For the years ended June 30, 2007 & 2006

CALIFORNIA

Financial Statements & Supplementary Information

STAE WATER PROJECT

STATE WATER RESOURCES DEVELOPMENT SYSTEM

Arnold Schwarzenegger
Governor, State of California

Michael J. Chrisman
Secretary of Resources, The Resources Agency

Lester A. Snow
Director, Department of Water Resources

DEPARTMENT OF WATER RESOURCES
STATE OF CALIFORNIA

STATE OF CALIFORNIA
Arnold Schwarzenegger, Governor

THE RESOURCES AGENCY
Michael J. Chrisman, Secretary for Resources

DEPARTMENT OF WATER RESOURCES
Lester A. Snow, Director

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The Director of the State of California
Department of Water Resources

Independent Auditor's Report

We have audited the accompanying basic financial statements of the State Water Resources Development System (System), a component unit of the State of California, as of and for the year ended June 30, 2007. 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 audit. The financial statements of the System as of June 30, 2006, were audited by other auditors whose report dated March 1, 2007, expressed an unqualified opinion on those statements.

We conducted our audit 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 from material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2007, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the System's basic financial statements. The supplementary information 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 audit 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.

Macias Gini & O'Connell LLP

Certified Public Accountants

Sacramento, California
January 21, 2008

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 approximately 700 miles of the System has 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 $171 million on total operating revenues of $952 million. This did not cause an increase in net assets as a result of appropriately reflecting the timing differences in the deferral of expenses incurred and the deferral of capital recovery.

- In December 2006, the Water Contractors were notified that work on the Peripheral Canal will remain in the Delta Facilities Peripheral Canal classification but that all other existing projects or facilities presently in the Delta Facilities category not associated with the Peripheral Canal will be reclassified to the California Aqueduct, Delta to Dos Amigos Pumping Plant category for project purpose cost allocations. This change to project purpose cost allocation resulted in a change in recreation allocation to the State of California from 14% to 3.4%. The 10.6% costs allocated to the Water Contractor's will be recovered in the Delta Water Charge from 2007 to 2035 at the completion of the water supply contracts.

- On March 13, 2007, the System issued $250,000,000 in Central Valley Project Bond Anticipation Bonds - Series 2007A for a two year term maturing on March 1, 2009 in a weekly variable interest rate mode. The bonds are tax-exempt and were privately placed. The interest rates for the variable debt from March 13, 2007 to June 30, 2007 ranged from 4.218% to 4.476%. Debt service payments are made semi-annually on June 1 and December 1 and principal is due at maturity. The proceeds of the Series 2007A bonds were used to fund $219,330,778 of System capital projects, fund capitalized interest of $29,137,412, and cover cost of issuance of $315,603 and interest on construction loans of $1,216,207.

- During fiscal 2007, the System was a party to certain power purchasing 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, 2007, the System had 829 future contracts in place, for a total realized loss of $11.2 million for FY2007. This loss is recoverable through the Variable revenue collected by the System.

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, noncapital 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.

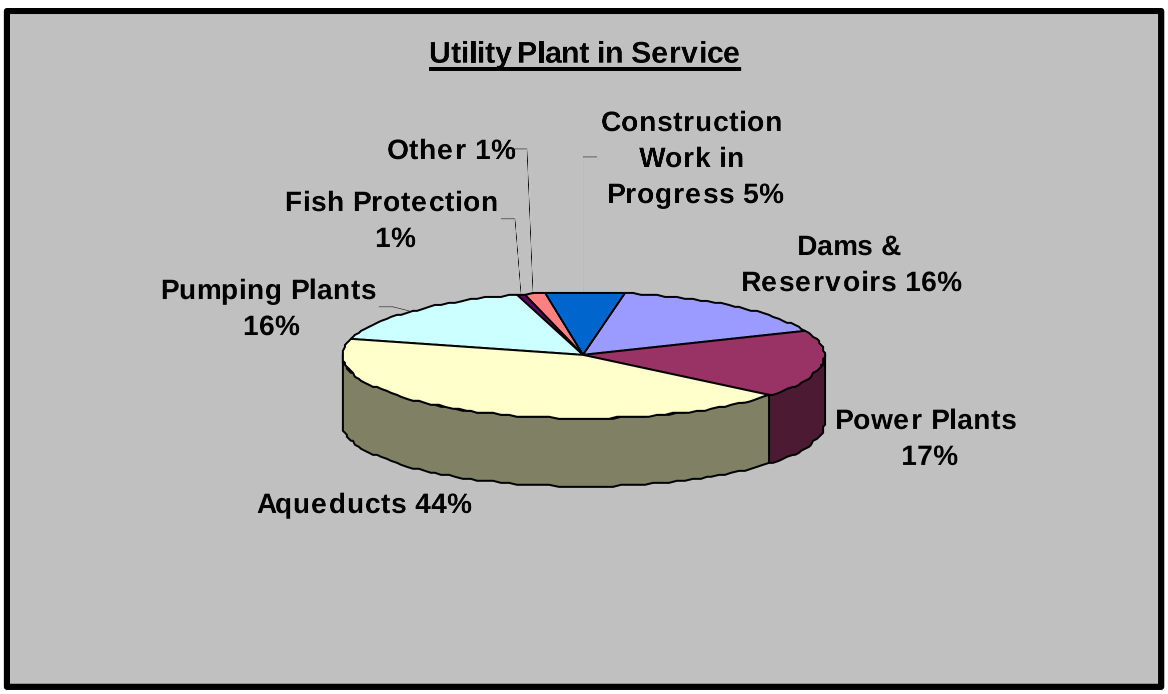
	2007	2006 (in thousands)	2005	%Change 2007-2006	%Change 2006-2005
Condensed Statements of Net Assets					
Total utility plant	$ 3,037,663	$ 3,020,602	$ 2,988,884	0.6%	1.1%
Other assets	2,156,502	2,002,486	1,991,589	7.7%	0.5%
Total assets	$ 5,194,165	$ 5,023,088	$ 4,980,473	3.4%	0.9%
Capitalization:					
Net assets:					
Capital, net of related debt	$ 98,490	$ 224,246	$ 210,933	-56.1%	6.3%
Restricted	1,106,941	981,185	994,498	12.8%	-1.3%
Total net assets	1,205,431	1,205,431	1,205,431	0.0%	0.0%
Total long-term debt	3,210,305	3,081,964	3,065,854	4.2%	0.5%
Total capitalization	4,415,736	4,287,395	4,271,285	3.0%	0.4%
Other liabilities	778,429	735,693	709,188	5.8%	3.7%
Total net assets and liabilities	$ 5,194,165	$ 5,023,088	$ 4,980,473	3.4%	0.9%
Condensed Statements of Revenues, Expenses, and Changes in Net Assets					
Water supply	$ 704,921	$ 642,322	$ 630,955	9.7%	1.8%
Power sales	222,206	291,793	104,521	-23.8%	179.2%
Federal reimbursements	24,463	15,576	14,806	57.1%	5.2%
Total operating revenues	951,590	949,691	750,282	0.2%	26.6%
Operations and maintenance expense	344,464	289,296	324,926	19.1%	-11.0%
Purchased power	374,568	330,665	196,023	13.3%	68.7%
Depreciation expense	78,065	77,980	77,321	0.1%	0.9%
Operating expenses (deferred) recovered, net	(24,972)	85,742	(19,889)	-129.1%	-531.1%
Total operating expenses	772,125	783,683	578,381	-1.5%	35.5%
Income from operations	179,465	166,008	171,901	8.1%	-3.4%
Capital expenses (deferred) recovered	4,377	(12,884)	-	-134.0%	0.0%
Interest expense	(151,746)	(150,170)	(152,847)	1.0%	-1.8%
Other (expense) income	(32,096)	(2,954)	(165)	986.5%	1690.3%
Increase (decrease) in net assets	-	-	18,889	0.0%	-100.0%
Net assets, beginning of year	1,205,431	1,205,431	1,186,542	0.0%	1.6%
Net assets, end of year	$ 1,205,431	$ 1,205,431	$ 1,205,431	0.0%	0.0%

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 33 storage facilities, 20 pumping plants, four generating plants, ten power plants, as well as fish protection facilities and aqueducts.

Utility plant in service, net of accumulated depreciation (UPIS) decreased by $60 million during fiscal 2007 to a balance of $2,785 million. This is compared to a net decrease in fiscal 2006 of $72 million. While depreciation expense remained constant for the two years at $78 million, the amount of additions in the current year was $18.3 million compared to a $6 million increase in 2006. Prior to FY2007, the System's equipment was fully depreciated within a month following the capitalization date resulting in a zero book value for equipment reported within UPIS. Equipment is now depreciated over the life of the asset increasing UPIS by the net book value of $3.1 million. In addition, a credit of $15.2 million was reclassified from UPIS to deferred operations and maintenance expense to appropriately match operational revenues resulting from the sales of assets with operational expenses. 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 $76.8 million during the year, which represents a 43.56% increase over fiscal 2006. In fiscal 2006, construction work in progress increased by $103.4 million, or 142% over fiscal 2005. The current year increase is attributable to additions made to new and on-going projects including East Branch Extension Phase II projects of $2.8 million, Reid Gardner projects in the amount of $3.4 million, South Bay Aqueduct projects of

$20.2 million, the Tehachapi 2nd Afterbay project of $13.4 million, and other Water Systems projects totaling $37 million. The increase in fiscal 2006 from fiscal 2005 was attributable to additions made to new and on-going projects including the 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, 2007, total construction work in progress was comprised of $11.2 million of East Branch Extension Phase II projects, $8.7 million of Reid Gardner projects, $39.3 million for the South Bay aqueduct, $73.3 million of Tehachapi 2nd Afterbay projects, and $120.50 million of Water Systems projects.

Restricted Cash and Investments
Restricted cash and cash equivalents increased by $1.3 million during fiscal 2007 to a total of $220.6 million. This compares to a balance of $219.3 million in fiscal 2006, and $207.7 million in fiscal 2005. The current year change is due in part to a $2.8 million increase in plant replacement reserves, resulting from reimbursement from the variable revenues for Hyatt powerplant refurbishment costs. This increase was offset by a $2.9 million reduction in the amount restricted for debt service. In addition to annual principal payments reducing outstanding Revenue Bond debt, the System did not issue additional Revenue Bonds in FY2007 resulting in a reduction in the amount restricted for debt service. The FY2007 increase is the result of an additional $1.5 million restricted for the margin requirements related to the System's natural gas hedging program for a total of $5.2 million compared to FY2006 of $3.7 million.

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 $25.9 million remains outstanding at the end of fiscal 2007 compared to an outstanding balance of $26.4 million at the end of fiscal 2006, and $28.3 million at the end of fiscal 2005. Due From Other State Funds represents the System's advance of $92 million to DWR's internal service fund, this functions as a revolving working capital facility for DWR.

Cash and Cash Equivalents
In fiscal 2007, cash and cash equivalents increased by $96 million to a balance of $391 million. The increase is mainly due to the issuance of the Bond Anticipation Bonds (BAB), Series A for $250 million. The bond proceeds are to finance future construction costs from March 2007 to March 2009 allowing the System to continue construction until the Revenue Bond Program resumes activities. As of June 30, 2007, the Construction Fund had $172 million in bond proceeds invested in SMIF for future construction. The Bond Fund had a $76 million decrease in SMIF investments resulting from a $20 million credit to the Water Contractors for the 2005 over collection of transportation minimum revenues. In addition, an under collection in 2007 of $20 million in Transportation minimum revenues, an estimated $8-$10 million under collection of transportation variable revenues and a decrease of $10 million in the Revenue Fund resulting from a debt service reserve over collection refund to the Water Contractors, has contributed to the net increase of $96 million in SMIF investments for FY2007.

Receivables
In fiscal 2007, water supply and power billings receivable increased from $110 million to $151 million as compared to fiscal 2006. The fiscal 2007 increase of $41 million is mainly attributable to the increase in uncollected variable revenue invoices of $36.5 million at year-end resulting from the late issuance of the Water Contractors 2007 Statement of Charges (SOC) Rebill. The

SOC Rebill was completed in April of 2007. The variable billings are due 30 days from the date of billing with a 30 day grace period contributing to the increase in variable billing receivables. In addition, Power Sales receivables increased by $7.5 million compared to 2006 and transportation minimum receivables decreased by $3 million compared to fiscal 2006.

Deferred Charges

Deferred charges represent timing differences between expenses incurred by the System and their ultimate recovery from the Water Contractors. Expense recognition is expected to match recovery from the Water Contractors in the future. In total, deferred charges increased by $6 million to an ending balance of $1,240 million compared to $1,234 million for 2006, as the System defers expenses to be recovered from future revenues from the Water Contractors. In fiscal 2006, the System experienced a decrease of deferred charges of $87 million, as the System collected revenues from the Water Contractors for previously deferred costs.

Liabilities

Revenue Bonds

The System has issued 30 series of Water System Revenue Bonds totaling $5,720 million in the aggregate principal, of which $2,475 million remains outstanding at the end of fiscal 2007. This compares to outstanding balance of $2,292 million and $2,325 at the end of fiscal year 2006 and 2005, respectively. During the year, the System completed the issuance of CVP Water Systems Revenue Bond, Bond Anticipation Bonds of $250 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, $93 million is outstanding at the end of fiscal 2007, compared to $97 million at fiscal 2006 and $100 million at fiscal 2005.

	2007	2006	2005
CVP revenue bonds par amount	$ 2,449,735	$ 2,267,160	$ 2,311,741
Unamortized bond issuance premiums/(discounts)	46,025	50,023	43,611
Deferred loss on defeasance	(21,142)	(24,750)	(30,291)
Total CVP revenue bonds outstanding	2,474,618	2,292,433	2,325,061
Devil Canyon - Castaic revenue bond par amount	93,465	96,900	100,140
Total revenue bonds outstanding	2,568,083	2,389,333	2,425,201
Less current maturities	(75,535)	(70,860)	(55,460)
Total long term portion	$ 2,492,548	$ 2,318,473	$ 2,369,741

General Obligation Bonds

In addition to the revenue bond obligation 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 $635 million remains outstanding at the end of fiscal 2007 compared to $684 million at fiscal 2006 and $731 for fiscal 2005. 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 $147 million at June 30, 2007, compared to $115 million in fiscal 2006, and $132 million in fiscal 2005. The increase of $32 million in the current year represents an overall increase in expenses and a timing difference in the transfer of cash settlements with the DWR's Internal Service Fund. In fiscal 2006, the $17 million decrease was due in part to the reclassification of expenses to capitalized cost and the issuance of commercial paper for payment of those cost reducing the liability to other State funds, offset by an overall increase in payments to vendors.

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 $18 million during fiscal 2007 to an ending balance of $99 million. This increase is due to the collection of an additional $10 million in fiscal 2007 from the Water Contractors to increase the working capital for the System's natural gas hedging program. In addition, $8 million in proceeds from the bond sales were set aside in a capitalized interest account for Series AB totaling $5.9 million and Series AB totaling $2.1 million. This $8 million set aside was not used to make final interest payments on bond series and will be refunded to the Water Contractors.

In fiscal 2006 Proceeds Due to Water Contractors increased by $8 million to $82 million in comparison to $73 million for fiscal 2005. The increase was the result of the collection of $10 million from the Water Contractors to fund the System's natural gas hedging program.

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 $2 million in fiscal 2007 to $166 million. This compares to $4 million decrease in fiscal 2006. These decreases represent the recognition of revenue equal to the amount of depreciation recorded.

Deferred Capital Credits Due to Water Contractors
The System deferred $8.5 million of capital revenues in fiscal 2007 compared to $12.8 million in fiscal 2006. This represents excess capital revenues collected that will be adjusted in future capital billings, the decrease in fiscal 2007 is due to the reduction of Fourth Priority funds available in fiscal 2007.

Deferred Power Sales Credit Due to Water Contractors
The deferred power sales credit results from a timing difference of revenue collected from certain Water Contractors for power generated by the Hyatt-Thermalito power plant and the corresponding credit that is issued to all Water Contractors through a reduced capital charge. In fiscal 2007 and 2006, the credits issued through the Delta Water Charge of $17.9 million were offset in part by the $14.7 million of revenue collected through the Variable charge for power

generated at Hyatt-Thermalito for a $3.3 million decrease in the deferral for 2007 and 2006 fiscal years.

Advances for Plant Replacements

Advances for plant replacements represents amounts collected in advance from the Water Contractors for future plant equipment replacements. In fiscal 2007, advances for plant replacements decreased by $3 million to a total of $27.7 million. The decrease is due to an increase in expenses of $9.4 million, offset in part by a decrease in revenues of $6.5 million resulting in the $3 million decrease in deferred Replacement revenues. In fiscal 2007 a change was made for the collection of the costs for Hyatt-Thermalito power plant. It was determined that the costs would be collected through the Variable revenue component rather then the Replacement revenue component resulting in a decrease of Replacement revenues for 2007.

Operating Revenues

Operating revenues for fiscal 2007 were $952 million compared to $950 million in fiscal 2006 and $750 million in fiscal 2005. The increase in fiscal 2007 was primarily due to a decrease in power sales revenue of $69.6 million with offsetting increases in water supply revenue of $62.6 million and federal reimbursements of $8.9 million. The $200 million increase in fiscal 2006 was primarily due to increased power sales revenue of $187 million plus an increase in water supply revenue of $11 million.

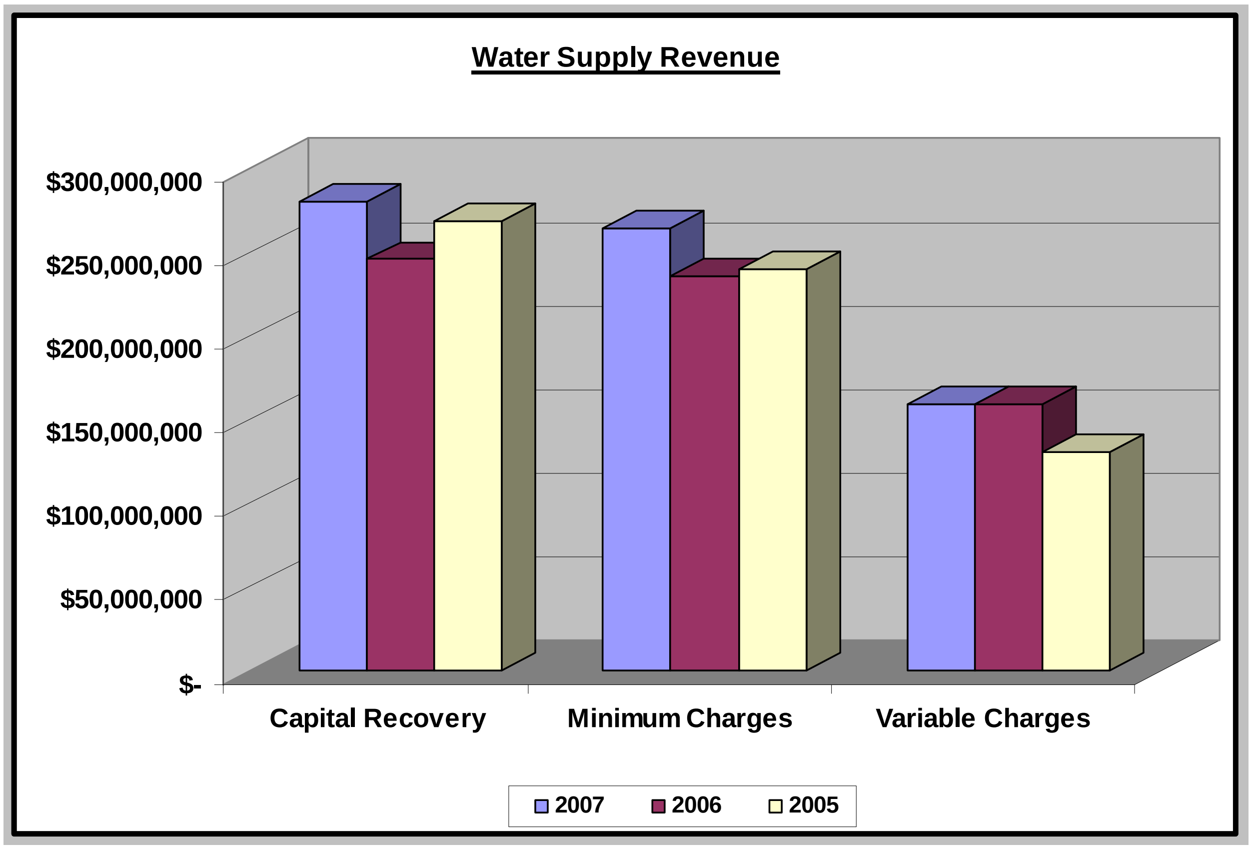
Water Supply Revenue

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

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

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 to each Water 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 2007, the System generated $705 million in water supply revenue, compared to $642 million in fiscal 2006, and $631 million in fiscal 2005. The table below shows a comparative breakdown of the components of water supply revenue for fiscal years 2007, 2006 and 2005.



Water Supply Billings increased by $62.5 million in 2007 to a total of $705 million. This increase is due to several factors. Reducing Rate Management Credits by $26.2 million contributed to the increase of $33.8 million in Capital recovery revenues. Further construction on the East Branch Enlargement Project has further increased Capital recovery revenues by $6.8 million. Transportation and Conservation Capital revenues had a minor increase of $1 million. In addition, Operating & Maintenance (O&M) recovery revenues increased by $30.9 million resulting from an increase in operating expenses of $24.9 million and a $6 million decrease in over collection credits. An additional $5.8 million in water supply revenue was offset by $7.9 million decreases in Replacement revenues as a result of the Hyatt Facilities cost recovery classification change from Replacement revenues to Variable Power revenues.

In fiscal 2006, Water Supply Billings increased by $11 million to a total of $642 million. There were several contributing 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 Water 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.

Overview of the System's Power Activities

The SWP is one of the largest consumers and suppliers of electric power in the western United States. Since the commencement of the major facilities of the SWP in the 1960s, the System has been an active participant in the power markets of California and the western United States. The System has provided for the financing, construction and operation of a variety of power projects including hydroelectric, geothermal and coal-fired electric generating facilities and facilities to transmit electric energy. The System currently owns nine power plants with a total nameplate capacity of approximately 1,770 Mw and with total annual generation of approximately 4,000 to 6,000 Gwh. The System also owns approximately 17 pumping plants with a total load, when operational, of approximately 1,200 Mw and with total annual consumption of 4,000 to 9,000 Gwh. Typically, the majority of generation is during the on-peak hours; however, ancillary services are provided in all hours of the day.

On a daily basis there will be mitigating factors such as outages on units, plants and transmission lines that impacts the System's power resources necessary for the movement of water. The majority of outages whether scheduled or not, do not have a tremendous impact on annual sales and purchases. In FY 2005, the largest impact to the SWP was the ending of the Edison contract at the end of 2004. This created a change in DWR's philosophy and power operations transitioned into increased use of term contracts and day-ahead and hour-ahead energy trading. The event that had the most impact to power transactions from FY2006 to FY2007 was simply the weather. These extremes in weather conditions during 2006 and 2007 were highly unusual and were financially felt by the SWP.

In October of 2005 the rainy season usually begins and ends around March 2006. Unfortunately the rainy season pushed through April, May and into June. Then the heat wave hit in July of 2006. Rain this late in the season is very rare and forced DWR to generate more power due to excess water. In 2007 the weather was dramatically different. The rainy season began around October and lasted through December 2006, then it stopped. No rain was reported in January in the Sacramento area. Some rain fell in February, but no significant rain fell from March through June. Therefore, FY2006 was a very wet year followed by FY 2007 that was extremely dry. This severe change in weather impacted the System's power operations, water management, and water deliveries. The weather over the past two years has had the greatest impact on overall power sales and purchases.

Power Sales

As mentioned previously, the System employs a strategy to run its pumping plants as much as possible during off-peak hours, when energy prices are generally lower, and generate energy during on-peak hours, when prices are generally higher. However, in any given year, a combination of factors, including environmental constraints, 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 2007, power sales decreased by $70 million to a total of $222 million. Of that decrease, $97 million is attributable to decreased energy sales offset by an increase in the average Mwh rate resulting in $27 million in increased power sales revenues while changes in transmission remained flat. In energy sales, while the average rate per Mwh sold increased by 10% from $74.06 to $81.49, the System sold 33% or 1.2 million less units in fiscal 2007 than fiscal 2006.

From January through April 2006, the approximate power sales were $88 million. As compared to the same period of 2007 which showed approximate power sales of $35 million, about 40% of 2006 revenue. The reason for this high 2006 revenue was high precipitation, forcing DWR to keep generation high at the Oroville complex to minimize controlled releases from the dam. During periods of heavy rain, DWR is generating power at the Oroville-Thermalito power plant to help with water elevation control resulting in power sales. The actual energy sold during the four month period was approximately 1640 Gwh for 2006, and during 2007 the approximate energy sold was 625 Gwh, about 40% of 2006. With very little precipitation in 2007, there was a limited supply of water available to generate power to sell in the market. In addition, during 2006 when DWR was in spill conditions at the Oroville dam and energy was abundant, prices tend to fall also impacting revenue.

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 units in fiscal 2006 than fiscal 2005. The first table below shows the effect of the rate and volume between fiscal 2007 and fiscal 2006. This can be compared to the second table below for fiscal years 2006 and 2005.

	Total Sold	Transmission Sold	Sold	MWh Sold	Rate/MWh
2006	$ 291,792,938	$ (27,120,286)	$ 264,672,652	3,573,556	$ 74.06
2007	222,205,762	(27,619,792)	194,585,970	2,387,758	81.49
Change in total MWh sold					(1,185,798)
Multiplied by 2007 rate/MWh					$ 81.49
Difference attributed to decreases sales					$ (96,634,000)
Change in MWh rate					$ 7.43
Multiplied by 2006 MWh sold					3,573,556
Difference attributed to rate change					$ 26,548,000
Total decrease in power sales					$ (70,086,000)

	Total Sold	Transmission Sold	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	$ 171,720,000
Change in MWh rate	$ (0.55)
Multiplied by 2005 MWh sold	1,255,034
Difference attributed to rate change	$ (685,000)
Total increase in power sales	$ 171,035,000

Federal Reimbursements Revenue

Federal reimbursements revenue for fiscal 2007 was $24 million, compared to $16 million and $15 million for fiscal years 2006 and 2005. The increase in fiscal 2007 of $9 million is attributable to an adjusting entry of $7.6 million for operating revenue accruals. The remaining $1.3 million is due to an increase in expenses 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 decreased by $11 million for 2007 to a total of $772 million. The decrease is due to an increase in deferred expenses of $111 million represented by a $25 million expense deferral in 2007 and recognition of expense in 2006 of $86 million. The increase in deferred expense of $111 million is offset by the increase in power purchases of $44 million and operations and maintenance of $55 million resulting in a net change of $11 million.

Operations and Maintenance Expense

Total operations and maintenance expenses were $344 million for fiscal 2007, compared to $289 million for fiscal 2006 and $325 for fiscal 2005. The increase in fiscal 2007 is attributable to several factors. Salaries increased in fiscal 2007 by $21 million with a corresponding increase in overhead of $7 million due in part to the pay increases effective in fiscal 2007. In addition, the increase in operating costs of $11 million at the Reid Gardner power facility compared to fiscal 2006, also contributed to the overall increase of $55 million for 2007.

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 $44 million in fiscal 2007 to a total of $375 million. Of that increase, $46 million is attributable to increased Mwh's purchased in fiscal 2007 of 774 thousand units while changes in transmission remained flat. In energy purchases, the average rate per Mwh purchased decreased from $59.35 in fiscal 2006 to $58.99 in fiscal 2007 resulting in a decrease of $2 million in power purchases expense.

Power purchases are equally impacted by weather. From January through April 2006 the approximate power purchases were 1178 Gwh and during 2007 for the same period, there were approximate purchases of 1722 Gwh. The difference in 2006 can be attributed to the Water Contractors being inundated with rain resulting in a decrease in the demand on the System to deliver water. In comparison, the same period in 2007, there was very little precipitation and the temperatures were relatively warm. DWR increased power purchases to move water to respond to the higher than normal water demand. In addition, there is a corresponding decrease in abundant energy driving energy prices higher. Energy cost during the 2006 period was approximately $66 million as opposed to the 2007 energy costs of $95 million.

In fiscal 2006, purchased power increased $135 million over fiscal 2005 to a total of $331 million. Of that amount, $100 million is attributed to increased power costs, $17 million is attributed to transmission purchases, and an increase of $18 million due to an increase in the average rate per Mwh purchased.

The tables below show the relationship between volume and rate for fiscal 2007 compared to fiscal 2006, and fiscal 2006 compared to fiscal 2005.

	Total Purchased	Transmission Purchased	Power Purchased	MWh Purchased	Rate/MWh
2006	$ 330,665,202	$ (45,238,555)	$ 285,426,648	4,808,879	$ 59.35
2007	374,568,387	(45,244,343)	329,324,044	5,582,482	58.99
Change in MWh purchased					773,603
Multiplied by 2007 rate					$ 58.99
Difference attributed to increased purchases					$ 45,637,000
Change in MWh rate					$ (0.36)
Multiplied by 2006 purchased					4,808,879
Difference attributed to rate change					$ (1,739,000)
Total increase in power purchases					43,898,000

	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	(45,238,555)	285,426,648	4,808,879	59.35

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

Capital Revenues Recovered (Deferred)

Capital revenues recovered (deferred) represents the timing difference between net capital revenue recovered, and certain operating costs incurred. Capital revenues recovered (deferred) increased by $17.2 million in 2007 to a total of $4.4 million in capital revenues recovered from the Water Contracts as the System recognizes prior year capital revenues to cover current year Fourth Priority capital costs, compared to a $13 million revenue deferral in fiscal 2006.

Operating Expenses Recovered (Deferred)

In fiscal 2007, $25 million in operating expenses were deferred, compared to fiscal 2006 in which the System recognized $85 million in operating expenses. In fiscal 2005, the System deferred $20 million in operating expenses. The 2007 net change of $110 million is the result of an increase in deferred depreciation of $4.8 million, an increase in deferred operation and maintenance expense of $9 million and unamortized projects amortization increased marginally from $8.7 million in fiscal 2006 to $9.2 million in fiscal 2007. Due to the change in the recreation allocation from 14% to 3.4% for projects or facilities presently in the Delta Facilities category not associated with the Peripheral Canal, unbilled interest earnings on conservation capital facilities had a significant increase of $30 million. Also, in fiscal 2006 a prior year adjustment of $107 million was included in the $88 million reported and the first recorded deferral of capital credits of $12.8 million was posted. The adjustment was a one time audit adjustment for activities representing timing differences between expenses made by the System and their eventual recovery from the Water Contractors. The capital recovery is no longer reported on this line and is reported as Capital Credit Due to Water Contractors.

Interest Expense

Interest expense for fiscal 2007 was $152 million, which represents an increase of $2 million from the prior year. The increase of $2 million is due in part to the $1.2 million in interest expense incurred on interim financing secured until the Bond Anticipation Bonds (BAB) could be issued and BAB administration fees of $316 thousand.

Interest expense for fiscal 2006 was $150 million, which represents a decrease of $3 million from fiscal 2005. This decrease is due to in part to the decreasing debt portfolio that results from annual principal payments, offset by increased amortization of deferred losses on bond defeasance.

Other Expenses

Other expenses was $32 million in fiscal 2007, compared to $3 million in fiscal 2006 and a negligible amount in fiscal 2005. The $28 million increase is the result of a refund to the Water Contractor's for $52.4 million in 2007 offset by an increase in investment earnings of $5.4 million, an increase in SMIF interest earnings of $14.9 million and a decrease in market value of $3.4 million on Fannie Mae investments held in the Revenue Fund.

Change in Net Assets

Overall, the System recorded no change in net assets. This is reflective of the System's operations where revenue is billed at a rate to be sufficient to recover all the costs of operating the System.

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

	2007	2006	2005
Increases:			
Investment income net of refunds to water contractors	$ 12,193,924	$ 6,070,965	$ 7,460,181
Capital revenue in excess of capital costs	6,761,111	40,996,971	31,848,187
Other miscellaneous income (expense)	-	-	429,327
Total increases	18,955,035	47,067,936	39,737,695
Decreases:			
Rate management credit	(12,363,621)	(38,645,957)	(12,739,841)
Deferred Capital Recovery	4,376,971	(60,912)	-
Recreation costs	(10,564,898)	(8,036,082)	(8,054,706)
Suspended costs	(403,488)	(324,984)	(54,213)
Total decreases	(18,955,036)	(47,067,935)	(20,848,760)
One time adjustments:			
Prior year suspended costs, retroactively adjusted	-	-	-
Total one time adjustments	-	-	-
TOTAL Change in net assets	**$ -**	**$ -**	**$ 18,888,935**

State Water Resources Development System
Statements of Net Assets
June 30, 2007 and 2006 (in thousands)

	2007	2006
Assets		
Utility plant:		
Utility plant in service	$ 4,584,669	$ 4,566,362
Less accumulated depreciation	(1,800,158)	(1,722,093)
Net utility plant in service	2,784,511	2,844,269
Construction work in progress	253,152	176,333
Total utility plant	3,037,663	3,020,602
Long-term assets:		
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	32,729	29,911
Cash and investments restricted for debt service	172,663	175,621
Cash and cash equivalents on deposit with revenue bond trustee	9,977	10,144
Cash and cash equivalents on deposit with AG Edwards	5,292	3,711
Loans receivable from local water agencies	25,928	26,403
Due from other state funds	91,517	91,517
Total long-term assets	338,106	337,307
Current assets:		
Cash and cash equivalents	391,517	295,326
Receivables:		
Interest on investments	8,224	5,349
Water supply and power billings	151,009	109,952
Due from federal government	15,381	7,495
Due from other state funds	6	-
Inventories	12,606	13,450
Other	-	100
Total current assets	578,743	431,672
Deferred charges:		
Amounts recoverable through future billings under long-term water supply contracts:		
Operations and maintenance expense	122,204	103,550
Capital costs	229,687	260,756
Unamortized project costs	375,109	384,355
Unbilled interest earnings on capital costs	512,653	484,846
Total deferred charges	1,239,653	1,233,507
Total assets	$ 5,194,165	$ 5,023,088

State Water Resources Development System
Statements of Net Assets (continued)
June 30, 2007 and 2006 (in thousands)

	2007	2006
Capitalization and Liabilities		
Capitalization:		
Net assets:		
Capital, net of related debt	$ 98,490	$ 224,246
Restricted	1,106,941	981,185
Total net assets	1,205,431	1,205,431
Long-term debt, less current maturities:		
General obligation bonds	584,395	634,750
Revenue bonds	2,492,548	2,318,473
Commercial paper	133,362	128,741
Total long-term debt	3,210,305	3,081,964
Total capitalization	4,415,736	4,287,395
Current liabilities:		
Current maturities of bonds	125,890	119,825
Accounts payable	108,163	70,124
Accrued vacation	19,666	18,189
Accrued interest on long-term debt	19,278	19,713
Due to other state funds	-	7,158
Proceeds due to water contractors	99,462	81,535
Total current liabilities	372,459	316,544
Deferred credits:		
Deferred revenue - State and Federal capital recovery	166,020	168,399
Capital credit due to water contractors	8,507	12,884
Power sales credit due to water contractors	203,730	207,075
Advances for plant replacements	27,713	30,791
Total deferred credits	405,970	419,149
Total net assets and liabilities	$ 5,194,165	$ 5,023,088

State Water Resources Development System
Statements of Revenues, Expenses, and Changes in Net Assets
For the years ended June 30, 2007 and 2006 (in thousands)

	2007	2006
Operating revenues:		
Water supply	$ 704,921	$ 642,322
Power sales	222,206	291,793
Federal reimbursements	24,463	15,576
Total operating revenues	951,590	949,691
Operating expenses:		
Operations and maintenance	344,464	289,296
Purchased power	374,568	330,665
Depreciation expense	78,065	77,980
Operating expenses recovered (deferred), principally under long-term water supply contracts, net	(24,972)	85,742
Total operating expenses	772,125	783,683
Income from operations	179,465	166,008
Nonoperating revenue/expenses:		
Capital revenues recovered (deferred)	4,377	(12,884)
Interest expense	(151,746)	(150,170)
Other expenses	(32,096)	(2,954)
Change in net assets	-	-
Net assets, beginning of year	1,205,431	1,205,431
Net assets, end of year	$ 1,205,431	$ 1,205,431

State Water Resources Development System
Statements of Cash Flows
For the years ended June 30, 2007 and 2006 (in thousands)

	2007	2006
Cash flows from operating activities:		
Receipts from customers	$ 946,659	$ 967,872
Payments to employees for services	(203,021)	(185,503)
Payments to suppliers	(494,782)	(450,074)
Net cash provided by operating activities	248,856	332,295
Cash flows from noncapital financing activities:		
Collateral calls under gas hedging contracts	(5,292)	(3,711)
Other income/expenses	(62,745)	(20,035)
Net cash used by noncapital financing activities	(68,037)	(23,746)
Cash flows from capital and related financing activities:		
Proceeds from issuance of revenue obligation bonds, net of issuance discounts and premiums	250,000	116,207
Principal payments on long-term debt	(119,825)	(199,650)
Commercial paper notes issued	4,621	127,008
Commercial paper notes paid off	-	(12,413)
Interest payments on long-term debt	(152,571)	(151,166)
Additions to utility plant and unamortized project costs	(95,124)	(124,457)
Net cash used by capital and related financing activities	(112,899)	(244,471)
Cash flows from investing activities:		
Cash received from investment earnings	(22,335)	17,100
Loan Payments from local water agencies	475	1,981
Net cash provided by (used by) investing activities	(21,860)	19,081
Net increase in cash and cash equivalents	46,060	83,159
Cash and cash equivalents, beginning of year	466,160	383,001
Cash and cash equivalents, end of year	$ 512,220	$ 466,160

State Water Resources Development System
Statements of Cash Flows (continues)
For the years ended June 30, 2007 and 2006 (in thousands)

	2007	2006
Reconciliation to the statement of net assets:		
Cash and cash equivalents	$ 391,517	$ 295,326
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	32,729	29,911
Cash and cash equivalents restricted for debt service (net of $99,958 and $48,553 of U.S. Agency and U.S. Treasury securities for 2007 and 2006, respectively)	72,705	127,068
Cash and cash equivalents on deposit with revenue bond trustee	9,977	10,144
Cash and cash equivalents on deposit with AG Edwards	5,292	3,711
Cash and cash equivalents	$ 512,220	$ 466,160

	2007	2006
Reconciliation of income from operations to net cash provided by operating activities:		
Income from operations	$ 179,465	$ 166,008
Adjustment to reconcile income from operations to net cash provided by operations:		
Depreciation expense	78,065	77,980
(Increase) decrease in deferred charges and credits, net	(10,955)	113,097
Changes in assets and liabilities:		
Increase in receivables	(41,057)	(13,255)
(Increase) decrease in inventories	845	(3,497)
Increase in due from federal government	(7,786)	(384)
Increase in accounts payable and accrued vacation	39,516	27,722
Decrease in due to other state funds	(7,164)	(43,481)
Increase in current proceeds due to Water Contractors	17,927	8,105
Total adjustments	69,391	166,287
Net cash provided by operating activities	$ 248,856	$ 332,295

For the years ended June 30, 2007 and 2006 (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.

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, restricted cash for plant replacements, restricted cash for debt service, restricted cash on deposit with revenue bond trustee, and restricted cash on deposit with AG Edwards.. 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 $17.3 million on deposit with AG Edwards for natural gas hedging activities, $5.3 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 is part of the State of California Pooled Money Investment Account (PMIA), which as of June 30, 2007 and 2006 had a balance of $65.6 billion and $63.3 billion, respectively. The weighted average to maturity of PMIA investments was 176 days and 152 days as of June 30, 2007 and 2006, respectively. The total amount of deposits in SMIF as of June 30, 2007 and 2006 was $30.6 billion and $26.8 billion, respectively. The Pooled Money Investment Board (PMIB) has oversight responsibility for SMIF. The Board consists of three members as designated by state statute. The value of the pool shares in SMIF which may be withdrawn is determined on an amortized cost basis, which is different than the fair value of the System's portion of the pool. PMIA funds are on deposit with the State's Centralized Treasury System and are not SEC registered, but 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. Included in PMIA's investment portfolio are structured notes and asset-backed securities totaling $774 million and $1.5 billion as of June 30, 2007 and $225 million and $1.4 billion as of June 30, 2006.

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, 2007, are of a similar nature as those held at June 30, 2006.

Due From Other State Funds
Due From Other State Funds represents the System's advance of $92 million to DWR's internal service fund, this 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 $151,009 and $109,952, net of the allowance for uncollectible amounts, at June 30, 2007 and 2006, respectively. Additionally, the Federal government owed the System $15,381 and $7,495 at June 30, 2007 and 2006, respectively, related to reimbursement for certain costs related to flood control and jointly owned facilities. The allowance for uncollectible amounts totaled $500 and $576 at June 30, 2007 and 2006, 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 expenses 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% for the years ended June 30, 2007 and 2006.

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 to the carrying value of the bonds outstanding and are amortized over the lives of the related debt instruments.

Deferred Loss on 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 $12,364 and $38,646 during the years ended June 30, 2007 and 2006, 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 and 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 $45,337 and $42,513 for the years ended June 30, 2007 and 2006, respectively, are recorded as liabilities in the financial statements. The System refunded $43,312 and $41,083 for the years ended June 30, 2007 and 2006, respectively, to the Water Contractors for the 25% bond cover requirement.

The System's water supply revenue is derived from 29 Water Contractors, including the Metropolitan Water District of Southern California whose System billings constituted 61% and 60% of total System water supply revenue for the years ended June 30, 2007 and 2006, respectively, and Kern County Water Agency whose System billings constituted 8% of total System water supply revenue for the years ended June 30, 2007 and 2006.

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, which are 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.

Future Pronouncements

<u>GASB 45</u>

Effective not later than the year ending June 30, 2008, the System will be required to implement Governmental Accounting Standards Board Statement (GASB) 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 costs 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 not later than the year ending June 30, 2009, the System will be required to implement 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 post-closure 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.

GASB 50
Effective not later than the year ending June 30, 2008, the System will be required to implement GASB 50, *Pension Disclosures, an amendment of GASB Statements No. 25 and No. 27.* This Statement more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits (OPEB) and, in doing so, enhances information disclosed in notes to financial statements or presented as required supplementary information (RSI) by pension plans and by employers that provide pension benefits. The reporting changes required by this Statement amend applicable note disclosure and RSI requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

GASB 50 requires the System to disclose the current funded status of the pension plan as of the most recent actuarial valuation date in the notes to the financial statements. In addition, the System is required to disclose the funded status and present a multi-year schedule of funding progress using the entry age actuarial cost method.

GASB 51
Effective not later than the year ending June 30, 2010, the System will be required to implement GASB 51, *Accounting and Financial Reporting for Intangible Assets.* The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to enhance the comparability of the accounting and financial reporting of such assets among state and local governments. The requirements in this Statement improve financial reporting by reducing inconsistencies that have developed in accounting and financial reporting for intangible assets. These inconsistencies will be reduced through the clarification that intangible assets subject to the provisions of this Statement should be classified as capital assets, and through the establishment of new authoritative guidance

that addresses issues specific to these intangible assets given their nature (for example, recognition provisions for internally generated intangible assets, including computer software). This Statement also fosters greater comparability among state and local government financial statements and results in a more faithful representation of the service capacity of intangible assets-and therefore the financial position of governments—and of the periodic cost associated with the usage of such service capacity in governmental financial statements.

3. Interests in Jointly Owned Facilities

At June 30, 2007, the System owned the following undivided interests in jointly owned facilities:

		System's Share (in thousands)	
	% Owned by System	Ultility Plant in Service	Accumulated Depreciation
Reid Gardner Power Plant Unit No. 4	67.8%	$ 332,209	$ 264,075
San Luis joint use facilities	55.0%	255,932	107,348

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 revenues, expenses, and changes in net assets.

DWR does not operate the 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.

For the years ended June 30, 2007 and 2006 (in thousands)

4. Utility Plant

The following activity in utility plant occurred during the years ending June 30, 2007 and 2006:

	Utility Plant in Service			CWIP	Total
	Cost	Accumulated Depreciation	Net Value	Cost	
Beginning 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**
Additions	18,307	(78,065)	**(59,758)**	76,819	**17,061**
Deletions	-	-	**-**	-	**-**
Ending Balance, June 30, 2007	$ 4,584,669	$ (1,800,158)	**$ 2,784,511**	$ 253,152	**$ 3,037,663**

5. Investments

At June 30, 2007 and 2006, the System's cash deposits consisted of restricted cash and cash equivalents maintained with a fiscal agent in the amount of $5,292 and $3,711, respectively.

As of June 30, 2007, the System's investments and credit ratings are as follows:

	Credit Rating (S&P)	Maturities Under 30 Days	31-180 Days	181-365 Days	1-5 Years	Over 5 Years	Fair Value
Investments:							
Money Market Funds	AAA	11,975	-	-	-	-	$ 11,975
State of California Pooled Money	Not Rated	-	484,977	-	-	-	484,977
US Federal Agency Notes:							
Federal Home Loan Mortgage Corp.	AAA	-	50,722	-	-	-	50,722
Federal National Mortgage Association	AAA	-	-	-	-	22,218	22,218
US Treasury Securites	N/A	-	27,018	-	-	-	27,018
							596,910
Investment with Fiscal Agent							
Money Market Funds	AAA	9,977	-	-	-	-	9,977
Total Investments							$ 606,887

For the years ended June 30, 2007 and 2006 (in thousands)

As of June 30, 2006, the System's investments and credit ratings are as follows:

	Credit Rating (S&P)	Maturities Under 30 Days	31-180 Days	181-365 Days	1-5 Years	Over 5 Years	Fair Value
Investments:							
Money Market Funds	AAA	6,545	-	-	-	-	$ 6,545
State of California Pooled Money	Not Rated	-	445,760	-	-	-	445,760
US Federal Agency Notes:							
Federal National Mortgage Association	AAA	-	-	-	-	22,909	22,909
US Treasury Securites	N/A	-	25,644	-	-	-	25,644
							500,858
Investment with Fiscal Agent							
Money Market Funds	AAA	10,144	-	-	-	-	10,144
Total Investments							$ 511,002

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 the various maximum 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.

Custodial Credit Risk: For deposits, custodial credit risk is that in the event of the failure of a depository financial institution, a government will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of its investment or collateral securities that are in the possession of another party. The California Government Code does not contain legal or policy requirements that would limit the exposure to custodial credit risk for deposits or investments, other than the following provision for deposits: The California Government Code requires that a financial institution secure deposits made by state or local governmental units by pledging securities in an undivided collateral pool held by depository regulated under stated law. The market value of the pledged securities in the collateral pool must equal at least 110% of the total amount deposited by the public agencies.

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.

For the years ended June 30, 2007 and 2006 (in thousands)

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. Nearly 12%, of the System's investments at year-end are in U.S. Agency Securities. There is no limitation on amounts invested in these types of issues. Investments in any one issuer (other than U.S. Treasury Notes, mutual funds and external investment pools) that represented 5% or more of the total investments of the System is as follows:

Federal Home Loan Mortgage Corporation	$50,722

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and averaged 5.12% and 3.84% for the years ended June 30, 2007 and 2006, respectively. For the years ended June 30, 2007 and 2006, interest earned on the deposits with PMIA approximated $23,098 and $16,987, 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 the System's investments (U.S. Federal Agency Notes and U.S. Treasury Securities) is calculated as follows:

	2007	2006
Fair value of investments at the beginning of the fiscal year	$ 48,553	$ 50,862
Add: Purchase of investments in fiscal year	50,435	-
Add: Amortization of discounts	61	1,026
Change in fair value of investments during fiscal year	909	(3,335)
Fair value of investments at the end of the fiscal year	$ 99,958	$ 48,553

For the years ended June 30, 2007 and 2006 (in thousands)

6. Long-term Debt

The following is a summary of changes in long-term debt during the years ended June 30, 2007 and 2006:

	General Obligation Bonds	Revenue Bonds				Commercial Paper	Total Long Term Debt
	Par Amount	Par Amount	Unamortized (Discounts) and Premium	Deferred Loss on Refunding	Total Revenue Bonds	Par Amount	
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
Additions	-	250,000	-	-	250,000	4,621	254,621
Payments/Amortization	(48,965)	(70,860)	(3,998)	3,608	(71,250)	-	(120,215)
Balance at June 30, 2007	634,750	2,543,200	46,025	(21,142)	2,568,083	133,362	3,336,195
Less Current Portion	(50,355)	(75,535)	-	-	(75,535)	-	(125,890)
Total Long Term Debt	$ 584,395	$ 2,467,665	$ 46,025	$ (21,142)	$ 2,492,548	$ 133,362	$ 3,210,305

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, 2007, 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.

For the years ended June 30, 2007 and 2006 (in thousands)

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

Year of Issue	Series	Fixed Rates	Fiscal Year of Final Maturity	Amounts Outstanding 2007	Amounts Outstanding 2006
1964	A	0.1-3.6%	2014	$ 27,500	$ 31,000
4964	B&C	.05-3.7%	2015	44,750	50,000
1965	D&E	3.0-3.8%	2016	68,500	75,300
1966	F&G	3.5-4.1%	2017	78,600	85,000
1967	H,J&K	3.0-4.9%	2018	124,300	133,700
1968	L&M	4.0-4.9%	2019	91,200	97,200
1970	N&P	5.0-5.8%	2020	97,200	103,000
1971	Q&R	4.8-5.2%	2021	77,250	81,450
1972	S	5.3-5.5%	2022	21,720	22,800
1991	W	6.0-10.0%	2012	2,250	2,700
1993	X	4.6-4.8%	2024	850	900
1994	Y	6.6-7.1%	2025	630	665
Total General Obligation bond debt outstanding at par				634,750	683,715
Less current maturities				(50,355)	(48,965)
Total Long term General Obligation bond debt outstanding				$ 584,395	$ 634,750

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. However, the bondholders cannot put the bonds back to the System. The average rates for interest and fees for Series AB were 3.71% and 3.02% for the years ended June 30, 2007, and 2006, respectively.

For the years ended June 30, 2007 and 2006 (in thousands)

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 2007	Amounts Outstanding 2006
Devil Canyon-Castaic Facilities:						
1973	A&B	5.3-6.8%	2023	1983	$ 93,465	$ 96,900
Bond Anticipation Bonds						
2007	A	Variable	2009	Any	250,000	-
CVP Water System:						
1992	J	5.5-7.0%	2013	2001	82,085	108,870
1996	O	4.8-5.0%	2030	2006	126,160	126,160
1997	Q	5.1-6.0%	2027	2007	94,585	99,155
1998	S	4.4-5.0%	2030	2008	108,885	117,360
1998	T	5.0-5.5%	2013	2009	90,460	91,465
1999	U	4.0-5.1%	2030	2009	149,340	154,890
1999	V	6.25%	2025	None	20,580	20,580
2001	W	4.0-5.5%	2030	2012	221,775	223,400
2002	X	3.5-5.5%	2030	2013	152,665	154,130
2003	Y	5.0%	2026	2013	316,555	329,885
2003	Z	2.0-5.0%	2020	2013	155,365	159,600
2003	AA	5.0%	2024	2013	108,705	108,705
2004	AB	Variable	2030	2004	189,625	189,625
2005	AC	2.8-5.0%	2030	2015	270,580	270,945
2006	AD	3.0-5.0%	2030	2016	112,370	112,390
	Total revenue bond debt outstanding at par				2,543,200	2,364,060
	Net unamortized bond issuance premiums/discounts				46,025	50,023
	Net deferred gain/loss on refunding				(21,142)	(24,750)
	Current fiscal maturities				(75,535)	(70,860)
	Total long term bond debt outstanding				$ 2,492,548	$ 2,318,473

For the years ended June 30, 2007 and 2006 (in thousands)

Future Debt Service Requirements

Future principal and interest payment requirements on bonds are as follows at June 30, 2007:

	General Obligation Bonds		Revenue Bonds		
Year	**Principal**	**Interest**	**Principal**	**Interest**	**Total**
2008	$ 50,355	$ 27,039	$ 75,535	$ 125,059	$ 277,988
2009	52,695	24,806	329,720	119,608	526,829
2010	54,785	22,474	87,245	104,991	269,495
2011	56,375	20,061	91,220	100,505	268,161
2012	58,165	17,563	98,160	95,562	269,450
2013-2017	274,075	51,012	507,510	398,998	1,231,595
2018-2022	88,095	8,228	547,965	262,765	907,053
2023-2027	205	16	515,215	125,609	641,045
2028-2031	-	-	290,630	19,742	310,372
Total	$ 634,750	$ 171,199	$ 2,543,200	$ 1,352,839	$ 4,701,988

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, 2007 and 2006, there were borrowings of $133,362 and $128,741, respectively, outstanding under this program. The weighted average for interest expense approximated 3.54% and 3.23% for the years ended June 30, 2007, and 2006, 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. The Water Supply Contracts in their original form provide for two charges to the Water Contractors: (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 Water 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. DWR expects to redeem its commercial paper liability with proceeds of the additional commercial paper draws until DWR 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 Bonds (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.

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 Bonds (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 total amount of bonds refunded in advance and still outstanding was $171,910 at June 30, 2007.

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, 2007 and 2006 (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, 2007, was 17.00% and 16.78% for State Miscellaneous Tier 1 and Tier 2, respectively. For the fiscal year ended June 30, 2006, the required employer contribution rate for Tiers 1 and 2 were 15.942% and 15.890%, 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, 2007 and 2006, the System's annual pension cost and actual contribution amounted to approximately $19.5 million and $16.7 million, respectively. Annual covered payroll is not available for the System. However the actuarially determined contributions for the years ended June 30, 2007 and 2006, approximated 1.3% and 0.8%, respectively, of the total actuarially determined contribution requirements for the State Miscellaneous Category and approximately 14.84% and 14.15%, respectively, of the total System payroll. The required contribution for the 2007 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.

Trend information for the last three years regarding the System's required contributions and the percentage contributed, is as follows:

Three-year Trend Information

Year Ended June 30,	Required Contribution	Percentage of Required Contribution Contributed
2005	$ 12,300	100%
2006	16,700	100%
2007	19,500	100%

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. Expenses for health care benefits for DWR's active employees and retirees for the years ended June 30, 2007 and 2006 were approximately $19,697 and $18,078, respectively. DWR represents approximately 0.66% of the State of California's total expenses for health care benefits. Post-retirement health care data for DWR's retirees alone are not available and cannot be reasonably estimated.

For the years ended June 30, 2007 and 2006 (in thousands)

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, 2007 and June 30, 2006, approximated $82,838 and $26,340 respectively.

Power Transmission and Purchase

The System has long-term power transmission service contracts requiring future payments of approximately $177,576 over periods ranging from one to 34 years. Payments made under these contracts approximated $17,873 and $17,840 for the years ended June 30, 2007 and 2006, respectively.

The System has also entered into long-term power purchase contracts requiring future payments of approximately $610,910 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 $63,330 and $75,935 for the years ended June 30, 2007 and 2006, respectively.

The remaining amounts of fixed obligations under the long-term power purchase and transmission contracts as of June 30, 2007, are as follows:

For the year ended:	Fixed Obligations	
2008	$	84,644
2009		84,644
2010		84,098
2011		66,334
2012		66,334
Thereafter		402,431
	$	788,485

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 $16,492 and $16,770 during the years ended June 30, 2007 and 2006, 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, 2007, are as follows:

For the years ended June 30, 2007 and 2006 (in thousands)

For the year ended	Fixed Obligations
2008	$ 4,882
2009	4,885
2010	4,874
2011	4,862
2012	5,089
Thereafter	40,237
	$ 64,829

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, 2007 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. One exchange and one sales contract expire in 2009. The long-term energy purchase contracts involve energy delivered from the Reid Gardner and Pine Flat Power Plants which expire in 2013 and 2035, 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 $13 million for the years ended June 30, 2007 and 2006, respectively.

	Number of Contracts	Total Capacity (MWh)	Fair Value at June 30, 2007
Energy sales	7	273	$ 19,768
Energy purchases	16	675	1,072
Energy exchanges	3	392 sales; 326 purchases	(1,723)
Long-term energy purchases	3	465	258,098
Total			$ 277,215

The System also has entered into transactions to hedge the price of natural gas through bilateral arrangements and has 786 contracts outstanding at June 30, 2007 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 2007 through June 2010.

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. 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 generally be 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 the System'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 the Federal Energy Regulatory Commission (FERC) relating to the System as operator of the SWP. 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. The System is participating in these proceedings, since the outcome of these proceedings has the potential to increase the System's annual power costs. However, the System 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 a group of California entities agreed to suspend the running of the statute of limitations through March 1, 2007. Denial of these claims may allow the claimants to file lawsuits against the governmental entity sellers, including the System. However, the System believes that amounts, if any, that the System might be 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.

10. 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.

State Water Resources Development System
Notes to Financial Statements
For the years ended June 30, 2007 and 2006 (in thousands)

11. 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, 2007 and 2006:

	2007			2006		
	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	$ 872,425	$ 2,165,238	$ 3,037,663	$ 854,887	$ 2,165,715	$ 3,020,602
Other assets	1,125,408	452,351	1,577,759	1,111,780	459,034	1,570,814
Current assets	198,034	380,709	578,743	213,497	218,175	431,672
Total assets	$ 2,195,867	$ 2,998,298	$ 5,194,165	$ 2,180,164	$ 2,842,924	$ 5,023,088
Capitalization and Liabilities						
Capitalization:						
Net assets:						
Capital (deficit), net of related debt	$ 530,127	$ (431,637)	$ 98,490	$ 462,043	$ (237,797)	$ 224,246
Restricted	669,284	437,657	1,106,941	699,859	281,326	981,185
Total net assets	1,199,411	6,020	1,205,431	1,161,902	43,529	1,205,431
Long-term liabilities	584,395	2,625,910	3,210,305	634,750	2,447,214	3,081,964
Total capitalization	1,783,806	2,631,930	4,415,736	1,796,652	2,490,743	4,287,395
Current liabilities	172,116	200,343	372,459	132,762	183,782	316,544
Other liabilities	239,950	166,020	405,970	250,750	168,399	419,149
Total capitalization and liabilities	$ 2,195,872	$ 2,998,293	$ 5,194,165	$ 2,180,164	$ 2,842,924	$ 5,023,088
Condensed Statements of Activities:						
Operating revenues:						
Water supply	$ 441,261	$ 263,660	$ 704,921	$ 409,524	$ 232,798	$ 642,322
Power sales	204,582	17,624	222,206	267,963	23,830	291,793
Federal reimbursements	23,355	1,108	24,463	13,724	1,853	15,576
	669,198	282,392	951,590	691,211	258,481	949,691
Depreciation expense	(27,768)	(50,297)	(78,065)	(28,704)	(49,276)	(77,980)
Other operating expense	(626,665)	(67,395)	(694,060)	(616,752)	(88,951)	(705,703)
Income from operations	14,765	164,700	179,465	45,755	120,254	166,008
Capital revenue recovered (deferred)	4,377	-	4,377	(12,884)	-	(12,884)
Interest expense	(26,647)	(125,099)	(151,746)	(30,384)	(119,786)	(150,170)
Other (expense) income	7,505	(39,601)	(32,096)	(2,486)	(468)	(2,954)
Change in net assets	-	-	-	-	-	-
Net assets, beginning of year	1,178,475	26,956	1,205,431	1,178,475	26,956	1,205,431
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	$ 130,440	$ 118,416	$ 248,856	$ 138,157	$ 190,427	$ 328,584
Noncapital financing activities	(4,333)	(63,704)	(68,037)	(6,972)	(13,063)	(20,035)
Capital and related financing activities	(160,450)	47,551	(112,899)	(78,453)	(166,018)	(244,471)
Investing activities	7,823	(29,683)	(21,860)	5,883	13,198	19,081
Net (decrease) increase in cash and cash equivalents	(26,519)	72,580	46,060	58,615	24,544	83,159
Cash and equivalents, beginning of year	134,400	331,760	466,160	75,785	307,216	383,001
Cash and equivalents, end of year	$ 107,880	$ 404,340	$ 512,220	$ 134,400	$ 331,760	$ 466,160

Supplementary Information

State Water Resources Development System
Calculation of Adequacy of Debt Service Coverage
For the years ended June 30, 2007 and 2006 (in thousands)

Water supply revenues, including $43,119 in refundable proceeds	$	285,091
Less: Operations and maintenance expense		43,750
Net revenues available for debt service	$	241,341
Principal and interest for revenue bonds	$	178,964
Debt service coverage		134.9%

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 calculation above includes the amounts applicable to the CVP Revenue Bonds and excludes amounts applicable to the State Water Resources Development General Obligation Bonds.