

**DEPARTMENT OF WATER RESOURCES
ELECTRIC POWER FUND**

Financial Statements

For the Years Ended June 30, 2014 and 2013

Department of Water Resources Electric Power Fund Financial Statements

For the years ended June 30, 2014 and 2013



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INDEPENDENT AUDITOR'S REPORT

To the Director of the Department of Water Resources
Department of Water Resources Electric Power Fund
Sacramento, California

Report of the Financial Statements

We have audited the accompanying financial statements of the Department of Water Resources Electric Power Fund (Fund) of the State of California, as of and for the years ended June 30, 2014 and 2013, and the related notes to financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund of the State of California as of June 30, 2014 and 2013, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 2, the financial statements present only the Department of Water Resources Electric Power Fund and do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2014 and 2013, the changes in its financial position, or where applicable, its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis, as listed in the table of contents, be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated October 9, 2014 on our consideration of the State of California's internal control over financial reporting as it relates to the Fund and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants agreements and other matters as it relates to the Fund. 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State of California's internal control over financial reporting and compliance as it relates to the Fund.

Maciar Mini & O'Connell LLP

Sacramento, California
October 9, 2014

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

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 report 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 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 customers of the IOUs and "direct access" Electric Service Providers (ESPs) such that the Fund will always have monies to meet its revenue requirements.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

CONDENSED STATEMENTS OF NET POSITION

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

	2014	2013	2012
Long-term restricted cash, equivalents and investments	\$ 929	\$ 937	\$ 1,186
Recoverable costs	4,490	5,083	5,278
Restricted cash and equivalents:			
Operating and priority contract accounts	137	210	398
Bond charge collection and bond charge payment accounts	514	554	581
Recoverable costs receivable	156	111	132
Interest receivable	3	4	4
Other assets	-	14	45
Total assets	<u>6,229</u>	<u>6,913</u>	<u>7,624</u>
Deferral of loss on defeasance	80	104	135
Deferral of derivative cash outflows	-	2	2
Total deferred outflows of resources	<u>80</u>	<u>106</u>	<u>137</u>
Total assets and deferred outflows of resources	<u>\$ 6,309</u>	<u>\$ 7,019</u>	<u>\$ 7,761</u>
Long-term debt, including current portion	\$ 6,249	\$ 6,951	\$ 7,634
Derivative instruments	-	2	7
Other postretirement benefits and accrued vacation	6	5	5
Other current liabilities	54	61	115
Total liabilities	<u>\$ 6,309</u>	<u>\$ 7,019</u>	<u>\$ 7,761</u>

Long-Term Restricted Cash, Equivalents and Investments

The \$8 million decrease in long-term restricted cash, equivalents and investments during fiscal 2014 is a result of the reduction in the Operating Reserve Account to \$10 million from \$18 million. The amount is determined in accordance with 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) and is equal to twelve percent of the Department's total projected annual 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 as the maximum future annual debt service was unchanged.

The \$249 million decrease in long-term restricted cash, equivalents and investments during fiscal 2013 was a result of the reduction in the Operating Reserve Account to \$18 million from \$267 million. The amount was determined in accordance with the Trust Indenture and was equal to the maximum one month priority contract cost amount under stress conditions for calendar year 2013 as forecasted in the Fund's 2013 revenue requirement determination. The decrease was caused by lower prospective power costs because only three purchase power contracts remain. The Debt Service Reserve Account remained at \$919 million as the maximum future annual debt service was unchanged.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

Recoverable Costs

Recoverable costs consist of costs that are recoverable through future billings. The \$593 million decrease during fiscal 2014 is due to 1) negative recovery of operating costs of \$47 million, as a result of the reduction in excess reserves returned to IOU customers and 2) bond charges plus interest income exceeding interest and investment expense by \$640 million. The surplus of Bond Charge Collections over interest costs is primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

The \$195 million decrease during fiscal 2013 was due to 1) negative recovery of recoverable operating costs of \$448 million, as a result of the reductions in remittances due to lower required Operating Reserve Account balances offset by, 2) bond charges plus interest income exceeding interest and investment expense by \$638 million and 3) a \$5 million change in the unrealized gain on open and ineffective natural gas hedges at year end. The surplus of Bond Charge Collections over interest costs was primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

Restricted Cash and Equivalents

The Operating and Priority Contract Accounts decreased by \$73 million in 2014 due to the return of excess amounts to IOU customers as power purchase contracts expired and lower reserve account balances were required by the Trust Indenture.

The Operating and Priority Contract Accounts decreased by \$188 million in 2013 due to lower reserve account levels that resulted from reductions in expected expenses as power purchase contracts expired offset by \$21 million in cash received from energy settlements. The \$210 million balance in the Operating and Priority Contract Accounts at June 30, 2013 was \$43 million higher than forecasted in the Fund's calendar year 2013 revenue requirement determination.

The Bond Charge Collection and Bond Charge Payment Accounts decreased by \$40 million in 2014 and \$27 million in 2013 in accordance with revenue requirement determinations that these balances be reduced to Trust Indenture required levels.

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 \$156 million of recoverable costs receivable at June 30, 2014 is \$45 million higher than at June 30, 2013. The increase is primarily due to receipt of several energy settlements after the end of the fiscal year.

The \$111 million of recoverable costs receivable at June 30, 2013 was \$21 million lower than at June 30, 2012. The decrease was primarily due to lower expected power charge remittances from the decline in delivered volumes after the expiration of all but three purchase power contracts during fiscal 2012 offset by surplus sales of energy and natural gas.

Other Assets

At June 30, 2014, there are no other assets as all natural gas swap hedge contracts expired during the year and the remaining money market investments and collateral balances were transferred back into the Operating Account.

At June 30, 2013, other assets were valued at \$14 million and consisted of money market investments, US Treasury bills and government bonds valued at \$10 million and other derivative collateral balances including margin deposits valued at \$4 million.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

Deferred Outflows of Resources

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

Deferral of loss on defeasance decreased by \$24 million at June 30, 2014 from June 30, 2013 due to the amortization of deferred loss on defeasance.

Long-Term Debt

Long-term debt decreased to \$6,249 million as of June 30, 2014 from \$6,951 million as of June 30, 2013. Revenue bond principal payments were \$611 million in fiscal year 2014. Net amortization of bond premium was \$91 million in fiscal year 2014.

Long-term debt decreased to \$6,951 million as of June 30, 2013 from \$7,634 million as of June 30, 2012. Revenue bond principal payments were \$574 million in fiscal year 2013. Net amortization of bond premium was \$109 million in fiscal year 2013.

Derivative Instruments - Liabilities

The Fund is no longer party to natural gas hedging positions that would be considered derivatives under provisions of GASB Statement No. 53 and were included on the Statements of Net Position in prior years.

Derivative financial instrument liabilities decreased to \$2 million at June 30, 2013 from \$7 million at June 30, 2012 due to reductions in the value of derivatives for power related activities.

Other Postemployment Benefits and Accrued Vacation

In addition to the pension benefits, the State of California provides postemployment health care benefits to all employees who retire on or after attaining certain age and length of service requirements. The State of California is funding postemployment benefits on a pay-as-you-go basis. The Fund's other postemployment benefits (OPEB) and accrued vacation time liability are \$6 million at June 30, 2014 and \$5 million in 2013. OPEB liability increased since the annual required contribution was \$1.7 million and the Fund made a contribution of \$0.6 million.

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 at June 30, 2014 is \$3 million lower than at June 30, 2013 as a result of power purchase contract volumes decreasing due to the expiration of two power supply contracts.

Accounts payable at June 30, 2013 was \$49 million lower than at June 30, 2012. The difference results from lower power costs after the expiration of most of the remaining long-term power contracts during the year along with lower costs for natural gas purchases as less fuel was needed to supply the remaining natural gas-fired power contract.

Accrued interest payable at June 30, 2014 is \$4 million lower than at June 30, 2013 due to fewer bonds outstanding resulting from the maturity of \$611 million in bonds in fiscal 2014.

Accrued interest payable at June 30, 2013 was \$5 million lower than at June 30, 2012 due to fewer bonds outstanding resulting from the maturity of \$574 million in bonds in fiscal 2013

**Department of Water Resources Electric Power Fund
Management's Discussion and Analysis
June 30, 2014 and 2013**

CONDENSED STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

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

	2014	2013	2012
Revenues:			
Power charges, net of refunds	\$ (47)	\$ (405)	\$ 2
Surplus sales	3	3	32
Bond charges	862	875	861
Interest income	19	21	25
Total revenues	<u>837</u>	<u>494</u>	<u>920</u>
Expenses:			
Power purchases	39	43	824
Energy settlements	(53)	(21)	(35)
Interest expense	241	258	274
Investment loss	2	6	5
Administrative expenses	15	18	21
Recovery of recoverable costs	593	190	(169)
Total expenses	<u>837</u>	<u>494</u>	<u>920</u>
Net increase in net position	-	-	-
Net position, beginning of year	-	-	-
Net position, end of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

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 customers of each IOU.

Power Charges revenue increased by \$358 million during fiscal year 2014 compared to fiscal year 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 fiscal year 2014, the Fund returned \$93 million in these monthly payments.

Power Charges revenue in fiscal 2013 resulted in a net refund of \$405 million versus a net revenue of \$2 million in fiscal 2012. The difference was due to lower power sales to end use customers as only three power purchase contracts remained, the return of prior year over-collections and the return of reserves as lower reserve levels were required with the expiration of purchase power contracts. These payments were the allocation of prior year over-collections from ratepayers and reserves in excess of Trust Indenture required levels. During fiscal 2013, the Fund returned \$449 million in these monthly payments.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

Surplus Sales

The Fund receives revenue from the sale of excess natural gas and energy. Surplus sales for the year ended June 30, 2014 were \$3 million, unchanged from the same period in 2013.

Surplus sales for the year ended June 30, 2013 were \$29 million lower than the same period in 2012. Lower surplus sales were due to lower volumes of energy and excess natural gas sold as less power was purchased under the contracts.

Bond Charges

Bond Charges provide revenue for the payment of debt service on the revenue bonds and are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to all IOU customers and certain ESP customers. Bond Charges for the years ended June 30, 2014, 2013 and 2012 were \$862 million, \$875 million and \$861 million respectively, and were 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. The \$13 million decrease in 2014 is due to a combination of lower Bond Charge rates and lower sales to IOU customers. The \$14 million increase in 2013 was due to an \$8 million accrual for an expected refund of previously paid arbitrage earnings taxes on the Fund's 2002 Series B, C and D bonds to the Internal Revenue Service and higher total consumption by end use customers.

Interest Income

Interest income for 2014 is \$2 million lower than in 2013, due to lower balances and lower interest rates earned on investments in the State of California Surplus Money Investment Fund (SMIF). The average yield earned on SMIF for the year ended June 30, 2014 was 0.25% compared to 0.31% for the year ended June 30, 2013.

Interest income for 2013 was \$4 million lower than in 2012, due to declines in the interest rates earned on investments in the SMIF. The average yield earned on SMIF for the year ended June 30, 2013 was 0.31% compared to 0.38% for the year ended June 30, 2012.

Power Purchases

Power costs decreased by \$4 million in 2014 compared to 2013 and decreased by \$781 million in 2013 compared to 2012. The differences are primarily a result of lower volumes of power purchased because two power purchase contracts have been expiring and are not replaced.

Energy Settlements

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

Energy settlements received in 2014 were \$53 million. The Fund received \$5 million from Avista Corporation and is entitled to \$48 million from TransAlta Energy Marketing (US), of which \$25 million was received on July 3, 2014. The remaining balance of \$23 million will be received in July 2015. These settlements were a result of FERC approved settlement agreements to resolve certain claims arising from events and transactions in Western Energy Markets during the period January 1, 2000 through June 20, 2001.

Energy settlements in 2013 totaled \$21 million. The Fund received \$20 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. The Fund also received a total of \$1 million from the California Independent System Operator (CAISO) and Cal Polar as the final distribution for market re-runs for 2001 and a FERC approved settlement, respectively.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

June 30, 2014 and 2013

Interest Expense

Interest expense is \$17 million lower in 2014 when compared to 2013. The decrease is due to lower total interest paid on outstanding debt and lower amortization of loss on defeasance offset by lower amortization of bond premium.

Interest expense was \$16 million lower in 2013 when compared to 2012. The decrease was due to lower total interest paid on outstanding debt and lower amortization of loss on defeasance offset slightly by lower amortization of bond premium.

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 changes in fair value of the natural gas swap hedge contracts, the Fund realized net investment losses of \$2 million, \$6 million and \$5 million during the fiscal year 2014, 2013 and 2012 respectively.

Administrative Expenses

Administrative expenses decreased by \$3 million in 2014 and by \$3 million in 2013 primarily as a result of continued reductions in staffing levels and consultants due to lower workload in administering power purchase contracts as those contracts expired.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis June 30, 2014 and 2013

Recovery of Recoverable Costs

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

	2014	2013	2012
Operations	\$ (47)	\$ (448)	\$ (781)
Debt service and related costs	640	638	612
	<u>\$ 593</u>	<u>\$ 190</u>	<u>\$ (169)</u>

Operations

The negative \$47 million operations recovery in the year ended June 30, 2014 results from return of excess reserves to ratepayers partially offset by energy settlements received during the year.

The negative \$448 million operations recovery in the year ended June 30, 2013 resulted from lower net remittances as Operating Reserve Account levels continue to be reduced.

Debt Service and Related Costs

The recovery of debt service and related costs in all three years is a result of bond charges and interest income providing funds to pay interest expense and retire debt. The recovery in fiscal year 2014 was consistent with fiscal year 2013. The recovery in fiscal year 2013 was higher due to higher bond charge revenue and lower interest expense.

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 of \$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 a2 from Aa3 with a stable outlook.

Department of Water Resources Electric Power Fund
Statements of Net Position
June 30, 2014 and 2013

(in millions)

	2014	2013
Assets		
Long-term assets:		
Restricted cash, equivalents and investments:		
Operating Reserve Account	\$ 10	\$ 18
Debt Service Reserve Account	919	919
Recoverable costs	4,490	5,083
Total long-term assets	<u>5,419</u>	<u>6,020</u>
Current assets:		
Restricted cash and equivalents:		
Operating and Priority Contract Accounts	137	210
Bond Charge Collection and Bond Charge Payment Accounts	514	554
Recoverable costs receivable	156	111
Interest receivable	3	4
Other assets	-	14
Total current assets	<u>810</u>	<u>893</u>
Total assets	<u>6,229</u>	<u>6,913</u>
Deferred outflows of resources		
Deferral of loss on defeasance	80	104
Deferral of derivative cash outflows	-	2
Total deferred outflows of resources	<u>80</u>	<u>106</u>
Total assets and deferred outflows of resources	<u>\$ 6,309</u>	<u>\$ 7,019</u>
Liabilities		
Non-Current liabilities:		
Long-term debt	\$ 5,555	\$ 6,249
Other postemployment benefits and accrued vacation	6	5
Total non-current liabilities	<u>5,561</u>	<u>6,254</u>
Current liabilities:		
Current portion of long-term debt	694	702
Derivative instruments, current portion	-	2
Accounts payable	6	9
Accrued interest payable	48	52
Total current liabilities	<u>748</u>	<u>765</u>
Total liabilities	<u>\$ 6,309</u>	<u>\$ 7,019</u>

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

Department of Water Resources Electric Power Fund
Statements of Revenue, Expenses and Changes in Net Position
For the years ended June 30, 2014 and 2013 **(in millions)**

	2014	2013
Operating revenues:		
Power charges, net of refunds	\$ (47)	\$ (405)
Surplus sales	3	3
Total operating revenues	<u>(44)</u>	<u>(402)</u>
Operating expenses:		
Power purchases	39	43
Energy settlements	(53)	(21)
Administrative expenses	15	18
Recovery of recoverable operating costs	(47)	(448)
Total operating expenses	<u>(46)</u>	<u>(408)</u>
Income from operations	2	6
Nonoperating revenues and expenses:		
Bond charges	862	875
Interest income	19	21
Interest expense	(241)	(258)
Investment loss from gas related derivatives	(2)	(6)
Recovery of recoverable debt service and related costs	<u>(640)</u>	<u>(638)</u>
Net increase in net position	-	-
Net position, beginning of year	-	-
Net position, end of year	<u>\$ -</u>	<u>\$ -</u>

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

Department of Water Resources Electric Power Fund
Statements of Cash Flows
For the years ended June 30, 2014 and 2013

(in millions)

	2014	2013
Cash flows from operating activities:		
Receipts:		
Power charges, net of refunds	\$ (42)	\$ (376)
Surplus sales	4	5
Energy settlements	-	21
Payments to employees for services	(4)	(6)
Payments for power purchases and other expenses	(38)	(73)
Net cash used in operating activities	<u>(80)</u>	<u>(429)</u>
Cash flows from non-capital financing activities:		
Receipt of bond charges	864	869
Bond payments	(611)	(574)
Interest payments	(312)	(341)
Net cash used in non-capital financing activities	<u>(59)</u>	<u>(46)</u>
Cash flows from investing activities:		
Interest received on investments	20	21
Loss from derivative investments	(2)	(10)
Net cash provided by investing activities	<u>18</u>	<u>11</u>
Net decrease in cash and equivalents	(121)	(464)
Restricted cash and equivalents, beginning of period	<u>1,401</u>	<u>1,865</u>
Restricted cash and equivalents, end of period	<u>\$ 1,280</u>	<u>\$ 1,401</u>
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 June 30, 2014 and 2013, respectively)	619	619
Operating and Priority Contract Accounts	137	210
Bond Charge Collection and Bond Charge Payment Accounts	514	554
Restricted cash and equivalents, end of year	<u>\$ 1,280</u>	<u>\$ 1,401</u>
Reconciliation of operating income to net cash used in operating activities:		
Income from operations	\$ 2	\$ 6
Adjustments to reconcile operating income to net cash used in operating activities:		
Recovery of recoverable operating costs	(47)	(448)
	<u>(45)</u>	<u>(442)</u>
Changes in net assets and liabilities to reconcile operating income to net cash used in operations:		
Recoverable costs receivable	(47)	27
Other assets	14	35
Other postemployment benefits and accrued vacation	1	-
Accounts payable	(3)	(49)
Net change in operating assets & liabilities:	<u>(35)</u>	<u>13</u>
Net cash used in operating activities	<u>\$ (80)</u>	<u>\$ (429)</u>

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

Department of Water Resources Electric Power Fund

Notes to Financial Statements

June 30, 2014 and 2013

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 and 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 customers through the transmission and distribution systems of the IOUs and payments from 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 Re10. The Fund is accounted for with a set of self-balancing accounts that comprise of 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 flow, 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 the financial position of the State of California and the changes in its financial position and, where applicable, its cash flows in conformity with accounting principles generally accepted in the United States of America.

Future Change in Accounting Principles

In June 2012, the GASB issued Statement No. 68 Accounting and Financial Reporting for Pensions – amendment of GASB Statement No. 27. The objective of this Statement is to improve accounting and financial reporting by state and local government for pensions. This Statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expense/expenditures. The Fund will be required to recognize a liability equal to its share of the net pension liability related to the California Public Employees' Retirement System (CalPERS) determined under the provision of the standard in its financial statements prepared using the economic resources measurement focus and accrual basis of accounting. The Fund has not

Department of Water Resources Electric Power Fund

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determined what impact this pronouncement will have on the financial statements. The provisions of this Statement are effective for the Fund's year ended June 30, 2015.

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. As of December 31, 2013, the last two priority power purchase contracts expired and the only priority natural gas contract was amended to remove the priority designation.
- 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 Operating Account and/or 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 by 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

Department of Water Resources Electric Power Fund

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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 were accounted for as other assets on the Statements of Net Position. The brokerage firm that facilitated the Fund's hedging contracts required that the Fund maintain a security deposit, which was invested in compliance with the California Government Code. These funds were invested in money market mutual funds and were carried at fair value.

As all remaining natural gas hedges expired during the second quarter of FY 2014, 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 energy dispatched by the California Independent System Operator (CAISO) for grid reliability from the Fund's power purchase agreements and natural gas not needed for the generation of power.

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3. Restricted Cash and Investments

As of June 30, 2014 and 2013, the Fund had the following cash, equivalents and investments (in millions):

Investment	Maturity		2014	2013
	June 30, 2014	June 30, 2013		
State of California Pooled Money				
Investment Account - Surplus Money				
Investment Fund	7.6 months avg.	9.1 months avg.	\$ 1,276	\$ 1,398
Cash			4	3
Total cash and equivalents			1,280	1,401
Guaranteed investment contracts	May 1, 2022		200	200
Forward purchase agreement	November 1, 2014		100	100
			<u>\$ 1,580</u>	<u>\$ 1,701</u>
Reconciliation to Statements of Net Position:				
Operating Reserve Account			\$ 10	\$ 18
Debt Service Reserve Account			919	919
Operating and Priority Contract Accounts			137	210
Bond Charge Collection and				
Bond Charge Payment Accounts			514	554
			<u>\$ 1,580</u>	<u>\$ 1,701</u>

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 June 30, 2014 and 2013, 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

Department of Water Resources Electric Power Fund
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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 June 30, 2014, the Fund's investments in the FPA and two GICs individually exceed 5.0% of total investments. The ratings of the investments and their relative percentages of total investments is shown in the following table:

	<u>Amount</u>	<u>S&P Credit Rating</u>	<u>Percent of Total Investments</u>	
			<u>2014</u>	<u>2013</u>
FPA Provider				
Merrill Lynch: FHLMC				
Discounted Notes	<u>\$ 100</u>	Not Rated	6.33%	5.88%
GIC Providers				
FSA	\$ 100	Not Rated	6.33%	5.88%
Royal Bank of Canada	100	Not Rated	6.33%	5.88%
	<u>\$ 200</u>			

Interest on deposits in the SMIF varies with the rate of return of the underlying portfolio and approximated 0.2% at June 30, 2014 and 2013, respectively. For the years ended June 30, 2014 and 2013, interest earned on the deposit in the SMIF was \$4 million and \$5 million, respectively.

Interest on the GICs is paid semi-annually at interest rates ranging from 5.3% to 5.5%. Interest earned on the GICs was \$11 million for the years ended June 30, 2014 and 2013.

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 years ended June 30, 2014 and 2013.

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2014 and 2013 (in millions):

	<u>Revenue Bonds</u>	<u>Unamortized Premium</u>	<u>Total</u>
Balance, June 30, 2012	\$ 7,128	\$ 506	\$ 7,634
Payments	(574)	-	(574)
Amortization	-	(109)	(109)
Balance, June 30, 2013	6,554	397	6,951
Payments	(611)	-	(611)
Amortization	-	(91)	(91)
Balance, June 30, 2014	5,943	306	6,249
Less current portion	618	76	694
	<u>\$ 5,325</u>	<u>\$ 230</u>	<u>\$ 5,555</u>

Department of Water Resources Electric Power Fund
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Long-term debt consists of the following at June 30, 2014 and 2013, respectively (in millions):

<u>Series</u>	<u>Rates</u>	<u>Fiscal Year of Final maturity</u>	<u>Fiscal Year of First Call Date</u>	<u>Amount Outstanding 2014</u>	<u>Amount Outstanding 2013</u>	<u>Current Portion</u>
F	Fixed (4.38-5.00%)	2022	2018	\$ 348	\$ 348	\$ -
G	Fixed (4.35-5.00%)	2018	Non-callable	173	173	-
H	Fixed (3.75-5.00%)	2022	2018	1,007	1,007	-
K	Fixed (4.00-5.00%)	2018	Non-callable	279	279	-
L	Fixed (2.50-5.00%)	2022	2020	2,447	2,708	312
M	Fixed (2.00-5.00%)	2020	Non-callable	884	1,234	267
N	Fixed (2.00-5.00%)	2021	Non-callable	805	805	39
				5,943	6,554	618
Plus unamortized bond premium				306	397	76
				<u>\$ 6,249</u>	<u>\$ 6,951</u>	<u>\$ 694</u>

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 June 30, 2014 (in millions):

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$ 618	\$ 286	\$ 904
2016	669	258	927
2017	686	227	913
2018	714	194	908
2019	749	160	909
2020-22	2,507	253	2,760
	<u>\$ 5,943</u>	<u>\$ 1,378</u>	<u>\$ 7,321</u>

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5. Derivative Financial Instruments

GASB Statement No. 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 was party to natural gas hedging positions that were considered to be derivatives under the provisions of GASB Statement No. 53.

The fair values, classification and notional amounts outstanding for the Fund's natural gas hedge derivatives accounted for as derivative financial instruments on June 30, 2013 are summarized in the following table:

As of June 30, 2013		Business-type	Value	Notional
Effective hedges			(in millions)	
Liabilities				
	Current	Gas Swaps	\$ (2)	460,000 MMBtu

All effective and ineffective hedges in asset and liability positions are included within the tables above and have been recorded in the Statements of Net Position as derivative instruments. Changes in fair value for effective hedges are recorded in the Statements of Net Position as deferred cash inflows or outflows. Changes in fair value for ineffective gas hedges are recorded as investment loss from gas related contracts on the Statements of Revenues, Expenses and Changes in Net Position.

Commodity contracts

At June 30, 2013, the Fund no longer has any outstanding natural gas options 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 fiscal year.

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 (loss) on the Statement of Revenues, Expenses and Changes in Net Position.

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

Credit Risk: The Fund does not have any natural gas hedge positions as of June 30, 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.

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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 cannot 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, the amount by which refunds payable to the Fund will be reduced on account of the Fund's sales to the CAISO. Refund 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 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 agreement 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 volume is established for each IOU as the maximum total kWh supplied by all other providers to distribution customers of the 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.

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Decision 10-03-033 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 has not resulted in impacts to the Power Charges. Regardless of the level of direct access participation within the IOU service area, 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 remaining life of up to two fiscal years. Payments under the power purchase and natural gas transmission capacity contracts approximated \$39 million and \$49 million for fiscal years 2014 and 2013, respectively.

The remaining amounts of fixed obligations under the contracts as of June 30, 2014, are as follows (in millions):

For the Year Ending June 30,	Fixed Obligation (in millions)
2015	\$ 26
2016	16
2017	15
2018	12
	\$ 69

In addition to the fixed costs, there are variable costs associated with the contract. Management projected as of June 30, 2014 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate \$73 million. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

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.

Energy settlements in 2014 totaled \$53 million. The Fund received \$5 million from Avista Corporation and is entitled to \$48 million from TransAlta Energy Marketing (US), of which \$25 million was received on July 3, 2014. The remaining balance of \$23 million will be received in July 2015. These settlements are as a result of FERC approved settlement agreements to resolve certain claims arising from events and transactions in Western Energy Markets during the period January 1, 2000 through June 20, 2001.

Energy settlements in 2013 totaled \$21 million. The Fund received \$20 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. The Fund also received a total of \$1 million from the California Independent System Operator (CAISO) and Cal Polar as the final distribution for market runs for 2001 and a FERC approved settlement respectively.

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8. Retirement Plan and Postemployment Benefits

Retirement Plan Description

The State of California is a member of the California Public Employees' Retirement System (CalPERS), an agent multiple-employer pension system that provides a contributory defined-benefit pension for substantially all State employees. The Fund is included in the State Miscellaneous Category (Tier 1 and Tier 2) within CalPERS, thereby limiting the availability of certain Fund pension data. CalPERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including the Fund, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of CalPERS' comprehensive annual financial report may be obtained from their executive office at 400 P Street, Sacramento, California 95814. The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon an employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

Annual Pension Cost

The Fund's annual pension cost payable from the Fund and actual contribution allocated to the Fund based on the Fund's payroll costs at June 30, 2014 is \$0.5 million compared to \$1 million at June 30, 2013.

The following tables shows the Department's annual pension cost and the percentage contributed for the past three fiscal years (in millions):

<u>Year Ended</u>	<u>Annual Required Contribution (ARC)</u>	<u>Percentage of ARC Contributed</u>
6/30/2012	\$ 1.0	100%
6/30/2013	1.0	100%
6/30/2014	0.5	100%

Other Postemployment Benefits and Accrued Vacation

In addition to the pension benefits, the State of California provides postemployment health care benefits, in accordance with Section 22754 (g) of the State Government Code, to all employees who retire on or after attaining certain age and length of service requirements. The State of California is funding postemployment benefits on a pay-as-you-go basis.

A portion of the State's postemployment benefit costs have been allocated to the Fund as follows (in millions):

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	<u>2014</u>	<u>2013</u>
Annual required contribution	\$ 1.7	\$ 1.1
Interest on net OPEB obligation	0.2	0.1
Adjustment to annual required contribution	<u>(0.2)</u>	<u>(0.1)</u>
Annual OPEB cost (expense)	1.7	1.1
Contributions made	<u>(0.6)</u>	<u>(0.4)</u>
Increase in net OPEB obligation	1.1	0.7
Net OPEB obligation - beginning of year	4.5	3.8
Net OPEB obligation - end of year	<u>\$ 5.6</u>	<u>\$ 4.5</u>

The Fund's net OPEB obligation is included in the other postemployment benefits and accrued vacation on the Statements of Net Position.

The Fund's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for the years ended June 30, 2014, 2013, and 2012 were as follows (in millions):

<u>Year Ended</u>	<u>Annual OPEB Cost</u>	<u>Percentage of OPEB Cost Contributed</u>	<u>Net OPEB Obligation</u>
6/30/2012	\$ 1.2	36%	\$ 3.8
6/30/2013	1.1	35%	4.5
6/30/2014	1.7	35%	5.6

Additional disclosure detail required by Government Accounting Standards Board Statement No.45, regarding other postemployment benefits is presented in the State's Comprehensive Annual Financial Report for the year ended June 30, 2013, which is the latest available.

9. Subsequent Event

Litigation Settlement

Subsequent to the end of fiscal 2014, the Fund received energy settlements from Powerex Corporation and William Companies, Inc., formerly known as Williams Energy Marketing and Trading Company on August 8, 2014 of \$140 million and \$2 million. These settlements are to resolve certain claims arising from events and transactions in Western Energy Markets during the period January 1, 2000 through June 20, 2001.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Director of the Department of Water Resources
Department of Water Resources Electric Power Fund
Sacramento, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Department of Water Resources Electric Power Fund (Fund) of the State of California, as of and for the year ended June 30, 2014, and the related notes to financial statements, and have issued our report thereon dated October 9, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the State of California's internal control over financial reporting (internal control) as it relates to the Fund to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of California's internal control as it relates to the Fund. Accordingly, we do not express an opinion on the effectiveness of the State of California's internal control as it relates to the Fund.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of the State's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing on internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Macior Mini & O'Connell LLP

Sacramento, California

October 9, 2014