



U.S. Department of Energy
Office of Inspector General
Office of Audits and Inspections

Audit Report

Southwestern Federal Power System's Fiscal Year 2010 Financial Statement Audit



Department of Energy
Washington, DC 20585

July 30, 2012

MEMORANDUM FOR THE ADMINISTRATOR, SOUTHWESTERN POWER
ADMINISTRATION

FROM: *Daniel M. Weeber*
Daniel M. Weeber
Assistant Inspector General
for Audits and Administration
Office of Inspector General

SUBJECT: INFORMATION: Southwestern Federal Power System's Fiscal Year
2010 Financial Statement Audit

The attached report present the results of the independent certified public accountants' audit of the Southwestern Federal Power System's (SWFPS) combined balance sheets, as of September 30, 2010 and 2009, and the related combined statements of revenues and expenses, changes in net Federal investment and cash flows.

To fulfill the Office of Inspector General's (OIG) audit responsibilities, we contracted with the independent public accounting firm of KPMG, LLP (KPMG) to conduct the audit, subject to our review. KPMG is responsible for expressing an opinion on the SWFPS's financial statements and reporting on applicable internal controls and compliance with laws and regulations. The OIG monitored audit progress and reviewed the audit report and related documentation. This review disclosed no instances where KPMG did not comply, in all material respects, with generally accepted Government auditing standards. The OIG did not express an independent opinion on the SWFPS's financial statements.

KPMG concluded that the combined financial statements fairly present, in all material respects, the respective financial position of the Southwestern Federal Power System as of September 30, 2010 and 2009, and the results of its operations and its cash flow for the years then ended, in conformity with United States generally accepted accounting principles.

As part of this review, the auditors also considered the SWFPS's internal controls over financial reporting and tested for compliance with certain provisions of laws, regulations, contracts and grant agreements that could have a direct and material effect on the determination of financial statement amounts. The audit identified the following deficiencies in internal control over financial reporting, as reported in the Independent Auditor's Report on Internal Control over Financial Reporting based on the Southwestern Federal Power System's Fiscal Year 2006, 2007, 2008 and 2009 Financial Statement Audits, which were considered to be material weaknesses:

- Four internal control deficiencies were identified over accounting for utility plant, each of which were considered to be significant. When combined together, these four conditions were considered a material weakness; and,
- Five internal control deficiencies were identified over Accounting Policies and Procedures, each of which were considered to be significant. When combined together, these five conditions were considered a material weakness.

U.S. Army Corps of Engineers and Southwestern Power Administration management agreed with the findings and recommendations that pertained to them and agreed to take necessary corrective action by June 30, 2012.

The audit disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Report No.: OAS-FS-12-10

Attachment

cc: Acting Deputy Chief Financial Officer, CF-2
Director, Office of Finance and Accounting, CF-10
Director, Financial Management Division, Southwestern Power Administration
Director, Office of Financial Risk, Policy and Controls, CF-50
Assistant Director, Office of Financial Risk, Policy and Controls, CF-50
Audit Resolution Specialist, Office of Financial Risk, Policy and Controls, CF-50
Team Leader, Office of Financial Risk, Policy and Controls, CF-50



SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Financial Statements

September 30, 2010 and 2009

(With Independent Auditors' Report Thereon)



KPMG LLP
Suite 310
100 West Fifth Street
Tulsa, OK 74103

Independent Auditors' Report

Administrator, The Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:

We have audited the accompanying combined balance sheets of the Southwestern Federal Power System (SWFPS), as of September 30, 2010 and 2009, and the related combined statements of changes in net Federal investment, revenues and expenses, and cash flows for the years then ended. As described in note 1(a), the combined financial statement presentation includes all of the hydroelectric generating and power operations of one federal agency (hereinafter referred to as the generating agency), and the transmission and disposition of the related power by the Southwestern Power Administration (Southwestern), a separate federal agency. These combined financial statements are the responsibility of the managements of Southwestern and the generating agency. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the combined 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 Southwestern and the generating agency'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 combined financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the respective financial position of the Southwestern Federal Power System, as of September 30, 2010 and 2009, and the results of its operations and its cash flow for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our reports dated June 18, 2012 on our consideration of Southwestern and the generating agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Our audits were conducted for the purpose of forming an opinion on the 2010 and 2009 SWFPS's combined financial statements taken as a whole. The supplementary information in the combining financial statements is presented for purposes of additional analysis and is not a required part of the basic combined financial statements. The supplementary information has been subjected to the auditing procedures applied in the audit of the basic combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic combined financial statements taken as a whole.

KPMG LLP

June 18, 2012

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Balance Sheets

September 30, 2010 and 2009

Assets	<u>2010</u>	<u>2009</u>
Utility plant:		
Plant in service	\$ 1,377,538,963	1,349,499,896
Accumulated depreciation	(622,185,997)	(608,686,560)
Construction work in progress	139,153,832	112,616,706
Net utility plant	<u>894,506,798</u>	<u>853,430,042</u>
Current assets:		
Cash	239,419,661	208,531,459
Funds held in escrow	48,913,656	56,882,873
Accounts receivable	17,451,483	14,295,361
Material and supplies, at average cost	2,210,042	2,511,866
Total current assets	307,994,842	282,221,559
Banking exchange receivables	3,492,029	3,360,544
Deferred workers' compensation	15,687,514	16,679,751
Other assets	22,189,755	30,821,588
Total assets	<u>\$ 1,243,870,938</u>	<u>1,186,513,484</u>
Federal Investment and Liabilities		
Federal Investment:		
Net investment of U.S. government	\$ 887,066,788	883,672,623
Accumulated net revenues	243,535,704	220,102,353
Total Federal investment	<u>1,130,602,492</u>	<u>1,103,774,976</u>
Current liabilities:		
Accounts payable and accrued liabilities	9,835,341	11,954,483
Advances for construction	16,957,829	22,244,110
Total current liabilities	26,793,170	34,198,593
Accrued workers' compensation	16,890,284	17,841,615
Purchased power and banking exchange deferral	47,832,866	30,698,300
Hydropower water storage reallocation deferral	21,752,126	—
Total liabilities	113,268,446	82,738,508
Commitments and contingencies (notes 5 and 6)		
Total Federal Investment and Liabilities	<u>\$ 1,243,870,938</u>	<u>1,186,513,484</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Balance Sheet Data

September 30, 2010

Assets	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 298,976,824	1,078,562,139	1,377,538,963
Accumulated depreciation	(141,870,612)	(480,315,385)	(622,185,997)
Construction work in progress	19,153,942	119,999,890	139,153,832
Net utility plant	<u>176,260,154</u>	<u>718,246,644</u>	<u>894,506,798</u>
Current assets:			
Cash	77,463,789	161,955,872	239,419,661
Funds held in escrow	19,501,069	29,412,587	48,913,656
Accounts receivable	17,371,647	79,836	17,451,483
Material and supplies, at average cost	2,210,042		2,210,042
Total current assets	<u>116,546,547</u>	<u>191,448,295</u>	<u>307,994,842</u>
Banking exchange receivables	3,492,029	—	3,492,029
Deferred workers' compensation	3,798,002	11,889,512	15,687,514
Other assets	22,189,755	—	22,189,755
Total assets	<u>\$ 322,286,487</u>	<u>921,584,451</u>	<u>1,243,870,938</u>
Federal Investment and Liabilities			
Federal Investment:			
Net investment of U.S. government	\$ 143,611,177	743,455,611	887,066,788
Accumulated net revenues	81,295,933	162,239,771	243,535,704
Total Federal investment	<u>224,907,110</u>	<u>905,695,382</u>	<u>1,130,602,492</u>
Current liabilities:			
Accounts payable and accrued liabilities	6,151,898	3,683,443	9,835,341
Advances for construction	16,957,829	—	16,957,829
Total current liabilities	<u>23,109,727</u>	<u>3,683,443</u>	<u>26,793,170</u>
Accrued workers' compensation	4,684,658	12,205,626	16,890,284
Purchased power and banking exchange deferral	47,832,866	—	47,832,866
Hydropower water storage reallocation deferral	21,752,126	—	21,752,126
Total liabilities	<u>97,379,377</u>	<u>15,889,069</u>	<u>113,268,446</u>
Commitments and contingencies (notes 5 and 6)			
Total federal investment and liabilities	<u>\$ 322,286,487</u>	<u>921,584,451</u>	<u>1,243,870,938</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Balance Sheet Data

September 30, 2009

Assets	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 280,587,206	1,068,912,690	1,349,499,896
Accumulated depreciation	(141,398,600)	(467,287,960)	(608,686,560)
Construction work in progress	26,760,007	85,856,699	112,616,706
Net utility plant	<u>165,948,613</u>	<u>687,481,429</u>	<u>853,430,042</u>
Current assets:			
Cash	66,763,859	141,767,600	208,531,459
Funds held in escrow	24,501,415	32,381,458	56,882,873
Accounts receivable	13,801,756	493,605	14,295,361
Material and supplies, at average cost	2,290,127	221,739	2,511,866
Total current assets	<u>107,357,157</u>	<u>174,864,402</u>	<u>282,221,559</u>
Banking exchange receivables	3,360,544	—	3,360,544
Deferred workers' compensation	3,787,931	12,891,820	16,679,751
Other assets	30,821,588	—	30,821,588
Total assets	<u>\$ 311,275,833</u>	<u>875,237,651</u>	<u>1,186,513,484</u>
Federal Investment and Liabilities			
Federal Investment:			
Net investment of U.S. government	\$ 141,849,869	741,822,754	883,672,623
Accumulated net revenues	106,696,922	113,405,431	220,102,353
Total Federal investment	<u>248,546,791</u>	<u>855,228,185</u>	<u>1,103,774,976</u>
Current liabilities:			
Accounts payable and accrued liabilities	5,179,260	6,775,223	11,954,483
Advances for construction	22,244,110	—	22,244,110
Hydropower water storage reallocation deferral	—	—	—
Total current liabilities	<u>27,423,370</u>	<u>6,775,223</u>	<u>34,198,593</u>
Accrued workers' compensation	4,607,372	13,234,243	17,841,615
Purchased power and banking exchange deferral	30,698,300	—	30,698,300
Hydropower water storage reallocation deferral	—	—	—
Total liabilities	<u>62,729,042</u>	<u>20,009,466</u>	<u>82,738,508</u>
Commitments and contingencies (notes 5 and 6)			
Total federal investment and liabilities	<u>\$ 311,275,833</u>	<u>875,237,651</u>	<u>1,186,513,484</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM
 Combined Statements of Changes in Net Federal Investment
 Years ended September 30, 2010 and 2009

	Net investment of U.S. government	Accumulated net revenues	Total federal investment
Total Federal investment as of September 30, 2008	\$ 841,516,494	162,209,865	1,003,726,359
Additions:			
Congressional appropriations	143,443,238	17,730,000	161,173,238
Interest on Federal investment and other	17,761,900	—	17,761,900
Total additions to net Federal investment	<u>161,205,138</u>	<u>17,730,000</u>	<u>178,935,138</u>
Deductions:			
Funds returned to Treasury	(124,315,915)	—	(124,315,915)
Transfer to/from other Federal agencies, net	5,266,906	—	5,266,906
Total deductions to Federal investment	<u>(119,049,009)</u>	<u>—</u>	<u>(119,049,009)</u>
Net revenues for 2009	<u>—</u>	<u>40,162,488</u>	<u>40,162,488</u>
Total Federal investment as of September 30, 2009	<u>883,672,623</u>	<u>220,102,353</u>	<u>1,103,774,976</u>
Additions:			
Congressional appropriations	125,566,027	—	125,566,027
Interest on Federal investment and other	16,397,365	—	16,397,365
Total additions to net Federal investment	<u>141,963,392</u>	<u>—</u>	<u>141,963,392</u>
Deductions:			
Funds returned to Treasury	(138,536,376)	—	(138,536,376)
Transfer to/from other Federal agencies, net	(32,851)	—	(32,851)
Total deductions to Federal investment	<u>(138,569,227)</u>	<u>—</u>	<u>(138,569,227)</u>
Net revenues for 2010	<u>—</u>	<u>23,433,351</u>	<u>23,433,351</u>
Total Federal investment as of September 30, 2010	<u>\$ 887,066,788</u>	<u>243,535,704</u>	<u>1,130,602,492</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Changes in Net Federal Investment Data

Years ended September 30, 2010 and 2009

	Southwestern net investment of U.S. government	Southwestern accumulated net revenues (deficit)	Southwestern total federal investment	Corps net investment of U.S. government	Corps accumulated net revenues (deficit)	Corps total federal investment	Total federal investments
Total Federal investment as of September 30, 2008	\$ 133,697,835	86,434,184	220,132,019	707,818,659	75,775,681	783,594,340	1,003,726,359
Additions:							
Congressional appropriations	28,414,000	17,730,000	46,144,000	115,029,238	—	115,029,238	161,173,238
Interest on Federal investment and other	3,430,945	—	3,430,945	14,330,955	—	14,330,955	17,761,900
Total additions to net Federal investment	<u>31,844,945</u>	<u>17,730,000</u>	<u>49,574,945</u>	<u>129,360,193</u>	<u>—</u>	<u>129,360,193</u>	<u>178,935,138</u>
Deductions:							
Funds returned to Treasury	(11,204,990)	—	(11,204,990)	(113,110,925)	—	(113,110,925)	(124,315,915)
Transfer to/from other Federal agencies, net	(12,487,921)	—	(12,487,921)	17,754,827	—	17,754,827	5,266,906
Total deductions to Federal investment	<u>(23,692,911)</u>	<u>—</u>	<u>(23,692,911)</u>	<u>(95,356,098)</u>	<u>—</u>	<u>(95,356,098)</u>	<u>(119,049,009)</u>
Net revenues (deficit) for 2009	<u>—</u>	<u>2,532,738</u>	<u>2,532,738</u>	<u>—</u>	<u>37,629,750</u>	<u>37,629,750</u>	<u>40,162,488</u>
Total Federal investment as of September 30, 2009	<u>141,849,869</u>	<u>106,696,922</u>	<u>248,546,791</u>	<u>741,822,754</u>	<u>113,405,431</u>	<u>855,228,185</u>	<u>1,103,774,976</u>
Additions:							
Congressional appropriations	13,076,000	—	13,076,000	112,490,027	—	112,490,027	125,566,027
Interest on Federal investment and other	3,020,246	—	3,020,246	13,377,119	—	13,377,119	16,397,365
Total additions to net Federal investment	<u>16,096,246</u>	<u>—</u>	<u>16,096,246</u>	<u>125,867,146</u>	<u>—</u>	<u>125,867,146</u>	<u>141,963,392</u>
Deductions:							
Funds returned to Treasury	443,279	—	443,279	(138,979,655)	—	(138,979,655)	(138,536,376)
Transfer to/from other Federal agencies, net	(14,778,217)	—	(14,778,217)	14,745,366	—	14,745,366	(32,851)
Total deductions to Federal investment	<u>(14,334,938)</u>	<u>—</u>	<u>(14,334,938)</u>	<u>(124,234,289)</u>	<u>—</u>	<u>(124,234,289)</u>	<u>(138,569,227)</u>
Net revenues (deficit) for 2010	<u>—</u>	<u>(25,400,989)</u>	<u>(25,400,989)</u>	<u>—</u>	<u>48,834,340</u>	<u>48,834,340</u>	<u>23,433,351</u>
Total Federal investment as of September 30, 2010	\$ <u>143,611,177</u>	<u>81,295,933</u>	<u>224,907,110</u>	<u>743,455,611</u>	<u>162,239,771</u>	<u>905,695,382</u>	<u>1,130,602,492</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Revenues and Expenses

Years ended September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Operating revenues:		
Sales of electric power	\$ 182,808,151	166,999,249
Transmission and other operating revenues	<u>22,112,654</u>	<u>16,236,646</u>
Total operating revenues before deferrals	204,920,805	183,235,895
Net purchased power and banking exchange deferral	<u>(15,679,782)</u>	<u>(23,647,784)</u>
Total operating revenues	189,241,023	159,588,111
Non reimbursable revenues	<u>453,029</u>	<u>798,830</u>
Total revenues	<u>189,694,052</u>	<u>160,386,941</u>
Operating expenses:		
Operation and maintenance	80,501,155	61,537,944
Purchased power and banking exchange	4,121,266	2,674,735
Depreciation and amortization	29,116,177	29,305,410
Transmission service charges by others	3,074,161	3,093,593
Retirement and other employee benefit expense	7,353,818	6,346,124
Non reimbursable expenses	<u>27,350,877</u>	<u>1,300,718</u>
Total operating expenses	<u>151,517,454</u>	<u>104,258,524</u>
Net operating revenues	<u>38,176,598</u>	<u>56,128,417</u>
Interest expense:		
Interest on Federal investment and other	17,933,659	18,182,717
Allowance for funds used during construction	<u>(3,190,412)</u>	<u>(2,216,788)</u>
Net interest expense	<u>14,743,247</u>	<u>15,965,929</u>
Net revenues	<u>\$ 23,433,351</u>	<u>40,162,488</u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Revenues and Expenses Data

Year ended September 30, 2010

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Operating revenues:			
Sales of electric power	\$ 182,808,151	—	182,808,151
Transmission and other operating revenues	19,491,730	2,620,924	22,112,654
Total operating revenues before deferrals	202,299,881	2,620,924	204,920,805
Net purchased power and banking exchange deferral	(15,679,782)	—	(15,679,782)
Revenue distributed to Corps	(132,497,234)	132,497,234	—
Total operating revenues	54,122,865	135,118,158	189,241,023
Non reimbursable revenues	421,900	31,129	453,029
Total revenues	54,544,765	135,149,287	189,694,052
Operating expenses:			
Operation and maintenance	24,045,326	56,455,829	80,501,155
Purchased power and banking exchange	4,121,266	—	4,121,266
Depreciation and amortization	13,718,157	15,398,020	29,116,177
Transmission service charges by others	3,074,161	—	3,074,161
Retirement and other employee benefit expense	4,801,605	2,552,213	7,353,818
Non reimbursable expenses	27,350,877	—	27,350,877
Total operating expenses	77,111,392	74,406,062	151,517,454
Net operating revenues (deficit)	(22,566,627)	60,743,225	38,176,598
Interest expense:			
Interest on Federal investment and other	4,553,825	13,379,834	17,933,659
Allowance for funds used during construction	(1,719,463)	(1,470,949)	(3,190,412)
Net interest expense	2,834,362	11,908,885	14,743,247
Net revenues (deficit)	\$ (25,400,989)	48,834,340	23,433,351
Accumulated net revenues (deficit):			
Balance, beginning of year	\$ 106,696,922	113,405,431	220,102,353
Congressional appropriations	—	—	—
Net revenues (deficit)	(25,400,989)	48,834,340	23,433,351
Balance, end of year	\$ 81,295,933	162,239,771	243,535,704

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Revenues and Expenses Data

Year ended September 30, 2009

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Operating revenues:			
Sales of electric power	\$ 166,999,249	—	166,999,249
Transmission and other operating revenues	<u>14,987,972</u>	<u>1,248,674</u>	<u>16,236,646</u>
Total operating revenues before deferrals	181,987,221	1,248,674	183,235,895
Net purchased power and banking exchange deferral	(23,647,784)	—	(23,647,784)
Revenue distributed to Corps	<u>(108,625,473)</u>	<u>108,625,473</u>	<u>—</u>
Total operating revenues	49,713,964	109,874,147	159,588,111
Non reimbursable revenues	<u>701,452</u>	<u>97,378</u>	<u>798,830</u>
Total revenues	<u>50,415,416</u>	<u>109,971,525</u>	<u>160,386,941</u>
Operating expenses:			
Operation and maintenance	21,298,669	40,239,275	61,537,944
Purchased power and banking exchange	2,674,735	—	2,674,735
Depreciation and amortization	12,288,093	17,017,317	29,305,410
Transmission service charges by others	3,093,593	—	3,093,593
Retirement and other employee benefit expense	4,278,137	2,067,987	6,346,124
Non reimbursable expenses	<u>1,300,718</u>	<u>—</u>	<u>1,300,718</u>
Total operating expenses	<u>44,933,945</u>	<u>59,324,579</u>	<u>104,258,524</u>
Net operating revenues	<u>5,481,471</u>	<u>50,646,946</u>	<u>56,128,417</u>
Interest expense:			
Interest on Federal investment and other	4,088,168	14,094,549	18,182,717
Allowance for funds used during construction	<u>(1,139,435)</u>	<u>(1,077,353)</u>	<u>(2,216,788)</u>
Net interest expense	<u>2,948,733</u>	<u>13,017,196</u>	<u>15,965,929</u>
Net revenues	\$ <u><u>2,532,738</u></u>	<u><u>37,629,750</u></u>	<u><u>40,162,488</u></u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Cash Flows

Years ended September 30, 2010 and 2009

	2010	2009
Cash provided by operating activities:		
Net revenues	\$ 23,433,351	40,162,488
Adjustments to reconcile net revenues to net cash provided by operating activities:		
Depreciation and amortization	29,116,177	29,305,410
Benefit expense paid by other Federal agencies	3,880,912	3,012,173
Interest expense on Federal investment and other	16,397,365	17,761,900
Allowance for funds used during construction	(3,190,412)	(2,216,788)
(Increase) decrease in assets:		
Accounts receivable	(3,156,122)	2,188,908
Materials and supplies	301,824	97,222
Banking exchange receivables	(131,485)	560,275
Deferred workers' compensation	992,237	207,847
Other assets	8,631,833	(7,944,418)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(2,119,142)	3,315,333
Accrued workers' compensation	(951,331)	(236,263)
Purchased power and banking exchange deferral	17,134,566	24,265,206
Advances for construction	(5,286,281)	10,505,544
Net cash provided by operating activities	85,053,492	120,984,837
Cash used in investing activities:		
Additions to utility plant	(67,002,521)	(60,774,397)
Cash provided by (used in) financing activities:		
Congressional appropriations	125,566,027	161,173,238
Funds returned to U.S. Treasury	(138,536,376)	(124,315,915)
Transfer to/from other Federal agencies	(3,913,763)	2,254,733
Hydropower water storage reallocation deferral	21,752,126	—
Funds held in escrow	7,969,217	(16,508,544)
Net cash provided by (used in) financing activities	12,837,231	22,603,512
Net increase in cash	30,888,202	82,813,952
Cash at beginning of year	208,531,459	125,717,507
Cash at end of year	\$ 239,419,661	208,531,459

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Cash Flows Data

Year ended September 30, 2010

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Cash provided by operating activities:			
Net revenues (deficit)	\$ (25,400,989)	48,834,340	23,433,351
Adjustments to reconcile net revenues to net cash provided by (used in) operating activities:			
Revenue distributed to Corps	132,497,234	(132,497,234)	—
Depreciation and amortization	13,718,157	15,398,020	29,116,177
Benefit expense paid by other Federal agencies	1,644,005	2,236,907	3,880,912
Interest expense on Federal investment and other	3,020,246	13,377,119	16,397,365
Allowance for funds used during construction	(1,719,463)	(1,470,949)	(3,190,412)
(Increase) decrease in assets:			
Accounts receivable	(3,569,891)	413,769	(3,156,122)
Materials and supplies	80,085	221,739	301,824
Banking exchange receivables	(131,485)	—	(131,485)
Deferred workers' compensation	(10,071)	1,002,308	992,237
Other assets	8,631,833	—	8,631,833
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	972,638	(3,091,780)	(2,119,142)
Accrued workers' compensation	77,286	(1,028,617)	(951,331)
Purchased power and banking exchange deferral	17,134,566	—	17,134,566
Advances for construction	(5,286,281)	—	(5,286,281)
Net cash provided by operating activities	<u>141,657,870</u>	<u>(56,604,378)</u>	<u>85,053,492</u>
Cash used in investing activities:			
Additions to utility plant	(22,310,235)	(44,692,286)	(67,002,521)
Cash provided by (used in) financing activities:			
Congressional appropriations	13,076,000	112,490,027	125,566,027
Funds returned to U.S. Treasury	(132,053,955)	(6,482,421)	(138,536,376)
Transfer to/from other Federal agencies	(16,422,222)	12,508,459	(3,913,763)
Hydropower water storage reallocation deferral	21,752,126	—	21,752,126
Funds held in escrow	5,000,346	2,968,871	7,969,217
Net cash used in financing activities	<u>(108,647,705)</u>	<u>121,484,936</u>	<u>12,837,231</u>
Net increase in cash	10,699,930	20,188,272	30,888,202
Cash at beginning of year	<u>66,763,859</u>	<u>141,767,600</u>	<u>208,531,459</u>
Cash at end of year	\$ <u><u>77,463,789</u></u>	<u><u>161,955,872</u></u>	<u><u>239,419,661</u></u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Cash Flows Data

Year ended September 30, 2009

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Cash provided by operating activities:			
Net revenues	\$ 2,532,738	37,629,750	40,162,488
Adjustments to reconcile net revenues to net cash provided by (used in) operating activities:			
Revenue distributed to Corps	108,625,473	(108,625,473)	—
Depreciation and amortization	12,288,093	17,017,317	29,305,410
Benefit expense paid by other Federal agencies	1,286,608	1,725,565	3,012,173
Interest expense on Federal investment and other	3,430,945	14,330,955	17,761,900
Allowance for funds used during construction	(1,139,435)	(1,077,353)	(2,216,788)
(Increase) decrease in assets:			
Accounts receivable	2,503,714	(314,806)	2,188,908
Materials and supplies	97,222	—	97,222
Banking exchange receivables	560,275	—	560,275
Deferred workers' compensation	34,860	172,987	207,847
Other assets	(7,944,418)	—	(7,944,418)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	(688,295)	4,003,628	3,315,333
Accrued workers' compensation	(61,002)	(175,261)	(236,263)
Purchased power and banking exchange deferral	24,265,206	—	24,265,206
Advances for construction	10,505,544	—	10,505,544
Net cash provided by operating activities	<u>156,297,528</u>	<u>(35,312,691)</u>	<u>120,984,837</u>
Cash used in investing activities:			
Additions to utility plant	(21,249,904)	(39,524,493)	(60,774,397)
Cash provided by (used in) financing activities:			
Congressional appropriations	46,144,000	115,029,238	161,173,238
Funds returned to U.S. Treasury	(119,830,463)	(4,485,452)	(124,315,915)
Transfer to/from other Federal agencies	(13,774,529)	16,029,262	2,254,733
Hydropower water storage reallocation deferral	—	—	—
Funds held in escrow	(18,731,166)	2,222,622	(16,508,544)
Net cash used in financing activities	<u>(106,192,158)</u>	<u>128,795,670</u>	<u>22,603,512</u>
Net increase in cash	28,855,466	53,958,486	82,813,952
Cash at beginning of year	<u>37,908,393</u>	<u>87,809,114</u>	<u>125,717,507</u>
Cash at end of year	\$ <u><u>66,763,859</u></u>	<u><u>141,767,600</u></u>	<u><u>208,531,459</u></u>

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

(1) Summary of Significant Accounting Policies

(a) *General Information and Basis of Preparation of Financial Statements*

The Southwestern Federal Power System (SWFPS) financial statements combine all of the activities associated with the production, transmission, and disposition of all Federal power marketed by the Southwestern Power Administration (Southwestern), an agency of the U.S. Department of Energy (DOE). The accompanying combined financial statements include the accounts of Southwestern and the related hydroelectric generating facilities and power operations of the U.S. Army Corps of Engineers (Corps), an agency of the U.S. Department of Defense (DOD). Southwestern and the Corps are separately managed and financed and each maintains their own accounting records. For purposes of financial and operational reporting, the facilities and related operations of Southwestern and the Corps (power purpose) are combined as SWFPS.

The Corps has constructed and operates hydroelectric generating facilities in the states of Arkansas, Missouri, Oklahoma, and Texas. Operating expenses and net assets of multi-purpose Corps projects are allocated to power and nonpower purposes (primarily irrigation, recreation, and flood control). Only the portion of such project costs and net assets allocated to power are included in the combined financial statements. Southwestern, as designated by the Secretary of Energy, transmits and markets power generated from these hydroelectric generating facilities.

The SWFPS is subject to the accounting regulations of the Federal Energy Regulatory Commission (FERC). Accounts are maintained in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) as established by Financial Accounting Standards Board (FASB), the uniform system of accounts prescribed for electric utilities by the FERC, the accounting practices and standards established by the DOE and DOD, and the requirements of specific legislation and executive directives issued by government agencies. SWFPS's combined financial statements follow the accounting and reporting guidance contained in FASB Accounting Standards Codification (ASC) Topic 980, *Regulated Operations*. Allocation of costs and revenues to accounting periods for rate-making and regulatory purposes may differ from bases generally applied by nonregulated companies. Such allocations to meet regulatory accounting requirements are considered to be U.S. GAAP for regulated utilities provided that there is a demonstrable ability to recover any deferred costs in future rates and such costs or revenues are accounted for as regulatory assets or liabilities.

(b) *Confirmation and Approval of New Rates*

SWFPS is not a public utility within the jurisdiction of FERC under the Federal Power Act. Under a Delegation Order issued by the Secretary of Energy, the Administrator of Southwestern has the authority to develop power and transmission rates for the SWFPS. Such rates are approved on an interim basis by the Deputy Secretary of Energy. FERC has the exclusive authority to confirm, approve, and place into effect on a final basis, to remand, or to disapprove, rates developed by the Administrator.

FERC's review is limited to: 1) whether the rates are the lowest possible consistent with sound business principles; 2) whether the revenue levels generated are sufficient to recover the costs of producing and transmitting electric energy including repayment within the period permitted by law;

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

and 3) the assumptions and projections used in developing the rates component. FERC shall reject decisions of the Administrator only if it finds them to be arbitrary, capricious, or in violation of the law.

The rates in effect as of September 30, 2010 are summarized as follows:

The Integrated System rate schedules were placed into effect January 1, 2010 and were approved on a final basis by the FERC on October 4, 2010. These rate schedules incorporated a 10.8% revenue increase and remain in effect through September 30, 2013.

The Robert D. Willis project rate required no rate action during fiscal year (FY) 2010. The Robert D. Willis project rate was approved and confirmed by the FERC on April 27, 2009, for the period October 1, 2008 through September 30, 2012. The Sam Rayburn Dam project rate required no rate action during FY 2009. The current rate in effect from January 1, 2009 through September 30, 2012 was confirmed and approved by the FERC on the final basis March 30, 2009.

(c) *Utility Plant and Depreciation*

Utility plant includes items such as dams, spillways, generators, turbines, substations and related components (generating facilities), and transmission lines and related components. Utility plant is stated at original cost. Property transferred from other government agencies is transferred at net book value. Cost includes direct labor and material, payments to contractors, indirect charges for engineering, supervision and similar overhead items, and an allowance for funds used during construction. The costs of additions and betterments are capitalized. Repairs and minor replacements are charged to operation and maintenance expense. Generally, the cost of utility plant retired, together with removal costs less salvage, is charged to accumulated depreciation when the property is removed from service. Gains and losses are recognized only on sales of significant identifiable assets.

Depreciation on utility plant is computed on a straight-line basis over the estimated service lives of the various classes of property. Service lives currently range from 5 to 100 years for transmission plant and generating facility components.

(d) *Cash and Funds Held in Escrow*

Cash represents the unexpended balance of funds authorized by Congress, customer advances, and spectrum relocation funds, held at the U.S. Department of the Treasury (Treasury). Cash received from the sale of power is generally deposited directly with the Treasury and is reflected as "Funds returned to U.S. Treasury" in the accompanying combined financial statements. Cash held for customer advances is restricted for the purposes agreed to between Southwestern and the customer.

Funds held in escrow represents the unexpended balance of funds held in a bank trust account under agreements with certain customers restricted specifically to fund operation, maintenance, rehabilitation, and modernization activities at hydroelectric generating facilities of the Corps in SWFPS's marketing region. Under the agreements, funds deposited to the escrow account by customers are credited by Southwestern against accounts receivable for power and energy sold to the customer. The escrowed funds are transferred to the Corps, as needed, to meet contractual

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

obligations as outlined in the agreements. Unused funds held in escrow, if any, will be returned to Southwestern and then to the Treasury upon termination of the agreements.

(e) ***Congressional Appropriations***

Southwestern and the Corps receive Congressional Appropriations through DOE and DOD, respectively, to finance their operations. The Corps also receives appropriations to finance construction of its hydroelectric projects. In accordance with the Flood Control Act of 1944 (the Flood Control Act), Southwestern is responsible for repayment to the Federal government, with interest, of its appropriations, and the portion of Congressional Appropriations allocated to the Corps for construction and operations of the power projects.

Congressional Appropriations received by the Corps are authorized and allocated to individual projects on a total project basis. These total project allocations are further distributed between power and nonpower purposes at the discretion of the Corps project management. Power purpose allocations may vary from actual amounts expended during the year. It is the intent of the Corps' project management to distribute Congressional Appropriations in amounts approximating estimated current year expenses and to adjust the distribution as necessary within the limits of the transfer authority residing at the district level.

(f) ***Purchased Power and Banking Exchange Deferral and Receivable***

SWFPS utilizes a separate rate component (purchased power adder) to recover the estimated cost of purchased power based upon the average purchased power costs expected to occur in the future. If the actual expenses of purchased power exceed the revenue generated from this adder, the cost is deferred for future recovery through rates. Likewise, if the expense is less than the adder, the excess revenue is deferred. From time to time, Southwestern may utilize a separate rate component (adder adjustment), to manage additional purchased power expenses or excess revenues, respectively.

SWFPS has arrangements with certain customers in which excess power available on the power system is banked with the customer until needed by the power system and the customer has power available. The power system records a receivable for the power banked at the cost specified in the marketing arrangement, under the provisions of ASC Topic 845, *Nonmonetary Transactions*. The net revenue or expense associated with banking activity is deferred until the power is returned or delivered.

(g) ***Operating Revenues***

Operating revenues are recorded on the basis of service rendered. Rates are established under requirements of the Flood Control Act, related legislation and executive departmental directives, and are to provide sufficient revenues to meet all required repayment of system costs, including operation and maintenance expenses less depreciation, interest, and payment to the Treasury for the Federal investment in utility plant. Rates are intended to provide for recovery of the Federal investment in transmission and generating facilities not to exceed 50 years from the date placed in service, while operation and maintenance costs and interest on Federal investment are intended to be recovered annually.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

As set forth in “Utility Plant, and Depreciation” above, assets are being depreciated for financial reporting purposes using the straight-line method over their estimated service lives, which currently range from 5 to 100 years for transmission and generating facility components. Accordingly, annual depreciation charges are not matched with the recovery of the related capital costs and will, in the case of generating facilities, continue beyond the period within which such costs will have been recovered through rates.

While energy and transmission rates are established to recover the costs of operating the power projects, rates are also required to be at the lowest possible level, consistent with sound business principles. Over the life of the power system, accumulated net revenues represent differences between the timing of the recognition of expenses and related revenues, resulting primarily from the difference between the recognition of depreciation and the related recovery of the Treasury’s investment in utility plant. SWFPS is a Federal entity, thus at any given time the accumulated net revenues, to the extent available, are committed to the repayment of the Federal investments.

The practices followed by Southwestern and the Corps are in conformity with the accounting practices and standards established by DOE and DOD and the requirements of specific legislation and executive directives issued by government agencies. Based upon guidelines established in DOE Order RA 6120.2, revenues distributed to the Corps cover annual operating expenses including interest, with the remainder applied to the unpaid generation investment.

(h) *Accounts Receivable*

SWFPS’s accounts receivable consist generally of receivables for power and energy sold to its customers who are primarily public bodies and cooperatives. SWFPS provides for uncollectible accounts if collection is in doubt. No allowance for uncollectible accounts was considered necessary for any year presented herein.

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

(i) *Interest on Federal Investment*

Interest on repayable Federal investment is a cost mandated by the Secretary of Energy and by the FERC. SWFPS computes interest in accordance with DOE Order RA 6120.2, which provides that interest be computed on the remaining investment after revenues have been applied to recovery of costs during the year, any prior year unpaid costs, and then to Federal investment bearing the highest interest rate.

(j) *Allowance for Funds Used During Construction (AFUDC)*

The FERC Uniform System of Accounts defines AFUDC as the net costs for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. While cash is not realized currently from this allowance, it is realized under the rate

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

making process over the repayment life of the related property through increased revenues resulting from a higher recoverable investment. The interest rates used are established by law, administrative order, or administrative policy for the fiscal year during which the construction commenced (4.000% for FY 2010 and 4.500% for FY 2009).

(k) Retirement Benefits

SWFPS employees participate in one of the following contributory defined benefit plans: the Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS). Agency contributions are based on eligible employee compensation and are submitted to benefit program trust funds administered by the Office of Personnel Management (OPM). Based on statutory contribution rates, the FY 2010 and FY 2009 cost factors under CSRS were 30.1% and 25.8%, respectively, of basic pay. The cost factor under FERS was 13.8% of basic pay for FY 2010 and 12.3% of basic pay for FY 2009. The contribution levels, however, are legislatively mandated and do not reflect the current full cost requirements to fund the plans. Other retirement benefits administered by the OPM include the Federal Employees Health Benefits Program which costs \$5,906 and \$5,756, per enrolled employee, for FY 2010 and FY 2009, respectively, and the Federal Employees Group Life Insurance Program which had a FY 2010 cost factor of 0.02% of basic pay, the same as for FY 2009.

In addition to the amounts contributed to the CSRS and FERS as stated above, SWFPS recorded an expense and related liability for the pension and other postretirement benefits in the combined financial statements of \$3,880,912 and \$3,012,173 for the years ended September 30, 2010 and 2009, respectively. This amount reflects the contribution made on behalf of SWFPS by OPM to the benefit program trust funds.

As a Federal agency, all post-retirement activity is managed by OPM, therefore, neither the assets of the plans nor the actuarial data with respect to the accumulated plan benefits relative to Southwestern and the Corps employees are included in this report.

(l) Workers' Compensation

Workers' compensation consists of two elements: actuarial liability associated with workers' compensation cases incurred for which additional claims may still be made in the future (future claims) and a liability for expenses associated with actual claims incurred and paid by the Department of Labor (DOL), the program administrator, whom SWFPS must reimburse. DOL, DOE, and DOD determined Southwestern and the Corps actuarial liability associated with workers' compensation cases. The actuarial liability for future claims was determined using historical benefit payment patterns and the Treasury discount rates.

The recovery of these future claims will be deferred for purposes of the rate-making process until such time as the future claims are actually submitted and paid by the DOL. Therefore, the recognition of the expense associated with this actuarially determined liability has been recorded as deferred workers' compensation in the combined balance sheets in accordance with ASC Topic 980 to reflect the effects of the rate-making process.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

(m) *Income Taxes*

As agencies of the U.S. Government, Southwestern and the Corps are exempt from all income taxes imposed by any governing body, whether it is a Federal, state, or commonwealth of the United States.

(n) *Use of Estimates*

The preparation of the combined financial statements in conformity with U.S. GAAP requires management of SWFPS to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the useful lives of completed utility plant; allowances for doubtful accounts; employee benefit obligations; and other contingencies. Actual results could differ from those estimates.

(o) *Denison Hydropower Water Storage Reallocation*

Section 838 of P.L. 99-662 (Section 838) authorized the Corps of Engineers to reallocate hydropower storage to water supply storage at Lake Texoma, in increments as needed, up to 150,000 acre-feet for users in the State of Texas and up to 150,000 acre-feet for users in the State of Oklahoma. Section 838 directed that the Corps would provide credits to Southwestern equal to the replacement cost of the hydropower lost as a result of the reallocations, and Southwestern would reimburse the preference customers (Denison allottees) for an amount equal to the customers' replacement cost of the hydropower lost as a result of the reallocations.

In FY 2010, the Corps executed water supply contracts for the 150,000 acre-feet of storage authorized for customers in the State of Texas by Section 838. According to a June 2010 agreement between Southwestern and the Corps, the Corps agreed to deposit all cost of storage payments for storage reallocated under Section 838 into the U.S. Treasury and to provide credits in the same amount to the hydropower income account. During FY 2010, the Corps received \$21,611,724 in payments for the reallocated water supply storage and credited the total amount to Southwestern. The total amount was deferred by Southwestern for the provision of the reimbursement to the Denison allottees' and Southwestern for future hydropower storage revenues foregone.

A September 2010 agreement between Southwestern and the Denison allottees provided the initial hydropower replacement cost as determined by Southwestern and the methodology for providing the reimbursement to the Denison allottees as authorized under Section 838. Beginning with the invoice for the October 2010 service month, reimbursement pursuant to Section 838 began as a credit on the Denison allottees monthly invoices.

(p) *Nonreimbursable Activities*

Federal and Non-Federal Projects

Southwestern has agreements with customers to provide services on a fee basis where the fee is generally paid in advance. The operating revenues and expenses related to these services are excluded from the rate-making process, a portion of which is accounted for on a net basis. A portion

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

of cash and advances from construction in the accompanying combined financial statements relate to these activities.

Escrow Interest Revenue

Interest revenue represents the interest earned on funds held in escrow. These funds are authorized specifically to fund operation, maintenance, rehabilitation, and modernization activities at hydroelectric generating facilities of the Corps in SWFPS's marketing region. This activity is not reimbursable through the rate-making process.

White River Minimum Flows Project

Section 132 of P.L. 109-103 (Section 132) authorized the Corps of Engineers to implement the White River Minimum Flows Project at the Federal Bull Shoals and Norfork projects in Arkansas. The legislation directed Southwestern to determine the hydropower impacts to the Federal projects and to Federal Energy Regulatory Commission (FERC) Project No. 2221 resulting from the implementation of minimum flows. Section 132 provided that all Federal costs for the White River Minimum Flows Project be considered nonreimbursable.

Southwestern determined the Federal and non-Federal hydropower impacts through an extensive public process. Additionally, as directed in Section 132, the non-Federal hydropower impacts on FERC Project No. 2221 were determined in consultation with the project licensee and the relevant state public utility commissions. Throughout the entire process, the administrative costs incurred during Southwestern's determination of the Federal and non-Federal hydropower impacts of the White River Minimum Flows Project were accounted for and were considered nonreimbursable.

In October 2009, Section 314 of P.L. 111-85 (Section 314) amended the Section 132 language by authorizing the establishment of a Special Receipts and Disbursement Account (Special Account) and providing that Southwestern would provide the compensation to the non-Federal licensee of FERC Project No. 2221 using receipts collected in the Special Account. According to the legislation, such payment shall be considered nonreimbursable. Further, Section 314 also established the date of implementation for the minimum flows project to be October 28, 2009. Accordingly, when Southwestern's determination of the non-Federal hydropower impacts was finalized in June 2010, Southwestern began collecting receipts in the Special Account and provided full compensation of \$26,563,700, as non reimbursable expense, to the non-Federal licensee in September 2010.

Section 132 provided that losses to Federal hydropower shall be offset by a reduction in the costs allocated to the Federal hydropower purpose, and the reduction shall be based on the future lifetime impacts of the minimum flows project. As determined by Southwestern, the offset will take into account the multiple impacts of minimum flows on Federal hydropower. Those impacts include lost on-peak energy and capacity, lost off-peak energy, increased costs due to dissolved oxygen impacts, and increased maintenance costs at Bull Shoals.

Spectrum Relocation Fund

In December 2004, the U.S. Congress passed and the President signed the Commercial Spectrum Enhancement Act (CSEA, Title II of P.L. 108-494), creating the Spectrum Relocation Fund (SRF) to streamline the relocation of Federal systems from existing spectrum bands to accommodate

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

commercial use by facilitating reimbursement to affected agencies of relocation costs. In FY 2009 and FY 2007 Southwestern received \$17,730,000 and \$8,091,360, respectively, in spectrum relocation funds, as approved by the Office of Management and Budget, and as reported to the Congress. This activity is not reimbursable through the rate-making process.

Global Climate Change Project

Section 9505 of the Secure Water Act of 2009 (Public Law 111-11) directed the Secretary of Energy (DOE), in consultation with the Federal Power Marketing Administrations (PMAs), to submit a Report to Congress on the effects of global climate change on federal hydropower systems. Southwestern has participated in the global climate change assessment and development of the Report to Congress. In accordance with Public Law 111-11, any costs incurred by PMAs for this effort are to be nonreimbursable.

The components of non reimbursable activity in each of the years are as follows:

	FY 2010	FY 2009
Operating revenues:		
Non reimbursable		
Federal project revenue	\$ 403,598	612,934
Interest revenue	49,431	185,896
Total non reimbursable revenues	\$ 453,029	798,830
Operating expenses:		
Non reimbursable		
Federal project expense	\$ 403,598	612,934
White River Minimum Flows compensation and administrative expense	26,749,718	324,965
Spectrum Relocation Fund expense	194,103	362,819
Global Climate project expense	3,458	
Total non reimbursable expenses	\$ 27,350,877	1,300,718

(q) Derivative and Hedging Activities

Southwestern analyzes derivative financial instruments under FASB ASC Topic 815, *Derivatives and Hedging*. This standard requires that all derivative instruments, as defined by ASC Topic 815, be recorded on the combined balance sheets at fair value, unless exempted. Changes in a derivative instrument's fair value must be recognized currently in the combined statement of revenues and expenses, unless the derivative has been designated in a qualifying hedging relationship. The application of hedge accounting allows a derivative instrument's gains and losses to offset related results of the hedged item in the combined statements of revenues and expenses to the extent effective. ASC Topic 815 requires that the hedging relationship be highly effective and that an organization formally designate a hedging relationship at the inception of the contract to apply hedge accounting.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

Southwestern enters into contracts for the sale of electricity for use in its business operations. ASC Topic 815 requires Southwestern to evaluate these contracts to determine whether the contracts are derivatives. Certain contracts that literally meet the definition of a derivative may be exempted from ASC Topic 815 as normal purchases or normal sales. Normal purchases and sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold over a reasonable period in the normal course of business. Contracts that meet the requirements of normal purchases or sales are documented and exempted from the accounting and reporting requirements of ASC Topic 815.

Southwestern's policy is to fulfill all derivative and hedging contracts by providing power to a third party as provided for in each contract. Southwestern's policy does not authorize the use of derivative or hedging instruments for speculative purposes such as hedging electricity pricing fluctuations beyond Southwestern's estimated capacity to deliver power. Accordingly, Southwestern evaluates all of its contracts to determine if they are derivatives and, if applicable, to ensure that they qualify and meet the normal purchases and normal sales designation requirements under ASC Topic 815. Normal sales contracts are accounted for as executory contracts as required under U.S. GAAP. As of September 30, 2010 and 2009, Southwestern has no contracts accounted for as derivatives.

(r) *Fair Value of Financial Instruments*

In April 2009, the FASB issued an update to FASB ASC Topic 825, *Financial Instruments*. The update to ASC Topic 825 requires disclosure of the fair value of financial instruments, and was effective for SWFPS in fiscal year 2009. Fair value estimation methods for individual classes of financial instruments are described below.

(s) *Short-Term Financial Instruments*

The carrying (recorded) value of short-term financial instruments, including cash, funds held in escrow, accounts receivable, accounts payable and accrued liabilities, and advances for construction, approximates the fair value of these instruments. The fair value of certain unfunded and actuarially based liabilities cannot be determined as the future payout dates have yet to be determined.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

(2) Utility Plant

Plant in service and construction work in progress consist principally of generating and transmission facilities as follows:

	2010	2009
Plant in service:		
Generating facilities	\$ 1,079,073,181	1,068,912,690
Transmission facilities	298,976,824	280,587,206
	<u>1,378,050,005</u>	<u>1,349,499,896</u>
Less accumulated depreciation	(622,697,039)	(608,686,560)
Construction work in progress:		
Generating facilities	119,999,890	85,856,699
Transmission facilities	19,153,942	26,760,007
	<u>139,153,832</u>	<u>112,616,706</u>
Net utility plant	<u>\$ 894,506,798</u>	<u>853,430,042</u>

(3) Regulatory Assets and Liabilities

Regulatory assets and liabilities at September 30 consist of the following:

	2010	2009
Regulatory assets:		
Deferred workers' compensation	\$ 15,687,514	16,679,751
Total	<u>\$ 15,687,514</u>	<u>16,679,751</u>
Regulatory liabilities:		
Hydropower water storage reallocation deferral	\$ 21,752,126	—
Purchased power and banking exchange deferral	47,832,866	30,698,300
Total	<u>\$ 69,584,992</u>	<u>30,698,300</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

Southwestern's purchased power and banking exchange deferral account represents the deferral of net revenue or expenses associated with net purchased power and banking exchange activities as follows:

	<u>Purchased power and banking exchange deferral</u>
September 30, 2008	\$ (6,433,094)
Purchased power adder revenue	(25,135,057)
Purchased power expense	1,480,275
Net banking exchange	<u>6,998</u>
Net purchased power and banking exchange deferral	(23,647,784)
Interest on deferred activities and other	<u>(617,422)</u>
September 30, 2009	<u>(30,698,300)</u>
Purchased power adder revenue	(17,988,721)
Purchased power expense	2,407,192
Net banking exchange	<u>(98,253)</u>
Net purchased power and banking exchange deferral	(15,679,782)
Interest on deferred activities and other	<u>(1,454,784)</u>
September 30, 2010	<u><u>\$ (47,832,866)</u></u>

The deferred workers' compensation represents a regulatory asset that will be expensed as future claims are actually submitted and paid by the DOL (see note 1 (1)).

(4) Financing Sources

SWFPS's financing sources include annual appropriations, Federal power receipts (Use of Receipts) and alternative financing arrangements to fund its operations.

(a) Federal Investment

Construction and operation of Southwestern's transmission system and the Corps generating facilities and operations are financed through Congressional Appropriations. The exceptions are capital assets and maintenance activities funded through the alternative financing arrangements and the funding by non-Federal parties of the construction of the Robert Douglas Willis project. The U.S. Government's investment in each generating project and each year's investment in the transmission system is to be repaid to the Treasury over a period not to exceed 50 years from the time the facility is placed in service. There is no requirement for repayment of a specific amount on an annual basis.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

Revenues received from the sale of Federal power and purchased power are generally deposited with the Treasury. Annual revenues are first applied to the current year operating expenses (less depreciation) and interest expense. All annual amounts for such expenses have been paid through fiscal year 2010. Remaining revenues are to be first applied to repayment of operating deficits (which include all expenses except depreciation), if any, and then to repayment of the Federal investment. To the extent possible, while still complying with the repayment period established for each increment of investment and unless otherwise required by legislation, repayment of the investment is to be accomplished by a repayment of the highest interest-bearing investment first. Interest rates applied to the unamortized initial investment of the U.S. Government in the Corps' hydroelectric generating facilities range from 2.50% to 5.75% for unpaid facilities in service prior to FY 2010 and 4.00% for facilities placed in service during FY 2010. The rates have been set by law, by administrative order pursuant to law, or by administrative policies using the U.S. Senate Document No. 97 formula for the fiscal year during which the appropriations were requested.

(b) *Alternative Financing*

Due to fluctuations in the amount of annual appropriations received to fund operations, maintenance, rehabilitation, and modernization of the SWFPS facilities, SWFPS has established an alternative financing program under reimbursable authority regulations. Under agreements with customers to finance projects, which benefit the SWFPS, funds received from the sale of power are net billed, allowing a portion of the funds to be utilized to finance agreed-upon projects rather than returned to the Treasury. Under the agreements with certain customers, alternative financing restricted specifically to fund operation, maintenance, rehabilitation, and modernization activities at the hydroelectric generating facilities are held in escrow. All other alternative financing arrangements are collected by Southwestern and deposited as cash held by the Treasury, and are reflected as other assets with an offsetting liability included in Advances for Construction, until completion of the project at which time the asset and liability are eliminated.

(5) *Commitments and Contingencies*

(a) *General*

Based on the 2010 Integrated System Power Repayment Study prepared as of September 30, 2010, the projected increase in capital investment in 2010 is \$104,115,864, which includes \$17,246,501 for transmission facilities and \$86,869,363 for generating facilities. The five-year investment increase projected in the 2010 Integrated System Power Repayment Study for FY 2010 through FY 2014 is estimated to cost \$590,948,013.

Southwestern sells the majority of its marketable power to customers under long-term power sales contracts of 15 years, which require Southwestern to provide 1,200 kilowatt hours per kilowatt of peaking contract demand per year, subject to scheduling constraints outlined in each customer's contract. If sufficient power is unavailable to Southwestern from Corps hydroelectric facilities to meet these commitments, Southwestern may be required to purchase power from other sources to meet these commitments. The cost to purchase such power is recovered through the purchased power adder discussed more fully in note 1(f).

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 2010 and 2009

(b) Legal

SWFPS has exposure to certain claims and legal actions arising in the ordinary course of business. In management's opinion, any resulting actions will not have a material adverse effect on the financial condition or results of operations of SWFPS during FY 2009 through FY 2010.

(6) Leases

SWFPS is obligated under a 10-year operating lease for office space. This lease consists of a 5-year firm term for the first 5-years and the option to terminate during the second 5-year term. This lease commenced January 1, 2004 and is scheduled to terminate December 31, 2013. Future minimum lease payments as of September 30, 2010 are as follows:

Year ending September 30:		
2011	\$	656,000
2012		672,000
2013		679,000
2014		<u>174,000</u>
Total future minimum lease payments	\$	<u><u>2,181,000</u></u>

Rent expense for operating leases during the years ended September 30, 2010 and 2009 was \$691,000 and \$671,000, respectively.

(7) Subsequent Events

SWFPS has evaluated subsequent events from the balance sheet date through October 31, 2011, the date at which the financial statements were available to be issued, and such events are disclosed in these accompanying notes.



SOUTHWESTERN POWER ADMINISTRATION

Internal Control over Financial Reporting

September 30, 2010 and 2009



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**Independent Auditor's Report on Internal Control Over Financial Reporting
Based on an Audit of Combined Financial Statements Performed in
Accordance With *Government Auditing Standards***

Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:

We have audited the combined balance sheets of the Southwestern Federal Power System (SWFPS) as of September 30, 2010 and 2009, and the related combined statements of changes in net Federal investment, revenues and expenses, changes in capitalization, and cash flows for the years then ended, and have issued our report thereon dated June 18, 2012. The combined financial statement presentation includes the hydroelectric power generating functions operated by the U.S. Army Corps of Engineers (hereinafter referred to as the generating agency or the Corps), for which Southwestern Power Administration (Southwestern) markets and transmits power. 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.

Managements of Southwestern and the generating agency are responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered SWFPS's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the combined financial statements, but not for the purpose of expressing an opinion on the effectiveness of Southwestern and the generating agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Southwestern and the generating agency's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies we consider to be significant deficiencies.

A deficiency in internal control over financial reporting 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 combination of deficiencies, in internal control over financial reporting, 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. We



Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:
June 18, 2012
Page 2 of 6

consider the deficiencies in Southwestern and the generating agency's internal control over financial reporting described in the following schedule of findings and responses to be material weaknesses. We previously identified the following deficiencies in Southwestern and the generating agency's internal control over financial reporting and considered them to be material weaknesses as reported in the Independent Auditor's Report on Internal Control Over Financial Reporting Based on an Audit of Combined Financial Statements Performed in Accordance With *Government Auditing Standards* dated December 16, 2011, which date is subsequent to the September 30, 2010 audit that this letter pertains to.

The responses to the findings identified in our audit provided by Southwestern and the Corps are presented below. We did not audit these responses, and, accordingly, we express no opinion on them.

A. Material Weakness in Internal Control over Utility Plant

The combined financial statements include the hydroelectric power generating functions of the U.S. Army Corps of Engineers (Corps), for which Southwestern markets and transmits power. Southwestern maintains the responsibility of preparing the combined financial statements and related footnotes in accordance with DOE Order RA 6120.2, dated September 20, 1979.

Southwestern owns and maintains over 1,400 miles of high voltage transmission lines, substations and communication sites. Southwestern and the Corps own and operate more than \$850 million of utility plant, net of accumulated depreciation, and more than \$110 million of construction work in progress (CWIP). Southwestern and the generating agency are responsible for properly accounting for property, plant, and equipment, including additions, assigning useful lives, and classifying acquisitions into asset categories.

During our test work over the combined financial statements, we identified the following conditions:

- We identified one exception at the Fort Worth Army Corps of Engineers district in 2008, where the Corps made changes on a retrospective basis to the useful lives of various assets, which created a cumulative catch up entry in CEFMS. The impact of this entry was made by the Corps against the general ledger accounts for beginning status of cost recovery and accumulated depreciation. This resulted in approximately \$3.6 million of a difference between the 2007 year end net federal investment and the 2008 beginning balance of net federal investment.
- We identified one exception at the Little Rock district where the Norfolk bridge assets were carried at the cost allocation percentage of 10.50%, however the accumulated depreciation and depreciation expense was calculated using the Norfolk cost allocation percentage of 29.04%. This resulted in an overstatement of depreciation expense and



Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:
June 18, 2012
Page 3 of 6

accumulated depreciation. We discussed this with the Little Rock Corps personnel, and agreed that the accumulated depreciation and related depreciation expense should be calculated using the same cost allocation percentage as the related assets.

- We identified one exception at the Little Rock Corps District where the district had an adjustment in 2008 to Plant in Service (PIS) and Accumulated Depreciation of approximately \$10 million. These assets and related depreciation had been erroneously left off of the power reports in the prior year. As the amount were corrected in 2008, KPMG did not propose an adjustment to the power reports in the prior years, as the amounts resulted in a gross down of the balance sheet. KPMG notes that the Little Rock Corps District does not have appropriate procedures in place to accurately reconcile their Plant in Service and Accumulated Depreciation accounts.
- We identified one exception at the Vicksburg Corps District where a generator rewind at Blakely was initially identified as a repair project beginning in 2007 and the Corps initially expensed approximately \$6 million related the project from 2007 to 2009. KPMG identified the error and adjusting entries were made to the 2007, 2008, and 2009 combined financial statements to properly capitalize the assets.

Recommendations

We recommend that the Corps perform the following:

1. Regarding the capitalization versus expensing of costs, we recommend that management perform the following:
 - a. Work with the various U.S. Army Corps of Engineers Districts to improve its internal controls and management review procedures to ensure that costs are properly accounted for.
 - b. Key Corps personnel at the U.S. Army Corps of Engineers Districts should obtain training over the purpose, presentation and reporting requirements of the Corps hydroelectric power generation function to gain a better understanding of the overall effect of Corps data within SWFPS's combined financial statements.
2. Regarding the accounting for Utility Plant assets, we recommend the following:
 - a. The U.S. Army Corps of Engineers Districts should establish a consistent set of policies, procedures, internal controls and management review procedures to ensure that changes related to the useful lives of assets are accounted for on a prospective basis.
 - b. The U.S. Army Corps of Engineers Districts should improve its internal controls and management review procedures to ensure that allocation procedures are accurately applied to the financial statements.



Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:
June 18, 2012
Page 4 of 6

- c. The U.S. Army Corps of Engineers Districts should improve its internal controls and management review procedures to ensure that accounts are properly reconciled and reviewed so that variances from the prior year and current year are properly identified and accounted for.
- d. Key Corps personnel at the U.S. Army Corps of Engineer Districts should obtain training over the purpose, presentation and reporting requirements of the Corps hydroelectric power generation function to gain a better understanding of the overall effect of Corps data within SWFPS's combined financial statements.

Management's Response

U.S. Army Corps of Engineers Management agrees with the findings and recommendations related to the internal control over utility plant and will implement the necessary actions by June 30, 2012.

B. Material Weakness in Internal Control over Accounting Policies and Procedures

During our test work over the combined financial statements, we identified instances where Southwestern or the generating agency did not maintain sufficient accounting policies and procedures, did not effectively implement accounting policies and procedures, or the established accounting policies and procedures were not consistent with U.S. GAAP or DOE and FERC regulations. We identified the following conditions:

- Southwestern does not have appropriate processes in place to appropriately account for the Alternative Financing received from customers in order to provide funding for the U.S. Army Corps of Engineers. Southwestern had originally accounted for all funds received as transfers to other agencies, rather than considering the effect of funds that were held in bank trust accounts and had not been distributed to the various Corps Districts. A correcting adjustment was made by Southwestern to reclassify the funds held in escrow at the Liberty Bank of Arkansas to Funds Held in Escrow on the combined financial statements to properly state the balances.
- The Vicksburg Corps District does not have appropriate procedures in place to properly account for funding received through Alternative Financing. Funding received since the inception of the program, and the use of such funds has been omitted from the power reports. A correcting adjustment was made to properly state the PIS, Funds Held with Treasury, and Transfer from Other Agencies balances for 2006 – 2009.
- The Tulsa Corps District does not have procedures in place to properly account for Interest on Federal Investment. KPMG identified \$2.3 million of interest expense related to a nonpower purpose code that had been capitalized to the power purpose Interest on Federal Investment account. A correcting adjustment was made by Southwestern to properly state the balance in the combined financial statements.



Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:
June 18, 2012
Page 5 of 6

- The Little Rock Corps District does not have appropriate procedures in place to properly accrue for accounts payable at year end. KPMG identified \$2.8 million of CWIP expenditures that had not been accrued for at September 30, 2009 at Norfolk and \$1.4 million of CWIP items that had not been accrued for at September 30, 2008 at Ozark. A correcting adjustment was made by Southwestern to properly state the accounts payable balance in the combined financial statements.
- The Little Rock Corps District does not perform an annual rollforward of Congressional Appropriations. Rather, the account is used to balance the power reports, if the financials are out of balance. This has resulted in multiple material correcting adjustment to the Little Rock Corps District power reports, in order to properly state the Congressional Appropriations balance in the combined financial statements.

Recommendations

We recommend that management perform the following:

1. Regarding the proper accounting for the funding received through Alternative Financing:
 - a. Southwestern should establish policies and procedures to account for the receipt and use of funds between agencies to ensure that funding balances are properly recorded within CEFMS when the funding is received.
2. Regarding the proper accrual for accounts payable:
 - a. We recommend that management work with Corps management to implement policies and procedures to ensure expenses are recognized when incurred and reported in the proper accounting period.
3. Regarding the proper accounting for Congressional Appropriations and Interest on Federal Investment:
 - a. The U.S. Army Corps of Engineers Districts should establish a consistent set of policies, procedures, internal controls and management review procedures to ensure that these activities are accounted for by all Corps Districts.
 - b. Key Corps personnel at the U.S. Army Corps of Engineer Districts should obtain training over the purpose, presentation and reporting requirements of the Corps hydroelectric power generation function to gain a better understanding of the overall effect of Corps data within SWFPS's combined financial statements.



Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:
June 18, 2012
Page 6 of 6

Management's Response

Southwestern's management concurs with the recommendation to establish policies and procedures to account for the receipt and use of alternative financing funds between agencies. The target policy implementation date is June 30, 2012.

U.S. Army Corps of Engineers Management agrees with the findings and recommendations related to the internal control over accounting policies and procedures and will put into operation the needed actions by June 30, 2012.

We also noted certain other matters that we reported to management of Southwestern Power Administration, the generating agencies, the DOE, the DOE office of Inspector General in a separate letter dated June 18, 2012.

This report is intended solely for the information and use of management of Southwestern Power Administration, the generating agency, the DOE, the DOE Office of Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

June 18, 2012



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100 West Fifth Street
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Report on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Administrator, Southwestern Power Administration and
The Inspector General, U.S. Department of Energy:

We have audited the combined balance sheets of the Southwestern Federal Power System (SWFPS) as of September 30, 2010, and 2009, and the related combined statements of changes in net Federal investment, revenues and expenses, and cash flows for the years then ended, and have issued our report thereon dated June 18, 2012. The combined financial statement presentation includes all of the hydroelectric generating and power operations of one federal agency (hereinafter referred to as the generating agency), and the transmission and disposition of the related power by the Southwestern Power Administration (Southwestern), a separate federal agency. 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.

As part of obtaining reasonable assurance about whether SWFPS's financial statements are free of material misstatement, we performed tests of its 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*.

This report is intended solely for the information and use of management of Southwestern Power Administration, the generating agencies, the DOE, the DOE Office of Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

June 18, 2012

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