

memorandum

DATE: December 4, 1997

REPLY TO

ATTN OF: IG-30

SUBJECT: Southwestern Federal Power System Fiscal Year 1996 Financial Statement Audit
(WR-FC-98-01)

TO: Administrator, Southwestern Power Administration

The attached report presents the results of the independent certified public accountants' audit of the Southwestern Federal Power System's (SWFPS) combined power system statements of assets, Federal investment and liabilities, and the related combined statements of revenues, expenses and accumulated net revenues, and cash flows.

The 1996 financial statement audit was made under the provisions of the Inspector General Act (5 U.S.C. App.), as amended, the Government Management Reform Act (31 U.S. C. 3515), and Office of Management and Budget implementing guidance. The auditors' work was conducted in accordance with generally accepted government auditing standards. To fulfill our audit responsibilities, we contracted with the independent public accounting firm of KPMG Peat Marwick LLP (KPMG) to conduct the audit for us, subject to our review.

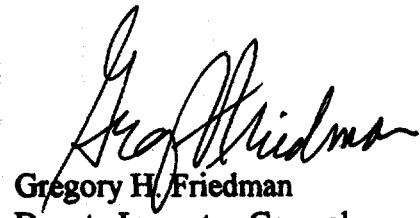
The auditor's report on SWFPS's internal control structure disclosed a reportable condition directed to the Southwestern Power Administration concerning a delay in properly classifying the value of plant assets. The report also included two reportable conditions directed to the Army Corps of Engineers regarding the inconsistent calculation of depreciation expense and the misallocation of multipurpose costs. None of these reportable conditions were considered to be material weaknesses. Southwestern provided concurrence and a corrective action plan for its reportable condition and, therefore, no further action is required by Southwestern. However, the Corps did not concur with the recommendations.

The auditors' report on SWFP's compliance with laws and regulations disclosed no new instances of noncompliance by Southwestern. However, the report disclosed one new instance of noncompliance by the Army Corps of Engineers regarding the use of incorrect estimated useful lives when calculating depreciation expense.

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MASTER

Based on KPMG's unqualified opinion and our review of their audit work, we believe the financial statements fairly present the financial condition and results of operations of the SWFPS for the period under audit.



Gregory H. Friedman
Deputy Inspector General
for Audit Services

Attachment

**cc: Audit Liaison, Southwestern Power Administration
Team Leader, Audit Liaison Division (CR-2)
Manager, Western Regional Audit Office**



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SOUTHWESTERN FEDERAL POWER SYSTEM

**Combined Financial Statements
and Supplemental Schedules**

(With Independent Auditors' Reports Thereon)

For the Years Ended September 30, 1996 and 1995

SOUTHWESTERN FEDERAL POWER SYSTEM

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SOUTHWESTERN FEDERAL POWER SYSTEM

OVERVIEW

The Southwestern Federal Power System

The Southwestern Federal Power System encompasses the operation of 24 hydroelectric power plants by the U.S. Army Corps of Engineers and the marketing of power and energy from those plants by the Southwestern Power Administration of the U.S. Department of Energy.

To integrate the operation of these hydroelectric generating plants and to transmit power from the dams to its customers, Southwestern Power Administration (Southwestern) maintains 2,220 kilometers (1,380 miles) of high-voltage transmission lines, 24 substations, and 46 microwave and VHF radio sites. Southwestern's headquarters are in Tulsa, Oklahoma; its dispatch center is in Springfield, Missouri; and its maintenance crews are based in Jonesboro, Arkansas, in Gore and Tupelo, Oklahoma, and in Springfield, Missouri. Three offices - Corporate Operation, Maintenance, and Corporate Services - are responsible for meeting Southwestern's mission.

Twelve of the 24 generating plants are scheduled directly by Southwestern, and a total of 19 contribute to the interconnected system operations. Generation at the five remaining projects (Denison, Narrows, Sam Rayburn, Whitney, and Willis) is used to serve specific customer loads.

At the end of fiscal year 1996, Southwestern marketed power and energy to 10 generation and transmission cooperatives, one distribution cooperative, three military installations, 44 municipal utilities, and three municipal utility joint-action agencies. One of the joint-action agencies has its own allocation of power from Southwestern; the other two serve 33 municipal utilities to whom Southwestern has allocated power. The total number of power allocation customers is 92. Additionally, excess energy is occasionally sold to non-allocation utilities.

Mission Statement

Southwestern Power's employees market federally generated hydroelectric power to public power customers and operate and maintain a high-voltage transmission system, at cost-based rates which return the taxpayers' investment in the power system.

Section 5, Flood Control Act of 1944

Section 5 of the Flood Control Act of 1944 as set out in Title 16 U.S.C.A. Section 825s sets forth the mission of Southwestern Power Administration, which was established in 1943.

Electric power and energy generated at reservoir projects under the control of the Department of the Army, and in the opinion of the Secretary of the Army, not required in the operation of such projects shall be delivered to the Secretary of Energy. The Secretary of Energy shall transmit and dispose of such power and energy in such manner as to encourage the most widespread use thereof at the lowest possible rates to consumers consistent with sound business principles, the rate schedules to become effective upon confirmation and approval by the Secretary of Energy.

Rate schedules shall be drawn having regard to the recovery (upon the basis of the application of such rate schedules to the capacity of the electric facilities of the projects) of the cost of producing and transmitting such electric energy, including the amortization of the capital investment allocated to power over a reasonable period of years. Preference in the sale of such power and energy shall be given to public bodies and cooperatives. The Secretary of Energy is authorized, from funds to be appropriated by the Congress, to construct or acquire, by purchase or other agreement, only such transmission lines and related facilities as may be necessary in order to make the power and energy generated at said projects available in wholesale quantities for sale on fair and reasonable terms and conditions to facilities owned by the Federal Government, public bodies, cooperatives, and privately owned companies. All the monies received from such sales shall be deposited in the Treasury of the United States as miscellaneous receipts.

Financial Statement Presentation

1. The combined financial statements have been prepared to report the financial position and results of operations of the Southwestern Federal Power System.
2. While the statements have been prepared from the books and records of the Southwestern Power Administration and the related U.S. Army Corps of Engineers in accordance with the formats prescribed by the Office of Management and Budget, the statements are different from the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.
3. The combined financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Performance Measurements

Performance measurements which are used to determine effectiveness and efficiency of programs in the areas of financial performance and program performance are:

- Customer satisfaction
- Work environment
- Financial stability
- Public trust
- Reliability

National Performance Review

Southwestern is developing plans in response to the National Performance Review mandate which directs specific areas of reform within the Government. Those reforms target reducing the Federal budget and increasing net income by:

- decreasing Federal employment,
- increasing employee-to-supervisor ratios,
- reducing service contracts by 20 percent,
- decreasing the number of directives and regulations by half, and
- increasing net income from the Power Marketing Administrations.

Government agencies have been allowed three to five years to comply with the individual mandates.

PERFORMANCE MEASUREMENTS

Southwestern Power Administration developed a list of program-specific performance measurements to help monitor specific areas of interest. These five measures will be accomplished through ten objectives.

These performance measurements will be utilized to research and collect electric utility data. Southwestern will compare its strengths and weaknesses with other electric utilities, allowing specific areas to be focused on for future improvement.

Customer Satisfaction

1. Competitive Power Sales Rate (by limiting expenditures)

Southwestern's target for FY 1996 is to limit operations and maintenance expenses to the 3.1 percent Consumer Price Index for inflation. Southwestern did not achieve this goal. Actual operations and maintenance expenditures exceeded FY 1995's by 4 percent.

The FY 1997 target for this objective will be a 10 percent reduction of the prior year's indirect and overhead expenses.

2. Improved Customer Service

This is a measure of Southwestern's performance as validated through customer responses to an annual survey. This goal's target is to achieve an overall average performance rating of 80 percent or better. The survey results published in September 1996, indicated that Southwestern exceeded this goal by 3 percent with an overall average customer satisfaction rating of 83 percent.

The FY 1997 target for this objective will be an overall rating of 84 percent.

Work Environment

3. Attract a diverse, flexible, and highly competent workforce

The goal is that twenty-five percent of all Southwestern's new hires will be from the under utilized classes (women and minorities). Seven employees were hired during FY 1996. Of these, five were from the under utilized classes, bringing Southwestern's performance to 71 percent, well exceeding the goal.

The FY 1997 target for this objective remains the same.

4. Increase personal development

With this measure, Southwestern intends to increase total training hours 10 percent while maintaining a training budget equal to FY 1995. Southwestern did not meet this goal in FY 1996. Although training dollars spent were reduced by 26 percent, training hours were reduced by 38 percent.

During FY 1997, Southwestern's plan is a 10 percent increase in the average training hours per employee, while reducing the average training cost per employee by 10 percent. FY 1996 will be the base year for the new comparison.

5. Improved Safety Record

Southwestern was successful in exceeding its goal of a 10 percent reduction from the reportable incident rate prescribed by the Bureau of Labor for FY 1995. To determine this rate, the number of accidents is multiplied by 200,000 hours then divided by the total hours worked. This is compared to the Bureau of Labor accident rate, which is based on a 200,000 hour standard (100 full time employees working 40 hours per week, 50 weeks per year). Southwestern achieved a rate of 1.96, with a target rate of 5.22 (Bureau of Labor rate less 10 percent).

During FY 1997, the performance measurement will change from the reportable incident rate to the number of lost work days. The target will be not to exceed 50 lost workdays.

Financial Stability

6. Timely Investment Repayment

The goal of timely repayment of investment is based on the annual Power Repayment Study (PRS), which includes factors such as expected water generation, expenses, and revenues. Southwestern's target is to meet or exceed the annual repayment schedule. In anticipation of an average year of water generation for FY 1996, the goal was set at \$23,784,000. However, due to less than average rainfall during FY 1996, the agency was unable to meet its repayment schedule.

7. Positive Net Revenues

Annual revenues will exceed annual costs resulting in positive net revenues for the fiscal year. Southwestern was successful in this objective by achieving net revenues of \$1.2 million.

For FY 1997, the financial stability goal has been redesigned to become a more effective measure. The new objective will be to reduce the uncotted obligation balance to less than 35 percent of annual costs.

Public Trust

8. Environmental Compliance

Environmental compliance is achieved by issuing disposal orders for all hazardous waste identified prior to August 1 of the fiscal year. Southwestern issued disposal orders for all the hazardous materials identified during the fiscal year, thereby achieving this goal.

The target for this objective for FY 1997 remains the same.

9. Enhanced Community Participation

This measures the number of Southwestern employees participating in work-related activities in the local community. Examples of this type of involvement include school volunteer programs, adopt-a-highway, and professional organizations. The agency's target is to have at least 50 percent of its employees participate in such programs. Southwestern was successful in this objective with a 57 percent participation level. The target for FY 1997 has been set at 65 percent of the employees participating in community-related activities.

10. Increased Operational Reliability of the Integrated System

Customers are dependent upon Southwestern for a reliable source of energy. As a reliability measure, the industry measure is the system average interruption duration index (SAIDI). Southwestern achieved its goal of not more than 150 minutes of total outage per year for 95 percent of its delivery points.

Southwestern has modified this objective for FY 1997. The target will be not more than 150 minutes total of preventable outages per year for 96 percent of its points of delivery. In addition, hourly inadvertent power flow will be less than 14 MWhs for 90 percent of all hours delivered.

A second objective has been added to the reliability goal for FY 1997. The new objective is increased reliability through efficient maintenance scheduling. The target is a combination of two maintenance aspects. The first is to reduce the substation work backlog indicated in MMIS (Maintenance Management Information System) by 10 percent in each area office. The second is to install 75 miles of fiber optic overhead wire, 250 poles and crossarms, 300 braces, 5 circuit breakers, and clear 400 miles of right-of-way.

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INDEPENDENT AUDITORS' REPORT

The Administrator of
Southwestern Power Administration
U.S. Department of Energy:

We have audited the accompanying combined statements of assets, Federal investment, and liabilities of the Southwestern Federal Power System (SWFPS) as of September 30, 1996 and 1995, and the related combined statements of revenues, expenses, and accumulated net revenues, and cash flows for the years then ended as described in Note 1. These combined financial statements are the responsibility of SWFPS' management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of the SWFPS as of September 30, 1996 and 1995, and the results of its operations and changes in accumulated net revenues, and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued reports dated June 23, 1997, on our consideration of the SWFPS' internal control structure and on its compliance with laws and regulations.

Our audits were made for the purpose of forming an opinion on the combined financial statements referred to in the first paragraph of this report, taken as a whole. The accompanying combining information is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, results of operations, and cash flows of individual projects. The combining information has been subjected to the auditing procedures applied in the audit of the combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

The information presented in management's *Overview and Performance Measurements* is not a required part of the combined financial statements, but is supplementary information required by OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the combined financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the financial statements and, accordingly, we do not express an opinion on it. The performance information included in management's *Overview and Performance Measurements* is addressed in our auditors' report on the internal control structure in accordance with OMB Bulletin 93-06.

This report is intended for the information of the management of the Southwestern Power Administration, the U.S. Army Corps of Engineers, and the U.S. Department of Energy. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

K PMA Peat March 1997

Tulsa, Oklahoma
June 23, 1997

SOUTHWESTERN FEDERAL POWER SYSTEM
Combined Statements of Assets, Federal Investment, and Liabilities
September 30, 1996 and 1995

<u>Assets</u>	<u>1996</u>	<u>1995</u>
Utility plant:		
Plant in service	\$ 1,082,406,966	1,058,911,719
Accumulated depreciation	(292,245,862)	(273,942,832)
Construction work in progress	50,261,335	45,351,831
Retirement work in progress	<u>(413,766)</u>	<u>(349,673)</u>
Net utility plant	<u>840,008,673</u>	<u>829,971,045</u>
Current assets:		
Unexpended appropriations	30,669,866	31,019,959
Accounts receivable	17,886,396	15,484,614
Materials and supplies, at average cost	<u>6,712,874</u>	<u>6,363,435</u>
	<u>55,269,136</u>	<u>52,868,008</u>
Banking exchange receivable	8,055,144	15,111,062
Other assets	<u>57,651</u>	<u>907,921</u>
	<u>\$ 903,390,604</u>	<u>898,858,036</u>
<u>Federal Investment and Liabilities</u>		
Federal investment:		
Congressional appropriations	\$ 2,060,466,664	1,989,518,289
Interest on Federal investment	658,502,522	638,860,346
Transfers from other federal agencies	<u>26,849,882</u>	<u>26,869,060</u>
Gross Federal investment	2,745,819,068	2,655,247,695
Funds returned to U.S. Treasury	<u>(1,978,492,808)</u>	<u>(1,895,286,471)</u>
Net outstanding Federal investment	767,326,260	759,961,224
Accumulated net revenues	<u>93,632,027</u>	<u>92,478,305</u>
Total Federal investment	<u>860,958,287</u>	<u>852,439,529</u>
Current liabilities - accounts payable and accrued liabilities		
	18,171,100	13,107,202
Purchase power and banking exchange deferral	23,929,497	32,994,983
Hydropower revenue deferral	331,720	316,322
Commitments and contingencies (Notes 3 and 5)		
	<u>42,432,317</u>	<u>46,418,507</u>
Total liabilities	<u>\$ 903,390,604</u>	<u>898,858,036</u>
Total Federal investment and liabilities		

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

SOUTHWESTERN FEDERAL POWER SYSTEM
Combined Statements of Revenues, Expenses,
and Accumulated Net Revenues
Years ended September 30, 1996 and 1995

	<u>1996</u>	<u>1995</u>
Operating revenues:		
Sales of electric power:		
Cooperatives	\$ 55,812,384	69,395,297
Municipalities	24,951,334	29,090,080
Federal and state agencies	4,876,969	3,809,122
Banking exchange	3,549,173	4,175,241
Transmission service charges for others	3,449,214	3,217,493
Other	<u>783,582</u>	<u>656,432</u>
Total operating revenues before deferrals	<u>93,422,656</u>	<u>110,343,665</u>
Net purchase power credit and banking exchange	<u>10,305,254</u>	<u>3,920,513</u>
Total operating revenues	<u>103,727,910</u>	<u>114,264,178</u>
Operating expenses:		
Operation and maintenance	49,601,162	49,435,490
Purchase power and banking exchange	13,502,379	6,569,731
Depreciation	17,469,577	12,774,661
Transmission service charges by others	<u>3,795,172</u>	<u>3,603,303</u>
Total operating expenses excluding interest	<u>84,368,290</u>	<u>72,383,185</u>
Net operating revenues	<u>19,359,620</u>	<u>41,880,993</u>
Interest on Federal investment	20,845,354	20,272,609
Allowance for funds used during construction (AFUDC)	<u>(2,639,456)</u>	<u>(3,087,573)</u>
Net interest expense	<u>18,205,898</u>	<u>17,185,036</u>
Net revenues	1,153,722	24,695,957
Accumulated net revenues:		
Balance, beginning of year	<u>92,478,305</u>	<u>67,782,348</u>
Balance, end of year	<u>\$ 93,632,027</u>	<u>92,478,305</u>

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

SOUTHWESTERN FEDERAL POWER SYSTEM
Combined Statements of Cash Flows
Years ended September 30, 1996 and 1995

	<u>1996</u>	<u>1995</u>
Cash flows from operating activities:		
Net revenues	\$ 1,153,722	24,695,957
Adjustments to reconcile net revenues to net cash provided by operating activities:		
Depreciation	17,469,577	12,774,661
Interest expense on Federal investment	20,845,354	20,272,609
(Increase) decrease in:		
Accounts receivable	(2,401,782)	(5,175,708)
Materials and supplies	(349,439)	(823,488)
Banking exchange receivable	7,055,918	1,033,050
Other assets	850,270	74,893
Increase (decrease) in:		
Accounts payable and accrued liabilities	5,063,898	1,985,954
Purchase power and banking exchange deferral	(9,065,486)	(2,613,982)
Hydropower revenue deferral	<u>15,398</u>	<u>14,665</u>
Net cash provided by operating activities	<u>40,637,430</u>	<u>52,238,611</u>
Cash flows from investing activities:		
Additions to utility plant	(24,850,337)	(29,900,045)
Allowance for funds used during construction	<u>(2,639,456)</u>	<u>(3,087,573)</u>
Net cash used in investing activities	<u>(27,489,793)</u>	<u>(32,987,618)</u>
Cash flows from capital financing activities:		
Congressional appropriations	70,948,375	65,330,528
Funds returned to U.S. Treasury	(83,206,337)	(98,143,399)
Interest on Federal investment - purchase power deferral	<u>(1,239,768)</u>	<u>(1,306,531)</u>
Net cash used in capital financing activities	<u>(13,497,730)</u>	<u>(34,119,402)</u>
Net decrease in cash	(350,093)	(14,868,409)
Cash at beginning of year	<u>31,019,959</u>	<u>45,888,368</u>
Cash at end of year	<u>30,669,866</u>	<u>31,019,959</u>
Noncash investing activities and other transactions -		
Transfer of plant in service from other Federal agencies	\$ <u>32</u>	<u>145,325</u>
AFUDC included in interest expense on Federal investment	<u>\$ 2,639,456</u>	<u>3,087,573</u>

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

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 1996 and 1995

(1) Summary of Significant Accounting Policies

General Information and Basis of Preparation of Financial Statements

The accompanying combined financial statements of the Southwestern Federal Power System (SWFPS) include the accounts of the Southwestern Power Administration (Southwestern), a unit of the U.S. Department of Energy (DOE), and the accounts of the Southwestern hydroelectric generating plants and power operations of the U.S. Army Corps of Engineers (Corps), a unit of the U.S. Department of Defense. Southwestern and the Corps are separately managed and financed and each maintains its own accounting records. For purposes of financial and operational reporting, the facilities and related operations are considered one entity.

The Corps has constructed and operates hydroelectric generating plants in the states of Oklahoma, Missouri, Arkansas, and Texas. Costs of multi-purpose Corps projects are allocated to power and non-power purposes. The portion of such project costs allocated to power is included in the financial statements. Southwestern, as designated by the Secretary of the DOE, purchases, transmits, and markets power.

The SWFPS is subject to the regulations of the Federal Energy Regulatory Commission (FERC). Accounts are maintained in accordance with generally accepted accounting principles, the uniform system of accounts prescribed for electric utilities by the FERC, the accounting practices and standards established by the DOE, and the requirements of specific legislation and executive directives issued by government agencies. The SWFPS' financial statements are prepared in accordance with Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71), which requires that the effects of the rate-making process be recorded. Such effects can provide reasonable assurance about the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise.

Confirmation and Approval of New Rates

Integrated system rate schedules were confirmed and approved by the FERC on a final basis on September 18, 1991. These rates were placed into effect on a two-step incrementally increasing basis for the period October 1, 1990, through September 30, 1994. The final increase of 5.7 percent became effective April 1, 1992. On August 16, 1995, the rates were extended through September 30, 1996, by the Deputy Secretary of Energy. The Sam Rayburn and Robert Douglas Willis projects are presently under rates which were confirmed and approved by FERC on a final basis on August 11, 1993, and are in effect from October 1, 1993, through September 30, 1997.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

Utility Plant and Depreciation

Plant in service and construction and retirement work in progress are stated at original cost or at appraisal value for property transferred from other government agencies. Cost includes direct labor and materials, payments to contractors, indirect charges for engineering, supervision and similar overhead items, and allowance for funds used during construction. The costs of additions and betterments are capitalized. Repairs and minor replacements are charged to operation and maintenance expense. Generally, the cost of utility plant retired, together with removal costs less salvage, is charged to accumulated depreciation when it is removed from service. Gains and losses are recognized only on sales of significant identifiable assets.

Depreciation on utility plant is computed on a straight-line basis over the estimated service lives of the various classes of property. Service lives currently range from 15 to 100 years for transmission plant and generating plant components.

Unexpended Appropriations

Unexpended appropriations consist of the unexpended balance of funds appropriated by Congress for construction and operation and maintenance purposes and are maintained by the U.S. Treasury. For purposes of the statements of cash flows, unexpended appropriations are considered to be cash.

Congressional Appropriations

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

Purchase Power and Banking Exchange Deferral and Receivable

A separate rate component (adder) recovers the cost of purchased power based upon the average purchased power costs over the past several years. If the actual expenses of purchased power exceed the revenue generated from this adder, the cost is deferred for future recovery through rates. Likewise, if the expense is less than the adder, the excess revenue is deferred. In 1988, the SWFPS determined that the deferred revenue accumulated from the adder exceeded estimated requirements. As a result, refunds of the adder have been accomplished by including a purchase power credit in the rate schedules approved for the period July 1, 1988, through September 30, 1996. The SWFPS calculates interest on the purchased power deferral at the applicable current interest rate established in the fiscal year of the deferral. Such interest is deferred to offset future purchase power costs.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

The SWFPS has arrangements with certain customers in which excess power generated by the SWFPS is banked with the customer until needed by the SWFPS and the customer has excess power available. The SWFPS records a receivable for the power banked at the customers' cost of generation. The net revenue or expense associated with banking activity is deferred.

Operating Revenues

Operating revenues are recorded on the basis of service rendered. Rates are established under requirements of the Flood Control Act of 1944, related legislation and executive departmental directives, and are to provide sufficient revenues to meet all required payments for system costs, including operation and maintenance expenses less depreciation, interest, and payment to the U.S. Treasury for the Federal investment in utility plant. Rates are intended to provide for recovery of the Federal investment in transmission and generating facilities within the service lives of the assets, not to exceed 50 years from the date placed in service, while operation and maintenance costs and interest on Federal investment are intended to be recovered annually.

As set forth in "Utility Plant and Depreciation" above, assets are being depreciated for financial reporting purposes using the straight-line method over their estimated service lives which currently range from 15 to 100 years for transmission facilities components and generating facilities components. Accordingly, annual depreciation charges are not matched with the recovery of the related capital costs and will, in the case of generating facilities, continue beyond the period within which such costs will have been recovered through rates.

While energy and transmission rates are established to recover the costs of operating the power projects, rates are also required to be at the lowest possible level, consistent with sound business principles. Over the life of the power system, accumulated net revenues represent differences between the timing of the recognition of expenses and related revenues, resulting primarily from the difference between the recognition of depreciation and the related recovery of the U.S. Treasury's investment in utility plant. The SWFPS is a nonprofit agency, thus at any given time the accumulated net revenue (deficit) balance is deemed to represent deferred revenue or expense, respectively.

The practice followed by the SWFPS is in conformity with the accounting practices and standards established by the DOE and the requirements of specific legislation and executive directives issued by government agencies.

Interest on Federal Investment

Interest on Federal investment is a cost mandated by the Secretaries of the Departments of Energy and Defense and the FERC. Southwestern computes interest in accordance with DOE Order RA 6120.2, which provides that interest be computed on the remaining investment after revenues have been applied to recovery of costs during the year, any prior year unpaid costs, and then to Federal investment bearing the highest interest rate (see Note 4).

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

Allowance for Funds Used During Construction (AFUDC)

The FERC Uniform System of Accounts defines AFUDC as the net costs for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. While cash is not realized currently from this allowance, it is realized under the rate making process over the repayment life of the related property through increased revenues resulting from higher recoverable investment. The interest rates used are established by law, administrative order or administrative policy for the fiscal year during which the construction commenced (7.625 percent for fiscal year 1996).

Retirement Benefits

The SWFPS employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), both of which are contributory defined benefit pension plans. Retirement benefit expenses under the CSRS are equivalent to 7 percent of eligible employee compensation. Under the FERS, expenses are variable based on the options chosen by the participant, but do not exceed 12.2 percent of eligible employee compensation. These contributions are submitted to benefit program trust funds administered by the Office of Personnel Management (OPM).

The contribution levels as legislatively mandated do not reflect the total current cost/full cost requirements to fund the pension plans. Additional sources of funding include direct appropriations as provided to the OPM, not the individual agencies. The costs of health and life insurance benefit programs are similarly administered and paid through the OPM.

Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, directs the full cost reporting of employment benefits by employing entity. Under this concept, Southwestern (and the agencies identified above comprising the reporting entity) will be required to accrue the costs to the Federal government of providing pension, life, health, and other post-employment benefits (severance payments, counseling and training, workers compensation benefits, etc.), "regardless of whether the benefits are funded by the reporting entity or by direct appropriations to the trust funds." SFFAS No. 4 will be effective after September 30, 1997.

Income Taxes

The SWFPS' income and facilities are exempt from taxation.

(2) Utility Plant

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

	<u>1996</u>	<u>1995</u>
Generating facilities	\$ 953,812,539	940,862,978
Transmission facilities	<u>178,441,996</u>	<u>163,050,899</u>
	<u>\$ 1,132,254,535</u>	<u>1,103,913,877</u>

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

(3) Tentative Cost Allocations

Allocations of plant cost and operation and maintenance expense between power and non-power purposes for three of the Corps' operating projects are presently based on tentative allocations. At September 30, 1996, total plant costs for these three projects were \$1,095,978,846, of which \$289,735,930 was tentatively allocated to power and subject to adjustment. The amount of adjustments that may be necessary when final allocations are approved for these projects is not presently determinable. When final allocations are made, the cumulative effect will be determined and reflected as an adjustment to the financial statements at that time.

The Harry S. Truman project has a tentative cost allocation of \$159,164,640. Since being placed in service, this project's operations have been restricted because of limited water flow. The restrictions have prevented the project from producing power to its design capacity. A final determination of when, if ever, the project can reach full generating capacity has not yet been made. If the restriction on generating capacity is not removed, some change in allocation of cost may be required. If such a change in allocation is required, the cumulative effect will be determined and reflected as an adjustment to the financial statements at that time.

(4) Investment of U.S. Government

Construction and operation of the SWFPS transmission system and the Corps' generating plants and operations are financed through Congressional appropriations, except for the Robert Douglas Willis project which is financed by other parties. The U.S. Government's investment in each generating project and each year's investment in the transmission system is to be repaid to the U.S. Treasury within the service lives of the assets, not to exceed 50 years from the time the facility is placed in service. There is no requirement for repayment of a specific amount on an annual basis. Annual revenues are first applied to the current year operating expenses (less depreciation) and interest expense. All annual amounts for such expenses have been paid through fiscal year 1996. Remaining revenues are to be first applied to repayment of operating deficits (which include all expenses except depreciation), if any, and then to repayment of the Federal investment. To the extent possible, while still complying with the repayment period established for each increment of investment and unless otherwise required by legislation, repayment of the investment is to be accomplished by repayment of the highest interest-bearing investment first. Interest rates applied to the unamortized initial investment of the U.S. Government in the Corps' hydroelectric plants range from 2.5 percent to 3.125 percent for facilities in service at the beginning of the year and 7.625 percent for facilities placed in service during 1996. Interest rates applied to the unamortized investment of the U.S. Government in Southwestern transmission facilities are approximately 2.5 percent for facilities in service at the beginning of the year and 7.625 percent for facilities placed in service during 1996. The rates have been set either by law, by administrative order pursuant to law, or by administrative policies using the U.S. Senate Document No. 97 formula for the fiscal year during which the appropriations were requested.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

(5) Commitments and Contingencies

Based on the 1996 Integrated System Power Repayment Study, the projected increase in capital investment in 1997 is \$12,878,900 which includes \$10,331,100 for transmission facilities and \$2,547,800 for generating facilities. The 5-year investment increase projected in the 1996 Power Repayment Study for 1997 through 2001 is estimated to cost \$111,315,657.

The SWFPS is a party to certain claims and legal actions arising in the ordinary course of business. In addition, the Corps has begun studies for the purpose of determining whether possible environmental contamination exists at various dam locations. The cost of remediation, if any, at these sites is unknown. In management's opinion, these actions will not have a material adverse effect on the financial condition or results of operations of the SWFPS.

(6) Restatement of Federal Investment

It was not determined how to properly recognize interest on Federal investment for power assets placed into service by the Corps districts within the SWFPS between 1970 and 1988. Interior Department Order 2929 was issued in 1970 and generally requires the use of annual interest rates as set by the U.S. Treasury Department for new power projects. The Corps and the DOE agreed in 1983 to begin using the U.S. Treasury interest rate in the calculation of the interest on the Federal investment related to new power projects. The agreement also stipulated that the interest rates from 1970 to 1983 be analyzed to insure compliance with the agreement. No Corps district had implemented the U.S. Treasury interest rate provisions prior to fiscal year 1989.

Additional interest, if any, on Federal investment for the period 1970 to 1988 has not been included in the accompanying financial statements. Resolution of this matter may require additional interest on Federal investment to be recognized.

SOUTHWESTERN FEDERAL POWER SYSTEM
Combining Statements of Assets, Federal Investment, and Liabilities
September 30, 1996

<u>Assets</u>	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 142,132,557	940,274,409	1,082,406,966
Accumulated depreciation	(31,294,977)	(260,950,885)	(292,245,862)
Construction work in progress	36,779,007	13,482,328	50,261,335
Retirement work in progress	<u>(469,568)</u>	<u>55,802</u>	<u>(413,766)</u>
 Net utility plant	 <u>147,147,019</u>	 <u>692,861,654</u>	 <u>840,008,673</u>
Current assets:			
Unexpended appropriations	19,594,155	11,075,711	30,669,866
Accounts receivable	17,857,981	28,415	17,886,396
Materials and supplies, at average cost	<u>6,712,874</u>	<u>-</u>	<u>6,712,874</u>
 Banking exchange receivable	 <u>44,165,010</u>	 <u>11,104,126</u>	 <u>55,269,136</u>
Other assets	8,055,144	-	8,055,144
	<u>21,148</u>	<u>36,503</u>	<u>57,651</u>
 \$ 199,388,321	 <u>704,002,283</u>	 <u>704,002,283</u>	 <u>903,390,604</u>

Federal Investment and Liabilities

Federal investment:			
Investment of U.S. Government:			
Congressional appropriations	\$ 619,116,452	1,441,350,212	2,060,466,664
Interest on Federal investment	37,587,683	620,914,839	658,502,522
Transfers from other federal agencies	<u>14,564,948</u>	<u>12,284,934</u>	<u>26,849,882</u>
Gross Federal investment	<u>671,269,083</u>	<u>2,074,549,985</u>	<u>2,745,819,068</u>
Funds returned to U.S. Treasury	(604,736,813)	(1,373,755,995)	(1,978,492,808)
Net investment of U.S. Government	<u>66,532,270</u>	<u>700,793,990</u>	<u>767,326,260</u>
Accumulated net revenues (deficit)	<u>96,856,854</u>	<u>(3,224,827)</u>	<u>93,632,027</u>
 Total Federal investment	 <u>163,389,124</u>	 <u>697,569,163</u>	 <u>860,958,287</u>
 Current liabilities - accounts payable and accrued liabilities	 11,737,980	 6,433,120	 18,171,100
Purchase power and banking exchange deferral	23,929,497	-	23,929,497
Hydropower revenue deferral	<u>331,720</u>	<u>-</u>	<u>331,720</u>
 Total liabilities	 <u>35,999,197</u>	 <u>6,433,120</u>	 <u>42,432,317</u>
 Total Federal investment and liabilities	 \$ <u>199,388,321</u>	 <u>704,002,283</u>	 <u>903,390,604</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Assets, Federal Investment, and Liabilities

September 30, 1995

<u>Assets</u>	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 126,152,967	932,758,752	1,058,911,719
Accumulated depreciation	(31,563,665)	(242,379,167)	(273,942,832)
Construction work in progress	37,247,605	8,104,226	45,351,831
Retirement work in progress	<u>(349,673)</u>	-	<u>(349,673)</u>
Net utility plant	<u>131,487,234</u>	<u>698,483,811</u>	<u>829,971,045</u>
Current assets:			
Unexpended appropriations	19,901,806	11,118,153	31,019,959
Accounts receivable	15,447,141	37,473	15,484,614
Materials and supplies, at average cost	<u>6,363,435</u>	-	<u>6,363,435</u>
	<u>41,712,382</u>	<u>11,155,626</u>	<u>52,868,008</u>
Banking exchange receivable	15,111,062	-	15,111,062
Other assets	<u>22,591</u>	<u>885,330</u>	<u>907,921</u>
	<u>\$ 188,333,269</u>	<u>710,524,767</u>	<u>898,858,036</u>
<u>Federal Investment and Liabilities</u>			
Federal investment:			
Investment of U.S. Government:			
Congressional appropriations	\$ 589,384,453	1,400,133,836	1,989,518,289
Interest on Federal investment	35,903,899	602,956,447	638,860,346
Transfers from other federal agencies	<u>14,574,521</u>	<u>12,294,539</u>	<u>26,869,060</u>
Gross Federal investments	639,862,873	2,015,384,822	2,655,247,695
Funds returned to U.S. Treasury	<u>(575,482,361)</u>	<u>(1,319,804,110)</u>	<u>(1,895,286,471)</u>
Net investment of U.S. Government	64,380,512	695,580,712	759,961,224
Accumulated net revenues	<u>83,660,315</u>	<u>8,817,990</u>	<u>92,478,305</u>
Total Federal investment	<u>148,040,827</u>	<u>704,398,702</u>	<u>852,439,529</u>
Current liabilities - accounts payable and accrued liabilities			
Purchase power and banking exchange deferral	6,981,137	6,126,065	13,107,202
Hydropower revenue deferral	<u>32,994,983</u>	-	32,994,983
	<u>316,322</u>	-	<u>316,322</u>
Total liabilities	<u>40,292,442</u>	<u>6,126,065</u>	<u>46,418,507</u>
Total Federal investment and liabilities	<u>\$ 188,333,269</u>	<u>710,524,767</u>	<u>898,858,036</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

**Combining Statements of Revenues, Expenses,
and Accumulated Net Revenues**

Year ended September 30, 1996

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Operating revenues:			
Sales of electric power:			
Cooperatives	\$ 55,812,384	-	55,812,384
Municipalities	24,951,334	-	24,951,334
Federal and state agencies	4,876,969	-	4,876,969
Banking exchange	3,549,173	-	3,549,173
Transmission service charges for others	3,449,214	-	3,449,214
Other	<u>117,998</u>	<u>665,584</u>	<u>783,582</u>
Total operating revenues before deferrals	<u>92,757,072</u>	<u>665,584</u>	<u>93,422,656</u>
Net purchase power credit and banking exchange	10,305,254	-	10,305,254
Revenue distributed to Corps	<u>(51,864,714)</u>	<u>51,864,714</u>	<u>-</u>
Total operating revenues	<u>51,197,612</u>	<u>52,530,298</u>	<u>103,727,910</u>
Operating expenses:			
Operation and maintenance	17,299,278	32,301,884	49,601,162
Purchase power and banking exchange	13,502,379	-	13,502,379
Depreciation	3,058,412	14,411,165	17,469,577
Transmission service charges by others	<u>3,795,172</u>	<u>-</u>	<u>3,795,172</u>
Total operating expenses excluding interest	<u>37,655,241</u>	<u>46,713,049</u>	<u>84,368,290</u>
Net operating revenues	<u>13,542,371</u>	<u>5,817,249</u>	<u>19,359,620</u>
Interest expense on Federal investment	2,923,552	17,921,802	20,845,354
Allowance for funds used during construction (AFUDC)	<u>(2,577,720)</u>	<u>(61,736)</u>	<u>(2,639,456)</u>
Net interest expense	<u>345,832</u>	<u>17,860,066</u>	<u>18,205,898</u>
Net revenues	13,196,539	(12,042,817)	1,153,722
Accumulated net revenues (deficits):			
Balance, beginning of year	<u>83,660,315</u>	<u>8,817,990</u>	<u>92,478,305</u>
Balance, end of year	<u>\$ 96,856,854</u>	<u>(3,224,827)</u>	<u>93,632,027</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

**Combining Statements of Revenues, Expenses,
and Accumulated Net Revenues**

Year ended September 30, 1995

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Operating revenues:			
Sales of electric power:			
Cooperatives	\$ 69,395,297	-	69,395,297
Municipalities	29,090,080	-	29,090,080
Federal and state agencies	3,809,122	-	3,809,122
Banking exchange	4,175,241	-	4,175,241
Transmission service charges for others	3,217,493	-	3,217,493
Other	<u>111,733</u>	<u>544,699</u>	<u>656,432</u>
Total operating revenues before deferrals	<u>109,798,966</u>	<u>544,699</u>	<u>110,343,665</u>
Net purchase power credit and banking exchange	3,920,513	-	3,920,513
Revenue distributed to Corps	<u>(71,181,999)</u>	<u>71,181,999</u>	<u>-</u>
Total operating revenues	<u>42,537,480</u>	<u>71,726,698</u>	<u>114,264,178</u>
Operating expenses:			
Operation and maintenance	16,621,233	32,814,257	49,435,490
Purchase power and banking exchange	6,569,731	-	6,569,731
Depreciation	2,912,747	9,861,914	12,774,661
Transmission service charges by others	<u>3,605,947</u>	<u>(2,644)</u>	<u>3,603,303</u>
Total operating expenses excluding interest	<u>29,709,658</u>	<u>42,673,527</u>	<u>72,383,185</u>
Net operating revenues	<u>12,827,822</u>	<u>29,053,171</u>	<u>41,880,993</u>
Interest expense on Federal investment	2,681,979	17,590,630	20,272,609
Allowance for funds used during construction (AFUDC)	<u>(2,492,581)</u>	<u>(594,992)</u>	<u>(3,087,573)</u>
Net interest expense	<u>189,398</u>	<u>16,995,638</u>	<u>17,185,036</u>
Net revenues	<u>12,638,424</u>	<u>12,057,533</u>	<u>24,695,957</u>
Accumulated net revenues (deficits):			
Balance, beginning of year	<u>71,021,891</u>	<u>(3,239,543)</u>	<u>67,782,348</u>
Balance, end of year	<u>\$ 83,660,315</u>	<u>8,817,990</u>	<u>92,478,305</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Cash Flows

Year ended September 30, 1996

	Southwestern	Corps	Total
Cash flows from operating activities:			
Net revenues	\$ 13,196,539	(12,042,817)	1,153,722
Adjustments to reconcile net revenues to net cash provided by (used in) operating activities:			
Revenue distributed to Corps	51,864,714	(51,864,714)	-
Depreciation	3,058,412	14,411,165	17,469,577
Interest expense on Federal investment	2,923,552	17,921,802	20,845,354
(Increase) decrease in:			
Accounts receivable	(2,410,840)	9,058	(2,401,782)
Materials and supplies	(349,439)	-	(349,439)
Banking exchange receivable	7,055,918	-	7,055,918
Other assets	1,443	848,827	850,270
Increase (decrease) in:			
Accounts payable and accrued liabilities	4,756,843	307,055	5,063,898
Purchase power and banking exchange deferral	(9,065,486)	-	(9,065,486)
Hydropower revenue deferral	<u>15,398</u>	<u>-</u>	<u>15,398</u>
Cash provided by (used in) operating activities	<u>71,047,054</u>	<u>(30,409,624)</u>	<u>40,637,430</u>
Cash flows from investing activities:			
Additions to utility plant	(16,150,050)	(8,700,287)	(24,850,337)
Allowance for funds used during construction	<u>(2,577,720)</u>	<u>(61,736)</u>	<u>(2,639,456)</u>
Cash used in investing activities	<u>(18,727,770)</u>	<u>(8,762,023)</u>	<u>(27,489,793)</u>
Cash flows from capital financing activities:			
Congressional appropriations	29,731,999	41,216,376	70,948,375
Funds returned to U.S. Treasury	(81,119,166)	(2,087,171)	(83,206,337)
Interest on Federal investment - purchase power deferral	<u>(1,239,768)</u>	<u>-</u>	<u>(1,239,768)</u>
Cash provided by (used in) capital financing activities	<u>(52,626,935)</u>	<u>39,129,205</u>	<u>(13,497,730)</u>
Net decrease in cash	(307,651)	(42,442)	(350,093)
Cash at beginning of year	<u>19,901,806</u>	<u>11,118,153</u>	<u>31,019,959</u>
Cash at end of year	<u>\$ 19,594,155</u>	<u>11,075,711</u>	<u>30,669,866</u>
Noncash investing activities and other transactions -			
Transfer of plant in service (to) from other Federal agencies	<u>\$ (9,573)</u>	<u>9,605</u>	<u>32</u>
AFUDC included in interest expense on Federal investment	<u>\$ 2,577,720</u>	<u>61,736</u>	<u>2,639,456</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Cash Flows

Year ended September 30, 1995

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Cash flows from operating activities:			
Net revenues	\$ 12,638,424	12,057,533	24,695,957
Adjustments to reconcile net revenues to net cash provided by (used in) operating activities:			
Revenue distributed to Corps	71,181,999	(71,181,999)	-
Depreciation	2,912,747	9,861,914	12,774,661
Interest expense on Federal investment	2,681,979	17,590,630	20,272,609
(Acrease) decrease in:			
Accounts receivable	(5,174,778)	(930)	(5,175,708)
Materials and supplies	(823,488)	-	(823,488)
Banking exchange receivable	1,033,050	-	1,033,050
Other assets	(12,098)	86,991	74,893
Increase (decrease) in:			
Accounts payable and accrued liabilities	210,819	1,775,135	1,985,954
Purchase power and banking exchange deferral	(2,613,982)	-	(2,613,982)
Hydropower revenue deferral	<u>14,665</u>	<u>-</u>	<u>14,665</u>
Cash provided by (used in) operating activities	<u>82,049,337</u>	<u>(29,810,726)</u>	<u>52,238,611</u>
Cash flows from investing activities:			
Additions to utility plant	(15,988,568)	(13,911,477)	(29,900,045)
Allowance for funds used during construction	<u>(2,492,581)</u>	<u>(594,992)</u>	<u>(3,087,573)</u>
Cash used in investing activities	<u>(18,481,149)</u>	<u>(14,506,469)</u>	<u>(32,987,618)</u>
Cash flows from capital financing activities:			
Congressional appropriations	21,316,001	44,014,527	65,330,528
Funds returned to U.S. Treasury	(96,675,066)	(1,468,333)	(98,143,399)
Interest on Federal investment - purchase power deferral	<u>(1,306,531)</u>	<u>-</u>	<u>(1,306,531)</u>
Cash provided by (used in) capital financing activities	<u>(76,665,596)</u>	<u>42,546,194</u>	<u>(34,119,402)</u>
Net decrease in cash	(13,097,408)	(1,771,001)	(14,868,409)
Cash at beginning of year	<u>32,999,214</u>	<u>12,889,154</u>	<u>45,888,368</u>
Cash at end of year	<u>\$ 19,901,806</u>	<u>11,118,153</u>	<u>31,019,959</u>
Noncash investing activities and other transactions -			
Transfer of plant in service from other Federal agencies	<u>\$ -</u>	<u>145,325</u>	<u>145,325</u>
AFUDC included in interest expense on Federal investment	<u>\$ 2,492,581</u>	<u>594,992</u>	<u>3,087,573</u>

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INDEPENDENT AUDITORS' REPORT ON THE INTERNAL CONTROL STRUCTURE

The Administrator of
Southwestern Power Administration
U.S. Department of Energy:

We have audited the combined financial statements of the Southwestern Federal Power System (SWFPS) as of and for the year ended September 30, 1996, and have issued our report thereon dated June 23, 1997.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

The management of the SWFPS is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that transactions, including those relating to obligations and costs, are executed in compliance with applicable laws and regulations that could have a direct and material effect on the combined financial statements and any other laws and regulations that the OMB, management, or the U.S. Department of Energy (DOE) have identified as being significant and for which compliance can be objectively measured and evaluated; funds, property, and other assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and properly recorded and accounted for to permit the preparation of reliable financial reports in accordance with generally accepted accounting principles and to maintain accountability over the assets; and that data supporting reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audits of the combined financial statements of the SWFPS for the year ended September 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk, and we performed tests of the internal control structure, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measure control objective, we obtained an understanding of the relevant internal control structure policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to ensure that the objectives of the internal control structure, as previously defined, are being achieved.

Those matters that we consider to be reportable conditions are summarized below:

Southwestern Power Administration (SWPA)

Assets Misclassified

Department of Energy regulations require that work in process (WIP) be transferred to Plant-in-Service at the time that a completed project is placed in service. Southwestern had not transferred costs from WIP to Plant-in-Service on a work order for the SCADA system although the project was placed in service six months earlier. Southwestern did not transfer the costs when the project was placed in service because they were experiencing minor problems with the system's software. The delay in properly classifying the value of plant assets results in overstating interest during construction, and understating depreciation expense and interest on federal investment in the SWFPS combined financial statements.

Audit Recommendation

Southwestern should establish controls to ensure that substantially complete work orders are transferred to Plant-in-Service when the assets become operational to prevent misclassification of assets.

SWPA Response

Concur. It has been the policy at Southwestern to close work orders only after the entire project is completed in order to maintain the validity of the total project cost. In the future Southwestern will close work orders when the assets are placed in service. This was a system wide project and at the time of inception financial management felt that tighter controls could be maintained by tracking costs on one work order instead of multiple work orders. The work order was not closed earlier due to the fact that the entire project was not and has not been completed. There are three remote terminal units remaining to be installed as well as software problems and warranty work to be completed.

U. S. Army Corps of Engineers (Corps)

Depreciation Expense Calculation Not Consistent

The Corps of Engineers Financial Management System (CEFMS), the recently installed accounting system, facilitates calculating depreciation expense on an individual asset basis. For fiscal year 1996, two Corps of Engineers (Corps) districts calculated depreciation expense on an individual asset basis using CEFMS. The remaining four Corps districts calculated depreciation expense using a composite rate, a method previously used by all districts before converting to CEFMS. Although it appears that the Corps intended for all districts to use CEFMS to calculate depreciation on an asset by asset basis, the Corps did not provide specific guidance requiring such implementation.

Audit Recommendation

The Corps should provide guidance requiring the use of a consistent method to calculate depreciation expense at all districts to preclude using different depreciation amounts for similar assets.

Corps Response

Non-concur. The straight line depreciation method was used in COEMIS and CEFMS. Straight line was correctly computed on the actual information by individual asset. Since COEMIS did not allow this it had to be calculated by an average. When all districts have converted to CEFMS, straightline depreciation calculated on asset by asset basis will be used by all.

Allocation of Multipurpose Project Cost

CEFMS requires that the joint capitalized costs related to power generation equal the total multipurpose plant-in-service cost for the project multiplied by the construction power allocation percentage. In fiscal year 1996, the Corps made significant adjustments of Plant-in-Service and related accumulated depreciation expense balances. Corps personnel stated that the adjustments were needed because a recently completed inventory of all personal and real property disclosed that certain assets were not expensed or capitalized correctly. In addition, Corps personnel stated that joint costs had previously not been allocated correctly under the Corps of Engineers Management Information System (COEMIS), the old accounting system replaced by CEFMS. Instead of making the recalculations of construction power allocation percentages, Corps personnel made further adjustments to the plant-in-service or depreciation balances for each instance where the joint capitalized costs related to power generation in CEFMS did not agree to the joint capitalized cost in COEMIS.

Audit Recommendation

The Corps should require that the construction power allocation percentages are recalculated annually to ensure that power generation is accurately allocated its fair share of joint project costs.

Corps Response

Non-concur. The Corps performed physical inventories to ensure that all capitalized assets were properly accounted for in REMIS and CEFMS. While this inventory did not note items which had been improperly expensed, it did serve to disclose all Corps-owned assets and the value assigned to each. This inventory revealed cost that had been improperly categorized, which resulted in adjustments to the applicable features/purposes. Final allocations had previously been made and adjustments were made to reflect these changes. We do agree, however, that the Corps should continue to ensure that joint costs are being properly allocated, and that real estate records agree with accounting records.

* * * * *

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited, or material to a performance measure or aggregation of related performance data, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended for the information of the management of the SWFPS, the Corps, and the U.S. Department of Energy. However, this report is a matter of public record and its distribution is not limited.

KPMG Peat Marwick LLP

Tulsa, Oklahoma
June 23, 1997

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The Administrator of
Southwestern Power Administration
U. S. Department of Energy:

We have audited the combined financial statements of the Southwestern Federal Power System (SWFPS) as of and for the year ended September 30, 1996, and have issued our report thereon dated June 23, 1997.

We conducted our audits in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance that the combined financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the SWFPS is the responsibility of the SWFPS' management. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we performed tests of the SWFPS' compliance with certain provisions of laws and regulations that may directly affect the combined financial statements and certain other laws and regulations designated by the OMB and the U.S. Department of Energy, including:

- Budget Accounting and Procedures Act
- Chief Financial Officer Act of 1990
- Prompt Payment Act
- Fair Labor Standards Act
- Federal Labor Standards Act
- DOE Order RA 6120.20
- Buy America Act
- Flood Control Act of 1944
- Anti-Deficiency Act
- 18 Code of Federal Regulations (CFR) Part 300
- 10 CFR 903 - Power and Transmission Rates
- DOE Delegation Order No. 02304-108 - Approval of PMA Power and Transmission Rates
- DOE Order 2110.1 - Pricing of Departmental Services
- U.S. Army Corps of Engineers Directives ER 37-2-10 and SWDR 37-2-5
- Federal Managers' Financial Integrity Act

However, the objective of our audit of the combined financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

As a part of our audit, we also obtained an understanding of management's process at Southwestern only, for evaluating and reporting on internal control and accounting systems as required by the Federal Managers' Financial Integrity Act (FMFIA) and compared Southwestern's most recent FMFIA reports with the evaluation we conducted of Southwestern's internal control system.

The results of our tests of compliance disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards* for which the ultimate resolution cannot presently be determined. Accordingly, the financial statement impact that may result has not been recognized in the combined financial statements.

Audit Comment

Federal statute requires power marketing agencies to establish power rates at levels sufficient to allow for repayment of the Federal investment and related interest, plus power project operating costs. In our 1995 report, we reported that Southwestern is not including the costs of certain post-employment benefits paid by the Office of Personnel Management in rates charged to utility users, and is therefore not fully recovering the costs of operating the power projects. Our report also included a recommendation that Southwestern work with the Office of Personnel Management to obtain the information necessary to include post-employment benefit costs in its rate structure and accrue such costs in the SWFPS combined financial statements in accordance with the Standards of the Federal Accounting Standards Advisory Board.

The Department of Energy's Chief Financial Officer, in a Departmental Position issued September 29, 1995, concurred in principle with our recommendation. The Departmental Position states, "Statement of Federal Financial Accounting Standards Advisory Board No. 4, *Managerial Cost Accounting Concepts and Standards for Federal Government* (Statement 4) requires, for cost accounting purposes, that employee benefits incurred by 'responsibility segments' be directly traced or assigned to outputs, regardless of whether they are funded by the reporting entity or by direct appropriation to the trust funds. Agencies are not required to implement this requirement of the standard until implementation guidance is issued by the OMB."

Therefore, Southwestern has deferred action on our recommendation to recover all power project costs until implementation guidance for Statement 4 is issued by the OMB.

Audit Recommendation

No further recommendation is made, pending the issuance of implementation guidance by the OMB.

Response

Concur. The Federal Accounting Standards Advisory Board issued its Statement of Federal Financial Accounting Standards Number 5 (SFFAS-5), "Accounting for Liabilities of the Federal Government" on December 20, 1995. SFFAS-5 is not required until fiscal year 1997. On October 21, 1996 the Office of Personnel Management issued Financial Management Letter Number F-97-07, subject: Accounting for Pensions and Other Retirement Benefits. This Letter provides Southwestern with the information needed to compute expenses for "pensions" (the Civil Service Retirement System and the Federal Employees Retirement System) and post-retirement health benefits and life insurance for fiscal year 1996. The fiscal year 1997 cost factors will be provided to us by October 15, 1997.

For fiscal year 1996 there is no regulatory mandate specifying that post retirement benefits paid by the Office of Personnel Management be recovered by Southwestern. Southwestern will record the unfunded liability in the FY 1997 financial statements.

Audit Comment

The Corps manual, OM37-2-10, provided guidance on the estimated useful life for calculating depreciation expense for specific categories of fixed assets. For items tested at the Tulsa District, certain useful lives in the CEFMS did not agree with the useful lives in OM37-2-10. COE officials could not explain the differences but thought they were caused by input errors when implementing CEFMS.

Audit Recommendation

The Corps should require that the Tulsa district verify the accuracy of asset useful lives in its CEFMS to the useful lives for those same categories of assets in OM-37-2-10 to assure that depreciation expense is calculated correctly.

Response

Concur. We are waiting for HQUSACE guidance on the determination of life years.

We considered these instances of noncompliance in forming our opinion on whether the SWFPS' combined financial statements for the year ended September 30, 1996, are presented fairly, in all material respects, in conformity with applicable accounting policies in effect for Southwestern during the preparation of the SWFPS' combined financial statements, and this report does not affect our report on those financial statements dated June 23, 1997.

Except as described above, the results of our tests of compliance disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB 93-06.

Southwestern has received a waiver from OMB with respect to the financial statement provisions of OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, however, Southwestern is required to comply with overview and performance measures requirements of the OMB Bulletin.

This report is intended for the information of the management of the SWFPS, the Corps, and the U.S. Department of Energy. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

kpm4 Peat Marwick LLP

Tulsa, Oklahoma
June 23, 1997

Attachment

IG Report No. WR-FC-98-01

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