# DEPARTMENT OF WATER RESOURCES
# ELECTRIC POWER FUND

Financial Statements

For the Fiscal Years Ended June 30, 2013 and 2012

MGO Certified Public Accountants.

# Department of Water Resources
# Electric Power Fund
# Financial Statements
**For the years ended June 30, 2013 and 2012**

# Department of Water Resources Electric Power Fund
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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 year ended June 30, 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 audit. We conducted our audit 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.



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***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, 2013, and the changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

***Emphasis of Matters***

*Fund Only Financial Statements*

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, 2013, the changes in its financial position, or where applicable, its cash flows for the year 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.

*Change in Accounting Principles*

As described in Note 2 to the financial statements, during the year ended June 30, 2013 the State of California adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. 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.

*Prior Year Financial Statements*

The financial statements of the Fund as of and for the year ended June 30, 2012, were audited by other auditors, whose opinion dated October 31, 2012 on those statements was unmodified. As discussed in Note 2, the State of California has restated its 2012 Fund financial statements during the current year to eliminate deferred cost of issuance and reclassify other deferred items, in accordance with accounting principles generally accepted in the United States of America. The other auditors reported on the 2012 Fund financial statements before the restatement.

As part of our audit of the 2013 Fund financial statements, we also audited adjustments described in Note 2 that were applied to restate the 2012 Fund financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 2012 financial statements of the Fund other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance of the 2012 Fund financial statements as a whole.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 18, 2013 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.

Macias Gini & O'Connell LLP

Sacramento, California
October 18, 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 conjunction with the financial statements as a whole, which follows Management's Discussion and Analysis. This discussion and analysis and the financial statements do not relate to DWR's other governmental and proprietary funds.

The 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 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 June 30, 2012 and the last of the power supply contracts expires in September 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.

### CONDENSED STATEMENTS OF NET POSITION

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

| | 2013 | 2012 (As Restated) | 2011 (As Restated) |
|---|---|---|---|
| Long-term restricted cash, equivalents and investments | $ 937 | $ 1,186 | $ 1,207 |
| Recoverable costs | 5,083 | 5,278 | 5,111 |
| Derivative instruments | - | - | 7 |
| Restricted cash and equivalents: | | | |
| Operating and priority contract accounts | 210 | 398 | 1,133 |
| Bond charge collection and bond charge payment accounts | 554 | 581 | 618 |
| Recoverable costs receivable | 111 | 132 | 220 |
| Interest receivable | 4 | 4 | 6 |
| Other assets | 14 | 45 | 79 |
| Total assets | 6,913 | 7,624 | 8,381 |
| Deferral of loss on defeasance | 104 | 135 | 159 |
| Deferral of derivative cash outflows | 2 | 2 | 30 |
| Total deferred outflows of resources | 106 | 137 | 189 |
| Total assets and deferred outflows of resources | $ 7,019 | $ 7,761 | $ 8,570 |
| Long-term debt, including current portion | $ 6,951 | $ 7,634 | $ 8,297 |
| Derivative instruments | 2 | 7 | 36 |
| Other postretirement benefits and accrued vacation | 5 | 5 | 4 |
| Other current liabilities | 61 | 115 | 230 |
| Total liabilities | 7,019 | 7,761 | 8,567 |
| Deferral of derivative cash inflows | - | - | 3 |
| Total liabilities and deferred inflows of resources | $ 7,019 | $ 7,761 | $ 8,570 |

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

The $249 million decrease in long-term restricted cash, equivalents and investments during fiscal 2013 is a result of the reduction in the Operating Reserve Account to $18 million from $267 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 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 is 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.

The $21 million decrease in long-term restricted cash, equivalents and investments during fiscal 2012 was a result of the reduction in the Operating Reserve Account to $267 million from $288 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 2012 as forecasted in the Fund's 2012 revenue requirement determination. The decrease was caused by lower prospective power costs because all but three purchase power contracts had expired by the end of the year. The Debt

Service Reserve Account remained at $919 million as the maximum future annual debt service was unchanged.

### Recoverable Costs

Recoverable costs consist of costs that are recoverable through future billings. The $195 million decrease during fiscal 2013 is 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 is primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

The $167 million increase during fiscal 2012 was due to 1) negative recovery of recoverable operating costs of $781 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 $612 million and 3) a $2 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.

### Derivative Instruments - Assets

There are no outstanding derivative assets at June 30, 2013. All remaining natural gas swap hedge contracts have negative fair value.

There were no outstanding derivative assets at June 30, 2012, a decrease of $7 million from June 30, 2011 due primarily to the reduction in the total size of the natural gas hedging portfolio as purchase power contracts expired and as the Fund ceased purchases of additional hedges.

Deferral of derivative cash outflows remained at $2 million at June 30, 2013 and 2012 as the Fund no longer enters into new natural gas hedge contracts.

### Restricted Cash and Equivalents

The Operating and Priority Contract Accounts decreased by $188 million in 2013 due to lower account levels that result from reductions in expected expenses as power purchase contracts expire 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 is $43 million higher than forecasted in the Fund’s calendar year 2013 revenue requirement determination.

The Operating and Priority Contract Accounts decreased by $735 million in 2012 due to lower account levels that resulted from reductions in expected expenses as power purchase contracts expired offset by $35 million in cash received from energy settlements. The $398 million balance in the Operating and Priority Contract Accounts at June 30, 2012 was $151 million higher than forecasted in the Fund’s calendar year 2012 revenue requirement determination.

The Bond Charge Collection and Bond Charge Payment Accounts decreased by $27 million in 2013 in accordance with the revenue requirement determination as excess bond charge accounts balances are reduced.

The Bond Charge Collection and Bond Charge Payment Accounts decreased by $37 million in 2012 due to increased interest expense from a higher proportion of fixed rate debt in 2012 that resulted from refunding of variable rate debt with fixed rate debt.

### 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

$111 million of recoverable costs receivable at June 30, 2013 is $21 million lower than at June 30, 2012. The decrease is 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.

The $132 million recoverable costs receivable at June 30, 2012 was $88 million lower than at June 30, 2011. The decrease was primarily due to lower expected remittances from the decline in delivered volumes after the expiration of most purchase power contracts during the year offset by surplus gas sales.

### Other Assets

At June 30, 2013, other assets are 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.

At June 30, 2012, other assets were valued at $45 million, and consisted of money market investments, US Treasury bills and government bonds valued at $35 million and other derivative collateral balances including margin deposits valued at $10 million.

### Long-Term Debt

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 and $556 million in fiscal 2013 and 2012, respectively. Net amortization of bond premium was $109 million and $117 million at June 30, 2013 and 2012, respectively.

In fiscal 2012, to address credit risk associated with credit support providers on variable rate debt and to take advantage of favorable market conditions, the Fund issued $960 million of Series 2011 N revenue bonds with a premium of $158 million to refund $948 million of variable rate debt, consisting of $25 million of Series 2002 B bonds, and $923 million of Series 2002 C bonds. In addition, $158 million of the fixed rate debt Series 2002 A bonds were advance refunded to take advantage of lower interest rates. The Series 2011 N bonds were issued with coupons ranging from 2% to 5%. With the Series 2011 N refunding transaction, the Fund has no variable rate bonds outstanding. The Fund terminated all of the outstanding credit enhancement facilities relating to those bonds.

### Derivative Instruments - Liabilities

The Fund is party to natural gas hedging positions that are considered to be derivatives under provisions of GASB Statement No. 53 and included on the Statements of Net Position for the years ended June 30, 2013, 2012 and 2011.

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.

In fiscal 2012 derivative liability decreased to $7 million from $36 million at the end of fiscal 2011. Power related derivatives declined due to the reduction in the size of the natural gas hedge portfolio as less natural gas was purchased after the expiration of several power purchase contracts and reductions in purchases of new hedges.

### 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 was unchanged at $5 million at June 30, 2013 and 2012, as a $1 million increase in the OPEB obligation was offset by a $1 million reduction in accrued vacation time. Accrued vacation time decreased as a result of lower staffing levels and as current employees draw down their balances.

### 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, 2013 is $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 is needed to supply the remaining natural gas-fired power contract.

Accounts payable at June 30, 2012 was $116 million lower than at June 30, 2011. The difference resulted 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 is needed to supply those long-term power contracts.

Accrued interest payable at June 30, 2013 is $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.

Accrued interest payable at June 30, 2012 was $1 million higher than at June 30, 2011 due to higher fixed interest costs that resulted from a refunding transaction in August 2011.

### 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):

| | 2013 | 2012 (As Restated) | 2011 (As Restated) |
|---|---|---|---|
| Revenues: | | | |
| Power charges, net of refunds | $ (405) | $ 2 | $ 1,311 |
| Surplus sales | 3 | 32 | 132 |
| Bond charges | 875 | 861 | 860 |
| Interest income | 21 | 25 | 30 |
| Total revenues | 494 | 920 | 2,333 |
| Expenses: | | | |
| Power purchases | 43 | 824 | 2,122 |
| Energy settlements | (21) | (35) | (236) |
| Interest expense | 258 | 274 | 416 |
| Investment loss | 6 | 5 | 16 |
| Administrative expenses | 18 | 21 | 26 |
| Recovery of recoverable costs | 190 | (169) | (11) |
| Total expenses | 494 | 920 | 2,333 |
| 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 in fiscal 2013 resulted in a net refund of $405 million versus a net revenue of $2 million in fiscal 2012. The difference is due to lower power sales to end use customers as only three power purchase contracts remain, the return of prior year over-collections and the return of reserves as lower reserve levels are required with the expiration of purchase power contracts. The return of prior year over-collections and reserves is implemented through an adjustment to the power charge and separate monthly payments to ratepayers in the Pacific Gas and Electric Company (PG&E) and Southern California Edison Company (SCE) service territories. These payments are the allocation of prior year over-collections from ratepayers and reserves in excess of Trust Indenture required levels. The allocation of excess reserves was authorized by the CPUC in Decision 12-11-040. During fiscal 2013, the Fund returned $449 million in these monthly payments.

Power Charges were $1,309 million lower in fiscal 2012 than in fiscal 2011. The difference was due to lower power sales to end use customers as a result of the expiration of several power purchase contracts, the return of prior year over-collections and the return of reserves as lower reserve levels are required with the expiration of power purchase contracts. As with fiscal 2013, the return of reserves was implemented through an adjustment to Power Charges and separate monthly payments to ratepayers in the PG&E and SCE service territories. The allocation of excess reserves was authorized by the CPUC in Decision 11-12-005. During fiscal 2012, the Fund returned $640 million in these monthly payments.

### Surplus Sales

The Fund receives revenue from the sale of excess natural gas and energy from counterparties. Surplus sales for the year ended June 30, 2013 are $29 million lower than the same period in 2012. Lower surplus sales are due to lower volumes of energy and excess natural gas sold as less power was purchased under the contracts.

Surplus sales for the year ended June 30, 2012 were $100 million lower than the same period in 2011. Lower surplus sales were due to lower natural gas prices and a lower volume of natural gas sold as less total gas was purchased for generation of electricity.

### 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, 2013, 2012 and 2011 were $875 million, $861 million and $860 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 $14 million increase in 2013 is 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 2013 is $4 million lower than in 2012, due to lower balances and lower interest rates earned on investments in the State of California Surplus Investment Fund (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.

Interest income for 2012 was $5 million lower than in 2011, 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, 2012 was 0.38% compared to 0.50% for the year ended June 30, 2011.

### Power Purchases

Power costs are $781 million lower in fiscal 2013 than in fiscal 2012 and were $1,298 million lower in fiscal 2012 than in fiscal 2011. The differences are primarily a result of lower volumes of power purchased as only three purchase power contracts remain.

### Energy Settlements

Energy settlements received, 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 in 2013 total $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.

Energy settlements in 2012 totaled $35 million. The Fund received $9 million from the CAISO as a result of market re-runs for 2001. The Fund also received $9 million from the California Power Exchange (CalPX) as a result of a FERC ordered and Bankruptcy Court approved distribution of funds related to the energy crisis. In total, the Fund received $14 million as part of the FERC refund settlement agreements signed by the California Parties (CPUC, the State Attorney General, California Department of Water Resources acting through the Fund, SCE, SDG&E and Electric Company, and PG&E) and the City of

Pasadena, the Modesto Irrigation District, Nevada Power, the City of Glendale and AEP. The Fund also received $3 million from a California litigation escrow account as the final payment from a settlement agreement reached with Sempra in 2010.

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 not be recognized until, if and when the contingencies are resolved.

### Interest Expense

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

Interest expense was $142 million lower in 2012 when compared to 2011. The decrease was due the expensing of cost of issuance for Series 2010 M bonds in fiscal 2011.

### 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 gas related hedges, the Fund realized net investment loss of $6 million, $5 million and $16 million during the years ended June 30, 2013, 2012 and 2011, respectively.

### Administrative Expenses

Administrative expenses decreased by $3 million in 2013 and by $5 million in 2012 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.

### Recovery of Recoverable Costs

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

| | 2013 | 2012 (As Restated) | 2011 (As Restated) |
|---|---|---|---|
| Operations | $ (448) | $ (781) | $ (485) |
| Debt service and related costs | 638 | 612 | 474 |
| | $ 190 | $ (169) | $ (11) |

Operations
The negative $448 million operations recovery in the year ended June 30, 2013 results from lower net remittances as Operating Reserve Account levels continue to be reduced. As power purchase contracts expire and fixed payments for purchased power decline, lower Operating Reserve Account balances are required.

The negative $781 million operations recovery in the year ended June 30, 2012 resulted from lower net remittances as Operating Reserve Account levels were 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 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.

In fiscal 2012, to address credit risk associated with credit support providers on variable rate debt and to take advantage of favorable market conditions, the Fund issued $960 million of Series 2011 N revenue bonds to refund $948 million of variable rate debt, consisting of $25 million of Series 2002 B bonds, and $923 million of Series 2002 C bonds. In addition, $158 million of the fixed rate debt Series 2002 A bonds were advance refunded to take advantage of lower interest rates. The Series 2011 N bonds were issued with coupons ranging from 2% to 5%. With the Series 2011 N refunding transaction, the Fund has no variable rate bonds outstanding. The Fund terminated all of the outstanding credit enhancement facilities relating to those bonds.

There were no changes to bond ratings in fiscal 2013 or 2012.

# Department of Water Resources Electric Power Fund
## Statements of Net Position
## June 30, 2013 and 2012 (in millions)

| | 2013 | 2012 (As Restated) |
|---|---|---|
| **Assets** | | |
| Long-term assets: | | |
| Restricted cash, equivalents and investments: | | |
| Operating Reserve Account | $ 18 | $ 267 |
| Debt Service Reserve Account | 919 | 919 |
| Recoverable costs | 5,083 | 5,278 |
| Total long-term assets | 6,020 | 6,464 |
| Current assets: | | |
| Restricted cash and equivalents: | | |
| Operating and Priority Contract Accounts | 210 | 398 |
| Bond Charge Collection and | | |
| Bond Charge Payment Accounts | 554 | 581 |
| Recoverable costs receivable | 111 | 132 |
| Interest receivable | 4 | 4 |
| Other assets | 14 | 45 |
| Total current assets | 893 | 1,160 |
| Total assets | 6,913 | 7,624 |
| **Deferred outflows of resources** | | |
| Deferral of loss on defeasance | 104 | 135 |
| Deferral of derivative cash outflows | 2 | 2 |
| Total deferred outflows of resources | 106 | 137 |
| Total assets and deferred outflows of resources | $ 7,019 | $ 7,761 |
| **Liabilities** | | |
| Non-Current liabilities: | | |
| Long-term debt | $ 6,249 | $ 6,951 |
| Derivative instruments | - | 1 |
| Other postemployment benefits and accrued vacation | 5 | 5 |
| Total non-current liabilities | 6,254 | 6,957 |
| Current liabilities: | | |
| Current portion of long-term debt | 702 | 683 |
| Derivative instruments, current portion | 2 | 6 |
| Accounts payable | 9 | 58 |
| Accrued interest payable | 52 | 57 |
| Total current liabilities | 765 | 804 |
| Total liabilities | $ 7,019 | $ 7,761 |

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 Revenue, Expenses and Changes in Net Position
## For the years ended June 30, 2013 and 2012 (in millions)

| | 2013 | 2012 (As Restated) |
|---|---|---|
| Operating revenues: | | |
| Power charges, net of refunds | $ (405) | $ 2 |
| Surplus sales | 3 | 32 |
| Total operating revenues | (402) | 34 |
| Operating expenses: | | |
| Power purchases | 43 | 824 |
| Energy settlements | (21) | (35) |
| Administrative expenses | 18 | 21 |
| Recovery of recoverable operating costs | (448) | (781) |
| Total operating expenses | (408) | 29 |
| Income from operations | 6 | 5 |
| Bond charges | 875 | 861 |
| Interest income | 21 | 25 |
| Interest expense | (258) | (274) |
| Investment income from debt related derivatives | - | 16 |
| Investment loss from gas related derivatives | (6) | (21) |
| Recovery of recoverable debt service and related costs | (638) | (612) |
| 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 years ended June 30, 2013 and 2012 (in millions)

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Cash flows from operating activities: | | | | |
| Receipts: | | | | |
| Power charges, net of refunds | $ | (376) | $ | 90 |
| Surplus sales | | 5 | | 42 |
| Energy settlements | | 21 | | 35 |
| Payments to employees for services | | (6) | | (6) |
| Payments for power purchases and other expenses | | (73) | | (920) |
| Net cash used in operating activities | | (429) | | (759) |
| Cash flows from non-capital financing activities: | | | | |
| Receipt of bond charges | | 869 | | 855 |
| Bond payments | | (574) | | (556) |
| Interest payments | | (341) | | (354) |
| Proceeds from issuance of revenue bonds | | - | | 1,118 |
| Defeasance of revenue bonds | | - | | (1,120) |
| Net cash used in non-capital financing activities | | (46) | | (57) |
| Cash flows from investing activities: | | | | |
| Interest received on investments | | 21 | | 26 |
| Loss from derivative investments | | (10) | | (3) |
| Net cash provided by investing activities | | 11 | | 23 |
| Net decrease in cash and equivalents | | (464) | | (793) |
| Restricted cash and equivalents, beginning of period | | 1,865 | | 2,658 |
| Restricted cash and equivalents, end of period | $ | 1,401 | $ | 1,865 |
| Restricted cash and equivalents included in: | | | | |
| Operating Reserve Account | $ | 18 | $ | 267 |
| Debt Service Reserve Account (a component of the total of $919 and $919 at June 30, 2013 and 2012, respectively) | | 619 | | 619 |
| Operating and Priority Contract Accounts | | 210 | | 398 |
| Bond Charge Collection and Bond Charge Payment Accounts | | 554 | | 581 |
| Restricted cash and equivalents, end of year | $ | 1,401 | $ | 1,865 |
| Reconciliation of operating income to net cash used in operating activities: | | | | |
| Income from operations | $ | 6 | $ | 5 |
| Adjustments to reconcile operating income to net cash used in operating activities: | | | | |
| Recovery of recoverable operating costs | | (448) | | (781) |
| | | (442) | | (776) |
| Changes in net assets and liabilities to reconcile operating income to net cash used in operations: | | | | |
| Recoverable costs | | 27 | | 95 |
| Other assets | | 35 | | 37 |
| Other postemployment benefits and accrued vacation | | - | | 1 |
| Accounts payable | | (49) | | (116) |
| Net change in operating assets & liabilities: | | 13 | | 17 |
| Net cash used in operating activities | $ | (429) | $ | (759) |

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 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 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 Re10. 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 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 fairly the financial position of the State of California as of June 30, 2013 and 2012, 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.

### Change in Accounting Principles

During the year, the Fund implemented GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*.

A summary of the fiscal year 2012 financial statement items restated in connection with the adoption of GASB Statement No. 65 is shown in the following tables:

**Statement of Net Position (in millions)**

| | Balance previously reported at June 30, 2012 | GASB 65 adjustment | June 30, 2012 (As Restated) |
|---|---|---|---|
| **Assets** | | | |
| Long-term assets: | | | |
| Recoverable costs | $ 5,038 | $ 240 | $ 5,278 |
| **Deferred outflows of resources** | | | |
| Deferral of loss on defeasance | - | 135 | 135 |
| **Liabilities** | | | |
| Non-current liabilities: | | | |
| Long-term debt | 6,667 | 284 | 6,951 |
| Current liabilities: | | | |
| Current portion of long-term debt | 592 | 91 | 683 |

**Statement of Revenues, Expenses and Changes in Net Position (in millions)**

| | Balance previously reported for the year ended June 30, 2012 | GASB 65 adjustment | For the year ended June 30, 2012 (As Restated) |
|---|---|---|---|
| Interest expense | $ (336) | $ 62 | $ (274) |
| Recovery of recoverable debt service and related costs | (550) | (62) | (612) |

### Reclassification

The Fund reclassified postemployment benefits and accrued vacation from current to non-current liabilities. This reclassification caused accounts payable to decrease by $5 million and non-current liabilities to increase by $5 million in the Statements of Net Position at June 30, 2012. In the Statements of Cash Flows for the year ended June 30, 2012, payments for power purchases and other expenses decreased by $6 million and were reclassified to payments to employees for services. Also, accounts payable increased $1 million from $115 million to $116 million and other post employment benefits and accrued vacation increased to $1 million to reconcile operating income to net cash used in operating activities.

**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 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 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.

At June 30, 2013, other assets are valued at $14 million, and consisted of money market investments valued at $10 million and other collateral balances valued at $4 million. At June 30, 2012, other assets consist of money market investments valued at $35 million and other collateral balances valued at $10 million.

### 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 gas not needed for the generation of power and energy dispatched by the California Independent System Operator (CAISO) from the Fund's power purchase agreements for grid reliability.

### 3. Restricted Cash and Investments

As of June 30, 2013 and 2012, the Fund had the following cash, equivalents and investments (in millions):

| Investment | Maturity June 30, 2013 | Maturity June 30, 2012 | 2013 | 2012 |
|---|---|---|---|---|
| State of California Pooled Money Investment Account - Surplus Money Investment Fund | 9.1 months avg. | 8.8 months avg | $ 1,398 | $ 1,861 |
| Cash | | | 3 | 4 |
| Total cash and equivalents | | | 1,401 | 1,865 |
| Guaranteed investment contracts | May 1, 2022 | | 200 | 200 |
| Forward purchase agreement | November 1, 2013 | | 100 | 100 |
| | | | $ 1,701 | $ 2,165 |

| Reconciliation to Statements of Net Position: | 2013 | 2012 |
|---|---|---|
| Operating Reserve Account | $ 18 | $ 267 |
| Debt Service Reserve Account | 919 | 919 |
| Operating and Priority Contract Accounts | 210 | 398 |
| Bond Charge Collection and Bond Charge Payment Accounts | 554 | 581 |
| | $ 1,701 | $ 2,165 |

*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, 2013 and 2012, 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 June 30, 2013, 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:

| | Amount | S&P Credit Rating | Percent of Total Investments 2013 | Percent of Total Investments 2012 |
|---|---|---|---|---|
| FPA Provider | | | | |
| Merrill Lynch: FHLMC Discounted Notes | $ 100 | Not Rated | 5.88% | 4.62% |
| GIC Providers | | | | |
| FSA | $ 100 | Not Rated | 5.88% | 4.62% |
| Royal Bank of Canada | 100 | Not Rated | 5.88% | 4.62% |
| | $ 200 | | | |

Interest on deposits in the SMIF varies with the rate of return of the underlying portfolio and approximated 0.2% and 0.4% at June 30, 2013 and 2012, respectively. For the years ended June 30, 2013 and 2012, interest earned on the deposit in the SMIF was $5 million and $9 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, 2013 and 2012.

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, 2013 and 2012.

### 4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2013 and 2012 (in millions):

| | Revenue Bonds | Unamortized Premium | Total |
|---|---|---|---|
| Balance, June 30, 2011 | $ 7,830 | $ 467 | $ 8,297 |
| Refunding | | | |
| Issuance of Debt | 960 | 158 | 1,118 |
| Defeasance of Debt | (1,106) | (2) | (1,108) |
| Payments | (556) | - | (556) |
| Amortization | - | (117) | (117) |
| Balance, June 30, 2012 | 7,128 | 506 | 7,634 |
| Payments | (574) | - | (574) |
| Amortization | - | (109) | (109) |
| Balance, June 30, 2013 | 6,554 | 397 | 6,951 |
| Less current portion | 611 | 91 | 702 |
| | $ 5,943 | $ 306 | $ 6,249 |

Long-term debt consists of the following at June 30, 2013 and 2012, respectively (in millions):

| Series | Rates | Fiscal Year of Final maturity | Fiscal Year of First Call Date | Amount Outstanding 2013 | Amount Outstanding 2012 (As Restated) | Current Portion |
|---|---|---|---|---|---|---|
| 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 | 2,708 | 2,708 | 261 |
| M | Fixed (2.00-5.00%) | 2020 | Non-callable | 1,234 | 1,653 | 350 |
| N | Fixed (2.00-5.00%) | 2021 | Non-callable | 805 | 960 | - |
| | | | | 6,554 | 7,128 | 611 |
| Plus unamortized bond premium | | | | 397 | 506 | 91 |
| | | | | $ 6,951 | $ 7,634 | $ 702 |

### Bond refunding transactions

The Fund has issued revenue refunding bonds to advance refund various bonds that were previously issued. The net proceeds from these sales were used to purchase U.S. Treasury Securities that were deposited in irrevocable escrow trust accounts with the State Treasurer acting as an independent fiscal agent to provide for all future debt service on the bonds being refunded. As a result, those bonds are considered defeased and the related liabilities have been excluded from the Fund's financial statements. At June 30, 2013 and 2012, there was no outstanding debt that has been considered defeased.

On August 31, 2011, the Fund issued $960 million of revenue bonds at a true interest cost of 2.42% to refund $948 million of variable rate debt, consisting of $25 million of Series 2002 B bonds, and $923 million of Series 2002 C bonds. In addition, $158 million of the fixed rate debt Series 2002 A bonds were advance refunded to take advantage of lower interest rates. The Series 2011 N bonds were issued at a premium of $158 million with coupons ranging from 2.0% to 5.0%. The transaction resulted in a net cash flow savings of $7.8 million and an economic gain (difference between the present values of the debt service payments on the old debt and the new debt) of $4.9 million. The difference between the book value of the old debt and the amount required to retire the debt is deferred and amortized over the original remaining life of the old debt or the life of the new debt, whichever is less. The Fund incurred an accounting loss of $7 million. Due to implementation of GASB Statement No. 65 the cost of issuance was eliminated (see Notes to Financial Statements, Summary of Significant Accounting Policies). Effective in fiscal year 2013, deferred loss on defeasance is reclassified as deferred outflows of resources in the Statements of Net Position. Such amounts will be amortized over the life of the Series 2011 N bonds since all defeased bonds had maturities that were similar to the maturities of the Series 2011 N bonds.

With the Series 2011 N refunding transaction, the Fund has no variable rate bonds outstanding. The Fund terminated all of the outstanding credit enhancement facilities relating to those bonds.

### 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 or any political subdivision thereof, other than DWR.

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, 2013 (in millions):

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2014 | $ 611 | $ 314 | $ 925 |
| 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 | $ 1,692 | $ 8,246 |

### 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 is party to natural gas hedging positions that are considered to be derivatives under the provisions of GASB Statement No. 53 and included on the Statements of Net Position as of June 30, 2013 and 2012.

The fair values, classification and notional amounts outstanding for the Fund's natural gas hedge derivatives accounted for as derivative financial instruments at June 30, 2013 and 2012 are summarized in the following tables:

**As of June 30, 2013**

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

**As of June 30, 2012**

| | | Business-type activities | Value (in millions) | Notional | |
|---|---|---|---|---|---|
| **Effective hedges** | | | | | |
| Liabilities | | | | | |
| | Current | Gas Swaps | $ (1) | 305,000 | MMBtu |
| | Long-Term | Gas Swaps | (1) | 382,500 | MMBtu |
| | | | $ (2) | | |
| **Investment hedges** | | | | | |
| Liabilities | | | | | |
| | Current | Gas Swaps | $ (5) | 990,000 | 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 option 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.

For the Fund's natural gas futures contracts that are effective hedges, unrealized gains and losses are deferred on the Statements of Net Position as deferred outflows of resources. The deferred amount recorded on the Statements of Net Position reflects the deferred outflow associated with the derivative financial instruments.

In fiscal 2013, 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 are 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 previous tables were determined based on quoted market prices for similar financial instruments.

*Credit Risk:* The Fund's open natural gas hedge positions at June 30, 2013 have been entered into through the Fund's brokerage accounts and the associated clearing accounts have collateral requirements that limit the Fund's counterparty credit risk.

*Termination Risk:* With regards to gas hedge agreements, the Fund or the counterparty may terminate an agreement if the other party fails to perform under the terms of the contract. In addition, the agreements allow either party to terminate in the event of a significant loss of creditworthiness by the other party. If a termination were to occur, the Fund or the counterparty would owe the other a payment equal to the fair value of the open positions.

## 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 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 (CalPX) markets during 2000 and 2001. FERC ruled that the Fund would not be entitled in that proceeding to approximately $3.5 billion in refunds associated with the Fund's approximately $5.0 billion of short-term purchases because the Fund made those purchases bilaterally, not in the CalPX 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 $5.0 billion in short-term bilateral purchases, $2.9 billion 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. However, because the Fund would likely be the primary recipient of any refunds on energy it sold to the CAISO, the Fund's potential net liability associated with its sales to the CAISO would be substantially reduced. Settlements executed to date with various sellers have reduced that potential liability even further.

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

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

In addition, in September 2005, the Ninth Circuit Court of Appeals ruled that FERC could not require governmental entities such as the Fund to pay refunds. Refunds owed to the Fund for purchases it made in a given hour may, however, be offset by the amount of refunds owed by the Fund for its sales to the market during that same hour. Such offsets, however, will not change the Fund's status as a net refund recipient.

*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.

During fiscal year 2011, three of the Fund's power purchase contracts were novated. Management does not believe it is likely that there will be additional contract novations because only one power purchase contract will remain after December 31, 2013.

*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, therefore no amounts are accrued.

### Commitments

The Fund has power purchase contracts that have remaining lives of up to four years. Payments under these and gas purchase contracts approximated $49 million and $824 million for fiscal 2013 and 2012, respectively.

In addition to the remaining purchased power contracts, 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.

The remaining amounts of fixed obligations under the contracts as of June 30, 2013, are as follows (in millions):

| For the Year Ending June 30, | Fixed Obligation (in millions) |
|---|---|
| 2014 | $ 35 |
| 2015 | 27 |
| 2016 | 17 |
| 2017 | 15 |
| 2018 | 12 |
| | $ 106 |

In addition to the fixed costs, there are variable costs under several of the contracts. Management projected as of June 30, 2013 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate $113 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.

All of the power contracts qualify under the normal purchases and normal sales exclusion under the provisions of GASB Statement No. 53 since it is probable that the Fund will take delivery of the commodity and the Fund uses the commodity in its operations as in the normal course of business.

## 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 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 CAISO and Cal Polar as the final distribution for market re-runs for 2001 and a FERC approved settlement, respectively.

In fiscal 2012, settlements totaled $35 million. The Fund received $9 million from the CAISO as a result of market re-runs for 2001. The Fund also received $9 million from the CalPX as a result of a FERC ordered and Bankruptcy Court approved distribution of funds related to the energy crisis. In total, the Fund received $14 million as part of the FERC refund settlement agreements signed by the California Parties (CPUC, the State Attorney General, California Department of Water Resources acting through the Fund and the IOUs) and the City of Pasadena, the Modesto Irrigation District, Nevada Power, the City of Glendale and AEP. The Fund also received $3 million from a California litigation escrow account as the final payment from a settlement agreement reached with Sempra in 2010.

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 not be recognized until, if and when the contingencies are resolved.

## 8. Related Party Transactions

During fiscal 2012, the Fund refunded all outstanding variable rate debt and terminated their associated credit support facilities. Among the counterparties that provided credit support was the California State Teachers' Retirement System (CalSTRS), which is part of the California state government. With the refunding, the Fund no longer has a contractual relationship with CalSTRS.

## 9. 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

For the years ended June 30, 2013, 2012 and 2011, the Fund's annual pension cost payable from the Fund and actual contribution allocated to the Fund based on the Fund's payroll costs approximated $1 million each year.

### 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):

| | 2013 | 2012 |
|---|---|---|
| Annual required contribution | $ 1.1 | $ 1.1 |
| Interest on net OPEB obligation | 0.1 | 0.1 |
| Adjustment to annual required contribution | (0.1) | - |
| Annual OPEB cost (expense) | 1.1 | 1.2 |
| Contributions made | (0.4) | (0.4) |
| Increase in net OPEB obligation | 0.7 | 0.8 |
| Net OPEB obligation - beginning of year | 3.8 | 3.0 |
| Net OPEB obligation - end of year | $ 4.5 | $ 3.8 |

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, 2013, 2012, and 2011 were as follows (in millions):

| Year Ended | Annual OPEB Cost | Percentage of OPEB Cost Contributed | Net OPEB Obligation |
|---|---|---|---|
| 6/30/2011 | $ 1.3 | 37% | $ 3.0 |
| 6/30/2012 | 1.2 | 36% | 3.8 |
| 6/30/2013 | 1.1 | 35% | 4.5 |

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, 2012, which is the latest available.

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# 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 contacted 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, 2013, and the related notes to financial statements, and have issued our report thereon dated October 18, 2013.

## 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.

Macias Gini & O'Connell LLP

Sacramento, California
October 18, 2013