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State Water Resources Development System

Financial Statements and Supplementary Information For the years ended June 30, 2006 and 2005

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Financial Statements:

Supplementary Information:

PRICEWATERHOUSECOOPERS

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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, at June 30, 2006 and 2005, and its changes in financial position 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2006 and 2005, 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.

The Management's Discussion and Analysis presented on pages 3 through 16 are 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 measurement 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 42 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

March 1, 2007

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 total assets of $42.6 million on total operating revenues of $950 million. In fiscal 2006, the System more narrowly defined net revenues available for Rate Management reductions; such that all income and expense not included in other regulatory assets or liabilities are included in the Rate Management calculation resulting in a zero change in net assets.

- During fiscal 2006, the System was a party to certain power purchase contracts with Morgan Stanley. These contracts require the System to pay market rates for the natural gas used to produce such power. As a result, the System established a natural gas hedging program designed to stabilize the cost of its natural gas. This hedging program causes the System to enter into contracts for the future purchase of natural gas at known costs to hedge against market swings in price. As of June 30, 2006, the System had 486 future contracts in place, for a total unrealized loss of $2.7 million, resulting in an average unrealized loss per contract of $5,555. This loss is recoverable through the Variable revenue collected by the System.

- The Department issued the Central Valley Project Water System Revenue Bonds Series AD in July 2005, in the principal amount of $112,390,000 at an average yield on the bonds of 4.36%. The financing included an advance refunding component and a current refunding of the Department's then outstanding Commercial Paper Notes. The Department realized the following benefits: (1) the Department used the issuance of the Series AD bonds to provide debt service savings of approximately $10.7 million to the System from the date of issuance through December 1, 2029 with a net present value of $5.8 million; (2) the Department used proceeds of the issuance and debt service reserves to advance refund $104,750,000 of outstanding Series O, P, S, U, and W Revenue Bonds; and (3) the Department was able to retire $12,414,000, of its outstanding Commercial Paper Notes.

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 revenues, expenses and changes in net assets 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.

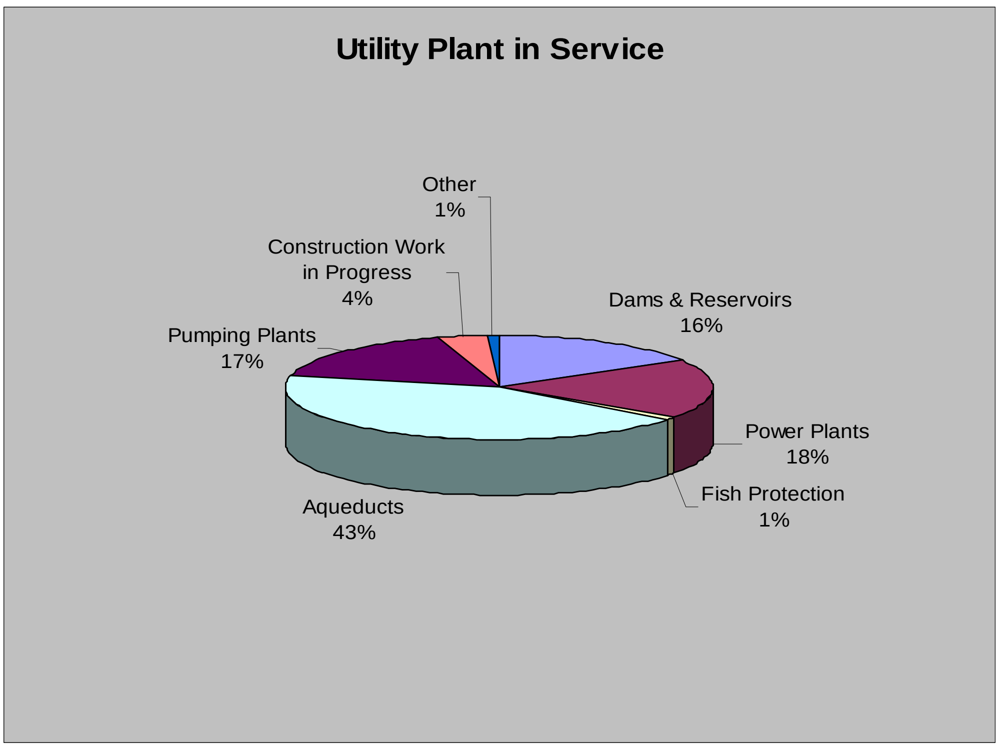
	2006	2005 (in thousands)	2004	%Change 2006-2005	%Change 2005-2004
Condensed Statements of Net Assets					
Total utility plant	$ 3,020,602	$ 2,988,884	$ 3,030,356	1.1%	-1.4%
Other assets	2,002,486	1,991,589	1,993,431	0.5%	-0.1%
Total assets	$ 5,023,088	$ 4,980,473	$ 5,023,787	0.9%	-0.9%
Capitalization:					
Net assets:					
Capital, net of related debt	$ 224,246	$ 210,933	$ 185,676	6.3%	13.6%
Restricted	981,185	994,498	1,000,866	-1.3%	-0.6%
Total net assets	1,205,431	1,205,431	1,186,542	0.0%	1.6%
Total long-term debt	3,081,964	3,065,854	3,135,020	0.5%	-2.2%
Total capitalization	4,287,395	4,271,285	4,321,562	0.4%	-1.2%
Other liabilities	735,693	709,188	702,225	3.7%	1.0%
Total net assets and liabilities	$ 5,023,088	$ 4,980,473	$ 5,023,787	0.9%	-0.9%
Condensed Statements of Revenues, Expenses, and Changes in Net Assets					
Water supply	$ 642,322	$ 630,955	$ 640,417	1.8%	-1.5%
Power sales	291,793	104,521	59,289	179.2%	76.3%
Federal reimbursements	15,576	14,806	14,941	5.2%	-0.9%
Total operating revenues	949,691	750,282	714,647	26.6%	5.0%
Operations and maintenance expense	289,296	324,926	321,060	-11.0%	1.2%
Purchased power	330,665	196,023	174,556	68.7%	12.3%
Depreciation expense	77,980	77,321	77,388	0.9%	-0.1%
Operating expenses recovered (deferred), net	85,742	(19,889)	(14,423)	-531.1%	37.9%
Total operating expenses	783,683	578,381	558,581	35.5%	3.5%
Income from operations	166,008	171,901	156,066	-3.4%	10.1%
Capital expenses (deferred) recovered	(12,884)	-	-	100.0%	0.0%
Interest expense	(150,170)	(152,847)	(167,873)	-1.8%	-9.0%
Other expense	(2,954)	(165)	(4,645)	1690.3%	-96.4%
Increase (decrease) in net assets	-	18,889	(16,452)	-100.0%	-214.8%
Net assets, beginning of year	1,205,431	1,186,542	1,202,994	1.6%	-1.4%
Net assets, end of year	$ 1,205,431	$ 1,205,431	$ 1,186,542	0.0%	1.6%

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 $72 million during fiscal 2006 to a balance of $2,844 million. This is compared to a net decrease in fiscal 2005 of $77 million. While depreciation expense remained relatively constant for the two years at $78 and $77 million respectively, the amount of additions in the current year are $6 million compared to no additions in fiscal 2005. The majority of this difference, or $5 million, relates to the transfer of completed Reid-Gardner improvements from Construction Work in Progress (CWIP). 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 $103 million during the year, which represents a 142% increase over fiscal 2005. In fiscal 2005, Construction work in progress increased by $36 million, or 97% over fiscal 2004. The current year increase is attributable to additions made to new and on-going projects including East Branch Extension Phase II projects of $3.6 million, Reid Gardner projects of $1.7 million, South Bay Aqueduct projects of $7.3 million, the Tehachapi 2nd Afterbay project of $41.2 million, and other Water Systems projects totaling $49.6 million. At June 30, 2006, total construction work in progress was comprised of $8.5 million of East Branch Extension Phase II projects, $6.5 million of Reid-Gardner projects, $18 million for the South Bay aqueduct, $59.8 million of Tehachapi 2nd Afterbay projects, and $83.5 million of Water Systems projects.

Restricted Cash and Investments
Restricted cash and cash equivalents increased by $11 million during fiscal 2006 to a total of $219 million. This compares to a balance of $208 million in fiscal 2005, and $ 202 million in fiscal 2004. The current year change is due in part to a $9 million increase in plant replacement reserves, resulting from reimbursement for Hyatt Power Plant refurbishment costs. In addition, an amount of $4 million was restricted for the margin requirements related to the System's natural gas hedging program. These increases were offset in part by a $1 million decrease in debt service reserves resulting from the refunding activity of Series AD.

For fiscal 2005, the 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 $1.2 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
As required by the Davis-Grunsky Act, the System has made loans to local water agencies of which a long-term portion of $26 million remains outstanding at the end of fiscal 2006 compared to an outstanding balance of $28 million at the end of fiscal 2005, and $32 million at the end of fiscal 2004.
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.

Lastly, during fiscal 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 2006, cash and cash equivalents increased by $69 million to a balance of $295 million. The increase is due in part to a $28 million over-collection of Variable revenue that resulted from stronger than anticipated sales of power generated by the System. The remaining increase is the result of timing differences between cost expenditures and the recovery of such costs. Refer to the Statements of Cash Flows for a detailed summary of cash in-flows and out-flows.

By comparison, in fiscal 2005, cash and equivalents decreased by $44 million to a balance of $226 million. This was primarily due to refund paid to water contractors for Off-Aqueduct Power Facilities and a repayment to the other state funds, plus a an increase in net revenues.

Receivables
In fiscal 2006, water supply and power billings receivable increased from $97 million to $110 million as compared to fiscal 2005. The fiscal 2006 increase is predominately attributable to an increase in Power Sales revenue compared to fiscal 2005. Interest receivable on investments also increased in fiscal 2006 by $2 million to a total of $5 million. This increase is due mainly to the increased State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF) cash balances combined with an increase in SMIF interest rates. During fiscal 2005 Water supply and power billings receivable increased by $10 million. The fiscal 2005 increase is mainly attributable to an increase in power sales revenues, offset in part by a decrease in operating revenues recorded compared to fiscal 2004. Refer to "Operating Revenues" section for a discussion of revenue fluctuations. Interest receivable on investments also increased in fiscal 2005 by $1 million to a total of $3 million, as a result of increased SMIF interest rates.

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 decreased by $87 million to an ending

balance of $1,234 million, as the System collected revenues from the Contractors for previously deferred costs. In fiscal 2005, the System experienced an increase of deferred charges of $31 million related to expenses that hadn't been recovered from the Contractors.

Liabilities

Revenue Bonds

The System has issued 30 series of Water System Revenue Bonds totaling $5,470 million in aggregate principal, of which $2,292 million remains outstanding at the end of fiscal 2006. This compares to outstanding balances of $2,325 million and $2,347 million at the end of fiscal years 2005 and 2004, respectively. During the year, the System completed the issuance of CVP Water Systems Revenue Bond, Series AD totaling $112 million. The majority of the proceeds from the issuance were used to defease portions of the bonds of Series O, P, S, U, and W, while the remainder was used to pay off all outstanding commercial paper as of the date of issuance. The refunding is projected to provide a net present value savings to the System of approximately $6 million.

The System has also issued $139 million of revenue bonds to finance the Devil Canyon – Castaic power facility. Under the Devil Canyon – Castaic bond resolution, $97 million is outstanding as of fiscal 2006, compared to $100 million at Fiscal 2005 and $103 million at fiscal 2004.

	2006	2005	2004
CVP revenue bonds par amount	$ 2,267,160	$ 2,311,741	$ 2,343,880
Unamortized bond issuance premiums/(discounts)	50,023	43,611	23,071
Deferred loss on defeasance	(24,750)	(30,291)	(20,290)
Total CVP revenue bonds outstanding	2,292,433	2,325,061	2,346,661
Devil Canyon - Castaic revenue bond par amount	96,900	100,140	103,195
Total revenue bonds outstanding	2,389,333	2,425,201	2,449,856
Less current maturities	(70,860)	(55,460)	(56,645)
Total long term portion	$ 2,318,473	$ 2,369,741	$ 2,393,211

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 $684 million remains outstanding at the end of fiscal 2006 compared to $731 million at fiscal 2005 and $778 million at fiscal 2004. 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 $115 million at June 30, 2006, compared to $132 million in fiscal 2005, and $106 million in fiscal 2004. The decrease of $17 million in the current year is the payment of due to other State funds with commercial paper proceeds, offset by an overall increase in payments to vendors. In fiscal 2005, timing differences in payments created an increase of $26 million in other current liabilities from fiscal 2004.

Proceeds Due to Water Contractors
Proceeds due to Water Contractors are comprised primarily of the additional 25% billing for revenue bond debt service in excess of debt service requirements (known as "cover"), plus 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 increased by $8 million during fiscal 2006 to an ending balance of $82 million. This increase is due primarily to the collection of $10 million from the Contractors to fund the System's natural gas hedging program.

In fiscal 2005 Proceeds due to Water Contractors decreased by $17 million to $73 million in comparison to $90 million for FY2004. This decrease was the result of a refund made for Off-Aqueduct Power facilities of $37 million, offset in part by additional Off-Aqueduct Power facility refunds accrued of $11 million, plus an accrual for additional Rate Management adjustments of $12 million.

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. Those funds are deferred and then recognized as revenue as the projects are depreciated. Deferred revenue decreased $4 million in fiscal 2006 to $168 million. This compares to a $4 million decrease in fiscal 2005. These decreases represent the recognition of revenue equal to the amount of depreciation recorded.

Capital Credit Due to Water Contractors
The System deferred $13 million of net capital revenues in fiscal 2006. This represents excess capital revenues collected that will be adjusted in future capital billings.

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 both fiscal 2006 and 2005, credits issued through the Delta Water Charge of $18 million were offset in part by $15 million of revenue collected through the Variable charge for power generated at Hyatt-Thermalito for a $3 million decrease in the deferral.

Advances for Plant Replacements
Advances for plant replacements represents amounts collected in advance from the Water Contractors for future plant equipment replacements. In fiscal 2006, advances for plant replacements increased by $13 million to a total of $31 million. This increase was due to a $15 million reimbursement of certain Hyatt-Thermalito refurbishment expenditures, offset in part by $2 million in net uses for replacement projects. In fiscal 2005 additional revenues of $5 million were collected for the replenishment of the Conservation advance account, causing the overall advance amount to increase by $4 million to a total of $18 million.

Statement of Activities

Operating Revenues

Operating revenues for the year were $950 million compared to $750 million in fiscal 2005 and $715 million in fiscal 2004. The increase in fiscal 2006 was primarily due to increased power sales revenue of $187 million plus an increase in water supply revenue of $10 million. The increase in fiscal 2005 was due to increased power sales revenue of $45 million offset in part by a decrease in water supply revenue of $9 million.

Water Supply Revenue

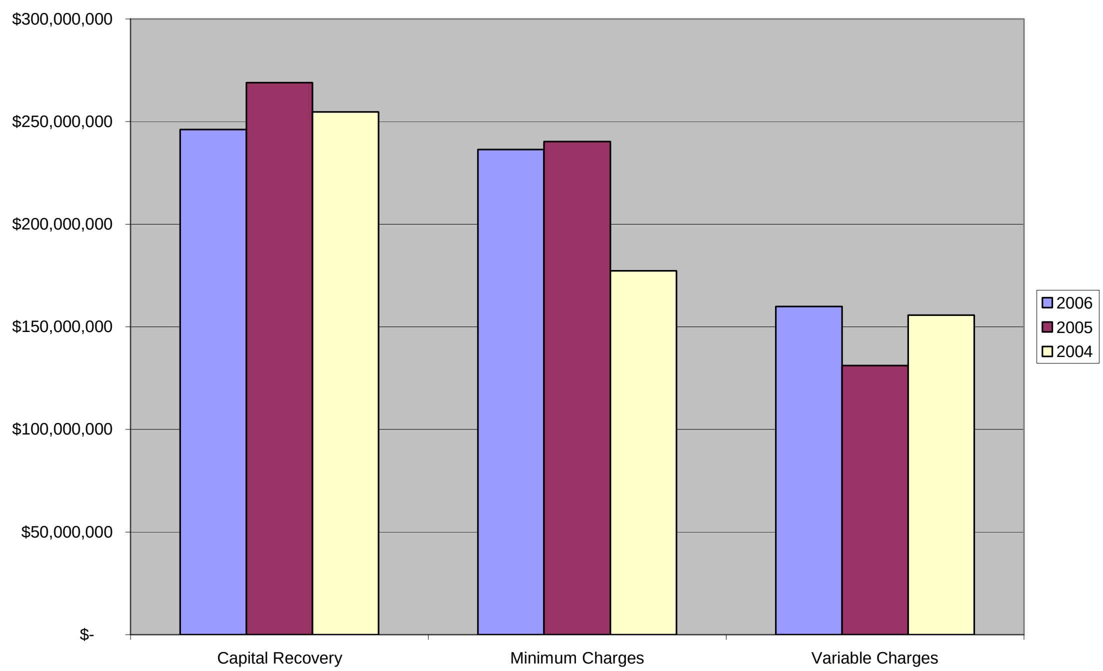
Under the terms of the water supply contracts, the System is required to collect from the Water Contractors all costs of the SWP allocated in proportion to each Contractor's contractual allocation of water. Generally, the System's costs, including the costs of gathering, storing, conveying and delivering 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. Finally, the Variable component of revenue enables the System to recover the net cost of energy used to deliver water to the Water Contractors.

On or before July 1 of each year, the System furnishes each Water Contractor with a statement of estimated charges for the Capital, Minimum, and Variable components for the following calendar year. The Capital components are due on January 1 and July 1 of the year following receipt of the statement of charges. The Minimum and Variable component payments are due in twelve monthly installments commencing on January 1 of the year following receipt of the statement of charges. On or about July 1 of each year, the System determines the rate (per acre-foot) to be charged each Contractor in the following calendar year for the Variable components. The Variable components in such calendar year are calculated and billed monthly based on metered water deliveries for the preceding month and the rate determined on July 1st of each year. However, this rate can be modified over the course of the next year. On July 1 of each year, the System furnishes each Water Contractor with a statement showing the difference between the estimated water charges paid and the actual costs incurred in the prior calendar year. The difference is paid by or credited to each Water Contractor, as applicable, in equal monthly installments commencing on January 1 of the year following the "true-up" calculation. This process results in an approximately two-year delay in the reconciliation of estimated charges paid and actual costs reimbursed to the System.

In 2006, the System generated $642 million in water supply revenue, compared to $631 million in fiscal 2005, and $640 million in fiscal 2004. The table below shows a comparative breakdown of the components of water supply revenue for fiscal years 2006, 2005 and 2004.

Water Revenue Supply



Water Supply Billings increased by $11 million in 2006 to a total of $642 million. This increase is due to several factors. Increases occurred as a result of an over-collection of Variable revenue of $28 million, plus an increase in Minimum revenue of $15 million that was due to fewer credits issued in fiscal 2006 for prior year over-collections. The over-collection of Variable revenue was due primarily to greater than expected power sales, which help to lower the overall cost of power that is billed to the Contractors. These increases were offset in part by decreased capital revenue of $32 million that was mainly the result of increased Rate Management adjustments in the fiscal 2006 compared to fiscal 2005. The increases were also offset by reduced capital charges for the East Branch Enlargement due to reduced principal payments in fiscal 2006.

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 in fiscal 2005 was 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. Of the total deliveries to Southern California Contractors 58% 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.

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 MWh 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 MWh 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.

In fiscal 2006, power sales increased by $187 million to a total of $292 million. Of that increase, $171 million is attributable to increased energy sales, while the remaining $16 million is attributable to increased power transmission sales. In energy sales, while the average rate per MWh sold remained relatively constant at $74 for both fiscal 2005 and fiscal 2006, the System sold 2.3 million more MWh in fiscal 2006 than fiscal 2005.

This increase in MWh sold is attributable to several factors. An exchange contract with Southern California Edison (SCE) that called for the System to provide SCE with up to 575 MWh of on-peak power per day in exchange for up to 1,550 MWh of off-peak power per day expired during 2006. This created up to an additional 208,000 MWh (575MWh x 362 days) of power available for sale in 2006. Second, 2006 was an extremely wet year in terms of rainfall, so the System was able to generate power for sale that was the result of releasing excess water from its reservoirs to maintain proper reservoir levels. Lastly, the System's current power management strategy caused there to be excess power available for sale from the timing differences of projected power needs by month, for which the System made purchase commitments, and the actual power needs in a given month.

The increase in power transmission sales is commensurate with the increase in energy sales.

The system experienced an increase in power sales in fiscal 2005 compared to fiscal 2004 of $45 million for a total of $105 million. This variance though, is due in part to adjustments recorded in fiscal 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 fiscal 2005, the System sold 1,255,034 MWh's at an average rate of $74.61, compared to 837,911 MWh's at an average rate of $70.76 in fiscal 2004. The first table below shows the effect of the rate and volume between fiscal 2006 and fiscal 2005. This can be compared to the second table below for fiscal years 2005 and 2004.

	Total $ Sold	Transmission $ Sold	Power $ Sold	MWh Sold	Rate/MWh
2005	104,521,063	(10,882,930)	93,638,133	1,255,034	$ 74.61
2006	291,792,938	(27,120,286)	264,672,652	3,573,556	$ 74.06

Change in total MWh sold	2,318,522
Multiplied by 2006 rate/MWh	$ 74.06
Difference attributed to increased sales (rounded to nearest thousand)	$ 171,720,000
Change in MWh rate	$ (0.55)
Multiplied by 2005 MWh sold	1,255,034
Difference attributed to rate change (rounded to nearest thousand)	$ (685,000)
Total increase in power sales (rounded to nearest thousand)	$ 171,035,000

	Total $ Sold	Transmission $ Sold	Power $ Sold	MWh Sold	Rate/MWh
2004	59,289,000	-	59,289,000	837,911	$ 70.76
2005	104,521,063	(10,882,930)	93,638,133	1,255,034	$ 74.61

Change in total MWh sold	417,123
Multiplied by 2005 rate/MWh	$ 74.61
Difference attributed to increased sales (rounded to nearest thousand)	$ 31,122,000
Change in MWh rate	$ 3.85
Multiplied by 2004 MWh sold	837,911
Difference attributed to rate change (rounded to nearest thousand)	$ 3,228,000
Total increase in power sales (rounded to nearest thousand)	$ 34,350,000

Federal Reimbursement Revenue

Federal reimbursements revenue for fiscal 2006 was $16 million, compared to $15 million for fiscal years 2005 and 2004. The increase in fiscal 2006 of $1 million is attributable to increased 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

Total operating expenses increased $205 million for the year to a total of $784 million. This increase is due to increases in power purchases of $135 million plus a reduction in deferred expenditures of $106 million, offset in part by decreased operations and maintenance expense of $36million.

Operations and Maintenance Expense

Total operations and maintenance expenses were $289 million, compared to $325 million last year, and $321 million in fiscal 2004. The decrease in fiscal 2006 is due mainly to timing differences in the capitalization of certain construction costs, offset in part by decreased consulting costs compared to prior years, in which the System was investing in information systems related to the management of its power activities. In fiscal 2005, certain increases in coal costs and overhead costs were offset in reductions in maintenance costs.

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.

Power purchases increased $135 million in fiscal 2006 to a total of $331 million. Of that increase, $118 million is attributable to increased energy purchases, while the remaining $17 million is attributable to increased power transmission purchases. For energy purchases, the average rate per MWh purchased increased from $53.71 in fiscal 2005 to $59.35 in fiscal 2006. This rate increase accounted for $18 million of the total increase. The remaining $100 million is attributable to increased MWh's purchased in fiscal 2006 of 1.7 million units.

This increase in units purchased is attributable to several factors. An exchange contract with Southern California Edison that called for the System to provide SCE with up to 575 MWh of on-peak power per day in exchange for up to1, 550 MWh of off-peak power per day expired. This caused the System to purchase up to an additional 560,000 MWh (1,550 MWh x 362 days) of power in fiscal 2006. Second, water deliveries increased in fiscal 2006 by about 12%, from 3.2 million acre-feet to 3.6 million acre-feet, so power purchases increased accordingly. Lastly, the System's current power management strategy resulted in additional purchases to cover timing differences of projected power needs by month, for which the System made purchase commitments, and the actual power needs in a given month. Any excesses created by timing differences were sold by the System in the open market, which contributed to increased power sales in fiscal 2006.

In fiscal 2005, purchased power increased $21 million over fiscal 2004, to a total of $196 million. Of that amount, $28 million is attributed to transmission purchases. The increase is due mainly to increased costs per MWh, offset slightly by decreased MWh's purchased, and a commensurate decrease in transmission purchases.

The tables below show the relationship between volume and rate for fiscal 2006 compared to fiscal 2005, and fiscal 2005 compared to fiscal 2004.

	Total $ Purchased	Transmission Purchased	Power Purchased	MWh Purchased	Rate/MWh
2005	$ 196,023,348	$ (28,339,405)	$ 167,683,943	3,122,290	$ 53.71
2006	$ 330,665,202	$ (45,238,554)	$ 285,426,648	4,808,879	$ 59.35

Change in MWh purchased	1,686,589
Multiplied by 2006 rate	$ 59.35
Difference attributed to decreased purchases (rounded to nearest thousand)	$ 100,106,000
Change in MWh rate	$ 5.65
Multiplied by 2005 purchased	3,122,290
Difference attributed to rate change (rounded to nearest thousand)	$ 17,637,000
Total increase in power purchases (rounded to nearest thousand)	117,743,000

	Total $ Purchased	Transmission Purchased	Power Purchased	MWh Purchased	Rate/MWh
2004	$ 174,556,779	$ (31,405,334)	$ 143,151,000	3,152,000	$ 45.42
2005	$ 196,023,348	$ (28,339,405)	$ 167,683,943	3,122,290	$ 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)	$ 26,129,000
Total increase in power purchases (rounded to nearest thousand)	24,533,000

Capital Revenues Deferred

Capital expenses deferred was $13 million in fiscal 2006. This represents the timing difference between the Rate Management reductions granted to the Water Contractors from estimated available net revenues and actual net revenues.

Operating Expenses Recovered

In fiscal 2006, operating expenses in the amount of $86 million was recovered, compared to operating expenses deferred of $20 million in fiscal 2005 and $14 million in fiscal 2004, respectively. The recovery of expenses previously deferred in fiscal 2006 is due mainly to the over-collection of variable revenue and the decrease in operations and maintenance expenses described above. This activity 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 $150 million, which represents a decrease of $3 million from the prior year. This decrease is due to in part to the decreasing cost of borrowing resulting from the series AD refunding and normal principal payments, offset by increased amortization of deferred losses on bond defeasance.

Interest expense for fiscal 2005 was $153 million, which represents a decrease of $15 million from fiscal 2004. 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 million, compared to $12 million in fiscal 2004.

Other Expense

Other Expense was $3 million in fiscal 2006, compared to a negligible amount in fiscal 2005 and $5 million in fiscal 2004. The changes in this line relate mainly to the changes in the market value of securities held by the System and income earned thereon, offset by the cost of operating the System's recreation facilities.

Change in Net Assets

Overall, for the year ended June 30, 2006, the System recorded no change in net assets. This is reflective of the System's actions in fiscal 2006 to more narrowly define net revenues available for Rate Management reductions; such that all income and expense not included in other regulatory assets or liabilities are included in the Rate Management calculation resulting in a zero change in net assets.

The table below explains the primary sources of the change in net assets.

		2006	2005	2004
Increases:				
Investment income net of refunds to water contractors		$ 6,070,965	$ 7,460,181	$ 1,452,258
Capital revenue in excess of capital costs		40,996,971	31,848,187	7,392,815
Other miscellaneous income (expense)		-	429,327	1,835,787
Total increases		47,067,936	39,737,695	10,680,860
Decreases:				
Rate management credit		(38,645,957)	(12,739,841)	(23,235,084)
Deferred Capital Recovery:				
Reversal of 2005 Deferred Capital Recovery	$ 12,823,100 (a)			
2006 Deferred Capital Recovery	$ (12,884,012)			
Net Deferred Capital Recovery	$ (60,912)	(60,912)		
Recreation costs		(8,036,082)	(8,054,706)	(7,933,189)
Suspended costs		(324,984)	(54,213)	(1,163,355)
Total decreases		(47,067,935)	(20,848,760)	(32,331,628)
One time adjustments:				
Prior year suspended costs, retroactively adjusted		-	-	5,197,225
Total one time adjustments		-	-	5,197,225
Change in net assets		$ 0	$ 18,888,935	$ (16,453,543)

(a) In fiscal 2005, the deferral of Capital Recovery was recorded as a reduction of Water Supply Revenues. In fiscal 2006, a separate line was added to the Statement of Activities for this deferral

State Water Resources Development System
Statements of Net Assets
June 30, 2006 and 2005 (in thousands)

	2006	2005
Assets		
Utility plant:		
Utility plant in service	$ 4,566,362	$ 4,560,047
Less accumulated depreciation	(1,722,093)	(1,644,113)
Net utility plant in service	2,844,269	2,915,934
Construction work in progress	176,333	72,950
Total utility plant	3,020,602	2,988,884
Long-term assets:		
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	29,911	20,917
Cash and investments restricted for debt service	175,621	177,013
Cash and cash equivalents on deposit with revenue bond trustee	10,144	9,844
Cash and cash equivalents on deposit with AG Edwards	3,711	-
Loans receivable from local water agencies	26,403	28,384
Due from other state funds	91,517	91,517
Total long-term assets	337,307	327,675
Current assets:		
Cash and cash equivalents	295,326	226,090
Receivables:		
Interest on investments	5,349	3,060
Water supply and power billings	109,952	96,697
Due from federal government	7,495	7,208
Inventories	13,450	9,953
Other	100	3
Total current assets	431,672	343,011
Deferred charges:		
Amounts recoverable through future billings under long-term water supply contracts:		
Operations and maintenance expense	103,550	169,782
Capital costs	260,756	286,964
Unamortized project costs	384,355	376,566
Unbilled interest earnings on capital costs	484,846	487,591
Total deferred charges	1,233,507	1,320,903
Total assets	$ 5,023,088	$ 4,980,473

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

State Water Resources Development System
Statements of Net Assets, continued
June 30, 2006 and 2005 (in thousands)

	2006	2005
Capitalization and Liabilities		
Capitalization:		
Net assets:		
Capital, net of related debt	$ 224,246	$ 210,933
Restricted	981,185	994,498
Total net assets	1,205,431	1,205,431
Long-term debt, less current maturities:		
General obligation bonds	634,750	683,715
Revenue bonds	2,318,473	2,369,741
Commercial paper	128,741	12,398
Total long-term debt	3,081,964	3,065,854
Total capitalization	4,287,395	4,271,285
Current liabilities:		
Current maturities of bonds	119,825	103,035
Accounts payable	70,124	48,206
Accrued vacation	18,189	12,385
Accrued interest on long-term debt	19,713	20,709
Due to other state funds	7,158	50,639
Proceeds due to water contractors	81,535	73,430
Total current liabilities	316,544	308,404
Deferred credits:		
Deferred revenue - State and Federal capital recovery	168,399	172,484
Capital credit due to water contractors	12,884	-
Power sales credit due to water contractors	207,075	210,261
Advances for plant replacements	30,791	18,039
Total deferred credits	419,149	400,784
Commitments and Contingencies (Note 9)		
Total net assets and liabilities	$ 5,023,088	$ 4,980,473

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, 2006 and 2005 (in thousands)

	2006	2005
Operating revenues:		
Water supply	$ 642,322	$ 630,955
Power sales	291,793	104,521
Federal reimbursements	15,576	14,806
Total operating revenues	949,691	750,282
Operating expenses:		
Operations and maintenance	289,296	324,926
Purchased power	330,665	196,023
Depreciation expense	77,980	77,321
Operating expenses recovered (deferred), principally under long-term water supply contracts, net	85,742	(19,889)
Total operating expenses	783,683	578,381
Income from operations	166,008	171,901
Capital revenues deferred	(12,884)	-
Interest expense	(150,170)	(152,847)
Other expense	(2,954)	(165)
Increase in net assets	-	18,889
Net assets, beginning of year	1,205,431	1,186,542
Net assets, end of year	$ 1,205,431	$ 1,205,431

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, 2006 and 2005 (in thousands)

	2006	2005
Cash flows from operating income:		
Receipts from customers and state and federal governments	$ 967,872	$ 712,327
Payments to employees for services	(185,503)	(183,096)
Payments to suppliers	(450,074)	(312,564)
Net cash provided by operating activities	332,295	216,667
Cash flows from noncapital financing activities:		
Collateral calls under natural gas hedging contracts	(3,711)	-
Other expense	(20,035)	(14,589)
Net cash used in noncapital financing activities	(23,746)	(14,589)
Cash flows from capital and related financing activities:		
Proceeds from issuance of revenue obligation bonds, net of issuance discounts and premiums	116,207	278,647
Principal payments on long-term debt	(199,650)	(349,622)
Commercial paper notes issued	127,008	15,556
Commercial paper notes redeemed	(12,413)	(13,677)
Interest payments on long-term debt	(151,166)	(153,080)
Additions to unamortized project costs	(16,507)	-
Additions to utility plant	(107,950)	(35,881)
Net cash used in capital and related financing activities	(244,471)	(258,057)
Cash flows from investing activities:		
Cash received from investment earnings	17,100	11,092
Payments received on loans receivable from local water agencies	1,981	3,575
Reduction of advance to PG&E	-	1,022
Net cash provided by investing activities	19,081	15,689
Net increase (decrease) in cash and pooled investments	83,159	(40,290)
Cash and cash equivalents at beginning of year	383,001	423,291
Cash and cash equivalents at end of year	$ 466,160	$ 383,001
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	$ 166,008	$ 171,901
Adjustment to reconcile operating income to net cash provided by operations:		
Depreciation expense	77,980	77,321
Increase in deferred charges and credits, net	113,097	(20,559)
Changes in assets and liabilities:		
Increase in receivables	(13,255)	(10,049)
(Increase) decrease in inventories	(3,497)	274
(Increase) decrease in other assets	(384)	833
Increase in accounts payable and accrued vacation	27,722	10,036
(Decrease) increase in due to other state funds	(43,481)	15,998
Increase (decrease) in current proceeds due to Water Contractors	8,105	(29,088)
Total adjustments	166,287	44,766
Net cash provided by operating activities	$ 332,295	$ 216,667

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

For the years ended June 30, 2006 and 2005 (in thousands)

1. Reporting Entity

The State Water Resources Development System (a component unit of the State of California) (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, 2006 and 2005, interest expense of $1,748 and $185, 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 reserve funds held with a major national bank for Series AB of the Water Systems Revenue Bonds.

Of the $10.2 million on deposit with AG Edwards for natural gas hedging activities, $3.7 million is restricted to cover margin requirements.

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, 2006, are of a similar nature as those held at June 30, 2005.

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 $109,952 and $96,697 at June 30, 2006 and 2005, respectively. Additionally, the Federal government owed the System $7,495 and $7,208 at June 30, 2006 and 2005, respectively, related to reimbursement for certain costs related to flood control and jointly owned facilities. The allowance for uncollectible amounts totaled $576 and $1,188 at June 30, 2006 and 2005, respectively. Uncollectible amounts are generally recoverable from the Water Contractors.

Deferred Charges and Credits
The System has the authority to establish the level of rates to recover all System costs, including debt service. As a regulated entity, the System's financial statements are prepared in accordance with SFAS No. 71, "*Accounting for the Effects of Certain Types of Regulation*", which requires that the effects of the rate-making process be recorded in the financial statements. Accordingly, certain expenses and credits, normally reflected in the change in net assets, as incurred, are recognized when included in rates and recovered from, or refunded to customers and the state and federal governments. The System records various regulatory assets and credits to reflect rate-making actions of management.

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 and operations and maintenance costs.

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 earned on un-recovered capital costs are classified as deferred charges until billed under the terms of the water supply contracts. Unbilled interest earned represents 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, 2006 and 2005.

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 capital credit due to the water contractors arises from differences between the Rate Management reductions granted to the Water Contractors from estimated available net revenues and actual net revenues.

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 amortized over time by a credit issued to the Water Contractors through the Delta Water Capital Charge.

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

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 weighted average lives of the new debt or the refunded debt.

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.

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 $38,646 and $12,740 during the years ended June 30, 2006 and 2005, 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 and past un-recovered 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 $42,513 and $41,930 in the years ended June 30, 2006 and 2005, respectively, are recorded as liabilities in the financial statements. The System refunded $41,083 and $45,671 in the years ended June 30, 2006 and 2005, 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 constituted 60% and 64% of total System water supply revenue for the years ended June 30, 2006 and 2005, respectively, and Kern County Water Agency whose System billings constituted 8% for each year ended June 30, 2006 and 2005.

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.

New Accounting Pronouncement

For the year ending June 30, 2006, DWR implemented the provisions of Governmental Accounting Standards Board Statement No. 42 (GASB 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.

GASB 42 did not have a material impact on the financial statements upon implementation.

Future Pronouncements

GASB 45

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 Post-Employment 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.

GASB 49

Effective for the year ending June 30, 2009, the System will be required to implement Governmental Accounting Standards Board Statement No. 49 (GASB 49), *Accounting and Financial Reporting for Pollution Remediation Obligations*. This Statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. The scope of the document excludes pollution prevention or control obligations with respect to current operations, and future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning. If any one of five specified obligating events occurs, the System will be required to estimate the components of expected pollution remediation outlays and determine whether outlays for those components should be accrued as a liability or, if appropriate, capitalized when goods and services are acquired.

3. Interests in Jointly Owned Facilities

At June 30, 2006, the System owned the following undivided interests in jointly owned facilities:

	% Owned by System	System's Share (in thousands) Utility Plant in Service	System's Share (in thousands) Accumulated Depreciation
Reid Gardner Power Plant Unit No. 4	67.8%	$ 332,209	$ 251,759
San Luis joint use facilities	55.0%	$ 255,931	$ 103,654

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 revenues, expenses, and changes in net assets. 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 revenues, expenses, and changes in net assets.

4. Utility Plant

The following activity in utility plant occurred during the years ending June 30, 2006 and 2005:

	Utility Plant in Service			CWIP	Total
	Cost	Accumulated Depreciation	Net Value	Cost	
Beginning 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
Additions	54	(77,980)	(77,926)	109,644	31,718
Transfers	6,261	-	6,261	(6,261)	-
Ending balance, June 30, 2006	$ 4,566,362	$ (1,722,093)	$ 2,844,269	$ 176,333	$ 3,020,602

5. Cash and Investments

At June 30, 2006, the System’s cash deposits, including interest-bearing deposits, included restricted cash and cash equivalents on deposit with certain revenue bond trustee in the amount of $10,144. Of the bank balance, $200 is federally insured and $9,944 is uncollateralized. Also included in the System’s cash deposits are uncollateralized cash and cash equivalents on deposit with a fiscal agent in the amount of $10,255, of which $3,711 is restricted.

For the years ended June 30, 2006 and 2005 (in thousands)

Investment	Maturity	Fair Value 2006	2005
State of California Pooled Money Investment Account - State Money Investment Fund	5.5 months average	$ 445,760	$ 373,158
U.S. Government and Agency Securities	5.75 years average	48,553	50,862
Cash and equivalent on deposit with revenue bond trustee	Liquid	10,144	9,844
Cash with Fiscal Agent	Liquid	10,256	-
Total cash and investments		$ 514,713	$ 433,864

	2006	2005
Reconciliation to combined balance sheet:		
Cash and cash equivalents restricted for plant replacements	$ 29,911	$ 20,917
Cash and investments restricted for debt service	175,621	177,013
Cash and cash equivalents on deposit with revenue bond trustee	10,144	9,844
Cash and cash equivalents	295,326	226,090
Cash with Fiscal Agent	3,711	-
Total cash and investments	$ 514,713	$ 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.

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 discussed in Note 2. 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 3.84% and 2.26% for the years ended June 30, 2006 and 2005, respectively. For the years ended June 30, 2006 and 2005, interest earned on the deposit with PMIA approximated $16,987 and $9,951, 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:

For the years ended June 30, 2006 and 2005 (in thousands)

	2006	2005
Fair value of investments at the beginning of the fiscal year	$ 50,862	$ 48,829
Less: Proceeds of investments matured in fiscal year	-	-
Add: Amortization of discounts	1,026	1,860
Change in fair value of investments during fiscal year	(3,335)	173
Fair value of investments at the end of the fiscal year	$ 48,553	$ 50,862

6. Long-term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2006 and 2005:

	General Obligation Bonds	Revenue Bonds				Commercial Paper	Total Long Term Debt
	Par Amount	Par Amount	Unamortized (Discounts) and Premium	Deferred Loss on Defeasance	Total Revenue Bonds	Par Amount	
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	24,119	(17,544)	278,646	15,553	294,199
Payments/amortization	(46,320)	(307,265)	(3,579)	7,543	(303,301)	(13,674)	(363,295)
Balance at June 30, 2005	731,290	2,411,881	43,611	(30,291)	2,425,201	12,398	3,168,889
Additions	-	112,390	8,569	(4,752)	116,207	128,756	244,963
Payments/amortization	(47,575)	(160,211)	(2,157)	10,293	(152,075)	(12,413)	(212,063)
Balance at June 30, 2006	683,715	2,364,060	50,023	(24,750)	2,389,333	128,741	3,201,789
Less current portion	(48,965)	(70,860)	-	-	(70,860)	-	(119,825)
Total long-term debt	$ 634,750	$2,293,200	$ 50,023	$ (24,750)	$2,318,473	$ 128,741	$3,081,964

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, 2006, 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. 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) 2006	2005
1964	A	0.1-3.6%	2014	$ 31,000	$ 34,500
1964	B&C	.05-3.7%	2015	50,000	55,250
1965	D&E	3.0-3.8%	2016	75,300	81,800
1966	F&G	3.5-4.1%	2017	85,000	91,200
1967	H,J&K	3.0-4.9%	2018	133,700	142,800
1968	L&M	4.0-4.9%	2019	97,200	103,000
1970	N&P	5.0-5.8%	2020	103,000	108,600
1971	Q&R	4.8-5.2%	2021	81,450	85,500
1972	S	5.3-5.5%	2022	22,800	23,840
1991	W	6.0-10.0%	2012	2,700	3,150
1993	X	4.7-4.8%	2024	900	950
1994	Y	6.6-7.1%	2025	665	700
Total General Obligation bond debt outstanding at par				683,715	731,290
Less current maturities				(48,965)	(47,575)
Total Long term General Obligation bond debt outstanding				$ 634,750	$ 683,715

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 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. In the event of a failed auction, the System is not responsible to repurchase the bonds. The average rates for interest and fees for Series AB were 3.02% and 2.01% for the years ended June 30, 2006, and 2005, 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) 2006	2005
Devil Canyon-Castaic Facilities:						
1973	A&B	5.3-6.8%	2023	1983	$ 96,900	$ 100,140
CVP Water System:						
1992	J	5.5-7.0%	2013	2001	108,870	134,160
1996	O	4.8-7.0%	2030	2006	126,160	155,635
1996	P	-	-	-	-	38,210
1997	Q	5.1-6.0%	2027	2007	99,155	103,520
1998	S	4.4-5.0%	2030	2008	117,360	154,500
1998	T	5.0-5.5%	2013	2009	91,465	92,415
1999	U	4.3-5.1%	2030	2009	154,890	161,675
1999	V	6.25%	2025	None	20,580	20,580
2001	W	4.0-5.5%	2030	2012	223,400	231,505
2002	X	3.5-5.5%	2030	2013	154,130	155,545
2003	Y	5.0-5.3%	2026	2013	329,885	329,885
2003	Z	2.0-5.0%	2020	2013	159,600	163,710
2003	AA	5.0%	2024	2013	108,705	108,705
2004	AB	Variable	2030	2004	189,625	189,626
2005	AC	2.8-5.0%	2030	2015	270,945	272,070
2006	AD	3.0-5.0%	2030	2016	112,390	-
	Total revenue bond debt outstanding at par				2,364,060	2,411,881
	Net unamortized bond issuance premiums/discounts				50,023	43,611
	Net deferred gain/loss on defeasance				(24,750)	(30,291)
	Current fiscal maturities				(70,860)	(55,460)
	Total long term bond debt outstanding				$ 2,318,473	$ 2,369,741

For the years ended June 30, 2006 and 2005 (in thousands)

Future Debt Service Requirements
Future principal and interest payment requirements on bonds are as follows at June 30, 2006:

	General Obligation Bonds		Revenue Bonds		
Year	Principal	Interest	Principal	Interest	Total
2007	$ 48,965	$ 29,195	$ 70,860	$ 117,160	$ 266,180
2008	50,355	27,039	75,535	113,314	$ 266,243
2009	52,695	24,806	79,720	109,133	$ 266,354
2010	54,785	22,474	87,245	105,149	$ 269,653
2011	56,375	20,061	91,220	100,478	$ 268,134
2012-2016	285,495	62,915	496,970	425,863	$ 1,271,243
2017-2021	132,955	13,779	541,895	291,130	$ 979,759
2022-2026	2,090	125	544,495	152,303	$ 699,013
2027-2031	-	-	376,120	35,019	$ 411,139
Total	$ 683,715	$ 200,394	$ 2,364,060	$ 1,449,549	$ 4,697,718

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 programs, the System entered into a revolving credit agreement with a commercial bank equal to the authorized amount of commercial paper. At June 30, 2006 and 2005, there were borrowings of $128,741 and $12,398, respectively, outstanding under this program. The weighted average for interest expense approximated 3.23 % and 1.77% for the years ended June 30, 2006, and 2005, respectively. The proceeds from the issuance of commercial paper are restricted to construction costs of certain State water projects, reimbursements 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. Under the Water Supply Contracts in their original form provide for two charges to the Contractor: (a) a Delta Water Charge and (b) a Transportation Charge. These charges are computed so as to return to the State the costs of the facilities necessary to deliver water to the Contractors, including capital costs (with interest) and operation and maintenance costs, and expressly including, in the case of the facilities to be financed with commercial paper and the related Water System Revenue Bonds, debt service and 1.25 debt service coverage requirements to be satisfied from revenues. The Department expects to redeem its commercial paper liability with proceeds of the additional commercial paper draws until the Department issues Water System Revenue Bonds to provide permanent financing for those Water System Projects financed with commercial paper.

7. Debt Refundings

In July 2005, the System issued $112,390 in CVP Water System Revenue Bonds-Series AD with an average yield on the bonds of 4.36%. These bonds were used to defease $104,750 of outstanding bonds, redeem commercial paper borrowings of $12,414, fund capitalized interest of $869, and cover costs of issuance of $1,165. The proceeds of the Series AD 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 AD advance refunding resulted in an accounting loss of approximately $4.7 million for fiscal year 2006, which has been deferred and is being amortized over 17 years. However, the System effectively reduced its aggregate debt service payments by approximately $10.7 million over the next 25 years and obtained an economic gain (difference between the present values of the old and new debt service payments) of $5.8 million.

In January 2005, the System issued $272,070 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 $13,674, fund capitalized interest of $648, and cover costs of issuance of $2,568. 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 is being amortized over ten years. 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.

The total amount of bonds refunded in advance and still outstanding was $298,885 at June 30, 2006.

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.

For the years ended June 30, 2006 and 2005 (in thousands)

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, 2006, was 15.942% and 15.890% for State Miscellaneous Tier 1 and Tier 2, respectively. For the fiscal year ended June 30, 2005, the required employer contribution rate for Tiers 1 and 2 were 17.022% and 13.216%, 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.

Annual Pension Cost

For the years ended June 30, 2006 and 2005, the System's annual pension cost and actual contribution amounted to approximately $16.7 million and $12.3 million, respectively. Annual covered payroll is not available for the System. However the actuarially determined contributions for the years ended June 30, 2006 and 2005, approximated .8% and .8%, respectively, of the total actuarially determined contribution requirements for the State Miscellaneous Category and approximately 14.15% and 15.47%, respectively, of the total System payroll. The required contribution for the 2006 fiscal year was determined as part of the June 30, 2004, 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, 2005, the date of the most recent actuarial valuation, was 29 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, 2004 (date of the actuarial valuation used to determine the required contribution for the year ended June 30, 2006), is as follows:

Three-Year Trend Information

Fiscal Year Ended June 30	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation (NPO)
2004	$ 1,337,430	100%	$ -
2005	$ 1,543,175	100%	$ -
2006	$ 1,447,044	100%	$ -

For the years ended June 30, 2006 and 2005 (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%
2005	48,708,236	58,266,633	9,558,397	84%	8,345,626	115%

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, 2006 and 2005 were approximately $18,078 and $16,161, 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, 2006 and June 30, 2005, approximated $26,340 and $104,137 respectively.

Power Transmission and Purchase
The System has long-term power transmission service contracts requiring future payments of approximately $189,549 over periods ranging from one to 34 years. Payments made under these contracts approximated $17,840 and $27,001 for the years ended June 30, 2006 and 2005, respectively.

For the years ended June 30, 2006 and 2005 (in thousands)

The System has also entered into long-term power purchase contracts requiring future payments of approximately $858,061 over periods ranging from one to 28 years. Payments made under these contracts, excluding payments to the Kings River Conservation District (District) to cover debt service, approximated $75,935 and $55,987 for the years ended June 30, 2006 and 2005, respectively.

The remaining amounts of fixed obligations under the long-term power purchase and transmission contracts as of June 30, 2006, are as follows:

For the year ended:	Fixed Obligation
2007	$ 105,866
2008	105,866
2009	105,866
2010	104,201
2011	79,869
Thereafter	545,942
	$ 1,047,610

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 $16,770 and $10,651 during the years ended June 30, 2006 and 2005, 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, 2006, are as follows:

For the year ended	Fixed Obligation
2007	$ 4,894
2008	4,882
2009	4,885
2010	4,874
2011	4,862
Thereafter	45,326
	$ 69,723

For the years ended June 30, 2006 and 2005 (in thousands)

Market value information for certain power purchase, sale and exchange contracts is required to be disclosed under the provisions of Governmental Accounting Standards Board Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets.* The fair value of these contracts at June 30, 2006 is disclosed below, using forward market prices discounted at the prevailing risk-free interest rate. Except as discussed below, all energy sale, purchase and exchange contracts expire before December 31, 2007. Two purchase contracts expire in 2010 and 2015. The long-term energy purchase contracts involve energy delivered from the Reid Gardner and Pine Flat Power Plants which expire in 2013 and 2034, respectively, and a contract with Metropolitan Water District of Southern California (Metropolitan), one of the Water Contractors, which has no explicit termination date, although either party can terminate the contract with a ten-year notice. As such, the Metropolitan contract was valued out to ten years. Amounts paid to Metropolitan approximated $13 million and $17 million for the years ended June 30, 2006 and 2005, respectively. The value of the long-term energy contracts do not contemplate any reserves to account for the uncertainty of market prices used beyond observable periods.

	Number of Contracts	**Total Capacity (MWh)**	**Fair Value at June 30, 2006**
Energy sales	13	475	$ 8,304
Energy purchases	34	1,400	(2,952)
Energy exchanges	2	210 sales; 191 purchases	6,118
Long-term energy purchases	3	445	158,527
Total			$ 169,997

The System also has entered into transactions to hedge the price of natural gas through bilateral arrangements and has 486 contracts outstanding at June 30, 2006 with a total fair value approximating $(3) million, using forward market prices. Each transaction volume is for 10,000 mmBtu per month. The contracts expire at various times from July 2006 through June 2008.

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-Thermalito Power Plants) 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. Plaintiffs have filed an amended complaint joining two additional contractors and adding several new causes of action. The court has granted the System's motion to bifurcate the trial into liability and damages phases. Discovery is now proceeding. 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 also filed a claim based on its Notice of Contest with the Victim Compensation and Government Claims Board, which the Board denied. The Board’s denial allows the Contractor to file a lawsuit based on the claim. However, the System and the Contractor entered into a tolling agreement which extends the time in which such a lawsuit must be filed until March 31, 2007 to allow the parties to discuss resolving the issues and are currently discussing a further extension of the date specified in the tolling agreement. The System has been reviewing these Notices of Contest and investigating the items raised.

One item that has been determined to have merit, contested the System’s practice since 2000 of charging the Water Contractors for certain financing costs of the recreation and fish and wildlife enhancement portion of facilities financed with Water System Revenue Bonds. The System intends to restate past bills to Water Contractors to credit back approximately $9.5 million, which the System has determined to be the amount of such charges, plus interest. The System also intends to take other actions to provide for the costs of the recreation and fish and wildlife enhancement portion of System facilities with sources other than direct charges to the Water Contractors for such costs. Due to this matter, the System has not refunded commercial paper with a Water Systems Revenue Bond since July 2005. Outstanding commercial paper has reached the maximum level defined. However, construction has not been interrupted. The System is currently funding construction with reserve funds and a $40 million advance from the State of California General Fund received in January 2007. The advance from the General Fund is to be generally repaid within one year, from the proceeds of a pending bond anticipation bond. The bond anticipation bonds will be repaid upon the resolution of this matter and the issuance of a revenue bond. Interest on the advance from the General Fund is calculated at the lesser of the stated PMIA interest rate in effect on the date preceding each appropriation from the General Fund or the average of the annual rate for the three preceding fiscal years.

Although the full impact of these actions remains uncertain, they are not expected to have a material effect on the System’s results of 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 (Claims Board) against the governmental entity sellers, including the System. The claims were denied by the Claims Board in April, 2006. In August DWR and the group of California entities agreed to suspend the running of the statute of limitations through March 1, 2007. Denial of these 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, 2006 and 2005 (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, 2006 and 2005:

	2006			2005		
	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	$ 854,887	$ 2,165,715	$ 3,020,602	$ 884,413	$ 2,104,471	$ 2,988,884
Other assets	1,111,780	459,034	1,570,814	1,169,028	479,550	1,648,578
Current assets	213,497	218,175	431,672	156,320	186,691	343,011
Total assets	$ 2,180,164	$ 2,842,924	$ 5,023,088	$ 2,209,761	$ 2,770,712	$ 4,980,473
Capitalization and Liabilities						
Capitalization:						
Net assets:						
Capital (deficit), net of related debt	$ 462,043	$ (237,797)	$ 224,246	$ 439,475	$ (228,542)	$ 210,933
Restricted	699,859	281,326	981,185	739,000	255,498	994,498
Total net assets	1,161,902	43,529	1,205,431	1,178,475	26,956	1,205,431
Long-term liabilities	634,750	2,447,214	3,081,964	683,715	2,382,139	3,065,854
Total capitalization	1,796,652	2,490,743	4,287,395	1,862,190	2,409,095	4,271,285
Current liabilities	132,762	183,782	316,544	119,271	189,133	308,404
Other liabilities	250,750	168,399	419,149	228,300	172,484	400,784
Total capitalization and liabilities	$ 2,180,164	$ 2,842,924	$ 5,023,088	$ 2,209,761	$ 2,770,712	$ 4,980,473
Condensed Statements of Activities:						
Operating revenues:						
Water supply	$ 409,524	$ 232,798	$ 642,322	$ 399,223	$ 231,732	$ 630,955
Power sales	267,963	23,830	291,793	93,901	10,620	104,521
Federal reimbursements	13,724	1,853	15,576	12,759	2,047	14,806
	691,211	258,481	949,691	505,883	244,399	750,282
Depreciation expense	(28,704)	(49,276)	(77,980)	(23,072)	(54,249)	(77,321)
Other operating expense	(616,752)	(88,951)	(705,703)	(400,866)	(100,194)	(501,060)
Income from operations	45,755	120,254	166,008	81,945	89,956	171,901
Capital expenses (deferred) recovered	(12,884)		(12,884)			
Interest expense	(30,384)	(119,786)	(150,170)	(32,416)	(120,431)	(152,847)
Other (expense) income	(2,486)	(468)	(2,954)	(3,838)	3,673	(165)
Increase (decrease) in net assets	-	-	-	45,691	(26,802)	18,889
Net assets, beginning of year	1,178,475	26,956	1,205,431	1,132,784	53,758	1,186,542
Net assets, end of year	$ 1,178,475	$ 26,956	$ 1,205,431	$ 1,178,475	$ 26,956	$ 1,205,431
Condensed Statements of Cash Flows:						
Net cash provided by (used in):						
Operating activities	$ 138,157	$ 190,427	$ 328,584	$ 61,695	$ 154,972	$ 216,667
Noncapital financing activities	(6,972)	(13,063)	(20,035)	(7,586)	(7,003)	(14,589)
Capital and related financing activities	(78,453)	(166,018)	(244,471)	(81,030)	(177,027)	(258,057)
Investing activities	5,883	13,198	19,081	6,327	9,362	15,689
Net (decrease) increase in cash and cash equivalents	58,615	24,544	83,159	(20,594)	(19,696)	(40,290)
Cash and equivalents, beginning of year	75,785	307,216	383,001	96,379	326,912	423,291
Cash and equivalents, end of year	$ 134,400	$ 331,760	$ 466,160	$ 75,785	$ 307,216	$ 383,001

Supplementary Information

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

Water supply revenues, including $41,513 in refundable proceeds	$ 276,041
Less: Operations and maintenance expense	57,590
Net revenues available for debt service	$ 218,451
Principal and interest for revenue bonds	$ 165,321
Debt service coverage	132.1%

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.