State Water Resources Development System

Financial Statements and Supplementary Information For the years ended June 30, 2005 and 2004

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Report of Independent Auditors

The Director of the State of California
Department of Water Resources

In our opinion, the accompanying statements of net assets and the related statements of revenues, expenses, and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the State Water Resources Development System (System), a component unit of the State of California, as of June 30, 2005 and 2004, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the System's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with 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. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the System are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the System. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 18, 2006, on our consideration of the System’s internal control over financial reporting and on our tests of its compliance with laws and regulations, contracts and grants for the year ended June 30, 2005. 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 read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis, presented on pages 4 through 17, is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental information on page 43 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

PricewaterhouseCoopers LLP

January 18, 2006

Management's Discussion and Analysis

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 the financial position of the State Water Resources Development System (the System), 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 follow *Management's Discussion and Analysis*. This discussion and analysis and the financial statements do not relate to DWR's other governmental and proprietary funds. The System includes the State Water Project (SWP), the Davis-Grunsky Act Program and the San Joaquin Drainage Implementation Program.

The SWP encompasses a complex of dams, reservoirs, pumping plants, power plants, aqueducts and pipelines owned and operated by the State of California. The SWP was developed in order to deliver water to areas of need throughout the State for domestic, industrial and agricultural purposes, as well as to provide flood control, recreation, fish and wildlife enhancement, hydroelectric power and other benefits. DWR is responsible for the planning, construction and operation of the SWP. The construction program commenced in 1957 and all 647 miles of the initially planned aqueduct system have been completed. The System has entered into long-term water supply contracts with 29 customers; known as the "Water Contractors," in order to recover substantially all System costs. The Water Contractors may request up to maximum annual amounts totaling 4,172,786 acre-feet of water from the System. This maximum does not assure delivery of that amount of water, but rather provides the basis for proportional allocation of available supplies among the Water Contractors.

Portions of the SWP system consist of facilities developed and used jointly with the Federal Central Valley Water Project (CVP) operated by the U.S. Bureau of Reclamation (USBR). In addition, both projects have primary sources of water north of the Sacramento-San Joaquin Delta (Delta), transport water across the Delta and draw water from the southern edge of the Delta. The CVP, like the SWP, provides water for irrigation in the Central Valley, urban water supply, water quality, flood control, power, recreation, and fish and wildlife enhancement. Costs for the jointly developed facilities are shared approximately 55 percent State and 45 percent Federal. In 1986, the System and USBR entered into a Coordinated Operation Agreement (COA) under which the SWP and the CVP coordinate operations, including releases from upstream reservoirs and pumping from the Delta. The COA permits increased operational efficiency of both projects, ensures that each project receives an equitable share of available surplus water, and provides for sharing of responsibilities in meeting certain Delta water quality standards.

Financial Highlights

- The System recorded an increase in net assets of $19 million on total operating revenues of $750 million. This result is in line with expectations as the System has incurred certain timing differences in the issuance of rate management adjustments as provided in the Monterey Agreement.

- DWR issued the Central Valley Project Water System Revenue Bonds Series AC in January 2005, in the principal amount of $272,070,000 at an average yield on the bonds of 4.31%. The financing included an advance refunding component and a current refunding of DWR's then outstanding Commercial Paper Notes. DWR realized the following benefits: (1) DWR used the issuance of the Series AC bonds to provide debt service savings of more than $18.2 million to the System from the date of issuance through December 1, 2027, with a net present value of $11.7

million; (2) DWR retired $13,677,000 of Water Systems revenue bonds and outstanding Commercial Paper Notes; and (3) the refunding released the commercial paper program's borrowing capacity for future capital projects.

Overview of Financial Statements

Reports Included in Financial Statements

The System is accounted for as an enterprise fund. Enterprise funds account for the acquisition, operation, and maintenance of governmental facilities and services that are entirely or predominantly self-supported by user charges. This financial report consists of three financial statements, prepared on the accrual basis of accounting, with accompanying disclosure notes. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statements of net assets include all the assets, liabilities and the net assets of the System. The statements of activities report all of the revenues and expenses incurred during the fiscal years presented. The statements of cash flows report the cash inflows and outflows classified by operating, investing, non-capital financing, and capital and related financing activities during the reporting periods presented. The notes to the financial statements communicate information that is required by generally accepted accounting principles.

	2005	2004 (in thousands)	2003	%Change 2005-2004	%Change 2004-2003
Condensed Statements of Net Assets					
Total utility plant	$ 2,988,884	$ 3,030,356	$ 3,094,895	-1.4%	-2.1%
Other assets	1,991,589	1,993,431	1,972,219	-0.1%	1.1%
Total assets	$ 4,980,473	$ 5,023,787	$ 5,067,114	-0.9%	-0.9%
Capitalization:					
Net assets:					
Capital, net of related debt	$ 210,933	$ 185,676	$ 246,567	13.6%	-24.7%
Restricted	994,498	1,000,866	956,427	-0.6%	4.6%
Total net assets	1,205,431	1,186,542	1,202,994	1.6%	-1.4%
Total long-term debt	3,065,854	3,135,020	3,154,588	-2.2%	-0.6%
Total capitalization	4,271,285	4,321,562	4,357,582	-1.2%	-0.8%
Other liabilities	709,188	702,225	709,532	1.0%	-1.0%
Total net assets and liabilities	$ 4,980,473	$ 5,023,787	$ 5,067,114	-0.9%	-0.9%

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

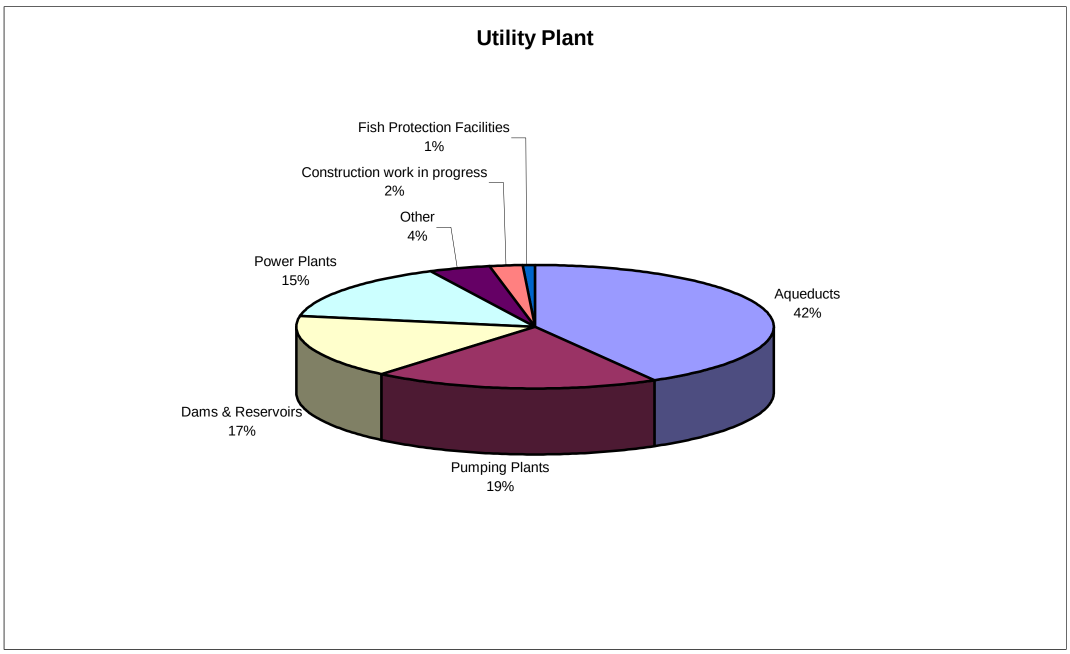
	2005	2004	2003	%Change 2005-2004	%Change 2004-2003
Water supply	$ 630,955	$ 640,417	$ 587,624	-1.5%	9.0%
Power sales	104,521	59,289	85,735	76.3%	-30.8%
Federal reimbursements	14,806	14,941	16,072	-0.9%	-7.0%
Total operating revenues	750,282	714,647	689,431	5.0%	3.7%
Operations and maintenance expense	324,926	321,060	279,441	1.2%	14.9%
Purchased power	196,023	174,556	98,971	12.3%	76.4%
Depreciation expense	77,321	77,388	75,698	-0.1%	2.2%
Operating expenses (deferred) recovered, net	(19,889)	(14,423)	101,889	37.9%	-114.2%
Total operating expenses	578,381	558,581	555,999	3.5%	0.5%
Income from operations	171,901	156,066	133,432	10.1%	17.0%
Interest expense	(152,847)	(167,873)	(183,820)	-9.0%	-8.7%
Other (expense) income	(165)	(4,645)	4,135	-96.4%	-212.3%
Increase (decrease) in net assets	18,889	(16,452)	(46,253)	-214.8%	-64.4%
Net assets, beginning of year	1,186,542	1,202,994	1,249,247	-1.4%	-3.7%
Net assets, end of year	$ 1,205,431	$ 1,186,542	$ 1,202,994	1.6%	-1.4%

Assets

Utility Plant

Utility Plant represents the accumulated original costs of labor, materials and indirect costs incurred during the construction of the SWP that are in service to provide water deliveries. The SWP utility includes 19 dams, 20 storage facilities, 20 pumping plants, three generating-pumping plants, ten power plants, as well as fish protection facilities and aqueducts.

Utility plant in service, net of accumulated depreciation (UPIS) decreased by $77 million during 2005 to a balance of $2,916 million. This is compared to a net increase in fiscal 2004 of $41 million. While depreciation expense remained constant for the two years at $77 million, there were no additions in the current year compared to $118 million in fiscal 2004. Annual depreciation expense will remain relatively constant, as the majority of the System is complete and depreciation is recorded on a straight-line basis over the estimated useful life of the assets, which range from 30 to 100 years.



Construction Work in Progress

Construction work in progress increased by $36 million during the year, which represents a 97% increase over 2004. Construction work in progress decreased by $106 million for 2004 or 74% from 2003. The increase compared to 2004 is attributable to additions made to new and on-going projects including East Branch Extension Phase II projects of $5 million, Reid Gardner IV projects in the amount of $5 million, South Bay Aqueduct projects of $8.5 million, the Tehachapi 2nd Afterbay project of $10.5 million, and other Water Systems projects totaling $7 million. At June 30, 2005, total construction work in progress was comprised of $5 million of East Branch Extension Phase II projects, $5 million of Reid-Gardner projects, $13 million for the South Bay aqueduct, $19 million of Tehachapi 2nd Afterbay projects, and $30 million of Water Systems projects.

Restricted Cash and Investments
Restricted cash and cash equivalents increased by $5.6 million during fiscal 2005. This change is in part the result of a net cash increase of $3.8 million for plant replacement reserves, which is due to increased collections for Conservation Replacements of $5 million, and a $1.1 million increase in Debt Service reserves due to the increased reserve requirements related to the fiscal 2005 issuance of CVP Water System Revenue Bonds - Series AC.

Other Long-term Assets
Due From Other State Funds represents the System’s advance of $92 million to DWR’s internal service fund, which functions as a revolving working capital facility for DWR. Additionally in the past, the System has made loans to local water agencies through the Davis-Grunsky Act of which a long-term portion of $28 million remains outstanding at the end of fiscal 2005 compared to an outstanding balance of $32 million at the end of fiscal 2004, and $34 million at the end of fiscal 2003. Lastly, during fiscal year 2005, the System received final payment on an advance to Pacific Gas & Electric Company for transmission line reinforcements, which had a remaining balance of $1 million outstanding at the end of fiscal 2004.

Cash and Cash Equivalents
In fiscal 2005, cash and cash equivalents decreased by $44 million to a balance of $226 million. The decrease is due primarily to fiscal 2005 refunds paid to water contractors for Off - Aqueduct Power Facilities of $37 million and a repayment to other state funds of $11.5 million, offset in part by increased net revenues. Refer to the Statements of Cash Flows for a detailed summary of cash in-flows and out-flows. By comparison, in fiscal 2004, cash and equivalents increased by $22 million to a balance of $270 million. This was primarily due to an increase in revenue over fiscal year 2003, plus payments received from the U.S. Bureau of Reclamation (USBR) on older outstanding amounts due.

Receivables
In fiscal 2005, water supply and power billings receivable increased from $87 million to $97 million as compared to fiscal year 2004. The 2005 increase is mainly attributable to an increase in operating revenues recorded compared to the prior year. Water supply and power billings receivable increased by $3 million during fiscal 2004. The 2004 increase is mainly attributable to increased operating revenues recorded compared to the prior year, offset in part by collection of older outstanding amounts from the USBR of approximately $10 million, and accruals made for power sales adjustments relating to the pending FERC pricing mitigation settlement and a transmission loss calculation adjustment from prior years totaling $23 million. Refer to “Operating Revenues” section for a discussion of revenue fluctuations.

Deferred Charges
Deferred charges represent timing differences between expenditures incurred by the System and their ultimate recovery from the Water Contractors. Expense recognition is expected to match recovery from the Water Contractors in the future. In total, deferred charges increased by $30 million to an ending balance of $1,320 million, as the System deferred expenditures not yet recovered from the Contractors. In fiscal 2004, the System experienced an increase of deferred charges of $12 million related to expenses not yet recovered from the Contractors.

Liabilities

Revenue Bonds

The System has issued 29 series of Water System Revenue Bonds totaling $5,358 million in aggregate principal, of which $2,312 million remains outstanding at the end of fiscal 2005. This compares to outstanding balances of $2,344 million and $2,297 million at June 30, 2004 and 2003, respectively. During the year, the System completed the issuance of CVP Water Systems Revenue Bond, Series AC totaling $272 million. The majority of the proceeds from the issuance were used to defease portions of the bonds of Series O, P, Q, S, U, and W, while the remainder was used to pay off all outstanding commercial paper as of the date of issuance. The refundings are projected to provide a net present value savings to the System of approximately $12 million.

The System has also issued $1,526 million of revenue bonds under three separate bond resolutions to finance certain power facilities. Under the Devil Canyon – Castaic bond resolution, $100 million is outstanding as of fiscal 2005, compared to $103 million at fiscal 2004 and $106 million at fiscal 2003. Bonds issued under the other two bond resolutions have been fully retired.

	2005	2004	2003
CVP revenue bonds par amount	$ 2,311,740	$ 2,343,880	$ 2,297,350
Unamortized bond issuance premiums/(discounts)	43,611	23,071	20,813
Deferred loss on defeasance	(30,291)	(20,290)	(27,024)
Total CVP revenue bonds outstanding	2,325,060	2,346,661	2,291,139
Devil Canyon - Castaic revenue bond par amount	100,140	103,195	106,080
Total revenue bonds outstanding	2,425,200	2,449,856	2,397,219
Less current maturities	(55,460)	(56,645)	(52,335)
Total long term portion	$ 2,369,740	$ 2,393,211	$ 2,344,884

General Obligation Bonds

In addition to the revenue bond obligations described above, a large portion of the SWP was financed by the sale of general obligation bonds of the State pursuant to the provisions of the Burns-Porter Act, which authorized the issuance of $1,750 million of such bonds for the construction of the SWP. The Burns-Porter Act was adopted by the voters at the State's general election of November 1960. Of that authorization, $1,582 million (including the entire amount available for construction of the initial components of the SWP) has been issued, of which $731 million remains outstanding at the end of fiscal 2005 compared to $778 million at fiscal 2004 and $822 million at fiscal 2003. The un-issued $168 million of the authorization is available only to provide funds for the construction of certain additional water conservation facilities.

Accounts Payable and Other Current Liabilities

Accounts payable and other current liabilities totaled $131 million at June 30, 2005, compared to $106 million in 2004, and $123 million in fiscal 2003. The increase of $25 million in the current year is due to an overall increase in expenditures and timing differences in payments made. In fiscal 2004, similar timing differences in payments created a decrease of $17 million in other current liabilities from fiscal 2003.

Proceeds Due to Water Contractors

Proceeds due to Water Contractors is comprised of the additional 25% billing for revenue bond debt service in excess of debt service requirements (known as "cover"), certain investment income and off-aqueduct power sales, all defined as refundable to the Water Contractors under terms of the water supply contracts. Proceeds due to Water Contractors decreased by $16 million during 2005 to an ending balance of $73 million. This decrease is the result of a refund made for Off-Aqueduct Power Facilities of $37 million, offset in part by additional off-Aqueduct refunds accrued of $11.3 million, plus an accrual for additional rate management adjustments of $12 million. In fiscal 2004, the proceeds due increased by $15 million to $90 million. That increase was attributed to a net $26 million Off-Aqueduct power facilities cost adjustment that related to 2003 and 2002 plan to actual differences, which was offset in part by increased refunds made for interest and cover compared to the prior year.

Deferred Revenue – State and Federal Capital Recovery

The System received funds from the State and Federal governments to build certain projects that relate to recreational use and flood control. That revenue has been deferred until those projects are depreciated. Deferred revenue decreased $5 million in fiscal 2005 to $172 million. This compares to a $4 million decrease in fiscal 2004. These decreases represent the recognition of revenue equal to the amount of depreciation recorded.

Deferred Power Sales Credit

The deferred power sales credit results from a timing difference of revenue collected from certain Water Contractors for power generated by the Hyatt-Thermalito power plant and the corresponding credit that is issued to all Water Contractors through a reduced capital charge. In fiscal 2005 and 2004, the Delta Water Charge, which recovers the cost of conservation facilities, was reduced by $17 million for the principal portion of the power sales credit, which was offset in part by $15 million of revenue collected through the variable charge for power generated at Oroville.

Advances for Plant Replacements

Advances for plant replacements totaled $18 million in fiscal 2005. Advances for plant replacements represents amounts collected in advance from the Water Contractors for future plant equipment replacements. As actual replacements have occurred more slowly than originally anticipated, advances collected from the Water Contractors have been reduced. In fiscal 2005 however, additional revenues of $5 million were collected for the replenishment of the Conservation advance account, causing the overall advance amount to increase by $4.4 million. In fiscal 2004, expenditures exceeded revenues by $2 million.

Statement of Activities

Operating Revenues

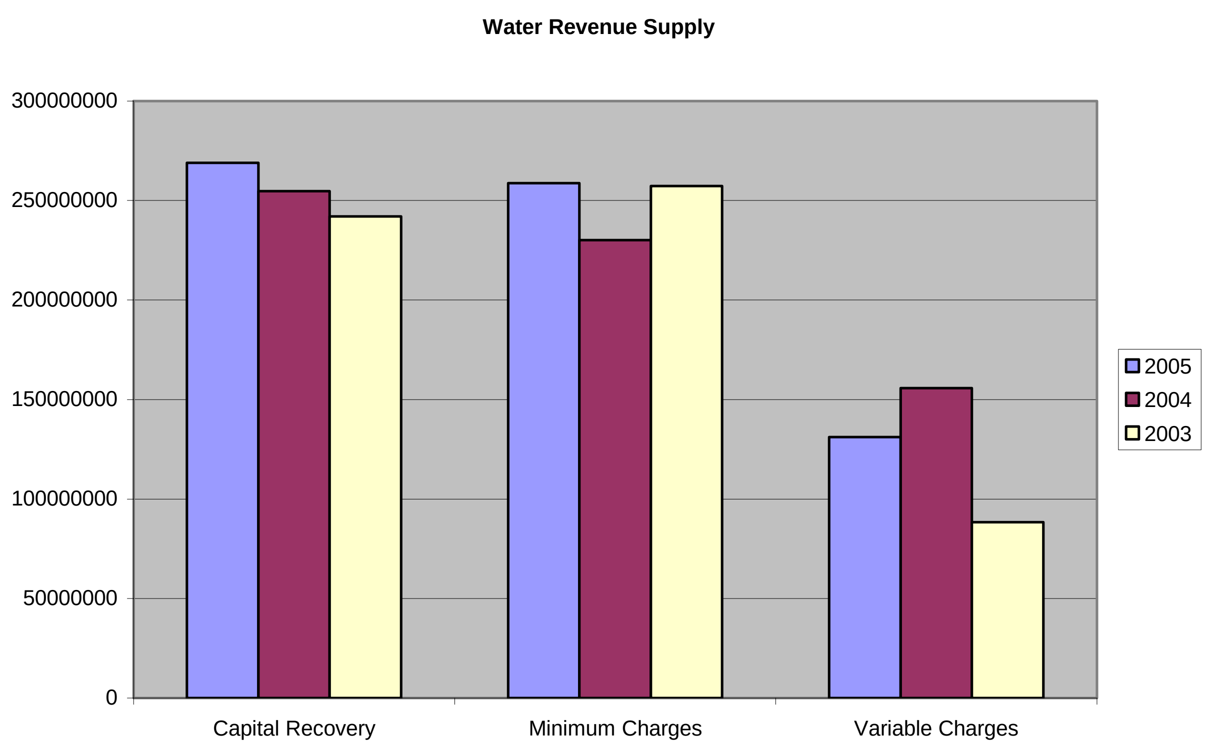
Operating revenues for the year were $750 million compared to $715 million in fiscal 2004 and $689 million in fiscal 2003. The increase in fiscal 2005 was primarily due to increased power sales revenue of $45 million offset by a decrease in water supply revenue of $10 million. The increase in fiscal 2004 was due to increased water supply revenue of $53 million offset in part by a decrease in power sales revenue of $26 million.

Water Supply Revenue

Under the terms of the water supply contracts, the System is required to collect from the Water Contractors all costs of the SWP allocated in proportion to each Contractor's contractual allocation of water. Generally, the System's costs, including the costs of gathering, storing, conveying and delivering water, and interest, are billable to Water Contractors whether or not water is delivered.

Water supply revenues consist of three main categories, as defined in the water supply contracts: Capital, Minimum and Variable. The Capital component of revenue enables the System to recover all the costs plus interest related to the construction of the System facilities, including its dams, aqueducts, pumping stations and power plants. Once a project is completed, its cost plus interest are amortized and recovered over the remaining term of the water supply contracts (through 2035). The Minimum component of revenue enables the System to recover the operating and maintenance costs associated with operating the System. These costs are generally recovered as they are incurred. Finally, the Variable component of revenue enables the System to recover the net cost of energy used to deliver water to the Water Contractors. Like Minimum, these costs, net of on-aqueduct power sales, are generally recovered as they are incurred.

In 2005, the System generated $631 million in water supply revenue, compared to $640 million in fiscal 2004, and $588 million in fiscal 2003. The table below shows a comparative breakdown of the components of water supply revenue for fiscal years 2005, 2004 and 2003.



In fiscal 2005, a decrease in Variable revenue of $25 million was offset in part by an increase in capital revenue of $14 million resulting from the timing of rate management adjustments, plus additional billings for Conservation replacements.

The decrease in Variable is the result of fewer total water deliveries in 2005 of 321,000 acre-feet, combined with the timing of deliveries to Water Contractors in Southern California. 58% of the total deliveries to Southern California Contractors occurred in the first half of the fiscal year, when the mill rate for such deliveries was $23.38, compared to a mill rate in the second half of the year of $32.27. The increase in the mill rate is due to the increasing market rate of power.

In fiscal 2004, the $67 million increase in Variable revenue is attributable to three items. First, in fiscal 2003, a settlement in the amount of $30 million was received from Southern California Edison (SCE) relating to prior year power purchase transactions. SCE paid DWR $30 million that DWR recorded as an offset to power purchases in 2003. In turn, DWR gave the Water Contractors credit for the settlement through the Variable charge, thus decreasing the Variable charge on a comparative basis by $30 million for fiscal 2003. Second, total water deliveries for the year increased by 496,000 acre-feet, or 16% over fiscal 2003. As a result, $25 million of the fiscal 2004 increase is attributed to the increased water deliveries. Third, the average mill rate used to determine the Variable charge factor for each Contractor increased from $23.37 to $26.75 in 2004, which represents a 14.5% increase. When applied to 2003 Variable revenue, approximately $12 million of the 2004 change is attributed to this increase in the mill rate.

The increase in Capital revenue is due mainly to the timing of Rate Management credits issued to the Water Contractors in fiscal 2005 as compared to fiscal 2004.

The $27 million decrease in Minimum revenue in 2004 reflects billing decreases to account for differences between actual expenditures and estimated expenditures. Of these, approximately $18 million relates to information technology project costs that had been projected but were not incurred.

Overview of the System's Power Activities

The SWP is one of the largest consumers and suppliers of electric power in the western United States. Since the commencement of the major facilities of the SWP in the 1960s, the System has been an active participant in the power markets of California and the western United States. The System has provided for the financing, construction and operation of a variety of power projects including hydroelectric, geothermal and coal-fired electric generating facilities and facilities to transmit electric energy. The System currently owns nine power plants with a total nameplate capacity of approximately 1,770 MW and with total annual generation of approximately 4,000 to 6,000 GWh. The System also owns approximately 17 pumping plants with a total load, when operational, of approximately 1,200 MW and with total annual consumption of 4,000 to 9,000 GWh. The pumping plants, which are the SWP's major power-consuming components, can be operated principally during the off-peak portion of the daily electricity consumption cycle due to their large pumping capacity. Similarly, the designed capacity of most of the System's hydroelectric generation facilities permits those facilities to be operated at 100 percent of generation capacity during on-peak hours and generally held idle during off-peak hours. This flexibility in the scheduling of the System's generation and load enables the System to sell relatively high value power during on-peak hours and buy less expensive power during off-peak hours.

Power Sales

As mentioned previously, the System employs a strategy to run its pumping plants during off-peak hours, when energy prices are generally lower, and generate energy during on-peak hours, when prices are generally higher. This enables the System to maximize its power generation capabilities by selling excess power to third parties at a higher rate. However, in any given year, a combination of factors, including hydrological production, energy market rates, energy market supply and demand, and the System's own energy requirements can affect the volume of power the System has available for sale. Also, during California's 2000 - 2001 energy crisis, the variance between off-peak and on-peak prices significantly narrowed. The system experienced an increase in power sales in fiscal year 2005 compared to fiscal year

2004 of $45 million for a total of $105 million. This variance though, is due in part to adjustments recorded in 2004. First, an adjustment was made to reduce power sales by $9.8 million which represents the estimated refunds the System will make relating to the FERC's Mitigated Market Clearing Prices (MMCP) settlement. Second, an adjustment was made to reduce power sales by $13 million for a transmission loss calculation adjustment that occurred in a prior year. When normalized to actual current year activity, power sales increased by $22 million in fiscal 2005 compared to fiscal 2004. This increase is due primarily to an increase in the amount of power sold, offset in part by a lessened price per megawatt. In 2005, the System sold 1,255,034 MWh's at an average rate of $83.28, compared to 837,911 MWh's at an average rate of $97.97 in 2004. In 2004, the variance to 2003 of only $3 million is due largely to the fact that the rates per MWh were generally flat between fiscal 2004 and fiscal 2003, at $97.97 and $98.70, respectively, as were the MWh sold, at 838,000 MWh's and 869,000 MWh's, respectively. The first table below shows the effect of the rate and volume between 2005 and 2004. This can be compared to the second table below for fiscal years 2004 and 2003, where the volume and price are relatively flat.

	MWh Sold	**$ Sold**	**Rate/MWh**
2004	837,911	$ 59,289,000	$ 97.97 *
2005	1,255,034	$ 104,521,063	$ 83.28
Change in total MWh sold			417,123
Multiplied by 2005 rate/MWh			$ 83.28
Difference attributed to decreased sales (rounded to nearest thousand)			$ 34,738,000
Change in MWh rate			$ (14.69)
Multiplied by 2004 MWh sold			837,911
Difference attributed to rate change (rounded to nearest thousand)			$ (12,309,000)
Total increase in power sales (rounded to nearest thousand)			$ 22,429,000

* The rate/MWh has been adjusted to eliminate the effect of retroactive adjustments to the previous year's sales.

	MWh Sold	$ Sold	Rate/MWh	
2003	868,671	$ 85,735,000	$ 98.70	
2004	837,911	$ 59,289,000	$ 97.97	*

Change in total MWh sold	(30,760)
Multiplied by 2005 rate/MWh	$ 97.97
Difference attributed to decreased sales (rounded to nearest thousand)	$ (3,014,000)
Change in MWh rate	$ (0.73)
Multiplied by 2004 MWh sold	868,671
Difference attributed to rate change (rounded to nearest thousand)	$ (632,000)
Plus retroactive adjustments to previous year sales	$ (22,800,000)
Total decrease in power sales (rounded to nearest thousand)	$ (26,446,000)

* The rate/MWh has been adjusted to eliminate the effect of retroactive adjustments to the previous year's sales.

Federal Reimbursement Revenue

Federal reimbursements revenue for fiscal years 2005 and 2004 was $15 million. Federal reimbursements revenue declined $1 million from fiscal 2003, attributable to the decreased expenditures incurred for the portion of the San Luis and Suisun Marsh facilities for which the System is reimbursed by the Federal government.

Operating Expenses

Operating expenses increased $20 million for the year to a total of $578 million. This increase is due primarily to increased power costs. In 2004, operating expenses of $559 million increased compared to fiscal 2003 by $3 million, due to a number of items, including the $30 million settlement received from SCE in fiscal 2003, increased costs relating to information technology projects, and increased facilities repairs and maintenance costs. These cost increases are offset, in part, by a reduction of operating expenses recovered from previous years.

Operations and Maintenance Expense

Total operations and maintenance expense was $325 million, compared to $321 million last year, and $279 million in fiscal 2003. Overall operations and maintenance costs for 2005 were roughly flat compared to 2004. Certain increases in coal costs and overhead costs were offset by reductions in maintenance costs. The increase from 2003 to 2004 is attributable to several items. First, operating costs at the Reid-Gardner power plant were greater in 2004 by $5.8 million. Second, consulting services increased over 2003 by $11 million. This is due in part to increased costs associated with the information technology projects, as well as a resumption of services provided for IT support. Third, the System incurred costs for the implementation of a power management system that resulted in a $2.5 million cost increase over 2003. Fourth, the System recorded one-time credits in fiscal 2003 relating to a comprehensive power transmission agreement with PG&E of approximately $15 million. Finally, facilities repairs and maintenance costs exceeded 2003 by $15 million.

Power Purchases

As discussed above, the System uses a significant amount of power to operate its pumping stations in order to deliver water to Water Contractors. Its sources of power include self-generated power by the nine power plants owned by the System, along with purchases of power from third party suppliers. As with power sales, in any given year, a combination of factors, including hydrological production, energy market rates, and energy market supply and demand, impact the System's energy requirements. Purchased power increased $24 million over 2004, to a total of $168 million, before total transmission costs of $28 million. This increase is due mainly to increased costs per MWh, offset slightly by fewer MWh's purchased. Purchased power was $143 million in fiscal 2004 before transmission costs of $31 million, compared to $113 million in fiscal 2003 (adjusted for the $30 million SCE credit for comparability) before transmission costs of $16 million. The increase in 2004 is due to an increased volume of power purchased, offset in part by a lower cost per MWh. The tables below show the relationship between volume and rate for fiscal 2005 compared to fiscal 2004, and fiscal 2004 compared to fiscal 2003.

	MWh Purchased	Power Purchased	Rate/MWh
2004	3,152,000	$ 143,151,000	$ 45.42
2005	3,122,290	$ 167,683,943	$ 53.71
Change in MWh purchased			(29,710)
Multiplied by 2005 rate			$ 53.71
Difference attributed to decreased purchases (rounded to nearest thousand)			$ (1,596,000)
Change in MWh rate			$ 8.29
Multiplied by 2004 purchased			3,152,000
Difference attributed to rate change (rounded to nearest thousand)			$ 26,130,000
Total increase in power purchases (rounded to nearest thousand)			24,534,000
Plus decrease in transmission purchased			(3,067,000)
Total difference			$ 21,467,000

	MWh Purchased	Power Purchased	Rate/MWh	
2003	1,947,061	$ 112,616,989	$ 57.84	*
2004	3,152,252	$ 143,151,446	$ 45.41	
Change in MWh purchased			1,205,191	
Multiplied by 2004 rate			$ 45.41	
Difference attributed to decreased purchases (rounded to nearest thousand)			$ 54,730,000	
Change in MWh rate			$ (12.43)	
Multiplied by 2003 purchased			1,947,061	
Difference attributed to rate change (rounded to nearest thousand)			$ (24,196,000)	
Total increase in power purchases (rounded to nearest thousand)			30,534,000	
Plus increase in transmission costs			16,051,000	
Total difference			$ 46,585,000	

* The rate/MWh has been adjusted to eliminate the effect of retroactive adjustments to the previous year's purchases.

Operating Expenses Recovered

Operating expenses deferred were $20 million, which is $6 million more than was deferred in 2004. In 2004, operating expenses deferred were $14 million, which represents a $116 million decrease compared to fiscal 2003. This amount represents timing differences between expenditures made by the System and their eventual recovery from the Water Contractors through the Minimum and Variable components of revenue.

Interest Expense

Interest expense for the fiscal year was $153 million, which represents a decrease of $15 million from the prior year. This decrease is due in part to decreased costs associated with the issuance of Series AC. Those costs, including amortization of deferred amounts, were $4.2 million, compared to $12 million in 2004. Interest expense for fiscal year 2004 was $168 million and $16 million less than in fiscal 2003. The 2003/2004 decrease is due primarily to the difference of the losses recorded in conjunction with the issuances of Series Z, Y, and AA in fiscal 2003, and Series AB in fiscal 2004. The losses, including amortization of deferred amounts, recorded in fiscal 2003 were $25 million, compared to $12 million in fiscal 2004. When adjusted to exclude the charges related to debt issuance, actual interest expense has declined from $159 million in fiscal 2003 to $156 million in fiscal 2004 and $149 million in fiscal 2005.

Other Income (Expense)

Other Income/(Expense) was negligible in 2005, as recreation costs were offset by increases in the market value of federal securities held. Other expense increased in 2004 by $9 million compared to fiscal 2003, and was roughly flat compared to fiscal 2002. The increase was due primarily to an increase in the market value on investment securities of approximately $9 million in fiscal 2004.

Change in Net Assets

Overall, the System recorded an increase in net assets of $18.9 million. This amount represents timing differences from prior years due mainly to the timing of rate management adjustments.

The table below explains the primary sources of the change in net assets. The reversal of prior year suspended costs in 2004 represents costs associated with the San Joaquin Drainage program that were ultimately determined to be collectible under the terms of long-term water supply contracts.

	2005	2004	2003
Increases:			
Investment income net of refunds to water contractors	$ 7,460,181	$ 1,452,258	$ 10,915,320
Capital revenue in excess of capital costs	40,302,346	7,392,815	(5,944,227)
Other miscellaneous income (expense)	429,327	1,835,787	1,519,121
Total increases	48,191,854	10,680,860	6,490,215
Decreases:			
Rate management credit	(21,194,000)	(23,235,084)	(40,470,168)
Recreation costs	(8,054,706)	(7,933,189)	(10,910,157)
Suspended costs	(54,213)	(1,163,355)	(1,363,251)
Total decreases	(29,302,919)	(32,331,628)	(52,743,576)
One time adjustments:			
Prior year suspended costs, retroactively adjusted	-	5,197,225	-
Total one time adjustments	-	5,197,225	-
Change in net assets	$ 18,888,935	$ (16,453,543)	$ (46,253,362)

State Water Resources Development System
Statements of Net Assets
June 30, 2005 and 2004 (in thousands)

	2005	2004
Assets		
Utility plant:		
Utility plant in service	$ 4,560,047	$ 4,560,047
Less accumulated depreciation	(1,644,113)	(1,566,792)
Net utility plant in service	2,915,934	2,993,255
Construction work in progress	72,950	37,101
Total utility plant	2,988,884	3,030,356
Long-term assets:		
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	20,917	17,092
Cash and investments restricted for debt service	177,013	175,823
Cash and cash equivalents on deposit with revenue bond trustee	9,844	9,210
Loans receivable from local water agencies	28,384	31,959
Advances to Pacific Gas & Electric Company	-	1,022
Due from other state funds	91,517	91,516
Total long-term assets	327,675	326,622
Current assets:		
Cash and cash equivalents	226,090	269,996
Receivables:		
Interest on investments	3,060	1,761
Water supply and power billings	96,697	86,648
Due from federal government	7,208	7,978
Inventories	9,953	10,227
Other	3	66
Total current assets	343,011	376,676
Deferred charges:		
Amounts recoverable through future billings under long-term water supply contracts:		
Operations and maintenance expense	169,782	109,338
Capital costs	286,964	308,202
Unamortized project costs	376,566	384,841
Unbilled interest earnings on capital costs	487,591	487,752
Total deferred charges	1,320,903	1,290,133
Total assets	$ 4,980,473	$ 5,023,787

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

State Water Resources Development System
Statements of Net Assets, continued
For the years ended June 30, 2005 and 2004 (in thousands)

	2005	2004
Capitalization and Liabilities		
Capitalization:		
Net assets:		
Capital, net of related debt	$ 210,933	$ 185,676
Restricted	994,498	1,000,866
Total net assets	1,205,431	1,186,542
Long-term debt, less current maturities:		
General obligation bonds	683,715	731,290
Revenue bonds	2,369,741	2,393,211
Commercial paper	12,398	10,519
Total long-term debt	3,065,854	3,135,020
Total capitalization	4,271,285	4,321,562
Current liabilities:		
Current maturities of bonds	103,035	102,965
Accounts payable	48,206	39,156
Accrued vacation	12,385	11,430
Accrued interest on long-term debt	20,709	20,942
Due to other state funds	50,639	34,640
Proceeds due to water contractors	73,430	89,693
Total current liabilities	308,404	298,826
Deferred credits:		
Deferred revenue - State and Federal capital recovery	172,484	176,569
Power sales credit due to water contractors	210,261	213,224
Advances for plant replacements	18,039	13,606
Total deferred credits	400,784	403,399
Commitments and Contingencies (Note 9)		
Total net assets and liabilities	$ 4,980,473	$ 5,023,787

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

State Water Resources Development System
Statements of Revenues, Expenses, and Changes in Net Assets
For the years ended June 30, 2005 and 2004 (in thousands)

	2005	2004
Operating revenues:		
Water supply	$ 630,955	$ 640,417
Power sales	104,521	59,289
Federal reimbursements	14,806	14,941
Total operating revenues	750,282	714,647
Operating expenses:		
Operations and maintenance	324,926	321,060
Purchased power	196,023	174,556
Depreciation expense	77,321	77,388
Operating expenses deferred, principally under long-term water supply contracts, net	(19,889)	(14,423)
Total operating expenses	578,381	558,581
Income from operations	171,901	156,066
Interest expense	(152,847)	(167,873)
Other expense	(165)	(4,645)
Increase (decrease) in net assets	18,889	(16,452)
Net assets, beginning of year	1,186,542	1,202,994
Net assets, end of year	$ 1,205,431	$ 1,186,542

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

State Water Resources Development System
Statements of Cash Flows
For the years ended June 30, 2005 and 2004 (in thousands)

	2005	2004
Cash flows from operating income:		
Receipts from customers	$ 712,327	$ 728,995
Payments to employees for services	(183,096)	(171,466)
Payments to suppliers	(312,564)	(340,799)
Net cash provided by operating activities	216,667	216,730
Cash flows from noncapital financing activities:		
Other expense	(14,589)	(12,772)
Net cash used in noncapital financing activities	(14,589)	(12,772)
Cash flows from capital and related financing activities:		
Proceeds from issuance of revenue obligation bonds, net of issuance discounts and premiums	278,647	186,898
Principal payments on long-term debt	(349,622)	(190,460)
Commercial paper notes issued	15,556	70,643
Commercial paper notes redeemed	(13,677)	(92,218)
Interest payments on long-term debt	(153,080)	(157,663)
Additions to utility plant	(35,881)	(15,772)
Net cash used in capital and related financing activities	(258,057)	(198,572)
Cash flows from investing activities:		
Cash received from investment earnings	11,092	11,240
Payments received on loans receivable from local water agencies	3,575	2,219
Reduction of advance to PG&E	1,022	2,045
Net cash provided by investing activities	15,689	15,504
Net (decrease) increase in cash and pooled investments	(40,290)	20,890
Cash and cash equivalents at beginning of year	423,291	402,401
Cash and cash equivalents at end of year	$ 383,001	$ 423,291
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	$ 171,901	$ 156,066
Adjustment to reconcile operating income to net cash provided by operations:		
Depreciation expense	77,321	77,388
Increase in deferred charges and credits, net	(20,559)	(23,099)
Changes in assets and liabilities:		
Increase in receivables	(10,049)	(3,237)
(Decrease) increase in inventories	274	(1,467)
Decrease in other assets	833	8,950
Increase in accounts payable and accrued vacation	10,036	12,201
Increase (decrease) in due to other state funds	15,998	(24,811)
(Decrease) increase in current proceeds due to Water Contractors	(29,088)	14,739
Total adjustments	44,766	60,664
Net cash provided by operating activities	$ 216,667	$ 216,730

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

For the years ended June 30, 2005 and 2004 (in thousands)

1. Reporting Entity

The State Water Resources Development System (a component unit of the State of California (State)) (System) including the State Water Project (SWP), the Davis-Grunsky Act Program and the San Joaquin Drainage Implementation Program, was constructed as the result of initial legislation in 1951 and subsequent legislation in the 1960s providing various financing mechanisms. The SWP is a complex of dams, water storage facilities, aqueducts, pumping stations and electric generation facilities which have been constructed for the purposes of developing firm water supply and conveying water to areas of need within the State and providing flood control, recreation, fish and wildlife enhancement and hydroelectric power. The System has entered into long-term water supply contracts with 29 customers (Water Contractors) in order to recover substantially all System costs. The 29 Water Contractors are principally located in the San Francisco Bay Area, the Central Valley and Southern California and their service areas encompass approximately 25% of the State's land area and 70% of its population.

The System is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The System 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 System has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The System is administered by the State of California Department of Water Resources (DWR).

2. Summary of Significant Accounting Policies

Utility Plant

Utility plant is recorded at original cost. Cost includes labor, materials and indirect items such as engineering, supervision, transportation and interest on borrowed funds incurred during construction. Repairs, maintenance and minor purchases of equipment are charged to expense as incurred. During the years ended June 30, 2005 and 2004, interest expense of $185 and $4,235, respectively, was capitalized.

Depreciation

Depreciation is provided on a straight-line basis over the estimated useful lives of the various classes of utility plant, as follows:

Aqueducts	100 years
Dams and reservoirs	85 years
Power plants	30 - 50 years
Pumping plants	40 years

Cash and Cash Equivalents

Cash and cash equivalents, for purposes of the statement of cash flows, includes cash on hand and restricted cash on deposit with revenue bond trustee. Amounts in short-term investments include deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF) and instruments with original maturities of three months or less. Cash and cash equivalents do not include U.S. Government and agency securities.

Restricted Cash and Investments
Cash on deposit with revenue bond trustee consists of debt service reserve funds held with a major national bank for the Series 1973 Devil Canyon-Castaic Facilities bonds and debt service funds held with another major national bank for Series AB of the Water Systems Revenue Bonds.

Cash and investments with the State Treasurer for plant replacements and debt service are restricted as required by the provisions of the water supply contracts and bond resolutions. Restricted funds consist of investments of the same type as those described below.

Investments
Cash not required for current use, including restricted cash, is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). 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 System is authorized by statute to invest in the same types of investment vehicles permitted by the State's Centralized Treasury System. U.S. Treasury and agency debt securities are carried at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, and is determined from published data provided by the exchanges, computerized pricing sources, the National Association of Securities Dealers' National Market System, securities custodians, and other authoritative sources. Investments made by the System during the year ended June 30, 2005, are of a similar nature as those held at June 30, 2004.

Due From Other State Funds
Due From Other State Funds represents the System's advance of $92 million to DWR's internal service fund, which functions as a revolving working capital facility for the System.

Accounts Receivable
Accounts receivable include amounts due from the Water Contractors and organizations that purchase power from the System, totaling $96,697 and $86,648 at June 30, 2005 and 2004, respectively, Additionally, the Federal government owed the System $7,208 and $7,978 at June 30, 2005 and 2004, respectively, related to reimbursement for certain costs related to flood control and jointly owned facilities. The allowance for uncollectible amounts totaled $1.2 million and $1.5 million at June 30, 2005 and 2004, respectively. Uncollectible amounts are generally recoverable from the Water Contractors.

Deferred Charges and Credits
The System records costs that are recoverable through future billings as deferred charges and revenues that are in excess of total project costs from inception of the SWP as deferred credits. These costs include capital costs (depreciation) and operations and maintenance.

Unamortized project costs represent abandoned utility plant and research and development expenditures that are recoverable through future billings to the Water Contractors under the terms of the water supply contracts.

Unbilled interest charged and recoverable by the System on unrecovered capital costs are classified as deferred charges until billed under the terms of the water supply contracts. Unbilled interest earnings represent the System's unrecovered interest since inception, recalculated annually at the System's cumulative weighted average cost of borrowing (Project Interest Rate). The System's Project Interest Rate was 4.610% at both June 30, 2005 and 2004.

Deferred revenue represents payments by the State and Federal governments for their share of the System's recreation and flood control capital costs in excess of the related depreciation expense recognized in the statements of revenues, expenses, and changes in net assets.

The deferred power sales credit arises from revenue collected for the power generated by the Oroville-Thermalito power plant. The deferred power sales credit is ratably decreased over time by a corresponding credit issued to the Water Contractors through a reduced capital charge.

Advances for plant replacements represent billings under the terms of water supply contracts for future replacement of certain System assets. Assets received from such billings are restricted. Costs of plant replacements are charged to the reserve as incurred.

Net Assets
The System classifies its net assets into two components, invested in capital assets, net of related debt and restricted net assets. Net assets invested in capital assets includes total utility plant, net of accumulated depreciation, related long-term debt and other assets and liabilities relating to the recovery of utility plant. The remaining net assets of the System are classified as restricted due to the requirements of legislation that created the System and authorized the construction of the SWP, to use the System's net assets solely in support of the SWP, the Davis-Grunsky Act Program and the San Joaquin Drainage Implementation Program.

Bond Issuance Discounts and Premiums
Bond issuance discounts and premiums are reflected as a reduction / increase of bonds outstanding and are amortized over the lives of the related debt instruments.

Deferred Loss on Advanced Refunding
Losses associated with the advance refunding of debt are deferred and amortized over the shorter of the life of the new debt or the refunded debt.

Revenues
The cost of providing services from the System is required to be recovered through user charges and other reimbursements. Under the terms of the long-term water supply contracts, the System granted the Water Contractors rate management reductions of approximately $21,194 and $23,218 during the years ended June 30, 2005 and 2004, respectively. Rate management reductions are permanent reductions in capital related billings to the Water Contractors.

Revenues under long-term water supply contracts are recognized when billings are due and payable. The billings cover debt service requirements, an additional 25% of revenue bond debt service to satisfy certain bond covenants, current operations and maintenance costs and past-unrecovered operations and maintenance costs. The water supply contracts provide that the 25% portion of the billings collected for the purpose of satisfying certain bond covenants be refunded in the subsequent year. These billings, which totaled $40,930 and $40,710 in the years ended June 30, 2005 and 2004, respectively, are recorded as liabilities in the financial statements. The System refunded $45,671 and $46,021 in the years ended June 30, 2005 and 2004, respectively, to the Water Contractors for the 25% bond cover requirement.

The System's water supply revenue is derived from 29 Water Contractors, including Metropolitan Water District of Southern California whose System billings constitute 64% of total System water supply revenue for the years ended June 30, 2005 and 2004, respectively.

Revenues from the sale of surplus power are recognized as the power is delivered.

The Federal government reimburses the System for certain operating and capital costs incurred by the System for flood control purposes. In addition, the Federal government reimburses the System for the Federal government’s 45% share of the operating costs of the San Luis joint use facilities and other water facilities. Revenue from the State and Federal government in excess of their share of the related depreciation expense is deferred until the related depreciation expense is recognized.

Segments
The System has two segments, defined under governmental accounting standards as an identifiable activity for which one or more revenue bonds or other revenue-backed debt instruments are outstanding:

1) Activities Allowed Under the Burns-Porter Act – This segment accounts for the costs to build, operate and maintain the facilities financed by general obligation bonds as authorized by the Burns-Porter Act. Transportation and conservation revenues from the Water Contractors are recorded in this segment as well as power sales and reimbursements from Federal and State governments, and interest on investments. Expenses are limited to operations and maintenance of the SWP constructed with general obligation bond proceeds, power purchases, replacements and debt service on the general obligation bonds.

2) Activities Allowed Under the Central Valley Project Act – This segment accounts for the costs to build, operate and maintain the facilities financed by the Central Valley Project Water Systems revenue bonds. Capital and operations revenues from the Water Contractors for projects financed by revenue bond proceeds are recorded in this segment as well as commercial paper sales, reimbursements from Federal and State governments for San Luis Dam and Reservoir, Suisun Marsh and recreation costs, and interest on investments. Expenses are limited to the construction and operation of SWP facilities constructed with revenue bond proceeds and power facilities, and debt service payments on the revenue bonds.

Reclassifications

Certain amounts in the 2004 financial statements have been reclassified in conformity with the 2005 presentation. Such reclassifications do not have a material impact on the System's financial position, results of operations or cash flows.

New Accounting Pronouncement

For the year ended June 30, 2005, DWR implemented the provisions of Government Accounting Standards Board Statement No. 40 (GASB 40), *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3*. GASB 40 requires disclosure of credit risk, concentration of credit risk, interest rate risk, and foreign currency risk and modifies previous custodial credit risk disclosure requirements.

Future Pronouncements

<u>GASB 42</u>

Effective for the year ending June 30, 2006, Governmental Accounting Standards Board Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,* (GASB 42) establishes accounting and financial reporting standards for impairment of capital assets and clarifies and establishes accounting requirements for insurance recoveries. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Governments will be 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 generally should be considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset. 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 diminished service utility of the capital asset.

<u>GASB 45</u>

Effective not later than the year ending June 30, 2008, the System will be required to implement Governmental Accounting Standards Board Statement No. 45**,** *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (known as OPEBs). The System offers postretirement medical and dental benefits. GASB 45 establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The cost of OPEB, like the cost of pension benefits, generally should be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided. In current practice, most OPEB plans are financed on a pay-as-you-go basis, and financial statements generally do not report the financial effects of OPEB until the promised benefits are paid.

Upon implementation of GASB 45, the System will be required to record an annual OPEB cost based on the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize unfunded actuarial liabilities over a period not to exceed thirty years. The System has not completed the process of evaluating the impact that will result from adopting GASB 45.

3. Interests in Jointly Owned Facilities

At June 30, 2005, the System owned the following undivided interests in jointly owned facilities:

		System's Share (in thousands)	
	% Owned by System	Utility Plant in Service	Accumulated Depreciation
Reid Gardner Power Plant Unit No. 4	67.8%	$ 327,069	$ 239,380
San Luis joint use facilities	55.0%	$ 255,931	$ 99,961

The amounts above include the System's share of direct costs related to building the facilities. Each participant provides its own financing for the jointly owned facility.

DWR is the operator of the San Luis joint use facilities. All of the operating expenses related to these facilities are included as operating expenses in the statement of activities. The Federal government is billed for its share of the operating expenses, and these billings are included as operating revenues in the statement of activities.

DWR does not operate Reid Gardner Power Plant Unit No. 4. The portion of Reid Gardner Power Plant Unit No. 4 operations attributable to the System’s share is included in operations and maintenance expense in the statement of activities.

For the years ended June 30, 2005 and 2004 (in thousands)

4. Utility Plant

The following activity in utility plant occurred during the years ending June 30, 2005 and 2004:

	Utility Plant in Service	Accumulated Depreciation	Net Utility Plant in Service	Construction Work in Progress	Total Utility Plant
Beginning balance, June 30, 2003	$ 4,441,688	$ 1,489,403	$ 2,952,285	$ 142,610	$ 3,094,895
Additions	-	77,389	(77,389)	12,850	(64,539)
Transfers	118,359	-	118,359	(118,359)	-
Ending Balance, June 30, 2004	4,560,047	1,566,792	2,993,255	37,101	3,030,356
Additions	-	77,321	(77,321)	35,849	(41,472)
Ending Balance, June 30, 2005	$ 4,560,047	$ 1,644,113	$ 2,915,934	$ 72,950	$ 2,988,884

5. Cash and Investments

At June 30, 2005, the System's cash deposits, including interest-bearing deposits, included restricted cash and cash equivalents on deposit with a revenue bond trustee in the amount of $9,844. Of the bank balance, $200 is federally insured and $9,644 is uncollateralized.

Investment	Maturity	Fair Value
State of California Pooled Money Investment Account - State Money Investment Fund	5.5 months average	$ 373,158
U.S. Government and Agency Securities	6.5 years average	50,862
Cash and equivalent on deposit with revenue bond trustee	Liquid	9,844
Total cash and investments		$ 433,864

Reconciliation to combined balance sheet:	
Cash and cash equivalents restricted for plant replacements	$ 20,917
Cash and investments restricted for debt service	177,013
Cash and cash equivalents on deposit with revenue bond trustee	9,844
Cash and cash equivalents	226,090
Total cash and investments	$ 433,864

Interest Rate Risk: In accordance with its investment policy, the State of California manages its exposure to declines in fair values by spreading investments over various maturities: U.S. Treasury securities, 5 years; federal agency securities, 5 years; bankers acceptances – domestic and foreign, 180 days; certificates of deposits, 5 years; collateralized time deposits, 5 years; commercial paper, 180 days; corporate bonds and notes, 5 years; repurchase agreements and reverse repurchase agreements, 1 year.

For the years ended June 30, 2005 and 2004 (in thousands)

Credit Risk: 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 is not rated.

Concentration of Credit Risk: The PMIA's concentration of credit risk is limited by spreading the investment mix over different investment types, credit ratings and issuers to minimize the impact any one industry, investment class, or institution can have on the PMIA portfolio.

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and averaged 2.26% and 1.53% for the years ended June 30, 2005 and 2004, respectively. For the years ended June 30, 2005 and 2004, interest earned on the deposit with PMIA approximated $9,951 and $7,101, respectively.

Total interest and investment income is comprised of interest, dividends, realized gains and losses, and unrealized gains and losses due to changes in the fair value of investments held at year-end. The change in fair value of investments is calculated as follows:

	2005	2004
Fair value of investments at the beginning of the fiscal year	$ 48,829	$ 51,712
Less: Proceeds of investments matured in fiscal year	-	-
Add: Amortization of discounts	1,860	1,721
Change in fair value of investments during fiscal year	173	(4,604)
Fair value of investments at the end of the fiscal year	$ 50,862	$ 48,829

For the years ended June 30, 2005 and 2004 (in thousands)

6. Long-term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2005 and 2004:

	General Obligation Bonds	Revenue Bonds	Unamortized (Discounts) and Premium	Deferred Loss on Defeasance	Total Revenue Bonds	Commercial Paper	Total Long-Term Debt
Balance at June 30, 2003	$ 822,090	$ 2,403,430	$ 20,813	$ (27,024)	$ 2,397,219	$ 32,094	$ 3,251,403
Additions	-	189,625	(2,727)	(2,641)	184,257	70,643	254,900
Payments/Amortization	(44,480)	(145,980)	4,985	9,375	(131,620)	(92,218)	(268,318)
Balance at June 30, 2004	777,610	2,447,075	23,071	(20,290)	2,449,856	10,519	3,237,985
Additions		272,071	21,963	(15,387)	278,647	15,556	294,203
Payments/Amortization	(46,320)	(307,265)	(1,423)	5,386	(303,302)	(13,677)	(363,299)
Balance at June 30, 2005	731,290	2,411,881	43,611	(30,291)	2,425,201	12,398	3,168,889
Less Current Portion	(47,575)	(55,460)	-	-	(55,460)	-	(103,035)
Total Long Term Debt	$ 683,715	$ 2,356,421	$ 43,611	$ (30,291)	$ 2,369,741	$ 12,398	$ 3,065,854

General Obligation Bonds
The Burns-Porter Act authorized the issuance of State Water Resources Development (WRD) General Obligation Bonds in the amount of $1,750,000 for construction of the System. This amount included $130,000 to be set aside for financial assistance to local water agencies as provided in the Davis-Grunsky Act. The Burns-Porter Act also made a continuing appropriation of the California Water Fund, a fund unrelated to the System, to supplement the bond authorization. Certain revenues from the Water Contractors have been pledged for the payment of the WRD General Obligation Bonds. To the extent Water Fund money was used for construction of the State water facilities in lieu of bond proceeds, an equal amount of bond authorization was set aside to be used only for the construction of additional facilities of the System that meet certain requirements set forth in the Burns-Porter Act.

WRD General Obligation Bonds of $168 million are authorized but unissued as of June 30, 2005, and may only be used for additional facilities meeting certain requirements of the Burns-Porter Act.

WRD General Obligation Bonds Series A through Series S may be called at any time for early redemption. If a series is called, the bonds of that series must be redeemed in reverse order of maturity, at a premium of 1/8 of 1% for each year until original maturity or 2003, whichever is earlier. WRD General Obligation Bonds Series W through Series Y do not have early redemption provisions.

WRD General Obligation Bonds consist of the following at June 30:

Fiscal Year of Issue	Series	Fixed Rates	Fiscal Year of Final Maturity	Amounts Outstanding (in thousands) 2005	2004
1964	A	0.1-3.6%	2013	$ 34,500	$ 38,000
1964	B&C	.05-3.7%	2014	55,250	60,500
1965	D&E	3.0-3.8%	2015	81,800	88,100
1966	F&G	3.5-4.1%	2016	91,200	97,200
1967	H,J&K	3.0-4.9%	2017	142,800	151,600
1968	L&M	4.0-5.0%	2018	103,000	108,600
1970	N&P	5.0-5.8%	2020	108,600	114,000
1971	Q&R	4.8-5.2%	2021	85,500	89,400
1972	S	5.3-5.5%	2022	23,840	24,840
1991	W	6.0-10.0%	2011	3,150	3,600
1993	X	4.4-4.8%	2023	950	1,000
1994	Y	6.4-7.1%	2025	700	770
				731,290	777,610
Less current maturities				(47,575)	(46,320)
				$ 683,715	$ 731,290

Revenue Bonds

The Central Valley Project Water System (CVP) Revenue Bonds have been issued for the acquisition or construction of projects to provide water and power for the SWP. Annual payments of principal and semi-annual interest payments are collateralized solely by certain payments to the System under the water supply contracts between the System and the Water Contractors. The System is subject to certain bond covenants, the most restrictive of which requires that the revenues in each year shall be at least equal to 1.25 times the debt service payable from revenues on all bonds outstanding in such year, plus operating costs, and the required funding of a debt service reserve account. The bonds are limited special obligations of the System; neither the principal nor any interest thereon constitutes a debt of the State. The bonds are callable at rates varying from 100% to 103.5%.

Series AB bonds issued during fiscal year 2004 are variable rate bonds and have 35 day auction periods. However, the bondholders cannot put the bonds back to the System. The interest rate for Series AB averaged 1.75% and 4% for the years ended June 30, 2005 and 2004, respectively.

CVP Revenue Bonds consist of the following at June 30:

Fiscal Year of Issue	Series	Fixed Rates	Fiscal Year of Final Maturity	Fiscal Year of First Call Date	Amounts Outstanding (in thousands) 2005	2004
Devil Canyon - Castaic Facilities:						
1973	A&B	5.3-5.4%	2022	Callable	$ 100,140	$ 103,195
CVP Water System:						
1992	J	5.87-7.0%	2012	2001	134,160	151,345
1993	L	5.25%	2005	Called	-	11,635
1996	O	4.8-8.3%	2030	2006	155,635	242,155
1996	P	5.3-9.3%	2029	2006	38,210	69,365
1997	Q	4.5-6.0%	2028	2007	103,520	199,965
1998	S	4.3-5.0%	2030	2008	154,500	183,165
1998	T	5.0-5.5%	2013	2009	92,415	93,330
1999	U	4.0-5.1%	2030	2009	161,675	175,120
1999	V	6.25%	2025	None	20,580	20,580
2001	W	4.0-5.5%	2030	2012	231,505	244,375
2002	X	2.5-5.5%	2029	2013	155,545	156,930
2003	Y	5.0-5.3%	2026	2013	329,885	329,885
2003	Z	2.0-5.0%	2020	2013	163,710	167,700
2003	AA	5.00%	2024	2013	108,705	108,705
2004	AB	Variable	2030	Callable	189,626	189,625
2005	AC	2.75-5.0%	2029	2015	272,070	-
					2,411,881	2,447,075
	Unamortized bond issuance premiums, net				43,611	23,071
	Deferred loss on defeasance				(30,291)	(20,290)
	Current maturities				(55,460)	(56,645)
					$ 2,369,741	$ 2,393,211

For the years ended June 30, 2005 and 2004 (in thousands)

Future Debt Service Requirements

Future principal and interest payment requirements on bonds are as follows at June 30, 2005:

	General Obligation Bonds		Revenue Bonds		
Year	Principal	Interest	Principal	Interest	Total
2006	$ 47,575	$ 31,283	$ 55,460	$ 120,122	$ 254,440
2007	48,965	29,195	70,840	116,757	265,757
2008	50,355	27,039	75,120	112,928	265,442
2009	52,695	24,806	79,295	108,939	265,735
2010	54,785	22,474	86,820	104,783	268,862
2011-2015	291,955	75,233	482,535	450,130	1,299,853
2016-2020	174,275	20,995	533,500	317,939	1,046,709
2021-2025	10,685	652	549,380	179,755	740,472
2026-2030	-	-	478,930	55,511	534,441
	$ 731,290	$ 231,677	$ 2,411,880	$ 1,566,864	$ 4,941,711

Commercial Paper Notes

The System has a commercial paper borrowing program of up to $141.5 million. Under this program, the System may issue commercial paper at prevailing interest rates for periods of not more than 270 days from the date of issuance. To provide liquidity for the program, the System entered into a revolving credit agreement with a commercial bank equal to the authorized amount of commercial paper. At June 30, 2005 and 2004, there were borrowings of $12,398 and $10,519, respectively, outstanding under this program. Interest expense approximated 2% and 1% for the years ended June 30, 2005 and 2004, respectively. The proceeds from the issuance of commercial paper are restricted to construction costs of certain State water projects, reimbursement of construction costs of certain State water projects, and interest and issuance costs of the commercial paper notes. The liability has been classified as long-term as it is the System's policy to redeem the commercial paper outstanding with the issuance of CVP Revenue Bonds. The System’s obligation to make debt service payments on the commercial paper notes is subordinate to its payment obligations under the resolutions for the CVP Revenue Bonds and WRD General Obligation Bonds. The same revenues from the Water Contractors that collateralize the CVP Revenue Bonds also collateralize the commercial paper notes. Under the terms of the related commercial paper agreements, the System is to meet the same 1.25 debt service coverage requirement as is required by the CVP Revenue Bonds.

7. Debt Refundings

In January 2005, the System issued $272,071 in CVP Water System Revenue Bonds – Series AC with an average interest rate of 4.31%. These bonds were used to refund $250,620 of outstanding bonds, redeem commercial paper borrowings of $13,677, fund capitalized interest of $648 and cover costs of issuance of $249. The proceeds of the Series AC advance refundings (after payment of underwriting refunding fees, other issuance costs and deposits to the debt service reserve account) were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for future debt service payments on the advance refunded bonds. As a result the advance refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements. The Series AC advance refunding resulted in an accounting loss of approximately $18 million for fiscal year 2005, which has been deferred and will be amortized over the shorter of the life of new or advance refunded debt. However, the System effectively reduced its aggregate debt service payments by approximately $18.2 million over the next 23 years and obtained an economic gain (difference between the present values of the old and new debt service payments) of $11.7 million.

In March 2004, the System issued $189,625 in CVP Water System Revenue Bonds – Series AB in a variable interest rate mode of 35-day auction periods. The interest rates for the variable debt from March 18, 2004 to June 30, 2004 ranged from 0.75% to 1.12%. These bonds, together with other monies, were used to refund $93,645 of outstanding bonds, redeem commercial paper borrowings of $92,210, fund capitalized interest $3,852 and cover costs of issuance of $1,865. The proceeds of Series AB used for current refunding (after the payment of underwriting refunding fees, other issuance costs and deposits to the Debt Service Reserve Accounts) together with other available monies, were used to refund debt that was called. The current refunding resulted in the recognition of an accounting loss of approximately $2.6 million for fiscal year 2004. However, the System effectively reduced its aggregate debt service payments by approximately $6.3 million over the next 27 years and obtained an economic gain (difference between the present values of the old and new debt service payments) of $5.5 million.

The total amount of bonds refunded in advance and still outstanding was $496,870 at June 30, 2005.

In July 2005, the System issued $112,390,000 in CVP Water System Revenue Bonds – Series AD with an interest rates ranging from 3% to 5%, which was used to advance refund $104,750,000 of outstanding bonds and redeem commercial paper borrowings of $12,314,000.

8. Retirement Plan

Plan Description

The State 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. The System 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 the System, 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 that reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by State statute.

Funding Policy

Active members who participate in Social Security under the State Miscellaneous Tier 1 category are required to contribute 5% of their annual covered salary after excluding the first $513 of gross monthly pay. Active members who do not participate in Social Security under the State Miscellaneous Tier 1 category are required to contribute 6% of their annual covered salary after excluding the first $317 of gross monthly pay. Active members who participate in Social Security under the State Miscellaneous Tier 2 category are not required to make contributions to PERS.

The System is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The actuarial methods and assumptions used are those adopted by the PERS Board of Administration. The required employer contribution rate for the fiscal year ended June 30, 2005, was 17.022% and 13.216% for State Miscellaneous Tier 1 and Tier 2, respectively. For the fiscal year ended June 30, 2004, the required employer contribution rate for Tiers 1 and 2 were 14.843% and 10.265%, respectively. The contribution requirements of the plan members are established by State statute and the employer contribution rate is established and may be amended by PERS.

For the years ended June 30, 2005 and 2004 (in thousands)

Annual Pension Cost

For the years ended June 30, 2005 and 2004, the System's annual pension cost and actual contribution amounted to approximately $12.3 million and $10.7 million, respectively. Annual covered payroll is not available for the System. However the actuarially determined contributions for the years ended June 30, 2005 and 2004, approximated .8% and .8%, respectively, of the total actuarially determined contribution requirements for the State Miscellaneous Category and approximately 15.47% and 13.71%, respectively, of the total System payroll. The required contribution for the 2005 fiscal year was determined as part of the June 30, 2003, actuarial valuation using the entry age normal actuarial cost method with the contributions determined as a percent of pay. The actuarial assumptions included (a) 7.75% investment rate of return (net of administrative expenses), (b) projected salary increases for miscellaneous members that vary by duration of service and age of entry into the system ranging from 3.25% to 13.35%, (c) 3.25% overall payroll growth, and (d) 3.0% inflation adjustment. The actuarial value of the System's assets was determined using a technique that smoothes the effect of short-term volatility in the market value of investments over a three-year period. The plan's unfunded actuarial accrued liability (or excess assets) is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 2004, the date of the most recent actuarial valuation, was 30 years. The changes in the overall assumptions had a minimal impact on employer contributions for Tier 1 employees and were the primary cause for the increase in the contribution rates for Tier 2 employees.

Trend Information

Trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. Information as to the Net Pension Obligation for the State Miscellaneous Category (Tier 1 and Tier 2) determined in accordance with Governmental Accounting Standards Board Statement No. 27, *Accounting For Pensions by State and Local Governmental Employers*, for the three years ended June 30, 2003 (date of the actuarial valuation used to determine the required contribution for the year ended June 30, 2005), is as follows:

Three-Year Trend Information

Fiscal Year Ended June 30	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation (NPO)
2003	$ 607,631	100%	$ -
2004	$1,337,430	100%	$ -
2005	$1,543,175	100%	$ -

For the years ended June 30, 2005 and 2004 (in thousands)

Analysis of Funding Progress

	(A)	(B)	(C)	(D)	(E)	(F)
Actuarial Valuation Date June 30	**Actuarial Asset Value**	**Actuarial Accrued Liability**	**Unfunded Actuarial Accrued Liability (Excess Assets) [(B)-(A)]**	**Funded Ratio [(A)/(B)]**	**Covered Payroll**	**Unfunded Actuarial Liability (Excess Assets) as Percentage of Covered Payroll {[(B)-(A)]/(E)}**
1996	$ 28,356,559	$ 31,742,109	$ 3,385,550	89%	$ 6,881,124	49%
1997	32,362,809	32,557,433	194,624	99%	6,623,624	3%
1998	39,910,539	34,169,378	(5,741,161)	117%	6,592,210	-87%
1999	43,548,065	35,771,215	(7,776,850)	122%	7,332,110	-106%
2000	46,841,738	42,386,045	(4,455,693)	111%	8,246,460	-54%
2001	47,258,102	45,261,495	(1,996,607)	104%	8,190,102	-24%
2002	43,483,087	48,118,210	4,635,123	90%	8,582,663	54%
2003	43,256,806	51,558,913	8,302,107	84%	8,636,968	96%
2004	46,122,429	54,700,513	8,578,084	84%	8,516,397	101%

Post-employment Benefits Other Than Pensions
In addition to the pension benefits provided by the State, the State also provides post-retirement health care benefits, in accordance with Section 22754(g) of the State Government Code, to all employees who retire from the State on or after attaining certain age and length of service requirements. The post-retirement health care benefits are funded by the State General Fund on a pay-as-you-go basis. Expenditures for health care benefits for DWR's active employees and retirees for the years ended June 30, 2005 and 2004 were approximately $16,161 and $15,457, respectively. DWR represents approximately 0.66% of the State of California's total expenditures for health care benefits. Post-retirement health care data for DWR's retirees alone are not available and cannot be reasonably estimated.

9. Commitments and Contingencies

Commitments

Construction
The System has entered into long-term construction contract commitments for the State water facilities. The remaining value of contracts in process as of June 30, 2005 and June 30, 2004, approximated $104,137 and $77,523 respectively.

Power Transmission and Purchase
The System has long-term power transmission service contracts requiring future payments of approximately $221,728 over periods ranging from one to 34 years. Payments made under these contracts approximated $27,001 and $32,350 for the years ended June 30, 2005 and 2004, respectively.

For the years ended June 30, 2005 and 2004 (in thousands)

The System has also entered into long-term power purchase contracts requiring future payments of approximately $730,280 over periods ranging from one to 29 years. Payments made under these contracts, excluding payments to the Kings River Conservation District (District) to cover debt service, approximated $55,987 and $26,054 for the years ended June 30, 2005 and 2004, respectively.

The remaining amounts of fixed obligations under the long-term power purchase and transmission contracts as of June 30, 2005, are as follows:

For the year ended:	Fixed Obligation
2006	$ 89,836
2007	89,836
2008	89,836
2009	89,836
2010	89,836
Thereafter	951,560
	$ 1,400,740

The System has a contract with the District that provides that the System receive all power generated by the Pine Flat Power Plant Project (Project). Under the contract, the System is obligated to pay fixed amounts each year to cover the debt service on bonds issued by the District to build the Project, operations and maintenance expenses, and a charge for power supplied. Such payments are to be made until all of the bonds issued by the District to finance the Project have been retired in 2020. Payments to the District totaled approximately $10,651 and $10,846 during the years ended June 30, 2005 and 2004, respectively.

The amounts of fixed obligations of the System related to future principal and interest payments of the District's bonds as of June 30, 2005, are as follows:

For the year ended	Fixed Obligation
2006	$ 4,900
2007	4,894
2008	4,882
2009	4,884
Thereafter	55,062
	$ 74,622

Contingencies

Litigation and Claims

Monterey Amendment
In 1994, the System and certain Water Contractors adopted a set of principles pursuant to which additional amendments to the water supply contracts have since been negotiated (Monterey Amendment). The Monterey Amendment includes provisions related to the transfer of land and related assets, known as the Kern Water Bank, to the Kern County Water Agency (KCWA) (one of the Water Contractors), the operation of certain System reservoirs, transfers of water allocations

between contractors, establishment of certain operating reserves, and the revision of calculating certain Water Contractor billings.

The Monterey Amendment has been executed by SWP and 27 of the 29 Water Contractors, who receive approximately 99% of water delivered annually and who pay approximately 99% of annual water supply revenue. Certain parties have disputed the validity of the Monterey Amendment by challenging the validity of the related environmental impact report (EIR). While the courts have allowed SWP to proceed with the implementation of the Monterey Amendment, SWP has been required to prepare a new EIR, which remains in process. After the EIR process is completed, the plaintiffs involved could again challenge, on limited grounds, the EIR and certain provisions of the Monterey Amendment. SWP, however, does not expect that there would be any material adverse impact on the ability of SWP to meet its payment obligations, even if such a challenge occurs and is successful.

2005 Contractor Lawsuit Regarding Oroville Power Credits
On April 25, 2005 the Kern County Water Agency and thirteen other Water Contractors filed a lawsuit against the System in Sacramento County Superior Court for declaratory relief and breach of contract. The complaint alleges that pursuant to the water supply contracts, the System is required, but has failed, to credit all revenues from power generated by certain project conservation facilities (primarily the Hyatt and Thermalito Powerplants) to certain capital billings, and, as a result, has overcharged the Water Contractor plaintiffs. The complaint seeks a declaration that all “benefits” derived from the sale or other disposal of power from project conservation facilities be credited “in conformity with the terms of the water supply contracts”, along with damages and costs in an unspecified amount. The Metropolitan Water District of Southern California and entities representing 13 other southern Contractors received court permission on December 12, 2005 to intervene in the lawsuit as defendants. If the Water Contractor plaintiffs are ultimately successful, the System believes certain Water Contractors would pay more to the System under the Water Supply Contracts, while others would pay less and that this cost shifting would not materially adversely impact the System’s financial position or results from operations.

Other Claims by Water Contractors
In accordance with the water supply contracts, in December 2005, 27 Water Contractors and entities representing Water Contractors filed “Notices of Contest” with the System challenging the accuracy of various charges in the System's billings. One Water Contractor has also filed a claim based on its Notice of Contest with the Victim Compensation and Government Claims Board. The System will be reviewing these Notices of Contest and working to resolve the issues raised. However, the System does not believe that any adjustments that might be made in response to the Notices would have a material impact on the System's financial position or results from operations.

General
The System, during the ordinary course of its operations, has been named in a number of additional suits and claims, several of which are still pending.

In the opinions of management and SWP's legal counsel, such legal actions, including the Monterey Amendment, will not have a material effect on the System's financial position or results of operations. If incurred, such costs would be recoverable from project beneficiaries under the long-term water supply contracts.

Federal Energy Regulatory Commission Proceedings

There are a number of proceedings pending before FERC relating to SWP as operator of the System. Some of these proceedings address requests from the California Independent System Operator, investor-owned utilities, and others to increase or adjust rates or allocate responsibility for costs for transmission and other services provided to the System and other entities in California. SWP is participating in these proceedings, since the outcome of these proceedings has the potential to increase the System's annual power costs. However, SWP does not believe that any increased charges arising from these proceedings will materially impact SWP's operations or ability to pay the System's debt service. Any increased charges will be passed through to the Water Contractors under the water supply contracts in the form of higher operations charges.

Claims for Partial Energy Purchase Refunds

FERC proceedings have also been instituted to address power purchaser requests for partial refunds from sellers of energy and related services in 2000 and 2001, including the System. However, in September 2005, the United States Ninth Circuit Court of Appeals ruled that FERC lacked jurisdiction under the Federal Power Act to order governmental entities, such as the System, to provide refunds in these types of proceedings. As a result of this Ninth Circuit Court of Appeals' ruling, a group of California entities filed similar claims for partial energy purchase refunds with the California Victims Compensation and Government Claims Board against the governmental entity sellers, including the System. Denial of these Government Claims Board claims may allow the claimants to file lawsuits against the governmental entity sellers, including the System. However, the System believes that amounts, if any, the System is required to refund as a result of these claims would not have a material impact on the System's financial position or results from operations because the impact of any refunds would be passed through to the Water Contractors under the water supply contracts in the form of higher operating charges.

Self-Insurance

The System is self-insured for all completed facilities of the SWP other than a portion of the Reid Gardner Project. The System is also self-insured for workers' compensation, general liability and other risks. All workers' compensation claims and other losses are on a "pay as you go" basis. The long-term water supply contracts provide for recovery of such losses from the Water Contractors. Additionally, the CVP Act and the related bond resolutions authorize the issuance of additional bonds, payable from available revenues or federal reimbursements under the National Disaster Act, for the purpose of providing funds for emergency repairs to power projects or water system projects necessitated by natural disasters, provided that certain conditions are met.

For the years ended June 30, 2005 and 2004 (in thousands)

10. Segment Information

The table below presents the condensed statements of net assets, the statements of activities and the statements of cash flows for the System's two segments, as of and for the years ended June 30, 2005 and 2004:

	2005			2004		
	Activities Allowed Under			Activities Allowed Under		
	Burns-Porter Act	Central Valley Project Act	Total	Burns-Porter Act	Central Valley Project Act	Total
Condensed Statements of Net Assets:						
Assets						
Capital assets	$ 884,413	$ 2,104,471	$ 2,988,884	$ 905,686	$ 2,124,670	$ 3,030,356
Other assets	1,169,028	479,550	1,648,578	1,109,547	507,208	1,616,755
Current assets	156,320	186,691	343,011	172,026	204,650	376,676
Total assets	$ 2,209,761	$ 2,770,712	$ 4,980,473	$ 2,187,259	$ 2,836,528	$ 5,023,787
Capitalization and Liabilities						
Capitalization:						
Net assets:						
Capital (deficit), net of related debt	$ 439,475	$ (228,542)	$ 210,933	$ 416,227	$ (230,551)	$ 185,676
Restricted	739,000	255,498	994,498	716,557	284,309	1,000,866
Total net assets	1,178,475	26,956	1,205,431	1,132,784	53,758	1,186,542
Long-term liabilities	683,715	2,382,139	3,065,854	731,290	2,403,730	3,135,020
Total capitalization	1,862,190	2,409,095	4,271,285	1,864,074	2,457,488	4,321,562
Current liabilities	119,271	189,133	308,404	96,356	202,470	298,826
Other liabilities	228,300	172,484	400,784	226,829	176,570	403,399
Total capitalization and liabilities	$ 2,209,761	$ 2,770,712	$ 4,980,473	$ 2,187,259	$ 2,836,528	$ 5,023,787
Condensed Statements of Activities:						
Operating revenues:						
Water supply	$ 399,223	$ 231,732	$ 630,955	$ 447,980	$ 192,437	$ 640,417
Power sales	93,901	10,620	104,521	39,674	19,615	59,289
Federal reimbursements	12,759	2,047	14,806	12,901	2,040	14,941
	505,883	244,399	750,282	500,555	214,092	714,647
Depreciation expense	(23,072)	(54,249)	(77,321)	(23,072)	(54,316)	(77,388)
Other operating expense	(400,866)	(100,194)	(501,060)	(351,237)	(129,956)	(481,193)
Income from operations	81,945	89,956	171,901	126,246	29,820	156,066
Interest expense	(32,416)	(120,431)	(152,847)	(34,790)	(133,083)	(167,873)
Other (expense) income	(3,838)	3,673	(165)	(2,461)	(2,184)	(4,645)
Increase (decrease) in net assets	45,691	(26,802)	18,889	88,995	(105,447)	(16,452)
Net assets, beginning of year	1,132,784	53,758	1,186,542	1,043,789	159,205	1,202,994
Net assets, end of year	$ 1,178,475	$ 26,956	$ 1,205,431	$ 1,132,784	$ 53,758	$ 1,186,542
Condensed Statements of Cash Flows:						
Net cash provided by (used in):						
Operating activities	$ 61,695	$ 154,972	$ 216,667	$ 103,264	$ 113,466	$ 216,730
Noncapital financing activities	(7,586)	(7,003)	(14,589)	(16,781)	4,009	(12,772)
Capital and related financing activities	(81,030)	(177,027)	(258,057)	(73,035)	(125,537)	(198,572)
Investing activities	6,327	9,362	15,689	14,425	1,079	15,504
Net (decrease) increase in cash and cash equivalents	(20,594)	(19,696)	(40,290)	27,873	(6,983)	20,890
Cash and equivalents, beginning of year	96,379	326,912	423,291	68,506	333,895	402,401
Cash and equivalents, end of year	$ 75,785	$ 307,216	$ 383,001	$ 96,379	$ 326,912	$ 423,291

Supplementary Information

State Water Resources Development System
Calculation of Adequacy of Debt Service Coverage

Water supply revenues, including $41,804 in refundable proceeds	$ 280,065
Investment earnings	3,004
	283,069
Less: Operations and maintenance expense	74,322
Net revenues available for debt service	$ 208,747
Principal and interest for revenue bonds	$ 166,727
Debt service coverage	125.2%

Note: The general bond resolution for the Central Valley Project (CVP) Water System Revenue Bonds requires the System to collect revenues under the long-term water supply contracts equal to 1.25 times the annual debt service. The Schedule includes the amounts applicable to the CVP Revenue Bonds and excludes amounts applicable to the Water Resources Development General Obligation Bonds.