Operating Expenses

2011 compared to 2010 Operating expenses were $1,161.8 million in 2011, an increase of $5.5 million from 2010. Purchased power expense was $18.2 million lower in 2011, mainly due to lower average prices as compared to 2010, even though more energy was purchased than in 2010. Approximately 12 percent more energy was purchased in 2011 at prices that averaged 17 percent lower than in 2010.

In 2011, net fuel costs for generation, a component of production costs, were approximately $281.0 million (inclusive of ineffective hedges reported as investment expense), or $14.3 million lower than 2010. Less fuel was used in 2011 (4.8 million decatherms), primarily due to lower production at the component unit generation plants (13 percent). Average net fuel prices were higher by 7 percent in 2011 as compared to 2010.

In 2011, power supply costs made up approximately 56 percent of total operating expenses as compared to 59 percent for 2010.

Depreciation expense increased by $7.3 million due to a decrease in the remaining service life for meters as SMUD transitions to advanced metering technology, and due to software, hardware, and other normal capital plant additions.

Regulatory deferrals collected in rates increased $6.0 million due to amortization of remediation obligations related to the North City substation.

Administrative, general and customer expenses, were $4.5 million higher in 2011 than in 2010, mainly due to higher Home Performance Program expense offset by a decrease in uncollectible energy efficiency loans.

2010 compared to 2009 Operating expenses were $1,156 million in 2010, approximately $22 million lower than in 2009. Purchased power expense was $84 million lower in 2010 mainly due to less energy purchased and slightly lower average prices as compared to 2009. Approximately 24 percent less energy was purchased in 2010 at average prices that were one percent lower than in 2009. Purchased power expense increased by $4 million for precipitation hedges and insurance.

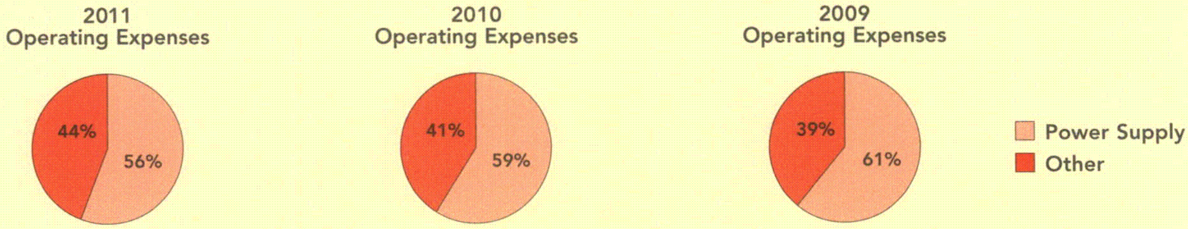
In 2010, net fuel costs for generation, a component of production costs, were approximately $295 million (inclusive of ineffective hedges reported as investment expense), or $24 million higher than 2009. More fuel was used in 2010 (1.2 million decatherms), primarily due to higher production at the component unit generation plants (6 percent). Average net fuel prices were higher by 6 percent in 2010 as compared to 2009.

Administrative, general and customer expenses were $3 million lower in 2010 than in 2009 reflecting lower Cosumnes Power Plant litigation costs and efforts to reduce expenses.

Depreciation expense increased by $12 million due to a change in the remaining service life for meters as SMUD transitions to advanced metering technology and due to normal capital plant additions.

In 2010, power supply costs made up approximately 59 percent of total operating expenses as compared to 61 percent for 2009.

The following charts compare the relative cost of purchased power, production expenses, and depletion of the Rosa gas field (power supply costs) to all other operating expenses in 2011, 2010, and 2009:



Other Revenues (Expenses)

2011 compared to 2010 Other revenues were $9.0 million higher in 2011 as compared to 2010. Interest income was $7.8 million higher due to interest received from settlement wholesale power settlement (see Note 18). Grant revenue and pass through expenditures increased $8.9 million. These increases were partially offset by an $8.5 million increase in investment expense related to ineffective hedges.

2010 compared to 2009 Other revenues were $20 million higher in 2010 as compared to 2009. Interest income was $2 million lower due to significantly lower interest rates. Other income – net was $7 million higher due to higher Build America Bond interest subsidies. Investment expense related to ineffective hedges was lower by $14 million.

Interest Charges

2011 compared to 2010 Total interest charges were $0.8 million higher in 2011 compared to 2010.

2010 compared to 2009 Interest charges in 2010 were $30 million higher than in 2009, due mainly to a 2009 gain on the extinguishment of a portion of the Northern California Gas Authority long-term debt.

Extraordinary Income SMUD recognized extraordinary income of $0.1 million in 2011 for power settlements.

CONSOLIDATED BALANCE SHEETS

Assets	December 31, 2011	December 31, 2010
	(thousands of dollars)	
Electric Utility Plant		
Plant in service	$ 4,747,914	$ 4,505,686
Less accumulated depreciation and depletion	(1,917,439)	(1,755,534)
Plant in service – net	2,830,475	2,750,152
Construction work in progress	417,819	254,064
Total electric utility plant – net	3,248,294	3,004,216
Restricted and Designated Assets		
Revenue bond, debt service and construction reserves	201,941	239,533
Nuclear decommissioning trust fund	30,890	30,335
Rate stabilization fund	91,964	41,471
Other funds	654	750
Less current portion	(85,172)	(107,649)
Total restricted and designated assets	240,277	204,440
Current Assets		
Unrestricted cash and cash equivalents	261,709	371,090
Restricted and designated cash and cash equivalents	39,846	39,056
Restricted and designated investments	45,326	68,593
Receivables – net:		
Retail customers	153,612	154,489
Wholesale	9,624	47,594
Energy efficiency loans due within one year, interest receivable, grants receivable and other	52,521	33,524
Regulatory costs to be recovered within one year	20,856	52,626
Deferred outflow resources to be recovered within one year	113,730	104,556
Investment derivative instruments maturing within one year	758	905
Hedging derivative instruments maturing within one year	4,031	13,232
Materials and supplies	48,145	44,518
Prepaid gas to be delivered within one year	21,194	21,309
Credit support collateral deposits	24,835	22,761
Prepayments	11,844	14,676
Total current assets	808,031	988,929
Noncurrent Assets and Deferred Charges		
Regulatory costs for future recovery	202,427	205,052
Deferred outflow resources for future recovery	101,994	113,064
Prepaid Gas	384,851	406,046
Advance capacity payments	11,877	16,795
Hedging derivative instruments	38,410	27,654
Unamortized debt issuance costs	26,895	31,459
Energy efficiency loans – net	48,778	57,959
Credit support collateral deposits	29,215	27,139
Preliminary project studies and other	11,698	11,081
Total noncurrent assets and deferred charges	856,145	896,249
Total Assets	**$ 5,152,747**	**$ 5,093,834**

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

CONSOLIDATED BALANCE SHEETS

Liabilities	December 31, 2011	2010
	(thousands of dollars)	
Long-Term Debt – net	$ 3,012,935	$ 3,156,447
Current Liabilities and Deferred Credits		
Commercial paper notes	200,000	200,000
Accounts payable	143,011	77,422
Purchased power payable	20,475	52,104
Credit support collateral obligation	360	6,050
Long-term debt due within one year	102,520	99,935
Accrued decommissioning	4,935	1,893
Interest payable	41,808	47,119
Accrued salaries and compensated absences	36,612	37,747
Investment derivative instruments maturing within one year	15,480	29,076
Hedging derivative instruments maturing within one year	117,761	117,787
Regulatory credits to be recognized within one year	18,474	11,941
Customer deposits and other	35,531	36,207
Total current liabilities and deferred credits	736,967	717,281
Noncurrent Liabilities and Deferred Credits		
Accrued decommissioning	172,245	165,603
Investment derivative instruments	44,873	43,703
Hedging derivative instruments	140,404	140,717
Regulatory credits	372,584	281,740
Due to affiliated entity	9,497	9,448
Due to U.S. Bureau of Reclamation	6,179	6,300
Self insurance, deferred credits and other	40,114	25,908
Total noncurrent liabilities and deferred credits	785,896	673,419
Total Liabilities	4,535,798	4,547,147
Net Assets		
Invested in capital assets, net of related debt	413,845	96,871
Restricted	109,831	100,889
Unrestricted	93,273	348,927
Total Net Assets	616,949	546,687
Commitments and Contingencies (Notes 17 and 18)		
Total Liabilities and Net Assets	**$ 5,152,747**	**$ 5,093,834**

The accompanying not[illegible]egral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

	Year Ended December 31, 2011	2010
	(thousands of dollars)	
Operating Revenues		
Residential	$ 559,424	$ 526,860
Commercial and industrial	662,267	640,727
Street lighting and other	30,692	28,762
Wholesale	158,572	119,490
Senate Bill – 1 revenue (deferral)	(454)	1,232
Rate stabilization fund transfers	(50,493)	6,217
Total operating revenues	1,360,008	1,323,288
Operating Expenses		
Operations:		
Purchased power	237,360	255,523
Production	404,770	404,845
Transmission and distribution	50,878	49,879
Administrative, general and customer	144,547	140,025
Public good	58,063	53,236
Maintenance	74,688	74,498
Depreciation	169,987	162,708
Depletion	11,500	10,894
Decommissioning	4,047	4,704
Regulatory deferrals collected in rates	6,000	-0-
Total operating expenses	1,161,840	1,156,312
Operating Income	198,168	166,976
Non-Operating Revenues And Expenses		
Other revenues and (expenses)		
Interest income	17,877	10,123
Investment expense	(38,682)	(30,175)
Revenue – Grants	17,882	6,354
Pass through expenditures – Grants	(2,971)	(365)
Other income – net	18,691	17,906
Total other revenues and (expenses)	12,797	3,843
Interest charges		
Interest on debt	146,685	145,148
Loss on debt extinguishment and refundings	59	-0-
Allowance for funds used during construction	(5,907)	(5,079)
Total interest charges	140,837	140,069
Increase (Decrease) In Net Assets Before Extraordinary Income	70,128	30,750
Extraordinary Income		
Natural gas and power settlement proceeds	134	3
Increase in Net Assets	70,262	30,753
Net Assets – Beginning of Year	546,687	515,934
Net Assets – End Of Year	$ 616,949	$ 546,687

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2011	Year Ended December 31, 2010
	(thousands of dollars)	
Cash Flows From Operating Activities		
Receipts from retail customers	$ 1,245,166	$ 1,184,802
Receipts from surplus power sales	128,194	56,696
Receipts from surplus gas sales	90,657	55,745
Receipts from steam sales	7,885	8,565
Natural gas and power settlement proceeds	134	3
Other receipts	7,336	11,753
Payments for credit support collateral, net	(9,840)	(38,900)
Issuance/repayment of energy efficiency loans, net	8,904	(778)
Payments to employees – payroll and other	(210,527)	(226,522)
Payments for wholesale power	(270,551)	(261,617)
Payments for gas purchases	(319,783)	(313,559)
Payments to vendors/others	(184,643)	(149,455)
Payments for weather hedge/insurance	(630)	(3,462)
Payments for decommissioning	(3,406)	(4,801)
Net cash provided by operating activities	488,896	318,470
Cash Flows From Noncapital Financing Activities		
Repayment of debt	(22,370)	(23,465)
Receipts from federal and state grants	74,124	20,432
Interest on debt	(18,159)	(19,335)
Net cash provided by (used in) noncapital financing activities	33,595	(22,368)
Cash Flows From Capital Financing Activities		
Sale of Solano Wind Phase 3 deposit	28,000	-0-
Construction expenditures	(389,759)	(194,207)
Contributions in aid of construction	9,654	6,566
Net proceeds from bond issues	367,876	247,777
Repayments and refundings of debt	(483,417)	(83,310)
Interest on debt	(132,692)	(123,440)
Net cash used in capital financing activities	(600,338)	(146,614)
Cash Flows From Investing Activities		
Sales and maturities of securities	236,239	116,368
Purchases of securities	(234,735)	(173,586)
Interest and dividends received	20,356	10,306
Investment revenue/expenses, net	(38,682)	(30,176)
Securities lending collateral – net	-0-	(5,247)
Net cash used in investing activities	(16,822)	(82,335)
Net increase (decrease) in cash and cash equivalents	(94,669)	67,153
Cash and cash equivalents at the beginning of the year	537,992	470,839
Cash and cash equivalents at the end of the year	$443,323	$537,992
Cash and cash equivalents included in:		
Unrestricted cash and cash equivalents	$ 261,709	$ 371,090
Restricted and designated cash and cash equivalents	39,846	39,056
Revenue bond, debt service and construction reserves (a component of the total of $201,941 and $239,533 at December 31, 2011 and 2010, respectively)	141,768	127,846
Cash and cash equivalents at the end of the year	$ 443,323	$ 537,992

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

SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of the consolidated statements of cash flows operating activities to operating income is as follows:

	Year Ended December 31, 2011	2010
	(thousands of dollars)	
Operating income	$ 198,168	$ 166,976
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	169,987	162,708
Depletion	11,500	10,894
Decommissioning	10,047	4,704
Amortization of advance capacity & other	5,505	5,464
Amortization of prepaid gas supply	21,310	22,113
Revenue (recognized from) deferred to regulatory credits, net	50,674	(7,466)
Natural gas and power settlement proceeds	134	3
Payments for credit support collateral, net	(9,840)	(38,900)
Other receipts/payments	861	5,525
Changes in operating assets and liabilities:		
Customer and wholesale receivables	60,868	(10,727)
Energy efficiency loans	8,904	(778)
Other assets	(1,610)	6,808
Payables and accruals	(34,206)	(4,053)
Decommissioning	(3,406)	(4,801)
Net cash provided by operating activities	$ 488,896	$ 318,470

The supplemental disclosure of noncash financing and investing activities is as follows:

	Year Ended December 31, 2011	2010
	(thousands of dollars)	
Gain or (Loss) on debt extinguishment and refundings	(59)	-0-
Amortization of debt related costs	(1,287)	(1,546)
Unrealized holding gain or (loss)	152	(92)
Change in valuation of derivative financial instruments	14,174	(115,690)
Amortization of revenue for assets contributed in aid of construction	11,251	9,133
Allowance for funds used during construction	5,907	5,079
Construction costs included in accounts payable	66,627	31,189

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

The Sacramento Municipal Utility District (SMUD) was formed and operates under the State of California Municipal Utility District Act (Act). The Act gives SMUD the rights and powers to fix rates and charges for commodities or services it furnishes, and to incur indebtedness and issue bonds or other obligations.

As a community-owned utility, SMUD is not subject to regulation or oversight by the California Public Utilities Commission.

SMUD is responsible for the acquisition, generation, transmission, and distribution of electric power to its service area, which includes most of Sacramento County and small adjoining portions of Placer and Yolo Counties. The Board of Directors (Board) determines SMUD's rates.

SMUD is exempt from payment of federal and state income taxes and, under most circumstances, real and personal property taxes. SMUD is not exempt from real and personal property taxes on assets it holds outside of California. In addition, SMUD is responsible for the payment of a portion of the property taxes associated with its real property in California that lies outside of its service area.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Method of Accounting. SMUD's accounting records are maintained in accordance with Generally Accepted Accounting Principles (GAAP) for proprietary funds as prescribed by the Governmental Accounting Standards Board (GASB) and, where not in conflict with GASB pronouncements, accounting principles prescribed by the Financial Accounting Standards Board (FASB). References to GAAP issued by the FASB in these footnotes are to the *FASB Accounting Standards Codification*™, sometimes referred to as the Codification or ASC. SMUD's accounting records generally follow the Uniform System of Accounts for Public Utilities and Licensees prescribed by the Federal Energy Regulatory Commission (FERC), except as it relates to the accounting for contributions of utility property in aid of construction. SMUD's Consolidated Financial Statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows. Electric revenues and costs that are directly related to the acquisition, generation, transmission, and distribution of electricity are reported as operating revenues and expenses. All other revenues and expenses are reported as non-operating revenues and expenses.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Financial Reporting Entity. These Consolidated Financial Statements include SMUD and its component units. Although the component units are legally separate from SMUD, they are blended into and reported as part of SMUD because of the extent of their operational and financial relationships with SMUD. All significant inter-component transactions have been eliminated in consolidation.

Component Units. The component units include the Central Valley Financing Authority (CVFA), the Sacramento Cogeneration Authority (SCA), the Sacramento Power Authority (SPA), the Sacramento Municipal Utility District Financing Authority (SFA), and the Northern California Gas Authority No. 1 (NCGA). The primary purpose of CVFA, SCA, SPA and SFA is to own and operate electric utility plants that supply power to SMUD. The primary purpose of NCGA is to prepay for natural gas and to sell the natural gas to SMUD. SMUD's Board comprises the Commissions that govern these entities.

Plant in Service. The cost of additions to Plant in Service and replacement property units is capitalized. Repair and maintenance costs are charged to expense when incurred. When SMUD retires portions of its Electric Utility Plant, retirements are recorded against Accumulated Depreciation and the retired portion of Electric Utility Plant is removed from Plant in Service. The costs of removal and the related salvage value, if any, are charged or credited as appropriate to Accumulated Depreciation. SMUD generally computes depreciation on Plant in Service on a straight-line, service-life basis. The consolidated average annual composite depreciation rates for 2011 and 2010 were 3.84 and 3.88 percent, respectively. Depreciation is calculated using the following estimated lives:

Generation	5 to 80 years
Transmission and Distribution	5 to 50 years
Gas Pipeline	5 to 90 years
General	2 to 50 years

Investments in Joint Power Agency (JPA). SMUD's investment in the Transmission Agency of Northern California (TANC) is accounted for under the equity method of accounting and is reported as a component of Plant in Service. SMUD's share of the TANC debt service costs and operations and maintenance expense, inclusive of depreciation, is included in Transmission and Distribution expense in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Investments in Gas Properties. SMUD has an approximate 21 percent non-operating ownership interest in the Rosa Unit gas properties in New Mexico of which, SMUD's portion of the extracted gas is transported for use in its component unit natural gas-fired power plants (see Note 6). SMUD uses the successful efforts method of accounting for its investment in gas producing properties. Costs to acquire mineral interests in gas properties, to drill and equip exploratory wells that find proved reserves, and to drill and equip development wells are capitalized as a component of Plant in Service on the Consolidated Balance Sheets. Costs to drill exploratory wells that do not find proved reserves, geological and geophysical costs, and costs of carrying and retaining unproved properties are expensed. SMUD has purchased proven reserves and has not participated in exploratory drilling. Capitalized costs of producing gas properties, after considering estimated residual salvage values, are depleted by the unit-of–production method based on the estimated future production of the proved developed producing wells. SMUD's investment in gas properties is reported as a component of Plant in Service.

Restricted and Designated Assets. Cash, cash equivalents, and investments, which are restricted under terms of certain agreements for payments to third parties or Board actions limiting the use of such funds, are included as restricted assets. When SMUD restricts funds for a specific purpose, and both restricted and unrestricted resources are available for use, it is SMUD's policy to use restricted resources first, then unrestricted resources as they are needed.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Restricted Bond Funds. SMUD's Indenture Agreements (Indenture) and Bond Resolutions require the maintenance of minimum levels of reserves for debt service and certain construction costs intended by the related debt offerings.

Nuclear Decommissioning Trust Fund. SMUD made annual contributions to its Nuclear Decommissioning Trust Fund (Trust Fund) through 2008 to cover the cost of its primary decommissioning activities associated with the Rancho Seco facility. Primary decommissioning excludes activities associated with the spent fuel storage facility after 2008 and most non-radiological decommissioning tasks. SMUD determined early in 2008 that there were enough funds in the trust to complete the radiological decommissioning of the Rancho Seco nuclear plant site, and stopped contributing to the Trust Fund (see Note 13).

Interest earnings on the Trust Fund assets are recorded as Interest Income and are accumulated in the Trust Fund. Annual Decommissioning Expense is made up of the annual interest earned on the Trust Fund and fuel storage costs that cannot be taken from the Trust Fund.

Accrued Decommissioning. SMUD accrues decommissioning costs related to Utility Plant when an obligation to decommission facilities is legally required. Adjustments are made to such liabilities based on estimates by SMUD staff in accordance with FASB ASC 410, *Asset Retirement and Environmental Obligations* (FASB ASC 410). For active plants, such costs are included in the Utility Plant's cost and included as a component of Operating Expense over the Utility Plant's life. Expenditures for decommissioning activities are recorded as reductions to Accrued Decommissioning liability. Changes in the Rancho Seco decommissioning liability estimates arising from inflation, annual accretion, and other changes to the cost assumptions are recorded directly to Accrued Decommissioning with a corresponding adjustment to the related regulatory deferral. The current portion of the Accrued Decommissioning liability represents SMUD's estimate of actual expenditures in the next year, as set forth in the annual budget.

SMUD has identified potential retirement obligations related to certain generation, distribution and transmission facilities. SMUD's non-perpetual leased land rights generally are renewed continuously because SMUD intends to utilize these facilities indefinitely. Since the timing and extent of any potential asset retirements are unknown, the fair value of any obligations associated with these facilities cannot be reasonably estimated. Accordingly, a liability has not been recorded.

At December 31, 2011 and 2010, SMUD's Accrued Decommissioning balance in the Consolidated Balance Sheets relating to Rancho Seco was $168.6 million and $160.5 million, respectively (see Note 13). The Accrued Decommissioning balance in the Consolidated Balance Sheets relating to other electricity generation and gas production facilities totaled $8.5 million and $7.0 million as of December 31, 2011 and 2010, respectively.

Cash and Cash Equivalents. Cash and cash equivalents include all debt instruments purchased with an original maturity of 90 days or less, all investments in the Local Agency Investment Fund (LAIF), and money market mutual funds. LAIF has an equity interest in the State of California (State) Pooled Money Investment Account (PMIA). PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters, and maximum maturity of investments. SMUD's deposits with LAIF comprise cash representing demand deposits up to $50.0 million maximum, and cash equivalents representing amounts above $50.0 million which may be withdrawn once per month after a thirty-day period. The debt instruments and money market mutual funds are reported at amortized cost which approximates fair value, and the LAIF is reported at the value of its pool shares.

Investments. SMUD's investments are reported at fair value. Realized and unrealized gains and losses are included in Interest and Other Income in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. Premiums and discounts on zero coupon bonds are amortized using the effective interest method. Premiums and discounts on other securities are amortized using the straight-line method, which approximates the effective interest method.

Electric Operating Revenues. Electric revenues are billed on the basis of monthly cycle bills and are recorded as revenue when the electricity is delivered. SMUD records an estimate for unbilled revenues earned from the dates its retail customers were last billed to the end of the month. At December 31, 2011 and 2010, unbilled revenues were $68.3 million and $67.6 million, respectively.

Purchased Power Expenses. A portion of SMUD's power needs are provided through power purchase agreements. Expenses from such agreements, along with associated transmission costs paid to other utilities, are charged to Purchased Power expense on the Consolidated Statements of Revenues, Expenses and Changes in Net Assets in the period the power is received. The costs, or credits, associated with energy swap agreements (gas and electricity) or other arrangements that affect the net cost of Purchased Power are recognized in the period in which the underlying power delivery occurs. Contract termination payments and adjustments to prior billings are included in Purchased Power expense once the payments or adjustments can be reasonably estimated.

Advanced Capacity Payments. Some long-term agreements to purchase energy or capacity from other providers call for up-front payment. Such costs are generally recorded as an asset and amortized over the length of the contract.

Credit and Market Risk. SMUD enters into forward purchase and sales commitments for physical delivery of gas and electricity with utilities and power marketers. SMUD is exposed to credit risk related to nonperformance by its wholesale counterparties under the terms of these contractual agreements. In order to limit the risk of counterparty default, SMUD has a wholesale counterparty risk policy which includes using the credit agency ratings of SMUD's counterparties, credit enhancements for counterparties that do not meet an acceptable risk level, and the use of standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. SMUD is also subject to similar requirements for many of its gas and electricity purchase agreements. At December 31, 2011 and 2010, SMUD held $0.4 million and $6.1 million on deposit by counterparties, respectively. The amount is recorded as unrestricted cash with an associated short-term and long-term liability. At December 31, 2011, SMUD had $54.1 million in collateral on deposit with counterparties. SMUD has a $50 million letter of credit facility to support collateral requirements under SMUD's various energy and natural gas purchase, sale and swap agreements.

Accounts Receivable and Allowance for Doubtful Accounts. Accounts Receivable is recorded at the invoiced amount and does not bear interest, except for accounts related to energy efficiency loans. SMUD recognizes an estimate of uncollectible accounts for its receivables related to electric service, energy efficiency loans, and other non-electric billings, based upon its historical experience with collections and current energy market conditions. For large wholesale receivable balances, SMUD determines its bad debt reserves based on the specific credit issues for each account. SMUD records bad debts for its estimated uncollectible accounts related to electric service and other non-electric billings as a reduction to the related operating revenues in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. SMUD records bad debts for its estimated uncollectible accounts related to energy efficiency loans in Administrative, General and Customer expense in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The summarized activity of the changes in the allowance for doubtful accounts during 2011 and 2010 is presented below.

	Balance at beginning of Year	Additions	Write-offs and Recoveries	Balance at end of Year
		(thousands of dollars)		
California ISO and PX:				
December 31, 2011	$ 24,007	$ -0-	$ 24,007	$ -0-
December 31, 2010	$ 23,848	$ 222	$ 63	$ 24,007
Other Non-Electric:				
December 31, 2011	$ 1,219	$ 568	$ 411	$ 1,376
December 31, 2010	$ 1,518	$ 659	$ 958	$ 1,219
Retail Customers:				
December 31, 2011	$ 3,946	$ 6,390	$ 6,433	$ 3,903
December 31, 2010	$ 3,548	$ 7,432	$ 7,034	$ 3,946
Energy Efficiency Loans:				
December 31, 2011	$ 3,283	$ (40)	$ 527	$ 2,716
December 31, 2010	$ 2,978	$ 2,312	$ 2,007	$ 3,283

Regulatory Deferrals. The Board has the authority to establish the level of rates charged for all SMUD services. As a regulated entity, SMUD's financial statements are prepared in accordance with FASB ASC 980, *Regulated Operations*, which requires that the effects of the rate-making process be recorded in the financial statements. Accordingly, certain expenses and credits, normally reflected in Net Increase (Decrease) in Net Assets as incurred, are recognized when included in rates and recovered from, or refunded to, customers. SMUD records various regulatory assets and credits to reflect rate-making actions of the Board.

Materials and Supplies. Materials and supplies are stated at average cost, which approximates the first-in, first-out method.

Unamortized Debt Issuance Costs. The costs incurred in connection with the issuance of debt obligations, principally underwriters fees and legal costs, are recorded as Unamortized Debt Issuance Costs in the Consolidated Balance Sheets and are amortized over the terms of the related obligations using the effective interest method.

Compensated Absences. SMUD accrues vacation leave and compensatory time when employees earn the rights to the benefits. SMUD does not record sick leave or other leave as a liability until it is taken by the employee, since there are no cash payments for sick leave or other leave made when employees terminate or retire. At December 31, 2011 and 2010, the total estimated liability for vacation and other compensated absences was $24.1 million and $24.4 million, respectively.

Public Good. Public Good expenses consist of non-capital expenditures for energy efficiency programs, low income subsidies, renewable energy resources and technologies research and development.

Gains/Losses on Bond Refundings. Gains and losses resulting from bond refundings are included as a component of Long-Term Debt on the Consolidated Balance Sheets and amortized as a component of Interest on Debt in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets over the shorter of the life of the refunded debt or the new debt using the effective interest method.

Gains/Losses on Bond Defeasances or Extinguishments. Gains and losses resulting from bond defeasances or extinguishments that were not financed with the issuance of new debt are included as a component of Interest on Debt in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Allowance for Funds Used During Construction (AFUDC). SMUD capitalizes, as an additional cost of Construction Work In Progress (CWIP), AFUDC, which represents the cost of borrowed funds used for such purposes. The amount capitalized is determined by a formula prescribed by FERC. The AFUDC rate for both 2011 and 2010 was 3.9 percent, of eligible CWIP.

Derivative Financial Instruments. SMUD records derivative financial instruments (interest rate swap and gas price swap agreements, certain wholesale sales agreements, certain electricity purchase agreements and option agreements) at fair value on its Consolidated Balance Sheets. SMUD generally does not enter into agreements for trading purposes. Fair market value is estimated by comparing contract prices to forward market prices quoted by third party market participants and/or provided in relevant industry publications. SMUD is exposed to risk of nonperformance if the counterparties default or if the swap agreements are terminated. SMUD reports derivative financial instruments with remaining maturities of one year or less and the portion of long-term contracts with scheduled transactions over the next twelve months as current on the Consolidated Balance Sheets (see Note 9).

Interest Rate Swap Agreements. SMUD enters into interest rate swap agreements to modify the effective interest rates on outstanding debt (see Note 9).

Gas and Electricity Price Swap and Option Agreements. SMUD uses forward contracts to hedge the impact of market volatility on gas commodity prices for its gas-fueled power plants and for energy prices on purchased power for SMUD's retail load (see Note 9).

Deposits. SMUD entered into an agreement to sell the Solano Wind Phase 3 plant in December 2011. As part of that agreement, SMUD received $28.0 million in December 2011, which is recorded as a component of Accounts Payable on the Consolidated Balance Sheets. SMUD is obligated to complete construction of the plant, which is expected to occur in March 2012, and after that, SMUD will receive the remainder of the sale amount. At that point, SMUD will account for the full transaction. See Note 17 for language about the Power Purchase Agreement.

Precipitation Hedge Agreements. SMUD enters into non-exchange traded precipitation hedge agreements to hedge the cost of replacement power caused by low precipitation years (Precipitation Agreements). SMUD records the intrinsic value of the Precipitation Agreements on the Consolidated Balance Sheets. Settlement of the Precipitation Agreements is not performed until the end of the period covered (water year ended September 30). The intrinsic value of a Precipitation Agreement is the difference between the expected results from a monthly allocation of the cumulative rainfall amounts, in an average rainfall year, and the actual rainfall during the same period.

Insurance Programs. SMUD records liabilities for unpaid claims at their present value when they are probable in occurrence and the amount can be reasonably estimated. SMUD records a liability for unpaid claims associated with general, auto, workers' compensation, and short-term and long-term disability based upon estimates derived by SMUD's claims administrator or SMUD staff. The liability comprises the present value of the claims outstanding, and includes an amount for claim events incurred but not reported based upon SMUD's experience.

Net Assets. SMUD classifies its net assets into three components as follows:

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, net of Accumulated Depreciation reduced by the outstanding debt balances, net of unamortized debt expenses.
- Restricted – This component consists of net assets with constraints placed on their use, either externally or internally. Constraints include those imposed by debt indentures (excluding amounts considered in net capital, above), grants or laws and regulations of other governments, or by law through constitutional provisions or enabling legislation or by the Board.
- Unrestricted – This component of net assets consists of net assets that do not meet the definition of "Invested in Capital Assets, Net of Related Debt" or "Restricted."

Contributions in Aid of Construction (CIAC). SMUD records CIAC from customer contributions, primarily relating to expansions to SMUD's distribution facilities, as Non-Operating Revenues in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. Contributions of capital are valued at estimated market cost. For rate-making purposes, the Board does not recognize such revenues when received; rather, CIAC is included in revenues as such costs are amortized over the estimated useful lives of the related distribution facilities.

Revenues and Expenses. SMUD distinguishes operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with SMUD's principal ongoing operations. The principal operating revenues of SMUD are charges to customers for sales and services. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Grants. SMUD receives grant proceeds from federal and state assisted programs for its advanced and renewable technologies, electric vehicle, and energy efficiency programs. SMUD also periodically receives grant proceeds from federal or state assistance programs as partial reimbursements for costs it has incurred as a result of storm damages. Additionally, SMUD received several large American Recovery and Reinvestment Act (ARRA) grants in 2009. When applicable, these programs may be subject to financial and compliance audits pursuant to regulatory requirements. SMUD considers the possibility of any material disallowances to be remote. During 2011, SMUD recorded $75.3 million of grant proceeds and recognized $17.9 million as a component of Interest and Other Income, in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets, $41.9 million as a Regulatory Deferral (Note 8), and $15.5 million as deferred revenues as a component of Self Insurance, Deferred Credits and Other on the Consolidated Balance Sheets. During 2010, SMUD recorded $26.5 million of grant proceeds and recognized $6.4 million as a component of Interest and Other Income, in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets, $19.5 million as a Regulatory Deferral (Note 8), and $0.6 million as deferred revenues as a component of Self Insurance, Deferred Credits and Other on the Consolidated Balance Sheets.

In 2010, SMUD issued taxable Build America Bonds. SMUD will receive an interest subsidy from the federal government equal to 35 percent of the interest paid (see Note 10). In 2011 and 2010, SMUD recognized $9.8 and $6.7 million in revenues for its Build America Bonds, as a component of Interest Income, in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Extraordinary Income. In 2011, SMUD received and recognized an additional $0.1 million of extraordinary income for purchased power settlements. In 2010, SMUD received and recognized an additional $3 thousand of extraordinary income for purchased power.

Pollution Remediation. In December 2009, SMUD identified a pollution remediation obligation at its North City Substation. This substation was built on a former landfill, and the site requires remediation. As part of the 2010 Budget Resolution, the Board authorized SMUD to defer the expense for rate-making purposes, and SMUD recorded a pollution remediation liability of $12.0 million and a corresponding regulatory asset for the remediation project. SMUD has expensed $6.0 million of the costs in 2011 (see Note 8).

Customer Sales and Excise Taxes. SMUD is required by various governmental authorities, including states and municipalities, to collect and remit taxes on certain customer sales. Such taxes are presented on a net basis and excluded from revenues and expenses in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Termination Benefits. Termination benefits are benefits provided to employees as an incentive to hasten the termination of services, as a result of a voluntary early termination, or as a consequence of involuntary early termination.

SMUD has identified a termination benefit liability related to certain employees related to the Rancho Seco site. There are voluntary separation programs and retention agreements for certain employees. Benefits provided include up to six months of paid Consolidated Omnibus Reconciliation Act of 1985 (COBRA) medical benefits, outplacement services, and severance, based on length of service and type of termination agreement. Employees with sufficient length of service are eligible for Other Post Employment Benefits (OPEB) after termination. As of December 31, 2011, 2 employees had retention agreements totaling $0.1 million, recorded as a component of Customer Deposits and Other on the Consolidated Balance Sheets.

In October 2009, SMUD announced that the installation of "Smart Meters" would affect certain job classifications. A separation package and talent retention program was outlined with employees. Benefits provided include up to 12 weeks of paid leave, plus pay in lieu of benefits for up to 12 weeks. Because some of the affected employees must work through December 2012, the amount of the termination liability is being recognized ratably on a monthly basis through December 2012. There is also a termination liability for another separation package for employees that will work through January 2012. As of December 31, 2011, there were approximately 36 positions affected, and SMUD had a termination liability of $0.4 million, recorded as a component of Customer Deposits and Other on the Consolidated Balance Sheets.

Subsequent events. Subsequent events for SMUD have been evaluated through February 17, 2012, which is the date that the financial statements were available to be issued.

Reclassifications. Certain amounts in the 2010 Consolidated Financial Statements have been reclassified in order to conform to the 2011 presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Recent Accounting Pronouncements. In January 2010, FASB issued Accounting Standards Update No. 2010-06 ***"Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements"*** (ASU 2010-06). ASU 2010-06 seeks to improve disclosure relating to fair values. The update requires the separate disclosure of and explanation of significant transfers in and out of fair values based on Level 1 and Level 2 inputs. The update also requires the presentation of separate information about purchases, sales, issuances, and settlements activity for fair values based on Level 3 inputs. SMUD has assessed the financial statement impact of adopting the new statement, and its impact is not material.

In April 2010, FASB issued Accounting Standards Update No. 2010-17 ***"Revenue Recognition – Milestone Method (Topic 605): Milestone Method of Revenue Recognition – a consensus of the FASB Emerging Issues Task Force"*** (ASU 2010-17). ASU 2010-17 establishes authoritative guidance for revenue recognition relating to milestone contracts. This update provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition. This update was effective for SMUD for 2011. SMUD has assessed the financial statement impact of adopting the new statement, and its impact is not material.

In May 2011, FASB issued Accounting Standards Update No. 2011-04 ***"Fair Value Measurement (Topic 820)"*** (ASU 2011-04). ASU 2011-04 clarifies guidance for the measurement and disclosure of fair value measurements. This statement is effective for SMUD for 2012. SMUD is currently assessing the financial statement impact of adopting this portion of the statement, but does not believe that its impact will be material.

In June 2007, GASB issued SGAS No. 51, ***"Accounting and Financial Reporting for Intangible Assets"*** (GASB No. 51). GASB No. 51 provides guidance regarding how to identify, account for and report intangible assets. Intangible assets are defined as assets that lack physical substance, are non-financial in nature, and have an initial useful life extending beyond a single reporting period. The statement provides that intangible assets be classified as capital assets, except for items explicitly excluded from the scope of the standard. This statement was effective for SMUD beginning in 2010. SMUD has assessed the financial statement impact of adopting the new statement, and its impact was not material.

In June 2007, GASB issued SGAS No. 53, ***"Accounting and Financial Reporting for Derivative Instruments"*** (GASB No. 53). GASB No. 53 provides a comprehensive framework for the measurement, recognition and disclosure of derivative financial instrument transactions entered into by state and local governments. The statement requires that all derivative financial instruments be measured at fair value which will be reported on the Consolidated Balance Sheets, and that all derivative financial instruments are tested for effectiveness. The change in valuation of ineffective hedges should be reported as Investment Revenue on the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. This statement was effective for SMUD beginning in 2010.

In December 2009, GASB issued SGAS No. 57, ***"OPEB Measurements by Agent Employers and Agent Multiple – Employer Plans"*** (GASB No. 57). GASB No. 57 addresses issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer OPEB plans. The statement amends previous GASB statements on OPEB plans, and will improve the consistency of reporting for OPEB plans. This statement is effective for SMUD for 2012. SMUD is currently assessing the financial statement impact of adopting this portion of the statement, but does not believe that its impact will be material.

In June 2010, GASB issued SGAS No. 59, ***"Financial Instruments Omnibus"*** (GASB No. 59). GASB No. 59 addresses topics relating to the reporting and disclosure of certain financial instruments and external investment pools, and includes some clarifications to GASB No. 53. This statement is effective for SMUD for 2011. SMUD has assessed the financial statement impact of adopting the new statement, and its impact was not material.

In November 2010, GASB issued SGAS No. 61, ***"The Financial Reporting Entity – Omnibus – An Amendment of GASB Statements No. 14 and No. 34"*** (GASB No. 61). GASB No. 61 modifies requirements for inclusion of component units and amends criteria for reporting of component units. The statement also clarifies the reporting of equity interests in legally separate organizations. This statement is effective for SMUD for 2013. SMUD is currently assessing the financial statement impact of adopting this portion of the statement, but does not believe that its impact will be material.

In June 2011, GASB issued SGAS No. 63, ***"Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position"*** (GASB No. 63). GASB No. 63 provides guidance on reporting deferred inflows and outflows of resources. The statement will standardize the presentation of deferred inflows and outflows of resources and their effect on a government's net position. This statement is effective for SMUD for 2012. SMUD is currently assessing the financial statement impact of adopting the statement, but does not believe that its impact will be material.

In June 2011, GASB issued SGAS No. 64, ***"Derivative Instruments: Application of Hedge Accounting Termination Provisions, An Amendment of GASB Statement No. 53"*** (GASB No. 64). GASB No. 64 provides clarification of whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider. This statement is effective for SMUD for 2012. SMUD is currently assessing the financial statement impact of adopting the statement, but does not believe that its impact will be material.

NOTE 3. ACCOUNTING CHANGE

In December 2010, GASB issued SGAS No. 62, "***Codification of Accounting and Financial Reporting Guidance Contained in the Pre-November 30, 1989 FASB and AICPA Pronouncements***" (GASB No. 62). GASB No. 62 incorporates into GASB's authoritative literature certain accounting and financial reporting guidance issued on or before November 30, 1989 included in: FASB Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the AICPA Committee on Accounting Procedure that do not conflict with or contradict GASB pronouncements. The statement also supersedes SGAS No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting" which eliminates the election for business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. This statement would have been effective for SMUD for 2012, but SMUD early implemented the standard for 2011. SMUD has assessed the financial statement impact of adopting the new statement, and its impact is not material.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. UTILITY PLANT

The summarized activity of SMUD's utility plant during 2011 is presented below:

	Balance December 31, 2010	Additions	Transfers and Deletions	Balance December 31, 2011
		(thousands of dollars)		
Nondepreciable Utility Plant:				
Land	$ 115,197	$ 1,026	$ (2)	$ 116,221
CWIP	254,064	415,454	(251,699)	417,819
Total nondepreciable utility plant	369,261	416,480	(251,701)	534,040
Depreciable Utility Plant:				
Generation	1,434,299	5,775	(136)	1,439,938
Transmission	236,908	35,341	(1,544)	270,705
Distribution	1,670,777	165,743	(5,239)	1,831,281
Investment in gas properties	192,612	8,118	-0-	200,730
Investment in JPAs	11,801	969	-0-	12,770
Intangibles	179,605	13,431	(1,698)	191,338
General	664,487	29,283	(8,839)	684,931
	4,390,489	258,660	(17,456)	4,631,693
Less: accumulated depreciation and depletion	(1,751,386)	(181,247)	19,655	(1,912,978)
Less: accumulated amortization on JPAs	(4,148)	(313)	-0-	(4,461)
	(1,755,534)	(181,560)	19,655	(1,917,439)
Total depreciable plant	2,634,955	77,100	2,199	2,714,254
Total Utility Plant – net	$3,004,216	$ 493,580	$ (249,502)	$ 3,248,294

The summarized activity of SMUD's utility plant during 2010 is presented below:

	Balance December 31, 2009	Additions	Transfers and Deletions	Balance December 31, 2010
		(thousands of dollars)		
Nondepreciable Utility Plant:				
Land	$ 101,258	$ 13,943	$ (4)	$ 115,197
CWIP	244,324	190,602	(180,862)	254,064
Total nondepreciable utility plant	345,582	204,545	(180,866)	369,261
Depreciable Utility Plant:				
Generation	1,423,331	12,451	(1,483)	1,434,299
Transmission	221,223	17,224	(1,539)	236,908
Distribution	1,587,736	88,700	(5,659)	1,670,777
Investment in gas properties	186,824	5,788	-0-	192,612
Investment in JPAs	10,391	1,410	-0-	11,801
Intangibles	175,098	8,096	(3,589)	179,605
General	636,897	40,500	(12,910)	664,487
	4,241,500	174,169	(25,180)	4,390,489
Less: accumulated depreciation and depletion	(1,604,624)	(173,363)	26,601	(1,751,386)
Less: accumulated amortization on JPAs	(3,835)	(313)	-0-	(4,148)
	(1,608,459)	(173,676)	26,601	(1,755,534)
Total depreciable plant	2,633,041	493	1,421	2,634,955
Total Utility Plant – net	$2,978,623	$ 205,038	$ (179,445)	$ 3,004,216

NOTE 5. INVESTMENT IN JOINT POWERS AGENCY

TANC. SMUD and fourteen other California municipal utilities are members of TANC, a JPA. TANC, along with the other California municipal utilities, own and operate the California-Oregon Transmission Project (COTP), a 500-kilovolt transmission line between central California and southern Oregon. SMUD is obligated to pay approximately 30.0 percent of TANC's COTP debt service and operations costs in exchange for entitlement to approximately 419 megawatts (MW) of TANC's 1,390 MW transfer capability. Additionally, SMUD has a 48 MW share of TANC's 300 MW firm, bi-directional transmission over Pacific Gas and Electric's (PG&E) system between PG&E's Tesla and Midway substations (SOT).

In December 2009, SMUD entered into a long-term reallocation agreement with TANC and the City of Santa Clara. Effective January 2010 through 2013, SMUD has an additional 30 MW, which makes SMUD's entitlement a 78 MW share of the SOT.

The long-term debt of TANC, which totals $396.7 million (unaudited) at December 31, 2011, is collateralized by a pledge and assignment of net revenues of TANC supported by take-or-pay commitments of SMUD and other members. Should other members default on their obligations to TANC, SMUD would be required to make additional payments to cover a portion of such defaulted payments, up to 25 percent of its current obligation.

Copies of the TANC annual financial reports may be obtained from SMUD at 6201 S Street, P.O. Box 15830, Sacramento, California 95852.

SMUD recorded transmission expenses related to TANC of $18.3 million and $18.5 million in 2011 and 2010, respectively.

Summary financial information for TANC is presented below:

	December 31, 2011 (Unaudited)	December 31, 2010 (Unaudited)
	(thousands of dollars)	
Total assets	$ 463,090	$ 488,664
Total liabilities	$ 451,810	$ 479,982
Total net assets	11,280	8,682
Total liabilities and net assets	$ 463,090	$ 488,664
Changes in net assets for the six months ended December 31	$ 8,842	$ (2,199)

Balancing Authority of Northern California (BANC). SMUD, City of Redding, City of Roseville and Modesto Irrigation District formed BANC, as a JPA, in 2009. In 2011, Operational Control of Balancing Authority (BA) operations was transferred from SMUD to BANC. In addition, in September of 2011, under the direction of the BANC Commission, an Interim General Manager was hired. BANC performs FERC approved BA reliability functions that are managed by North American Electric Reliability Corporation (NERC), nationally, and by Western Electricity Coordinating Council functions (WECC) in the west.

Copies of the BANC annual financial reports may be obtained from SMUD at 6201 S Street, P.O. Box 15830, Sacramento, California 95852.