# Department of Water Resources
# Electric Power Fund
# Financial Statements
**For the years ended June 30, 2012 and 2011**

California
Energy
Resources
Scheduling
Department of
Water Resources

## STATE OF CALIFORNIA
***Edmund G. Brown Jr., Governor***

## THE NATURAL RESOURCES AGENCY
***John Laird, Secretary for Natural Resources***

## DEPARTMENT OF WATER RESOURCES
***Mark W. Cowin, Director***

| | | |
|---|---|---|
| Carl Torgersen<br>Acting Deputy Director | Dale Hoffman-Floerke<br>Chief Deputy Director | Kathie Kishaba<br>Deputy Director |
| Paul Helliker<br>Deputy Director | John Pacheco<br>Acting Deputy Director | Gary Bardini<br>Deputy Director |

| | |
|---|---|
| Cathy Crothers<br>Chief Counsel | Kasey D. Schimke<br>Assistant Director |

### Division of Fiscal Services
Perla M. Netto-Brown, Chief

### This document was prepared under the direction of:

Rita Sanko……………………………………………………………………………………………............................................Deputy Comptroller

### CERS Financial Management Office

Michael Wofford……………………………………………………………………………………….Acting Chief of Financial Management Office
Ben Arikawa……………………………………………………………………………………………………Senior HEP Utilities Engineer

### CERS Financial Reporting and Analysis Office

Maria Vacaru.....................................................................................................................................Accounting Administrator I
Kelly Fish…………………………………………………………………………………………………….... Associate Accounting Analyst
Emmalynn Harvey.………………………………………………………………………………………….... Associate Accounting Analyst
Majid Shahmirzadi ……………………………………………............................................................ Associate Accounting Analyst

# Department of Water Resources Electric Power Fund
## Index

MOSS-ADAMS LLP
Certified Public Accountants | Business Consultants

**REPORT OF INDEPENDENT AUDITORS**

To the Director of the Department of Water Resources
Department of Water Resources Electric Power Fund

We have audited the accompanying statement of net assets of the Department of Water Resources Electric Power Fund (the "Fund"), a component unit of the State of California, as of June 30, 2012, and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Department of Water Resources Electric Power Fund as of and for the year ended June 30, 2011, were audited by other auditors whose report dated November 8, 2011, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2012, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 2 through 10 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic 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 basic financial statements, and other knowledge we obtained during our audit of the basic 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.

Moss Adams LLP

Portland, OR
October 31, 2012

USING THIS REPORT

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

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of revenues, expenses and changes in net assets, and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of the year-end date. The statement of revenues, expenses and changes in net assets presents all of the current year's revenues, expenses, and changes in net assets. The statement of cash flows reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities: operating, financing and investing. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund is required to follow accounting standards promulgated by the Governmental Accounting Standards Board.

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 at the end of June 2012 and the last of the contracts expires in 2015.

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

STATEMENTS OF NET ASSETS

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Long-term restricted cash, equivalents and investments | $ 1,186 | $ 1,207 | $ 1,490 |
| Recoverable costs | 5,038 | 4,809 | 4,881 |
| Derivative instruments | - | 7 | 25 |
| Deferral of derivative cash outflows | 2 | 30 | 195 |
| Restricted cash and equivalents: | | | |
| Operating and priority contract accounts | 398 | 1,133 | 1,257 |
| Bond charge collection and bond charge payment accounts | 581 | 618 | 630 |
| Recoverable costs, current portion | 132 | 220 | 339 |
| Interest receivable | 4 | 6 | 7 |
| Other assets | 45 | 79 | 92 |
| Total assets | $ 7,386 | $ 8,109 | $ 8,916 |
| Net assets | $ - | $ - | $ - |
| Long-term debt, including current portion | 7,259 | 7,836 | 8,417 |
| Derivative instruments | 7 | 36 | 203 |
| Deferral of derivative cash inflows | - | 3 | 8 |
| Other current liabilities | 120 | 234 | 288 |
| Total capital and liabilities | $ 7,386 | $ 8,109 | $ 8,916 |

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

The $21 million decrease in long-term restricted cash, equivalents and investments during fiscal 2012 is a result of the reduction in the Operating Reserve Account to $267 million from $288 million. The amount is determined in accordance with the bond indenture and is equal to the maximum one month priority contract cost amount under stress conditions for calendar year 2012 as forecasted in the Fund's 2012 revenue requirement determination. The decrease is caused by lower prospective power costs because purchase power contracts have expired. The Debt Service Reserve Account remained at $919 million as the maximum future annual debt service was unchanged.

The $283 million decrease in long-term restricted cash, equivalents and investments during fiscal 2011 is a combination of a $261 million decrease in the Operating Reserve Account and a $22 million decrease in the Debt Service Reserve Account.

During fiscal 2011, the Operating Reserve Account decreased by $261 million to $288 million. The Debt Service Reserve Account decreased to $919 million from $941 million due to decreased debt service cost assumptions resulting from a bond refunding transaction in October 2010, described in the Long Term Debt section.

### Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The $229 million increase during fiscal 2012 is due to 1) operating expenses exceeding operating revenues by $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 $550 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 is primarily a result of the Fund's rate design which includes funding for annual debt service, including principal payments.

The $72 million decrease during fiscal 2011 is due to 1) operating expenses exceeding operating revenues by $485 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 $557 million.

### Restricted Cash, Equivalents and Investments

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 expire 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 is $151 million higher than forecasted in the Fund’s calendar year 2012 revenue requirement determination.

The Operating and Priority Contract Accounts decreased by $124 million in 2011 due to lower account levels that resulted from reductions in expected expenses as power purchase contracts expire offset by $236 million in cash received from energy settlements. The $1,133 million balance in the Operating and Priority Contract Accounts at June 30, 2011 is $359 million higher than forecasted in the Fund’s calendar year 2011 revenue requirement determination.

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.

The Bond Charge Collection and Bond Charge Payment Accounts decreased by $12 million in 2011 due to increased interest expense from a higher proportion of fixed rate debt in 2011 that resulted from refunding of variable rate debt with fixed rate debt.

### Recoverable Costs, Current Portion

The current portion of recoverable costs reflects power and bond charges to IOU customers that have not yet been collected and amounts due from surplus sales of energy and gas and litigation settlements. The $132 million current portion of recoverable costs at June 30, 2012 is $88 million lower than at June 30, 2011. The decrease is 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.

The $220 million current portion of recoverable costs at June 30, 2011 is $119 million lower than at June 30, 2010. The decrease is primarily due to lower expected remittances from the decline in delivered volumes after the expiration of several purchase power contracts during the year offset by higher surplus gas sales.

### Other Assets

The Fund purchases natural gas as fuel for the production of power under the terms of certain power purchase contracts and maintains a brokerage account with a national brokerage firm in order to hedge natural gas costs. Until 2009 the Fund classified certain collateral assets in the brokerage account and certain bilateral hedge instruments as other assets on the statements of net assets.

As a result of implementing GASB 53, the Fund no longer classifies hedging instruments as other assets. The hedging instruments are now classified as derivative instruments and recorded as either an asset or liability according to the provisions of GASB 53.

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.

At June 30, 2011, other assets were valued at $79 million, and consisted of money market investments, US Treasury bills and government bonds valued at $41 million and other derivative collateral balances including margin deposits valued at $38 million.

### Derivative Instruments - Assets

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.

Derivative assets decreased to $7 million at June 30, 2011 from $25 million at June 30, 2010 due primarily to the reduction in the total size of the natural gas hedging portfolio as purchase power contracts expired and as the Fund significantly reduced its hedge activities.

Deferral of derivative cash outflows decreased to $2 million at June 30, 2012 from $30 million at June 30, 2011 primarily due to the reduction in the total size of the natural gas hedging portfolio.

### Long-Term Debt

Long-term debt decreased to $7,259 million as of June 30, 2012 from $7,836 million as of June 30, 2011. Revenue bond principal payments were $556 million and $460 million in fiscal 2012 and 2011, respectively. Net amortization of bond premium and deferred loss on defeasance were $19 million and $4 million in fiscal 2012 and 2011, 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 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, $159 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.

In fiscal 2011, to address the upcoming expiration of letters of credit and reduce the risk and dependency from credit support providers and interest rate swap counterparties, the Fund completed a refunding of existing debt in October 2010. The proceeds from the October issuance of Series 2010 M fixed rate debt were used to refund $1,054 million in variable rate debt, consisting of $5 million in Series 2002 B bonds, $423 million in Series 2002 C bonds, $409 million in Series 2005 G bonds and $217 million in Series 2008 J bonds. In addition, $813 million of the fixed rate debt Series 2002 A bonds were refunded to lower interest fixed rate bonds. Also, $102 million of the proceeds were used to terminate the remaining $1,053 million in notional value of interest rate swaps. The Series 2010 M bonds were issued with coupons ranging from 1.0% to 5.0%. The bonds were sold at a premium of $183 million and the Fund incurred an accounting loss of $172 million, which includes cost of issuance of $9 million.

With the Series 2010 M refunding transaction, the Fund reduced the amount of outstanding variable rate bonds to $948 million and lowered the amount of expiring credit enhancement capacity needing to be renewed during fiscal 2011 to $605 million. Subsequently, in November 2010, the Fund remarketed the $605 million variable rate bonds outstanding with expiring facilities, with replacement credit facilities and credit providers, all in weekly mode. The new facilities were signed with two year terms expiring by December 1, 2012.

### Other Current Liabilities

Other current liabilities consist of Accounts payable and Accrued interest payable.

Accounts payable at June 30, 2012 is $115 million lower than at June 30, 2011. 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 those long term power contracts. Accounts payable includes $1 million in accrued leave time, which includes vested unpaid vacation, annual leave and other paid leave. Accounts payable also includes $4 million in other post-employment benefits (OPEB).

Accounts payable at June 30, 2011 is $49 million lower than at June 30, 2010. The difference results from lower power costs after the expiration of several 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. Accounts payable includes $1 million in accrued leave time, which includes vested unpaid vacation, annual leave and other paid leave. Also included in accounts payable are $3 million in OPEB.

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

Accrued interest payable at June 30, 2011 is $5 million lower than at June 30, 2010 due to lower fixed interest costs that resulted from a refunding transaction in October 2010.

### Derivative Instruments - Liabilities

The Fund has recorded derivative instruments on the balance sheet for the years ended June 30, 2012, 2011 and 2010 in accordance with GASB 53.

Derivative liability decreased to $7 million at June 30, 2012 from $36 million at June 30, 2011 due to reductions in derivative values for power related activities. In fiscal 2011 derivative liability decreased to $36 million from $203 million at the end of fiscal 2010. Power related derivatives declined due to the reduction in the size of the natural gas hedge portfolio as less natural gas will need to be purchased after the expiration of several power purchase contracts and reductions in purchases of new hedges.

In fiscal 2011, concurrent with the issuance of the Series 2010 M bonds, the Fund terminated all remaining interest rate swaps, paying $102 million in termination payments.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Revenues: | | | |
| Power charges | $ 2 | $ 1,311 | $ 2,915 |
| Surplus sales | 32 | 132 | 108 |
| Bond charges | 861 | 860 | 864 |
| Interest income | 25 | 30 | 36 |
| Total revenues | 920 | 2,333 | 3,923 |
| Expenses: | | | |
| Power purchases | 824 | 2,122 | 2,805 |
| Energy settlements | (35) | (236) | (62) |
| Interest expense | 336 | 333 | 357 |
| Investment Expense | 5 | 16 | 15 |
| Administrative expenses | 21 | 26 | 37 |
| Recovery of recoverable costs | (231) | 72 | 771 |
| Total expenses | 920 | 2,333 | 3,923 |
| Net increase in net assets | - | - | - |
| Net assets, beginning of year | - | - | - |
| Net assets, 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 were $1,309 million lower in fiscal 2012 than in fiscal 2011. The difference is 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. The return of reserves is implemented through an adjustment to Power Charges 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 indenture required levels. During fiscal 2012, the Fund returned $640 million in these monthly payments. The allocation of excess reserves was authorized by the CPUC in Decision 11-12-005.

Power Charges were $1,604 million lower in fiscal 2011 than in fiscal 2010. The difference is due to lower power sales to end use customers as a result of the expiration of several power purchase contracts, lower remittance rates implemented in January 2011 and the return of prior year overcollections and reserves as lower reserve levels are required with the expiration of power purchase contracts.

Power Charges during the last six months of fiscal 2011 also include the effect of the return of excess amounts and previously received remittances as separate monthly payments to ratepayers in the PG&E service territory. During fiscal 2011, the Fund returned $243 million to ratepayers through these payments. The allocation of prior year over-collections and excess reserves was authorized by the CPUC in Decision 10-12-006.

### Surplus Sales

The Fund receives revenue from the sale of excess natural gas and energy from counterparties. . Surplus sales, primarily of surplus natural gas, 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.

Surplus sales for the year ended June 30, 2011 were $24 million higher than the same period in 2010. Higher surplus sales were due to higher volume of natural gas sold due to less gas being needed 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, 2012, 2011 and 2010 were $861 million, $860 million and $864 million, respectively, and were adequate to meet all debt service requirements and maintain bond indenture required account balances in the Bond Charge Collection, Bond Charge Payment, and Debt Service Reserve Accounts. The $1 million increase in 2012 results from slightly higher total volumes due to warmer summer weather.

### Interest Income

Interest income for 2012 was $5 million lower than in 2011, due to lower interest rates earned on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund (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.

Interest income for 2011 was $6 million lower than in 2010, due to declines in the interest rates earned on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund (SMIF). The average yield earned on SMIF for the year ended June 30, 2011 was 0.50% compared to 0.65% for the year ended June 30, 2010.

### Investment Income (Expense)

Under GASB 53, the Fund realizes investment income (expense) 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 expense of ($5) million, ($16) million and ($15) million during the years ended June 30, 2012, 2011 and 2010, respectively.

### Power Purchases

Power costs were $1,298 million lower in fiscal 2012 than in fiscal 2011 and were $683 million lower in fiscal 2011 than in fiscal 2010. The differences are primarily a result of lower volumes purchased as power purchase contracts have expired over the two years.

### 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 2012 totaled $35 million. The Fund received $9 million from the California Independent System Operator (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, San Diego Gas 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.

In fiscal 2011, energy settlements totaled $236 million. The Fund received $233 million in proceeds in settlement of litigation with Sempra Generation to settle various claims involving Sempra and relating to the California energy crisis of 2000 and 2001. Under the terms of the settlement, in exchange for a cash payment by Sempra of approximately $410 million and certain other consideration, Sempra and certain of its affiliates exchanged mutual releases with the Fund, the CPUC, the State Attorney General, SCE and PG&E (the Settling Parties) except for a limited number of enumerated exceptions, the mutual releases cover all claims related to the long term power purchase agreement between the Fund and Sempra, and all claims related to the short-term energy or ancillary services transactions in the western energy markets during 2000 and 2001. The Fund’s proceeds of $233 million from the settlement amounts were allocated by the Settling Parties based on each party’s claims. Under the terms of the settlement the Fund and Sempra continue to perform their respective obligations under the power purchase agreement and the agreement costs will continue to be included in the Fund’s revenue requirement. This settlement was announced in fiscal 2010, but FERC approval was not obtained until late December 2010. The proceeds were received by the Fund in January and February 2011.

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 was $3 million higher in 2012 when compared to 2011. The increase is due primarily to higher interest payments on the current level of fixed rate debt after a refunding of all remaining variable rate debt in August 2011.

Interest expense was $24 million lower in 2011 when compared to 2010. The decrease is due primarily to lower interest rate payments as a result of the refunding transactions in 2010.

### Other Expenses

Other expenses decreased by $5 million in 2012 and by $11 million in 2011 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 (Deferral) of Recoverable Costs

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Operations | $ (781) | $ (485) | $ 227 |
| Debt service and related costs | 550 | 557 | 544 |
| | $ (231) | $ 72 | $ 771 |

Operations
The $781 million deferral in the year ended June 30, 2012 resulted 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 $485 million deferral in the year ended June 30, 2011 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 deferral in 2012 was lower due to lower interest income and higher interest expense.

### LIQUIDITY

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, $159 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.

In fiscal 2011, the Fund reduced the amount of outstanding variable rate bonds to $948 million, and lowered the amount of expiring credit enhancement capacity that needed to be renewed by December 1, 2010 to $605 million. On November 19, 2010 the Fund executed a remarketing of those bonds with replacement credit facilities, completing the renewal or replacement of all current outstanding facilities. After the remarketing, there are no facility expirations until fiscal year 2013.

# Department of Water Resources Electric Power Fund
## Statements of Net Assets
## For the years ending June 30, 2012 and 2011 (in millions)

| | 2012 | 2011 |
|---|---|---|
| **Assets** | | |
| Long-term assets: | | |
| Restricted cash, equivalents and investments: | | |
| Operating Reserve Account | $ 267 | $ 288 |
| Debt Service Reserve Account | 919 | 919 |
| Deferral of derivative cash outflows | 1 | - |
| Recoverable costs | 5,038 | 4,809 |
| Total long-term assets | 6,225 | 6,016 |
| Current assets: | | |
| Restricted cash and equivalents: | | |
| Operating and Priority Contract Accounts | 398 | 1,133 |
| Bond Charge Collection and Bond Charge Payment Accounts | 581 | 618 |
| Recoverable costs, current portion | 132 | 220 |
| Interest receivable | 4 | 6 |
| Derivative instruments, current portion | - | 7 |
| Deferral of derivative cash outflows, current portion | 1 | 30 |
| Other assets | 45 | 79 |
| Total current assets | 1,161 | 2,093 |
| Total assets | $ 7,386 | $ 8,109 |
| **Capitalization and Liabilities** | | |
| Capitalization: | | |
| Net assets | $ - | $ - |
| Long-term debt | 6,667 | 7,275 |
| Non-Current liabilities: | | |
| Derivative instruments | 1 | 3 |
| Total capitalization and non-current liabilities | 6,668 | 7,278 |
| Current liabilities: | | |
| Current portion of long-term debt | 592 | 561 |
| Derivative instruments, current portion | 6 | 33 |
| Deferral of derivative cash inflows, current portion | - | 3 |
| Accounts payable | 63 | 178 |
| Accrued interest payable | 57 | 56 |
| Total current liabilities | 718 | 831 |
| Commitments and Contingencies (Note 6) | | |
| Total capitalization and liabilities | $ 7,386 | $ 8,109 |

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

## Department of Water Resources Electric Power Fund
### Statements of Revenues, Expenses and Changes in Net Assets
### For the years ending June 30, 2012 and 2011 (in millions)

| | 2012 | 2011 |
|---|---|---|
| Operating revenues: | | |
| Power charges | $ 2 | $ 1,311 |
| Surplus sales | 32 | 132 |
| Total operating revenues | 34 | 1,443 |
| Operating expenses: | | |
| Power purchases | 824 | 2,122 |
| Energy settlements | (35) | (236) |
| Administrative expenses | 21 | 26 |
| Recovery (deferral) of recoverable operating costs | (781) | (485) |
| Total operating expenses | 29 | 1,427 |
| Income (Expense) from operations | 5 | 16 |
| Bond charges | 861 | 860 |
| Interest income | 25 | 30 |
| Interest expense | (336) | (333) |
| Investment income from debt related derivatives | 16 | - |
| Investment income (expense) from gas related derivatives | (21) | (16) |
| Recovery of recoverable debt service and related costs | (550) | (557) |
| Net increase in net assets | - | - |
| Net assets, beginning of year | - | - |
| Net assets, 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 ending June 30, 2012 and 2011 (in millions)

| | 2012 | 2011 |
|---|---|---|
| Cash flows from operating activities: | | |
| Receipts: | | |
| Power charges | $ 90 | $ 1,410 |
| Surplus sales | 42 | 136 |
| Energy settlements | 35 | 250 |
| Payments for power purchases and other expenses | (926) | (2,182) |
| Net cash (used in) provided by operating activities | (759) | (386) |
| Cash flows from non-capital financing activities: | | |
| Receipt of bond charges | 855 | 862 |
| Bond Payments | (556) | (460) |
| Interest payments | (354) | (344) |
| Proceeds from issuance of revenue bonds | 1,118 | 1,923 |
| Defeasance of revenue bonds | (1,120) | (2,040) |
| Net cash provided by non-capital financing activities | (57) | (59) |
| Cash flows from investing activities: | | |
| Interest received on investments | 26 | 31 |
| Income received from derivative investments | (3) | (5) |
| Net cash provided by investing activities | 23 | 26 |
| Net increase (decrease) in cash and equivalents | (793) | (419) |
| Restricted cash and equivalents, beginning of period | 2,658 | 3,077 |
| Restricted cash and equivalents, end of period | $ 1,865 | $ 2,658 |
| Restricted cash and equivalents included in: | | |
| Operating Reserve Account | $ 267 | $ 288 |
| Debt Service Reserve Account (a component of the total of $919 and $919 at June 30, 2012 and 2011, respectively) | 619 | 619 |
| Operating and Priority Contract Accounts | 398 | 1,133 |
| Bond Charge Collection and Bond Charge Payment Accounts | 581 | 618 |
| Restricted cash and equivalents, end of year | $ 1,865 | $ 2,658 |
| Reconciliation of operating income to net cash (used in) provided by operating activities: | | |
| Income from operations | $ 5 | $ 16 |
| Adjustments to reconcile operating income to net cash provided by (used in) operating activities: | | |
| (Deferral) recovery of recoverable operating costs | (781) | (485) |
| | (776) | (469) |
| Changes in net assets and liabilities to reconcile operating income to net cash (used in) provided by operations: | | |
| Recoverable costs | 95 | 119 |
| Other assets | 37 | 13 |
| Accounts payable | (115) | (49) |
| Net change in operating assets & liabilities: | 17 | 83 |
| Net cash (used in) provided by operating activities | $ (759) | $ (386) |

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 (a component unit of the State of California) (the Fund), administered by DWR, was established in January 2001 through legislation adding Division 27 to the California Water Code (the Code).

The Fund purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (collectively referred to as the investor owned utilities or IOUs). 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 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 (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 customer rates that meet the Fund's revenue needs to assure the payment of debt service, power purchases, administrative expenses and changes in 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. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, net assets, revenues and expenses.

The financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2012 and 2011, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

**Restricted Cash, Equivalents and Investments**

Under the terms of the Bond 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 must maintain a balance equal to the greater of (i) seven months of projected negative operating cash flows under a stress scenario, as defined, or (ii) twelve percent of projected annual operating expenses of the Fund, as defined.

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, swap payments 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, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- Debt Service Reserve Account: 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, including net scheduled swap payments.

Restricted cash and equivalents, for purposes of the statements of cash flows, include cash on hand and deposits in the State of California Investment Pooled Money Investment Account-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 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 (the 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 market. 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 below.

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 (the FPA). The GICs are carried at cost and the U.S. government backed agency security is carried at amortized cost.

**Net Assets**

The Fund does not record the difference between assets and liabilities as net assets. The difference between assets and liabilities on the balance sheet are recorded in the long term recoverable such that there are no net assets outstanding. The Fund anticipates that amounts in the long term recoverable will be recovered in subsequent years prior to program expiration.

**Other Assets**

The Fund enters into futures and option contracts for the purpose of hedging of natural gas fuel costs. Collateral values, net trade equity and reserve investments held in a brokerage account are accounted for as other assets on the balance sheet. The brokerage firm that facilitates certain of 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, 2012, other assets were valued at $45 million, and consisted of money market investments valued at $35 million and other collateral balances valued at $10 million. At June 30, 2011, other assets consist of money market investments, US Treasury bills and government bonds valued at $79 million.

**Revenues and Recoverable Costs**

The Fund is required to at least annually establish a revenue requirement determination to recover all Fund costs, including debt service. The revenue requirement determination is submitted to the CPUC which then sets customer remittance rates. The Fund's financial statements are prepared in accordance with Topic 980 of the Financial Accounting Standards Board 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 assets as incurred, are recognized when recovered from IOU customers. Costs that are recoverable through future billings are recorded as long-term assets.

Amounts that have been earned but not collected by the Fund are recorded as the current portion of recoverable costs.

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 the IOU customers. Certain customers of "direct access" Electric Service Providers (ESPs) are assessed a "cost responsibility surcharge" that is used by the Fund for the same purposes as power charge revenues. 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 surplus 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, 2012 and 2011, the Fund had the following cash, equivalents and investments (in millions):

| Investment | Maturity | 2012 | | 2011 | |
|---|---|---|---|---|---|
| State of California Pooled Money Investment Account - State Money Investment Fund | 8.8 months avg. | $ | 1,861 | $ | 2,651 |
| Cash | | | 4 | | 7 |
| Total cash and equivalents | | | 1,865 | | 2,658 |
| Guaranteed investment contracts | May 1, 2022 | | 200 | | 200 |
| Forward purchase agreement | November 1, 2012 | | 100 | | 100 |
| | | $ | 2,165 | $ | 2,958 |
| Reconciliation to Statement of Net Assets: | | | | | |
| Operating Reserve Account | | $ | 267 | $ | 288 |
| Debt Service Reserve Account | | | 919 | | 919 |
| Operating and Priority Contract Accounts | | | 398 | | 1,133 |
| Bond Charge Collection and Bond Charge Payment Accounts | | | 581 | | 618 |
| | | $ | 2,165 | $ | 2,958 |

*Custodial Credit Risk:* Custodial credit risk is the risk associated with a lack of diversification, such as having substantial unsecured deposits in a few individual financial institutions, thereby exposing the organization to greater risks resulting from adverse economic, political, regulatory, geographic or credit developments. 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. As of June 30, 2012, none of the Fund's cash balances were uninsured and uncollateralized. As of June 30, 2011, $3 million of the Fund's cash balances were uninsured and uncollateralized.

*Interest Rate Risk:* 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 duration, tend to be more sensitive to changes in interest rates and, therefore, more volatile than those with shorter durations. 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*: 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.

The Fund's investments in the GICs and the Forward Purchase Agreement (FPA) are rated as follows, by Standard & Poor's (S&P) and Moody's, respectively, at June 30, 2012 (in millions):

| | | Amount | S&P | Moody's |
|---|---|---|---|---|
| GIC Providers | | | | |
| FSA | $ | 100 | AA- | Aa3 |
| Royal Bank of Canada | | 100 | AA- | Aa3 |
| | $ | 200 | | |
| FPA Provider | | | | |
| Merrill Lynch: FHLMC Discounted Notes | $ | 100 | AA+ | Aaa |

*Concentration of Credit Risk*: The PMIA's 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 PMIA portfolio.

Interest on deposits in the PMIA varies with the rate of return of the underlying portfolio and approximated 0.4% and 0.5% at June 30, 2012 and 2011, respectively. For the years ended June 30, 2012 and 2011, interest earned on the deposit in the PMIA was $9 million and $15 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, 2012 and 2011.

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, 2012 and 2011.

### 4. Long-Term Debt and Subsequent Event

The following activity occurred in the long-term debt accounts during the years ended June 30, 2012 and 2011 (in millions):

| | Revenue Bonds | Unamortized Premium | Deferred Loss on Defeasance | Deferred Cost of Issuance | Total |
|---|---|---|---|---|---|
| Balance, June 30, 2010 | $ 8,395 | $ 398 | $ (157) | $ (219) | $ 8,417 |
| Refunding | | | | | |
| Issuance of Debt | 1,763 | 183 | - | - | 1,946 |
| Defeasance of Debt | (1,868) | (23) | (25) | (147) | (2,063) |
| Payments | (460) | - | - | - | (460) |
| Amortization | - | (91) | 23 | 64 | (4) |
| Balance, June 30, 2011 | 7,830 | 467 | (159) | (302) | 7,836 |
| Refunding | | | | | |
| Issuance of Debt | 960 | 158 | - | - | 1,118 |
| Defeasance of Debt | (1,106) | (2) | (7) | (5) | (1,120) |
| Payments | (556) | - | - | - | (556) |
| Amortization | - | (117) | 31 | 67 | (19) |
| Balance, June 30, 2012 | 7,128 | 506 | (135) | (240) | 7,259 |
| Less current portion | 574 | 109 | (31) | (60) | 592 |
| | $ 6,554 | $ 397 | $ (104) | $ (180) | $ 6,667 |

Long-term debt consists of the following at June 30, 2012 and 2011, respectively (in millions):

| Series | Rates | Fiscal Year of Final maturity | Fiscal Year of First Call Date | Amount Outstanding 2012 | Amount Outstanding 2011 | Current Portion |
|---|---|---|---|---|---|---|
| A | Fixed (3.8-5.5%) | 2013 | 2012 | $ - | $ 473 | $ - |
| B | Variable | 2020 | Callable | - | 25 | - |
| C | Variable | 2022 | Callable | - | 923 | - |
| F | Fixed (4.38-5.00%) | 2022 | 2018 | 348 | 348 | - |
| G | Fixed (4.35-5.00%) | 2018 | Non-callable | 173 | 173 | - |
| H | Fixed (3.75-5.0%) | 2022 | 2018 | 1,007 | 1,007 | - |
| K | Fixed (4.0-5.0%) | 2018 | Non-callable | 279 | 279 | - |
| L | Fixed (2.5-5.0%) | 2022 | 2020 | 2,708 | 2,919 | - |
| M | Fixed (2.0-5.0%) | 2020 | Non-callable | 1,653 | 1,683 | 419 |
| N | Fixed (2.0-5.0%) | 2021 | Non-callable | 960 | - | 155 |
| | | | | $ 7,128 | $ 7,830 | $ 574 |
| Plus unamortized bond premium | | | | 506 | 467 | 109 |
| Less deferred loss on defeasance | | | | (135) | (159) | (31) |
| Less costs of issuance | | | | (240) | (302) | (60) |
| | | | | $ 7,259 | $ 7,836 | $ 592 |

### 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 basic financial statements. At June 30, 2012 and 2011, there was no outstanding debt and $3.6 million of outstanding debt, respectively, considered to be 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, $159 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 $12 million, which included cost of issuance of $5 million. Bonds payable are reported net of these deferred costs. 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.

In fiscal 2011, the Fund completed a refunding of existing debt in October 2010 to address the upcoming expiration of letters of credit and reduce the risk and dependency from credit support providers and interest rate swap counterparties. The proceeds from the October 2010 issuance of Series 2010 M fixed rate debt were used to refund $1,054 million in variable rate debt, consisting of $5 million in Series 2002 B bonds, $423 million in Series 2002 C bonds, $409 million in Series 2005 G bonds and $217 million in Series 2008 J bonds. In addition, $813 million of the fixed rate debt Series 2002 A bonds were refunded to lower interest fixed rate bonds. Also, $102 million of the proceeds were also used to terminate the remaining $1,053 million in notional value of interest rate. The Series 2010 M bonds were issued with coupons ranging from 1.0% to 5.0%.

With the Series M refunding transaction, the Fund reduced the amount of outstanding variable rate bonds to $948 million and lowered the amount of expiring credit enhancement capacity needing to be renewed during fiscal 2011 to $605 million. Subsequently, in November 2010, the Fund remarketed the $605 million variable rate bonds outstanding with expiring facilities, with replacement credit facilities and credit providers, all in weekly mode. The new facilities were signed with two year terms expiring by December 1, 2012.

**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, 2012 (in millions):

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2013 | $ 574 | $ 340 | $ 914 |
| 2014 | 611 | 314 | 925 |
| 2015 | 618 | 286 | 904 |
| 2016 | 669 | 258 | 927 |
| 2017 | 686 | 227 | 913 |
| 2018-22 | 3,970 | 607 | 4,577 |
| | $ 7,128 | $ 2,032 | $ 9,160 |

## 5. Derivative Financial Instruments

The Fund implemented GASB 53 during the year ended June 30, 2010. GASB 53 requires governments to record derivative instruments on the statement of net assets 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 53 and included on the statements of net assets as of June 30, 2012 and 2011.

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, 2012 and 2011 are summarized in the following tables:

**As of June 30, 2012**

| | | Business-type activities | Value (in mllions) | | Notional | |
|---|---|---|---|---|---|---|
| **Effective hedges** | | | | | | |
| Assets | | | | | | |
| | Current | Gas Swaps | $ | - | - | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | | | $ | - | | |
| Liabilities | | | | | | |
| | Current | Gas Swaps | $ | (1) | 305,000 | MMBtu |
| | Long Term | Gas Swaps | | (1) | 382,500 | MMBtu |
| | | | $ | (2) | | |
| **Investment hedges** | | | | | | |
| Assets | | | | | | |
| | Current | Gas Swaps | $ | - | - | MMBtu |
| | Current | Gas Options | | - | 200,000 | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | Long Term | Gas Options | | - | - | MMBtu |
| | | | $ | - | | |
| Liabilities | | | | | | |
| | Current | Gas Swaps | $ | (5) | 990,000 | MMBtu |
| | Current | Gas Options | | - | - | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | Long Term | Gas Options | | - | - | MMBtu |
| | | | $ | (5) | | |

Note: The Fund holds certain natural gas options in assets that have little value but still offer some price protection.

**As of June 30, 2011**

| | | Business-type activities | Value (in mllions) | | Notional | |
|---|---|---|---|---|---|---|
| **Effective hedges** | | | | | | |
| Assets | | | | | | |
| | Current | Gas Swaps | $ | 3 | 7,485,000 | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | | | $ | 3 | | |
| Liabilities | | | | | | |
| | Current | Gas Swaps | $ | (30) | 16,925,000 | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | | | $ | (30) | | |
| **Investment hedges** | | | | | | |
| Assets | | | | | | |
| | Current | Gas Swaps | $ | 2 | 10,982,500 | MMBtu |
| | Current | Gas Options | | 2 | 33,937,500 | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | Long Term | Gas Options | | - | 200,000 | MMBtu |
| | | | $ | 4 | | |
| Liabilities | | | | | | |
| | Current | Gas Swaps | $ | (3) | 3,250,000 | MMBtu |
| | Current | Gas Options | | - | (1,220,000) | MMBtu |
| | Long Term | Gas Swaps | | - | - | MMBtu |
| | Long Term | Gas Options | | (3) | 990,000 | MMBtu |
| | | | $ | (6) | | |

Note: The Fund holds certain natural gas options in assets and liabilities that have little value but still offer some price protection.

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 assets as derivative instruments. Changes in fair value for effective hedges are recorded in the statement of net assets as deferred cash inflows or outflows. Changes in fair value for ineffective gas hedges are recorded as investment expense from gas related contracts on the statement of revenues, expenses and changes in net assets.

**Commodity contracts**

The Fund enters into forward gas futures and options contracts to hedge the cost of natural gas. Most of the Fund's forward gas futures are being treated as Normal Purchase Normal Sale (NPNS) contracts and are therefore not required to be recorded prior to settlement. Forward gas futures not qualifying as NPNS are recorded on the statements of net assets at fair value. All natural gas options are treated as derivatives and are classified as investment derivatives since they do not meet GASB 53 hedging criteria.

For the Fund's gas hedging contracts that are effective hedges, unrealized gains and losses are deferred on the statement of net assets as current assets or liabilities for contracts with less than 12 months remaining until expiration, or as long-term assets or liabilities for contracts with over 12 months remaining until expiration. The deferred amount recorded on the statements of net assets reflects the deferred inflow or outflow associated with the derivative financial instruments.

Changes in fair value of derivatives that are classified as investment derivatives are included as investment income (expense) on the statement of revenues, expenses and changes in net assets.

*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, 2012 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.

As of June 30, 2011, the Fund's open natural gas hedge positions were with nine different counterparties, all of which have credit ratings of at least A-/Baa1. At June 30, 2011, the Fund had credit risk exposure to three counterparties totaling $2 million, representing transactions with market values that are in the Fund's favor. There was no substantial credit exposure to the remaining six counterparties, as the decrease of natural gas prices has resulted in valuations in the counterparties' favor and fewer hedges are outstanding as the need for natural gas has decreased with the expiration of power purchase contracts. The remaining gas hedge positions 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.

### Interest Rate Swaps

In fiscal 2011, the Fund terminated all remaining interest rate swaps for $102 million to settle the negative fair market value of the swap agreements. The interest rate swap derivative values were removed from the statements of net assets and the loss incurred on termination is being deferred and amortized as part of the refunding transaction.

In prior years, the Fund entered into interest rate swap agreements with various counterparties to reduce variable interest rate risk. The pay-fixed swaps created a synthetic fixed rate for the Fund. The Fund had agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of the Fund's variable rate debt.

The notional amounts of the swaps matched the principal amounts of the associated debt. The swap agreements contained scheduled reductions in notional amounts that follow scheduled amortization of the associated debt.

Net amounts paid under all swaps amounted to $10 million in fiscal 2011.

## 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 $3,500 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 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 $5,000 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. 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.

Accordingly, although subject to uncertainty, the Fund expects it likely will be a net refund recipient in the FERC proceedings. Due to pending litigation that could significantly increase or decrease the level of the refunds the Fund would be entitled to receive, the Fund has not recorded any amounts related to this issue. However, the Fund does not expect that FERC will order it to pay more in refunds than it receives on a market-wide basis.

*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 three power purchase contracts remain after June 30, 2012.

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

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

### Other Contingencies

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

### Commitments

The Fund has power purchase contracts that have remaining lives of up to four years. Payments under these and gas purchase contracts approximated $824 million and $2,122 million for fiscal 2012 and 2011, 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, 2012, are as follows (in millions):

| For the Year Ending June 30, | Fixed Obligation (in millions) |
|---|---|
| 2013 | $ 42 |
| 2014 | 34 |
| 2015 | 25 |
| 2016 | 16 |
| 2017 | 15 |
| 2018 | 12 |
| | $ 144 |

In addition to the fixed costs, there are variable costs under several of the contracts. Management projected as of June 30, 2012 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate $159 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 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 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 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, San Diego Gas 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.

In fiscal 2011, energy settlements totaled $236 million. The Fund received $233 million in proceeds in settlement of litigation with Sempra Generation to settle various claims involving Sempra and relating to the California energy crisis of 2000 and 2001. Under the terms of the settlement, in exchange for a cash payment by Sempra of approximately $410 million and certain other consideration, Sempra and certain of its affiliates exchanged mutual releases with the Fund, the CPUC, the State Attorney General, SCE and PG&E (the Settling Parties) except for a limited number of enumerated exceptions, the mutual releases cover all claims related to the long term power purchase agreement between the Fund and Sempra, and all claims related to the short-term energy or ancillary services transactions in the western energy markets during 2000 and 2001. The Fund's proceeds of $233 million from the settlement amounts were allocated by the Settling Parties based on each party's claims. Under the terms of the settlement the Fund and Sempra continue to perform their respective obligations under the power purchase agreement and the agreement costs will continue to be included in the Fund's revenue requirement. This settlement was announced in fiscal 2010, but FERC approval was not obtained until late December 2010. The proceeds were received by the Fund in January and February 2011.

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 Postretirement 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, 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 per year.

### Postretirement Benefits

In addition to the pension benefits, the State of California provides post-retirement 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 postretirement benefits on a pay-as-you-go basis. The annual required contribution for the Fund amounted to $1.0 million for the years ended June 30, 2012 and 2011, respectively. The Fund's net OPEB obligation increased by $1 million at June 30, 2012 to $4 million. The Fund's annual required contribution represents 0.02% of the State's total annual required contribution for the year ended June 30, 2012. The State's unfunded actuarial accrued liability at July 1, 2011 attributable to all State employees is $62,140 million.