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.

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.

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.

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.

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.

SMUD recorded expenses related to BANC of $0.4 million in 2011 and $0.2 million in 2010.

Summary financial information for BANC is presented below:

	December 31, 2011 (Unaudited)	December 31, 2010 (Audited)
	(thousands of dollars)	
Total assets	$ 159,040	$ 37,201
Total liabilities	$ 159,040	$ 37,201
Total net assets	-0-	-0-
Total liabilities and net assets	$ 159,040	$ 37,201
Changes in net assets for the twelve months ended December 31	$ -0-	$ -0-

NOTE 6. COMPONENT UNITS

CVFA Carson Cogeneration Project. CVFA is a JPA formed by SMUD and the Sacramento Regional County Sanitation District. CVFA operates the Carson Project, a 65 MW (net) natural gas-fired cogeneration facility and a 43 MW (net) natural gas-fired simple cycle peaking plant. In 2010, the turbine for the combined cycle cogeneration facility was upgraded, which increased plant capacity by 8 MW, which is included in the 65 MW total. The revenue stream to pay the CVFA bonds' debt service is provided by a take or pay purchase power agreement between SMUD and CVFA.

SCA Procter & Gamble Cogeneration Project. SCA is a JPA formed by SMUD and the SFA. SCA operates the Procter & Gamble Project, a 136 MW (net) natural gas-fired cogeneration facility and a 50 MW (net) natural gas-fired simple cycle peaking plant. In 2010, the turbine for the peaking plant was upgraded, which increased plant capacity by 6 MW, which is included in the 50 MW total. The revenue stream to pay the SCA bonds' debt service is provided by a take or pay purchase power agreement between SMUD and SCA.

SFA Cosumnes Power Plant Project. SFA is a JPA formed by SMUD and the Modesto Irrigation District. SFA operates the Cosumnes Power Plant Project (CPP Project), a 501 MW (net) natural gas-fired, combined cycle facility. The revenue stream to pay the SFA bonds' debt service is provided by a take and pay power purchase agreement between SMUD and SFA.

SPA Campbell Soup Cogeneration Project. SPA is a JPA formed by SMUD and the SFA. SPA operates the Campbell Soup Project, a 160 MW (net) natural gas-fired cogeneration facility, and the McClellan Project, a 72 MW (net) natural gas-fired simple cycle peaking plant. The revenue stream to pay the SPA bonds' debt service is provided by a take and pay power purchase agreement between SMUD and SPA.

NCGA. NCGA is a JPA formed by SMUD and the SFA. NCGA has a prepaid gas contract with Morgan Stanley Capital Group (MSCG) expiring in 2027, which is financed primarily by NCGA revenue bonds. SMUD has contracted with NCGA to purchase all of the gas delivered by MSCG to NCGA, based on market prices. NCGA is obligated to pay the principal and interest on the bonds. Neither SMUD nor SFA is obligated to make debt service payments on the bonds. NCGA can terminate the prepaid gas contract under certain circumstances including a failure by MSCG to meet its gas delivery obligation to NCGA or a drop in MSCT's credit rating below a specified level. If this occurs, MSCG will be required to make a termination payment to NCGA based on the unamortized prepayment proceeds received by MSCG.

As described in Note 2, all of the activities and balances of the component units are blended into and reported as part of SMUD because of the extent of their operational and financial relationships with SMUD. Copies of CVFA's, SCA's, SFA's, SPA's and NCGA's annual financial reports may be obtained from their Executive Office at 6201 S Street, P.O. Box 15830, Sacramento, California 95852.

NOTE 7. CASH, CASH EQUIVALENTS, AND INVESTMENTS

Cash Equivalents and Investments. SMUD's investment policies are governed by the California State and Municipal Codes and its Indenture, which restricts SMUD's investment securities to obligations which are unconditionally guaranteed by the United States (U.S.) Government or its agencies or instrumentalities; direct and general obligations of the State or any local agency within the State; bankers' acceptances; certificates of deposit; repurchase agreements; and taxable government and tax-exempt money market portfolios. SMUD's investment policy includes restrictions for investments relating to maximum amounts invested as a percentage of total portfolio and with a single issuer, maximum maturities, and minimum credit ratings.

Credit Risk. To mitigate the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment, SMUD limits investments to those rated, at a minimum, "A-1" or equivalent for commercial paper and "A" or equivalent for medium-term corporate notes by a nationally recognized rating agency.

Custodial Credit Risk. This is the risk that, in the event of the failure of a depository financial institution or counterparty to a transaction, SMUD's deposits may not be returned or SMUD will not be able to recover the value of its deposits, investments or collateral securities that are in the possession of another party. SMUD does not have a deposit policy for custodial credit risk.

On November 9, 2010, the Federal Deposit Insurance Corporation (FDIC) issued a Final Rule implementing section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which will provide unlimited insurance coverage for non-interest bearing transaction deposit accounts at FDIC-insured institutions. This unlimited insurance coverage is temporary and will remain in effect until December 31, 2012.

Due to this temporary program, all of SMUD's commercial cash deposits were fully insured at December 31, 2011 and 2010. The bank balance is also, per a depository pledge agreement between SMUD and SMUD's bank, collateralized at 133 percent and 755 percent of the collective funds on deposit (increased by the amount of accrued but uncredited interest, reduced by deposits covered by FDIC) at December 31, 2011 and 2010, respectively. At December 31, 2011, SMUD had money market accounts of $91.2 million and a money market deposit account of $35.0 million which were uninsured. SMUD's investments and money market mutual funds and money market deposit accounts are held in SMUD's name.

Concentration of Credit Risk. This is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. SMUD places no limit on the amounts invested in any one issuer for repurchase agreements and federal agency securities. The following are the concentrations of risk greater than five percent in either year:

	December 31, 2011	2010
Investment Type:		
Federal National Mortgage Association (Fannie Mae)	6%	7%
Federal Home Loan Banks	10%	0%
Municipal Bonds – State of California	0%	11%
Freddie Mac	5%	0%

Interest Rate Risk. This is the risk of loss due to the fair value of an investment falling due to interest rates rising. Though SMUD has restrictions as to the maturities of some of the investments, it does not have a formal policy that limits investment maturities as means of managing its exposure to fair value losses arising from increasing interest rates.

The following schedules indicate the credit and interest rate risk at December 31, 2011 and 2010. The credit ratings listed are from Standard & Poors (S&P). (N/A is defined as not applicable to the rating disclosure requirements).

At December 31, 2011, SMUD's cash, cash equivalents, and investments consist of the following:

		Remaining Maturities (in years)			
Description	Credit Rating	Less Than 1	1-5	More than 5	Total Fair Value
		(thousands of dollars)			
Cash and Cash Equivalents:					
LAIF	Not Rated	302,373	-0-	-0-	302,373
Money Market Mutual Funds	AAAm/N/A	91,231	-0-	-0-	91,231
Money Market Deposit Account	A-1+	35,000	-0-	-0-	35,000
Commercial Paper	A-1	14,719	-0-	-0-	14,719
Total cash and cash equivalents		443,323	-0-	-0-	443,323
Investments:					
Fannie Mae	AA+	-0-	35,282	-0-	35,282
Federal Farm Credit Bonds	AA+	-0-	20,044	-0-	20,044
Federal Home Loan Banks	AA+	42,878	14,656	-0-	57,534
Freddie Mac	AA+	24,980	5,995	-0-	30,975
Total investments		67,858	75,977	-0-	143,835
Total cash, cash equivalents, and investments		$ 511,181	$ 75,977	$ -0-	$ 587,158

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2010, SMUD's cash, cash equivalents, and investments consist of the following:

Description	Credit Rating	Remaining Maturities (in years) Less Than 1	1-5	More than 5	Total Fair Value
		(thousands of dollars)			
Cash and Cash Equivalents:					
Cash Deposits	N/A	$ 4,418	$ -0-	$ -0-	$ 4,418
LAIF	Not Rated	352,185	-0-	-0-	352,185
Money Market Mutual Funds	AAAm/N/A	85,669	-0-	-0-	85,669
Money Market Deposit Account	A-1+	30,000	-0-	-0-	30,000
Commercial Paper	A-1+/A-1	65,720	-0-	-0-	65,720
Total cash and cash equivalents		537,992	-0-	-0-	537,992
Investments:					
Fannie Mae	AAA	29,985	20,107	-0-	50,092
Federal Home Loan Banks	AAA	-0-	4,501	-0-	4,501
Federal Home Loan Mortgage Corp.	AAA	2,086	-0-	-0-	2,086
Municipal Bonds	SP-1	75,579	-0-	-0-	75,579
Corporate Note	AAA/AA+	12,929	-0-	-0-	12,929
Total investments		120,579	24,608	-0-	145,187
Total cash, cash equivalents, and investments		$ 658,571	$ 24,608	$ -0-	$ 683,179

At December 31, 2011, SMUD reported its book overdraft of $0.2 million as a component of Accounts Payable on the Consolidated Balance Sheets.

SMUD's cash, cash equivalents, and investments are classified in the Consolidated Balance Sheets as follows:

	December 31, 2011	2010
	(thousands of dollars)	
Total Cash, Cash Equivalents, and Investments:		
Revenue bond reserve, debt service and construction funds:		
Revenue bond reserve fund	$ 30,984	$ 53,271
Debt service fund	42,717	47,691
Component unit bond reserve and construction funds	128,240	138,571
Total revenue bond reserve, debt service and construction funds	201,941	239,533
Nuclear decommissioning trust fund	30,890	30,335
Rate stabilization fund	91,964	41,471
Other restricted funds	654	750
Unrestricted funds	261,709	371,090
Total cash, cash equivalents, and investments	$ 587,158	$ 683,179

NOTE 8. REGULATORY DEFERRALS

The Board has taken various regulatory actions that result in differences between the recognition of revenues and expenses for rate-making purposes and their treatment under generally accepted accounting principles for non-regulated entities. These actions result in regulatory assets and liabilities, which are summarized in the tables below. Changes to these balances, and their inclusion in rates, occur only at the direction of the Board.

Regulatory Assets (Costs)

Decommissioning. SMUD's regulatory asset relating to the unfunded portion of its decommissioning liability is being collected through interest earnings on the Trust Fund. Nuclear fuel storage costs and non-radiological decommissioning costs have been collected in rates since 2009.

Wholesale Power Receivables. SMUD's regulatory asset relating to its wholesale receivables due from the California Power Exchange was fully reserved as uncollectible in 2001. The balance of $24.0 million at December 31, 2010 was fully collected in 2011 (see Note 18).

TANC Operations Costs. SMUD's regulatory asset relating to deferred TANC costs comprises the difference between its cash payments made to TANC and its share of TANC's accrual-based costs of operations. This regulatory asset is being collected in rates over the life of TANC's assets during the period that cash payments to TANC exceed TANC's accrual-based costs.

U.S. Bureau of Reclamation. In December 2004, SMUD established a regulatory asset to defer recognizing the expense related to the settlement with the U.S. Bureau of Reclamation (Bureau) on a billing dispute. SMUD will make increased payments in future rates to settle the dispute. This regulatory asset will be collected in rates for future water service over the twenty-five year period SMUD is committed to making the increased rate payments to the Bureau.

Derivative Financial Instruments. SMUD's regulatory costs and/or credits relating to Investment Derivative Instruments are intended to defer the net difference between the fair value of derivative instruments and their cost basis, if any. Investment Derivative Instruments are reflected in rates at contract cost and as such, the balance is charged or credited into rates as the related asset or liability is utilized (see Note 9).

Pollution Remediation. With the adoption of the 2010 Budget Resolution, SMUD established a regulatory asset to defer recognition of the expense related to the investigation, design and remediation necessary for the North City Substation site. SMUD has recorded a liability for the full $12.0 million estimated for the project. A portion of this regulatory asset, $6.0 million, was collected in rates in 2011 and the remaining $6.0 million will be collected in 2012.

SMUD's total regulatory costs for future recovery are presented below:

	December 31, 2011	December 31, 2010
	(thousands of dollars)	
Regulatory Costs for Future Recovery:		
Decommissioning	$ 142,011	$ 134,050
Wholesale power receivables	-0-	24,007
TANC operations costs	9,497	9,447
U.S. Bureau of Reclamation	6,180	6,300
Derivative financial instruments	59,595	71,874
Pollution remediation	6,000	12,000
Total regulatory costs	223,283	257,678
Less: regulatory costs to be recovered within one year	(20,856)	(52,626)
Total regulatory costs for future recovery – net	$ 202,427	$ 205,052

Regulatory Liabilities (Credits)

CIAC. In 2011 and 2010 SMUD capitalized CIAC totaling $9.7 million and $6.6 million, respectively, in Plant in Service in the Consolidated Balance Sheets and recorded $9.3 million and $9.1 million, respectively, of Depreciation Expense in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. SMUD's regulatory credit relating to CIAC is intended to offset the revenue and expense associated with this accounting treatment. Thus, this regulatory credit is being amortized into rates over the depreciable lives of the related contributed distribution plant assets in order to offset the earnings effect of these non-exchange transactions.

Rate Stabilization. SMUD's regulatory credit relating to Rate Stabilization is intended to defer the need for future rate increases when costs exceed existing rates. At the direction of the Board, amounts may be either transferred into this fund (which reduces revenues), or amounts are transferred out of this fund (which increases revenues). The Board authorizes Rate Stabilization Fund transfers on an event driven basis. In 2011, $10.1 million was transferred from revenue to the RSF as a result of higher energy deliveries from Western Area Power Administration (Western).

Hydro Rate Stabilization. The Hydro Generation Adjustment (HGA) mechanism will automatically adjust rates in April each year based on the precipitation results from the previous April 1 through March 31. The increase or decrease in rates will be limited to a maximum rate change of four percent. The HGA also established a Hydro Rate Stabilization Fund (HRSF). In 2011, $40.4 million was transferred from revenue to the HRSF as a result of high precipitation.

Grant Revenues. In 2009, SMUD was awarded several large grants under the ARRA, which provided large amounts of reimbursements for capital expenditures. In 2010, the Board authorized the deferral of grant income for capital expenditures as regulatory liabilities. Thus, this regulatory credit will be deferred to match the depreciable lives of the related capital assets in order to offset the earnings effect of these non-exchange transactions.

Public Good. SMUD's regulatory credit relating to Public Good comprises the amounts collected in rates for specifically identified Public Good programs that have not been fully expended. These regulatory deferrals are credited to revenue in the period when the expenditures on identified projects occur. There were no further regulatory credits at December 31, 2011.

Precipitation Hedges. Settlements of Precipitation Agreements are included in rates in the year settled and accordingly, the intrinsic value of open precipitation hedges is deferred as regulatory assets or liabilities.

Senate Bill 1. SMUD implemented a per kilowatt hour solar surcharge, effective January 1, 2008 in order to fund investments in solar required by Senate Bill 1 (SB-1). The difference between the surcharge revenues received and the funds spent on solar initiatives will be deferred into future years. In 2011, SMUD spent less than it collected in SB-1 revenues, and has recorded a regulatory credit.

SMUD's total regulatory credits for future revenue recognition are presented below:

	December 31, 2011	December 31, 2010
	(thousands of dollars)	
Regulatory Credits for Future Revenue Recognition:		
CIAC	$ 227,440	$ 227,127
Rate stabilization	51,593	41,471
Hydro rate stabilization	40,371	-0-
Grant revenues	59,080	19,042
Public good	-0-	273
Precipitation hedge	6,352	-0-
SB-1	6,222	5,768
Total regulatory credits for future revenue recognition	391,058	293,681
Less: regulatory credits to be recognized within one year	(18,474)	(11,941)
Total regulatory credits – net	$ 372,584	$ 281,740

NOTE 9. DERIVATIVE FINANCIAL INSTRUMENTS

To help provide stable electric rates and to meet the forecasted power needs of its retail customers reliably, SMUD enters into various physical and financial fixed price purchase contracts for electricity and natural gas. These fixed price contracts and swap agreements are intended to hedge the exposure due to highly volatile and fluctuating commodity prices. SMUD also enters into interest rate swap agreements to reduce interest rate risk, or to enhance the relationship between the risk and return regarding SMUD's assets or debt obligations. SMUD utilizes these derivative financial instruments to mitigate its exposure to certain market risks associated with our ongoing operations. It should be noted that SMUD does not use derivative financial instruments for trading or speculative purposes. These contracts are evaluated pursuant to GASB No. 53 to determine whether they meet the definition of derivative instruments, and if so, whether they effectively hedge the expected cash flows associated with interest rate and commodity price risk exposures.

SMUD applies hedge accounting for derivatives that are deemed effective hedges. Under hedge accounting, the increase or (decrease) in the fair value of a hedge is reported as a deferred inflow or deferred outflow on the Consolidated Balance Sheets. Derivatives that do not meet the effectiveness tests, that would be recorded on the Consolidated Statements of Revenues, Expenses and Changes in Net Assets, are deferred for rate-making purposes as regulatory assets or liabilities on the Consolidated Balance Sheets (see Note 8).

SMUD implemented GASB No. 53 in 2010. During 2011 and 2010, SMUD executed numerous new gas and power related purchase agreements, some of which are recorded as hedging or investment derivatives and are therefore included in the table below. All hedging or investment derivatives are recorded at fair value on our Consolidated Balance Sheets.

For electricity and gas derivatives, fair values are estimated by comparing contract prices to forward market prices quoted by an independent external pricing service. When external quoted market prices are not available for derivative contracts, SMUD uses an internally developed valuation model utilizing short term observable inputs. For interest rate derivatives, SMUD subscribes to a financial information service that it uses to verify fair value estimates obtained from its counterparties.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following is a summary of the fair values, changes in fair value and notional amounts of derivative instruments, grouped by trading strategy, outstanding at December 31, 2011 (amounts in thousands; gains shown as positive amounts, losses as negative):

	2011 Changes in Fair Value		Fair Value at December 31, 2011		
Cash Flow Hedges:	Current Amount	NonCurrent Amount	Current Amount	NonCurrent Amount	Notional
	(thousands of dollars)				(thousands of Dth)
Asset: Investment Derivative Instruments					
Gas – Basis	$ (695)	$ -0-	$ -0-	$ -0-	
Gas – Commodity	634	-0-	634	-0-	620 Dth
Gas – Storage	(86)	-0-	124	-0-	155 Dth
Total Investment Derivative Instruments:	$ (147)	$ -0-	$ 758	$ -0-	
Asset: Hedging Derivative Instruments					
Gas – Basis	$ (9,068)	$ -0-	$ -0-	$ -0-	
Gas – Commodity	591	-0-	591	-0-	420 Dth
Gas – Storage	(1,846)	74	106	74	1,351 Dth
Interest Rate	1,122	10,682	3,334	38,336	$ 131,030
Total Hedging Derivative Instruments:	$ (9,201)	$ 10,756	$ 4,031	$ 38,410	
Liability: Investment Derivative Instruments					
Gas – Transportation	$ 14	$ -0-	$ 14	$ -0-	228 Dth
Gas – Commodity	(14,859)	(7,211)	9,962	4,623	4,770 Dth
Gas – Storage	135	-0-	212	-0-	1,364 Dth
Interest Rate	1,114	8,381	5,292	40,250	$ 380,995
Total Investment Derivative Instruments:	$ (13,596)	$ 1,170	$ 15,480	$ 44,873	
Liability: Hedging Derivative Instruments					
Gas – Basis	$ 74	$ -0-	$ 74	$ -0-	2,002 Dth
Gas – Transportation	312	-0-	312	-0-	3,777 Dth
Gas – Commodity	2,444	(315)	117,262	140,404	115,303 Dth
Gas – Storage	(24)	-0-	113	-0-	1,419 Dth
Electric - Commodity	(2,832)	-0-	-0-	-0-	
Total Hedging Derivative Instruments:	$ (25)	$ (315)	$ 117,761	$ 140,404	

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following is a summary of the fair values, changes in fair value and notional amounts of derivative instruments outstanding at December 31, 2010 (amounts in thousands; gains shown as positive amounts, losses as negative):

	2010 Changes in Fair Value		Fair Value at December 31, 2010		
Cash Flow Hedges:	Current Amount	NonCurrent Amount	Current Amount	NonCurrent Amount	Notional
	(thousands of dollars)				(thousands of Dth)
Asset: Investment Derivative Instruments					
Gas – Basis	$ (1,096)	$ (282)	$ 695	$ -0-	10,045 Dth
Gas – Commodity	-0-	(12)	-0-	-0-	
Gas – Storage	210	-0-	210	-0-	450 Dth
Total Investment Derivative Instruments:	$ (886)	$ (294)	$ 905	$ -0-	
Asset: Hedging Derivative Instruments					
Gas – Basis	$ (5,210)	$ (12,649)	$ 9,068	$ -0-	17,035 Dth
Gas – Commodity	-0-	(221)	-0-	-0-	
Gas – Storage	1,060	(13)	1,952	-0-	1,093 Dth
Interest Rate	317	2,070	2,212	27,654	$ 131,030
Total Hedging Derivative Instruments:	$ (3,833)	$ (10,813)	$ 13,232	$ 27,654	
Liability: Investment Derivative Instruments					
Gas – Basis	$ 123	$ -0-	$ -0-	$ -0-	
Gas – Commodity	(12,949)	(6,079)	24,821	11,834	43,048 Dth
Gas – Storage	(77)	-0-	77	-0-	341 Dth
Interest Rate	(828)	(5,206)	4,178	31,869	$ 380,995
Total Investment Derivative Instruments:	$ (13,731)	$ (11,285)	$ 29,076	$ 43,703	
Liability: Hedging Derivative Instruments					
Gas – Basis	$ 26	$ -0-	$ -0-	$ -0-	
Gas – Commodity	(36,805)	(35,943)	114,818	140,717	90,753 Dth
Gas – Storage	(50)	39	137	-0-	737 Dth
Electric - Commodity	(2,832)	717	2,832	-0-	166 MWh
Total Hedging Derivative Instruments:	$ (39,661)	$ (35,187)	$ 117,787	$ 140,717	

Objective and terms of hedging derivative instruments. The objectives and terms of SMUD's hedging derivative instruments that were outstanding at December 31, 2011 are summarized in the table below. The table is aggregated by the trading strategy. Credit ratings of SMUD's counterparties can be found in the table under Credit Risk. Details of SMUD's interest rate derivative instruments can be found in Note 10.

	Notional Amount	Beginning Date	Ending Date	Minimum Price	Maximum Price
Gas – Basis	2,002	01/01/12	03/31/12	$ (0.21)	$ (0.16)
Gas – Commodity	121,113	01/01/08	12/31/22	3.94	8.92
Gas – Storage	4,289	01/01/12	01/31/13	0.01	4.68
Gas – Transportation	4,005	01/01/12	03/31/12	0.00	0.15

The objectives and terms of SMUD's hedging derivative instruments that were outstanding at December 31, 2010 are summarized in the table below. The table is aggregated by the trading strategy.

	Notional Amount	Beginning Date	Ending Date	Minimum Price	Maximum Price
Gas – Basis	27,080	12/1/10	12/31/11	$ (0.27)	$ (1.15)
Gas – Commodity	133,800	01/1/08	12/31/22	6.00	10.80
Gas – Storage	2,621	01/1/11	03/31/11	0.01	7.30
Electric	166	07/1/11	09/30/11	77.72	77.72

SMUD hedges its interest costs. The interest rate swaps are designed to synthetically fix the cash flows associated with variable rate bonds (see Note 10).

SMUD hedges its power and natural gas costs so that it can offer predictable rates to its retail electric customers and support its credit rating. SMUD maintains a risk management program to control the price, credit, and operational risks arising from its power and natural gas market activities. Under the program, authorized SMUD employees assemble a portfolio of swaps, futures, and forward contracts over time with the goal of making SMUD's purchased power and fuel budget more predictable.

These hedged risks include those related to interest rate and commodity price fluctuations associated with certain forecasted transactions, including interest rate risk on our long-term debt, and forward purchases of gas and electricity to meet our load.

Derivatives not designated as hedging instruments.

Gas and Electric Contracts. SMUD utilizes certain gas swap and electric swap agreements under GASB No. 53 not designated as hedging derivative instruments to mitigate exposure to changes in the market price of natural gas and electricity. The fair value of each agreement, excluding the actual settlements to be paid or received as of the end of the period, is recorded in either Current or Noncurrent Assets, Investment Derivative Instruments on the Consolidated Balance Sheets if in an asset position or Current or Noncurrent Liabilities, Investment Derivative Instruments on the Consolidated Balance Sheets if in a liability position. An offsetting amount is included in Current or Noncurrent Regulatory Costs or Regulatory Credits for future recovery in the Consolidated Balance Sheets. The actual settlement payable is recorded in Accounts Payable on the Consolidated Balance Sheets, and the actual settlement receivable is recorded in Energy Efficiency Loans Due Within One Year, Interest Receivable, Grants Receivable and Other on the Consolidated Balance Sheets. The payments and receipts of the actual settlement are recorded as Investment Expense in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Interest Rate Contracts. SMUD utilizes certain interest rate swap agreements not designated as hedging derivative instruments under GASB No. 53 to mitigate exposure to changes in the fair value of variable rate debt resulting from fluctuations in interest rates. The fair value of each agreement, excluding the balance of interest to be paid or received as of the end of the period, is recorded in either Current or Noncurrent Assets, Investment Derivative Instruments on the Consolidated Balance Sheets if in an asset position or Current or Noncurrent Liabilities, Investment Derivative Instruments on the Consolidated Balance Sheets if in a liability position. An offsetting amount is included in Current or Noncurrent Regulatory Costs or Regulatory Credits for future recovery in the Consolidated Balance Sheets. The interest receivable is recorded in Energy Efficiency Energy Efficiency Loans Due Within One Year, Interest Receivable, Grants Receivable and Other on the Consolidated Balance Sheets, and the interest payable is recorded in Accrued interest on the Consolidated Balance Sheets. The payments or receipts of the actual settlement are recorded as Investment Expense in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

The Board has deferred recognition of the effects of reporting the fair value of Investment Derivative Instruments for rate-making purposes, and maintains regulatory accounts to defer the accounting impact of these accounting adjustments (see Note 8). Market values may have changed significantly since December 31, 2011.

Interest rate risk. Interest rate risk is the risk that changes in interest rates will adversely affect the fair values of SMUD's interest rate swaps. SMUD is exposed to interest rate risk on its interest rate swaps, as London Interbank Offered Rate (LIBOR) or the Securities Industry and Financial Markets Association (SIFMA) swap index decreases, SMUD's net payment on the swap increases.

Basis risk. Basis risk is the risk that arises when a hedged item and a derivative that is attempting to hedge that item are based on different indices. SMUD is exposed to basis risk when it hedges its natural gas purchases, which are priced at various locations, with NYMEX futures contracts, which settle based on the price in Henry Hub, Louisiana. SMUD enters into basis swaps to hedge against this risk.

Termination risk. Termination risk is the risk that a derivative will terminate prior to its scheduled maturity due to a contractual event. Contractual events include bankruptcy, illegality, default, credit events upon merger, and other events. One aspect of termination risk is that SMUD would lose the hedging benefit of a derivative that becomes subject to a termination event. Another aspect of termination risk is that, if at the time of termination the mark to market value of the derivative was a liability to SMUD, SMUD could be required to pay that amount to the counterparty. Termination risk is associated with all of SMUD's derivatives up to the fair value amounts.

Credit Risk. Credit risk is the risk of loss resulting when the counterparty is unable or unwilling to fulfill its present and future financial obligations. SMUD is exposed to counterparty credit risk on all of its Investment Derivative Instruments. SMUD seeks to minimize credit risk by transacting with creditworthy counterparties. SMUD has established and maintained strict counterparty credit guidelines and enters into contracts only with institutions that are investment grade or better. SMUD continuously monitors counterparty credit risk, and utilizes numerous counterparties to minimize exposure to potential defaults. Under certain conditions as outlined in SMUD's credit risk management policy, SMUD may require collateral under these agreements.

Some of SMUD's derivative master agreements contain credit contingent provisions that enable SMUD to maintain unsecured credit as a result of positive investment quality credit ratings from each of the major credit rating agencies. If SMUD's debt were to go down below investment grade, it would trigger some of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions.

The counterparty's current credit rating at December 31, 2011 is shown in the table below:

Counterparty	Counterparty Credit Rating
Gas Contracts:	
Barclays Bank PLC	A+
Citigroup Energy	A-
Conoco Phillips	A
Credit Suisse Energy LLC	A+
Deutsche Bank AG	A+
BNP Paribas Energy Trading Group	AA-
J.P. Morgan Ventures Energy Corp.	A
Macquarie Bank Limited	A
Merrill Lynch Commodities, Inc	A-
Morgan Stanley Capital Group, Inc	A-
Powerex Corp.	AA-
Shell Energy North America (US), L.P.	A-
Interest Rate Contracts:	
Goldman Sachs Capital Markets, L.P.	A
Goldman Sachs Mitsui Marine Derivative Products L.P.	AAA
Morgan Stanley Capital Services, Inc	A

NOTE 10. LONG-TERM DEBT

SMUD's total long-term debt is presented below:

	December 31, 2011	December 31, 2010
	(thousands of dollars)	
Electric Revenue Bonds:		
Electric revenue bonds, 3.0%–6.5%, 2012–2036	$ 2,022,995	$ 2,143,690
Subordinated electric revenue bonds, 0.09%–0.10%, 2018–2028	197,850	197,850
Total electric revenue bonds	2,220,845	2,341,540
Component unit project revenue bonds, 2.5%–5.50%, 2012–2030	447,520	470,310
Gas supply prepayment bonds 3.85%–4.3%, 2012–2027	408,630	431,000
Total long-term debt outstanding	3,076,995	3,242,850
Bond premiums – net	103,972	76,386
Deferred losses on bond refundings – net	(65,512)	(62,854)
Total long-term debt	3,115,455	3,256,382
Less: amounts due within one year	(102,520)	(99,935)
Total long-term debt – net	$ 3,012,935	$ 3,156,447

The summarized activity of SMUD's long-term debt during 2011 is presented below:

	December 31, 2010	Additions	Payments or Amortization	December 31, 2011	Amounts Due Within One Year
			(thousands of dollars)		
Electric revenue bonds	$ 2,143,690	$ 325,550	$ (446,245)	$ 2,022,995	$ 56,940
Subordinate electric revenue bonds	197,850	-0-	-0-	197,850	-0-
Component unit project revenue bonds	470,310	-0-	(22,790)	447,520	23,605
Gas supply prepayment bonds	431,000	-0-	(22,370)	408,630	21,975
Total	3,242,850	325,550	(491,405)	3,076,995	$ 102,520
Unamortized premiums – net	76,386	42,326	(14,740)	103,972	
Deferred losses on bond refundings – net	(62,854)	(15,609)	12,951	(65,512)	
Total long-term debt	$ 3,256,382	$ 352,267	$ (493,194)	$ 3,115,455	

The summarized activity of SMUD's long-term debt during 2010 is presented below:

	December 31, 2009	Additions	Payments or Amortization	December 31, 2010	Amounts Due Within One Year
			(thousands of dollars)		
Electric revenue bonds	$ 1,948,645	$ 250,000	$ (54,955)	$ 2,143,690	$ 54,775
Subordinate electric revenue bonds	207,850	-0-	(10,000)	197,850	-0-
Component unit project revenue bonds	488,665	-0-	(18,355)	470,310	22,790
Gas supply prepayment bonds	454,465	-0-	(23,465)	431,000	22,370
Total	3,099,625	250,000	(106,775)	3,242,850	$ 99,935
Unamortized premiums – net	86,951	-0-	(10,565)	76,386	
Deferred losses on bond refundings – net	(71,893)	-0-	9,039	(62,854)	
Total long-term debt	$ 3,114,683	$ 250,000	$ (108,301)	$ 3,256,382	

At December 31, 2011 scheduled annual principal maturities and interest are as follows:

	Principal	Interest	Total
		(thousands of dollars)	
2012	$ 102,520	$ 141,849	$ 244,369
2013	117,495	139,376	256,871
2014	135,895	134,057	269,952
2015	138,425	128,161	266,586
2016	145,680	122,080	267,760
2017 – 2021 (combined)	815,560	505,120	1,320,680
2022 – 2026 (combined)	759,535	332,341	1,091,876
2027 – 2031 (combined)	476,070	176,955	653,025
2032 – 2036 (combined)	385,815	62,540	448,355
Total Requirements	$ 3,076,995	$ 1,742,479	$ 4,819,474

Interest in the preceding table includes interest requirements for fixed rate debt at their stated rates, variable rate debt covered by interest rate swaps at their fixed rate, and variable rate debt not covered by interest rate swaps using the debt interest rate of 0.09 and 0.10 percent in effect at December 31, 2011 for the issue.

2011 Bond Refundings and Redemptions. In October 2011, SMUD issued $325.6 million of 2011 Series X Electric Revenue Refunding Bonds. Proceeds from the 2011 bonds and $22.6 million of available funds were used to refund $373.9 million of the outstanding 2001, 2002 and 2003 revenue bonds through a legal defeasance, and accordingly, the liability for the defeased bonds has been removed from Long-Term Debt in the Consolidated Balance Sheets. The refunding resulted in the recognition of a deferred accounting loss of $15.6 million, which is being amortized over the life of the refunding issue. The 2011 refunding reduced future aggregate debt service payments by $70.2 million and resulted in a total economic gain of $37.3 million, which is the net present value of the difference between the old and new debt service payments.

In August 2011, SMUD redeemed $17.6 million of SMUD 2001 Series O & P Bonds. This bond redemption resulted in a current accounting loss of $59 thousand, which is included in Loss on Debt Extinguishment and Refundings in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets. Redeeming the bonds reduced the aggregate future debt service payments by $18.9 million.

2010 Bond Issuances. In July 2010, SMUD issued $250.0 million of 2010 Series W Electric Revenue Bonds at par. These bonds were issued as taxable Build America Bonds under the provisions of the ARRA of 2009. SMUD expects to receive a cash subsidy payment from the U.S. Treasury equal to 35 percent of the interest payable on the bonds which will be recorded as a component of Interest and Other Income, in the Consolidated Statements of Revenues, Expenses and Changes in Net Assets.

Interest Rate Swap Agreements. A summary of SMUD's three swap agreements are as follows. The credit ratings listed are from S&P:

Initial Notional Amount (thousands)	SMUD Pays	Fixed Rate	Floating Rate	Termination Date	Counterparty Credit Rating
$ 131,030	Variable	5.154%	SIFMA	07/01/24	A
269,095	Fixed	4.345%	70% of LIBOR	08/15/18	AAA
111,900	Fixed	2.894%	63% of LIBOR	08/15/28	A

SMUD has a fixed-to-variable interest rate swap agreement with an initial notional amount of $131.0 million, which is equivalent to the principal amount of SMUD's 1997 Series K Electric Revenue Bonds. Under this swap agreement, SMUD pays a variable rate equivalent to the SIFMA Index (0.10 percent at December 31, 2011) and receives fixed rate payments of 5.154 percent. In connection with the swap agreement, SMUD has a put option agreement, also with an initial notional amount of $131.0 million, which gives the counterparty the right to sell to SMUD, at par, either the 1997 Series K Bonds, or a portfolio of securities sufficient to defease the 1997 Series K Bonds. The exercise of the option terminates the swap at no cost to SMUD. The term of both the swap and the put is equal to the maturity of the 1997 Series K Bonds.

Additionally, SMUD has two variable-to-fixed interest rate swap agreements with a combined initial notional amount of $381.0 million originally entered into for the purpose of fixing the effective interest rate associated with certain of its subordinated bonds that were refunded during 2008. The notional values of the two swaps are amortized over the life of the respective swap agreements. SMUD can terminate all swap agreements at any time, with payment or receipt of the fair market value of the swaps as of the date of termination. The obligations of SMUD under the swap agreements are not secured by a pledge of revenues of SMUD's electric system or any other property of SMUD.

Component Unit Interest Rate Swap Agreements. NCGA has four swap agreements, which are summarized as follows. The credit ratings listed are from S&P:

Initial Notional Amount (thousands)	NCGA Pays	Fixed Rate	Floating Rate	Termination Date	Credit Support Provider Credit Rating
$ 43,770	Fixed	3.851%	67% of LIBOR +.45%	07/01/13	A-
100,385	Fixed	4.062%	67% of LIBOR +.60%	07/01/17	A-
65,865	Fixed	4.144%	67% of LIBOR +.63%	07/01/19	A-
458,450	Fixed	4.304%	67% of LIBOR +.72%	07/01/27	A-

NCGA has four variable-to-fixed interest rate swap agreements with a counterparty for the purpose of fixing the effective interest rate associated with the 2007 Series B Bonds. NCGA pays the counterparty a fixed rate on the notional amount and receives a floating rate equal to 67 percent of the three month LIBOR (0.58 percent at December 31, 2011) plus an interest rate spread, as specified in each swap agreement. The total notional amount of the four swaps at December 31, 2011 was $408.6 million and was equivalent to the outstanding principal balance on the NCGA Bonds. The swaps are amortized over the life of their respective swap agreements in a manner corresponding to the principal repayment schedule of the NCGA Bonds. Early termination of the swaps would occur upon termination of the prepaid agreement for any reason. Upon early termination, the swaps would have no value to either party.

Subordinated Electric Revenue Bonds. Payment of and interest on the Subordinated Electric Revenue Bonds is subordinate to the payment of the principal and interest on SMUD's Electric Revenue Bonds.

Variable Rate Bonds. SMUD's Variable Rate Bonds bear interest at weekly rates, ranging from 0.09 percent to 0.10 percent at December 31, 2011. SMUD can elect to change the interest rate period or fix the interest rate, with certain limitations. SMUD's Variable Rate Bonds can be put to SMUD's Trustee by the bondholders; however, SMUD has in place a reimbursement agreement with Bank of America to enable SMUD to pay off the bonds over five years if the bonds are put. Accordingly, SMUD has recorded such bonds as Long-Term Debt, less amounts scheduled for redemption within one year.

Component Unit Bonds. The component units of SMUD have each issued bonds to finance their respective projects. The revenue stream to pay the SPA, NCGA and SFA bonds' debt service is provided by a take and pay purchase agreement. Principal and interest associated with these bonds are paid solely from the component units' revenues and receipts collected in connection with the operation of the projects. Most operating revenues earned by the component units are collected from SMUD in connection with the sale of gas or electricity to SMUD. The ability to service debt for SPA and SFA is dependent upon the successful availability of operations, and for NCGA is dependent on various parties (particularly Morgan Stanley Capital Group Inc., as gas supplier) meeting their contractual obligations. The ability of SCA and CVFA to service their debt is no longer dependent upon the successful operation of the project, as SMUD is now required, under a "take-or-pay" contract to make payments sufficient to pay principal and interest and all other payments required to be made under CVFA and SCA's indenture of trust, regardless of the continued successful operation of the Project.

Callable Bonds. SMUD has $647.9 million of Electric System Revenue Bonds that are currently callable, $450.0 million of which are fixed rate Build America Bonds debt and $197.9 million of subordinate Variable Rate Demand Notes (VRDN's). SMUD also has $1,137.9 million of bonds that become callable from 2012 through 2021, and these bonds can be called until maturity.

Collateral. The principal and interest on SMUD's bonds are payable exclusively from, and are collateralized by a pledge of, the net revenues of SMUD's electric system. Neither the credit nor the taxing power of SMUD is pledged to the payment of the bonds and the general fund of SMUD is not liable for the payment thereof.

Covenants. SMUD's bond resolutions contain various covenants that include requirements to maintain minimum debt service coverage ratios, certain other financial ratios, stipulated minimum funding of revenue bond reserves, and various other requirements including a rate covenant to raise rates to maintain minimum debt service coverage.

SMUD has pledged future net electric revenues, component unit net project revenues, and net gas supply prepayment revenues to repay $3,077.0 million and $3,242.9 million at December 31, 2011 and 2010, respectively, in electric revenue, component unit project revenue, and gas supply prepayment revenue bonds issued from 1993 through 2011. Proceeds from the bonds provided financing for various capital improvement projects, component unit capital projects, and the prepayment of a twenty-year supply of natural gas. The bonds are payable solely from the net revenues generated by SMUD's electrical sales, component unit project revenues, and gas supply prepayment revenues and are payable through 2036 at December 31, 2011 and 2010. Annual principal and interest payments on the bonds required approximately 27 and 30 percent of net revenues for the years ending December 31, 2011 and 2010, respectively. The total principal and interest remaining to be paid on the bonds is $4,819.5 million and $5,171.3 million at December 31, 2011 and 2010, respectively. Principal and interest paid was $250.8 million for 2011, and $249.6 million for 2010. Total net revenues were $943.0 million for 2011 and $828.8 million for 2010.

NOTE 11. COMMERCIAL PAPER NOTES

SMUD issues Commercial Paper Notes (Notes) to finance or reimburse capital expenditures. At December 31, 2011 and 2010 Notes outstanding totaled $200 million. The effective interest rate for the Notes outstanding at December 31, 2011 was 0.1 percent and the average term was 29 days. SMUD has a $204.9 million letter of credit agreement, and there have not been any term advances under it.

The summarized activity of SMUD's Notes during 2011 and 2010 is presented below:

	Balance at beginning of Year	Additions	Reductions	Balance at end of Year
		(thousands of dollars)		
December 31, 2011	$ 200,000	$ -0-	$ -0-	$ 200,000
December 31, 2010	$ 200,000	$ -0-	$ -0-	$ 200,000

NOTE 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate the value:

Investments. The fair values of investments, including cash equivalents, are based upon quoted market prices.

Long-Term Debt. The fair value of Long-Term Debt, which includes the short-term portion, was calculated by determining the value of each individual series using a standard bond pricing formula and market yields from representative yield curves. For debt with a stepped interest rate, the fair market value of debt was calculated by discounting future interest and principal payments using a market yield from a representative yield curve. Due to the weakened financial condition of bond insurers, the yield curve for insured municipal bonds was not used for SMUD's debt. SMUD's electric revenue bonds, SCA bonds, and CVFA bonds were instead valued at the yield curve for "A" rated municipal power bonds. For the same reasons, the yield curve for "BBB" rated municipal power bonds was used for insured component unit bonds of SPA and SFA instead of the "A" ratings used in past years. The SMUD 2008 Series J and K, and the NCGA 2007B bonds are included in the fair value total at par as they are variable rate obligations. All yield curves were obtained from Bloomberg, L.P.

Interest Rate Swap and Put Agreements. The fair values of interest rate swap and put agreements are based on values provided by counterparties.

Gas and Electricity Related Derivatives. The fair values of gas and electricity price swap agreements and electricity option agreements are based on forward prices from established indexes for the applicable regions. The fair values of gas and electricity purchase agreements are based on forward prices from established indexes from applicable regions and discounted using established interest rate indexes.

Asset Retirement Obligation. SMUD values its ARO for Rancho Seco based on significant unobservable inputs (Level 3). During 2011, the ARO was updated to reflect new information and revise the estimated costs. The information used to develop the inputs was a combination of actual historical costs and published data with contingencies to account for uncertainties in future costs. There was no change in the methodology used from the prior estimate.

The estimated fair values of SMUD's financial instruments are presented below. Of the items listed below, all are required to be recorded at fair market value except for the long-term debt. Market values may have changed significantly since December 31, 2011.

	December 31, 2011	
	Recorded Value	Fair Value
	(thousands of dollars)	
Investments, including cash and cash equivalents	$ 587,158	$ 587,158
Long-term debt	(3,076,995)	(3,277,812)
Interest rate swap and put agreements - net	(3,872)	(3,872)
Gas and electricity related derivatives - net	(271,447)	(271,447)
Asset Retirement Obligation	(168,633)	(168,633)

	December 31, 2011	
	Recorded Value	Fair Value
	(thousands of dollars)	
Investments, including cash and cash equivalents	$ 683,179	$ 683,179
Long-term debt	(3,242,850)	(3,216,440)
Interest rate swap and put agreements – net	(6,181)	(6,181)
Gas and electricity related derivatives – net	(283,311)	(283,311)
Asset Retirement Obligation	(160,492)	(160,492)

NOTE 13. RANCHO SECO DECOMMISSIONING LIABILITY

Background. The Rancho Seco decommissioning liability relates to the nuclear decommissioning of the former 913 MW nuclear power plant, which terminated commercial operations in 1989. Nuclear decommissioning is the process of safely removing nuclear facilities from service and reducing residual radioactivity to a level that permits termination of the Nuclear Regulatory Commission (NRC) license, and release of the property for unrestricted use. The NRC has approved SMUD's decommissioning plan, which delineates a phased process, and the first phase of physical work was completed in 2008.

In 2009, the NRC released all of the land under the Part 50 license for unrestricted use with the exception of the 1 acre fenced area around the Interim Onsite Storage Building that houses the stored class B and C wastes. This waste will be stored for an unspecified period pending availability of appropriate disposal sites. The facility operating license will be terminated after the waste is removed.

The Department of Energy (DOE), under the Nuclear Waste Policy Act of 1982, is responsible for permanent disposal of spent nuclear fuel and high-level radioactive waste. SMUD has a contract with the DOE for the removal and disposal of spent nuclear fuel and high-level (greater than class "C": GTCC) radioactive waste. However, the date when fuel and GTCC waste removal will be complete is uncertain. In 2010, the DOE formally withdrew the application for licensing of Yucca Mountain as a high-level waste repository, essentially removing Yucca Mountain as an option for disposal of SMUD's used nuclear fuel. The DOE also announced in January 2010 the creation of a Blue Ribbon Commission to study alternatives for developing a repository for the nation's used nuclear fuel. The Commission is tasked with providing a final report on alternatives in January 2012. At this time, there is no credible information available to determine when the DOE would remove the used nuclear fuel from the Rancho Seco facility. SMUD maintains a separately licensed on-site independent spent fuel storage facility (Storage Facility) which stores all of SMUD's spent fuel and GTCC waste in sealed canisters. The Storage Facility will remain under the regulation of the NRC until such time as it is decommissioned after the DOE removes the nuclear fuel and GTCC radioactive waste.

Asset Retirement Obligations. These financial statements reflect SMUD's current estimate of its obligation for the cost of decommissioning (including the cost of managing the Storage Facility until it can be decommissioned) under the requirements of FASB ASC 410, based on studies completed each year. Each year, SMUD evaluates the estimate of costs of decommissioning and there was a slight increase in cost in the 2011 study. The ARO estimate assumes all spent nuclear fuel will be removed from the site by 2028.

Rancho Seco's ARO is presented below:

	December 31, 2011	December 31, 2010
	(thousands of dollars)	
Active decommissioning	$ 33,847	$ 25,940
Spent fuel management	134,786	134,552
Total ARO	$ 168,633	$ 160,492
Less: current portion	(4,935)	(1,893)
Total Non-current portion of ARO	$ 163,698	$ 158,599

The summarized activity of the Rancho Seco ARO during 2011 and 2010 are presented below. The annual adjustments include a savings computed as the difference between the fair value of the obligation as if the decommissioning activities were performed by a third party and the amount actually incurred by SMUD performing the decommissioning activities.

	December 31, 2011	December 31, 2010
	(thousands of dollars)	
ARO at beginning of year	$ 160,492	$ 158,817
Accretion	7,955	7,879
Expenditures	(3,867)	(4,512)
Change in Study	6,920	140
Annual adjustments	(2,867)	(1,832)
Total ARO	$ 168,633	$ 160,492

NOTE 14. PENSION PLANS

Defined Benefit Pension Plan. SMUD participates in the California Public Employees' Retirement System (PERS), an agent multiple-employer public employee defined benefit pension plan. PERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. PERS acts as a common investment and administrative agent for participating public entities within the State. Benefit provisions and all other requirements are established by State statute and SMUD policies. The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon employees years of credited service, age, and final compensation. Copies of PERS' annual financial report may be obtained from their Executive Office at 400 Q Street, Sacramento, California 95814.

Funding Policy. Participants are required to contribute approximately 7 percent of their annual covered salary. SMUD makes either the full or partial contributions required of SMUD employees on their behalf and for their account. SMUD is currently required to contribute 11.0 percent of payroll to the plan. The contribution requirements of plan members and SMUD are established and may be amended by PERS.

Annual Pension Cost. PERS payments made by SMUD in 2011 were $30.5 million. The Annual Pension Cost for 2011 was $30.0 million, and $0.5 million was paid by employees for purchase of additional service credits. Overall, SMUD paid $30.0 million, and employees paid $0.5 million. PERS payments made by SMUD in 2010 were $28.1 million. The Annual Pension Cost for 2010 was $28.6 million, and $0.5 million was paid by employees for purchase of additional service credits. Overall, SMUD paid $27.6 million, and employees paid $0.5 million. Contributions are determined by actuarial valuations, which are performed based on the entry age normal actuarial cost method. The contribution for the first half of 2011 was determined by PERS as part of the annual actuarial valuation as of June 30, 2009; the contribution for the second half of 2011 was determined by PERS as part of the annual actuarial valuation as of June 30, 2010. The actuarial assumptions included: (a) a 7.75 percent investment rate of return (net of administrative expenses), (b) projected annual salary increases that vary by duration of service, and (c) 3.0 percent per year cost-of-living adjustments. Both (a) and (b) also included an inflation component of 3.0 percent. The actuarial value of PERS' assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over different periods. All changes in liability due to plan amendments, and changes in actuarial assumptions or methodology are amortized separately over a 20 year period. All gains or losses are amortized over a rolling 30 year period, with the exception of special gains and losses for fiscal years 2008-2009 through 2010-2011. These fiscal years gains and losses will be amortized over fixed and declining 30 year periods. If a plan's accrued liability exceeds the actuarial value of assets, the annual contribution with respect to the total unfunded liability may not be less than the amount produced by a 30 year amortization of the unfunded liability.

Three-year trend information for PERS is presented below:

Fiscal Year	Annual Pension Cost (APC)	Percentage of APC Contribution
	(thousands of dollars)	
6/30/11	$ 30,217	100%
6/30/10	$ 28,617	100%
6/30/09	$ 27,372	100%

Funded Status and Funding Progress. As of June 30, 2010, the most recent actuarial valuation date, the plan was 93.2 percent funded. The actuarial accrued liability for benefits was $1,577.2 million, and the actuarial value of assets was $1,469.2 million, resulting in an unfunded actuarial accrued liability (UAAL) of $108.0 million. The covered payroll (annual payroll of active employees covered by the plan) was $185.0 million, and the ratio of the UAAL to the covered payroll was 58.4 percent. The schedule of funding progress, presented as Required Supplementary Information (RSI) following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Other Plans. SMUD provides its employees with two cash deferred compensation plans: one pursuant to Internal Revenue Code (IRC) Section 401(k) [401(k) Plan] and one pursuant to IRC Section 457 (457 Plan) (collectively, the Plans). The Plans are contributory plans in which SMUD's employees contribute the funds. Each of SMUD's eligible full-time or permanent part-time employees may participate in either or both Plans, and amounts contributed are vested immediately. Such funds are held by a Trustee in trust for the employees upon retirement from SMUD service and, accordingly, are not subject to the general claims of SMUD's creditors. SMUD is responsible for ensuring compliance with IRC requirements concerning the Plans and has the duty of reasonable care in the selection of investment alternatives, but neither SMUD, nor its Board or officers have any liability for market variations in the Plans' asset values. SMUD employees are responsible for determining how their funds are to be invested and pay all ongoing fees related to the Plans. The Plans are currently not subject to discrimination testing, nor the requirements of the Employee Retirement Income Security Act of 1974. SMUD employees participating in the Plans are allowed to contribute a portion of their gross income not to exceed the annual dollar limits prescribed by the IRC.

SMUD makes annual contributions to the 401(k) Plan on behalf of certain employees pursuant to a memorandum of understanding with both of its collective bargaining units. SMUD does not match employee contributions, nor make contributions on behalf of its employees to the 457 Plan. Participating employees and SMUD made contributions into the Plans totaling $15.1 million and $1.1 million in 2011, respectively, and $15.2 million and $1.2 million in 2010, respectively.

NOTE 15. OTHER POSTEMPLOYMENT BENEFITS

SMUD provides postemployment healthcare benefits, in accordance with SMUD policy and negotiated agreements with employee representation groups in a single employer defined benefit plan, to all employees who retire from SMUD, and their dependents. SMUD also provides postemployment healthcare benefits to covered employees who are eligible for disability retirement. SMUD contributes the full cost of coverage for retirees hired before January 1, 1991, and a portion of the cost based on credited years of service for retirees hired after January 1, 1991. SMUD also contributes a portion of the costs of coverage for these retirees' dependents. Retirees are required to contribute the portion that is not paid by SMUD. The benefits, benefit levels, retiree contributions and employer contributions are governed by SMUD and can be amended by SMUD through its personnel manual and union contracts. At December 31, 2011, 2,835 postemployment participants, including retirees, spouses of retirees, surviving spouses, and eligible dependents, participated in SMUD's healthcare benefits program.

OPEB arises from an exchange of salaries and benefits for employee services rendered, and refers to postemployment benefits other than pension benefits such as post employment healthcare benefits. SMUD considers the following benefits to be OPEB: Medical, Dental and Long-Term Disability.

Plan Description. SMUD is a member of the California Employers Retiree Benefit Trust (CERBT) for prefunding of OPEB obligations. The CERBT Fund is an IRC Section 115 Trust set up for the purpose of receiving employer contributions to prefund health and other postemployment benefits for retirees and their beneficiaries. The plan is an agent multiple employer plan administered by PERS, which provides medical, dental and long-term disability benefits for retirees and their beneficiaries. Any changes to these benefits would be approved by SMUD's Board and union contracts. To obtain a CERBT report, please contact PERS at 888-CALPERS.

The funding of a plan occurs when the following events take place: the employer makes payments of benefits directly to or on behalf of a retiree or beneficiary; the employer makes premium payments to an insurer; or the employer irrevocably transfers assets to a trust or other third party acting in the role of trustee, where the plan assets are dedicated to the sole purpose of the payments of the plan benefits, and creditors of the government do not have access to those assets.

Funding Policy. SMUD has elected to net fund to PERS, so the contributions are the Annual Required Contribution (ARC) less the estimated cash flow for retiree benefit costs for each year. SMUD can elect to put in additional contributions into the trust, and in 2011 funded an additional $0.9 million to the CERBT. In 2011 and 2010, the net ARC contribution to the CERBT was $4.2 and $5.9 million, respectively. During 2011 and 2010, SMUD made the following healthcare benefit contributions by paying actual medical costs of $19.5 and $17.3 million, respectively.

Funding Status and Funding Progress. At December 31, 2011 and 2010, SMUD estimates that the actuarially determined accumulated postemployment benefit obligation was approximately $349.3 million and $311.0 million, respectively. The plan was 12.3 percent and 9.9 percent funded in 2011 and 2010, respectively. The covered payroll (annual payroll of active employees covered by the plan) is $168.7 million for 2011. The ratio of the UAAL to covered payroll is 181.5 percent for 2011.

Annual OPEB Cost. The annual OPEB cost (expense) is calculated based on the ARC of the employer, an amount actuarially determined in accordance with the parameters of SGAS No. 45, ***"Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions"***. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. For 2011, SMUD's annual OPEB Cost (expense) of $22.4 million was equal to the ARC.

The following table shows the components of SMUD's annual OPEB cost for the year, the amount actually paid in premiums, and changes in the net OPEB obligation:

	Year Ended December 31, 2011	2010
	(thousands of dollars)	
Annual required contribution	$ 22,396	$ 21,441
Interest on net OPEB obligation	-0-	-0-
Annual OPEB cost (expense)	22,396	21,441
Contributions made	(24,516)	(23,133)
(Decrease) in net OPEB obligation	(2,120)	(1,692)
Net OPEB (asset), beginning of year	(2,220)	(528)
Net OPEB (asset), end of year	$ (4,340)	$ (2,220)

SMUD's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for 2011 and the two preceding years is as follows:

Year Ending	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB (Asset)
	(thousands of dollars)		
December 31, 2011	$ 22,396	109%	(4,340)
December 31, 2010	$ 21,441	108%	(2,220)
December 31, 2009	$ 19,582	103%	(528)

Actuarial Methods and Assumptions. Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing the benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The entry age normal was used in the December 31, 2011 and 2010 actuarial valuation. Actuarial assumptions used a 7.75 percent investment rate of return (net of administrative expenses), and a 3.25 percent inflation assumption. For 2011, the actuarial assumptions for an annual healthcare cost trend growth of 8.5 percent for the current year, 8.0 percent for 2012, 7.5 percent for 2013, and declining 0.5 percent per year until 5 percent is reached. The 5 percent growth is used on a go-forward basis. The UAAL will be amortized as a percentage of payroll over an open 30-year period. The actuarial value of assets was $43.1 million and $30.8 million in 2011 and 2010, respectively.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the ARC of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as RSI following the notes to the financial statements, presents multiyear trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

NOTE 16. INSURANCE PROGRAMS AND CLAIMS

SMUD is exposed to various risks of loss related to torts, theft of and destruction to assets, errors and omissions, and natural disasters. In addition, SMUD is exposed to risks of loss due to injuries to, and illnesses of, its employees. SMUD carries commercial insurance coverage to cover most claims in excess of specific dollar thresholds, which range from $5 thousand to $2.5 million per claim with total excess liability insurance coverage for most claims of $120.0 million. SMUD's property insurance coverage is based on the replacement value of the asset. There have been no significant reductions in insurance coverage, and in some cases, certain coverages increased in 2011. In 2011, 2010 and 2009, the insurance policies in effect have adequately covered all settlements of the claims against SMUD. No claims have exceeded the limits of property or liability insurance in any of the past three years.

The claims liability is included as a component of Self Insurance, Deferred Credits and Other in the Consolidated Balance Sheets.

SMUD's total claims liability, comprising claims received and claims incurred but not reported, at December 31, 2011, 2010, and 2009 is presented below:

	2011	2010	2009
		(thousands of dollars)	
Workers' compensation claims	$ 9,454	$ 11,338	$ 9,605
General and auto claims	626	1,260	1,221
Short- and long-term disability claims	185	87	73
Claims liability	$ 10,265	$ 12,685	$ 10,899

Changes in SMUD's total claims liability during 2011, 2010, and 2009 is presented below:

	2011	2010	2009
		(thousands of dollars)	
Claims liability, beginning of year	$ 12,685	$ 10,899	$ 7,906
Add: provision for claims, current year	1,943	3,025	2,512
Increase in provision for claims in prior years	1,804	2,923	3,763
Less: payments on claims attributable to current & prior years	(6,167)	(4,162)	(3,282)
Claims liability, end of year	$ 10,265	$ 12,685	$ 10,899

NOTE 17. COMMITMENTS

Electric Power and Gas Supply Purchase Agreements. SMUD has numerous power purchase agreements with other power producers to purchase capacity, transmission, and associated energy to supply a portion of its load requirements. SMUD has minimum take-or-pay commitments for energy on some contracts. Certain contracts allow SMUD to exchange energy, received primarily in the summer months, when SMUD most needs the energy and to return energy during the winter months, or other subsequent periods. SMUD has numerous long-term natural gas supply, gas transportation and gas storage agreements with Canadian and U.S. companies to supply a portion of the consumption needs of SMUD's natural gas-fired power plants, which expire through 2040.

At December 31, 2011, the approximate minimum obligations for the take or pay contracts over the next five years are as follows:

	Electric	Gas
	(thousands of dollars)	
2012	$ 53,834	$ 18,248
2013	49,255	18,127
2014	49,408	17,640
2015	41,803	14,972
2016	37,032	12,922

At December 31, 2011, the approximate minimum obligations for the remaining contracts, assuming the energy or gas is delivered over the next five years, are as follows:

	Electric	Gas
	(thousands of dollars)	
2012	$ 142,043	$ 140,098
2013	137,757	134,335
2014	137,433	155,365
2015	106,749	142,749
2016	98,278	137,384

Contractual Commitments beyond 2016 – Electricity. Several of SMUD's purchase power and transmission contracts extend beyond the five-year summary presented above. These contracts expire between 2017 and 2033 and provide for power under various terms and conditions. SMUD estimates its annual minimum commitments under the take or pay contracts ranges between $37.0 million in 2017 and $5.0 million in 2033. SMUD estimates its annual minimum commitments under the remaining contracts, assuming the energy is delivered, ranges between $99.3 million in 2017 and $24.1 million in 2032. SMUD's largest purchase power source is the Western Base Resource contract, whereby SMUD receives 31.25 percent of the amount of energy made available by Western, after meeting Central Valley Project use requirements, in any given year at a 31.25 percent share of their revenue requirement. On January 1, 2015, SMUD's percentage share changes to approximately 25 percent. The Western contract expires on December 31, 2024.

Contractual Commitments beyond 2016 – Gas. Several of SMUD's natural gas supply, gas transportation and gas storage contracts extend beyond the five-year summary presented above. These contracts expire between 2017 and 2040 and provide for transportation and storage under various terms and conditions. SMUD estimates its annual minimum commitments under the take or pay contracts ranges between $11.1 million in 2017 and $1.1 million in 2040. SMUD estimates its annual minimum commitments under the remaining contracts, assuming the gas is delivered, ranges between $136.6 million in 2017 and $31.8 million in 2040.

Additional Contracts. SMUD has entered into two additional power contracts that have been excluded from the table above due to unknown start dates. Both contracts are based on generation that has not been built and is expected online between 2013 and 2014. Because of the uncertainty of the start dates, they have been excluded from the table above.

In December 2011, SMUD entered into an agreement to sell the Solano Wind Phase 3 project (see Note 2). SMUD will buy all output from the plant under the terms of the Purchase Power Agreement. The plant is expected to be commercially available around March 2012, and at that time SMUD will begin receiving output from the plant. SMUD is currently receiving all test energy generated prior to commercial operation. Under the terms of the various agreements, SMUD has the option to buy the plant back at certain discrete future dates. Due to uncertainty over the term of the contract, and the fact that the plant has not yet achieved commercial operations, it has been excluded from the table above. The cost of the power is estimated around $7.0 million per year. In addition to the cost of the power, SMUD is responsible to pay for Excess Energy and Renewable Energy Credits. The Renewable Energy Credits and Excess Energy are based on production and are estimated around $2.6 million dollars per year.

Gas Price Swap Agreements. SMUD has entered into numerous variable to fixed rate swaps with notional amounts totaling 125,247,000 million British Thermal Units (mmbtu) for the purpose of fixing the rate on SMUD's natural gas purchases for its gas-fueled power plants and gas indexed electric contracts. These gas price swap agreements result in SMUD paying fixed rates ranging from $3.44 to $8.92 per mmbtu. The swap agreements expire periodically from January 2011 through December 2022.

Gas Transport Capacity Agreements. SMUD has numerous long-term natural gas transport capacity agreements with Canadian and U.S. companies to transport natural gas to SMUD's natural gas-fired power plants from the supply basins in Alberta to the California-Oregon border and from supply basins in the southwest and Rocky Mountains to the Southern California border. These gas transport capacity agreements provide for the delivery of gas into SMUD-owned pipeline capacity within California. The gas transport capacity agreements provide SMUD with 56,000 dekatherms (Dth) per day (Dth/d) of natural gas pipeline capacity from the North, including the Canadian Basins through 2023 and 54,000 Dth/d from the Southwest or Rocky Mountain Basins through at least 2018.

Gas Storage Agreements. SMUD also has an agreement for the storage of up to 3.25 million Dth of natural gas at regional facilities through March 2012, dropping to 2.0 million Dth through March 2014, and then to 1 million Dth through March 2015.

NOTE 18. CLAIMS AND CONTINGENCIES

Replacement Reserves Dispute. In August 2003, PG&E issued invoices totaling $2.2 million for replacement reserve charges purportedly incurred by PG&E for energy scheduled through the Rancho Seco intertie point from July 2000 through June 2002. In September 2003, SMUD provided PG&E notice of dispute of the invoices arguing that the billing was inconsistent with the Restated Interim Agreement, the primary agreement between the parties governing such transactions; and therefore, no Replacement Reserve charges are due. PG&E functioned as the Scheduling Coordinator on SMUD's behalf for transactions with the California Independent System Operator (ISO) at this intertie point until June 2002, when SMUD became its own balancing authority. These Replacement Reserve charges purportedly relate to power purchased by the ISO to cover deviations between actual load and forecasted load.

SMUD believes that, even if the charges were appropriate, PG&E's delay in billing within a reasonable timeframe compromised SMUD's ability to modify its operations or scheduling procedures to eliminate or mitigate the charges. In October 2003, SMUD and PG&E entered into a tolling agreement, which among other things, tolls any applicable statute of limitations and may be terminated by either party upon thirty days written notice. SMUD estimates its maximum liability for this matter at $2.2 million; however, SMUD management believes that it is not likely that it will be found liable for any charges in this matter; and therefore, no liability has been recorded.

Claims for 2000 and 2001 Power Sales. On December 6, 2005, PG&E, Southern California Edison Company, San Diego Gas & Electric Company and the Electricity Oversight Board (collectively the California Parties) filed a claim for damages pursuant to California Government Code § 910.4 (Tort Claims Act). The California Parties' claim arises from SMUD's power sales from May 1, 2000, through June 20, 2001 (Refund Period), in the wholesale electricity markets operated by the ISO and the California Power Exchange Corporation (PX) under tariffs filed with the FERC.

In a related matter, the State of California and the California Department of Water Resources (DWR) (collectively, the State Entities) filed a complaint in 2006, as amended in 2007, seeking damages similar to those sought by the California Parties. The complaint further claimed damages arising of SMUD's voluntary power sales to DWR and the ISO, for which DWR paid, from May 1, 2000 through June 20, 2001. On February 23, 2007, SMUD entered into a tolling agreement with the State Entities, under which the State Entities agreed to dismiss without prejudice its claim against SMUD on or before March 1, 2007. The State Entities' complaint was dismissed without prejudice. The tolling agreement served to put a temporary hold on all future action in the State's prosecution of its claims, and in any claims which SMUD may bring against the State Entities, until the California Parties, the State Entities and SMUD (collectively, the Parties) had a better understanding of the progress of other related proceedings.

On February 22, 2011, the Parties entered into a Settlement Agreement that resolved all disputes between the Parties with respect to the transactions in the Western Energy Markets during the Refund Period. It also resolved any potential claim that the State Entities would have against SMUD for any bilateral or market sales made during the Refund Period. The Settlement Agreement, among other things, provided that, upon FERC approval of the Settlement Agreement, the PX and the ISO shall pay to SMUD $31.0 million from its receivables and accrued interest at the PX and the ISO. FERC approved the Settlement Agreement on April 21, 2011. The Settlement Agreement became effective on May 2, 2011. On May 6, 2011, SMUD received its $31.0 million settlement payment in resolution of the above-referenced claims for power sales in 2000-2001, and all pending lawsuits have been dismissed with prejudice.

NERC Compliance Investigation. In April 2009, SMUD received notice from the NERC that it initiated a NERC Compliance Violation Investigation in response to possible compliance violations as a result of a system disturbance that occurred on December 26, 2008. A preliminary investigation revealed that the disturbance was caused by a failing battery charger at the Orangevale Substation.

The final NERC investigation alleged that SMUD violated certain NERC reliability standards associated with the system disturbance and the events and actions leading up to it and proposed a penalty of $100,000. SMUD did not contest the violations and entered into a settlement agreement with NERC wherein SMUD agreed to, among other things, pay the $100,000 penalty. NERC filed the settlement agreement with FERC on December 30, 2011. FERC approved the settlement on January 28, 2012 and this matter is fully resolved.

Fru-Con Construction Corporation Construction Matters. In August 2003, SMUD entered into a fixed-price contract (the Contract) for $106.8 million with Fru-Con Construction Corp. (Fru-Con) to construct the 500 megawatt CPP Project. St. Paul Travelers Company, the successor surety to Travelers Casualty and Surety Company of America (Travelers), is obligated under a performance bond to guarantee Fru-Con's performance under the Contract. Construction of the CPP Project began in October 2003, with a scheduled commercial operation date of September 2005.

Soon after contract award, Fru-Con advanced change orders that would substantially raise the contract price and delay the CPP Project schedule. The parties agreed to three change orders raising the total contract price to approximately $108.1 million. However, in October 2004, Fru-Con asserted additional claims totaling almost $26 million. Beginning in October 2004 and continuing until early February 2005, SMUD and Fru-Con participated in negotiations to resolve disputes over both cost and delays in the CPP Project schedule. SMUD also notified Travelers in January 2005 about Fru-Con's defaults. The parties were unable to resolve the disputes to the satisfaction of SMUD and in February 2005, SMUD terminated its contract with Fru-Con on the basis of breach of contract by Fru-Con, and took steps to complete the CPP Project. Under the Contract, Fru-Con and its surety, Travelers, are liable to SMUD for any additional costs attributable to Fru-Con's breach and for liquidated damages for delay. In February 2005, SMUD filed suit in the Sacramento County Superior Court against Fru-Con and one of its sub-contractors alleging breach of contract and violation of the California False Claims Act (State Court Action).

In March, 2005, Fru-Con filed a complaint against SMUD in federal court, alleging breach of contract (Federal Court Action) and attempted to move the State Court Action to federal court. In May, 2005, the federal court granted SMUD's motion to remand, and transferred the State Court Action back to the Sacramento County Superior Court.

SMUD also pursued a claim against Travelers under the performance bond. In September, 2005, Travelers denied SMUD's claim and filed a declaratory relief action in the same federal court as the Fru-Con Federal Court Action. SMUD filed a counterclaim in response to Travelers' lawsuit. In general, SMUD is seeking to recover from Travelers all of the damages it claims against Fru-Con plus attorneys' fees related to the Travelers suit. Fru-Con's federal case has been consolidated with the Travelers lawsuit for purposes of discovery.

In June 2007, the Sacramento County Superior Court issued a summary adjudication order upholding SMUD's right to terminate the contract based on Fru-Con's refusal to remove defective concrete, leaving for trial only the issue of the amount of damages owing by Fru-Con to SMUD. In September, 2007, the California Supreme Court denied Fru-Con's Petition for Review seeking to overturn the Court of Appeal decision, which had denied their petition to reverse the Superior Court order.

The Superior Court trial commenced in January, 2009. SMUD presented evidence at trial to support an award of $47.1 million net in damages, excluding interest and attorneys' fees, comprised of SMUD's cost to complete Fru-Con's scope of work ($38.8 million), contract liquidated damages ($8.2 million) and statutory damages for false claims ($153,000). This net total included offsets for Fru-Con's legitimate change order requests for out-of-scope work that Fru-Con actually performed prior to termination and the $7.8 million in retained funds held by SMUD. In contrast, Fru-Con presented evidence at trial that SMUD should not be awarded any damages, and instead that Fru-Con should be awarded roughly $45 million, inclusive of claims for extra work for change orders, delays and inefficiencies allegedly caused by SMUD, and attorneys' fees.

In April, 2009, after nearly three months in trial, the case was submitted to the jury. In June, 2009, the jury rendered a verdict awarding SMUD $42.2 million in damages, excluding interest and attorneys' fees ($35.6 million cost to complete, $6.6 million in liquidated damages, and $10,000 for False Claims), and awarding Fru-Con $1.5 million for change orders.

In December, 2009, following a hearing on motions for pre-judgment interest and attorneys' fees, the judge issued a Final Judgment on Verdict. In addition to the $42.2 million in damages, SMUD was awarded $13 million in prejudgment interest through the date of judgment, and Fru-Con's net award was reduced to $1.2 million, which offsets against SMUD's award, resulting in a net total of approximately $54 million, plus costs to be submitted. The judge denied SMUD's request for attorneys' fees.

In February, 2010, Fru-Con filed a Notice of Appeal of the final judgment (and prejudgment orders). SMUD cross-appealed on the trial court's order denying SMUD's request for attorneys' fees. In March, 2010, Travelers posted a statutory Appeal Bond on behalf of Fru-Con in the amount of $82.5 million. That same day, the appellate court ruled that the case was not suitable for mediation and set that date as the commencement date for scheduling the appeal. In January, 2011, Fru-Con filed Appellant's opening brief, and in April, 2011, SMUD filed Respondent's brief and Cross-Appellant's opening brief (regarding entitlement to attorneys' fees). In August, 2011, Fru-Con filed Respondent's brief and Appellant's reply brief, and in September, 2011, SMUD filed its reply brief. SMUD expects the appellate court to hear the matter in 2012.

Meanwhile in September, 2009, the Federal District Court issued a Stay Order. This Stay Order puts a hold on the federal trial pending the final resolution of the state court proceedings. In September, 2009, Fru-Con filed an appeal of the Stay Order to the Ninth Circuit Court of Appeal, followed by a similar appeal by Travelers. Fru-Con and Travelers also filed motions to expedite appeal and to consolidate. In October, 2009, the Ninth Circuit ordered the appeals consolidated, but denied Fru-Con's and Travelers' motions to expedite the appeal, retaining the regular briefing schedule. The court further ordered that no party can move for an extension of the briefing schedule and that the matter will be set as soon as possible after completion of briefing. In January, 2010, Fru-Con and Travelers filed opening briefs, and in February, 2010, SMUD filed opposing briefs. In July, 2010, oral argument was heard before the Ninth Circuit panel. In August, 2010, the Ninth Circuit panel denied Fru-Con and Travelers appeal and upheld the Judge's Stay Order. Consequently, there will be no additional Federal District Court activity in this case until the State court proceedings are resolved.

SMUD management continues to believe that over the course of the state and federal appellate review proceedings and any follow-up trial court proceedings, SMUD is reasonably likely to be successful in refuting, at a minimum, a majority of Fru-Con's claims and to prevail in a majority of its claims against Fru-Con, as well as the surety Travelers. SMUD management also believes that the outcome of this matter will not have a material adverse impact on SMUD's financial position or results of operations. No liability or receivable has been recorded by SMUD in connection with these disputes.

North City Environmental Remediation. In 1950, SMUD purchased property from the City of Sacramento and the Western Railroad Company (the "Site"). Portions of the Site prior to the sale had been operated as a municipal landfill by the City of Sacramento. SMUD currently operates a bulk substation on the Site. SMUD intends to assure compliance with the State standards at closed landfill sites and is in the process of determining the appropriate remediation of the Site. In 2009, SMUD established a regulatory asset to defer recognition of the expense related to the investigation, design and remediation necessary for the Site, and has recorded a liability for the full $12.0 million estimated for the project.

Other Construction Matters. SMUD contracts with various other firms to design and construct facilities for SMUD. Currently, SMUD is party to various claims, legal actions and complaints on some of these construction projects. SMUD management believes that it will be successful in refuting these allegations, and estimates that the ultimate resolution of these matters will not have a material adverse effect on SMUD's financial position or results of operations.

Environmental Matters. SMUD is one of many potentially responsible parties that have been named in a number of actions relating to environmental claims and/or complaints. Due to the nature of these claims, legal actions or complaints, SMUD is unable to predict the range of costs for resolution of these actions and intends to take all actions necessary to defend its position. Some of these matters name SMUD along with other electric utilities as potentially responsible parties. SMUD has estimated its exposure to such costs based on its proportionate share of the potential claim and recorded its share as a liability; in most instances this is a relatively small percentage. However, should other named responsible parties become insolvent and unable to pay their share of the claims, SMUD's share of these contingent liabilities would increase and could be material. SMUD management does not believe this will occur, and accordingly, management believes that the outcome of these environmental claims will not have a material adverse impact on SMUD's financial position or results of operations.

Other Matters. In the normal operation of business, SMUD is party to various claims, legal actions and complaints. Management and SMUD's legal counsel believe that there are no other material loss contingencies that would have a material adverse impact on SMUD's financial position or results of operations.

REQUIRED SUPPLEMENTARY INFORMATION (unaudited)

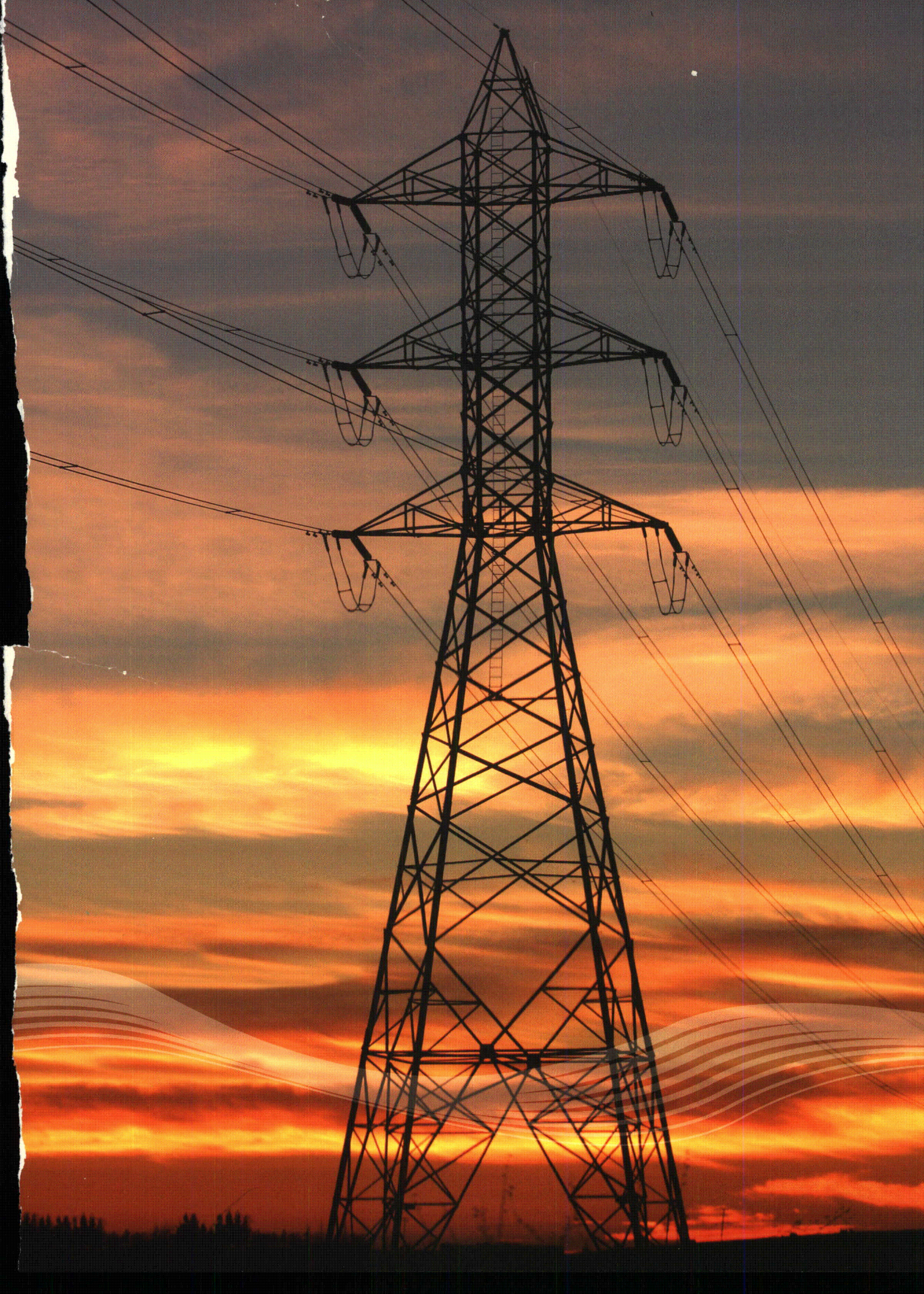
Schedules of Funding Progress

PERS Pension. The schedule of funding progress for PERS is presented below for the three most recent years for which SMUD has available data:

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) – Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
			(thousands of dollars)			
6/30/10	$ 1,469,218	$ 1,577,200	$ 107,982	93.2%	$ 185,018	58.4%
6/30/09	$ 1,419,866	$ 1,531,728	$ 111,862	92.7%	$ 185,474	60.3%
6/30/08	$ 1,373,974	$ 1,393,705	$ 19,731	98.6%	$ 180,362	10.9%

OPEB. The schedule of funding progress for the other post-employment benefit healthcare plan is presented below for the three recent years for which SMUD has available data:

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
			(thousands of dollars)			
1/1/2011	$ 43,095	$ 349,261	$ 306,166	12.3%	$ 168,670	181%
1/1/2010	$ 30,781	$ 310,993	$ 280,212	9.9%	$ 195,413	143%
1/1/2009	$ 16,570	$ 286,874	$ 270,304	5.8%	$ 197,772	137%



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