ANNUAL REPORT

State Water Resources Development System

Financial Statements and Supplementary Information

YEARS ENDED JUNE 30

2010-2009

STATE OF CALIFORNIA
Arnold Schwarzenegger, Governor

THE NATURAL RESOURCES AGENCY
Lester A. Snow, Secretary for Natural Resources

DEPARTMENT OF WATER RESOURCES
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State Water Resources Development System

Financial Statements and
Supplementary Information
For the years ended June 30, 2010 and 2009

State Water Resources Development System
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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 fiscal years ended June 30, 2010 and 2009, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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. Accordingly, we express no such opinion. 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 audits provide 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, 2010 and 2009, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, effective July 1, 2009, the System implemented Governmental Accounting Standards Board (GASB) Statements No. 51, *Accounting and Financial Reporting for Intangible Assets*.

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 as listed in the table of contents 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
December 6, 2010

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 a decrease in total assets of $46.1 million on total operating revenues of $1.04 billion. This did not cause a decrease 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 2009, the System issued CVP Water System Revenue Bonds Series AG with a par amount of $169.1 million and a premium of $11.0 million with an average yield on the bonds of 4.41%. The bond proceeds along with System funds on hand in the amount of $144 thousand were used to defease $168.4 million of outstanding bonds, redeem commercial paper borrowings of $9.9 million, fund capitalized interest of $437 thousand, fund deposits to the debt service reserve account of $376 thousand, and cover costs of issuance of $1.1 million.

- DWR entered into a Power Sales Agreement with the Northern California Power Agency (NCPA) and other project participants on May 24, 2010 to participate in the Lodi Energy Center Project (LEC Project), which will consist of a 296-megawatt natural gas-fired combined cycle power plant constructed by NCPA in Lodi, California. The terms of the agreement provide that the DWR will receive 33.5 percent of the output of the LEC Project. Participation in the LEC Project will assist DWR in meeting future State Water Project energy requirements, including the replacement of energy currently provided by the Reid Gardner Project. NCPA issued bonds on June 24, 2010 for DWR's share of the LEC with a par amount of $140.8 million and an all-in interest cost of 3.7%, the final bonds mature in 2035. Construction of the LEC Project commenced in early August 2010 with scheduled operation beginning in June 2012.

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 note disclosures. 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 certain information required by generally accepted accounting principles.

Condensed Statements of Net Assets

	2010	2009 *	2008	%Change 2010-2009	%Change 2009-2008
	(amounts in thousands)				
Total utility plant	$ 3,215,188	$ 3,207,727	$ 3,074,755	0.2%	4.3%
Other assets	1,797,764	1,851,314	2,097,223	-2.9%	-11.7%
Total assets	$ 5,012,952	$ 5,059,041	$ 5,171,978	-0.9%	-2.2%
Capitalization:					
Net assets:					
Capital, net of related debt	$ 486,347	$ 381,106	$ 127,858	27.6%	198.1%
Restricted	719,084	824,325	1,077,573	-12.8%	-23.5%
Total net assets	1,205,431	1,205,431	1,205,431	0.0%	0.0%
Total long-term debt	2,975,096	3,055,642	3,156,526	-2.6%	-3.2%
Total capitalization	4,180,527	4,261,073	4,361,957	-1.9%	-2.3%
Other liabilities	832,425	797,968	810,021	4.3%	-1.5%
Total net assets and liabilities	$ 5,012,952	$ 5,059,041	$ 5,171,978	-0.9%	-2.2%

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

	2010	2009 *	2008	%Change 2010-2009	%Change 2009-2008
	(amounts in thousands)				
Water supply	$ 853,158	$ 721,253	$ 752,853	18.3%	-4.2%
Power sales	165,664	175,318	215,430	-5.5%	-18.6%
Federal reimbursements	24,021	18,266	20,992	31.5%	-13.0%
Total operating revenues	$ 1,042,843	914,837	989,275	14.0%	-7.5%
Operations and maintenance expense	435,801	466,708	409,150	-6.6%	14.1%
Purchased power expense	212,658	206,632	323,236	2.9%	-36.1%
Depreciation expense	80,813	79,632	79,136	1.5%	0.6%
Operating expenses recovered, net	189,000	21,257	40,976	789.1%	-48.1%
Total operating expenses	918,272	774,229	852,498	18.6%	-9.2%
Income from operations	124,571	140,608	136,777	-11.4%	2.8%
Capital expenses (deferred) recovered	19,823	44,344	(20,595)	-55.3%	-315.3%
Interest expense	(151,390)	(131,481)	(156,716)	15.1%	-16.1%
Other (expense) income	6,996	(53,471)	40,534	-113.1%	-231.9%
Change in net assets	-	-	-	0.0%	0.0%
Net assets, beginning of year	1,205,431	1,205,431	1,205,431	0.0%	0.0%
Net assets, end of year	1,205,431	$ 1,205,431	$ 1,205,431	0.0%	0.0%

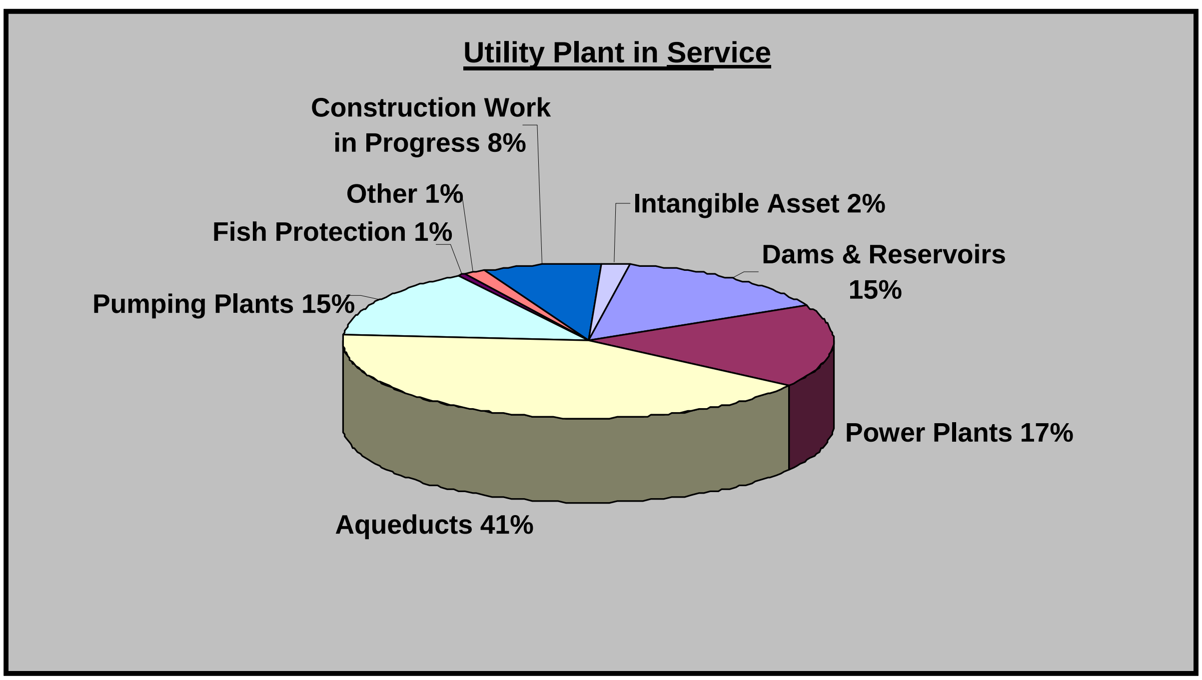
*Amounts have been restated and reclassified from amounts presented in the prior year in order to be consistent with the current year's presentation.

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, 23 pumping plants, four generating plants, eight power plants, as well as fish protection facilities and aqueducts.

Utility plant in service, net of accumulated depreciation (UPIS) increased by $68.4 million during fiscal 2010 to a balance of $2,815 million. The increase is attributable to the transfer of $144.7 million from Construction Work in Progress to UPIS for projects including Tehachapi East Afterbay of $80.8 million, Hyatt Pump-Turbine Refurbishment of $32.6 million, and Reid Gardner Power Plant of $31.3 million and the recording of $1.3 million for Federal Energy Regulatory Commission (FERC) re-licensing costs as required by Governmental Accounting Standards Board (GASB) Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. In comparison, there was a decrease of $71 million in fiscal 2009; offset by an increase of $108 million for recording intangible assets in accordance with GASB 51, which resulted in a net increase of $37 million. While depreciation expense usually remains fairly constant each year, fiscal 2010 experienced an increase of $1.2 million in depreciation expense compared to fiscal 2009 due to additional vehicles, machinery, and equipment which were depreciated. Depreciation expense for fiscal 2009 was $79.6 million. The amount of additions and transfers to UPIS in the current year was $149.3 million compared to a $7.7 million in 2009. 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 decreased by $60.9 million during the year, which represents a 13.2% decrease from fiscal 2009. In fiscal 2009, construction work in progress increased by $95.9 million, or 26.3% over fiscal 2008. The current year decrease is attributable to the transfer of $144.7 million from Construction Work in Progress to Utility Plant in Service for projects including Tehachapi East Afterbay in the amount of $80.8 million, Hyatt Pump-Turbine Refurbishment of $32.6 million and Reid Gardner Pumping Plant of $31.3 million. These transfers were offset by increases to new and ongoing projects including the East Branch Extension Phase II projects of $9.7 million, Reid Gardner projects of $1.6 million, South Bay Aqueduct projects of $24.6 million, the Tehachapi East Afterbay project of $1.7 million and other Water Systems projects totaling $46.2 million. The increase in fiscal 2009 from fiscal 2008 was primarily due to additions made to new and on-going projects including the East Branch Extension Phase II projects of $7.0 million, Reid Gardner projects of $9.1 million, South Bay Aqueduct projects of $25 million, the Tehachapi East Afterbay project of $2.5 million and other Water Systems projects totaling $52.3 million. At June 30, 2010, total construction work in progress was comprised of $35.5 million of East Branch Extension Phase II projects, $134.7 million for the South Bay aqueduct, and $230 million of other Water Systems projects.

Restricted Cash and Investments

Restricted cash and cash equivalents decreased slightly by less than $1 million during fiscal 2010 to a total of $161.7 million. This compares to a balance of $162.6 million in fiscal 2009, and $141.3 million in fiscal 2008. The current year decrease is primarily due to a decrease of $3.5 million in the account held with a brokerage firm for natural gas hedging offset by a $2.4 million increase in cash restricted for plant replacements. As of November 2009, there were no more hedging or open positions to transact, resulting in a decrease to the cash on deposit with the brokerage firm. The increase in the cash restricted for plant replacements is due to more revenues received from the water contractors than expenses for plant replacements during the fiscal year.

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 $20.4 million remains outstanding at the end of fiscal 2010 compared to an outstanding balance of $22.4 million at the end of fiscal 2009, and $24.1 million at the end of fiscal 2008. Advances to Other State Funds represent the System's advance of $92 million to DWR's internal service fund, which functions as a revolving working capital facility for DWR.

Cash and Cash Equivalents

In fiscal 2010, cash and cash equivalents increased by $89 million to a balance of $459.2 million. This increase is mainly due to $83.6 million rise in cash held in the Surplus Money Investment Fund, $9.7 million in gas hedging program funds available from the closing of investment contracts at the request of the Water Contractors, offset by a decrease of $2.4 million of remittance advices in transit to the State Treasurer's Office. The rise in the cash balance is primarily due to over collections from the Water Contractors for variable charges, which have not yet been returned.

Receivables
In fiscal 2010, water supply and power billings receivable increased by $9.6 million as compared to fiscal 2009. The variable billings are due 30 days from the date of billing with a 30 day grace period. An increase of $2.5 million is attributed to increases in the variable water deliveries and variable rates for May through June 2010 as compared to May through June 2009 which were outstanding as of June 30. Another $3.9 million is due to an increase in water supply billings. The remaining increase is due to delayed billings and disputed items which were outstanding as of June 2010.

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 decreased by $142.9 million to an ending balance of $931 million compared to $1,074 million for 2009, as the System defers expenses to be recovered from future revenues from the Water Contractors. In fiscal 2009, recoveries resulted in a decrease of deferred charges of $120.6 million.

Liabilities

Revenue Bonds
The System has issued 33 series of Water System Revenue Bonds totaling $6,560 million in the aggregate principal, of which $2,418 million remains outstanding at the end of fiscal 2010. This compares to outstanding balance of $2,493 million and $2,547 million at the end of fiscal year 2009 and 2008, respectively. During the year, the System completed the issuance of CVP Water Systems Revenue Bond Series AG of $169 million. The majority of the proceeds from the issuance were used to refund the Series O and S bonds, and pay off all outstanding commercial paper as of the date of issuance, make a deposit to the Debt Service Reserve Account, fund interest on a portion of the Series AG Bonds, and pay costs of issuance of Series AG Bonds.

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, $82 million is outstanding at the end of fiscal 2010, compared to $86 million at fiscal 2009 and $90 million at fiscal 2008.

	2010	2009	2008
	(amounts in thousands)		
CVP revenue bonds par amount	$ 2,339,310	$ 2,431,825	$ 2,484,945
Unamortized bond issuance premiums/(discounts)	104,948	93,176	85,674
Deferred amount on refunding	(26,084)	(31,808)	(23,675)
Total CVP revenue bonds outstanding	2,418,174	2,493,193	2,546,944
Devil Canyon - Castaic revenue bond par amount	81,875	85,965	89,825
Total revenue bonds outstanding	2,500,049	2,579,158	2,636,769
Less current maturities	(108,870)	(97,359)	(78,035)
Total long-term portion	$ 2,391,179	$ 2,481,799	$ 2,558,734

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 $477 million remains outstanding at the end of fiscal 2010 compared to $532 million at fiscal 2009 and $584 for fiscal 2008. The un-issued $168 million of the authorization is available only to provide funds for the construction of certain additional water conservation facilities.

Pooled Money Investment Loan

The System applied for and received a loan from the Pooled Money Investment Account pursuant to Government Code section 16313 for $29.6 million. The proceeds of the loan were used to establish escrow accounts that defeased certain Water System Revenue Bonds that financed recreation, fish, and wildlife enhancement related costs of the acquisition and construction of the System. The loan is to be repaid with surplus revenues of the System made available under Water Code section 12937(b)(4). The DWR executed the Pooled Money Investment Board Loan on March 26, 2008. The loan agreement requires minimum quarterly payments of $1 million on the first day of every March, June, September and December; the first payment was made on September 1, 2008. Interest is computed on the unpaid principal balance of the loan at the Variable Rate on the basis of a 360-day year or twelve 30-day months and the number of days elapsed. The Variable Rate means (a) for the period from the date of the Loan Agreement, March 26, 2008, through and including the day before the first Reset Date (March 25, 2009), five percent per annum, and (b) for each Renewal Period thereafter, the greater of (i) five percent per annum, or (ii) the last available daily rate of return by the PMIA on the day before the Reset Date on which such Renewal Period commences. In fiscal 2010, the outstanding long-term PMIA loan balance decreased from $24.6 million to $21.1 million due to $3.4 million of principal payments made during fiscal 2010.

Postemployment Benefits Other than Pensions

The Postemployment Benefits Other than Pensions (OPEB) liability increased by $23.5 million in fiscal 2010 due to the difference between the Annual Required Contribution (ARC) to fully fund the obligation as calculated pursuant to the requirements of GASB 45 and the actual contribution charged by the California Department of Finance through pro rata charges. The $23.5 million increase for fiscal 2010 reflects the System's under funding of the annual required contribution. The increase of $28.2 million for fiscal 2009 also reflects under funding of the ARC. In fiscal 2009, DWR revised the calculation method in order to more accurately base the OPEB liability solely on the allocation of labor.

Accounts Payable and Other Current Liabilities

Accounts payable and other current liabilities totaled $137.7 million at June 30, 2010, compared to $131.9 million in fiscal 2009, and $158.6 million in fiscal 2008. The increase of $5.7 million in the current year is due to a decrease of $8.1 million in accounts payable; a decrease of $800 thousand for accrued vacation, due to the reclassification of accrued vacation between current and long-term liabilities; a decrease of $1.8 million in interest payable due to a decrease in accrual for the Capitalized Interest Fund; an increase of $400 thousand for the current portion of the System's pollution remediation obligation for the Reid Gardner Power Plant; and an increase of $16 million due to a timing difference in the transfer of cash settlements with DWR's Internal

Service Fund. In fiscal 2009, the $26.7 million decrease was due to a decrease in interest payable of $9.3 million from the issuance of Series AF Bonds, a decrease of $5 million in accounts payable, a decrease of $10.6 million for accrued vacation, due to the reclassification of accrued vacation between current and long-term liabilities, whereas in prior years the accrued vacation time was reported as a lump sum in current liability; and $1.8 million decrease due to the timing difference in the transfer of cash settlements with DWR's Internal Service Fund.

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 $600 thousand during fiscal 2010 to an ending balance of $121 million.

In fiscal year 2010, Proceeds Due to Water Contractors increased by $6.9 million due to advance funding of the North Bay Aqueduct Alternate Intake, an increase in cover for various facilities, and revenue collected for delivery structures, but not yet recognized. In addition, interest refunds increased by $6.4 million as DWR withheld returning the interest earnings pending re-allocation of the debt service reserve account. However, these increases were offset by a decrease in deferred operating revenue prepayments of $12.8 million for Off Aqueduct power facilities adjustments primarily due to reduced power sales, decreased transmission costs, and increases in fuel costs.

In fiscal year 2009, Proceeds Due to Water Contractors increased from $119 million to $120.4 million, an increase of $1.4 million. The increase was due to an increase in collateral deposits to be returned to the Water Contractors and an increase for interest refunds.

Deferred Revenue – State and Federal Capital Recovery

The System received funds from the State and Federal governments to build certain projects that relate to recreational use and flood control. Those funds are deferred and then recognized as revenue as the projects are depreciated. Deferred revenue decreased $4.0 million in fiscal 2010 to $154 million. This compares to $4 million decrease in fiscal 2009. These decreases represent the recognition of revenue equal to the amount of depreciation recorded.

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 year 2010, the credits issued through the Delta Water Charge of $21.2 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 $6.6 million decrease in the deferral for 2010 fiscal year.

Advances for Plant Replacements

Advances for plant replacements represents amounts collected in advance from the Water Contractors for future plant equipment replacements. Advances for plant replacements decreased from $42 million in fiscal 2009 to a total of $39.5 million in fiscal 2010. In FY 2010, revenue collection of $10.3 million was offset by $8 million paid for replacements at Gianelli, Buena Vista, and Pearblossom pumping plants.

Operating Revenues

Operating revenues for fiscal 2010 were $1.04 billion compared to $914.8 million in fiscal 2009 and $989 million in fiscal 2008. The increase in fiscal 2010 was due to an increase in water supply revenue of $131.9 million, a decrease in power sales revenue of $9.7 million and an increase of $5.8 million in federal reimbursements. The decrease in fiscal 2009 was due to a decrease in water supply revenue of $32 million, a decrease in power sales revenue of $40 million, and a decrease of $2.7 million in federal reimbursements.

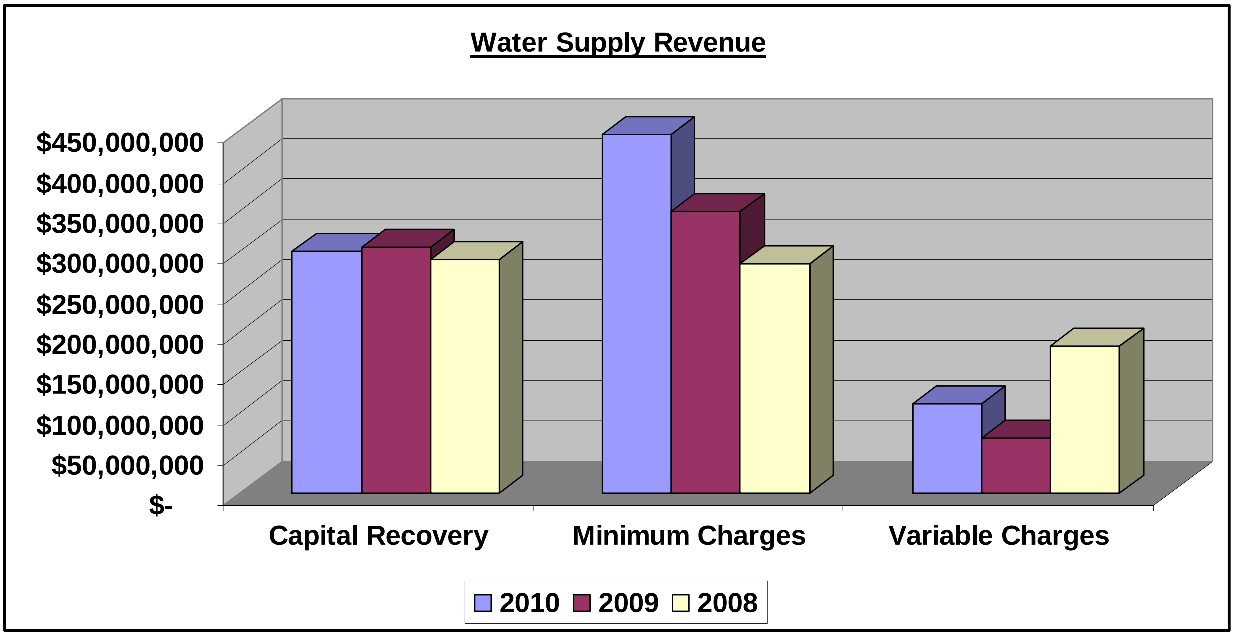
Water Supply Revenue

Under the terms of the water supply contracts, the System is required to collect from the Water Contractors all costs of the SWP allocated to water supply in proportion to each Water 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 2010, the System generated $853.2 million in water supply revenue, compared to $721.2 million in fiscal 2009, and $752.9 million in fiscal 2008. The table on the following page shows a comparative breakdown of the components of water supply revenue for fiscal years 2010, 2009 and 2008.



Water Supply Billings increased by $131.9 million in 2010 to a total of $853.2 million. This increase is due to a $95.6 million increase in Operating & Maintenance (O&M) recovery, and an increase of $41.8 in Variable recovery and an offsetting decrease of $5.5 million in Capital recovery.

The Capital recovery revenues decrease of $5.5 million is primarily due to increased rate management credits given to the Water Contractors for Capital Transportation and Delta Water Charge Capital.

Three factors contributed to most of the $95.6 million increase in O&M recovery revenues for FY 2010. The largest increase of $50.5 million was primarily for recovery revenues for the Delta Habitat Conservation and Conveyance Program (DHCCP). The next most significant is a $20.2 million increase in the Minimum Delta Water Charge due to a change in methodology for escalating future conservation costs. Previously there was no escalation. The third factor was an increase of $13.9 million in Off-Aqueduct O&M due to reduced refunds to the Water Contractors in the current year as a result of decreased Off-Aqueduct power sales.

The $41 million increase in Variable recovery revenues is due in part to the 7.7% increase in actual water deliveries. Deliveries in 2010 were 2.29 million acre-feet compared to 2.13 million acre-feet in fiscal 2009. Although the average mil rate decreased from 34.43 mills/kWh in fiscal 2009 to 34.03 mills/kWh in 2010, the increase in water deliveries occurred in the southern part of the state where the cost to deliver water is higher, resulting in additional recovery revenues. This was offset by a decrease in revenues of $5.3 million for prior year over collections which amounted to $29.8 million in fiscal 2010 compared to $23.3 million in fiscal 2009.

In fiscal 2009, Water Supply Billings decreased by $31.6 million to a total of $721.3 million. There were several contributing factors. A $15.5 million increase occurred as a result of Capital recovery revenues, a $65.7 million increase occurred as a result of O&M recovery, with an offsetting decrease of $112.8 in Variable recovery. The Capital recovery increase was due in part to an increase of $13.1 million in the Water Systems Revenue Bond Surcharge, an increase of $8.7 in Capital recovery for Off-Aqueduct facilities, an increase of $4.5 million due to a decrease in Rate Management adjustments, and an offsetting decrease of $11.2 million for recovery of construction costs for the East Branch Enlargement Project. The O&M recovery revenues increased primarily due to increases of $23.7 million for DHCCP, $23.9 million for recovery of salary and overhead costs, and $5.9 million in Off-Aqueduct facilities adjustments. The variable recovery decrease was primarily as a result of decreased rates, decreased water deliveries, and adjustments for over-collection of revenues in 2008.

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 eight power plants with a total nameplate capacity of approximately 1,843 Mw and with total annual generation of approximately 3,100 to 7,500 Gwh. The System also owns approximately 23 pumping plants with a total load, when operational, of approximately 2,000 Mw and with total annual consumption of 5,300 to 10,000 Gwh. Typically, the majority of generation is during the on-peak hours; however, ancillary services are provided in all hours of the day.

Every hour the SWP must enter the power market to facilitate the operation of the California aqueduct. Operations continue 24 hours a day, seven days a week, with constant coordination with other utilities, water contractors, the California Independent System Operator (CAISO), and State Water Project pumping and generating plants. The power market controlled by CAISO can affect the bottom line cost or revenue from the System's hydroelectric facilities.

Every year the DWR is confronted with factors that affect how the operation of the SWP is conducted. Some factors include plant or unit outages, environmental concerns, weather, fluctuation in natural gas prices, transmission line outages and wild fires. Of the numerous events that occur throughout the year, the primary factor affecting operation of the SWP in fiscal year 2010 continues to be low reservoir storage due to the lack of any significant rainfall over the past couple of years. These low storages influence the overall operation of the SWP.

In Northern California, the rainy season usually begins in October and ends near March. The lack of significant rainfall for fiscal 2010 has impacted the State Water Project's ability to recover reservoir storage. No significant rain fell until January 2010 and continued through June 2010. This moderate rainfall allowed for slight recovery of storage in the SWP reservoirs but was offset in part by the evaporative affects of warmer weather on the System. Despite the difficulties, the System will continue efforts to prepare for the high water demand during the summer.

In April of 2009, the CAISO implemented the Market Redesign and Technology Upgrades (MRTU). The new MRTU market required DWR to implement a new scheduling tool to conduct business in the new power market. The new CAISO market requires all SWP load and generation be submitted into the market and priced using Locational Marginal Pricing (LMP). The implementation of the new energy market by the CAISO has completely changed the way the SWP handles bi-lateral transactions. In prior years, the financial aspect of the bi-lateral market was handled between the counterparties. In today's market, the bi-lateral trades have financial impact with both the CAISO and the trading counterparty. In addition, the new market requires every megawatt of generation or load to have a price and therefore, a financial impact to the scheduling party.

Power Sales

Energy sales from SWP hydroelectric generating plants allow some recovery of cost from the System's hydroelectric pumping plants. With low reservoir storages, the SWP's ability to recover costs is greatly impacted. The Oroville complex is the largest SWP resource and required by FERC to help mitigate negative environmental impacts. Mitigation could include controlling river temperatures, to assisting with after-bay and fore-bay elevation control, to help with nesting Grebe or Garter snake habitat. Mitigation can occur despite having minimal storage available at Oroville Lake.

In fiscal 2010, power sales decreased by $9.7 million to a total of $166 million. This is due to a decrease in the quantity of energy sold and a decrease in the MWh rate offset by an increase in the Transmission sold. In fiscal 2010, 1,850,294 units were sold compared to 2,111,027 units in fiscal 2009, a 12.35% decline from the prior year. The overall rate decreased by 1.5%, from $73.24 in fiscal 2009 to $72.19 in fiscal 2010. The decrease in revenue and energy is expected due to the fact that reservoir storages were quite low. Additionally, low natural gas prices helped keep overall energy prices low. Elevated natural gas prices tend to keep off-peak energy prices high. An increase of $11.4 million in Transmission sold represents a combination of increases in water deliveries and an increase in transmission services provided through CAISO. Water deliveries increased from 2,129,268 acre feet in fiscal 2009 to 2,294,243 acre feet in 2010, an increase of 164,975 acre feet or 8%.

In fiscal 2009, power sales decreased by $40 million to a total of $175 million. Of that decrease, $9 million is attributable to decreased energy sales and $32 million is the result of a decrease in the average MWh rate. This is offset by an increase of $1 million in Transmission sold. In energy sales, while the average rate per MWh sold decreased by 17% from $88.63 to $73.24, the System sold 5% or .01 million less units in fiscal 2009 than fiscal 2008. The first table on this page shows the effect of the rate and volume between fiscal 2010 and fiscal 2009. This can be compared to the second table on the following page for fiscal years 2009 and 2008.

	Total Sold	Transmission Sold	Power Sold	MWh Sold	Rate/MWh
2009	$ 175,318,367	$ (20,696,756)	$ 154,621,611	2,111,027	$ 73.24
2010	165,663,966	(32,091,514)	133,572,452	1,850,294	72.19
Change in total MWh sold					(260,733)
Multiplied by 2009 rate/MWh					$ 73.24
Difference attributed to decrease in sales					$ (19,096,000)
Change in MWh rate					$ (1.05)
Multiplied by 2010 MWh sold					1,850,294
Difference attributed to rate change					$ (1,952,000)
Total decrease in power sales					$ (21,048,000)

	Total Sold	Transmission Sold	Power Sold	MWh Sold	Rate/MWh
2008	$ 215,429,580	$ (19,289,231)	$ 196,140,349	2,213,122	$ 88.63
2009	175,318,367	(20,696,756)	154,621,611	2,111,027	73.24

Change in total MWh sold	(102,095)
Multiplied by 2008 rate/MWh	$ 88.63
Difference attributed to decrease in sales	$ (9,049,000)
Change in MWh rate	$ (15.37)
Multiplied by 2009 MWh sold	2,111,027
Difference attributed to rate change	$ (32,446,000)
Total decrease in power sales	$ (41,495,000)

Federal Reimbursements Revenue

Federal reimbursements revenue for fiscal 2010 was $24 million, compared to $18.3 million and $21 million for fiscal years 2009 and 2008. The current year increase of $5.8 million is attributable to increased expenses incurred at the Gianelli Pumping Plant and the Dos Amigos Pumping Plant. Both plants are located within the San Luis and Suisun Marsh facilities for which the System is reimbursed by the Federal government.

Operating Expenses

Total operating expenses increased by $144 million for 2010 to a total of $918 million. The increase is due to an increase in deferred expenses of $167.7 million, an increase in power purchases of $6 million, and an increase in depreciation expense of $1.2 million offset by a decrease of $30.9 million in operations and maintenance expense. The increase in deferred expenses is represented by $189 million of recognized expense in 2010 and $21.2 million of recognized of expense in 2009.

Total operating expenses for 2009 decreased by $78 million to a total of $774 million. The decrease was due to a decrease in deferred expenses of $20 million and a decrease in power purchases of $116 million offset by an increase of $58 million in operations and maintenance expense.

Operations and Maintenance Expense

Total operations and maintenance expenses were $436 million for fiscal 2010, compared to $467 million for fiscal 2009 and $409 million for fiscal 2008. The decrease of $30.9 million in fiscal 2010 is mainly attributable to the following: a decrease of $14.8 million for consulting fees, a decrease of $4.6 million for postemployment benefits, a decrease of $5.1 million for general expense, and a $5.2 million decrease in coal and natural gas purchases. The decrease of $14.8 million for consulting fees is primarily due to the refund of $9.4 million related to the Lodi Energy Center project.

Total operations and maintenance expenses increased by $58 million in fiscal 2009 due to an increase of $35.7 million in consulting fees for DHCCP and expenses related to the Lodi Energy Center project; an increase of $8.5 million for postemployment benefits due to increased staffing levels; an increase of $5.2 million for repairs and maintenance; a $3.3 million increase for legal fees; a $4.5 million increase in coal and natural gas purchases, and an increase of $4 million in salaries and wages.

Power Purchases

The System uses a significant amount of power to operate its pumping stations in order to deliver water to the Water Contractors. The System's sources of power include self-generated power by the eight 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 $6 million in fiscal 2010 to a total of $213 million. Of that increase, $23 million is attributable to increased MWh's purchased in fiscal 2010 of 496 thousand units and $9.6 million is due to increases in transmission purchased. Although the units purchased increased, the average rate per MWh purchased decreased from $54.87 in fiscal 2009 to $46.31 in fiscal 2010 resulting in a decrease of $26.5 million in power purchases.

Power purchases are generally for off-peak pumping and are a reflection of water demand. A six-month snapshot from January through June 2010 shows energy purchases of 1,253 GWh, while the same period in 2009 shows 989 GWh. The 2010 six-month snapshot showed an increase in energy purchases by 264 GWh compared to 2009. One primary factor that contributed to increased purchases in 2010 was reduced amounts of rainfall compared to 2009. The cost of energy during the period of January through June 2010 was $46 million, significantly above the cost in 2009 of $30 million.

In fiscal 2009, purchased power decreased $117 million from fiscal 2008 to a total of $207 million. Of that amount, $76 million is attributed to decreased units purchased and $37 million is attributed to a decrease in the average rate per MWh purchased, while changes in transmission decreased by $4 million.

The tables on the following page show the relationship between volume and rate for fiscal 2010 compared to fiscal 2009, and fiscal 2009 compared to fiscal 2008.

	Total Purchased	Transmission Purchased	Power Purchased	MWh Purchased	Rate/MWh
2009	$ 206,632,303	$ (36,355,972)	$ 170,276,331	3,103,403	$ 54.87
2010	212,658,256	(45,960,886)	166,697,370	3,599,322	46.31

Change in MWh purchased	495,919
Multiplied by 2010 rate	$ 46.31
Difference attributed to increased purchases	$ 22,967,768
Change in MWh rate	$ (8.55)
Multiplied by 2009 purchased	3,103,403
Difference attributed to rate change	$ (26,546,729)
Total decrease in power purchases	$ (3,578,961)

	Total $ Purchased	Transmission Purchased	Power Purchased	MWh Purchased	Rate/MWh
2008	$ 323,236,179	$ (40,048,849)	$ 283,187,330	4,480,357	$ 63.21
2009	$ 206,632,303	$ (36,355,972)	$ 170,276,331	3,103,403	$ 54.87

Change in MWh purchased	(1,376,954)
Multiplied by 2009 rate	$ 54.87
Difference attributed to decreased purchases (rounded to nearest thousand)	$ (75,550,186)
Change in MWh rate	$ (8.34)
Multiplied by 2008 purchased	4,480,357
Difference attributed to rate change (rounded to nearest thousand)	$ (37,360,813)
Total Decreased in power purchases (rounded to nearest thousand)	(112,910,999)

Operating Expenses Recovered

In fiscal 2010, $189 million in operating expenses were recognized, compared to fiscal 2009 in which the System recognized $21.3 million in operating expenses. The 2010 net change of $167.7 million is the result of an increase of $148.3 million in deferred operation and maintenance expense, an increase in deferred depreciation of $19.9 million, an increase of $856 thousand in the power sales credit, and a decrease of $400 thousand in unamortized projects.

In fiscal 2009, $21.3 million in operating expenses were recognized, compared to fiscal 2008 in which the System recognized $41 million in operating expenses. The 2009 net change of $19.7 million is a result of an increase of $1.3 million in the power sales credit, an increase in deferred depreciation of $15.8 million, a decrease of $31.4 million in deferred operation and maintenance expense, and a decrease of $3.1 million in unamortized projects.

Capital Revenues Recovered

Capital revenues recovered represents the timing difference between net capital revenue recovered, and certain operating costs incurred. Capital revenues recovered decreased by $24.5 million in 2010 to a total of $19.8 million recovered compared to $44.3 million in capital revenues recovered from the Water Contractors in fiscal 2009.

Capital revenues recovered (deferred) increased by $64.9 million in 2009 to a total of $44.3 million recovered compared to $20.6 million in capital revenues deferred from the Water Contractors in fiscal 2008.

Interest Expense

Interest expense for fiscal 2010 was $151 million, which represents an increase of $19.9 million from the prior year. This $19.9 million increase is attributable to three major factors. First, an $8.3 million increase in bond amortization of premium and discount was due in part to a $11.1 million addition relating to the issuance of the Series AG bonds; a reduction of $7.7 million relating to the write off of the Series O & S bonds which were refunded by the Series AG bonds; and a $1.6 million adjustment related to a change in the amortization method from the effective interest rate method to the straight-line method. Second, a $7.8 million increase in amortization of the deferred amount on refunding is attributable to a $ 3.2 million loss relating to Series AG bonds, a $3.5 million write off of Series S bonds, which was refunded by Series AG, and a $2.5 million adjustment related to a change in the amortization method from the effective interest rate method to the straight-line method. Third, a $4.6 million increase of debt service was attributed to a $9.4 million adjustment relating to a prior period; interest expense, excluding this adjustment actually decreased by $4.6 million.

Interest expense for fiscal 2009 was $131 million, which represents a decrease of $25.6 million from the prior year. The decrease of $25.6 million is due in part to a $11.4 million decrease in bond amortization of premium and discount due in part to a one time adjustment for the change to the effective interest rate method in fiscal 2008; $8.7 million decrease in interest on the bonds and commercial paper notes due to the refunding of the Bond Anticipation Bonds (BAB) in fiscal 2008 and a reduction in outstanding commercial paper during the year; $3.4 million decrease in bond amortization of deferred amount on refundings due to a gain on the issuance of bond Series AF and related write offs and a $1.4 million write off for bonds refunded by bond Series AF and the inclusion of PMIA loan interest expense of $1.4 million previously reported as O&M expenses.

Other Revenues (Expenses)
Other revenues were $7 million in fiscal 2010, versus $53.5 million in expenses in fiscal 2009 and $40.5 million in revenues in 2008. The $60.5 million increase in 2010 is primarily the result a $41.5 million change in the fair value of the gas hedging account, $23.3 million change due to the release of debt service reserves in accordance with the Springing Amendment recorded in fiscal 2009 and $4.7 million change in the amounts refunded to the Water Contractors, offset by a decrease of $7.8 million in income from surplus money investments attributable to a decline in average interest rate from 2.2% in FY 2009 to 0.648% in FY 2010.

Economic Factors and Other Information
The Kings River Conservation District issued the Pine Flat Power Revenue Refunding Bonds, Series G on January 20, 2010 with a par amount of $32.9 million. The revenue bond refunding had average interest rate of 2.68% and with the latest bonds maturing in 2019. The refunding generated a Net Present Value savings of $3.3 million or 8.4%, annual debt service will be reduced by approximately $378. The Series G bonds refunded all outstanding Series E bonds. The outstanding Series F Bonds were defeased with funds deposited in the District's debt Service Reserve Fund. At June 30, 2010, the Series G bonds were the only outstanding bonds. 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 2019. The System's payments to the District for debt service will be reduced by $3.8 million over the life of the bonds with a yearly reduction of $378 thousand.

State Water Resources Development System
Statements of Net Assets
June 30, 2010 and 2009 (in thousands)

	2010	2009
Assets		
Utility plant:		
Utility plant in service	$ 4,909,265	$ 4,762,129
Less accumulated depreciation	(2,094,306)	(2,015,610)
Net utility plant in service	2,814,959	2,746,519
Construction work in progress	400,229	461,208
Total utility plant	3,215,188	3,207,727
Long-term assets:		
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	40,670	38,242
Cash and investments restricted for debt service	111,883	111,652
Cash and cash equivalents on deposit with revenue bond trustee	9,208	9,207
Cash and cash equivalents on deposit with Wells Fargo Advisors	-	3,533
Loans receivable from local water agencies	20,357	22,360
Advance to other state funds	91,517	91,517
Total long-term assets	273,635	276,511
Current assets:		
Cash and cash equivalents	459,226	369,820
Receivables:		
Interest on investments	1,774	2,680
Water supply and power billings (net)	85,046	75,447
Due from federal government	24,314	39,110
Due from other state funds	-	123
Inventories	23,081	13,988
Total current assets	593,441	501,168
Deferred charges:		
Amounts recoverable through future billings under long-term water supply contracts:		
Operations and maintenance expense	-	79,533
Capital costs	41,487	122,742
Capital credit due from water contractors	35,065	15,242
Unamortized project costs	351,416	358,538
Unbilled interest incurred on capital costs	502,720	497,580
Total deferred charges	930,688	1,073,635
Total assets	$ 5,012,952	$ 5,059,041

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

State Water Resources Development System
Statements of Net Assets (continued)
June 30, 2010 and 2009 (in thousands)

	2010	2009
Capitalization and Liabilities		
Capitalization:		
Net assets:		
Capital, net of related debt	$ 486,347	$ 381,106
Restricted	719,084	824,325
Total net assets	1,205,431	1,205,431
Long-term liabilities		
General obligation bonds	420,540	476,915
Revenue bonds	2,391,179	2,481,799
Commercial paper	46,473	9,897
Other postemployment benefits	71,448	47,897
Pooled Money Investment Account Loan	21,055	24,603
Accrued vacation	19,921	14,531
Pollution remediation	4,480	-
Total long-term liabilities	2,975,096	3,055,642
Total capitalization	4,180,527	4,261,073
Current liabilities:		
Current maturities of bonds	165,245	152,144
Accounts payable	77,954	86,096
Accrued vacation	10,857	11,609
Pollution remediation	400	-
Accrued interest on long-term debt	17,401	19,251
Pooled Money Investment Account Loan	2,857	2,685
Due to other state funds	28,283	12,222
Proceeds due to water contractors	121,038	120,382
Total current liabilities	424,035	404,389
Deferred credits:		
Deferred revenue - State and Federal capital recovery	153,997	157,973
Operations and maintenance expense	27,860	-
Power sales credit due to water contractors	187,012	193,573
Advances for plant replacements	39,521	42,033
Total deferred credits	408,390	393,579
Total net assets and liabilities	$ 5,012,952	$ 5,059,041

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

State Water Resources Development System
Statements of Revenues, Expenses, and Changes in Net Assets
For the years ended June 30, 2010 and 2009 (in thousands)

	2010	2009
Operating revenues:		
Water supply	$ 853,158	$ 721,253
Power sales	165,664	175,318
Federal reimbursements	24,021	18,266
Total operating revenues	1,042,843	914,837
Operating expenses:		
Operations and maintenance	435,801	466,708
Purchased power	212,658	206,632
Depreciation expense	80,813	79,632
Operating expenses recovered, principally under long-term water supply contracts, net	189,000	21,257
Total operating expenses	918,272	774,229
Income from operations	124,571	140,608
Nonoperating revenue (expenses):		
Capital revenues recovered	19,823	44,344
Interest expense	(151,390)	(131,481)
Other revenues (expenses), net	6,996	(53,471)
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

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

State Water Resources Development System
Statements of Cash Flows
For the years ended June 30, 2010 and 2009 (in thousands)

	2010	2009
Cash flows from operating activities:		
Receipts from customers	$ 1,037,401	$ 964,880
Payments to employees for services	(228,070)	(220,493)
Payments to suppliers	(388,496)	(422,552)
Other expenses	(1,638)	(71,178)
Net cash provided by operating activities	419,197	250,657
Cash flows from capital and related financing activities:		
Proceeds from issuance of revenue obligation bonds including premium	11,781	36,064
Principal payments on long-term debt	(152,145)	(130,730)
Commercial paper notes issued	46,503	23,905
Principal payments on commercial paper notes	(9,927)	(33,360)
Principal payments on PMIA note	(3,376)	(2,312)
Interest payments on long-term debt	(146,770)	(156,451)
Additions to utility plant and CWIP	(88,274)	(103,648)
Net cash used by capital and related financing activities	(342,208)	(366,532)
Cash flows from investing activities:		
Cash received from investment earnings	9,425	18,705
Proceeds of investments matured	252,173	201,739
Purchases of investments	(252,173)	(201,740)
Loan payments from local water agencies	2,003	1,744
Net cash provided by investing activities	11,428	20,448
Net increase (decrease) in cash and cash equivalents	88,417	(95,427)
Cash and cash equivalents, beginning of year	456,977	552,404
Cash and cash equivalents, end of year	$ 545,394	$ 456,977
Noncash capital and related financing activities:		
Principal retirements of long-term debt on proceeds received from issuance of Series AG and AF Water System Revenue Bonds	$ 168,360	$ 266,680

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

State Water Resources Development System
Statements of Cash Flows (continued)
For the years ended June 30, 2010 and 2009 (in thousands)

Reconciliation to the statement of net assets:	2010	2009
Cash and cash equivalents	$ 459,226	$ 369,820
Restricted assets:		
Cash and cash equivalents restricted for plant replacements	40,670	38,242
Cash and cash equivalents restricted for debt service (net of $75,593 and $75,477 of U.S. Agency securities for 2010 and 2009, respectively)	36,290	36,175
Cash and cash equivalents on deposit with revenue bond trustee	9,208	9,207
Cash and cash equivalents on deposit with Wells Fargo Advisors	-	3,533
Cash and cash equivalents	$ 545,394	$ 456,977

Reconciliation of income from operations to net cash provided by operating activities:	2010	2009
Income from operations	$ 124,571	$ 140,608
Adjustment to reconcile income from operations to net cash provided by operating activities		
Depreciation expense	80,813	79,632
Other expenses	(1,638)	(71,178)
Decrease in deferred charges and credits, net	177,581	47,827
Changes in assets and liabilities:		
(Increase) decrease in receivables	(9,476)	34,205
(Increase) decrease in inventories	(9,093)	5,047
(Increase) decrease in due from federal government	14,796	(12,142)
Increase in accounts payable, accrued vacation, pollution remediation and other postemployment benefits	24,926	27,086
Increase (decrease) in due to other state funds	16,061	(1,838)
Increase in current proceeds due to Water Contractors	656	1,410
Total adjustments	294,626	110,049
Net cash provided by operating activities	$ 419,197	$ 250,657

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

For the years ended June 30, 2010 and 2009 (in thousands)

1. Reporting Entity

The State Water Resources Development System (System), a component unit of the State of California (State), includes 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 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
Machinery, equipment and vehicles	3 - 5 years

The System's intangible assets, consisting of software, easements and costs associated with the FERC license for the Hyatt-Thermalitto power plant, are included in utility plant in service. Software costs are being amortized on a straight line basis over a 10 year useful life. Easements are considered permanent with an indefinite useful life, and are not amortized.

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 Wells Fargo Advisors. Such amounts 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 with original maturities of more than three months.

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.

The System maintains deposits with a brokerage firm as a requirement for natural gas hedging activities. The amount of deposits totaled $15.8 million and $20.7 million, as of June 30, 2010 and 2009, respectively. A portion of these deposits is restricted to cover margin requirements. As of June 30, 2010 the System was not required to maintain a security deposit to cover margin requirements. The amounts restricted were $0 and $3.5 million for June 30, 2010 and 2009, respectively. The amount of deposits, excluding the cash restricted for margin requirements totaled $15.8 million and $17.2 million as of June 30, 2010 and 2009, respectively.

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, which is stated at fair value. SMIF is part of the State of California Pooled Money Investment Account (PMIA), which as of June 30, 2010 and 2009 had a balance of $69.4 billion and $50.7 billion, respectively. The weighted average to maturity of PMIA investments was 203 days and 235 days as of June 30, 2010 and 2009, respectively. The total amount of deposits in SMIF as of June 30, 2010 and 2009 was $37.4 billion and $35.7 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 $0.6 billion and $3.1 billion as of June 30, 2010 and $5.1 billion and $2.3 billion as of June 30, 2009.

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, 2010, are of a similar nature as those held at June 30, 2009.

Advances to Other State Funds
Advance to Other State Funds represents the System's advance of $92 million to DWR's internal service fund, and 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 $85,046 and $75,447, net of the allowance for uncollectible amounts, at June 30, 2010 and 2009, respectively. Additionally, the Federal government owed the System $24,314 and $39,110 at June 30, 2010 and 2009, respectively, related to reimbursement for certain costs related to flood control and jointly owned facilities. The allowance for uncollectible amounts totaled $23,790 and $369 at June 30, 2010 and 2009, 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 unrecovered 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 4.608% for the years ended June 30, 2010 and 2009.

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

The deferred power sales credit arises from revenue collected for the power generated by the Hyatt-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 Amount on Refunding
Gains or 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 $31,727 and $11,141 during the years ended June 30, 2010 and 2009, 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 unrecovered operations and maintenance costs. The water supply contracts provide that the 25% portion of the billings collected for the purpose of satisfying certain bond covenants be refunded in the subsequent year. These billings, which totaled $53,257 and $49,999 for the years ended June 30, 2010 and 2009, respectively, are recorded as liabilities in the financial statements. The System refunded $49,321 and $44,116 for the years ended June 30, 2010 and 2009, respectively, to the Water Contractors for the 25% bond cover requirement.

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 System revenue bonds. Capital and operating 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 the San Luis Dam and Reservoir, Suisun Marsh and recreation costs, and interest on investments. Expenses are limited to the construction and operation of SWP facilities constructed with revenue bond proceeds and power facilities, and debt service payments on the revenue bonds.

Reclassifications
Certain amounts presented in the prior year have been reclassified in order to be consistent with the current year's presentation.

New Accounting Pronouncements

GASB 49
Effective July 1, 2008, the System implemented 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 GASB 49 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 is 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. The implementation of GASB 49, during the year ended June 30, 2009, did not have a material effect on the System's financial statements.

GASB 51
Effective July 1, 2009, the System implemented 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 of GASB 51 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 GASB 51 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). GASB 51 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. As a result of the implementation of GASB 51, the System retroactively restated and increased its capital assets as of July 1, 2008, by $108,956 for the capitalization of certain intangible assets. The System has also retroactively restated certain deferred charges, operating expenses and nonoperating revenues (expenses) from amounts previously reported. Deferred charges decreased by $108,125 as of June 30, 2009, and operating expenses increased by $18,399, and nonoperating revenues (expenses) decreased by $2,362, for the year ended June 30, 2009.

For the years ended June 30, 2010 and 2009 (in thousands)

3. Interests in Jointly Owned Facilities

At June 30, 2010 and 2009, the System owned the following undivided interests in jointly owned facilities:

	% Owned by System		System's Share: Utility Plant in Service		System's Share: Accumulated Depreciation	
	2010	2009	2010	2009	2010	2009
Reid Gardner Power Plant Unit No. 4	67.8%	67.8%	$ 363,504	$ 332,209	$ 301,089	$ 288,751
San Luis joint use facilities	55.0%	55.0%	255,932	255,932	117,654	114,348

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.

4. Utility Plant

The utility plant in service includes land, machinery, equipment, vehicles, dam and reservoirs, power plants, aqueducts, pumping plants, and intangible assets. Intangible assets include the FERC license to operate the Hyatt-Thermalito power plants, permanent easements, and the SAP Enterprise Resource Planning computer software upgrade. The following activity in utility plant occurred during the years ending June 30, 2010 and 2009:

	Utility Plant in Service			CWIP	Total
	Cost	Accumulated Depreciation	Net Value	Cost	
Beginning Balance, June 30, 2008	$ 4,755,552	$ (1,937,138)	**$ 2,818,414**	$ 365,297	**$ 3,183,711**
Additions	7,737	(79,632)	**(71,895)**	95,911	**24,016**
Disposals	(1,160)	1,160	**-**	-	**-**
Ending Balance, June 30, 2009	4,762,129	(2,015,610)	**2,746,519**	461,208	**3,207,727**
Additions	4,498	(80,813)	**(76,315)**	83,776	**7,461**
Disposals	(2,117)	2,117	**-**	-	**-**
Transfers	144,755	-	**144,755**	(144,755)	**-**
Ending Balance, June 30, 2010	$ 4,909,265	$ (2,094,306)	**$ 2,814,959**	$ 400,229	**$ 3,215,188**

Due to the implementation of GASB 51, utility plant in service (UPIS) costs and accumulated depreciation have been restated. The beginning balance at June 30, 2008 for UPIS increased from $4,641,870 to $4,755,552, an increase of $113,682, while the accumulated depreciation increased from $1,932,412 to $1,937,138, an increase of $4,726, resulting in an increase of $108,956 in the net value. Additions to UPIS during fiscal 2009 changed from $6,205 to $7,737, an increase of $1,532, while additions to accumulated depreciation changed from $77,269 to $79,632, an increase of $2,363. This impacted the ending balance at June 30, 2009 for UPIS increasing it from $4,646,914 to $4,762,129 and accumulated depreciation from $2,008,520 to $2,015,610. There was no impact on CWIP as a result of the implementation of GASB 51.

For the years ended June 30, 2010 and 2009 (in thousands)

5. Investments

As of June 30, 2010 and 2009, the System's cash deposits consisted of restricted cash and cash equivalents maintained with a fiscal agent in the amount of $0 and $3,533, respectively. The System was no longer required to restrict cash and cash equivalents with a fiscal agent as of June 30, 2010.

As of June 30, 2010, the System's investments and credit ratings are as follows:

		Maturities					
	Credit Rating (S&P)	Under 30 Days	31-180 Days	181-365 Days	1-5 Years	Over 5 Years	Fair Value
Investments:							
Money Market Mutual Funds	Not Rated	$ 15,849	$ -	$ -	$ -	$ -	$ 15,849
State of California Pooled Money	Not Rated	-	-	520,337	-	-	520,337
US Federal Agency Notes							
Federal National Mortgage Association	AAA	-	51,136	-	-	24,457	75,593
							611,779
Investment with Fiscal Agent							
Money Market Mutual Funds	AAA	9,208	-	-	-	-	9,208
Total Investments							$ 620,987

As of June 30, 2009, the System's investments and credit ratings are as follows:

		Maturities					
	Credit Rating (S&P)	Under 30 Days	31-180 Days	181-365 Days	1-5 Years	Over 5 Years	Fair Value
Investments:							
Money Market Mutual Funds	Not Rated	$ 7,509	$ -	$ -	$ -	$ -	$ 7,509
State of California Pooled Money	Not Rated	-	-	436,728	-	-	436,728
US Federal Agency Notes							
Federal National Mortgage Association	AAA	-	-	-	-	23,697	23,697
Federal Home Loan Mortgage Corp	AAA	-	51,780	-	-	-	51,780
							519,714
Investment with Fiscal Agent							
Money Market Mutual Funds	AAA	9,207	-	-	-	-	9,207
Total Investments							$ 528,921

Interest Rate Risk: In accordance with its investment policy, the State of California manages its exposure to declines in fair value 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.

For the years ended June 30, 2010 and 2009 (in thousands)

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.

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. As of June 30, 2010 and 2009, nearly 12% and 14%, respectively of the System's investments at year-end were 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 as of June 30, 2010 and 2009, was as follows:

	2010	**2009**
Federal National Mortgage Association	$ 75,593	$ 23,697
Federal Home Loan Mortgage Corporation	-	51,780

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and averaged 0.651% and 2.224% for the years ended June 30, 2010 and 2009, respectively. For the years ended June 30, 2010 and 2009, interest earned on the deposits with PMIA approximated $3,438 and $12,441, respectively and are included in the other expenses line item on the statement of revenues, expenses and change in net assets.

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 Securities) is calculated as follows:

For the years ended June 30, 2010 and 2009 (in thousands)

	2010	2009
Fair value of investments at the beginning of the fiscal year	$ 75,477	$ 74,135
Less: Proceeds of investments matured in fiscal year	(252,173)	(201,739)
Add: Purchase of investments in fiscal year	252,173	201,739
Add: Amortization of discounts	63	63
Change in fair value of investments during the fiscal year	53	1,279
Fair value of investments at the end of the fiscal year	$ 75,593	$ 75,477

6. Long-term Debt

The following is a summary of changes in long-term debt for the years ended June 30, 2010 and 2009:

	General Obligation Bonds	Revenue Bonds				Commercial Paper	PMIA Loan	Total Long Term Debt
	Par Amount	Par Amount	Unamortized (Discounts) and Premium	Deferred Amount on Refunding	Total Revenue Bonds	Par Amount		
Balance at June 30, 2008	$ 584,395	$ 2,574,770	$ 85,674	$ (23,675)	$ 2,636,769	$ 19,352	$ 29,600	$ 3,270,116
Additions	-	287,735	15,009	(10,960)	291,784	23,905	-	$ 315,689
Payments/amortization	(52,695)	(344,715)	(7,507)	2,827	(349,395)	(33,360)	(2,312)	(437,762)
Balance at June 30, 2009	531,700	2,517,790	93,176	(31,808)	2,579,158	9,897	27,288	3,148,043
Additions	-	169,115	11,026	3,284	183,425	46,503	-	229,928
Payments/amortization	(54,785)	(265,720)	746	2,440	(262,534)	(9,927)	(3,376)	(330,622)
Balance at June 30, 2010	476,915	2,421,185	104,948	(26,084)	2,500,049	46,473	23,912	3,047,349
Less current portion	(56,375)	(108,870)	-	-	(108,870)	-	(2,857)	(168,102)
Total Long-term Debt	$ 420,540	$ 2,312,315	$ 104,948	$ (26,084)	$ 2,391,179	$ 46,473	$ 21,055	$ 2,879,247

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. To the extent Water Fund money was used for construction of the State Water Project 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.

Under the Burns-Porter Act, revenues of the System, other than revenues attributable to facilities financed with Central Valley Project Water System (CVP) Revenue Bonds, are deposited in the California Water Resources Development Bond Fund and are to be used annually only for the following purposes and in the following order of priority:

(1) To pay the maintenance, operation and replacement costs of the System,
(2) To pay, or reimburse the General Fund of the State for, the principal of and interest on the WRD General Obligation Bonds issued for the System as the bonds become due,

(3) To reimburse the California Water Fund for funds utilized from said fund for construction of the System (complete reimbursement has been made), and
(4) To pay additional costs of the acquisition and construction of the System.
All such revenues are pledged for those uses and purposes for the benefit of the owners of the WRD General Obligation Bonds.

As of June 30, 2010 the amount of the revenues pledged to repay the Burns-Porter Act WRD General Obligation Bonds debt service is $573,795 with payments through 2025. Principal and interest paid for the current year were $77,259 and Burns-Porter Act Water Supply operating revenues were $547,435. As of June 30 2009 the amount of the revenues pledged to repay the Burns-Porter Act WRD General Obligation Bonds debt service were $651,054 with payments through 2025. Principal and interest paid for the year were $77,501 and Burns-Porter Act Water Supply operating revenues were $454,921.

WRD General Obligation Bonds of $168 million are authorized but un-issued as of June 30, 2010 and 2009, 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, 2010 and 2009 (in thousands)

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

Fiscal Year of Issue	Series	Fixed Rates	Fiscal Year of Final Maturity	Amounts Outstanding 2010	Amounts Outstanding 2009
1964	A	0.1-3.6%	2014	$ 16,000	$ 20,000
1964	B&C	0.05-3.7%	2015	28,000	34,000
1965	D&E	3.0-3.8%	2016	46,500	54,100
1966	F&G	3.5-4.1%	2017	57,800	65,000
1967	H,J&K	3.0-4.8%	2018	93,900	104,500
1968	L&M	4.0-4.9%	2019	72,000	78,600
1970	N&P	5.0-5.8%	2020	78,600	85,000
1971	Q&R	4.8-5.2%	2021	63,750	68,400
1972	S	5.3-5.5%	2022	18,240	19,440
1991	W	6.5-10.0%	2012	900	1,350
1993	X	4.75%	2024	700	750
1994	Y	6.8-7.1%	2025	525	560
Total General Obligation bond debt outstanding at par				476,915	531,700
Less current maturities				(56,375)	(54,785)
Total Long term General Obligation bond debt outstanding				$ 420,540	$ 476,915

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. Under the statute pursuant to which CVP Revenue Bonds are issued, principal of and interest on the bonds are secured by and payable solely from revenues attributable to the facilities financed by the bonds, primarily certain payments under the water supply contracts between the System and Water Contractors.

As of June 30, 2010, the amount of the revenues pledged to repay the (CVP) Revenue Bonds debt service is $3,649,000 with payments through 2033. Principal and interest paid for the current year were $220,306 and Central Valley Project Act Water Supply operating revenues were $305,723. As of June 30, 2009, the amount of the revenues pledged to repay the (CVP) Revenue Bonds debt service were $3,866,414 with payments through 2033. Principal and interest paid for the year were $201,477 and Central Valley Project Act Water Supply operating revenues were $266,332.

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. Certain of the bonds are redeemable prior to maturity at redemption prices varying from 100% to 101%.

For the years ended June 30, 2010 and 2009 (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 2010	Amounts Outstanding 2009
Devil Canyon-Castaic Facilities:						
1973	A&B	5.3-5.4%	2023	1983	$ 81,875	$ 85,965
CVP Water System:						
1992	J	5.5-7.0%	2013	2001	53,535	53,535
1996	O	4.8-5.0%	2030	2006	-	125,595
1997	Q	5.1-6.0%	2011	2007	8,955	17,415
1998	S	4.8-5.0%	2030	2008	-	42,765
1999	V	6.25%	2025	None	20,235	20,235
2001	W	4.6-5.5%	2030	2012	177,985	198,625
2002	X	4.0-5.5%	2030	2012	149,540	149,540
2003	Y	5.0-5.3%	2026	2013	268,270	283,705
2003	Z	3.0-5.0%	2020	2013	118,955	134,920
2003	AA	5.00%	2024	2013	107,215	107,215
2005	AC	3.0-5.0%	2030	2015	267,115	267,500
2006	AD	3.0-5.0%	2030	2015	109,955	110,370
2008	AE	3.0-5.0%	2030	2018	616,190	632,670
2009	AF	2.0-5.0%	2033	2019	272,245	287,735
2010	AG	2.0-5.0%	2033	2020	169,115	-
Total revenue bond debt outstanding at par					2,421,185	2,517,790
Net Unamortized bond issuance premiums/discounts					104,948	93,176
Net Deferred amount on refunding					(26,084)	(31,808)
Current fiscal maturities					(108,870)	(97,359)
Total long term bond debt outstanding					$ 2,391,179	$ 2,481,799

For the years ended June 30, 2010 and 2009 (in thousands)

Future Debt Service Requirements

Future principal and interest payment requirements on the bonds are as follows at June 30, 2010:

	General Obligation Bonds		Revenue Bonds		
Year	**Principal**	**Interest**	**Principal**	**Interest**	**Total**
2011	$ 56,375	$ 20,061	$ 108,870	$ 118,469	$ 303,775
2012	58,165	17,563	116,150	113,000	304,878
2013	59,455	15,008	122,483	106,844	303,790
2014	61,085	12,503	114,190	100,940	288,718
2015	56,875	10,098	111,469	95,488	273,930
2016-2020	174,275	20,995	609,477	387,516	1,192,263
2021-2025	10,685	652	641,141	228,835	881,313
2026-2030	-	-	590,455	75,955	666,410
2031-2033	-	-	6,950	518	7,468
	$ 476,915	$ 96,880	$ 2,421,185	$ 1,227,565	$ 4,222,545

Pooled Money Investment Loan (PMIA)

The System applied for and received a loan from the Pooled Money Investment Account pursuant to Government Code section 16313 for $29.6 million. The proceeds of the loan were used to establish escrow accounts that defeased certain Water System Revenue Bonds that financed recreation, fish, and wildlife enhancement related cost of the acquisition and construction of the System. The loan is to be repaid with surplus revenues of the System made available under Water Code section 12937(b)(4). DWR executed the Pooled Money Investment Board Loan on March 26, 2008. The loan agreement requires minimum quarterly payments of $1 million on the first day of every March, June, September and December; the first payment was made on September 1, 2008. Interest is computed on the unpaid principal balance of the loan at the Variable Rate on the basis of a 360-day year or twelve 30-day months and the number of days elapsed. The Variable Rate means (a) for the period from the date of the Loan Agreement, March 26, 2008, through and including the day before the first Reset Date (March 25, 2009), five percent per annum, and (b) for each Renewal Period thereafter, the greater of (i) five percent per annum, or (ii) the last available daily rate of return by the PMIA on the day before the Reset Date on which such Renewal Period commences.

For the years ended June 30, 2010 and 2009 (in thousands)

The minimum future principal and interest payment requirements on the PMIA loan are as follows at June 30, 2010:

Year	Principal	Interest	Total
2011	$ 2,857	$ 1,143	$ 4,000
2012	3,003	997	4,000
2013	3,156	844	4,000
2014	3,317	683	4,000
2015	3,486	514	4,000
2016 - 2018	8,093	494	8,587
	$ 23,912	$ 4,675	$ 28,587

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, 2010 and 2009, there were borrowings of $46,473 and $9,897, respectively, outstanding under this program. The weighted average for interest expense approximated 0.31% and 1.70% for the years ended June 30, 2010, and 2009, 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 December 2009, the System issued CVP Water System Revenue Bonds-Series AG in the amount of $169,115 plus the premium of $11,026, for a total of $180,141 with an average yield on the bonds of 4.41%. The bond proceeds and the System's releases of $144 in debt service reserve funds were used to defease $168,360 of outstanding bonds, redeem commercial paper borrowings of $9,927 fund capitalized interest of $437, fund deposits to the debt service reserve account of $376, and cover costs of issuance of $1,140. The proceeds of the Series AG were used to current refund CVP Water System Revenue Bonds

Series O with a par amount of $125,595 and CVP Water System Revenue Bonds Series S with a par amount of $42,765. The proceeds (after payment of underwriting refunding fees, other issuance costs, redeeming commercial paper borrowings and deposits to the debt service reserve account) were deposited in an irrevocable trust with an escrow agent. Series O and S were redeemed in December 2009 as a current refunding. As a result, the current refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

Revenue Bond debt service has increased by $2,640 over the life of the bonds when compared to debt service prior to the issuance of Series AG.

The refunding of Series O and Series S bonds resulted in a total economic gain (Net Present Value) of approximately $5,225 and $2,885 respectively. In addition, the refunding transactions resulted in cash flow savings of approximately $9,514 on Series O bonds and $4,851 on Series S bonds.

The total amount of bonds refunded in advance and still outstanding was $65,655 and $76,340 as of June 30, 2010 and 2009, respectively.

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. 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, 2010 and 2009 (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 year ended June 30, 2010, was 16.92% and 16.74% for State Miscellaneous Tier 1 and Tier 2, respectively. For the year ended June 30, 2009, the required employer contribution rate for Tiers 1 and 2 were 16.57% and 16.47%, 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, 2010 and 2009, the System's annual pension cost and actual contribution amounted to approximately $18.4 million and $19.8 million, respectively. Annual covered payroll is not available for the System. However the actuarially determined contributions for the years ended June 30, 2010 and 2009, approximated 1.1% and 1.3%, respectively, of the total actuarially determined contribution requirements for the State Miscellaneous Category and approximately 14.28% and 14.39%, respectively, of the total System payroll. The required contribution for the year ended June 30, 2010 was determined as part of the June 30, 2008, actuarial valuation using the entry age normal actuarial cost method with the contributions determined as a percentage of covered payroll.

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
2008	$ 18,400	100%
2009	19,815	100%
2010	18,384	100%

9. Postemployment Benefits Other Than Pensions

The State provides health care and dental benefits to annuitants of the retirement systems to which the State contributes as an employer. To be eligible for these benefits, first-tier plan annuitants must retire on or after age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within 120 days of separation from employment to be eligible to receive these benefits. In accordance with the California Government Code, the State generally pays 100% of the health insurance cost for annuitants, plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the California Government Code does not specify the State's contribution toward dental insurance costs, the State generally pays all or a portion of the dental insurance cost for annuitants, depending upon the completed years of credited state service at retirement and the dental coverage selected by the annuitant. The System participates in the State's plan on a cost sharing basis. The System recognizes the costs of providing health and dental insurance to annuitants based on the required contribution, which is actuarially determined, and is funded on a pay-as-you-go basis.

For the years ended June 30, 2010 and 2009 (in thousands)

The System's required contributions and resulting net OPEB obligation is as follows:

	2010	**2009**
Annual required contribution (ARC)	$ 35,525	$ 41,464
Interest on net OPEB obligation	1,922	1,046
Adjustment to the ARC	(1,686)	(918)
Annual OPEB cost	35,761	41,592
Contributions made	(12,210)	(13,403)
Increase in net OPEB obligation	23,551	28,189
Net OPEB obligation - beginning of year	47,897	19,708
Net OPEB obligation - end of year	$ 71,448	$ 47,897

The System's annual required contribution, percentage of the ARC contributed to the plan, and the net OPEB obligation for the fiscal year ended June 30, 2010 and 2009, were as follows:

Fiscal Year Ended	Annual Required Contribution	Percentage of ARC Contributed	Net OPEB Obligation
6/30/2009	$41,464	32%	$47,897
6/30/2010	$35,525	34%	$71,448

The OPEB liability of the System is not evaluated at the fund level. Additional detail disclosures required by GASB Statement No. 45, regarding the State's postemployment benefit plan are presented in the financial statements of the State of California for the year ended June 30, 2010.

10. Commitments and Contingencies

Commitments

Construction
The System has entered into long-term construction contract commitments for the State Water Project facilities. The remaining value of contracts in process as of June 30, 2010 and June 30, 2009, approximated $51,261 and $35,779, respectively.

Power Transmission and Purchase
The System has long-term power transmission service contracts requiring future payments of approximately $96,292 over periods ranging from one to 30 years. Payments made under these contracts approximated $5,348 and $13,343 for the years ended June 30, 2010 and 2009, respectively.

The System has also entered into long-term power purchase contracts requiring future payments of approximately $296,057 over periods ranging from one to 27 years. Payments made under these contracts, excluding payments to the Kings River Conservation District (District) to cover debt service, approximated $43,423 and $56,919 for the years ended June 30, 2010 and 2009, respectively.

For the years ended June 30, 2010 and 2009 (in thousands)

The remaining amounts of fixed obligations under the long-term power purchase and Transmission contracts as of June 30, 2010, are as follows:

For the year ended	Fixed Obligations
2011	$ 58,837
2012	58,837
2013	58,837
2014	52,138
2015	50,719
2016 - 2039	112,981
	$ 392,349

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 2019. Payments to the District totaled approximately $12,996 and $11,246 during the years ended June 30, 2010 and 2009, 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, 2010 are as follows:

For the year ended	Fixed Obligations
2011	$ 4,205
2012	4,335
2013	4,310
2014	4,302
2015	4,272
2016 - 2019	17,019
	$ 38,443

DWR entered into a Power Sales Agreement with the Northern California Power Agency (NCPA) and other project participants on May 24, 2010 to participate in the Lodi Energy Center Project (LEC Project), which will consist of a 296 megawatt natural gas-fired combined cycle power plant constructed by NCPA in Lodi, California. The terms of the agreement provide that DWR will receive 33.5 percent of the output of the LEC Project. Participation in the LEC Project will assist DWR in meeting future State Water Project energy requirements, including the replacement of energy currently provided by the Reid Gardner Project. NCPA issued revenue bonds on June 24, 2010 for the DWR's share of construction costs. Construction of the LEC Project commenced in early August 2010 with scheduled operation beginning in June 2012. DWR anticipates that the LEC will be one of the most efficient thermal generating units in California and that it will be economically dispatched before other gas-fired units, resulting in power revenues that are sufficient to cover the operational costs and a portion of DWR's debt service on the bonds.

For the years ended June 30, 2010 and 2009 (in thousands)

The amounts of fixed obligations of the System related to future principal and interest payments of the LEC's bonds as of June 30, 2010 are as follows:

For the year ended	Fixed Obligations
2011	$ -
2012	-
2013	6,173
2014	9,131
2015	9,207
2016 - 2020	46,039
2021 - 2025	46,046
2026 - 2030	46,036
2031 - 2035	46,040
	$ 208,672

Market value information for certain purchase power, sale and exchange contracts are disclosed at June 30, 2010, using forward market prices discounted at the prevailing risk-free interest rate. Except as discussed below, all energy sales and purchases expire before December 31, 2010. Ten purchase and eight sales contracts expire in 2010, eight purchase contracts expire in 2011, six purchase contracts expire in 2012, three purchase contracts expire in 2013, and one purchase contract expires in 2015. 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 $5.9 and $7.1 million for the years ended June 30, 2010 and 2009, respectively.

	Number of Contracts	Total Capacity (MWh)	Fair Value at June 30, 2010
Energy sales	24	675	$ 6,706
Energy purchases	50	1975	(32,389)
Long-term energy purchases	3	450	184,563
Total			$ 158,880

The System also has entered into transactions to hedge the price of natural gas through bilateral arrangements and has terminated and settled all contracts, including Futures and Options, as of June 30, 2010 and as a result, the System incurred a $4.9 million loss. This loss was offset against the deposit held at the brokerage firm and was recorded as a deferred amount as of June 30, 2010. The amount of the loss will be recognized in fiscal year 2010-11 when the service contracts expire. The fair value of the Futures and Options was $15.8 million and $9.7 million as of June 30, 2010 and 2009, respectively. The contracts expire at various times from December 2010 through October 2011. The System recognized a loss of $4.9 million and $4.7 million for fiscal 2010 and 2009, respectively.

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 the System 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 Monterey Amendment by challenging the validity of the related environmental impact report (EIR). While the courts have allowed the System to proceed with the implementation of the Monterey Amendment, the System was required to prepare a new EIR. DWR completed the new Final EIR in February 2010 and filed its Notice of Determination in May 2010. In June 2010, two Delta water agencies and several environmental organizations and individuals filed a lawsuit in Sacramento Superior Court challenging the Department's California Environmental Quality Act (CEQA) compliance and the validity of the Monterey Amendment, including DWR's transfer of the Kern Fan Element to the KCWA. In July 2010, the same plaintiffs in the Sacramento Superior Court case filed a lawsuit in Kern County Superior Court challenging the transfer of the Kern Fan Element from KCWA to the Kern Water Bank Authority, a local joint powers agency which now has responsibility for the management of the Kern Fan Element and Kern Water Bank. In addition, in June 2010, two water districts in Kern County filed a separate lawsuit in Kern County Superior Court, primarily challenging DWR's CEQA compliance with respect to the Kern Fan Element transfer from the DWR to KCWA. It is expected that the two lawsuits filed in Kern County Superior Court will be transferred to the Sacramento Superior Court. The System, however, does not believe that there would be any material adverse impact on the System's financial position or results from operations, even if these lawsuits are successful.

2005 Contractor Lawsuit Regarding Oroville Power Credits

In April, 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 the Delta Water charge in the Water Contractor 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 12 other southern Water Contractors received court permission in December, 2005 to intervene in the lawsuit as defendants. Plaintiffs thereafter filed an amended complaint joining two additional contractors. A non-jury trial was held in November and December 2008. In October 2009, the Court issued its decision in favor of DWR and the Water Contractors which intervened in support of the DWR, finding that DWR's determinations and administration of the provisions regarding Oroville power credits were consistent with the water supply contracts. In May 2010, the Superior Court entered its judgment in favor of DWR and in July 2010, the Water Contractor plaintiffs appealed the lower court's decision to the Court of Appeal. If the Water Contractor plaintiffs are ultimately successful in their efforts to reverse the Superior Court's decision, DWR 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, Including Claims Concerning Charges for Recreation and Fish and Wildlife Enhancement

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 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 rectified the situation by restating past bills to provide appropriate credits back to the Water Contractors for the contested charges and taking other actions to pay 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. Such actions included obtaining a loan from the State Pooled Money Investment Account (PMIA) in the amount of $29.6 million, which was used together with certain other available funds to retire or provide for the defeasance of approximately $28.2 million principal amount of revenue bonds and commercial paper notes, the proceeds of which had been used to pay costs allocated by the System to the development of recreation or fish and wildlife enhancement. The System has agreed to pay a minimum of $4 million per year to repay the PMIA loan.

With the receipt of the PMIA loan and the waivers in the 2007 and 2008 Tolling and Waiver Agreement obtained from the 27 Water Contractors who signed the Monterey Amendment, the System sold revenue bonds in May 2008. The sale of System revenue bonds had been suspended pending the resolution of the recreation and fish and wildlife enhancement issue.

In addition to waivers included in the 2007 and 2008 Tolling and Waiver Agreements, which helped to facilitate the resumption of the sale of System revenue bonds, the Tolling and Waiver Agreements, as amended, also tolled (i.e. suspended) until December 31, 2010 the running of the time period and statute of limitations for filing by the Water Contractors of (1) protests regarding the System's bills to the Water Contractors for the years 2007 through 2011, (2) claims arising from the System's revisions to prior year invoices that were made to adjust for improper charges to the Water Contractors for recreation and fish and wildlife enhancement costs, and (3) certain other specified claims. The Tolling and Waiver Agreement also tolled the running of the time period for bringing an action on the Victim Compensation and Government Claims Board claim regarding the 2006 invoice that was filed by one of the Water Contractors. In the meantime, the System and Water Contractors are continuing their efforts to resolve issues that are covered by the Tolling and Waiver Agreement. However, no assurance can be given that the Water Contractors will not file additional Notices of Contest, claims and/or lawsuits with respect to the issues under discussion once the Tolling and Waiver Agreements expire.

Lawsuits Regarding 2004 Delta Levee Failure

Four lawsuits have been filed to recover damages caused when a Delta levee failed and flooded the Upper Jones Tract and Lower Jones Tract in June 2004. Three of the lawsuits name as defendants a local Delta reclamation district, the State Reclamation Board and the DWR. A cause of action in each of these three lawsuits alleges that the System's operations and activities in the Delta were a cause of the damage. All four lawsuits have been consolidated, although the fourth lawsuit does not involve the DWR or any other state agency. The consolidated cases are now in the pre-trial stage. The System does not believe that an adverse court decision in any of these consolidated cases would have a material adverse impact on the System's finances or operations because such costs would be recoverable under the long-term water supply contracts.

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 from 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) that may impact the cost of System operations. 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 the System's financial position or results from operations. 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 Victim 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, which allows the claimants to file lawsuits against the governmental entity sellers, including the System. However, DWR and a group of California entities have agreed to suspend the running of the statute of limitations for the filing of a lawsuit through March 1, 2011. 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.

Pollution Remediation

Reid Gardner Power Plant

The Reid Gardner (R-G) Power Plant, located near Moapa, Nevada, is operated by Nevada Energy (NVE) and consists of four coal-powered generators—Units 1 through 4. Units 1–3 are 100% owned by NVE, whereas the capital ownership of Unit 4 is shared between the DWR and NVE at 67.8% and 32.2%, respectively. Additionally, DWR has a 29.2% share of the R-G facilities necessary for and common to all four units.

In February 2008, NVE entered into an Administrative Order on Consent (AOC) with the Nevada Division of Environmental Protection (NDEP). Pursuant to the AOC, NVE agreed to undertake investigatory activities and also to remediate the groundwater contamination attributable to the R-G facility. Groundwater and soils have been affected by certain chemicals of interest associated with flue gas desulfurization effluent settlement and evaporation ponds. Since some of this contamination can be associated with the Unit 4 ponds, DWR, as co-owner of Unit 4, has voluntarily commenced participation in NVE's groundwater remediation activities. These activities are projected to continue through at least 2023.

Based on a review of NVE's planned remediation activities, it is estimated that DWR's equitable share of the current value of outlays could range between $2 million and $8.4 million, with the lower value considered to be a better estimate because it is based on a quantitative assessment of constituents of concern currently known to DWR. DWR calculated the potential financial liability by estimating a reasonable range of potential outlays and applying an estimated probability of occurrence to the potential outlays, yielding a current total expected liability of $4,880. DWR expects to pay $400 of the total expected liability during FY 2010/2011. The total remediation outlay estimate is expected to be refined, and adjusted accordingly, as additional site assessment information is available to DWR.

For the years ended June 30, 2010 and 2009 (in thousands)

11. 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.

12. Economic Dependency

The System's water supply revenue is derived from 29 Water Contractors, including the Metropolitan Water District of Southern California whose System billings constituted 57% and 58% of total System water supply revenue for the years ended June 30, 2010 and 2009, respectively, and Kern County Water Agency whose System billings constituted 9% and 10% of total System water supply revenue for the years ended June 30, 2010 and 2009, respectively.

The System sold power to 16 power companies during the year ended June 30, 2010. The highest percentage of power revenues came from the California Independent System Operator. The following table shows power sales to companies which exceeded 5% of the total power sold by the System.

	2010	% Total	2009	% Total
California Independent System Operator	$ 58,979	40.91%	$ 25,632	13.61%
Southern California Edison	-	-	21,186	11.25%
BP Energy Company	19,170	13.30%	-	-
Pacific Gas & Electric Company	-	-	13,318	7.07%
San Diego Gas and Electric Company	-	-	11,524	6.12%
Cargill Inc.	-	-	16,851	8.95%
Citigroup Energy Inc.	19,153	13.29%	10,085	5.36%
Nevada Energy	-	-	14,484	7.69%
UBS Energy	-	-	9,639	5.12%
Iberdrola Renewables Inc	-	-	9,723	5.16%
Sempra Energy Trading Corp	25,132	17.43%	15,011	7.97%

Similarly, the System purchased power from 18 power suppliers during the year ended June 30, 2010 with the California Independent System Operator providing the highest percentage to the System at 36.31% of the total. The table on the following page shows power purchases from suppliers which exceeded 5% of the total power purchased by the System.

For the years ended June 30, 2010 and 2009 (in thousands)

	2010	% Total	2009	% Total
Morgan Stanley Capital Group Inc.	$ 46,820	22.65%	$ 61,160	26.37%
California Independent System Operator	75,044	36.31%	38,834	16.75%
Citigroup Energy Inc.	-	-	19,826	8.55%
Sempra Energy Trading Corp.	21,147	10.23%	14,200	6.12%
Southern California Edison Co.	-	-	13,827	5.96%
Metropolitan Water District of Southern California	-	-	12,094	5.21%
Kings River Conservation District	13,844	6.70%	11,813	5.09%

For the years ended June 30, 2010 and 2009 (in thousands)

13. 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, 2010 and 2009.

	2010			2009*		
	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	$ 907,303	$ 2,307,885	$ 3,215,188	$ 933,515	$ 2,274,212	$ 3,207,727
Other assets	1,086,846	117,477	1,204,323	1,039,782	310,364	1,350,146
Current assets	286,591	306,850	593,441	192,309	308,859	501,168
Total assets	$ 2,280,740	$ 2,732,212	$ 5,012,952	$ 2,165,606	$ 2,893,435	$ 5,059,041
Capitalization and Liabilities						
Capitalization:						
Net assets:						
Capital (deficit), net of related debt	$ 693,632	$ (207,285)	$ 486,347	$ 661,684	$ (280,578)	$ 381,106
Restricted	484,843	234,241	719,084	516,791	307,534	824,325
Total net assets	1,178,475	26,956	1,205,431	1,178,475	26,956	1,205,431
Long-term liabilities	532,966	2,442,130	2,975,096	563,948	2,491,694	3,055,642
Total capitalization	1,711,441	2,469,086	4,180,527	1,742,423	2,518,650	4,261,073
Current liabilities	178,011	246,024	424,035	187,576	216,813	404,389
Other liabilities	391,288	17,102	408,390	235,607	157,972	393,579
Total capitalization and liabilities	$ 2,280,740	$ 2,732,212	$ 5,012,952	$ 2,165,606	$ 2,893,435	$ 5,059,041
Condensed Statements of Revenues, Expenses and Changes in Net Assets:						
Operating revenues:						
Water supply	$ 547,435	$ 305,723	$ 853,158	$ 454,921	$ 266,332	$ 721,253
Power sales	158,427	7,237	165,664	160,858	14,460	175,318
Federal reimbursements	22,491	1,530	24,021	16,234	2,032	18,266
	728,353	314,490	1,042,843	632,013	282,824	914,837
Depreciation expense	(30,653)	(50,160)	(80,813)	(29,482)	(50,150)	(79,632)
Other operating expense	(654,613)	(182,846)	(837,459)	(546,452)	(148,145)	(694,597)
Income from operations	43,087	81,484	124,571	56,079	84,529	140,608
Capital expenses (deferred) recovered	(32,007)	51,830	19,823	(1,275)	45,619	44,344
Interest expense	(22,290)	(129,100)	(151,390)	(25,206)	(106,275)	(131,481)
Transfers In	(13,275)	(81,057)	(94,332)	(6,798)	(155,775)	(162,573)
Transfers Out	92,609	1,723	94,332	82,987	79,586	162,573
Other (expense) income	(68,124)	75,120	6,996	(105,787)	52,316	(53,471)
Increase (decrease) 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	$ 291,929	$ 127,268	$ 419,197	$ 149,732	$ 100,925	$ 250,657
Capital and related financing activities	(164,815)	(177,393)	(342,208)	(163,899)	(202,633)	(366,532)
Investing activities	3,473	7,955	11,428	5,321	15,127	20,448
Net (decrease) increase in cash and cash equivalents	130,587	(42,170)	88,417	(8,846)	(86,581)	(95,427)
Cash and equivalents, beginning of year	127,546	329,431	456,977	136,392	416,012	552,404
Cash and equivalents, end of year	$ 258,133	$ 287,261	$ 545,394	$ 127,546	$ 329,431	$ 456,977

*Certain amounts presented in the prior year have been adjusted to reflect the retroactive recording of the System's intangible assets as required by GASB 51.

14. Subsequent Events

In November 2010, the System issued CVP Water System Revenue Bonds Series AH with a par amount of $97.6 million and a premium of $13.3 million with an average yield on the bonds of 3.33%. The bond proceeds along with System funds on hand in the amount of $.7 million were used to defease $29.8 million of outstanding bonds by depositing $33.4 million in an irrevocable trust with an escrow agent, redeem commercial paper borrowings of $71.5 million, fund capitalized interest of $3.6 million, fund deposits to the debt service reserve account of $2.5 million and cover costs of issuance of $.6 million.

DWR will deliver the CVP Water System Revenue Bonds Series AI on or about September 7, 2011 pursuant to a purchase agreement among the Department, the State Treasurer and the Underwriters executed on November 1, 2010. The delayed delivery of the Series AI Bonds is necessary to achieve a current refunding of the Series W Refunded Bonds for purposes of the Internal Revenue Code 1986, as amended. DWR anticipates that the CVP Water System Revenue Bonds Series AI will have a par amount of $92.3 million and a premium of $12.5 million with an average yield on the bonds of 3.06%. The bond proceeds along with System funds on hand in the amount of $1.8 million will be used to defease $103.2 million of outstanding bonds by depositing $105.9 million in an escrow account and cover costs of issuance of $.7 million.

Supplementary Information

State Water Resources Development System
Calculation of Adequacy of Debt Service Coverage for the Central Valley Project Revenue Bonds
For the years ended June 30, 2010 and 2009 (in thousands)

	2010	2009
Water supply revenues, including $54,085 in 2010 and $48,985 in 2009 in refundable proceeds	$ 349,034	$ 328,044
Less: Operation and maintenance expense	(55,072)	(64,522)
Net revenues available for debt service	293,962	263,522
Principal and interest for revenue bonds	$ 211,786	$ 192,973
Debt service coverage	138.8%	136.6%

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.

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