LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Basic Financial Statements and
Required Supplementary Information

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

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KPMG LLP
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568

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 sheets of the City of Los Angeles' Department of Water and Power's Power Revenue Fund (Power System), an enterprise fund of the City of Los Angeles, California, as of June 30, 2006 and 2005, and the related statements of revenues, expenses, and changes in fund net assets and cash flows for the years 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 audits. The partial 2004 comparative information has been derived from the Power System's 2004 financial statements which were audited by other auditors whose report dated December 9, 2005 included explanatory paragraphs that described the adoption of Governmental Accounting Standards Board Statements 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,* Statement No. 45, *Accounting and Financial Reporting by Employers for Postretirement Benefits Other Than Pensions*, and the restatement of the Power System's June 30, 2004 financial statements.

We conducted our audits 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 the Power System's 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 audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the financial position of the Power System and do not purport to, and do not, present fairly the financial position of the City of Los Angeles, California, as of June 30, 2006 and 2005, the changes in its financial position and its cash flows for the years ended June 30, 2006, 2005, and 2004, in conformity with U.S. generally accepted accounting principles.

In our opinion, the 2006 and 2005 financial statements referred to above present fairly, in all material respects, the financial position of the Power System, as of June 30, 2006 and 2005, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 7, 2006 on our consideration of the Power System's 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 audits.

The management's discussion and analysis included on pages 3 through 12 and the schedules of funding progress for the pension plan and postretirement health care plan on pages 53 (note 12(d)) and 61 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. 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

November 7, 2006

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 Revenue Fund (Power System), provides an overview of the financial activities for the fiscal years ended June 30, 2006 and 2005. Descriptions and other details pertaining to the Power System are included in the notes to the financial statements. This discussion and analysis should be read in conjunction with the Power System's financial statements, which begin on page 13.

Using This Financial Report

This annual financial report consists of the basic financial statements and required supplementary information and reflects the self-supporting activities of the Power System 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 the Power System's financial health. The balance sheets include all of the Power System's 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, cash payments for bond principal, and capital additions and betterments.

(Continued)

The following table summarizes the financial condition and changes in fund net assets of the Power System as of and for the fiscal years ended June 30, 2006, 2005, and 2004:

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

(Amounts in millions)

		June 30,	
Assets	**2006**	**2005**	**2004**
Utility plant, net	$ 5,709	5,299	5,165
Restricted investments	955	1,036	978
Other noncurrent assets	1,362	1,307	1,360
Current assets	1,720	1,314	1,241
	$ 9,746	8,956	8,744
Liabilities and Fund Net Assets			
Long-term debt, net of current portion	$ 4,262	3,481	3,357
Other long-term liabilities	710	732	610
Current liabilities	662	681	726
	5,634	4,894	4,693
Fund net assets:			
Invested in capital assets, net of related debt	1,774	1,641	1,664
Restricted	1,159	1,482	1,218
Unrestricted	1,179	939	1,169
Total fund net assets	4,112	4,062	4,051
	$ 9,746	8,956	8,744

Table 1 (Continued)

(Amounts in millions)

Revenues, Expenses, and Changes in Fund Net Assets	Year ended June 30, 2006	2005	2004
Residential	$ 759	693	718
Commercial and industrial	1,545	1,421	1,461
Sales for resale	153	102	74
Other	39	39	35
Total operating revenues	2,496	2,255	2,288
Fuel for generation and purchased power	1,283	1,113	1,096
Maintenance and other operating expenses	1,004	969	939
Total operating expenses	2,287	2,082	2,035
Operating income	209	173	253
Nonoperating activity:			
Investment income	123	113	92
Other nonoperating revenues and expenses, net	13	5	17
Debt expenses	(167)	(146)	(134)
Income before capital contributions, transfers, and extraordinary items	178	145	228
Capital contributions	30	26	39
Transfer to the reserve fund of the City of Los Angeles	(158)	(160)	(210)
Extraordinary loss on extinguishment of debt	—	—	(6)
Increase in fund net assets	50	11	51
Beginning balance of fund net assets	4,062	4,051	3,693
Adjustment due to change in accounting principle from SFAS No. 106 to GASB No. 45	—	—	307
Ending balance of fund net assets	$ 4,112	4,062	4,051

(Continued)

Assets

Utility Plant

During fiscal years 2006 and 2005, the Power System put into service $331 million and $607 million, respectively, of additions, including transfers from construction work in progress to utility plant in service. Of the $331 million, $186 million, or 56.0%, related to distribution plant assets. In addition, during 2006, the Power System capitalized $61 million related to generation assets. Of the $607 million in 2005, $403 million, or 66.0%, related to generation plant assets. The majority of these additions were incurred as part of the Power System's Integrated Resource Plan. Furthermore, the Power System 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 increased by $136 million in 2006 and decreased by $218 million in fiscal year 2005. The increase in 2006 was mostly attributable to the Pinetree Wind Project and other generation improvements. The decrease in 2005 was primarily as a result of ongoing local generation projects under the Integrated Resource Plan being placed in commercial service.

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, 2006, the Department has incurred $1.3 billion related to such upgrades.

Additional information regarding the Power System's utility plant assets can be found in note 4 in the accompanying notes to the financial statements.

On July 1, 2005, the Power System and other members of the Southern California Public Power Authority (SCPPA) completed the acquisition of natural gas reserves and other real property located in Pinedale, Wyoming. The transaction totaled in excess of $300 million, of which the Power System contributed approximately $230 million. This is the first natural gas reserves acquisition for the Power System. Additional information regarding the natural gas field can be found in note 1 in the accompanying notes to the financial statements.

The table below summarizes the generating resources available to the Department as of June 30, 2006. 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

Resource type	Number of units		Net maximum capacity (MWs)	Net * dependable
Steam:				
Gas	22		3,421	3,354
Coal	5		1,621	1,621
Nuclear	3		374	367
Large Hydro	8	**	1,666	1,535
Renewable	28		255	202
EE, DSM, DG ***	1		46	46
Subtotal	67		7,383	7,125
Typical CDWR obligation****			(65)	(65)
Total			7,318	7,060

* Capacity that the thermal units can obtain during varying types of weather conditions, less the energy needed to power normal auxiliaries in service.

** Hoover Plant Station is counted as one unit and seven Castaic units.

*** EE, DSM, DG refer to energy efficiency, demand-side management and distributed generation.

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

Liabilities and Fund Net Assets

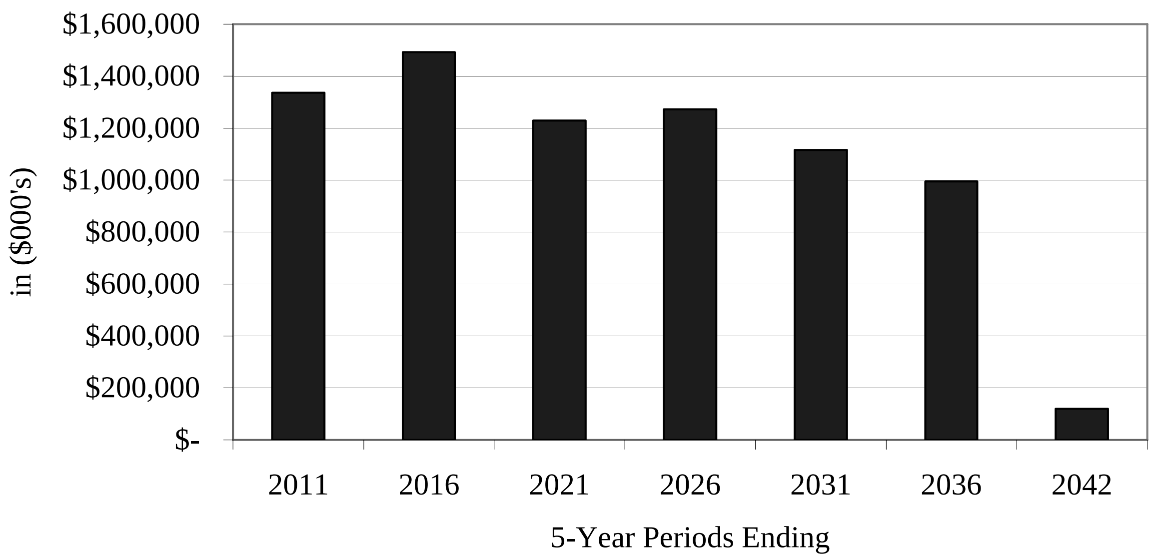
Long-Term Debt

As of June 30, 2006, the Power System's total long-term debt balance was $4.45 billion. The increase of $793 million over the prior year resulted primarily from the net effect of the issuance of $932 million in revenue bonds, scheduled maturities of $56 million, and the defeasance of $116 million of Power System revenue bonds.

(Continued)

Outstanding principal, plus scheduled interest as of June 30, 2006, is scheduled to mature as shown in the chart below:

Chart 1: Debt Service Requirements



As of June 30, 2006, $179 million principal amount of long-term debt is considered defeased and remains 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 sheet.

In addition, the Power System had $451 million and $601 million on deposit in trust funds restricted for the use of debt reduction as of June 30, 2006 and 2005, respectively.

During fiscal year 2006, Standard & Poor's Rating Services, Moody's Investors Service, and Fitch Ratings affirmed the Power System's bond rating of AA-, Aa3, and AA-, respectively, due to the Power System's broad revenue stream, sound financial metrics, and significant progress on economically defeasing one-half of the Power System's off-balance sheet commitments. Additional information regarding the Power System's 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 the Power System 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. Table 3 summarizes the percentage contribution of retail revenues from each customer segment in fiscal years 2006 and 2005.

Table 3 – Operating Revenues and Percent of Revenue By Customer Class

(Amounts in thousands)

Customer type	Fiscal Year 2006 Revenue	Fiscal Year 2006 Percent	Fiscal Year 2005 Revenue	Fiscal Year 2005 Percent
Residential	$ 758,932	32.0%	$ 693,559	32.0%
Commercial	1,320,870	56.0	1,223,230	57.0
Industrial	223,985	10.0	197,773	9.0
Other	39,122	2.0	38,714	2.0
Total retail revenue	$ 2,342,909	100.0%	$ 2,153,276	100.0%

While commercial customers consume the most electricity, residential customers represent the largest customer class. As of June 30, 2006 and 2005, the Power System had approximately 1.4 million customers. As shown in Table 4, 1.2 million, or 86.0%, of total customers were in the residential customer class.

Table 4 – No. of Customers and Percent of Customers By Customer Class

(in thousands)

Customer type	Fiscal Year 2006 Number	Fiscal Year 2006 Percent	Fiscal Year 2005 Number	Fiscal Year 2005 Percent
Residential	1,242	86.0%	1,237	86.0%
Commercial	186	13.0	183	13.0
Industrial	14	1.0	14	1.0
Other	3	—	3	—
	1,445	100.0%	1,437	100.0%

Fiscal Year 2006

Retail revenues increased $189.6 million and wholesale revenues increased $51 million, respectively, from fiscal year 2005. The increase in retail revenue is mostly due to discontinuing the deferral of revenue collected for out-of-market purchased power costs and beginning to recognize prior deferred amounts. The increase in wholesale revenue is due to increased sales activity in both the forward and real-time energy and capacity markets.

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.

Operating Expenses

Fuel for generation and purchased power are two of the largest expenses that the Power System 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 the Power System's 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 5.0% 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.

The tables below summarize the Power System's operating expenses during fiscal years 2006 and 2005:

Table 5 – Operating Expenses and Percent of Expense
By Type of Expense

(Amounts in thousands)

	Fiscal Year 2006		Fiscal Year 2005	
Type of expense	**Expense**	**Percent**	**Expense**	**Percent**
Fuel for generation	$ 541,659	23.7%	$ 478,201	23.0%
Purchased power	741,810	32.4	634,923	30.5
Other operating costs	472,394	20.7	484,905	23.3
Maintenance	260,217	11.4	237,565	11.4
Depreciation and amortization	270,841	11.8	246,597	11.8
	$ 2,286,921	100.0%	$ 2,082,191	100.0%

Fiscal Year 2006

Fiscal year 2006 operating expenses were $205 million higher as compared to fiscal year 2005. Fuel for generation expense increased by $63 million due to higher cost of natural gas. Purchased power costs increased due to economic purchases being made. Economic purchases are purchases of energy on the open market where the Department has determined that the cost of acquiring the energy is less expensive than using available generation resources to meet customer demand.

Maintenance and deprecation increased by $23 million and $24 million, respectively. The increase in maintenance was due to addition work being performed on transmission assets. The increase in deprecation was due to additional assets being placed in service. These increases were offset by a decrease in other operating costs related to distribution assets.

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 increased 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.

Nonoperating Revenues and Expenses

Fiscal Year 2006

The major nonoperating activities of the Power System for fiscal year 2006 included the transfer of $157.9 million to the City's General Fund, income earned on investments of $123 million, and $167.5 million in debt expenses.

The transfer to the City is based on 7.0% of the previous year's operating revenues. Operating revenues for fiscal year 2005 were $2.3 billion, which generated a City transfer of $157.9 million.

Investment income increased $10 million due to interest rates trending higher in fiscal year 2006 as compared to 2005.

The increase in debt expense is due to the issuance $932 million of revenue bonds and higher interest rates on variable rate debt. The variable rate bonds' daily and weekly rate range increased from 2.22% to 2.27% as of June 30, 2005 to 3.94% to 3.95% as of June 30, 2006.

Fiscal Year 2005

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

The transfer to the City is based on 7.0% 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.

Investment 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.

Investment income decreased in fiscal year 2004 due to 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.

Other Significant Matters

On August 16, 2006, the City Council approved the unfreezing of the energy cost adjustment factor. This change took effect October 1, 2006.

On September 19, 2006, the Board of Water and Power Commissioners (the Board) approved the creation of a Retiree Health Benefits Fund to be maintained by the Retirement Plan Office. During fiscal year 2007, the assets held by both the Water and the Power System will be transferred to this newly created fund. This transfer will reduce the Power System's restricted investments and restricted fund net assets.

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Balance Sheets

June 30, 2006 and 2005

(Amounts in thousands)

Assets	2006	2005
Noncurrent assets:		
Utility plant:		
Generation	$ 3,444,102	3,385,763
Transmission	906,848	871,968
Distribution	4,288,601	4,114,437
General	948,407	987,556
	9,587,958	9,359,724
Accumulated depreciation	(4,701,006)	(4,508,330)
	4,886,952	4,851,394
Construction work in progress	570,418	434,105
Nuclear fuel, at amortized cost	14,578	13,472
Natural gas field, net	237,403	—
	5,709,351	5,298,971
Restricted investments	955,340	1,036,114
Long-term California wholesale energy receivable, net	116,367	116,438
Long-term notes and other receivables, net of current portion	1,144,941	1,075,482
Net pension asset	99,793	114,521
Total noncurrent assets	8,025,792	7,641,526
Current assets:		
Cash and cash equivalents – unrestricted	315,298	145,367
Cash and cash equivalents – restricted	731,205	405,561
Cash collateral received from securities lending transactions	73,509	192,799
Customer and other accounts receivable, net of allowance for losses of $33,432 in 2006 and $30,872 in 2005	280,723	247,832
Current portion of long-term notes receivable	32,887	45,000
Accrued unbilled revenue	140,386	125,277
Materials and fuel	112,107	117,202
Prepayments and other current assets	33,948	35,295
Total current assets	1,720,063	1,314,333
Total assets	$ 9,745,855	8,955,859

See accompanying notes to financial statements.

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Balance Sheets (continued)

June 30, 2006 and 2005

(Amounts in thousands)

Fund Net Assets and Liabilities		**2006**	**2005**
Fund net assets:			
Invested in capital assets, net of related debt	$	1,774,252	1,641,388
Restricted:			
Debt service		600,750	721,928
Capital projects		97,017	323,596
Other postemployment benefits		231,496	199,914
Pension benefits		99,793	114,521
Other purposes		129,304	121,564
Unrestricted		1,178,955	938,775
Total fund net assets		4,111,567	4,061,686
Long-term debt, net of current portion		4,261,748	3,480,712
Other noncurrent liabilities:			
Deferred credits		564,164	625,555
Net other postemployment benefit obligation		110,823	71,168
Accrued workers' compensation claims		35,558	35,558
Commitments and contingencies (notes 6 and 15)			
Total other noncurrent liabilities		710,545	732,281
Current liabilities:			
Current portion of long-term debt		188,821	176,871
Accounts payable and accrued expenses		223,434	160,007
Accrued interest		80,249	62,365
Accrued employee expenses		82,575	71,730
Due to Water System		13,407	17,408
Obligation under securities lending transactions		73,509	192,799
Total current liabilities		661,995	681,180
Total liabilities		5,634,288	4,894,173
Total liabilities and fund net assets	$	9,745,855	8,955,859

See accompanying notes to financial statements.

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Statements of Revenues, Expenses, and Changes in Fund Net Assets

Years ended June 30, 2006, 2005, and 2004

(Amounts in thousands)

	2006	2005	2004
Operating revenues:			
Residential	$ 758,932	693,559	717,912
Commercial and industrial	1,544,855	1,421,003	1,460,814
Sales for resale	153,480	102,357	73,959
Other	50,579	48,275	49,682
Uncollectible accounts	(11,457)	(9,561)	(14,271)
	2,496,389	2,255,633	2,288,096
Operating expenses:			
Fuel for generation	541,659	478,201	434,122
Purchased power	741,810	634,923	662,070
Maintenance and other operating expenses	732,611	722,470	661,404
Depreciation and amortization	270,841	246,597	264,126
Loss on asset impairment and abandoned projects	—	—	13,634
	2,286,921	2,082,191	2,035,356
Operating income	209,468	173,442	252,740
Nonoperating revenues (expenses):			
Investment income	122,734	112,780	91,849
Other nonoperating income	17,394	9,695	21,066
	140,128	122,475	112,915
Other nonoperating expenses	(4,246)	(4,164)	(3,967)
	135,882	118,311	108,948
Debt expenses:			
Interest on debt	(170,839)	(148,347)	(135,793)
Allowance for funds used during construction	3,339	1,618	1,903
	(167,500)	(146,729)	(133,890)
Income before capital contributions, transfers, and extraordinary item	177,850	145,024	227,798
Capital contributions	29,925	25,896	38,514
Transfers to the reserve fund of the City of Los Angeles	(157,894)	(160,167)	(210,214)
Extraordinary loss on extinguishment of debt	—	—	(5,624)
Increase in fund net assets	49,881	10,753	50,474
Fund net assets:			
Beginning of year	4,061,686	4,050,933	3,693,062
Adjustment due to change in accounting principle from SFAS No. 106 to GASB No. 45 (note 2)	—	—	307,397
End of year	$ 4,111,567	4,061,686	4,050,933

See accompanying notes to financial statements.

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Statements of Cash Flows

Years ended June 30, 2006, 2005, and 2004

(Amounts in thousands)

		2006	2005	2004
Cash flows from operating activities:				
Cash receipts:				
Cash receipts from retail customers	$	2,326,817	2,286,794	2,306,676
Cash receipts from retail customers for other agency services		349,767	345,361	289,096
Cash receipts from wholesale customers		118,910	57,902	96,988
Cash receipts from interfund services provided		286,947	325,848	286,023
Other cash receipts		14,671	626	—
Cash disbursements:				
Cash payments to employees		(431,114)	(421,955)	(388,834)
Cash payments to suppliers		(1,462,463)	(1,296,277)	(1,374,458)
Cash payments for interfund services used		(342,519)	(363,321)	(396,332)
Cash payments to other agencies for fees collected		(319,998)	(323,399)	(302,871)
Other cash payments		—	—	(11,101)
		541,018	611,579	505,187
Cash flows from noncapital financing activities:				
Payments to the reserve fund of the City of Los Angeles		(157,894)	(220,167)	(179,214)
Interest paid on noncapital revenue bonds		(17,060)	(10,391)	(5,402)
		(174,954)	(230,558)	(184,616)
Cash flows from capital and related financing activities:				
Additions to plant and equipment, net		(677,882)	(378,867)	(547,527)
Capital contributions		12,186	16,813	45,477
Proceeds from escrow investment maturities		—	—	34,262
Principal payments and maturities on long-term debt		(172,600)	(46,228)	(1,125,282)
Proceeds from issuance of bonds and revenue certificates		956,171	199,832	1,222,461
Debt interest payments		(133,831)	(137,247)	(115,458)
		(15,956)	(345,697)	(486,067)
Cash flows from investing activities:				
Purchases of investment securities		(2,122,855)	(2,547,736)	(4,026,043)
Sales and maturities of investment securities		2,214,078	2,538,717	4,129,278
Purchase of long-term notes receivable		(92,385)	—	—
Proceeds from notes receivable		44,999	61,081	64,453
Investment income		101,630	112,430	102,106
		145,467	164,492	269,794
Net increase in cash and cash equivalents		495,575	199,816	104,298
Cash and cash equivalents:				
Cash and cash equivalents at July 1 (including $405,561, $162,762, and $120,742 reported in restricted accounts, respectively)		550,928	351,112	246,814
Cash and cash equivalents at June 30 (including $731,205, $405,561, and $162,762 reported in restricted accounts, respectively)	$	1,046,503	550,928	351,112

See accompanying notes to financial statements.

(Continued)

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Statements of Cash Flows (continued)

Years ended June 30, 2006, 2005, and 2004

(Amounts in thousands)

	2006	2005	2004
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$ 209,468	173,442	252,740
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization	270,841	246,597	264,126
Provision for losses on customer and other accounts receivable	11,457	9,561	14,271
Loss on asset impairment and abandoned projects	—	—	13,634
Provision for obsolete inventory	11,500	—	—
Changes in assets and liabilities:			
Customer and other accounts receivable	(25,843)	(16,738)	(20,445)
Accrued unbilled revenue	(15,108)	5,249	(11,674)
Materials and fuel	(6,405)	(8,486)	2,521
Net pension asset	14,728	7,750	(3,073)
Accounts payable and accrued expenses	63,427	(5,377)	(46,777)
Deferred credits	(61,391)	85,412	73,975
Due (from) to Water System	(4,001)	37,415	(68,588)
Net other postemployment benefit liability	39,655	25,269	38,065
Workers' compensation liability and other	32,690	51,485	(3,588)
Net cash provided by operating activities	$ 541,018	611,579	505,187

See accompanying notes to financial statements.

(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 Revenue Fund (Power System) is responsible for the generation, transmission, and distribution of electric power for sale in the City. The Power System is operated as an enterprise fund of the City.

(a) Method of Accounting

The accounting records of the Power System are maintained in accordance with U.S. generally accepted accounting principles (GAAP) 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 Statement of Financial Accounting Standards (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, the Power System 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 the Power System 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 U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(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, the Power System 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, *Employer's Accounting for Postretirement Benefits Other Than Pensions* (SFAS No. 106). As a result of the adoption of GASB Statement No. 45, *Accounting and Financial Reporting by Employees for Postemployment Benefit Other Than Pensions* (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 5.0% 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 3.0%, 2.8%, and 3.2% for each of the fiscal years ended 2006, 2005, and 2004, respectively.

(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 the Power System's 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 Power System'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, 2006 and 2005, the Power System has recorded $116.6 million and $115.3 million, respectively, to accumulated depreciation to provide for the decommissioning liability.

Prior to December 1999, the Power System 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 $1.3 million and $4.4 million of investment income in fiscal years 2006 and 2005, respectively. Decommissioning funds, which are included in restricted investments, totaled $97.0 million and $95.7 million as of June 30, 2006 and 2005 (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 the Power System's $1 per megawatt hour of nuclear generation. The Power System includes this charge as a current year expense in fuel for generation. See note 15 for discussion of spent nuclear fuel disposal.

(h) Natural Gas Field

In July 2005, the Power System acquired approximately a 74.5% ownership interest in gas properties located in Pinedale, Wyoming. The Power System uses the successful efforts method of accounting for its investment in gas producing properties. Costs to acquire the mineral interest in gas properties, to drill and equip exploratory wells that find proven reserves, and to drill and equip development wells are capitalized. Costs to drill exploratory wells that do not find proven reserves are expensed. Capitalized costs of producing gas properties are depleted by the unit-of-production method based on the estimated future production of the proven and developed producing wells.

(Continued)

Depletion expense related to the gas field is recorded as a component of fuel for generation expense. During fiscal year 2006, the Power System recorded $12.9 million of depletion expense.

(i) Cash and Cash Equivalents

As provided for by the California Government Code, the Power System's cash is deposited with the City Treasurer in the City's general investment pool for the purpose of maximizing interest earnings through pooled investment activities. Cash and cash equivalents in the City's general investment pool are reported at fair value and changes in unrealized gains and losses are recorded in the statements of revenues, expenses, and changes in fund net assets. Interest earned on such pooled investments is allocated to the participating funds based on each fund's average daily cash balance during the allocation period. The City Treasurer invests available funds of the City and its independent operating departments on a combined basis. The Power System classifies all cash and cash equivalents that are restricted either by creditors, the Board, or by law, as restricted cash and cash equivalents on the balance sheets. The Department considers its portion of pooled investments with an original maturity of three months or less to be cash equivalents.

At June 30, 2006 and 2005, restricted cash and cash equivalents include the following (amounts in thousands):

		June 30,	
		2006	**2005**
Bond redemption and interest funds	$	149,308	122,079
Construction funds		515,471	54
Self-insurance fund		63,862	52,475
Funds for purchase of gas field		—	227,791
Other		2,564	3,162
	$	731,205	405,561

(j) 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.

(k) Accrued Unbilled Revenue

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

(l) 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).

(m) 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, 2006 and 2005 (amounts in thousands):

		Balance as of June 30,	
		2006	**2005**
Type of expenses:			
Accrued payroll	$	31,178	24,112
Accrued vacation		35,125	33,100
Accrued sick time		8,399	7,709
Compensatory time		7,873	6,809
Total	$	82,575	71,730

(n) 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 accompanying statements of revenues, expenses, and changes in fund net assets.

(o) 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).

(p) 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).

(q) 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. The Water System is responsible for collection, maintenance, and refunding of these deposits for all Department customers, including those of the Power System. As such, the Water System's balance sheets include a deposit liability of $67.9 million and $59.3 million as of June 30, 2006 and 2005, respectively, for all customer deposits collected. In the event that the Water System defaults on refunds of such deposits, the Power System would be required to pay amounts owing to its customers.

(r) Revenues

The Power System's rates are established by a rate ordinance, which is approved by the City Council. The Power System sells energy to other City departments at rates provided in the ordinance. The Power System 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.

(s) 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.

(t) 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 4.6%, 3.3%, and 4.9% for each of fiscal years 2006, 2005, and 2004, respectively.

(u) Use of Restricted and Unrestricted Resources

The Power System's 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.

(v) Comparative Information

The financial statements include partial 2004 comparative information. Such information does not include all of the information and disclosures required for a complete set of basic financial statements. Accordingly, such information should be read in conjunction with the Power System's financial statements for the year ended June 30, 2004, from which such partial comparative information was derived.

(w) Reclassifications

Certain financial statement items for 2005 have been reclassified to conform to the 2006 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 Institutions, Investments (including Repurchase Agreements), and Reverse Purchase Agreements*, related to required disclosures of custodial credit risk to one category 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 SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (SFAS No. 106).

The Power System does not administer its plan for postretirement benefits other than pensions (health care benefits) as a trust or equivalent arrangement. The Power System 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 the Power System, 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 Power System assets and are reported as such in the accompanying balance sheets as of June 30, 2006 and 2005. Currently, retiree premium payments are made from the Power System's 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 the Power System's 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).

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

Balance sheet item		Reported as of June 2003	Adjustments	Adjusted balance
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 System		(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 the Power System and Water System 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 was 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 cost 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 the Power System. The Power System paid $32.4 million for retiree premiums during fiscal year 2004, leaving $38.5 million as a liability on the Power System's books as of June 30, 2004.

The Power System has established a restricted investment trust for postretirement health care expenses. These monies are restricted assets on the Power System's balance sheets. In 2004, the Department made additional contributions to the postretirement investment trust. As a result, the postretirement obligation and restricted investments on the Power System's books as of June 30, 2004 is as follows (amounts in thousands):

		June 30, 2004
Postretirement liability	$	(38,487)
Restricted investments – postretirement trust assets		197,670

(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, the Power System 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 Power System adopted GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units* (GASB No. 39). This statement amends GASB Statement No. 14, *The Financial Reporting Entity* (GASB No. 14) 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. The Power System 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 the Power System 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 Power System's financial statements as a result of adopting this statement. This Statement was effective for the Power System beginning in fiscal year 2004.

(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 (CAISO). 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 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, renewable energy sources, and distributed generation. The plan was redrafted in 2006 to incorporate the Power System's goal of increasing its portion of renewable energy sales to 20.0% by 2010. This plan has been amended to allow for a total budget of $2.0 billion, and as of June 30, 2006, the Department has incurred $1.3 billion related to such upgrades.

(Continued)

(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. The Power System's 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, the Power System 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, 2006, these agencies, the CAISO, and the California Power Exchange (CPX), have made minimal payments since April 2001 on amounts outstanding to counterparties, including the Power System, 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. 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, 2006 and 2005, a total of $166.5 million was due to the Power System from the CAISO and the CPX. The FERC has questioned whether amounts charged for energy sold to the CAISO 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.

The Power System has recorded a $50.0 million liability as of June 30, 2006 and 2005 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 the Power System 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 the Power System's 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 on January 1, 2012.

The Department defers public benefit 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 2006, 2005, and 2004, the Department spent \$50.6 million, \$39.2 million, and \$64.2 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, 2006 and 2005, the Department has recorded a deferred credit in the amount of \$25.3 million and \$12.7 million due to public benefit expenses below 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, Senate Bill 1078 was enacted, which requires, among other things, the IOUs to generate 20.0% of their electricity from renewable energy sources, such as wind, solar, biomass, and geothermal energy, by no later than 2017. Publicly owned utilities such as the Department are exempt from the direct provisions of this California law and must establish their own renewable portfolio standard considering the intent of the Legislature.

(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 in the Federal Power Act (FPA). 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 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 proceedings 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.

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 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.

(4) Utility Plant

The Power System had the following activity in utility plant during fiscal year 2006 (amounts in thousands):

	Balance June 30, 2005	Additions	Retirements and disposals	Transfers	Balance June 30, 2006
Nondepreciable utility plant:					
Land and land rights	$ 148,568	6,619	(10,566)	—	144,621
Construction work in progress	434,105	324,694	—	(188,381)	570,418
Nuclear fuel	13,472	6,306	(5,200)	—	14,578
Natural gas field	—	250,342	(12,939)	—	237,403
Total nondepreciable utility plant	596,145	587,961	(28,705)	(188,381)	967,020
Depreciable utility plant:					
Generation	3,376,741	27,926	(8,666)	33,567	3,429,568
Transmission	792,262	797	(895)	37,332	829,496
Distribution	4,070,937	78,343	(11,733)	107,524	4,245,071
General	971,216	35,831	(77,803)	9,958	939,202
Total depreciable utility plant	9,211,156	142,897	(99,097)	188,381	9,443,337
Less accumulated depreciation:					
Generation	(1,835,185)	(107,409)	7,677	—	(1,934,917)
Transmission	(340,535)	(16,806)	183	96	(357,062)
Distribution	(1,676,710)	(109,044)	1,384	(3)	(1,784,373)
General	(655,900)	(35,537)	66,876	(93)	(624,654)
Total accumulated depreciation	(4,508,330)	(268,796)	76,120	—	(4,701,006)
Total utility plant, net	$ 5,298,971	462,062	(51,682)	—	5,709,351

Depreciation and amortization expense during fiscal 2006 was $270.8 million.

The Power System had the following activity in utility plant during fiscal year 2005 (amounts in thousands):

	Balance June 30, 2004	Additions	Retirements and disposals	Transfers	Balance June 30, 2005
Nondepreciable utility plant:					
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
Depreciable utility plant:					
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)
Total utility plant, net	$ 5,165,082	148,334	(14,445)	—	5,298,971

Depreciation and amortization expense during fiscal 2005 was $246.6 million.

(5) Jointly Owned Utility Plant

The Power System has direct interests in several electric generating stations and transmission systems, which are jointly owned with other utilities. As of June 30, 2005 and 2006, utility plant includes the following amounts related to the Power System's' ownership interest in each jointly owned utility plant (amounts in thousands, except as indicated):

	Ownership interest	Share of capacity (MWs)	Utility plant in service June 30, 2006 Cost	Utility plant in service June 30, 2006 Accumulated depreciation	Utility plant in service June 30, 2005 Cost	Utility plant in service June 30, 2005 Accumulated depreciation
Palo Verde Nuclear Generating Statio	5.7%	217	$ 546,915	284,929	529,634	270,898
Navajo Generating Station	21.2	477	318,440	243,618	315,739	230,093
Mohave Generating Station	10.0	158	70,136	68,619	69,681	68,510
Pacific Intertie DC Transmission Line	40.0	1,240	211,709	66,690	204,003	62,660
Other transmission systems		Various	77,598	39,897	77,010	37,912
			$ 1,224,798	703,753	1,196,067	670,073

The Power System 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. The Power System's proportionate share of the operating costs of the joint plants is included in the corresponding categories of operating expenses.

(6) Purchase Power Commitments

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

	Agency	Agency share	Power System's interest in agency's share Interest	Power System's interest in agency's share Capacity MWs	Power System's interest in agency's share Outstanding principal
Intermountain Power Project	IPA	100.0%	63.9%	1,121	$ 1,451,044
Palo Verde Nuclear Generating Station	SCPPA	5.9	67.0	151	83,924
Mead-Adelanto Project	SCPPA	68.0	36.0	291	81,826
Mead-Phoenix Project	SCPPA	17.8 – 22.4	25.0	148	17,881
Southern Transmission System	SCPPA	100.0	60.0	1,142	540,777

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). The Power System 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 the Power System to make certain minimum payments, which are based primarily upon debt service requirements. In addition to average annual fixed charges of approximately $301 million during each of the next five years, the Power System is required to pay for operating and maintenance costs related to actual deliveries of energy under these agreements (averaging approximately $316 million annually during each of the next five years). The Power System made total payments under these agreements of approximately $433 million, $468 million, and $551 million in fiscal years 2006, 2005, and 2004, respectively. These agreements are scheduled to expire from 2027 to 2030.

The Power System earned fees under the IPP Project Manager and Operating Agent agreements totaling $16.9 million, $16.3 million, and $18.2 million in fiscal years 2006, 2005, and 2004, 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 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.

On July 20, 2005, the Department paid $97 million to IPA in exchange for additional long-term notes receivable. IPA used the proceeds to defease bonds with a face value of $92 million.

The IPA notes are subordinate to all of IPA's publicly held debt obligations. The Power System's future payments to IPA will be partially offset by interest payments and principal maturities from the subordinated notes receivable. The net IPA notes receivable balance totaled $1.17 billion and $1.12 billion as of June 30, 2006 and 2005, 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. The Power System's share of capacity at Hoover is approximately 500 megawatts. The cost of power purchased under this contract was $13 million, $13 million, and $12 million in each of fiscal years 2006, 2005, and 2004, respectively.

(7) Cash, Cash Equivalents, and Investments

(a) Restricted and Other Investments

A summary of the Power System's restricted investments is as follows (amounts in thousands):

Description		June 30, 2006	2005
Restricted and other investments:			
Restricted investments:			
Debt reduction trust funds	$	450,561	601,130
Postretirement health care benefit trust		342,319	271,082
Nuclear decommissioning trust fund		97,017	95,750
Natural gas trust fund		25,043	25,022
SCPPA Palo Verde investment		40,400	43,094
Other investments		—	36
Total restricted investments		955,340	1,036,114
Other investments:			
Cash collateral received from the Department's securities lending transactions* (see note 8)		—	155,481
Total restricted and other investments	$	955,340	1,191,595

* The Power System also has $73,509 and $37,318 of cash collateral received from securities lending transactions in the City' s securities lending program, respectively, (see notes 7(b) and 8).

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

i. *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 IPP and 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.

ii. *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).

iii. *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).

iv. *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.

v. *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.

vi. *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.

As of June 30, 2006, the Power System's securities lending, cash collateral, and restricted investments and their maturities are as follows (in thousands):

		Investment maturities				
Investment type	**Fair value**	**1 to 30 days**	**31 to 60 days**	**61 to 365 days**	**366 days to 5 years**	**Over 5 years**
U.S. Government agencies	$ 462,387	4,149	24,032	145,872	206,038	82,296
Medium-term notes	190,489	11,634	19,744	107,470	51,641	—
Commercial paper	158,070	121,009	27,168	9,893	—	—
Negotiable CDs	94,889	—	62,688	32,201	—	—
Money market funds	9,105	9,105	—	—	—	—
Securities lending cash collateral repurchase agreements	73,509	73,509	—	—	—	—
SCPPA Palo Verde investment	40,400	40,400	—	—	—	—
	$ 1,028,849	259,806	133,632	295,436	257,679	82,296

As of June 30, 2005, the Power System's securities lending, cash collateral, and restricted 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. Government 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
	$ 1,191,595	380,790	67,510	355,260	244,972	143,063

vii. *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.

viii. *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, 2006 and 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 Corporation (S&P), Aaa by Moody's Investors Services (Moody's), and AAA by Fitch Ratings (Fitch).

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.

(Continued)

Government. As of June 30, 2006 and 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 medium-term corporate notes must be rated in a rating category of "A" or its equivalent or better by a NRSRO. Of the Department's investments in corporate notes as of June 30, 2006, $3,385,560 (2.0%) was rated in the category of AAA, $129,933,595 (68.0%) was rated in the category of AA, and $57,170,056 (30.0%) was rated in the category of A by at least one NRSRO. Of the Power System's investments in corporate notes as of June 30, 2005, $15,337,713 (8.0%) was rated in the category of AAA, $81,553,979 (44.0%) was rated in the category of AA, and $90,095,668 (48.0%) was rated in the category of A by at least one NRSRO.

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, 2006 and 2005, all of the Power System's' 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, 2006 and 2005, all of the Power System's' investments in negotiable certificates of deposits were of the highest ranking by three NRSROs.

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, 2006, the Power System did not have any securities on loan under securities lending transactions and therefore had no related reinvestments in repurchase agreements. 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 102.0% of the repurchase agreements.

ix. *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 30.0% of the cost value of the portfolio may be invested in the securities of any single U.S. Government agency issuer.

Of the Power System's total investments as of June 30, 2006, $148,351,195 (16.0%) was invested in securities issued by the Federal Home Loan Bank; $144,048,527 (16.0%) was invested in securities issued by the Federal Home Loan Mortgage Corporation; and

 (Continued)

$129,360,590 (14.0%) was invested in securities issued by the Federal National Mortgage Association;

Of the Power System's total investments as of June 30, 2005, $198,249,683 (17.0%) was invested in securities issued by the Federal Home Loan Bank; $188,329,998 (16.0%) was invested in securities issued by the Federal National Mortgage Association; $168,174,337 (15.0%) was invested in securities issued by the Federal Home Loan Mortgage Corporation; and $52,214,278 (5.0%) 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.

Of the Power System's total investments as of June 30, 2005, all cash collateral received from securities lending transactions of $155,481,114 (14.0%) was invested in open repurchase agreements with Goldman Sachs & Co.

(b) Pooled Investments

The Power System 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, 2006 and 2005, the Power System's share of the City's General and Special Investment Pool was $1,120,012,000 and $588,246,000, which represents approximately 15.0% and 9.0% of the Pool, respectively.

At June 30, 2006, the investments held in the City Treasury's General and Special Investment Pool Programs and their maturities are as follows (amounts in thousands):

		Investment maturities			
Type of investments	**Amount**	**1 to 30 days**	**31 to 60 days**	**61 to 365 days**	**366 days to 5 years**
U.S. Treasury notes	$ 750,633	—	—	—	750,633
U.S. Treasury bills	7,193	7,193	—	—	—
U.S. Government agencies	3,483,994	229,854	259,964	519,398	2,474,778
Medium term notes	1,077,004	—	—	125,689	951,315
Commercial paper	1,298,356	1,173,459	52,464	72,433	—
State of California LAIF	2,204	2,204	—	—	—
Short-term investment funds	13	13	—	—	—
Securities lending cash collateral:					
U.S. Treasury notes	607,597	—	—	—	607,597
U.S. Government agencies	344,340	—	—	—	344,340
Total general and special pools	$ 7,571,334	1,412,723	312,428	717,520	5,128,663

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	1 to 30 days	31 to 60 days	61 to 365 days	366 days to 5 years
			Investment maturities			
U.S. Treasury notes	$	526,446	—	25,102	50,690	450,654
U.S. Government 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. Government agencies		395,396	—	—	—	395,396
Total general and special pools	$	6,627,816	1,134,864	206,561	599,593	4,686,798

i. *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.

ii. *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: S&P A-1/A; Moody's P-1/A2; 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 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.

iii. *Concentration of Credit Risk*

The City's investment policy does not allow more than 10.0% 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 30.0% 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 5.0% or more of total investments; the City does not have such investments.

(8) Securities Lending Transactions

The Power System participates in two securities lending programs as follows (collateral amounts in thousands):

Program		Balance as of June 30, 2006	2005
Department Program	$	—	155,481
City of Los Angeles Program		73,509	37,318
	$	73,509	192,799

In December 1999, the Department initiated a securities lending program managed by its custodial bank to increase interest income. The bank lends up to 20.0% 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 102.0% 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 the Power System's portion of the Department's securities lending program as of June 30, 2006 and 2005 is as follows (amounts in thousands):

Securities lent for cash collateral		2006 Fair value of underlying securities	2006 Collateral value	2005 Fair value of underlying securities	2005 Collateral value
U.S. Government and agency securities	$	—	—	152,315	155,481

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 borrower or lending agent default losses during fiscal years 2006 and 2005.

General Investment Pool Program

The Power System 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, 2006 and 2005, the Power

System's attributed share of cash collateral and the related obligation from the City's program was $73.5 million and $37.3 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), the Power System 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. The Power System had three main types of derivative instruments as of June 30, 2006 and 2005: electricity swaps, financial natural gas hedges, and gas forward contracts. As of June 30, 2006 and 2005, the fair values of these outstanding derivative instruments were $85.9 million and $104.3 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, 2006 and 2005, the Power System had no deferred option revenue relating to options entered into prior to the fiscal year end.

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 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.

(c) 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.

As of June 30, 2006, the Power System had the following derivatives, which were not recorded on its balance sheet:

Derivative description	Total contract quantities	Contract price range $ per unit	First effective date	Last termination date	Fair value ($000's)	Cash received at derivative inception ($000's)
Electricity swaps:						
Purchases	121,600 MWs	63.00	10/1/06	12/31/06	(52,507)	—
Sales	121,600 MWs	66.50	10/1/06	12/31/06	478,107	—
Electricity options	30,800 MWs	75.50	7/1/06	9/30/06	(54,993)	345,884
Financial Natural Gas:						
Hedges*	91,336,000 MMBtu	4.30 – 7.49	10/1/05	6/1/10	85,521	—

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

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

Derivative description	Total contract quantities	Contract price range $ per unit	First effective date	Last termination date	Fair value ($000's)	Cash received at derivative inception ($000's)
Electricity swaps:						
Purchases	6,150 MWs	68.02	7/1/05	9/30/05	(1)	—
Sales	6,150 MWs	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.

(e) Credit Risk

The Power System 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, 2006, 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 S&P as follows: two at AA+, one at AA, two at AA-, and three at A+.

As discussed in note 3, during fiscal year 2001, the Power System experienced nonperformance and material counterparty default with the CISO and the CPX. The Power System does not anticipate nonperformance by any other of its counterparties and has no reserves related to nonperformance at June 30, 2006 and 2005. Apart from the events discussed in note 3, the Power System did not experience any material counterparty default during fiscal years 2006, 2005, or 2004.

(f) Termination Risk

The Power System or its counterparties may terminate the contractual agreements if the other party fails to perform under the terms of the contract.

(10) Long-Term Debt

Long-term debt outstanding as of June 30, 2006 and 2005 consists of revenue bonds and refunding revenue bonds due serially in varying annual amounts as follows (amounts in thousands):

Bond issues	Date of issue	Effective interest rate	Fiscal year of last scheduled maturity		Principal outstanding 2006	Principal outstanding 2005
Issue of 2001, Series A1	03/20/01	4.931%	2025	$	1,023,800	1,060,475
Issue of 2001, Series A2	11/06/01	5.109	2022		109,095	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	620,600
Issue of 2001, Series C1	11/15/01	4.788	2017		4,543	4,582
Issue of 2002, Series A	08/22/02	Variable	2036		388,500	388,500
Issue of 2002, Series C2	11/22/02	4.375	2018		11,846	13,537
Issue of 2003, Series A1	07/31/03	3.409	2017		422,380	440,110
Issue of 2003, Series A2	08/19/03	4.662	2032		515,830	515,830
Issue of 2003, Series B	08/28/03	5.013	2036		200,000	200,000
Issue of 2004, Series C3	04/07/04	4.298	2020		12,192	12,362
Issue of 2005, Series A1	12/28/05	4.700	2041		616,895	—
Issue of 2005, Series A2	12/28/05	4.700	2031		315,195	—
Issue of 2006, Series C4	03/01/06	4.040	2017		8,618	—
	Total principal amount				4,249,494	3,481,386
	Revenue Certificates				200,000	200,000
	Unamortized debt-related costs (including net loss on refundings)				1,075	(23,803)
	Debt due within one year (including current portion of variable rate debt)				(188,821)	(176,871)
				$	4,261,748	3,480,712

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

(a) Long-Term Debt Activity

The Power System had the following activity in long-term debt for the fiscal years ended June 30, 2006 and 2005 (amounts in thousands):

	Balance at June 30, 2005	Additions	Reductions	Balance at June 30, 2006	Current portion
Long-term debt:					
Bonds	$ 3,457,583	966,155	(173,169)	4,250,569	168,821
Revenue Certificates	200,000	—	—	200,000	20,000
Total	$ 3,657,583	966,155	(173,169)	4,450,569	188,821

	Balance at June 30, 2004	Additions	Reductions	Balance at June 30, 2005	Current portion
Long-term debt:					
Bonds	$ 3,503,386	567	(46,370)	3,457,583	156,871
Revenue Certificates	—	200,000	—	200,000	20,000
Total	$ 3,503,386	200,567	(46,370)	3,657,583	176,871

(b) New Issuances

Fiscal Year 2006

In December 2005, the Power System issued $932 million of Power System Revenue Certificates. Also, in March 2006, the Power System issued $8.9 million of Mini-Bonds. The net proceeds from both transactions were deposited into the construction fund to be used for capital improvements

Fiscal Year 2005

In September 2004, the Power System 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, the Power System 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 $60 million in cash were used to defease bonds with a par value of $1.025 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 $57 million, of which $53.5 million was deferred and is being amortized over the shorter of the life of the bonds retired or the life of the new bonds, and $3.5 million was recognized in fiscal year 2004 as part of debt expenses.

In August 2003, the Power System 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 Power System issued $10 million of Power System 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

The Power System 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 the Power System's financial statements.

In July 2005, the Power System defeased the $116.3 million Power System Revenue Bonds, Series A, Sub-series A-3, with a carrying amount of $115.3 million, by utilizing $110.7 million from the debt reduction trust fund to purchase securities placed in an irrevocable trust to provide for all future debt service on the bonds. The transaction resulted in a realized gain of $4.6 million that was netted against interest on debt.

At June 30, 2006, the following revenue bonds outstanding are considered defeased and remained outstanding (amounts in thousands):

Bond issues		Principal outstanding
Third Issue of 1991	$	350
Issue of 1992		990
Second Issue of 1993		9,085
Refunding Issue of 1994		46,165
Issue of 1994		6,105
Issue 2001, Series A3		116,295
	$	178,990

(d) Variable Rate Bonds and Revenue Certificates

The variable rate bonds currently bear interest at daily and weekly rates (ranging from 3.95% to 5.31% as of June 30, 2006). The Power System 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 an average rate of 3.49%. The Power System 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.

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 Power System 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 Power System the ability to refinance on a long-term basis and the Power System 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 were tendered and purchased by the commercial banks under the standby agreements have been included in the current portion of long-term debt and was $120.9 million at June 30, 2006 and 2005.

(e) Scheduled Principal Maturities and Interest

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

		Principal	**Interest and amortization**
Fiscal years ending June 30:			
2007	$	67,911	194,951
2008		41,826	193,378
2009		58,525	191,257
2010		98,952	187,274
2011		120,345	181,846
2012-2016		680,632	811,303
2017-2021		561,202	668,183
2022-2026		792,906	479,359
2027-2031		822,430	293,432
2032-2036		894,105	100,076
2037-2041		110,660	9,273
Total requirements	$	4,249,494	3,310,332

The maturity schedule presented above reflects the scheduled debt service requirements for all of the Power System's 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 Power System convert all of the revenue certificates under the line of credit, the Power System 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 2007, $241.8 million in each of the fiscal years 2008 through 2011, and $121.0 million in fiscal year 2012. Accordingly, the balance sheets include the possibility of the exercise of the tender options and reflect the $120.9 million that could be due in fiscal year 2007 as a current portion of long-term debt payable. Interest and amortization includes interest requirements for variable rate bonds, using the variable debt interest rate in effect at June 30, 2006 of 3.95% for tax-exempt bonds and 5.31% for taxable bonds.

(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 6.0% 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 the Power System and the Water System 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. The Plan is an independent pension trust fund of the City.

Plan amendments must be approved by both the Retirement Board and the Board. 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):

	Year ended June 30, 2006	Year ended June 30, 2005
Annual required contribution	$ 118,342	79,201
Interest on net pension asset	(13,023)	(13,938)
Adjustment to annual required contribution	19,405	20,764
APC (including $36.2 million and $24.4 million of amounts capitalized in fiscal 2006 and 2005, respectively)	124,724	86,027
Department contributions	(101,630)	(75,501)
Change in NPO	23,094	10,526
NPO (asset) – beginning of year	(171,658)	(182,184)
NPO (asset) – end of year	$ (148,564)	(171,658)

The Power System's allocated share of APC and NPO consists of the following (amounts in thousands):

		Year ended June 30,	
		2006	2005
Annual required contribution	$	78,106	52,272
Interest on net pension asset		(8,595)	(9,199)
Adjustment to annual required contribution		12,807	13,704
APC (including $21.6 million and $13.9 million of amounts capitalized in fiscal 2006 and 2005, respectively)		82,318	56,777
Department contributions		(67,590)	(49,027)
Change in NPO		14,728	7,750
NPO (asset) – beginning of year		(114,521)	(122,271)
NPO (asset) – end of year	$	(99,793)	(114,521)

Annual required contributions are determined through actuarial valuations using the entry age normal 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:

Actuarial valuation date July 1	Normal cost	Surplus amortization	Contribution rate
2005	10.77%	7.69%	19.20%
2004	10.83	2.10	13.45
2003	10.89	(2.76)	8.45

The significant actuarial assumptions include an investment rate of return of 8.0%, projected inflation-adjusted salary increases of 5.5%, and postretirement benefit increases of 3.0%. The actuarial value of assets 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.

(Continued)

Trend information for fiscal years 2006, 2005, and 2004 for the Power System is as follows (amounts in thousands):

Year ended June 30	NPO (asset)	Percentage of APC contributed	APC
2006	$ (99,793)	82.0%	$ 82,318
2005	(114,521)	86.0	56,777
2004	(122,271)	109.0	33,831

Disability and Death Benefits

The Power System's allocated share of disability and death benefit plan costs and administrative expenses totaled $9 million, $9 million, and $8 million for each of the fiscal years 2006, 2005, and 2004, respectively.

(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 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 16,750 and 16,450 at June 30, 2006 and 2005, 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 $2,429 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 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 2006 and 2005, the Department increased the postretirement trust assets by $100 million (Power System's portion, $66 million) in addition to the $53 million it paid for current retiree premiums (Power System's portion, $34.6 million). These trust assets are irrevocably committed to funding participant benefits.

(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 No. 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 contributed to the Plan, and changes in the net other postretirement benefit obligation (amounts in thousands):

		Year ended June 30,	
		2006	**2005**
Annual required contribution	$	110,813	99,684
Interest on net OPEB obligation		7,094	4,030
Adjustment to annual required contribution		(5,353)	(510)
		112,554	103,204
Contributions made		(52,990)	(52,544)
Change in net other postretirement benefit obligation		59,564	50,660
Net other postretirement benefit obligation – beginning of year		109,140	58,480
Net other postretirement benefit obligation – end of year	$	168,704	109,140

The following table shows the components of the Power System's 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):

		Year ended June 30,	
		2006	**2005**
Annual required contribution	$	73,137	64,795
Interest on net OPEB obligation		4,682	2,620
Adjustment to annual required contribution		(3,533)	(332)
		74,286	67,083
Contributions made		(34,631)	(34,402)
Change in net other postretirement benefit obligation		39,655	32,681
Net other postretirement benefit obligation – beginning of year		71,168	38,487
Net other postretirement benefit obligation – end of year	$	110,823	71,168

(Continued)

The reconciliation of the postretirement trust assets as of June 30, 2006, representing the set aside assets in the irrevocable employer trust, is as follows (dollar amount in thousands):

		Department	Power System's share
Postretirement trust assets – beginning of year	$	396,361	271,082
Contributions to trust		107,650	71,237
Postretirement trust assets – end of year	$	504,011	342,319

The Department's annual OPEB costs, the percentage of annual required contribution contributed to the Plan, and the net postretirement obligation for fiscal years 2006 and 2005, were as follows (amounts in thousands):

		2006	2005
Annual OPEB cost	$	112,554	103,204
Percentage of the ARC contributed		47.0%	51.0%
Net postretirement obligation	$	168,704	109,140

The Power System's share in the annual OPEB cost, the percentage of annual required contribution contributed to the Plan, and the net postretirement obligation for fiscal years 2006 and 2005, were as follows (amounts in thousands):

		2006	2005
Annual OPEB cost	$	74,285	67,083
Percentage of the ARC contributed		47.0%	51.0%
Net postretirement obligation	$	110,823	71,168

(d) Funded Status and Funding Progress (Unaudited)

As of July 1, 2005, the Department's actuarial accrued liability for benefits was $1.7 billion resulting in an unfunded actuarial accrued liability (UAAL) of $1.7 billion. The covered payroll (annual payroll of active employees covered by the Plan) was $612.3 million, and the ratio of the UAAL to the covered payroll was 277.0%.

As of July 1, 2004, the Department's actuarial accrued liability for benefits was $1.6 billion resulting in an 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 297.0%.

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, 2005 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 11.0% initially, reduced by decrements to an ultimate rate of 5.0% after six years. Both rates include a 4.0% 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, 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 12.0% initially, reduced by decrements to an ultimate rate of 5.0% 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 28.0% of prescription drug costs between $250 and $5,000 for each Medicare-eligible retiree who does not join Part D.

(13) Other Long-Term Liabilities

(a) Other Long-Term Liabilities

The Power System had the following other long-term liabilities:

		Balance at June 30, 2005	Additions	Reductions	Balance at June 30, 2006
Deferred credits:					
Purchased power	$	612,828	—	(78,556)	534,272
Public benefits		12,727	12,601	—	25,328
Other		—	4,564	—	4,564
	$	625,555	17,165	(78,556)	564,164
Accrued workers' compensation claims	$	35,558	10,934	(10,934)	35,558

		Balance at June 30, 2004	Additions	Reductions	Balance at June 30, 2005
Deferred credits:					
Purchased power	$	540,150	72,678	—	612,828
Public benefits		—	12,727	—	12,727
	$	540,150	85,405	—	625,555
Accrued workers' compensation claims	$	31,352	8,415	(4,209)	35,558

(b) Deferred Credits

During fiscal year 2006, the Board approved the suspension of deferring precollected purchased power costs and the reversal of the precollected purchased power costs recorded in prior years. The amount reversed is the cost of energy from IPP less the amount designated in rates for out-of-market purchased power costs. The reversal of the deferred credit is credited to retail sales. During fiscal year 2006, the Power System reversed $78.5 million related to precollected purchase power costs. At June 30, 2006 and 2005, $534.3 million and $612.8 million, respectively, remain as part of deferred credits related to precollected purchased power costs.

(c) Public Benefits

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. As of June 30, 2006 and 2005, the Department has recorded a deferred credit in the amount of $25.3 million and $12.7 million, respectively, due to public benefit expenses below revenues.

(d) 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 3.0% at June 30, 2006. The Department has third-party insurance coverage for workers' compensation claims over $1 million.

Overall indicated reserves for workers' compensation claims, for both the Water System and the Power System, undiscounted, have decreased from $63.8 million as of June 30, 2005 to $61.2 million as of June 30, 2006. This decrease is mainly attributable to favorable development stems for prior fiscal years due to changes in reserving practices. In addition a number of legislative reforms impacting workers compensation costs were passed in 2002, 2003, and 2004. The reforms increase statutory benefits and put in place controls for medical utilization. Industry estimates of the impact of the reforms on medical costs are a decrease of 36.0%.

Changes in the Department's liability since June 30, 2004 are summarized as follows (amounts in thousands):

		June 30,		
		2006	2005	2004
Balance at beginning of year	$	63,785	55,990	45,535
Current year claims and changes in estimates		12,646	15,166	16,715
Payments applied		(15,258)	(7,371)	(6,260)
Balance at end of year	$	61,173	63,785	55,990

The Power System's portion of the discounted reserves is $35.6 million as of June 30, 2006 and 2005.

(14) Loss on Asset Impairment and Abandoned Project

During fiscal year 2006, the Mohave Generating Station (Mohave) was shut down due to the lack of remediation efforts to comply with environmental, water, and coal issues. This closure was anticipated in 2004, and as such the Department recorded a loss on 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*. During fiscal year 2004, the Department discontinued using a procurement system. The Power System's portion of the loss related to this system totaled $5.5 million.

(Continued)

(15) Commitments and Contingencies

(a) Transfers to the Reserve Fund of the City of Los Angeles

Under the provisions of the City Charter, the Power System 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 statements of revenues, expenses, and changes in fund net assets.

The Department authorized total transfers of $157.9 million, $160.2 million, and $210.2 million in fiscal years 2006, 2005, and 2004, respectively, from the Power System to the reserve fund of the City. Included in these amounts was a transfer of $60.0 million, which was accrued as liabilities as of June 30, 2004. 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 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.

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 the Power System's facilities and operations. The Department monitors its compliance with environmental laws and regulations and reviews its remediation obligations on an ongoing basis. The following topics highlight some of the major environmental compliance issues affecting the Power System:

Air Quality – Nitrogen Oxide (NOx) Emissions

The Power System's generating station facilities are subject to the Regional Clean Air Incentives Market (RECLAIM) 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 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 1, 2007, power producers can reenter the RECLAIM market. 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 until 2010.

Air Quality – Greenhouse Gas Emissions

In September 2006, Governor Schwarznegger signed the California Global Warming Solutions Act of 2006 (AB32) and Senate Bill 1368, Electricity: Emissions of Greenhouse Gases (SB1368). AB32 requires the California Air Resources Board to develop regulations and market mechanisms that will ultimately reduce California's greenhouse gas emissions by 25.0% by 2020. Mandatory caps will begin in 2012 for significant sources and be gradually reduced to meet the 2020 goals. As specified in AB32, all emissions from electricity that are consumed in the state, whether it is generated in California or in other states, will be subject to the cap. As a result, the Power System's share of emissions from IPP and other facilities outside California will be subject to this program. SB1368 will require local publicly owned electric utilities to comply with a greenhouse gas emission performance standard prior to entering into a long-term financial commitment for baseload generation. As defined in SB1368, "long-term financial commitment means either a new ownership investment in baseload generation or a new or renewed contract with a term of five or more years, which includes procurement of baseload generation." Baseload generation refers to power plants with an annualized capacity factor of at least 60.0%.

It is uncertain at this time what impact these statutes will have on the Power System's operations. If a cap and trade program is established under AB32, the primary issue will be how allowances will be allocated to the Department and other power producers. The target date for the Air Resources Board to adopt regulations is January 1, 2011. The goal of the AB32 regulations would be to "achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas, including provisions for using both market mechanisms and alternative compliance mechanisms." As required under SB1368, the California Energy Commission will adopt regulations to implement a greenhouse gas emission performance standard for local publicly owned utilities by June 30, 2007. Once adopted, the Department will be required to meet the emission performance standard for new contracts and major investments at its existing facilities. The Department will be actively participating in the rulemaking process for both AB32 and SB1368

Power Plant Once-Through Cooling Water Systems

Once-through cooling is the process where water is drawn from a source, pumped through equipment to provide cooling, and then discharged. Some type of cooling process is necessary for nearly every type of traditional electrical generating station, and the once-through cooling process is utilized by many electrical generating stations located next to large bodies of water. Typically the water used for cooling is not chemically changed in the process, although its temperature is increased.

Regulatory agencies have made several changes recently that could significantly impact operations at the Haynes, Scattergood, and Harbor Generating Stations. The Environmental Protection Agency has adopted new regulations that would affect the water that is drawn into these plants for cooling purposes, and for the Haynes and Harbor stations, the Regional Water Quality Control Board reclassified the body of water that the once-through cooling water is discharged to. For Haynes, this reclassification includes requirements that cannot currently be met with its existing cooling configuration. The Department is in the process of reviewing the regulations and conducting studies. Once the studies are reviewed, the Department will determine an appropriate course of action.

(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 the Power System's financial position, results of operations, or cash flows as of June 30, 2006 and 2005.

(e) Risk Management

The Power System is subject to certain business risks common to the utility industry. The majority of these risks are mitigated by external insurance coverage obtained by the Power System. For other significant business risks, however, the Power System has elected to self-insure. Management believes that exposure to loss arising out of self-insured business risks will not materially impact the Power System's financial position, results of operations, or cash flows as of June 30, 2006 and 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, 2006 and 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.

(16) Subsequent Event

On September 19, 2006, the Board approved the creation of a Retiree Health Benefits Fund to be maintained by the Retirement Plan Office. During fiscal year 2007, the assets held by both the Water and the Power System are to be transferred to this newly created fund. This transfer will reduce the Power System's restricted investments and restricted fund net assets.

On August 16, 2006, the City Council approved the unfreezing of the energy cost adjustment factor. This change took effect October 1, 2006.

LOS ANGELES DEPARTMENT OF WATER AND POWER
POWER SYSTEM

Required Supplementary Information

June 30, 2006

(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 the Water System and the Power System (amounts in thousands):

Actuarial valuation date July 1,	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)
2005	$ 6,331,048	6,763,080	432,032	94.0%	$ 616,270	70.0%
2004	6,251,421	6,421,814	170,393	97.0	581,039	29.0
2003	6,128,376	6,042,087	(86,289)	101.0	527,787	(16.0)

Postretirement 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 the Water System and the Power System (amounts in thousands):

Actuarial valuation date July 1,	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)
2005	$ —	1,695,666	1,695,666	—%	$ 612,270	277.0%
2004	—	1,597,835	1,597,835	—	628,898	297.0
2003	—	1,729,706	1,729,706	—	571,726	303.0

See accompanying independent auditors' report.