

COMMONWEALTH UTILITIES CORPORATION

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

YEAR ENDED SEPTEMBER 30, 2002

COMMONWEALTH UTILITIES CORPORATION

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

INDEPENDENT AUDITORS' REPORT

Board of Directors
Commonwealth Utilities Corporation:

We have audited the accompanying statements of net assets of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), as of September 30, 2002 and 2001, and the related statements of revenues, expenses and changes in net assets and 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 paragraph, 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 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.

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, 2002 and 2001. In addition, we were unable to determine that accounts payable, accrued liabilities and accrued payroll were fairly stated at September 30, 2001. Furthermore, in our judgment, these balances materially affect the determination of results of operations and cash flows for the years ended September 30, 2002 and 2001. In addition, CUC management was unable to provide minutes of Board of Directors meetings subsequent to December 14, 2004. Accordingly, there was an incomplete record of management and 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 the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease as of September 30, 2002 and 2001 been determined, and had the propriety of accounts receivable, accounts payable, accrued liabilities and accrued payroll as of September 30, 2001 been determined, and their effect on the results of operations and cash flows, been determinable, and had we received minutes of the Board of Directors meetings subsequent to December 14, 2004 as discussed in the third paragraph, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in note 1 to the accompanying financial statements, CUC adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*.

The Management's Discussion and Analysis on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the GASB. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However we did not audit the information and express no 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 and Expenses on a Divisional Basis for the year ended September 30, 2002 (page 20) 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 and Expenses on a Divisional Basis for the year ended September 30, 2002 has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, except as discussed in the third paragraph 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 March 21, 2005, on our consideration of internal control over financial reporting and 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

March 21, 2005



Commonwealth Utilities Corporation



MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Commonwealth Utilities Corporation's (CUC) annual financial report presents the analysis of CUC's financial performance during the fiscal year ended September 30, 2002 as compared to fiscal year ended September 30, 2001. Please read it in conjunction with the financial statements, which follow this section.

	<u>2002</u>	<u>2001</u>
Assets		
Net utility plant	\$ 109,103,175	\$ 113,244,403
Current assets	39,570,265	36,002,501
Restricted assets	<u>7,902,199</u>	<u>7,188,372</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>
Net Assets and Liabilities		
Net assets	\$ (4,294,157)	\$ 2,785,602
Long-term debt	7,672,884	8,761,219
Current liabilities	<u>153,196,912</u>	<u>144,888,455</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>
Revenues, Expenses and Changes in Net Assets		
Operating revenues	\$ 70,153,781	\$ 68,338,849
Operating expenses	<u>72,312,473</u>	<u>75,335,977</u>
Loss from operations	<u>(2,158,692)</u>	<u>(6,997,128)</u>
Capital contributions	4,697,950	4,594,970
Interest income	399,110	794,168
Settlement income	-	5,950,000
Recovery of bad debts	-	1,747,674
Interest expense	(9,381,066)	(8,872,557)
Contribution to primary government	<u>(637,061)</u>	<u>(703,563)</u>
Total nonoperating revenues (expenses), net	<u>(4,921,067)</u>	<u>3,510,692</u>
Change in net assets	<u>\$ (7,079,759)</u>	<u>\$ (3,486,436)</u>

REQUIRED FINANCIAL STATEMENTS

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

The Statement of Net Assets includes all of CUC's assets and liabilities associated with the operation of proprietary funds. It provides information about the nature and amount of investments in resources and the obligations to the creditors. Theoretically, net assets represent the resources an entity has left to use after its debts are settled. Those resources, however, may not always be available for spending; restrictions may be attached to them. To clarify these issues, net assets is divided into three categories: capital assets, net of related debt, which cannot be sold or converted to cash; restricted assets, which must be retained in perpetuity; and unrestricted net assets, which may be used in any purpose, but are not in a form that can be spent.

The Statement of Revenues, Expenses and Changes in Net Assets account for the all the revenues and expenses and gains and losses arising from the ongoing operations of CUC. This statement measures the success of CUC in using the resources committed to its operations. The components in this report are very important and can be used to predict future income and cash flows.

The Statement of Cash Flows provides information about the CUC's cash flows for the period classified according to four main categories: operating activities, noncapital financing activities, capital and related financing activities and investing activities. The statement reports the net cash provided by or used by each category and explains the net increase or decrease in cash and cash equivalents.

FINANCIAL ANALYSIS OF CUC AS A WHOLE

For the year ended September 30, 2002, CUC had a loss from operations of over \$2 million as compared to the September 30, 2001 loss from operations of over \$6.9 million.

During the year ended September 30, 2002, CUC operating revenues increased overall by about \$1.8 million (3 percent). Revenues increased for power, over \$1.2 million (2 percent), for water, about \$378,000 (5 percent), and for sewer, over \$8,500 (0.4 percent). The increase in power revenue is due primarily to the addition of one large tourist-related facility to the customer base. The increases in water and sewer revenues are attributable to increased customer billings. The decrease in franchise income is due to the establishment of the Commonwealth Telecommunications Commission (CTC) that replaced CUC. Since CTC now has oversight responsibility for telecommunications activities, it now collects the franchise fees associated with these activities.

During the year ended September 30, 2002, expenses decreased for production fuel by over \$5 million (15 percent) and for supplies by about \$101,000 (15 percent). Conversely, expenses increased for maintenance by about \$223,000 (2 percent) and for other production by over \$654,000 (17 percent) when compared to expenses for the year ended September 30, 2001.

Capital contributions received from direct grants from federal government and pass-thru grants received from the CNMI government amounted to about \$4.6 million for fiscal year 2002 as compared to over \$4.5 million for fiscal year 2001. These grants are used for capital improvement projects such as upgrading of power distribution lines, design and construction of waterlines and sewage system.

CUC received over \$5.9 million for the settlement of damages related to a power plant generator during the year ended September 30, 2001.

ECONOMIC FACTORS AND NEXT YEAR'S PLAN OF ACTION

In order to settle the \$61.5 million notes payable and related accrued interest payable of over \$68 million with the Commonwealth Development Authority (CDA), CUC and CDA have entered into a Memorandum of Agreement (MOA). The MOA provides for a waiver of a portion of the notes payable owed by CUC to CDA, certain specified interest payments and to convert the balance into equity ownership. CUC has been authorized to issue cumulative nonconvertible non-transferable preferred shares valued at \$45.5 million.

CUC management is looking at changing its regulations to aggressively approach its accounts receivable issues, especially with the CNMI Government.

CONTACTING CUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide CUC's rate payers and creditors with a general overview of CUC's finances and to demonstrate CUC's accountability for the money it receives. If you have questions about this report, or need additional information, contact CUC's Comptroller at Commonwealth Utilities Corporation, P.O. Box 501220, Saipan MP 96950, at telephone number (670) 235-7025 or e-mail ssamari@cuc.gov.mp.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets
September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
<u>ASSETS</u>		
Utility plant:		
Electric plant	\$ 113,875,907	\$ 107,377,339
Water plant	57,003,580	55,414,456
Sewer plant	21,810,302	20,132,601
Administrative equipment	4,247,150	4,326,926
Construction work in progress	<u>9,210,617</u>	<u>15,971,168</u>
	206,147,556	203,222,490
Less accumulated provision for depreciation	<u>(97,044,381)</u>	<u>(89,978,087)</u>
Net utility plant	<u>109,103,175</u>	<u>113,244,403</u>
Current assets:		
Cash and cash equivalents	<u>14,887,833</u>	<u>14,572,414</u>
Accounts receivable:		
Utility	26,658,256	24,022,809
Other	<u>2,043,918</u>	<u>2,165,789</u>
	28,702,174	26,188,598
Less accumulated provision for uncollectible accounts	<u>(16,215,304)</u>	<u>(14,742,373)</u>
Net accounts receivable	<u>12,486,870</u>	<u>11,446,225</u>
Inventory, less allowance for obsolescence inventory of \$1,159,467 in 2002 and 2001	<u>10,973,209</u>	<u>9,983,862</u>
Due from grantor agencies	<u>1,222,353</u>	<u>-</u>
Total current assets	<u>39,570,265</u>	<u>36,002,501</u>
Restricted assets:		
Cash and cash equivalents	1,802,686	7,188,372
Time certificates of deposit	<u>6,099,513</u>	<u>-</u>
Total restricted assets	<u>7,902,199</u>	<u>7,188,372</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets, Continued
September 30, 2002 and 2001

NET ASSETS AND LIABILITIES

	<u>2002</u>	<u>2001</u>
Net assets:		
Investment in capital assets, net of related debt	\$ 38,707,165	\$ 42,125,434
Restricted	7,902,199	7,188,372
Unrestricted	<u>(50,903,521)</u>	<u>(46,528,204)</u>
Total net assets	<u>(4,294,157)</u>	<u>2,785,602</u>
Long-term debt:		
Obligations under capital lease, less current maturities	7,426,149	8,473,332
Loan payable less current maturities	246,735	287,887
Compensated absences, less current portion	<u>337,489</u>	<u>202,666</u>
	<u>8,010,373</u>	<u>8,963,885</u>
Commitments and contingencies		
Current liabilities:		
Current maturities of long-term debt	61,609,902	61,607,527
Current obligations under capital lease	1,113,224	750,223
Accounts payable	7,274,818	9,615,752
Accrued liabilities	1,178,298	103,331
Accrued payroll	754,379	204,840
Compensated absences, current portion	702,682	676,560
Deferred revenue	-	110,165
Customer deposits	7,740,558	7,654,130
Due to primary government	3,997,847	3,420,786
Interest payable	<u>68,487,715</u>	<u>60,542,475</u>
Total current liabilities	<u>152,859,423</u>	<u>144,685,789</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Operating revenues:		
Power	\$ 59,149,741	\$ 57,869,281
Water	7,897,698	7,519,825
Sewer	2,178,191	2,169,662
Franchise income	-	209,599
Other	<u>928,151</u>	<u>570,482</u>
Total operating revenues	<u>70,153,781</u>	<u>68,338,849</u>
Operating expenses:		
Production fuel	27,553,429	32,591,674
General and administrative	18,907,336	18,609,111
Maintenance	9,745,199	9,522,327
Depreciation	9,271,636	8,552,050
Other production	4,442,408	3,787,981
Bad debts	1,764,084	1,043,486
Supplies	586,206	687,914
Other	<u>42,175</u>	<u>541,434</u>
Total operating expenses	<u>72,312,473</u>	<u>75,335,977</u>
Loss from operations	<u>(2,158,692)</u>	<u>(6,997,128)</u>
Nonoperating revenues (expenses):		
Interest income	399,110	794,168
Settlement income	-	5,950,000
Recovery of bad debts	-	1,747,674
Interest expense	(9,381,066)	(8,872,557)
Contribution to the primary government	<u>(637,061)</u>	<u>(703,563)</u>
Total nonoperating revenues (expenses), net	<u>(9,619,017)</u>	<u>(1,084,278)</u>
Net loss before capital contributions	(11,777,709)	(8,081,406)
Capital contributions	<u>4,697,950</u>	<u>4,594,970</u>
Change in net assets	(7,079,759)	(3,486,436)
Net assets - beginning	<u>2,785,602</u>	<u>6,272,038</u>
Net assets - ending	\$ <u>(4,294,157)</u>	\$ <u>2,785,602</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Cash received from customers	\$ 67,435,481	\$ 74,817,469
Cash payments to suppliers for goods and services	(50,172,421)	(55,503,906)
Cash payments to employees for services	(13,734,382)	(13,223,110)
Net cash provided by operating activities	<u>3,528,678</u>	<u>6,090,453</u>
Cash flows from noncapital financing activities:		
Payments to primary government	(60,000)	(59,999)
Net cash used for noncapital financing activities	<u>(60,000)</u>	<u>(59,999)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(5,130,408)	(7,649,802)
Capital contributions	4,697,950	4,594,970
Principal repayment of debt	(722,959)	(119,847)
Interest paid on outstanding debt	(1,435,826)	(1,666,196)
Net disbursements for capital grants	(247,299)	644,874
Increase in restricted assets	(713,827)	(1,004,128)
Net cash used for capital and related financing activities	<u>(3,552,369)</u>	<u>(5,200,129)</u>
Cash flows from investing activities:		
Interest received on time certificates of deposit	399,110	794,168
Net cash provided by investing activities	<u>399,110</u>	<u>794,168</u>
Net increase in cash and cash equivalents	315,419	1,624,493
Cash and cash equivalents at beginning of year	<u>14,572,414</u>	<u>12,947,921</u>
Cash and cash equivalents at end of year	\$ <u>14,887,833</u>	\$ <u>14,572,414</u>
Reconciliation of loss from operations to net cash provided by operating activities:		
Loss from operations	\$ (2,158,692)	\$ (6,997,128)
Adjustments to reconcile loss from operations to net cash provided by operating activities:		
Depreciation	9,271,636	8,552,050
Provision for bad debts	1,764,084	1,043,486
Recovery of bad debts	-	1,747,674
Settlement income	-	5,950,000
(Increase) decrease in assets:		
Accounts receivable:		
Utility	(2,926,600)	(1,420,751)
Other	121,871	(111,126)
Inventory	(989,347)	(352,982)
Increase (decrease) in liabilities:		
Accounts payable	(2,340,934)	(1,957,326)
Accrued liabilities	150,693	(201,632)
Accrued payroll	549,539	(474,635)
Customer deposits	<u>86,428</u>	<u>359,515</u>
Net cash provided by operating activities	\$ <u>3,528,678</u>	\$ <u>6,137,145</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	\$ 1,085,219	\$ -
Noncash increase in accrued liabilities	<u>(1,085,219)</u>	<u>-</u>
	\$ -	\$ -

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(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.

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.

New Accounting Standards

GASB has issued Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*. These statements establish financial reporting standards for governmental entities which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements. CUC adopted GASB Statement No. 34, as amended by GASB Statement No. 37, and certain provisions of GASB Statement No. 38 in fiscal year 2002.

To conform to the requirements of GASB 34, the following changes have been made to CUC's financial statements:

- Retained earnings have been reclassified into the following net assets categories:
 - Investment in capital assets net of related debt; capital assets, net of accumulated depreciation, less outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

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

New Accounting Standards, Continued

- **Restricted:**

Nonexpendable - Net assets subject to externally imposed stipulations that CUC maintain them permanently. For the years ended September 30, 2002 and 2001, CUC does not have nonexpendable net assets.

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. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

- The statement of cash flows has been presented using the direct method.

For fiscal year 2005, CUC will be implementing GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)* and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. As of September 30, 2002, CUC has not evaluated the financial statement impact of GASB Statement Nos. 40 and 42.

Estimates

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

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 on 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.

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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2002 and 2001

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

Cash and Cash Equivalents and Time Certificates of Deposit

For purposes of the statements of net assets and cash flows, cash and cash equivalents and restricted 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 statement of net assets. At September 30, 2002 and 2001, cash and cash equivalents were \$16,690,519 and \$21,760,786, respectively, and the corresponding bank balances were \$16,803,863 and \$21,850,546, respectively. Of the bank balance amounts, \$16,803,863 and \$21,850,546 are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance as of September 30, 2002 and 2001, respectively. Bank deposits in the amount of \$200,000 and \$186,661 were FDIC insured as of September 30, 2002 and 2001, respectively. CNMI law does not require component units to collateralize their bank accounts and thus, CUC's deposits in excess of FDIC insurance are uncollateralized.

Time certificates of deposit of \$6,099,513 as of September 30, 2002 and cash and cash equivalents of \$1,742,536 and \$6,874,265 as of September 30, 2002 and 2001, respectively, represent customer deposits, which must be segregated pursuant to CUC policy, and accordingly, are classified as restricted in the accompanying financial statements. Cash and cash equivalents of \$60,150 and \$314,107 as of September 30, 2002 and 2001, 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.

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 are stated at cost, where 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, 2002 and 2001, eligible interest expense was not considered significant and consequently no interest has been capitalized.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(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 multiple 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, 2002, 2001 and 2000 were \$2,620,144, \$2,731,623, and \$2,687,910, respectively, equal to the required contributions for each year.

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, 2002 and 2001 amounted to \$1,040,171 and \$879,226, respectively. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The sick pay benefit liability as of September 30, 2002 and 2001, was approximately \$2,287,928 and \$2,004,456, respectively.

Franchise Income

Franchise income was received from a local telecommunications company for the right to provide telecommunication services within the CNMI. In February 2001, the CNMI established the Commonwealth Telecommunications Commission (CTC), which was tasked to regulate telecommunication services in the CNMI. CTC began receiving the franchise income in February, 2001.

(2) Due From (Deferred Revenue) 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 (deferred revenue) grantor agencies accounts for the years ended September 30, 2002 and 2001, are as follows:

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(2) Due From (Deferred Revenue) Grantor Agencies, Continued

	<u>2002</u>	<u>2001</u>
Balance at beginning of year	\$ (110,165)	\$ 534,709
Adjustments	418,434	(124,167)
Deductions - cash receipts from grantor agencies	(3,783,866)	(5,200,536)
Additions - program outlays	<u>4,697,950</u>	<u>4,679,829</u>
Balance at end of year	<u>\$ 1,222,353</u>	<u>\$ (110,165)</u>

(3) Utility Plant

Utility plant at September 30, 2002 and 2001, consists of the following:

	Estimated Useful Lives	Balance at October 1, 2001	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2002
Utility plant:						
Electric plant	20 years	\$ 107,377,339	\$ 1,076,044	\$ (373)	\$ 5,422,897	\$ 113,875,907
Water plant	20 years	55,414,456	4,308,952	-	(2,719,828)	57,003,580
Sewer plant	20 years	20,132,601	1,688,018	-	(10,317)	21,810,302
Administrative equipment	3 - 5 years	<u>4,326,926</u>	<u>344,626</u>	-	(424,402)	<u>4,247,150</u>
		187,251,322	7,417,640	(373)	2,268,350	196,936,939
Less accumulated provision for depreciation		<u>(89,978,087)</u>	<u>(9,271,636)</u>	<u>373</u>	<u>2,204,969</u>	<u>(97,044,381)</u>
		97,273,235	(1,853,996)	-	4,473,319	99,892,558
Construction work in progress		<u>15,971,168</u>	-	-	<u>(6,760,551)</u>	<u>9,210,617</u>
		<u>\$ 113,244,403</u>	<u>\$ (1,853,996)</u>	<u>\$ -</u>	<u>\$ (2,287,232)</u>	<u>\$ 109,103,175</u>

	Estimated Useful Lives	Balance at October 1, 2000	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2001
Utility plant:						
Electric plant	20 years	\$ 105,998,553	\$ 6,710,923	\$ -	\$ (5,332,137)	\$ 107,377,339
Water plant	20 years	50,297,630	8,563,687	-	(3,446,861)	55,414,456
Sewer plant	20 years	16,783,489	3,349,112	-	-	20,132,601
Administrative equipment	3 - 5 years	<u>4,032,335</u>	<u>406,713</u>	<u>(15,995)</u>	<u>(96,127)</u>	<u>4,326,926</u>
		177,112,007	19,030,435	(15,995)	(8,875,125)	187,251,322
Less accumulated provision for depreciation		<u>(81,452,997)</u>	<u>(8,552,050)</u>	<u>15,995</u>	<u>10,965</u>	<u>(89,978,087)</u>
		95,659,010	10,478,385	-	(8,864,160)	97,273,235
Construction work in progress		<u>18,487,641</u>	-	-	<u>(2,516,473)</u>	<u>15,971,168</u>
		<u>\$ 114,146,651</u>	<u>\$ 10,478,385</u>	<u>\$ -</u>	<u>\$ (11,380,633)</u>	<u>\$ 113,244,403</u>

(4) Notes Payable

A schedule of CUC's long-term debt as of September 30, 2002 and 2001, is as follows:

	<u>2002</u>	<u>2001</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

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(4) Notes Payable, Continued

	<u>2002</u>	<u>2001</u>
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, 2002 and 2001, 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, 2002 and 2001, associated with the notes payable to CDA along with interest payable on these notes of \$68,487,715 and \$60,542,475 as at September 30, 2002 and 2001, respectively, has been classified as current liabilities within the accompanying financial statements.

(5) Loan 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, 2002 and 2001, 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, 2002 and 2001:

	<u>2002</u>	<u>2001</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.	\$ 287,887	\$ 326,664
Less current portion	<u>41,152</u>	<u>38,777</u>
Long-term loan payable	<u>\$ 246,735</u>	<u>\$ 287,887</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(5) Loan Payable, Continued

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>
2003	\$ 41,152	\$ 17,633	\$ 58,785
2004	43,672	15,113	58,785
2005	46,347	12,438	58,785
2006	49,186	9,599	58,785
2007	52,199	6,586	58,785
2008	<u>55,331</u>	<u>3,389</u>	<u>58,720</u>
	<u>\$ 287,887</u>	<u>\$ 64,758</u>	<u>\$ 352,645</u>

(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, 2002 and 2001, CUC had an outstanding payable to the primary government in the amount of \$3,997,847 and \$3,420,786, respectively.

(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 upon. 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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(7) Capital Lease, Continued

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%.

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	\$ 8,821,000
End of year 5	\$ 7,750,000
End of year 6	\$ 6,540,000
End of year 7	\$ 5,200,000
End of year 8	\$ 3,900,000

CUC entered into a capital lease agreement with a contractor for a generator. The agreement is for a guaranteed price of \$485,000, payable over two years in monthly installments of \$10,000, inclusive of interest, with a final payment of \$245,000 on March 20, 2003.

The annual requirement to amortize all debt of CUC outstanding as of September 30, 2002 is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003	\$ 1,113,224	\$ 1,417,817	\$ 2,531,041
2004	888,122	1,271,878	2,160,000
2005	1,062,758	1,097,242	2,160,000
2006	1,271,733	888,267	2,160,000
2007	1,521,801	638,199	2,160,000
2008 - 2009	<u>2,681,735</u>	<u>378,269</u>	<u>3,060,004</u>
	\$ <u>8,539,373</u>	\$ <u>5,691,672</u>	\$ <u>14,231,045</u>

(8) Settlement Income

CUC received \$5,950,000 for the settlement of damages related to a generator during the year ended September 30, 2001.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(9) 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, 2002 and 2001, 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 will expire on July 31, 2006 and renewable for an additional ten year period to expire on July 31, 2016. Future minimum commitments related to the purchase of electric power are as follows:

<u>Year ending September 30,</u>	<u>Minimum Payment</u>
2003	\$ 2,960,880
2004	3,101,040
2005	3,101,040
2006	<u>2,584,200</u>
	<u>\$ 11,747,160</u>

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 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. 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 \$251,166 have been set forth in CUC's Single Audit Report for the year ended September 30, 2002. 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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(10) Subsequent Events

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. At September 30, 2002, terms of the MOA are being negotiated between CDA and CUC and thus debt has not been waived and preferred stock has not been issued.

In January 2004, the Memorandum of Agreement (MOA), entered into on November 21, 2002 between CUC and CDA was amended to exclude a certain 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.

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. For calendar year 2006, the formula included in the fuel surcharge regulation will be applied to establish a new ceiling and the fuel surcharge may be increased to that ceiling over the course of the year.

During the year ended September 30, 2003, CUC and the CNMI Government, with the concurrence of OPA, offset a portion of the liability related to CNMI OPA funding against utility receivables of the CNMI Government. The offset was performed through an exchange of checks for \$3,997,847.

COMMONWEALTH UTILITIES CORPORATION

Statement of Revenues, Expenses and Changes in Net Assets on a Divisional Basis
Year Ended September 30, 2002

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses (1)	Total
Operating revenues:						
Governmental:						
CNMI Government	\$ 6,152,925	\$ 2,131,211	\$ 907,320	\$ -	\$ -	\$ 9,191,456
CNMI agencies	4,101,469	904,320	443,177	-	(2,504,783)	2,944,183
Total governmental	10,254,394	3,035,531	1,350,497	-	(2,504,783)	12,135,639
Commercial	33,994,923	2,058,569	714,470	-	-	36,767,962
Residential	16,822,013	2,802,551	113,131	-	-	19,737,695
Grants and contributions	583,194	1,047	93	-	-	584,334
Other	-	-	-	928,151	-	928,151
Total operating revenues	61,654,524	7,897,698	2,178,191	928,151	(2,504,783)	70,153,781
Operating expenses:						
Production fuel	27,553,429	-	-	-	-	27,553,429
General and administrative	7,011,402	3,051,832	1,468,435	7,375,667	-	18,907,336
Maintenance	8,273,432	794,112	402,756	274,899	-	9,745,199
Depreciation	5,235,918	2,964,318	845,145	226,255	-	9,271,636
Other production	4,369,362	2,577,829	-	-	(2,504,783)	4,442,408
Bad debts	-	-	-	1,764,084	-	1,764,084
Supplies	201,708	155,545	46,418	182,535	-	586,206
Other	-	-	-	42,175	-	42,175
Total operating expenses	52,645,251	9,543,636	2,762,754	9,865,615	(2,504,783)	72,312,473
Earnings (loss) from operations	9,009,273	(1,645,938)	(584,563)	(8,937,464)	-	(2,158,692)
Nonoperating revenues (expenses):						
Interest income	-	-	-	399,110	-	399,110
Interest expense	(8,556,990)	(824,076)	-	-	-	(9,381,066)
Contribution to the primary government	-	-	-	(637,061)	-	(637,061)
Total nonoperating revenues (expenses), net	(8,556,990)	(824,076)	-	(237,951)	-	(9,619,017)
Net earnings (loss) before capital contributions	452,283	(2,470,014)	(584,563)	(9,175,415)	-	(11,777,709)
Capital contributions	4,697,950	-	-	-	-	4,697,950
Change in net assets	\$ 5,150,233	\$ (2,470,014)	\$ (584,563)	\$ (9,175,415)	\$ -	\$ (7,079,759)

(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.