Water 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
Water Services
Financial Statements and Required Supplementary Information
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Description **Pages**

Los Angeles Department of Water and Power
Water 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), Water System Fund (Water Services), provides an overview of the financial activities for the fiscal year ended June 30, 2002. Descriptions and other details pertaining to Water Services are included in the notes to the financial statements. This discussion and analysis should be read in conjunction with the Water Services' financial statements, which begin on page 14.

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 Water 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 The Department of Public Service was superceded in 1925 when a new Charter was adopted creating the Department.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 Water Services.

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

Transfers to the Reserve Fund of the City of Los Angeles

Under the provisions of the City Charter, Water Services transfers funds at its discretion to the reserve fund of the City. Pursuant to covenants contained in the bond indentures, the transfers may not be in excess of net income of the prior fiscal year. Such payments are not in lieu of taxes and are recorded as a reduction of fund net assets in accordance with governmental accounting standards. Water Services made a transfer of 5% of its fiscal 2001 operating revenues, totaling $27 million, to the reserve fund of the City in fiscal 2002. Water Services expects to transfer 5% of its fiscal 2002 revenues, or $28 million, to the reserve fund of the City in fiscal 2003.

Critical Accounting Policies

Method of Accounting

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

Water 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.

Current Rate Ordinance

A conservation-based water rate ordinance has been in effect since February 16, 1993. The ordinance incorporates marginal cost pricing through a two-tiered rate structure. The upper block rate is established at the estimated marginal cost for water. The lower block price is established to generate the revenue required for efficient operations. As a result of concerns expressed about the rate structure's impact on larger volume single-family residential customers, the first tier allowances were revised effective June 1, 1995. The revisions established five lot size categories and three temperature zones (as the basis for the first tier usage blocks for each category). Extra units (one unit equals 100 cubic feet or 748 gallons) at the first tier rate are available based on household sizes. The rates also reflect equity considerations for water-intensive businesses, large turf customers, and other customers having high seasonal variation in their water usage. Fixed monthly service availability charges apply only to private fire service.

The Water System's rate ordinance contains a water procurement adjustment factor under which the cost of purchased water, including water purchased from the Metropolitan Water District (MWD), demand-side management programs and reclaimed water projects are recovered by direct adjustments to customers' bills. In addition, the ordinance contains a water quality improvement adjustment which recovers expenditures to upgrade and equalize water quality throughout the City and to construct facilities to meet State and federal water quality standards, including the payment of debt service on bonds issued for such purposes. The ordinance currently limits to $0.36 per billing unit the recovery of combined expenditures for demand-side management, water reclamation, and water quality improvement.

The Water System's rate ordinance also contains a revenue adjustment mechanism in the form of a surcharge that is designed to assure a minimum level of base rate revenue each fiscal year based on an annual revenue target of $294 million. The revenue adjustment factor becomes effective upon a determination by the Board that the surcharge is needed. The rate ordinance limits the surcharge to $0.18 per billing unit, unless a higher amount is approved by the Board and the City Council.

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 Water System. The Department has completed the major portion of its refunding program, including the issuance of several series of refunding bonds payable from the Water Revenue Fund under a Master Bond Resolution adopted by the Board on February 6, 2001.

Using This Financial Report

This financial annual report consists of the financial statements and reflects the self-supporting activities of Water Services that are funded primarily through the sale of water to the public it serves.

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

The financial statements provide an indication of Water Services' financial health. The Balance Sheets include all of Water 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 Revenue, 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 Water Services as of and for the fiscal years ended 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	$ 2,695	$ 2,455
Investments	7	107
Other long-term assets	60	53
Current assets	385	549
	$ 3,147	$ 3,164
Liabilities and Fund Net Assets		
Long-term debt	$ 1,000	$ 1,092
Other long-term liabilities	114	83
Current liabilities	245	258
Fund net assets:		
Invested in capital assets, net of related debt	1,701	1,655
Restricted fund net assets	87	96
Unrestricted fund net deficit	-	(20)
Total fund net assets	1,788	1,731
	$ 3,147	$ 3,164
Revenue, Expenses, and Changes in Fund Net Assets		
Operating revenues	$ 551	$ 541
Operating expenses	(446)	(405)
Operating income	105	136
Investment income	9	27
Other income and expenses, net	7	(14)
Debt expenses	(37)	(44)
Transfers to the reserve fund of the City of Los Angeles	(27)	(26)
Extraordinary loss on extinguishment of debt	-	(3)
Increase in fund net assets	57	76
Beginning balance of fund net assets	1,731	1,655
Ending balance of fund net assets	$ 1,788	$ 1,731

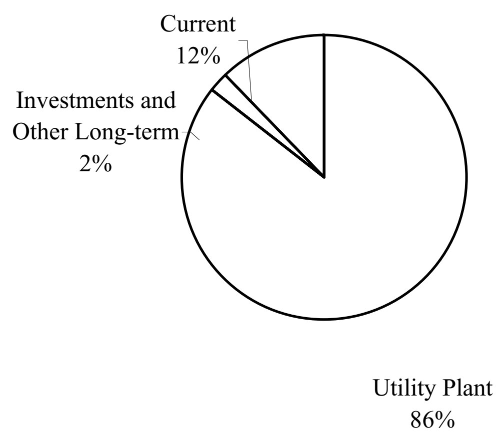
** As restated, for the adoption of GASBS 34, as amended.*

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 86% of the total assets of Water Services.

Chart 1 - Total Assets by Type



During fiscal year 2002, Water Services capitalized $317 million of additions to utility plant. Of the $317 million, $170 million, or 54% related to distribution utility plant assets, and $113 million was added to source of supply assets. The remaining $34 million of additions were incurred for normal capital activities to maintain and support general plant, pumping and purification systems.

Water Services utility plant assets fall into five major categories: source of water supply, pumping, purification, distribution, and general. Each category of assets is important to providing water services and has a specific purpose. Source of water supply assets are the assets that the Department has constructed and/or purchased to help ensure an adequate supply of water. The Department has four major sources of water. These include:

- Los Angeles Aqueduct and Second Los Angeles Aqueduct supply imported water from the Owens Valley and the Mono Basin;
- Local groundwater supply (with pumping rights in the San Fernando, Sylmar, Central and West Coast Basins);
- Purchased supply from MWD;
- Recycled water.

All sources of water, except for recycled water, are supplied for potable use; that is, the water from these sources is of drinkable quality. Table 2 below shows the percentage of potable water delivered from the major sources.

Table 2 - Sources of Potable Water Supplied During Fiscal Year 2002

Source	Millions of Gallons	Percent
Aqueduct	77,872	34%
Wells	27,717	11%
Purchases	111,891	55%
	217,480	100%

Water storage is essential for the conservation of water during low demand, cold, or wet periods and to supply the extra water needed during warm weather or emergency situations.

The Water System's 104 tanks and reservoirs, ranging in size from 10 thousand to 60 billion gallons, have a current capacity of approximately 353,079 acre-feet, or 115.05 billion gallons. Eight aqueduct reservoirs provide 89% of the Water System's storage capacity; major and minor distribution reservoirs provide the remaining 11%.

Underrecovered costs

Underrecovered costs is a current asset on Water Services' balance sheet. Underrecovered costs are the costs that Water Services has incurred for water supply and other designated costs in excess of amounts billed to the customer. Expenses that can be recovered through this rate include purchased water expense, water quality expense, reclaimed water expense, and demand-side management (or conservation expense). Underrecovered costs increased by $5 million from June 30, 2001 to June 30, 2002, due to a change in estimate of revenue allocation for certain customers, offset by a reduction in the overrecovered costs related to reclaimed water.

Investments

The Department sets aside funds to be used in future years for specified purposes. At June 30, 2002, $7 million in restricted and other investments was held by Water Services, consisting primarily of U.S. government securities. These investments are set aside for the purpose of paying interest on previously issued refunding debt. In addition, Water Services has a share of the Department's postretirement health care benefit trust fund, established to provide for the payment of the Department's postretirement health care benefits. These investments have been recorded as a reduction to Water Services' postretirement liability.

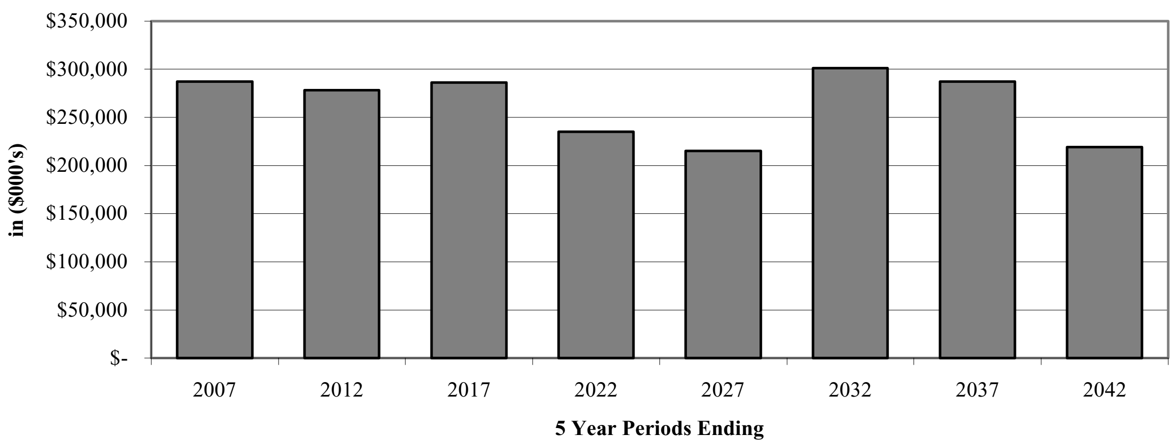
The Department has a securities lending program which, for Water Services, allows it to lend up to 20% of its investments held in the postretirement benefits trust fund for securities, cash collateral or letters of credit equal to 102% of the market value of the loaned securities and interest, if any. In addition, Water 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 was $34 million and $64 million, respectively.

Liabilities and Fund Net Assets

Long-term debt

During fiscal year 2002, Water Services' maintained a long-term debt balance of approximately $1 billion. In addition, the Department implemented its Mini-Bond program, and issued $4 million of Water Services' long-term debt to employees and retirees. Outstanding principal, plus scheduled interest and amortization 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, $0.3 billion principal amount of long-term debt is considered defeased and remains outstanding.

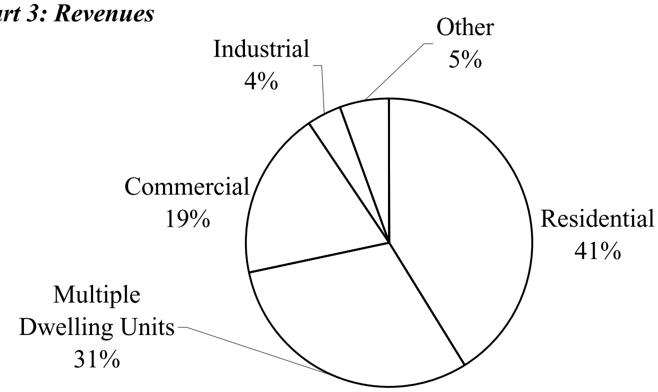
Changes in Fund Net Assets

Revenues

The operating revenues of Water Services are generated from selling water to its customers. The current water rate has two components, a base rate, and an adjustable rate, which we refer to as a pass through rate. The pass through rate is in place to recover the cost of particular expenses. These expenses include purchased water, water quality, reclaimed water, and demand-side management (or conservation expense). This is important to understand from a revenue standpoint because revenue can increase or decrease from one year to the next based on Water Services incurring greater or lesser expenses in these particular categories.

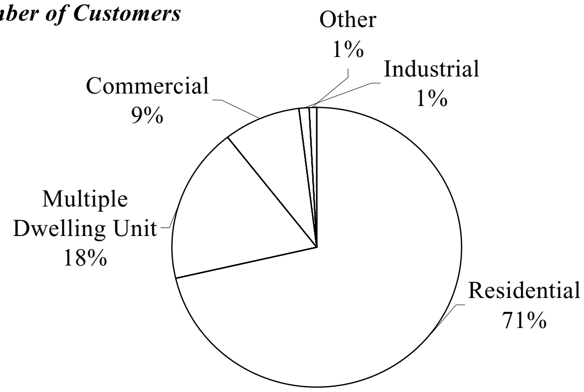
Water Services has five major customer categories. These categories include residential, multiple dwelling units, commercial, industrial, and other. Chart 3 summarizes the percentage contribution of revenues from each customer category during fiscal year 2002:

Chart 3: Revenues



Residential customers provide 41% of the revenue and they are Water Services' largest class of customers. As of June 30, 2002, Water Services had approximately 655 thousand customers. As shown in Chart 4, 468 thousand, or 71% of total customers, were in the residential customer class.

Chart 4: Number of Customers

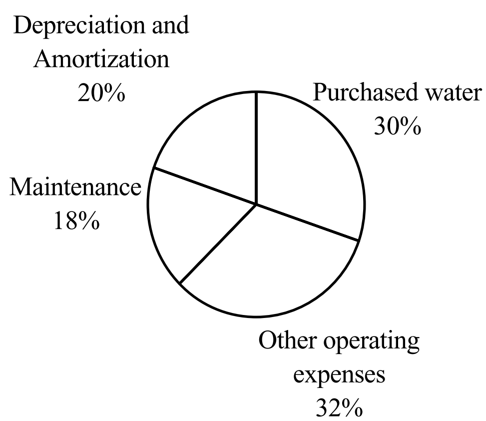


Operating revenues increased by $9 million, or 2% from fiscal year 2001 levels due to an increase in pass-through recoverable costs.

Operating Expenses

Purchased water expense is the single largest expense that Water Services incurs each fiscal year. Purchased water expense represents the cost of buying water, primarily from the Metropolitan Water District. For fiscal year 2002, 55% of the potable water supplied to Water Services' customers was purchased water. Chart 5 summarizes Water Services' operating expenses for fiscal year 2002:

Chart 5: Operating Expenses



Fiscal year 2002 operating expenses were $40 million higher as compared to the prior year. This increase was mostly due to an increase in other operating and maintenance expenses of $33 million, and an increase of $7 million in depreciation and amortization expense.

Other operating and maintenance expenses increased primarily as a result of increased security costs associated with increasing patrols and surveillance of the Department's water systems and sources. In addition, Water Services experienced an increase in environmental costs associated with Owens Valley, legal costs, as well as bad debt expense.

The increase in depreciation and amortization expense is associated with utility plant additions.

Non-Operating Revenue and Expenses

The major non-operating activities of Water Services for fiscal year 2002 include the abandonment of various construction projects totaling $16 million; the transfer of $27 million to the reserve fund of the City of Los Angeles; interest income earned on our investments of $9 million, paying $40 million in interest expenses, and contributions in aid of construction of $17 million.

Interest on investments followed the general trend in interest rates and declined from an average yield of 5.28% in fiscal year 2001 to 4.28% 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

Water Services' primary business is to provide its customers with safe and reliable water service. Water Services manages its overall cost of providing service by monitoring its water supply and demand data. In addition, Water Services purchases water for customers when the Department's supply is maximized.

The Department has traditionally acquired the majority of its water from the Los Angeles Aqueduct, the Second Los Angeles Aqueduct, local wells, and purchases from MWD. The Department believes that proper management of these sources, coupled with water recycling and conservation programs, will provide adequate water supplies to meet the needs of the City for the foreseeable future. However, as rules and regulations surrounding water quality and the environment become more stringent, the Department may incur additional capital expenditures in order to meet those requirements. Requirements currently in place that affect Water Services include the Surface Water Treatment Rule, and environmental remediation relating to Owens Valley. Water Services expects that it will incur a total of approximately $843 million to meet those two requirements.

With respect to water supply, the Department is working at protecting the reliability of existing supplies and sources. It is the Department's intent to ensure the reliability of imported water. The Department has adopted a goal of meeting as much of the additional water demands arising from growth over the next 20 years through water conservation and reclamation programs as possible. Any additional amount will be obtained through purchases from MWD. However, the Department cannot be certain that these programs will guarantee the additional supply requirements of the City.

PRICEWATERHOUSECOOPERS

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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 Water System (Water 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.

The management's discussion and analysis included on pages 1 through 12 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
Water Services Balance Sheets, as restated
(Amounts in thousands)

	June 30, 2002	June 30, 2001
Assets		
Non-Current Assets		
Utility Plant		
Source of water supply	$ 462,420	$ 348,947
Pumping	190,207	189,235
Purification	241,774	229,955
Distribution	2,526,522	2,354,977
General	327,559	311,146
	3,748,482	3,434,260
Accumulated depreciation	1,328,057	1,242,737
	2,420,425	2,191,523
Construction work in progress	274,433	263,137
	2,694,858	2,454,660
Restricted investments	7,586	107,383
Net pension asset	59,848	52,822
	67,434	160,205
Current Assets		
Cash and cash equivalents - unrestricted	103,305	26,025
Cash and cash equivalents - restricted	75,355	274,378
Cash collateral received from securities lending transactions	33,781	63,953
Customer and other accounts receivable, net of $3,500 allowance for losses	73,458	76,686
Underrecovered costs	24,169	19,487
Due from Energy Services	6,024	7,340
Accrued unbilled revenue	41,287	48,569
Materials and supplies, at average cost	17,752	17,671
Prepayments and other current assets	9,685	15,017
	384,816	549,126
	$ 3,147,108	$ 3,163,991
Fund Net Assets and Liabilities		
Fund Net Assets		
Invested in capital asset, net of related debt	$ 1,701,161	$ 1,655,323
Restricted fund net assets	87,053	95,784
Unrestricted fund net deficit	(605)	(20,410)
	1,787,609	1,730,697
Long-term Debt		
Long-term debt	1,000,414	1,011,233
Advance refunding bonds	-	80,603
	1,000,414	1,091,836
Other Non-Current Liabilities		
Accrued postretirement liability	105,391	82,890
Accrued workers' compensation claims	8,700	-
Commitments and contingencies (Note 11)	-	-
	114,091	82,890
Current Liabilities		
Current portion of long-term debt	45,137	42,685
Accounts payable and accrued expenses	86,346	76,510
Accrued interest	9,247	11,018
Accrued employee expenses	26,001	23,856
Obligations under securities lending transactions	33,781	63,953
Customer deposits	44,482	40,546
	244,994	258,568
	$ 3,147,108	$ 3,163,991

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

Los Angeles Department of Water and Power
Water 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	$ 225,611	$ 217,029	$ 207,873
Multiple dwelling units	169,279	167,309	153,356
Commercial and industrial	125,716	126,927	118,311
Other	29,863	29,728	28,185
	550,469	540,993	507,725
Operating Expenses			
Purchased water	135,049	134,480	91,275
Maintenance and other operating expenses	223,341	190,083	184,485
Depreciation and amortization	87,493	80,910	75,339
	445,883	405,473	351,099
Operating Income	104,586	135,520	156,626
Other Income and Expense			
Investment income	9,075	27,350	9,476
Gain on sale of land	4,896	462	601
Other non-operating income	5,918	5,432	3,727
	19,889	33,244	13,804
Other non-operating expenses	4,709	4,609	3,764
	15,180	28,635	10,040
Loss on asset impairment and abandoned projects	(15,550)	(35,601)	-
	(370)	(6,966)	10,040
Debt Expenses			
Interest on debt	40,223	46,234	47,958
Allowance for funds used during construction	(3,409)	(2,023)	(1,246)
	36,814	44,211	46,712
Contributions in aid of construction	16,757	19,790	12,718
Change in fund net assets before transfers to the reserve fund of the City of Los Angeles and extraordinary item	84,159	104,133	132,672
Transfers to the reserve fund of the City of Los Angeles	27,247	25,500	22,200
Increase in fund net assets before extraordinary item	56,912	78,633	110,472
Extraordinary loss on extinguishment of debt	-	(3,096)	-
Increase in fund net assets	56,912	75,537	110,472
Fund net assets			
Beginning of period	1,730,697	1,655,160	1,544,688
End of period	$ 1,787,609	$ 1,730,697	$ 1,655,160

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

Los Angeles Department of Water and Power
Water 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 customers	$ 599,034	$ 544,729	$ 507,113
Cash receipts from customers for other agency services	360,216	356,004	356,575
Cash receipts from interfund services provided	238,918	227,218	194,828
Cash Disbursements			
Cash payments to employees	(176,869)	(159,916)	(129,686)
Cash payments to suppliers	(229,037)	(277,672)	(149,856)
Cash payments for interfund services used	(201,228)	(175,907)	(198,503)
Cash payments to other agencies for fees collected	(355,254)	(357,459)	(355,695)
Other operating cash payments	(8,789)	(5,534)	(6,562)
	226,991	151,463	218,214
Cash Flows from Noncapital Financing Activities:			
Payments to the reserve fund of the City of Los Angeles	(27,247)	(25,500)	(22,200)
Cash Flows from Capital and Related Financing Activities:			
Additions to plant and equipment, net	(324,283)	(218,847)	(211,251)
Contributions in aid of construction	24,043	18,819	15,259
Purchases of escrow investments	-	(103,927)	(9,613)
Proceeds from escrow investment maturities	96,648	307,632	13,555
Principal payments and maturities on long-term debt, net	(105,614)	(643,185)	(18,720)
Issuance of bonds, net	4,029	730,482	99,132
Proceeds from California Department of Water Resources loan	13,253	-	-
Debt interest payments	(49,066)	(56,745)	(59,333)
	(340,990)	34,229	(170,971)
Cash Flows from Investing Activities:			
Investment income	19,503	33,335	19,267
Cash and Cash Equivalents:			
Net (decrease) increase	(121,743)	193,527	44,310
Beginning of year	300,403	106,876	62,566
End of year	$ 178,660	$ 300,403	$ 106,876

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

Method of accounting

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

The Department's rates are determined by the Board of Water and Power Commissioners (the Board) and are subject to review and approval by the City Council. As a regulated enterprise, the Department 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, Water Services records various regulatory assets and liabilities to reflect the Board's actions. Management believes that Water Services meets the criteria for continued application of SFAS No. 71, but will continue to evaluate its applicability based on changes in the regulatory and competitive environment.

Use of estimates

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

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. Estimated service lives range from 5 to 70 years. Depreciation and amortization expense as a percentage of average depreciable utility plant in service was 2.6% for each of the fiscal years ended 2002, 2001 and 2000, respectively. Amortization expense for computer software is computed using the straight-line method over 5 years.

NOTE 1: (continued)

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.

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

	June 30,	
	2002	2001
Bond redemption and interest funds	$ 14	$ 11
Construction funds	52	254
Self insurance fund	9	9
	$ 75	$ 274

Restricted investments

Water Services' restricted investments consist of escrow investments held to pay interest on previously issued refunding revenue bonds. Such investments include U.S. government and governmental agency securities. 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.

NOTE 1: (continued)

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 revenue, expenses, and changes in fund net assets.

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

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

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

The rate ordinance limits Water Services' recovery of combined expenditures for demand-side management, water reclamation, and water quality improvement. During fiscal year 2002 and 2001, Water Services incurred expenditures of $24 and $27 million, respectively, in excess of these limits, which is being funded through funds received from the issuance of debt (see Note 6). These expenditures were not recovered during fiscal year 2002 or 2001; however, Water Services' rate ordinance permits future recovery of principal and interest payments related to debt used to fund approved expenditures over the life of the related debt issues.

During fiscal year 2002, Water Services changed its underrecovered cost estimate for certain customers. This change resulted in a $12 million increase to underrecovered costs.

NOTE 1: (continued)

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 used by Water Services was 5.8%, 5.8%, and 6.3% for each of fiscal years 2002, 2001 and 2000.

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 Water 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 Water Services beginning in fiscal 2003. The Department does not expect the adoption of the Statement to have a material impact on Water Services' financial statements.

NOTE 1: (continued)

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 Water 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 and unspent debt proceeds.
- 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 assets, net of related debt."

Under GASBS 34, 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).

The Department restated its prior year financial statements to retroactively apply GASBS 34, as amended.

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 $550 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	$ 120
- Contributions in aid of construction	12
- Transfers to the reserve fund of the City of Los Angeles	(22)
Increase in fund net assets, as restated	110
Fund net assets	
Beginning of year, as restated	1,545
End of year, as restated	$ 1,655

NOTE 3: Utility Plant

Water 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	$ 64	$ -	$ -	$ -	$ 64
Construction work in progress	263	328	-	(317)	274
Total nondepreciable utility plant	327	328	-	(317)	338
Depreciable utility plant					
Source of water supply	303	-	-	113	416
Pumping	187	-	-	1	188
Purification	230	-	-	12	242
Distribution	2,342	-	-	170	2,512
General	309	-	(3)	21	327
Total depreciable utility plant	3,371	-	(3)	317	3,685
Less accumulated depreciation	(1,243)	(88)	3	-	(1,328)
Total utility plant, net	$ 2,455	$ 240	$ -	$ -	$ 2,695

Additions to accumulated depreciation include capitalized depreciation.

NOTE 4: Restricted Investments

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

	June 30, 2002		June 30, 2001	
Escrow investments	$	7	$	107
Cash collateral received from securities lending transactions (see Note 5)	$	34	$	64
Postretirement health care benefit trust fund	$	19	$	18
	$	60	$	189

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 pay interest on previously issued refunding revenue bonds.

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 care benefits. Accrued postretirement liabilities are recorded net of the trust fund (see Note 8).

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, Water Services' restricted and other investments are categorized as follows (amounts in millions):

NOTE 4: (continued)

Type of Investments	Category 1	Category 2	Category 3	Total
Investments - categorized				
U.S. government securities	$ 15	$ -	$ -	$ 15
Bonds	4	-	-	4
Repurchase agreements	-	7	-	7
Total categorized restricted and other investments	$ 19	$ 7	$ -	26
Investments - not categorized				
Investments held by broker-dealers:				
U.S. government securities				7
General pooled securities lending cash collateral				27
Total				$ 60

At June 30, 2001, Water 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	$ 113	$ -	$ -	$ 113
Bonds	4	-	-	4
Commercial paper	1	-	-	1
Repurchase agreements	-	7	-	7
Total categorized restricted and other investments	$ 118	$ 7	$ -	125
Investments - not categorized				
Investments held by broker-dealers:				
U.S. government securities				7
General pooled securities lending cash collateral				57
Total				$ 189

Repurchase agreements relate to the Department's securities lending program (see Note 5).

NOTE 5: 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 Water Services' 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 Water 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
U.S. government and agency securities	$ 7	$ 7	$ 7	$ 7

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, Water Services' attributed share of cash collateral and the related obligation from the City's program was $27 and $57 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 6: 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, and other long-term debt, as follows (amounts in millions):

Bond Issues	Date of Issue	Effective Interest Rate	Fiscal Year of Last Scheduled Maturity	Principal Outstanding
Revenue and Advance Refunding Bonds				
Refunding Issue of 1993	04/15/93	5.880%	2024	$ 80
Second Refunding Issue of 1993	12/01/93	5.297%	2030	117
Refunding Issue of 1998	10/15/98	4.689%	2035	236
Issue of 2001, Series A	02/01/01	5.202%	2042	314
Issue of 2001, Series B	02/28/01	Variable	2036	325
Issue of 2001, Series C	11/15/01	4.788%	2017	4
	Total principal amount			1,076
	Unamortized debt-related costs (including net loss on refundings)			(44)
	Debt due within one year (including current portion of variable rate debt)			(45)
				987
Other Long-term Debt				
Loan payable to California Department of Water Resources (CDWR)	12/27/01	2.320%	2022	13
	Current portion of loan from CDWR			-
				13
				$ 1,000

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 Water Services' net income, as defined, will be sufficient to pay certain amounts of future annual bond interest and of future annual aggregate bond interest and principal maturities. Revenue bonds and refunding bonds are collateralized by the future revenues of Water Services.

NOTE 6: (continued)

Long term debt activity

Water 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 loan from CDWR	$ 1,011	$ 17	$ (109)	$ 81	$ 1,000	$ 45
Advance refunding bonds	81	-	-	(81)	-	-
Total long-term debt	$ 1,092	$ 17	$ (109)	$ -	$ 1,000	$ 45

New issuances

Fiscal Year 2002

In November 2001, the Department issued $4 million of Water Services fixed rate bonds as part of the Mini Bond Program for employees and retirees. Water 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 water system capital improvements.

In May 2001, the Department entered into a loan agreement with the California Department of Water Resources. The loan agreement allows for a total maximum loan of $18 million, at a fixed interest rate of 2.32%. In December 2001, the Department received $13 million under the agreement. The proceeds are being used to fund water quality capital improvements.

Fiscal Year 2001

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

Deposits to construction funds	$ 312
Defeasance of selected revenue bonds	318
	$ 630

NOTE 6: (continued)

A portion of the proceeds was used to defease bonds with par amounts of $305 million. Based on an assumed interest cost of 5.1% for the variable rate bonds, the defeasance is expected to increase total debt payments over the life of the new issues by approximately $30 million and is expected to result in present value savings of approximately $17 million. The actual savings will vary depending on future interest rates. An increase in the average rate of the variable bonds to 5.8% would change the total increase in net debt service by $47 million and the present value savings to $8 million. These transactions resulted in a net loss for accounting purposes of $12 million, which was deferred and will be amortized over the shorter of the life of the bonds retired or the life of the new bonds.

In November 2000, the Department issued $100 million of short term revenue certificates. These certificates were among the long-term debt issues defeased upon the issuance of the $325 million in variable rate bonds described above.

Cash tender and defeasance

In February 2001, the Department deposited $14 million into a trust established for the purpose of making future debt service payments on specified revenue bonds with a par value of $13 million. During fiscal 2002, the related bonds were called and the funds in the escrow account were used to pay for the call.

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

NOTE 6: (continued)

Outstanding debt defeased

As discussed above, Water 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 Water Services' financial statements. At June 30, 2002, the following revenue bonds outstanding are considered defeased (amounts in millions):

Bond Issues	Principal Outstanding
Second Issue of 1992	66
Issue of 1994	49
Issue of 1995	47
Issue of 1999	100
	$ 262

Variable rate bonds

The variable rate bonds currently bear interest at daily and weekly rates (ranging from 1.13% to 1.71% 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 $325 million to provide liquidity for these bonds. The initial and extended Standby Agreements expire in March 2004 and November 2002. The agreement which expires in November 2002 has been further extended for an additional 364 day period. 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 $33 million as of June 30, 2002 and 2001.

NOTE 6: (continued)

Advance refunding bonds

In prior years, Water Services established irrevocable escrow trusts with proceeds from the issuance of refunding bonds. During fiscal year 2002, bonds with a par value of $83 million were refunded using proceeds from the balance in the restricted escrow investments. Escrow investments of $7 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.

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	$ 13	$ 45
2004	14	44
2005	13	43
2006	13	43
2007	17	42
2008 - 2012	83	195
2013 - 2017	118	168
2018 - 2022	94	141
2023 - 2027	99	116
2028 - 2032	208	93
2033 - 2037	220	67
2038 - 2042	197	22
Total Requirements	$ 1,089	$ 1,019

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 1.42%.

NOTE 6: (continued)

Fair value

The fair value of long-term debt and refunding bonds is $0.9 and $1.1 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.

NOTE 7: Retirement, Disability, and Death Benefit Insurance Plan

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

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

Plan amendments must be approved by both the Retirement Board and the Board of Commissioners.

NOTE 7: (continued)

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

	Year Ended June 30, 2002	2001
Annual required contribution	$ -	$ -
Interest on net pension asset	(3)	(3)
Adjustment to annual required contribution	5	5
APC (including $1 million of amounts capitalized in fiscal 2002 and 2001)	2	2
Department contributions	(9)	(9)
Shared operating expenses (see Note 9)	-	-
Change in NPO	(7)	(7)
NPO (asset) at beginning of year	(53)	(46)
NPO (asset) at end of year	$ (60)	$ (53)

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	Required Contribution Rate
2001	10.64%	-13.65%	0.00%
2000	10.59%	-14.52%	0.00%
1999	10.57%	-26.72%	0.00%

NOTE 7: (continued)

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 Water Services is as follows (amounts in millions):

Year ended June 30,	NPO	Percentage of APC Contributed	APC
2002	$ (60)	400%	$ 2
2001	$ (53)	413%	$ 2
2000	$ (46)	71%	$ 8

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%

NOTE 7: (continued)

Disability and death benefits

Water Services' allocated share of disability and death benefit plan costs and administrative expenses totaled $3, $3, and $4 million for each of the fiscal years 2002, 2001 and 2000, respectively.

NOTE 8: 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 Water Services of providing such benefits amounted to $39, $33, and $25 million for fiscal years 2002, 2001 and 2000, respectively. Of these costs, $17, $12, and $9 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.

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

	Year ended June 30,		
	2002	2001	2000
Service cost	$ 5	$ 4	$ 2
Interest cost	19	16	9
Expected return on plan assets	(1)	(1)	(1)
Amortization of transition obligation	5	5	4
Amortization of prior service costs	3	3	2
Amortization of actuarial losses	3	-	-
	$ 34	$ 27	$ 16

NOTE 8: (continued)

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

	June 30, 2002	June 30, 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
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)
Water Services' allocated share of accrued benefit cost	$ (105)	$ (83)

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

	June 30, 2002	June 30, 2001	June 30, 2000
Discount rate	7.25%	7.25%	7.75%
Expected return on plan assets	6.50%	6.50%	7.00%

NOTE 8: (continued)

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

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. Water Services' allocated $11 million share of this increase is being amortized through 2008, the remaining average service period. This change also resulted in an $12, $11, and $8 million increase in postretirement benefit costs for fiscal years 2002, 2001 and 2000, respectively, of which $4, $4, and $2 million respectively, was allocated to Water Services.

NOTE 9: Shared Operating Expenses

Water Services shares certain administrative functions with the Department's Energy Services. Generally, the costs of these functions are allocated on the basis of the benefits provided. Operating expenses shared with Energy Services were $514, $455, and $466 million for fiscal years 2002, 2001 and 2000, respectively, of which $186, $154, and $150 million were allocated to Water Services.

NOTE 10: Loss on Asset Impairment and Abandoned Projects

During fiscal year 2001, management approved the sale of one of its administrative facilities and Water Services reported its portion of the loss on asset impairment of $12 million. The completion of the sale is expected to occur within 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.

NOTE 10: (continued)

During fiscal year 2002, management formally abandoned certain water projects and reported a loss on abandonment totaling approximately $16 million in the statement of revenue, expenses, and changes in fund net assets. Projects abandoned included design work related to a well field and a filter plant, and small construction projects that will not be completed.

During fiscal year 2001, management formally abandoned one of its customer information system projects and Water Services reported its portion of the loss on abandonment of $24 million in the statement of revenue, expenses, and changes in fund net assets.

NOTE 11: Commitments and Contingencies

Transfers to the reserve fund of the City of Los Angeles

Under the provisions of the City Charter, Water Services transfers funds at its discretion to the reserve fund of the City. Pursuant to covenants contained in the bond indentures, the transfers may not be in excess of net income of the prior fiscal year. Such payments are not in lieu of taxes and are recorded as a non-operating expense in the statement of revenue, expenses, and changes in fund net assets in accordance with GASBS 33 (see Note 2).

The Department made payments of $27, $26, and $22 million in fiscal years 2002, 2001 and 2000, respectively, from Water Services to the reserve fund of the City. The Department expects to make an additional transfer declaration from Water Services of approximately $28 million during fiscal year 2003.

Surface Water Treatment Rule

The State of California Surface Water Treatment Rule (SWTR) imposes increased filtration requirements at any open distribution reservoirs exposed to surface water runoff. The Department has had four major reservoirs in its system subject to the SWTR: Upper and Lower Hollywood, Lower Stone Canyon, and Encino. To comply with the SWTR, the Department has designed projects to remove these reservoirs from regular service through construction of larger pipelines and storage facilities. These changes will improve water quality while maintaining flexibility in the water system.

The Hollywood Water Quality Improvement Project was completed in July 2002. Upper and Lower Hollywood Reservoirs were removed from service and functionally replaced by two 30 Million Gallon tanks and additional pipelines. The Encino and Stone Canyon Water Quality Improvement Projects are scheduled to begin construction in November 2002 and March 2003, respectively. As of June 30, 2002, the cost of SWTR compliance related to engineering studies and construction activities at the four reservoirs and for the addition of key pipelines in the San Fernando Valley totaled $281 million and are expected to reach $428 million at completion in 2007.

NOTE 11: (continued)

Owens Valley

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

Under the MOA, the City committed to providing control measures on the lakebed in a phased manner until the lakebed emissions are reduced to a level that complies with the requirements of the Federal Clean Air Act. In addition, the District agreed to adopt a revised State Implementation Plan (SIP) that extends the period for the City to complete the installation of control measures until 2006, which is the deadline currently required by the Clean Air Act. In November 1998, the District approved the revised SIP, which incorporated the provisions of the MOA. The SIP was subsequently approved by the California Air Resources Board and ultimately by the United States Environmental Protection Agency in August 1999. The original SIP required the City to have control measures in place over a minimum of 22.5 square miles of the lakebed by 2006. In late 2003, the District will issue a revised SIP that will define the entire boundary on the lakebed that must be controlled. It is expected that the revised SIP will require the City to have control measures in place over a minimum of 16.5 square miles of the lakebed by 2003. This will include areas beyond that which the City has already controlled. In addition, it is estimated that up to 60,000 acre-feet of water will be required on an annual basis to operate the pollution control facilities. The current plan assumes that a portion of this water will be obtained from the local sub-potable groundwater basin; however, the actual quantity available will not be known until additional studies are completed.

As of June 30, 2002, the Department has incurred capital costs of approximately $172 million associated with the Owens Dry Lake. Based on the anticipated 2003 SIP, management estimates that the total capital related costs of implementing the pollution control measures through 2006 will be approximately $415 million; however, the cost estimate may change as additional information becomes available.

Litigation

A number of claims and suits are pending against the Department for alleged damages to persons and property and for other alleged liabilities arising out of its operations. In the opinion of management, any ultimate liability, which may arise from these actions, are not expected to materially impact Water Services' financial position, changes in fund net assets, or cash flows as of June 30, 2002.

NOTE 11: (continued)

Risk management

Water Services is subject to certain business risks common to the utility industry. The majority of these risks are mitigated by external insurance coverage obtained by Water Services. For other significant business risks, however, Water Services has elected to self-insure. Management believes that exposure to loss arising out of self-insured business risks will not materially impact Water Services' financial position, changes in fund net assets, 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 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 12: Supplemental Cash Flow Information

A reconciliation of the statement of cash flows' operating activities to operating income is as follows during fiscal years ended June 30, 2002, 2001 and 2000 (amounts in millions):

	Year Ended June 30,		
	2002	2001	2000
Operating income	$ 105	$ 135	$ 157
Adjustments to reconcile operating income to net cash provided by operating activities			
Depreciation and amortization	87	81	75
Provision for losses on customer and other accounts receivable	5	4	2
Loss on asset impairment and abandoned projects	(16)	(36)	-
Extraordinary loss on extinguishment of debt	-	(3)	-
Changes in assets and liabilities:			
Customer and other accounts receivable	(10)	(11)	6
Net pension asset	(7)	(7)	2
Accounts payable and accrued expenses	10	4	12
Underrecovered / Overrecovered costs	(5)	(20)	(37)
Accrued postretirement liability	23	14	12
Workers' compensation liability and other	35	(10)	(11)
Cash provided by operating and other activities	$ 227	$ 151	$ 218