Department of Water Resources Electric Power Fund

Financial Statements
As of June 30, 2001, and for the period from January 19, 2001 (date of inception) to June 30, 2001

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PricewaterhouseCoopers LLP
555 Capitol Mall, Suite 1200
Sacramento CA 95814-4602
Telephone (916) 930 8100
Facsimile (916) 930 8450

Report of Independent Accountants

The Director of the State of California
Department of Water Resources

In our opinion, the accompanying balance sheet and the related statement of operations and retained earnings, and cash flows present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund (Fund), a component unit of the State of California, as of June 30, 2001, and the results of its operations and its cash flows for the period from January 19, 2001 (date of inception) to June 30, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of management of the Department of Water Resources Electric Power Fund; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements 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 of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As explained in Note 1 to the financial statements, the Fund is involved in certain lawsuits and regulatory proceedings that could impact the timing of the sale of the bonds described in Notes 1 and 4, the revenue requirements and rate structure needed to repay the debt payable from the Fund, and the terms and conditions of the power purchase contracts. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 14, 2001, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with laws and regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing standards and should be read in conjunction with this report in considering the results of our audit.

PricewaterhouseCoopers LLP

December 14, 2001

Department of Water Resources Electric Power Fund
Balance Sheet
June 30, 2001 (in millions)

Assets		
Current assets		
Cash and investments	$	4,241
Restricted cash on deposit with agent		186
Recoverable costs, current portion		1,591
Interest receivable		10
Due from other funds		7
Total current assets		6,035
Recoverable costs, net of current portion		6,127
Total assets	$	12,162
Capitalization and Liabilities		
Capitalization:		
Long-term debt, less current maturities		
Advances from State General Fund including accrued interest of $75, net of current portion	$	6,169
Interim loan		4,300
Total capitalization		10,469
Current liabilities:		
Current portion of advances from State General Fund		116
Accounts payable (including $779 due to California Independent System Operator Corporation)		1,574
Accrued interest on interim loan		3
Total current liabilities		1,693
Commitments and Contingencies (Notes 1 and 6)		
Total capitalization and liabilities	$	12,162

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

Department of Water Resources Electric Power Fund
Statement of Operations and Retained Earnings
For the period from January 19, 2001, (date of inception) to June 30, 2001

	(in millions)
Operating revenues:	
Power sales	$ 2,733
Total operating revenues	2,733
Operating expenses:	
Power purchases	8,764
Administrative expenses	13
Deferral of operating expenses	(6,127)
Total operating expenses	2,650
Income from operations	83
Costs incurred in anticipation of sale of long-term bonds	(15)
Interest income	10
Interest expense	(78)
Net income	-
Retained earnings, January 19, 2001	-
Retained earnings, June 30, 2001	$ -

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

Department of Water Resources Electric Power Fund
Statement of Cash Flows
For the period from January 19, 2001, (date of inception) to June 30, 2001

	(in millions)
Cash flows from operating income:	
Receipts from customers	$ 1,135
Payments for power purchases and other costs	(7,203)
Net cash used in operating activities	(6,068)
Cash flows from non-capital financing activities:	
Proceeds from interim loan	4,300
Advances from State of California General Fund	6,210
Payment of financing costs	(15)
Net cash provided by non-capital financing activities	10,495
Net increase in cash and pooled investments	4,427
Cash and pooled investments at January 19, 2001	-
Cash and pooled investments at June 30, 2001	$ 4,427
Reconciliation of operating income to net cash used in operating activities:	
Operating income	$ 83
Changes in net assets and liabilities to reconcile operating income to net cash used in operations:	
Recoverable costs	(7,718)
Due from other funds	(7)
Accounts payable	1,574
Total adjustments	(6,151)
Net cash used in operating activities	$ (6,068)

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 state-wide 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 the Department of Water Resources (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 (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001 (SB7X)) (Act) 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 end use 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.
- Authorizes DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges for purposes of the Act 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 under the Act, including debt service, the costs of power purchases, administrative costs and reserves.
- Restricts 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 end use customers (Customers) in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and in short-term and spot market transactions. DWR electricity 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 service agreements approved and/or ordered by the CPUC. DWR 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.

Litigation and Uncertainties
The Fund is party to several lawsuits and regulatory proceedings. These include, among others, an IOU contesting DWR's determination that its revenue requirement submissions to the CPUC are just and reasonable and a CPUC filing with the Federal Energy Regulatory Commission (FERC) to protest the reasonableness of long-term contracts entered into by DWR. In addition, the CPUC has approved only interim rates for the sale of power provided 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 IOU's 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 expire in December 2001, management estimates that the Fund will have paid approximately $350 million for energy provided by the contracts.

These lawsuits and regulatory proceedings could impact the timing of the sale of bonds (Note 4), the revenue requirements and rate structure needed to repay the debt, and the terms and conditions of the power purchase contracts (Note 6).

Management believes that the existing lawsuits and regulatory proceedings will be resolved in calendar year 2002. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

2. Summary of Significant Accounting Policies

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 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.

Cash and Investments
Cash and investments, for purposes of the statement of cash flows, includes cash on hand and amounts in short-term investments. Amounts in short-term investments include 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.

PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. These investments consist of U.S. government securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest bearing time deposits in California banks, prime-rated commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase and reverse repurchase agreements. The PMIA policy limits the use of reverse repurchase agreements subject to limits of no more than 10% of PMIA. The PMIA does not invest in leveraged products or inverse floating rate securities. The PMIA cash and investments are recorded at amortized cost which approximates market.

The investment in PMIA, an investment pool managed by the State of California, does not meet the criteria to require risk categorization.

Restricted Cash on Deposit with Agent

Restricted cash on deposit with agent consists of pre-funded interest costs associated with the Interim Loan. The cash is held by JP Morgan Chase as agent for the lenders and is uncollateralized.

Revenues and Recoverable Costs

The cost of providing energy by the Fund is intended to be recovered through charges to the Customers of three investor owned utilities and other entities as allowed by AB1X and regulated by the CPUC. Revenues are recognized when billings are due and payable. The billings cover debt service, the costs of power purchases, administrative costs and reserves. These costs are recovered over a period of time as determined by the rate making process between DWR and the CPUC through the IOU's billings to the Customers.

In June 2001, the billings were reduced by $64 million of rebates given to the end-use customers of the IOUs under the Governor's "20-20 Energy Rebate Program," which, from June 1, 2001 through September 30, 2001, generally granted the end-use customers a 20% reduction in their monthly power bills if they reduced their energy use by 20% from the same period in 2000. These reductions extend the period of time over which the Fund will recover its costs.

Amounts that have been billed but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.

Future Pronouncements

Effective for years beginning after June 15, 2001, the Fund will be required to implement Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements -- and Management's Discussion and Analysis – for State and Local Governments*. GASB 34 establishes new reporting requirements for the annual financial statements of state and local governments, including requirements for both a "management's discussion and analysis" and other expanded "required supplementary information".

3. Cash and Investments

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 5.73% at June 30, 2001. For the period ended June 30, 2001, interest earned on the deposit with PMIF was $10 million.

4. Long-Term Debt

Advances from State General Fund

In conjunction with the Governor's emergency proclamation in January 2001, approximately $302 million of DWR general fund appropriations were expended for energy purchases. SB7X appropriated an additional $400 million for the Fund on January 19, 2001. AB1X appropriated an additional $500 million on February 1, 2001, and provided for additional appropriations upon a 10-day notice to the Legislature. Through June 30, 2001, the total AB1X appropriations transferred from the State of California General Fund to the Fund were $5.508 billion. As of June 30, 2001, a total of $6.210 billion, plus interest, is due to the General Fund. Of this amount, $116 million, the remaining cash balance in the Fund at the time the Interim Loan described below was implemented, was transferred back to the General Fund in July 2001, and is recorded as a current liability. The remaining amount due the General Fund is recorded as a long-term obligation as the enabling legislation requires that the remaining General Fund appropriations be repaid when revenue bonds are sold, currently anticipated for completion in calendar year 2002.

Interest on the advances from the General Fund is calculated at the stated PMIA interest rate in effect on the date of each appropriation from the General Fund. The average interest rate on advances approximated 5.64% at June 30, 2001. For the period ended June 30, 2001, interest expense on the advances from the General Fund was $75 million.

Interim Loan
On June 26, 2001, the Fund received an Interim Loan from a financial consortium lead by Morgan Guaranty Trust Company of New York. The net proceeds from the Interim Loan, equal to $4.3 billion gross proceeds less $194 million in origination fees, pre-funded interest, and other costs, are used to fund power purchases. The Interim Loan was structured with both taxable and tax-exempt components of $2.3 billion and $2.0 billion, respectively, and is payable from revenues. The Interim Loan is collateralized by revenues described in Note 2 and investment income. The financing was structured as a term loan due to be paid on or before October 31, 2001, from the proceeds of the sale of long-term bonds. As bonds were not issued by October 31, 2001, the interim financing converted to a three-year term loan with quarterly principal and interest payments. The first interest and principal payments will be due in March and April 2002, respectively. Principal payments due by fiscal year are as follows:

For the year ending June 30,	Amount (in millions)
2002	$ 391
2003	1,564
2004	1,564
2005	781
	$ 4,300

As of June 30, 2001, the interest rates for the taxable and non-taxable components of the loan were 4.48% and 3.78%, respectively. The interest rate for the three-year term loan, which became effective October 31, 2001, is based on the greater of prime of Federal Funds rate plus 0.5% and is applicable to both the taxable and non-taxable components of the loan. In the case of an event of non-compliance the interest rate is increased 2%. As of November 30, 2001, the interest rate on the three-year term loan was 7.0%, because of an event of non-compliance, the lack of having a rate agreement in place between DWR and the CPUC.

5. Retirement Plan

Plan Description
The State of California is a member of the California Public Employees' Retirement System (PERS), an agent multiple-employer pension system which provides a contributory defined-benefit pension for substantially all State employees. DWR is included in the State Miscellaneous Category (Tier 1 and Tier 2) within PERS, thereby limiting the availability of certain System pension data. PERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including DWR, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of PERS' comprehensive annual financial report may be obtained from their executive office at 400 P Street, Sacramento, California 95814.

The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

Annual Pension Cost
For the period ended June 30, 2001, DWR's annual pension cost and actual contribution allocated to the Fund based on the Fund's payroll costs amounted to less than $1 million

6. Commitments and Contingencies

Commitments
The Fund has entered into long-term power purchase contracts ranging from one to eleven years. Payments made under these contracts approximated $1.1 billion for the period ended June 30, 2001.

The amounts of fixed obligations under the long-term contracts as of June 30, 2001, are as follows:

For the year ending June 30,	Fixed Obligation (in millions)
2002	$ 2,616
2003	3,314
2004	3,791
2005	3,457
2006	2,977
Thereafter	17,114
	$ 33,269

In addition to the fixed costs there are variable costs associated with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate $42 billion as of June 30, 2001. 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 costs of natural gas:

a. Dispatchable contracts: Dispatchable contracts provide DWR with the ability to call on more energy as required. The $42 billion is based on the forecasted dispatch of these contracts to meet the forecasted IOU load. The variability of energy requirements fluctuate with the weather (on hot summer days with heavy air conditioner usage, energy requirements can increase substantially over forecasted amounts).

b. Gas prices: Many of the contracts contain a pass through component whereby DWR has the ability to purchase the natural gas that is used to power the generating plants. The total long-term power purchase obligation of $42 billion is based on forecasted natural gas prices used in the modeling of these contracts. Natural gas prices are subject to market forces and so will vary throughout the duration of the contracts.

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 the end-use customers of the IOU's.

7. Related Party Transactions

During the period ended June 30, 2001, the Fund purchased power approximating $80 million from the State Water Resources Development System (System), another enterprise fund administered by DWR.