

# Department of Water Resources Electric Power Fund Financial Statements

September 30, 2008



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# Department of Water Resources Electric Power Fund Management's Discussion and Analysis

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## 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 a specified date. The statement of revenues, expenses and changes in net assets presents all revenues, expenses, and changes in net assets for a specific period. 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.

This report should be read in conjunction with the Fund's June 30, 2008 audited financial statements.

## BACKGROUND

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. However, DWR retains the legal and financial responsibility for the contracts until such time as there is complete assignment of the contracts to the IOUs and release of DWR. DWR is entitled to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, other expenses and reserves.

# Department of Water Resources Electric Power Fund Management's Discussion and Analysis

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## STATEMENTS OF NET ASSETS

The Fund's assets, liabilities and net assets as of September 30, 2008 and June 30, 2008 are summarized as follows (in millions):

	September 30, 2008	June 30, 2008
Long-term restricted cash, equivalents and investments	\$ 1,465	\$ 1,465
Recoverable costs, net of current portion	6,134	5,934
Restricted cash and investments:		
Operating and priority contract accounts	923	1,227
Bond charge collection and bond charge payment accounts	854	619
Recoverable costs, current portion	545	511
Interest receivable	29	27
Other assets	56	261
Total assets	<u>\$ 10,006</u>	<u>\$ 10,044</u>
Net assets	\$ -	\$ -
Long-term debt, including current portion	9,505	9,509
Other current liabilities	501	535
Total capital and liabilities	<u>\$ 10,006</u>	<u>\$ 10,044</u>

### Long-Term Restricted Cash and Investments

There is no change in the \$548 million balance in the Operating Reserve Account at September 30, 2008 from June 30, 2008. The amount is determined in accordance with the bond indenture and is equal to the maximum one month priority contract cost amount under stress conditions for calendar year 2008 as forecast in the DWR 2008 revenue requirement determination. The balance of the Debt Service Reserve Account remains at \$917 million, and was also determined in accordance with bond indenture requirements.

### Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The \$200 million net increase in long-term recoverable costs during the three month period ended September 30, 2008 is the net of 1) operating expenses exceeding operating revenues by \$345 million, and 2) bond charge revenue exceeding interest expense by \$145 million.

### Restricted Cash and Investments

The Operating and Priority Contract Accounts decreased by \$304 million during the three month period ended September 30, 2008. This decrease was higher than the \$118 million planned decrease in balances for the three month period reflected in the 2008 revenue requirement due to higher than expected power costs for July and August 2008. As a result of the higher than expected gas prices from April through August 2008, the balance in the Operating and Priority Contract Accounts at September 30, 2008 is \$51 million lower than forecast in DWR's 2008 revenue requirement determination.

The Bond Charge Collection and Bond Charge Payment Accounts increased by \$235 million in the period ended September 30, 2008 in anticipation of the semi-annual interest payment on fixed rate bonds due in November 1, 2007, and the next principal payment due May 1, 2008.

## **Department of Water Resources Electric Power Fund Management's Discussion and Analysis**

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From the dates of issuance of the revenue bonds through September 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 billings 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 increased by \$34 million in the three months ended September 30, 2008. This increase is primarily attributable to the seasonally higher sale of power in the summer months to end use customers.

### **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.

Other assets decreased by \$205 million in the three months ended September 30, 2008 to \$56 million as a result of volatile natural gas prices that decreased substantially from the levels existing at June 30, 2008. With the decline in natural gas prices in September 2008, \$50 million was transferred from the Operating Account to the brokerage account and used to fund realized losses, provide collateral for current positions, and enable future hedging activities. At September 30, 2008, other assets consisted of money market obligations, US Treasury bills, and government bonds valued at \$22 million and financial options valued at \$34 million.

### **Long-Term Debt**

The \$4 million decrease in long-term debt for the three month period ended September 30, 2008 is attributable to the net amortization of bond premium and deferred loss on the advance bond refunding.

### **Other Current Liabilities**

Accounts payable reflect one month's accrual for power and fuel purchases, as payments are normally made on the 20th of the month following purchase. At September 30, 2008 accounts payable are \$34 million lower than at June 30, 2008 as a sharp decline in natural gas prices from levels in June offset higher seasonal contract volumes.

The \$49 million increase in accrued interest payable is anticipated as the fixed rate bonds provide for semi-annual payments on May 1<sup>st</sup> and November 1<sup>st</sup>, while the variable rate bonds provide for more frequent payments.

# Department of Water Resources Electric Power Fund Management's Discussion and Analysis

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## STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

The Fund's activities for the three months ended September 30, 2008 and 2007 are summarized as follows (in millions):

	2008	2007
Revenues:		
Power charges	\$ 962	\$ 1,173
Surplus sales	107	107
Bond charges	218	221
Interest income	26	44
Total revenues	<u>1,313</u>	<u>1,545</u>
Expenses:		
Power purchases	1,417	1,305
Energy settlements	(8)	(9)
Interest expense	99	101
Other expenses	5	5
(Deferral) recovery of recoverable costs	(200)	143
Total expenses	<u>1,313</u>	<u>1,545</u>
Net increase in net assets	-	-
Net assets, beginning of period	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>

### Power Charges

Power charges decreased by \$211 million in the three months ended September 30, 2008 compared to the same three month period in 2007. 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.

### Surplus Sales

Surplus sales of energy and natural gas in the three month period ended September 30, 2008 were equal to amounts sold in the same period in 2007. The amount of sales of natural gas were comparable due to lower volumes of excess natural gas sold offset by higher dollar values received per unit sold in the three month period ended September 30, 2008. Surplus energy sales were substantially the same when compared to the same period in 2007.

### Bond Charges

Bond charges for the three months ended September 30, 2008 are \$3 million lower than the same period in 2007, and are 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.

# Department of Water Resources Electric Power Fund Management's Discussion and Analysis

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## Interest Income

Interest income for the three months ended September 30, 2008 is \$18 million lower than the interest income for the same period in 2007 and is attributable to lower outstanding cash balances along with a decline in interest rates earned on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund due to a decline in interest rates over the last year. The average monthly yield for the three month period ending September 30, 2008 decreased to 2.78% from 5.25% earned in the same period in 2007.

## Power Purchases

Power costs are \$112 million higher in the three months ended September 30, 2008 than in the same period in 2007. The increase in costs is due to the substantially higher price of natural gas in July and August 2008 along with an increase in amounts needed to meet margin calls in the natural gas hedging accounts in September as prices began to fall. The higher costs were partially offset by 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.

## Energy Settlements

Energy settlements for the three months ended September 30, 2008 total \$8 million. DWR received \$4 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 \$4 million in other settlements.

## Interest Expense

Interest expense in the three months ended September 30, 2008 is \$2 million lower than the amounts paid in the same period in 2007. The slight decrease was attributed to lower variable interest rates resulting from the declining interest rate environment offset by greater amounts of fixed rate debt outstanding in the portfolio as a result of the refunding transactions in early 2008.

## Other Expenses

Other expenses in the three months ended September 30, 2008 were comparable to the same period in 2007.

## (Deferral) Recovery of Recoverable Costs

The individual components of the (deferral) recovery of recoverable costs are as follows for the three months ended September 30, 2008 and 2007 (in millions):

	2008	2007
Operations	\$ (345)	\$ (21)
Debt service and related costs	145	164
	<u>\$ (200)</u>	<u>\$ 143</u>

### Operations

There was a deferral of recoverable costs of \$345 million for the three months ended September 30, 2008, versus the \$21 million deferral in the same period in 2007. The larger deferral in the three months

## **Department of Water Resources Electric Power Fund Management's Discussion and Analysis**

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ended September 30, 2008 reflects higher power costs than planned due to the sharp increase in natural gas prices in July and August 2008.

### **Debt Service and Related Costs**

The recovery of debt service and bond related costs are \$19 million lower for the three months ended September 30, 2008 compared to the same period in 2007. The recovery is comprised solely of the difference between bond charges and interest income less interest expense. The smaller recovery is primarily due to lower interest income due to the decline in cash balances and interest rates earned on those balances.

### **FUTURE OPERATIONS**

DWR has the authority to administer all power supply contracts entered into before December 31, 2002, for the life of the contracts. Over 95% of the annual volume of power under the contracts expires by December 31, 2011 and the last of the contracts expires in 2015.

On November 21, 2008, the California Public Utilities Commission approved Decision 08-11-056 which adopts a plan with the goal of an earlier exit of DWR from its role as a supplier of power. Under this plan, DWR's power supply contracts would be replaced by agreements between the IOUs and DWR's power supplier counterparties that are not detrimental to ratepayers, through novation and/or negotiation. The Decision sets a goal for the execution of replacement agreements for all of the power supply contracts by January 1, 2010. Although Decision 08-11-056 sets a goal of January 1, 2010, the decision also recognizes that it may become necessary to adjust that goal, depending upon the progress of negotiations for acceptable replacement contracts.

# Department of Water Resources Electric Power Fund

## Statements of Net Assets

September 30, 2008 and June 30, 2008

(in millions)

	September 30, 2008	June 30, 2008
<b>Assets</b>		
Long-term assets:		
Restricted cash, equivalents and investments:		
Operating Reserve Account	\$ 548	\$ 548
Debt Service Reserve Account	917	917
Recoverable costs, net of current portion	<u>6,134</u>	<u>5,934</u>
Total long-term assets	<u>7,599</u>	<u>7,399</u>
Current assets:		
Restricted cash and investments:		
Operating and Priority Contract Accounts	923	1,227
Bond Charge Collection and Bond Charge Payment Accounts	854	619
Recoverable costs, current portion	545	511
Interest receivable	29	27
Other assets	56	261
Total current assets	<u>2,407</u>	<u>2,645</u>
Total assets	<u>\$ 10,006</u>	<u>\$ 10,044</u>
<b>Capitalization and Liabilities</b>		
Capitalization:		
Net assets	\$ -	\$ -
Long-term debt:		
Revenue bonds	<u>8,996</u>	<u>8,999</u>
Total capitalization	<u>8,996</u>	<u>8,999</u>
Current liabilities:		
Current portion of long-term debt	509	510
Accounts payable	390	475
Accrued interest payable	<u>111</u>	<u>60</u>
Total current liabilities	<u>1,010</u>	<u>1,045</u>
Commitments and contingencies (Note 5)		
Total capitalization and liabilities	<u>\$ 10,006</u>	<u>\$ 10,044</u>

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 three months ended September 30, 2008 and 2007**

**(in millions)**

	2008	2007
Operating revenues:		
Power charges	\$ 962	\$ 1,173
Surplus sales	107	107
Total operating revenues	<u>1,069</u>	<u>1,280</u>
Operating expenses:		
Power purchases	1,417	1,305
Energy settlements	(8)	(9)
Other expenses	5	5
Deferral of recoverable operating costs	(345)	(21)
Total operating expenses	<u>1,069</u>	<u>1,280</u>
Income from operations	-	-
Bond charges	218	221
Interest income	26	44
Interest expense	(99)	(101)
Recovery of recoverable debt service and related costs	<u>(145)</u>	<u>(164)</u>
Net increase in net assets	-	-
Net assets, beginning of period	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>

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

# Department of Water Resources Electric Power Fund

## Statements of Cash Flows

For the three months ended September 30, 2008 and 2007

(in millions)

	2008	2007
Cash flows from operating activities:		
Receipts:		
Power charges	\$ 836	\$ 1,129
Surplus sales	174	112
Energy settlements	8	9
Payments for power purchases and other expenses	<u>(1,301)</u>	<u>(1,321)</u>
Net cash used in operating activities	<u>(283)</u>	<u>(71)</u>
Cash flows from non-capital financing activities:		
Receipt of bond charges	242	241
Interest payments	<u>(52)</u>	<u>(58)</u>
Net cash provided by non-capital financing activities	<u>190</u>	<u>183</u>
Cash flows from investing activities:		
Interest received	<u>24</u>	<u>37</u>
Net cash provided by investing activities	<u>24</u>	<u>37</u>
Net (decrease) increase in cash and equivalents	(69)	149
Restricted cash and equivalents, beginning of period	<u>2,861</u>	<u>2,658</u>
Restricted cash and equivalents, end of period	<u>\$ 2,792</u>	<u>\$ 2,807</u>
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 September 30, 2008 and 2007, respectively)	467	330
Operating and Priority Contract Accounts	923	1,119
Bond Charge Collection and Bond Charge Payment Accounts	<u>854</u>	<u>746</u>
Restricted cash and equivalents, end of period	<u>\$ 2,792</u>	<u>\$ 2,807</u>
Reconciliation of operating income to net cash used in operating activities:		
Income from operations	\$ -	\$ -
Changes in net assets and liabilities to reconcile operating income to cash net used in operations:		
Recoverable costs	(199)	(57)
Accounts payable	<u>(84)</u>	<u>(14)</u>
Total adjustments	<u>(283)</u>	<u>(71)</u>
Net cash used in operating activities	<u>\$ (283)</u>	<u>\$ (71)</u>

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

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**September 30, 2008**

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**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.

In January 2001, DWR began selling electricity to approximately ten million investor owned utility (IOU) retail customers. DWR currently purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 and delivers the power to the customers through the transmission and distribution systems of the IOUs. 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.

**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, fund equity, 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 September 30, 2008 and 2007, and the changes in its financial position and its cash flows, where applicable, for the periods then ended in conformity with accounting principles generally accepted in the United States of America.

**2. Restricted Cash and Investments**

The State of California has a deposit policy for custodial credit risk. As of September 30, 2008, \$20 million of the Fund's cash balances were uninsured and uncollateralized.

As of September 30, 2008, the Fund had the following investments (in millions):

Investment	Maturity	Amount
State of California Pooled Money Investment Account - State Money Investment Fund	5.5 months average	\$ 2,745
Cash		48
		<u>2,793</u>
Guaranteed investment contracts	May 1, 2022	350
Forward purchase agreement	November 1, 2007	100
		<u>\$ 3,243</u>

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
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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 September 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	A+	Aa3
	<u>\$ 350</u>		
FPA Provider			
Merrill Lynch: FHLMC Discounted Notes	<u>\$ 100</u>	AAA	Aaa

**3. Long-Term Debt**

The following activity occurred in the long-term debt accounts during the three months ended September 30, 2008 (in millions):

	Revenue Bonds	Unamor- tized Premium	Deferred Loss on Defeasance	Total Revenue Bonds
Balance, June 30, 2008	\$ 9,525	\$ 166	(182)	\$ 9,509
Amortization		(8)	4	(4)
Less current portion	(494)	(30)	15	(509)
Balance, September 30, 2008	<u>\$ 9,031</u>	<u>\$ 128</u>	<u>\$ (163)</u>	<u>\$ 8,996</u>

The tax exempt revenue bonds consist of the following at September 30, 2008 (in millions):

Series	Rates	Final maturity	Call Date	Outstanding
A	3.1-6.0%	2022	2012	\$ 2,826
B	Variable	2020	Callable	1,000
C	Variable	2021	Callable	2,333
F	Variable	2022	Callable	759
G	Variable	2018	Callable	841
H	3.75-5.0%	2022	Non-callable	1,007
I	Variable	2022	Callable	150
J	Variable	2018	Callable	330
K	4.9-5.0%	2018	Non-callable	279
				<u>\$ 9,525</u>
Plus unamortized bond premium				158
Less deferred loss on defeasance				(178)
Less current maturities				(509)
				<u>\$ 8,996</u>

**Department of Water Resources Electric Power Fund**  
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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 2009 to 2022. The interest rates for the variable debt for the three months ended September 30, 2008, ranged from 0.55% to 10.00%. Variable rate markets were adversely affected by the global credit market turmoil that negatively affected banks and insurance companies during the period. DWR's outstanding variable rate bonds with associated credit enhancement and bond insurance incurred interest costs reflecting the heightened credit risk.

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.

At September 30, 2008, negative credit market impacts increased borrowing costs on variable rate bonds that have experienced interest rate resets at higher rates and also caused the remarketing failure of \$71 million of bonds, which were bank bonds as of that date. DWR remarkets bonds on a daily basis, including bank bonds. The level of bank bonds can fluctuate daily.

Letters of credit and liquidity facilities enhancing \$575 million of variable rate bonds were scheduled to expire December 1, 2008. Subsequent to September 30, 2008 DWR renewed a letter of credit enhancing \$150 million of those bonds. In addition, on December 1, 2008 DWR converted \$75 million of those variable rate bonds to fixed rate as part of a \$173 million conversion transaction. DWR was unsuccessful in renewing the credit facilities or converting to fixed rate bonds for the remaining \$350 million with expiring facilities. On December 1, 2008 those bonds became bank bonds incurring interest at prime plus 2% and are subject to an accelerated amortization schedule. DWR plans to continue remarketing and conversion efforts or to find new credit enhancement before early amortization occurs. If unsuccessful, DWR's current portion of debt service would increase by \$39 million for 2009, and would increase by \$52 million annually thereafter until fully repaid.

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

<b>Fiscal Year</b>	<b>Principal</b>	<b>Interest <sup>1</sup></b>	<b>Total</b>
2009	\$ 494	\$ 502	\$ 996
2010	518	607	1,125
2011	545	578	1,123
2012	573	542	1,115
2013	602	504	1,106
2014-2018	3,447	1,894	5,341
2019-2022	3,346	552	3,898
	<u>\$ 9,525</u>	<u>\$ 5,179</u>	<u>\$ 14,704</u>

<sup>1</sup> Variable portion of interest cost calculated using the September 30, 2008 Securities Industry and Financial Markets Association Swap Index (SIFMA).

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The most recent SIFMA rate of 7.96% as of September 30, 2008 was used to forecast future payment requirements in the schedule above. Subsequent to the end of the quarter, interest rates began to decline to more normalized levels and SIFMA was 1.03% at December 1, 2008, reducing the estimated interest costs shown in the above schedule by approximately 65%

**4. Interest Rate Swaps**

The terms, fair values, and credit ratings of counterparties for the various swap agreements at September 30, 2008 are summarized in the following table (in millions):

Outstanding	Notional	Fixed Rate	Variable Rate <sup>1</sup>	Fair	Swap	Counterparty						
						Amount	Paid by	Received by	Fair	Termination	Credit Rating	S&P
		Fund	Fund	Value	Date							
\$	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%	SIFMA	(4)	May 1, 2013	AA	Aaa	AA-				
	95	3.405%	SIFMA	(2)	May 1, 2013	A+	A1	AA-				
	28	3.405%	SIFMA	(1)	May 1, 2013	A	A2	A+				
	194	3.204%	67% of LIBOR	(6)	May 1, 2014	AA	Aaa	AA-				
	287	3.184%	66.5% of LIBOR	(7)	May 1, 2015	BBB+	A2	A-				
	174	3.280%	67% of LIBOR	(6)	May 1, 2015	AAA	Aaa	AAA				
	202	3.342%	67% of LIBOR	(8)	May 1, 2016	AA+	Aa1	AA				
	485	3.228%	66.5% of LIBOR	(14)	May 1, 2016	AA+	Aa1	AA				
	202	3.389%	67% of LIBOR	(9)	May 1, 2017	A+	A1	AA-				
	480	3.282%	66.5% of LIBOR	(13)	May 1, 2017	AA-	Aa2	A+				
	515	3.331%	66.5% of LIBOR	(13)	May 1, 2018	AA-	Aa1	AA-				
	306	3.256%	64% of LIBOR	(7)	May 1, 2020	AA-	Aa1	AA-				
	453	3.325%	64% of LIBOR	(9)	May 1, 2022	AA-	Aaa	AA				
<b>\$</b>	<b>3,939</b>			<b>\$ (107)</b>								

<sup>1</sup> One month U.S. Dollar London Interbank Offered Rate or Securities Industry and Financial Markets Association (SIFMA)

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 September 30, 2008, the variable rates on DWR's hedged bonds ranged from 0.55% to 10.00%, while 64%, 66.5% and 67% of LIBOR received on a portion of the swaps was equal to 1.59%, 1.65%, and 1.67% respectively and SIFMA received on a portion of the swaps was 7.96%.

**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). 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).

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The terms, fair values, and credit ratings of the counterparties for the basis swaps at September 30, 2008 are summarized in the following table (in millions):

Outstanding Notional Amount	Variable Rate <sup>1</sup> Paid by Fund	Variable Rate <sup>2</sup> Received by Fund	Fair Value	Swap Termination Date	Counterparty Credit Rating		
					S&P	Moody's	Fitch
\$ 234	67% of LIBOR	62.83% of CMS	\$ 3	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	2	May 1, 2015	AA	Aaa	AA-
202	67% of LIBOR	62.80% of CMS	3	May 1, 2016	AA+	Aa1	AA
202	67% of LIBOR	62.66% of CMS	3	May 1, 2017	AA	Aaa	AA-
<u>\$ 1,006</u>			<u>\$ 14</u>				

<sup>1</sup> One month U.S. Dollar London Interbank Offered Rate

<sup>2</sup> Five year Constant Maturity Swap

As of September 30, 2008, 67% of LIBOR paid on the basis swaps was equal to 1.67% while the variable rates received based on the 5 year CMS Index varied from 4.063 to 4.299%.

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

*Credit Risk:* DWR has a total of twenty swap agreements with ten different counterparties. 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.

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*Swap Payments and Associated Debt:* As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of September 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):

Fiscal Year	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2009	127	234	36	\$ 397
2010	80	302	40	\$ 422
2011	241	294	43	\$ 578
2012	258	274	46	\$ 578
2013-2017	1,959	1,085	201	\$ 3,245
2018-2022	1,274	253	54	\$ 1,581
	<u>\$ 3,939</u>	<u>\$ 2,442</u>	<u>\$ 420</u>	<u>\$ 6,801</u>

Interest rates at September 30, 2008 were negatively affected by the credit market turmoil. The most recent SIFMA rate of 7.96% was used to forecast Swap Payments and Associated Debt. Subsequent to September 30, 2008, interest rates normalized and SIFMA was 1.03% at December 1, 2008 reducing the total estimated net debt service costs and swap payments on the associated debt shown in the above schedule by approximately 30%.

**5. Commitments and Contingencies**

**Litigation and Regulatory Proceedings**

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

*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.

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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.

**Commitments**

DWR has power purchase contracts that have remaining lives of up to eleven years. Payments under these contracts approximated \$1.4 billion and \$1.3 billion each for the three month periods ended September 30, 2008 and 2007 respectively.

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

Fiscal Year	Fixed Obligation
2009	\$ 1,178
2010	1,501
2011	1,070
2012	460
2013	75
Thereafter	33
	<u>\$ 4,317</u>

In addition to the fixed costs there are variable costs under several of the contracts. Management projects as of September 30, 2008 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate \$10 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.

Six of the power purchase contracts do not qualify as normal purchases and normal sales 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*, 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 September 30, 2008 approximated \$(316) million, using forward market prices discounted at prevailing LIBOR rates.

DWR also has entered into transactions to hedge the price of natural gas through bilateral arrangements. The fair value of the various transactions at September 30, 2008 approximated

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\$(12) million, 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 November 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 contracts that were valued in DWR's favor at September 30, 2008. Subsequent to the end of the quarter, energy prices continued to fall and further decreased the credit exposure to those two counterparties, thus DWR does not believe there is significant credit risk with its power purchase contracts.

DWR has open natural gas hedge positions with eleven different counterparties at September 30, 2008. All counterparties have credit ratings of at least A-/A2. DWR has small amounts of credit risk exposure to all counterparties since the values are slightly in DWR's favor, but have significantly fallen given the sharp decrease of natural gas prices through the latter part of the quarter. Subsequent to the end of the quarter, energy prices continued to fall, eliminating DWR's credit exposure to counterparties.

*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 during the quarter and is described in Note 6 below.

#### 6. Termination Event

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 was 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, acted as a remarketing agent for \$1.066 billion of outstanding DWR variable rate bonds at the filing date.

The obligations of LBCS were 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 30, 2008 DWR had no credit exposure to Eagle Energy, as DWR was a net buyer of gas for amounts delivered in September and has no future delivery contracts outstanding. Subsequent to the end of the quarter, Eagle was purchased by Électricité de France. DWR continues to transact with Eagle after the transaction.

After the bankruptcy filing, Barclays Bank Plc purchased the broker-dealer operations of LBI and continues to remarket the bonds.