

COMMONWEALTH UTILITIES CORPORATION

**REPORT ON THE AUDIT OF FINANCIAL
STATEMENTS IN ACCORDANCE
WITH OMB CIRCULAR A-133**

YEAR ENDED SEPTEMBER 30, 2005

COMMONWEALTH UTILITIES CORPORATION

**FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2005 AND 2004

INDEPENDENT AUDITORS' REPORT

Board of Directors
Commonwealth Utilities Corporation:

We have audited the accompanying statements of net deficiency of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), as of September 30, 2005 and 2004, and the related statements of revenues, expenses and changes in net deficiency, and of cash flows for the years then ended. These financial statements are the responsibility of CUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraphs, 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of CUC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 connection with our audit of the financial statements for the year ended September 30, 2005, we were unable to obtain responses from CUC's legal counsel and attorney to inquiries concerning litigation, claims and assessments that might affect such financial statements. Accordingly, we were unable to determine the impact of this matter on the accompanying financial statements.

Because of inadequacies in the accounting records and internal control, we were unable to determine that inventory, due from grantor agencies, utility plant and obligations under capital lease were fairly stated as of September 30, 2005 and 2004. Furthermore, in our judgment, these balances materially affect the determination of results of operations and cash flows for the years ended September 30, 2005 and 2004. CUC management was unable to provide minutes of Board of Directors' meetings subsequent to December 14, 2004. Accordingly, there is an incomplete record of Board of Directors' actions and decisions.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we received responses from CUC's legal counsel and attorney concerning litigation, claims and assessments, had the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease as of September 30, 2005 and 2004 been determined, and had we received minutes of the Board of Directors' meetings subsequent to December 14, 2004, as discussed in the third and fourth paragraphs above, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2005 and 2004, and the changes in its net deficiency and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Our audits were conducted for the purpose of forming an opinion on the Commonwealth Utilities Corporation's basic financial statements. The Statement of Revenues, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis for the year ended September 30, 2005 (page 26) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. The Statement of Revenues, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis for the year ended September 30, 2005 has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, except for the effect of the matters discussed in the third and fourth paragraphs above, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 19, 2007, on our consideration of the Commonwealth Utilities Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of 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* and should be considered in assessing the results of our audit.

Deloitte & Touche LLC

July 19, 2007



Commonwealth Utilities Corporation



MANAGEMENT'S DISCUSSION AND ANALYSIS

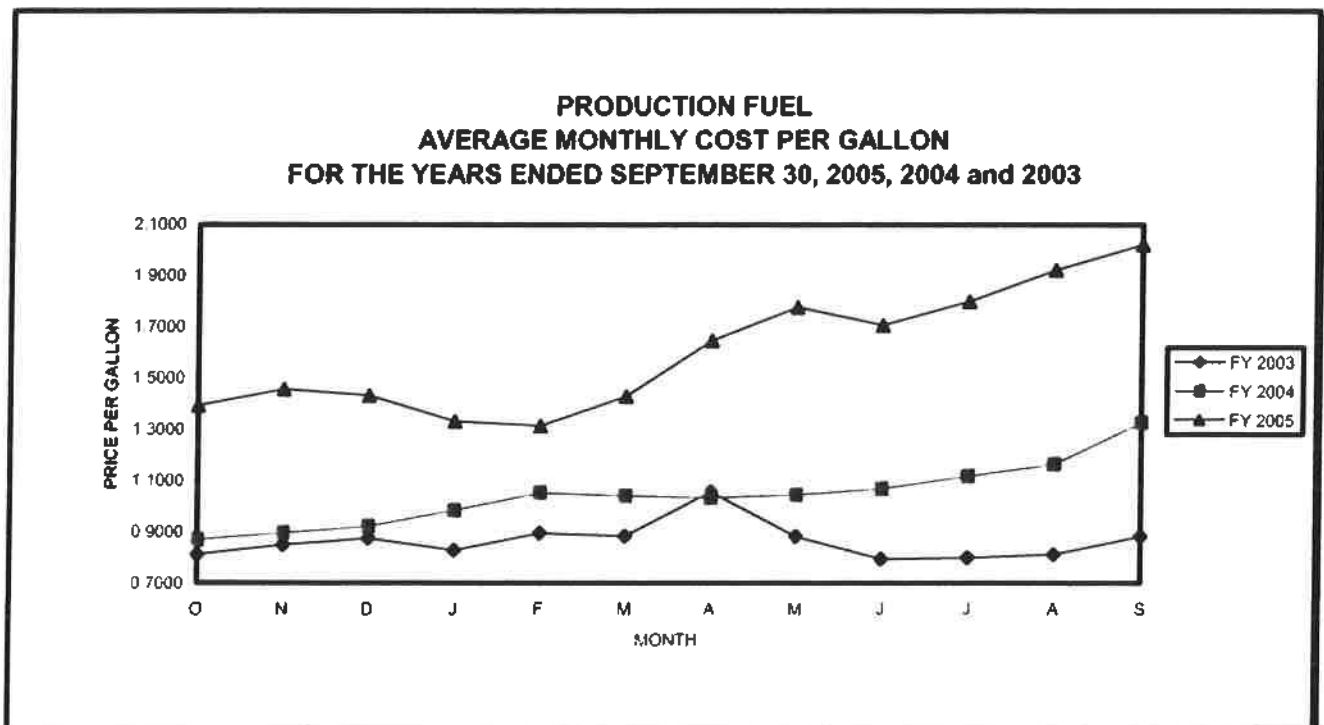
This section of the annual financial report for the Commonwealth Utilities Corporation (CUC) presents a discussion of events that had a significant impact on CUC operations and provides an analysis of its financial performance during the current fiscal year ended September 30, 2005, as compared to the previous fiscal year ended September 30, 2004. This discussion and analysis should be read in conjunction with the financial statements, which follow this section.

DISCUSSION OF EVENTS

To say the least, fiscal year 2005 was a tumultuous year for CUC due to the ever-rising cost of production fuel. This one item accounted for 75.6% of the CUC operating expenses for the power division. This cost was beyond the control of CUC. The price of fuel is driven by the worldwide economics of supply and demand. For most utility companies, changes in fuel prices, whether increases or decreases, do not present a problem. Most utilities have implemented a mechanism, commonly referred to as a fuel adjustment clause, to pass through such price changes to their customers. However, CUC did not have such a mechanism in place.

During fiscal year 2005, CUC fuel costs reached an all time high of \$59.25 million, which represents an increase of \$19.44 million (48.8%) over the fiscal year 2004 fuel costs of \$39.81 million. When compared to the fiscal year 2003 fuel costs of \$33.33 million, the increase is even more significant: \$25.92 million (77.8%) in just a 2-year period. Based on future projections, it appears that fuel prices are likely to continue on an upward trend.

The chart below shows the enormity of these increases.



During fiscal year 2004, CUC management realized that in light of the escalating fuel costs, the current electric rate schedules would not provide the revenue needed for CUC to fully meet its budgeted operating costs. Rates remained at their January 1989 levels. As a result, CUC was drawing down its cash reserves just to maintain a steady supply of production fuel. Initially, these reserves were to have been used for the refurbishment of the power generation and distribution systems. Hence, the refurbishment of these systems was being neglected. So, in March 2004, the Executive Director brought this issue to the attention of the CUC Board of Directors and recommended that CUC begin the process of implementing a fuel surcharge fee, as provided by its enabling statute, Public Law 4-47. Shortly thereafter, the Board and management began in earnest to address this issue.

By the start of fiscal year 2005, CUC was ready to move forward with the fuel surcharge. In October 2004, CUC published a notice of the proposed fuel surcharge fee and, in November, held public hearings, as required. In January 2005, CUC adopted an initial fuel surcharge of 1.5 cents per kilowatt-hour (kWh), with an effective date of February 28. However, that rate was insufficient to ensure CUC's ability to pay for fuel, so the Board increased the rate to 3.5 cents per kWh, effective April 1.

This latter rate was also insufficient, but it was the maximum rate allowable by law that could be charged during the initial year of the fuel surcharge fee. As a result, CUC exhausted all its cash reserves and then relied on the CNMI central government to provide funds in order for CUC to maintain a somewhat steady supply of production fuel and to make only emergency repairs to the power systems. Even so, CUC began to experience an increase in the number and length of both scheduled and unscheduled power outages during the remainder of fiscal year 2005.

Because the majority of CUC funds went toward the purchase of fuel, this had a negative impact on the operations of both the water and sewer divisions. Only a limited amount of funds were available for these divisions. Further, it should be noted that water rates remained at 1995 levels, when last increased in December of that year. As for the sewer rates, these had remained unchanged since CUC was established in October 1987.

Thus, in May 2005, CUC sought the services of a ratemaking firm to conduct cost-of-service studies for all three utilities - power, water, and sewer. In September, a contract was awarded, with the studies beginning in October 2005.

Further, the Governor noted that CUC's financial condition presented an urgent situation, which threatened CUC's ability to continue as a going concern. It was found that CUC would soon be unable to purchase an adequate supply of fuel and its generation capacity was reduced to the point of almost zero reserve capacity. Without electricity, CUC water and sewer pumping and treatment systems would fail. Such a failure would present an extreme, immediate, and imminent emergency.

Thus, on May 19, 2005, the Governor issued a State of Emergency Declaration, which he found necessary to ensure a continual source of power needed for the health, safety and welfare of those residing within the boundaries of the CNMI. In doing so, the Governor: (1) assumed full control of CUC, (2) suspended all regulatory statutes applicable to CUC, (3) suspended all powers, authorities and responsibilities of the CUC Board of Directors and (4) provided for the reprogramming of funds needed to address the conditions noted above. Thereafter, the Governor renewed the Declaration every month through the end of fiscal year 2005.

ANALYSIS OF FINANCIAL PERFORMANCE

Required Financial Statements

CUC accounting policies conform to accounting principles generally accepted in the United States of America, as applicable to government entities, specifically proprietary funds. CUC activities are financed and operated in a manner similar to a business enterprise.

The Statements of Net Deficiency include all of the CUC assets and the net deficiency and liabilities associated with the operation of proprietary funds. These statements provide information about the nature and amount of investments in resources and the obligations to the creditors. Net assets represent the resources an entity has left to use after its debts are settled. However, those resources may not always be available for spending; restrictions may be attached. To clarify these issues, net assets are divided into three categories: capital assets, net of related debt, which cannot be sold or converted to cash; restricted assets; and unrestricted net assets, which may be used in any purpose.

The Statements of Revenues, Expenses and Changes in Net Deficiency account for all the revenues and expenses and the gains and losses arising from the ongoing operations of CUC. Such statements measure the success of CUC in using the resources committed to its operations. The components in this report are important in that they can be used to predict future income and cash flows.

The Statements of Cash Flows provide information about CUC's cash flows for the period, which are classified according to four main activities: (1) operating, (2) noncapital financing, (3) capital and related financing and (4) investing. The statements report the net cash provided by and or used for each activity and explains the net increase or decrease in cash and cash equivalents.

	2005	2004	2003
Assets			
Net utility plant	\$ 100,677,687	\$ 104,542,037	\$ 104,424,658
Current assets	25,826,751	24,849,221	37,883,170
Restricted assets	<u>7,591,615</u>	<u>14,853,353</u>	<u>8,621,642</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>	<u>\$ 150,929,470</u>
Net Deficiency and Liabilities			
Net deficiency	\$ (52,781,063)	\$ (30,332,640)	\$ (12,932,748)
Noncurrent liabilities	4,734,650	6,127,696	6,920,434
Current liabilities	<u>182,142,466</u>	<u>168,449,555</u>	<u>156,941,784</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>	<u>\$ 150,929,470</u>
Revenues, Expenses and Changes in Net Deficiency			
Gross operating revenues	\$ 80,018,743	\$ 71,388,171	\$ 71,353,881
Bad debts	(1,139,757)	(6,921,530)	(2,784,360)
Operating expenses	<u>(95,040,718)</u>	<u>(79,943,257)</u>	<u>(70,340,366)</u>
Loss from operations	<u>(16,161,732)</u>	<u>(15,476,616)</u>	<u>(1,770,845)</u>
Interest income	276,790	203,568	311,181
Interest expense	(10,598,165)	(10,177,630)	(9,760,707)
Settlement income and gain on sale of capital assets	823,065	-	-
Contribution to the primary government	<u>(694,759)</u>	<u>(666,695)</u>	<u>(648,468)</u>
Total non-operating revenues (expenses), net	<u>(10,193,069)</u>	<u>(10,640,757)</u>	<u>(10,097,994)</u>
Capital contributions	<u>3,906,378</u>	<u>8,717,481</u>	<u>3,230,248</u>
Change in net deficiency	(22,448,423)	(17,399,892)	(8,638,591)
Net deficiency, beginning of year	<u>(30,332,640)</u>	<u>(12,932,748)</u>	<u>(4,294,157)</u>
Net deficiency, end of year	<u>\$ (52,781,063)</u>	<u>\$ (30,332,640)</u>	<u>\$ (12,932,748)</u>

Financial Analysis of CUC as a Whole

For the year ended September 30, 2005, CUC had a loss from operations of \$16.16 million as compared to a loss of \$15.48 million for the year ended September 30, 2004. The loss for fiscal year 2005 exceeded the loss for fiscal year 2004 by \$685,000 (4.4%).

During the year ended September 30, 2005, CUC gross operating revenues increased overall by \$8.63 million (12.1%), when compared to revenues for the year ended September 30, 2004. Revenues increased for power by about \$8.25 million (13.9%) and for water by \$176,000 (1.9%). The increase in power revenues was due primarily to the implementation of the fuel surcharge fee. The increase in water revenues was due primarily to the installation of water meters to now measure and bill water charges based on actual consumption rather than the previous method that was based on an estimated flat rate assessment. On the other hand, the decrease in sewer revenues was about \$85,000 (3.7%), which was due mainly to adjustments to prior billings. The increase in other revenues (late fees) was about \$286,000 (51.4%), which was also due, in part, to the implementation of the fuel surcharge fee. Customers were experiencing difficulty paying their bills within the allowable time limit.

Regarding bad debts, each month CUC establishes an allowance for doubtful accounts (utility receivables) through a provision for bad debts that is charged to expense. Generally, the allowance is equal to 100 percent of all amounts that are past due more than 75 days, except those that are due from the CNMI government. Previously, CUC considered government receivables to be collectible, regardless of the number of days past due. Thus, no allowance had been established for these receivables. However, government receivables had increased steadily in recent years and, based on the independent external auditors' recommendation, management decided to include government receivables in its allowance for doubtful accounts for fiscal year 2004. The allowance for doubtful accounts included \$4.87 million for government receivables, which was 71% of the total bad debts of \$6.92 million for the fiscal year ended September 30, 2004.

However, during fiscal year 2005, CUC revisited its decision regarding government receivables. As mentioned earlier, CUC was now relying heavily on the CNMI central government to provide funds for the purchase of production fuel and for emergency repairs to the power systems. These funds were in addition to those received as payment of current utility charges. Further, given the current price of fuel and the absence of any prospect of being able to significantly increase electric rates in the foreseeable future, CUC anticipated that the additional payments, when applied to government receivables, would soon set-off the utility charges that were now in arrears. As such, for fiscal year 2005, bad debt expense was only about \$1.14 million, which included only non-government (residential and commercial) utility receivables.

During the year ended September 30, 2005, overall operating expenses increased \$15.10 million (18.9%), when compared to expenses for the year ended September 30, 2004. However, only two expense categories increased: production fuel, over \$19.44 million (48.8%) and maintenance, \$105,000 (2.1%). All other expense categories decreased by the following amounts: general and administrative, \$2.41 million (12.9%); depreciation, \$925,000 (10.2%); other production (purchased power from independent power producers), \$891,000 (14.4%); supplies, \$104,000 (15.3%); and other (miscellaneous), \$111,000 (24.8%).

By far, the single largest increase was for production fuel. This increase was brought on primarily by: (1) worldwide demand for petroleum products and (2) escalating political tensions in various parts of the world. These factors gave rise to fears of shortages of petroleum-related products; triggering significant increases in fuel prices. Thus, CUC's average cost of fuel for the year ended September 30, 2005, had risen to over \$1.60 per gallon as compared to an average of about \$1.04 per gallon for the year ended September 30, 2004.

For those expenses that decreased, this was due primarily to the implementation of austerity measures. Without such measures, CUC and the CNMI central government would have experienced a great deal of difficulty in maintaining an adequate supply of fuel needed to provide continuous utility services to its customers.

CUC received capital contributions as direct grants from the federal government and as pass-thru grants received from the CNMI government, which amounted to \$3.91 million for fiscal year 2005, as compared to the \$8.72 million that CUC received during fiscal year 2004, a decrease of \$4.81 million (55.2%). These grants were used for the design and construction of water and sewer capital improvement projects. In addition, the U.S. Department of Homeland Security, Federal Emergency Management Agency (FEMA), provided public assistance to repair and or replace power, water, and sewer systems and related equipment that were damaged during Typhoon Chaba. Please refer to note 3 in the financial statements for detail of activity in CUC's plant accounts.

ECONOMIC FACTORS AND NEXT YEAR'S PLAN OF ACTION

In an effort to fully recover its operating costs and to comply with its enabling statute, CUC has contracted for cost-of-service studies to develop new rate schedules for the three utility services provided by CUC. The rates would be developed in accordance with generally accepted rate making principles. Further, such rates and fees would be set at levels that would allow CUC to be financially independent of all appropriations by the CNMI legislature and be sufficient to recover all costs associated with the operation, maintenance, transmission, generation and delivery of each utility service; to repay any debt associated with the applicable service; and to repair and or replace related capital equipment.

In addition, CUC plans to continue its cost-cutting efforts and to streamline its operations. In this regard, CUC will place emphasis on the privatization of the power plants located on Saipan and Rota. Currently, CUC has engaged the services of a consulting firm to develop a plan of action to achieve this goal.

To improve its financial position, CUC plans to continue negotiations with the Commonwealth Development Authority (CDA) to resolve the issue of CUC's long-outstanding debt of \$61.57 million and the related accrued interest payable of \$95.03 million as of September 30, 2005. To move this issue forward, CUC will seek the support and assistance of the CNMI central government and the legislature.

Also, management will take a more proactive and aggressive approach toward the collection of its utility receivables, especially those that are due from the CNMI government. Presently, CUC has contracts with two private collection agencies to assist in the collection of long-outstanding receivables that are due from residential and commercial customers.

CONTACTING CUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide CUC creditors and ratepayers with a general overview of CUC's finances and to demonstrate its accountability for the monies received. If you have questions about this report, or need additional information, contact CUC's Chief Financial Officer at:

Commonwealth Utilities Corporation
P.O. Box 501220
Saipan, MP 96950-1220

Or, call (670) 235-7025 through 7032 or email at acguerrero@cuc.gov.mp.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Deficiency September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
<u>ASSETS</u>		
Utility plant:		
Electric plant	\$ 118,129,929	\$ 117,816,572
Water plant	59,176,887	60,255,604
Sewer plant	23,697,843	23,615,456
Administrative equipment	<u>4,440,907</u>	<u>4,535,054</u>
	205,445,566	206,222,686
Less accumulated provision for depreciation	<u>(122,324,311)</u>	<u>(114,204,984)</u>
	83,121,255	92,017,702
Construction work in progress	<u>17,556,432</u>	<u>12,524,335</u>
Net utility plant	<u>100,677,687</u>	<u>104,542,037</u>
Current assets:		
Cash and cash equivalents	<u>3,794,728</u>	<u>1,598,359</u>
Accounts receivable:		
Utility	35,507,347	34,253,028
Other	<u>2,735,316</u>	<u>1,904,273</u>
	38,242,663	36,157,301
Less accumulated provision for uncollectible accounts	<u>(26,773,815)</u>	<u>(25,781,504)</u>
Net accounts receivable	<u>11,468,848</u>	<u>10,375,797</u>
Inventory, less allowance for obsolescence of \$701,462 and \$743,317 in 2005 and 2004, respectively	<u>9,328,099</u>	<u>11,463,810</u>
Due from grantor agencies	<u>1,235,076</u>	<u>1,411,255</u>
Total current assets	<u>25,826,751</u>	<u>24,849,221</u>
Restricted assets:		
Cash and cash equivalents	7,591,615	8,613,144
Time certificates of deposit	<u>-</u>	<u>6,240,209</u>
Total restricted assets	<u>7,591,615</u>	<u>14,853,353</u>
	\$ <u>134,096,053</u>	\$ <u>144,244,611</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Deficiency, Continued September 30, 2005 and 2004

NET DEFICIENCY AND LIABILITIES

	<u>2005</u>	<u>2004</u>
Net deficiency:		
Invested in capital assets, net of related debt	\$ 30,230,687	\$ 36,232,197
Restricted	4,345,350	5,630,207
Unrestricted	<u>(87,357,100)</u>	<u>(72,195,044)</u>
Total net deficiency	<u>(52,781,063)</u>	<u>(30,332,640)</u>
Commitments and contingencies		
Noncurrent liabilities:		
Obligations under capital lease, less current maturities	4,203,536	5,475,269
Long-term debt less current maturities	107,529	156,716
Compensated absences, less current portion	<u>423,585</u>	<u>495,711</u>
	<u>4,734,650</u>	<u>6,127,696</u>
Current liabilities:		
Current maturities of long-term debt	64,864,202	61,615,097
Current obligations under capital lease	1,271,733	1,062,758
Accounts payable	9,342,340	9,971,996
Accrued liabilities	133,957	155,821
Accrued payroll	553,220	415,548
Compensated absences, current portion	399,822	438,552
Customer deposits	9,219,337	8,573,435
Due to primary government	1,331,453	636,694
Interest payable	<u>95,026,402</u>	<u>85,579,654</u>
Total current liabilities	<u>182,142,466</u>	<u>168,449,555</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Deficiency Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues:		
Power	\$ 59,800,839	\$ 59,176,587
Water	9,541,082	9,365,015
Sewer	2,205,589	2,290,258
Fuel surcharge	7,629,234	-
Other	<u>841,999</u>	<u>556,311</u>
	80,018,743	71,388,171
Less bad debts	<u>(1,139,757)</u>	<u>(6,921,530)</u>
Net operating revenues	<u>78,878,986</u>	<u>64,466,641</u>
Operating expenses:		
Production fuel	59,246,625	39,812,826
General and administrative	16,270,152	18,680,894
Depreciation	8,182,733	9,107,348
Other production	5,291,414	6,182,042
Maintenance	5,132,005	5,026,514
Supplies	579,358	683,814
Other	<u>338,431</u>	<u>449,819</u>
Total operating expenses	<u>95,040,718</u>	<u>79,943,257</u>
Loss from operations	<u>(16,161,732)</u>	<u>(15,476,616)</u>
Nonoperating revenues (expenses):		
Settlement income	795,800	-
Interest income	276,790	203,568
Gain on sale of capital assets	27,265	-
Interest expense	(10,598,165)	(10,177,630)
Contribution to the primary government	<u>(694,759)</u>	<u>(666,695)</u>
Total nonoperating revenues (expenses), net	<u>(10,193,069)</u>	<u>(10,640,757)</u>
Net loss before capital contributions	<u>(26,354,801)</u>	<u>(26,117,373)</u>
Capital contributions	<u>3,906,378</u>	<u>8,717,481</u>
Change in net deficiency	<u>(22,448,423)</u>	<u>(17,399,892)</u>
Net deficiency - beginning	<u>(30,332,640)</u>	<u>(12,932,748)</u>
Net deficiency - ending	<u>\$ (52,781,063)</u>	<u>\$ (30,332,640)</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Cash Flows Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Cash received from customers	\$ 79,227,637	\$ 67,228,321
Cash payments to suppliers for goods and services	(69,396,022)	(55,086,809)
Cash payments to employees for services	(12,607,597)	(15,150,153)
Net cash used for operating activities	<u>(2,775,982)</u>	<u>(3,008,641)</u>
Cash flows from noncapital financing activities:		
Payments to primary government	-	(618,469)
Net cash used for noncapital financing activities	<u>-</u>	<u>(618,469)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(4,318,383)	(9,224,727)
Proceeds from sale of capital assets	27,265	-
Capital contributions received	4,449,216	8,381,616
Principal repayment of debt	(1,572,858)	(931,794)
Interest paid on outstanding debt	(1,151,417)	(1,286,990)
Net decrease (increase) in restricted time certificates of deposit	6,240,209	(57,069)
Net cash provided by (used for) capital and related financing activities	<u>3,674,032</u>	<u>(3,118,964)</u>
Cash flows from investing activities:		
Interest received on time certificates of deposit	276,790	203,568
Net cash provided by investing activities	<u>276,790</u>	<u>203,568</u>
Net change in cash and cash equivalents	<u>1,174,840</u>	<u>(6,542,506)</u>
Cash and cash equivalents at beginning of year	<u>10,211,503</u>	<u>16,754,009</u>
Cash and cash equivalents at end of year	<u>\$ 11,386,343</u>	<u>\$ 10,211,503</u>
Reconciliation of loss from operations to net cash used for operating activities:		
Loss from operations	\$ (16,161,732)	\$ (15,476,616)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation	8,182,733	9,107,348
Provision for bad debts	1,139,757	6,921,530
Reduction in provision for inventory obsolescence	-	(271,811)
Settlement income	795,800	-
(Increase) decrease in assets:		
Accounts receivable:		
Utility	(1,401,765)	(5,315,273)
Other	(831,043)	994,457
Inventory	2,135,711	(1,656,237)
Increase (decrease) in liabilities:		
Accounts payable	3,080,362	3,445,165
Accrued liabilities	(388,523)	(461,285)
Accrued payroll	137,672	(440,562)
Compensated absences	(110,856)	(16,323)
Customer deposits	645,902	160,966
Net cash used for operating activities	<u>\$ (2,775,982)</u>	<u>\$ (3,008,641)</u>
Supplemental disclosure of noncash capital and related financing and operating activities:		
Accrual of progress billings related to various ongoing capital projects:		
Noncash increase in due from grantor agencies	\$ 366,659	\$ 20,000
Noncash increase in accrued liabilities	(366,659)	(20,000)
	<u>\$ -</u>	<u>\$ -</u>
Conversion of accounts payable to Mobil to note payable (note 5):		
Noncash decrease in accounts payable	\$ (3,710,018)	\$ -
Noncash decrease in long-term debt	3,710,018	-
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies

The Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), was established as a Public Corporation by CNMI Public Law 4-47, as amended by Public Law 5-47, effective October 1, 1985, and began operations on October 1, 1987. CUC was given responsibility for supervising the construction, maintenance, operations, and regulation of all utility services, including power, sewage, refuse collection, telephone, cable television, and water, provided however, that whenever feasible, CUC shall contract for private businesses to assume its duties with respect to one or more of these divisions. CUC was also designated the responsibility to establish rates, meter, bill and collect fees in a fair and rational manner from all customers of utility services in order for CUC to become financially independent of appropriations by the CNMI Legislature. CUC is governed by a nine-member Board of Directors, appointed for terms of four years by the Governor of the CNMI.

Public Law 4-47 effected transfer to CUC of identifiable assets, liabilities, operations, and unexpended capital improvement funding allocations formerly administered directly by the CNMI Department of Public Works.

On May 19, 2005, the Governor of the CNMI declared CUC in a State of Disaster Emergency. Through the state of emergency, the Governor invoked his constitutional authority to take all necessary measures, including but not limited to: assuming full control of CUC, suspension of regulatory statute provisions and regulations applicable to CUC including procurement, suspension of CUC's Board of Directors' powers, authority and/or responsibility during the period of the state of emergency, except as provided in writing by the Governor, and reprogramming of necessary funds to allow CUC to continue operations. The State of Disaster Emergency declaration on CUC was subsequently extended through October 2005.

The accounting policies of CUC conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. CUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets.

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Revenues are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the most recent cycle billing.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies, Continued

Budgets

In accordance with CNMI Public Law 3-68, the Planning and Budgeting Act of 1983, CUC submits annual budgets to the CNMI Office of the Governor.

Concentrations of Credit Risk

Financial instruments which potentially subject CUC to concentrations of credit risk consist principally of cash demand deposits, time certificates of deposit and accounts receivable.

At September 30, 2005 and 2004, CUC has cash deposits and time certificates of deposit in bank accounts that exceed federal depository insurance limits. CUC has not experienced any losses in such accounts.

Cash and Cash Equivalents and Time Certificates of Deposit

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by CUC or its agent in CUC's name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in CUC's name; or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in CUC's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, CUC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. CUC does not have a deposit policy for custodial credit risk.

For purposes of the statements of net deficiency and cash flows, cash and cash equivalents are defined as cash on hand, cash in checking and savings accounts, and short-term time certificates of deposit with a maturity date within three months of the date acquired. Time certificates of deposit with original dates greater than ninety days are separately classified on the statements of net deficiency. At September 30, 2005 and 2004, cash and cash equivalents and time certificates of deposit were \$11,386,343 and \$16,451,712, respectively, and the corresponding bank balances were \$11,722,264 and \$16,878,706, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$135,441 and \$115,681 were FDIC insured as of September 30, 2005 and 2004, respectively. CNMI law does not require component units to collateralize their cash deposits; therefore deposit levels in excess of FDIC insurance are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents and Time Certificates of Deposit, Continued

Of the cash and cash equivalents of \$7,561,398 at September 30, 2005, \$7,500,000 represents customer deposits held as security pursuant to a letter of credit obtained from a financial institution to secure a \$7,500,000 credit limit for fuel purchases with a vendor. Cash and cash equivalents of \$0- and \$5,630,207 as of September 30, 2005 and 2004, respectively, represent an escrow fund to be used specifically for contract payments and as security pursuant to a loan agreement with a contractor, and accordingly, are classified as restricted in the accompanying financial statements. Time certificates of deposit of \$6,240,209 and cash and cash equivalents of \$2,953,271 as of September 30, 2004 represent customer deposits, segregated pursuant to CUC policy, and accordingly, are classified as restricted in the accompanying financial statements.

Cash and cash equivalents of \$30,217 and \$29,666 as of September 30, 2005 and 2004, respectively, represent advances from a grantor agency for the use on a specific project and, accordingly, are classified as restricted in the accompanying financial statements.

Receivables and Allowance for Doubtful Accounts

CUC provides utility services to customers within the CNMI and bills for these services on a monthly basis. The accumulated provision for uncollectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense. Current policy is to provide one hundred percent of account balances greater than seventy-five days old.

Inventory

Inventories of fuel are valued at the lower of cost (first-in, first-out) or market (net realizable value). Inventories of supplies and materials are valued at average cost.

Utility Plant and Depreciation

Utility plant is stated at cost, where costs are available. Cost of certain utility plant transferred from the CNMI Department of Public Works, is based on contract amounts to construct certain utility plant. Depreciation is calculated on the straight-line method based on the estimated useful lives of the respective assets. Current policy is to capitalize items in excess of \$300.

Capitalization of Interest

CUC capitalizes interest in order to recognize all costs associated with non-contributed construction projects based on CUC's weighted average borrowing rate. During the years ended September 30, 2005 and 2004, eligible interest expense was not considered significant and consequently no interest has been capitalized.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies, Continued

Retirement Plan

CUC contributes to the Northern Mariana Islands Retirement Fund (the Fund), a cost-sharing multi-employer defined benefit pension plan administered by the CNMI. The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the CNMI Government and CNMI agencies, instrumentalities, and public corporations. CNMI Public Law 6-17, the Northern Mariana Retirement Fund Act of 1988 assigns the authority to establish and amend benefit provisions to the Fund's Board of Trustees. The Fund issues a publicly available financial report that includes financial statements and required supplementary information for the Fund. That report may be obtained by writing to the Northern Mariana Islands Retirement Fund, P.O. Box 501247, Saipan, MP, 96950-1247.

Plan members are required to contribute 6.5% and 9.0% of their annual covered salary for Class I and Class II members, respectively, and CUC is required to contribute at an actuarially determined rate. The current rate is 26.4% of annual covered payroll. The contribution requirements of plan members and CUC are established and may be amended by the Fund's Board of Trustees. CUC's contributions to the Fund for the years ended September 30, 2005, 2004 and 2003 were \$2,451,132, \$2,903,663, and \$2,648,761, respectively, equal to the required contributions for each year.

Revenue Recognition

CUC defines operating revenues as revenue generated from power, water and sewer sales and services. Operating expenses are costs incidental to the generation of operating revenues. Revenues and expenses not meeting the above definitions are classified as nonoperating revenues and expenses.

Power, water and sewer sales are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the subsequent cycle billing. Unbilled receivables at September 30, 2005 and 2004 are \$5,157,463 and \$4,206,455, respectively.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. The liability at September 30, 2005 and 2004 amounted to \$823,407 and \$934,263, respectively. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The outstanding sick pay benefit available to employees as of September 30, 2005 and 2004, was approximately \$2,119,613 and \$2,250,816, respectively.

Net Assets

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, requires CUC to establish net asset categories as follows:

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies, Continued

Net Assets, Continued

- Invested in capital assets; capital assets, net of accumulated depreciation and reduced by the outstanding balances of any notes or other borrowings that are attributable to the acquisition, construction or improvement of these assets.

- Restricted:

Nonexpendable - Net assets subject to externally imposed stipulations that CUC maintain them permanently.

Expendable - Net assets whose use by CUC is subject to externally imposed stipulations that can be fulfilled by actions of CUC pursuant to those stipulations or that expire by the passage of time.

- Unrestricted; Net assets that are not subject to externally imposed stipulations.

New Accounting Standards

During fiscal year 2005, CUC implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*. GASB Statement No. 40 addresses common deposit and investment risks such as credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, GASB Statement No. 40 requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates.

In November 2003, GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 establishes standards for impairment of capital assets when their service utility has declined significantly and unexpectedly. The provisions of this Statement are effective for periods beginning after December 15, 2004. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In May 2004, GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section, an amendment to NCGA Statement 1*. GASB Statement No. 44 improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(1) Organization and Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In July 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In December 2004, GASB issued Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefit Expenditures/Expense and Liabilities by Cost-Sharing Employers*. GASB Technical Bulletin No. 2004-2 clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers. Management does not believe the implementation of this pronouncement will have a material effect on the financial statements of CUC.

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe the implementation of this Statement will have a material effect on the financial statements of CUC.

In June 2005, GASB issued Statement No. 47, *Accounting for Termination Benefits*. GASB Statement No. 47 establishes guidance for state and local governmental employers on accounting and financial reporting for termination benefits. These benefits include incentives for voluntary terminations (e.g., early retirement window programs) and severance payments with respect to involuntary terminations. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

Estimates

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

Reclassification

Certain 2004 balances in the accompanying financial statements have been reclassified to conform to the 2005 presentation.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(2) Due From Grantor Agencies

CUC is a subrecipient of federal grants received by the CNMI from various U.S. federal agencies. CUC follows the accounting principle generally accepted in the United States of America of recording grants-in-aid for construction or acquisition of facilities and equipment as contributions. Excess grant disbursements over receipts are recognized as due from grantor agencies until funds are received in accordance with grant terms and conditions.

Changes in the due from grantor agencies accounts for the years ended September 30, 2005 and 2004, are as follows:

	2005	2004
Balance at beginning of year	\$ 1,411,255	\$ 1,055,390
Adjustment	(121,014)	(31,698)
Deductions - cash receipts from grantor agencies	(3,961,543)	(8,329,918)
Additions - program outlays	<u>3,906,378</u>	<u>8,717,481</u>
Balance at end of year	\$ <u>1,235,076</u>	\$ <u>1,411,255</u>

(3) Utility Plant

Utility plant at September 30, 2005 and 2004, consists of the following:

	Estimated Useful Lives	Balance at October 1, 2004	Additions	Deletions	Adjustments/Reclassifications	Balance at September 30, 2005
Utility plant:						
Electric plant	20 years	\$ 117,816,572	\$ 33,116	\$ (3,838)	\$ 284,079	\$ 118,129,929
Water plant	20 years	60,255,604	50,419	(10,184)	(1,118,952)	59,176,887
Sewer plant	20 years	23,615,456	62,761	(582)	20,208	23,697,843
Administrative equipment	3 - 5 years	<u>4,535,054</u>	<u>18,443</u>	<u>(36,854)</u>	<u>(75,736)</u>	<u>4,440,907</u>
		206,222,686	164,739	(51,458)	(890,401)	205,445,566
Less accumulated provision for depreciation		<u>(114,204,984)</u>	<u>(8,182,733)</u>	-	<u>63,406</u>	<u>(122,324,311)</u>
		92,017,702	(8,017,994)	(51,458)	(826,995)	83,121,255
Construction work in progress		<u>12,524,335</u>	<u>3,388,730</u>	-	<u>1,643,367</u>	<u>17,556,432</u>
		\$ <u>104,542,037</u>	\$ <u>(4,629,264)</u>	\$ <u>(51,458)</u>	\$ <u>816,372</u>	\$ <u>100,677,687</u>
	Estimated Useful Lives	Balance at October 1, 2003	Additions	Deletions	Adjustments/Reclassifications	Balance at September 30, 2004
Utility plant:						
Electric plant	20 years	\$ 114,917,960	\$ 802,500	\$ -	\$ 2,096,112	\$ 117,816,572
Water plant	20 years	57,091,249	381,813	-	2,782,542	60,255,604
Sewer plant	20 years	22,023,014	360,404	-	1,232,038	23,615,456
Administrative equipment	3 - 5 years	<u>4,407,120</u>	<u>158,536</u>	-	<u>(30,602)</u>	<u>4,535,054</u>
		198,439,343	1,703,253	-	6,080,090	206,222,686
Less accumulated provision for depreciation		<u>(105,351,027)</u>	<u>(9,107,348)</u>	-	<u>253,391</u>	<u>(114,204,984)</u>
		93,088,316	(7,404,095)	-	6,333,481	92,017,702
Construction work in progress		<u>11,336,342</u>	<u>8,290,851</u>	-	<u>(7,102,858)</u>	<u>12,524,335</u>
		\$ <u>104,424,658</u>	\$ <u>886,756</u>	\$ -	\$ <u>(769,377)</u>	\$ <u>104,542,037</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(4) Notes Payable

A schedule of CUC's long-term debt as of September 30, 2005 and 2004, is as follows:

	<u>2005</u>	<u>2004</u>
Promissory note payable to the Commonwealth Development Authority (CDA), a component unit of the CNMI. Principal amount available to \$30,000,000, interest at 7% per annum, with a maturity date of February 17, 2013. Principal and interest payments are due in quarterly payments of \$658,469.	\$ 30,000,000	\$ 30,000,000
Promissory note payable to CDA. Principal amount available to \$16,135,650, interest at 5% per annum, with a maturity date of January 12, 2014. Principal and interest payments are due in quarterly payments of \$359,514.	16,068,750	16,068,750
Promissory note payable to CDA. Principal amount available to \$5,500,000, interest at 7% per annum, with a maturity date of January 30, 2000. Principal and interest payments are due in quarterly payments of \$276,471.	5,500,000	5,500,000
Promissory note payable to CDA. Principal amount available to \$10,000,000 and interest at 7% per annum. Principal and interest payments are due in monthly payments of \$58,509. No promissory agreement related to this note has been signed.	<u>10,000,000</u>	<u>10,000,000</u>
	<u>\$ 61,568,750</u>	<u>\$ 61,568,750</u>

At September 30, 2005 and 2004, and subsequent to that date, CUC was in default of repayment terms of all notes payable to CDA. In accordance with the associated loan agreements, in the event of default, CDA may accelerate all remaining amounts due. Thus, \$61,568,750 at September 30, 2005 and 2004, associated with the notes payable to CDA along with interest payable on these notes of \$95,026,402 and \$85,579,654 as at September 30, 2005 and 2004, respectively, has been classified as current liabilities within the accompanying financial statements.

On November 21, 2002, a Memorandum of Agreement (MOA) was established between CDA and CUC to waive a portion of the notes payable to CDA and the conversion into equity ownership of the balance. Public Law 13-35 effectuated terms of the MOA allowing CDA to waive \$16,068,750 and waive certain specified interest payments and for other purposes. Public Law 13-36 effectuated terms of the MOA by authorizing CUC to issue shares to CDA of cumulative nonconvertible non-transferable preferred stock valued at \$45,500,000. In January 2004, the Memorandum of Agreement (MOA), entered into on November 21, 2002 between CUC and CDA was amended to exclude a provision requiring CUC to obtain legislative approval for rate increases. As terms of the MOA are in the process of negotiations, no adjustments have been made to the accompanying financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(5) Loans Payable

On June 29, 1988, the CNMI executed a loan contract with the United States Department of Agriculture, Farmers Home Administration in the amount of \$1,033,400. The loan contract bears interest at 6.125% per annum with repayments due on January 1 beginning in 1989 and continuing through 2008. Proceeds of the loan are to be used for the acquisition and construction of improvements and replacements to the Saipan Water System, which is administered by CUC. CUC is required to deposit all water system revenue and funds it receives through the "Covenant to Establish a CNMI in Political Union With the United States of America (the Covenant)" into a water system revenue fund to provide for repayment of the loan. As of September 30, 2005 and 2004, CUC had not established the required water system revenue fund but has established separate general ledger accounts to summarize water system revenues and Covenant funds. It is CUC's intention to repay the loan from these sources and management is of the opinion that its process of accounting for water system revenues and Covenant funds is in compliance with the intent of the loan agreement.

The following summarizes this loan payable as of September 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Loan payable to the U.S. Department of Agriculture with repayments due on January 1, beginning in 1989 through 2008, bearing interest at 6-1/8% per annum.	\$ 156,716	\$ 203,063
Less current portion	<u>49,187</u>	<u>46,347</u>
Long-term loan payable	\$ <u>107,529</u>	\$ <u>156,716</u>

Future repayment commitments of principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 49,187	\$ 9,599	\$ 58,786
2007	52,198	6,586	58,784
2008	<u>55,331</u>	<u>3,389</u>	<u>58,720</u>
	\$ <u>156,716</u>	\$ <u>19,574</u>	\$ <u>176,290</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(5) Loans Payable, Continued

Changes in long-term liabilities for the years ended September 30, 2005 and 2004, are as follows:

	Balance October 1, 2004	Additions	Reductions	Balance September 30, 2005	Due Within One Year
Notes and loans payable	\$ 61,771,813	\$ 3,710,018	\$ 510,100	\$ 64,971,731	\$ 64,864,202
Other liabilities:					
Obligations under capital lease	6,538,027	-	1,062,758	5,475,269	1,271,733
Compensated absences	934,263	666,359	777,215	823,407	399,822
	<u>\$ 69,244,103</u>	<u>\$ 4,376,377</u>	<u>\$ 2,350,073</u>	<u>\$ 71,270,407</u>	<u>\$ 66,535,757</u>
	Balance October 1, 2003	Additions	Reductions	Balance September 30, 2004	Due Within One Year
Notes and loans payable	\$ 61,815,485	\$ -	\$ 43,672	\$ 61,771,813	\$ 61,615,097
Other liabilities:					
Obligations under capital lease	7,426,149	-	888,122	6,538,027	1,062,758
Compensated absences	950,586	810,215	826,538	934,263	438,552
	<u>\$ 70,192,220</u>	<u>\$ 810,215</u>	<u>\$ 1,758,332</u>	<u>\$ 69,244,103</u>	<u>\$ 63,116,407</u>

On June 3, 2005, CUC executed a debt rescheduling agreement with Mobil Oil Micronesia Islands, Inc. (Mobil) for the repayment of an outstanding payable balance of \$3,710,018 as of June 2005 related to fuel purchases under a fuel supply agreement between CUC and Mobil. Under the agreement, the principal balance of \$3,710,018 plus interest thereon, determined at a fluctuating rate equal to 3% points above the prime interest rate on the principal amount of the balance remaining from time to time unpaid, is payable in consecutive monthly installments of \$168,497 each beginning on July 15, 2005 until December 15, 2005 and thereafter in consecutive monthly installments of \$505,490 each beginning on January 15, 2006 until June 15, 2006. At September 30, 2005, CUC had an outstanding loan payable to Mobil in the amount of \$3,246,265 that has been classified in current maturities of long-term debt within the accompanying financial statements.

(6) Primary Government Funding

Public Law 9-66, enacted October 19, 1995, requires government agencies to pay the Commonwealth Treasurer an amount not less than the greater of 1% of its total operations budget from sources other than legislative appropriations or pursuant to any other formula, which the Public Auditor and the agency may agree, to fund the Office of the Public Auditor (OPA). At September 30, 2005 and 2004, CUC had an outstanding payable to the primary government in the amount of \$1,331,453 and \$636,694, respectively.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(7) Capital Lease

On June 10, 1997, CUC entered into an agreement with a contractor for the construction, maintenance and operation, and transfer of ownership of a 10 megawatt power plant on the island of Tinian. The agreement is for a guaranteed price of \$9,959,000 plus interest and fees of \$11,641,000 payable over ten years in equal monthly installments of \$180,000. During this period, the contractor will maintain and operate the power plant and be paid operation, production and maintenance fees of \$50,000 per month in addition to the guaranteed price. Additionally, CUC will pay a production fee of two cents (\$0.02) per plant-produced kilowatt hour for as long as the operations and maintenance portion of the contract is in effect. The power plant will be turned over to CUC at the end of the ten year period from the date of substantial completion. On December 13, 1998, CUC executed a change order to expand the 10 Megawatt Power Plant to 30 Megawatts. Such expansion is to be fulfilled within the ten year period as stated in the original agreement.

On May 10, 2001, CUC executed another change order (Expanded Agreement) to extend the term of the original agreement to be effective upon the execution of the expanded agreement until the later of March 31, 2020 or the completion of the term as mutually agreed. The expanded agreement provides for CUC to pay a base loan rate of \$0.03 plus applicable price adjustments per kilowatt-hour CUC uses each month effective March 1, 2009 until March 31, 2020. Additionally, the contractor will operate and maintain the existing distribution system of CUC for the duration of the expanded agreement at no cost to CUC. During the term of the expanded agreement, CUC is not allowed to purchase electric energy from any other producer other than the contractor for the island of Tinian. On May 6, 2003, CUC and the contractor executed another change order to create a specific limited exception for the allowance of certain liens to be placed on the power plant as designed and built in accordance with the terms and conditions of the original agreement and previous change orders.

CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, which provides guidance in determining when purchase agreements may be subject to lease accounting. CUC has determined that the agreement to purchase electricity is in fact a capital lease to acquire the plant and that the capacity payments made under the agreement are lease payments. The operation, production and maintenance payments and production fees under the agreement are reflected as energy conversion costs under other production expense.

The effects of adopting EITF No. 01-8 were to increase plant and obligations under capital lease by \$9,959,000. CUC has not obtained the actual cost of the power plant and has not obtained an appraisal to determine the fair value of the leased property, which is required by accounting principles generally accepted in the United States of America. As a result, management has not been able to assess its compliance with the EITF requirements and the impact of this matter on the accompanying financial statements is uncertain. The lease has an effective interest rate of 18%.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(7) Capital Lease, Continued

CUC may, without penalty, discharge the entire outstanding balance of the guaranteed price by paying a discounted amount equal to the adjusted guaranteed price as follows:

<u>Period</u>	<u>Amount</u>
End of year 4	\$25,000,000
End of year 5	\$21,000,000
End of year 6	\$17,250,000
End of year 7	\$14,000,000
End of year 8	\$11,000,000

The annual requirement to amortize the capital lease obligations of CUC outstanding as of September 30, 2005 is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 1,271,733	\$ 888,267	\$ 2,160,000
2007	1,521,801	638,199	2,160,000
2008	1,821,040	338,960	2,160,000
2009	<u>860,695</u>	<u>39,305</u>	<u>900,000</u>
	<u>\$ 5,475,269</u>	<u>\$ 1,904,731</u>	<u>\$ 7,380,000</u>

(8) Fuel Surcharge Fee

On October 26, 2004, CUC published proposed amendments to the Electrical Service Regulations (ESR) for a fuel surcharge. The regulation limited the fuel surcharge to a maximum of 3.5 cents per kilowatt hour (kwh) for the first calendar year after adoption of the regulation, but allowed for full cost recovery in subsequent calendar years. The regulation includes an exception, required by statute, limiting the annual increase for low volume users. After notices and hearings, the fuel surcharge was adopted in January 2005. The final regulation was published on February 17, 2005 and became effective by operation of law on February 28, 2005. As a result of the regulation being finalized in 2005, the 3.5 per kwh cents cap on the surcharge will remain in effect until the end of calendar year 2005. Fuel surcharge revenue for the year ended September 30, 2005 amounted to \$7,629,234.

(9) Settlement Income

During the year ended September 30, 2005, CUC assessed \$500,000 to a customer as a settlement of all claims that CUC may have against the customer relating to waste discharged by the customer's business operations into CUC's sewer system in prior years. At September 30, 2005, CUC also received \$295,800 from an insurance company as performance bond for the default by a contractor to execute the terms of a construction agreement previously entered into with CUC.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2005 and 2004

(10) Commitments and Contingencies

Commitments

CUC has entered into a commitment to borrow \$89,000,000 from the Commonwealth Development Authority for proposed capital improvement projects. As of September 30, 2005 and 2004, CUC had entered into promissory note agreements for \$30,000,000, \$16,135,650, and \$5,500,000 against the \$89,000,000. Although CUC retains the ability to borrow, management does not believe that future borrowing will occur.

On September 23, 1996, CUC entered into an agreement with a third party for the purchase of electric power and associated services. The agreement provides for a monthly minimum purchase of 7,300,000 kilowatt-hours (KWH) at \$0.033 per KWH after January 1, 1998. Additionally, the agreement provides for periodic adjustment of the prices agreed upon but not to exceed 10% of the price then in effect. The agreement expires on July 31, 2006 and is renewable for an additional ten year period to expire on July 31, 2016. Future minimum commitment related to the purchase of electric power for the year ending September 30, 2006 amounts to \$2,584,200.

Contingencies

CUC entered into certain memorandums of understanding (MOUs) with developers who paid CUC sewer connection fees in excess of that required by CUC's regulations. To the extent that CUC has not complied with obligations imposed on it by the MOUs (i.e., depositing the contributions in a special fund, making accountings, and spending the contributions for specified capital improvement projects), developers could consider CUC to have breached the terms of the MOUs. The maximum amount that CUC could be required to expend pursuant to the MOUs is \$3,027,951. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. CUC currently does not maintain insurance coverage with respect to its inventory and utility plant. In the event of a loss, CUC will be self insured for the entire amount. CUC currently reports all of its risk management activities as they are incurred. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC participates in a number of federally assisted grant programs funded by the United States Government. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of \$1,245,922 have been set forth in CUC's Single Audit Report for the year ended September 30, 2005. The ultimate disposition of these questioned costs can be determined only by final action of the respective grantor agencies. Therefore, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

(11) Subsequent Events

On January 27, 2006, the CNMI Governor issued Executive Order No. 2006-1 which provided for the transfer of CUC to the Department of Public Works (DPW) of the CNMI for purposes of administration and coordination as a major component of DPW equivalent to a division which will have its own chief executive officer who will have the rank of a Division Director. The Board of Directors of CUC was abolished and its functions transferred to DPW.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(11) Subsequent Events, Continued

Subsequently, on May 5, 2006, the CNMI Governor issued Executive Order No. 2006-4 which provided for the reorganization of CUC. Under Executive Order No. 2006-4, the functions and duties of CUC are reorganized as a public corporation of the CNMI that has as its head an executive director. The role of the CUC Board of Directors is advisory. With respect to utility services that are generated or delivered in whole or in part by private businesses, the CUC Board of Directors will act as a public utility commission with respect to those services only until such time as the legislature establishes a public utility commission and the commission notifies the board that it is ready to assume its duties and responsibilities with respect to utility services.

On June 6, 2006, the Governor of the CNMI approved Public Law (P.L.) No. 15-12 which authorized CDA to waive the sum of \$45,500,000 of the principal amount owed by CUC, such amount being the aggregate sum of all outstanding sewer and water project loans given to CUC and referenced in the amended MOA executed in January 2004, by CUC and CDA. Pursuant to the same amended MOA, CDA is authorized to waive any and all accrued interest owed by CUC on all outstanding loans in accordance with the terms and conditions of the amended MOA. Section 2 of the P.L. provides that in the event that the power generation system for the CNMI is privatized and controlled by an independent power producer, fifty percent of the principal amount of \$45,500,000 shall be paid by the independent power producer to CDA. On January 23, 2007, the Governor of the CNMI approved P.L. 15-44 to amend section 2 of P.L. 15-12. P.L. 15-44 removes the fifty per cent (\$22,750,000) payment requirement by the independent power producer and instead requires such amount to be rebated to residential power consumers in the event that the power generation system is privatized and controlled by an independent power producer. The rebate shall be subject to review and approval of the Public Utilities Commission upon privatization. As of September 30, 2005, no adjustments have been made to the accompanying financial statements as CUC and CDA have yet to finalize an agreement on the execution of the provisions of P.L. 15-2 and 15-44.

In July 2006, the CUC Electric Service Regulations, Part 24 Rate Schedules was amended to implement an adjustment of the utility rate structure. The amendment of the CUC Electric Service Regulations is in accordance with the recommendations and findings set forth in a comprehensive electric, sewer and wastewater rate study prepared for CUC by a consultant. The fuel surcharge fee, made effective on February 27, 2005, as Part 24.5.8 of the CUC Electric Service Regulations, was rescinded as of the effective date of the amendments to Part 24 of the CUC Electric Service Regulations. The new utility rate is effective beginning with August 2006 utility consumption and was formally adopted on October 24, 2006.

In July 2006, CUC decided not to renew the agreement, which expires on July 31, 2006, with a contractor for the purchase of electric power and associated services. However, the contractor is defending its rights to the extension of the agreement. Under the agreement, the contract is renewable for an additional ten year period to expire on July 31, 2016. CUC may have to pay the contractor approximately \$8,000,000 if the contract is terminated. The arrangements between CUC and the contractor on this matter are currently under negotiation. At September 30, 2005, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statement of Revenues, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis Year Ended September 30, 2005

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses (1)	Total
Operating revenues:						
Governmental:						
CNMI Government	\$ 6,747,943	\$ 2,537,335	\$ 1,044,492	\$ -	\$ -	\$ 10,329,770
CNMI agencies	3,808,080	1,908,369	433,130	-	(2,281,614)	3,867,965
Total governmental	10,556,023	4,445,704	1,477,622	-	(2,281,614)	14,197,735
Commercial	38,320,760	2,318,384	569,063	-	-	41,208,207
Residential	20,675,707	2,958,324	130,391	-	-	23,764,422
Other	159,197	(181,330)	28,513	841,999	-	848,379
	69,711,687	9,541,082	2,205,589	841,999	(2,281,614)	80,018,743
Less bad debts	-	-	-	(1,139,757)	-	(1,139,757)
Net operating revenues	69,711,687	9,541,082	2,205,589	(297,758)	(2,281,614)	78,878,986
Operating expenses:						
Production fuel	59,246,625	-	-	-	-	59,246,625
General and administrative	5,605,530	2,277,563	1,117,291	7,269,768	-	16,270,152
Depreciation	4,810,365	2,199,916	972,851	199,601	-	8,182,733
Other production	4,573,661	2,300,929	601,508	96,930	(2,281,614)	5,291,414
Maintenance	4,008,660	588,874	386,578	147,893	-	5,132,005
Supplies	155,624	238,204	45,247	140,283	-	579,358
Other	-	-	-	338,431	-	338,431
Total operating expenses	78,400,465	7,605,486	3,123,475	8,192,906	(2,281,614)	95,040,718
Earnings (loss) from operations	(8,688,778)	1,935,596	(917,886)	(8,490,664)	-	(16,161,732)
Nonoperating revenues (expenses):						
Settlement income	-	-	-	795,800	-	795,800
Interest income	-	-	-	276,790	-	276,790
Gain on sale of capital assets	-	-	-	27,265	-	27,265
Interest expense	(9,781,660)	(816,505)	-	-	-	(10,598,165)
Contribution to the primary government	-	-	-	(694,759)	-	(694,759)
Total nonoperating revenues (expenses), net	(9,781,660)	(816,505)	-	405,096	-	(10,193,069)
Net income (loss) before capital contributions	(18,470,438)	1,119,091	(917,886)	(8,085,568)	-	(26,354,801)
Capital contributions	479,560	645,947	2,742,783	38,088	-	3,906,378
Change in net assets (deficiency)	\$ (17,990,878)	\$ 1,765,038	\$ 1,824,897	\$ (8,047,480)	\$ -	\$ (22,448,423)

(1) The Water and Sewer Divisions recognize an expense for power supplied by the Power Division to operate their facilities. The Power division recognizes internal revenue for the corresponding amount.

See accompanying independent auditors' report.