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

Audit Report

Southwestern Federal Power System's Fiscal Year 2011 Financial Statement Audit

OAS-FS-13-06

November 2012

Department of Energy
Washington, DC 20585

November 29, 2012

MEMORANDUM FOR THE ADMINISTRATOR, SOUTHWESTERN POWER ADMINISTRATION

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

SUBJECT: INFORMATION: Audit Report on "Southwestern Federal Power System's Fiscal Year 2011 Financial Statement Audit"

The attached report presents the results of the independent certified public accountants' audit of the Southwestern Federal Power System's (SWFPS) combined balance sheets, as of September 30, 2011 and 2010, and the related combined statements of changes in capitalization, revenues and expenses, and cash flows for the years then ended.

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 present fairly, in all material respects, the respective financial position of SWFPS as of September 30, 2011 and 2010, 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 SWFP's Fiscal Year 2006, 2007, 2008 and 2009 Financial Statement Audits. As SWFPS had not completed its remediation of the material weaknesses, nor have such remediation efforts been subjected to auditing procedures, these deficiencies are still 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.

- 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 December 31, 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-13-06

Attachment

cc: Acting Deputy Chief Financial Officer, CF-2
Director, Office of Financial Control and Reporting, CF-12
Director, Financial Management Division, Southwestern Power Administration

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Financial Statements

September 30, 2011 and 2010

(With Independent Auditors' Report Thereon)

KPMG LLP
210 Park Avenue, Suite 2850
Oklahoma City, OK 73102-5683

Independent Auditors' Report

Administrator, 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, 2011 and 2010, and the related combined statements of changes in capitalization, 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, 2011 and 2010, 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 August 27, 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 2011 and 2010 SWFPS's combined financial statements taken as a whole. The supplementary information in schedules 1 through 4 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 combined financial statements taken as a whole.

KPMG LLP

August 27, 2012

KPMG LLP
210 Park Avenue, Suite 2850
Oklahoma City, OK 73102-5683

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

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

We have audited the combined financial statements of the Southwestern Federal Power System (SWFPS) as of September 30, 2011 and 2010, and the related combined statements of revenues and expenses, changes in capitalization, and cash flows for the years then ended, and have issued our report thereon dated August 27, 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.

Internal Control over Financial Reporting

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 Southwestern and the generating agency'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.

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 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. As SWFPS has not completed its remediation of the material weaknesses as of August 27, 2012, nor have such remediation efforts been subject to audit procedures, we still consider these deficiencies to be material weaknesses.

The responses to the findings identified in our audit provided by Southwestern and the generating agency's 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 $756 million of utility plant, net of accumulated depreciation, and more than $188 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 Norfork bridge assets were carried at the cost allocation percentage of 10.50%, however the accumulated depreciation and depreciation expense was calculated using the Norfork cost allocation percentage of 29.04%. This resulted in an overstatement of depreciation expense and 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 follow:

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 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.

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.

   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 December 31, 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 Payable to U.S. Treasury. KPMG identified $2.3 million of interest expense related to a nonpower purpose code that had been capitalized to the power purpose Interest on Payable to U.S. Treasury account. A correcting adjustment was made by Southwestern to properly state the balance in the combined financial statements.
- 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 Norfork 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 Payable to U.S. Treasury:

    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.

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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.

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 December 31, 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 December 31, 2012.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Southwestern and the generating agency'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 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

August 27, 2012

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Balance Sheets

September 30, 2011 and 2010

Assets	**2011**	**2010**
Plant in service	$ 1,406,429,371	1,377,538,963
Accumulated depreciation	(650,831,140)	(622,185,997)
Construction work in progress	188,497,435	139,153,832
Net utility plant	944,095,666	894,506,798
Cash	224,826,826	239,419,661
Funds held in escrow	54,204,016	48,913,656
Accounts receivable	15,274,574	17,451,483
Material and supplies, at average cost	2,688,809	2,210,042
Banking exchange receivables	3,965,017	3,492,029
Deferred workers' compensation	12,764,665	15,687,514
Other assets	31,224,421	22,189,755
Total assets	$ 1,289,043,994	1,243,870,938
Liabilities and Capitalization		
Liabilities:		
Accounts payable and accrued liabilities	$ 14,871,451	9,835,341
Advances for construction	22,742,722	16,957,829
Accrued workers' compensation	13,954,623	16,890,284
Purchased power and banking exchange deferral	54,221,980	47,832,866
Hydropower water storage reallocation deferral	59,711,040	21,752,126
Total liabilities	165,501,816	113,268,446
Capitalization:		
Payable to U.S. Treasury	858,413,041	887,066,788
Accumulated net revenues	265,129,137	243,535,704
Total capitalization	1,123,542,178	1,130,602,492
Commitments and contingencies (notes 5 and 6)		
Total liabilities and capitalization	$ 1,289,043,994	1,243,870,938

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Changes in Capitalization

Years ended September 30, 2011 and 2010

	Payable to U.S. Treasury	Accumulated net revenues	Total capitalization
Total capitalization as of September 30, 2009	$ 883,672,623	220,102,353	1,103,774,976
Additions:			
Congressional appropriations	125,566,027	—	125,566,027
Interest on payable to U.S. Treasury and other	16,397,365	—	16,397,365
Total additions to capitalization	141,963,392	—	141,963,392
Deductions:			
Payments to U.S. Treasury	(138,536,376)	—	(138,536,376)
Transfers of property and services, net	(32,851)	—	(32,851)
Total deductions to capitalization	(138,569,227)	—	(138,569,227)
Net revenues for the year ended September 30, 2010	—	23,433,351	23,433,351
Total capitalization as of September 30, 2010	887,066,788	243,535,704	1,130,602,492
Additions:			
Congressional appropriations	97,324,419	—	97,324,419
Interest on payable to U.S. Treasury and other	15,426,630	—	15,426,630
Total additions to capitalization	112,751,049	—	112,751,049
Deductions:			
Payments to U.S. Treasury	(140,381,828)	—	(140,381,828)
Transfers of property and services, net	(1,022,968)	—	(1,022,968)
Total deductions to capitalization	(141,404,796)	—	(141,404,796)
Net revenues for the year ended September 30, 2011	—	21,593,433	21,593,433
Total capitalization as of September 30, 2011	$ 858,413,041	265,129,137	1,123,542,178

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Revenues and Expenses

Years ended September 30, 2011 and 2010

		2011	2010
Operating revenues:			
Sales of electric power	$	153,841,907	182,808,151
Transmission and other operating revenues		17,673,345	22,112,654
Total operating revenues before deferrals		171,515,252	204,920,805
Net purchased power and banking exchange deferral		(4,361,377)	(15,679,782)
Total operating revenues		167,153,875	189,241,023
Non reimbursable revenues		3,320,398	1,138,661
Total revenues		170,474,273	190,379,684
Operating expenses:			
Operation and maintenance		77,709,646	80,501,155
Purchased power and banking exchange		10,094,337	4,121,266
Depreciation and amortization		30,263,579	29,116,177
Transmission service charges by others		3,078,739	3,074,161
Retirement and other employee benefit expense		7,254,781	7,353,818
Non reimbursable expenses		6,437,955	28,036,509
Total operating expenses		134,839,037	152,203,086
Net operating revenues		35,635,236	38,176,598
Interest expense:			
Interest on payable to U.S. Treasury and other		19,081,977	17,933,659
Allowance for funds used during construction		(5,040,174)	(3,190,412)
Net interest expense		14,041,803	14,743,247
Net revenues	$	21,593,433	23,433,351

See accompanying notes to combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Cash Flows

Years ended September 30, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Net revenues	$ 21,593,433	23,433,351
Adjustments to reconcile net revenues to net cash provided by operating activities:		
Depreciation and amortization	30,263,579	29,116,177
Benefit expense paid by other Federal agencies	3,717,549	3,880,912
Interest on payable to U.S. Treasury and other	19,630,324	17,930,306
Allowance for funds used during construction	(5,040,174)	(3,190,412)
(Increase) decrease in assets:		
Accounts receivable	2,176,909	(3,156,122)
Materials and supplies	(478,767)	301,824
Banking exchange receivables	(472,988)	(131,485)
Deferred workers' compensation	2,922,849	992,237
Other assets	(9,034,666)	8,631,833
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	5,036,110	(2,119,142)
Accrued workers' compensation	(2,935,661)	(951,331)
Purchased power and banking exchange deferral	4,493,035	15,742,027
Advances for construction	5,784,893	(5,286,281)
Net cash provided by operating activities	77,656,425	85,193,894
Cash flows from investing activities:		
Additions to utility plant	(74,812,273)	(67,002,521)
Cash flows from financing activities:		
Congressional appropriations	97,324,419	125,566,027
Payments to U.S. Treasury	(140,381,828)	(138,536,376)
Transfers of property and services, net	(4,740,517)	(3,913,763)
Hydropower water storage reallocation deferral	35,651,299	21,611,724
Funds received in escrow	(26,596,891)	(14,236,679)
Funds disbursed from escrow	21,306,531	22,205,896
Net cash (used in) provided by financing activities	(17,436,987)	12,696,829
Net increase (decrease) in cash	(14,592,835)	30,888,202
Cash, beginning of year	239,419,661	208,531,459
Cash, end of year	$ 224,826,826	239,419,661
Supplemental cash flow information:		
Interest deferred on regulatory liabilities	$ 4,203,694	1,532,941

See accompanying notes to combined financial statements.

(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 under Section 5 of the Flood Control Act of 1944 (the Flood Control Act) 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 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; 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, 2011 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 2011. 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 fiscal year 2011. 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, net of contributions by external entities. 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.

The policy of Southwestern and the Corps is to move capitalized costs into completed utility plant at the time a project or feature of a project is deemed to be substantially complete. A project is substantially complete when it is providing benefits and services for the intended purpose, and is generating project purpose revenue, where applicable.

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 "Payments 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 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. Certain of Southwestern's appropriations are offset by the use of receipts collected from the sale of Federal hydroelectric power, resulting in a net zero appropriation. The Corps also receives appropriations to finance construction of its hydroelectric projects. In accordance with 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. 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. Project costs that are not specific to a project purpose are distributed between power and nonpower purposes based on project cost allocation.

(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, SWFPS 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 FASB 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 U.S. Treasury for the Payable to U.S. Treasury in utility plant. Rates are intended to provide for recovery of the Payable to U.S. Treasury in transmission and generating facilities not to exceed 50 years from the date placed in service, while operation and maintenance costs and interest on Payable to U.S. Treasury are intended to be recovered annually.

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 U.S. 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 Payable to U.S. Treasury.

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) Regulatory Assets

Regulatory assets are assets that result from rate actions of Southwestern's Administrator and other regulatory agencies. These assets arise from specific costs that would have been included in the determination of net revenue in one period, but are deferred until a different period for purposes of developing rates to charge for services, per the requirements of ASC Topic 980. SWFPS defers costs as regulatory assets so that the costs will be recovered through the rates during the periods when the costs are scheduled to be repaid. This ensures the matching of revenues and expenses. SWFPS does not earn a rate of return on its regulatory assets.

(Continued)

(i) 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.

Billing methods used by Southwestern include net billing and bill crediting. Net billing is an agreement between Southwestern and a customer, whereby the customer's power invoice is credited and the funds received from the sale of power are used to fund transmission and generation activities. Net billing is discussed more fully in note 4(b). Bill crediting involves a billing arrangement among Southwestern, a customer, and a third party, whereby the customer's power invoice is credited and the customer pays a third party for goods or services received by Southwestern. Under Southwestern billing methods, purchase and sale transactions are reported "gross" in the combined financial statements.

(j) Concentration of Credit Risk

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.

(k) Interest on Payable to U.S. Treasury

Interest on Payable to U.S. Treasury 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.

(l) 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 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 (4.125% for fiscal year 2011 and 4.000% for fiscal year 2010).

(m) 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 fiscal years 2011 and 2010 cost factors under CSRS were 30.1% of basic pay. The cost factors under FERS were 13.8% of basic pay for fiscal years 2011 and 2010. The contribution levels, however, are legislatively mandated and do not reflect the current full cost requirements to fund the plans. Costs incurred by OPM on behalf of SWFPS are included as transfers of property and services, net within the Payable to U.S. Treasury on the combined balance sheets.

Other retirement benefits administered by the OPM include the Federal Employees Health Benefits Program (FEHB) and the Federal Employees Group Life Insurance Program (FEGLI). FEHB is calculated at $6,027 and $5,906, per enrolled employee, for fiscal years 2011 and 2010, respectively, and FEGLI is based on 0.02% of basic pay for each employee enrolled in these programs.

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 $3,717,549 and $3,880,912 for the years ended September 30, 2011 and 2010, respectively. These amounts reflect the contributions 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.

(n) 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.

(o) Transfers of Property and Services, Net

Transfers of property and services, net is a component of total capitalization that represents the cumulative receipt of transfers of assets or costs offset by the cumulative disbursement of transfers of revenues. Transfers are recognized upon physical delivery of the asset of performance of the service. Transfers occur between projects, project types, and other Federal entities. Transfers between Southwestern and the generating agency eliminate upon consolidation.

(p) 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.

(q) 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.

(r) Denison Hydropower Water Storage Reallocation

Section 838 of P.L. 99-662 (Section 838) authorized the Corps 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 fiscal year 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. In fiscal years 2011 and 2010, the Corps received $37,174,287 and $21,611,724, respectively, 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.

(s) Non Reimbursable Activities

Non reimbursable activity as of September 30, 2011 and 2010 consists of the following:

		2011	2010
Operating revenues:			
Non reimbursable			
Non Federal project revenue	$	1,099,209	685,632
Federal project revenue		1,974,964	403,598
Interest revenue		246,225	49,431
Total non reimbursable revenues	$	3,320,398	1,138,661
Operating expenses:			
Non reimbursable			
Non Federal project expense	$	1,099,209	685,632
Federal project expense		1,974,964	403,598
White River Minimum Flows compensation and administrative expense		1,992,124	26,749,718
Spectrum Relocation Fund expense		1,321,658	194,103
Endangered Species expense		50,000	—
Global Climate project expense		—	3,458
Total non reimbursable expenses	$	6,437,955	28,036,509

Federal and Non Federal Projects

Southwestern has agreements with Federal and non Federal entities to provide services on a cost basis. Non Federal entities are required to provide advance payment for Southwestern’s services. The operating revenues and expenses related to these services are excluded from the rate-making process. A portion 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 non reimbursable through the rate-making process.

White River Minimum Flows Project

Section 132 of P.L. 109-103 (Section 132) authorized the Corps 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 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 non reimbursable.

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 non reimbursable.

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 non reimbursable. 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 commercial use by facilitating reimbursement to affected agencies of relocation costs. In fiscal years 2009 and 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. In fiscal years 2011 and 2010, Southwestern expensed $1,321,658 and $194,103, respectively. Expenses incurred represent labor, service contracts, travel, and other administrative costs. This activity is non 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 non reimbursable.

(t) 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 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 of time 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, 2011 and 2010, Southwestern has no contracts accounted for as derivatives.

(u) Fair Value of Financial Instruments

FASB ASC Topic 825, *Financial Instruments*, requires disclosure of the fair value of 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.

(v) Reclassifications

Certain 2010 amounts have been reclassified to conform to the current year presentation.

(2) Utility Plant

Utility plant as of September 30, 2011 and 2010 consists of the following:

	2011	2010
Plant in service:		
Generating facilities	$ 1,096,795,371	1,078,562,139
Transmission facilities	309,634,000	298,976,824
	1,406,429,371	1,377,538,963
Less accumulated depreciation	(650,831,140)	(622,185,997)
Construction work in progress:		
Generating facilities	167,926,381	119,999,890
Transmission facilities	20,571,054	19,153,942
	188,497,435	139,153,832
Net utility plant	$ 944,095,666	894,506,798

In accordance with FERC guidelines, SWFPS excludes contributed plant within the combined balance sheets to eliminate the impact on power rates. As of September 30, 2011 and 2010, contributed plant, net used in SWFPS's operations totaled $16,946,019.

(3) Regulatory Assets and Liabilities

Regulatory assets and liabilities as of September 30, 2011 and 2010 consists of the following:

	2011	2010
Regulatory assets:		
Deferred workers' compensation	$ 12,764,665	15,687,514
Total	$ 12,764,665	15,687,514
Regulatory liabilities:		
Hydropower water storage reallocation deferral	$ 59,711,040	21,752,126
Purchased power and banking exchange deferral	54,221,980	47,832,866
Total	$ 113,933,020	69,584,992

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 l (n)).

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:

		Purchased power and banking exchange deferral
September 30, 2009	$	(30,698,300)
Purchased power adder revenue		(17,988,721)
Purchased power expense		2,407,192
Net banking exchange		(98,253)
Net purchased power and banking exchange deferral		(15,679,782)
Interest on deferred activities and other		(1,454,784)
September 30, 2010		(47,832,866)
Purchased power adder revenue		(14,918,065)
Purchased power expense		10,815,520
Net banking exchange		(258,832)
Net purchased power and banking exchange deferral		(4,361,377)
Interest on deferred activities and other		(2,027,737)
September 30, 2011	$	(54,221,980)

(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) Payable to U.S. Treasury

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.

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 2011. 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 Payable to U.S. Treasury. 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 fiscal year 2011 and 4.125% for facilities placed in service during fiscal year 2011. 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 2011 Integrated System Power Repayment Study prepared as of September 30, 2011, the projected increase in capital investment in 2011 is $143,587,769, which includes $16,008,688 for transmission facilities and $127,579,081 for generating facilities. The five-year investment increase projected in the 2011 Integrated System Power Repayment Study for fiscal year 2011 through 2015 is estimated to cost $695,005,535.

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).

(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 as of September 30, 2011 and 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, 2011 are as follows:

Year ending September 30:		
2012	$	673,000
2013		680,000
2014		178,000
Total future minimum lease payments	$	1,531,000

Rent expense for operating leases during the years ended September 30, 2011 and 2010 was $692,000 and $691,000, respectively.

(7) Subsequent Events

On March 5, 2012, the FERC approved on a final basis a change to the Integrated System rate schedules and the new rate schedules incorporated a 5.4% increase. The rates were placed into effect January 1, 2012 and will remain in effect through September 30, 2015.

SWFPS has evaluated subsequent events from the balance sheet date through August 27, 2012, the date at which the financial statements were available to be issued, and such events are disclosed in these accompanying notes.

Schedule 1

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Balance Sheet Data

September 30, 2011

Assets		**Southwestern**	**Corps**	**Total**
Plant in service	$	309,634,000	1,096,795,371	1,406,429,371
Accumulated depreciation		(150,584,367)	(500,246,773)	(650,831,140)
Construction work in progress		20,571,054	167,926,381	188,497,435
Net utility plant		179,620,687	764,474,979	944,095,666
Cash		72,723,700	152,103,126	224,826,826
Funds held in escrow		27,687,926	26,516,090	54,204,016
Accounts receivable		15,069,679	204,895	15,274,574
Material and supplies, at average cost		2,664,178	24,631	2,688,809
Banking exchange receivables		3,965,017	—	3,965,017
Deferred workers’ compensation		4,712,667	8,051,998	12,764,665
Other assets		31,224,421	—	31,224,421
Total assets	$	337,668,275	951,375,719	1,289,043,994
Liabilities and Capitalization				
Liabilities:				
Accounts payable and accrued liabilities	$	6,720,305	8,151,146	14,871,451
Advances for construction		22,742,722	—	22,742,722
Accrued workers’ compensation		5,690,186	8,264,437	13,954,623
Purchased power and banking exchange deferral		54,221,980	—	54,221,980
Hydropower water storage reallocation deferral		59,711,040	—	59,711,040
Total liabilities		149,086,233	16,415,583	165,501,816
Capitalization:				
Payable to U.S. Treasury		107,130,923	751,282,118	858,413,041
Accumulated net revenues		81,451,119	183,678,018	265,129,137
Total capitalization		188,582,042	934,960,136	1,123,542,178
Commitments and contingencies (notes 5 and 6)				
Total liabilities and capitalization	$	337,668,275	951,375,719	1,289,043,994

See accompanying independent auditors’ report.

Schedule 1

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Balance Sheet Data

September 30, 2010

Assets		**Southwestern**	**Corps**	**Total**
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		176,260,154	718,246,644	894,506,798
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
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	$	322,286,487	921,584,451	1,243,870,938
Liabilities and Capitalization				
Liabilities:				
Accounts payable and accrued liabilities	$	6,151,898	3,683,443	9,835,341
Advances for construction		16,957,829	—	16,957,829
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		97,379,377	15,889,069	113,268,446
Capitalization:				
Payable to U.S. Treasury		143,611,177	743,455,611	887,066,788
Accumulated net revenues		81,295,933	162,239,771	243,535,704
Total capitalization		224,907,110	905,695,382	1,130,602,492
Commitments and contingencies (notes 5 and 6)				
Total liabilities and capitalization	$	322,286,487	921,584,451	1,243,870,938

See accompanying independent auditors' report.

Schedule 2

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Changes in Capitalization Data

Years ended September 30, 2011 and 2010

	Southwestern payable to U.S. Treasury	Southwestern accumulated net revenues (deficit)	Southwestern total capitalization	Corps payable to U.S. Treasury	Corps accumulated net revenues (deficit)	Corps total capitalization	Total capitalization
Total capitalization as of September 30, 2009	$ 141,849,869	106,696,922	248,546,791	741,822,754	113,405,431	855,228,185	1,103,774,976
Additions:							
Congressional appropriations	13,076,000	—	13,076,000	112,490,027	—	112,490,027	125,566,027
Interest on payable to U.S. Treasury and other	3,020,246	—	3,020,246	13,377,119	—	13,377,119	16,397,365
Total additions to capitalization	16,096,246	—	16,096,246	125,867,146	—	125,867,146	141,963,392
Deductions:							
Payments to U.S. Treasury	443,279	—	443,279	(138,979,655)	—	(138,979,655)	(138,536,376)
Transfers of property and services, net	(14,778,217)	—	(14,778,217)	14,745,366	—	14,745,366	(32,851)
Total deductions to capitalization	(14,334,938)	—	(14,334,938)	(124,234,289)	—	(124,234,289)	(138,569,227)
Net revenues (deficit) for the year ended September 30, 2010	—	(25,400,989)	(25,400,989)	—	48,834,340	48,834,340	23,433,351
Total capitalization as of September 30, 2010	143,611,177	81,295,933	224,907,110	743,455,611	162,239,771	905,695,382	1,130,602,492
Additions:							
Congressional appropriations	13,049,848	—	13,049,848	84,274,571	—	84,274,571	97,324,419
Interest on payable to U.S. Treasury and other	501,686	—	501,686	14,924,944	—	14,924,944	15,426,630
Total additions to capitalization	13,551,534	—	13,551,534	99,199,515	—	99,199,515	112,751,049
Deductions:							
Payments to U.S. Treasury	(29,473,838)	—	(29,473,838)	(110,907,990)	—	(110,907,990)	(140,381,828)
Transfers of property and services, net	(20,557,950)	—	(20,557,950)	19,534,982	—	19,534,982	(1,022,968)
Total deductions to capitalization	(50,031,788)	—	(50,031,788)	(91,373,008)	—	(91,373,008)	(141,404,796)
Net revenues for the year ended September 30, 2011	—	155,186	155,186	—	21,438,247	21,438,247	21,593,433
Total capitalization as of September 30, 2011	$ 107,130,923	81,451,119	188,582,042	751,282,118	183,678,018	934,960,136	1,123,542,178

See accompanying independent auditors' report.

Schedule 3

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Revenues and Expenses Data

Year ended September 30, 2011

	Southwestern	Corps	Total
Operating revenues:			
Sales of electric power	$ 153,841,907	—	153,841,907
Transmission and other operating revenues	15,842,893	1,830,452	17,673,345
Total operating revenues before deferrals	169,684,800	1,830,452	171,515,252
Net purchased power and banking exchange deferral	(4,361,377)	—	(4,361,377)
Revenue distributed to Corps	(101,312,538)	101,312,538	—
Total operating revenues	64,010,885	103,142,990	167,153,875
Non reimbursable revenues	3,306,895	13,503	3,320,398
Total revenues	67,317,780	103,156,493	170,474,273
Operating expenses:			
Operation and maintenance	26,771,360	50,938,286	77,709,646
Purchased power and banking exchange	10,094,337	—	10,094,337
Depreciation and amortization	12,591,664	17,671,915	30,263,579
Transmission service charges by others	3,078,739	—	3,078,739
Retirement and other employee benefit expense	4,902,723	2,352,058	7,254,781
Non reimbursable expenses	6,437,955	—	6,437,955
Total operating expenses	63,876,778	70,962,259	134,839,037
Net operating revenues	3,441,002	32,194,234	35,635,236
Interest expense:			
Interest on payable to U.S. Treasury and other	4,703,762	14,378,215	19,081,977
Allowance for funds used during construction	(1,417,946)	(3,622,228)	(5,040,174)
Net interest expense	3,285,816	10,755,987	14,041,803
Net revenues	$ 155,186	21,438,247	21,593,433

See accompanying independent auditors' report.

Schedule 3

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Revenues and Expenses Data

Year ended September 30, 2010

	Southwestern	Corps	Total
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	1,107,532	31,129	1,138,661
Total revenues	55,230,397	135,149,287	190,379,684
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	28,036,509	—	28,036,509
Total operating expenses	77,797,024	74,406,062	152,203,086
Net operating revenues (deficit)	(22,566,627)	60,743,225	38,176,598
Interest expense:			
Interest on payable to U.S. Treasury 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	$ (25,400,989)	48,834,340	23,433,351

See accompanying independent auditors’ report.

Schedule 4

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Cash Flows Data

Year ended September 30, 2011

		Southwestern	Corps	Total
Cash flows from operating activities:				
Net revenues	$	155,186	21,438,247	21,593,433
Adjustments to reconcile net revenues to net cash provided by operating activities:				
Revenue distributed to Corps		101,312,538	(101,312,538)	—
Depreciation and amortization		12,591,664	17,671,915	30,263,579
Benefit expense paid by other Federal agencies		1,577,930	2,139,619	3,717,549
Interest on payable to U.S. Treasury and other		4,705,380	14,924,944	19,630,324
Allowance for funds used during construction		(1,417,946)	(3,622,228)	(5,040,174)
(Increase) decrease in assets:				
Accounts receivable		2,301,968	(125,059)	2,176,909
Materials and supplies		(454,136)	(24,631)	(478,767)
Banking exchange receivables		(472,988)	—	(472,988)
Deferred workers' compensation		(914,665)	3,837,514	2,922,849
Other assets		(9,034,666)	—	(9,034,666)
Increase (decrease) in liabilities:				
Accounts payable and accrued liabilities		568,407	4,467,703	5,036,110
Accrued workers' compensation		1,005,528	(3,941,189)	(2,935,661)
Purchased power and banking exchange deferral		4,493,035	—	4,493,035
Advances for construction		5,784,893	—	5,784,893
Net cash provided by (used in) operating activities		122,202,128	(44,545,703)	77,656,425
Cash flows from investing activities:				
Additions to utility plant		(14,534,251)	(60,278,022)	(74,812,273)
Cash flows from financing activities:				
Congressional appropriations		13,049,848	84,274,571	97,324,419
Payments to U.S. Treasury		(130,786,376)	(9,595,452)	(140,381,828)
Transfers of property and services, net		(22,135,880)	17,395,363	(4,740,517)
Hydropower water storage reallocation deferral		35,651,299	—	35,651,299
Funds received in escrow		(26,583,388)	(13,503)	(26,596,891)
Funds disbursed from escrow		18,396,531	2,910,000	21,306,531
Net cash (used in) provided by financing activities		(112,407,966)	94,970,979	(17,436,987)
Net decrease in cash		(4,740,089)	(9,852,746)	(14,592,835)
Cash, beginning of year		77,463,789	161,955,872	239,419,661
Cash, end of year	$	72,723,700	152,103,126	224,826,826
Supplemental cash flow information:				
Interest deferred on regulatory liabilities	$	4,203,694	—	4,203,694

See accompanying independent auditors' report.

Schedule 4

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Schedule of Cash Flows Data

Year ended September 30, 2010

		Southwestern	Corps	Total
Cash flows from operating activities:				
Net revenues (deficit)	$	(25,400,989)	48,834,340	23,433,351
Adjustments to reconcile net revenues (deficit) to net cash provided by 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 on payable to U.S. Treasury and other		4,553,187	13,377,119	17,930,306
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		15,742,027	—	15,742,027
Advances for construction		(5,286,281)	—	(5,286,281)
Net cash provided by (used in) operating activities		141,798,272	(56,604,378)	85,193,894
Cash flows from investing activities:				
Additions to utility plant		(22,310,235)	(44,692,286)	(67,002,521)
Cash flows from financing activities:				
Congressional appropriations		13,076,000	112,490,027	125,566,027
Payments to U.S. Treasury		(132,053,955)	(6,482,421)	(138,536,376)
Transfers of property and services, net		(16,422,222)	12,508,459	(3,913,763)
Hydropower water storage reallocation deferral		21,611,724	—	21,611,724
Funds received in escrow		(8,205,550)	(6,031,129)	(14,236,679)
Funds disbursed from escrow		13,205,896	9,000,000	22,205,896
Net cash (used in) provided by financing activities		(108,788,107)	121,484,936	12,696,829
Net increase in cash		10,699,930	20,188,272	30,888,202
Cash, beginning of year		66,763,859	141,767,600	208,531,459
Cash, end of year	$	77,463,789	161,955,872	239,419,661
Supplemental cash flow information:				
Interest deferred on regulatory liabilities	$	1,532,941	—	1,532,941

See accompanying independent auditors' report.

IG Report No. OAS-FS-13-06

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