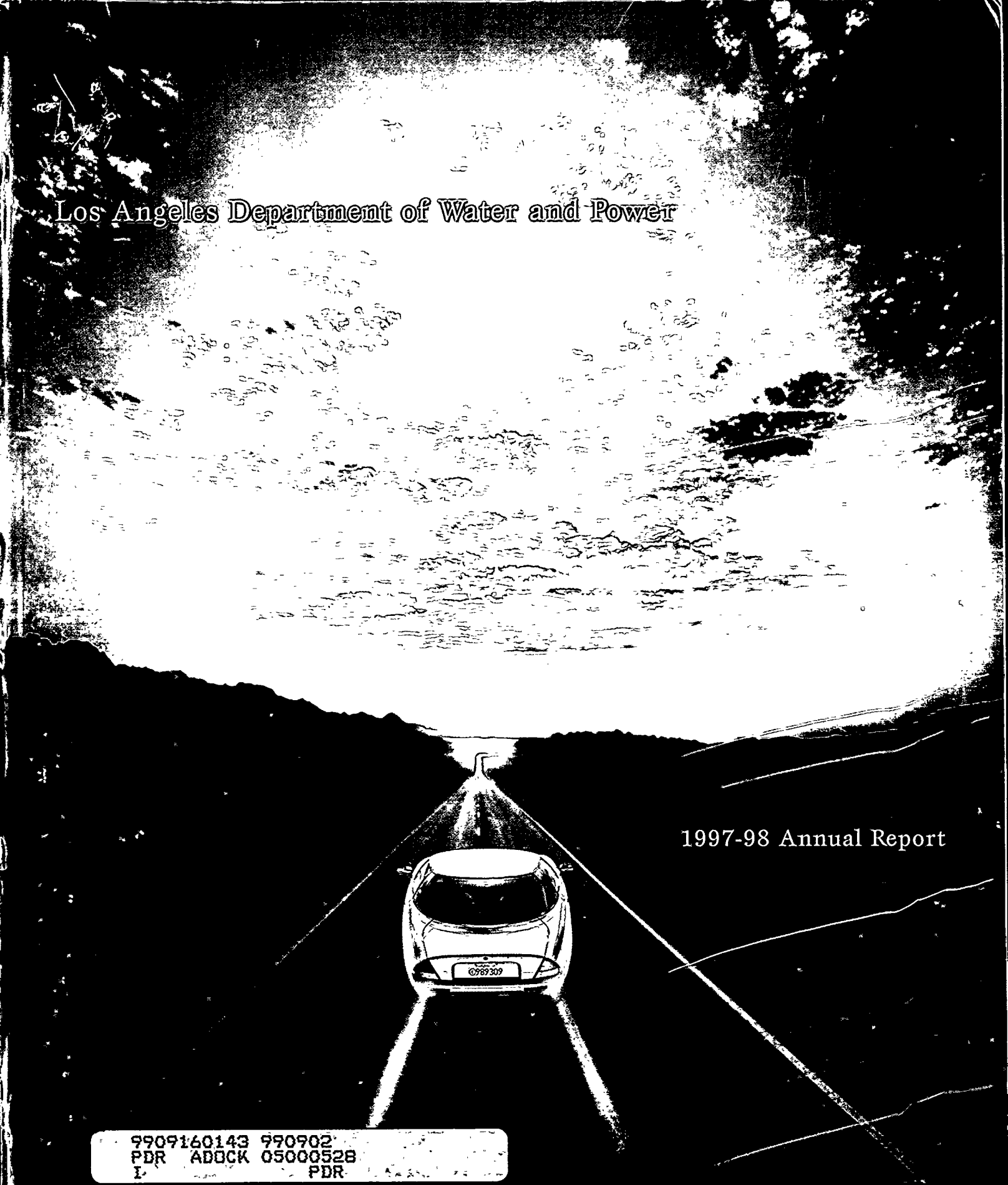
Los Angeles Department of Water and Power



1997-98 Annual Report

The Los Angeles Department of Water and Power (DWP) is charging into the new millennium as a leaner, more efficient organization committed to our city, our customers and our environment. For more than a decade, DWP has been striving to make tomorrow's air a little easier to breathe by promoting and supporting the use of emission-free electric transportation such as the GM EV1 on our cover.

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President's Message

This was a year of historic progress for the Los Angeles Department of Water and Power. The Department accomplished difficult change and continued as the nation's leading municipal utility. Leaner now, more efficient and implementing an aggressive business plan, DWP is committed to meeting the energy and water demands of the city's 3.7 million residents – and delivering these resources at the lowest possible price.

An action plan and management team were put in place to streamline operations and prepare DWP to compete successfully in a deregulated utility market. Tremendous strides were made in debt reduction and restructuring. These disciplined efforts gained the confidence of Wall Street analysts and placed the Department on solid footing as it prepares itself for competition.

The Department's 6,700 employees have risen to the challenge, demonstrating resiliency and innovation. DWP continued with successful energy efficiency and new technology initiatives, community partnership efforts and customer service programs that distinguish the Department in the industry. Many of these advances are profiled in this report.

An historic agreement was struck to bring an end to the longstanding Owens Valley water dispute. The Department's highly acclaimed water conservation and watershed management initiatives continued with success.

We celebrated the 85th anniversary of the Los Angeles Aqueduct by lighting the "Cascades" – the dramatic entry point of water into Los Angeles from the Owens Valley. It allowed us to reflect on DWP's pivotal role in past, present and future Los Angeles.

Truly, much progress has been made. And much work remains to be done. But it is clear DWP continues to light the way for the City of Los Angeles. It is, therefore, with great pride that we submit this annual report.

Rick J. Caruso,
Board President

City of Los Angeles

Richard J. Riordan
Mayor of Los Angeles

John Ferraro
President, City Council
Councilman, Fourth District

Mike Hernandez
Councilman, First District

Joel Wachs
Councilman, Second District

Laura Chick
Councilwoman, Third District

Michael Feuer
Councilman, Fifth District

Ruth Galanter
Councilwoman, Sixth District

Richard Alarcon
Councilman, Seventh District

Mark Ridley-Thomas
Councilman, Eighth District

Rita Walters
Councilwoman, Ninth District

Nate Holden
Councilman, Tenth District

Cindy Miscikowski
Councilwoman, Eleventh District

Hal Bernson
Councilman, Twelfth District

Jackie Goldberg
Councilwoman, Thirteenth District

Richard Alatorre
Councilman, Fourteenth District

Rudy Svorinich, Jr.
Councilman, Fifteenth District

James K. Hahn
City Attorney

Rick Tuttle
Controller

1998 Board of Water and Power Commissioners

Kenneth T. Lombard
Vice President

Dominick W. Rubalcava
Commissioner

Rick J. Caruso
President

Judy M. Miller
Commissioner

Marcia F. Volpert
Commissioner

S. David Freeman
General Manager

General Manager's Letter

Nineteen ninety-eight was a year that marked a substantial step forward in preparing for a competitive, deregulated electric marketplace. And on the water side of our business, DWP achieved several goals, including the historic Owens Valley settlement and preparing to add fluoride to our city's drinking water.

Our vision for DWP is to be more than just competitive on price, reliability and customer service. We strive to be the nation's model public power utility. We will lead efforts to promote renewable energy, resource conservation and cleaner air, with special emphasis on projects that also serve the city's most economically disadvantaged communities. We must achieve this vision in order to justify a role for public power in California's deregulated marketplace.

Toward that end, significant progress was made in 1997-98. The DWP:

- Achieved a massive work force reduction which is expected to result in savings of $100 million per year.
- Reduced operating expenses and created new revenue sources, placing this utility on solid financial footing in preparation for deregulation.
- Reduced generation unit debt by approximately $500 million, which is comprised of maturities and cash available for the debt reduction fund, and is on target to eliminate this debt by 2003.
- Froze the electric rates of all DWP residential customers until 2002, at which time residential rates will be reduced at least 5 percent. This is in addition to the 10 to 15 percent savings DWP residential customers currently enjoy compared to California's investor-owned utilities.
- Developed a visionary $54.4 million Public Benefits Program that includes important investments in renewable technologies, energy efficiency and economic development in our city's disadvantaged communities.
- Transferred $110.2 million to the city's general fund to provide for essential city services like police and fire protection.
- Impressed both the Moody's and Standard & Poor's rating agencies with our progress, garnering accolades in their reports.
- Completed the staff reduction plan. The team of DWP employees – now 6,700 strong – is working together to cultivate a 21st century organizational culture that prides itself on innovation, customer service and dependability.

In the area of water service, DWP continues to lead by example:

- DWP brought an end to a 20-year dispute with the Owens Valley by reaching a settlement that will ensure Great Basin residents are breathing air that meets federal standards by 2006.
- We began the important process of preparing to fluoridate the city's water supply to protect our children from tooth decay.
- Our customers continued to conserve water at record levels. Consider this fact:

The city's population in 1998 was 30 percent larger than it was in 1972, yet overall water usage remained the same.

- DWP's ultra low-flush toilet program – already the nation's largest – continued its expansion throughout the city. Annually, this program saves more than 27,500 acre feet of water (almost nine billion gallons), enough to provide for the average water usage of 55,000 families of four.

Even with these achievements in the water and power sides of our business, tremendous challenges lie ahead. The job of turning DWP around is far from over.

It is critical that DWP take a strong leadership position on regional and national water policy issues in the areas of conservation, supply and quality. In addition, DWP must make the necessary investments to expand our program to replace and repair our city's aging water infrastructure.

On the power side, the commitment to cost cutting, revenue creation, customer service and marketing must continue. New programs in the areas of community reinvestment, economic development, energy efficiency, environmental protection and renewable resources must gain momentum and flourish.

Perhaps no other new initiative has more promise than DWP's Green Power Program. In 1999, DWP will offer renewable energy to any customer who requests it. Los Angeles has the opportunity to be a model for the nation in the use of power generated by the sun, wind and water.

The Green Power Program exemplifies DWP's commitment to the environment and the improvement of the communities we serve. Additional programs being offered include: an energy efficiency effort that includes the distribution of super-efficient refrigerators for low-income residents, energy incentives for businesses locating within the city's empowerment zone and enterprise communities, and continuation of the "Cool Schools" tree planting program with the Los Angeles Unified School District.

The DWP is committed to providing the residents of Los Angeles, the owners of the DWP, a substantial return on their investment – one of the benefits of a public utility. This comes in the form of DWP's financial support for vital city services including police and fire services, parks, libraries and other community activities that help make Los Angeles a leading city in the world. DWP is, in effect, the city's largest taxpayer.

In 1998, DWP turned the corner in preparing itself for a competitive marketplace. Much of the most painful work is behind us. Working with our outstanding employees, DWP will continue to forge ahead, providing exceptional customer service, reliability, low rates and community re-investment. These characteristics will pervade this organization in 1999, and in the millennium that lies ahead.

S. David Freeman
General Manager

Comparative Highlights

Year ended June 30	WATER 1998	WATER 1997	WATER % Increase (Decrease)	POWER 1998	POWER 1997	POWER % Increase (Decrease)
SERVICE	GALLONS IN BILLIONS			KILOWATT HOURS IN BILLIONS		
Sales	185.8	193.6	-4.0%	22.9	23.0	-0.4%
Customers — average number (thousands)	645.5	639.8	0.9%	1,370.1	1,358.0	0.9%
FINANCIAL	IN MILLIONS			IN MILLIONS		
Revenue [A]	$ 435.6	$ 426.8	2.1%	$2,230.4	$2,060.7	8.2%
Operating Costs [B]	254.6	235.9	7.9%	1,491.5	1,469.6	1.5%
Net Income	71.9	82.4	-12.7%	328.1	163.5	100.7%
Transfers to City of Los Angeles [C]	25.9	21.1	22.7%	80.4	97.3	-17.4%
Capital additions, net	151.1	163.8	-7.8%	144.6	188.9	-23.5%
Net utility plant	2,087.6	2,000.0	4.4%	4,464.5	4,569.0	-2.3%
Capitalization — equity and long-term debt [D]	2,093.1	2,045.7	2.3%	5,044.1	4,982.5	1.2%

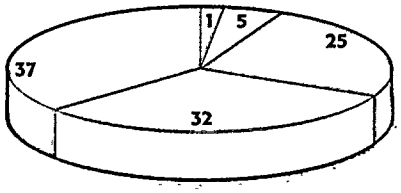
(A) Includes other income and expenses - net

(B) Excludes depreciation expense

(C) Includes Water Services payable of $5.0 in fiscal year 1998
Includes Energy Services payable of $8.9 in fiscal year 1997

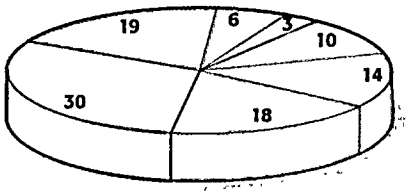
(D) Excludes advance refunding bonds

Revenue and Expenditure Dollar



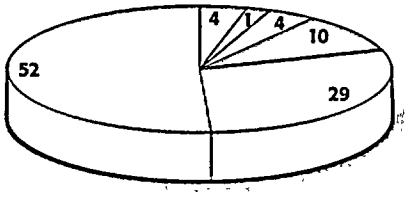
Water Revenue
dollar in cents

37 Single dwelling residential
32 Multi-dwelling residential
25 Commercial and industrial
5 Governmental
1 Other



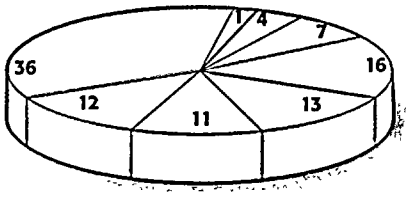
Water Expenditure
dollar in cents

19 Capital improvements
30 Other operating expenses
18 Operating salaries and wages
14 Debt service costs
10 Purchased water
3 Retirement Plan costs related to operations
6 Transfers to the City*
*Includes payable of $5 million



Energy Revenue
dollar in cents

52 Commercial
29 Residential
10 Industrial
4 Other
1 Street lighting
4 Regulatory gain through rate restructuring



Energy Expenditure
dollar in cents

36 Purchased energy
12 Other operating expenses
11 Debt service costs
13 Operating salaries and wages
16 Capital improvements
7 Fuel
4 Transfers to the City
1 Retirement Plan costs related to operations

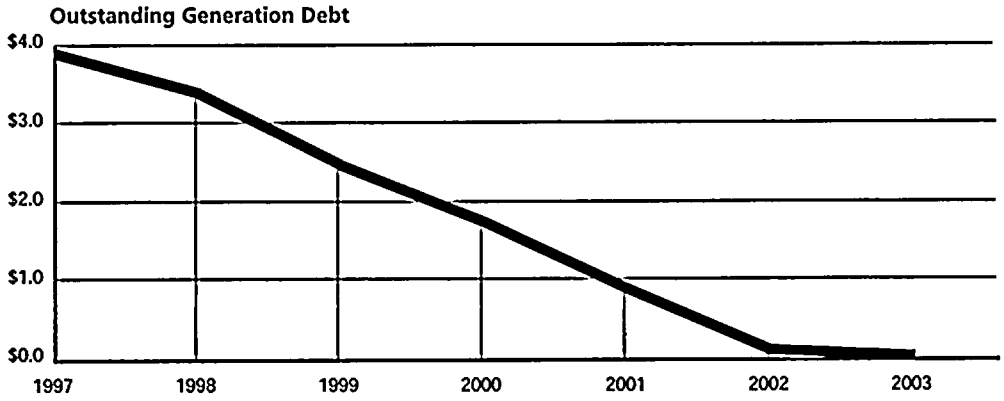
- Debt Reduction
- Management Reorganization and Workforce Reduction
- Credit Rating
- New Revenue Sources
- Preparing for Year 2000

Promoting Fiscal Responsibility

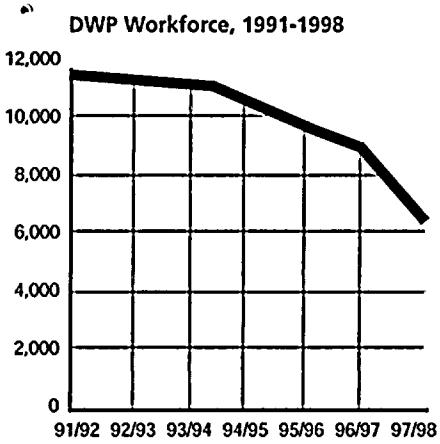
Los Angeles DWP's goal is to enter the competitive marketplace with electric rates that match or beat the offerings of other utilities, while continuing to provide reliability and outstanding customer service.

Debt Reduction: Eliminating its generation unit debt by 2003 is critical in preparing DWP to compete successfully in California's deregulated utility marketplace. Through a mix of cost cutting and new revenue generation measures, we are on course to eliminate approximately $4 billion in generation debt DWP had acquired as we entered fiscal year 1997-98.

During the 1997-98 fiscal year, DWP reached its goal to cut its generation unit debt by approximately $500 million, which is comprised of maturities and cash available for the debt reduction fund, to $3.5 billion. With operating efficiencies and new long-term revenue sources, the Department is expected to trim an additional $800 million in debt in the coming fiscal year, keeping our utility on track to reach the goal of a debt-free generation unit by 2003.



Management Reorganization and Workforce Reduction: To achieve operating efficiencies, DWP reorganized its management structure and reduced the workforce by 2,064 employees in 1998. Approximately 90 percent of the cost



of the buyout package, which was approved by the Los Angeles City Council, was funded by excess investment in DWP's retirement system. Today's DWP workforce of more than 6,700 is 40 percent smaller than it was in 1991.

Credit Rating: DWP's financial plan to prepare for competition was well received in many circles, including Wall Street. The Department earned an Aa3 credit rating from Moody's Investor Service. In its analysis, Moody's wrote:

> *"The Aa3 credit rating on the Los Angeles Department of Water and Power's (DWP) electric revenue bonds is supported by its significant resources and role as a major municipal electric utility in the western region, its demonstrated sound financial record, management's strategic capabilities, and the evident political support for the city-owned utility's transition to a competitive electricity market... Moody's believes his [David Freeman's] direction will move the Department to where it needs to be before it offers customers a choice of a power supplier."*

New Revenue Sources: As part of the action plan, DWP identified various assets that could be better utilized to generate additional cash for debt reduction. In fiscal year

Phyllis Currie and her financial team prepare the report for Moody's Investor Service.

1997-98, DWP significantly increased revenues from wholesale marketing of excess energy and transmission services, generating $45 million in revenues.

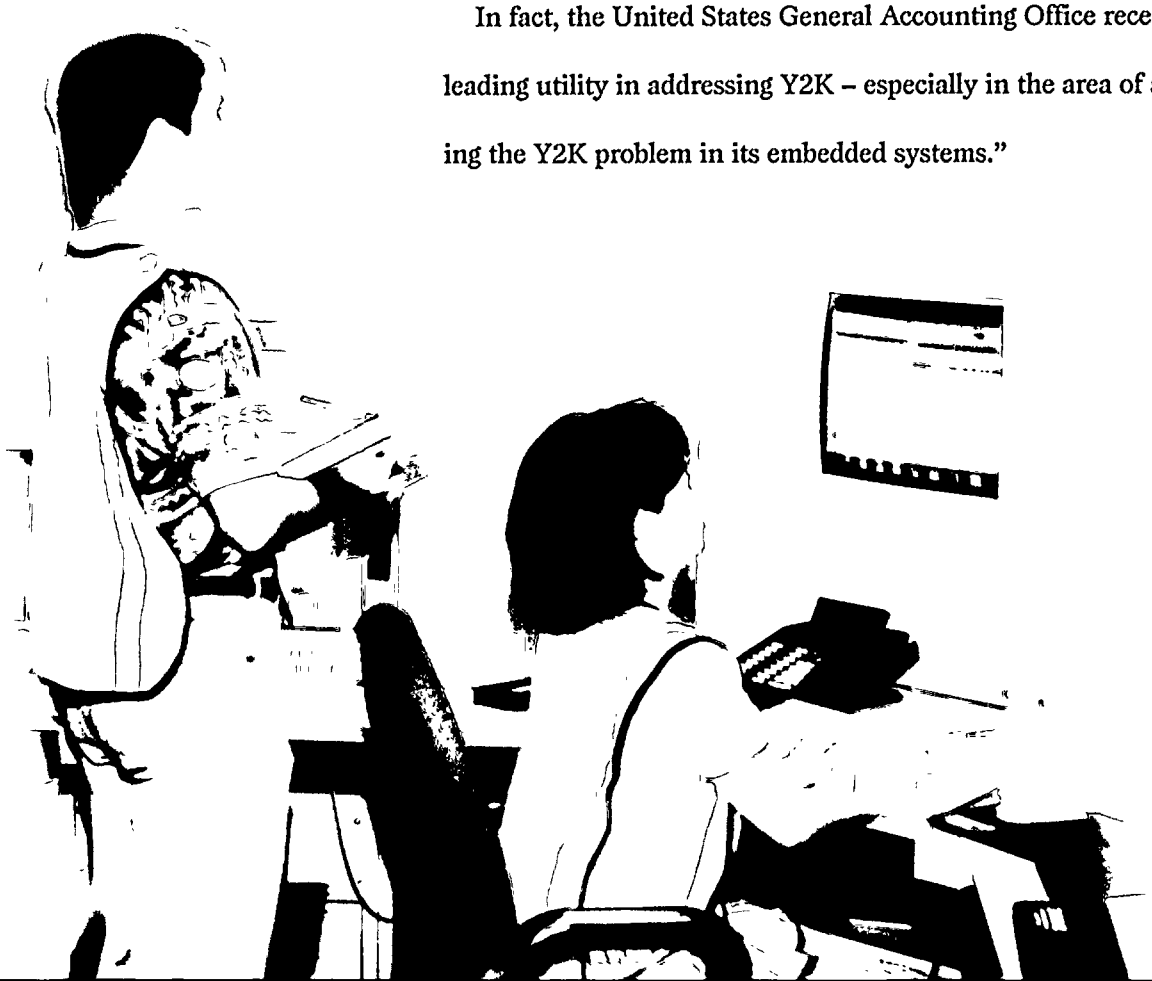
DWP also generated nearly $10 million in new revenue through asset sales and leases. DWP sold four helicopters, downsized its sedan fleet, sold real estate properties and easements, and leased two of its properties.

Preparing for Year 2000: DWP's James Brainerd and his team are working intensively on DWP's Year 2000 (Y2K) Readiness Project. Significant resources have been allocated to this project in an effort to avoid serious business operation failures or customer service delays, dedicating more than 200 Department and contract employees to work on the project.

DWP is confident that its Year 2000 Readiness Project will successfully achieve its goal of having all mission-critical systems ready for the year 2000 by June 30, 1999 – six months ahead of schedule.

In fact, the United States General Accounting Office recently cited DWP "as a leading utility in addressing Y2K – especially in the area of assessing and remediating the Y2K problem in its embedded systems."

Through a process of inventorying, assessment, testing and remediation, the Department's Y2K Project Management Office will ensure the Department's mission-critical systems will be ready for the year 2000 date change by June 1999.



Striving to Meet Customer Needs

DWP is constantly re-evaluating the needs of its customers in an attempt to provide the best service possible in the most convenient manner. In 1997-98, DWP instituted new programs in response to customer needs.

New Payment Options: After identifying customer needs, DWP now offers three new payment methods to better serve customers. In addition to the standard forms of payment by mail – at a branch office and by credit card payment via telephone – DWP now has automatic debit, payment-by-phone and pay-by-internet plans. In response to customer demand, DWP also plans to offer monthly billing by August 1999.

Service Guarantees: Furthering its commitment to its customers, DWP became the first municipal utility in the country to offer customer service guarantees in 1997. DWP and its employees guarantee on-time arrival for all appointments and response to reported service outages within four hours or DWP will provide the customer a $25 credit. "This is something our customers want and something we guarantee to deliver," said Fred Puglia, DWP director of customer service. "It's a bold step for a public utility, but the DWP team is ready to serve," he added.

DWP Service Guarantees

- *We guarantee to arrive on time for scheduled appointments.*
- *We guarantee to notify you at least two business days in advance of any planned service outage lasting longer than two hours.*
- *We guarantee to complete routine service turn-on on the agreed-upon date.*
- *We guarantee to respond to service outage reports within four hours.*
- *We guarantee to respond to temporary shut-off requests within four hours.*
- *We guarantee to fix it if we're at fault for breaking it.*

DWP – Working in Partnership with our Customers

At DWP, we're proving that our customers are our top priority. We adopted the most sweeping customer service guarantees in the utility industry and are forging new partnerships with our business and residential customers.

Whether it was assisting in the development of the new Getty Center or rebuilding California State University, Los Angeles, DWP was there offering innovative and efficient ways to deliver water and electricity.

The Getty Center and DWP – Working Together for A New Era in Los Angeles

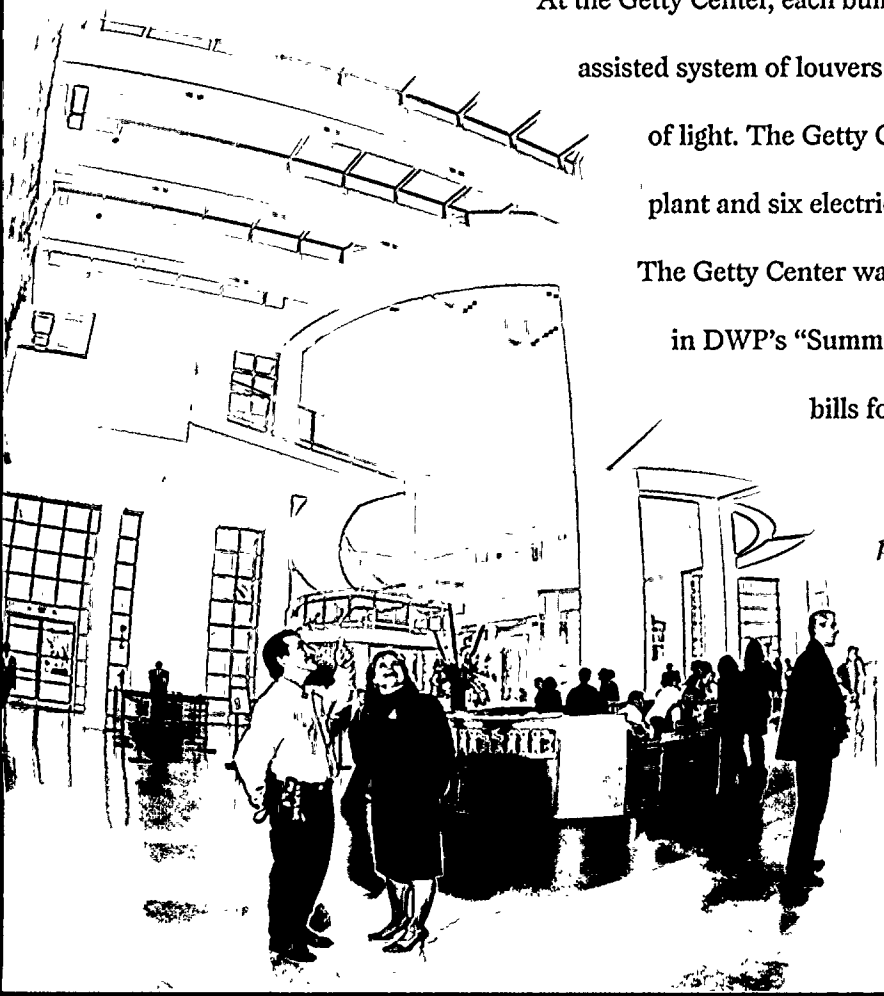
Long before Los Angeles and the rest of the world began to anticipate the opening of the Getty Center in 1997, DWP was helping to design a cutting-edge, energy efficient facility.

At the Getty Center, each building has natural lighting controlled by a computer-assisted system of louvers and shades that adjust the intensity and quality of light. The Getty Center also has a highly efficient central power plant and six electric vehicle charging stations installed by DWP.

The Getty Center was one of the first business customers to participate in DWP's "Summary Bill" pilot program, which consolidated the bills for over 40 accounts into one simple statement.

"The Getty Center looks forward to a continued partnership with DWP, developing creative solutions for the future of Los Angeles," said Dr. Barry Munitz, president and chief executive officer of The J. Paul Getty Trust.

Major Account Representative Heidi Bass visits the Getty Museum where DWP helped design an energy efficient lighting system.



Cal State LA and DWP – Partnership for Efficiency Solutions

Major Account Representative Chris Moser (l.) inspects the thermal storage unit at CSULA.

California State University, Los Angeles (CSULA) was struggling with a major issue not unlike many college campuses in the area. They had an obsolete heating and cooling system that either needed major repairs or total replacement.

CSULA asked DWP for assistance in determining the best way to handle the issue given the limited resources available to the campus. The DWP account team was able to identify cutting-edge technology and secure $2.7 million in DWP incentive funds that enabled CSULA to build a thermal storage unit for heating and cooling the campus buildings.

"DWP's knowledge and support allowed CSULA to identify and build a new thermal storage unit that will operate in an efficient and cost-effective manner for years to come," said Dr. James Rosser, president, CSULA.

Jesse Lord Country Home Bakers – A Family-Owned Manufacturer

Steve Gutenberg (l.) checks on the electric equipment at the Jesse Lord Home Bakers, his major account customer.

Jesse Lord Country Home Bakers, a family-owned business in Los Angeles, wanted to double its wholesale pie sales over the next two years. This major business expansion plan would mean doubling the company's freezing unit capacity.

Exploring both gas and electric equipment options, Jesse Lord selected electric freezing units after DWP account representative John Gutenberger demonstrated that electric equipment was more energy efficient, released fewer pollutants and had lower maintenance costs. Gutenberger was also able to secure DWP incentive funds to help offset the costs of the super-efficient motors.

"I appreciate DWP's ability to work with us in a timely manner, developing efficient ways for our business to grow," said Jesse Rodriguez, general manager of Jesse Lord Country Home Bakers.

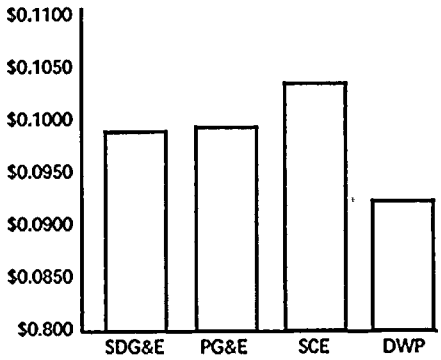
- Revenue Transfer to City General Fund
- Green Power
- Economic Development Initiatives
- Partnering with Law Enforcement
- Precedent-Setting Public Benefits Program
- DWP in the Community

DWP's "Return to Shareholders" – Programs Benefiting the Residents and Businesses of Los Angeles

Unlike investor-owned utilities, DWP is a public utility whose shareholders are the people of Los Angeles. As such, DWP provides many shareholder returns in the form of lower rates and community reinvestment.

Revenue Transfer: In fiscal year 1997-98, DWP honored its commitment to transfer $110.2 million to the city's general fund to support critical municipal services such as libraries, parks and police and fire protection. *"This level of general fund transfer . . . illustrates the willingness of DWP to maintain its commitment to its service area while implementing meaningful cost-cutting measures,"* according to Prudential Securities Municipal Research Department.

How Do DWP Rates Compare?
(cost per Kilowatt Hour)



Green Power: In November of 1998, the Los Angeles City Council unanimously approved a Green Power ordinance that will enable the Department to provide its customers with clean, renewable energy. This is good for the environment, for job creation and for DWP's positioning in a competitive utility marketplace.

Economic Development Initiatives: DWP also embarked on precedent-setting initiatives designed to spur job creation, recruit businesses to the city, and develop the most comprehensive Green Power Program in the country.

The Public Power for Jobs Program, approved by the DWP Commission and pending City Council consideration, will give DWP authority to enter into three-year contracts with new and expanding customers located in the

federally designated empowerment zones.

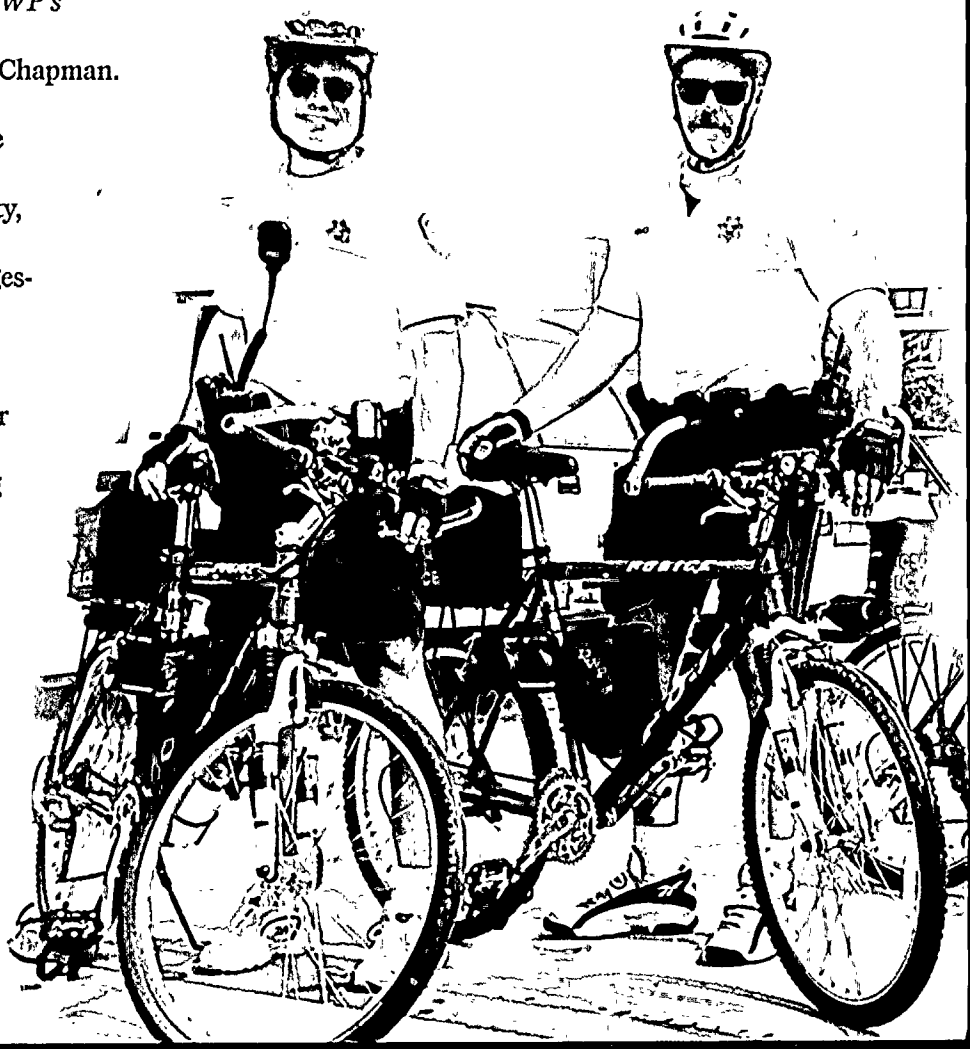
Under the program, DWP will offer low-cost power to empowerment zone businesses that create a new job for every 10 kilowatts of power used. DWP projects that this program could create as many as 20,000 new jobs. DWP also is proposing amendments to the enterprise zone program to offer new and expanding businesses a greater incentive to locate in one of the city's state-designated enterprise zones.

Partnering with Law Enforcement: DWP is providing electric bicycles to campus police units to familiarize customers and the community with electric transportation and to assist law enforcement in doing its job. DWP provided ten electric bicycles to UCLA campus patrol officers.

"The new electric bikes give our officers the ability to respond to situations better because they can get to calls faster, even beating patrol cars to the scene. We're very happy and appreciate DWP's generosity," said UCLA Police Chief Clarence Chapman.

The use of bicycles over patrol cars has the environmental benefits of improved air quality, reduced fuel consumption and less traffic congestion. Electric bicycles have an added benefit because they allow officers to maintain higher speeds over greater distances without exerting as much physical energy.

UCLA's bicycle patrol officers have gone electric with the presentation of a fleet of electric bicycles from DWP.



DWP's Precedent-Setting Public Benefits Program

DWP is proud of its Public Benefits Program, which we believe to be a model program in California. The program represents a continuation of the best of DWP's existing programs, coupled with an exciting array of new activities geared toward the world we live in today.

The DWP Commission and the City Council approved a broad Public Benefits program that earmarked $54.4 million for the following actions:

- *Low-Income Assistance* – Consists of the Department's special rates for low income and lifeline customers, as well as support programs for low-income, at-risk youth, such as the Youth Services Academy – a program jointly administered with the LAUSD.
- *Energy Efficiency* – Delivers "bill reduction" services to all customer classes through investment in proven energy-saving technologies. The portfolio of services include technical assistance, in-home energy analysis; retail discounts for energy efficient lighting; and cash incentives for efficient lighting, space conditioning systems and refrigeration unit maintenance.
- *Renewable Resources* – Wind, solar, geothermal, and other renewable energy resources are receiving tremendous attention at DWP. Because L.A. enjoys so much sunshine, it represents an ideal location for rooftop photovoltaic energy systems. DWP is leading the way in installing these systems.
- *New Technology* – One of the most exciting area of the Public Benefits program is the exploration of new technologies such as battery-powered leaf blowers and lawnmowers, advanced

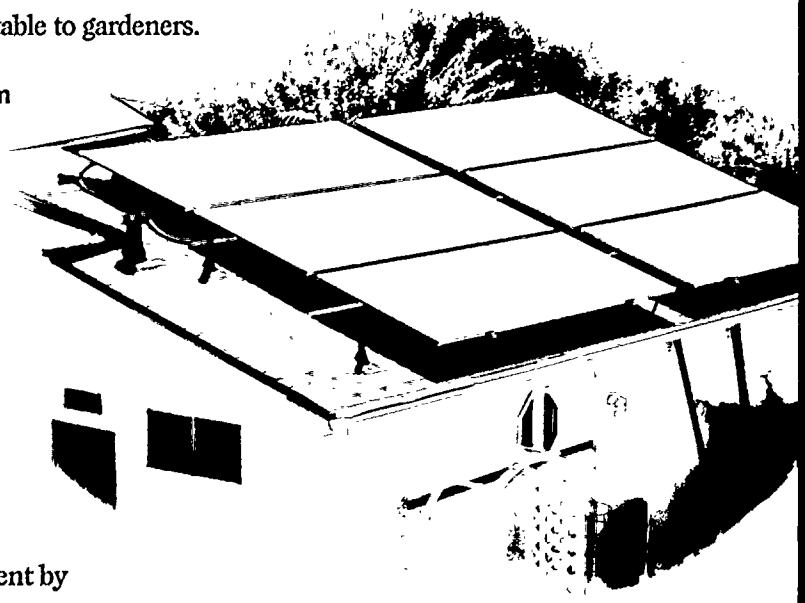
DWP's prototype electric leaf blower is a quiet yet powerful tool to help Los Angeles gardeners comply with new regulations.

lighting sources, electric tolls and electric transportation.

New Technology Demonstration – The Electric Leaf Blower One of the early tangible dividends of the Public Benefits program was the development of a quiet, powerful, zero-emission prototype electric leaf blower that will enable gardeners to continue to work in compliance with city ordinances that ban gasoline-powered models.

DWP and AeroVironment Inc. jointly developed the prototype model in response to a request from City Council for DWP to research and assist in the commercialization of a leaf blower that meets the city's new standards and is acceptable to gardeners.

Renewable Energy Resources – Photovoltaic Rooftop Program DWP is looking for customers who believe that a greener Los Angeles begins at home – literally on top of their home. DWP is partnering with its customers who are interested in installing photovoltaic (PV) systems on the roofs of their homes and businesses to generate clean power for their community at no installation cost.



L.A. residents can help capture the power of the sun by having DWP install photovoltaic panels on their rooftops.

The program benefits DWP customers and the environment by providing a clean source of electricity that helps reduce air pollution and the harmful effects of global warming. It also benefits the city by providing a new source of jobs and economic development.

The PV system operates by converting the energy from radiated light, which is composed of photons, into electricity.

Energy Efficiency – Programs for Small Businesses Small businesses are the backbone of our economy, and the first business group to benefit from DWP's targeted efficiency solutions. DWP staff offers technical assistance in the design of lighting systems, as well as industry-leading incentives for the installation of low-mercury

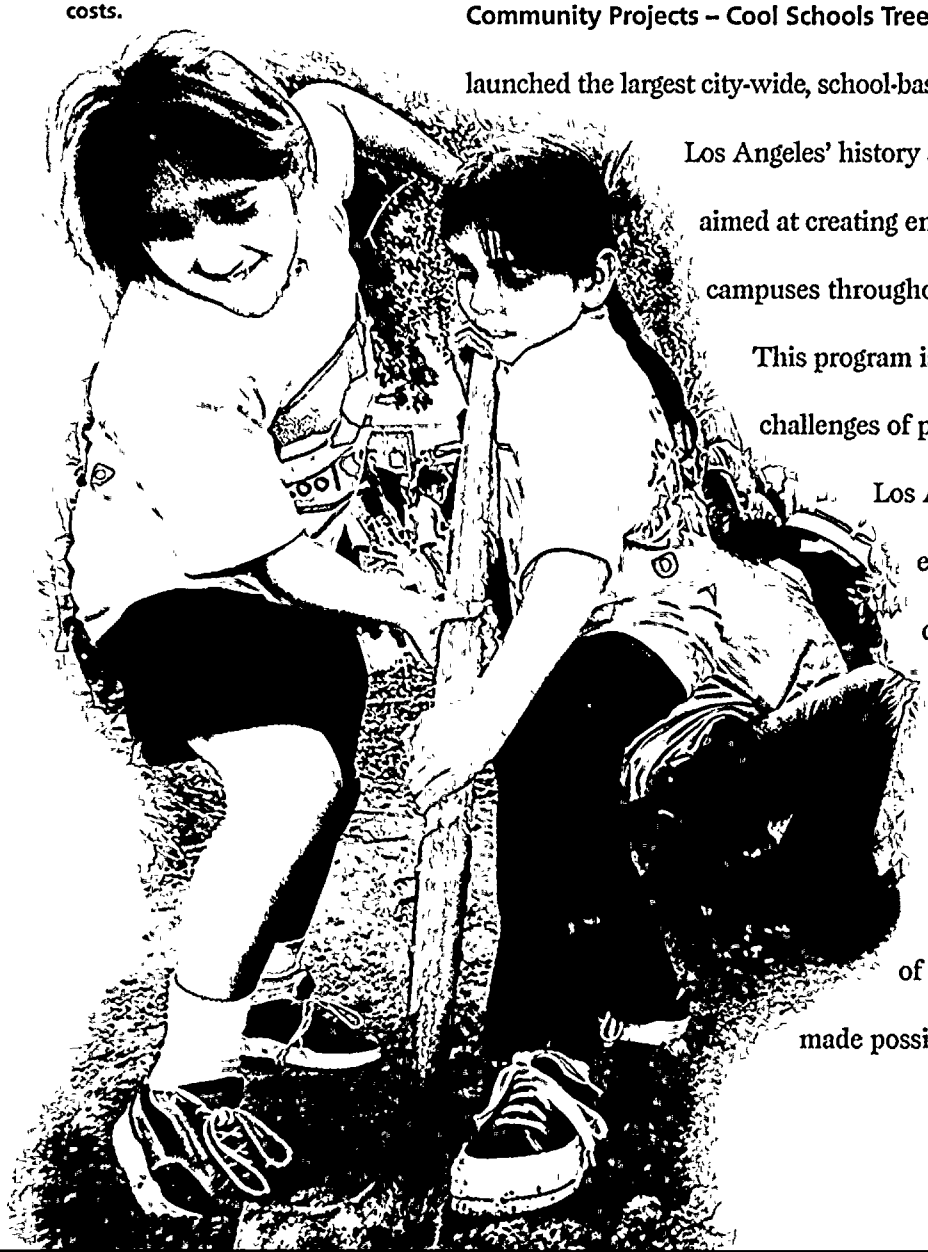
fluorescent lighting. DWP will reimburse customers for disposing of old lamps and ballasts in an environmentally friendly manner.

DWP also offers incentives to replace older, inefficient air conditioners with new, efficient CFC-free models. These new models not only save energy, they help protect our ozone layer from harmful CFCs.

A novel program available only to DWP customers is the refrigeration maintenance program. The cleaning and maintenance services DWP provides for refrigeration units can dramatically reduce the energy used by these appliances. This can have a significant impact on the bottom line for smaller business customers.

Community Projects – Cool Schools Tree Planting Program The Department launched the largest city-wide, school-based community tree planting program in Los Angeles' history as part of a new Cool Schools effort. It is aimed at creating energy-efficient, environmentally friendly campuses throughout the Los Angeles Unified School District. This program is an innovative approach to addressing the challenges of providing more comfortable classrooms for Los Angeles public school students, lowering energy bills for the district and improving air quality for residents. More than 4,000 trees will be planted at 42 LAUSD schools throughout the first year of the program.

The Cool Schools program is also coordinated with the school district's installation of air conditioning and asphalt resurfacing made possible by voter-approved Proposition BB fund.



Students get a hands-on lesson that planting trees around school buildings can reduce air conditioning costs.

Supporting Electric Transportation DWP also is spearheading Quick Charge L.A., a program to establish or upgrade electric vehicle charging stations at nearly 200 public and private locations. DWP is working with community partners to install an increasing number of charging stations in the city to demonstrate that electric vehicles are viable and useful to a growing number of consumers and businesses.

In 1998, Kaiser Permanente Woodland Hills Medical Center celebrated the opening of its electric vehicle charging stations. EV drivers can now charge their zero-tail-pipe-emission vehicles in the Woodland Hills Medical Center parking structure, free of charge. Other Kaiser Permanente medical centers that have or will install charging stations include the Kaiser Sunset, West Los Angeles, Panorama City and Harbor City locations.

The Quick Charge L.A. program, sponsored by DWP, received both the Governor's Environmental and Economic Leadership Award, and the 1998 SCAQMD Clean Air Award for Model Community Achievement.

With more than 200 charging stations DWP has installed across the city, L.A. residents can charge their electric vehicles free of charge while they bank, dine, work or play.

DWP in the Community

"We're L.A.'s Home Team, Too": This slogan is not only the theme of DWP's partnership with the Los Angeles Dodgers, but it is the guiding principle for our work in the community as the public utility for the City of Los Angeles.

Becoming an essential part of this city's fabric is what DWP is all about. That is why DWP supports so many community events throughout the year, with a special emphasis on our city's youth.

DWP's role in these events varies from serving as a sponsor, to contributing volunteers or providing electricity. We strive to do whatever we can to make Los Angeles a better place to live and work.

Some of the events we supported this year

Los Angeles Dodgers Partnership: As a major sponsor of the Dodgers 1998 baseball season, DWP created two community events linked to the Dodgers organization.

The Scholar Athlete of the Week program was a unique partnership between the Los Angeles Unified School District, the Dodgers and DWP in which student athletes from local high schools received recognition for their outstanding performance in the classroom and on the field. Students were selected weekly and were profiled in radio ads, honored with plaques and recognized on the Dodger Stadium field before cheering, sell-out crowds. Power Hitters brought together the Manny Mota Foundation, Los Angeles Parks and Recreation Department, L.A. Kids,

the Dodgers and DWP for three community events in which kids from all across the city shared in a rare opportunity to receive baseball tips directly from Dodger players. Children aged 7-13 competed for the chance to hit a baseball at Dodger Stadium.

Among our community outreach programs, employees are active in DWP's 11 adopted schools.

Adopt-A-School: This year, DWP employees spent hundreds of volunteer hours augmenting and improving the curriculum at one of 11 schools DWP has "adopted" through the Los Angeles Unified School District's Adopt-A-School program. DWP employees bring their individual areas of expertise to the classroom and help improve the learning experience for Los Angeles' students.

Science Bowl: The Department is a long-time sponsor of the DWP Science Bowl, a regional competition in which local high school students answer questions covering a wide range of scientific, mathematical and technological subjects. Students compete to win a trip to the National Science Bowl sponsored by the U.S. Department of Energy. More than 200 students in 42 teams from 26 schools competed in this year's Science Bowl with North Hollywood High School placing second in the national finals. This follows national championships won by DWP teams Van Nuys High School in 1995 and Venice High School in 1996 and 1997.

The DWP-sponsored Science Bowl team from North Hollywood High School took second place in the national competition.

- Infrastructure Improvements
- Water Quality Improvements
- Fluoridation System Infrastructure
- State Leader on THM Issue

Water Services Activities

In 1998, DWP celebrated the 85th Anniversary of the Aqueduct, designed by William Mulholland, DWP's first general manager. The availability of fresh, clean water was critical to the growth and development of Southern California. At the time the first water was delivered to Los Angeles, the city's population was around 320,000. Eighty-five years hence the city has 3.7 million residents, and the aqueduct continues to serve most of the city's water needs.

DWP delivers water every day, whenever and wherever it is needed within our 465-square-mile service area. Water for Los Angeles is imported from several hundred miles away and pumped from hundreds of feet below ground. It is carried to homes and businesses via a network of pipes that, if laid in a straight line, would stretch from Los Angeles to New York, back to Los Angeles and then to Denver.

Infrastructure Improvements: In the coming decade, DWP plans to invest more than $2 billion to improve reliability and safeguard the water supply for Los Angeles. Time has caught up with the city's infrastructure, and new federal water quality regulations will require significant system improvements. Cost-effective, long-range programs are necessary to rehabilitate and improve these facilities. On a parallel track, DWP will add a greater margin of safety to the water supply by building new treatment plants and instituting more comprehensive monitoring programs to ensure all water in Los Angeles continues to comply with new and anticipated water quality regulations.

DWP's 7,100-mile water distribution system is made up of trunk lines, mains, services, and meters, some of which are 50 to 90 years old. DWP expects to invest more than $150 million for major trunk line replacements; $310 million for main

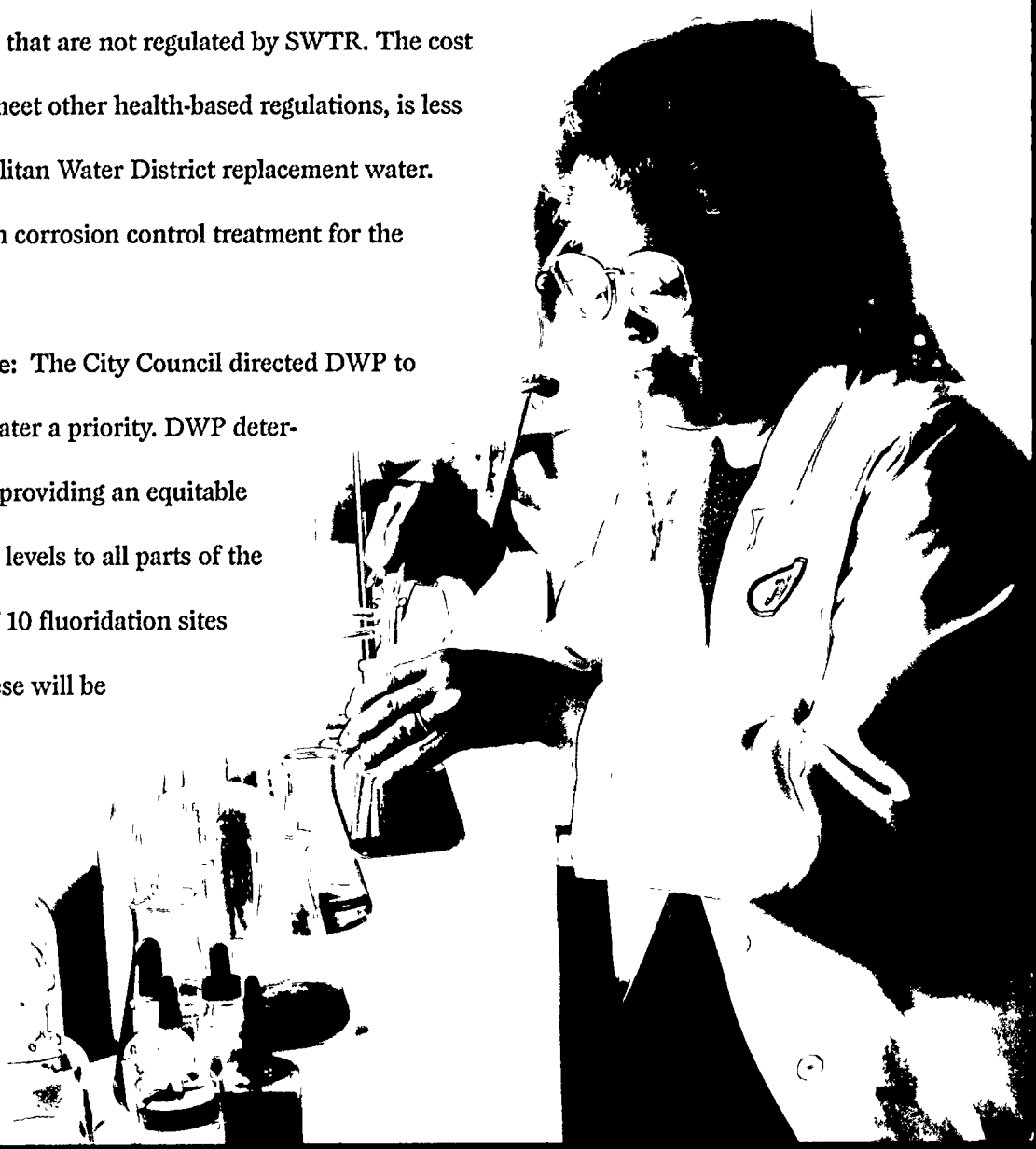
replacements; and $200 million for service line and meter replacements. Most of this work began this fiscal year and will continue beyond 2004. Failure to replace these older facilities will result in increased vulnerability to outages, and higher operation and maintenance costs.

Water Quality Improvements: DWP's water quality improvements make up the majority of the capital program expenditures in response to recent increased drinking water standards. The program also calls for infrastructure projects that have significant water quality benefits.

DWP is working to bring four open storage reservoirs into compliance with the Surface Water Treatment Rule (SWTR), and will make water quality improvements at open reservoirs that are not regulated by SWTR. The cost for these improvements, which meet other health-based regulations, is less than the current cost of Metropolitan Water District replacement water. Additional funds will be spent on corrosion control treatment for the new Lead and Copper Rule.

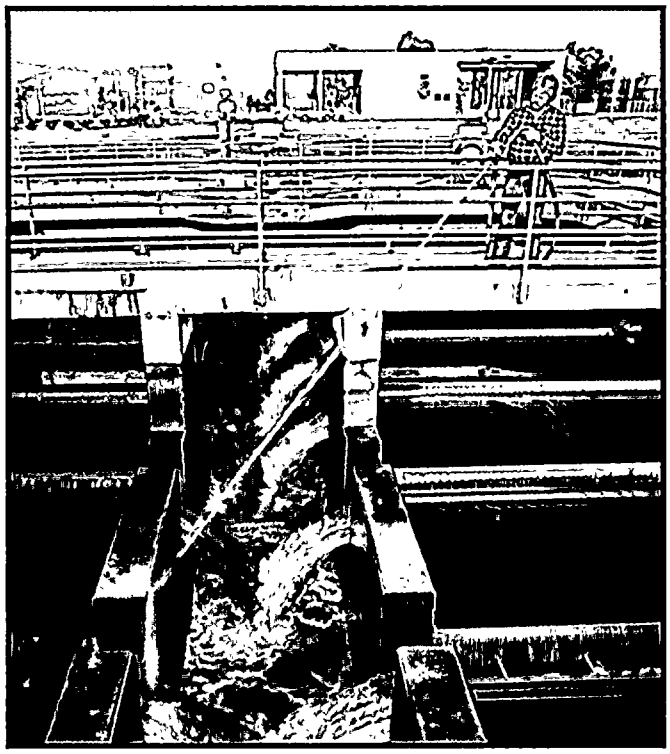
Fluoridation System Infrastructure: The City Council directed DWP to make fluoridation of the city's water a priority. DWP determined the cost and feasibility of providing an equitable distribution of optimum fluoride levels to all parts of the city. DWP began construction of 10 fluoridation sites throughout the city in 1998. These will be completed in winter 1999. The costs for this three-year program will be managed within the

DWP water is consistently tested to ensure a safe supply.



current water rate, so this added health benefit will not increase customer water rates. The Department of Health Services and the dental community endorse DWP's water fluoridation program.

State Leader on THM Issue: In February 1998, the California Department of Health Services released the results of a study that found a link, albeit weak, between a disinfectant by-product, trihalomethanes (THM), in tap water and increased risk of miscarriages during the first trimester of pregnancy.



DWP remains a leader in the water utility industry and is committed to maintaining high quality water for Los Angeles.

The DWP, as one of the state's largest water suppliers, took a leadership position, developing a comprehensive communications plan to reach out to its customers with direct, practical and localized information on this important issue. The Department briefed the City Council and the media, in addition to expanding the hours of its Water Quality Hotline for consumers. DWP's technical staff continues to provide leadership statewide and nationally on this important issue.

Environmental Achievements

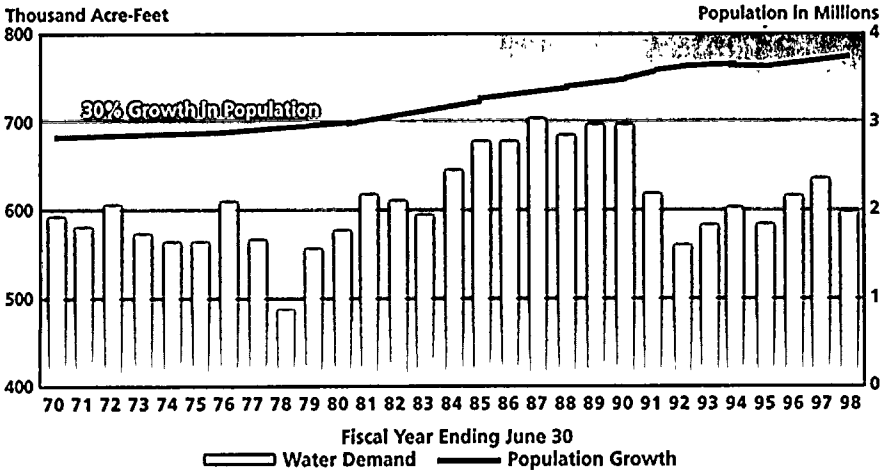
- Owens Valley Settlement
- Water Conservation

Owens Valley Settlement: The City of Los Angeles and the Great Basin Unified Air Pollution Control District reached a historic settlement that resolved a long-standing conflict regarding the Owens Valley. This historic pact commits the city to reducing dust from Owens Lake, complying with the Federal Clean Air Act by the 2006 deadline. It is part of a series of actions in which the City of Los Angeles and DWP have taken positive steps to resolve decades of hostility between the city and its neighbors in parts of the state that provide much of the city's water supply.

Water Conservation: DWP leads the nation in water conservation efforts through its ultra-low-flush toilet program. This program saves enough water each year to fill the LA Reservoir, the largest in Los Angeles. Since 1990, more than 750,000 toilets have been delivered, free of charge, to DWP customers through a partnership with local community-based organizations.

DWP has made progress in resolving conflicts in the Owens Valley, source of most of the city's water supply.

Los Angeles Water Demand and Population Growth (in acre-feet)



- Wholesale Energy Marketing
- Preparing for El Niño
- Most Skilled Electric Crews in the World

Energy Services Activities

Fiscal year 1997-98 was an exciting and challenging year for the electric utility industry. This year signaled a dramatic change in the way energy will be bought and sold in California. With the onset of deregulation, DWP's Energy Services operation demonstrated the type of system reliability, revenue generation and customer service that will enable the Department to be a fierce competitor in the new marketplace.

Net income nearly doubled from $163.5 million for fiscal 1996-97, to $328.1 million for fiscal 97-98. The increase was due to an increase in energy sales, growth in the Southern California economy and gain from a rate restructuring of natural gas contracts.

Since 1917, DWP has provided energy to meet the needs of a growing city. Today, DWP supplies electricity to 1.37 million customers in the City of Los Angeles. Residents of the city always have benefited from lower rates. DWP residential rates are still 10 to 15 percent lower than the state's investor-owned utilities (IOUs), despite the IOUs 10 percent deregulation reduction. The good news for DWP residential customers is that they will continue to enjoy lower electric rates because DWP has frozen the rates until 2002. At that time, DWP will reduce rates by five percent. DWP's commercial and industrial rates will continue to be competitive. The Department will continue to offer a host of services and options to help businesses increase their bottom line by reducing energy costs.

The Department's energy mix includes sources from hydro, nuclear, coal and natural gas-fired thermal generation sources. Beginning this year, DWP will offer customers the choice of purchasing energy from environmentally friendly, renewable sources. These sources of energy, while in part purchased from outside sources, will be delivered to customers over the Department's highly reliable and well-maintained network of

transmission and distribution lines. DWP's transmission and generation systems have proven to be valuable assets in the emerging wholesale energy market.

Wholesale Energy Marketing: In preparing for competition, the Department is on course with the General Manager's Action Plan that includes extensive cost reduction and creation of new revenue sources. DWP's Wholesale Marketing group is causing a ripple of excitement in generating new revenues from marketing surplus energy and energy services.

Wholesale Marketing is a combined effort of the generation, transmission and marketing units of the Department. It allows DWP to tap into the value of its extensive generation and transmission assets to generate new revenues. While the DWP service area is not yet open to retail competition, DWP actively participates in the wholesale energy market.

The operational mission of the Wholesale Marketing organization is to develop the lowest cost supply of energy to serve retail customers, and to optimize the return on investment of generation and transmission assets by selling surplus energy and services. Skilled energy traders purchase energy when market prices are lower than the production costs of DWP resources. Energy traders sell surplus energy when market prices are higher than DWP production costs, and at times purchase inexpensive energy for resale.

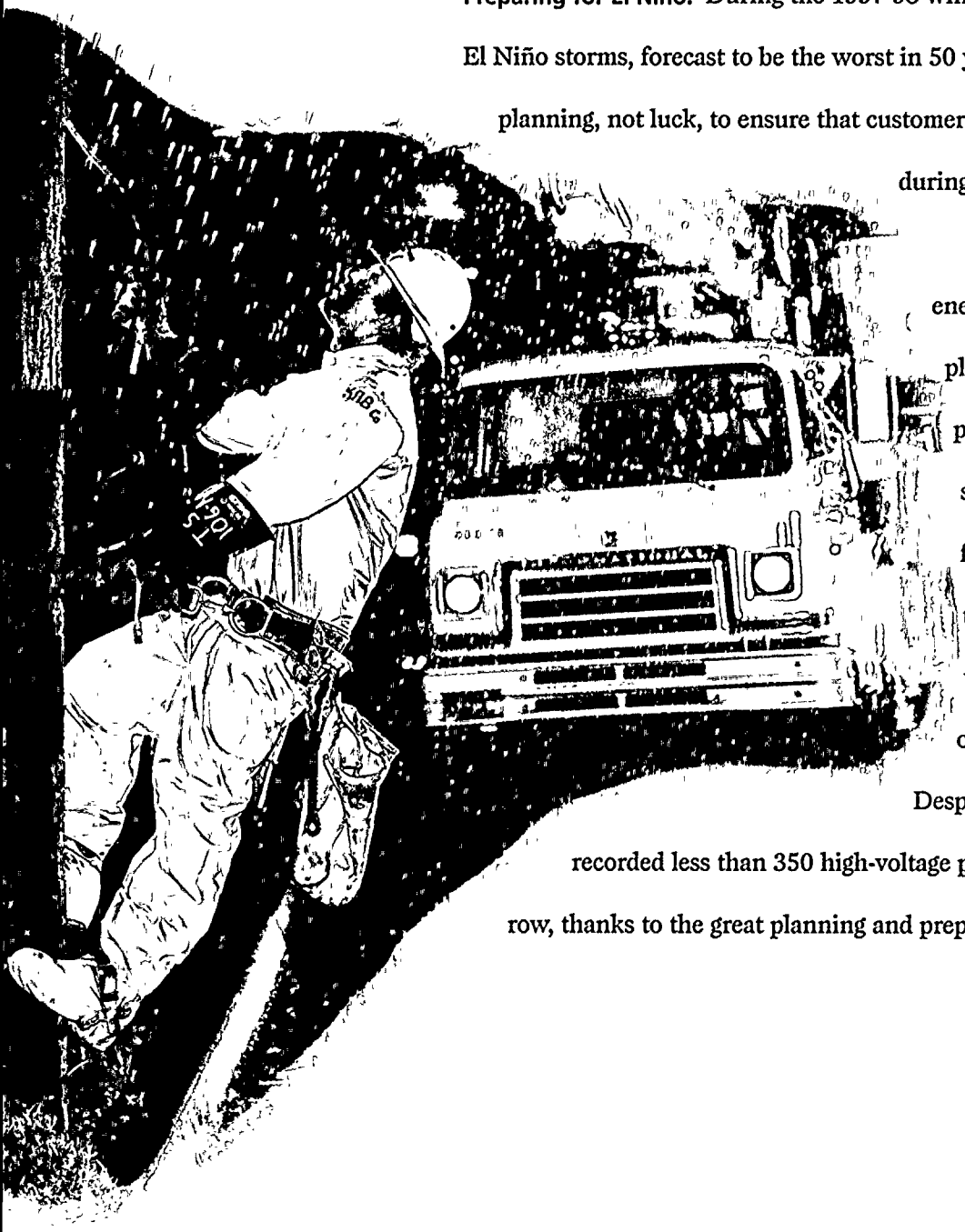
The Wholesale Marketing group's performance has been impressive, with estimated revenues for FY 98/99 of $130 million. This performance is close to 200 percent higher than wholesale sales revenues produced the previous year. The group plans several enhancements to the wholesale marketing program and is expecting continued record financial performance in the coming years.

DWP – Providing Reliable Service

Preparing for El Niño: During the 1997-98 winter, Los Angeles prepared itself for El Niño storms, forecast to be the worst in 50 years. DWP knew that it would take planning, not luck, to ensure that customers would experience minimal outages during the rains.

Bob Spease, DWP director of energy distribution, and his team began planning in early 1997. Knowing that power outages occur when windstorms tear down trees and transformers, Spease directed DWP crews to work overtime to ensure trees were trimmed and extra materials ordered to minimize outages.

Despite abnormally large storms, DWP recorded less than 350 high-voltage power outages for the 10th year in a row, thanks to the great planning and preparation of the Department.



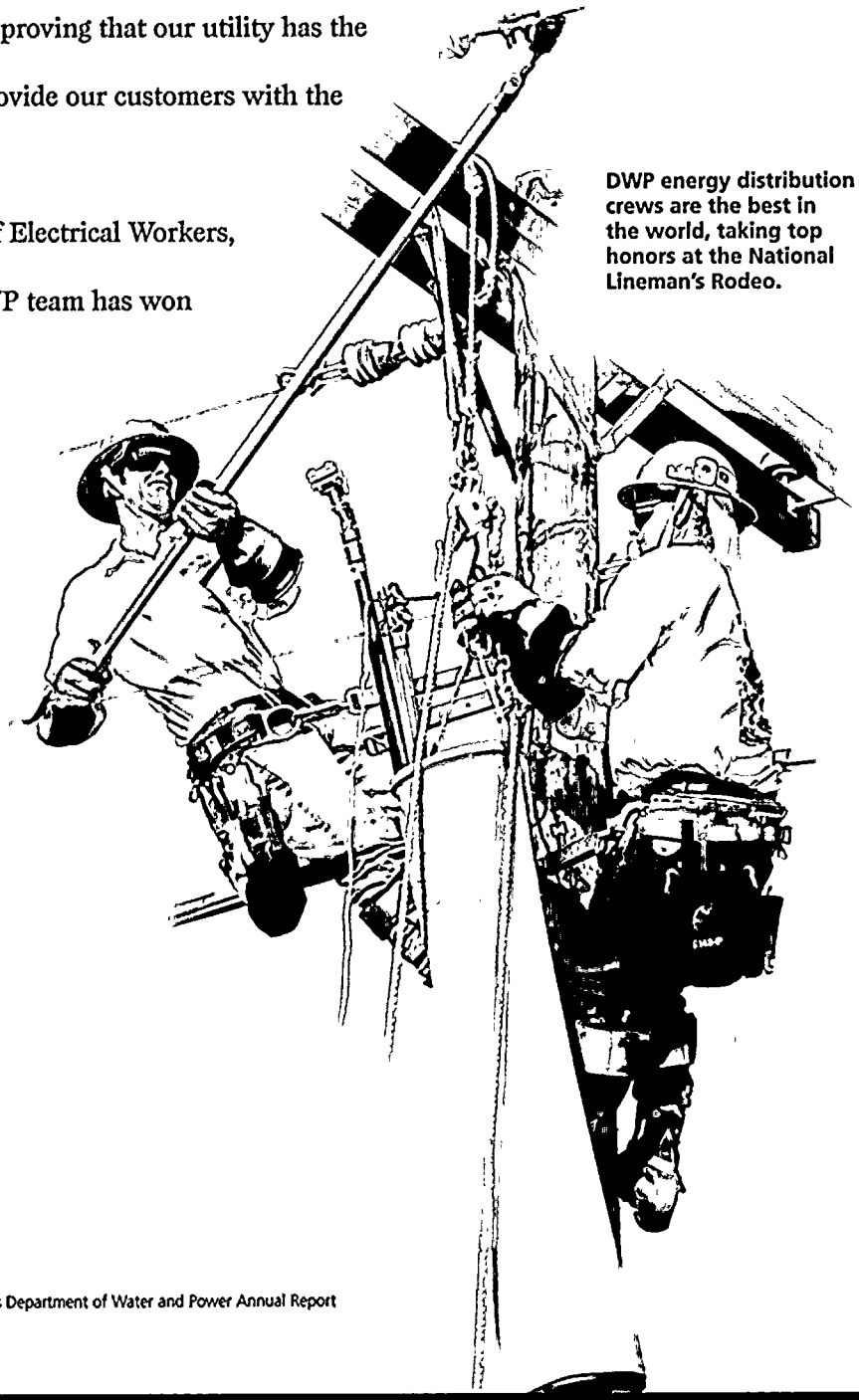
During the series of El Niño storms, DWP power crews kept the lights on for millions of L.A. residents.

DWP has the Most Skilled Electric Crews in World: DWP's utility repair team placed first at the 15th Annual International Lineman's Rodeo in Kansas City, MO, after qualifying at the Southern California regional event in June.

The Lineman's Rodeo challenges electric crews to test their skills while competing against their peers. The competition includes climbing power poles, changing out pole equipment, rescuing an injured person on a power pole, splicing ropes and much more.

"DWP is very proud of our team's success, proving that our utility has the best electric repair crews in the world who provide our customers with the best possible repair service," said Spease.

DWP and the International Brotherhood of Electrical Workers, Local 18, sponsored this year's team. The DWP team has won numerous awards over the years, including winning first place twice in the municipality category. This year's award distinguished DWP as the top overall team, internationally, for all categories.



DWP energy distribution crews are the best in the world, taking top honors at the National Lineman's Rodeo.

1997 – 1998 Financial Statements

Water Services

Balance Sheet

Statement of Income

Statement of Retained Income Reinvested in the Business

Statement of Cash Flows

Notes to Financial Statements

Energy Services

Balance Sheet

Statement of Income

Statement of Retained Income Reinvested in the Business

Statement of Cash Flows

Notes to Financial Statements

Water Services Balance Sheet, as restated

(In Thousands)	June 30, 1998	1997
ASSETS		
Utility Plant		
Source of water supply	$ 282,995	$ 276,260
Pumping	163,774	160,363
Purification	195,237	186,753
Distribution	1,991,160	1,889,535
General	304,221	287,813
	2,937,387	2,800,724
Accumulated depreciation	1,011,476	941,059
	1,925,911	1,859,665
Construction work in progress	161,740	140,307
	2,087,651	1,999,972
Restricted Investments	142,554	154,580
Current Assets		
Cash and cash equivalents	83,185	102,366
Cash collateral received from securities lending transactions	27,964	35,227
Customer and other accounts receivable, net of $5,400 and $7,250 allowance for losses	62,272	59,967
Due from Energy Services	10,278	14,426
Accrued unbilled revenue	35,928	40,834
Materials and supplies, at average cost	17,978	12,093
Prepayments and other current assets	71,585	8,841
	309,190	273,754
	$ 2,539,395	$ 2,428,306
CAPITALIZATION AND LIABILITIES		
Equity		
Retained income reinvested in the business	$ 890,222	$ 844,270
Contributions in aid of construction	550,214	533,009
	1,440,436	1,377,279
Long-term Debt	652,641	668,409
Advance Refunding Bonds	138,676	153,100
	2,231,753	2,198,788
Current Liabilities		
Debt due within one year	18,400	15,430
Accrued interest	13,120	14,267
Accounts payable and accrued expenses	165,043	90,003
Obligations under securities lending transactions	27,964	35,227
Overrecovered costs	43,488	34,849
Customer deposits	39,627	39,742
	307,642	229,518
Commitments and Contingencies (see Note 8)		
	$ 2,539,395	$ 2,428,306

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

Water Services Statement of Income, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Operating Revenues			
Residential	$ 159,407	$ 168,643	$ 166,627
Commercial and industrial	240,168	224,930	230,477
Other	25,475	24,698	25,772
	425,050	418,271	422,876
Operating Expenses			
Purchased water	40,719	35,530	47,285
Other operating expenses	148,771	137,181	108,908
Maintenance	65,098	63,156	65,190
Depreciation	65,362	61,881	58,730
	319,950	297,748	280,113
Operating Income	105,100	120,523	142,763
Other Income and Expenses, Net	10,594	8,554	14,650
	115,694	129,077	157,413
Debt Expenses			
Interest on debt	45,738	48,532	48,417
Allowance for funds used during construction	(1,910)	(1,907)	(1,213)
	43,828	46,625	47,204
Net Income	$ 71,866	$ 82,452	$ 110,209

Statement of Retained Income Reinvested in the Business, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Balance at beginning of year	$ 844,270	$ 782,962	$ 693,000
Net income for the year	71,866	82,452	110,209
Less - Transfers to the reserve fund of the City of Los Angeles	25,914	21,144	20,247
Balance at end of year	$ 890,222	$ 844,270	$ 782,962

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

Water Services Statement of Cash Flows, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Cash Flows from Operating Activities:			
Operating income	$ 105,100	$ 120,523	$ 142,763
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation	65,362	61,881	58,730
Provision for losses on customer and other accounts receivable	3,595	1,522	8,161
Other	(957)	(1,855)	8,099
Changes in assets and liabilities:			
Customer and other accounts receivable	(6,553)	14,114	(10,098)
Due from Energy Services	4,148	3,239	3,870
Accrued unbilled revenue	4,906	3,480	(6,343)
Materials and supplies	(5,885)	3,451	(1,321)
Prepayments and other current assets	(62,744)	588	7,442
Accounts payable and accrued expenses	70,040	7,510	3,255
Overrecovered costs	8,639	15,820	(9,842)
Customer deposits	(115)	(4,429)	712
	185,536	225,844	205,428
Cash Flows from Noncapital Financing Activities:			
Payments to the reserve fund of the City of Los Angeles	(20,914)	(21,144)	(26,247)
Cash Flows from Capital and Related Financing Activities:			
Additions to plant and equipment	(151,131)	(163,802)	(157,816)
Contributions in aid of construction	17,205	26,275	21,773
Proceeds from escrow investment maturities	14,742	16,341	43,304
Principal payments and maturities on long-term debt	(27,222)	(29,912)	(56,403)
Debt interest payments	(54,581)	(48,661)	(49,874)
	(200,987)	(199,759)	(199,016)
Cash Flows from Investing Activities:			
Cash collateral received under securities lending transactions	7,263	(35,227)	–
Obligations under securities lending transactions	(7,263)	35,227	–
Investment income	17,184	8,183	7,625
	17,184	8,183	7,625
Cash and Cash Equivalents:			
Net decrease	(19,181)	13,124	(12,210)
Beginning of year	102,366	89,242	101,452
	$ 83,185	$ 102,366	$ 89,242

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

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Department – 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. 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 generally accepted accounting principles applicable to governmental utilities. 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 which are not in conflict with statements issued by the GASB. The accounting records generally follow the Uniform System of Accounts for Public Utilities and Licensees prescribed by the California Public Utilities Commission (CPUC), except for the method of accounting for contributions in aid of construction described below.

The Department's rates are subject to review and approval by the City Council. As a regulated enterprise, the Department's financial statements are prepared in accordance with Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (SFAS 71), which requires that the effects of the ratemaking process be recorded in the financial statements. Such effects primarily concern the time at which various items enter into the determination of net income in order to follow the principle of matching costs and revenues. Accordingly, Water Services records various regulatory assets and liabilities to reflect the regulator's actions. Management believes that Water Services meets the criteria for continued application of SFAS 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 generally accepted accounting principles 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.

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 operation and maintenance expense accounts. The original cost of property retired, plus removal cost, less salvage, is charged to accumulated depreciation.

Depreciation – Depreciation expense is computed using the straight-line method based on service lives. Estimated service lives range from 5 to 70 years. Depreciation expense as a percentage of average depreciable utility plant in service was 2.6%, 2.7% and 2.7% for fiscal years 1998, 1997 and 1996, respectively.

Cash and cash equivalents – The Department's cash is deposited with the City Treasurer in the City's general investment pool. The City Treasurer invests available funds of the City and its independent operating departments on a combined basis. At June 30, 1998 and 1997, cash and cash equivalents included $12 million of internally-designated balances relating to bond redemption and interest funds and a self-insurance fund. The Department considers all unrestricted investments with an original maturity of three months or less to be cash equivalents.

Restricted investments – Restricted escrow investments are held to call revenue bonds at scheduled maturity dates.

Contributions in aid of construction – Under the provisions of the City Charter, amounts received from customers and others for constructing utility plant are combined with retained income reinvested in the business and represent equity for purposes of computing Water Services' borrowing limits. Accordingly, contributions in aid of construction are shown in the accompanying balance sheet as a component of equity.

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 and include amounts resulting from a cost adjustment formula designed to permit the full recovery of purchased water and other expenditures specifically approved for inclusion by rate ordinance. The Department is also authorized to collect certain demand-side management and water reclamation expenditures, and expenditures to upgrade water quality and to improve facilities to meet State and Federal water quality standards, including related debt service; a substantial part of these revenues relate to billings for water reclamation and water quality expenditures and are dedicated to those capital projects. The Department estimates these costs to establish the cost recovery component of customer billings and any difference between billed and actual costs, resulting in over or underrecovery of such costs, is adjusted in subsequent billings.

Debt expenses – Debt premium, discount and issue expenses are deferred and amortized to expense over the lives of the related debt issues. Premiums, discounts and issue expenses related to bonds redeemed by advance refunding bonds are amortized over the life of the advance refunding bonds.

Allowance for funds used during construction – AFUDC represents the cost of borrowed funds used for the construction of utility plant. Capitalized AFUDC is shown as part of the cost of utility plant and as a reduction of debt expenses. The average AFUDC rate was 6.4% for each of the fiscal years 1998, 1997 and 1996.

Reclassification – Certain financial statement items for fiscal years 1997 and 1996 have been reclassified to conform to the 1998 presentation.

NOTE 2: ACCOUNTING CHANGES

Pensions – On July 1, 1997, the Department adopted GASB Statement No. 27 (GASBS 27), *Accounting for Pensions by State and Local Government Employers.* This statement establishes standards for measurement, recognition and disclosure of pension information in the financial statements.

Investments – On July 1, 1997, the Department adopted GASB Statement No. 31 (GASBS 31), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* This statement applies to the Department's cash and cash equivalents and restricted investments and requires that investments be reported at fair value. All investment income, including changes in fair value, are included in Other Income and Expense. Prior to the adoption of GASBS 31, cash and investments were reported at amortized cost.

Securities Lending Transactions – On July 1, 1997, the Department adopted GASB Statement No. 28 (GASBS 28), *Accounting and Financial Reporting for Securities Lending Transactions.* This statement requires that cash received as collateral on securities lending transactions and the related obligations be reported on the balance sheet. The Department participates in securities lending through its deposits with the City Treasurer and records its share of cash collateral received by the City's pooled investment fund based on a pro rata allocation of its funds on deposit compared to the total pool. The Department has adopted GASBS 28 retroactive to July 1, 1996, the date at which the City began allocating income from securities lending to participants in the fund.

Effect of Adoption – The Department restated prior year financial statements to retroactively apply GASBS 27 and GASBS 31. The cumulative effect of adoption of GASBS 27 and GASBS 31 resulted in a $6 million decrease to Retained Income Reinvested in the Business effective July 1, 1995, including $2 million and $4 million related to the adoption of GASBS 27 and GASBS 31, respectively.

The adoption of GASBS 27 and GASBS 31 also resulted in a restatement of prior year net income as follows (amounts in millions):

	Year ended June 30, 1997	1996
Net income, as previously reported	$ 89,149	$ 119,881
Adoption of GASBS 27	(8,645)	(9,154)
Adoption of GASBS 31	1,948	(518)
	(6,697)	(9,672)
Net income, as restated	$ 82,452	$ 110,209

The adoption of GASBS 28 required no restatement of net income as the Department recorded its allocation of income related to securities lending as part of its investment income in the prior year. The adoption of GASBS 27 and GASBS 31 also resulted in fiscal year 1998 net income of $48 million more than would have been reported under the Department's prior accounting policies, including approximately $45 million and $3 million related to the adoption of GASBS 27 and GASBS 31, respectively.

NOTE 3: SECURITIES LENDING TRANSACTIONS

The City Treasurer's investment policy for its general investment pool (the Pool) includes a securities lending program (the Program) which was approved by the City Council on October 28, 1991. The City's custodial bank serves as the securities lending agent and indemnifies the City from losses incurred as a result of its operational failure, its failure to carry out adequate credit analysis and/or insufficient collateralization of the loaned securities. The City does not have the ability to pledge or sell collateral assets unless the borrower is in default of its obligation.

Under the Program, up to 50% of the par value of pooled investments are available for loan on a short-term basis. Collateral, which is limited to cash, U.S. Treasury certificates and non-callable U.S. Government Agency securities, must be at least equal to 102% of the market value of the loaned securities as of the loan initiation date; in addition, matched maturities, which include investments associated with term loans and overnight investments associated with open loans, must represent at least 75% of securities loaned under the Program.

The Department recognizes its proportionate share of the fair value of cash collateral received for securities loaned and the related obligation. At June 30, 1998, there is no credit risk exposure for the Department because the amounts owed to the borrowers by the Pool exceed the amounts the borrowers owe to the Pool.

NOTE 4: LONG-TERM DEBT AND ADVANCE REFUNDING BONDS

Long-term debt and advance refunding bonds consisted of the following (amounts in millions):

Maturing In Fiscal Year	Effective Interest Rate	June 30, 1998	1997
1998	4.1% - 7.8%	$ -	$ 15
1999 - 2003	4.9% - 7.2%	109	123
2004 - 2008	5.1% - 7.2%	141	148
2009 - 2013	5.1% - 7.2%	157	158
2014 - 2018	5.3% - 7.2%	147	144
2019 - 2023	5.3% - 7.2%	119	116
2024 - 2028	5.3% - 7.1%	91	91
2029 - 2033	5.3% - 7.1%	53	51
2034 - 2035	6.3%	3	3
	Total principal amount	820	849
Unamortized premium and discount		(11)	(12)
Long-term debt due within one year		(18)	(15)
		$ 791	$ 822
Escrow funds available to call certain of the above bonds at scheduled crossover dates		$ 143	$ 155

Long-term debt outstanding at June 30, 1998 consisted of revenue bonds due serially in varying annual amounts through 2035. The revenue bonds generally are callable ten years after issuance. Scheduled annual principal maturities during the five years following June 30, 1998 are $18, $20, $22, $24 and $25 million, respectively. Revenue bonds are secured by the future revenues of Water Services.

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.

During fiscal year 1998, bonds with a par value of $15 million were refunded using proceeds from the balance in the restricted escrow investments. The remaining escrow investments of $143 million will be used to refund bonds presently included in long-term debt with a par value of $140 million at scheduled crossover dates. The balance of $139 million of advance refunding bonds will be reclassified to long-term debt at the time that the bonds to be refunded are called. Interest expense from refunding bonds and interest income earned on related escrow investments are included in Other Income and Expense.

Fair Value – The fair value of long-term debt and advance refunding bonds is $826 and $912 million at June 30, 1998 and 1997, respectively. Management has estimated fair value based on the present value of interest and principal payments on the long-term debt and advance refunding bonds, discounted using current interest rates obtainable by the Department for debt of similar quality and maturities.

NOTE 5: STAFF REDUCTION PROGRAM

During fiscal year 1998, the Board of Water and Power Commissioners (the Board of Commissioners) approved a Staff Reduction Program (the SRP) offering monetary compensation or enhanced retirement benefits to the Department's employees. The SRP included an acceptance period from June 1, 1998 to July 15, 1998. Employee acceptances during the enrollment period were as follows:

	Fiscal Year 1998	1999
Monetary benefits	438	284
Enhanced retirement	839	502
	1,277	786

The cost of monetary benefits offered under the SRP is recognized in the year an employee elects to accept the package. The Department's total cost of monetary benefits offered under the SRP is $32 million, which includes $20 million and $12 million related to employee acceptances in fiscal years 1998 and 1999, respectively. Water Services included its fiscal year 1998 share of $5 million in Other operating expenses and will recognize its additional $3 million share in fiscal year 1999. Payments due under the SRP will be made in fiscal year 1999. The cost of enhanced retirement benefits will be considered in the determination of future actuarially required contributions to the retirement plan (see Note 6).

NOTE 6: EMPLOYEE BENEFITS

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 also 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 employees' 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 percentage of covered payroll as determined by the Plan's independent actuary.

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 Commissioners. The Plan is considered an independent pension trust fund of the Department.

Plan amendments must be approved by both the Retirement Board and the Board of Commissioners. During March 1998, two amendments were made to the Plan. The amendments change the retirement age required to receive unreduced benefits with thirty years of service from 55 to 50 years of age, and provide participants with the option of purchasing other governmental service for purposes of enhancing benefits and eligibility for retirement. These amendments increased the Department's actuarial accrued liability (AAL) by approximately $200 million. The Department's AAL also increased by approximately $270 million as a result of enhanced retirement benefits provided to certain employees electing early retirement as a result of the SRP. Water Services' share of increases due to the plan amendments and early retirements is approximately $50 and $70 million, respectively, and will be considered in the determination of future actuarially determined annual required contributions.

Annual pension cost (APC) and net pension obligation (NPO) for the current year consisted of the following (amounts in millions):

	Year Ended June 30, 1998
Annual required contribution	$ 8
Interest on NPO	(1)
Adjustment to annual required contribution	2
APC (including $3 million of amounts capitalized)	9
Department contributions	32
Change in NPO	(23)
NPO at beginning of year	(7)
NPO (asset) at end of year	$ (30)

The NPO is included in Prepayments and other current assets at June 30, 1998. The annual required contribution for the current year was determined as part of the June 30, 1997 actuarial valuation using the entry age normal actuarial cost method. The actuarial asset in excess of the AAL is being amortized by level contribution offsets over the period ending June 30, 2003. The actuarially determined contribution rate for fiscal year 1998 was 7.32% of covered payroll, which consisted of normal cost of 9.14% less amortization of surplus UAL of 1.82%. The significant actuarial assumptions include an investment rate of return of 8.0%, projected inflation-adjusted salary increases of 5.5%, and postretirement benefit increases of 3.0%. The actuarial value of assets was 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 the current and two preceding fiscal years is as follows (amounts in millions):

Year Ended June 30,	APC	Percentage of APC Contributed	NPO
1998	$ 9	350%	$ (30)
1997	$ 26	108%	$ (7)
1996	$ 30	95%	$ (6)

The following schedule represents required supplemental information for the current and two preceding fiscal years. This schedule provides information about progress made in accumulating sufficient assets to pay benefits when due (amounts in millions):

Actuarial Valuation Date June 30,	Actuarial Value of Assets	AAL	Actuarial Assets Over/(Under) AAL	Funded Ratio	Covered Payroll	Over/(Under) Funding as a % of covered Payroll
1997	$ 886	$ 877	$ 9	101%	$ 99	9%
1996	$ 782	$ 851	$ (69)	92%	$ 99	-69%
1995	$ 705	$ 805	$ (100)	88%	$ 108	-93%

Disability and death benefit plan costs and administrative expenses totaled $4 million for each of fiscal years 1998, 1997, and 1996.

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 16,000 at June 30, 1998. The cost to Water Services of providing such benefits amounted to $23, $29, and $29 million for fiscal years 1998, 1997 and 1996, respectively. Of these costs, $8, $10, and $7 million were capitalized and the remainder was charged to expense for fiscal years 1998, 1997 and 1996, respectively.

The Department accounts for postretirement benefits based on Statement of Financial Accounting Standards 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 is amortizing its actuarially determined transition obligation related to prior service over 20 years.

Postretirement benefit costs, included in health care benefits above, are summarized as follows (amounts in millions):

	Year Ended June 30,		
	1998	1997	1996
Service cost	$ 3	$ 2	$ 2
Interest cost	7	7	7
Actual return on plan assets	(1)	–	–
Amortization of transition obligation	4	4	4
Curtailment and termination effect	13	–	–
	$ 26	$ 13	$ 13

The accrued postretirement liability is as follows (amounts in millions):

	June 30,	
	1998	1997
Accumulated postretirement benefit obligation (APBO):		
Active employees	$ 34	$ 49
Retirees and surviving spouses	75	50
	109	99
Plan assets at fair value	15	14
APBO in excess of plan assets	94	85
Unrecognized net gain	9	7
Unrecognized transition obligation	(53)	(65)
Unrecognized prior service cost	(6)	–
Postretirement liability	$ 44	$ 27

The postretirement liability is included in Accounts payable and accrued expenses at June 30, 1998 and 1997.

During fiscal year 1998, the Department implemented two changes in postretirement benefits to employees. The changes increase the subsidy rate applicable to retirees under age 65 with a spouse under age 65 and granted service credit years to employees and retirees with qualified service to other governmental organizations. These permanent changes resulted in a $25 million increase in the Department's accumulated postretirement benefit obligation at June 30, 1998. Water Services' $6 million share of this increase will be amortized over the remaining average service period of approximately 12 years.

During fiscal year 1998, the Department recognized curtailment and termination charges of $49 million related to employees who accepted benefits under the SRP. The Department will incur additional estimated termination charges of approximately $9 million due to employees resigning during fiscal year 1999. Water Services' $13 million share of current year curtailment and termination benefits is included in fiscal year 1998 postretirement benefit costs. Water Services will recognize its $2 million share of additional estimated termination charges in fiscal year 1999.

The assumed health care cost trend rate was 5.0% and 5.5% per year for fiscal years 1998 and 1997, respectively. Increasing the health care cost trend rate by one percentage point would increase the APBO as of June 30, 1998 by approximately $15 million and periodic cost by approximately $2 million. The discount rate used in determining the plan's accumulated postretirement benefit obligation was 6.75% and 7.50% in fiscal years 1998 and 1997, respectively. Plan assets were contributed in June 1997; however, no long-term return on plan assets was considered in the computation of fiscal year 1997 postretirement benefit costs. The expected long-term rate of return on plan assets was 7.0% in fiscal year 1998. As of June 30, 1998, plan assets consist primarily of short-term treasury obligations. No funding policy has been established for the future benefits to be provided under this plan.

NOTE 7: SHARED OPERATING EXPENSES

Water 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 $440, $522, and $501 million for fiscal years 1998, 1997 and 1996, respectively, of which $143, $184, and $162 million were allocated to Water Services.

NOTE 8: 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 distributions of retained income.

The Department made payments of approximately $21 million in fiscal year 1998 from Water Services to the reserve fund of the City. An additional transfer of $5 million was authorized by the Board of Commissioners in June 1998. This transfer will be paid in fiscal year 1999. The Department expects to make an additional transfer declaration of approximately $16 million during fiscal year 1999.

Environmental matters – New regulations concerning filtration of surface water supplies will require increased commitment of resources by the Department. Major capital expenditures will be necessary to comply with the filtration requirements at open distribution reservoirs because of the State of California Surface Water Treatment Rule (SWTR). The Department has four major reservoirs subject to SWTR, which became effective in June1993. Planning studies and discussions with local community representatives are ongoing to determine the system improvements necessary to bring these reservoirs into compliance. The Department has entered into an agreement with the State Department of Health Services that established a time schedule to come into compliance with the SWTR. Under the terms of this agreement, the four reservoirs are scheduled to be in compliance by 2003.

As of June 30, 1998, capital expenditures of approximately $70 million had been incurred which primarily related to preliminary engineering. The estimated total capital cost of the SWTR compliance program is approximately $400 million.

During July 1997, the Great Basin Unified Air Pollution Control District (the District) adopted an initial State Implementation Plan (SIP) and an implementing order requiring the Department to initiate pollution control measures to control particulate matters emitting from the Owens 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 commits 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 agrees to adopt a revised SIP that would extend 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. The MOA anticipates that the City will have control measures in place over a minimum of 22.5 miles of the lake bed by 2006. It is estimated that about 40,000 acre feet of water will be required on an annual basis to operate the pollution control facilities. The current plan assumes that a portion of this water will be obtained from the local sub-potable groundwater basin; however, the actual quantity available will not be known until additional studies are completed.

Based on the current plan, management estimates that the cost of implementing the pollution control measures through 2006 will be approximately $120 million; however, the cost estimate may change as additional information becomes available. The MOA also provides that the District shall develop a new SIP in 2003 to incorporate actual experience and to revise the schedule and plan as necessary to meet the air quality standards.

Litigation – A number of claims and suits are pending against the Department for alleged damages to persons and property and for other alleged liabilities arising out of its operations. In the opinion of management, any ultimate liability which may arise from these actions will not materially affect Water Services' financial position as of June 30, 1998.

Risk management – Water Services is subject to certain business risks common to the utility industry. The majority of these risks are mitigated by external insurance coverage obtained by Water Services. For other significant business risks, however, Water Services has elected to self-insure. It is management's belief that exposure to loss arising out of self-insured business risks will not materially affect Water Services' financial position as of June 30, 1998.

Credit risk – Financial instruments which potentially expose the Department to concentrations of credit risk consist primarily of trade accounts receivable. The Department's customer base is concentrated among commercial, industrial, residential and governmental customers located within the City. Although the Department is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 1998 except as provided in the allowance for losses. The Department manages its credit exposure by requiring deposits from certain customers and through procedures designed to identify and monitor credit risk.

NOTE 9: SUBSEQUENT EVENT (UNAUDITED)

On October 6, 1998, the Department issued advance refunding bonds with principal amount of approximately $236 million. These funds are held in escrow accounts for calling specified revenue bonds at scheduled maturity dates.

Report of Independent Accountants

September 22, 1998

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

In our opinion, the accompanying balance sheet and the related statements of income, of retained income reinvested in the business and of cash flows present fairly, in all material respects, the financial position of the Water System (Water Services) of the Department of Water and Power of the City of Los Angeles at June 30, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 1998, in conformity with generally accepted accounting principles. 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 generally accepted auditing standards 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 the opinion expressed above.

As discussed in Note 2 to the financial statements, the Department changed its method of accounting for pensions and for investments retroactive to July 1, 1995 and for securities lending transactions retroactive to July 1, 1996.

Price Waterhouse Coopers LLP · Simpson & Simpson

Los Angeles, California

Energy Services Balance Sheet, as restated

(In Thousands)	June 30, 1998	1997
ASSETS		
Utility Plant		
Generation	$ 2,327,186	$ 2,296,760
Transmission	769,077	762,055
Distribution	3,219,453	3,119,072
General	806,013	798,718
	7,121,729	6,976,605
Accumulated depreciation	2,869,554	2,633,322
	4,252,175	4,343,283
Construction work in progress	200,210	214,909
Nuclear fuel, at amortized cost	12,088	10,774
	4,464,473	4,568,966
Restricted and Trust Funds Investments	1,440,031	1,407,426
Current Assets		
Cash and cash equivalents	256,257	282,055
Cash collateral received from securities lending transactions	85,175	95,717
Customer and other accounts receivable, net of $11,900 and $13,200 allowance for losses	208,526	198,654
Accrued unbilled revenue	102,676	113,384
Materials and fuel, at average cost	95,157	100,105
Prepayments and other current assets	89,870	27,218
	837,661	817,133
	$ 6,742,165	$ 6,793,525
CAPITALIZATION AND LIABILITIES		
Equity		
Retained income reinvested in the business	$ 2,269,546	$ 2,021,878
Contributions in aid of construction	262,654	244,074
	2,532,200	2,265,952
Long-term Debt	2,511,897	2,716,554
Advance Refunding Bonds	952,674	1,075,490
	5,996,771	6,057,996
Current Liabilities		
Debt due within one year	139,760	161,650
Accrued interest	55,699	65,420
Accounts payable and accrued expenses	329,624	236,676
Due to Water Services	10,278	14,426
Obligations under securities lending transactions	85,175	95,717
Overrecovered energy costs	–	130,192
	620,536	704,081
Deferred Credits	124,858	31,448
Commitments and Contingencies (Note 13)		
	$ 6,742,165	$ 6,793,525

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

Energy Services Statement of Income, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Operating Revenues			
Residential	$ 625,696	$ 599,914	$ 580,011
Commercial and industrial	1,327,864	1,303,665	1,275,843
Other	119,094	113,487	90,997
Regulatory gain from rate restructuring	90,262	–	–
	2,162,916	2,017,066	1,946,851
Operating Expenses			
Fuel for generation	158,705	156,427	151,039
Purchased power	770,507	751,380	707,938
Other operating expenses	396,092	375,481	370,396
Maintenance	166,235	186,296	197,494
Depreciation	245,117	239,693	231,847
	1,736,656	1,709,277	1,658,714
Operating Income	426,260	307,789	288,137
Other Income and Expenses, net	67,480	43,636	14,255
Loss on Abandoned Projects	–	(12,784)	(28,694)
	493,740	338,641	273,698
Debt Expenses			
Interest on debt	168,532	179,527	181,200
Allowance for funds used during construction	(2,899)	(4,414)	(5,191)
	165,633	175,113	176,009
Net Income	$ 328,107	$ 163,528	$ 97,689

Statement of Retained Income Reinvested in the Business, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Balance at beginning of year	$ 2,021,878	$ 1,955,693	$ 1,917,921
Net income for the year	328,107	163,528	97,689
Less - Transfers to the reserve fund of the City of Los Angeles	80,439	97,343	59,917
Balance at end of year	$ 2,269,546	$ 2,021,878	$ 1,955,693

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

Energy Services Statement of Cash Flows, as restated

(In Thousands)	Year Ended June 30, 1998	1997	1996
Cash Flows from Operating Activities:			
Operating income	$ 426,260	$ 307,789	$ 288,137
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation	245,117	239,693	231,847
Amortization of nuclear fuel	6,835	7,500	6,792
Provision for losses on customer and other accounts receivable	14,581	16,873	16,954
Other	7,722	4,761	3,717
Changes in assets and liabilities:			
Customer and other accounts receivable	(30,216)	(19,726)	(12,776)
Accrued unbilled revenue	10,708	(6,907)	3,887
Materials and fuel	4,948	18,736	16,720
Prepayments and other current assets	(62,652)	(551)	15,658
Accounts payable and accrued expenses	101,809	(8,811)	6,834
Due to Water Services	(4,148)	(3,239)	(3,870)
Overrecovered energy costs	(130,192)	30,341	31,894
Deferred credits	93,410	(1,822)	(1,024)
	684,182	584,637	604,770
Cash Flows from Noncapital Financing Activities:			
Payments to the reserve fund of the City of Los Angeles	(89,300)	(97,343)	(62,717)
Cash Flows from Capital and Related Financing Activities:			
Additions to plant and equipment	(144,560)	(188,922)	(190,701)
Loss on abandoned projects	–	(12,784)	(28,694)
Contributions in aid of construction	18,580	18,813	9,933
Purchases of escrow investments	(227,447)	(161,755)	–
Proceeds from escrow investment maturities	509,573	38,467	96,799
Principal payments and maturities on long-term debt	(485,763)	(99,908)	(161,570)
Issuance of revenue certificates, net	136,400	162,100	–
Debt interest payments	(231,188)	(181,470)	(184,757)
	(424,405)	(425,459)	(458,990)
Cash Flows from Investing Activities:			
Purchases of investment securities	(1,246,506)	(185,651)	(28,931)
Proceeds from maturities of investment securities	952,207	35,753	17,184
Cash collateral received under securities lending transactions	10,542	95,717	–
Obligations under securities lending transactions	(10,542)	(95,717)	–
Investment income	98,024	27,115	21,934
	(196,275)	(122,783)	10,187
Cash and Cash Equivalents:			
Net decrease	(25,798)	(60,948)	93,250
Beginning of year	282,055	343,003	249,753
	$ 256,257	$ 282,055	$ 343,003

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

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Department – 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. 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 generally accepted accounting principles applicable to governmental utilities. 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 which are not in conflict with statements issued by the GASB. The accounting records generally follow the Uniform System of Accounts for Public Utilities and Licensees prescribed by the Federal Energy Regulatory Commission (FERC) and the California Public Utilities Commission (CPUC), except for the method of accounting for contributions in aid of construction described below.

The Department's rates are subject to review and approval by the City Council. As a regulated enterprise, the Department's financial statements are prepared in accordance with Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS 71), which requires that the effects of the ratemaking process be recorded in the financial statements. Such effects primarily concern the time at which various items enter into the determination of net income in order to follow the principle of matching costs and revenues. Accordingly, Energy Services records various regulatory assets and liabilities to reflect the regulator's actions. Management believes that Energy Services meets the criteria for continued application of SFAS 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 generally accepted accounting principles 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.

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 operation and maintenance expense accounts. The original cost of property retired, plus removal cost, less salvage, is charged to accumulated depreciation.

Depreciation – Depreciation expense is computed using the straight-line method based on service lives for all projects completed after July 1, 1973, and for all office and shop structures, related furniture and equipment, and transportation and construction equipment. Depreciation for facilities completed prior to July 1, 1973 is computed using the 5% sinking fund method based on estimated service lives. Estimated service lives range from 5 to 75 years. Depreciation expense as a percentage of average depreciable utility plant in service was 3.7% for each of the fiscal years 1998, 1997 and 1996.

Nuclear decommissioning – The total cost to decommission the Department's 5.7% direct ownership interest in the Palo Verde Nuclear Generating Station (PVNGS) is estimated to be $82 million in 1995 dollars to be spent over a fourteen year period beginning in 2024. This estimate is based on a site specific study prepared by an independent consultant, assuming the prompt removal/ dismantlement method of decommissioning authorized by the Nuclear Regulatory Commission (NRC). Estimated decommissioning costs are accrued over the estimated useful life of the PVNGS. The Department recorded decommissioning expense of $11 million for each of the fiscal years 1998, 1997 and 1996.

The Department contributes to external trusts set up in accordance with the Arizona Nuclear Power Plant participation agreement and NRC requirements. As of June 30, 1998, decommissioning funds of approximately $57 million are classified as Restricted and Trust Fund Investments in the accompanying balance sheet.

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 assumed responsibility for the future disposal of spent nuclear fuel and assesses each utility with nuclear operations, including the Department, $1 per megawatt hour of nuclear generation to fund this future disposal.

Cash and cash equivalents – The Department's cash is deposited with the City Treasurer in the City's general investment pool. The City Treasurer invests available funds of the City and its independent operating departments on a combined basis. At June 30, 1998 and 1997, cash and cash equivalents included $60 and $28 million, respectively, of internally-designated balances relating to bond redemption and interest funds and a self-insurance fund. In addition, at June 30, 1997, cash and cash equivalents included $31 million designated for energy cost stabilization. These funds were transferred to a restricted trust during fiscal year 1998 as a result of the new Energy Services rate ordinance (see Note 3). The Department considers all unrestricted investments with an original maturity of three months or less to be cash equivalents.

Contributions in aid of construction – Under the provisions of the City Charter, amounts received from customers and others for constructing utility plant are combined with retained income reinvested in the business and represent equity for purposes of computing Energy Services' borrowing limits. Accordingly, contributions in aid of construction are shown in the accompanying balance sheet as a component of equity.

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.

Debt expenses – Debt premium, discount and issue expenses are deferred and amortized to expense over the lives of the related debt issues. Premiums, discounts and issue expenses related to bonds redeemed by advance refunding bonds are amortized over the life of the advance refunding bonds.

Allowance for funds used during construction – AFUDC represents the cost of borrowed funds used for the construction of utility plant. Capitalized AFUDC is shown as part of the cost of utility plant and as a reduction of debt expenses. The average AFUDC rate was 6.0% for each of the fiscal years 1998, 1997 and 1996.

Reclassification – Certain financial statement items for fiscal years 1997 and 1996 have been reclassified to conform to the 1998 presentation.

NOTE 2: ACCOUNTING CHANGES

Pensions – On July 1, 1997, the Department adopted GASB Statement No. 27 (GASBS 27), *Accounting for Pensions by State and Local Government Employers.* This statement establishes standards for measurement, recognition and disclosure of pension information in the financial statements.

Investments – On July 1, 1997, the Department adopted GASB Statement No. 31 (GASBS 31), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* This statement applies to the Department's cash and cash equivalents and restricted investments and requires that investments be reported at fair value. All investment income, including changes in fair value, are included in Other Income and Expense. Prior to the adoption of GASBS 31, investments were reported at amortized cost.

Securities Lending Transactions – On July 1, 1997, the Department adopted GASB Statement No. 28 (GASBS 28), *Accounting and Financial Reporting for Securities Lending Transactions.* This statement requires that cash received as collateral on securities lending transactions and the related obligations be reported on the balance sheet. The Department participates in securities lending through its deposits with the City Treasurer and records its share of cash collateral received by the City's pooled investment fund based on a pro rata allocation of its funds on deposit compared to the total pool. The Department has adopted GASBS 28 retroactive to July 1, 1996, the date at which the City began allocating income from securities lending to participants in the fund.

Effect of Adoption – The Department restated prior year financial statements to retroactively apply GASBS 27 and GASBS 31. The cumulative effect of adoption of GASBS 27 and GASBS 31 resulted in a $26 million decrease to Retained Income Reinvested in the Business effective July 1, 1995, including $6 million and $20 million related to the adoption of GASBS 27 and GASBS 31, respectively.

The adoption of GASBS 27 and GASBS 31 also resulted in a restatement of prior year net income as follows (amounts in millions):

	Year ended June 30, 1997	1996
Net income, as previously reported	$173,528	$132,710
Adoption of GASBS 27	(22,598)	(25,115)
Adoption of GASBS 31	12,598	(9,906)
	(10,000)	(35,021)
Net income, as restated	$163,528	$ 97,689

The adoption of GASBS 28 required no restatement of net income as the Department recorded its allocation of income related to securities lending as part of its investment income in the prior year. The adoption of GASBS 27 and GASBS 31 also resulted in fiscal year 1998 net income of $124 million more than would have been reported under the Department's prior accounting policies, including approximately $105 million and $19 million related to the adoption of GASBS 27 and GASBS 31, respectively.

NOTE 3: REGULATORY MATTERS

Effective May 1, 1998, the City Council approved a new rate ordinance for Energy Services. The previous rate ordinance included an energy cost adjustment factor (ECAF) designed to permit the full recovery of current and future energy costs, funding requirements of nuclear plant decommissioning costs and the costs of funding certain conservation programs intended to reduce current and future energy consumption. The new rate ordinance froze the ECAF at the rate in effect as of October 1, 1997. Management believes the frozen rates are adequate to cover future associated costs.

Regulatory Gain from Rate Restructuring – Under the previous rate ordinance, the Department estimated recoverable costs to establish the energy cost component of customer billings and any difference between billed and actual costs was deferred and recorded as a regulatory liability. The Department is no longer required to defer and offset these amounts in future billings; therefore, overrecovered costs of $90 million were recognized as a regulatory gain on May 1, 1998. In accordance with the new ordinance, the Department transferred a related amount of cash to the debt reduction trust funds (see Note 6).

Deferred Credits – On January 2, 1991, pursuant to a City Rate Ordinance, the Department established an energy cost stabilization account with surplus construction funds received from the Intermountain Power Agency. These funds were used at the discretion of management to reduce purchased power costs. In accordance with the new rate ordinance, the remaining balance of $31 million was transferred from the energy cost stabilization account to the debt reduction trust funds. The related regulatory liability was recognized as an offset to purchased power expense.

The Department's current rates include amounts designated for the precollection of out-of-market future purchase power costs. These amounts are included in Deferred Credits and will be recognized as revenue when the related purchase power expense is incurred. The Overrecovered balance at June 30, 1997 included approximately $40 million related to precollections. This balance and additional collections of $63 million accumulated through April 30, 1998, were transferred to Deferred Credits as a result of the new rate ordinance.

Deregulation – Effective April 1, 1998, competition was introduced into California's electric utility market and customers of the state's investor-owned utilities (IOUs) became eligible for direct access. The implementation of competition in accordance with state Assembly Bill 1890 (AB 1890) resulted in significant structural changes to the electric power industry, including mandated direct access for IOU customers, energy sales through a Power Exchange, and management of transmission assets through an Independent System Operator (ISO). AB 1890 also legislated the recovery of stranded investment through the assessment of a non-bypassable competition transition charge (CTC).

The deregulation legislation applies to the state's investor-owned utilities and does not compel participation by publicly-owned utilities, such as the Department. Although publicly-owned utilities are not required to comply with AB 1890, utilities that do not elect to participate in direct access and the ISO will not be entitled to recovery of stranded investment through the state legislated non-bypassable CTC. Management is currently considering the issues involved with the decision to participate in direct access and the ISO.

If the Department chooses to offer a direct access program to it customers, it is likely that its generation business will no longer qualify for accounting under SFAS 71. Management has evaluated its generation assets and the potential stranded investment that would arise in the event of offering direct access to customers and consequently ceasing to apply SFAS 71 to this portion of the business. Management estimates that the Department's total stranded costs and obligations, including obligations related to its purchase power contracts, is between approximately $3 and $4 billion, depending on the assumed market price of energy. Differences between the assumed market price of energy and actual prices in the future competitive market could result in material changes to the above estimate of stranded costs and obligations.

Although AB 1890 provides for the full recovery of stranded investment, a current voter initiative seeks to overturn major portions of this legislation. At this time management is unable to predict if the implementation of a direct access program will have a material adverse effect on the Department's financial position or results of operations.

NOTE 4: JOINTLY-OWNED UTILITY PLANT

Energy Services has undivided interests in several electrical generating stations and transmission systems which are jointly-owned with other utilities. Each project participant is responsible for financing its share of construction and operating costs. Energy Services' ownership interest in each jointly-owned utility plant as of June 30, 1998 is as follows (amounts in millions, except as indicated):

			Plant In Service		
Projects	Ownership Interest	Share of Capacity (MWh)	Cost	Accumulated Depreciation	Construction Work in Progress
Palo Verde Nuclear Generating Station	5.7%	217	$ 514	$ 156	$ –
Navajo Generating Station	21.2%	477	207	124	85
Mohave Generating Station	20.0%	316	119	60	2
Pacific Intertie DC Transmission Line	40.0%	1240 MW	192	44	6
Other transmission systems	Various		77	30	–
			$ 1,109	$ 414	$ 93

Energy Services will incur certain minimum operating costs on 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.

NOTE 5: PURCHASE POWER COMMITMENTS

The Department has entered into a number of energy and transmission service contracts which involve substantial commitments, scheduled to expire from 2027 to 2030, as follows (amounts in millions, except as indicated):

Projects	Agency	Department Share Interest	Department Share Capacity MWh	Department Share Debt Outstanding	Commitment Expiration Date
Intermountain Power Project	IPA	66.8%	1,068	$ 2,348	2027
Palo Verde Nuclear Generating Station	SCPPA	67.0%	151	$ 599	2030
Mead-Adelanto Project	SCPPA	35.7%	291	$ 96	2030
Mead-Phoenix Project	SCPPA	24.8%	148	$ 22	2030
Southern Transmission System	SCPPA	59.5%	1,142	$ 718	2027

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.

The above agreements require Energy Services to make certain minimum payments, which are based mainly upon debt service requirements. In addition to fixed charges of approximately $350 million in 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 (approximately $230 million in each of the next five years). The Department made total payments under these agreements of approximately $620, $570, and $550 million in fiscal years 1998, 1997 and 1996, respectively.

Energy Entitlement – The Department also 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 $10, $11, and $11 million in fiscal years 1998, 1997 and 1996, respectively.

NOTE 6: RESTRICTED AND TRUST FUND INVESTMENTS

A summary of Energy Services' restricted and trust fund investments is presented below (amounts in millions):

	June 30, 1998	June 30, 1997
Escrow investments	$ 963	$ 1,064
Debt reduction trust funds	420	138
Nuclear decommissioning trust funds	57	43
Revenue certificate escrow fund	–	162
	$ 1,440	$ 1,407

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

Escrow investments – Escrow investments are held to call 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 purchase power obligations arising from the Department's participation in the Intermountain Power Project and the Southern California Public Power Authority (see Note 5). Purchase power precollections are transferred to these accounts as amounts are collected from customers; funds from operations may 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.

Revenue certificate escrow fund – The revenue certificate trust fund was established during fiscal year 1997 with $162 million received from the issuance of revenue certificates. These funds were held for calling specified revenue bonds and revenue certificates at scheduled maturity dates. During fiscal year 1998, all funds accumulated in this fund were applied to retire revenue bonds and certificates.

NOTE 7: SECURITIES LENDING TRANSACTIONS

The City Treasurer's investment policy for its general investment pool (the Pool) includes a securities lending program (the Program) which was approved by the City Council on October 28, 1991. The City's custodial bank serves as the securities lending agent and indemnifies the City from losses incurred as a result of its operational failure, its failure to carry out adequate credit analysis and/or insufficient collateralization of the loaned securities. The City does not have the ability to pledge or sell collateral assets unless the borrower is in default of its obligation.

Under the Program up to 50% of the par value of pooled investments are available for loan on a short-term basis. Collateral, which is limited to cash, U.S. Treasury certificates and non-callable U.S. Government Agency securities, must be at least equal to 102% of the market value of the loaned securities as of the loan initiation date; in addition, matched maturities, which include investments associated with term loans and overnight investments associated with open loans, must represent at least 75% of securities loaned under the Program.

The Department recognizes its proportionate share of the fair value of cash collateral received for securities loaned and the related obligation. At June 30, 1998, there is no credit risk exposure for the Department because the amounts owed to the borrowers by the Pool exceed the amounts the borrowers owe to the Pool.

NOTE 8: LONG-TERM DEBT AND ADVANCE REFUNDING BONDS

Long-term debt and advance refunding bonds consisted of the following (amounts in millions):

Maturing In Fiscal	Effective Interest Rate	June 30, 1998	1997
1998	4.0% - 7.8%	$ –	$ 72
1999 - 2003	4.3% - 7.4%	349	466
2004 - 2008	4.8% - 7.4%	481	597
2009 - 2013	4.8% - 7.4%	576	670
2014 - 2018	4.8% - 7.4%	565	617
2019 - 2023	4.8% - 7.4%	521	538
2024 - 2028	5.2% - 7.4%	478	494
2029 - 2033	5.2% - 7.4%	279	279
2034	5.2% - 5.3%	7	7
	Total principal amount	3,256	3,740
Revenue certificates		389	252
Unamortized premium and discount		(40)	(38)
Current portion of revenue certificates		(80)	(90)
Long-term debt due within one year		(60)	(72)
		$ 3,465	$ 3,792
Escrow funds available to call certain of the above bonds at scheduled crossover dates		$ 963	$ 1,064

Long-term debt outstanding at June 30, 1998 consisted of revenue bonds due serially in varying annual amounts through 2034. The revenue bonds generally are callable ten years after issuance. Scheduled annual principal maturities during the five years following June 30, 1998 are $60, $59, $71, $79 and $80 million, respectively. Revenue bonds are secured by the future revenues of Energy Services.

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.

During fiscal year 1998, bonds with a par value of $118 million were refunded using proceeds from the balance in the restricted escrow investments. The remaining escrow investments of $963 million will be used to refund bonds presently included in long-term debt with a par value of $944 million at scheduled crossover dates. The balance of $953 million of advance refunding bonds will be reclassified to long-term debt at the time that the bonds to be refunded are called. Interest expense from refunding bonds and interest income earned on related escrow investments are included in Other Income and Expense.

Revenue Certificates – As of June 30, 1998, the Department has outstanding commercial paper of $389 million bearing interest at an average rate of 3.55%. The commercial paper matures not more than 182 days from the date of issuance. The Department intends and has the ability to refinance $309 million of the outstanding revenue certificates upon their maturity and, therefore, has included this portion of the balance outstanding in long-term debt at June 30, 1998. The commercial paper is an unsecured obligation of the Department.

Letter of Credit and Reimbursement Agreement – During fiscal year 1997, the Department arranged a $432 million multi-year letter of credit. The letter of credit is available for refinancing amounts outstanding under the commercial paper program and may be utilized on a revolving basis through January 2000.

Fair Value – The fair value of long-term debt and advance refunding bonds is $2.9 and $3.9 billion at June 30, 1998 and 1997, respectively. Management has estimated fair value based on the present value of interest and principal payments on the long-term debt and advance refunding bonds, discounted using current interest rates obtainable by the Department for debt of similar quality and maturities.

The carrying amount of revenue certificates payable of $389 and $252 million for fiscal years 1998 and 1997, respectively, approximates fair value due to the short maturity of these liabilities.

NOTE 9: STAFF REDUCTION PROGRAM

During fiscal year 1998, the Board of Water and Power Commissioners (the Board of Commissioners) approved a Staff Reduction Program (the SRP) offering monetary compensation or enhanced retirement benefits to the Department's employees. The SRP included an acceptance period from June 1, 1998 to July 15, 1998. Employee acceptances during the enrollment period were as follows:

	Fiscal Year	
	1998	1999
Monetary benefits	438	284
Enhanced retirement	839	502
	1,277	786

The cost of monetary benefits offered under the SRP is recognized in the year an employee elects to accept the package. The Department's total cost of monetary benefits offered under the SRP is $32 million, which includes $20 million and $12 million related to employee acceptances in fiscal years 1998 and 1999, respectively. Energy Services included its fiscal year 1998 share of $15 million in Other operating expenses and will recognize its additional $9 million share in fiscal year 1999. Payments due under the SRP will be made in fiscal year 1999. The cost of enhanced retirement benefits will be considered in the determination of future actuarially required contributions to the retirement plan (see Note 10).

NOTE 10: EMPLOYEE BENEFITS

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 also 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 employees' 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 percentage of covered payroll as determined by the Plan's independent actuary.

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 Commissioners. The Plan is considered an independent pension trust fund of the Department.

Plan amendments must be approved by both the Retirement Board and the Board of Commissioners. During March 1998, two amendments were made to the Plan. The amendments change the retirement age required to receive unreduced benefits with thirty years of service from 55 to 50 years of age, and provide participants with the option of purchasing other governmental service for purposes of enhancing benefits and eligibility for retirement. These amendments increased the Department's actuarial accrued liability (AAL) by approximately $200 million. The Department's AAL also increased by approximately $270 million as a result of enhanced retirement benefits provided to certain employees electing early retirement as a result of the SRP. Energy Services' share of increases due to the plan amendments and early retirements is approximately $150 and $200 million, respectively, and will be considered in the determination of future actuarially determined annual required contributions.

Annual pension cost (APC) and net pension obligation (NPO) for the current year consisted of the following (amounts in millions):

	Year Ended June 30, 1998
Annual required contribution	$ 23
Interest on NPO	(2)
Adjustment to annual required contribution	5
APC (including $5 million of amounts capitalized)	26
Department contributions	92
Change in NPO	(66)
NPO at beginning of year	(22)
NPO (asset) at end of year	$ (88)

The NPO is included in Prepayments and other current assets at June 30, 1998.

The annual required contribution for the current year was determined as part of the June 30, 1997 actuarial valuation using the entry age normal actuarial cost method. The actuarial asset in excess of the AAL is being amortized by level contribution offsets over the period ending June 30, 2003. The actuarially determined contribution rate for fiscal year 1998 was 7.32% of covered payroll, which consisted of normal cost of 9.14% less amortization of surplus UAL of 1.82%. The significant actuarial assumptions include an investment rate of return of 8.0%, projected inflation-adjusted salary increases of 5.5%, and postretirement benefit increases of 3.0%. The actuarial value of assets was 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 the current and two preceding fiscal years is as follows (amounts in millions):

Year Ended June 30,	APC	Percentage of APC Contributed	NPO
1998	$ 26	350%	$ (88)
1997	$ 70	108%	$ (22)
1996	$ 84	95%	$ (16)

The following schedule represents required supplemental information for the current and two preceding fiscal years. This schedule provides information about progress made in accumulating sufficient assets to pay benefits when due (amounts in millions):

Actuarial Valuation Date June 30,	Actuarial Value of Assets	AAL	Actuarial Assets Over/(Under) AAL	Funded Ratio	Covered Payroll	Over/(Under) Funding as a % of covered Payroll
1997	$ 2,965	$ 2,935	$ 30	101%	$ 331	9%
1996	$ 2,618	$ 2,848	$ (230)	92%	$ 332	-69%
1995	$ 2,361	$ 2,696	$ (335)	88%	$ 361	-93%

Disability and death benefit plan costs and administrative expenses totaled $9, $8 and $9 million for fiscal years 1998, 1997, and 1996, respectively.

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 16,000 at June 30, 1998. The cost to Energy Services of providing such benefits amounted to $66, $66, and $68 million for fiscal years 1998, 1997 and 1996, respectively. Of these costs, $13, $14, and $18 million were capitalized and the remainder was charged to expense for fiscal years 1998, 1997 and 1996, respectively.

The Department accounts for postretirement benefits based on Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which requires that the cost of postretirement benefits be recognized as expense over employees' service periods. Energy Services is amortizing its actuarially determined transition obligation related to prior service over 20 years.

Postretirement benefit costs, included in health care benefits above, are summarized as follows (amounts in millions):

	Year Ended June 30, 1998	1997	1996
Service cost	$ 8	$ 7	$ 7
Interest cost	23	20	21
Actual return on plan assets	(2)	–	–
Amortization of transition obligation	14	14	14
Curtailment and termination effect	36	–	–
	$ 79	$ 41	$ 42

The accrued postretirement liability is as follows (amounts in millions):

	June 30, 1998	1997
Accumulated postretirement benefit obligation (APBO):		
Active employees	$ 95	$ 132
Retirees and surviving spouses	250	168
	345	300
Plan assets at fair value	50	48
APBO in excess of plan assets	295	252
Unrecognized net gain	24	21
Unrecognized transition obligation	(176)	(216)
Unrecognized prior service cost	(19)	-
Postretirement liability	$ 124	$ 57

The postretirement liability is included in Accounts payable and accrued expenses at June 30, 1998 and 1997.

During fiscal year 1998, the Department implemented two changes in postretirement benefits to employees. The changes increase the subsidy rate applicable to retirees under age 65 with a spouse under age 65 and granted service credit years to employees and retirees with qualified service to other governmental organizations. These permanent changes resulted in a $25 million increase in the Department's accumulated postretirement benefit obligation at June 30, 1998. Energy Services' $19 million share of this increase will be amortized over the remaining average service period of approximately 12 years.

During fiscal year 1998, the Department recognized curtailment and termination charges of $49 million related to employees who accepted benefits under the SRP. The Department will incur additional estimated termination charges of approximately $9 million due to employees resigning during fiscal year 1999. Energy Services' $36 million share of current year curtailment and termination benefits is included in fiscal year 1998 postretirement benefit costs. Energy Services will recognize its $7 million share of additional estimated termination charges in fiscal year 1999.

The assumed health care cost trend rate was 5.0% and 5.5% per year for fiscal years 1998 and 1997, respectively. Increasing the health care cost trend rate by one percentage point would increase the APBO as of June 30, 1998 by approximately $44 million and periodic cost by approximately $4 million. The discount rate used in determining the plan's accumulated postretirement benefit obligation was 6.75% and 7.50% in fiscal years 1998 and 1997, respectively. Plan assets were contributed in June 1997; however, no long-term return on plan assets was considered in the computation of fiscal year 1997 postretirement benefit costs. The expected long-term rate of return on plan assets was 7.0% in fiscal year 1998. As of June 30, 1998, plan assets consist primarily of short-term treasury obligations. No funding policy has been established for the future benefits to be provided under this plan.

NOTE 11: SHARED OPERATING EXPENSES

Energy Services shares certain administrative functions with the Department's Water Services. Generally, the costs of these functions are allocated on the basis of the benefits provided. Operating expenses shared with Water Services were $440, $522, and $501 million for fiscal years 1998, 1997 and 1996, respectively, of which $297, $338, and $339 million were allocated to Energy Services.

NOTE 12: LOSS ON ABANDONED PROJECTS

In fiscal years 1997 and 1996, management formally abandoned several significant projects and reported losses on abandonment of $13 and $29 million, respectively. Projects abandoned during fiscal year 1997 were information technology and construction-related; projects abandoned during fiscal year 1996 included studies and research related to construction projects.

NOTE 13: COMMITMENTS AND CONTINGENCIES

Transfers to the reserve fund of the City of Los Angeles – Under the provisions of the City Charter, Energy Services transfers funds at its discretion to the reserve fund of the City. Pursuant to covenants contained in the bond indentures, the transfers may not be in excess of net income of the prior fiscal year. Such payments are not in lieu of taxes and are recorded as distributions of retained income.

The Department made payments of approximately $89 million in fiscal year 1998 from Energy Services to the reserve fund of the City, including $4 million related to the remaining $9 million payable from an additional transfer authorization received in June 1994 from the Board of Commissioners. The additional transfer was subject to the Department's ability to raise the necessary cash from non-operating activities such as the sale of land and inventories. During fiscal year 1998, Energy Services completed the final sales of identified assets and the remaining $5 million is not expected to be transferred.

The Department expects to make a transfer declaration of approximately $108 million during fiscal year 1999.

Palo Verde Nuclear Generating Station – 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 $8.9 billion per incident. Participants in the Palo Verde Nuclear Generating Station 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% 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, per year.

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. Continued compliance and remediation activities have the potential to substantially minimize capital and operating costs. Compliance with annual limits will be accomplished through retrofitting nitrogen oxide controls on generating units and/or purchasing Regional Clean Air Incentive Market trading credits from the marketplace. Based on the current resource plan, these retrofit pollution controls are projected to achieve compliance with emission limits through 2005.

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 will not materially affect Energy Services' financial position as of June 30, 1998.

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. It is management's belief that exposure to loss arising out of self-insured business risks will not materially affect Energy Services' financial position as of June 30, 1998.

Credit risk – Financial instruments which potentially expose the Department to concentrations of credit risk consist primarily of trade accounts receivable. The Department's customer base is concentrated among commercial, industrial, residential and governmental customers located within the City. Although the Department is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 1998 except as provided in the allowance for losses. The Department manages its credit exposure by requiring deposits from certain customers and through procedures designed to identify and monitor credit risk.

Report of Independent Accountants

September 22, 1998

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

In our opinion, the accompanying balance sheet and the related statements of income, of retained income reinvested in the business 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, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 1998, in conformity with generally accepted accounting principles. 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 generally accepted auditing standards 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 the opinion expressed above.

As discussed in Note 2 to the financial statements, the Department changed its method of accounting for pensions and for investments retroactive to July 1, 1995 and for securities lending transactions retroactive to July 1, 1996.

PricewaterhouseCoopers LLP Simpson & Simpson

Los Angeles, California

Water Services Selected Financial Data And Statistics

($ Millions)	1998	Restated 1997	Restated 1996	1995	1994
Statement of Income					
Operating revenues					
Residential	$ 159.4	$ 168.6	$ 166.6	$ 150.8	$ 163.6
Commercial and industrial	240.2	224.9	230.5	228.6	237.7
Other	25.5	24.7	25.8	25.5	29.3
Total revenues	$ 425.1	$ 418.2	$ 422.9	$ 404.9	$ 430.6
Operating income	105.1	120.5	142.8	93.5	100.5
As % of revenues	24.7%	28.8%	33.8%	23.1%	23.3%
Net Income	$ 71.9	$ 82.5	$ 110.2	$ 54.1	$ 59.9
Balance Sheet					
Net utility plant	$ 2,087.7	$ 2,000.0	$ 1,896.1	$ 1,795.0	$ 1,709.7
Capital additions, net	151.1	163.8	157.8	140.4	130.3
Capitalization					
Equity	1,440.4	1,377.3	1,289.7	1,183.8	1,153.5
Long-term debt	652.6	668.4	682.4	693.9	608.4
Advance refunding bonds	138.7	153.1	170.2	215.5	215.1
Total capitalization	2,231.7	2,198.8	2,142.3	2,093.2	1,977.0
Debt as % of net utility plant [(A)]	31.3%	33.4%	36.0%	38.7%	35.6%
Interest on debt	45.7	48.5	48.4	46.8	44.0
Transfers to City of L.A.	25.9	21.1	20.2	40.0	20.5
Operations					
Gallons sold (billions)	185.8	193.6	190.5	179.1	178.1
Customers — average number (thousands)	645.5	639.8	642.1	638.2	638.4
Average revenue per hundred cu. ft. sold (in cents)					
Residential	175.1	169.3	175.0	173.0	187.0
Commercial and industrial	168.4	160.0	162.8	170.1	177.3
Water supply (billions of gallons)					
Local supply	33.1	37.0	25.2	32.9	10.1
DWP Aqueduct	128.9	145.2	151.0	83.3	69.5
Metropolitan Water District	33.0	24.8	21.5	75.0	116.4
Gross supply	195.0	207.0	197.7	191.2	196.0
Diversion from (to) local storage	(0.8)	(0.4)	0.9	(2.0)	1.2
Net supply to distribution systems	194.2	206.6	198.6	189.2	197.2

(A) Excludes revenue notes and advance refunding bonds

Water Services Facts in Brief

	Year ended June 30 1998	1997
Use of Water		
Average Los Angeles population served	3,748,500	3,707,700
Average daily use per capita (gallons)	135.9	143.0
Water sales for fiscal year (billion gallons)	185.8	193.6
Maximum daily demand (million gallons)	790.4	743.3
Water Supply (in billions of gallons)		
Local supply (groundwater)	33.1	37.0
Los Angeles Aqueduct (Owens Valley)	128.9	145.2
Metropolitan Water District (California and Colorado River Aqueducts)	33.0	24.8
Gross supply	195.0	207.0
Diversion from (to) local storage	(0.8)	(0.4)
Net supply to distribution systems	194.2	206.6

Energy Facts in Brief

	Year ended June 30 1998	1997
Number of Customers		
Residential	1,177,328	1,166,300
Commercial	173,608	172,600
Industrial	15,965	16,200
All others	3,194	2,900
Total customers of all classes	1,370,095	1,358,000
Power Use		
Sales to ultimate customers – kilowatt (kW) hours	21,583,627,000	21,409,426,000
Sales to other utilities – kW hours	1,360,162,000	1,549,832,000
Average annual kW hours per residential customer	5,341	5,290
Net dependable capacity, kilowatts	6,555,000	6,555,000

Energy Services Selected Financial Data and Statistics

($ Millions)	1998	Restated 1997	Restated 1996	1995	1994
Statement of Income					
Operating revenues					
Residential	$ 625.7	$ 599.9	$ 580.0	$ 591.2	$ 569.3
Commercial and industrial	1,327.9	1,303.7	1,275.9	1,276.0	1,272.1
Other	119.1	113.5	91.0	105.6	91.9
Regulatory gain from rate restructuring	90.3	–	–	–	–
Total revenues	$ 2,163.0	$ 2,017.1	$ 1,946.9	$ 1,972.8	$ 1933.3
Operating income	426.3	307.8	288.1	220.5	252.9
As % of revenues	19.7%	15.3%	14.8%	11.2%	13.1%
Net Income	$ 328.1	$ 163.5	$ 97.7	$ 59.9	$ 69.3
Balance Sheet					
Net utility plant	$ 4,464.5	$ 4,569.0	$ 4622.8	$ 4,663.6	$ 4,641.3
Capital additions, net	144.6	188.9	190.7	230.0	305.3
Capitalization					
Equity	2,532.2	2,265.9	2,180.9	2,159.6	2,144.5
Long-term debt	2,511.9	2,716.6	2,622.3	2,691.5	2,750.2
Advance refunding bonds	952.7	1,075.5	1,112.5	1,117.2	1,145.0
Total capitalization	5,996.8	6,058.0	5,915.7	5,968.3	6,039.7
Debt as % of net utility plant [(A)]	56.3%	59.5%	56.7%	57.7%	59.3%
Interest on debt	168.5	179.5	181.2	186.2	189.9
Transfers to City of L.A.	80.4	97.3	59.9	69.3	175.9
Operations					
Kilowatt hours sold (billions)	22.9	23.0	22.2	21.7	21.2
Customers — average number (thousands)	1,370.1	1,358.0	1,350.8	1,338.5	1,349.4
Average revenue per kWh sold (in cents)					
Residential	10.3	9.7	9.6	9.9	9.8
Commercial and industrial	9.3	8.8	8.6	9.0	8.9
Energy production (billion kWh)					
Hydro	2.6	1.9	1.6	0.9	1.0
Thermal	9.9	8.7	9.1	13.2	12.7
Total generation	12.5	10.6	10.7	14.1	13.7
Purchases	14.1	15.4	14.5	10.8	11.1
Total production	26.6	26.0	25.2	24.9	24.8
Net system capability (thousand megawatts)					
Hydro	1.5	1.5	1.5	1.4	1.4
Thermal	3.2	3.2	3.2	3.0	3.0
	4.7	4.7	4.7	4.4	4.4
Jointly-owned and firm purchases	2.9	2.9	2.9	2.9	2.9
	7.6	7.6	7.6	7.3	7.3

(A) Excludes revenue notes and advance refunding bonds