



**LOS ANGELES  
DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Basic Financial Statements and  
Required Supplementary Information

June 30, 2005 and 2004

(With Independent Auditors' Report Thereon)

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

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## **Independent Auditors' Report**

The Board of Water and Power Commissioners  
Department of Water and Power  
City of Los Angeles:

We have audited the accompanying balance sheet of the Power System Fund (Energy Services), an enterprise fund of the City of Los Angeles, California, as of June 30, 2005, and the related statements of revenues, expenses, and changes in fund net assets and cash flows for the year then ended. These financial statements are the responsibility of the Los Angeles Department of Water and Power's (the Department) management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements of Energy Services as of June 30, 2004 and for the years ended June 30, 2004 and 2003 were audited by other auditors whose report dated December 9, 2005, on those statements included explanatory paragraphs that described the adoption of Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and the restatement of Energy Services' June 30, 2004 financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Energy Services' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only Energy Services and do not purport to, and do not, present fairly the financial position of the City of Los Angeles, California, as of June 30, 2005 and 2004, the changes in its financial position or its cash flows for the years ended June 30, 2005, 2004, and 2003 in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the 2005 financial statements referred to above present fairly, in all material respects, the financial position of Energy Services as of June 30, 2005 and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 23, 2005 on our consideration of Energy Services' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis included on pages 3 through 15 and the schedules of funding progress for the pension plan and postemployment healthcare plan on page 61 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

December 23, 2005

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

The following discussion and analysis of the financial performance of the City of Los Angeles' (the City) Department of Water and Power's (the Department) Power System Fund (Energy Services) provides an overview of the financial activities for the fiscal years ended June 30, 2005 and 2004. Descriptions and other details pertaining to Energy Services are included in the notes to the financial statements. This discussion and analysis should be read in conjunction with Energy Services' financial statements, which begin on page 16.

**Using This Financial Report**

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

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

The basic financial statements provide an indication of Energy Services' financial health. The balance sheets include all of Energy Services' assets and liabilities, using the accrual basis of accounting, as well as an indication about which assets can be utilized for general purposes, and which assets are restricted as a result of bond covenants and other commitments. The statements of revenues, expenses, and changes in fund net assets report all of the revenues and expenses during the time periods indicated. The statements of cash flows report the cash provided and used by operating activities, as well as other cash sources such as investment income and cash payments for bond principal and capital additions and betterments.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

The following table summarizes the financial condition and changes in fund net assets of Energy Services as of and for the fiscal years ended June 30, 2005, 2004, and 2003 (amounts in millions):

**Table 1 – Summary of Financial Condition and Changes in Fund Net Assets**

(Amounts in millions)

Assets	June 30		
	2005	2004	2003
Utility plant, net	\$ 5,299	5,165	4,964
Investments	1,036	978	1,004
Other noncurrent assets	1,307	1,360	1,412
Current assets	1,314	1,241	1,096
	<u>\$ 8,956</u>	<u>8,744</u>	<u>8,476</u>
<b>Liabilities and Fund Net Assets</b>			
Long-term debt	\$ 3,481	3,357	3,232
Other long-term liabilities	732	610	722
Current liabilities	681	726	829
	<u>4,894</u>	<u>4,693</u>	<u>4,783</u>
Fund net assets:			
Invested in capital assets, net of related debt	1,641	1,664	1,568
Restricted	1,482	1,218	1,188
Unrestricted	939	1,169	937
	<u>4,062</u>	<u>4,051</u>	<u>3,693</u>
Total fund net assets	<u>\$ 8,956</u>	<u>8,744</u>	<u>8,476</u>

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Management's Discussion and Analysis

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(Unaudited)

<b>Revenues, Expenses, and Changes in Fund Net Assets</b>	<b>Year ended June 30</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Residential	\$ 693	718	644
Commercial and industrial	1,421	1,461	1,403
Sales for resale	102	74	64
Other	39	35	35
Total operating revenues	<u>2,255</u>	<u>2,288</u>	<u>2,146</u>
Fuel for generation and purchased power	1,113	1,096	972
Maintenance and other operating expenses	969	939	952
Total operating expenses	<u>2,082</u>	<u>2,035</u>	<u>1,924</u>
Operating income	173	253	222
Nonoperating activity:			
Investment income	113	92	132
Other nonoperating revenues and expenses, net	5	17	12
Debt expenses	<u>(146)</u>	<u>(134)</u>	<u>(139)</u>
Income before capital contributions and transfers and extraordinary item	145	228	227
Capital contributions	26	39	26
Transfer to the reserve fund of the City of Los Angeles	(160)	(210)	(185)
Extraordinary loss on extinguishment of debt	<u>—</u>	<u>(6)</u>	<u>—</u>
Increase in fund net assets	11	51	68
Beginning balance of fund net assets	4,051	3,693	3,625
Adjustment due to change in accounting principle from SFAS No. 106 to GASB No. 45	<u>—</u>	<u>307</u>	<u>—</u>
Ending balance of fund net assets	<u><u>\$ 4,062</u></u>	<u><u>4,051</u></u>	<u><u>3,693</u></u>

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Management's Discussion and Analysis

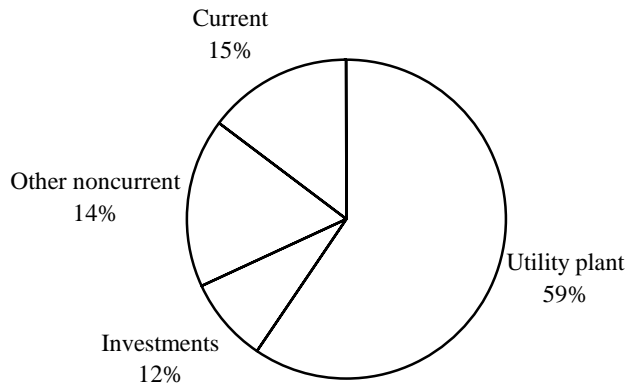
June 30, 2005 and 2004

(Unaudited)

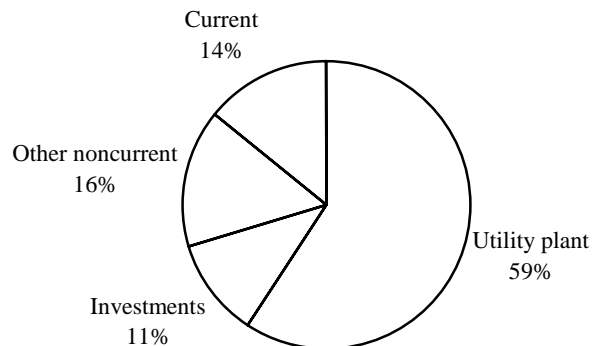
**Assets**

***Utility Plant***

Utility plant is the first category of assets shown on the balance sheet. The utility industry is unique in this regard as most other industries list their long-term assets such as plant and equipment after current assets on the balance sheet. This difference is due to the capital-intensive nature of the utility industry with the most significant portion of that capital being invested in utility plant. As depicted in the chart below, utility plant, net of accumulated depreciation, makes up 59% of the total assets of Energy Services as of June 30, 2005:



***Chart 1: Total Assets by Type Fiscal Year 2004***





**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

During fiscal years 2005 and 2004, Energy Services capitalized \$607 million and \$642 million of additions, including transfers from construction work in progress to utility plant in service. Of the \$607 million, \$403 million, or 66%, related to generation plant assets. Of the \$642 million, \$378 million, or 59%, related to generation plant assets. The majority of these additions were incurred as part of Energy Services' Integrated Resource Plan. Furthermore, Energy Services had capital improvements to its transmission and distribution utility plant assets to maintain and support normal load growth of the distribution and transmission systems.

Construction work in progress decreased by \$218 million and \$111 million from fiscal years 2004 and 2003, respectively, primarily as a result of ongoing local generation projects under the Integrated Resource Plan being placed in commercial service.

Energy Services has budgeted approximately \$628 million of capital expenditures for fiscal year 2006. Additional information regarding Energy Services utility plant assets can be found in note 4.

The Department's strategy is to have generating utility plant assets that can produce energy from a variety of fuel types. This is referred to as a hedged power supply. This is important in that if the costs related to a particular fuel type rise substantially in a short period of time, the Department can utilize its mix of generation assets to meet customer demand and to minimize increases in fuel expense. The Department has implemented a \$2 billion, ten-year plan to upgrade its local power plants and to implement a program that includes demand side management, alternative energy sources, and distributed generation. Through June 30, 2005, the Department has incurred \$1.2 billion related to such upgrades.

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(Unaudited)

The table below summarizes the generating resources available to the Department as of June 30, 2005. These resources include those owned by the Department (either solely or jointly with other utilities) as well as resources available through long-term purchase agreements. Generating station capacity is measured in megawatts (MWs).

**Table 2 – Generation Resources**

<b>Resource type</b>	<b>Number of units</b>	<b>Net maximum capacity (MWs)</b>	<b>Net dependable</b>
Steam:			
Gas	22	3,425	3,358
Coal	7	1,789	1,767
Nuclear	3	374	367
Large Hydro	7	1,666	1,535
Renewable	21 *	227	173
Subtotal	60	7,481	7,200
Typical CDWR obligation**		(65)	(65)
Total		7,416	7,135

\* Hoover Plant Station is counted as one unit. Six of seven units are operational at the Castaic Pump Storage Power Plant.

\*\* Energy payable to the California Department of Water Resources (CDWR).

**Liabilities and Fund Net Assets**

***Long-Term Debt***

As of June 30, 2005, Energy Services' total long-term debt balance was \$3.7 billion. The increase of \$154 million from the prior year mainly resulted from the issuance of \$200 million of revenue certificates, less \$46 million of scheduled maturities. The increase of \$107 million in 2004 mainly resulted from the issuance of new money bonds to fund capital expenditures, less \$36 million of scheduled maturities.

As of June 30, 2004, Energy Services' total long-term debt balance was \$3.5 billion. The increase of \$108 million from the prior year mainly resulted from the issuance of \$200 million of new money bonds to fund capital expenditures, less \$36 million of scheduled maturities. Furthermore, Energy Services issued \$956 million in revenue bonds and used \$93 million in cash to refund \$1.06 billion of revenue bonds outstanding. Energy Services also issued an additional \$10 million in Mini-Bonds to employees and retirees.

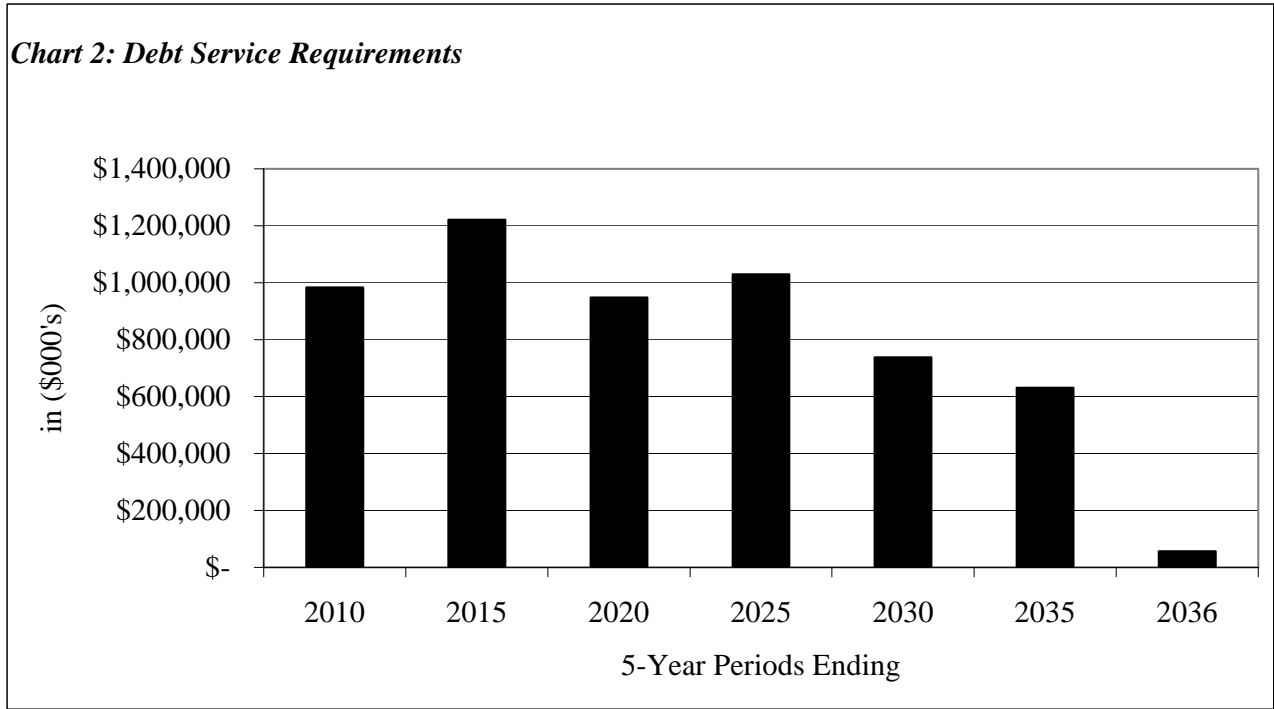
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June 30, 2005 and 2004

(Unaudited)

Outstanding principal, plus scheduled interest as of June 30, 2005, is scheduled to mature as shown in the chart below:



As of June 30, 2005 and 2004, \$173 million and \$432 million, respectively, of principal amounts of long-term debt are considered defeased and remain outstanding. This debt, together with assets in trust funds set aside for its full repayment at scheduled maturity dates, is not reflected on the balance sheets.

***Debt Management Program***

The debt restructuring element of the Debt Management Program includes the issuance of refunding bonds to achieve debt service savings and to accelerate the maturity of certain bonds while maintaining an appropriate overall annual debt service schedule for all of the Department's obligations in connection with Energy Services. As of June 30, 2004, the Department completed its refunding program, including the issuance of several series of refunding bonds payable from the Power Revenue Fund under a Master Bond Resolution adopted by the Board on February 6, 2001. Pursuant to this refunding program, the Department issued \$3.1 billion principal amount of refunding bonds to redeem, defease, or purchase \$2.5 billion principal amount of Department revenue bonds payable from the Power Revenue Fund and \$0.6 billion principal amount of Intermountain Power Agency (IPA) bonds. As of August 2003, Energy Services had completed its refunding program.

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In addition, Energy Services had \$601 million and \$664 million on deposit in trust funds restricted for the use of debt reduction as of June 30, 2005 and 2004, respectively. The Debt Management Program is intended to bring Energy Services' cost structure to a competitive level.

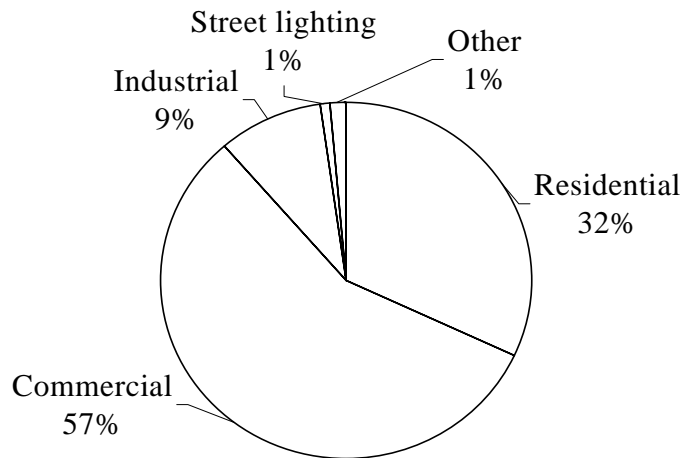
As of December 2005, Standard & Poor's Rating Services, Moody's Investors Service, and Fitch Ratings affirmed Energy Services' bond rating of AA-, Aa3, and AA-, respectively, due to Energy Services' broad revenue stream, sound financial metrics, and significant progress on economically defeasing one-half of Energy Services' off-balance sheet commitments. Additional information regarding Energy Services' long-term debt can be found in note 10 in the notes to the financial statements.

**Changes in Fund Net Assets**

***Operating Revenues***

The operating revenues of Energy Services are generated from wholesale and retail customers. There are four major customer categories of retail revenue. These categories include residential, commercial, industrial, and other, which includes public street lighting. Chart 3 summarizes the percentage contribution of retail revenues from each customer segment in fiscal years 2005 and 2004.

***Chart 3: Operating Revenues 2005***



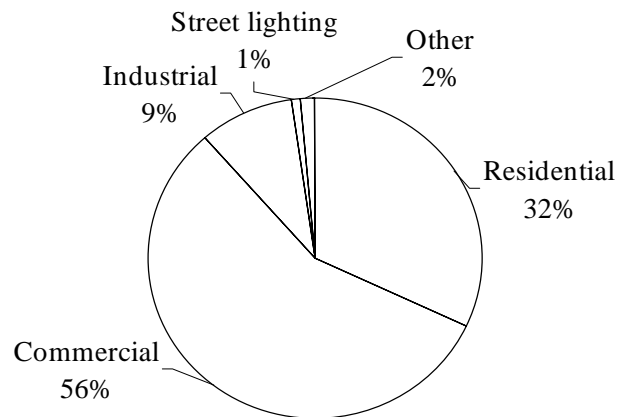
**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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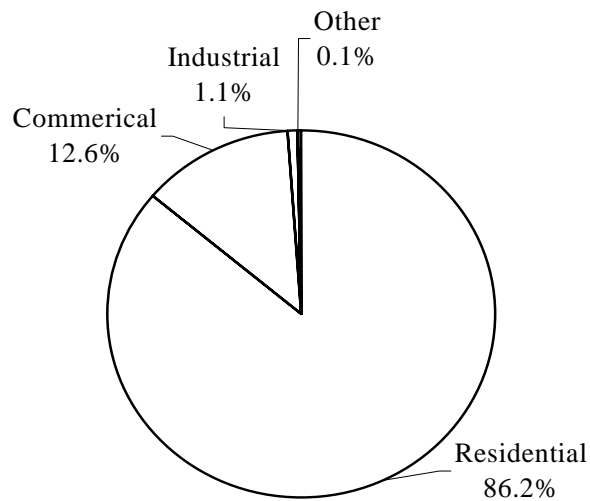
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***Chart 3: Operating Revenues 2005***



While commercial customers consume the most electricity, residential customers represent the largest customer class. As of June 30, 2005 and 2004, Energy Services had approximately 1.4 million customers. As shown in Chart 4, 1.2 million, or 86%, of total customers were in the residential customer class.

***Chart 4: Number of Customers 2005 and 2004***



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*Fiscal Year 2005*

Wholesale revenues increased from 2004 while retail revenues in all customer classes decreased from fiscal year 2004 due to a decrease in consumption. The decrease is mostly due to milder weather. The increase in wholesale revenue is due to increased sales from 2004.

*Fiscal Year 2004*

Wholesale and retail revenues in all customer classes increased from fiscal year 2003 due to an increase in consumption. The increase is mostly due to increased consumption in the months of April and May 2004 due to warmer than expected weather.

*Operating Expenses*

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

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

Depreciation expense is computed using the straight-line method based on service lives for all projects completed after July 1, 1973, and for all office and shop structures, related furniture and equipment, and transportation and construction equipment. Depreciation for facilities completed prior to July 1, 1973 is computed using the 5% sinking fund method based on estimated service lives. The Department uses the composite method of depreciation and therefore groups assets into composite groups for purposes of calculating depreciation expense. Estimated service lives range from 5 to 75 years. Amortization expense for computer software is computed using the straight-line method over 5 years.

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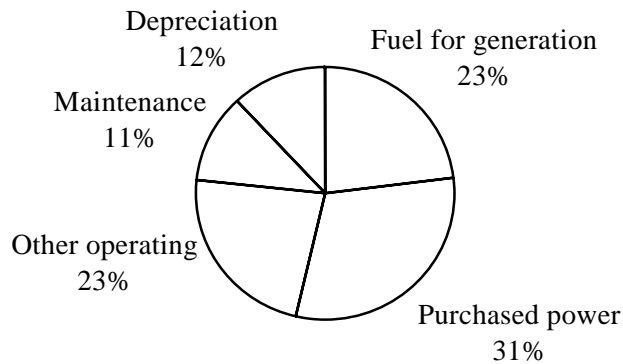
Management's Discussion and Analysis

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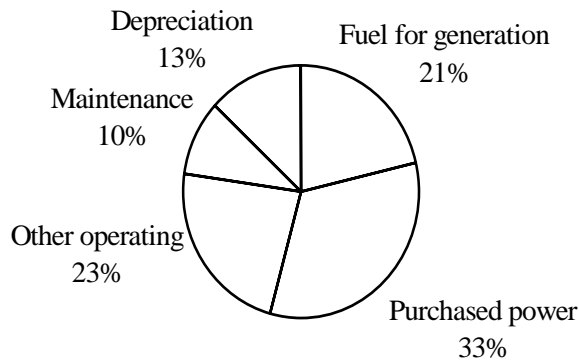
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The charts below summarize Energy Services' operating expenses during fiscal years 2005 and 2004:

***Chart 5: Operating Expenses 2005***



***Chart 5: Operating Expenses 2004***



***Fiscal Year 2005***

Fiscal year 2005 operating expenses were \$47 million higher as compared to fiscal year 2004. Fuel for generation expense increased by \$44 million due to higher cost of natural gas, and other operating and maintenance expenses increased by \$61 million due to increase labor costs, including pension expense. These increases were offset by decreases in purchased power costs and depreciation expense.

Depreciation expense decreased during fiscal year 2005 as compared to fiscal year 2004, mainly due to the implementation of the 2003 Depreciation Study. The Depreciation Study was adopted in the fourth quarter of 2004. The decrease was offset by additional depreciation in the current year as a result of additions to utility plant.

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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

*Fiscal Year 2004*

Fiscal year 2004 operating expenses were \$111 million higher as compared to the prior year. Fuel for generation expense had the largest increase of \$160 million due to increased natural gas costs. These costs were offset by lower purchased power costs, and lower health care costs that needed to be distributed due to an accounting change.

Depreciation expense decreased slightly during fiscal year 2004 as compared to fiscal year 2003, mainly due to the implementation of the 2003 Depreciation Study. The Depreciation Study was adopted in the fourth quarter of 2004 and resulted in an \$11 million reduction to depreciation expense. The decrease was offset by additional depreciation in the current year as a result of additions to utility plant.

Furthermore, Energy Services recognized a \$13 million impairment charge during fiscal year 2004 relating to the expected closure of the Mohave Generating Station and discontinued use of a procurement software program. See note 15 in the notes to the financial statements for further discussion.

***Nonoperating Revenues and Expenses***

*Fiscal Year 2005*

The major nonoperating activities of Energy Services for fiscal year 2005 included the transfer of \$160 million to the City's General Fund, interest income earned on investments of \$113 million, and \$147 million in debt expenses.

The transfer to the City is based on 7% of the previous year's operating revenues. Operating revenues for fiscal year 2004 were \$2.3 billion, which generated a City transfer of \$160 million.

Interest income increased \$21 million due to interest rates trending higher in fiscal year 2005 as compared to 2004.

The increase in debt expense is due to the issuance \$200 million of revenue certificates in September 2004 and higher interest rates on variable rate debt. The variable rate bonds' daily and weekly rate range increased from 1.06% to 1.13% as of June 30, 2004 to 2.22% to 2.27% as of June 30, 2005.

*Fiscal Year 2004*

The major nonoperating activities of Energy Services for fiscal year 2004 included the transfer of \$210 million to the City's General Fund, interest income earned on investments of \$92 million, and \$134 million in debt expenses.

The transfer to the City is based on 7% of the previous year's operating revenues. Operating revenues for fiscal year 2003 were \$2.1 billion, which generated a City transfer of \$150 million. However, the Board declared an additional \$60 million to be transferred which brought the total to \$210 million.



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Interest income decreased in fiscal year 2004 due a \$175 million reduction in investments and interest rates following the general trend and decreasing during fiscal year 2004.

Interest on debt declined due to lower rates on variable rate debt and the effects of the debt restructuring program which lowered average interest rates on fixed rate debt.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Balance Sheets

June 30, 2005 and 2004

(Amounts in thousands)

Assets	<u>2005</u>	<u>2004</u>
Noncurrent assets:		
Utility plant:		
Generation	\$ 3,385,763	2,989,566
Transmission	871,968	855,561
Distribution	4,114,437	3,999,153
General	987,556	942,117
	<u>9,359,724</u>	<u>8,786,397</u>
Accumulated depreciation	<u>(4,508,330)</u>	<u>(4,286,243)</u>
	4,851,394	4,500,154
Construction work in progress	434,105	652,375
Nuclear fuel, at amortized cost	13,472	12,553
	<u>5,298,971</u>	<u>5,165,082</u>
Restricted investments	1,036,114	978,245
Long-term California wholesale energy receivable, net	116,438	116,486
Long-term notes and other receivables, net of current portion	1,075,482	1,121,096
Net pension asset	114,521	122,271
	<u>7,641,526</u>	<u>7,503,180</u>
Total noncurrent assets		
Current assets:		
Cash and cash equivalents – unrestricted	145,367	188,350
Cash and cash equivalents – restricted	405,561	162,762
Cash collateral received from securities lending transactions	192,799	225,995
Customer and other accounts receivable, net of \$30,872 and \$28,585 allowance for losses, respectively	247,832	232,308
Current portion of long-term notes receivable	45,000	55,076
Due from Water Services	—	20,007
Accrued unbilled revenue	125,277	130,527
Materials and fuel	117,202	108,716
Prepayments and other current assets	35,295	117,033
	<u>1,314,333</u>	<u>1,240,774</u>
Total current assets		
Total assets	<u>\$ 8,955,859</u>	<u>8,743,954</u>

See accompanying notes to financial statements.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Balance Sheets

June 30, 2005 and 2004

(Amounts in thousands)

<b>Fund Net Assets and Liabilities</b>	<b>2005</b>	<b>2004</b>
Fund net assets:		
Invested in capital assets, net of related debt	\$ 1,641,388	1,663,861
Restricted:		
Debt service	721,928	776,491
Capital projects	323,596	91,338
Other postemployment benefits	199,914	159,183
Pension benefits	114,521	122,271
Other purposes	121,564	68,574
Unrestricted	938,775	1,169,215
Total fund net assets	4,061,686	4,050,933
Long-term debt, net of current portion	3,480,712	3,356,548
Other noncurrent liabilities:		
Deferred credits	625,555	540,143
Net other postemployment benefit obligation	71,168	38,487
Accrued workers' compensation claims	35,558	31,352
Commitments and contingencies (notes 6 and 15)		
Total other noncurrent liabilities	732,281	609,982
Current liabilities:		
Current portion of long-term debt	176,871	146,838
Accounts payable and accrued expenses	160,007	165,384
Payable to the reserve fund of the City of Los Angeles	—	60,000
Accrued interest	62,365	63,005
Accrued employee expenses	71,730	65,269
Due to Water Services	17,408	—
Obligation under securities lending transactions	192,799	225,995
Total current liabilities	681,180	726,491
Total liabilities	4,894,173	4,693,021
Total liabilities and fund net assets	\$ 8,955,859	8,743,954

See accompanying notes to financial statements.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Statements of Revenues, Expenses, and Changes in Fund Net Assets

Years ended June 30, 2005, 2004, and 2003

(Amounts in thousands)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating revenues:			
Residential	\$ 693,559	717,912	643,641
Commercial and industrial	1,421,003	1,460,814	1,403,422
Sales for resale	102,357	73,959	64,097
Other	48,275	49,682	47,544
Uncollectible accounts	(9,561)	(14,271)	(12,791)
	<u>2,255,633</u>	<u>2,288,096</u>	<u>2,145,913</u>
Operating expenses:			
Fuel for generation	478,201	434,122	273,905
Purchased power	634,923	662,070	697,824
Maintenance and other operating expenses	722,470	661,404	675,181
Depreciation and amortization	246,597	264,126	268,612
Loss on asset impairment and abandoned projects	—	13,634	8,330
	<u>2,082,191</u>	<u>2,035,356</u>	<u>1,923,852</u>
Operating income	<u>173,442</u>	<u>252,740</u>	<u>222,061</u>
Nonoperating revenues (expenses):			
Investment income	112,780	91,849	132,431
Other nonoperating income	9,695	21,066	17,013
	<u>122,475</u>	<u>112,915</u>	<u>149,444</u>
Other nonoperating expenses	<u>(4,164)</u>	<u>(3,967)</u>	<u>(4,807)</u>
	<u>118,311</u>	<u>108,948</u>	<u>144,637</u>
Debt expenses:			
Interest on debt	(148,347)	(135,793)	(141,238)
Allowance for funds used during construction	1,618	1,903	1,799
	<u>(146,729)</u>	<u>(133,890)</u>	<u>(139,439)</u>
Income before capital contributions, transfers, and extraordinary item	145,024	227,798	227,259
Capital contributions	25,896	38,514	25,818
Transfers to the reserve fund of the City of Los Angeles	(160,167)	(210,214)	(185,358)
Extraordinary loss on extinguishment of debt	—	(5,624)	—
Increase in fund net assets	10,753	50,474	67,719
Fund net assets:			
Beginning of year:	4,050,933	3,693,062	3,625,343
Adjustment due to change in accounting principle from SFAS No. 106 to GASB No. 45 (note 2)	—	307,397	—
End of year	<u>\$ 4,061,686</u>	<u>4,050,933</u>	<u>3,693,062</u>

See accompanying notes to financial statements.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Statements of Cash Flows

Years ended June 30, 2005, 2004, and 2003

(Amounts in thousands)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:			
Cash receipts:			
Cash receipts from retail customers	\$ 2,286,794	2,306,676	2,195,695
Cash receipts from retail customers for other agency services	345,361	289,096	269,158
Cash receipts from wholesale customers	57,902	96,988	112,613
Cash receipts from interfund services provided	325,848	286,023	283,803
Other cash receipts	626	—	—
Cash disbursements:			
Cash payments to employees	(421,955)	(388,834)	(368,289)
Cash payments to suppliers	(1,296,277)	(1,374,458)	(1,133,505)
Cash payments for interfund services used	(363,321)	(396,332)	(287,448)
Cash payments to other agencies for fees collected	(323,399)	(302,871)	(271,246)
Other operating cash payments	—	(11,101)	(8,196)
	<u>611,579</u>	<u>505,187</u>	<u>792,585</u>
Cash flows from noncapital financing activities:			
Payments to the reserve fund of the City of Los Angeles	(220,167)	(179,214)	(181,358)
Interest paid on noncapital revenue bonds	(10,391)	(5,402)	(6,862)
	<u>(230,558)</u>	<u>(184,616)</u>	<u>(188,220)</u>
Cash flows from capital and related financing activities:			
Additions to plant and equipment, net	(378,867)	(547,527)	(672,865)
Capital contributions	16,813	45,477	26,025
Purchases of escrow investments	—	—	(34,408)
Proceeds from escrow investment maturities	—	34,262	28,593
Principal payments and maturities on long-term debt	(46,228)	(1,125,282)	(419,320)
Issuance of bonds and revenue certificates	199,832	1,222,461	402,385
Debt interest payments	(137,247)	(115,458)	(143,462)
	<u>(345,697)</u>	<u>(486,067)</u>	<u>(813,052)</u>
Cash flows from investing activities:			
Purchases of investment securities	(2,547,736)	(4,026,043)	(4,637,343)
Proceeds from sales and maturities of investment securities	2,538,717	4,129,278	4,636,609
Proceeds from notes receivable	61,081	64,453	70,322
Investment income	112,430	102,106	135,690
	<u>164,492</u>	<u>269,794</u>	<u>205,278</u>
Net increase (decrease)	199,816	104,298	(3,409)
Cash and cash equivalent:			
Cash and cash equivalents at July 1 (including \$162,762, \$120,742, and \$83,463 reported in restricted accounts)	<u>351,112</u>	<u>246,814</u>	<u>250,223</u>
Cash and cash equivalents at June 30 (including \$405,561, \$162,762, and \$120,742 reported in restricted accounts)	\$ <u>550,928</u>	<u>351,112</u>	<u>246,814</u>

See accompanying notes to financial statements.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Statements of Cash Flows

Years ended June 30, 2005, 2004, and 2003

(Amounts in thousands)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	\$ 173,442	252,740	222,061
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization	246,597	264,126	268,612
Provision for losses on customer and other accounts receivable	9,561	14,271	12,791
Loss on asset impairment and abandoned projects	—	13,634	8,330
Changes in assets and liabilities:			
Customer and other accounts receivable	(16,738)	(20,445)	43,697
Accrued unbilled revenue	5,249	(11,674)	1,175
Materials and fuel	(8,486)	2,521	(3,646)
Net pension asset	7,750	(3,073)	6,457
Accounts payable and accrued expenses	(5,377)	(46,777)	63,439
Deferred credits	85,412	73,975	44,335
Due (from) to Water Services	37,415	(68,588)	61,423
Net other postemployment benefit liability	25,269	38,065	49,863
Workers' compensation liability and other	51,485	(3,588)	14,048
Net cash provided by operating activities	\$ <u>611,579</u>	<u>505,187</u>	<u>792,585</u>

See accompanying notes to financial statements.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Notes to Financial Statements

June 30, 2005 and 2004

**(1) Summary of Significant Accounting Policies**

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

**(a) Method of Accounting**

The accounting records of Energy Services are maintained in accordance with accounting principles generally accepted in the United States of America for governmental entities. The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Prior to fiscal year 2003, the Department applied all statements issued by the Governmental Accounting Standards Board (GASB) and all statements and interpretations issued by the Financial Accounting Standards Board (FASB), which are not in conflict with statements issued by GASB. In fiscal year 2003, the Department changed its election under the guidance in GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting* (GASB No. 20), to follow all GASB statements and only FASB statements and interpretations issued on or before November 30, 1989. See note 2.

The Department's rates are determined by the Board of Water and Power Commissioners (the Board) and are subject to review and approval by the City Council. As a regulated enterprise, the Department utilizes SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71), which requires that the effects of the rate making process be recorded in the financial statements. Such effects primarily concern the time at which various items enter into the determination of changes in fund net assets. Accordingly, Energy Services records various regulatory assets and liabilities to reflect the Board's actions. Regulatory liabilities were recorded in deferred credits and regulatory assets were included as prepayments on the balance sheets. Management believes that Energy Services meets the criteria for continued application of SFAS No. 71, but will continue to evaluate its applicability based on changes in the regulatory and competitive environment. See note 3.

**(b) Use of Estimates**

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

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Notes to Financial Statements

June 30, 2005 and 2004

**(c) Utility Plant**

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

During fiscal year 2004, Energy Services reversed previously capitalized postretirement health care costs of \$70 million from utility plant assets, net. These costs were capitalized as construction charges as a component of labor expenses determined under SFAS No. 106. As a result of the adoption of GASB No. 45, these costs were eliminated.

**(d) Impairment of Long-Lived Assets**

Effective fiscal year 2004, the Department adopted GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* (GASB No. 42). Governments are required to evaluate prominent events or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Under GASB No. 42, impaired capital assets that will no longer be used by the government should be reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the government should be measured using the method that best reflects the cause of the diminished service utility of the capital asset (see notes 2 and 15.)

**(e) Depreciation and Amortization**

Depreciation expense is computed using the straight-line method based on service lives for all projects completed after July 1, 1973, and for all office and shop structures, related furniture and equipment, and transportation and construction equipment. Depreciation for facilities completed prior to July 1, 1973 is computed using the 5% sinking fund method based on estimated service lives. The Department uses the composite method of depreciation and therefore groups assets into composite groups for purposes of calculating depreciation expense. Estimated service lives range from 5 to 75 years. Amortization expense for computer software is computed using the straight-line method over 5 years. Depreciation and amortization expense as a percentage of average depreciable utility plant in service were 2.8%, 3.2%, and 3.4% for fiscal years 2005, 2004, and 2003, respectively.



**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Notes to Financial Statements

June 30, 2005 and 2004

**(f) *Nuclear Decommissioning***

The Department owns a 5.7% direct ownership interest in the Palo Verde Nuclear Generating Station (PVNGS). In addition, through its participation in the Southern California Public Power Authority (SCPPA), the Department is party to a contract for an additional 3.95% of the output of PVNGS. Nuclear decommissioning costs associated with Energy Services' output entitlement are included in purchased power expense (see note 6).

Decommissioning of PVNGS is expected to commence subsequent to the year 2024. The total cost to decommission the Department's direct ownership interest in PVNGS is estimated to be \$130 million in 2004 dollars. This estimate is based on an updated site-specific study prepared by an independent consultant in 2004. As of June 30, 2005 and 2004, Energy Services has recorded \$115.3 million and \$110.9 million, respectively, to accumulated depreciation to provide for the decommissioning liability.

Prior to December 1999, Energy Services contributed \$70.2 million to external trusts established in accordance with the PVNGS participation agreement and Nuclear Regulatory Commission requirements. During fiscal year 2000, the Department suspended contributing additional amounts to the trust funds, as management believes that contributions made, combined with reinvested earnings, will be sufficient to fully fund the Department's share of decommissioning costs. The Department will continue to reinvest its investment income into the decommissioning trusts. The Department reinvested \$4.4 million and \$0.7 million of investment income in fiscal years 2005 and 2004, respectively. Decommissioning funds, which are included in restricted investments, totaled \$95.7 million and \$91.3 million as of June 30, 2005 and 2004 (at fair value), respectively. The Department's current accounting policy recognizes any realized and unrealized investment earnings from nuclear decommissioning trust funds as a component of accumulated depreciation.

**(g) *Nuclear Fuel***

Nuclear fuel is amortized and charged to fuel for generation on the basis of actual thermal energy produced relative to total thermal energy expected to be produced over the life of the fuel. Under the provisions of the Nuclear Waste Policy Act of 1982, the federal government assesses each utility with nuclear operations, including Energy Services, \$1 per megawatt hour of nuclear generation. Energy Services includes this charge as a current year expense in fuel for generation. See note 15 for discussion of spent nuclear fuel disposal.

**(h) *Cash and Cash Equivalents***

As provided for by the California Government Code, Energy Services' cash is deposited with the City Treasurer in the City's general investment pool for the purpose of maximizing interest earnings through pooled investment activities. Cash and cash equivalents in the City's general investment pool are reported at fair value and changes in unrealized gains and losses are recorded in the statements of revenues, expenses, and changes in fund net assets. Interest earned on such pooled investments is allocated to the participating funds based on each fund's average daily cash balance during the allocation period. The City Treasurer invests available funds of the City and its independent operating departments on a combined basis. Energy Services classifies all cash and cash

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
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Notes to Financial Statements

June 30, 2005 and 2004

equivalents that are restricted either by creditors, the Board, or by law, as restricted cash and cash equivalents on the balance sheet. The Department considers its portion of pooled investments with an original maturity of three months or less to be cash equivalents.

At June 30, 2005 and 2004, restricted cash and cash equivalents include the following (amounts in thousands):

	<b>June 30</b>	
	<b>2005</b>	<b>2004</b>
Bond redemption and interest funds	\$ 122,079	114,983
Construction funds	54	2,164
Self-insurance fund	52,475	42,475
Funds for purchase of gas field (note 16)	227,791	—
Other	3,162	3,140
	<u>\$ 405,561</u>	<u>162,762</u>

**(i) *Materials and Fuel***

Materials and supplies are recorded at average cost. Fuel is recorded at lower of cost or market, on an average cost basis.

**(j) *Accrued Unbilled Revenue***

Accrued unbilled revenue is the receivable for estimated energy sales during the period for which the customer has not been billed.

**(k) *Restricted Investments***

Restricted investments include primarily commercial paper, U.S. government and governmental agency securities, and corporate bonds. Investments are reported at fair value and changes in unrealized gains and losses are recorded in the statements of revenues, expenses, and changes in fund net assets except for Nuclear Decommissioning Trust Funds. The stated fair value of investments is generally based on published market prices or quotations from major investment dealers (see note 7).

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Notes to Financial Statements

June 30, 2005 and 2004

**(l) Accrued Employee Expenses**

Accrued employee expenses include accrued payroll and an estimated liability for vacation leave, sick leave, and compensatory time, which is accrued when employees earn the rights to the benefits. Below is a schedule of accrued employee expenses as of June 30, 2005 and 2004 (amounts in thousands):

	<b>Balance as of June 30</b>	
	<b>2005</b>	<b>2004</b>
Type of expenses:		
Accrued payroll	\$ 24,112	21,231
Accrued vacation	33,100	31,701
Accrued sick time	7,709	6,745
Compensatory time	6,809	5,592
Total	<u>\$ 71,730</u>	<u>65,269</u>

**(m) Debt Expenses**

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

**(n) Gas and Electricity Option and Location Swap Agreements**

Gas and electricity option and location swap agreements were previously reported at fair value on the balance sheets. With the change in election under GASB No. 20, the Department now accounts for these contracts on a settlement basis (see note 9).

**(o) Accrued Workers' Compensation Claims**

Liabilities for unpaid workers' compensation claims are recorded at their present value when they are probable of occurrence and the amount can be reasonably estimated. See note 13.

**(p) Customer Deposits**

Customer deposits represent deposits collected from customers upon opening of new accounts. These deposits are obtained when the customer does not have a previously established credit history with the Department. Original deposits plus interest are paid to the customer once a satisfactory payment history is maintained, generally after one to three years.

**LOS ANGELES DEPARTMENT OF WATER AND POWER  
ENERGY SERVICES**

Notes to Financial Statements

June 30, 2005 and 2004

Water Services is responsible for collection, maintenance, and refunding of these deposits for all Department customers, including those of Energy Services. As such, Water Services' balance sheets include a deposit liability of \$59.3 million and \$49.9 million as of June 30, 2005 and 2004, respectively, for all customer deposits collected. In the event that Water Services defaults on refunds of such deposits, Energy Services would be required to pay amounts owing to its customers.

**(q) 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.

Operating revenues are revenues generally derived from activities that are billable in accordance with the Electric rate ordinance approved by the City Council.

**(r) Capital Contributions**

Capital contributions (formally referred to as contributions in aid of construction) and other grants received by the Department for constructing utility plant and other activities are recognized when all applicable eligibility requirements, including time requirements, are met.

**(s) Allowance for Funds Used During Construction**

Allowance for funds used during construction (AFUDC) represents the cost of borrowed funds used for the construction of utility plant. Capitalized AFUDC is included as part of the cost of utility plant and as a reduction of debt expenses. The average AFUDC rate was 3.3%, 4.9%, and 4.2% for each of fiscal years 2005, 2004, and 2003.

**(t) Use of Restricted and Unrestricted Resources**

Energy Services policy is to use unrestricted resources prior to restricted resources to meet expenses to the extent that it is prudent from an operational perspective. Once it is not prudent, restricted resources will be utilized to meet intended obligations.

**(u) Reclassifications**

Certain financial statement items for prior years have been reclassified to conform to the 2005 presentation.

**(2) Accounting Changes**

**(a) GASB Statement No. 40**

Effective July 1, 2004, the Department adopted GASB Statement No. 40, *Deposit and Risk Investment Disclosures, an amendment of GASB Statement No. 3* (GASB No. 40). GASB No. 40 requires specific disclosures if applicable for credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. It also modifies GASB Statement No. 3, *Deposits with Financial*

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*Institutions, Investments (including Repurchase Agreements), and Reverse Purchase Agreements*, related to required disclosures of custodial credit risk of deposits and investments. See note 7 for disclosures.

**(b) GASB Statement No. 45**

On July 1, 2003, the Department adopted GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB No. 45), and discontinued following Financial Accounting Standards Board Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (SFAS No. 106).

Energy Services does not administer its plan for postretirement benefits other than pensions (health care benefits) as a trust or equivalent arrangement. Energy Services has not established the plan as a separate legal entity or documented the plan's objectives and parameters, the duties and responsibilities of the plan's governing body or the plan retirees' and beneficiaries' rights that would require a legal separation of employer and plan assets and liabilities. While certain assets that will fund liabilities of the plan have been placed into an irrevocable trust and can only be used to pay for plan liabilities on behalf of Energy Services, current postretirement benefit payments are not made from the trust, and as such, under the requirements of GASB No. 45, they are not considered contributions of the plan. Therefore, the assets placed into the trust remain restricted Energy Services' assets and are reported as such in the accompanying balance sheets as of June 30, 2005 and 2004. Currently, retiree premium payments are made from Energy Services' operations. Further, separate financial statements of the plan are not prepared. See note 12 for a description of the plan.

Prior to July 1, 2003, the Department was applying SFAS No. 106 in accounting for other postretirement costs. The postretirement obligation at June 30, 2003 amounted to \$362 million. The adoption of GASB No. 45 allows the Department to set the beginning postretirement obligation to zero and reverse any previously reported obligation. To eliminate Energy Services' postretirement liability, management reviewed the charges for health care costs created by SFAS No. 106 and reversed the costs as of July 1, 2003. Costs were reversed from previous capitalized labor charges included in utility plant and other operating expenses recorded in prior fiscal years.

The change from SFAS No. 106 to GASB No. 45 had no change to the health plan benefits to active or retired employees. The change also did not affect the assets designated for postretirement benefits. The change from SFAS No. 106 to GASB No. 45 changed the postretirement liability as of July 1, 2003, the determination of the annual required funding contribution for subsequent fiscal years, and the actuarial accrued liability (see note 12).

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As a result of the adoption of GASB No. 45, the following adjustments were recorded to Energy Services' balance sheet as of July 1, 2003 (dollar amounts in thousands):

<b>Balance sheet item</b>	<b>Reported as of June 2003</b>	<b>Adjustments</b>	<b>Adjusted balance</b>
Generation assets	\$ 2,622,137	(4,109)	2,618,028
Transmission assets	829,457	(7,761)	821,696
Distribution assets	3,893,836	(64,375)	3,829,461
General assets	915,054	(8,675)	906,379
Accumulated depreciation	(4,073,466)	14,880	(4,058,586)
Prepayments and other current assets	95,635	(3,370)	92,265
Due to Water Services	(67,447)	18,867	(48,580)
Accrued postretirement liability/asset	(230,693)	361,940	131,247
Fund net assets	(3,693,062)	(307,397)	(4,000,459)

With the adoption of GASB No. 45, the Department's postretirement annual required contribution for both Energy Services and Water Services combined decreased from \$119.7 million in fiscal year 2003 under SFAS No. 106 to \$107 million in fiscal year 2004 under GASB No. 45. The difference is due to a change in the discount rate from 5.75% to 6.5%, a change in the actuarial cost method from the projected unit credit cost method to the entry age normal method, and a change in the amortization period for prior service costs from 20 to 30 years. See note 12 for the required information under GASB No. 45.

Of the \$107 million postretirement annual required contribution recorded under GASB No. 45, \$70.9 million was allocated to Energy Services. Energy Services paid \$32.4 million for retiree premiums during fiscal year 2004 leaving \$38.5 million as a liability on Energy Services' books as of June 30, 2004.

Energy Services has established a restricted investment trust for postretirement healthcare expenses. These monies are restricted assets on Energy Services balance sheet. In 2004, the Department made additional contributions to the postretirement investment trust. As a result, the postretirement obligation and restricted investments on Energy Services books as of June 30, 2004 is as follows (amounts in thousands):

	<b>June 30, 2004</b>
Postretirement liability	\$ (38,487)
Restricted investments – postretirement trust assets	197,670

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**(c) GASB Statement No. 42**

In November 2003, GASB issued GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* (GASB No. 42). This statement established accounting and financial reporting standards for impairment of capital assets. In fiscal year 2004, Energy Services early adopted GASB No. 42 and calculated the impairment to its Mohave Generating Station and a procurement system. No retroactive restatement was required. See note 15 for a discussion on the impairment.

**(d) GASB Statement No. 39**

As of July 1, 2003, the Department adopted GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. This statement amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units, based on the nature and significance of their relationship with the primary government. Generally, it requires reporting, as a component unit, an organization that raises and holds economic resources for the direct benefit of a governmental unit. Energy Services is an enterprise fund of the City of Los Angeles and will continue to be included as part of the City's comprehensive annual financial report. As part of the adoption of GASB No. 39, the Department reviewed its relationships between Energy Services and the Intermountain Power Agency, and the Southern California Public Power Authority. Neither of these relationships met the component unit requirements of GASB No. 39. As a result, there was no material impact to the Energy Services' financial statements as a result of adopting this statement.

**(3) Regulatory Matters**

Effective April 1, 1998, customers of California's investor-owned utilities (IOU) became eligible for direct access. The introduction of direct access resulted in significant structural changes to the electric power industry, including plant divestitures and management of IOU transmission assets through the California Independent System Operator (CISO). In 2001, legislation was enacted to suspend direct access to retail customers in California. No definitive plan for allowing direct access to customers in the Department's service area has been adopted; however, if the Department implements direct access in the future, it is likely that its generation business will no longer qualify for accounting under SFAS No. 71. SFAS No. 71 requires that the effects of the rate making process be recorded in the financial statements.

As a government-owned utility, the Department was not compelled to participate in direct access or to divest its generation assets. Management continues to evaluate the Department's alternatives in response to deregulation, the introduction of direct access, and participation in the CISO. In addition, management has implemented debt and cost reduction programs and restructured certain purchase power commitments in response to the changes in the electric utility market. Furthermore, in August 2000, the City Council approved a \$1.7 billion, ten-year plan to upgrade the Department's local power plants and to implement a program that includes demand side management, alternative energy sources, and distributed generation. This plan has been amended to allow for a total budget of \$2.0 billion. Through June 30, 2005, the Department has incurred \$1.2 billion related to such upgrades.

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**(a) *Federal Energy Regulatory Commission Price Mitigation Plan***

In June 2001, the Federal Energy Regulatory Commission (FERC) issued a price mitigation plan on spot market sales in the Western Electric Coordinating Council (WECC). The plan imposes price limits on the sale of electricity in WECC based on a calculation that estimates the cost of production of the least efficient gas-fired generation plant in California and a fixed factor to account for other variable costs. Energy Services' purchases and sales of electricity occur entirely within the WECC and as such are subject to these measures. These measures have, in part, contributed to stabilizing the market and resulting in overall lower wholesale prices.

**(b) *California Receivables and FERC Refund Hearings***

During fiscal year 2001, Energy Services made sales to two California agencies that were formed by Assembly Bill 1890 to facilitate the purchase and sale of energy and ancillary services in the State of California. Through June 30, 2005, these agencies, the CISO, and the California Power Exchange (CPX), have made minimal payments since April 2001 on amounts outstanding to counterparties, including Energy Services, for certain energy purchases in fiscal years 2000 and 2001. The CPX filed for protection under Chapter 11 of the Federal Bankruptcy Statute in January 2001. Two utilities with significant amounts due to these agencies, Southern California Edison Company and Pacific Gas & Electric, have previously stated in public disclosure documents that they may not be able to pay for all the power they consumed in 2001. Subsequently, Pacific Gas & Electric and Southern California Edison Company have paid all amounts due to the CPX; however, the amounts remain in an escrow account pending the resolution of disbursement of the funds.

As of June 30, 2005 and 2004, a total of \$166.5 million was due to Energy Services from the CISO and the CPX. The FERC has questioned whether amounts charged for energy sold to the CISO and the CPX during 2000 and 2001 represent "unlawful profits" that should be subject to refund. The FERC has considered various options for determination of a refund amount but has not issued definitive guidance on what represents unlawful profits for sales during the period. The Courts have opined that FERC has no jurisdiction over the Department; however, the Courts have stated that the California parties seeking the refund may have a cause of action. As such, the litigation in this area is continuing.

Energy Services has recorded a \$50.0 million liability as of June 30, 2005 and 2004 against the \$166.5 million receivable, for potential refunds pertaining to its wholesale sales during 2000 and 2001. Management believes that this is the most probable amount that will be refunded by Energy Services and is based on the most recent formula disclosed by FERC. While management has recorded its estimate of the most probable amounts that will be refunded, management does believe that it is entitled to all amounts due from sales to counterparties in California, including those named above. Furthermore, management believes that interest may be due to it on those amounts but any potential receivable is not estimable at this time. In addition, management does not believe that



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Energy Services' exposure to any additional losses with respect to these receivable balances is currently estimable. If final settlement of these receivables results in an amount less than the recorded balance, net of the \$50.0 million liability recorded, the Department will be required to record a loss in future periods.

**(c) *Public Benefits***

In accordance with Assembly Bill 1890, as amended by Assembly Bill 995 and pursuant to direction from the Board, a percentage of the Department's retail revenue is designated for use for qualifying public benefit programs. Qualifying programs include cost-effective demand side management services to promote energy efficiency and energy conservation, new investment in renewable energy resources and technologies, development and demonstration programs to advance science and technology, and services provided for low-income electricity customers. In accordance with current legislation and the Department's plans, the program is currently expected to cease January 1, 2012.

The Department defers public benefits revenue from customers in excess of costs incurred under qualifying programs and defers qualifying expenses in excess of collections pursuant to approval received from the Board. During fiscal years 2005, 2004, and 2003, the Department spent \$39.2 million, \$64.2 million, and \$74.9 million, respectively, on public benefits programs. These programs include investments in electric buses and vehicles, photovoltaics, or solar power and other alternative energy sources, and support for low-income and life support customers. As of June 30, 2005 and 2004, the Department has recorded a deferred credit in the amount of \$12.7 million due to public benefit expenses below revenues, and a deferred debit of \$9.7 million, due to public benefit expenses incurred in excess of revenues, respectively. Regulatory liabilities are reduced when adequate public benefit expenses are incurred, and regulatory assets are recovered when the corresponding revenue is earned.

**(d) *State Legislation***

On September 12, 2002, SB 1078 was enacted, which requires, among other things, the IOUs to generate 20% of their electricity from renewable energy sources such as wind, solar, biomass, and geothermal energy by no later than 2010. Publicly owned utilities such as the Department are exempt from the provisions of this California law and may establish their own renewable portfolio standard. The impact of SB 1078 on the market for renewable energy sources cannot be predicted at this time.

**(e) *Federal Regulation of Transmission Access***

The Energy Policy Act of 1992 (the Energy Policy Act) made fundamental changes in the federal regulation of the electric utility industry, particularly in the area of transmission. As amended by the Energy Policy Act, Sections 211, 212, and 213 of the Federal Power Act provide FERC authority, upon application by any electric utility, federal power marketing agency, or other person or entity generating electric energy for sale or resale, to require a transmitting utility to provide transmission services (including any enlargement of transmission capacity necessary to provide such services) to the applicant at rates, charges, terms, and conditions set by FERC based on standards and provisions

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in the Federal Power Act. Under the Energy Policy Act, electric utilities owned by municipalities and other public agencies which own or operate electric power transmission facilities which are used for the sale of electric energy at wholesale are “transmitting utilities” subject to the requirements of Sections 211, 212, and 213.

FERC is encouraging the voluntary formation of regional transmission organizations (RTOs) independent from owners of generation and other market participants that will provide transmission access on a nondiscriminatory basis to buyers and sellers of power. IOUs and publicly owned utilities are being encouraged to participate in the formation and operation of RTOs, but are not, at this time, being ordered by FERC to participate. FERC has adopted a “go slow” approach to the issue of RTO formation in the western United States; it is contemporaneously engaged in a wholesale overhaul of the California market design, referred to initially as the “MDO2 proceeding” and more recently as the “MRTU proceeding.” These FERC proceedings will have potential impacts on every electric utility doing business in California. It is not certain at this time what impact, if any, FERC’s final decision on “MDO2” or “MRTU” will have on the Power System or when FERC will issue a final order. In addition, the California ISO has announced its intention to implement further market changes over the next five years.

**(f) Federal Energy Legislation**

On August 8, 2005, the Energy Policy Act of 2005 (the Act) was enacted, the first comprehensive energy legislation in over a decade. One of the most significant provisions of the Act repeals the Public Utility Holding Company Act of 1935 (PUHCA) six months after the effective date of the Act, on February 8, 2006. PUHCA prevented investment in the public utility sector by entities such as financial institutions and industrial companies and was a barrier to consolidation within the industry through its requirement that merged companies operate within a single region.

Another significant provision of the Act empowers FERC to certify an Electric Reliability Organization (ERO) to improve the reliability of the “bulk-power system” through mandatory and enforceable electric reliability standards (in contrast to the current voluntary system). The definition of “bulk-power system” does not include facilities used in the local distribution of electric energy. The ERO will file any proposed reliability standard or modification with FERC. A “reliability standard” is a requirement that provides for reliable operation of the bulk-power system. Such a standard includes requirements for the operation of existing transmission facilities or the design of planned additions or modifications to the extent necessary to provide for reliable operation. It does not include, and the ERO may not impose, any requirement to enlarge existing facilities or to construct new transmission or generation. All users, owners, and operators of the bulk-power system are required to comply with the electric reliability standards. The ERO may impose a penalty on a user, owner, or operator for violating a reliability standard, and FERC may order compliance with such a standard and impose a penalty if it finds that a user, owner, or operator is about to engage in an act that would violate a reliability standard.

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The Act authorizes FERC to require nondiscriminatory access to transmission facilities owned by municipal, cooperative, and other transmission companies not currently regulated by FERC, unless exercising this authority would violate a private activity bond rule for purposes of Section 141 of the Internal Revenue Code of 1986. FERC is prohibited from requiring any such entities to join RTOs. The Act also allows FERC to issue permits for the construction of new transmission facilities when states have been unable or unwilling to act and allows load-serving entities to use the firm transmission rights, or equivalent tradable or financial transmission rights, in order to deliver output or purchased energy to the extent required to meet its service obligations. The Act does not relieve a load-serving entity from any obligation under state or local law to build transmission or distribution facilities adequate to meet its service obligations, or to abrogate preexisting firm transmission service contracts.

The Act directs FERC to establish, by rule, incentive-based rates for transmission no later than August 2006 and requires FERC to establish market transparency rules for the electric wholesale market (entities that have a “de minimis market presence” are exempt from the rules). The Act instructs that the market transparency rules must provide for the timely dissemination of information about the availability and prices of wholesale electric energy and transmission service to FERC, state commission, buyers and sellers of wholesale electric energy, users of transmission services, and the public. Within 180 days of the Act’s enactment, FERC and the Commodity Futures Trading Commission are required to enter into a memorandum of understanding regarding information sharing pursuant to these rules.

In addition, the Act prohibits any person from willfully and knowingly reporting false information to any federal agency on the price of wholesale electricity or availability of transmission capacity, or using (directly or indirectly) any manipulative device in contravention of any FERC rule. The Act increases civil and criminal penalties, modifies the procedures for review of FERC orders under the Federal Power Act (FPA), and changes the refund date under the FPA to be effective as of the date an applicable complaint is filed. The Act also establishes an entity’s right to a refund if (i) it makes a short-term sale of electric energy through an organized market in which the rates for the sale are set by a FERC-approved tariff (not by a contract) and (ii) the sale violates the terms of the tariff or applicable FERC rule in effect at the time of the sale.

The Act contains provisions for \$800 million in tax-credit bonds (which pay no interest but instead provide tax credits) to be issued in 2006 and 2007 to finance renewable energy projects for nonprofit utilities. No more than \$500 million of these bonds, however, may be issued for projects for governmental entities.

The overall impact of the Act on the Department cannot be predicted at this time.

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**(4) Utility Plant**

Energy Services had the following activity in utility plant during fiscal year 2005 (amounts in thousands):

	<b>Balance June 30, 2004</b>	<b>Additions</b>	<b>Retirements and disposals</b>	<b>Transfers</b>	<b>Balance June 30, 2005</b>
<b>Nondepreciable utility plant:</b>					
Land and land rights	\$ 157,788	25	(9,245)	—	148,568
Construction work in progress	652,375	219,572	—	(437,842)	434,105
Nuclear fuel	12,553	6,119	(5,200)	—	13,472
Total nondepreciable utility plant	822,716	225,716	(14,445)	(437,842)	596,145
<b>Depreciable utility plant:</b>					
Generation	2,980,568	28,646	(6,480)	374,007	3,376,741
Transmission	775,855	12,732	(10)	3,685	792,262
Distribution	3,946,432	68,679	(1,331)	57,157	4,070,937
General	925,754	52,714	(10,245)	2,993	971,216
Total depreciable utility plant	8,628,609	162,771	(18,066)	437,842	9,211,156
Less accumulated depreciation:					
Generation	(1,745,948)	(95,717)	6,480	—	(1,835,185)
Transmission	(324,677)	(15,868)	10	—	(340,535)
Distribution	(1,573,735)	(104,306)	1,331	—	(1,676,710)
General	(641,883)	(24,262)	10,245	—	(655,900)
Total accumulated depreciation	(4,286,243)	(240,153)	18,066	—	(4,508,330)
<b>Total utility plant, net</b>	<b>\$ 5,165,082</b>	<b>148,334</b>	<b>(14,445)</b>	<b>—</b>	<b>5,298,971</b>

Depreciation expense during fiscal 2005 was \$229.1 million.

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Energy Services had the following activity in utility plant during fiscal year 2004 (amounts in thousands):

	<b>Balance June 30, 2003</b>	<b>Adjustment due to GASBS 45 adoption (see note 2)</b>	<b>Adjusted beginning balance</b>	<b>Additions</b>	<b>Retirements and disposals</b>	<b>Transfers</b>	<b>Balance June 30, 2004</b>
<b>Nondepreciable utility plant:</b>							
Land and land rights	\$ 156,725	—	156,725	1,087	(24)	—	157,788
Construction work in progress	763,000	—	763,000	433,200	—	(543,825)	652,375
Nuclear fuel	13,431	—	13,431	5,709	(6,587)	—	12,553
Total nondepreciable utility plant	933,156	—	933,156	439,996	(6,611)	(543,825)	822,716
<b>Depreciable utility plant:</b>							
Generation	2,613,144	(4,109)	2,609,035	21,777	(6,292)	356,048	2,980,568
Transmission	749,750	(7,761)	741,989	2,880	(88)	31,074	775,855
Distribution	3,842,174	(64,375)	3,777,799	58,069	(5,106)	115,670	3,946,432
General	898,691	(8,675)	890,016	9,749	(15,044)	41,033	925,754
Total depreciable utility plant	8,103,759	(84,920)	8,018,839	92,475	(26,530)	543,825	8,628,609
Less accumulated depreciation:							
Generation	(1,666,323)	720	(1,665,603)	(86,637)	6,292	—	(1,745,948)
Transmission	(306,862)	1,360	(305,502)	(19,263)	88	—	(324,677)
Distribution	(1,477,096)	11,280	(1,465,816)	(113,025)	5,106	—	(1,573,735)
General	(623,185)	1,520	(621,665)	(35,262)	15,044	—	(641,883)
Total accumulated depreciation	(4,073,466)	14,880	(4,058,586)	(254,187)	26,530	—	(4,286,243)
<b>Total utility plant, net</b>	<b>\$ 4,963,449</b>	<b>(70,040)</b>	<b>4,893,409</b>	<b>278,284</b>	<b>(6,611)</b>	<b>—</b>	<b>5,165,082</b>

Depreciation expense during fiscal 2004 was \$238.5 million.

**(5) Jointly Owned Utility Plant**

Energy Services has direct interests in several electric generating stations and transmission systems, which are jointly owned with other utilities. As of June 30, 2005, utility plant includes the following amounts related to Energy Services' ownership interest in each jointly owned utility plant (amounts in thousands, except as indicated):

	<b>Ownership interest</b>	<b>Share of capacity (MW)</b>	<b>Utility plant in service June 30, 2005</b>		<b>Utility plant in service June 30, 2004</b>	
			<b>Cost</b>	<b>Accumulated depreciation</b>	<b>Cost</b>	<b>Accumulated depreciation</b>
Palo Verde Nuclear Generating Station	5.7%	217	\$ 529,634	270,898	529,063	256,458
Navajo Generating Station	21.2%	477	315,739	230,093	210,467	216,120
Mohave Generating Station	10.0%	158	69,681	68,510	68,163	67,459
Pacific Intertie DC Transmission Line	40.0%	1,240	204,003	62,660	195,712	56,047
Other transmission systems		Various	77,010	37,912	76,336	37,827
			<u>\$ 1,196,067</u>	<u>670,073</u>	<u>1,079,741</u>	<u>633,911</u>

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

**(6) Purchase Power Commitments**

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

	<u>Agency</u>	<u>Agency share</u>	<u>Department's interest in agency's share</u>		
			<u>Interest</u>	<u>Capacity MW</u>	<u>Outstanding principal</u>
Intermountain Power Project	IPA	100.0%	66.0%	1,158	\$ 1,576,916
Palo Verde Nuclear Generating Station	SCPPA	5.9%	67.0%	151	\$ 91,495
Mead-Adelanto Project	SCPPA	67.9%	35.7%	291	\$ 81,826
Mead-Phoenix Project	SCPPA	17.8% – 22.4%	24.8%	148	\$ 17,881
Southern Transmission System	SCPPA	100.0%	59.5%	1,142	\$ 559,512

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

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

The above agreements require Energy Services to make certain minimum payments, which are based primarily upon debt service requirements. In addition to average annual fixed charges of approximately \$300 million during each of the next five years, the Department is required to pay for operating and maintenance costs related to actual deliveries of energy under these agreements (averaging approximately \$289 million annually during each of the next five years). The Department made total payments under these agreements of approximately \$468 million, \$551 million, and \$546 million in fiscal years 2005, 2004, and 2003, respectively. These agreements are scheduled to expire from 2027 to 2030.

Energy Services earned fees under the IPP Project Manager and Operating agreements totaling \$16.3 million, \$18.2 million, and \$15.8 million in fiscal years 2005, 2004, and 2003, respectively.

**(a) Long-Term Notes Receivable**

Under the terms of its purchase power agreement with IPA, the Department is charged for its output entitlements based on its share of IPA's costs, including debt service. During fiscal year 2000, the Department restructured a portion of this obligation by transferring \$1.11 billion to IPA in exchange for long-term notes receivable. The funds transferred were obtained from the debt reduction trust

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funds and through the issuance of new variable rate debentures (see notes 7 and 10). IPA used the proceeds from these transactions to defease and to tender bonds with par values of approximately \$618 million and \$611 million, respectively.

On September 7, 2000, the Department paid \$187 million to IPA in exchange for additional long-term notes receivable. IPA used the proceeds to defease bonds with a face value of \$198 million.

The IPA notes are subordinate to all of IPA's publicly held debt obligations. Energy Services' future payments to IPA will be partially offset by interest payments and principal maturities from the subordinated notes receivable. The net IPA notes receivable balance totaled \$1.12 billion and \$1.17 billion as of June 30, 2005 and 2004, respectively.

**(b) Energy Entitlement**

The Department has a contract through 2017 with the U.S. Department of Energy for the purchase of available energy generated at the Hoover Power Plant. Energy Services' share of capacity at Hoover is approximately 500 megawatts. The cost of power purchased under this contract was \$13 million, \$12 million, and \$12 million in each of fiscal years 2005, 2004, and 2003.

**(7) Cash, Cash Equivalents, and Investments**

**(a) Restricted and Other Investments**

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

	<u>2005</u>	<u>2004</u>
<b>Restricted and other investments:</b>		
Restricted investments:		
Debt reduction trust funds	\$ 601,130	664,019
Postretirement health care benefit trust	271,082	197,670
Nuclear decommissioning trust fund	95,750	91,338
Natural gas trust fund	25,022	25,183
SCPPA Palo Verde Investment	43,094	—
Other investments	<u>36</u>	<u>35</u>
Total restricted investments	1,036,114	978,245
<b>Other investments:</b>		
Cash collateral received from securities lending transactions Department Program only* (see note 8)	<u>155,481</u>	<u>182,692</u>
<b>Total restricted and other investments</b>	<u>\$ 1,191,595</u>	<u>1,160,937</u>

\* Energy Services also has \$37,318 of cash collateral received from securities lending transactions in the City's securities lending program (see notes 7(b) and 8).

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

***Debt Reduction Trust Funds***

The debt reduction trust funds were established during fiscal year 1997 to provide for the payment of principal and interest on long-term debt obligations and purchased power obligations arising from the Department's participation in the Intermountain Power Project and the Southern California Public Power Authority (SCPPA) (see note 6). The Department has transferred funds from purchased power precollections into these trust funds. Funds from operations may also be transferred by management as funds become available.

***Postretirement Health Care Benefit Trust***

The postretirement health care benefit fund was established to provide for the payment of the Department's postretirement health care benefits. The adoption of GASB No. 45 had no impact on the amount or fair value of the trust (see note 12).

***Nuclear Decommissioning Trust Funds***

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

***Natural Gas Trust Fund***

The natural gas trust fund was established to serve as depository to pay for costs and to post margin or collateral in connection with contracts for the purchase and delivery of financial transactions for natural gas. These transactions are entered into to stabilize the natural gas portion of the Department's fuel for generation costs.

***SCPPA Palo Verde Investment***

The SCPPA Palo Verde investment is a fixed rate investment held by SCPPA to be drawn down over the next 12 years to pay for purchased power obligations arising from the Department's participation in the SCPPA Palo Verde project.

***Other Investments***

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



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As of June 30, 2005, Energy Services' investments and their maturities are as follows (in thousands):

Investment type	Fair value	Investment maturities				
		1 to 30 days	31 to 60 days	61 to 365 days	366 days to 5 years	Over 5 years
U.S. Agencies	\$ 606,968	70,464	22,977	220,265	193,293	99,969
Medium-term notes	186,988	21,239	28,260	85,810	51,679	—
Commercial paper	158,683	126,315	16,273	16,095	—	—
Negotiable CDs	33,090	—	—	33,090	—	—
Money market funds	7,291	7,291	—	—	—	—
Securities lending cash collateral repurchase agreements	155,481	155,481	—	—	—	—
SCPPA Palo Verde investment	43,094	—	—	—	—	43,094
	<u>\$ 1,191,595</u>	<u>380,790</u>	<u>67,510</u>	<u>355,260</u>	<u>244,972</u>	<u>143,063</u>

***Interest Rate Risk***

The Department's investment policy limits the maturity of its investments to a maximum of 30 years for U.S. Government Agency securities; 5 years for medium-term corporate notes, 270 days for commercial paper; 397 days for negotiable certificates of deposits; and 45 days for repurchase agreements purchased with cash collateral from securities lending agreements.

***Credit Risk***

Under its investment policy and the State of California Government Code, the Department is subject to the prudent investor standard of care in managing all aspects of its portfolios. The prudent investor standard requires that the Department "... shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency."

The Department's investment policy specifies that money market funds may be purchased as allowed under the State of California Government Code (Code), which requires that the fund must have either 1) attained the highest ranking or highest letter and numerical rating provided by not less than two nationally recognized statistical rating organizations (NRSRO) or 2) retained an investment advisor registered or exempt from registration with the Securities and Exchange Commission with not less than five years experience managing money market mutual funds with assets under management in excess of five hundred million dollars. As of June 30, 2005, each of the money market funds in the portfolio have attained the highest possible ratings by three NRSROs, specifically AAAM by Standard and Poor's, Aaa by Moody's Investors Service, and AAA by Fitch Ratings.

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The U.S. government agency securities in the portfolio consist of securities issued by government-sponsored enterprises, which are not explicitly guaranteed by the U.S. government. As of June 30, 2005, the U.S. government agency securities in the portfolio carried the highest possible credit ratings by the NRSROs that rated them.

The Department's investment policy specifies that commercial paper must be of the highest ranking or of the highest letter and number rating as provided for by at least two NRSROs. As of June 30, 2005, all of Energy Services' investments in commercial paper were rated with at least the highest letter and number rating as provided by at least two NRSROs.

The Department's investment policy specifies that negotiable certificates of deposit must be of the highest ranking or letter and number rating as provided for by at least two NRSROs. As of June 30, 2005, all of Energy Services' investments in negotiable certificates of deposits were of the highest ranking by three NRSROs.

The Department's investment policy specifies that corporate bonds must be rated in a rating category of "A" or its equivalent or better by a NRSRO. Of the Department's investments in corporate bonds as of June 30, 2005, \$15,337,713 (8%) was rated in the category of AAA, \$81,553,979 (44%) was rated in the category of AA, and \$90,095,668 (48%) was rated in the category of A by at least one NRSRO.

The Department's securities lending cash collateral investment policy specifies that repurchase agreement transactions shall be limited to broker-dealers or banks for which a securities lending line has been approved by the securities lending agent. Approved counterparties must be primary dealers in U.S. government securities that work directly with the Federal Reserve Bank of New York. Repurchase agreements must be adequately collateralized based on the margin requirements for the type of security listed in the investment policy. As of June 30, 2005, the counterparties to the repurchase agreements were approved primary dealers that were rated with the highest short-term letter and number ratings as provided by two NRSROs. The collateral for the repurchase agreements consisted of mortgage-backed securities issued by U.S. government agencies that had minimum credit ratings of AAA with a margin of 102% of the repurchase agreements.

***Concentration of Credit Risk***

The Department's investment policy specifies that there is no percentage limitation on the amount that can be invested in U.S. government agency securities, except that a maximum of 30% of the cost value of the portfolio may be invested in the securities of any single U.S. government agency issuer.

Of Energy Services' total investments as of June 30, 2005, \$198,249,683 (17%) was invested in securities issued by the Federal Home Loan Bank; \$188,329,998 (16%) was invested in securities issued by the Federal National Mortgage Association; \$168,174,337 (15%) was invested in securities issued by the Federal Home Loan Mortgage Corporation; and \$52,214,278 (5%) was invested in securities issued by the Farm Credit Bank.

For overnight or open repurchase agreements, the Department's securities lending policy does not limit the percentage of cash collateral that may be invested with one particular counterparty.

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Of the Energy Services' total investments as of June 30, 2005, all cash collateral received from securities lending transactions of \$155,481,114 (14%) was invested in open repurchase agreements with Goldman Sachs & Co.

**(b) Pooled Investments**

Energy Services' cash, cash equivalents and its collateral value of the City's securities lending program are included within the City Treasury's General and Special Investment Pool. As of June 30, 2005, Energy Services' share of the City's General and Special Investment Pool is \$588,246,000, which represents approximately 9% of the Pool.

At June 30, 2005, the investments held in the City Treasury's General and Special Investment Pool Programs and their maturities are as follows (amounts in thousands):

Type of investments	Amount	Investment maturities			
		1 to 30 days	31 to 60 days	61 to 365 days	366 days to 5 years
U.S. treasury notes	\$ 526,446	—	25,102	50,690	450,654
U.S. agencies	3,446,885	244,830	113,766	373,801	2,714,488
Medium-term notes	878,328	5,004	24,974	121,815	726,535
Commercial paper	861,293	844,318	16,500	475	—
State of California LAIF	40,703	40,703	—	—	—
Short-term investment funds	9	9	—	—	—
Securities lending cash collateral:					
U.S. treasury notes	478,756	—	26,219	52,812	399,725
U.S. agencies	395,396	—	—	—	395,396
Total general and special pools	\$ 6,627,816	1,134,864	206,561	599,593	4,686,798

**Interest Rate Risk**

The City's investment policy limits the maturity of its investments to a maximum of five years for U.S. Treasury and federal agency securities, medium-term corporate notes, and bonds issued by local agencies; 270 days for commercial paper; and 32 days for repurchase agreements.

**Credit Risk**

The City's investment policy requires that for all classes of investments, except linked banking certificates of deposits, the issuers must have minimum credit ratings as follows: Standard and Poor's Corporation (S&P) A-1/A; Moody's Investor Services (Moody's) P-1/A2; Fitch Ratings (Fitch), if available, F1/A. The City's investments in medium-term notes were rated A+ or better by S&P and A1 or better by Moody's, while investments in commercial paper were rated A-1+ by S&P, and P-1 by Moody's. As further required by the City's investment policy, corporations operating within the United States that have total assets in excess of \$500 million issued the medium-term

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notes, and the commercial paper issuers are corporations organized in the United States as special purpose corporations, trust or limited liability companies having program-wide credit enhancements. The State of California Local Agency Investment Fund is not rated.

***Concentration of Credit Risk***

The City's investment policy does not allow more than 10% of its investment portfolio, except U.S. Treasury and federal agencies, to be invested in securities of a single issuer, including its related entities. The City's investment policy further provides for a maximum concentration limit of 30% on any individual federal agency or government-sponsored entity. The City's pooled investments comply with these requirements. GAAP requires disclosure of certain investments in any one issuer that represent 5% or more of total investments, the City does not have such investment.

**(8) Securities Lending Transactions**

Energy Services participates in two securities lending programs as follows (collateral amounts in thousands):

<b>Program</b>	<b>Balance as of June 30</b>	
	<b>2005</b>	<b>2004</b>
Department Program	\$ 155,481	182,692
City of Los Angeles Program	37,318	43,303
	<u>\$ 192,799</u>	<u>225,995</u>

In December 1999, the Department initiated a securities lending program managed by its custodial bank to increase interest income. The bank lends up to 20% of the investments held in the debt reduction trust funds, decommissioning trust funds, postretirement health care benefits trust for securities, cash collateral or letters of credit equal to 102% of the market value of the loaned securities and interest, if any. The Department can sell securities received as collateral only in the event of borrower default. Both the investments purchased with the cash collateral received and the related liability to repay the cash collateral are reported on the balance sheets. A summary of Energy Services' portion of the Department's securities lending program as of June 30, 2005 and 2004 is as follows (amounts in thousands):

	<b>2005</b>		<b>2004</b>	
	<b>Fair value of underlying securities</b>	<b>Collateral value</b>	<b>Fair value of underlying securities</b>	<b>Collateral value</b>
<b>Securities lent for cash collateral</b>				
U.S. government and agency securities	\$ 152,315	155,481	179,017	182,692

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Cash collateral received is reinvested by the lending agent in open repurchase agreements. As such, the maturities of reinvested cash collateral always match the maturities of the underlying securities lent. The lending agent provides indemnification for borrower default. There were no violations of legal or contractual provisions and no borrower or lending agent default losses during fiscal years 2005 and 2004.

***General Investment Pool Program***

Energy Services also participates in the City's securities lending program through the pooled investment fund. The City's program has substantially the same terms as the Department's direct securities lending program. The Department recognizes its proportionate share of the cash collateral received for securities loaned and the related obligation for the general investment pool. As of June 30, 2005 and 2004, Energy Services' attributed share of cash collateral and the related obligation from the City's program was \$37.3 million and \$43.3 million, respectively.

Management believes that participation in these securities lending programs increases interest earnings and results in minimal credit risk exposure to the Department because the amounts owed to the borrowers exceed the amounts that have been loaned.

**(9) Derivative Instruments**

As a result of the Department's change in election under GASB No. 20 (see note 2), Energy Services no longer records its derivative instruments at fair value on the balance sheets, but instead discloses the derivatives in the financial statement footnotes and records the impact upon settlement of the derivatives. Energy Services has three main types of derivative instruments as of June 30, 2005 and 2004: electricity swaps, gas forward contracts, and financial natural gas hedges. As of June 30, 2005 and 2004, the fair values of these outstanding derivative instruments were \$104.3 million and \$24.8 million, respectively.

***(a) Objective of Electricity Swap and Options***

In order to obtain the highest market value on energy that is sold into the wholesale market, the Department monitors the sales price of energy which varies based on which hub the energy is to be delivered. There are three primary hubs within the Department's transmission region: Palo Verde, California-Oregon Border, and Mead. The Department enters into various locational swap transactions with other electric utilities in order to effectively utilize its transmission capacity and to achieve the most economical exchange of energy purchased and sold.

A call option is the right, but not the obligation, to buy energy at a fixed price on or before a specific date. Because the Department has excess electric generation available at certain times during the year, it sells call options for a premium to other utilities. If the buyer calls the option, the Department is obligated to sell the energy for a specified dollar amount and deliver it to a specific delivery point. If the buyer does not call the option, the Department has no obligation to deliver energy, but does retain the premium paid. Premiums received are deferred and amortized to income over the period the option is outstanding and are recorded as part of Sales for Resale revenue. As of June 30, 2005 and 2004, Energy Services had no deferred option revenue relating to options entered into prior to the fiscal year-end.

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The Department does not enter into gas and option agreements for trading purposes. The Department is exposed to risk of nonperformance if the counterparties default or if the swap agreements are terminated.

**(b) Objective of Gas Forward Contracts**

The Department enters into gas forward contracts in order to supply its gas requirements to produce electricity to serve its customers.

**(c) Objective of Financial Natural Gas Hedges**

The Department enters into natural gas hedging contracts in order to stabilize the cost of gas needed to produce electricity to serve its customers.

As of June 30, 2005, Energy Services had the following derivatives, which were not recorded at fair value on its balance sheet:

<u>Derivative description</u>	<u>Total contract quantities</u>	<u>Contract range \$ per unit</u>	<u>First effective date</u>	<u>Last termination date</u>	<u>Fair value (\$000's)</u>	<u>Cash received at derivative inception (\$000's)</u>
Electricity swaps:						
Purchases	6,150 MW	68.02	7/1/05	9/30/05	\$ (1)	—
Sales	6,150 MW	73.48	7/1/05	9/30/05	(10)	—
Gas contract*	11,132,490 MMBtu	5.93 – 7.82	3/15/91	3/15/06	(1,130)	—
Financial Natural Gas:						
Hedges**	95,466,500 MMBtu	4.05 – 7.39	7/1/05	6/30/09	105,443	—

\* The gas contract allows for volumetric optionality. The quantity included in this table is based on forecasted draws from this contract which follow a seasonal pattern. Contract prices are based in part on Gas Price Indices, including Henry Hub and Kern River Prices.

\*\* Financial hedges were variable to fixed rate swaps that serve to lock in a fixed cost of natural gas.

**(d) Fair Value**

All fair values were estimated using forward market prices available from broker quotes or exchange prices in the case of the gas contract.

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**(e) Credit Risk**

Energy Services is exposed to credit risk related to nonperformance by its wholesale counterparties under the terms of contractual agreements. In order to limit the risk of counterparty default, the Department has implemented a Wholesale Marketing Counterparty Evaluation Policy (the Policy). The Policy includes provisions to limit risk including: the assignment of internal credit ratings to all Department counterparties based on counterparty and/or debt ratings; the requirement for credit enhancements (including irrevocable letters of credit, escrow trust accounts, and parent company guarantees) for counterparties that do not meet an acceptable level of risk; and the use of standardized agreements which allow for the netting of positive and negative exposures associated with a single counterparty. As of June 30, 2005 the eight financial natural gas hedge counterparties were rated by Moody's as follows: three at Aa1, two at Aa2, and three at Aa3. The counterparties were rated by Standard and Poors as follows: two at AA+, one at AA, two at AA-, and three at A+.

As discussed in note 3, during fiscal year 2001, Energy Services experienced nonperformance and material counterparty default with the CISO and the CPX. Energy Services does not anticipate nonperformance by any other of its counterparties and has no reserves related to nonperformance at June 30, 2005 and 2004, respectively. Apart from the events discussed in note 3, Energy Services did not experience any material counterparty default during fiscal years 2005, 2004, or 2003.

**(f) Termination Risk**

Energy Services or its counterparties may terminate the contractual agreements if the other party fails to perform under the terms of the contract.

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**(10) Long-Term Debt**

Long-term debt outstanding as of June 30, 2005 consists of revenue bonds and refunding revenue bonds due serially in varying annual amounts as follows (amounts in thousands):

<b>Bond issues</b>	<b>Date of issue</b>	<b>Effective interest rate</b>	<b>Fiscal year of last scheduled maturity</b>	<b>Principal outstanding</b>
Issue of 2001, Series A1	03/20/01	4.931%	2025	\$ 1,060,475
Issue of 2001, Series A2	11/06/01	5.109%	2022	109,095
Issue of 2001, Series A3	04/01/01	5.095%	2025	116,295
Issue of 2001, Series B	06/05/01	Variable	2035	620,600
Issue of 2001, Series C1	11/15/01	4.788%	2017	4,582
Issue of 2002, Series A	08/22/02	Variable	2036	388,500
Issue of 2002, Series C2	11/22/02	4.375%	2018	13,537
Issue of 2003, Series A1	07/31/03	3.409%	2017	440,110
Issue of 2003, Series A2	08/19/03	4.662%	2032	515,830
Issue of 2003, Series B	08/28/03	5.013%	2036	200,000
Issue of 2004, Series C3	04/07/04	4.298%	2020	12,362
Total principal amount				3,481,386
Revenue certificates				200,000
Unamortized debt-related costs (including net loss on refundings)				(23,803)
Debt due within one year (including current portion of variable rate debt)				(176,871)
				<u>\$ 3,480,712</u>



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

**(a) Long-Term Debt Activity**

Energy Services had the following activity in long-term debt for the nine months ended June 30, 2005 (amounts in thousands):

	<b>Balance at June 30, 2004</b>	<b>Additions</b>	<b>Reductions</b>	<b>Balance at June 30, 2005</b>	<b>Current portion</b>
Long-term debt:					
Bonds	\$ 3,503,386	567	(46,370)	3,457,583	156,871
Revenue certificates	—	200,000	—	200,000	20,000
Total	<u>\$ 3,503,386</u>	<u>200,567</u>	<u>(46,370)</u>	<u>3,657,583</u>	<u>176,871</u>
	<b>Balance at June 30, 2003</b>	<b>Additions</b>	<b>Reductions</b>	<b>Balance at June 30, 2004</b>	<b>Current portion</b>
Long-term debt:					
Bonds	<u>\$ 3,395,268</u>	<u>1,250,000</u>	<u>(1,141,882)</u>	<u>3,503,386</u>	<u>146,838</u>

**(b) New Issuances**

**Fiscal Year 2005**

In September 2004, Energy Services issued \$200 million of Power System Revenue certificates. The net proceeds were deposited into the construction fund to be used for distribution system capital improvements.

**Fiscal Year 2004**

In July 2003, Energy Services issued \$956 million of Power System Revenue Bonds. The bonds were issued for the purpose of refunding portions of the Refunding Issue of 1993, the Second Issue of 1993, and the Issue of 2000. The net proceeds, along with \$93 million in cash, were used to defease bonds with a par value of \$1.06 billion. The defeasance is expected to reduce total debt payments over the life of the new issues by \$186 million and is expected to result in present value savings of approximately \$71 million. This transaction resulted in a net loss for accounting purposes of \$59.1 million, of which \$53.5 million, was deferred and is being amortized the shorter of the life of the bonds retired or the life of the new bonds and \$5.6 million, which was recognized in fiscal year 2004 as part of debt expenses.

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In August 2003, Energy Services issued \$200 million of Power System Revenue Bonds. The net proceeds were deposited into the construction fund to be used for distribution system capital improvements. Also, in April 2004, the Department issued \$10 million of Energy Services fixed-rate bonds as part of the Mini-Bond Program for employees and retirees. The net proceeds were deposited into the construction fund to be used for distribution system capital improvements.

**(c) Outstanding Debt Defeased**

As discussed above, Energy Services defeased certain revenue bonds in prior years by placing cash or the proceeds of new revenue bonds in irrevocable trusts to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in Energy Services' financial statements.

At June 30, 2005, the following revenue bonds outstanding are considered defeased (amounts in thousands):

<u>Bond issues</u>	<u>Principal outstanding</u>
Third issue of 1991	\$ 675
Issue of 1992	1,445
Second issue of 1993	113,600
Refunding issue of 1994	50,960
Issue of 1994	6,260
	<u>\$ 172,940</u>

**(d) Variable Rate Bonds and Revenue Certificates**

The variable rate bonds currently bear interest at daily and weekly rates (ranging from 2.22% to 3.32% as of June 30, 2005). The Department can elect to change the interest rate period of the bonds, with certain limitations. The bondholders have the right to tender the bonds to the tender agent on any business day with seven days prior notice. The revenue certificates bear interest at a weighted average rate of 2.63% as of June 30, 2005. Such certificates mature every 270 days, at which time the Department has the option to renew the certificates or convert them to five-year notes under a line of credit. The Department intends to refinance the revenue certificates on a long-term basis by uninterrupted renewal of the certificates and the related liability has been classified as long-term on the balance sheet. The Department has entered into Standby and Line of Credit Agreements with a syndicate of commercial banks in an initial amount of \$620.6 million, \$388.5 million, and \$200 million to provide liquidity for the variable rate bonds and revenue certificates. The extended Standby Agreements expire on February 8, 2007 for the \$620.6 million issue and on July 11, 2008 for the \$388.5 million issue. The \$200 million Line of Credit agreement for the revenue certificates expires on September 15, 2007.

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Bonds purchased under the agreements will bear interest that is payable quarterly at the greater of the Federal Funds Rate plus 0.50% or the bank's announced base rate, as defined. The unpaid principal of bonds purchased is payable in ten equal semiannual installments, commencing after the termination of the agreement. At its discretion, the Department has the ability to convert the outstanding bonds to fixed-rate obligations, which cannot be tendered by the bondholders. These bonds have been classified as long-term on the balance sheets as the liquidity facilities give the Department the ability to refinance on a long-term basis and the Department intends to either renew the facility or exercise its right to tender the debt as a long-term financing. That portion which would be due in the next fiscal year in the event that the outstanding variable rate bonds and revenue certificates were tendered and purchased by the commercial banks under the Standby and Line of Credit Agreements has been included in the current portion of long-term debt and was \$120.9 million and \$100.9 million as of June 30, 2005 and 2004, respectively.

**(e) Scheduled Principal Maturities and Interest**

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

	<u>Principal</u>	<u>Interest</u>
Fiscal years ending June 30:		
2006	\$ 55,961	143,081
2007	67,881	140,300
2008	41,826	138,508
2009	43,525	136,669
2010	82,653	133,021
2011 – 2015	647,158	574,223
2016 – 2020	512,127	436,293
2021 – 2025	764,900	264,348
2026 – 2030	614,815	123,154
2031 – 2035	593,935	37,811
2036	56,605	—
Total requirements	\$ <u>3,481,386</u>	<u>2,127,408</u>

The maturity schedule presented above reflects the scheduled debt service requirements for all of Energy Services long-term debt. The schedule is presented assuming that the tender options on the variable rate bonds, as discussed on the previous page, will not be exercised and that the full amount of the revenue certificates will be renewed. Should the bondholders exercise the tender options and the Department convert all of the revenue certificates under the line of credit, Energy Services would be required to redeem the \$1,209.1 million in variable rate bonds outstanding over the next six years, as follows: \$120.9 million in fiscal year 2006, \$241.8 million in each of the fiscal years 2007 through 2010, and \$121.0 million in fiscal year 2011. Accordingly, the balance sheets recognize the possibility of the exercise of the tender options and reflect the \$120.9 million that could be due in fiscal year 2006 as a current portion of long-term debt payable.

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

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

Plan amendments must be approved by both the Retirement Board and the Board of Commissioners. The Plan issues separately available financial statements on an annual basis. Such financial statements can be obtained from the Department of Water and Power Retirement Office, 111 N. Hope, Room 357, Los Angeles, CA 90012.

The annual pension cost (APC) and net pension obligation (NPO) for the Department's plan consists of the following (amounts in thousands):

	<b>Year ended June 30</b>	
	<b>2005</b>	<b>2004</b>
Annual required contribution	\$ 79,201	44,614
Interest on net pension asset	(13,938)	(13,558)
Adjustment to annual required contribution	20,764	20,203
APC (including \$24.4 million and \$16.1 million of amounts capitalized in fiscal 2005 and 2004, respectively)	86,027	51,259
Department contributions	(75,501)	(55,694)
Change in NPO	10,526	(4,435)
NPO (asset) at beginning of year	(182,184)	(177,749)
NPO (asset) at end of year	\$ (171,658)	(182,184)

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Energy Services' allocated share of APC and NPO consists of the following (amounts in thousands):

	<b>Year ended June 30</b>	
	<b>2005</b>	<b>2004</b>
Annual required contribution	\$ 52,272	29,445
Interest on net pension asset	(9,199)	(8,948)
Adjustment to annual required contribution	13,704	13,334
APC (including \$13.9 million and \$9.1 million of amounts capitalized in fiscal 2005 and 2004, respectively)	56,777	33,831
Department contributions	(49,027)	(36,904)
Change in NPO	7,750	(3,073)
NPO (asset) at beginning of year	(122,271)	(119,198)
NPO (asset) at end of year	\$ (114,521)	(122,271)

Annual required contributions are determined through actuarial valuations using the entry age normal actuarial cost method. The actuarial value of assets in excess of the Department's actuarial accrued liability (AAL) is being amortized by level contribution offsets over the period ended June 30, 2004. As a result of an April 2000 amendment to the Plan, the amortization period was changed to rolling 15-year periods effective July 1, 2000.

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

<b>Actuarial valuation date June 30</b>	<b>Normal cost</b>	<b>Surplus amortization</b>	<b>Contribution rate</b>
2004	10.83%	2.10%	13.45%
2003	10.89%	(2.76)%	8.45%
2002	10.97%	(2.64)%	8.66%

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

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Trend information for fiscal years 2005, 2004, and 2003 for Energy Services is as follows (amounts in thousands):

<b>Year ended June 30</b>		<b>NPO (asset)</b>	<b>Percentage of APC contributed</b>		<b>APC</b>
2005	\$	(114,521)	86%	\$	56,777
2004	\$	(122,271)	109%	\$	33,831
2003	\$	(119,198)	84%	\$	36,827

***Disability and Death Benefits***

Energy Services' allocated share of disability and death benefit plan costs and administrative expenses totaled \$9 million, \$8 million, and \$11 million for each of the fiscal years 2005, 2004, and 2003.

**(12) Postretirement Health Care Plan**

***(a) Plan Description***

The Department provides certain health care benefits to active and retired employees and their dependents. The health care plan is administered by the Department. The Retirement Board and the Board of Water and Power Commissioners have the authority to approve provisions and obligations. Eligibility for benefits for retired employees is dependent on a combination of age and service of the participants pursuant to a predetermined formula. Any changes to these provisions must be approved by the Boards. The total number of active and retired Department participants entitled to receive benefits was approximately 16,450 and 16,760 at June 30, 2005 and 2004, respectively.

The health plan is a single-employer defined benefit plan that is not administered as a trust or equivalent arrangement and, therefore, does not have separate financial statements.

***(b) Funding Policy***

The Department pays a monthly maximum subsidy of \$2,097 for medical and dental premiums depending on the employee's work location and benefits earned. Participants choosing plans with a cost in excess of the subsidy they are entitled to are required to pay the difference. No funding policy has been established for the future benefits to be provided under this plan. However, in fiscal years 2005 and 2004, the Department increased the postretirement trust assets by \$100 million (Energy Services portion, \$66 million), in addition to the \$49 million it paid for current retiree premiums (Energy Services portion, \$32.4 million). These trust assets are irrevocably committed to funding participant benefits.

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**(c) Annual OPEB Cost and Net OPEB Obligation**

The annual other postretirement benefit (OPEB) cost (expense) is calculated based on the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost under each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years.

The following table shows the components of the Department's annual OPEB cost for the year, the amount actually paid in premiums, and changes in the net other postretirement benefit obligation (amounts in thousands):

		<b>Year ended June 30</b>	
		<b>2005</b>	<b>2004</b>
Annual required contribution	\$	99,684	107,435
Interest on net OPEB obligation		4,030	—
Adjustment to annual required contribution		(510)	—
		103,204	107,435
Contributions made		(52,544)	(48,955)
Change in net other postretirement benefit obligation		50,660	58,480
Net other postretirement benefit obligation – beginning of year		58,480	—
Net other postretirement benefit obligation – end of year	\$	109,140	58,480

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The following table shows the components of Energy Services' share in annual OPEB cost for the year, the amount actually contributed to the plan, and changes in the net other postretirement obligation (amounts in thousands):

	<b>Year ended June 30</b>	
	<b>2005</b>	<b>2004</b>
Annual required contribution	\$ 64,795	70,907
Interest on net OPEB obligation	2,620	—
Adjustment to annual required contribution	(332)	—
	67,083	70,907
Contributions made	(34,402)	(32,420)
Change in net other postretirement benefit obligation	32,681	38,487
Net other postretirement benefit obligation – beginning of year	38,487	—
Net other postretirement benefit obligation – end of year	\$ 71,168	38,487

The reconciliation of the postretirement trust assets, representing the set aside of assets in an irrevocable employer trust, is as follows (dollar amount in thousands):

	<b>Department</b>	<b>Energy Services share</b>
Postretirement trust assets – beginning of year	\$ 285,564	197,670
Contributions to trust	110,797	73,412
Postretirement trust assets – end of year	\$ 396,361	271,082

The Department's annual OPEB cost the percentage of annual required contribution contributed to the plan and the net postretirement obligation for fiscal years 2005 and 2004 were as follows (amounts in thousands):

	<b>2005</b>	<b>2004</b>
Annual OPEB cost	\$ 103,204	107,435
Percentage of the ARC contributed	51%	46%
Net postretirement obligation	\$ 109,140	58,480



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Energy Services' share in the annual OPEB cost, the percentage of annual required contribution contributed to the plan, and the net retirement obligation for fiscal years 2005 and 2004 were as follows (amounts in thousands):

	<u>2005</u>	<u>2004</u>
Annual OPEB cost	\$ 67,083	70,907
Percentage of the ARC contributed	51%	46%
Net postretirement obligation	\$ 71,168	38,487

**(d) Funded Status and Funding Progress (Unaudited)**

As of July 1, 2004, the Department's actuarial accrued liability for benefits was \$1.6 billion resulting in an unfunded actuarial accrued liability (UAAL) of \$1.6 billion. The covered payroll (annual payroll of active employees covered by the plan) was \$629 million, and the ratio of the UAAL to the covered payroll was 297%.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the health care cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the Department are subject to continual revision as actual results are compared with past expectations and new estimates are made for the future. The schedule of funding progress, presented as required supplementary information, presents information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

**(e) Actuarial Methods and Assumptions**

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan understood by the Department and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the Department and the plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

In the July 1, 2004 actuarial valuation, the entry age normal cost method was used. The actuarial assumptions include 6.5% discount rate which represents the expected long-term return on plan assets, an annual health care cost trend rate of 12% initially, reduced by decrements to an ultimate rate of 5% after seven years. Both rates include a 3.5% inflation assumption. The actuarial value of assets was determined using techniques that spread UAAL being amortized as a level percentage of projected payroll over a 30-year period.

In the July 1, 2003 actuarial valuation, the entry age normal cost method was used. The actuarial assumptions include 6.5% discount rate which represents the expected long-term return on plan assets, an annual health care cost trend rate of 16% initially, reduced by decrements to an ultimate

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rate of 5.75% after seven years. Both rates include a 3.5% inflation assumption. The actuarial value of assets was determined using techniques that spread UAAL being amortized as a level percentage of projected payroll over a 30-year period.

**(f) New Legislation**

In December 2003, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 was enacted, effective in 2006. Two important aspects of the law may affect the employer's financial statements before 2006. First, the opportunity for retirees to obtain prescription drug benefits under new Medicare Part D will tend to shift benefits and related costs out of employer plans. Second, employers that provide prescription drug benefits that are at least as valuable as (actuarially equivalent) those under Medicare Part D will be entitled to annual subsidy from Medicare equal to 28% of prescription drug costs between \$250 and \$5,000 for each Medicare-eligible retiree who does not join part D. The Department has not yet determined the financial statement impact of adopting the new law.

**(13) Other Long-Term Liabilities**

**(a) Other Long-Term Liabilities**

Energy Services had the following other long-term liabilities:

	<b>Balance at June 30, 2004</b>	<b>Additions</b>	<b>Reductions</b>	<b>Balance at June 30, 2005</b>
Deferred credits	\$ 540,143	85,412	—	625,555
Accrued workers' compensation claims	31,352	8,415	(4,209)	35,558

	<b>Balance at June 30, 2003</b>	<b>Additions</b>	<b>Reductions</b>	<b>Balance at June 30, 2004</b>
Deferred credits	\$ 466,167	73,976	—	540,143
Accrued workers' compensation claims	25,163	9,978	(3,789)	31,352

**(b) Deferred Credits**

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. At the discretion of the Department and approval by the Board, these amounts will be recognized in future periods. At June 30, 2005 and 2004, \$625.6 million and \$540.1 million, respectively, of precollected purchased power costs have been deferred pending future rate treatment.

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**(c) Accrued Workers' Compensation Claims**

Liabilities for unpaid workers' compensation claims are recorded at their present value when they are probable of occurrence and the amount can be reasonably estimated. The liability is actuarially determined, based on an estimate of the present value of the claims outstanding and an amount for claim events incurred but not reported based upon the Department's loss experience, less the amount of claims and settlements paid to date. The discount rate used to calculate this liability at its present value was 4% at June 30, 2005, which approximates the Department's long-term investment yield. The Department has third-party insurance coverage for workers' compensation claims in excess \$1 million.

Changes in the Department's liability since June 30, 2003 are summarized as follows (amounts in thousands):

		<b>June 30</b>		
		<b>2005</b>	<b>2004</b>	<b>2003</b>
Balance at beginning of year	\$	55,990	45,535	30,000
Current year claims and changes in estimates		15,166	16,715	17,017
Claims payments		(7,371)	(6,260)	(1,482)
Balance at end of year	\$	<u>63,785</u>	<u>55,990</u>	<u>45,535</u>

Energy Services' portion of the discounted reserves as of June 30, 2005 and 2004 are \$35.6 million and \$31.4 million, respectively.

**(14) 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 \$575 million, \$642 million, and \$603 million for fiscal years 2005, 2004, and 2003, respectively, of which \$377 million, \$408 million, and \$384 million were allocated to Energy Services, respectively.

**(15) Loss on Asset Impairment and Abandoned Project**

During fiscal year 2004, the Department recorded a loss on the Mohave Generating Station (Mohave) totaling \$8.1 million. The loss was recorded using the service units approach under GASB No 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*.

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Department management believes Mohave will close in December 2005 due to environmental, water, and coal issues. As of June 2004, management did not have a plan to remedy the issues to keep Mohave operating after December 2005.

During fiscal year 2004, the Department discontinued using a procurement system. Energy Services' portion of the loss related to this system totaled \$5.5 million.

During fiscal year 2001, management approved the sale of one of its administrative facilities, and Energy Services reported its portion of the loss on asset impairment of \$28 million. The completion of the sale was expected to occur within 12 to 24 months for a total original purchase price of \$50 million, which was below the total asset carrying value. During fiscal year 2002, management became aware that the facility had mold in the structure. Management and the purchaser of the facility each conducted a study to determine an estimated cost for mold cleanup. As of June 30, 2002, no estimate was available to record a cleanup liability; however, as of June 30, 2003, management approved the sale of this administrative building for a reduced price of \$37 million. This reduction in price caused Energy Services to recognize an additional loss of \$8.3 million as of June 30, 2003. The sale of the building was completed in August 2005.

**(16) Commitments and Contingencies**

**(a) *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 the increase in fund net assets before transfers to the reserve fund of the City of the prior fiscal year. Such payments are not in lieu of taxes and are recorded as a transfer in the statement of revenues, expenses, and changes in fund net assets.

The Department authorized total transfers of \$160.2 million, \$210.2 million, and \$185.4 million in fiscal years 2005, 2004, and 2003, respectively, from Energy Services to the reserve fund of the City. Included in these amounts were transfers of \$60.0 million and \$29.0 million, which were accrued as liabilities as of June 30, 2004 and 2003, respectively. The \$29.0 million accrued as of June 30, 2003 was paid in July 2003, and the \$60.0 million accrued as of June 30, 2004 was paid in fiscal year 2005.

**(b) *Palo Verde Nuclear Generating Station (PVNGS) Matters***

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

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### **Notes to Financial Statements**

June 30, 2005 and 2004

In July 2002, a measure was signed into law designating the Yucca Mountain in the state of Nevada as the nation's high-level nuclear waste repository. The state of Nevada vetoed the President's recommendation. Congress approved the Yucca Mountain site, overriding the Nevada veto. The state of Nevada has filed several legal challenges relating to the site. As a result, it is unclear what actions will be taken in this area.

Capacity in existing fuel storage pools at PVNGS was exhausted in 2003. A Dry Cask Storage Facility (also called the Independent Spent Fuel Storage Facility) was built and completed in 2003 at a total cost of \$33.9 million (about \$3.3 million for the Department). The facility has the capacity to store all the spent fuel generated by the plant until the end of its life in 2026. The Department accrues for current nuclear fuel storage costs as a component of fuel expense as the fuel is burned. The Department's share of spent nuclear fuel costs related to its indirect interest in PVNGS is included in purchased power expense.

The Price-Anderson Act (the Act) requires that all utilities with nuclear generating facilities share in payment for claims resulting from a nuclear incident. Participants in PVNGS currently insure potential claims and liability through commercial insurance with a \$300 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 a maximum of \$100.6 million for each licensee for each nuclear incident occurring at any nuclear reactor in the United States; payments under the program are limited to \$10 million per incident, per year. Based on the Department's 5.7% direct interest and its 3.95% indirect investment interest through SCPPA, the Department would be responsible for a maximum assessment of \$9 million per incident, limited to payments of \$1 million per incident annually.

#### **(c) *Environmental Matters***

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

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

In May 2001, SCAQMD adopted amendments to RECLAIM, with the intent of lowering and stabilizing RTC prices. One key element of the amendments is that existing power plants were bifurcated from the rest of the RECLAIM market until 2004 and were required to install Best Available Retrofit Control Technology (BARCT). As required under SCAQMD rules, the Department met the BARCT compliance date of January 1, 2003. In January 2005, SCAQMD extended the date from the fall of 2004 until January 1, 2007 when power producers could reenter

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the RECLAIM market. However, as a result of the installation of NOx control equipment and the repowering of existing units, the Department has sufficient RTCs to meet its native load requirements for normal operations. The Department estimates that overall NOx emissions will be reduced by over 65% from 1999 levels.

**(d) *Litigation***

The state and a number of local government agencies that are electric customers of the Department claim that the Department has violated the state's False Claim Act by charging such governmental customers the standard rates applicable to both public and private customers in their respective customer rate categories. The plaintiffs allege that such rates include a capital facilities charge in violation of the state's statute. The plaintiffs are seeking unspecified amounts for treble damages, civil penalties, and injunctive relief. The Department intends to vigorously defend the claim.

A number of claims and suits are also 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, is not expected to materially impact Energy Services financial position, results of operations, or cash flows as of June 30, 2005.

**(e) *Risk Management***

Energy Services is subject to certain business risks common to the utility industry. The majority of these risks are mitigated by external insurance coverage obtained by Energy Services. For other significant business risks, however, Energy Services has elected to self-insure. Management believes that exposure to loss arising out of self-insured business risks will not materially impact Energy Services' financial position, results of operations, or cash flows as of June 30, 2005.

**(f) *Credit Risk***

Financial instruments, which potentially expose the Department to concentrations of credit risk, consist primarily of retail and wholesale receivables. The Department's retail customer base is concentrated among commercial, industrial, residential, and governmental customers located within the City. Although the Department is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 2005, except as provided in the allowance for losses. The Department manages its credit exposure by requiring credit enhancements from certain customers and through procedures designed to identify and monitor credit risk.

**(17) *Subsequent Event***

On July 1, 2005, Energy Services and other members of SCPPA completed the acquisition of natural gas reserves and other real property from Anschutz Corporation in Pinedale, Wyoming. The transaction totaled in excess of \$300 million, of which Energy Services contributed approximately \$228 million. As of June 30, 2005, Energy Services had restricted cash on hand to pay its portion of the transaction.

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Required Supplementary Information

June 30, 2005

(Unaudited)

**Pension Plan – Schedule of Funding Progress**

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

Actuarial valuation date June 30	Actuarial value of assets (a)	Actuarial accrued liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded ratio (a/b)	Covered payroll (c)	UAAL as a percentage of covered payroll (b-c/a)
2004	\$ 6,251,421	\$ 6,421,814	\$ 170,393	97%	\$ 581,039	29%
2003	\$ 6,128,376	\$ 6,042,087	\$ (86,289)	101%	\$ 527,787	(16)%
2002	\$ 5,790,263	\$ 5,714,525	\$ (75,738)	101%	\$ 430,398	(18)%

**Postemployment Health Care Plan – Schedule of Funding Progress**

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

Actuarial valuation date	Actuarial value of assets (a)	Actuarial accrued liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded ratio (a/b)	Covered payroll (c)	UAAL as a percentage of covered payroll ((b-a)/c)
July 1, 2004	\$ —	\$ 1,597,835	\$ 1,597,835	—%	\$ 528,898	297%
July 1, 2003	\$ —	\$ 1,729,706	\$ 1,729,706	—%	\$ 571,725	303%

See accompanying independent auditors' report.