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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Sacramento Municipal Utility District
Sacramento, California

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Sacramento Municipal Utility District and its blended component units, which comprise the Consolidated Statements of Net Position as of December 31, 2016 and 2015, and the related Consolidated Statements of Revenues, Expenses and Changes in Net Position, and Consolidated Statements of Cash Flows for the years then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control over financial reporting relevant to the Sacramento Municipal Utility District's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Sacramento Municipal Utility District's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sacramento Municipal Utility District and its blended component units at December 31, 2016 and 2015, and the changes in their financial position and their cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

To the Board of Directors of
Sacramento Municipal Utility District

Emphasis of Matter

As discussed in Note 3, the Sacramento Municipal Utility District has adopted the provisions of GASB Statement No. 72, *Fair Value Measurement and Application*, and GASB Statement No. 82, *Pension Issues – an Amendment of GASB Statements No. 67, No. 68, and No. 73* effective January 1, 2015. Accordingly, the accounting changes have been retroactively applied to prior periods presented. Our opinion is not modified with respect to this matter.

Other Matter

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and Schedule of Funding Progress information as listed in the table of contents be presented to supplement the financial statements. Such information, although not a part of the consolidated financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the consolidated financial statements, and other knowledge we obtained during our audit of the consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we will also issue a report on our consideration of Sacramento Municipal Utility District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Sacramento Municipal Utility District's internal control over financial reporting and compliance.

Baker Tilly Virchow Krause, LLP

Madison, Wisconsin
February 17, 2017

Sacramento Municipal Utility District Management's Discussion and Analysis (Unaudited)

Using this Financial Report

This annual financial report for Sacramento Municipal Utility District (SMUD) consists of management's discussion and analysis and the consolidated financial statements, including notes to the financial statements. The Consolidated Financial Statements consist of the Statements of Net Position, the Statements of Revenue, Expenses and Changes in Net Position and the Statements of Cash Flows.

SMUD maintains its accounting records in accordance with Generally Accepted Accounting Principles for proprietary funds as prescribed by the Governmental Accounting Standards Board (GASB). 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 accounting for contributions of utility property in aid of construction.

Overview of the Financial Statements

The following discussion and analysis of the financial performance of SMUD provides an overview of the financial activities for the years ended December 31, 2016 and 2015. This discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes, which follow this section.

The Consolidated Statements of Net Position provide information about the nature and amount of resources and obligations at a specific point in time.

The Consolidated Statements of Revenues, Expenses and Changes in Net Position report all of SMUD's revenues and expenses for the periods shown.

The Consolidated Statements of Cash Flows report the cash provided and used by operating activities, as well as other cash sources, such as investment income and debt financing, and other cash uses such as payments for debt service and capital additions.

The Notes to Consolidated Financial Statements provide additional detailed information to support the financial statements.

Nature of Operations

Under provisions of California's Municipal Utility District Act, the citizens of Sacramento voted in 1923 to form their own electric utility – SMUD. The independently run community-owned utility began operations on December 31, 1946 and is not subject to regulation or oversight by the California Public Utilities Commission. It is now the sixth largest community-owned electric utility in the nation.

Governed by an elected board of directors (Board), SMUD has the rights and powers to fix rates and charges for commodities and services it furnishes, incur indebtedness, and issue bonds or other obligations. SMUD is responsible for the acquisition, generation, transmission and distribution of electric power to its service area with a population of approximately 1.4 million – most of Sacramento County and small adjoining portions of Placer and Yolo Counties. Its purpose is to provide solutions for meeting customers' electrical energy needs with a vision of empowering customers with solutions and options that increase energy efficiency, protect the environment, reduce global warming, and lower the cost to serve the region.

The Board has independent authority to set SMUD's rates and charges. Changes in rates require a public hearing and formal action by the Board. In August 2013, the Board approved a 2.5 percent rate increase effective January 1, 2014, and an additional 2.5 percent rate increase effective January 1, 2015. The rate increases were designed to achieve a fixed charge ratio of at least 1.5. In July 2015, the Board approved another 2.5 percent rate increase for both 2016 and 2017 to allow for additional investments in technology and infrastructure. The Board also approved an optional residential Time of Use (TOU) rate that would be made available in 2016 and 2017 and declared its intent to make TOU rates the standard for residential customers in 2018. The TOU rate structure puts SMUD at the industry forefront by setting the stage to better align rates with the actual cost of electricity. Even with these increases, SMUD's rates continue to remain amongst the lowest in the state. In 2016, the average system rate was 29.2 percent below the nearest investor owned utility's average rate.

SMUD's vision is to be the trusted partner with its customers and the community, providing innovative solutions to ensure energy affordability and reliability, improve the environment, reduce our region's carbon footprint, and enhance the vitality of our community. SMUD's business strategy focuses on serving its customers in a progressive, forward looking manner, addressing current regulatory and legislative issues and potential competitive forces. This includes ensuring financial stability by establishing rates that provide acceptable cash coverage of all fixed charges on a consolidated basis, taking into consideration the impact of capital expenditures and other factors on cash flow.

Financial & Operational Highlights

In 2016, SMUD continued working toward realizing the vision of meeting increased customer expectations and improving operational efficiencies. SMUD launched its 5-year strategic plan which is the blueprint for transforming the new business model and also developed the Distributed Energy Resource strategy which provides guidance for technology investments for success in the changing utility environment. SMUD continues to experience the strongest bond ratings in almost 30 years by having its credit rating confirmed at AA- by all three major rating agencies. In addition to exceeding the fixed debt service coverage goal, the refunding of a portion of SMUD's bonds and locking in lower interest rates for additional debt to be refunded in 2018 produced significant long-term savings exceeding \$50.0 million. SMUD was recognized by its residential customers as the top California utility for the 15th consecutive year by J.D. Power and was again ranked first among midsize utilities in the West and No. 1 in California for the 11th consecutive year for business customer satisfaction. In addition, SMUD ranked first nationally in the large utility category for Corporate Citizenship and Belief of Supporting Local Development. The White House recognized SMUD for its "strong commitment to reducing greenhouse gas emissions in all of its operations, including a net long-term reduction of 90 percent from our 1990 levels by 2050." The Senate Bill (SB)-1 program was fully subscribed in 2016 which provides for 4,400 residential solar PV interconnections and 50 commercial PV systems with over 30 megawatts (MW) of customer-sited PV. SMUD's reliability compliance risk management program continued to receive external recognition, earning SMUD the privilege of being part of the Western Electricity Coordinating Council's Self-Logging Program for 2016 and 2017, trusting SMUD to manage oversight internally for most compliance matters. Development of the 10.88 MW Rancho Seco Solar Project was completed and will supply renewable energy for the commercial SolarShares program. The SolarShares program supports the 20-year agreement with the Sacramento Kings and the California Department of General Services, as well as CalTrans. Electricity from SolarShares will displace about 2,000 metric tons of CO2 emissions per year, which is the equivalent of taking about 400 cars off the road. Other accomplishments include hosting the first of its kind Tiny House Competition for college and university students to help cultivate the next generation of energy leaders and offering the first paid course at the state-accredited training facility, the Sacramento Power Academy. Through its economic development program, SMUD played a key role in the attraction, retention and expansion of several companies in its service territory which led to the creation of over 1,600 jobs.

In July 2014, FERC issued a new fifty year license for the Upper American River Project (UARP), which included authority to build the Iowa Hill pumped-storage project. The UARP consists of three relatively large storage reservoirs and eight powerhouses containing eleven turbines. The UARP is one of SMUD's lowest cost power sources. In addition to providing clean hydroelectric power and operational flexibility, it provides habitat for fish and wildlife and a variety of recreational

opportunities, including camping, fishing, boating, hiking, horseback riding, mountain biking, and cross-country skiing. The combined capacity of the UARP is approximately 673 MW and represents about 15 percent of SMUD's average annual retail energy requirements. The Iowa Hill pumped-storage project was a proposed 3 unit, 400 MW variable speed powerhouse and in December 2015, after much analysis, SMUD made the decision to terminate the Iowa Hill pumped-storage project as it was determined to no longer be financially feasible (Board approved February 2016). SMUD's other power generation facilities include 3 MW of solar photovoltaic installations, the 102 MW Solano Wind Project, and five local gas-fired power plants with total capacity of approximately 1,012 MW. In addition, SMUD has several power purchase agreements to help meet its remaining power requirements.

As part of the hydro relicensing process, SMUD entered into long-term contracts to provide certain services to four different government agencies – U.S. Department of Interior Bureau of Land Management, U.S. Department of Agriculture Forest Service, El Dorado County, and the California Department of Parks and Recreation. The aggregate present value of all contract payments of \$57.8 million was recorded as a liability at December 31, 2016.

While some effects of the long-term drought remain in California, SMUD had near normal snowfall and above average rainfall in its UARP watershed in 2016. A Hydro Rate Stabilization Fund (HRSF) was established to help absorb higher energy costs when hydroelectric production is down and to serve as a buffer against unexpected financial developments. In April 2015, \$3.1 million was transferred from the HRSF as a result of the effect of the drought, which brought the balance of the HRSF to zero. Accordingly, SMUD applied an automatic 12-month Hydro Generation Adjustment (HGA) surcharge of 1.3 percent to its customer's electric bills. In April 2016, \$10.0 million was transferred to the HRSF as a result of higher precipitation and the HGA was removed. The \$10.0 million balance in the HRSF at December 31, 2016 is an indicator of the significant impact of the rainfall and snowfall in 2016 as compared to just a year ago when the reserves were depleted as a result of the drought.

SMUD also has a long-term agreement with the Western Area Power Administration (WAPA) to purchase power generated by the Central Valley Project, a series of federal hydroelectric facilities operated by the U.S. Bureau of Reclamation. SMUD uses a Rate Stabilization Fund (RSF) to offset any excess or deficits in WAPA energy deliveries. In 2016 and 2015, WAPA's deliveries fell short which resulted in a \$5.1 million and \$12.0 million transfer from the RSF, respectively. At December 31, 2016 and 2015, the balance of the RSF was \$25.2 million and \$30.3 million, respectively.

Decommissioning

During 2014, SMUD made significant progress toward completing the Decommissioning Plan for its Rancho Seco nuclear facility, which was shut down in 1989. The plan consists of two phases that allow SMUD to terminate its possession-only license. Phase I of the decommissioning was completed at the end of 2008. Phase II consists of a storage period for the Class B and Class C radioactive waste overseen by the existing facility staff, followed by shipment of the waste for disposal, and then complete termination of the possession-only license. SMUD also established and funded an external decommissioning trust fund as part of its assurance to the Nuclear Regulatory Commission (NRC) to pay for the cost of decommissioning. In September 2013, SMUD entered into a contract with the operator of a low-level radioactive waste facility located in Andrews, Texas. Shipment of the previously stored Class B and Class C radioactive waste was completed in November 2014. The disposal and shipment costs totaling over \$22.0 million were funded from the decommissioning trust fund. The remaining Phase II decommissioning activities that will lead to termination of the possession-only license began during 2015 and was completed in early 2017. The Accrued Decommissioning balance in the Consolidated Statements of Net Position includes \$148.0 million and \$150.4 million for costs related to Rancho Seco as of December 31, 2016 and 2015, respectively.

As part of the Decommissioning Plan, the nuclear fuel and Greater Than Class C (GTCC) radioactive waste is being stored in a dry storage facility constructed by SMUD and licensed separately by the NRC. The U.S. Department of Energy (DOE), under the Nuclear Waste Policy Act of 1982, was responsible for permanent disposal of used nuclear fuel and GTCC radioactive waste and SMUD contracted with the DOE for removal and disposal of that waste. In 1998, SMUD filed a suit

against the DOE for breach-of-contract because the DOE never provided a permanent waste disposal site. In February 2015, SMUD received \$22.5 million from the U. S. Court of Claims for the period 2004 through 2009. In June 2015, SMUD filed a suit against DOE for costs incurred from 2010 through at least June 2015.

Employee Relations and Benefits

Effective January 1, 2013, SMUD began operating under a new five year memorandum of understanding (MOU) with both of its collective bargaining units, the International Brotherhood of Electrical Workers Local Union 1245 and the Organization of SMUD Employees.

SMUD participates in the California Public Employees' Retirement System (PERS), an agent multiple-employer public employee defined benefit pension plan. In 2015, SMUD implemented GASB Statement of Governmental Accounting Standards (SGAS) No. 68 "*Accounting and Financial Reporting for Pensions – An Amendment of GASB Statement No. 27*" (GASB No. 68). The primary objective of GASB No. 68 is to improve accounting and financial reporting by state and local governments for pensions. Under GASB No. 68, SMUD is required to report the net pension liability (i.e., the difference between the total pension liability and the pension plan's net position or market value of assets) in its Consolidated Statements of Net Position. This standard requires shorter amortization periods for recognition of non-investment gains and losses and actuarial assumption changes, as well as for recognition of investment gains and losses. GASB No. 68 also separates financial reporting from funding requirements for pension plans. Prior to this new guidance, a liability was recognized only to the extent that contributions made to the plan were less than the actuarially calculated contributions. At December 31, 2016 and 2015, the Net Pension Liability was \$499.2 million and \$381.3 million, respectively. SMUD elected to follow accounting for regulated operations under GASB SGAS No. 62 "*Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*" (GASB No. 62) and recorded a regulatory asset as of December 31, 2014, in the amount of \$425.7 million to account for the net effect of required prior period adjustments to recognize the net pension liability. Amortization of the regulatory asset will begin in 2018 over a period of 25 years.

SMUD provides postemployment healthcare benefits (OPEB) to all employees who retire from SMUD, and their dependents, in accordance with SMUD policy and MOUs. These benefits are funded through the PERS California Employer's Retiree Benefit Trust, an agent multiple-employer plan. SMUD opted to make additional \$17.9 million and \$22.0 million contributions to the trust in 2016 and 2015, respectively. At June 30, 2016, the plan was 59.7 percent funded and the balance of the OPEB asset at December 31, 2016 and 2015 was \$127.9 million and \$96.1 million, respectively.

Developments in the Energy Market

New developments in the energy market at both the federal and state level kept SMUD on high alert as it continued to monitor and address the potential impacts on the organization. Legislation at the federal level includes the Executive Order "Improving Critical Infrastructure Security" on cyber security, the Energy Policy Act of 1992 related to federal regulation of transmission access that includes FERC Order 1000, the North American Electric Reliability Corporation reliability standards, anti-market manipulation rules, and greenhouse gas emissions. Legislation at the state level includes Assembly Bill 32 Global Warming Solutions Act of 2006 (AB 32) establishing the cap-and-trade program for carbon allowances, SB-1 solar program, SB-2 1X the California Renewable Energy Resources Act that codifies the Renewable Portfolio Standards target, and SB-350 Clean Energy and Pollution Reduction Act of 2015, further defined the renewable portfolio standards.

Significant Accounting Policies

In accordance with GASB No. 62, the Board has taken regulatory actions for ratemaking that result in the deferral of expense and revenue recognition. These actions result in regulatory assets and liabilities. SMUD has regulatory assets that cover costs related to decommissioning, derivative financial instruments, SB-1 solar investments, debt issuance costs, and pension costs. As of December 31, 2016 and 2015, total regulatory assets were \$598.4 and \$623.3, respectively. SMUD also has regulatory credits that cover costs related to contributions in aid of construction, the RSF and HRSF, Energy Assistance Program Rate (EAPR) reserves, SB-1, grant revenues, and Transmission Agency of Northern California operations costs. As of December 31, 2016 and 2015, total regulatory credits were \$370.2 million and \$353.8 million, respectively.

FINANCIAL POSITION

CONDENSED CONSOLIDATED STATEMENTS OF NET POSITION

	<u>2016</u>	<u>December 31, 2015 (Restated)*</u>	<u>2014*</u>
	(millions of dollars)		
Assets			
Electric Utility Plant - net	\$ 3,345	\$ 3,324	\$ 3,332
Restricted and Designated Assets	57	47	137
Current Assets	1,084	1,021	1,062
Noncurrent Assets	<u>1,188</u>	<u>1,236</u>	<u>1,245</u>
Total Assets	\$ 5,674	\$ 5,628	\$ 5,776
Deferred Outflows of Resources	<u>279</u>	<u>263</u>	<u>219</u>
Total Assets and Deferred Outflows of Resources	<u>\$ 5,953</u>	<u>\$ 5,891</u>	<u>\$ 5,995</u>
Liabilities			
Long-Term Debt - net	\$ 2,504	\$ 2,674	\$ 2,882
Current Liabilities	630	650	661
Noncurrent Liabilities	<u>840</u>	<u>766</u>	<u>682</u>
Total Liabilities	\$ 3,974	\$ 4,090	\$ 4,225
Deferred Inflows of Resources	645	663	757
Net Position			
Net Investment in Capital Assets	816	658	485
Restricted	77	71	127
Unrestricted	<u>441</u>	<u>409</u>	<u>401</u>
Total Liabilities, Deferred Inflows of Resources, and Net Position	<u>\$ 5,953</u>	<u>\$ 5,891</u>	<u>\$ 5,995</u>

*See Note 3 of the financial statements for discussion on the restatement of the December 31, 2015 Consolidated Statement of Net Position. 2014 data was not restated.

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES

Electric Utility Plant - net

2016 compared to 2015

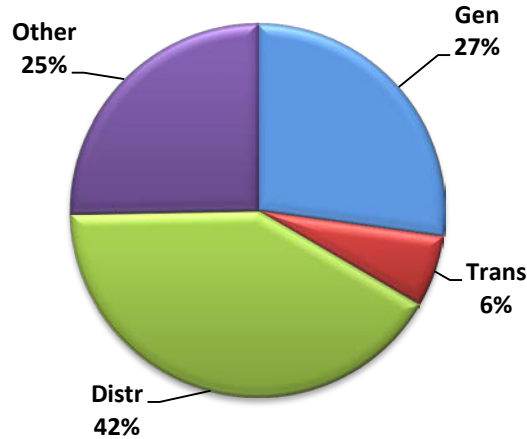
As of December 31, 2016, SMUD has invested approximately \$3,345.0 million in electric utility plant assets and construction work in progress (CWIP) net of accumulated depreciation. Electric Utility Plant - net makes up about 56 percent of SMUD's Total Assets and Deferred Outflow of Resources, which is similar to 2015. In 2016, SMUD capitalized approximately \$173.1 million of additions to electric utility plant in the Consolidated Statements of Net Position. The additions were primarily due to distribution line work, major overhauls in the JPAs and purchases related to the replacement of bulk substations. These additions were offset by the retirement of communication equipment, fleet assets, and hardware equipment.

2015 compared to 2014

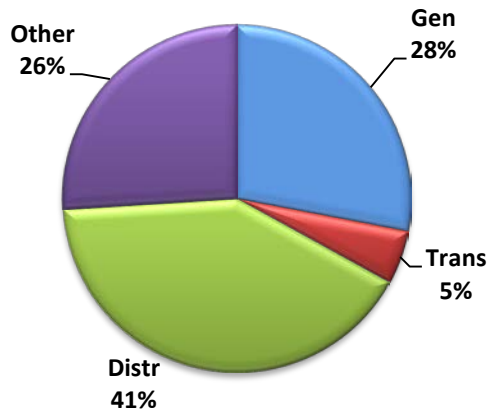
As of December 31, 2015, SMUD has invested approximately \$3,324.0 million in electric utility plant assets and construction work in progress (CWIP) net of accumulated depreciation. Electric Utility Plant - net makes up about 56 percent of SMUD's Total Assets and Deferred Outflow of Resources, which is about four percent less than 2014. In 2015, SMUD capitalized approximately \$123.0 million of additions to electric utility plant in the Consolidated Statements of Net Position. The additions were primarily due to distribution line work and purchases related to the replacement of bulk substations. These additions were offset by the retirement of a portion of SMUD's headquarters building in preparation for a major renovation, some fleet assets, and some hardware equipment.

The following charts show the breakdown of Electric Utility Plant - net by major plant category – Generation (Gen), Transmission (Trans), Distribution (Distr), and Other:

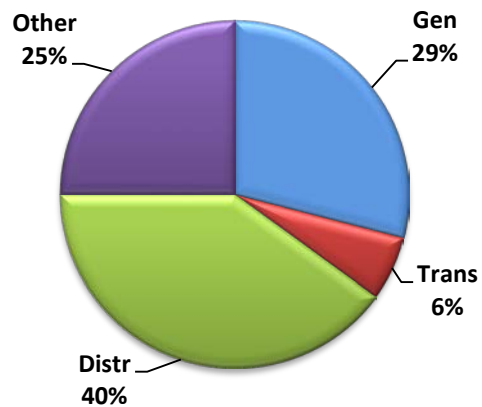
December 31, 2016



December 31, 2015



December 31, 2014



Restricted and Designated Assets

2016 compared to 2015

SMUD’s restricted and designated assets are comprised of debt service reserves, nuclear decommissioning trust funds, rate stabilization reserves, and other third party agreements or Board actions, less the current portion. These assets increased \$9.3 million during 2016. The increase was due to a net transfer of \$4.9 million to the RSF (including the HRSF) as a result of higher precipitation and lower energy deliveries from WAPA, an increase of \$2.5 million in both the revenue bond and debt service reserves and other funds, and a decrease of \$1.9 million in current portion.

2015 compared to 2014

SMUD’s restricted and designated assets are comprised of debt service reserves, nuclear decommissioning trust funds, rate stabilization reserves, and other third party agreements or Board actions, less the current portion. These assets decreased \$89.5 million during 2015. The decrease was due to a transfer of \$15.1 million from the RSF (including the HRSF) as a result of lower precipitation and lower energy deliveries from WAPA, and a \$16.2 million reduction in revenue bond and

debt service reserves. In addition, there was a decrease of \$57.5 million in the other funds due to the release of various restricted funds of the component units, Sacramento Municipal Utility District Financing Authority (SFA) and Sacramento Power Authority (SPA), as a result of SFA's bond refunding and SPA's bond redemptions.

Current Assets

2016 compared to 2015

Current assets increased \$63.7 million in 2016. The unrestricted investments increased by \$101.7 million, along with a total increase of \$6.9 million in receivables - net and prepaid gas to be delivered in one year. This increase was offset by total decreases of \$23.2 million in unrestricted cash and cash equivalents, regulatory costs to be recovered in one year, inventories, and prepayments, along with a decrease of \$20.5 million in credit support collateral deposits.

2015 compared to 2014

Current assets decreased \$41.1 million in 2015. The unrestricted cash and cash equivalents and investments decreased by \$78.9 million. This decrease was offset by increases in credit support collateral deposits of \$19.7 million, along with a total increase of \$18.3 million in receivables - net, inventories, prepaid gas to be delivered within one year, and prepayments.

Noncurrent Assets

2016 compared to 2015

Total noncurrent assets decreased \$47.4 million. There were reductions in regulatory costs for future recovery, prepaid gas, prepaid power and capacity, energy efficiency loans - net and credit support collateral deposits of \$80.6 million offset by increases in due from affiliated entity and prepayments and other of \$34.3 million.

2015 compared to 2014

Total noncurrent assets decreased \$9.5 million mainly due to a decrease in prepaid gas of \$27.8 million, offset by a \$21.8 million increase in credit support collateral deposits.

Deferred Outflows of Resources

2016 compared to 2015

Total deferred outflows of resources increased \$15.9 million due to a total of \$90.6 million increase in deferred pension outflows and amortization of bond losses, offset by a decrease of \$74.7 million in the value of hedging derivative instruments.

2015 compared to 2014

Total deferred outflows of resources increased \$44.2 million due to a \$47.9 million increase in the value of hedging derivative instruments and deferred pension outflows, offset by \$3.7 million amortization of bond losses.

LIABILITIES AND DEFERRED INFLOWS OF RESOURCES

Long-Term Debt - net

2016 compared to 2015

In June 2016, SMUD issued \$149.9 million of 2016 Series D Electric Revenue Refunding Bonds. Proceeds from the 2016 Series Bonds were used to refund \$125.4 million of the outstanding 2008 Series U Bonds, and \$43.6 million of outstanding 2011 Series X Bonds, through a legal defeasance, and accordingly, the liability for the defeased bonds has been removed from Long-Term Debt in the Consolidated Statements of Net Position. The refunding resulted in the recognition of a deferred accounting loss of \$12.6 million, which is being amortized over the life of the refunding issue. The 2016 refunding reduced future aggregate debt service payments by \$27.2 million and resulted in a total economic gain of \$23.4 million, which is the difference between the present value of the old and new debt service payments.

In October and November of 2016, SMUD completed transactions to convert all of the outstanding 2008 Series J, 2008 Series K, 2012 Series L, and 2012 Series M Bonds to direct placements, totaling \$341.9 million (see Note 10). As part of each transaction, new bonds were issued to defease the old bonds, and as a result, the reimbursement agreements with Bank of America, State Street, and US Bank were terminated. The scheduled principal payments remain unchanged unless the bonds aren't successfully remarketed at the end of the term. Accordingly, SMUD has recorded such bonds as Long-Term Debt, less amounts due within one year in the Consolidated Statements of Net Position. No additional deferred gain or loss or economic gain resulted from these transactions.

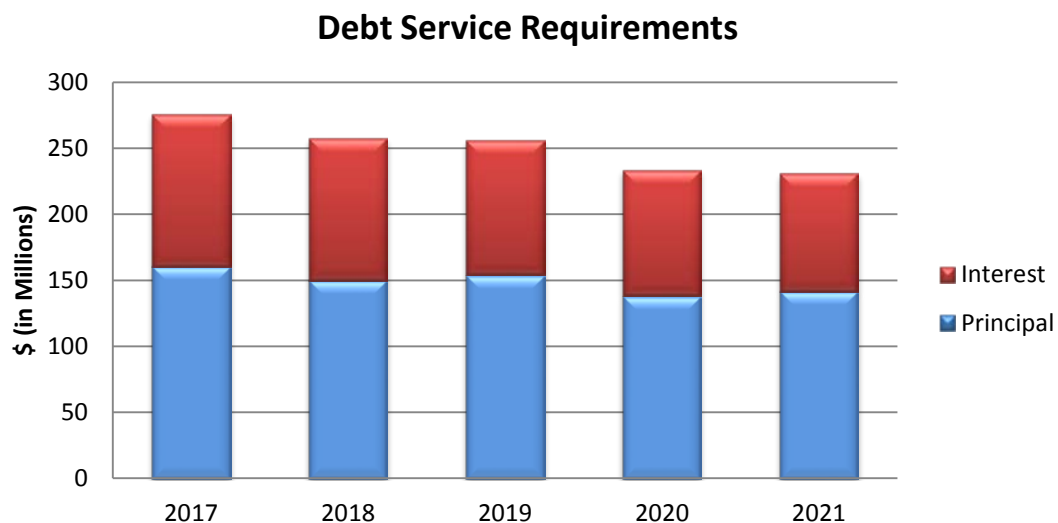
2015 compared to 2014

SMUD's long-term debt includes the component units' debt and consists of a variety of financial instruments, including interest rate swap agreements, subordinated electric revenue bonds and variable rate bonds. Proceeds from the bonds provide financing for various capital improvement projects, component unit capital projects, and the prepayment of a 20 year supply of natural gas.

In June 2015, SFA issued \$193.3 million of 2015 Series Cosumnes Project Revenue Refunding Bonds. Proceeds from the 2015 Series Bonds and \$24.8 million of available funds were used to refund \$233.2 million of the outstanding 2006 Series Bonds through a legal defeasance, and accordingly, the liability for the defeased bonds was removed from Long-Term Debt in the Consolidated Statements of Net Position. The refunding resulted in the recognition of a deferred accounting loss of \$4.4 million, which is being amortized over the life of the refunding issue, and a current period loss of \$0.03 million which is included in Interest on Debt in the Consolidated Statements of Revenues, Expenses and Changes in Net Position. As a result of the refunding, future aggregate debt service payments are reduced by \$46.7 million and there is a total economic gain of \$35.5 million.

In January and July 2015, SPA redeemed \$29.9 million and the remaining \$41.4 million, respectively, of the 2005 Series Bonds maturing July 2015 through July 2022, along with the accrued interest. The redemptions resulted in a current accounting loss of \$0.2 million, which is included in Interest on Debt in the Consolidated Statements of Revenues, Expenses and Changes in Net Position.

The following table shows SMUD’s future debt service requirements through 2021 as of December 31, 2016:



As of December 31, 2016, SMUD’s bonds had an underlying rating of “AA-” from Standard & Poor’s, “AA-” from Fitch, and “Aa3” from Moody’s. Some of SMUD’s bonds are insured and are rated by the rating agencies at the higher of the insurer’s rating or SMUD’s underlying rating.

Current Liabilities

2016 compared to 2015

Current liabilities decreased \$19.8 million during 2016. The difference is mainly due to decreases in investment and hedging derivative instruments maturing within one year of \$43.0 million, offset by increases in long-term debt due within one year and customer deposits and other totaling \$24.1 million.

2015 compared to 2014

Current liabilities decreased \$11.8 million during 2015. Current portion of long-term debt decreased \$18.4 million and accounts payable decreased \$6.7 million, offset by an increase of \$13.5 million in hedging derivative instruments maturing within one year.

Noncurrent Liabilities

2016 compared to 2015

Noncurrent liabilities increased \$74.3 million during 2016. The increase was mainly due to a \$117.9 million increase in the net pension liability, offset by a \$47.5 million decrease in investment and hedging derivative instruments.

2015 compared to 2014

Noncurrent liabilities increased \$84.8 million during 2015. The increase was mainly due to a \$54.6 million increase in the net pension liability and a \$33.6 million increase in investment and hedging derivative instruments.

Deferred Inflows of Resources

2016 compared to 2015

Total deferred inflows of resources decreased \$17.9 million due to a \$22.4 million reduction in deferred pension inflows and \$10.6 million for Solano Phase 3 wind facilities. These reductions were offset by a \$16.4 million increase in regulatory credits due to a \$4.9 million net transfer to the rate stabilization funds as a result of higher precipitation and lower energy deliveries from WAPA, and a \$10.0 million reserve for future expenditures for energy efficiency programs for EAPR customers.

2015 compared to 2014

Total deferred inflows of resources decreased \$94.6 million mainly due to a \$63.8 million reduction in deferred pension inflows. Other reductions include \$15.1 million in regulatory credits for transfers from the rate stabilization funds as a result of lower precipitation and lower energy deliveries from WAPA, and \$10.2 million for the Solano Phase 3 wind facilities.

RESULTS OF OPERATIONS

CONDENSED CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

	<u>2016</u>	<u>December 31,</u> <u>2015 (restated)*</u>	<u>2014*</u>
		(millions of dollars)	
Operating revenues	\$ 1,495	\$ 1,479	\$ 1,529
Operating expenses	<u>(1,240)</u>	<u>(1,271)</u>	<u>(1,320)</u>
Operating income	255	208	209
Other revenues	43	35	79
Interest charges	<u>(103)</u>	<u>(113)</u>	<u>(122)</u>
Change in net position	195	130	166
Net position - beginning of year	<u>1,139</u>	<u>1,009</u>	<u>847</u>
Net position - end of year	<u>\$ 1,334</u>	<u>\$ 1,139</u>	<u>\$ 1,013</u>

*See Note 3 of the financial statements for discussion on the restatement of the December 31, 2015 Consolidated Statement of Revenue, Expenses and Changes in Net Position. 2014 data was not restated.

Operating Revenues

2016 compared to 2015

Operating revenues decreased \$16.1 million in 2016 mainly due to higher retail revenues of \$29.2 million offset by a \$10.0 million deferral for public good. As of December 31, 2016, the number of customers remained flat at 626,460.

In 2016, SMUD transferred \$5.1 million from the RSF and \$10.0 million to the HRSF. In 2015, transfers from both the RSF and HRSF were made in the amounts of \$12.0 million and \$3.1 million, respectively. The 1.3 percent HGA surcharge that was implemented in 2015 was removed from customers' billings in 2016 as a result of higher precipitation.

Wholesale revenues are comprised of both surplus gas and energy sales which are part of the operational strategy in managing fuel and energy costs. In 2016, surplus gas sales were lower than 2015 by \$55.2 million due to lower gas prices and less gas sold. Energy sales were higher in 2016 by \$7.2 million as compared to 2015 due to higher prices and higher energy sales.

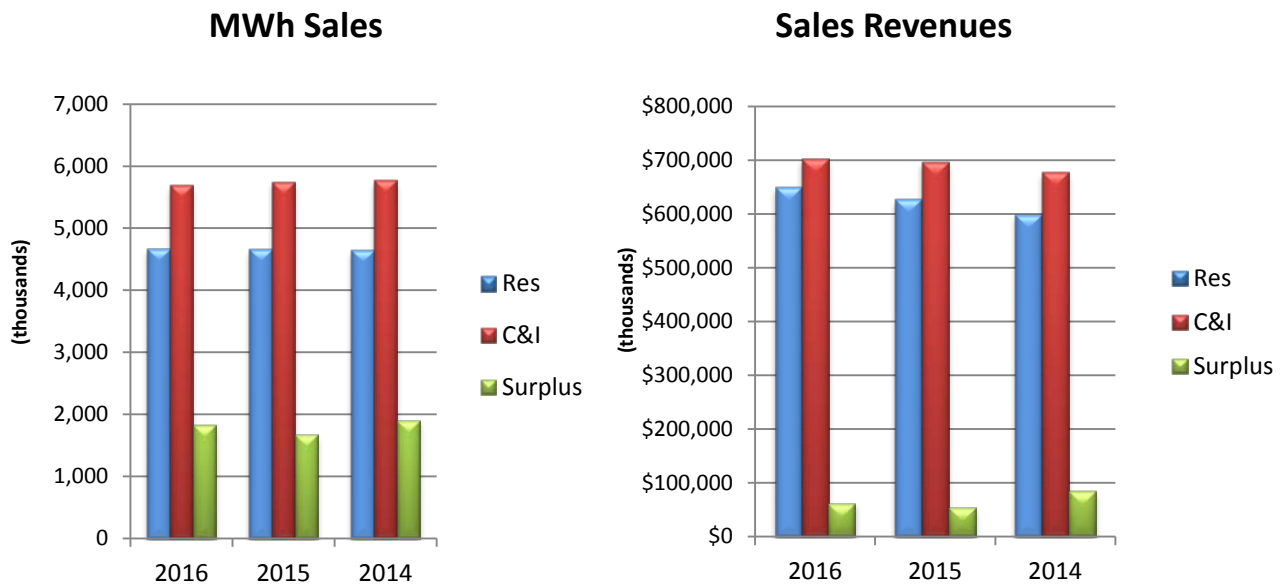
2015 compared to 2014

Operating revenues decreased \$50.6 million in 2015. Approximately \$47.2 million from retail sales includes the 2.5 percent rate increase that went into effect January 1, 2015. As of December 31, 2015, the number of customers increased to 621,990 at a slightly higher average revenue per kilowatt hour as compared to the end of 2014.

In 2015 and 2014, SMUD transferred \$12.0 million and \$11.8 million from the RSF and \$3.1 million and \$24.3 million from the HRSF, respectively. The transfer from the HRSF caused the fund to be depleted and subsequently the 1.3 percent HGA surcharge was implemented.

Wholesale revenues are comprised of both surplus gas and energy sales which are part of the operational strategy in managing fuel and energy costs. In 2015, surplus gas sales were lower than 2014 by \$55.2 million due to lower gas prices and less gas sold. Energy sales were also lower in 2015 by \$29.0 million as compared to 2014 due to lower prices and lower energy sales.

The following charts show the megawatt hour (MWh) sales, and sales revenue for the past three years by surplus energy sales (Surplus), commercial and industrial (C&I) and residential (Res) customers:



Operating Expenses

2016 compared to 2015

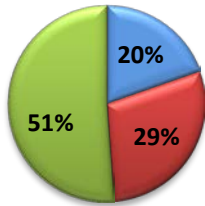
Operating expenses decreased \$31.0 million compared to 2015. Operations which includes purchased power, production, transmission and distribution, and depletion, decreased by \$40.9 million mainly due to lower gas and power prices as well as lower volumes. This decrease was offset by a \$9.9 million increase in the remaining other operating costs.

2015 compared to 2014

Operating expenses decreased \$49.1 million compared to 2014. Operations which includes purchased power, production, transmission and distribution, and depletion, decreased by \$69.7 million mainly due to lower gas and power prices as well as lower volumes. This decrease was offset by a \$19.9 million increase in administrative, general and customer costs.

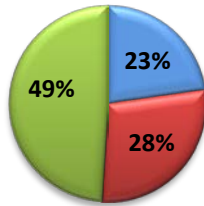
The following charts show the breakdown of operating expenses:

2016 Operating Expenses



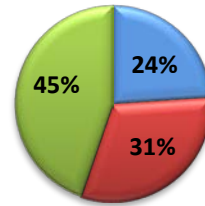
- Purchased Power
- Production
- Other

2015 Operating Expenses



- Purchased Power
- Production
- Other

2014 Operating Expenses



- Purchased Power
- Production
- Other

Other Revenues

2016 compared to 2015

Other revenues were \$8.0 million higher in 2016, which was mainly attributable to a \$17.9 million refund from PG&E, offset by higher ineffective gas swaps, lower equity earnings from affiliate and lower grant revenues.

2015 compared to 2014

Other revenues were \$44.1 million lower in 2015, which was partially attributable to the difference in the amount of settlement proceeds received related to the Rancho Seco nuclear waste disposal litigation. In 2015 and 2014, SMUD received settlement proceeds of \$22.5 million and \$53.1 million, respectively. In addition, \$16.9 million was written off for the terminated Iowa Hill Project.