTCs 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. Thus, the Department has established a program of installing NOx control equipment and repowering existing generating units with more efficient, cleaner equipment such that expected NOx emissions will be reduced by 65 percent from 1999 levels.

**NOTE 14: (continued)**

*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, 2002.

*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, 2002.

*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, 2002, 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 14: (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, 2002 and 2001, respectively. Apart from the events discussed in Note 3, Energy Services did not experience any material counterparty default during fiscal years 2002, 2001 or 2000.

## NOTE 15: Supplemental Cash Flow Information

A reconciliation of the statement of cash flows' operating activities to operating income is as follows during fiscal years June 2002, 2001 and 2000 (amounts in millions):

| | Year Ended June 30, | | |
|---|---|---|---|
| | **2002** | **2001** | **2000** |
| Operating income | $ 368 | $ 513 | $ 550 |
| Adjustments to reconcile operating income to net cash provided by operating activities | | | |
| Depreciation and amortization | 303 | 280 | 280 |
| Provision for losses on customer and other accounts receivable | 12 | 12 | 11 |
| Loss on asset impairment and abandoned projects | - | (44) | - |
| Loss on terminated power contract | - | - | (77) |
| Cumulative effect of change in accounting principle | - | (48) | - |
| Changes in assets and liabilities: | | | |
| Customer and other accounts receivable | 25 | (156) | (66) |
| Accrued unbilled revenue | 4 | 6 | (34) |
| Net pension asset | (13) | (12) | 8 |
| Accounts payable and accrued expenses | (33) | 35 | 28 |
| Deferred credits | 71 | 72 | 68 |
| Accrued postretirement liability | 41 | 29 | 26 |
| Workers' compensation liability and other | 7 | (24) | (9) |
| Cash provided by operating and other activities | $ 785 | $ 663 | $ 785 |