# Department of Water Resources
# Electric Power Fund
# Financial Statements

**March 31, 2014**

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## USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (the Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in the *Management's Discussion and Analysis* in conjunction with the financial statements that follow. This discussion and analysis and the financial statements do not relate to DWR's other governmental and proprietary funds.

The financial statements include three required statements, which provide different views of the Fund. They are: The Statements of Net Position, the Statements of Revenues, Expenses and Changes in Net Position, and the Statements of Cash Flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The Statements of Net Position include all assets, liabilities and deferred outflows and inflows of resources as of the period ending date. The Statements of Revenues, Expenses and Changes in Net Position present all of the current year's revenues, expenses, and changes in net position. The Statements of Cash Flows reports cash receipts, disbursements and the net change in cash resulting from four principal types of activities: operating, capital financing, non-capital financing and investing. In order for the financial statements to be complete, they must be accompanied by a complete set of notes. The notes to the financial statements provide disclosures which are required to conform to generally accepted accounting principles. The Fund is required to follow accounting standards promulgated by the Governmental Accounting Standards Board.

## PURPOSE OF FUND

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

The Fund has the authority to secure and retain title to power for resale to end use customers of the State's investor owned utilities (IOUs) under power supply contracts entered into prior to January 1, 2003. The scheduling, dispatch, and certain other administrative functions for the long-term contracts are performed by the IOUs as agents for the Fund. However, the Fund retains the legal and financial responsibility for each contract for the life of the contract or until such time as there is complete assignment of the contract to an IOU and release of the Fund. Most of the volume of power under contract expired by December 31, 2013. The one remaining power supply contract expires in 2015.

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

This report should be read in conjunction with the Fund's June 30, 2013 audited financial statements.

### CONDENSED STATEMENTS OF NET POSITION

The Fund's assets, liabilities and net position as of March 31, 2014 and June 30, 2013 are summarized as follows (in millions):

| | March 31, 2014 | June 30, 2013 |
|---|---|---|
| Long-term restricted cash, equivalents and investments | $ 929 | $ 937 |
| Recoverable costs | 4,686 | 5,083 |
| Derivative instruments | - | - |
| Restricted cash and equivalents: | | |
| Operating and priority contract accounts | 160 | 210 |
| Bond charge collection and bond charge payment accounts | 1,066 | 554 |
| Recoverable costs, receivable | 86 | 111 |
| Interest receivable | 7 | 4 |
| Other assets | - | 14 |
| Total assets | 6,934 | 6,913 |
| Deferral of loss on defeasance cash outflows | 86 | 104 |
| Deferral of derivative cash outflows | - | 2 |
| Total deferred outflows of resources | 86 | 106 |
| Total assets and deferred outflows of resources | $ 7,020 | $ 7,019 |
| Long-term debt, including current portion | $ 6,880 | $ 6,951 |
| Derivative instruments | - | 2 |
| Other postretirement benefits and accrued vacation | 5 | 5 |
| Other current liabilities | 135 | 61 |
| Total liabilities | 7,020 | 7,019 |
| Deferral of derivative cash inflows | - | - |
| Total liabilities and deferred inflows of resources | $ 7,020 | $ 7,019 |

### Long-Term Restricted Cash, Equivalents and investments

The balance in the Operating Reserve Account decreased $8 million from $18 million at June 30, 2013 to $10 million at March 31, 2014. The amount exceeds the requirements in the bond indenture and is equal to twelve percent of the Department's total projected Operating Expenses through the end of the program based on assumptions supporting the Fund's 2014 Revenue Requirement Determination. The Debt Service Reserve Account remained at $919 million and is the Fund's maximum annual debt service for any calendar year for the remaining life of the bonds.

### Recoverable Costs

Recoverable costs consist of costs that are recoverable through future billings. The $397 million decrease during the nine month period ended March 31, 2014 is due to 1) operating expenses exceeding operating revenues by $77 million, due to the return of excess reserve amounts to the IOUs customers, 2) bond charges plus interest income exceeding interest and investment expenses by $473 million and 3) $1 million change in the unrealized loss on open and ineffective natural gas futures contracts expired by December 31, 2013.

### Derivative Instruments – Assets

There are no outstanding derivative assets at March 31, 2014 and June 30, 2013. All remaining natural gas swap hedge contracts expired by December 31, 2013.

Deferral of derivative cash outflows decreased $2 million at March 31, 2014 from June 30, 2013 reflecting the expiration of the remaining natural gas hedge contracts by December 31, 2013.

### Restricted Cash and Equivalents

The Operating and Priority Contract Accounts decreased by $50 million during the nine month period ended March 31, 2014 due to the return of excess amounts to IOU customers as power purchase contracts expire and lower account balances are required by the Trust Indenture.

The Bond Charge Collection and Bond Charge Payment Accounts increased by $512 million in the period ended March 31, 2014 in anticipation of the annual principal and semi-annual interest payment on bonds due on May 1, 2014.

From the dates of issuance of the revenue bonds through March 31, 2014, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Trust Indenture.

### Recoverable Costs Receivable

Recoverable costs receivable reflects power and bond charges to IOU customers that have not yet been collected and amounts receivable from surplus sales of energy and gas and litigation settlements. The $86 million of recoverable costs receivable at March 31, 2014 is $25 million lower than that at June 30, 2013. The decrease is primarily the result of a reduction in expected revenues due to lower consumption by IOU customers.

### Other Assets

At March 31, 2014, there were no other assets as all natural gas hedges expired by December 31, 2013 and the remaining money market investments and collateral balances were transferred back into the Operating Account.

### Long-Term Debt

Long-term debt decreased to $6,880 million as of March 31, 2014 from $6,951 million at June 30, 2013 due to the net amortization of premium.

### Derivative Instruments – Liabilities.

The fund was party to natural gas hedging positions that were considered to be derivatives under provisions of GASB 53 and included on the Statements of Net Position for the periods ended June 30, 2013. As of March 31, 2014, there were no liabilities related to derivative instruments as all natural gas hedge positions had expired by the end of December 2013.

### Other Current Liabilities

Other current liabilities consist of accounts payable and accrued interest payable. Accounts payable reflect one month's accrual for power and fuel purchases, as payments are normally made in the latter half of the month following purchase.

Accounts payable decreased to $4 million at March 31, 2014 from $9 million at June 30, 2013 as a result of power purchase contract volumes decreasing due to the expiration of two power supply contracts.

Accrued interest payable at March 31, 2014 increased to $131 from $52 million at June 30, 2013 due to the approaching bond interest payment date of May 1, 2014.

### CONDENSED STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

The Fund's activities for the three and  months ended March 31, 2014 and 2013 are summarized as follows (in millions):

| | Three months ended March 31 | | Nine months ended March 31 | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues: | | | | |
| Power charges, net of refunds | $ (15) | $ (20) | $ (37) | $ (392) |
| Surplus sales | 1 | 1 | 3 | 2 |
| Bond charges | 194 | 206 | 641 | 671 |
| Interest income | 5 | 5 | 15 | 16 |
| Total revenues | 185 | 192 | 622 | 297 |
| Expenses: | | | | |
| Power purchases | 7 | 13 | 30 | 36 |
| Energy settlements | - | (1) | - | (21) |
| Interest expense | 61 | 81 | 183 | 242 |
| Investment loss | 0 | - | 2 | - |
| Administrative expenses | 4 | 4 | 11 | 13 |
| Recovery of recoverable costs | 113 | 95 | 396 | 27 |
| Total expenses | 185 | 192 | 622 | 297 |
| Net increase in net position | - | - | - | - |
| Net position, beginning of year | - | - | - | - |
| Net position, end of year | $ - | $ - | $ - | $ - |

### Power Charges

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

Power charges revenue increased by $355 million in the nine months ended March 31, 2014 compared to the same nine month period ended March 31, 2013. The difference primarily reflects a smaller return of excess amounts and previously received remittances to ratepayers.

The return of excess amounts and previously received remittances are an allocation of prior year over-collections from ratepayers and excess reserves. The return is implemented through an adjustment to the power charge and is administered through separate monthly payments to ratepayers for reserves the Fund holds in excess of Trust Indenture required levels. The allocation of excess amounts and reserves was authorized by the CPUC in Decision 12-11-040 for calendar year 2013 and in Decision 13-12-004 for calendar year 2014.   During the nine months ended March 31, 2014, the Fund returned $76 million in monthly payments.

### Surplus Sales

The Fund receives revenue from the sale of excess natural gas and energy from counterparties. Surplus sales for the nine-months ended March 31, 2014 are $1 million higher than the nine month period ended March 31, 2013.

### Bond Charges

Bond charges provide revenue for the payment of debt service on the revenue bonds and are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to all IOU customers and certain ESP customers.

Bond charges for the nine months ended March 31, 2014 are $30 million lower than the nine months ended March 31, 2013 due to lower sales to IOU customers. The amount collected is adequate to meet all debt service requirements and maintain Trust Indenture required account balances in the Bond Charge Collection, Bond Charge Payment, and Debt Service Reserve Accounts.

### Interest Income

Interest income of $15 million for the nine months ended March 31, 2014 is $1 million lower than the nine months ended March 31, 2013 due to lower effective investment yields and lower cash balances in the Fund's investments in the State of California Surplus Money Investment Fund (SMIF).

### Power Purchases

Power costs decreased $6 million for the nine months ended March 31, 2014 when compared to the nine months ended March 31, 2013 due to the expiration of two power supply contracts.

### Energy Settlements

Energy settlements decreased by $21 million at March 31, 2014 from March 31, 2013 as no revenues were received from energy settlements.

Future revenues under a number of settlements with larger suppliers including Mirant Corporation, Reliant Energy and Duke Energy Corporation are subjected to contingencies outlined in the underlying settlement and allocation agreements and will not be recognized until if and when the contingencies are resolved.

### Interest Expense

Interest expense in the nine months ended March 31, 2014 is $59 million lower when compared to March 31, 2013 due to lower total outstanding debt.

### Investment Loss

Under GASB Statement No. 53, the Fund realizes investment gain (loss) for the change in fair value of outstanding ineffective gas hedges. Due to all gas hedges expiring by December 31, 2013, the Fund realized net investment losses of $2 million for the nine months ended March 31, 2014.

### Administrative Expenses

Administrative expenses in the nine months ended March 31, 2014 were $2 million lower than the same period in 2013 as the operation of the Power Supply Program continues to decrease with contract expirations.

### Recovery of Recoverable Costs

The individual components of the recovery (deferral) of recoverable costs are as follows for the three and nine months ended March 31, 2014 and 2013 (in millions):

| | Three months ended March 31 | | Nine months ended March 31 | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Operations | $ (25) | $ (35) | $ (77) | $ (418) |
| Debt service and related costs | 138 | 130 | 473 | 445 |
| | $ 113 | $ 95 | $ 396 | $ 27 |

Operations
The $77 million deferral of operations recovery in the nine months ended March 31, 2014 results from less net power charge revenue received as Operating Reserve Account levels continue to be reduced as the Fund returns excess reserves to ratepayers following the expiration of power contracts..

Debt Service and Related Costs
The $473 million recovery of debt service and bond related costs is $28 million higher for the nine months ended March 31, 2014 compared to the same period in 2013 due to lower interest expense partially offset by lower bond charges received.

### LIQUIDITY

Various provisions of the Trust Indenture provide resources for the Fund to meet its cash requirements. In addition to its determination of revenue requirements, prepared annually or more frequently if necessary, to meet both operating and bond related expenditures, the Fund has an Operating Reserve and a Debt Service Reserve Fund in order to meet expenditures if revenue is impaired. The minimum balance in the Operating Reserve Account is set to be the greater of (i) the maximum seven-month difference between operating revenues and expenses as calculated under a high expense scenario, (ii) 12% of the Department's annual operating expenses and (iii) an amount equal to the maximum projected monthly power purchase contract cost. The minimum balance in the Debt Service Reserve Fund is set to be the maximum annual debt service over the remaining life of the Fund's bonds.

Under the Section 80130 of the California Water Code, the Fund has a total debt issuance limit $13.4 billion, which does not include refunding debt issued: (i) to obtain a lower interest rate, (ii) to convert variable rate debt to fixed rate debt or (iii) to replace debt for which the credit rating of the insurer or credit facility provider has been or will be downgraded or withdrawn.

On March 17, 2014, Moody's Investors Service upgraded the Fund's Power Supply Revenue Bonds to Aa2 from Aa3 with a stable outlook.

# Department of Water Resources Electric Power Fund
## Statements of Net Position
## March 31, 2014 and June 30, 2013 (in millions)

| | March 31, 2014 | June 30, 2013 |
|---|---|---|
| **Assets** | | |
| Long-term assets: | | |
| Restricted cash, equivalents and investments: | | |
| Operating Reserve Account | $ 10 | $ 18 |
| Debt Service Reserve Account | 919 | 919 |
| Recoverable costs | 4,686 | 5,083 |
| Total long-term assets | 5,615 | 6,020 |
| Current assets: | | |
| Restricted cash and equivalents: | | |
| Operating and Priority Contract Accounts | 160 | 210 |
| Bond Charge Collection and Bond Charge Payment Accounts | 1,066 | 554 |
| Recoverable costs, receivable | 86 | 111 |
| Interest receivable | 7 | 4 |
| Other assets | - | 14 |
| Total current assets | 1,319 | 893 |
| Total assets | 6,934 | 6,913 |
| **Deferred outflows of resources** | | |
| Deferral of loss on defeasance | 86 | 104 |
| Deferral of derivative cash outflows | - | 2 |
| Total deferred outflows of resources | 86 | 106 |
| Total assets and deferred outflows of resources | $ 7,020 | $ 7,019 |
| **Liabilities** | | |
| Non-Current liabilities: | | |
| Long-term debt | $ 6,189 | $ 6,249 |
| Derivative instruments | - | - |
| Other postemployment benefits and accrued vacation | 5 | 5 |
| Total non-current liabilities | 6,194 | 6,254 |
| Current liabilities: | | |
| Current portion of long-term debt | 691 | 702 |
| Derivative instruments, current portion | - | 2 |
| Accounts payable | 4 | 9 |
| Accrued interest payable | 131 | 52 |
| Total current liabilities | 826 | 765 |
| Total liabilities | $ 7,020 | $ 7,019 |

Commitments and Contingencies (Note 6)

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

# Department of Water Resources Electric Power Fund
## Statements of Expenses, Revenues and Changes in Net Position
## For the three and nine months ended March 31, 2014 and 2013 (in millions)

| | Three months ended March 31 | | Nine months ended March 31 | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Operating revenues: | | | | |
| Power charges, net of refunds | $ (15) | $ (20) | $ (37) | $ (392) |
| Surplus sales | 1 | 1 | 3 | 2 |
| Total operating revenues | (14) | (19) | (34) | (390) |
| Operating expenses: | | | | |
| Power purchases | 7 | 13 | 30 | 36 |
| Energy settlements | | (1) | - | (21) |
| Administrative expenses | 4 | 4 | 11 | 13 |
| Recovery of recoverable operating costs | (25) | (35) | (77) | (418) |
| Total operating expenses | (14) | (19) | (36) | (390) |
| Income from operations | - | - | 2 | - |
| Bond charges | 194 | 206 | 641 | 671 |
| Interest income | 5 | 5 | 15 | 16 |
| Interest expense | (61) | (81) | (183) | (242) |
| Investment income from debt related derivatives | | | - | - |
| Investment loss from gas related derivatives | - | | (2) | - |
| Recovery of recoverable debt service and related cost: | (138) | (130) | (473) | (445) |
| Net increase in net position | - | - | - | - |
| Net position, beginning of year | - | - | - | - |
| Net position, end of year | $ - | $ - | $ - | $ - |

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

# Department of Water Resources Electric Power Fund
## Statements of Cash Flows
## For the nine months ended March 31, 2014 and 2013 (in millions)

| | 2014 | 2013 |
|---|---|---|
| Cash flows from operating activities: | | |
| Receipts: | | |
| Power charges, net of refunds* | $ (27) | $ (361) |
| Surplus sales | 3 | 4 |
| Energy settlements | - | 21 |
| Payments to employees for services * | (3) | - |
| Payments for power purchases and other expenses | (29) | (70) |
| Net cash used in operating activities | (56) | (406) |
| Cash flows from non-capital financing activities: | | |
| Receipt of bond charges | 657 | 676 |
| Bond payments | - | - |
| Interest payments | (157) | (170) |
| Proceeds from issuance of revenue bonds | - | - |
| Defeasance of revenue bonds | - | - |
| Net cash used in non-capital financing activities | 500 | 506 |
| Cash flows from investing activities: | | |
| Interest received on investments | 12 | 13 |
| Loss from derivative investments | (2) | (4) |
| Net cash provided by investing activities | 10 | 9 |
| Net decrease in cash and equivalents | 454 | 109 |
| Restricted cash and equivalents, beginning of period | 1,401 | 1,865 |
| Restricted cash and equivalents, end of period | $ 1,855 | $ 1,974 |
| Restricted cash and equivalents included in: | | |
| Operating Reserve Account | $ 10 | $ 18 |
| Debt Service Reserve Account (a component of the total of $919 and $919 at March 31, 2014 and 2013, respectively) | 619 | 619 |
| Operating and Priority Contract Accounts | 160 | 242 |
| Bond Charge Collection and Bond Charge Payment Accounts | 1,066 | 1,095 |
| Restricted cash and equivalents, end of year | $ 1,855 | $ 1,974 |
| Reconciliation of operating income to net cash used in operating activities: | | |
| Income from operations | $ 2 | $ - |
| Adjustments to reconcile operating income to net cash used in operating activities: | | |
| Recovery of recoverable operating costs | (77) | (418) |
| | (75) | (418) |
| Changes in net assets and liabilities to reconcile operating income to net cash used in operations: | | |
| Recoverable costs | 9 | 29 |
| Other assets | 15 | 34 |
| Other postemployment benefits and accrued vacation* | - | - |
| Accounts payable | (5) | (51) |
| Net change in operating assets & liabilities: | 19 | 12 |
| Net cash used in operating activities | $ (56) | $ (406) |

* Reclassification from prior year

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

## 1. Reporting Entity

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

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

The Fund purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 for resale to customers of the State's investor owned utilities (IOUs): Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E). The Code prohibits the Fund from entering into new power purchase agreements, but allows the Fund to enter into gas purchase contracts to provide fuel for power generation

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

Under the Code, the Fund has the authority to establish a revenue requirement to recover all Fund costs, including debt service. At least annually, Fund management establishes a determination of the revenue requirement, which then is submitted to the CPUC. Under the terms of a rate agreement between the Fund and the CPUC, the CPUC implements the Fund's determination of its revenue requirements by establishing end use customer rates that meet the Fund's revenue needs to assure the payment of debt service, power purchases, administrative expenses and maintenance of operating and debt service reserves.

## 2. Summary of Significant Accounting Policies

### Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles, which considers the Fund a Regulated Operation under GASB codification Re 10. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, net position, revenues and expenses.

The financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of March 31, 2014 and 2013, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

### Restricted Cash, Equivalents and Investments

Under the terms of the Trust Indenture among the State of California, Department of Water Resources, Treasurer of the State of California, as Trustee and U.S. Bank, N.A, as Co-Trustee (Trust Indenture) separate restricted cash and investment accounts were established. The accounts and their purpose follow:

Power Charge Accounts:

- Operating Account: Power Charges (see Revenues and Recoverable Costs) and miscellaneous revenue are deposited into the operating account. Monthly, funds are transferred to the priority contract account as needed to make payments on priority contracts. Remaining monies are available for payment of all operating costs of the Fund other than priority contracts, debt service, and debt-related costs.
- Priority Contract Account: Priority contracts are those power purchase contracts that require monthly payment prior to any debt service payments. Monies in the priority contract account are used to make scheduled payments on priority contracts. After the monthly transfer from the operating account on the fifth of the month, the priority contract account is projected to have monies sufficient to make scheduled payments on priority contracts through the fifth of the following month.
- Operating Reserve Account: The Operating Reserve Account was initially funded with proceeds of the Series 2002 Bonds. The Operating Reserve Account must maintain a balance equal to the greater of (i) the maximum seven-month difference between operating revenues and expenses as calculated under a high expense scenario, (ii) 12% of the Department's annual operating expenses and (iii) an amount equal to the maximum projected monthly power purchase contract cost. If the Operating Reserve Account needed to be replenished, the funds would be transferred from the Operating Account.

Bond Charge Accounts:

- Bond Charge Collection Account: Bond Charges (see Revenues and Recoverable Costs) are deposited into the Bond Charge Collection account. Monthly, funds needed for debt service payments are transferred to the Bond Charge Payment account.
- Bond Charge Payment Account: Monies in the Bond Charge Payment account are used to pay debt service and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection account, the balance in the Bond Charge Payment account must at least equal debt service and fees estimated to accrue or be payable for the next succeeding three months.
- Debt Service Reserve Account: The Debt Service Reserve Account was initially funded with proceeds of the Series 2002 Bonds. The Debt Service Reserve Account is to be funded at all times with the amount of maximum aggregate annual debt service on all outstanding debt. If the Debt Service Reserve Account needed to be replenished, the funds would be transferred from either the Bond Charge Collection Account.

Restricted cash and equivalents, for purposes of the Statements of Cash Flows, include cash on hand and deposits in the Surplus Money Investment Fund (SMIF). The Operating Reserve Account and Debt Service Reserve Account (net of investments) are classified as long-term restricted cash due to requirements under the Trust Indenture to hold amounts in excess of anticipated current payments for operating and bond related expenses. Amounts required to be held in reserve are determined annually with the Fund's revenue requirement.

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

Long-term investments are held solely in the Debt Service Reserve Account by the bond co-trustee and consist of guaranteed investment contracts (GICs) and a U.S. government backed agency security in accordance with a forward purchase agreement (FPA). The GICs are carried at cost and the U.S. government backed agency security is carried at amortized cost and not at fair value because the investments are non-negotiable and non-transferable.

**Net Position**

The Fund does not record the difference between assets and liabilities as changes in net position. The difference between assets and deferred outflows of resources and liabilities on the Statements of Net Position is presented as recoverable costs such that there is no net position outstanding. The Fund anticipates that amounts in the recoverable costs will be recovered in subsequent years prior to program expiration.

**Other Assets**

The Fund entered into futures and option contracts for the purpose of hedging of the cost of natural gas used as fuel for power production. Collateral values, net trade equity and margin investments held in a brokerage account are accounted for as other assets on the Statements of Net Position. The brokerage firm that facilitates the Fund's hedging contracts requires that the Fund maintain a security deposit, which is invested in compliance with the California Government Code. These funds are invested in money market mutual funds and are carried at fair value.

As all remaining natural gas hedges expired during the second quarter, the natural gas hedge brokerage account was closed and all money market investments and other collateral balances were deposited in the Operating Account.

**Revenues and Recoverable Costs**

The Fund is required, at least annually, to establish a determination of the revenue requirement to be submitted to the CPUC, which then sets end use customer remittance rates. The Fund's financial statements are prepared in accordance with Section Re10 of the GASB Codification, "*Regulated Operations*", which requires that the effects of the revenue requirement process be recorded in the financial statements. Accordingly, all expenses and credits, normally reflected in the change in net position as incurred, are recognized as recoverable costs in the Statements of Net Position and are recovered from IOU customers. Costs that are recoverable through future billings are recorded as long-term assets.

Customer charges are separated into two primary components, power charges and bond charges. Power charge revenues recover the cost of power purchases, other expenses and operating reserves and are recognized when energy provided by the Fund is delivered to IOU customers. Bond charge revenues recover debt service, debt service reserves and other bond related costs and are recognized when energy provided by the Fund, the IOU, or an ESP, is delivered to IOU or ESP customers. Costs are recovered over the life of the bonds as determined by the Fund's revenue requirement process.

Surplus sales represent the Fund's sale of excess natural gas and energy not needed for the customers of the IOUs.

### 3. Restricted Cash and Investments

As of March 31, 2014, the Fund had the following investments (in millions):

| Investment | Maturity | | March 31, 2014 |
|---|---|---|---|
| State of California Pooled Money Investment Account - Surplus Money Investment Fund | 6.1 months avg. | $ | 1,852 |
| Cash | | | 3 |
| Total cash and equivalents | | | 1,855 |
| Guaranteed investment contracts | May 1, 2022 | | 200 |
| Forward purchase agreement | May 1, 2014 | | 100 |
| | | $ | 2,155 |
| Reconciliation to Statements of Net Position: | | | |
| Operating Reserve Account | | $ | 10 |
| Debt Service Reserve Account | | | 919 |
| Operating and Priority Contract Accounts | | | 160 |
| Bond Charge Collection and Bond Charge Payment Accounts | | | 1,066 |
| | | $ | 2,155 |

*Custodial Credit Risk:* Under GASB Statement No. 40, custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The State of California has a deposit policy for custodial credit risk that requires deposits held by financial institutions to be insured by federal depository insurance or secured by collateral held in the State's name. At March 31, 2014, one of the guaranteed investment contracts in the amount of $100 million was uninsured and uncollateralized.

*Interest Rate Risk:* Under GASB Statement No. 40, interest rate risk is the risk that the value of fixed income securities will decline because of changing interest rates. The prices of fixed income securities with a longer time to maturity, measured by effective maturity, tend to be more sensitive to changes in interest rates and, therefore, more volatile than those with shorter maturities. The State Treasurers Investment Policy, Pooled Money Investment Account, provides for spreading investments over various maturities to minimize the risk of portfolio depreciation due to a rise in interest rates. The State Treasurers Investment Policy limits investments to the following maximum maturities: U.S. Treasury securities, 5 years; federal agency securities, 5 years; bankers acceptances – domestic and foreign, 180 days; certificates of deposits, 5 years; commercial paper, 180 days; corporate bonds and notes, 5 years; repurchase agreements and reverse repurchase agreements, 1 year.

*Credit Risk*: Under GASB Statement No. 40, credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. These investments consist of U.S. government securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest bearing time deposits in California banks, prime-rated commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase and reverse repurchase agreements. The PMIA policy limits the use of reverse repurchase agreements to limits of no more than 10% of the PMIA and commercial paper to limits not to exceed 30% of the PMIA. The PMIA does not invest in leveraged products or inverse floating rate securities. The PMIA is not rated.

*Concentration of Credit Risk*: The SMIF concentration of credit risk is limited by spreading the investment mix over different investment types and issuers to minimize the impact any one industry, investment class, or institution can have on the SMIF portfolio. At March 31, 2014, The Fund's investments in the FPA and two GICs individually are 4.64% of total investments. The ratings of the investments and their relative percentages of total investments is shown in the following table:

| | Amount | Credit Rating | Percent of Total Investments March 31, 2014 |
|---|---|---|---|
| FPA Provider | | | |
| Merrill Lynch: FHLMC Discounted Notes | $ 100 | Not Rated | 4.64% |
| GIC Providers | | | |
| FSA | $ 100 | Not Rated | 4.64% |
| Royal Bank of Canada | 100 | Not Rated | 4.64% |
| | $ 200 | | |

Interest on deposits in the SMIF varies with the rate of return of the underlying portfolio and approximated 0.2% at March 31, 2014. For the nine months ended March 31, 2014, interest earned on the deposit in the SMIF was $3 million.

Interest on the GICs is paid semi-annually at interest rates ranging from 5.3% to 5.5%. Interest earned on the GICs was $8 million for the nine months ended March 31, 2014.

The FPA allows the Fund to continuously reinvest funds in U.S. government or U.S. government agency securities through May 2022 to earn a minimum rate of return of 4.7% as specified in the Reserve Fund Forward Purchase and Sale Agreement, dated May 1, 2004. The reinvested securities are to mature every six months. Interest earned on the FPA was $4 million for the nine months ended March 31, 2014.

## 4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the nine months ended March 31, 2014 (in millions):

| | Revenue Bonds | Unamortized Premium | Total |
|---|---|---|---|
| Balance, June 30, 2013 | $ 6,554 | $ 397 | $ 6,951 |
| Amortization | - | (71) | (71) |
| Balance, March 31, 2014 | 6,554 | 326 | 6,880 |
| Less current portion | 611 | 80 | 691 |
| | $ 5,943 | $ 246 | $ 6,189 |

The tax exempt revenue bonds consist of the following at March 31, 2014 (in millions):

| Series | Rates | Fiscal Year of Final maturity | Fiscal Year of First Call Date | Amount Outstanding 2014 | Current Portion |
|---|---|---|---|---|---|
| F | Fixed (4.38-5.00%) | 2022 | 2018 | $ 348 | $ - |
| G | Fixed (4.35-5.00%) | 2018 | Non-callable | 173 | - |
| H | Fixed (3.75-5.00%) | 2022 | 2018 | 1,007 | - |
| K | Fixed (4.00-5.00%) | 2018 | Non-callable | 279 | - |
| L | Fixed (2.50-5.00%) | 2022 | 2020 | 2,708 | 261 |
| M | Fixed (2.00-5.00%) | 2020 | Non-callable | 1,234 | 350 |
| N | Fixed (2.00-5.00%) | 2021 | Non-callable | 805 | - |
| | | | | 6,554 | 611 |
| Plus unamortized bond premium | | | | 326 | 80 |
| | | | | $ 6,880 | $ 691 |

### Key terms

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

The Series F, H, and L are callable at a redemption rate of 100 percent. The Series F and Series H are callable in 2018. The Series L bonds are callable in 2020. The Series G, K, M, and N are non-callable.

### Maturities

Future payment requirements on the revenue bonds are as follows at March 31, 2014 (in millions):

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2014 | $ 611 | $ 157 | $ 768 |
| 2015 | 618 | 286 | 904 |
| 2016 | 669 | 258 | 927 |
| 2017 | 686 | 227 | 913 |
| 2018 | 714 | 194 | 908 |
| 2019-22 | 3,256 | 413 | 3,669 |
| | $ 6,554 | $ 1,535 | $ 8,089 |

## 5. Derivative Financial Instruments

GASB 53 requires governments to record derivative instruments on the Statements of Net Position as either assets or liabilities depending on the underlying fair value of the derivative. The Fund is no longer party to natural gas hedging positions that are considered to be derivatives under the provisions of GASB 53.

There are no remaining fair values, classification and notional amounts outstanding for the Fund's natural gas hedge derivatives accounted for as derivative financial instruments since all hedge contracts expired by December 31, 2013.

**As of March 31, 2014**

| | | Business-type activities | Value | Notional |
|---|---|---|---|---|
| **Effective hedges** | | | | |
| Liabilities | | | | |
| | **Current** | **Gas Swaps** | $ - | |
| | | | $ - | |

**As of June 30, 2013**

| | | Business-type activities | Value | Notional |
|---|---|---|---|---|
| **Effective hedges** | | | (in millions) | |
| Liabilities | | | | |
| | Current | Gas Swaps | $ (2) | 460,000 MMBtu |
| | Long-Term | Gas Swaps | - | - MMBtu |
| | | | $ (2) | |

### Commodity contracts

At March 31, 2014, the Fund no longer has any outstanding natural gas futures contracts. In prior years, the Fund entered into natural gas hedge contracts, futures and options, to hedge the cost of natural gas. All natural gas options were treated as derivatives and were classified as investment derivatives since they do not meet GASB Statement No. 53 hedging criteria.

In prior periods, unrealized gains and losses were deferred on the Statements of Net Position as deferral of cash outflows or cash inflows. The deferred amount recorded on the Statements of Net Position reflects the deferred inflow or outflow associated with the derivative financial instruments. Deferred outflows decreased by $2 million with the expiration of the remaining positions during the nine-month period.

The Fund no longer has any forward natural gas purchase contracts. In prior years, most of the Fund's forward natural gas purchases were treated as Normal Purchase Normal Sale (NPNS) contracts and were therefore not required to be recorded prior to settlement. Natural gas forwards not qualifying as NPNS were recorded on the Statements of Net Position at fair value.

Changes in fair value of derivatives that are classified as investment derivatives are included as investment income (expense) on the Statements of Revenues, Expenses and Changes in Net Position.

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

*Credit Risk:* The Fund's has no open natural gas futures positions at March 31, 2014. Previously future positions were entered into through the Fund's brokerage accounts and the associated clearing accounts had collateral requirements that limited the Fund's counterparty credit risk.

*Termination Risk:* The Fund no longer has termination risk associated with any natural gas hedge agreements as they have all expired.

## 6. Commitments and Contingencies

### Litigation and Regulatory Proceedings

Certain pending legal and administrative proceedings involving the Fund or affecting the Fund's power supply program are summarized below.

*California Refund Proceedings:* During 2001 and 2002, the Fund purchased power in bilateral transactions (both short term and long term), sold power to the California Independent System Operator (CAISO), paid for power purchased by the CAISO and purchased power from the CAISO for sale to customers of the IOUs. In July 2001, the Federal Energy Regulatory Commission (FERC) initiated an administrative proceeding to calculate refunds for inflated prices in the CAISO and California Power Exchange (PX) markets during 2000 and 2001. FERC ruled that the Fund would not be entitled in that proceeding to approximately $3,500 million in refunds associated with the Fund's approximately $5,000 million of short term purchases because the Fund made those purchases bilaterally, not in the PX or CAISO markets. The Ninth Circuit Court of Appeals affirmed FERC, but left open the possibility of refunds on the Fund's bilateral purchases in other FERC proceedings. In contrast, FERC ruled that the Fund is entitled to refunds on purchases made by the CAISO where the Fund actually paid the bill.

Of the Fund's $5,000 million in short term bilateral purchases, $2,900 million was imbalance energy which the Fund sold to the CAISO at the Fund's cost in order to meet the CAISO's emergency needs during 2001. The Fund is treated in the FERC refund proceeding as a seller of that energy to CAISO, and in May 2004, FERC issued an order requiring the Fund to pay refunds on the sales to the CAISO. In September 2005, the Ninth Circuit Court of Appeals held that FERC does not have authority to order refunds from governmental entities such as the Fund. In November 2008, FERC found that although FERC can not order a governmental entity, such as the Fund, to pay refunds, it can enforce the terms of the CAISO's tariff, which requires that all purchases and sales in a given hourly settlement period are netted. But for the more than 50 refund settlements the Fund has entered into to date, this order would have resulted in a substantial reduction to the refunds payable to the Fund. Settlements executed to date with various sellers, however, have reduced to a de minimus amount. Refunds payable to the Fund will be offset to the extent that the Fund must pay refunds on its sales to the CAISO.

Proceedings before FERC, including related appeals, are ongoing and could, together with the terms of any future settlements entered into by the Fund to resolve its remaining claims in the California Refund Proceedings, increase or decrease the amount of refunds the Fund ultimately receives.

*Direct Access Proceeding:* On February 28, 2008, the CPUC approved a decision concluding that the suspension of direct access cannot be lifted at the present time because the Fund is still supplying power under the Act. However, the decision continued the proceeding to consider possible approaches to expediting the Fund's exit from its role of supplying power under the Act. On November 21, 2008, the CPUC adopted a plan with the goal of the early exit of the Fund from its role as supplier of power to retail electric customers. Under this plan, the Fund's power purchase contracts would be replaced by agreements between the IOUs and the Fund's power supplier counterparties that are not detrimental to ratepayers, through novation and/or negotiation.

*Senate Bill 695*: On October 11, 2009, Senate Bill (SB) 695 was signed into law as an urgency statute. SB 695 allows individual retail nonresidential end-use customers to acquire electric service from other providers in each IOU service area, up to a maximum allowable limit. Except for this express authorization for increased direct access transactions under SB 695, the previously enacted suspension of direct access remains in effect. On March 15, 2010, the CPUC issued Decision 10-03-022 which authorizes increases in the maximum direct access load for each IOU service area, as specified in SB 695. The maximum load of allowable direct access volumes is established for each IOU as the maximum total kWh supplied by all other providers to distribution customers of that IOU during any sequential 12-month period between April 1, 1998 and the effective date of the section of the Public Utilities Code modified by SB 695, October 11, 2009.

Decision 10-03-022 phases in the additional load allowance over a four-year period beginning on April 11, 2010. The annual phase-in of the limits combined with the concurrent expiration of several long-term contracts should result in limited impacts to the Power Charges attributable to the increased limits. Regardless of the level of direct access participation within the IOU service areas, direct access customers will still be assessed Bond Charges and the Fund's revenue requirement will be recovered in the same manner as has been successfully implemented over the duration of the Power Supply Program.

**Other contingencies**

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

**Commitments**

The Fund has one power purchase contract that has a remaining life of up to three fiscal years. In addition, the remaining fixed obligations include a natural gas transmission capacity contract that expires in fiscal 2018. There are no associated natural gas purchase requirements with this contract.

Payments under the power purchase and natural gas transmission capacity contracts approximated \$30 million and \$36 million for the nine month periods ended March 31, 2014 and 2013, respectively.

The remaining amounts of fixed obligations under the contracts as of March 31, 2014, are as follows (in millions):

| For the Year Ending June 30, | Fixed Obligation (in millions) |
|---|---|
| 2014 | $ 7 |
| 2015 | 26 |
| 2016 | 16 |
| 2017 | 15 |
| 2018 | 12 |
| | $ 76 |

In addition to the fixed costs there are variable costs associated with the contracts. Management projected as of March 31, 2014 that the amount of future fixed and variable obligations associated with the contracts would approximate $81 million. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with the dispatchable long-term power contract and the cost of natural gas.

## 7. Energy Settlements

The Fund and other parties have entered into settlement agreements with various energy suppliers which resolve potential and alleged causes of action against suppliers for their part in alleged manipulation of natural gas and electricity commodity and transportation markets during the 2000 - 2001 California energy crisis, and also received settlements from other FERC actions.

In the nine month period ended March 31, 2014, no revenues from energy settlements were received.

In the period ended March 31, 2013, the Fund received $21 million as a result of a FERC approved settlement agreement resolving energy crisis related litigation between the State of California, represented by the CPUC, and NRG Energy.

Future revenues associated with pending settlements with Mirant Corporation, Reliant Energy, and Duke Energy Corporation are subject to contingencies outlined in the underlying settlements and allocation agreements and will be recognized when and if the contingencies are resolved.