Department of Water Resources
Electric Power Fund
Financial Statements

For the years ended June 30, 2008 and 2007

Department of Water Resources Electric Power Fund
Index

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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, 2008 and 2007, 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 opinion.

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, 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, 2008 and 2007, 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 10 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

October 21, 2008

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. Most 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.

STATEMENTS OF NET ASSETS

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

	2008	2007	2006
Long-term restricted cash, equivalents and investments	$ 1,465	$ 1,542	$ 1,501
Recoverable costs, net of current portion	5,934	6,503	7,229
Restricted cash and equivalents:			
Operating and priority contract accounts	1,227	1,167	950
Bond charge collection and bond charge payment accounts	619	549	514
Recoverable costs, current portion	511	610	613
Interest receivable	27	41	33
Other assets	261	91	75
Total assets	$ 10,044	$ 10,503	$ 10,915
Net assets	$ -	$ -	$ -
Long-term debt, including current portion	9,509	9,995	10,465
Other current liabilities	535	508	450
Total capital and liabilities	$ 10,044	$ 10,503	$ 10,915

Long-Term Restricted Cash and Investments

The $77 million decrease in long-term restricted cash and investments during fiscal 2008 is a combination of a $64 million decrease in the Operating Reserve Account and a $13 million decrease in Debt Service Reserve Account.

The Operating Reserve Account declined to $548 million as a result of declining forecasted power costs in DWR's 2008 revenue requirement due to the renegotiation of a large long term power contract from fixed volume and price to dispatchable capacity, and the expiration of another contract. DWR was able to reduce required reserves and maintain the balance at a level determined in accordance with the bond indenture, equal to the maximum one month priority contract cost amount under stress conditions. The Debt Service Reserve Account declined to $917 million due to decreased debt service cost assumptions resulting from bond refunding transactions in March and April 2008, highlighted below in the Long Term Debt section.

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.

Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The $570 million decrease during fiscal 2008 is due to 1) operating expenses exceeding operating revenues by $35 million, and 2) bond charges plus interest income exceeding interest expense by $605 million. The surplus of bond charge collections over interest costs is primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

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 surplus of bond charge collections over interest costs is primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

Restricted Cash and Investments

The Operating and Priority Contract Accounts increased by $60 million in 2008 primarily due to lower than expected costs in the first six months of the fiscal year, $32 million in non-forecasted energy settlements and collection of $20 million in collateral funds collected from a counterparty to collateralize DWR's natural gas hedge investments. The $1,227 million balance in the Operating and Priority Contract Accounts at June 30, 2008 is $71 million higher than forecast in DWR's calendar 2008 revenue requirement determination.

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 Bond Charge Collection and Bond Charge Payment Accounts increased by $70 million in 2008 due to lower than forecast variable rate debt service costs with the declining interest rate markets during the fiscal year, and the replacement of approximately $1.3 billion of variable rate debt with fixed rate debt which has semi-annual interest payments rather than monthly interest payments.

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.

From the dates of issuance of the revenue bonds through June 30, 2008, 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, 2008 is $99 million lower than at June 30, 2007. The decrease reflects lower power sales volumes after a large fixed volume contract was renegotiated to dispatchable capacity and the expiration of another fixed volume contract, both taking effect on January 1, 2008. The lower expected power sales is partially offset by higher remittance rates per unit sold after implementation of the 2008 revenue requirement, an increase in natural gas hedging settlement revenues and higher surplus gas sales revenues as a result of higher natural gas prices.

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.

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. DWR also hedges natural gas costs by transacting directly with counterparties. Assets in this account and certain bilateral hedge instruments are classified as other assets on the Statements of Net Assets.

During 2008, other assets increased by $170 million. DWR funded the account with $40 million of cash to enable future hedging transactions. The remainder of the increase is due to higher asset values resulting from the natural gas market prices rising with higher commodity prices throughout 2008. At June 30, 2008, other assets consist of money market investments, US Treasury bills and government bonds valued at $62 million and financial options valued at $199 million.

During 2007, other assets increased by $16 million. DWR funded the account with $45 million in September 2006 to enable future hedging transactions.

Long-Term Debt

Revenue bond principal payments were $470 million and $447 million in fiscal 2008 and 2007, respectively. Net amortization of bond premium and deferred loss on defeasance were $18 million and $23 million in fiscal 2008 and 2007, respectively.

During 2008, DWR issued an aggregate of $1.766 billion in refunding revenue bonds (Series H, I, J, and K) to refund $1.825 billion of outstanding 2002 Series C and D and 2005 Series G variable rate bonds. The proceeds of the refunding bonds, along with funds released from the Bond Charge Payment Account ($4 million) and Debt Service Reserve Account ($20 million), were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to refund bonds and pay for underwriting fees and other issuance costs. The refunded bonds were all redeemed by May 2008.

Because the refunded bonds were variable rate bonds, the refunding did not result in an accounting loss.

Other Current Liabilities

Accounts payable at June 30, 2008 are $22 million higher than at June 30, 2007. The difference results from higher costs for natural gas as result of the substantially higher natural gas prices and a $6 million liability for postretirement health and dental liabilities due to the implementation of Governmental Accounting Standards Board Statement No. 45*, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions*. These are offset by reduced power purchases after the renegotiation of the large fixed price contract and expiration of another contract.

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

Accrued interest payable at June 30, 2008 is $5 million higher than at June 30, 2007 as DWR has a higher percentage of fixed rate debt in the bond portfolio after the 2008 refunding transactions. The higher fixed rate debt service costs are offset by declining interest costs on the remaining variable debt as interest rate markets have declined.

Accrued interest payable at June 30, 2007 was $1 million lower than at June 30, 2006, as interest rates were stable in 2007.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

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

	2008	2007	2006
Revenues:			
Power charges	$ 3,794	$ 4,433	$ 3,890
Surplus sales	529	410	480
Bond charges	868	855	842
Interest income	171	167	130
Total revenues	5,362	5,865	5,342
Expenses:			
Power purchases	4,356	4,732	5,038
Energy settlements	(32)	(47)	(288)
Interest expense	434	424	432
Other expenses	34	30	33
Recovery of recoverable costs	570	726	127
Total expenses	5,362	5,865	5,342
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 $639 million lower in 2008 than in the prior year. The difference reflects the lower volume of power sales to end use customers as a result of the renegotiation of a large fixed volume contract to dispatchable capacity, and the expiration of another fixed volume contract, both taking effect on January 1, 2008. The lower volumes were partially offset by higher per unit remittance rates implemented in January 2008 as part of the 2008 revenue requirement.

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.

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 revenues were $119 million higher in 2008 than in 2007. The increase is attributable to higher per unit prices received on sales of excess power and natural gas as commodity markets were volatile during the year. The higher prices for surplus energy sold were partially offset by 9% lower volumes sold.

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.

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, 2008, 2007 and 2006 were $868 million, $855 million, and $842 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 2008 was $4 million higher than in 2007, and interest income for 2007 was $37 million higher than in 2006. The increases are attributable to increased interest earned on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund (SMIF) from slightly higher cash and investment balances.

Power Purchases

Power costs are $376 million lower in 2008 than in 2007. The difference is primarily a result of lower volumes purchased after the renegotiation of a large fixed price contract to dispatchable capacity and the expiration of another fixed price contract, both taking effect January 1, 2008. The decreased amount of power purchased is partially offset by higher costs for natural gas as a result of the substantially higher prices in 2008.

Power costs are $306 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.

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 2008 total $32 million. DWR received $24 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 if and when there is a distribution of monies. The fund received an additional $8 million in other settlements.

In 2007, energy settlements totaled $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.

In 2006, DWR received energy settlements totaling $288 million, from Mirant Corporation ($96 million), Enron Corp ($53 million), Reliant Energy ($66 million) and Sempra Energy Resources ($73 million).

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 was $10 million higher in 2008 when compared to 2007. The increase is attributable to greater amounts of fixed rate debt outstanding in the portfolio as a result of the refunding transactions in 2008 described in the Long-term Debt section of Management's Discussion and Analysis. The increase was partially offset by declining interest rates on variable rate debt during 2008 and lower debt outstanding.

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

Other Expenses

Other expenses increased by $4 million in 2008 primarily as a result of the implementation of Governmental Accounting Standards Board Statement No. 45*, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions* and declined by $3 million in 2007 as a result of decreased costs for contract renegotiation, litigation and professional consulting services.

Recovery (Deferral) of Recoverable Costs

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

	2008	2007	2006
Operations	$ (35)	$ 128	$ (413)
Debt service and related costs	605	598	540
	$ 570	$ 726	$ 127

Operations

The $35 million deferral in the year ended June 30, 2008 reflected the planned under recovery of calendar 2007 operating costs while maintaining compliance with bond indenture requirements, offset by the unplanned receipt of $32 million in energy settlements.

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 $47 million in energy 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.

Debt Service and Related Costs
The recovery in all three years is a result of bond charges and interest income providing funds to pay interest expense and retire debt.

SUBSEQUENT EVENTS

Beginning in September 2008, the world-wide financial markets experienced severe credit and liquidity issues which have impacted many of the Fund's financial counterparties and service providers. As described in Note 10, Lehman Bros. declared bankruptcy which impacted the Fund's remarketing arrangements along with other financial and commodity operations which were transacted with Lehman Bros. and its affiliates. Additionally as described in Note 4, the Fund has experienced an inability to remarket some variable rate bonds resulting in a portion of the bonds becoming "bank bonds" and the Fund has not renewed or replaced credit support agreements which expire in December 2008 relating to $575 million in variable rate bonds. However, due to the structure of the Fund's credit support and related underlying credit agreements, management does not anticipate that any related liquidity constraints would be material to the Fund.

Department of Water Resources Electric Power Fund
Statements of Net Assets
June 30, 2008 and 2007 (in millions)

	2008	2007
Assets		
Long-term assets:		
Restricted cash, equivalents and investments:		
Operating Reserve Account	$ 548	$ 612
Debt Service Reserve Account	917	930
Recoverable costs, net of current portion	5,934	6,503
Total long-term assets	7,399	8,045
Current assets:		
Restricted cash and equivalents:		
Operating and Priority Contract Accounts	1,227	1,167
Bond Charge Collection and Bond Charge Payment Accounts	619	549
Recoverable costs, current portion	511	610
Interest receivable	27	41
Other assets	261	91
Total current assets	2,645	2,458
Total assets	$ 10,044	$ 10,503
Capitalization and Liabilities		
Capitalization:		
Net assets	$ -	$ -
Long-term debt	8,999	9,508
Total capitalization	8,999	9,508
Current liabilities:		
Current portion of long-term debt	510	487
Accounts payable	475	453
Accrued interest payable	60	55
Total current liabilities	1,045	995
Commitments and Contingencies (Note 7)		
Total capitalization and liabilities	$ 10,044	$ 10,503

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, 2008 and 2007 (in millions)

	2008	2007
Operating revenues:		
Power charges	$ 3,794	$ 4,433
Surplus sales	529	410
Total operating revenues	4,323	4,843
Operating expenses:		
Power purchases	4,356	4,732
Energy settlements	(32)	(47)
Administrative expenses	34	30
(Deferral) recovery of recoverable operating costs	(35)	128
Total operating expenses	4,323	4,843
Income from operations	-	-
Bond charges	868	855
Interest income	171	167
Interest expense	(434)	(424)
Recovery of recoverable debt service and related costs	(605)	(598)
Net increase in net assets	-	-
Net assets, beginning of year	-	-
Net assets, end of year	$ -	$ -

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, 2008 and 2007 (in millions)

	2008	2007
Cash flows from operating activities:		
Receipts:		
Power charges	$ 3,942	$ 4,439
Surplus sales	481	397
Energy settlements	32	47
Payments for power purchases and other expenses	(4,539)	(4,719)
Net cash (used in) provided by operating activities	(84)	164
Cash flows from non-capital financing activities:		
Receipt of bond charges	867	865
Bond payments	(470)	(447)
Interest payments	(447)	(448)
Proceeds from issuance of revenue bonds	1,827	-
Defeasance of revenue bonds	(1,825)	-
Net cash used in non-capital financing activities	(48)	(30)
Cash flows from investing activities:		
Interest received on investments	185	159
Refund of proceeds from termination of guaranteed investment contract	150	-
Net cash provided by investing activities	335	159
Net increase in cash and equivalents	203	293
Restricted cash and equivalents, beginning of year	2,658	2,365
Restricted cash and equivalents, end of year	$ 2,861	$ 2,658
Restricted cash and equivalents included in:		
Operating Reserve Account	$ 548	$ 612
Debt Service Reserve Account (a component of the total of $917 and $930 at June 30, 2008 and 2007, respectively)	467	330
Operating and Priority Contract Accounts	1,227	1,167
Bond Charge Collection and Bond Charge Payment Accounts	619	549
Restricted cash and equivalents, end of year	$ 2,861	$ 2,658
Reconciliation of operating income to net cash (used in) provided by operating activities:		
Income from operations	$ -	$ -
Changes in net assets and liabilities to reconcile operating income to cash net (used in) provided by operations:		
Recoverable costs	(63)	223
Accounts payable	(21)	(59)
Total adjustments	(84)	164
Net cash (used in) provided by operating activities	$ (84)	$ 164

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 implements DWR's determination of its revenue requirements by establishing customer rates that 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, 2008 and 2007, 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, 2008 and 2007 those amounts were $199 million and $52 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 $46 million and $23 million at June 30, 2008 and 2007, respectively, and the investments in treasury bills and government bonds amounted to $16 million at June 30, 2008 and 2007 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.

New Accounting Pronouncements

<u>GASB 45 Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions</u>

During the year ending June 30, 2008, the State of California was 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) (GASB 45). The State of California offers postretirement medical and dental benefits, previously 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). Under GASB 45, the State is required to record an annual OPEB cost based on the annual required contribution of the employer (ARC), in 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. Implementation of GASB 45 had an immaterial impact on the Fund.

<u>GASB 53 Accounting and Financial Reporting for Derivative Instruments</u>

For the year ended June 30, 2010, the Fund will be required to implement Governmental Accounting Standards Board Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* (GASB 53). GASB 53 requires governments to record most derivative instruments on the statement of net assets as either assets or liabilities depending on the underlying fair value of the derivative. The fair value of a derivative instrument is either the value of its future cash flows in today's dollars or the price it would bring if it could be sold on an open market. As discussed in Note 5, the Fund is party to interest rate swap agreements which are considered to be derivatives. As discussed in Note 7, certain of the power purchase agreements and natural gas hedging arrangements are considered derivatives. Under existing accounting standards, some of the gas hedging arrangements are already accounted for on the Fund's statement of net assets.

3. Restricted Cash and Investments

The State of California has a deposit policy to address custodial credit risk. As of June 30, 2008 and 2007, $16 million and $24 million, respectively, of the Fund's cash balances were uninsured and uncollateralized.

As of June 30, 2008 and 2007, the Fund had the following cash, cash equivalents and investments (in millions):

Investment	Maturity	2008	2007
State of California Pooled Money Investment Account - State Money Investment Fund	7.1 months average	$ 2,831	$ 2,618
Cash		30	40
Total cash and equivalents		2,861	2,658
Guaranteed investment contracts	May 1, 2022	350	500
Forward purchase agreement	November 1, 2008	100	100
		$ 3,311	$ 3,258

Interest Rate Risk: In accordance with its investment policy, the State of California manages its exposure to declines in fair values by limiting investments to the maximum maturities, as follows: U.S. Treasury securities, 5 years; federal agency securities, 5 years; bankers acceptances – domestic and foreign, 180 days; certificates of 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 to limits of no more than 10% of PMIA and commercial paper to limits not to exceed 30% 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, 2008 (in millions):

	Amount	S&P	Moody's
GIC Providers			
FSA	$ 100	AAA	Aaa
Royal Bank of Canada	100	AA-	Aaa
Sun America	150	AA+	Aa2
	$ 350		
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 2.9% and 5.3% at June 30, 2008 and 2007, respectively. For the years ended June 30, 2008 and 2007, interest earned on the deposit in PMIA was $128 million and $136 million, respectively. Additionally during the year ended June 30, 2008, the Fund earned $14 million on bond issuance proceeds while in escrow, which was paid to the Fund upon the close of escrow.

Interest on the GICs is paid semi-annually at interest rates ranging from 5.2% to 5.5%. Interest earned on the GICs was $24 million and $26 million for the years ended June 30, 2008 and 2007, respectively. The GICs mature in 2022. A GIC valued at $150 million was redeemed during 2008 and the proceeds invested in SMIF.

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, 2008 and 2007.

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2008 and 2007 (in millions):

	Revenue Bonds	Unamortized Premium	Deferred Loss on Defeasance	Total
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
Refunding				
Issuance of debt	1,766	61	-	1,827
Defeasance of debt	(1,825)	-	-	(1,825)
Payments	(470)	-	-	(470)
Amortization	-	(32)	14	(18)
Balance, June 30, 2008	9,525	166	(182)	9,509
Less current portion	494	31	(15)	510
	$ 9,031	$ 135	$ (167)	$ 8,999

The tax-exempt revenue bonds consist of the following at June 30, 2008 and 2007, respectively (in millions):

Series	Rates	Fiscal Year of Final maturity	Fiscal Year of First Call Date	Amount Outstanding 2008	2007
A	3.375-6.0%	2018	2012	$ 2,826	$ 3,274
B	Variable	2020	Callable	1,000	1,000
C	Variable	2021	Callable	2,333	2,733
D	Variable	2022	Callable	-	500
F	Variable	2022	Callable	759	759
G	Variable	2018	Callable	841	1,788
H	3.75-5.0%	2022	Non-callable	1,007	-
I	Variable	2022	Callable	150	-
J	Variable	2018	Callable	330	-
K	4.0-5.0%	2018	Non-callable	279	-
				9,525	10,054
Plus unamortized bond premium				166	137
Less deferred loss on defeasance				(182)	(196)
Less current maturities				(510)	(487)
				$ 8,999	$ 9,508

During 2008, DWR issued an aggregate $1.766 billion in refunding revenue bonds (Series H, I, J, and K) to refund $1.825 billion of outstanding 2002 Series C and D and 2005 Series G variable rate bonds.

The proceeds of the refunding bonds, along with funds released from the Bond Charge Payment Account ($4 million) and Debt Service Reserve Account ($20 million), were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to refund bonds and pay for underwriting fees and other issuance costs. The refunded bonds were all redeemed by May 2008.

Because the refunded bonds were variable rate bonds, the refunding did not result in an accounting loss.

The total amount of bonds refunded in advance in December 2005 and still outstanding was $2.353 billion at June 30, 2008. These bonds cannot be called until 2012.

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 of California.

Future payment requirements on the revenue bonds are as follows at June 30, 2008 (in millions):

Fiscal Year	Principal	Interest [1]	Total
2009	$ 494	$ 290	$ 784
2010	518	269	787
2011	545	247	792
2012	573	226	799
2013	602	202	804
2014-2018	3,447	657	4,104
2019-2022	3,346	202	3,548
	$ 9,525	$ 2,093	$ 11,618

[1] Variable portion of interest cost calculated using the June 30, 2008 Securities Industry and Financial Markets Association Swap Index (SIFMA).

Series B, C, F, G, I and J are variable rate bonds and have either daily or weekly rate reset modes. The variable rate bonds have a final stated maturity of 2022, but are scheduled to be retired in sinking fund installments from 2008 to 2022. The interest rates for the variable debt for the year ended June 30, 2008 and 2007, ranged from 0.30% to 10.94% and from 2.9% to 4.1%, respectively.

DWR bonds are remarketed by fourteen different broker-dealer remarketing agents, with credit enhancement provided by twenty one banks to spread its risk exposure among many firms. Due to credit market turmoil, remarketing agents can experience problems finding investors for certain bonds, including those with credit enhancement from banks and insurers that have perceived credit risk, as well as risk specific to their own company that carries negative perception with investors. Failed remarketings can result in the credit enhancing bank’s required purchase of the bonds, and they become “bank bonds”. If this occurs, DWR is required to pay a stated fixed interest rate quarterly until the bonds are successfully remarketed. If the agreements expire or are terminated, DWR is required to begin paying principal in quarterly installments six months after termination.

Subsequent to June 30, 2008, negative credit market impacts have increased borrowing costs on variable rate bonds that have experienced interest rate resets at higher rates and caused the remarketing failure of $71 million of bonds, which are now bank bonds. DWR remarkets bonds on a daily basis, including bank bonds. The level of bank bonds can fluctuate daily. DWR will continue to attempt to remarket bank bonds before early amortization is required, as these bonds do not have enhancement facilities expiring within the current fiscal year, and no termination provision condition is imminent. If early amortization is required, debt service costs will increase by $15 million annually until fully amortized. DWR also had a remarketing agent change due to the bankruptcy of Lehman Brothers described in Note 10.

The payment of principal and interest for all Series B bonds, $1.73 billion of Series C bonds, all Series F bonds, $90 million of Series G and all Series I and J 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. Bonds purchased under the letters of credit are required to be redeemed in equal installments over a five or seven year period beginning six months after the termination date of the letter of credit. There are no outstanding amounts on the letters of credit at June 30, 2008. 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, in a range from 0.35% to 0.38% per annum on the stated amount for the Series F and G bonds, and 0.53% per annum on the stated amount for the Series I and J bonds. The Series B and C letters of credit expire in fiscal year 2011, the Series F and G letters of credit expire between fiscal years 2009 and 2011, and the Series I and J letters of credit expire in fiscal year 2011.

After the 2008 refunding transactions, $600 million Series C bonds and $773 million Series G bonds remain that are credit enhanced by bond insurance for the timely payment of principal and interest. All insured bonds are enhanced by FSA bond insurance which was “AAA” rated at June 30, 2008. However, current credit default swap rates and other contemporaneous indicators of credit status for FSA have declined since June 30, 2008. 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, 2008. The liquidity facilities backing the $600 million in 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. One liquidity facility backing $75 million in Series G bonds expire in fiscal year 2009, four liquidity facilities backing $598 million expire in fiscal year 2011 and the final liquidity facility underlying $100 million expires in fiscal year 2013. The Fund pays fees of 0.15% to 0.19% per annum under the Series G liquidity facilities.

There are letters of credit and liquidity facilities enhancing $575 million of variable rate bonds that expire December 1, 2008. DWR has begun the renewal process for those agreements. If they cannot be renewed, the bonds may become bank bonds and are subject to the accelerated amortization schedule outlined above. If this were to occur, DWR’s current portion of debt service would increase by $30 million for 2009, and would increase by $121 million annually thereafter until fully repaid. Interest costs on the bank bonds may also be higher than rates attainable from variable reset rates.

DWR is considering other options available to remedy any lack of credit capacity to renew all expiring agreements. DWR may convert the bonds to a fixed mode or plan a fixed refunding for all bonds where credit enhancement is not renewed, with identical maturities to the currently enhanced bonds.

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, 2008 are summarized in the following table (in millions):

Outstanding Notional Amount	Fixed Rate Paid by Fund	Variable Rate [1] Received by Fund	Fair Value gain (loss)	Swap Termination Date	Counterparty Credit Rating S&P	Moody's	Fitch
$ 94	2.914%	67% of LIBOR	$ (1)	May 1, 2011	AAA	Aaa	AAA
234	3.024%	67% of LIBOR	(3)	May 1, 2012	AAA	Aaa	AAA
190	3.405%	SIFMA	(3)	May 1, 2013	AA-	Aa2	AA-
95	3.405%	SIFMA	(2)	May 1, 2013	A+	Aa3	AA-
28	3.405%	SIFMA	(1)	May 1, 2013	A	A1	A+
194	3.204%	67% of LIBOR	(4)	May 1, 2014	AA	Aa2	AA
287	3.184%	66.5% of LIBOR	(5)	May 1, 2015	A+	Aa3	AA-
174	3.280%	67% of LIBOR	(4)	May 1, 2015	AAA	Aaa	AAA
202	3.342%	67% of LIBOR	(5)	May 1, 2016	AA+	Aa1	AA
485	3.228%	66.5% of LIBOR	(8)	May 1, 2016	AA+	Aa1	AA
202	3.389%	67% of LIBOR	(5)	May 1, 2017	A+	Aa3	AA-
480	3.282%	66.5% of LIBOR	(7)	May 1, 2017	AA-	Aa3	AA-
515	3.331%	66.5% of LIBOR	(7)	May 1, 2018	AA	Aa1	AA-
306	3.256%	64% of LIBOR	(3)	May 1, 2020	AA	Aa1	AA-
453	3.325%	64% of LIBOR	(3)	May 1, 2022	AA-	Aaa	AA
$ 3,939			$ (61)				

[1] One month U.S. Dollar London Interbank Offered Rate or Securities Industry and Financial Markets Association (SIFMA) (formerly BMA)

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, 2008, the variable rates on DWR's hedged bonds ranged from 0.30% to 10.94%, while 64%, 66.5% and 67% of LIBOR received on the swaps was equal to 1.58%, 1.64%, and 1.66% 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.

DWR has 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) at June 30, 2008 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 gain (loss)	Swap Termination Date	Counterparty Credit Rating S&P	Moody's	Fitch
$ 234	67% of LIBOR	62.83% of CMS	$ 4	May 1, 2012	AA+	Aa1	AA
194	67% of LIBOR	62.70% of CMS	3	May 1, 2014	AA	Aa1	AA-
174	67% of LIBOR	62.60% of CMS	3	May 1, 2015	AA-	Aa2	AA-
202	67% of LIBOR	62.80% of CMS	4	May 1, 2016	AA+	Aa1	AA
202	67% of LIBOR	62.66% of CMS	4	May 1, 2017	AA-	Aa2	AA-
$ 1,006			$ 18				

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

2 Five year Constant Maturity Swap

As of June 30, 2008, 67% of LIBOR paid on the basis swaps was equal to 1.66% while the variable rates received based on the 5 year CMS Index varied from 3.44% to 5.52%.

Net amounts (paid) received under all swaps amounted to $(18) million and $11 million for the years ended June 30, 2008 and 2007, respectively.

Credit Risk: DWR has a total of twenty swap agreements with ten different counterparties at June 30, 2008. Approximately 23 percent of the swaps total notional value is with a single counterparty with a credit rating of AA+/Aa1/AA. Of the remaining swaps, two are held with one counterparty, approximating 21 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/A1/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, 2008, 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**
2009	$ 127	$ 61	$ 54	$ 241
2010	80	59	52	190
2011	241	57	50	348
2012	258	53	46	358
2013	54	50	45	149
2014-2018	2,420	180	175	2,774
2019-2022	759	31	34	825
	$ 3,939	$ 491	$ 456	$ 4,886

6. Retirement Plan and Postretirement Benefits

Retirement 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, 2008 and 2007, 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.

Postretirement Benefits
In addition to the pension benefits, the State of California provides post-retirement health care benefits, in accordance with Section 22754(g) of the State Government Code, to all employees who retire on or after attaining certain age and length of service requirements. The State of California is funding postretirement benefits on a pay-as-you-go basis. The annual required contribution for the Fund amounted to $9 million for the year ended June 30, 2008 and the net OPEB obligation amounted to $6 million at June 30, 2008. The Fund's annual required contribution represents 0.3% of the State's total annual required contribution for the year ended June 30, 2008. The State's unfunded actuarial accrued liability at July 1, 2007 attributable all State employees amounted to $47.88 billion.

7. Commitments and Contingencies

Litigation and Regulatory Proceedings
Certain pending legal and administrative proceedings involving DWR or affecting DWR's power supply program are summarized below.

California Refund Proceedings: During 2001 and 2002, DWR purchased power in bilateral transactions (both short term and long term), sold power to the California Independent System Operator (CAISO), paid for power purchased by the CAISO and purchased power from the CAISO for sale to customers of the IOUs. In July 2001, the Federal Energy Regulatory Commission (FERC) initiated an administrative proceeding to calculate refunds for inflated prices in the CAISO and California Power Exchange (PX) markets during 2000 and 2001. FERC ruled that DWR would not be entitled in that proceeding to approximately $3.5 billion in refunds associated with DWR's approximately $5 billion of short term purchases because DWR made those purchases bilaterally, not in the PX or CAISO markets. The Ninth Circuit Court of Appeals affirmed FERC, but left open the possibility of refunds on DWR's bilateral purchases in other FERC proceedings. In contrast, FERC ruled that DWR is entitled to refunds on purchases made by the CAISO where DWR actually paid the bill.

Of DWR's $5 billion in short term bilateral purchases, $2.9 billion was imbalance energy which DWR sold to the CAISO at DWR's cost in order to meet the CAISO's emergency needs during 2001. DWR is treated in the FERC refund proceeding as a seller of that energy to CAISO, and in May 2004, FERC issued an order requiring DWR to pay refunds on the sales to the CAISO. However, because DWR would likely be the primary recipient of any refunds on energy it sold to the CAISO, DWR's potential net liability associated with its sales to the CAISO would be substantially reduced. Settlements executed to date with various sellers have reduced that potential liability even further.

Under FERC's orders, therefore, DWR both owes refunds (on the energy it sold to the CAISO) and is entitled to refunds (on the energy that the CAISO purchased but DWR paid for); the effect of offsetting the two is likely to be that DWR would receive refunds.

As to refunds owed, FERC has ruled that to the extent DWR could demonstrate that payment of refunds would result in DWR's costs exceeding its revenues remaining after payment of refunds, DWR could request FERC to reduce the refunds. DWR made a cost recovery filing that DWR believes demonstrates that its costs related to sales to the CAISO exceeded its revenues, a demonstration that, if approved by FERC, would eliminate any refund amount DWR might otherwise be required to pay. In January 2006, FERC deferred action on DWR's cost filing on the basis that DWR, as described above, likely will be a net refund recipient, and net refund recipients, according to FERC, cannot make cost filings. Certain California parties have sought rehearing of that order.

In addition, in September 2005, the Ninth Circuit Court of Appeals ruled that FERC could not require governmental entities such as DWR to pay refunds.

Accordingly, DWR likely will be a net refund recipient in the FERC proceedings. Pending litigation could increase or decrease the level of the refunds DWR would be entitled to receive. DWR does not expect that FERC will order it to pay more in refunds than it receives on a market-wide basis.

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 seven years. Payments under these and gas purchase contracts approximated $4.3 billion and $4.7 billion for fiscal 2008 and 2007, respectively.

The remaining amounts of fixed obligations under the contracts as of June 30, 2008, are as follows (in millions):

Fiscal Year	**Fixed Obligation**
2009	$ 1,720
2010	1,501
2011	1,070
2012	460
2013	75
Thereafter	33
	$ 4,859

In addition to the fixed costs there are variable costs under several of the contracts. Management projected as of June 30, 2008 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate $13 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). 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.

Six power purchase contracts do not qualify as normal purchases and normal sales under the provisions of GASB TB 03-1 because either the pricing terms contain variables which are not clearly and closely related to the base energy price or the seller is not a generator of electricity. The fair value of these five contracts at June 30, 2008 and 2007 are approximately $459 million gain and $(251) million loss, respectively, based on quoted prices and price curves for derivatives. These contracts, with a total capacity of 2,385 MWh at June 30, 2008, 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 are not considered normal purchases or normal sales under GASB TB 03-1. The fair value of the various transactions at June 30, 2008 and 2007 approximated $292 million and $28 million, respectively, using forward market prices. The transaction volumes vary in size from 2,500 to 25,000 mmBtu per day, and they expire at various times from August 2008 through December 2011.

Credit Risk: Since DWR is a net buyer under all power purchase contracts and the majority of DWR's power purchase contracts are valued in the counterparties favor, DWR does not incur substantial credit risk. There are two large fixed price contacts that were valued in DWR's favor at June 30, 2008. Subsequent to the end of the year, the fall in energy prices has caused a decrease in exposure to those two contracts, thus DWR does not believe there is significant credit risk with its power purchase contracts.

DWR has open natural gas hedge positions with twelve different counterparties at June 30, 2008. All counterparties have credit ratings of at least A-/A2. DWR has credit risk exposure to all counterparties since the value is in DWR's favor with all counterparties, given the sharp increase of natural gas prices. Subsequent to June 30, 2008, natural gas prices declined sharply and the open exposure had fallen to $23 million as of September 30, 2008.

Termination Risk: None of the power purchase contracts have termination provisions that would require DWR to make payment in the event of a counterparty default. DWR is only required to make a termination payment upon a DWR default and the contract values in favor of the counterparty.

With regards to gas hedge agreements, DWR or the counterparty may terminate an agreement if the other party fails to perform under the terms of the contract. In addition, the agreements allow either party to terminate in the event of a significant loss of creditworthiness by the other party. If a termination were to occur, DWR or the counterparty would owe the other a payment equal to the open positions fair value in their favor. A termination event occurred subsequent to June 30, 2008 as described in Note 10 below.

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 2008 total $32 million. DWR received $24 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 if and when there is a distribution of monies. The fund received an additional $8 million in other settlements.

Energy settlements in 2007 total $47 million. DWR received $23 million from the 2006 Enron Corp. settlement through bankruptcy court distributions and an additional $24 million in other settlements, including $18 million from BP Energy Company.

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 three 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 three letters of credit underlying the CalPERS' participation approximates $157 million, of which one letter of credit for $76 million expires on December 1, 2008, and the other two letters of credit for $81 million expire October 30, 2011. There are no outstanding amounts on the letters of credit at June 30, 2008 or 2007.

10. Subsequent Events

On September 15, 2008, Lehman Brothers Holdings Inc. ("Lehman") filed for protection under Chapter 11 of the federal Bankruptcy Code in the United States Bankruptcy Court in the Southern District of New York. DWR has business relationships with subsidiaries of Lehman. DWR is a counterparty with Lehman Brothers Commodity Services Inc. ("LBCS") and Eagle Energy Partners 1, LP ("Eagle Energy"), subsidiaries of Lehman, in wholesale energy marketing transactions. Lehman Brothers Inc. ("LBI"), another Lehman subsidiary, acts as a remarketing agent for $1.066 billion of outstanding DWR variable rate bonds.

The obligations of LBCS are guaranteed by Lehman, and the Lehman bankruptcy filing gave DWR the right to terminate the transactions with LBCS. DWR exercised its right to terminate the transactions with LBCS on September 18, 2008. As of the effective termination date DWR had net credit losses of under $1 million, and issued a demand notice for amounts owed.

The obligations of Eagle Energy are not guaranteed by Lehman. As of September 15, 2008 DWR had no credit exposure to Eagle Energy, as DWR was a net buyer of gas for amounts delivered in August and the first half of September and has no future delivery contracts outstanding.

DWR does not believe the Lehman bankruptcy and the resulting effects on subsidiaries of Lehman will have a material adverse impact on the remarketing efforts of its bonds by LBI. After the bankruptcy filing, Barclays Bank Plc purchased the broker-dealer operations of LBI. DWR expects the operation to continue remarketing the bonds. DWR may explore reappointing new remarketing agents if management determines that there will be some adverse impact to the remarketing effort after the transaction.