



2006
ANNUAL
REPORT

Discovering Solutions

About the cover “Discovering solutions”

Securing reliable energy for the nation’s future requires a daily commitment from Western employees. There are challenges at every turn—equipment reaching the end of its service life, a continued stream of new industry regulations and shrinking budgets—yet employees are able to meet the Department’s goals of promoting reliable, clean and affordable energy by finding innovative solutions to these challenges.

In FY 2006, Western employees worked to solve transmission capacity issues on the eastern plains of Colorado and Kansas, accommodate additional generation in the Desert Southwest, upgrade our communication systems and help our customers ensure reliable service to their consumers.

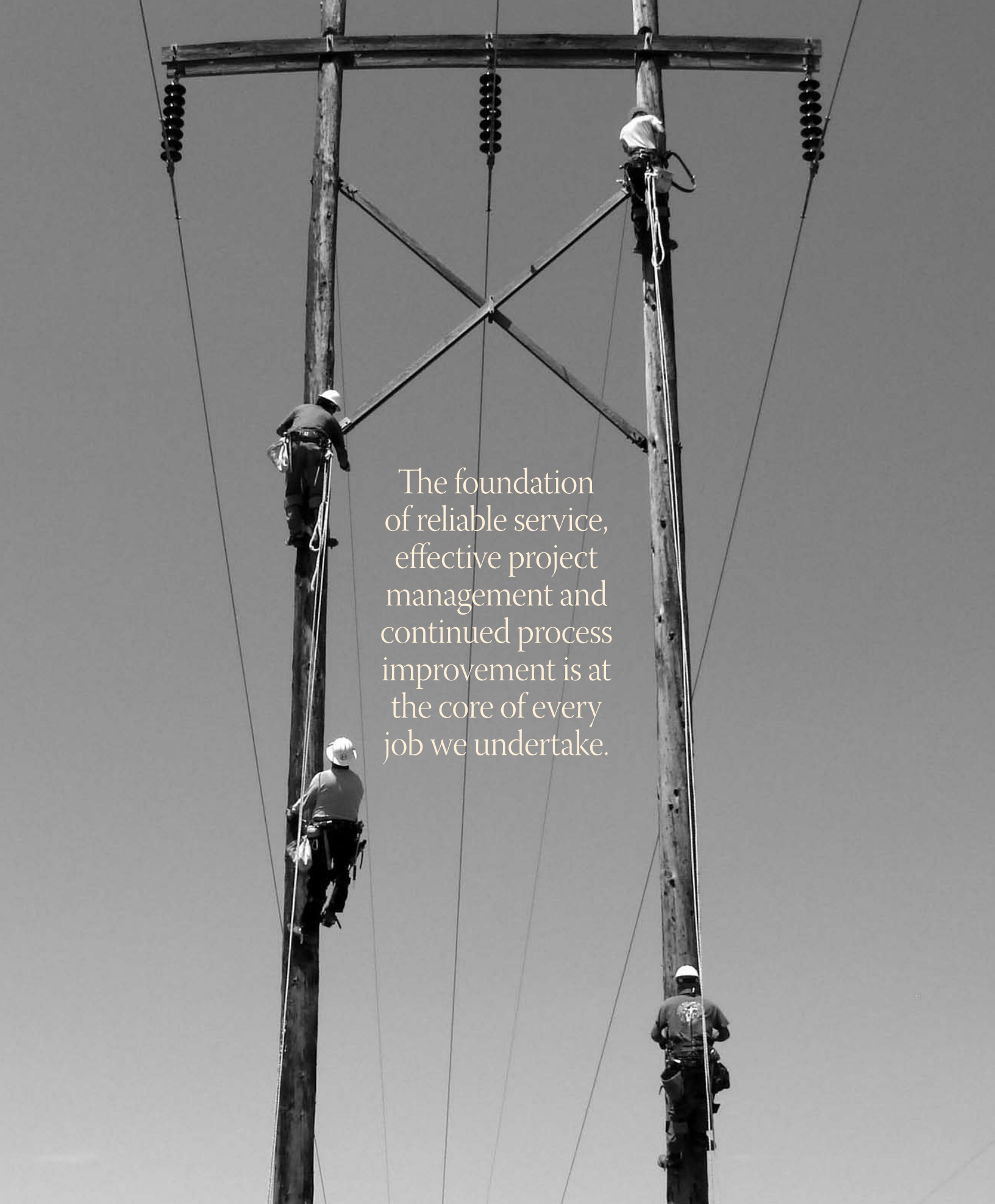
These and other challenges we encounter often require the resolve to make tough choices, sometimes under tight deadlines. But we know that the

discoveries we make today to ensure reliability of the bulk interconnected power grid will improve the quality of life for generations to come.



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The foundation
of reliable service,
effective project
management and
continued process
improvement is at
the core of every
job we undertake.

Western at a glance

Marketing profile		FY 2006
Firm energy sales		35.3 billion kWh
Nonfirm energy sales		3.7 billion kWh
Total		39.0 billion kWh

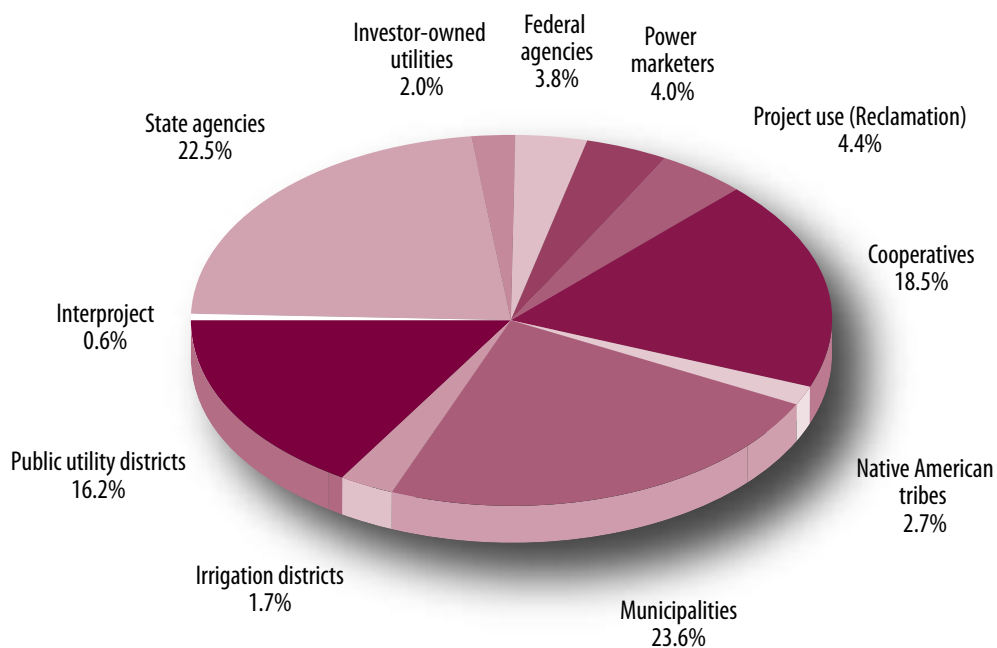
Customer profile		Number
Total		670

Repayment profile		
Change in cumulative principal repaid in FY 2006		\$42.3 million
Total repaid		\$3.0 billion

Financial profile		
Gross operating revenues		\$1.2 billion
Sales of electric power		\$879.5 million
Operating expenses		\$1.0 billion
Purchased power and transmission expense		\$553.8 million

Assets		
Substations		296
Transmission lines		17,008 miles

WHERE OUR ENERGY GOES (kWh)



Administrator's letter

The Honorable Samuel W. Bodman
Secretary of Energy
Washington, DC 20585

Dear Secretary Bodman:

In FY 2006, we at Western continued to discover solutions to ensure system reliability. From groundbreaking designs on our Mead Substation Upgrade to innovative upgrades to our communication systems, we owe much of our foresight to the leadership of my predecessor, Mike HacsKaylo, who kept us focused on providing exemplary service to our customers.

I am proud to have the opportunity to lead this great organization and will build upon the strong foundation that previous Western administrators have established. That foundation of reliable service, effective project management and continued process improvement is at the core of every job we undertake.

Because of our collaborative work with customers and industry partners, we continued to find creative ways to manage our Federal hydropower program in FY 2006 while ensuring Western repays the U.S. Treasury. With our alternative financing programs and our receipt funding authority—which allows us to fund purchase power expenses from power sales receipts—we manage our \$1 billion program budget with increased self-sufficiency. In fact, appropriations of \$234 million made up only 23 percent of our budget in FY 2006.

Other funding sources include 27 percent from power sale receipts, 16 percent from the revolving fund and 34 percent from customer advances for reimbursable work. In FY 2007, we will look for more ways to reduce our appropriation requirements by continuing to pursue receipt financing that will allow us to use our receipts for annual operating costs.

Revenues from power sales totaled more than \$879.5 million in FY 2006 from delivering almost 39 billion kWh of reliable energy to our customers. While the prolonged drought required us to continue to purchase power to meet long-term firm power contracts, the banner water year that Central Valley Project reservoirs experienced helped ease the impact. Despite continuing pressure from the seven-year drought, we repaid more than \$42.3 million in FY 2006.

While low reservoir levels, aging equipment, tight budgets and increased purchase power costs challenged us in FY 2006, we discovered new ways to ensure system reliability for our 670 wholesale customers, such as establishing partnerships on several proposed transmission upgrade projects. By providing non-Federal funding for new transmission line construction, such partnerships could help us find solutions to constrained paths identified in the Energy Policy Act of 2005.

The proposed Eastern Plains Transmission Project, which involves a partnership with Tri-State Generation and Transmission, Association Inc., may prove to be another example of how diverse sources of funding can enhance the regional bulk transmission system in the West. This project, which includes about 1,000 miles of

new high-voltage transmission lines, as well as eight new and four expanded substations in eastern Colorado and Kansas, could be one of the nation's largest transmission additions in the past five years.


Western proposes to participate in exchange for 275 MW of capacity rights on the new lines, which Tri-State would own and operate. If all goes well with the environmental work, we'll begin construction in 2009.

Another major project we turned our attention to in FY 2006 was the Mead Substation Upgrade, one of Western's largest projects. We are applying the successes from the California-Oregon Transmission Project and Path 15 to revise 1,700 control system design drawings, replace more than 48 power circuit breakers, add two new 230-kV circuit breakers and install five new 500-kV circuit breakers and four new 500/230-kV autotransformers to the substation by July 2007.

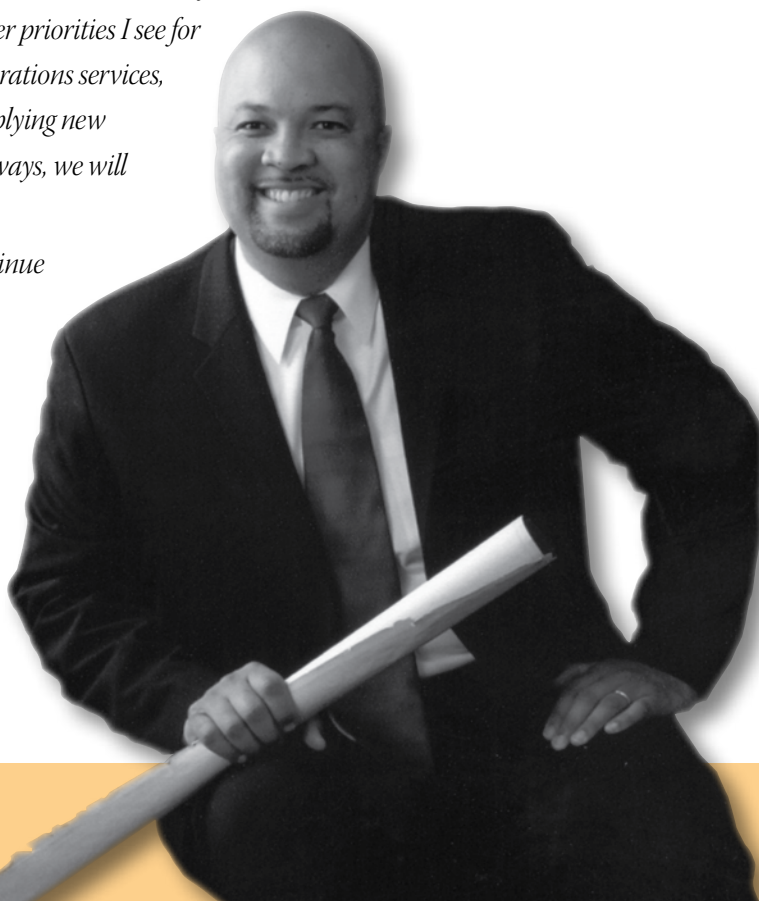
In FY 2007, I anticipate we will continue many of the same initiatives that were priorities last year, such as helping our tribal customers achieve economic self-sufficiency, assisting other Federal agencies in purchasing renewable energy, complying with industry regulations and ensuring a viable, skilled workforce to lead us into the future.

In fulfilling my new role as Western's Administrator, I plan to look for more ways that Western can connect more closely with our customers. I would like us to renew our partnerships and to find out which services we provide that our customers value most. Other priorities I see for Western in the future are expanding our transmission and operations services, integrating wind into our existing transmission system and applying new technologies to make our operations more efficient. And, as always, we will keep our focus on safety in all projects we undertake.

As we look ahead, I know that Western employees will continue to work effectively and efficiently to support the Department's mission to discover solutions and secure America's future with reliable energy.



*Timothy J. Meeks
Administrator*





Employees work around the clock to sell power, operate transmission and provide maintenance and engineering services.

W

estern is a Federal agency under the Department of Energy that markets and transmits wholesale electrical power from 56 Federal hydropower plants and one coal-fired plant. Western

sells about 40 percent of regional hydroelectric generation in a service area that covers 1.3 million square miles in 15 states. To provide this reliable electric power to most of the western half of the United States, Western markets and transmits about 10,000 megawatts of hydropower across an integrated 17,000-circuit mile, high-voltage transmission system.

Our customers include municipalities, cooperatives, public utility and irrigation districts, Federal and state agencies, Native American tribes, investor-owned utilities (only one of which has an allocation of Federal hydropower from Western) and marketers. They, in turn, provide retail electric service to millions of consumers in Arizona, California, Colorado, Iowa, Kansas, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Dakota, South Dakota, Texas, Utah and Wyoming.

Western's role in delivering power also includes managing 10 different rate-setting systems. These rate systems are made up of 14 multipurpose water resource projects and one transmission project. The systems include Western's transmission facilities along with power generation facilities owned and operated primarily by the U.S. Bureau of Reclamation, the U.S. Army Corps of Engineers and the U.S. State Department's International Boundary and Water Commission. We set power rates to recover all

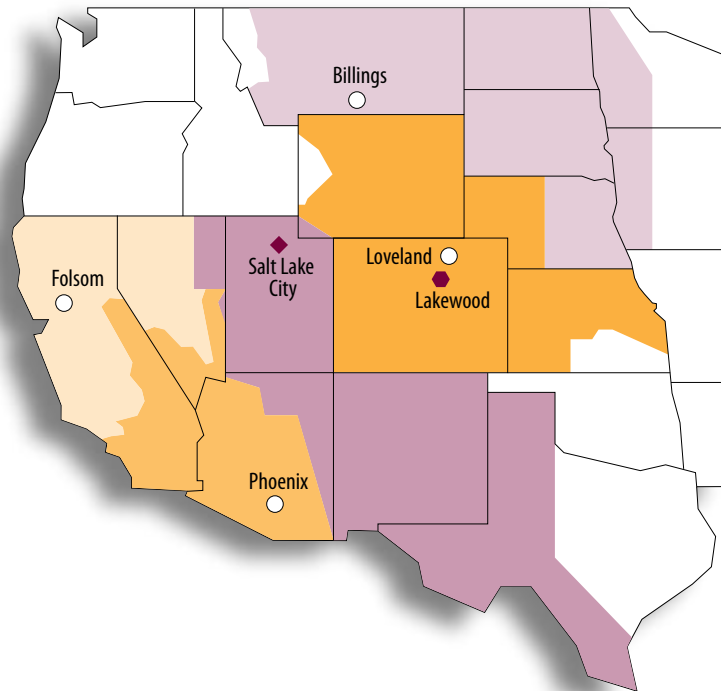
costs associated with our activities, as well as the Federal investment in the power facilities (with interest) and certain costs assigned to power from repayment, such as aid to irrigation development.

Employees work around the clock to sell power, operate transmission and provide maintenance and engineering services. Our duty locations include Western's Corporate Services Office in Lakewood, Colo., and four regions with offices in Billings, Mont.; Loveland, Colo.; Phoenix, Ariz.; and Folsom, Calif. We also market power from our Management Center in Salt Lake City, Utah, and manage system operations and maintenance from offices in Bismarck, N.D.; Fort Peck, Mont.; Huron, S.D.; and Watertown, S.D.

Since our inception on Dec. 21, 1977, Western employees have been dedicated to providing public service, including promoting environmental stewardship, energy efficiency and renewable energy as well as implementing new technologies to ensure our transmission system is the most reliable possible. ■

CUSTOMER SERVICE REGIONS

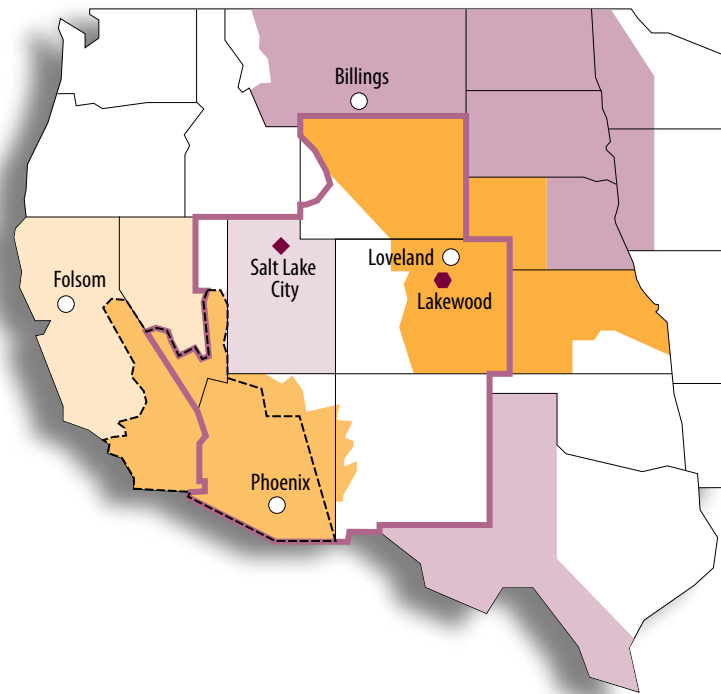
- Sierra Nevada Region
- CRSP Management Center
- Upper Great Plains Region
- Desert Southwest Region
- Rocky Mountain Region
- State boundaries
- Regional office
- Corporate Services Office
- ◆ CRSP Management Center



PROJECT MARKETING AREAS

Marketing area boundaries

- Central Valley and Washoe projects
- Parker-Davis
- Boulder Canyon and Central Arizona Project
- Falcon-Amistad Project
- Provo River Project
- Loveland Area Projects
- Pick-Sloan Missouri Basin Program – Western Division and Fryngan-Arkansas Project
- Pick Sloan Missouri Basin Program – Eastern Division
- Salt Lake City Area/Integrated Projects
Colorado River Storage Project, Collbran, Rio Grande, Seedskaadee and Dolores projects
- State Boundaries
- Regional Office
- Corporate Services Office
- ◆ CRSP Management Center



New tool improves transmission scheduling

To keep up with advances in scheduling energy, Western marketers implemented a new system that more efficiently captures information on energy and transmission transactions.

“Industry restructuring and the universal implementation of electronic ‘tags’ for energy transactions have dramatically changed the way the Energy Management and Marketing Office does business,” explained Software Development Lead **Tonya Baggett**. “They were having trouble making their existing tools work in the new business environment, resulting in duplication of effort and inefficient manual processes.”

Western’s EMMO team in Montrose, Colo., looked to Rocky Mountain’s software staff in Loveland, Colo., for help. In June 2001, RM integrated its tagging software package with TIGER 2.0 to give the Western Area Colorado Missouri control area a better tool to manage transmission transactions within WACM. “We used the tag-based data model from Loveland’s scheduling application, TIGER 2.0, and built a system for Montrose that would handle the marketer functions as well,” stated Baggett.

By using TIGER, merchant staff streamlined the EMMO’s business processes. “Marketers can capture all transaction information in a single step, and TIGER automatically generates an energy schedule and a tag,” Baggett explained, “or the marketer can approve a tag originated by an external

Marketers Tim Vigil, left, and Ken Otto verify that energy tags were transferred to the new electronic tagging system.

PROBLEM: Ten years ago, Western transmission customers set up a schedule—the predominant transmission transaction vehicle in the electric utility industry—and sent it either by telefax or by calling the control area. Dispatchers then passed it on to Western’s merchant staff. But as technology and the utility industry regulations have changed, Western’s scheduling management tools became obsolete.

SOLUTION: The Energy Management and Marketing Office staff in Montrose, Colo., began using a new scheduling tool—the Transmission, Interties, Generation, Energy and Reserves, or TIGER 3.0—in September 2005 to handle the complexities of managing Federal resources and meeting customer load requirements.

entity, referencing a transaction, and the system will send out the approval and convert the tag into a TIGER schedule.

“This helps Montrose marketers be more productive, since they have more time to find and execute better deals,” added Baggett. “Having all their critical information in TIGER also gives them financial data that is more auditable and reliable than before, which is very important to customers.” ■



Trinity Interconnection project to solve persistent outage problem

A new interconnection project is bringing Western and its customer, the Trinity County Public Utility District, together to solve a long-standing outage problem in Northern California.

PROBLEM: Customers of the Trinity County Public Utility District near Weaverville, Calif., routinely experience nearly 20,000 consumer outage hours per year, with many of the outages often lasting three to four days in the winter. The area's remote location and rough terrain have made the situation difficult for Trinity's transmission service provider—Pacific Gas & Electric Company—to restore power to these residents in a timely manner. Trinity PUD has been working for many years for a way to increase service reliability to its consumers.

SOLUTION: To stabilize and enhance service reliability, Trinity requested Western establish a new direct, higher-voltage connection between Trinity and Western's Central Valley Project transmission system. A direct tie may reduce the frequency and length of outages and would relieve PG&E of the responsibility for serving consumers located in this area since Trinity and Western crews could work together to restore service.

With Trinity's transmission service provider remotely located, Trinity has been challenged in restoring service to its customers.

"The problem is that Pacific Gas & Electric Company doesn't have people permanently assigned to the area. They have to come from Cottonwood maintenance center located 50 miles away. If an unanticipated outage occurs, and they get a lot of snow, sometimes the PG&E crews are not able to get there in a timely manner. To restore the system after devastating winter storms, Trinity PUD wants to be more proactive by working with Western's maintenance crews to be more in charge of its destiny when outages occur in the future," said **Krishna Shah**, Western's Sierra Nevada project manager.

This could be achieved by working together with Western's crew during restoration of the transmission line outages.

"The goal of the project is to improve reliability. The working relationship the District has with Western will enable us to have quicker response times and restore service faster," said **Andy Lethbridge**, Electrical Superintendent at Trinity.

Located about 25 miles west of Redding in Trinity County, Calif., Trinity County PUD receives power from the Central Valley Project and serves about 7,000 northern California customers through 550 miles of lower-voltage distribution line. This proposed project would enhance Trinity's service-reliability and fulfill the obligation established by the Trinity Division Act of Aug. 12, 1955, to construct, operate and maintain transmission facilities that may be required to deliver the output of power plants.

Western Lineman Dave Horton of the Redding line crew repairs a pole from one of Trinity's distribution lines after a winter storm hit the Redding, Calif., area.



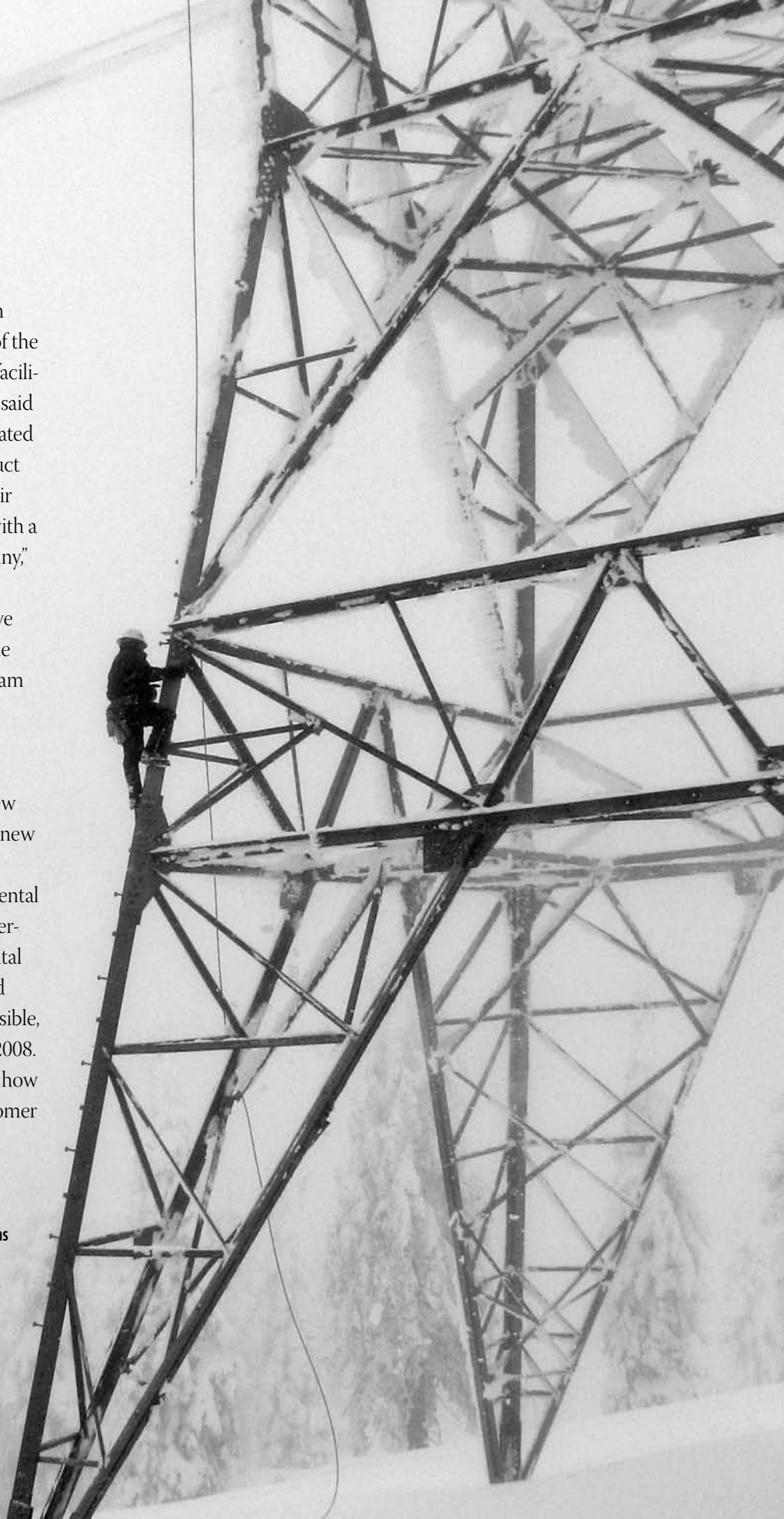
“When Congress passed legislation for the Trinity River Division facilities in 1955, the act authorized the Secretary of the Interior to also construct transmission facilities to deliver power to Trinity County,” said Shah. “Now that Congress has appropriated the funds, Western is moving to construct facilities to improve the reliability of their transmission service. We are working with a customer to take charge of its own destiny,” he said.

The proposed project would remove about 5.3 miles of 12-kV distribution line from Trinity Powerplant to Lewiston Dam to reuse the right of way and construct about 16 miles of new 60-kV transmission line, a tap structure and associated equipment. It also calls for building a new switchyard near Weaverville where the new line will terminate.

Western is analyzing the environmental impacts of the proposed project and alternatives and is preparing an Environmental Impact Statement. If environmental and technical studies show the project is feasible, Western could initiate construction in 2008.

“This project is another example of how Western can work together with a customer to ensure that power is available when people need it the most,” said Shah. ■

Western crews sometimes face harsh winter conditions to ensure customers receive reliable power. Here snow swirls around Lineman *Ryan Yeager* as he climbs a tower near Grizzly Peak in Northern California to restore an overhead groundwire.



Mead upgrades to solve increased generation needs in Desert Southwest

Upgrades to Western's Desert Southwest transmission system at Mead, Nev., are ensuring that the area's new generation can be accommodated without affecting reliability.

The modifications to Mead Substation will help accommodate a projected 3,000 MW of new generation capacity to the southern Nevada power grid, including 1,719 MW from the new Centennial

Project that will enter the grid through Mead via Nevada Power Company's 500-kV, 43-mile long Harry Allen-to-Mead transmission line.

Modifications to the 500-kV yard at Mead include changing the substation's layout to accommodate new transformers and NPC's new line. Interconnecting the Centennial Project to Mead was completed summer 2007.

"These changes provide more reliability to the system, especially

from a maintenance point of view," said **Ron Moulton**, Power Operations manager in Western's DSW Region.

The project calls for engineers to revise 1,700 control system design drawings, replace more than 48 power circuit breakers, add two new 230-kV circuit breakers and install five new 500-kV circuit breakers and four new 500/230-kV autotransformers to the substation.

Just the sheer number of new designs and revised drawings for the substation's outdoor and control work makes this project compare in size and scope to a substation yard of the California-Oregon Transmission Project, a major transmission upgrade to the west coast system in 1993 that added 340 miles of new 230- and 500-kV transmission line from northern California to the Oregon border. "Due to the amount of new and upgraded construction at Mead, the work at the substation is comparable to work done at a COTP yard," explained **John Work**, project lead system control designer at Western's Corporate Services Office.

Not only is the amount of work challenging, but it also has to be done while the substation remains in service throughout the entire project. Because Mead is a large energy hub in DSW, outages are only allowed for the specific equipment being replaced or installed. "This project is the largest modification to an existing energized substation Western has performed to date," said **Gary Lachvayder**, Mead Substation Upgrade project manager. However, he noted that only three, two-day outages of the 500-kV yard were needed to replace breakers around energized circuits.

PROBLEM: Growing populations in the Desert Southwest have led to increased generation in southern Nevada, requiring improvements to the existing transmission infrastructure. Since some of this new generation flows into Western's Mead Substation outside Boulder City, Nev., the existing substation yard needed upgrading to interconnect the generation into our system.

SOLUTION: The Mead Substation Upgrade, one of the largest projects Western has managed in its history, aims to increase the substation's reliability by offering extra power capacity and operational flexibility with an expanded 500-kV yard and an added interconnection.

Western Engineers *Gerry Hartill* and *Rick Schuler* review drawings for an upcoming scheduled outage to Mead's 500-kV yard.



These upgrades will be sufficient for several years. “However, as generation continues to come online, the breakers will eventually need to be upgraded again—if breaker technology can keep up,” said Moulton. The North American Electric Reliability Corporation projects that peak demand energy requirements for the Arizona-New Mexico-southern Nevada area will grow at an annual compound rate of 3.4 percent.

“As more generators seek to provide additional power in the Desert Southwest, Western must be prepared to make the necessary modifications to our facilities to accommodate new capacity,” Lachvayder said.

“Western will look for ways to solve the challenges of upgrading our current infrastructure so that our facilities can continue to handle the increased demands on the system,” Moulton concluded. ■



DSW Construction Representative *Jim Jennings* inspects the control cabinet of the 500/230-kV transformer (KT2A transformer bank) at the Mead Substation.



DSW Construction representative *Gary Frafford* inspects the control cabinet of one of the new 230-kV, 80-kVA breakers installed at the Mead Substation.

Mother Nature challenges UGP employees with ice storms

Mother Nature sometimes unloads a host of challenges on Western's crews. The winter of 2005/2006 called on UGP crews to solve numerous outage problems in South Dakota.

The Nov. 27 and 28, 2005, ice storm shut down three Western offices and sent Western and local cooperative line crews out to repair an estimated

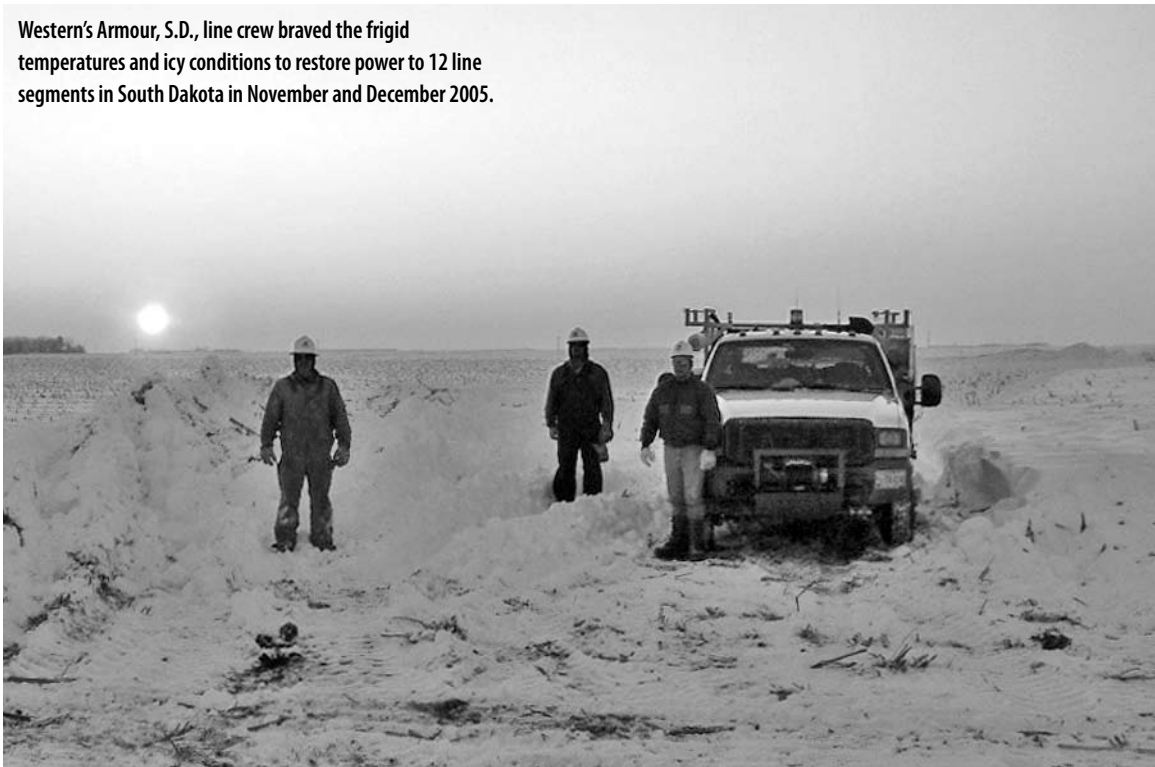
10,000 distribution poles and 8,000 miles of power lines downed, including 12 Western line segments. "The first thing I thought of when the storm hit was, 'I hope it will not be too serious,' said Huron Secretary **Judy Stewart**. "We have had many snow storms, but this type of ice storm hasn't happened since 1995."

With much of Watertown shut down Nov. 28 for the Thanksgiving holiday, essential staff were still required to keep the Dispatch Center running and the power flowing. "It's important to come into the Operations Center because thousands of people count on us to be there when the conditions become severe," said Watertown Reliability Dispatch Manager **Earl Cass**. "People have come to depend on electricity almost as much as air. Many find it extremely difficult to do their daily routines without the use of electricity. Communications, entertainment, eating, drinking water—nearly everything we do as a society involves the use of, and consumption of, electricity."

PROBLEM: Mother Nature blanketed much of South Dakota with freezing rain just after Thanksgiving 2005 and then again on April 17, 2006. The formidable storms coated static wires with ice, which then broke and fell into the conductors and left many South Dakota residents without power for several weeks.

SOLUTION: Western's dedicated employees—including Upper Great Plains line crews, electricians, dispatchers, computer technicians, managers and others—worked around the clock to restore power after each storm.

Western's Armour, S.D., line crew braved the frigid temperatures and icy conditions to restore power to 12 line segments in South Dakota in November and December 2005.




Then another ice storm swept through South Dakota, on April 17, 2006, leaving 110 transmission line structures on the Rapid City-to-Maurine 115-kV transmission line broken in its wake. “The wind caused the lines to gallop. They flop up and down in the wind and that, combined with the ice, was too much strain for the structures. Then it’s almost like once one goes down, it creates a domino effect, taking structure after structure down,” said South Dakota Maintenance Manager **Scott Mallard**.

As for linemen to handle the damage that affected the eastern third of South Dakota, Mallard called North Dakota Maintenance Manager **Brian Morris** and Montana Maintenance Manager **Eric Phillips** for line crew support in restoring power lines and downed structures. After restoring

Western’s line segments, crew also helped customers, like the East River Electric Power Cooperative, restore power to customers and residents.

“The best way we could help customers was to first restore our transmission lines and substations,” said Mallard. “After we did that—which is what most of them asked us to do—our line crews began working with customers on their systems, helping to get service restored.”

To prevent extensive damage like this in the future, crews will be installing more storm and dead-end structures along the line. To be designed by Corporate Services Office engineers, these structures will be bigger and have more supports, including guy wires, to keep them standing in extreme weather. ■



Western linemen **Corey Whitney** and **Thomas Wright** bury themselves in the deep snowdrifts to find the base of a broken transmission pole in the Armour, S.D., area.

EPTP aims to provide additional transmission paths

A proposed transmission project across Colorado and Kansas could provide an opportunity for Western and its customer, Tri-State Generation and Transmission Association, Inc. to solve transmission congestion along the eastern plains.

“Western expects to be involved in solutions to many current transmission challenges by partnering with our customers and neighbors where it makes good business sense for all of us,” said Administrator **Tim Meeks**.

“Western and Tri-State both serve customers in the eastern plains region, and serving those customers creates unique needs and common challenges for each organization,” said Eastern Plains Transmission Project Manager **Craig Knoell**.

Since both Western and Tri-State clearly identified a need to expand high-voltage transmission in eastern Colorado and Kansas, the two organizations signed a joint participation agreement in December

2005 to pursue a project to meet that need, creating the EPTP.

“We are approaching the EPTP as a once-in-a-lifetime opportunity,” said Knoell. He said Western’s mission is to complete EPTP on time, within budget and at a level of quality that exceeds our customers’ expectations.

Western’s role in the proposed project would be to acquire the right of way and to design and construct the transmission lines. For its contribution to the proposed project, Western would receive 275 MW of transmission system capacity, including an interconnection between the proposed project and Western’s Midway Substation and use of a portion of the communication system required to operate the system. Tri-State would own the remainder of the proposed project.

The new 1,000 miles of high-voltage transmission would generally run from southeastern Colorado northward across the eastern plains to termination points at substations in Wray and Brush, Colo. The project also includes a short line running east to connect to facilities in Holcomb, Kan.

Western will determine whether to move forward with this project based on the results of an Environmental Impact Statement that is being prepared. The draft EIS is expected to be issued in summer 2007. The final EIS Record of Decision is expected to be issued by winter 2007/spring 2008. Construction could begin in 2009 and the project would come on line in 2012. ■

PROBLEM: A lack of capacity on existing Federal transmission lines in the eastern plains of Colorado and in western Kansas challenges Western in meeting its commitments to firm power customers in Colorado and Kansas. When Western must purchase power from other suppliers, the lack of adequate transmission capacity sometimes prevents Western from accessing the most economical supplier. Western needs additional capacity and alternate transmission paths to deliver power to its customers in these areas and to provide access to a more diverse purchase-power market.

SOLUTION: Western teamed up with Tri-State Generation and Transmission Association, Inc., in December 2005 on the proposed Eastern Plains Transmission Project, which calls for constructing about 1,000 miles of new high-voltage transmission lines and related facilities in eastern Colorado and western Kansas, expanding existing substations and constructing new substations, access roads and fiber optic communication facilities. As currently planned, the EPTP would be one of the largest transmission additions in the United States in the past five years.

Jim Hartman, Western’s environmental manager in the Rocky Mountain Region, writes down local landowners’ comments about proposed transmission line siting near Brush, Colo.



Construction and Maintenance

Western oversees construction of new facilities, upgrades

Western employees successfully completed construction of many upgrades and new facility or transmission line projects in FY 2006. These upgrades and new additions assured that Western's grid would continue to be operated reliably.

DSW

In the Desert Southwest Region, crews completed the Mead Substation upgrade with an expanded 500-kV yard and an interconnection. The upgrade included installing new 230-kV circuit breakers and a new breaker ring bus arrangement to accommodate new transformers and a new transmission line being built by Nevada Power Company.

UGP

Major renovations in the Upper Great Plains Region included the Bonesteel, Groton, Mount Vernon, Vetal Tap, Woonsocket, Exira, Morris and Granite Falls substations. UGP crews replaced or upgraded 60-plus miles of line and installed more than 160 miles of fiber optics.

SN

In the Sierra Nevada Region, crews completed construction and commissioning of the Sacramento Area Operations Center Substation. To provide a primary source of power for Western's Operations Center in Folsom, Western tapped its existing 115-kV Folsom-Nimbus transmission line. As a result of this separate feed, station service reliability and security for SN's Operations Center will be improved since Western will no longer rely on or be impacted by any distribution-level outages or blackouts imposed by either the Sacramento Municipal Utility District or the California Independent System Operator.

Western crews heed call for help after Midwest storms

Six major storms and wildfire activity destroyed 36 structures and caused lightning damage to a transformer in the Upper Great Plains Region in 2006. In overcoming significant challenges to restoring service to customers after an ice storm in South Dakota, East River Cooperative recognized the region with "The Eminent Service Award."

RM

In the Rocky Mountain Region, Western agreed to participate with Tri-State Generation and Transmission, Association Inc., to jointly construct the proposed Eastern Plains Transmission Project. RM also awarded a contract for the Cheyenne-Miracle Mile 115-kV Transmission Line Project to rebuild 146 miles of line to increase transfer capability of the constrained TOT 3 path by about 75 MW. Progress also continued on the Granby-Windy Gap Transmission Line Project to rebuild a single-circuit, 69-kV line as a double-circuit line.

Western, Forest Service join forces on managing vegetation

To comply with the new North American Electric Reliability Corporation reliability standards, Western's Desert Southwest Region and the U.S. Forest Service jointly developed guidelines to administer special use authorizations to clear vegetation near power lines within national forests in Arizona.

Energy Services/Renewable Resources

Western facilitates green purchases

Through its Renewable Resources for Federal Agencies Program, Western coordinated a green tag purchase in 2006 for five Federal agencies and a municipal utility for almost 1.7 million MWh of renewable energy certificates for up to five years. The RECs, supplied by 3 Phases Energy, come from wind, biomass and geothermal energy. Western also solicited proposals in April 2006 to purchase 305 MWh of non-hydro renewable electric power to serve Edwards Air Force Base in California. TransAlta Energy Marketing sold that green power to Western on behalf of the Air Force.

IRP assistance provided to customers

To support customers in developing and implementing Integrated Resource Plans or energy efficiency activities, in September 2006 Western provided a workshop and two webcasts for customers on the benefits and risks of adding demand-side management tools to their resource portfolios.

Finance

New database whittles down reporting time

Western's Financial Reporting and IT staffs joined forces in November 2005 to streamline financial reporting processes and timelines. By developing a new corporate data repository for financial data, the team consolidated various reporting tools into one streamlined reporting system, created a way to permanently store audit adjustments and created a standardized reporting system for incoming generating agency data.

Human Resources/Training

Western exceeds 45-day hiring goals

Western continued to lead DOE with an average hiring time of 25 days, well below the 45-day standard. The 45-day hiring model was designed to reduce the number of days it takes from the date the vacancy closes to the day a candidate is offered the job. Western announced 254 vacancies in FY 2006.

Training Center enrollment increases

Enrollment at Western's Electric Power Training Center increased by more than 50 percent in FY 2006. The EPTC trains dispatchers and operators on everything from relaying schemes to emergency operations. EPTC staff also worked diligently last year to add a 50-MW wind farm simulator—the first of its kind in the country—to the EPTC's miniature power system.

First Career Progression participants graduate

The first five participants in Western's Career Progression Program graduated in January 2006 from the year-long developmental program that prepares entry-level employees for advanced positions. Two other developmental programs, apprentice programs and a Project Management Coaching group help prepare employees to lead Western into the future.

Information Technology

Enterprise Architecture streamlines Western

Western's Enterprise Architecture Team continued in FY 2006 to help eliminate duplicate systems and integration problems while streamlining Western's business models to support the agency mission. DOE recognized the team last spring for its success in identifying and implementing common IT solutions, eliminating redundant systems and using Enterprise Architecture to drive IT investment decisions. Western also received a "green" score on e-government performance on the President's Management Agenda.

Operations

NERC audits show confidence in Western

The North American Electric Reliability Corporation's audits of Western control areas in FY 2006 demonstrated that Western dispatchers are well prepared to handle emergency power system scenarios and O&M functions. In April, NERC gave the Western Area Colorado-Missouri Balancing Authority in Loveland its highest rating on performing reliability functions. DSW's Western Area Lower Colorado Balancing Authority and the Sierra Nevada sub-control area were recognized during their NERC audits for their cyber security efforts. In addition, Upper Great Plains control areas—the Western Area Upper Missouri-West and the Western Area Upper Missouri-East—met NERC, Mid-Continent Area Power Pool and Western Electricity Coordinating Council standards, including full compliance with industry standards.

Western expands its sub-control area

At the request of customers, Western expanded its sub-control area under the Sacramento Municipal Utility District to incorporate Modesto Irrigation District and the California-Oregon Transmission Project, one of the three lines that comprise the California-Oregon Intertie. This expansion required extensive coordination with our customers, Bonneville Power Administration, the Bureau of Reclamation, the California Independent System Operator, MID, SMUD and the Transmission Agency of Northern California as well as recertification of SMUD's control area footprint from the Western Electricity Coordinating Council to include both facilities.

Western implements pseudo-tie with CAISO

In December 2005, Western entered into a pseudo-tie arrangement with the California Independent System Operator for Calpine Corporation's Sutter Energy Center. At Calpine's request and in coordination with CAISO and the Sacramento Municipal Utility District, Western made the required modifications to its operational systems as a sub-control area within SMUD's control area to allow generation from Sutter to be dynamically scheduled into CAISO's control area. Sutter is a 550 MW, natural gas, combined cycle power facility that physically resides within Western's sub-control area. Sutter is interconnected to Western's 230-kV electric system near Yuba City, Calif., and takes firm transmission service from Western. Under this pseudo-tie arrangement, CAISO dispatches generation from the Sutter power facility as if it were physically within CAISO's control area so that Sutter's generation can be included in CAISO's ancillary service markets.

Alternate Control Center tests show emergency readiness

Western tested and placed in service two alternate control centers in FY 2006 to assure operational integrity. Sierra Nevada employees simulated an emergency situation to test their readiness as part of their continuity of operations plan. The exercise allowed normal business operations to continue without disruption, but demonstrated that if the Folsom operations center became inoperable, employees could still perform key operations and business functions from an alternative worksite. Rocky Mountain employees also prepared for operations in the event of an avian flu outbreak as part of their continuity of operations plan.

Western assists SWPA with SCADA system

Upper Great Plains staff helped Southwestern Power Administration to update SWPA's aging Supervisory Control and Data Acquisition system and develop a shared system for backups and reliability. The shared SCADA system will improve grid reliability as both agencies will have full freedom to make changes rapidly to respond to power industry requirements or system emergencies. The cooperative effort also allows the agencies to provide backup resources for each other in times of crises. Southwestern dispatchers began using UGP's SCADA system in December 2005.

Power Marketing

Parker-Davis Post 2008 final allocations offered

The Desert Southwest Region offered allocations for 17 megawatts of summer season capacity and 13 MW of winter season capacity of Parker-Davis Project power to 13 eligible preference customers for 20 years beginning Oct. 1, 2008. Among the recipients of these new allocations are six Native American customers. Western also published the proposed amended Navajo Marketing Plan that specifies how the U. S. entitlement to the Navajo Generating Station will be marketed after Central Arizona Project pumping requirements are met. This proposed amended plan outlines the sale and exchange of Navajo Surplus Power.

Western tribes work toward development goals

To assist tribes with economic development goals, Western provided hourly sales and purchase energy information to the Inter-Tribal Council on Utility Policy to recommend how wind generation could fit into Western's purchase needs. In March 2006, Western helped sponsor the First Annual American Indian Business Expo, held in Denver to bring together tribal leaders and government and corporate representatives to share strategies for marketing business enterprises. Also, a Western representative gave a presentation at the Annual Council of Energy Resource Tribes conference on Western's technical support to customers, such as our equipment loan program. We also continue to implement our Native American Bill Crediting program which most tribes use to provide economic benefits directly to their members in reduced utility bills.

Contract arrangements complete on Pick-Sloan Post 2005 allocations

UGP staff executed contractual arrangements with the Pick-Sloan Missouri Basin—Eastern Division Final Post 2005 allocation recipients, revising more than 350 firm power customers' contracts according to the resource pool allocations.

AMPUA honors Western for customer service

At its July 25, 2006, meeting in Flagstaff, Ariz., the Arizona Municipal Power Users' Association presented Western with its Public Power Recognition Award for creatively and professionally serving Arizona customers, as well as the association's electric service members, by helping them meet the increasing needs of almost 500,000 electric consumers.

Procurement

Western continues to support small business

Western continued to exceed small business goals set by DOE. In June 2006, Western won an award for Small Business Diversity Achievement for FY 2005, a prestigious honor because of its combination of program achievements. Western received the recognition for awarding contracts to a diverse group of small and disadvantaged businesses, including 8(a), small-disadvantaged, women-owned, service-disabled veteran and HUBZone firms.

Safety

Western's safety record lauded

Western continued to exceed industry safety standards in FY 2006. Our Recordable Accident Frequency Rate was 2.6, well below the targeted industry rate of 5.1, as calculated by DOE using statistics gathered by the National Safety Council, the Department of Labor and the National Institute for Occupational Safety and Health.

Transmission

Settlement reached with Public Service Company of New Mexico

Western and Public Service Company of New Mexico signed documents to implement the settlement agreement on the transmission rate case that the company filed at the Federal Energy Regulatory Commission last year. The agreement should save the Salt Lake City Area Integrated Projects between \$600,000 and \$1.2 million yearly in transmission expenses.

Western implements new integrated transmission rates

The Upper Great Plains implemented new Integrated Transmission System transmission rates on Oct. 1, 2005, for the Pick-Sloan Missouri Basin—Eastern Division. The Integrated Transmission System includes 10,080 miles of transmission lines owned by Basin, Heartland, Missouri River Energy Services, Northwestern Public Service and Western third-party usage.

FY 2006 IRP Summary

Western's Integrated Resource Planning requirements, based on Section 114 of the Energy Policy Act of 1992, give customers several options to meet these requirements. The IRP regulations allow customers to set action plan timelines (instead of a five-year minimum) to better correspond with their own situations. Alternatives to an IRP are the minimum investment report, small customer plan and energy efficiency and renewable energy report. Customers who meet the criteria of any one of these options may request permission to file the appropriate plan.

With the Energy Efficiency/Renewable Energy Report option, state, tribal or Federal end-use customers required by state, tribal or Federal mandate to conduct energy efficiency or renewable energy programs can provide an initial report and an annual report on these activities to comply with Western's requirements.

All firm power customers have complied with one of these options. In FY 2006, Western received 87 IRPs from individual customers, 23 plans from co-operatives, 77 minimum investment reports and 87 small customer plans. These plans represent 827 long-term firm power customers and customer members. Total savings from DSM activities was more than 2 million kW and 545 million kWh. Total savings from customer renewable activities was almost 1.5 million kW and close to 5 billion kWh.

Customer reported trends include:

- Increased demand for renewable energy technologies in all (commercial, industrial, residential and institutional) market segments
- Increased requests for education and information transfer on energy efficiency and renewable energy technologies
- Water management—efficient use, conservation, irrigation and pumping efficiency
- Continued re-emergence of demand-side management efficiency activities/programs
- Key accounts programs, tools and training

The most frequent demand-side management activities cited by Western's customers are:

- Lighting technologies
- HVAC technologies with emphasis on cooling and ventilation
- Audits for residential, commercial and industrial facilities
- Domestic hot water
- Irrigation
- Load management
- Weatherization
- Education

The top five renewable energy resource choices are:

- Hydro (large & small)
- Wind generation
- Solar photovoltaics
- Geothermal
- Biomass/gas

IRPs are driven by customer need and requests. Cost and reliability are still the highest priority, but factors such as renewable energy technologies and environmental concerns have an ever-increasing influence on both needs and requests. Additional factors include: foreign energy dependence, security issues, developing technologies, affordable options and regulations. ■

FY 2006 Customer IRP Accomplishments

Item	CRSP	DSW	RM	SN	UGP	Totals
DSM kW savings ¹	20,620	103,273	124,703	60,328	1,762,347	2,071,271
DSM kWh savings	50,936,465	165,502,816	104,602,680	180,313,942	43,742,487	545,098,390
DSM \$ expenditure	12,314,502	27,409,791	5,058,833	104,795,096	45,004,526	194,582,748
DSM \$ deviations ²	10,130,757	(524,711)	284,035	561,078	15,874,125	26,325,284
kW renewables	50,676	398,698	102,572	501,656	394,986	1,448,588
kWh renewables	208,901,181	1,145,208,756	291,565,089	1,705,704,650	1,557,532,017	4,908,911,693
Renewable \$ expenditure	3,458,020	50,277,007	9,735,394	19,368,714	80,325,991	163,165,126
Renewable program types	Waste to energy, solar, wind, small scale hydro	Solar, geothermal, hydro	Small hydro, wind, co-generation, biomass, solar	Small hydro, geothermal, solar, wind	Medium/large, wind, PV, waste to energy, hydro	Solar, hydro, wind, co-generation, biomass/gas, geothermal

1 DSM is Demand-Side Management activities the utility conducts to change customer energy use.

2 Deviations are any differences from their Integrated Resource Plan.



Management discussion and analysis

Federal Power Program¹ Financial Highlights

The ongoing drought in the western United States continues to significantly impact hydropower production and customer power rates. Although hydro conditions improved somewhat in FY 2006, resulting in additional sales of non-firm power, Western raised rates in a number of projects to meet increasing expenses and repayment requirements. FY 2006 revenue increased approximately \$72.9 million to \$879.5 million and signaled the beginning of drought recovery.

Other operating income increased by \$29.3 million to \$289.4 million as Western aggressively pursued additional sources of revenue from increased transmission sales, user and facility fees and new classes of service to mitigate the revenue requirement otherwise collected through power and transmission rates.

Years of drought have impacted Western's financial results and operations. While drought conditions improved in certain service territories, hydro generation remained low when compared to historical averages, resulting in a continued need to purchase power to meet contractual obligations. In response, Western revised its power marketing strategy and responsibilities to diminish the need to purchase power. In FY 2006, Western adjusted internal practices and procedures to acquire firming energy to control costs by avoiding the price volatility of short-term markets. Subsequently, Western purchased approximately 2.3 million less MWh (9.3 million MWh) of power in FY 2006, but unfortunately, the cost of power had increased significantly. On average, Western paid \$53 per MWh, or \$10 more per MWh than in FY 2005 and twice as much as in FY 2002.

Aging infrastructure led program partners to develop optimal routine maintenance strategies. For example, Western's Reliability Centered Maintenance Program emphasizes predictive maintenance in preserving important power system equipment functions. We can now better control and manage operation and maintenance costs, demonstrating minimal cost increases while maintaining or exceeding national reliability standards. From FY 2002 to FY 2006, O&M costs increased generally at the rate of inflation with modest increases from year to year. For example, the FY 2006 increase was approximately \$12.9 million above FY 2005 levels, or a 4-percent increase.

Purchased transmission expenses increased in FY 2006 to approximately \$59.7 million, an increase of \$13.8 million. This change is largely due to the increased cost to deliver power. Western purchased significantly less power in FY 2004, FY 2005 and FY 2006; however, we paid more to have that power delivered.

Repayment of Federal Power Program investment in FY 2006 was approximately \$42.3 million. Specifically, repayment of Federally-financed power investment totaled \$31.9 million, compared to \$13.1 million in FY 2005, while repayment of non-Federally-financed power investment was \$8.0 million, compared to \$4.3 million in FY 2005. Total investment repayment of \$3.0 billion paid through FY 2006 consists of: \$2.9 billion (51.8 percent investment repaid)—Federally-financed power; \$71.0 million (31.0 percent investment repaid)—non-Federally financed; and \$43.1 million (1.8 percent investment repaid)—nonpower. In addition, through FY 2006, the Federal Power Program has paid a total of \$4.1 billion in interest expense on Program investment.

Program participants continue to maximize the operational life of transmission and generation assets. Electric plant in service increased \$122.2 million in FY 2006 to \$5.9 billion. New plant in service for Program assets reflects not only our continued efforts to extend the life of facilities, but to increase efficiencies by expanding the capacity of operating equipment through technology. Specifically, uprating hydroelectric generator and turbine units at existing power plants is one of the most immediate, cost effective and environmentally-acceptable means to develop additional electrical power. For transmission, the focus is on system modernization, such as enhancements to mitigate some system constraints without adding new lines to the grid.

Program managers are responsible for ensuring the integrity and objectivity of the power financial statements as supported by audit results. The FY 2006 statements again received an unqualified opinion (since 1991) continuing the Program's success and commitment to providing accurate financial information supported by Program processes and related internal controls. In FY 2006, the Federal Power Program fully implemented the requirements of OMB Circular A-123, Appendix A, "Internal Controls over Financial Reporting". Modeled after Sarbanes-Oxley, the Program provides tools to assess the effectiveness of internal controls over financial reporting and, in turn, its accuracy.

The electric utility industry is dynamic. Renewable energy and transmission sufficiency (capability and reliability) continue to gain national interest as potential solutions to diversify the U.S. energy supply. Renewables lessen reliance on oil for energy production and reduce pollution and carbon dioxide emissions that may affect global climate change. Although the Federal Power Program has long provided renewable, pollution-free hydropower, we must improve transmission infrastructure to accommodate additional renewable sources to improve the U.S. energy security and the environment.

¹ As contained in the Notes to Combined Power System Financial Statements (1a), the Federal Power Program represents the marketing and transmission activities of the Western, and the power generating function of the U.S. Bureau of Reclamation; U.S. Army Corps of Engineers and International Boundary and Water Commission.

Performance perspective

To maximize the benefit of the Federal Power Program, Western has expanded performance reporting to include generation, specifically the U.S. Army Corps of Engineers and Bureau of Reclamation. Although reporting is currently limited, we will work closely in the future to develop performance measures/goals to assist managers and stakeholders in evaluating overall program efficiency. In FY 2006, we met nine of our 10 targets or measures, and partially met the remaining one, which is still under development.

Provide a reliable power supply

Facility reliability rating—power: Met

Reclamation performed all scheduled comprehensive facility reviews and completed an equipment condition assessment for major power train components at each of its hydropower facilities.

In FY 2003, Reclamation established an internal rating system of facility reliability to determine the condition of assets, infrastructure. The baseline goal: 96 percent of power facilities are ranked in fair to good condition annually. Since that year, all facilities (100 percent) have been rated fair to good.

The Corps is currently in the process of developing a Condition Efficiency Assessment Rating that will be similar to Reclamation's measure. This measure will enable plant managers to track the condition of individual generating units and better manage and plan for future maintenance.

Forced outages: Met

Reclamation's forced outage factor (1.2 percent) is less than or equal to the current industry average of 2.5 percent.

In FY 2005 and FY 2006, 40 percent of Corps regions achieved a system-wide forced outage rate of 2 percent or less.

Efficiency improvements to increase generation capacity: Met

Generation was increased by approximately 8 MW through the Hydro Efficiencies Program in FY 2006 as a result of new turbine runner installations in Unit No. 7 at the Glen Canyon Dam.

Provide reliable power delivery

Control Area Performance Standards (CPS) 1&2: Met

Western's annual average compliance ratings in FY 2006 were 184.42 percent for CPS1 and 98.69 percent for CPS2, far exceeding the North American Electric Reliability Corporation minimum compliance levels as outlined below, and also exceeding respective industry averages of 161.82 percent and 96.99 percent.

NERC ratings for: CPS1, which measures generation/load balance and support system frequency on one-minute intervals (rating > 100, max 200); and CPS2, which limits any imbalance magnitude to acceptable levels (rating > 90, max 100).

Accountable outages: Met

For FY 2006, Western recorded 23 outages, achieving our stated annual goal of not exceeding the average number of outages for the past five years (23).

Accountable transmission system outages quantify the efficiency of Western's efforts to reduce or eliminate avoidable outages—those caused by human error through improper or incorrect equipment operation, installation or maintenance.

Efficiency improvements to increase transmission capacity: Partially Met

Western is pursuing initiatives to increase transmission capacity and reliability, eliminate congestion points, respond to increased interest in renewable resources and accommodate additional requests for interconnections to Western's system.

Cost-effective power services and supply

Power production cost performance goal: Met

In FY 2006, Reclamation decreased powerplant production costs from the previous year by 4.30 percent, which is well below its annual goal of a 7.21-percent increase, established using a five-year rolling average.

The Corps will be developing a cost efficiency measure which compares its hydropower facility costs with other, non-Federal hydropower production facilities.

Repayment of Power Investment: Met

Unpaid investment is equal to or less than the allowable unpaid investment under DOE Order RA 6120.2 and Reclamation Law.

This ratio measures progress toward meeting long-term repayment over the life of the project/investment.

People and culture

Western maintains a capable workforce working safely in a culture and environment where partnering and teamwork result in enhanced performance and results.

President's Management Agenda: Met

Western achieved five green ratings for its President's Management Agenda initiatives. The scorecard evaluates agency performance in the areas of human capital, competitive sourcing, financial management, e-government and small business.

Safety: Met

Western achieved a total recordable accident frequency rate of 2.6 per 200,000 hours worked, which is well below the CY 2005 utility industry average of 5.1.

Reclamation achieved a lost time accident frequency rate of 1.7 per 200,000 hours worked, well below the utility industry average of 2.4.

Independent auditors' report

The Administrator

Western Area Power Administration

United States Department of Energy

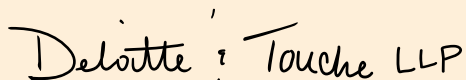
We have audited the accompanying combined power system balance sheets of the Western Area Power Administration (Western), an agency of the U.S. Department of Energy, and the Western affiliated power generating functions of the U.S. Department of the Interior, Bureau of Reclamation; the U.S. Department of Defense, Army Corps of Engineers; and the U.S. Department of State, International Boundary and Water Commission (collectively, the generating agencies), as of September 30, 2006 and 2005, and the related combined power system statements of revenues and expenses, and accumulated net deficit, and cash flows for the years then ended. These combined power system financial statements are the responsibility of Western and the generating agencies' management. Our responsibility is to express an opinion on these combined power system financial statements based on our audits. We did not audit the financial statements of the affiliated power generation function of the U.S. Department of the Interior, Bureau of Reclamation (Reclamation), whose statements reflect total assets constituting 31% of combined total assets as of September 30, 2006 and 2005, and total revenues constituting 21% and 23%, respectively, of combined total revenues for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Reclamation, is based solely on the report of such other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Western and the generating agencies' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the combined power system financial statements referred to above present fairly, in all material respects, the combined financial position of Western and its affiliated power generating agencies, as of September 30, 2006 and 2005, and their combined operations, changes in accumulated net deficit, and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 9, the accompanying combined power system financial statements as of and for the year ended September 30, 2005, have been restated.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 29, 2007, on our consideration of Western and the generating agencies' internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The logo for Deloitte Touche LLP, featuring the company name in a stylized, handwritten-style font.

Denver, Colorado

June 29, 2007

Combined Power System Balance Sheets

As of September 30, 2006 and 2005 (in thousands)

	2006	As Restated (See Note 9) 2005
Assets		
Utility plant:		
Completed plant	\$ 5,864,569	\$ 5,742,384
Accumulated depreciation	(2,671,840)	(2,581,370)
Net completed plant	3,192,729	3,161,014
Construction work-in-progress	129,764	158,517
Net utility plant	3,322,493	3,319,531
Cash	513,586	425,795
Accounts receivable, net	129,546	116,696
Other assets	190,306	195,190
Total assets	\$ 4,155,931	\$ 4,057,212
Federal investment & liabilities		
Federal investment:		
Congressional appropriations	\$ 12,090,628	\$ 11,607,495
Interest on Federal investment	4,598,580	4,425,068
Transfer of property & services, net	639,969	510,498
Gross Federal investment	17,329,177	16,543,061
Funds returned to U.S. Treasury	(13,015,516)	(12,509,631)
Net outstanding Federal investment	4,313,661	4,033,430
Accumulated net deficit	(604,465)	(429,091)
Total Federal investment	\$ 3,709,196	\$ 3,604,339
Commitments and contingencies (notes 1, 6, 7 and 8)		
Liabilities:		
Accounts payable	63,346	70,474
Other liabilities	383,389	382,399
Total liabilities	446,735	452,873
Total Federal investment & liabilities	\$ 4,155,931	\$ 4,057,212

See accompanying notes to combined power system financial statements.

Combined Power System Statements of Revenues and Expenses, and Accumulated Net Deficit

For the Years Ended September 30, 2006 and 2005 (in thousands)

	2006	As Restated (See Note 9) 2005
Operating revenues:		
Sales of electric power	\$ 879,477	\$ 806,576
Other operating income	289,428	260,114
Gross operating revenues	1,168,905	1,066,690
Income transfers, net	(121,798)	(121,492)
Total operating revenues	1,047,107	945,198
Operating expenses:		
Operation and maintenance	331,114	318,206
Administration and general	43,118	54,404
Purchased power	494,079	478,951
Purchased transmission services	59,728	45,930
Depreciation	108,785	123,428
Total operating expenses	1,036,824	1,020,919
Net operating revenues (deficit)	10,283	(75,721)
Interest expenses:		
Interest on Federal investment	180,767	169,596
Interest on non-Federally financed funding	10,392	4,927
Allowance for funds used during construction	(7,767)	(9,919)
Net interest expenses	183,392	164,604
Net deficit	(173,109)	(240,325)
Accumulated net deficit, beginning of year	(429,091)	(188,766)
Irrigation assistance	(2,265)	0
Accumulated net deficit, end of year	\$ (604,465)	\$ (429,091)

See accompanying notes to combined power system financial statements.

Combined Power System Statements of Cash Flows

For the Years Ended September 30, 2006 and 2005 (in thousands)

	2006	As Restated (See Note 9) 2005
Cash flows from operating activities:		
Net deficit	\$ (173,109)	\$ (240,325)
Adjustments to reconcile net deficit to net cash (used in) provided by operating activities:		
Depreciation	108,785	123,428
Interest on Federal investment	179,819	150,651
Income Transfers	0	113
Gain/Loss on disposition of assets	2,429	3,055
(Increase) decrease in assets:		
Accounts receivable	(12,850)	21,929
Other assets	(5,464)	(44,046)
Increase (decrease) in liabilities:		
Accounts payable	(7,128)	(56,806)
Other liabilities	(25,182)	26,309
Net cash (used in) provided by operating activities:	67,300	(15,692)
Cash flows from investing activities:		
Investment in utility plant	(86,811)	(98,136)
Cash flows from financing activities:		
Congressional appropriations, net	583,602	344,005
Funds returned to U.S. Treasury	(505,885)	(361,495)
Principal payments on non-federally financed funding	31,850	19,100
Irrigation assistance	(2,265)	0
Net cash (used in) provided by financing activities	107,302	1,610
Net (decrease) increase in cash	87,791	(112,218)
Cash, beginning of year	425,795	538,013
Cash, end of year	\$ 513,586	\$ 425,795
Supplemental schedule of noncash investing and financing activities		
Transfer of construction work-in-progress to completed plant	\$ 119,563	\$ 157,927
Capitalized interest during construction	\$ 7,767	\$ 9,919

See accompanying notes to combined power system financial statements.

Notes to combined power system financial statements

(1) Basis of Presentation and Summary of Significant Accounting Policies

(a) Principles of Combination

The combined power system financial statements include the financial position, results of operations and cash flows of the Western Area Power Administration (Western), an agency of the U.S. Department of Energy (DOE), and the power generating function of the U.S. Department of the Interior, Bureau of Reclamation (Reclamation); the U.S. Department of Defense, Army Corps of Engineers (Corps); and the U.S. Department of State, International Boundary and Water Commission (IBWC) (collectively known as the generating agencies) for the individual power systems. The jointly owned power systems are separately managed and financed, and maintain separate accounting records. Western, a Federal power marketing administration, markets and transmits hydroelectric power generated from these power systems operated and maintained by the generating agencies throughout 15 western states. The power systems, with the exception of the Central Arizona Project (CAP) and the Pacific Northwest-Pacific Southwest Intertie (Intertie), are part of multipurpose water resource projects and include certain Western transmission facilities and certain generating agency facilities.

Operating expenses and net assets of multipurpose water resource projects are allocated among project activities, which are primarily; power, irrigation, recreation, municipal and industrial water, navigation and flood control (see Note 4). The combined power system financial statements include only those expenses and net assets which are expected to be recovered through the sale of power and other related income.

Although Reclamation holds an entitlement to power from the coal-fired Navajo Generating Station and capacity from the CAP transmission facilities, the combined power system has no ownership in these facilities. As such, neither the CAP assets nor the associated entitlements are included in the combined power system financial statements.

Accounts are maintained in accordance with accounting principles generally accepted in the United States of America (GAAP) and the Federal Energy Regulatory Commission's (FERC) prescribed uniform system of accounts for electric utilities. Accounting policies also reflect specific legislation and executive directives issued by departments of the Federal government.

The combined power system financial statements are presented in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effect of Certain Types of Regulation*. The provisions of SFAS No. 71 require, among other things, that regulated enterprises reflect the regulator's rate actions in their financial statements, when appropriate. These rate actions can provide reasonable assurance of the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise.

For purposes of financial reporting, the facilities and related operations of Western and the generating agencies are considered one entity. All intra-entity balances and transactions have been eliminated from the combined power system financial statements.

The facilities and net revenues included in these combined power system financial statements are exempt from taxation.

(b) Confirmation and Approval of Rates

The Secretary of Energy (Secretary) has delegated authority to Western's Administrator to develop power and transmission rates for its controlled power systems. The Deputy Secretary of Energy has the authority to confirm, approve and place such rates in effect on an interim basis. The Secretary delegated to FERC the authority to confirm, approve and place such rates in effect on a final basis, to remand, or to disapprove such rates. Refunds with interest, as determined by the FERC, are authorized if rates finally approved are lower than rates approved on an interim basis. However, if at any time FERC determines that the administrative cost of a refund would exceed the amount to be refunded, no refunds will be required. No refunds are anticipated in connection with rates approved on an interim basis through September 30, 2006.

(c) Operating Revenues

Operating revenues are recognized when goods or services are provided to the public or another government agency. Except for power systems using revolving funds, cash received from sales is deposited directly with the U.S. Department of the Treasury (U.S. Treasury) and is reflected as Funds Returned to U.S. Treasury in the Combined Power System Balance Sheet. As such, these funds are unavailable for power system operating needs. For power systems using revolving funds, cash received is deposited in the U.S. Treasury and remains available to the power system. Cash collected into revolving funds in excess of operating requirements is used for repayment of Federal investment and interest.

Power and transmission rates are established under requirements of the power systems' authorizing legislation and related Federal statutes and are intended to provide sufficient revenue to recover all costs allocated to power and, in some power systems, a portion of irrigation-related costs (see Note 7). Costs allocated to power include repayment of Federal investment in power facilities and associated interest. Rates are structured to provide for repayment of Federal investment in power facilities, generally over 50 years, while operating expenses and interest on Federal investment are recovered annually. Replacements of utility plant are generally to be repaid over their expected service lives.

The power systems' legislation does not recognize annual depreciation based on actual service lives as a measure of the required repayment for investment in utility plant. This results in some assets being fully depreciated before costs are recovered; whereas, annual depreciation costs on other assets may continue after such costs have been recovered through revenues. Over the life of the combined power systems, accumulated net revenues represent timing differences between the recognition of expenses and related revenues. Because Western and the generating agencies are nonprofit Federal agencies, accumulated net revenues, to the extent that they are available, are committed to Federal investment repayment.

Other operating income represents the amount of funds collected from sources other than the sale of electric power. These revenues include rental of electric property, power wheeling and transmission services.

Net income transfers represent the amount of funds collected but subsequently transferred to Reclamation. This amount is primarily the surplus generation billed from the Navajo Generating Station by Western, on behalf of Reclamation's CAP.

(d) Cash

For purposes of the Combined Power System Financial Statements, cash consists principally of the undisbursed balance of funds authorized by Congress, customer advances and revolving fund balances at the U.S. Treasury.

(e) Accounts Receivable, Net

The estimate of the allowances is based on past experience in the collection of receivables and an analysis of the outstanding balances. The amounts due for receivables are stated net of an allowance of \$0.2 million and \$0.1 million for uncollectible accounts as of September 30, 2006 and 2005, respectively, from a gross amount of \$129.7 million and \$116.8 million respectively.

Billing methods used by Western include net billing and bill crediting. Net billing is a two-way agreement between Western and a customer, whereby both buy and sell power to each other. Monthly sales and purchases, including any customer advances received, are netted between the two parties and the customer is provided either an invoice or a credit. Bill crediting involves a three-way net billing arrangement among Western, a customer and a third party. For example, Western purchases power from a third-party supplier, delivers it to the customer; the customer then pays the third-party supplier and receives a credit on its bill from Western.

(f) Stores Inventory

Inventory consists of hardware, tools, and maintenance parts and supplies. Inventory is valued using the average cost method.

(g) Utility Plant

Utility plant is stated at original cost, net of contributions in aid of construction by entities outside of the combined power system. Costs include direct labor and materials; payments to contractors; indirect charges for engineering, supervision and administrative and general expense; and interest during construction. The costs of additions, major replacements and betterments are capitalized; whereas, repairs are charged to operation and maintenance expense.

The cost of retired utility plant, net of accumulated depreciation, is charged to operation and maintenance expense as a gain (loss) and the net of removal costs and salvage credits is capitalized as part of the direct replacement asset. If there is not a replacement asset, the net of removal costs and salvage credits is charged to operation and maintenance expense. Plant assets of the combined power system are currently depreciated using the straight-line method over estimated service lives ranging from 8 to 50 years for transmission assets and 13 to 100 years for generation assets. Power rights are amortized over 40 years.

(h) Interest on Federal Investment

Interest is accrued annually on the Federal investment based on the Federal statute and power system legislation. Such interest is reflected as an expense in the Combined Power System Statement of Revenues and Expenses. Western calculates interest annually based on the unpaid Federal investment owed to the U.S. Treasury using rates set by law, administrative orders pursuant to law or administrative policies.

All power systems recognize an annual interest credit for payments of interest on obligations that are due annually to the U.S. Treasury. Interest rates on unpaid Federal investments ranged from 2.5 to 12.4 percent for the years ended September 30, 2006 and 2005.

As provided by Federal law, interest is not assessed on Federal investment in irrigation facilities anticipated to be repaid through power sales (see Note 7).

(i) Allowance for Funds Used During Construction

Interest During Construction (IDC or Allowance for Funds Used During Construction) represents interest on funds borrowed from the U.S. Treasury during the construction of all generating and transmission facilities. Western calculates IDC based on the average annual outstanding balance of construction work-in-progress. Western and the generating agencies' policy is to capitalize IDC through the end of the fiscal year in which assets are placed in service. IDC is recovered over the repayment period of the related plant asset. Applicable interest rates ranged from 3.2 to 8.9 percent for the years ended September 30, 2006 and 2005, depending on the year in which construction on the transmission and generation facilities was initiated or the authorizing legislation.

(j) Pension and Other Retirement Benefits

Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, and SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, direct the full cost reporting of employment benefits by employing entity. These statements require Federal agencies to record the government's cost of providing pension, life and health insurance and other post-employment benefits (severance payment, counseling and training, workers' compensation benefits, etc.) regardless of the funding agency.

(k) Use of Estimates

Management of Western and the generating agencies have made many estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these combined power system financial statements in conformity with GAAP. Actual results could differ significantly from those estimates.

(l) Derivative and Hedging Activities

Western analyzes derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This statement requires that all derivative instruments, as defined by SFAS No. 133, be recorded on the balance sheet at fair value unless exempted. Changes in a derivative instrument's fair value must be recognized currently in earnings unless the derivative has been designated in a qualifying hedging relationship. The application of hedge accounting allows a derivative instrument's gains and losses to offset related results of the hedged item in the statement of operations, to the extent effective. SFAS No. 133 requires that the hedging relationship be highly effective and that a company formally designate a hedging relationship at the inception of the contract to apply hedge accounting.

Western enters into contracts for the purchase and sale of electricity for use in their business operations. SFAS No. 133 requires Western to evaluate these contracts to determine whether the contracts are derivatives. Certain contracts that literally meet the definition of a derivative may be exempted from SFAS No. 133 as normal purchases or normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold over a reasonable period in the normal course of business. Contracts that meet the requirements of normal are documented and exempted from the accounting and reporting requirements of SFAS No. 133.

Western's policy is to fulfill all derivative and hedging contracts by either providing power to a third party or by taking delivery of power from a third party as provided for in each contract. Western's policy does not authorize the use of derivative or hedging instruments for speculative purposes such as hedging electricity pricing fluctuations beyond Western's estimated capacity to deliver or receive power. Accordingly, Western evaluates all of its contracts to determine if they are derivatives and, if applicable, to ensure that they qualify and meet the

normal purchases and normal sales designation requirements under SFAS No. 133. Normal purchases and normal sales contracts are accounted for as executory contracts as required under generally accepted accounting principles.

(m) Concentrations of Credit Risks

General Credit Risk

Financial instruments, which potentially subject Western and the generating agencies to credit risk, include accounts receivable for customer purchases of power, transmission, or other products and services. These receivables are primarily with a group of diverse customers that are generally large, stable and established organizations which do not represent a significant credit risk. Although Western and the generating agencies are affected by the well-being of the utility industry, management does not believe a significant risk of loss from a concentration of credit exists.

(n) Moveable Equipment

Moveable equipment represents the acquisition cost of capitalized movable equipment having a unit cost of \$15,000 or more and an estimated useful life of two years or more. Examples of capitalized moveable equipment include computers, copiers, cranes, energy testing equipment, helicopters, trucks and wood chippers.

Western's internal use software is capitalized when the software has a service life of 3 years or more and a cost of \$150,000 or more upon the completion of the software development phase or upon purchase of commercial off-the-shelf software applications. Reclamation's internal use software is subject to a \$100,000 capitalization threshold with a service life of 2 years or more. No other generating agency has any capitalized internal use software.

(o) Abandoned Projects

In accordance with FERC regulations, Western's policy is to move capitalized costs into plant-in-service at the time the asset is placed in service. Occasionally, congressionally authorized projects originally planned for service are discontinued due to political and/or economic reasons. Western's policy is to classify these discontinued projects based on congressional action as abandoned projects and amortize them into the power rates over a reasonable period.

(p) Interchange Energy

Western's power contracts may include a provision for energy transfers between Western and a supplier that result in deferred energy debits or credits. Deferred energy debits or credits represent the valuation of excess energy delivered or received under the interchange energy contract provisions. The interchange balance is posted either as a deferred debit (other asset) when Western is the net supplier, or as a deferred credit (other liabilities) when Western is the net user.

(q) Recovery Implementation Program (RIP)

Section 8 of the Colorado River Storage Project Act of 1956, as amended, mandates that the U.S. Department of the Interior establish and implement programs to conserve fish and wildlife. Under this act and other legislation, Reclamation has established programs to preserve the habitat and otherwise aid endangered fish and wildlife. The RIP is one such program and is managed by the U.S. Fish and Wildlife Service.

On October 30, 2000, Congress passed Public Law 106-392 that authorized additional funding to Reclamation to continue the RIP. The legislation specifies that a total of \$17.0 million is to be collected by Western from its power customers and provided to Reclamation to finance capital costs and up to \$6.0 million a year starting in FY 2001 for operating expenses, adjusted annually for inflation thereafter. Furthermore, the legislation states that operating expenses are considered non-reimbursable to the U.S. Treasury and a repayment of the Federal investment. Conversely, capital funded costs must be repaid to the U.S. Treasury through future power sales. Operating expenses were \$6.7 million and \$1.6 million for the years ended September 30, 2006 and 2005 respectively. Reimbursable capital costs for the years ended September 30, 2006 and 2005, respectively, were \$0.0 million and \$3.2 million.

(r) Annual Leave

Unused annual leave represents accrued benefits which would be payable to employees upon retirement or separation from employment with the government. The amount not funded by revolving funds has been deferred as another asset in the Combined Power System Balance Sheet in accordance with SFAS No. 71.

(s) Transmission Termination Settlement

Western renegotiated certain CRSP long-term contractual obligations with third-party power providers. Under the terms of the settlement agreements, annual payments of \$0.6 million will be made through 2007 to PacifiCorp. The recognition of the expense associated with the settlements has been deferred as an other asset in the Combined Power System Balance Sheet in accordance with SFAS No. 71 (see Note 2).

(t) Customer Advances

Customer advances represent the current balance of advance payments received from power and other customers under co-sponsoring agreements with entities for construction, operation and maintenance, or other furnished items. Subsidiary accounts are maintained by customer to reflect the status of each advance. Also included are revenue financing contracts that provide for customer funds to be advanced for construction, maintenance or purchase power expenses. For these contracts, the customer is provided revenue credits on future power bills up to the amount of the advanced funds and, if applicable, any interest or fees.

(u) Workers' Compensation

Workers' compensation consists of two elements: a liability for expenses from actual claims incurred and paid by the Department of Labor (DOL) that Western and the generating agencies must reimburse; and an actuarial liability associated with cases incurred for which additional future claims may be made. In conjunction with SFAS Nos. 4 and 5, DOL determined the actuarial liability associated with future claims using historical benefit payment patterns discounted to present value (37 years) using economic assumptions for 10-year U.S. Treasury notes and bonds.

The recovery of future claims is deferred for rate-making purposes until such time the claims are submitted to and paid by the DOL. Therefore, the recognition of the expense associated with the actuarially determined liability has been deferred as an other asset in the Combined Power System Balance Sheet in accordance with SFAS No. 71 (see Note 2) to reflect the effects of the rate-making process.

(v) Capital Credits

Capital credits represent the investment made in non-profit organizations that result in equity ownership (patronage credits) that will result in a cash collection refund at a later date, which sometimes can be as long as 30 years. These credits are reported as income and deferred asset at the time of notification until the actual cash collection is made.

(2) Other Assets

Other assets as of September 30, 2006 and 2005 consist of the following (in thousands):

	2006	2005
Regulatory Assets		
Workers' compensation actuarial (see Note 1(u))	\$45,980	\$60,507
Accrued annual leave (see Note 1(r))	14,430	13,601
Abandoned project costs, net (see Note 1(o))	12,652	13,438
Recovery Implementation Program (see Note 1(q))	12,252	12,252
Transmission termination settlement (see Note 1(s))	1,000	1,000
Total Regulatory Assets	\$86,314	\$100,798
Other Assets		
Moveable equipment, net (see Note 1(n))	35,773	37,256
Deposit funds available	17,898	8,852
Stores inventory (see Note 1(f))	13,152	12,885
Energy banking deferral	12,636	1,965
Internal use software, net (see Note 1(n))	12,357	14,824
Interchange energy (see Note 1(p))	9,291	13,595
Other	2,370	4,045
Capital credits (see Note 1(v))	515	970
Total Other Assets	\$103,992	\$94,392
Total Regulatory and Other Assets	\$190,306	\$195,190

Abandoned project costs, net include the Celilo-Mead transmission line of \$12.7 million and \$13.4 million as of September 30, 2006 and 2005, respectively, which is being amortized over 23 years, through 2019.

The energy banking deferral is an arrangement between Western and a customer whereby excess power and/or transmission capacity is banked with the customer until power is needed to meet contractual obligations. Banked power and/or transmission capacity is recorded at a contractually agreed-upon price. The net revenue associated with the banking activity is deferred and recorded as an other liability.

(3) Utility Plant

Net Utility Plant as of September 30, 2006 consists of buildings, facilities, land and intangible power rights. Land costs for Western were \$74.0 million and \$73.7 million as of September 30, 2006 and 2005, respectively. Land costs for the generating agencies were \$94.5 million and \$92.1 million as of September 30, 2006 and 2005, respectively. Completed plant includes \$105.9 million and \$110.0 million of power rights, net of amortization of \$57.0 million and \$53.0 million as of September 30, 2006 and 2005, respectively.

(4) Federal Investment and Cost Allocation

(a) General

Federal investment consists of congressional appropriations, accumulated interest on unpaid Federal investment and the net transfers of property and services from other Federal agencies. Congressional appropriations is comprised of the cumulative appropriations received, net of expenses legislatively deemed non-reimbursable, and post-retirement benefits (see Note 8). Cumulative appropriations received, net of non-reimbursable expenses, totaled \$12.1 billion and \$11.6 billion as of September 30, 2006 and 2005, respectively. Post-retirement benefits for the same time period totaled \$125.7 million and \$106.8 million, respectively. All power systems, except Dolores, Seedskaadee, Boulder Canyon (BC) and the operations and maintenance and purchased power programs of the CRSP, are primarily financed through congressional appropriations for operation and maintenance, construction and rehabilitation and purchased power expenditures. A portion of construction and rehabilitation and purchased power expenditures are financed through other methods, such as advances from non-Federal entities; reimbursements from other Federal agencies; use of receipts authorization; and alternative methods such as net billing and bill crediting; or any combination of these methods.

Operating expenses (excluding depreciation expense) and interest on the unpaid Federal investment should be repaid annually. In cases where funds are not available for repayment, such unpaid annual net deficits become payable from the future years' revenues. Interest is accrued on cumulative annual net deficits until paid. Deficits for operating expenses begin to accrue interest in the year they occur, while interest expense deficits begin to accrue interest in the following year they occur. As of September 30, 2006 and 2005, certain power systems have incurred operating and interest expense deficits aggregating approximately \$468.0 million and \$405.0 million, respectively. In cases where funds are available, unless otherwise required by legislation, repayment of Federal investment is applied to the increment bearing the highest interest rate.

(b) Federal Investment in Multipurpose Facilities

The Federal investment in certain multipurpose facilities, primarily dams and structures integral to power generation, required to be repaid from the power sales, has been determined from preliminary cost allocation studies based on project evaluation standards approved by Congress. Allocations between power and non-power activities may be changed in future years; however, the project evaluation standards cannot be changed unless approved by Congress.

Final studies will be performed by Reclamation and the Corps, as appropriate, upon completion of each individual power project and are still pending for all but the Frypan-Arkansas Power System (FryArk). Reclamation completed the final FryArk study in 1993. The BC and Parker-Davis power systems are not subject to cost allocation studies since the power systems' enacting legislation require the total costs of the dams and appurtenant structures be repaid through power revenues.

With final cost allocation studies still pending for many of the individual power systems, the potential exists for significant future adjustment in the Federal investment for the cost of multipurpose facilities allocated to power and the related accrued interest on the unpaid Federal investment. Such reallocations could affect the individual power system rates. For example, in 1997, Reclamation studied the implications of a cost reallocation of the Pick-Sloan Missouri Basin Program (P-SMBP) on existing water and power rates. The study resulted in additional costs, ranging from \$0 to \$416 million (depending on the assumptions of the cost methodologies used), which may be reallocated to power facilities.

(5) Other Liabilities

Other liabilities as of September 30, 2006 and 2005 consist of the following (in thousands):

	2006	2005
Long-term construction financing	\$156,200	\$153,023
Customer advances	80,801	78,139
Workers' compensation actuarial (see Note 1(u))	45,980	60,507
Deposit funds available	17,897	8,876
Custodial liability	14,089	13,347
Accrued annual leave (see Note 1(r))	13,289	13,191
Energy banking deferral	12,636	1,965
Recovery Implementation Program (see Note 1(q))	12,252	12,252
Interchange energy (see Note 1(p))	9,291	13,595
Workers' compensation accrual (see Note 1(u))	8,684	8,025
Accrued payroll benefits	8,264	8,578
Other	3,006	4,001
Transmission termination settlement (see Note 1(s))	1,000	1,000
Litigation accrual	0	5,900
Total	\$383,389	\$382,399

The majority of long-term construction financing consists of three significant contractual arrangements. The first significant arrangement provides customer financing for the Boulder Canyon (BC) power system to upgrade each of the generating units at Hoover Dam. The obligation to these customers is scheduled to be satisfied through issuing credits on power bills over a period through fiscal year 2017, at interest rates ranging between 5.5 and 8.2 percent. As of September 30, 2006 and 2005, the outstanding obligation was \$109.0 million and \$114.1 million, respectively.

The second significant arrangement consists of the principal payable to the State of Wyoming for providing partial financing for improvements at Buffalo Bill Dam (P-SMBP Power System) and associated power plants. This liability is being repaid over a period of 35 years, which began in 1996, at an approximate interest rate of 11.1 percent. The outstanding obligation amounted to \$20.7 million and \$20.9 million as of September 30, 2006 and 2005, respectively.

The third significant arrangement is principal due to Griffith Energy LLC for providing financing for the construction of the Griffith-McConnico and Griffith-Peacock transmission lines along with certain assets at Peacock Substation, and McConnico Switching Station. Repayment is through power bill credits beginning in 2001 and ending in 2018. The interest rate is 8.5 percent. As of September 30, 2006 and 2005, the outstanding obligation totaled \$22.4 million and \$23.5 million, respectively.

Outstanding long-term construction financing as of September 30, 2006 is scheduled to be credited or repaid as follows (in thousands):

2007	\$8,143
2008	9,719
2009	10,451
2010	11,242
2011	12,014
2012+	104,631
Total	\$156,200

Custodial liabilities represent the amount of accrued revenue for the Central Arizona and BC power systems. The custodial revenue is transferred upon actual receipt of funds.

Western and the generating agencies included \$46.0 million and \$60.5 million as an actuarial liability for future workers' compensation claims in the Combined Power System Balance Sheet as of September 30, 2006 and 2005, respectively.

Cumulative unpaid expenses associated with actual claims incurred for Western and the generating agencies were \$8.7 million and \$8.0 million as of September 30, 2006 and 2005, respectively.

Western received a loan from the State of Colorado for \$5.5 million in December 2002 (fiscal year 2003) at an interest rate of 4.5 percent per year. Another \$5.9 million was received in December 2004 (fiscal year 2005) with an interest rate of 3.25 percent. The purpose of these loans was to fund Reclamation's endangered fish recovery implementation programs (see note 1(q)). Interest began accruing at the time loans were granted, and is being capitalized. These balances, with capitalized interest and fees, total \$12.3 million. The original principal balances and the associated capitalized interest will be repaid through power revenues beginning in 2012.

(6) Lease Commitments

Western and the generating agencies have several cancelable operating leases, primarily for general purpose motor vehicles and office and warehouse space that expire over the next 15 years.

Western has a non-cancelable lease that expires in 2009 for Western's Corporate Service Office. This lease represents an annual expense of approximately \$2.2 million. The General Services Administration is the leaseholder for all locations with the exception of the Electric Power Training Center where Western is the leaseholder. The right to relinquish space on cancelable leases is available with 120-day notice to terminate.

These leases generally contain renewal options for periods ranging from three to five years and require the lessee to pay all costs such as maintenance, insurance and taxes. Rental expense for operating leases was approximately \$10.9 million and \$9.5 million for the years ended September 30, 2006 and 2005, respectively.

(7) Commitments and Contingencies

(a) General

Western and the generating agencies are involved in various claims, suits and complaints routine to the nature of their business. These Federal government organizations are self-insured for claims pertaining to litigation, unemployment, long-term disability and health and life insurance. Liabilities for these claims, as reported in the combined power system financial statements, are based on reported pending claims, estimates of claims incurred but not yet reported, actuarial reports and historical analysis. It is management's opinion that the ultimate disposition of these claims will not have a material adverse effect on the combined power system financial statements.

(b) Irrigation Assistance

Federal statute requires that certain individual power systems repay the U.S. Treasury that portion of Reclamation's project capital costs allocated to irrigation purposes determined by the Secretary of the Interior to be beyond the ability of the irrigation customers to repay. Although these repayments may be recovered through power sales, they do not represent an operating cost of the individual power systems and are treated as distributions from accumulated net revenues at the time of repayment.

Power repayment studies indicate that approximately \$2.3 billion of existing non-power Federal investment will be repaid from future power revenues over a period not to exceed 60 years. Reclamation made irrigation assistance payments of \$2.3 million and \$0.0 million for the years ended September 30, 2006 and 2005, respectively.

(c) Boulder Canyon Power System Improvements

In 1987, Reclamation initiated a project designed to increase (uprate) the generating capacity of the BC power system. Certain BC customers agreed to provide funding for these improvements, primarily through issuing long-term bonds. In some cases, proceeds from the bonds exceeded the amount required to fund the improvements.

For purposes of measuring the liability related to the Uprating Program (the Program), the total amount of the advances received from customers is reported in the Combined Power System Balance Sheet (see Note 5). Bond issuance costs are included in determining interest expense and are recognized over the term of debt repayment. Net proceeds from issuing the debt, in excess of the amount advanced to Reclamation, have similarly been excluded from the assets of the power system. Interest expense on the liability is measured based on the total outstanding bonded indebtedness. Interest income from excess proceeds reduces interest costs subject to arbitrage regulations. Until any remaining excess funds are applied against outstanding debt, the total interest cost of financing the Program will be subject to uncertainty.

(d) Colorado River Storage Project

In October 1992, Congress passed the Grand Canyon Protection Act of 1992 (the Act) to "protect . . . and improve the values for which the Grand Canyon National Park and Glen Canyon National Recreation Area were established."

The Act relieves CRSP power customers of repayment obligations for costs equivalent to certain expenses of environmental impact studies, associated purchased power, and other miscellaneous expenses related to Glen Canyon Dam. As of September 30, 2006 and 2005, Western and Reclamation combined incurred

\$23.3 million and \$25.0 million, respectively, in environmental costs which were deemed non-reimbursable. Accordingly, such costs have been recognized as a reduction of congressional appropriations in the Combined Power System Balance Sheet.

(e) Power Contract Commitments

Western has entered into various agreements for power and transmission purchases that vary in length but generally do not exceed 20 years. Western's long-term commitments for these power and transmission contracts, subject to the availability of Federal funds and contingent upon annual appropriations from Congress, are as follows (in thousands):

Year ending September 30:	Purchased power	Purchased transmission	Total
2007	\$21,083	\$5,764	\$26,847
2008	16,076	5,239	21,315
2009	10,800	5,077	15,877
2010	2,605	3,805	6,410
2011	0	3,805	3,805
2012+	0	25,398	25,398
Total	\$50,564	\$49,088	\$99,652

In addition to these contracts, Western maintains other long-term contracts which provide the ability to purchase unspecified quantities of transmission services within a contractually determined range and rate. To fulfill its contractual obligations to deliver power, Western has historically had to purchase a certain level of transmission services under these agreements. Western intends and anticipates it will be necessary to acquire resources under these contracts up to a maximum of \$67.5 million through the life of the current contracts.

(f) Pacific Gas & Electric Company Settlement

Under the terms of the integration contract 14-06-200-2948A (2948A) between PG&E and Western, Western pays PG&E an estimated rate each year for energy purchases and records this amount as purchased power expense in the Combined Power System Statement of Revenues and Expenses. Provisions of the contract require the estimated rate to be adjusted to reflect PG&E's actual annual average thermal production costs, resulting in either Western paying an additional amount or receiving a refund for any overpayment. In the Combined Power System Statement of Revenues and Expense for fiscal year 2006, Western recorded purchased power expense of \$11.9 million related to calendar year 2004. During that time period, Western purchased approximately \$94.6 million in power from PG&E. Contract 2948A terminated on December 31, 2004.

(g) Central Valley Project

Western is engaged in legal discussions with a customer/supplier regarding disputed grid management charges. There is a reasonable possibility that Western could be liable for additional charges estimated at \$5.5 million.

(8) Pension and Other Retirement Benefits

Western, Reclamation, the Corps and IBWC employees participate in one of the following contributory defined benefit plans: the Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS). Agency contributions are based on eligible employee compensation and total 7.0 percent for CSRS and up to 11.2 percent for FERS. These contributions are submitted to benefit program trust funds administered by the Office of Personnel Management (OPM). Western and the generating agencies' contributions for the two plans amounted to \$19.2 million and \$19.9 million for the years ended September 30, 2006 and 2005, respectively.

The contribution levels as legislatively mandated do not reflect the full cost requirements to fund the CSRS or FERS pension plans (approximately 25.0 and 12.0 percent of base salary, respectively). Other post-retirement benefits administered and partially funded by OPM are the Federal Employees Health and Benefits Program (FEHB) and the Federal Employee Group Life Insurance Program (FEGLI). FEHB is calculated at \$5,229 and \$4,903 per employee in fiscal year 2006 and 2005, respectively, and FEGLI is based on 0.02 percent of base salary for each employee enrolled in these programs. In addition to the amounts contributed to the CSRS and FERS as stated above, Western and the generating agencies recorded an expense for the pension and other retirement benefits in the Combined Power System Statement of Revenues and Expenses of \$18.9 million for the year ended September 30, 2006 and \$16.8 million for the year ended September 30, 2005. This amount reflects the contribution made on behalf of Western and the generating agencies by OPM to the benefit program trust funds.

As a Federal agency, all post-retirement activity is managed by OPM. Accordingly, disclosure requirements of FASB SFAS No. 132 are accomplished by OPM.

(9) Restatement of Combined Power System Financial Statements

After the 2005 combined power system financial statements were issued, Western management identified prior-period errors related to the recording of customer advances and the computation of interest on Federal investment. The accompanying 2005 combined power system financial statements have been restated as a result of these prior-period accounting errors, including an understatement of other operating income and an overstatement of interest on

Federal investment expense. These errors occurred principally before September 30, 2004, and resulted in a cumulative increase to beginning accumulated net revenues(deficit) as of October 1, 2004 of \$79 million.

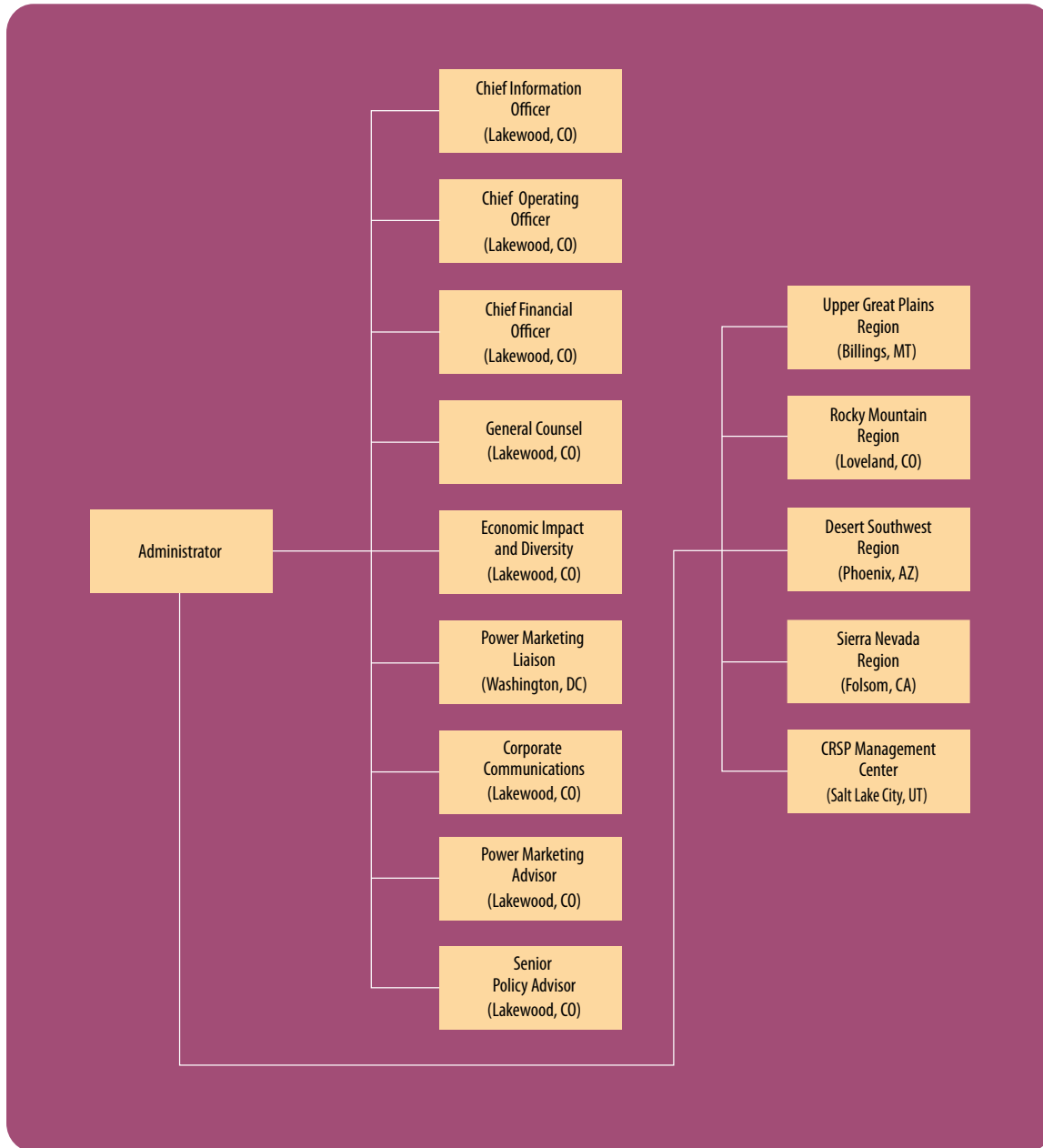
The understatement of other operating income related to customer advances provided to the Central Valley power system in fiscal years 2005 and prior, which were subsequently repaid through credits issued on the customers' power bills. The credits to power bills were recorded as a reduction to other operating income instead of as a reduction to the liability for customer advances. The cumulative impact of this adjustment to beginning accumulated net revenues(deficit) as of October 1, 2004 was an increase of \$45 million.

The overstatement of interest on Federal investment expense related to the financing of the Buffalo Bill Dam within the P-SMBP power system in fiscal years 2005 and prior. Both interest on Federal investment and interest on non-Federally financed funding were accrued for the portion of the Buffalo Bill Dam financed through advances from the State of Wyoming, resulting in a duplication of interest recorded, as well as an additional compounding impact of additional interest accruing on the overstated aggregate interest on Federal investment balance. The cumulative impact of this adjustment to beginning accumulated net revenues(deficit) as of October 1, 2004 was an increase of \$34 million.

The effects of the restatement adjustments on the 2005 combined power system financial statements are as follows (in thousands):

	As previously reported	Adjustment	As restated
Interest on Federal investment	\$ 4,461,428	\$ (36,360)	\$ 4,425,068
Other liabilities	434,657	(52,258)	382,399
Other operating income	252,871	7,243	260,114
Interest on Federal investment expense	249,682	(80,086)	169,596
Allowance for funds used during construction	(87,689)	77,770	(9,919)
Accumulated net deficit, beginning of year	(267,825)	79,059	(188,766)
Accumulated net deficit, end of year	(517,709)	88,618	(429,091)

WESTERN AREA POWER ADMINISTRATION



Contact Western

Call or write your local Western office or the Corporate Communications Office at our Corporate Services Office in Lakewood, Colo., to share your comments or to find out more about Western. Our addresses and phone numbers are listed below.

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