# Department of Water Resources
# Electric Power Fund
# Financial Statements
**September 30, 2003**

California
Energy
Resources
Scheduling
Department of
Water Resources

# Department of Water Resources Electric Power Fund
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## USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*.

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of activities and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of the year-end date. The statement of activities presents all of the current year's revenues and expenses. The final required statement is the statement of cash flows. This statement reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities; operating activities, financing activities and investing activities. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund has adopted accounting standards promulgated by the Governmental Accounting Standards Board.

This report should be read in conjunction with the Fund's June 30, 2003 audited financial statements.

## HISTORY AND FINANCING

The Fund was established in January 2001, in connection with the Governor of California's emergency proclamation and subsequent legislation to assist in mitigating the effects of a statewide energy supply emergency. The enabling legislation included the following powers and requirements:

- Authorization to secure and requirement to retain title to power for resale to end use customers of the State's investor owned utilities (IOUs).
- Authorization to enter into servicing arrangements with the IOUs for transmission, distribution, billing and collection services.
- Entitlement to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative costs and reserves.
- Authorization to enter into agreements with the California Public Utility Commission (CPUC) to ensure collection of DWR's revenue requirements.
- Restriction from entering into new power supply contracts after December 31, 2002.
- Authorization to administer existing power supply contracts after December 31, 2002.
- Authorization to issue revenue bonds not to exceed $13.4 billion.

Through June 26, 2001, advances of $6.2 billion from the State's General Fund were used to make payments for purchased power, as permitted by the enabling legislation. On June 26, 2001 additional funding for power purchases was provided from the net proceeds of a $4.3 billion term loan from a financial consortium led by JPMorgan Chase Bank.

In November 2002, DWR completed the issuance of $11.3 billion in revenue bonds. The proceeds of the bond issues, along with $2.1 billion of cash and investments in the Fund, were used to repay the outstanding balance of the term loan, repay advances from the State's General Fund with interest, and establish separate accounts in the Fund as required by the Bond Indenture. The bonds are payable from Bond Charges and, if necessary, other revenues, collected over a 20 year period.

DWR also entered into $1.4 billion notional amount of interest rate swaps, effective February 2003, reducing its un-hedged variable rate exposure to approximately 25% of the initial par value of the bonds issued.

TRANSITION OF RESPONSIBILITIES, DECREASE IN REQUIRED ACCOUNT BALANCES, AND IMPLEMENTATION OF 2003 SUPPLEMENTAL REVENUE REQUIREMENT

Effective January 1, 2003, DWR transitioned certain power procurement responsibilities to the IOUs. DWR no longer purchases power, except power provided under the terms of its existing contracts. DWR also transferred the scheduling, dispatch, and certain other administrative functions for the existing contracts to the IOUs. However, DWR retains the legal and financial responsibility for the existing contracts until such time as there is complete assignment of the contracts and release of DWR.

While DWR was responsible for procurement of the "residual net short" (as defined in the Bond Indenture), DWR was required under the terms of the Bond Indenture to maintain a minimum Operating Account balance of $1 billion. Under the terms of the Bond Indenture, with the end of that responsibility DWR was able to reduce the minimum Operating Account balance to the maximum amount projected by DWR by which operating expenditures may exceed Power Charges during any one calendar month, taking into account a range of possible future outcomes that DWR deems to be appropriate.

Also, because of the end of that responsibility, DWR was able to reduce its Operating Reserve Account balance to the greater of (i) seven months of projected negative operating cash flows, taking into account a range of possible future outcomes that DWR deems to be appropriate, or (ii) 12% of projected annual operating expenses of the Fund. Before the end of that responsibility, the second test was 18% of projected annual operating expenses of the Fund.

In the first half of calendar year 2003, DWR conducted an internal review of its 2003 Revenue Requirement, which was originally determined in August 2002. Upon completion of internal analyses, which included analyzing actual results through March 31, 2003, the 2003 Supplemental Revenue Requirement was developed and submitted to the CPUC for implementation on July 1, 2003. Based on 1) the ability to reduce reserves, 2) the expected receipt of cash for past due amounts being held in trust by PG&E, and 3) increases in actual and forecasted costs, the 2003 Supplement Revenue Requirement reduced DWR's 2003 revenue requirement needs by $1.002 billion.

A summary of the principal changes between the 2003 Supplemental Revenue Requirement and the original 2003 Revenue Requirement follows (in millions):

| | |
|---|---|
| January 1, 2003 Operating Account balance higher than originally forecasted | $ 44 |
| Reduction in required balance for Operating Account | 652 |
| Reduction in required balance for Operating Reserve Account | 147 |
| PG&E remittance of past due amounts owed to DWR | 539 |
| Increased costs under terms of contracts | (380) |
| Net Reduction in 2003 Revenue Requirement | $ 1,002 |

On September 4, 2003, the CPUC implemented the 2003 Supplemental Revenue Requirement which provides for credits for DWR Power Charges to IOU customers as follows (in millions):

| | |
|---|---|
| Pacific Gas & Electric Company (PG&E) | $ 444 |
| Southern California Edison Company (SCE) | 423 |
| San Diego Gas & Electric Company (SDG&E) | 135 |
| | $1,002 |

On September 4, 2003 the Fund transferred $147 million from the Operating Reserve Account to the Operating Account. The past due amount from PG&E (net of the $444 million bill credit for PG&E customers which is being held in trust by PG&E for DWR) was collected on September 11, 2003, and deposited in the Operating Account. The Operating Account then had sufficient funds on hand to be able to reduce its cash balances by $558 million through bill credits for the customers of SCE and SDG&E and still remain in compliance with the minimum cash balance requirements of the Bond Indenture. For SCE and SDG&E customers, the bill credit is being implemented by reducing customer remittances for Power Charges from the IOUs to the Fund until such time (approximately two months) as the IOUs have, in effect, been reimbursed for the credits. Because of the bill credit, customer remittances from SCE and SDG&E for the three months ended September 30, 2003 were $95 million less than what they otherwise would have been.

If the bill credit had been fully implemented by September 30, 2003 the Operating Account would have been $463 million less than what is reported herein and the current portion of recoverable costs would have been $463 million greater than what is reported herein. The balance in the Operating Account still would have exceeded the minimum cash balance required by the Bond Indenture.

STATEMENT OF NET ASSETS

The Fund's assets and liabilities as of September 30, 2003 and June 30, 2003 are summarized as follows (in millions):

| | September 30, 2003 | June 30, 2003 |
|---|---|---|
| Restricted cash and investments | $ 1,979 | $ 1,683 |
| Recoverable costs, current portion | 311 | 1,129 |
| Other current assets | 22 | 36 |
| Long-term restricted cash and investments | 1,557 | 1,704 |
| Recoverable costs, net of current portion | 8,394 | 7,568 |
| Total assets | $ 12,263 | $ 12,120 |
| | | |
| Long-term debt, including current portion | $ 11,625 | $ 11,636 |
| Other current liabilities | 638 | 484 |
| Total capital and liabilities | $ 12,263 | $ 12,120 |

**Restricted Cash and Investments**

As required by the Bond Indenture, there are six separate restricted cash and investments accounts. Four of the accounts are classified as current assets, while the Operating Reserve Account and Debt Service Reserve Account are classified as long-term assets. Restricted cash and investments total $3,536 million at September 30, 2003 compared to $3,387 million at June 30, 2003. From the dates of issuance of the revenue bonds through September 30, 2003, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Bond Indenture.

**Recoverable Costs**

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected. The current portion of recoverable costs decreased $818 million from June 30, 2003 to September 30, 2003, primarily due to application of the $463 million remaining bill credits due to customers of SCE and SDG&E and the collection of $521 million of past due amounts owed by PG&E. The offsetting difference of $166 million is due to increased sales of power in the summer months.

Long-term recoverable costs consist of costs that are recoverable through future billings. The $826 million increase is primarily attributable to the aforementioned bill credit.

**Revenue Bonds**

The amount of revenue bonds outstanding at September 30, 2003 and June 30, 2003 reflect the par value of the bonds issued plus unamortized premium. The first principal payment of $180 million on the revenue bonds is scheduled for May 2004

**Accrued Interest Payable**

Accrued interest payable is $170 million at September 30, 2003 as compared to $69 million at June 30, 2003. The $101 million increase in accrued interest payable during the three months results from interest payments on the fixed rate bonds being made semi-annually on May 1st and November 1st, while the variable rate bonds provide for more frequent payments.

STATEMENT OF ACTIVITIES

The Fund's activities for the three months ended September 30, are summarized as follows (in millions):

| | 2003 | 2002 |
|---|---|---|
| Revenues | | |
| Power charges | $ 495 | $ 1,283 |
| Bond charges | 277 | - |
| Interest | 14 | 16 |
| Total revenues | 786 | 1,299 |
| Expenses: | | |
| Power purchases | 1,527 | 1,235 |
| Interest expense | 105 | 154 |
| Other | 19 | 24 |
| Deferral of recoverable costs | (865) | (114) |
| Total expenses | 786 | 1,299 |
| Net income | - | - |
| Net assets, beginning of year | - | - |
| Net assets, end of quarter | $ - | $ - |

**Power Charges**

Power Charges decreased by $788 million in the three months ended September 30, 2003 as compared to the comparable period in 2002. This decrease is primarily attributable to recognizing the $1,002 billion bill credit to ratepayers as a reduction of Power Charges. Charges in 2002 were impacted by the State's "20-20 Energy Rebate Program," which during the three months ended September 30, 2002 provided a $90 million reduction in certain customer bills because they had reduced their energy use by at least 20% from 2000 levels. The remaining $124 million difference is attributable to increased energy sold to IOU customers by DWR in the three months ended September 30, 2003 over what had been provided in the same period in 2002. This was possible as new plants financed by the DWR contracts have been brought on line over the past year.

**Bond Charges**

The Bond Charge was established in November 2002 to pay for debt service on the revenue bonds. Bond Charges are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to customers in each IOU's service area and certain ESP customers. Bond Charges earned for the three months ended September 30, 2003, were $277 million and are comparable to those forecast in the cash flow analyses utilized in developing the revenue bond structure.

**Power Purchases**

DWR power costs were $292 million more in the three months ended September 30, 2003, than in the same period in 2002. Part of the increase is attributable to the purchase of more power in the three months ended September 30, 2003 as compared to the prior year. In addition, for the three months ended

September 30, 2002, approximately 30 percent of the power was purchased on the spot market at prices that were less than the prices of power purchased under long-term contracts. For the comparable period in 2003, with the successful transfer of spot purchasing to the IOUs, all DWR power was purchased under the terms of the long-term contracts and included capacity payments for dispatchable contracts and the purchase of natural gas.

**Administrative Expenses**

Administrative expenses incurred during the three months ended September 30, 2003, are $10 million more than incurred during the three months ended September 30, 2002. Approximately $7 million of the change is due to an increase in statewide "pro rata" costs assessed by the State Department of Finance to the Fund for centralized services provided by other state departments.

**Interest Expense**

Interest expense incurred during the three months ended September 30, 2003, is $33 million less than incurred during the three months ended September 30, 2002. While total debt was more than $1 billion higher during the three months ended September 30, 2003 than for the comparable period in 2002, the effective interest rate for the revenue bonds is less than the interest rates for both the General Fund advances and the term loan which were outstanding in 2002 and had rates of 5.3% and 5.7%, respectively. Additionally 25 percent of the current debt is in the form of un-hedged variable rate debt which accrued interest at rates approximating 1% during the three months ended September 30, 2003.

FUTURE OPERATIONS

DWR will administer the Fund until such time as the revenue bonds are completely retired. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required implement Bond Charges for the customers of the IOUs and ESPs such that the Fund will always have monies to pay bond related costs, including debt service and swap payments, when due.

DWR has financial and legal responsibility for the power supply contracts, including the purchase of natural gas for some of the contracts, for the life of the contracts. DWR cannot enter into any new power supply contracts and the last of the power supply contracts expires in 2013. Revenue requirements for the payment of energy purchased under the power supply contracts will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement Power Charges such that the Fund will receive necessary monies to meet its revenue requirements.

Ultimately the financial responsibility for the power supply contracts may be transferred to the IOUs as part of complete assignment of the contracts and release of DWR. However, there are a number of issues to be addressed, including IOU creditworthiness and counterparty approval, before the contracts can be assigned.

# Department of Water Resources Electric Power Fund
## Statements of Net Assets
## September 30, 2003 and June 30, 2003 (in millions)

| | September 30, 2003 | June 30, 2003 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Restricted cash and investments: | | |
| Operating Account | $ 1,280 | $ 1,177 |
| Priority Contract Account | 41 | 84 |
| Bond Charge Collection Account | 244 | 156 |
| Bond Charge Payment Account | 388 | 229 |
| Other investments | 26 | 37 |
| Recoverable costs, current portion | 311 | 1,129 |
| Interest receivable | 14 | 15 |
| Inventory - natural gas | 8 | - |
| Due from other funds | - | 21 |
| Total current assets | 2,312 | 2,848 |
| Long-term assets: | | |
| Restricted cash and investments: | | |
| Operating Reserve Account | 630 | 777 |
| Debt Service Reserve Account | 927 | 927 |
| Recoverable costs, net of current portion | 8,394 | 7,568 |
| Total long-term assets | 9,951 | 9,272 |
| Total assets | $ 12,263 | $ 12,120 |
| **Capitalization and Liabilities** | | |
| Capitalization: | | |
| Long-term debt: | | |
| Revenue bonds | $ 11,403 | $ 11,414 |
| Total capitalization | 11,403 | 11,414 |
| Current liabilities: | | |
| Current portion of long-term debt | 222 | 222 |
| Accounts payable | 468 | 415 |
| Accrued interest payable | 170 | 69 |
| Total current liabilities | 860 | 706 |
| Commitments and Contingencies (Note 5) | | |
| Total capitalization and liabilities | $ 12,263 | $ 12,120 |

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

# Department of Water Resources Electric Power Fund
## Statements of Activities
## For the three months ended September 30, 2003 and 2002 (in millions)

| | 2003 | 2002 |
|---|---|---|
| Operating revenues: | | |
| Power charges (net of bill credit of $1,002 million in 2003) | $ 495 | $ 1,283 |
| Total operating revenues | 495 | 1,283 |
| Operating expenses: | | |
| Power purchases | 1,527 | 1,235 |
| Administrative expenses | 19 | 9 |
| (Deferral) recovery of recoverable operating costs | (1,051) | 39 |
| Total operating expenses | 495 | 1,283 |
| Income from operations | - | - |
| Bond charges | 277 | - |
| Interest income | 14 | 16 |
| Costs incurred for issuance of revenue bonds | - | (15) |
| Interest expense | (105) | (138) |
| (Recovery) deferral of recoverable debt service and related costs | (186) | 137 |
| Net income | - | - |
| Net assets, beginning of year | - | - |
| Net assets, end of first quarter | $ - | $ - |

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

## Department of Water Resources Electric Power Fund
### Statements of Cash Flows
### For the three months ended September 30, 2003 and 2002 (in millions)

| | 2003 | 2002 |
|---|---|---|
| Cash flows from operating income: | | |
| Receipts from customers for power charges | $ 1,340 | $ 1,541 |
| Payments for power purchases and other costs | (1,438) | (1,333) |
| Net cash provided by (used in) operating activities | (98) | 208 |
| Cash flows from non-capital financing activities: | | |
| Receipts from customers for bond charges | 255 | - |
| Payments on term loan | - | (385) |
| Payment of interest expense and financing costs | (12) | (4) |
| Net cash provided by (used in) non-capital financing activities | 243 | (389) |
| Cash flows from investing activities: | | |
| Interest received on investments | 15 | 32 |
| Net cash provided by investing activities | 15 | 32 |
| Net increase (decrease) in cash and investments | 160 | (149) |
| Restricted (2003) and unrestricted (2002) cash and investments, beginning of year | 3,350 | 2,116 |
| Restricted (2003) and unrestricted (2002) cash and investments, end of first quarter | $ 3,510 | $ 1,967 |
| Reconciliation of operating income to net cash provided by (used in) operating activities: | | |
| Income from operations | $ - | $ - |
| Changes in net assets and liabilities to reconcile operating income to net cash used in operations: | | |
| Recoverable costs | (164) | 249 |
| Inventory - natural gas | (8) | - |
| Due from other funds | 21 | 1 |
| Accounts payable | 53 | (42) |
| Total adjustments | (98) | 208 |
| Net cash provided by (used in) operating activities | $ (98) | $ 208 |

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

## 1. Reporting Entity

**Background**

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (Fund) was established on January 19, 2001, by Senate Bill 7 from the First Extraordinary Session of 2001 (SB7X). Assembly Bill 1 from the First Extraordinary Session of 2001 (AB1X), enacted on February 1, 2001, added Division 27 to the California Water Code to clarify and expand the powers of DWR to incur debt for the purposes of the Fund and to use amounts in the Fund for the purchase of power. The Fund is administered by DWR. Division 27 of the California Water Code (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001) includes the following powers and requirements:

- Authorizes DWR to act on behalf of the State of California to secure necessary power supplies for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E) (collectively referred to as the investor owned utilities or IOUs).
- Requires DWR to retain title to all power sold, but authorizes DWR to enter into service agreements with the IOUs for transmission, distribution, billing and collection services.
- Authorize DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges to provide for recovery by DWR of its revenue requirements.
- Authorizes DWR to issue bonds in an amount not to exceed $13.4 billion and payable solely from the Fund, and to deposit the proceeds of the bonds in the Fund for use for any of the purposes of the Fund.
- Entitles DWR to recover its revenue requirements incurred in connection with its authorized activities, including debt service, the costs of power purchases, administrative costs and reserves.
- Prohibits DWR from entering into new power purchase agreements after December 31, 2002, but allows DWR to continue to administer existing contracts and enforce revenue requirements beyond that date.

DWR began selling electricity to approximately ten million retail customers in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and, through December 31, 2002, in short-term and spot market transactions. DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the CPUC. DWR initially financed its power purchases with advances from the General Fund of the State of California, loans from financial institutions, and revenues from power sales to customers. The advances from the General Fund and the remaining balance of the loans from financial institutions were repaid from the proceeds of revenue bonds issued in October and November 2002.

**Basis of Presentation**
The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

**Revenues and Recoverable Costs**
Before the issuance of revenue bonds, the cost of energy provided by DWR and debt service was recovered through charges to the customers of the IOUs as authorized by AB1X and established by the CPUC. Revenues were recognized when energy provided by DWR was delivered to the customers. Prior to the issuance of the revenue bonds, costs were recovered through Power Charges. Since the issuance of the revenue bonds, customer charges are separated into two primary components, Power Charges and Bond Charges. Power Charge revenues recover the cost of power purchases, administrative costs and operating reserves and are recognized when energy provided by DWR is delivered to the customers. Certain customers of ESPs are assessed "cost responsibility surcharges" that are used by DWR for the same purposes as Power Charge revenues. Bond Charge revenues recover debt service and debt service reserves and are recognized when energy provided by either DWR or the IOU, or an ESP, is delivered to customers. Costs are recovered over a period of time as determined by DWR's revenue requirement process. Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.

**2. Restricted Cash and Investments**
Restricted cash and investments, for purposes of the statements of cash flows, includes cash on hand and amounts in short-term investments. Amounts in short-term investments consist of deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

Cash not required for current use is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). The investments in PMIA are carried at fair value, which approximates amortized cost. Generally, the investments in PMIA are available for withdrawal on demand. Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 1.64% and 2.16% at September 30, 2003 and June 30, 2003, respectively.

**3. Long-Term Debt**

During October and November 2003, DWR issued $11.264 billion in revenue bonds. The proceeds from the bond issue, along with the cash balance in the Fund at the date of issuance, were used to repay previously incurred debt (General Fund advances and a term loan from a financial consortium) and fund restricted cash and investment accounts as required by the Bond Indenture.

For the three months ended September 30, 2002, the average interest rate for the General Fund advances approximated 5.3% and interest expense was $86 million. For the same time period, the average interest rate on the term loan was 5.7% and interest expense was $52 million.

The following activity occurred in the long-term debt accounts during the three months ended September 30, 2003 (in millions):

| | Revenue Bonds | Unamor-tized Premium | Total Revenue Bonds |
|---|---|---|---|
| Balance, June 30, 2003 | $ 11,264 | $ 372 | $ 11,636 |
| Amortization of premium | | (11) | (11) |
| Less current portion | (180) | (42) | (222) |
| Balance, September 30, 2003 | $ 11,084 | $ 319 | $ 11,403 |

The revenue bonds, all of which except Series E are tax-exempt, consist of the following at September 30, 2003:

| Series | Rates | Fiscal Year of Final maturity | Fiscal Year of First Call Date | Amounts Outstanding (in millions) |
|---|---|---|---|---|
| A | 3.0-6.0% | 2022 | 2012 | $ 6,314 |
| B | Variable | 2020 | Callable | 1,000 |
| C | Variable | 2022 | Callable | 2,750 |
| D | Variable | 2022 | Callable | 500 |
| E | 3.6-4.3% | 2006 | Not callable | 700 |
| | | | | 11,264 |
| Plus unamortized premium | | | | 361 |
| Less current maturities | | | | (222) |
| | | | | $ 11,403 |

Series B and C have daily and weekly rate modes, respectively, and Series D has 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from 2005 to 2022. Total interest expense and financing costs for the three months ended September 30, 2003 for all revenue bonds was $105 million. The interest rates for the variable debt for the three months ended September 30, 2003, ranged from 0.4% to 1.3%.

Principal and interest payments (and other bond related costs, including swap payments) are primarily secured by bond charges. The Fund is subject to certain bond covenants, including establishing funding and expenditure requirements for several restricted cash and investment accounts. The bonds are limited special obligations of the Fund; neither the principal nor any interest thereon constitutes a debt of the State. The payment of principal and interest for Series B (relating to $1 billion in principal) and certain Series C bonds ($1.75 billion out of a total Series C size of $2.75 billion) are paid from draws made under letters of credit. In the case of these bonds, draws made under the letters of credit are to be reimbursed on the same day by the Fund. There are no outstanding amounts on the letters of credit at September 30, 2003. The letters of credit expire in 2005. The Fund pays fees of 0.85% per annum on the stated amount of the letters of credit.

The remaining $1 billion of Series C bonds is credit enhanced by bond insurance. Liquidity support for these bonds is provided by bank liquidity facilities. Any funds paid under the bond insurance or liquidity facilities are immediately due and payable by the Fund. There are no outstanding amounts on liquidity facilities at September 30, 2003. Three liquidity facilities backing $300 million in Series C bonds expire in 2005, and two liquidity facilities underlying $700 million of Series C bonds expire in 2009. The Fund pays fees of between 0.22% and 0.37% per annum on the liquidity facilities.

Future payment requirements on the revenue bonds are as follows at September 30, 2003 (in millions):

| Fiscal Year | Principal | Interest [1] | Total |
|---|---|---|---|
| 2004 | $ 180 | $ 392 | $ 572 |
| 2005 | 388 | 397 | 785 |
| 2006 | 409 | 381 | 790 |
| 2007 | 427 | 363 | 790 |
| 2008 | 449 | 344 | 793 |
| 2009-2013 | 2,612 | 1,407 | 4,019 |
| 2014-2018 | 3,397 | 787 | 4,184 |
| 2019-2022 | 3,402 | 185 | 3,587 |
| | $ 11,264 | $ 4,256 | $ 15,520 |

[1] Variable portion of interest cost calculated using the September 30, 2003 Bond Market Association Municipal Swap Index (BMA).

## 4. Interest Rate Swaps

DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties, to reduce variable interest rate risk. The swaps create a synthetic fixed rate for DWR. DWR has agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of DWR's variable rate debt.

The terms, fair values, and credit ratings of counterparties for the various swap agreements are summarized in the following table (in millions):

| Outstanding Notional Amount at September 30, 2003 | Fixed Rate Paid by Fund | Variable Rate Received by the Fund [1] | Fair Values at September 30, 2003 | Swap Termination Date | Counterparty Credit Ratings (Moody's, Fitch's, S&P) |
|---|---|---|---|---|---|
| $ 94 | 2.914% | 80% of LIBOR [2] | $ (4) | 5/1/2011 | Aaa, AAA, AAA |
| 234 | 3.024% | 80% of LIBOR | (8) | 5/1/2012 | Aaa, AAA, AAA |
| 200 | 3.405% | BMA | (7) | 5/1/2013 | Aa3, AA-, AA- |
| 100 | 3.405% | BMA | (4) | 5/1/2013 | Aa3, AA-, A+ |
| 30 | 3.405% | BMA | (1) | 5/1/2013 | Aa3, AA-, A+ |
| 194 | 3.204% | 80% of LIBOR | (6) | 5/1/2014 | Aa1, AA, AA- |
| 174 | 3.280% | 80% of LIBOR | (8) | 5/1/2015 | Aaa, AAA, AAA |
| 202 | 3.342% | 80% of LIBOR | (7) | 5/1/2016 | Aa3, AA-, A+ |
| 202 | 3.389% | 80% of LIBOR | (7) | 5/1/2017 | Aa3, AA-, A+ |
| $ 1,430 | | | $ (52) | | |

[1] LIBOR based swaps convert to pay the Fund 67% of LIBOR on January 1, 2004
[2] One month U.S. Dollar London Interbank Offered Rate

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions to outstanding notional amounts that follow scheduled amortization of the associated debt.

*Fair Value:* Because interest rates have declined, all swaps had a negative fair value as of September 30, 2003. The reported fair values from the table above were provided by the counterparties, using the par value, or marked-to-market, method.

*Credit Risk:* As of September 30, 2003, the Fund was not exposed to credit risk because the swaps had negative fair values. However, should interest rates increase and the fair values become positive, the Fund would be exposed to credit risk in the amount of the swaps' fair value. DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35 percent of the total notional value are with one counterparty with a credit rating of Aaa/AAA/AAA. Of the remaining swaps, two are held with a single counterparty, approximating 21 percent of the outstanding notional value. That counterparty has credit ratings of Aa3/AA-/A+. The remaining four swaps are with separate counterparties, all having Aa3/AA-/A+ ratings or better.

*Basis Risk:* The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while DWR's floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's all-in costs would increase. As of September 30, 2003, the variable rate on DWR's bonds ranged from .40% to 1.30%, while 80% of LIBOR received on the swap was equal to 0.90%.

*Termination Risk:* DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness by the other party. DWR views such events to be remote at this time. If a termination were to occur, at the time of the termination, DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. The counterparty would be liable for any payment equal to the swap's fair value, if it had positive fair value at that time. In addition, a termination would mean that DWR's underlying floating rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk, unless it entered into a new hedge following termination.

*Rollover Risk:* Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

*Swap Payments and Associated Debt*: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of September 30, 2003, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows (in millions):

| Fiscal Year Ending June 30 | Variable Rate Bonds Principal | Variable Rate Bonds Interest | Interest Rate Swaps, Net | Total |
|---|---|---|---|---|
| 2004 | $ - | $ 10 | $ 26 | $ 36 |
| 2005 | - | 14 | 34 | 48 |
| 2006 | - | 14 | 34 | 48 |
| 2007 | - | 14 | 34 | 48 |
| 2008 | - | 14 | 34 | 48 |
| 2009-2013 | 658 | 64 | 161 | 883 |
| 2014-2017 | 772 | 19 | 48 | 839 |
| Total | $ 1,430 | $ 149 | $ 371 | $ 1,950 |

## 5. Commitments and Contingencies

### Litigation and Uncertainties

DWR is involved in several lawsuits and regulatory proceedings. In one action ("PG&E1"), PG&E contested the determination of DWR's revenue requirement submissions for calendar years 2001 and 2002. The trial court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The trial court also ruled that its decision did not affect any prior actions taken by the CPUC, including the implementation of cost recovery of DWR's calendar years 2001 and 2002 revenue requirements. This ruling was appealed and was affirmed in part and reversed in part, on October 2, 2003, with the appellate court concluding that "AB1X does require DWR to make a determination that its revenue requirement is just and reasonable, but neither AB1X nor the APA requires a public hearing or compliance with the APA procedures." The deadline for appeal having passed and no appeal having been filed, the appellate court's decision is now final.

In August 2002, during the pendency of the appeal of PG&E1, DWR determined its 2003 revenue requirement and re-examined its 2001-2002 revenue requirements and filed them with the CPUC. In October 2002, PG&E filed a lawsuit ("PG&E2") on the 2003 revenue requirements and the re-examined 2001-2002 revenue requirements, claiming that DWR had not adequately followed APA requirements or DWR's own regulations and claiming that a portion of DWR's revenue requirements were unjust and unreasonable and therefore invalid. On October 17, 2003, the Sacramento County Superior Court issued a tentative ruling in favor of PG&E. However, DWR requested a continuance of the hearing and supplemental briefing and no final decision has been issued by the court.

In another matter, two energy suppliers have petitioned the Federal Energy Regulatory Commission ("FERC"), contending that amounts totaling $58 million are owed by DWR for power purchased in the last half of January 2001, by DWR on behalf of PG&E and SCE in the California Independent System Operator (ISO) market. DWR maintains that the Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. The ISO distributed the Fund's January payment on a pro-rata basis to all market participants for the entire month, although DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the amounts owed them for power purchased in January by DWR on behalf of the two IOUs. On November 25, 2002, FERC issued an order finding that the ISO had "misapplied the payment it received from CERS" and directed the ISO to "reallocate its pro-rata disbursement for the entire month of January 2001, and disburse funds from DWR allocated for January 2001, to those that supplied power for the period January 17 – 31, 2001." The ISO recently submitted a filing to FERC outlining its process of calculating the distribution of funds from DWR. Resolution of this matter is still pending at FERC.

Additionally, various actions are underway contesting certain long-term power contracts entered into by DWR.

There are a number of other lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result because of potential impacts on the price or supply of energy in California. In one case, California Power Exchange Corporation (CalPX), certain IOUs and others have brought suit against the State of California claiming that the State's commandeering of CalPX's block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of $1.1 billion, which is their estimation of the fair value of the block forward contracts at the time of commandeering. Under the block forward contracts, which expired in December 2001, the Fund paid approximately $350 million for energy provided by the contracts.

These lawsuits and regulatory proceedings could impact power costs and the related revenue requirements, and the terms and conditions of the power purchase contracts.

Management believes that the existing lawsuits and regulatory proceedings will be resolved in calendar year 2004. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined

**Commitments**
DWR has entered into power purchase contracts that have remaining lives of up to eleven years. Payments made under these contracts approximated $1.4 billion and $1.1 billion for the three months ended September 30, 2003 and 2002, respectively.

The remaining amounts of fixed obligations under the contracts as of September 30, 2003, are as follows:

| For the Year Ending June 30, | Fixed Obligation (in millions) |
|---|---|
| 2004 | $ 2,506 |
| 2005 | 3,190 |
| 2006 | 2,809 |
| 2007 | 2,525 |
| 2008 | 2,378 |
| Thereafter | 5,681 |
| | $ 19,089 |

In addition to the fixed costs there are variable costs with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate $30 billion as of September 30, 2003. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

**Contingencies**
The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from customers as part of DWR’s revenue requirement.

## 6. Bill Credit

Based on 1) the ability to reduce reserves as allowed under the Bond Indenture, 2) the expected receipt of cash for past due amounts being held in trust by PG&E, and 3) increases in actual and forecasted costs, in July 2003, DWR decreased its 2003 revenue requirement by $1.002 billion. On September 4, 2003, the PUC ordered implementation of the decrease in revenue requirements through credits for DWR Power Charges in the monthly billings to IOU customers from mid September through mid October 2003. Amounts expected to be received from PG&E, net of PG&E customers portion of the bill credit, were received on September 11, 2003.

If the bill credit had been completely implemented by September 30, 2003, the Operating Account would have been reduced by $463 million and the current portion of recoverable costs would have been increased by $463 million.