Department of Water Resources
Electric Power Fund
Financial Statements

For the years ended June 30, 2007 and 2006

DEPARTMENT OF WATER RESOURCES
STATE OF CALIFORNIA

California
Energy
Resources
Scheduling
Department of
Water Resources

Department of Water Resources Electric Power Fund
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Report of Independent Auditors

The Director of the State of California
Department of Water Resources

In our opinion, the accompanying statements of net assets and the related statements of revenues, expenses and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund (the Fund), a component unit of the State of California, at June 30, 2007 and 2006, and its changes in financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Fund's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 2, the financial statements of the Fund, are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California at June 30, 2007 and 2006, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis presented on pages 2 through 8 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

PricewaterhouseCoopers LLP

September 26, 2007

USING THIS REPORT

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 financial position of the Department of Water Resources Electric Power Fund (the Fund), 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 follows *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 basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of revenues, expenses and changes in net assets, and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of the year-end date. The statement of revenues, expenses and changes in net assets presents all of the current year's revenues, expenses, and changes in net assets. The statement of cash flows reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities: operating, financing and investing. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund is required to follow accounting standards promulgated by the Governmental Accounting Standards Board.

PURPOSE OF FUND

The Fund was established in January 2001 through legislation to assist mitigation of the effects of a statewide energy supply emergency.

DWR has the authority to secure and retain title to power for resale to end use customers of the State's investor owned utilities (IOUs) under power supply contracts entered into prior to January 1, 2003. The scheduling, dispatch, and certain other administrative functions for the long-term contracts are performed by the IOUs as agents for DWR. However, DWR retains the legal and financial responsibility for each contract for the life of the contract or until such time as there is complete assignment of the contract to an IOU and release of DWR. Over 95% of the volume of power under contract expires by December 31, 2011 and the last of the contracts expires in 2015.

DWR is entitled to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative expenses and reserves. Revenue requirements are determined at least annually and submitted to the California Public Utilities Commission (CPUC) for implementation. Under the terms of the rate agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs and "direct access" Electric Service Providers (ESPs) such that the Fund will always have monies to meet its revenue requirements.

STATUS OF BLOCK FORWARD CONTRACTS LITIGATION

In early 2001, the State commandeered block forward contracts between the California Power Exchange and six suppliers. DWR paid approximately $352 million for energy provided under the contracts, which expired in December 2001. Certain market participants claimed they were entitled to damages in excess of $1 billion, their estimation of the fair value of the block forward contracts at the time of commandeering. In March 2007, the principal plaintiff, the California Power Exchange, dismissed its action against the State. Another plaintiff dismissed its claim in May 2007, leaving one plaintiff whose claim is not material.

Should the State be found liable for the remaining claim, and the Fund determined to be the source of moneys to pay damages, those damages would be recoverable from ratepayers through future DWR revenue requirements.

STATEMENT OF NET ASSETS

The Fund's assets, liabilities and net assets as of June 30, are summarized as follows (in millions):

	2007	2006	2005
Long-term restricted cash, equivalents and investments	$ 1,542	$ 1,501	$ 1,482
Recoverable costs, net of current portion	6,503	7,229	7,356
Restricted cash and equivalents:			
Operating and priority contract accounts	1,167	950	1,387
Bond charge collection and bond charge payment accounts	549	514	570
Recoverable costs, current portion	610	613	573
Interest receivable	41	33	26
Other assets	91	75	80
Total assets	$ 10,503	$ 10,915	$ 11,474
Net assets	$ -	$ -	$ -
Long-term debt, including current portion	9,995	10,465	10,982
Other current liabilities	508	450	492
Total capital and liabilities	$ 10,503	$ 10,915	$ 11,474

Long-Term Restricted Cash and Investments

The $41 million increase in long-term restricted cash and investments during fiscal 2007 is a combination of a $21 million increase in the Operating Reserve Account and a $20 million increase in Debt Service Reserve Account. The Operating Reserve Account was increased to $612 million to maintain the balance at a level determined in accordance with the bond indenture and is equal to twelve percent of the Fund's projected 2007 calendar year annual operating expenses as forecast in the DWR 2007 revenue requirement. The Debt Service Reserve Account was increased to $930 million due to higher interest rate assumptions for variable rate debt in the 2007 revenue requirement.

The net $19 million increase in long-term restricted cash and investments during 2006 is a combination of a $36 million increase in the Operating Reserve Account and a $17 million decrease in Debt Service Reserve Account. The increase in the Operating Reserve Account is due primarily to forecasted increases in natural gas costs which raised the balance to $591 million and is equal to twelve percent of projected annual operating expenses for calendar year 2006. The $17 million decrease in the Debt Service Reserve Account to $910 million is a result of issuing refunding bonds as described in the Long-Term Debt section below.

Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The $726 million decrease during fiscal 2007 is due to 1) operating revenues exceeding operating expenses by $128 million, and 2) bond charges plus interest income exceeding interest expense by $598 million.

The $127 million decrease during fiscal 2006 is net of 1) operating expenses exceeding operating revenues by $413 million, and 2) bond charges plus interest income exceeding interest expense by $540 million. Operating expenses exceeded operating revenue for 2006 due to the higher cost of natural gas than forecast, and the ability to decrease power charges for the first six months of the fiscal year through the calendar 2005 revenue requirement process and still maintain operating funds in excess of the amount required by the bond indenture.

Restricted Cash and Investments

The Operating and Priority Contract Accounts increased by $217 million in 2007 due to higher remittance rates in 2007, lower than forecast natural gas costs, and the receipt of $47 million in non-forecasted energy settlements. The $1,167 million balance in the Operating and Priority Contract Accounts at June 30, 2007 is $92 million higher than forecast in DWR's calendar 2007 revenue requirement determination.

The Operating and Priority Contract Accounts decreased by $437 million in 2006 due to a planned decrease of $576 million, receipt of $288 million in non-forecasted energy settlements, and a $149 million increase in natural gas costs over what had been forecast. The $950 million balance in the Operating and Priority Contract Accounts at June 30, 2006 is $139 million higher than forecast in DWR's calendar 2006 revenue requirement determination.

The Bond Charge Collection and Bond Charge Payment Accounts increased by $35 million in 2007 due to higher than expected interest earned on balances and lower than forecast debt service costs in the stable interest rate environment.

The Bond Charge Collection and Bond Charge Payment Accounts decreased by $56 million in 2006. This is attributable to a $42 million reduction as part of the bond refinancing in December 2005, discussed further in the Long-Term Debt section below, and a $21 million planned reduction in the combined 2006 and 2005 revenue requirements.

From the dates of issuance of the revenue bonds through June 30, 2007, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the bond indenture.

Recoverable Costs, Current Portion

The current portion of recoverable costs reflects power and bond charges to IOU customers that have not yet been collected and amounts due for surplus sales of energy and gas. The current portion of recoverable costs at June 30, 2007 is $3 million lower than at June 30, 2006, reflecting lower surplus sales volumes and the implementation of an 8% reduction of remittance rates in January 2007 through the 2007 revenue requirement process offsetting the 5% higher delivered volumes in the second half of fiscal 2007 over the same period in 2006.

The current portion of recoverable costs at June 30, 2006, is $40 million higher than at June 30, 2005, primarily due to higher remittance rates implemented at the beginning of calendar year 2006 resulting from increased natural gas prices and their impact on the 2006 revenue requirement.

Other Assets

DWR purchases natural gas as fuel for the production of power under the terms of certain power purchase contracts and maintains a brokerage account with a national brokerage firm in order to hedge natural gas costs. Assets in this account are classified as other assets on the Statements of Net Assets.

During 2007, other assets increased by $16 million. DWR funded the account with $45 million in September 2006 to enable future hedging transactions. At June 30, 2007, the account consists of money market obligations, US Treasury bills and government bonds valued at $39 million and financial options valued at $52 million. At June 30, 2007, DWR has open positions with an unrealized marked-to-market value decrease of $25 million, with the price environment being stable but lower since the high prices in fall 2005 and winter 2006, and the risk premium built into the market deflating with the passage of time. During 2006, other assets declined by $5 million. Also in 2006, DWR funded the account with an additional $125 million to collateralize unrealized losses and enable future hedging.

Long-Term Debt

Revenue bond principal payments were $447 million and $436 million in fiscal 2007 and 2006, respectively. Net amortization of bond premium and deferred loss on defeasance were $23 million and $32 million in fiscal 2007 and 2006, respectively.

In December 2005, DWR issued an aggregate $2.594 billion in variable rate refunding revenue bonds (Series F and G) to advance refund $2.353 billion of outstanding 2002 Series A fixed rate bonds.

The proceeds of the refunding bonds, along with funds released from the Bond Charge Payment Account ($42 million) and Debt Service Reserve Account ($17 million), were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for future debt service payments on the advance refunded bonds and pay for underwriting fees and other issuance costs. As a result, the advance refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

The refunding resulted in an accounting loss of $218 million which has been deferred over the life of the refunded debt. However, the Fund effectively reduced its aggregate debt service payments by approximately $278 million through 2022 and achieved an economic gain (difference between the present values of the old and new debt service payments) estimated at the date of bond issuance to be $145 million. The actual economic gain will be dependent on basis risk associated with the interest rate swaps described in the following paragraph.

In anticipation of the refunding, DWR entered into interest-rate swap agreements based on the London Inter-Bank Offered Rate (LIBOR) with a notional amount of $2.594 billion to pay fixed rates of interest and receive floating rate payments. The result is that the debt service on the refunding bonds is effectively fixed for the life of the bonds.

Other Current Liabilities

Accounts payable at June 30, 2007 are $59 million higher than at June 30, 2006, reflecting slightly higher energy contract volumes. Accounts payable at June 30, 2006 and 2005 are comparable.

Accrued interest payable at June 30, 2007 is $1 million lower than at June 30, 2006 as interest rates were stable during 2007. Accrued interest payable at June 30, 2006 is $12 million less than at June 30, 2005. The decrease is attributable to the refunding described in the Long-Term Debt section above which resulted in defeasance of $2.7 billion fixed rate debt, having semi-annual interest payments, with variable rate debt that is paid monthly.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

The Fund's activities for the years ended June 30, are summarized as follows (in millions):

	2007	2006	2005
Revenues:			
Power charges	$ 4,433	$ 3,890	$ 4,263
Surplus sales	410	480	451
Bond charges	855	842	845
Interest income	167	130	96
Total revenues	5,865	5,342	5,655
Expenses:			
Power purchases	4,732	5,038	4,965
Energy settlements	(47)	(288)	(191)
Interest expense	424	432	436
Other expenses	30	33	56
Recovery of recoverable costs	726	127	389
Total expenses	5,865	5,342	5,655
Net increase in net assets	-	-	-
Net assets, beginning of year	-	-	-
Net assets, end of year	$ -	$ -	$ -

Power Charges

The cost of providing energy is recoverable primarily through power charges to IOU customers and certain customers of ESPs. Charges are determined by applying a CPUC adopted rate for each IOU service area to the megawatt hours of power delivered by DWR to each IOU's customers.

Power charges were $543 million higher in 2007 than in 2006. Although the volume of power sold in each year was substantially the same, the average remittance rate was 12% higher in fiscal year 2007 than in 2006. Rates for the first six months of fiscal 2007 were 37% higher than in the same period in fiscal 2006 due to an anticipated increase in fuel costs for the full calendar year 2006. Rates effective January 2007 with the implementation of the 2007 revenue requirement are 8% lower than those in place during calendar 2006, as a result of lower anticipated fuel costs for the full 2007 calendar year.

Power charges decreased by $373 million in 2006 to $3.890 billion as compared to 2005. The lower amount reflects 7% less power sold throughout the year to end use customers as a major contract expired in December 2004, and decreased dispatchable peaking plant contract volumes due to milder temperatures in the first quarter of fiscal 2006.

Surplus Sales

DWR receives revenue from the sale of excess energy, based on DWR's pro-rata allocation of its share of energy provided to each IOU's service area to the total amount of energy provided by IOU generation in each respective IOU service area, and from the sale of surplus gas.

Surplus sales of energy and natural gas in fiscal 2007 are $70 million lower than in fiscal 2006, reflecting lower natural gas prices when compared to the hurricane related high price environment in late calendar 2005. There was also a decline in quantities of surplus energy sold during 2007 compared to 2006, as a result of increased consumption of power by ratepayers during the summer months. This quantity decrease was partially offset by higher prices received for surplus sales.

Surplus sales revenues are $29 million higher in 2006 than in 2005. The increase is attributable to the higher price of natural gas for surplus gas sales offset by lower sales volumes of excess contract energy. The high prices for natural gas in 2006 resulted in a 65% rise in amounts received for the sales of surplus gas as compared to 2005. This was offset by 14% lower sales of excess energy. The lower surplus energy sales were attributable to 32% lower volumes sold offset by 29% higher prices received for volumes sold.

Bond Charges

Bond charges provide revenue for the payment of debt service on the revenue bonds and are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to all IOU customers and certain ESP customers. Bond charges for the years ended June 30, 2007, 2006 and 2005 were $855 million, $842 million, and $845 million, respectively, and were adequate to meet all debt service requirements and maintain bond indenture required account balances in the Bond Charge Collection, Bond Charge Payment, and Debt Service Reserve Accounts.

Interest Income

Interest income for 2007 was $37 million higher than in 2006, and interest income for 2006 was $34 million higher than in 2005. These increases are attributable to increased interest earned on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund (SMIF) and larger cash and investment balances.

Power Purchases

Power costs are $293 million lower in 2007 than in 2006. This decrease is primarily attributable to lower natural gas costs in 2007, partially offset by 3% higher contract volumes in 2007. Gas costs in 2006 were higher because of the hurricane related high price environment.

Power costs increased by $74 million in 2006 as compared to 2005 as higher prices for natural gas increased variable costs, resulting in higher per megawatt hour prices. The gas purchased to produce power was $300 million higher in 2006 as compared to 2005, a 23% increase. The impact of higher fuel prices on total power costs was offset by a 7% decrease in volume of energy purchased and sold to ratepayers.

Energy Settlements

Energy settlements received, including those related to complex regulatory proceedings before the Federal Energy Regulatory Commission arising from events in California energy markets in 2001, are recorded as a decrease in operating expenses.

Energy settlements in 2007 total $47 million. DWR received $23 million from the 2006 Enron Corp. settlement through bankruptcy court distributions. Other amounts owed from the Enron Corp. settlement are subject to future bankruptcy court distributions and will be recognized as energy settlements at such time as there is a distribution of monies. The Fund received an additional $24 million in other settlements, including $18 million from BP Energy Company.

Energy settlements in 2006 total $288 million. First, as part of the energy settlement with Mirant Corporation in 2005, DWR received unsecured claims totaling $90 million plus accrued interest in the Mirant Corporation bankruptcy case. In December 2005, DWR sold its claims and received $96 million. Second, the energy settlement with Enron Corp. became effective and DWR received $53 million. In addition, an energy settlement with Reliant Energy became effective in December 2005 and $66 million was received in March 2006. Finally, in May, 2006, DWR received $73 million from an arbitration agreement with Sempra Energy Resources.

Energy settlements of $191 million recognized in 2005 include $99 million from Dynegy Inc., $76 million from Mirant Corporation, $14 million from Duke Energy Corporation, plus an additional $2 million from the 2004 settlement with El Paso Corporation.

Future revenues under the Mirant Corporation, Reliant Energy, Dynegy Inc, and Duke Energy Corporation settlements are subject to conditions outlined in the underlying settlement and allocation agreements.

Interest Expense

Interest expense declined $8 million in 2007 as compared to 2006. The net decrease is attributable to the December 2005 financing described in the following paragraph, reduced by higher interest rates on variable rate debt in 2007 as compared to 2006.

Interest expense declined $4 million in 2006 as compared to 2005. The December 2005 refinancing defeased fixed rate debt with rates ranging from 5.125% to 6% with variable rate debt that was effectively converted to fixed rate debt through interest rate swaps with fixed interest rates approximating 3.3%. This decrease in interest costs was partially offset by higher interest rates on other variable rate debt.

Other Expenses

Other expenses declined by $3 million in 2007 as a result of decreased costs for contract renegotiation, litigation and professional consulting services. Other expenses declined by $23 million in 2006. Approximately $14 million of the reduction reflects a decrease in charges for services provided to the Power Supply Program by other State agencies. The remaining decrease is attributable to decreased costs for contract renegotiation and litigation.

Recovery (Deferral) of Recoverable Costs

The individual components of the recovery (deferral) of recoverable costs are as follows (in millions):

	2007	2006	2005
Operations	$ 128	$ (413)	$ (116)
Debt service and related costs	598	540	505
	$ 726	$ 127	$ 389

Operations
The $128 million recovery of recoverable costs in the year ended June 30, 2007 reflects 1) lower than forecasted natural gas costs and 2) the unplanned receipt of settlement funds.

The $413 million deferral in the year ended June 30, 2006 reflected 1) greater than forecast natural gas costs, and 2) the planned under recovery of calendar 2005 operating costs while maintaining compliance with bond indenture requirements.

The $116 million deferral in 2005 is also attributable to DWR's ability to reduce power charges and still maintain operating funds that are in excess of the amount required by the bond indentures.

Debt Service and Related Costs
The recovery in all three years is anticipated as bond charges and interest income provide funds to pay interest expense and retire debt.

Department of Water Resources Electric Power Fund
Statements of Net Assets
June 30, 2007 and 2006 (in millions)

		2007		2006
Assets				
Long-term assets:				
Restricted cash, equivalents and investments:				
Operating Reserve Account	$	612	$	591
Debt Service Reserve Account		930		910
Recoverable costs, net of current portion		6,503		7,229
Total long-term assets		8,045		8,730
Current assets:				
Restricted cash and equivalents:				
Operating and Priority Contract Accounts		1,167		950
Bond Charge Collection and Bond Charge Payment Accounts		549		514
Recoverable costs, current portion		610		613
Interest receivable		41		33
Other assets		91		75
Total current assets		2,458		2,185
Total assets	$	10,503	$	10,915
Capitalization and Liabilities				
Capitalization:				
Net assets	$	-	$	-
Long-term debt:				
Revenue bonds		9,508		9,995
Total capitalization		9,508		9,995
Current liabilities:				
Current portion of long-term debt		487		470
Accounts payable		453		394
Accrued interest payable		55		56
Total current liabilities		995		920
Commitments and Contingencies (Note 7)				
Total capitalization and liabilities	$	10,503	$	10,915

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

Department of Water Resources Electric Power Fund
Statements of Revenues, Expenses and Changes in Net Assets
For the years ended June 30, 2007 and 2006 (in millions)

	2007	2006
Operating revenues:		
Power charges	$ 4,433	$ 3,890
Surplus sales	410	480
Total operating revenues	4,843	4,370
Operating expenses:		
Power purchases	4,732	5,038
Energy settlements	(47)	(288)
Other expenses	30	33
Recovery (deferral) of recoverable operating costs	128	(413)
Total operating expenses	4,843	4,370
Income from operations	-	-
Bond charges	855	842
Interest income	167	130
Interest expense	(424)	(432)
Recovery of recoverable debt service and related costs	(598)	(540)
Net increase in net assets	-	-
Net assets, beginning of year	-	-
Net assets, end of year	$ -	$ -

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

Department of Water Resources Electric Power Fund
Statements of Cash Flows
For the years ended June 30, 2007 and 2006 (in millions)

	2007	2006
Cash flows from operating activities:		
Receipts:		
Power charges	$ 4,439	$ 3,852
Surplus sales	397	498
Energy settlements	47	288
Payments for power purchases and other expenses	(4,719)	(5,097)
Net cash provided by (used in) operating activities	164	(459)
Cash flows from non-capital financing activities:		
Receipt of bond charges	865	823
Bond payments	(447)	(436)
Interest payments	(448)	(466)
Proceeds from issuance of revenue bonds	-	2,594
Cost of issuance net of underwriters discount	-	(25)
Defeasance of revenue bonds	-	(2,628)
Net cash used in non-capital financing activities	(30)	(138)
Cash flows from investing activities:		
Interest received on investments	159	123
Net cash provided by investing activities	159	123
Net increase (decrease) in cash and equivalents	293	(474)
Restricted cash and equivalents, beginning of year	2,365	2,839
Restricted cash and equivalents, end of year	$ 2,658	$ 2,365
Restricted cash and equivalents included in:		
Operating Reserve Account	$ 612	$ 591
Debt Service Reserve Account (a component of the total of $930 and $910 at June 30, 2007 and 2006, respectively)	330	310
Operating and Priority Contract Accounts	1,167	950
Bond Charge Collection and Bond Charge Payment Accounts	549	514
Restricted cash and equivalents, end of year	$ 2,658	$ 2,365
Reconciliation of operating income to net cash provided by (used in) operating activities:		
Income from operations	$ -	$ -
Changes in net assets and liabilities to reconcile operating income to cash net provided by (used in) operations:		
Recoverable costs	223	(429)
Accounts payable	(59)	(30)
Total adjustments	164	(459)
Net cash provided by (used in) operating activities	$ 164	$ (459)

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

1. Reporting Entity

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (the Fund), administered by DWR, was established in January 2001 through legislation adding Division 27 to the California Water Code (the Code).

DWR purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 for resale to ten million customers of Pacific Gas & Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company (collectively referred to as the investor owned utilities or IOUs). The Code prohibits DWR from entering into new power purchase agreements, but allows DWR to enter into gas purchase contracts to provide fuel for power generation.

DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the California Public Utilities Commission (CPUC).

Under the terms of a rate agreement between DWR and the CPUC, the CPUC will implement DWR's determination of its revenue requirements by establishing customer rates that will meet DWR's revenue needs to assure the payment of debt service, power purchases, administrative expenses and changes in reserves.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the 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 Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, net assets, revenues and expenses.

The financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2007 and 2006, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Restricted Cash and Investments
Under the terms of the Bond Indenture, separate restricted cash and investment accounts were established. The accounts and their purpose follow:

Power Charge Accounts:

- Operating Account: Power charges (see Revenues and Recoverable Costs) and miscellaneous revenue are deposited into the Operating Account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on priority contracts. Remaining monies are available for payment of all operating costs of the Fund other than priority contracts, debt service, and debt-related costs.

- Priority Contract Account: Priority contracts are those power purchase contracts that require monthly payment prior to any debt service payments. Monies in the Priority Contract Account are used to make scheduled payments on priority contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account is projected to have monies sufficient to make scheduled payments on priority contracts through the fifth of the following month.

- Operating Reserve Account: The Operating Reserve account must maintain a balance equal to the greater of (i) seven months of projected negative operating cash flows under a stress scenario, as defined, or (ii) twelve percent of projected annual operating expenses of the Fund, as defined.

Bond Charge Accounts:

- Bond Charge Collection Account: Bond charges (see Revenues and Recoverable Costs) are deposited into the Bond Charge Collection Account. Monthly, funds needed for debt service payments are transferred to the Bond Charge Payment Account.

- Bond Charge Payment Account: Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the balance in the Bond Charge Payment Account must at least equal debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.

- Debt Service Reserve Account: The Debt Service Reserve account is to be funded at all times with the amount of maximum aggregate annual debt service on all outstanding debt, including net scheduled swap payments.

Restricted cash and equivalents, for purposes of the statements of cash flows, include cash on hand and deposits in the State of California Investment Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). Generally, the investments in PMIA are available for withdrawal on demand. The PMIA cash and investments are recorded at amortized cost, which approximates market. PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, described in Note 3 below.

Long-term investments are held solely in the Debt Service Reserve Account by the bond co-trustee and consist of guaranteed investment contracts (GICs) and a U.S. government backed agency security in accordance with a forward purchase agreement (FPA). The GICs are carried at cost and the U.S. government backed agency security is carried at amortized cost.

Other Assets

The Fund enters into futures and option contracts for the purpose of hedging of natural gas fuel costs. The substantial majority of the next year's gas requirements are hedged through these instruments. DWR does not enter into natural gas futures and option agreements for trading purposes, but rather to take advantage of favorable pricing and to reduce fuel price volatility. DWR does not take delivery on these contracts; rather the contracts are financially settled, usually at the approximate maturity dates of the instruments.

Option agreements are reported at fair value and are included in other assets on the statement of net assets. At June 30, 2007 and 2006 those amounts were $52 million and $43 million respectively. Fair value is determined based on market quotes for those or similar instruments on active exchanges. Realized and unrealized gains and losses on such contracts are reflected as changes to fuel operating costs which are included in power purchases in the statement of revenues, expenses and changes in net assets.

The Fund is exposed to additional fuel price risk if the counterparties default. Further, volatility of the market prices could reduce the value of the contracts.

Future gas purchase contracts are recorded at amortized cost, if any. As described in Note 7, such contracts are considered derivatives for financial reporting purposes.

The brokerage firm that facilitates certain of the Fund's hedging contracts requires that the Fund maintain a security deposit, which is invested in compliance with the California Government Code. These funds are invested in money market mutual funds and government bonds and are carried at fair value. The investment in money market mutual funds amounted to $23 million and $5 million at June 30, 2007 and 2006, respectively, and the investments in treasury bills and government bonds amounted to $16 million at June 30, 2007 and 2006 all of which are included in other assets on the statement of net assets.

Revenues and Recoverable Costs

DWR is required to at least annually establish a revenue requirement determination to recover all Fund costs, including debt service. The revenue requirement determination is submitted to the California Public Utilities Commission which then sets customer remittance rates. The Fund'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 revenue requirement process be recorded in the financial statements. Accordingly, all expenses and credits, normally reflected in the change in net assets as incurred, are recognized when recovered from IOU customers. Costs that are recoverable through future billings are recorded as long-term assets.

Amounts that have been earned but not collected by DWR are recorded as the current portion of recoverable costs.

Customer charges are separated into two primary components, power charges and bond charges. Power charge revenues recover the cost of power purchases, other expenses and operating reserves and are recognized when energy provided by DWR is delivered to the IOU customers. Certain customers of "direct access" Electric Service Providers (ESPs) are assessed a "cost responsibility surcharge" that is used by DWR for the same purposes as power charge revenues. Bond charge revenues recover debt service, debt service reserves and other bond related costs and are recognized when energy provided by either DWR or the IOU, or an ESP, is delivered to IOU or ESP customers. Costs are recovered over the life of the bonds (2022) as determined by DWR's revenue requirement process.

Surplus sales represent DWR's 1) allocated portion of the IOUs total surplus energy sales and 2) the sale of gas not needed for the generation of power. The revenue from the sale of excess energy by the IOUs is shared on a pro-rata basis between DWR and the IOUs, based on the amount of energy provided by DWR relative to the total amount of energy provided from IOU generation in the individual IOU's service territory.

3. Restricted Cash and Investments

The State of California has a deposit policy for custodial credit risk. As of June 30, 2007 and 2006, $24 million and $23 million, respectively, of the Fund's cash balances were uninsured and uncollateralized.

As of June 30, 2007 and 2006, the Fund had the following cash, cash equivalents and investments (in millions):

Investment	Maturity	2007	2006
State of California Pooled Money Investment Account - State Money Investment Fund	5.5 months average	$ 2,618	$ 2,323
Cash		40	42
Total cash and equivalents		2,658	2,365
Guaranteed investment contracts	May 1, 2022	500	500
Forward purchase agreement (FPA)	November 1, 2007	100	100
		$ 3,258	$ 2,965

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

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

The Fund's investments in the guaranteed investment contracts and forward purchase agreement are rated as follows, by Standard & Poor's (S&P) and Moody's, respectively, at June 30, 2007 (in millions):

	Amount	**S&P**	**Moody's**
GIC Providers			
FSA	$ 100	AAA	Aaa
XL Capital	150	AAA	Aaa
Royal Bank of Canada	100	AA-	Aaa
Sun America	150	AA+	Aa2
	$ 500		
FPA Provider			
Merrill Lynch: FHLMC Discounted Notes	$ 100	AAA	Aaa

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

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 5.3% and 4.7% at June 30, 2007 and 2006, respectively. For the years ended June 30, 2007 and 2006, interest earned on the deposit in PMIA was $136 million and $98 million, respectively.

Interest on the GICs is paid semi-annually at interest rates ranging from 5.2% to 5.5%. Interest earned on the GICs was $26 million and $27 million for the years ended June 30, 2007 and 2006, respectively. The GICs mature in 2022.

The FPA allows the revenue bond trustee to continuously reinvest funds in U.S. government or U.S. government agency securities through May 2022 to earn a minimum rate of return of 4.7%, as specified in the Reserve Fund Forward Purchase and Sale Agreement, dated May 1, 2004. The reinvested securities are to mature every six months. Interest earned on the FPA was $5 million each for the years ended June 30, 2007 and 2006.

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2007 and 2006 (in millions):

	Revenue Bonds	Unamortized Premium	Deferred Loss on Defeasance	Total
Balance, June 30, 2005	$ 10,696	$ 286	$ -	$ 10,982
Refunding				
Issuance of debt	2,594	-	-	2,594
Defeasance of debt	(2,353)	(72)	(218)	(2,643)
Payments	(436)	-	-	(436)
Amortization	-	(40)	8	(32)
Balance, June 30, 2006	10,501	174	(210)	10,465
Payments	(447)			(447)
Amortization	-	(37)	14	(23)
Balance, June 30, 2007	10,054	137	(196)	9,995
Less current portion	470	31	(14)	487
	$ 9,584	$ 106	$ (182)	$ 9,508

The tax-exempt revenue bonds consist of the following at June 30, 2007 and 2006, respectively (in millions):

				Amount Outstanding	
Series	Rates	Fiscal Year of Final maturity	Fiscal Year of First Call Date	2007	2006
A	3.125-6.0%	2022	2012	$ 3,274	$ 3,684
B	Variable	2020	Callable	1,000	1,000
C, D, F	Variable	2022	Callable	3,992	4,009
G	Variable	2018	Callable	1,788	1,808
				10,054	10,501
Plus unamortized bond premium				137	174
Less deferred loss on defeasance				(196)	(210)
Less current maturities				(487)	(470)
				$ 9,508	$ 9,995

In December 2005, DWR issued an aggregate $2.594 billion in variable rate refunding revenue bonds (Series F and G) to advance refund $2.353 billion of outstanding 2002 Series A fixed rate bonds.

The proceeds of the refunding bonds, along with funds released from the Bond Charge Payment Account ($42 million) and Debt Service Reserve Account ($17 million), were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for future debt service payments on the advance refunded bonds and pay for underwriting fees and other issuance costs. As a result, the advance refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

The refunding resulted in an accounting loss of approximately $218 million which has been deferred over the life of the refunded debt. However, the Fund effectively reduced its aggregate debt service payments by approximately $278 million through 2022 and achieved an economic gain (difference between the present values of the old and new debt service payments) estimated at the date of bond issuance to be $145 million. The actual economic gain will be dependent on basis risk associated with the interest rate swaps described in the following paragraph.

The total amount of bonds refunded in advance and still outstanding was $2.353 billion at June 30, 2007. These bonds cannot be called until 2012.

Series B, C, F and G are variable rate bonds and have either daily or weekly rate reset modes, and Series D has 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from 2008 to 2022. The interest rates for the variable debt for the year ended June 30, 2007 and 2006, ranged from 2.9% to 4.1% and from 1.5% to 4.0%, respectively.

Principal and interest payments are payable from bond charges. The Fund is subject to certain bond covenants, including establishing funding and expenditure requirements for several restricted cash and investment accounts. The bonds are limited special obligations of the Fund. Neither the principal nor any interest thereon constitutes a debt of the State.

The payment of principal and interest for all Series B bonds, $1.73 billion of Series C bonds, all Series F bonds and $90 million of Series G bonds are paid from draws made under letters of credit. Draws made under the letters of credit are to be reimbursed on the same day by the Fund. There are no outstanding amounts on the letters of credit at June 30, 2007. The Fund pays fees of 0.45% per annum on the stated amount of the letters of credit for the Series B and C bonds, and range from 0.35% to 0.38% per annum on the stated amount for the Series F and G bonds. The Series B and C letters of credit expire in fiscal 2011, while the Series F and G letters of credit expire between fiscal years 2009 and 2011.

The remaining $1 billion Series C bonds and $1.7 billion Series G bonds are credit enhanced by bond insurance for the timely payment of principal and interest. Liquidity support for these variable rate bonds is provided by bank liquidity facilities. Any funds paid under the bond insurance facilities are immediately due and payable by the Fund. Bonds purchased under the initial liquidity facilities are required to be redeemed in equal installments over a five or seven year period beginning six months after the termination date of the liquidity facilities. There are no outstanding amounts due under liquidity facilities at June 30, 2007. Three liquidity facilities backing $400 million in Series C bonds expire in fiscal year 2011, and two liquidity facilities underlying $600 million of Series C bonds expire in fiscal year 2012. The Fund pays fees of 0.22% to 0.28% per annum under the Series C liquidity facilities. The Series G bonds have liquidity facilities that expire at various future dates. Four liquidity facilities backing $450 million in Series G bonds expire in fiscal year 2009, five liquidity facilities backing $648 million expire in fiscal year 2011, two liquidity facilities underlying $300 million expire in fiscal year 2013 and the remaining liquidity facility backing $300 million in Series G bonds expires in fiscal year 2016. The Fund pays fees of 0.15% to 0.19% per annum under the Series G liquidity facilities

Future payment requirements on the revenue bonds are as follows at June 30, 2007 (in millions):

Fiscal Year	Principal	Interest [1]	Total
2008	$ 470	$ 417	$ 887
2009	493	395	888
2010	518	371	889
2011	545	347	892
2012	573	321	894
2013-2017	3,330	1,165	4,495
2018-2022	4,125	449	4,574
	$ 10,054	$ 3,465	$ 13,519

[1] Variable portion of interest cost calculated using the June 30, 2007 Bond Market Association Municipal Swap Index (BMA).

5. Interest Rate Swaps

DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties to reduce variable interest rate risk. The swaps create a synthetic fixed rate for DWR. DWR has agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of DWR's variable rate debt.

The terms, fair values, and credit ratings of counterparties for the various swap agreements at June 30, 2007 are summarized in the following table (in millions):

Outstanding Notional Amount	Fixed Rate Paid by Fund	Variable Rate [1] Received by Fund	Fair Value	Swap Termination Date	Counterparty Credit Rating S&P	Moody's	Fitch
$ 94	2.914%	67% of LIBOR	$ 2	May 1, 2011	AAA	Aaa	AAA
234	3.024%	67% of LIBOR	6	May 1, 2012	AAA	Aaa	AAA
190	3.405%	BMA	1	May 1, 2013	AA	Aaa	AA-
95	3.405%	BMA	1	May 1, 2013	A+	Aa3	AA-
28	3.405%	BMA	-	May 1, 2013	AA-	Aa3	AA-
194	3.204%	67% of LIBOR	5	May 1, 2014	AA+	Aaa	AA
308	3.184%	66.5% of LIBOR	7	May 1, 2015	A+	Aa3	AA-
174	3.280%	67% of LIBOR	5	May 1, 2015	AAA	Aaa	AAA
202	3.342%	67% of LIBOR	6	May 1, 2016	AA+	Aa1	AA
485	3.228%	66.5% of LIBOR	16	May 1, 2016	AA+	Aa1	AA
202	3.389%	67% of LIBOR	6	May 1, 2017	A+	Aa3	AA-
480	3.282%	66.5% of LIBOR	17	May 1, 2017	AA	Aa1	AA-
515	3.331%	66.5% of LIBOR	19	May 1, 2018	AA-	Aa1	AA-
306	3.256%	64% of LIBOR	12	May 1, 2020	AA-	Aa1	AA-
453	3.325%	64% of LIBOR	19	May 1, 2022	AA-	Aaa	AA
$ 3,960			$ 122				

[1] One month U.S. Dollar London Interbank Offered Rate or Bond Market Association Municipal Swap Index

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions in notional amounts that follow scheduled amortization of the associated debt.

As of June 30, 2007, the variable rates on DWR's hedged bonds ranged from 2.92% to 4.05%, while 64%, 66.5% and 67% of LIBOR received on the swaps was equal to 3.40%, 3.54%, and 3.56% respectively.

Fair Value: The reported fair values from the table above were determined based on quoted market prices for similar financial instruments.

Basis Risk: The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while DWR's floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. When the relationship between LIBOR and the tax-exempt market change and move to convergence, or DWR's bonds trade at levels higher in rate in relation to the tax-exempt market, DWR's all-in costs would increase.

Effective July 1, 2006, DWR entered into the following basis swaps to mitigate this risk and optimize debt service by changing the variable rate received by the Fund to a 5 year Constant Maturity Swap Index (CMS). The fair values (in millions) were provided by the counterparties, using the par value, or marked-to-market, method.

Outstanding Notional Amount	Variable Rate [1] Paid by Fund	Variable Rate [2] Received by Fund	Fair Value	Swap Termination Date	Counterparty Credit Rating S&P	Moody's	Fitch
$ 234	67% of LIBOR	62.83% of CMS	$ -	May 1, 2012	AA+	Aa1	AA
194	67% of LIBOR	62.70% of CMS	-	May 1, 2014	AA-	Aa1	AA-
174	67% of LIBOR	62.60% of CMS	-	May 1, 2015	AA	Aaa	AA-
202	67% of LIBOR	62.80% of CMS	-	May 1, 2016	AA+	Aa1	AA
202	67% of LIBOR	62.66% of CMS	-	May 1, 2017	AA	Aaa	AA-
$ 1,006			$ -				

1 One month U.S. Dollar London Interbank Offered Rate

2 Five year Constant Maturity Swap

As of June 30, 2007, 67% of LIBOR paid on the basis swaps was equal to 3.56% while the variable rates received based on the 5 year CMS Index varied from 3.45 to 3.47%.

Net amounts received (paid) under all swaps amounted to $11 million and $(9) million for the years ended June 30, 2007 and 2006, respectively.

Credit Risk: DWR has a total of twenty swap agreements with ten different counterparties. Approximately 22 percent of the swaps total notional value is with one counterparty with a credit rating of AA+/Aa1/AA. Of the remaining swaps, two are held with a single counterparty, approximating 20 percent of the outstanding notional value. That counterparty has credit ratings of AA-/Aa1/AA-. The remaining swaps are with separate counterparties, all having A+/Aa3/A+ ratings or better.

Termination Risk: DWR's swap agreements do not contain any out-of-the-ordinary termination provisions that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness by the other party. DWR views the possibility of such events to be remote at this time. If a termination were to occur, at the time of the termination, DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. The counterparty would be liable for any payment equal to the swap's fair value, if it had positive fair value at that time. In addition, a termination would mean that DWR's underlying floating rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk, unless it entered into a new hedge following termination.

Rollover Risk: Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

Swap Payments and Associated Debt: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of June 30, 2007, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows (in millions):

	Variable Rate Bonds		Interest Rate	
Fiscal Year	**Principal**	**Interest**	**Swaps, Net**	**Total**
2008	$ 21	$ 148	$ (10)	$ 159
2009	127	146	(9)	264
2010	80	142	(9)	213
2011	241	138	(9)	370
2012	258	129	(7)	380
2013-2017	1,959	508	(26)	2,441
2018-2022	1,274	118	(4)	1,388
	$ 3,960	$ 1,329	$ (74)	$ 5,215

6. Retirement Plan and Postretirement Benefits

Plan Description

The State of California is a member of the California Public Employees' Retirement System (PERS), an agent multiple-employer pension system that provides a contributory defined-benefit pension for substantially all State employees. DWR is included in the State Miscellaneous Category (Tier 1 and Tier 2) within PERS, thereby limiting the availability of certain DWR pension data. PERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including DWR, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of PERS' comprehensive annual financial report may be obtained from their executive office at 400 P Street, Sacramento, California 95814. The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon an employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age

50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

Annual Pension Cost
For the years ended June 30, 2007 and 2006, DWR's annual pension cost payable from the Fund and actual contribution allocated to the Fund based on the Fund's payroll costs approximated $1 million per year.

GASB 45
Effective not later than the year ending June 30, 2008, the Fund will be required to implement Governmental Accounting Standards Board Statement No. 45***, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions*** (known as OPEBs). The State of California offers postretirement medical and dental benefits, which are currently accounted for on a pay-as-you-go basis. GASB 45 establishes standards for the measurement, recognition, display and disclosure of OPEB expense/expenditures and related liabilities (assets). Upon implementation of GASB 45, the State will be required to record an annual OPEB cost based on the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize unfunded actuarial liabilities over a period not to exceed thirty years.

The State has estimated that the unfunded liability of postretirement benefits approximates $48 billion. The amount that is allocable to the Fund is not expected to be material.

7. Commitments and Contingencies

Litigation and Regulatory Proceedings
DWR is involved in lawsuits and regulatory proceedings that could impact power costs and future revenue requirements.

In July, 2001, the Federal Energy Regulatory Commission (FERC) initiated a proceeding to calculate refunds for inflated prices in the California Independent System Operator (CAISO) and California Power Exchange Corporation markets through June 20, 2001. Because on a marketwide basis DWR is expected to be a net refund recipient in the FERC proceeding, this order poses no potential financial liability to DWR but in effect could reduce the award of refunds to DWR. DWR, along with other state agencies and the IOU's, is engaged in litigation at FERC and in the 9th Circuit Court of Appeal with the goal of increasing the refund amount and reversing FERC's orders which reduce the refunds awarded. It is not expected that DWR will be ordered to pay more in refunds than it receives on a marketwide basis. In addition, the Ninth Circuit Court of Appeals has ruled that FERC cannot require governmental entities such as DWR to pay refunds. Accordingly, DWR has two possible methods of increasing refunds to the State and eliminating reductions to the refund award: (1) successfully challenge on appeal FERC's ruling that DWR is required to pay refunds on its "sales" to the ISO; and (2) assert immunity based on FERC's lack of legal authority to order DWR to pay refunds. In the unlikely event that the Fund would be required to pay any refunds as a result of this proceeding, the refunds would be recoverable from ratepayers through future revenue requirements.

In February 2001, the State commandeered block forward contracts between the California Power Exchange and six suppliers. DWR paid approximately $352 million for energy provided under the contracts, which expired in December 2001. Certain market participants claimed they were entitled to damages in excess of $1 billion, their estimation of the fair value of the block forward contracts at the time of commandeering. In March 2007, the principal plaintiff, the California Power Exchange, dismissed its action against the State. Another plaintiff dismissed its claim in May 2007, leaving one plaintiff whose claim is not material. Should the State be found liable for the remaining claim, and the Fund determined to be the source of moneys to pay damages, those damages would be recoverable from ratepayers through future DWR revenue requirements.

Management believes it is unlikely that DWR will ultimately have a net obligation in connection with the actions described above. As such, no liability has been recorded. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

Other Contingencies
The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes the Fund's exposure to loss is immaterial and that any costs associated with such potential losses are recoverable from customers as part of DWR's revenue requirement.

Commitments
DWR has power purchase contracts that have remaining lives of up to twelve years. Payments under these contracts approximated $4.7 billion and $4.9 billion for fiscal 2007 and 2006, respectively.

The remaining amounts of fixed obligations under the contracts as of June 30, 2007, are as follows (in millions):

Fiscal Year	**Fixed Obligation**
2008	$ 2,378
2009	2,238
2010	1,805
2011	1,070
2012	460
Thereafter	108
	$ 8,059

In addition to the fixed costs there are variable costs under several of the contracts. Management projected as of June 30, 2007 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate $16 billion. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas. The fund enters into forward gas futures contracts to hedge the cost of natural gas.

All of the power purchase contracts and gas purchase contracts are considered derivatives under the provisions of Governmental Accounting Standards Board Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets* (GASB TB 03-1). However, most of the power purchase contracts qualify as normal purchases under GASB TB 03-1 and as a result, market valuation and certain risk information are not required to be disclosed.

However, six power purchase contracts do not qualify as normal purchases and normal sales under the provisions of GASB TB 03-1 primarily resulting from either pricing terms that contain variables which are not clearly and closely related to the base energy price or the seller is not a generator of electricity. As a result, certain information regarding these power purchase contracts is required to be disclosed. The fair value of these six contracts at June 30, 2007 and 2006 approximated $(251)

million and $(353) million, respectively, using forward market prices discounted at DWR's internal cost of capital. These contracts, with a total capacity of 2,385 MWh, expire at various times, from December 2010 through December 2011.

DWR also has entered into transactions to hedge the price of natural gas through bilateral arrangements. These contracts are considered derivatives and do not scope out as normal purchases or normal sales under GASB TB 03-1. The fair value of the various transactions at June 30, 2007 and 2006 approximated $42 million and $(1) million, respectively, using forward market prices. These transaction volumes vary in size from 2,500 to 25,000 mmBtu per day, and they expire at various times from August 2007 through December 2011.

8. Energy Settlements

DWR and other parties have entered into settlement agreements with various energy suppliers which resolve potential and alleged causes of action against suppliers for their part in alleged manipulation of natural gas and electricity commodity and transportation markets during the 2000 - 2001 California energy crisis.

Energy settlements in 2007 total $47 million. DWR received $23 million from the 2006 Enron Corp. settlement through bankruptcy court distributions. Other amounts owed from the Enron Corp. settlement are subject to future bankruptcy court distributions and will be recognized as an energy settlement at such time as there is a distribution of monies. The Fund received an additional $24 million in other settlements, including $18 million from BP Energy Company.

Energy settlements in 2006 total $288 million. First, as part of the energy settlement with Mirant Corporation in 2005, DWR received unsecured claims totaling $90 million plus accrued interest in the Mirant Corporation bankruptcy case. In December 2005, DWR sold its claims and received $96 million. Second, the energy settlement with Enron Corp. became effective and DWR received $53 million. In addition, an energy settlement with Reliant Energy became effective in December 2005 and $66 million was received in March 2006. Finally, in May, 2006, DWR received $73 million from an arbitration agreement with Sempra Energy Resources.

Future revenues under the Mirant Corporation, Reliant Energy, Dynegy Inc, and Duke Energy Corporation settlements are subject to conditions outlined in the underlying settlement and allocation agreements.

9. Related Party Transactions

The California State Teachers' Retirement System (STRS) and The California Public Employees' Retirement System (CalPERS), which are part of the California state government, participate in the Fund's letters of credit with two financial institutions. The total commitment for two letters of credit underlying the STRS' participation approximates $177 million and expires on October 30, 2010. The total commitment for the letter of credit underlying the CalPERS' participation approximates $75 million and expires on December 1, 2008. There are no outstanding amounts on the letters of credit at June 30, 2007 or 2006.