

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

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**REPORTS ON THE AUDITS OF FINANCIAL  
STATEMENTS IN ACCORDANCE WITH  
OMB CIRCULAR A-133**

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Year Ended  
September 30, 2006

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Years Ended September 30, 2006 and 2005

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**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

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**INDEPENDENT AUDITOR'S REPORT  
AND  
FINANCIAL STATEMENTS**

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**Years Ended  
September 30, 2006 and 2005**

J. Scott Magliari  
COMPANY

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**INDEPENDENT AUDITOR'S REPORT**

The Executive Director  
Commonwealth Utilities Corporation

I have audited the accompanying statement of net deficiency of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands, as of September 30, 2006, and the related statement of revenues, expenses and changes in net deficiency, and of cash flows for the year then ended. The prior year financial statements were audited by other auditors who expressed a qualified opinion on these statements. These financial statements are the responsibility of CUC's management. My responsibility is to express an opinion on these financial statements based on my audit.

Except as discussed in the following paragraphs, I conducted my audit 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 I 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 the CUC's internal control over financial reporting. Accordingly, I express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audit provides a reasonable basis for my opinion.

As discussed in Note 6, in fiscal year 2000 CUC recorded an increase in capital assets and obligation under capital lease at \$9,959,000. Accounting principles generally accepted in the United States of America require that the amount recorded should be the lesser of (a) the fair value of the leased asset at the inception of the lease or; (b) the present value of the minimum lease payments (excluding executory costs to be paid by the lessor and related profit) as of the beginning of the lease term. CUC has been unable to determine whether the guaranteed price of \$9,959,000, in fact, constitutes the fair value of the leased property. The amount by which this departure would affect the assets, net assets (deficiency), and revenues of CUC is not reasonably determinable. Furthermore, no physical count of capital assets was conducted in the past 4 years. CUC is unable to determine if the carrying value of its capital assets is recoverable.

CUC estimated an allowance for obsolescence of \$700,652 and was unable to provide a listing of the basis for this allowance. Obsolescence, deterioration, damage, changing prices, or other factors may cause an inventory's recorded cost to exceed its market value. In such cases, accounting principles generally accepted in the United States of America require inventory to be written down to market value and an unrealized loss to be recognized against current period income. The amount by which this departure would affect the assets, net assets (deficiency), and revenues of the CUC is not reasonably determinable.

In my opinion, except for the effect of such adjustments, if any, as might have been determined to be necessary had the propriety of inventory, capital assets and related obligation under capital lease, as discussed in the third, fourth and fifth paragraphs, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2006, and the changes in net deficiencies and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis (MD&A) on pages 3 to 13 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. I 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, I did not audit this information and express no opinion on it.

My audit was conducted for the purpose of forming opinion on the CUC'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, 2006 on page 19 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in my opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with the Government Auditing Standards, I have also issued my report dated February 28, 2008 on my consideration of CUC's internal control over financial reporting and on my 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 my 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 my audit.

*J. Scott Maglian & Company*

Saipan, Commonwealth of the Northern Mariana Islands

February 28, 2008, except for Note 11, as to which the date is March 31, 2008

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

**MANAGEMENT'S DISCUSSION & ANALYSIS**  
September 30, 2006

This discussion and analysis of the Commonwealth Utilities Corporation's (CUC's) financial performance provides an overview of CUC's activities for the fiscal year ended September 30, 2006 with comparisons to prior fiscal years ended September 30, 2005 and 2004. We encourage readers to consider the information presented here in conjunction with the financial statements and related notes (pages 14 through 39).

**FINANCIAL HIGHLIGHTS**

- Total assets on September 30, 2006, were \$139.0 million, an increase of \$6.1 million (4.6 percent) when compared to September 30, 2005, which had a decrease of \$11.4 million (7.9 percent) when compared to September 30, 2004. This was due primarily to increases in capital assets in 2006 and decreases in both capital and restricted assets in 2005.
- Total liabilities on September 30, 2006, were \$204.3 million, an increase of \$13.5 million (7.1 percent) when compared to September 30, 2005, which had an increase of \$16.3 million (9.3 percent) when compared to September 30, 2004. In both years, the increases were due primarily to accruals for interest payable.
- Total net operating revenues for fiscal year 2006 were \$88.3 million, an increase of \$9.4 million (12.0 percent) when compared to fiscal year 2005, which had an increase of \$14.4 million (22.4 percent) when compared to fiscal year 2004. In both years, the increases were due primarily to the inclusion of a fuel charge in the power rates.
- Total operating expenses for fiscal year 2006 were \$107.7 million, an increase of \$12.7 million (13.4 percent) when compared to fiscal year 2005, which had an increase of \$15.1 million (18.9 percent) when compared to fiscal year 2004. In both years, the increases were attributable to rising fuel costs.
- Non-operating revenues net of non-operating expenses for fiscal year 2006 were \$3.6 million or an increase of 135.7 percent compared to fiscal year 2005 non-operating expenses net of non-operating revenues. This was due primarily to the recovery of bad debts totaling \$15.3 million. Non-operating expenses net of non-operating revenues for fiscal year 2005 decreased by \$448,000 (4.2 percent) when compared to fiscal year 2004, which was due primarily to settlement income.
- In fiscal year 2006, CUC recognized \$7.3 million in capital contributions compared to \$3.9 million in fiscal year 2005 and \$8.7 million in fiscal year 2004. This was an increase of \$3.4 million (86.9 percent) when compared to 2005 and a decrease of \$4.8 million (55.2 percent) when 2005 is compared to 2004.
- CUC's net deficiency continued to increase in fiscal year 2006, but at a much lower rate than fiscal year 2005. In 2006, the net deficiency increased \$7.4 million (12.8 percent) when compared to 2005, which had an increase of \$27.6 million (91.1 percent) when compared to 2004.

COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

**OVERVIEW OF THE FINANCIAL STATEMENTS**

The Financial Section of this report presents the CUC's financial statements as two components: basic financial statements, and notes to the financial statements. It also includes supplemental information.

*Basic Financial Statements*

The *Statements of Net Assets (Deficiency)* presents information on assets and liabilities, with the difference between the two reported as net assets (deficiency). Changes in net assets (deficiency) over time may provide an indicator as to whether the financial position of the CUC is improving or deteriorating.

The *Statements of Revenues, Expenses and Changes in Net Assets (Deficiency)* reports how net assets have changed during the year. It compares related operating revenues and operating expenses connected with the CUC's principal business of providing power, water and sewer services. Operating expenses include the cost of direct services to customers, administrative expenses, contracted services and depreciation on capital assets. All other revenues and expenses are reported as non-operating.

The *Statements of Cash Flows* reports inflows and outflows of cash, classified into four major categories:

- Cash flows from operating activities include transactions and events reported as components of operating income in the Statement of Revenues, Expenses and Changes in Net Assets (Deficiency).
- Cash flows from non-capital financing activities include operating grant proceeds.
- Cash flows from capital and related financing activities include the borrowing and repayment (principal and interest) of capital-related debt, the acquisition and construction of capital assets, and the proceeds of capital grants and contributions.
- Cash flows from investing activities include proceeds from sale of investments, receipt of interest and changes in the fair value of investments subject to reporting as cash equivalents. Outflows in this category include the purchase of investments.

*Notes to the Financial Statements*

Various notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements and are found immediately following the financial statements to which they refer.

**COMMONWEALTH UTILITIES CORPORATION**  
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**MANAGEMENT'S DISCUSSION & ANALYSIS**  
September 30, 2006

*Other Information*

This report also presents certain supplementary information concerning CUC's Statements of Revenues, Expenses and Changes in net Deficiency on a divisional basis (see page 19).

**ANALYSIS OF BASIC FINANCIAL STATEMENTS**

**Net Assets (Deficiency)**

|  | <u>2006</u>            | <u>2005</u>            | <u>2004</u>            |
|--|------------------------|------------------------|------------------------|
| Current assets                                     | \$ 27,496,737          | \$ 25,026,751          | \$ 24,849,221          |
| Capital assets, net                                | 103,367,255            | 99,452,795             | 104,542,017            |
| Restricted assets                                  | <u>7,870,804</u>       | <u>7,591,615</u>       | <u>14,853,353</u>      |
| Total Assets                                       | <u>138,954,796</u>     | <u>132,071,161</u>     | <u>144,244,611</u>     |
| Current liabilities                                | 192,262,173            | 182,142,469            | 168,449,555            |
| Noncurrent liabilities                             | <u>12,077,587</u>      | <u>8,693,886</u>       | <u>6,127,696</u>       |
| Total Liabilities                                  | <u>204,339,710</u>     | <u>190,836,354</u>     | <u>174,577,251</u>     |
| Net Assets (Deficiency):                           |                        |                        |                        |
| Invested in capital assets,<br>net of related debt | 38,094,873             | 29,005,794             | 36,212,197             |
| Restricted   | 7,870,804              | 4,345,350              | 5,630,207              |
| Unrestricted                                       | <u>(111,350,591)</u>   | <u>(91,316,337)</u>    | <u>(72,135,044)</u>    |
| Net Deficiency                                     | <u>\$ (65,384,914)</u> | <u>\$ (57,965,193)</u> | <u>\$ (30,332,640)</u> |

|   | <u>2006</u>            | <u>2005</u>            | <u>2004</u>            |
|---|------------------------|------------------------|------------------------|
| Operating revenues, net   | \$ 98,326,321          | \$ 78,878,986          | \$ 64,466,641          |
| Operating expenses  | <u>117,729,841</u>     | <u>95,040,718</u>      | <u>79,943,257</u>      |
| Loss from operations  | (19,403,522)           | (16,161,732)           | (15,476,616)           |
| Nonoperating revenues(expenses), net<br>cost to be recovered in future period | <u>3,640,869</u>       | <u>(10,193,069)</u>    | <u>(10,640,757)</u>    |
| Net loss before capital contributions   | <u>(15,762,653)</u>    | <u>(26,354,801)</u>    | <u>(26,117,373)</u>    |
| Capital contributions   | <u>7,900,471</u>       | <u>3,906,378</u>       | <u>8,717,481</u>       |
| Change in net deficiency  | (7,419,721)            | (22,448,423)           | (17,399,892)           |
| Restatement   | -                      | (5,184,139)            | -                      |
| Net deficiency, beginning   | <u>(57,965,193)</u>    | <u>(30,332,640)</u>    | <u>(12,932,748)</u>    |
| Net Deficiency  | <u>\$ (65,384,914)</u> | <u>\$ (57,965,193)</u> | <u>\$ (30,332,640)</u> |



COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

Highlights of events affecting assets, liabilities and net deficiency balances follow.

During fiscal 2006, total assets increased \$6.1 million. Significant changes in account balances were noted for the following:

Accounts receivable increased \$2.4 million, which was brought on by new power rates that were substantially higher than the previous rates.

Inventory, primarily fuel, increased \$1.2 million due to increased fuel prices.

Deferred fuel cost was \$1 million. This represents the difference between actual fuel costs and electric fuel charge revenues, resulting in a net under-recovery of fuel costs.

Capital assets, net of accumulated depreciation, increased \$3.9 million due to additions to plant and equipment.

Cash and equivalents decreased \$2.3 million due to the timing of payments to major suppliers and contractors.

Total liabilities increased \$13.5 million. Significant changes in account balances were noted for the following:

Accounts payable increased \$2.2 million due to increased fuel prices.

Interest payable increased \$10.1 million. Interest continues to accrue on the notes payable to the Commonwealth Development Authority (CDA) totaling \$61.6 million. Although Legislation has authorized CDA to waive the principal and accrued interest, CUC and CDA have not yet finalized an agreement to carryout the provisions of the Public Laws.

Long-term debt, less current maturities, increased \$4.5 million. CUC acknowledged indebtedness to Commonwealth Ports Authority (CPA) for \$4.8 million for a sewerline, less current maturities.

Customer deposits increased \$500,000. This represents the net of deposits collected from customers with open accounts net of deposits refunded to customers with closed accounts.

Current maturities, long-term debt payable, decreased \$3.2 million.

Net deficiency increased \$7.4 million. Significant changes in balances were noted for the following:

Net deficiency decreased \$9.1 million primarily due to investments in capital assets, plant and equipment, of \$14.3 million less the related loan payable to CPA of \$4.8 million.

**COMMONWEALTH UTILITIES CORPORATION**  
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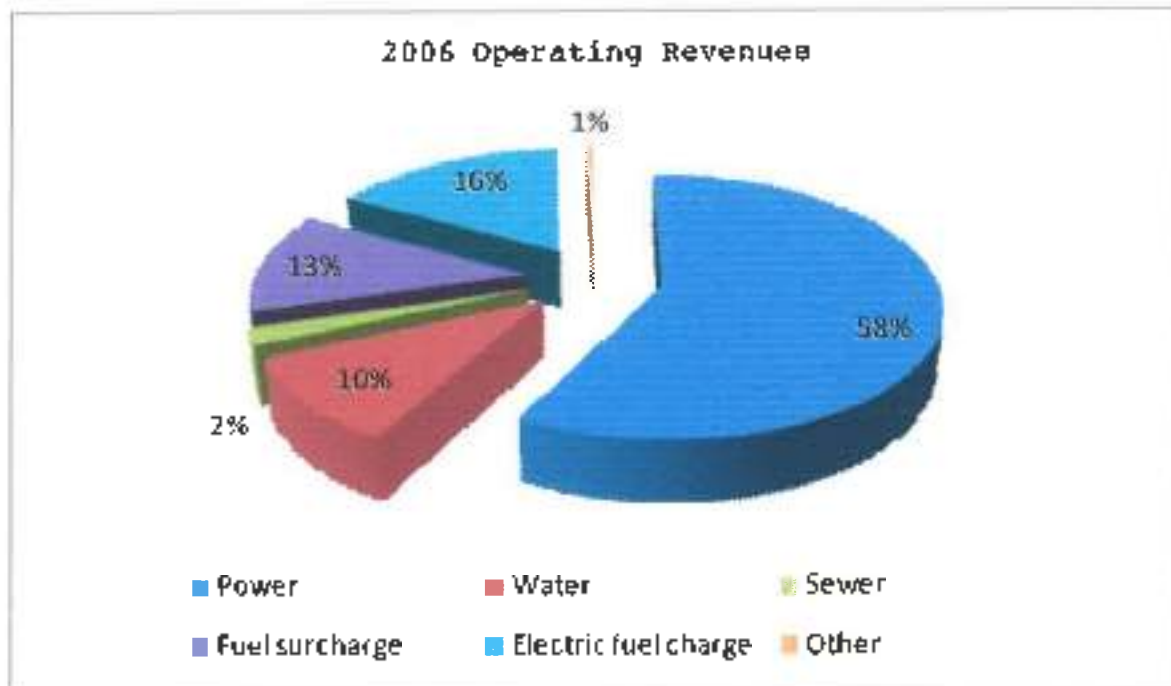
**MANAGEMENT'S DISCUSSION & ANALYSIS**  
 September 30, 2006

Net deficiency decreased \$3.5 million with the repayment of the loan payable to Mobil for \$4.4 million that was secured by restricted cash and equivalents.

Net deficiency increased \$18 million due primarily to the \$19.4 million loss from operations.

**Operating Revenues**

|                                | 2006                 | 2005                 | 2004                 |
|--------------------------------|----------------------|----------------------|----------------------|
| Power                          | \$ 51,232,196        | \$ 59,800,839        | \$ 59,176,587        |
| Water                          | 9,246,145            | 9,541,082            | 9,365,015            |
| Sewer                          | 1,849,869            | 2,205,589            | 2,290,258            |
| Fuel surcharge                 | 11,151,559           | 7,629,234            | -                    |
| Electric fuel charge           | 14,378,371           | -                    | -                    |
| Other                          | 498,181              | 841,999              | 556,311              |
| <b>Total</b>                   | <b>88,326,321</b>    | <b>80,018,743</b>    | <b>71,388,171</b>    |
| Bad debts                      | -                    | (1,139,757)          | (6,921,530)          |
| <b>Operating revenues, net</b> | <b>\$ 88,326,321</b> | <b>\$ 78,878,986</b> | <b>\$ 64,466,641</b> |



In 2006, operating revenues increased more than \$8.3 million (10.4 percent) when compared to revenues for 2005, which increased \$8.6 million (12.1 percent) when compared to 2004.

COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

All, or the majority of the increases were related to power revenues. In 2006, power revenues (including fuel surcharge and electric fuel charge) increased \$9.3 million (13.8 percent) when compared to revenues for 2005, which increased \$8.3 million (13.9 percent) when compared to 2004.

In February 2005, CUC implemented a fuel surcharge fee as an interim measure to offset some of the increases in fuel costs until such time as a cost of service study could be conducted. The study was completed and new electric rates were implemented in July 2006 to replace existing electric rates and the fuel surcharge fee.

In 2006, water, sewer, and other (late charge) revenues decreased \$1 million (8 percent) when compared to revenues for 2005, which increased \$400,000 (3 percent) when compared to 2004.

The decrease in water revenues was brought on by the following: (1) continued installation of additional water meters to measure and bill water charges based on actual consumption, rather than the previous method that was based on an estimated flat rate assessment, has encouraged customers to now conserve water to lower their water charges; (2) closure of many garment manufacturing businesses, which were large consumers of water, have resulted in reduced water sales; and (3) the steady decline in the number of tourists visiting the islands have resulted in reduced water sales to hotels and businesses that service tourists.

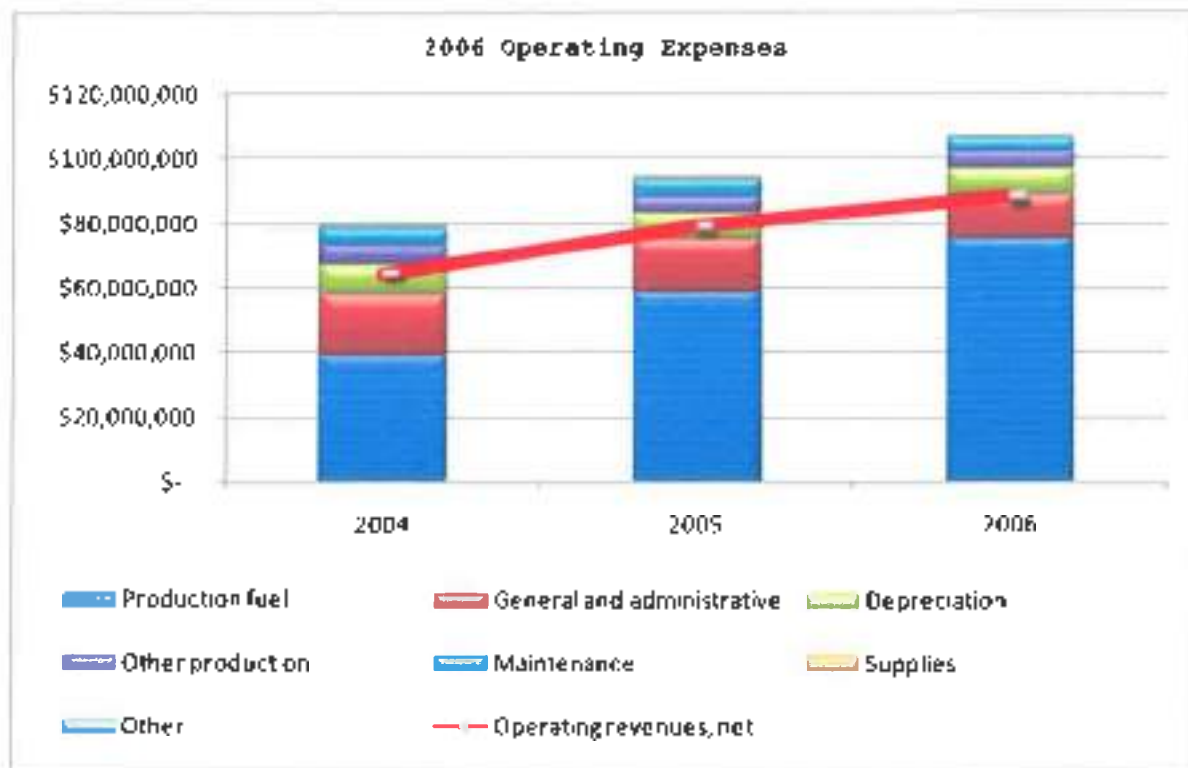
Because water consumption is used as a basis to assess and bill sewer charges, sewer revenues have declined for the same reasons mentioned for water.

**COMMONWEALTH UTILITIES CORPORATION**  
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**MANAGEMENT'S DISCUSSION & ANALYSIS**  
September 30, 2006

Operating Expenses

|                            | 2006                  | 2005                 | 2004                 |
|----------------------------|-----------------------|----------------------|----------------------|
| Production fuel            | \$ 76,027,452         | \$ 59,246,625        | \$ 39,812,826        |
| General and administrative | 13,425,821            | 16,270,152           | 18,680,894           |
| Depreciation               | 8,213,412             | 8,182,733            | 9,107,348            |
| Other production           | 5,392,323             | 5,291,414            | 6,182,042            |
| Maintenance                | 3,812,540             | 5,132,005            | 5,026,514            |
| Supplies                   | 350,495               | 579,358              | 683,814              |
| Other                      | 507,800               | 338,431              | 449,819              |
|                            | <u>\$ 107,729,843</u> | <u>\$ 95,040,718</u> | <u>\$ 79,943,257</u> |



This graph shows the total relationship of the total operating expenses (stacked bar graph) in relation to the total operating revenues (line graph).

In 2006, total operating expenses increased about \$12.7 million (13.4 percent) when compared to expenses for 2005, which increased \$15.1 million (18.9 percent) when compared to 2004.

Were it not for management's cost-cutting measures implemented in 2006 and 2005, the increase in operating expenses would have been much higher.

COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

In 2006, production fuel was \$76 million, an increase \$16.8 million (28.3 percent) when compared to 2005, which increased \$19.4 million (48.8 percent) when compared to 2004. Production fuel is the single largest expense of CUC, accounting for 70.6 percent of total expenses for 2006, 62.3 percent for 2005, and 49.8 percent for 2004. The increase in the price of production fuel was brought on primarily by worldwide demand for petroleum products and 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 that are beyond CUC's control. Thus, in fiscal year 2006, the overall average price of production fuel was \$2.15 per gallon, an increase of 55 cents per gallon (34.4 percent) when compared to 2005, which increased 56 cents per gallon (53.8 percent) when compared to 2004.

Nonetheless, sizeable reductions in operating expenses occurred in two areas in particular: (1) general and administrative expense and (2) maintenance expense.

In 2006, general and administrative expense, which is primarily personnel costs and related benefits, decreased \$2.8 million (17.5 percent) when compared to 2005, which also decreased by \$2.4 million (12.9 percent) when compared to 2004.

In 2006, maintenance expense decreased \$1.3 million (25.0 percent) when compared to 2005, which increased by only \$100,000 (2 percent) when compared to 2004.

Conversely, in 2006, other production expense increased by \$100,000 (2 percent) when compared to 2005, which decreased \$900,000 (14.4 percent) when compared to 2004. The increase in 2006 was brought on by the decrease in maintenance expense that resulted in equipment failures for some of the larger power generating equipment. In an effort to provide electric service to all CUC customers, CUC purchased additional production from its independent power producer.

In 2006, supplies and other expenses decreased a total of about \$100,000 (6.5 percent) when compared to 2005, which decreased by \$200,000 (19 percent) when compared to 2004.

**COMMONWEALTH UTILITIES CORPORATION**  
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**MANAGEMENT'S DISCUSSION & ANALYSIS**  
September 30, 2006

Capital Projects

CUC incurred capital expenditures and recognized related revenue in the form of capital contributions of \$7.3 million in fiscal year 2006, which is an increase of \$3.4 million (86.9 percent) when compared to fiscal year 2005.

The capital contributions, by source, are as follows:

|         | 2006                |               | 2005                |               |
|---------|---------------------|---------------|---------------------|---------------|
|         | Amount              | %             | Amount              | %             |
| Federal | \$ 4,121,841        | 56.5%         | \$ 2,767,319        | 70.8%         |
| Local   | 3,179,130           | 43.5%         | 1,139,059           | 29.2%         |
| Total   | <u>\$ 7,300,971</u> | <u>100.0%</u> | <u>\$ 3,906,378</u> | <u>100.0%</u> |

Following is a summary of the CUC's major capital expenditures for 2006:

Federal Assistance

The U.S. Department of the Interior provided \$3.2 million, for the following:

- Power Plant Rehabilitation \$1.5 million
- Sewer System Upgrade \$1.4 million
- Waterline Improvements \$ .3 million

The U.S. Department of Homeland Security, Federal Emergency Management Agency (FEMA), provided \$500,000 as public assistance to repair and or replace power, water, and sewer systems and related equipment damaged during typhoons.

The U.S. Environmental Protection Agency provided \$400,000 for the upgrade of sewer and water systems and related equipment.

Local Assistance

The Commonwealth Ports Authority provided \$2 million of the \$6.8 million required for a sewer system for the southern portion of Saipan.

The CNMI government, as a pass-through grant, provided \$1.2 million of Covenant 302 funds received from the U.S. Department of the Interior, for the upgrade of sewer and water systems and related equipment.

Additional information about capital activities appears in Note 4 - Capital Assets of the Notes to the Financial Statements.

COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

Debt

Long-term debts as of September 30, 2006 and 2005 are as follows:

|   | <u>2006</u>         | <u>2005</u>         |
|---|---------------------|---------------------|
| Commonwealth Development Authority      | \$61,568,750        | \$61,568,750        |
| Commonwealth Ports Authority            | 8,215,026           | 3,385,131           |
| Mobil Oil Mariana Islands, Inc.         | 574,105             | 3,820,372           |
| United States Department of Agriculture | <u>107,530</u>      | <u>156,716</u>      |
| Total                                   | 70,465,411          | 68,930,969          |
| Less current portion                    | <u>61,901,560</u>   | <u>64,864,204</u>   |
| Long-term debt, net of current portion  | <u>\$ 8,563,851</u> | <u>\$ 4,066,765</u> |

In July 2006, the Commonwealth Ports Authority (CPA) conveyed to CUC a sewerline situated in the southern portion of Saipan. In return, CUC acknowledged an obligation of \$4,829,894 for its share of the infrastructure costs for the design, management, and construction of the sewerline. Interest is 6.25 percent with monthly payments of \$93,938 for 5 years. First payment is due on October 31, 2007.

In addition, on June 30, 2006, CUC fully liquidated its debt rescheduling agreement with Mobil Oil Mariana Islands, Inc. that was for an outstanding liability of \$3,710,018 for fuel purchases.

Additional information about debt activities appears in Note 5 - Long-term Debt of the Notes to the Financial Statements.

COMMONWEALTH UTILITIES CORPORATION  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2006

ECONOMIC FACTORS AND FUTURE PLANS

With the implementation of new electric rates in July 2006, CUC believes that was the first major step in its efforts to achieve full cost recovery. Accordingly, CUC plans to have the electric rates reviewed and updated annually. In addition, CUC is moving forward with plans to have the water and wastewater cost of service studies finalized and new rates implemented at the earliest. Such rates would be developed in accordance with generally accepted rate making principles. The rates 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 operations. In this regard, CUC will place emphasis on the privatization of the power plants located on Saipan and Rota.

To improve its financial condition, CUC plans to continue negotiations with the Commonwealth Development Authority to resolve the issue of CUC's long-outstanding debt approximating \$61.6 million and the related accrued interest payable approximating \$105.1 million as of September 30, 2006. 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. If amounts are under dispute, CUC will work diligently toward their resolution and offer reasonable payment arrangements for unpaid amounts. When determined that a receivable is no longer collectible, CUC will promptly write-off the receivable.

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers and creditors with a general overview of the CUC's finances and to demonstrate accountability for the funds it manages. Please direct any questions about this report or requests for additional information about CUC's finances to:

Commonwealth Utilities Corporation  
Attn: Chief Financial Officer,  
PO Box 501220  
Saipan, MP 96950

Or, call (670) 235-7025 through 7032 or email at [acquerro@cuccgov.net](mailto:acquerro@cuccgov.net).



**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CMU Government)

Statements of Net Assets (Deficiency)  
September 30, 2006 and 2005

ASSETS

|   | 2006               | 2005<br>Restated   |
|---|--------------------|--------------------|
| <b>Current assets</b>   |                    |                    |
| <b>Current unrestricted assets</b>  |                    |                    |
| Cash and cash equivalents   | \$ 1,521,874       | \$ 3,794,728       |
| Accounts receivable - utility, net of allowance<br>of \$10,502,676 and \$25,875,748 in 2006 and<br>2005, respectively | 12,088,470         | 9,631,599          |
| Other receivables, net of allowance of \$899,067<br>in 2006 and 2005  | 1,532,775          | 1,837,249          |
| Due from grantor agencies   | 936,654            | 1,235,076          |
| Inventory, less allowance for obsolescence of<br>\$730,652 and \$701,462 in 2006 and 2005,<br>respectively            | 10,575,003         | 9,328,099          |
| Deferred fuel costs   | 1,641,561          | -                  |
| <b>Total current unrestricted assets</b>  | <b>27,696,737</b>  | <b>25,826,751</b>  |
| <b>Current restricted assets</b>  |                    |                    |
| Cash and cash equivalents   | 7,870,804          | 7,591,615          |
| <b>Total current restricted assets</b>  | <b>7,870,804</b>   | <b>7,591,615</b>   |
| <b>Total current assets</b>   | <b>35,567,541</b>  | <b>33,418,366</b>  |
| <b>Noncurrent assets</b>  |                    |                    |
| <b>Capital assets</b>   |                    |                    |
| Utility plant in service  |                    |                    |
| Electric plant  | 123,333,921        | 118,129,929        |
| Water plant   | 62,705,859         | 59,176,887         |
| Sewer plant   | 29,634,620         | 23,697,843         |
| Administrative equipment  | 4,588,582          | 4,440,307          |
| <b>Total</b>  | <b>219,762,982</b> | <b>205,445,566</b> |
| Accumulated depreciation  | (128,985,586)      | (120,844,555)      |
| <b>Net utility plant and administrative equipment</b>   | <b>90,777,396</b>  | <b>84,601,011</b>  |
| Construction in progress  | 12,613,859         | 14,851,784         |
| <b>Total capital assets</b>   | <b>103,391,255</b> | <b>99,452,795</b>  |
| <b>TOTAL ASSETS</b>   | <b>138,958,796</b> | <b>132,871,161</b> |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
 (A Component Unit of the CNMI Government)

Statements of Net Assets (Deficiency)  
 September 30, 2006 and 2005

|  | <u>2006</u>            | <u>2005</u><br>Restated |
|--|------------------------|-------------------------|
| <b><u>LIABILITIES</u></b>  |                        |                         |
| <b>Current liabilities</b>   |                        |                         |
| Current maturities of long-term debt   | \$ 61,620,948          | \$ 61,617,939           |
| Current obligations under capital lease  | 1,521,801              | 1,271,733               |
| Accounts payable   | 11,522,274             | 9,342,340               |
| Accrued liabilities  | 56,055                 | 133,957                 |
| Accrued payroll  | 301,463                | 553,220                 |
| Compensated absences, current portion  | 148,897                | 399,822                 |
| Due to primary government  | 2,026,212              | 1,331,453               |
| Interest payable   | 105,136,517            | 95,026,462              |
| Customer deposits  | 9,727,956              | 9,219,337               |
| Current maturities of long-term debt payable<br>from current restricted assets | -                      | 3,246,265               |
| <b>Total current liabilities</b>   | <u>192,262,123</u>     | <u>182,142,468</u>      |
| <b>Noncurrent liabilities</b>  |                        |                         |
| Long-term debt less current maturities   | 8,644,463              | 4,066,765               |
| Obligations under capital lease, less current maturities                       | 2,681,735              | 4,703,536               |
| Advances from CNMI Government  | 180,911                | -                       |
| Compensated absences, less current portion                                     | 370,478                | 423,585                 |
| <b>Total noncurrent liabilities</b>  | <u>12,077,587</u>      | <u>8,693,886</u>        |
| <b>TOTAL LIABILITIES</b>   | <u>204,339,710</u>     | <u>190,836,354</u>      |
| <b><u>NET ASSETS (DEFICIENCY)</u></b>  |                        |                         |
| <b>Net assets (deficiency)</b>   |                        |                         |
| Invested in capital assets, net of related debt                                | \$ 39,094,873          | \$ 29,005,394           |
| Restricted   | 7,870,804              | 4,345,350               |
| Unrestricted   | (111,350,391)          | (91,315,337)            |
| <b>NET DEFICIENCY</b>  | <u>\$ (65,384,914)</u> | <u>\$ (57,965,193)</u>  |
| <b>Commitments and contingencies</b>   |                        |                         |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Revenues, Expenses and Changes in Net Deficiency  
September 30, 2006 and 2005

|  | <u>2006</u>            | <u>2005</u><br><u>restated</u> |
|--|------------------------|--------------------------------|
| Operating revenues                           |                        |                                |
| Power  | \$ 51,202,196          | \$ 49,800,839                  |
| Water  | 9,246,145              | 9,541,082                      |
| Sewer  | 1,849,869              | 2,205,589                      |
| Electric fuel charge                         | 14,378,371             | -                              |
| fuel surcharge                               | 11,151,559             | 7,629,234                      |
| Other  | 498,181                | 841,999                        |
|  | <u>88,326,321</u>      | <u>80,018,743</u>              |
| Total  | 88,326,321             | 80,018,743                     |
| Less bad debts                               | -                      | (1,139,757)                    |
|  | <u>88,326,321</u>      | <u>78,878,986</u>              |
| Net operating revenues                       | <u>88,326,321</u>      | <u>78,878,986</u>              |
| Operating expenses                           |                        |                                |
| Production fuel                              | 76,027,452             | 59,246,625                     |
| General and administrative                   | 13,425,821             | 14,270,152                     |
| Depreciation                                 | 8,213,612              | 8,182,733                      |
| Other production                             | 5,392,323              | 7,291,414                      |
| Maintenance                                  | 3,812,540              | 5,132,005                      |
| Supplies                                     | 350,495                | 579,358                        |
| Other  | 507,800                | 338,431                        |
|  | <u>107,729,843</u>     | <u>95,040,718</u>              |
| Total operating expenses                     | <u>107,729,843</u>     | <u>95,040,718</u>              |
| Loss from operations                         | <u>(19,403,522)</u>    | <u>(16,161,732)</u>            |
| Non-operating revenues (expenses)            |                        |                                |
| Recovery of bad debts                        | 15,273,467             | -                              |
| Interest income                              | 352,287                | 276,790                        |
| Miscellaneous income                         | 67,104                 | -                              |
| Gain on sale of capital assets               | -                      | 27,265                         |
| Settlement income (expense)                  | (51,962)               | 795,800                        |
| Contribution to the primary government       | (694,759)              | (694,759)                      |
| Interest expense                             | (11,305,267)           | (10,598,165)                   |
|  | <u>3,640,869</u>       | <u>(10,193,069)</u>            |
| Total non-operating revenues (expenses), net | <u>3,640,869</u>       | <u>(10,193,069)</u>            |
| Cost to be recovered in future period        | <u>1,041,961</u>       | <u>-</u>                       |
| Net loss before capital contributions        | <u>(14,720,692)</u>    | <u>(26,354,801)</u>            |
| Capital contributions                        | <u>7,300,971</u>       | <u>3,936,378</u>               |
| Change in net deficiency                     | <u>(7,419,721)</u>     | <u>(22,418,423)</u>            |
| Net deficiency, beginning                    | <u>(57,965,193)</u>    | <u>(30,332,640)</u>            |
| Restatement                                  | <u>-</u>               | <u>(5,181,130)</u>             |
| Net deficiency, ending                       | <u>\$ (65,384,914)</u> | <u>\$ (57,965,193)</u>         |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Cash Flows  
September 30, 2006 and 2005

|  | <u>2006</u>         | <u>2005</u><br><u>Related</u> |
|--|---------------------|-------------------------------|
| Cash flows from operating activities:                                    |                     |                               |
| Cash received from customers   | \$ 86,615,439       | \$ 79,227,637                 |
| Cash payments to suppliers for goods and services                        | (79,994,105)        | (69,396,022)                  |
| Cash payments to employees for services                                  | (8,953,998)         | (12,607,597)                  |
| Net cash used for operating activities                                   | <u>(2,332,665)</u>  | <u>(2,775,982)</u>            |
| Cash flows from noncapital financing activities:                         |                     |                               |
| Advances from primary government   | <u>180,911</u>      | <u>-</u>                      |
| Net cash provided by noncapital financing activities                     | <u>180,911</u>      | <u>-</u>                      |
| Cash flows from capital and related financing activities:                |                     |                               |
| Acquisition and construction of capital assets                           | (1,752,064)         | (4,318,183)                   |
| Proceeds from sale of capital assets                                     | -                   | 27,265                        |
| Capital contributions received   | 7,599,393           | 4,449,216                     |
| Principal repayment of debt  | (4,567,186)         | (1,572,856)                   |
| Interest paid on outstanding debt  | (1,195,152)         | (1,151,417)                   |
| Net decrease (increase) in restricted time certificates of deposit       | <u>(279,189)</u>    | <u>6,240,209</u>              |
| Net cash provided by (used for) capital and related financing activities | <u>(134,198)</u>    | <u>3,674,032</u>              |
| Cash flows from investing activities:                                    |                     |                               |
| Interest received on time certificates of deposit                        | <u>352,287</u>      | <u>276,790</u>                |
| Net cash provided by investing activities                                | <u>352,287</u>      | <u>276,790</u>                |
| Net change in cash and cash equivalents                                  | (1,993,665)         | 1,174,840                     |
| Cash and cash equivalents at beginning of year                           | <u>11,386,343</u>   | <u>10,211,503</u>             |
| Cash and cash equivalents at end of year                                 | <u>\$ 9,392,678</u> | <u>\$ 11,386,343</u>          |
| <br>   |                     |                               |
| Cash and cash equivalents  | \$ 1,521,874        | \$ 3,794,728                  |
| Restricted cash and cash equivalents                                     | <u>7,870,804</u>    | <u>7,591,615</u>              |
|  | <u>\$ 9,392,678</u> | <u>\$ 11,386,343</u>          |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Cash Flows  
September 30, 2006 and 2005

|  | <u>2006</u>               | <u>2005</u><br>Restated   |
|--|---------------------------|---------------------------|
| Reconciliation of loss from operations to net cash used for operating activities:              |                           |                           |
| Loss from operations   | \$ (19,403,522)           | \$ (16,161,732)           |
| Adjustments to reconcile loss from operations to net cash used for operating activities:       |                           |                           |
| Depreciation   | 8,213,412                 | 8,182,733                 |
| Decrease in provision for inventory obsolescence   | -                         | -                         |
| Provision for bad debts  | -                         | 1,139,757                 |
| Recovery of bad debts  | (15,273,467)              | -                         |
| Miscellaneous income   | (67,104)                  | -                         |
| Settlement income  | 54,963                    | 795,600                   |
| Restatement  | 5,184,130                 | -                         |
| (Increase) decrease in assets:   |                           |                           |
| Accounts receivable - utility  | 12,816,596                | (1,401,765)               |
| Other receivables  | 304,474                   | (831,043)                 |
| Inventory  | (1,246,904)               | 2,135,711                 |
| Increase (decrease) in liabilities:  |                           |                           |
| Accounts payable   | 2,179,934                 | 3,080,362                 |
| Accrued liabilities  | (77,902)                  | (388,523)                 |
| Accrued payroll  | (251,757)                 | 137,672                   |
| Compensated absences   | (104,037)                 | (110,856)                 |
| Customer deposits  | 508,619                   | 645,902                   |
| Long-term debt   | 4,829,895                 | -                         |
| <br>Net cash used for operating activities   | <br><u>\$ (2,332,665)</u> | <br><u>\$ (2,775,982)</u> |
| <br>Supplemental disclosure of noncash capital and related financing and operating activities: |                           |                           |
| <br>Accrual of progress billings related to various ongoing capital projects:                  |                           |                           |
| Noncash increase in due from grantor agencies  | \$ -                      | \$ 366,659                |
| Noncash increase in accrued liabilities  | -                         | (366,659)                 |
|  | <u>\$ -</u>               | <u>\$ -</u>               |
| <br>Conversion of accounts payable to notes payable  |                           |                           |
| Noncash decrease in accounts payable   | \$ (4,829,895)            | \$ (3,710,018)            |
| Noncash increase long-term debt  | 4,829,895                 | 3,710,018                 |
|  | <u>\$ -</u>               | <u>\$ -</u>               |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

**Supplementary Information**  
**Statement of Revenues, Expenses and Changes in Net Deficiency on a Divisional Basis**  
**September 30, 2006**

|   | Public              | Water              | Sewer              | Administrative<br>and<br>General | Internal<br>Revenue<br>and<br>Expenses | Total<br>2006       |
|---|---------------------|--------------------|--------------------|----------------------------------|--|---------------------|
| <b>Operating revenues:</b>                            |                     |                    |                    |                                  |  |                     |
| Governmental  |                     |                    |                    |                                  |  |                     |
| CNMI Government                                       | \$ 7,911,168        | \$ 2,601,200       | \$ 1,011,744       | \$ -                             | \$ -                                   | \$ 11,524,112       |
| CNMI Agencies   | 4,652,610           | 1,604,893          | 445,336            | -                                | (2,201,614)                            | 4,499,229           |
| <b>Total governmental</b>                             | <b>12,563,778</b>   | <b>4,206,093</b>   | <b>1,457,080</b>   | <b>-</b>                         | <b>12,201,614</b>                      | <b>16,196,771</b>   |
| Commercial  | 45,224,203          | 2,252,592          | 539,045            | -                                | -                                      | 48,015,840          |
| Residential   | 22,956,091          | 3,355,838          | 153,649            | -                                | -                                      | 26,465,578          |
| Other   | (1,351,253)         | (113,382)          | (322,745)          | 490,152                          | -                                      | (1,297,228)         |
| <b>Total operating revenues</b>                       | <b>19,012,740</b>   | <b>8,246,144</b>   | <b>1,819,859</b>   | <b>490,152</b>                   | <b>12,201,614</b>                      | <b>31,770,419</b>   |
| Net debts   | -                   | -                  | -                  | -                                | -                                      | -                   |
| <b>Net operating revenues</b>                         | <b>19,012,740</b>   | <b>8,246,144</b>   | <b>1,819,859</b>   | <b>490,152</b>                   | <b>12,201,614</b>                      | <b>31,770,419</b>   |
| <b>Operating expenses:</b>                            |                     |                    |                    |                                  |  |                     |
| Production fuel                                       | 16,023,452          | -                  | -                  | -                                | -                                      | 16,023,452          |
| General and administrative                            | 5,106,840           | 2,163,221          | 1,032,630          | 5,397,150                        | -                                      | 13,700,041          |
| Depreciation  | 4,698,951           | 2,119,002          | 1,079,615          | 321,842                          | -                                      | 8,218,410           |
| Other production                                      | 4,441,231           | 7,401,564          | 629,738            | 346,396                          | (2,201,614)                            | 10,606,214          |
| Maintenance   | 3,316,012           | 332,309            | 49,214             | 15,005                           | -                                      | 3,712,540           |
| Supplies  | 50,285              | 243,461            | 7,755              | 44,184                           | -                                      | 345,585             |
| Other   | -                   | -                  | -                  | 502,360                          | -                                      | 502,360             |
| <b>Total operating expenses</b>                       | <b>33,636,775</b>   | <b>10,258,557</b>  | <b>2,819,312</b>   | <b>6,345,151</b>                 | <b>12,201,614</b>                      | <b>55,261,319</b>   |
| <b>Shortage (loss) from operations</b>                | <b>(14,624,035)</b> | <b>2,012,413</b>   | <b>(1,000,053)</b> | <b>(5,854,999)</b>               | <b>-</b>                               | <b>(19,466,684)</b> |
| <b>Non-operating revenues (expenses):</b>             |                     |                    |                    |                                  |  |                     |
| Recovery of bad debts                                 | -                   | -                  | -                  | 15,273,467                       | -                                      | 15,273,467          |
| Interest income                                       | -                   | -                  | -                  | 352,287                          | -                                      | 352,287             |
| Miscellaneous income                                  | -                   | -                  | -                  | 67,104                           | -                                      | 67,104              |
| Gain on sale of capital assets                        | -                   | -                  | -                  | -                                | -                                      | -                   |
| Settlement expenses                                   | -                   | -                  | -                  | (51,363)                         | -                                      | (51,363)            |
| Contributions to the primary government               | -                   | -                  | -                  | (694,158)                        | -                                      | (694,158)           |
| Interest expense                                      | (10,486,478)        | (813,798)          | (4,093)            | -                                | -                                      | (11,304,369)        |
| <b>Total non-operating revenues</b>                   | <b>(10,486,478)</b> | <b>(813,798)</b>   | <b>(4,093)</b>     | <b>14,946,136</b>                | <b>-</b>                               | <b>3,648,863</b>    |
| <b>Cost to be recovered in future period</b>          | <b>1,041,961</b>    | <b>-</b>           | <b>-</b>           | <b>-</b>                         | <b>-</b>                               | <b>1,041,961</b>    |
| <b>Net income (loss) before capital contributions</b> | <b>(14,171,553)</b> | <b>961,784</b>     | <b>(1,006,084)</b> | <b>9,445,161</b>                 | <b>-</b>                               | <b>(14,770,692)</b> |
| Capital contributions                                 | 7,023,750           | 852,281            | 4,815,952          | -                                | -                                      | 12,691,983          |
| <b>Change in net deficiency</b>                       | <b>(7,147,803)</b>  | <b>(1,044,303)</b> | <b>(1,011,136)</b> | <b>(9,445,161)</b>               | <b>-</b>                               | <b>(19,648,403)</b> |

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(1) Organization

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.

(2) Summary of Significant Accounting Policies

*Measurement Focus, Basis of Accounting and Basis of Presentation*

CUC maintains an enterprise fund to account for its operations. An enterprise fund is a proprietary fund, which is accounted for on the flow of economic resources measurement focus and uses the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Enterprise funds are used to account for operations that are financed and operated in a manner similar to a private business enterprise, where the intent of management is to finance the costs of providing services to the public primarily through user charges.

The accompanying financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP). The accompanying financial statements have been prepared in accordance with the reporting model defined by Governmental Accounting Standards Board (GASB) Statement No. 34, "Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments", as amended by GASB Statement No. 37, "Basic Financial Statements and Management's Discussion and Analysis - for State and Local Governments: Omnibus" - an Amendment of GASB Statements No. 21 and No. 34, and GASB Statement No. 38, "Certain Financial Statement Note Disclosures".

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Accounting Standards*

GASB Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting", requires that governments' proprietary activities apply all GASB pronouncements as well as pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, Financial Accounting Standards Board ("FASB") Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins. Governments are given the option whether or not to apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. CUC has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

*New Pronouncements*

GASB Statement No. 43 - In April 2004, the GASB issued Statement No. 43, "Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans". This statement establishes accounting and financial reporting standards for plans that provide postemployment benefits other than pension benefits (known as other postemployment benefits or OPEB). This statement did not have an impact on the financial statements of the CUC.

GASB Statement No. 45 - In June 2004, the GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions". This statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers. This statement is not effective until June 30, 2008. The CUC has not determined its effect on the financial statements.

GASB Statement No. 47 - In June 2005, the GASB issued Statement No. 47, "Accounting for Termination Benefits". This statement establishes accounting guidance and disclosure requirements for termination benefit arrangements. This statement is effective in two parts. For termination benefits provided through an existing defined OPEB, the provisions should be implemented simultaneously with GASB Statement No. 45. For all other termination benefits, this statement is effective for periods beginning after June 15, 2005. The CUC has not determined its effect on the financial statements.

GASB Statement No. 48 - In September 2006, the GASB issued Statement No. 48, "Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues". This statement addresses accounting and financial reporting standards for transactions where governments exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. This statement establishes criteria and reporting standards regarding the exchange as either a sale or collateralized borrowing, resulting in a liability. This statement is not effective until June 30, 2008. The CUC has not determined its effect on the financial statements.



COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

12) Summary of Significant Accounting Policies, Continued

*New Pronouncements, Continued*

GASB Statement No. 49 - In November 2006, the GASB issued Statement No. 49, "Accounting and Financial Reporting for Pollution Remediation Obligations". This statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. This statement is not effective until June 30, 2009. The CUC has not determined its effect on the financial statements.

GASB Statement No. 50 - In May 2007, the GASB issued Statement No. 50, "Pension Disclosures - an amendment of GASB Statements No. 25 and No. 27". This statement more closely aligns the financial reporting requirements for pensions with those for OPEB and, in doing so, enhances information disclosed in notes to financial statements or presented as RSI by pension plans and by employers that provide pension benefits. This statement is not effective until June 30, 2008. The CUC has not determined its effect on the financial statements.

GASB Statement No. 51 - In June 2007, the GASB issued Statement No. 51, "Accounting and Financial Reporting for Intangible Assets". This statement establishes accounting and financial reporting standards for many different types of assets that may be considered intangible assets, including easements, water rights, timber rights, patents, trademarks, and computer software. This statement is not effective until June 30, 2010. The CUC has not determined its effect on the financial statements.

*Budgets*

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

*Cash and Cash Equivalents*

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 Deficiencies.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Cash and Cash Equivalents, Continued*

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 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.

At September 30, 2006 and 2005, cash and cash equivalents were \$9,392,678 and \$11,386,343, respectively, and the corresponding bank balances were \$9,487,848 and \$11,722,264, respectively. Of the bank balance amounts, \$9,398,295 and \$11,693,707, respectively were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$200,000 and \$135,441, respectively were FDIC insured as of September 30, 2006 and 2005. 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.

*Restricted Cash and Cash Equivalents*

Of the restricted cash and cash equivalents of \$7,870,804 and \$7,591,615 at September 30, 2006 and 2005, respectively, \$7,840,588 in 2006 and \$7,561,399 in 2005 represents customer deposits, of which, \$7,500,000 in 2006 and 2005 is 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.

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September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Restricted Cash and Cash Equivalents, Continued*

Cash and cash equivalents of \$30,217 as of September 30, 2006 and 2005 represent advances from a grantor agency for the use on a specific project and, accordingly are classified as restricted in the accompanying financial statements.

*Accounts Receivable and Allowance for Uncollectable Accounts*

Accounts receivable are classified as current assets and are reported net of an allowance for uncollectible amounts.

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 (100%) of account balances greater than seventy-five (75) days old.

*Inventory*

Fuel and lubes inventory are valued at the lower of cost (first-in, first-out) or market (net realizable value). Material and supplies inventory are valued at average cost.

Inventory as of September 30, 2006 and 2005 are as follows:

|                                 | <u>2006</u>         | <u>2005</u>         |
|---------------------------------|---------------------|---------------------|
| Fuel and lubes                  | \$ 1,226,901        | \$ 1,020,358        |
| Materials and supplies          | <u>8,048,672</u>    | <u>8,608,203</u>    |
| Total                           | 11,275,655          | 10,029,561          |
| Less allowance for obsolescence | <u>700,652</u>      | <u>701,462</u>      |
| Inventory, net                  | <u>\$10,575,003</u> | <u>\$ 9,328,099</u> |

COMMONWEALTH UTILITIES CORPORATION  
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Notes to Financial Statements  
September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Fuel Oil Costs*

Fuel oil costs increase or decrease billings to customers based on price change in fuel oil purchased by CUC. Under or over recovery of fuel oil cost is recorded as deferred fuel cost asset or liability, respectively, in the accompanying Statement of Net Assets (Deficiency), and are recovered or deducted in future billings to customers based on the amendments to part 24 of the Electric Service Regulations of the CUC adopted on July 20, 2006. Electric fuel rates are computed monthly. Any difference between the actual fuel costs and the electric fuel rate shall be accumulated in a deferred account and subject to annual reconciliation. No interest will be charged or paid on any under- or over-recovery balance in the deferred account.

*Capital Assets and Depreciation*

Capital assets consist of utility plant, administrative equipment and construction-in-progress. Capital assets are stated at original cost, where costs are available, less accumulated depreciation. Depreciation is provided on the straight-line method based on the estimated useful lives of the respective assets, which range from 3 to 20 years. The costs of additions and replacements are capitalized. Repairs and maintenance are charged to expense as incurred. Retirements, sales and disposals are recorded by removing the cost and accumulated depreciation from the asset and accumulated depreciation accounts with any resulting gain or loss reflected in non-operating revenues (expenses) in the statements of revenues, expenses and changes in net deficiency. Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the fair value is less than the carrying amount of the asset, a loss is recognized for the difference.

Current policy is to capitalize items in excess of \$1,000. The costs of acquisition and construction of equipment and facilities are recorded as construction-in-progress until such assets are completed and placed in service, at which time the CUC commences recording depreciation expense.

*Compensated Absences*

Compensated absences are accrued and reported as a liability in the period earned. Annual leave to be paid out within the next fiscal year is accrued and is included in current liabilities. The liability at September 30, 2006 and 2005 was \$719,375 and \$823,407, respectively. No liability is recorded for non-vesting accumulating rights to receive sick pay benefits.

An employee cannot carry over to the following calendar year accumulated annual leave in excess of three hundred sixty (360) hours. However, any annual leave accumulated in excess of 360 hours as of the end of the calendar year can be converted to sick leave on the last day of such calendar year.

COMMONWEALTH UTILITIES CORPORATION  
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Notes to Financial Statements  
September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Net Assets (Deficiency)*

Net assets represent the residual interest in CUC's assets after liabilities while net deficiency represents the excess liability over assets. Net assets (deficiencies) consist of three sections: invested in capital assets, net of related debt; restricted expendable and unrestricted; and unrestricted. Net assets invested in capital assets, net of debt include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation, of the restricted net assets, \$340,587 and \$61,398 as of September 30, 2006 and 2005, respectively are expendable.

*Retirement Plan*

CUC contributes to the Northern Mariana Islands Retirement Fund (NMIRF), a defined benefit, cost-sharing multi-employer pension plan established and administered by the CNMI. NMIRF provides retirement, security and other benefits to employees of the CNMI government and CNMI agencies, instrumentalities and public corporations, and to their spouses and dependents. Benefits are based on the average annual salary over the term of credited service. Generally, benefits vest after three years of credited service. For early retirement, after 10 years of vesting service is required and members must be at least 52 years of age. Members, who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. CNMI Public Law 6-17, the Northern Mariana Islands Retirement Fund Act of 1988, is the authority under which benefit provisions are established.

As a result of the Fund's actuarial valuation report (as of October 1, 2003), it has been determined that for the year ended September 30, 2006, the funding requirement for employer is 36.7727% of covered payroll, and funding requirements for employees are 6.5% and 9.0% of covered payroll for Class I and Class II members, respectively.

Required contributions and the percentage actually contributed for the current year and for the preceding two years are as follows:

| <u>Fiscal Year</u> | <u>Required Contribution</u> | <u>Percentage of Covered Payroll</u> | <u>Actual Contribution</u> | <u>Percentage of Required Contributions Contributed</u> |
|--------------------|------------------------------|--------------------------------------|----------------------------|---|
| 2006               | \$3,136,714                  | 36.7727%                             | \$3,136,714                | 100%  |
| 2005               | \$2,451,132                  | 24.0000%                             | \$2,451,132                | 100%  |
| 2004               | \$2,903,663                  | 24.0000%                             | \$2,903,663                | 100%  |

COMMONWEALTH UTILITIES CORPORATION  
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Notes to Financial Statements  
September 30, 2006 and 2005

(2) Summary of Significant Accounting Policies, Continued

*Medical and Life Insurance Benefits*

In addition to providing pension benefits, the CNMI Government also ensures that employees are provided medical and life insurance benefits. The CNMI Government created the Group Health and Life Insurance Trust Fund (GHLITF), held in trust and administered by the Northern Mariana Islands Retirement Fund (NMIRF). CUC contributes to the Group Health and Life Insurance program. This is open to active employees who work at least 20 hours per week and retired CNMI government employees who retire as a result of length of service, disability or age, as well as their dependents. Further, those eligible persons must have elected to enroll during the period permitted in the Emergency Regulations adopted on September 5, 1996. Life insurance coverage are provided by a private carrier through the GHLITF. Contributions from employees and employers are based on rates as determined by NMIRF Board of Trustees. Employee deductions are made through payroll or pension benefit withholdings.

*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 non-operating 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, 2006 and 2005 are \$6,009,305 and \$5,157,463, respectively.

*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 2005 balances in the accompanying financial statements have been reclassified to conform to the 2006 presentation.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(3) Due from Grantor Agencies

CUC is a sub-recipient of federal grants received by the CNMI central government 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 account for the years ended September 30, 2006 and 2005 are as follows:

|  | <u>2006</u>       | <u>2005</u>        |
|--|-------------------|--------------------|
| Balance at beginning of year                     | \$1,235,076       | \$1,411,255        |
| Adjustment                                       | (139,038)         | (121,014)          |
| Deductions - cash receipts from grantor agencies | (4,994,154)       | (3,961,543)        |
| Additions - program outlays                      | <u>4,834,770</u>  | <u>3,906,378</u>   |
| Balance at end of year                           | <u>\$ 936,654</u> | <u>\$1,235,076</u> |

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2006 and 2005

14) Capital Assets

A Summary of the changes in capital assets activity for the years ended September 30, 2006 and 2005 were as follows:

|                                 | Estimated Useful Lives | Balance at October 1, 2006 | Acquisitions/ Transfers | Disposals/ Transfers | Adjustments/ Reconciliations | Balance at September 30, 2006 |
|---------------------------------|------------------------|----------------------------|-------------------------|----------------------|------------------------------|-------------------------------|
| <b>Utility plant in service</b> |                        |                            |                         |                      |                              |                               |
| Electric plant                  | 20 years               | \$110,179,929              | 5,041,972               | \$1,211,409          | 84,883,479                   | \$113,809,929                 |
| Water plant                     | 20 years               | 59,176,887                 | 186,440                 | -                    | 2,442,512                    | 61,795,887                    |
| Sewer plant                     | 20 years               | 23,697,813                 | 80,000                  | -                    | 1,856,777                    | 25,634,590                    |
| Administrative equipment        | 3-5 years              | 4,410,907                  | 44,817                  | -                    | 102,828                      | 4,558,552                     |
|                                 |                        | 205,445,566                | 853,199                 | (1,211,409)          | 15,485,026                   | 219,162,902                   |
| Accumulated depreciation        |                        | (126,844,555)              | (18,733,733)            | 21,409               | 46,512                       | (125,244,551)                 |
| Depreciable assets, net         |                        | 84,601,011                 | (7,860,213)             | -                    | 15,732,798                   | 92,473,596                    |
| Construction work-in-progress   |                        | 14,851,784                 | 2,842,135               | -                    | (2,080,662)                  | 15,613,257                    |
| Capital assets, net             |                        | \$99,452,795               | \$14,518,278            | \$-                  | \$13,652,136                 | \$127,623,159                 |
| <b>Utility plant in service</b> |                        |                            |                         |                      |                              |                               |
| Electric plant                  | 20 years               | \$117,216,577              | 513,115                 | \$13,338             | \$284,079                    | \$118,027,009                 |
| Water plant                     | 20 years               | 60,755,484                 | 50,419                  | (10,184)             | (1,181,757)                  | 59,613,887                    |
| Sewer plant                     | 20 years               | 23,615,454                 | 62,161                  | (502)                | 20,282                       | 23,691,295                    |
| Administrative equipment        | 3-5 years              | 4,535,054                  | 18,443                  | (16,354)             | (75,136)                     | 4,461,907                     |
|                                 |                        | 206,122,569                | 644,138                 | (29,984)             | (190,401)                    | 206,446,566                   |
| Accumulated depreciation        |                        | (114,204,984)              | (18,182,733)            | -                    | 1,543,262                    | (120,844,551)                 |
| Depreciable assets, net         |                        | 94,017,585                 | (17,538,595)            | (29,984)             | 152,161                      | 76,479,017                    |
| Construction work in progress   |                        | 12,524,735                 | 1,153,444               | -                    | (1,426,195)                  | 13,251,984                    |
| Capital assets, net             |                        | \$106,542,320              | \$16,385,150            | \$-                  | \$14,725,474                 | \$123,652,944                 |

Included in utility plant in service adjustments for fiscal year ended September 30, 2006 are completed projects transferred from construction work-in-progress of \$12,094,413.

Depreciation expense for the years ended September 30, 2006 and 2005 is \$9,213,412 and \$9,182,733, respectively.



**COMMONWEALTH UTILITIES CORPORATION**  
 [A Component Unit of the CMHI Government]

Notes to Financial Statements  
 September 30, 2006 and 2005

(5) Long-term Debt

Long-term debt at September 30, 2006 and 2005 is as follows:

|   | 2006                | 2005                |
|---|---------------------|---------------------|
| Commonwealth Development Authority      | \$61,568,750        | \$61,568,750        |
| Commonwealth Ports Authority            | 8,215,026           | 3,385,131           |
| Mobil Oil Mariana Islands, Inc          | 574,105             | 3,820,372           |
| United States Department of Agriculture | 107,530             | 156,716             |
| <b>Total</b>                            | <b>70,465,411</b>   | <b>68,930,969</b>   |
| Less current maturities                 | 61,620,948          | 64,864,204          |
| Long-term debt, net of current portion  | <u>\$ 8,844,463</u> | <u>\$ 4,066,765</u> |

Of the current portion of long-term debt \$0 and \$3,820,172 as of September 30, 2006 and 2005, respectively, are payable using restricted assets.

Changes in long-term debt for fiscal year ending September 30, 2006 are as follows:

|   | Balance at<br>October 1,<br>2004 | Additions          | Payments             | Balance at<br>September 30,<br>2005 |
|---|----------------------------------|--------------------|----------------------|-------------------------------------|
| Commonwealth Development Authority      | \$61,568,750                     | \$                 | -                    | \$ 61,568,750                       |
| Commonwealth Ports Authority            | 3,385,131                        | 4,829,895          | -                    | 8,215,026                           |
| Mobil Oil Mariana Islands, Inc          | 3,820,372                        | -                  | (3,246,267)          | 574,105                             |
| United States Department of Agriculture | 156,716                          | -                  | (49,186)             | 107,530                             |
| <b>Total</b>                            | <u>\$68,930,969</u>              | <u>\$4,829,895</u> | <u>\$(3,295,453)</u> | <u>\$ 70,465,411</u>                |

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(5) Long-term Debt, Continued

*Commonwealth Development Authority (CDA)*

A summary of CUC's loans payable to CDA as of September 30, 2006 and 2005 is as follows:

|  | 2006                | 2005                |
|--|---------------------|---------------------|
| Loan payable to CDA, a component unit of the CNMI, principal of \$30,000,000, interest at 7% per annum, with maturity date of February 17, 2013. Principal and interest payments are due in quarterly payments of \$658,469.   | \$30,000,000        | \$30,000,000        |
| Loan payable to CDA, principal of \$16,135,650, interest at 5% per annum with maturity date of January 12, 2014. Principal and interest payments are due in quarterly payments of \$359,514.   | 16,068,750          | 16,068,750          |
| Loan payable to CDA, principal of \$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           |
| Loan payable to CDA, principal of \$10,000,000 with 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 since the loan was obtained through Public Law 9-23. | 10,000,000          | 10,000,000          |
|  | <u>\$61,568,750</u> | <u>\$61,568,750</u> |

At September 30, 2006 and 2005, CUC was in default of repayment terms of all loans 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, 2006 and 2005, associated with the loans payable to CDA including interest payable on these notes of \$105,136,517 and \$95,026,402 as at September 30, 2006 and 2005, respectively, has been classified as current liabilities in 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 loans 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.

**COMMONWEALTH UTILITIES CORPORATION**  
{A Component Unit of the CNMI Government}

Notes to Financial Statements  
September 30, 2006 and 2005

(5) Long-term Debt, Continued

*Commonwealth Development Authority (CDA), Continued*

On 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.

On June 6, 2006, the Governor of the CNMI approved Public Law 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 Public Law 15-12 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.

*Commonwealth Ports Authority (CPA)*

A summary of CUC's loans payable CPA at September 30, 2006 and 2005 is as follows:

|   | 2006         | 2005         |
|---|--------------|--------------|
| Loan payable to CPA, a component unit of the CNMI, principal of \$3,385,131, interest at 6.25% per annum, with a maturity date of October 31, 2017. Principal and interest payments are due in monthly payments of \$38,008 beginning October 31, 2007. | \$ 3,385,131 | \$ 3,385,131 |
| Loan payable to CPA, principal of \$4,829,895, interest at 6.25% per annum with a maturity date of October 31, 2012. Principal and interest payments are due in monthly payments of \$93,938 beginning October 31, 2007.                                | 4,829,895    | -            |
| Total loans payable to CPA  | 8,215,026    | 3,385,131    |
| Less current portion  | -            | -            |
| Long-term debt, net of current portion  | \$ 8,215,026 | \$ 3,385,131 |

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2006 and 2005

(5) Long-term Debt, Continued

*Commonwealth Ports Authority (CPA), Continued*

Future repayment commitments of principal and interest are as follows:

| <u>Year ending</u><br><u>September 30,</u> | <u>Principal</u>   | <u>Interest</u>    | <u>Total</u>        |
|--|--------------------|--------------------|---------------------|
| 2008                                       | \$1,101,722        | \$481,631          | \$1,583,353         |
| 2009                                       | 1,171,967          | 411,387            | 1,583,354           |
| 2010                                       | 1,247,350          | 336,004            | 1,583,354           |
| 2011                                       | 1,327,501          | 255,773            | 1,583,354           |
| 2012                                       | 1,412,506          | 170,840            | 1,583,354           |
| 2013 - 2017                                | <u>1,953,900</u>   | <u>326,595</u>     | <u>2,280,495</u>    |
|  | <u>\$8,215,026</u> | <u>\$1,982,238</u> | <u>\$10,197,264</u> |

*United States Department of Agriculture*

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, 2006 and 2005, 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, 2006 and 2005:

|  | <u>2006</u>      | <u>2005</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. | \$ 107,529       | \$ 156,716        |
| Less current maturities  | <u>52,198</u>    | <u>49,187</u>     |
| Long-term loan payable   | <u>\$ 55,331</u> | <u>\$ 107,529</u> |

**COMMONWEALTH UTILITIES CORPORATION**  
 (A Component Unit of the CNMI Government)

Notes to Financial Statements  
 September 30, 2006 and 2005

15) Long-term Debt, Continued

*United States Department of Agriculture, Continued*

Future repayment commitments of principal and interest are as follows:

| <u>Year ending</u><br><u>September 30,</u> | <u>Principal</u>  | <u>Interest</u> | <u>Total</u>      |
|--|-------------------|-----------------|-------------------|
| 2007                                       | \$ 52,198         | \$ 6,586        | \$ 58,784         |
| 2008                                       | <u>55,331</u>     | <u>3,389</u>    | <u>58,720</u>     |
|  | <u>\$ 107,529</u> | <u>\$ 9,975</u> | <u>\$ 117,504</u> |

16) 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 ten (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.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government.)

Notes to Financial Statements  
September 30, 2006 and 2005

(6) Capital Lease, Continued

CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease", 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 | \$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 at September 30, 2006 is as follows:

| <u>Year ending<br/>September 30,</u> | <u>Principal</u>   | <u>Interest</u>    | <u>Total</u>       |
|--------------------------------------|--------------------|--------------------|--------------------|
| 2007                                 | \$1,521,801        | \$ 638,199         | \$2,160,000        |
| 2008                                 | 1,821,040          | 338,960            | 2,160,000          |
| 2009                                 | <u>860,695</u>     | <u>39,395</u>      | <u>900,000</u>     |
|                                      | <u>\$4,203,536</u> | <u>\$1,016,464</u> | <u>\$5,220,000</u> |

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(7) Due to Primary Government

Public Law 9-66, enacted on 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 CNMI Office of the Public Auditor (OPA) and the agency may agree, to fund the OPA. At September 30, 2006 and 2005, CUC had an outstanding payable to the primary government in the amount of \$2,026,212 and \$1,331,453, respectively.

(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 remained in effect until the end of calendar year 2005.

On July 2006, the CUC Electric Service Regulations, Part 24 Rate Schedules were 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, which includes an electric fuel charge, is effective beginning August 2006 utility consumption and was formally adopted on October 24, 2006.

Fuel surcharge revenue for the year ended September 30, 2006 and 2005 amounted to \$10,681,482 and \$7,629,234, respectively. The electric fuel charge was \$14,848,447 for the year ended September 30, 2006.

(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 a 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**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(10) Risk Management

The CNMI government is a self-insured entity. The government has limited its general liability to individuals to \$100,000 by statute. For this reason the government does not maintain any insurance on its buildings, or employees. At some future date, CUC may insure some of its assets, as an autonomous agency as it is not required to follow the CNMI's government of self-insurance.

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, however, requires performance bonds on all its construction projects.

(11) 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, 2006 and 2005, 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 original agreement expired on July 31, 2006 and was subsequently renewed for an additional ten year period to expire on July 31, 2016.

Contingencies

CUC is subject to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its operations, including customer disputes. Management believes that any liability that may ultimately result from the resolution of these matters will not have a material adverse effect on the financial position of the CUC.



**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

11) Commitments and Contingencies, Continued

Contingencies

CUC entered into certain memoranda of understanding (MOUs) with certain 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), CUC could be considered in breach of 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.

In 2004, CUC entered into contract with contractor for the construction of the Chinatown Wastewater Transmission Collection Project. The project was completed in fiscal year 2004, however the contractor threatened litigation to collect from CUC additional claims for \$656,786.96. 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, 2006. 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.

12) Subsequent Events

On January 23, 2007, the Governor of the CNMI approved P.L. No. 15-44 to amend section 2 of P.L. No. 15-12. P.L. No.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, 2006, no adjustments have been made to the accompanying financial statements as CUC and CUA have yet to finalize an agreement on the execution of the provisions of P.L. No. 15-12 and 15-44.

On August 17, 2007 and August 16, 2007, the House of Representatives and the Senate, respectively, overrode the Governor's disapproval of House Bill 15-252, creating P.L. No 15-80, the CUC Security Deposit Fairness Act of 2007. This law requires that the customer security deposit be placed in interest-earning trust fund that shall not be used for any other purpose.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2006 and 2005

(12) Subsequent Events, Continued

On December 3, 2007 and November 14, 2007, the House of Representatives and the Senate, respectively, overrode the Governor's disapproval of House Bill 15-293, creating P.L. No 15-123, to amend 4 CMC § 8143 requiring CUC to bill water, power and sewer separately effective December 3, 2007.

(13) Restatement

CUC has restated its previously issued 2005 financial statements for matters related to the following previously reported items: property and equipment, notes payable, depreciation expense and wharfage fees. The financial statements for 2006 have been restated to reflect the corrections.

The following is a summary of the restatements for 2005:

|  |                     |
|--|---------------------|
| To record wharfage fees and related loans payable incurred in October 1997 to May 2005                                     | (\$3,959,238)       |
| To record as prior year expense the difference between construction work-in progress subsidiary ledgers and general ledger | ( 2,581,732)        |
| To correct over depreciation of plant utility in prior years   | <u>1,356,840</u>    |
|  | <u>\$ 5,104,130</u> |

The effect of the abovementioned restatements to the previously issued September 30, 2005 balance sheet is summarized as follows:

|   | Previously<br>Reported | As restated   | Restatement         |
|---|------------------------|---------------|---------------------|
| Capital assets, net                     | \$ 100,677,688         | \$ 99,457,795 | \$ 1,224,893        |
| Long-term debt, less current maturities | 107,528                | 4,066,765     | <u>3,959,237</u>    |
| Total restatement                       |                        |               | <u>\$ 5,104,130</u> |

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

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**SINGLE AUDIT REPORTS**

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**Year Ended**  
**September 30, 2006**

J. Scott Magliari  
COMPANY

CLINTFIELD PUBLIC ACCOUNTANT

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**INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND  
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS  
PERFORMED IN ACCORDANCE WITH GOVERNMENTAL AUDITING STANDARDS**

Executive Director  
Commonwealth Utilities Corporation

I have audited the financial statements of the Commonwealth Utilities Corporation (CUC), as of and for the year ended September 30, 2006, and have issued my report thereon dated February 28, 2009, which report was qualified due to my inability to determine the propriety of inventory and utility plant and obligations under capital lease. Except as discussed in the preceding sentence, I conducted my audit 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 of America.

**Internal Control Over Financial Reporting**

In planning and performing my audit, I considered CUC's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the CUC's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of the CUC's internal control over financial reporting. My consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, I identified certain deficiencies in internal control over financial reporting that I consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. I consider the following deficiencies: 2006-1 through 2006-14, described in the accompanying Schedule of Findings and Questioned Costs to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

My consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, I believe that findings 2006-1, 2006-2, 2006-5 through 2006-9, 2006-11, and 2006-15 and 2006-16 of the significant deficiencies described above as a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CUC's financial statements are free of material misstatement, I performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed instances of noncompliance or other matters that are required to be reported under Government Auditing Standards and which are described in the accompanying Schedule of Findings and Questioned costs as findings 2006-5 and 2006-14 through 2006-17.

CUC's responses to the findings identified in my audit described in the accompanying Schedule of Findings and Questioned Costs are in a separate letter prepared by CUC's management. I did not audit CUC's response and, accordingly, I express no opinion on it.

This report is intended solely for the information and use of the management of CUC, the CNMI Office of the Public Auditor, the cognizant audit and other federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

*J. Scott Magliani & Company*  
Saipan, Commonwealth of the Northern Mariana Islands  
February 28, 2008

J. Scott Magliari  
COMPANY

CERTIFIED PUBLIC ACCOUNTANT

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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE  
WITH REQUIREMENTS APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM  
AND ON INTERNAL CONTROL OVER COMPLIANCE WITH OMB CIRCULAR A-133  
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

Executive Director  
Commonwealth Utilities Corporation

Compliance

I have audited the compliance of Commonwealth Utilities Corporation (CUC) with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement that are applicable to each of its major federal programs for the year ended September 30, 2006. CUC's major federal programs are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of CUC's management. My responsibility is to express an opinion on CUC's compliance based on my audit.

I conducted my audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America; and OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Those standards and OMB Circular A-133 require that I plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about CUC's compliance with those requirements and performing such other procedures as I considered necessary in the circumstances. I believe that my audit provides a reasonable basis for my opinion. My audit does not provide a legal determination of CUC's compliance with those requirements.

In my opinion, CUC complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2006.

Internal Control Over Compliance

The management of CUC is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing my audit, I considered CUC's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine my auditing procedures for the purpose of expressing my opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, I do not express an opinion on the effectiveness of the CUC's internal control over compliance.

A control deficiency in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

My consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. I did not identify any deficiencies in internal control over compliance that I consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of the management of CUC, the CNMI Office of the Public Auditor, the cognizant audit and other federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

*J. Scott Magliani & Company*  
Saipan, Commonwealth of the Northern Mariana Islands  
February 28, 2008

**COMMONWEALTH UTILITIES CORPORATION**  
 (A Component Unit of the CNMI Government)

**Schedule of Expenditures of Federal Awards**  
**For the Year Ended September 30, 2006**

| Federal Agency/Pass-Through Program<br>Program Title                   | Federal<br>CFDA Number/<br>Pass Through<br>Account & Number | Receivable   |              | Cash<br>Receipts<br>FY 2006 | Adjustments  | Repayments<br>FY 2006 | Receivable<br>(Outstanding Balance)<br>from September<br>30, 2006 |
|--|---|--------------|--------------|-----------------------------|--------------|-----------------------|---|
|  |   | 10/2005      | 11/2005      |                             |              |                       |   |
| <b>U.S. Environmental Protection Agency</b>                            |   |              |              |                             |              |                       |   |
| <b>Water Programs:</b>   |   |              |              |                             |              |                       |   |
| South Side Sewer System  | 66-818  | \$ -         | \$ -         | \$ 207,354                  | \$ -         | \$ 207,356            | \$ 15,238   |
| Treat Plant JMG Tank   | 66-818  | -            | 20,903       | -                           | -            | 20,903                | -   |
| Airport Sand Filtration Rehab: Filtration                              | 66-818  | -            | 15,911       | -                           | -            | 9,948                 | 1,039   |
| Agriplus Sewage Treatment Plant JMG Outfall                            | 66-818  | 2,114,537    | -            | -                           | -            | 165,124               | 165,224   |
| Abogoo/Tongog Filtration System  | 66-818  | 21,062       | 4,200        | -                           | -            | -                     | 14,213  |
|  |   | \$ 2,135,597 | \$ 14,405    | \$ 207,354                  | \$ -         | \$ 194,086            | \$ 164,737  |
| <b>U.S. Department of the Interior</b>                                 |   |              |              |                             |              |                       |   |
| <b>Booby System Grant</b>  |   |              |              |                             |              |                       |   |
|  | CNRP 2007-1   | \$ 14,005    | \$ 2,227     | \$ -                        | \$ (3,117)   | \$ -                  | \$ -  |
| Passed through the Government of the CNMI:<br>Federal Program:         |   |              |              |                             |              |                       |   |
| <b>Rehabilitation and Rehabilitation</b>                               |   |              |              |                             |              |                       |   |
| at Fender Plant  | 15-875  | 2,374,220    | 479,260      | 1,385,220                   | -            | 1,226,243             | 17,643  |
| Pinar Gable and Fender Plant Normal                                    | 15-875  | -            | -            | 40,000                      | -            | 40,000                | 5,208   |
| Airport Sand Filtration Rehabilitation                                 | 15-875  | -            | -            | 3,155                       | -            | 48,155                | -   |
| Simpson TIT Waterline  | 15-875  | -            | 191,446      | 208,000                     | -            | 17,257                | -   |
| South Side Sewer System  | 15-875  | -            | 62,473       | 1,308,457                   | -            | 1,289,717             | 5,192   |
| Caroline Agriculture Homestead Wasteline                               | 15-875  | 625,000      | -            | 52,972                      | -            | 52,972                | -   |
| Killebrew Sewer System   | 15-875  | -            | 10,662       | 44,719                      | -            | 34,719                | -   |
| Relocation of T-1 Salt Storage   | 15-875  | -            | -            | 179,165                     | -            | 179,165               | -   |
|  |   | \$ 3,431,066 | \$ 760,162   | \$ 2,290,226                | \$ (2,517)   | \$ 2,222,920          | \$ 182,245  |
| <b>Local Wastewater Program:</b>                                       |   |              |              |                             |              |                       |   |
| Beach Road Sewer System  | 15-875  | -            | 22,743       | 477,307                     | -            | 451,248               | 1,263   |
| Sanigalo TIT Waterline   | 15-875  | -            | 43,811       | -                           | 139,811      | -                     | -   |
| Roperville Sewer System  | 15-875  | -            | 32,000       | 48,433                      | -            | 38,433                | -   |
| Caroline Agriculture Homestead Wasteline                               | 15-875  | 805,720      | -            | -                           | -            | -                     | -   |
| Relocation of T-1 Salt Storage   | 15-875  | -            | -            | 231,428                     | -            | 231,428               | -   |
|  |   | \$ 805,720   | \$ -         | \$ 757,168                  | \$ (189,811) | \$ 322,622            | \$ 17,114   |
|  |   | \$ 4,296,220 | \$ 828,716   | \$ 3,055,394                | \$ (122,328) | \$ 2,945,221          | \$ 65,673   |
| <b>Administrative Matching Program</b>                                 |   |              |              |                             |              |                       |   |
|  |   | \$ 505,000   | \$ 62,356    | \$ 229,822                  | \$ (86,700)  | \$ 431,531            | \$ 65,462   |
|  |   | \$ 4,801,220 | \$ 891,072   | \$ 3,994,324                | \$ (139,039) | \$ 3,855,285          | \$ 91,654   |
| <b>U.S. Department of Homeland Security</b>                            |   |              |              |                             |              |                       |   |
| Passed through the Government of the CNMI:<br>Public Assistance Grants |   |              |              |                             |              |                       |   |
|  |   | \$ 1,433,117 | \$ 1,225,076 | \$ 4,994,324                | \$ (139,039) | \$ 4,855,285          | \$ 91,654   |
| <b>Total</b>   |   | \$ 8,431,066 | \$ 1,687,944 | \$ 6,244,620                | \$ (311,367) | \$ 5,933,253          | \$ 278,909  |

See accompanying notes to the schedule of expenditures of federal awards.



**COMMONWEALTH UTILITIES CORPORATION**  
 (A Component Unit of the CNMI Government.)

Schedule of Programs Selected for Audit  
 In Accordance with CMB circular A-133

Year Ended September 30, 2006

The following list specifies grants selected for detailed compliance testing in accordance with applicable A-133 requirements.

| <u>Original Grantor</u>              | <u>CFDA No</u> | <u>Description</u>   | <u>Amount of Expenditures</u> |
|--------------------------------------|----------------|--|-------------------------------|
| U.S. Department of the Interior      | 15.875         | OTIA Fiscal Year 1993, 1994, 1995 and 1996 - 2003 Capital Development Projects | \$ 3,945,553                  |
| U.S. Environmental Protection Agency | 15.875         | Construction Grants for Wastewater Treatment Works                             | 394,686                       |
| U.S. Department of Homeland Security | 15.875         | Public Assistance  | <u>494,531</u>                |
|                                      |                | Total program expenditures   | \$ 4,834,770                  |
|                                      |                | Local match  | <u>(742,625)</u>              |
|                                      |                | Total federal program expenditures   | <u>\$ 4,092,145</u>           |
|                                      |                | % of total federal program expenditures tested                                 | <u>100%</u>                   |

Dollar threshold used to distinguish between

Type A and Type B programs: \$ 300,000

Auditee qualified as low-risk auditee yes X no

There were no findings on direct funding for the fiscal years ended September 30, 2006 and 2005.

**COMMONWEALTH UTILITIES CORPORATION**  
{A Component Unit of the CNMI Government}

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2006

11. Scope of Audit

The Commonwealth Utilities Corporation (CUC) was established as a Public Corporation by the Commonwealth of the Northern Mariana Islands (CNMI) Public Law 4-47, effective October 1, 1985. CUC was given responsibility for supervising the construction, maintenance operations, and regulation of all utility services, including power, sewage, refuse collections and water, provided however, that, whenever feasible, CUC shall contract for private businesses to assume its duties with respect to one or more of its divisions. CUC was also designated with 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 Commonwealth Legislature. All projects of CUC that are funded either directly by U.S. federal agencies through the CNMI or indirectly as loans from the Commonwealth Development Authority (CDA), the U.S. Environmental Protection Agency and the U.S. Department of Agriculture are included in the scope of the OMB Circular A-133 audit (the "Single Audit"). The U.S. Department of the Interior has been designated as CUC's cognizant agency for the Single Audit.

A. Programs Subject to Single Audit

All of the programs presented in the Schedule of Expenditures of Federal Awards are subject to the Single Audit. U.S. Federal Covenant funds received as loans from CDA and funds received from the U.S. Department of Agriculture as loans are also subject to the Single Audit.

(2) Summary of Significant Accounting Policies

A. Basis of Accounting

For purposes of this report, certain accounting procedures were followed, which help illustrate the authorizations and expenditures of the individual programs. The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting. All authorizations represent the total allotment or grant awards received. All expenses and capital outlays are reported as expenditures.

Any federal funds expended in excess of federal funds received are recorded as a receivable from the grantor agency and any federal funds received in excess of federal funds expended are recorded as a payable to the grantor agency.

B. Indirect Cost Allocation

For fiscal year 2006, CUC had no indirect cost agreement with grantor agencies.

C. Matching Requirements

In allocating project expenditures between the federal share and the local share, a percentage is used based upon local matching requirements, unless funds are specifically identified to a certain phase of the project.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2006

(3) Adjustments

During the year ended September 30, 2006, CUC reconciled the amount due from grantor agencies resulting in a net adjustment of \$139,038 to reduce receivables due from grantors.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

SECTION I - SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued: Qualified

Internal control over financial reporting:

- Material weakness(es) identified?  yes  no
- Significant deficiency(ies) identified that are not considered to be material weaknesses?  yes  none reported

Noncompliance material to financial statements noted?  yes  no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified?  yes  no
- Significant deficiency(ies) identified that are not considered to be material weaknesses?  yes  none reported

Type of auditor's report issued on compliance for major federal programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?  yes  no

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings

Revenue/Receipts

Finding No. 2006-1

Criteria:

All recorded revenues and receivables should reflect collectible balances.

Condition:

Included in my testing of material long outstanding accounts with disputes are six (6) accounts amounting to \$520,154.08 that were not to be disconnected. Although these accounts are substantially supported, the explanation given for not disconnecting these accounts was that these customers had CUC wells, poles, pumps, etc., on their property, and therefore in-lieu of CUC rental payments for use of these customers' properties they are not paying for utility usage.

Cause:

The cause of the above condition is the lack of formal agreements with landowners.

Effect:

The effect of the above condition is the potential uncollectibility of accounts receivable and understatement of rental expense. Additionally, there could be inequalities in the consideration paid for certain parcels depending on the value of utilities used.

Recommendation:

CUC should execute formal agreements with all landowners for the use of land and ensure compliance to established policies and procedures.

Prior Year Status:

Lack of formal agreements with landowners for the use of land was reported as a finding in the audits of CUC for fiscal years 1996 through 2005. During 2007, CUC adopted a policy requiring all agreements to be prepared prior to using private properties. CUC also established procedures for easement claims.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Monitoring of Work Orders

Finding No. 2006-2

Criteria:

Construction-in-progress general ledger and subsidiary ledgers should be timely reconciled and costs accumulated for completed or cancelled work orders should be properly reclassified to capital assets or recorded as expenditure in a timely manner.

Condition:

In fiscal year ending September 30, 2006, CUC made a net adjustment of \$2,581,732 to record as prior year expenditures, several long outstanding open work orders and the difference between construction-in-progress subsidiary ledgers and general ledger balances.

Cause:

The cause of the above condition is the catch-up reconciliation made by CUC in fiscal year 2006 to reconcile capital expenditures with the CNMI Government Capital Improvement Projects Coordinator.

Effect:

The effect of the above condition is the restatement of beginning net assets to record decrease in capital assets and increase in prior year expenditures.

Recommendation:

CUC should ensure that reconciliations of construction-in-progress general ledger and subsidiary ledger are performed monthly to avoid material restatement of previously reported financial statements and to ensure that capital expenditures are properly recorded.

Prior Year Status:

Lack of reconciliation of capital expenditures with the CNMI Government Capital Improvement Projects Coordinator and lack of procedures in place to ensure that payment requests made to the CNMI Government are forwarded on a timely basis to CUC Accounting for recording was reported as a finding in the audits of CUC for fiscal years 2002 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Purchases/Disbursements

Finding No. 2006-3

Criteria:

Disbursements should be properly supported with approved requisition vouchers and purchase orders as evidence that the purchase of goods or performance of services is authorized. Such supporting documentation should be maintained and filed accordingly.

Conditions:

- a. The requisition voucher was not properly signed by requisitioner for 21 or 52.9% of the 40 purchase order files tested.

| <u>No.</u> | <u>Date</u> | <u>Purchase<br/>Order<br/>Number</u> | <u>Amount</u>       |
|------------|-------------|--------------------------------------|---------------------|
| 1.         | 10/14/2005  | 06 0054                              | \$ 300.00           |
| 2.         | 10/14/2005  | 06 0077                              | 2,000.00            |
| 3.         | 10/18/2005  | 06 0110                              | 124.00              |
| 4.         | 10/21/2005  | 06 0123                              | 250.00              |
| 5.         | 10/25/2005  | 06 0171                              | 305.00              |
| 6.         | 11/2/2005   | 06 0191                              | 643.03              |
| 7.         | 1/3/2006    | 06 0215                              | 890.06              |
| 8.         | 11/9/2005   | 06 0234                              | 722.50              |
| 9.         | 11/25/2005  | 06 0306                              | 3,799.60            |
| 10.        | 3/1/2006    | 06 0425                              | 512.82              |
| 11.        | 3/6/2006    | 06 0437                              | 3,050.00            |
| 12.        | 03/17/06    | 06 0468                              | 1,500.00            |
| 13.        | 03/10/06    | 06 0494                              | 362.50              |
| 14.        | 04/10/06    | 06 0530                              | 534.38              |
| 15.        | 06/26/06    | 06 0675                              | 440.00              |
| 16.        | 06/26/06    | 06 0676                              | 1,010.45            |
| 17.        | 07/11/06    | 06 0709                              | 550.00              |
| 18.        | 08/24/06    | 06 0813                              | 276.00              |
| 19.        | 09/12/06    | 06 0887                              | 810.94              |
| 20.        | 09/13/06    | 06 0915                              | 2,210.00            |
| 21.        | 09/30/06    | 06 0991                              | 930.00              |
|            |             |                                      | <u>\$ 21,191.28</u> |

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Purchases/Disbursements, Continued

Finding No. 2006-3

b. The purchase order files were not provided for my examination for 3 or 7.5% of the 40 purchase order files selected for testing.

| <u>Date</u> | <u>Purchase<br/>Order<br/>Number</u> | <u>Amount</u>    |
|-------------|--------------------------------------|------------------|
| 10/17/2005  | 06 0091                              | \$ 219.50        |
| 2/23/2006   | 06 0414                              | 307.10           |
| 4/7/2006    | 06 0523                              | <u>150.00</u>    |
|             |                                      | <u>\$ 736.60</u> |

Cause:

The cause of the above condition is failure to ensure completeness of relevant supporting documents prior to processing of purchase orders, a lack of strict compliance with established policies and procedures and a lack of proper and systematic filing of relevant supporting documents.

Effect:

The effect of the above condition is the potential for unauthorized/invalid expenditures and waste, fraud and abuse.

Recommendation:

I recommend that CUC ensure all expenditures are properly supported and properly authorized. Additionally, CUC should ensure that established policies and procedures regarding the processing of requisitions and purchase orders are strictly adhered to.



COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Payroll

Finding No. 2006-4

Criteria:

Personnel independent of the payroll process should perform the input of employee pay rates.

Condition:

During my testing of payroll expenses, I noted that the Payroll Department inputs the approved pay rate into the system.

Cause:

CUC's Human Resources (HR) Office does not have access to CUC's current payroll system and CUC is still in the process of sourcing for an HR module that will be able to address the requirements of CUC and at the same time facilitate the proper segregation of duties.

Effect:

The effect of the above condition is the potential for payroll personnel to alter pay rates.

Recommendation:

To compensate for the lack of segregation of duties, I recommend that an edit report should be printed on a bi-weekly basis detailing any changes made to the payroll master file. This report should be forwarded directly to the HR office by the IT department. The authorized payroll status change form used by Payroll Department as the source document to initiate changes to the payroll master file should also be forwarded to the HR office. The HR Office can then compare the report against the payroll status change form to determine whether changes were authorized and properly made.

Prior Year Status:

Lack of established policies and procedures over proper segregation of duties of payroll processing was reported as a finding in the audits of CUC for fiscal years 2002 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Accounts Receivable/Disconnection

Finding No. 2006-5

Criteria:

Pursuant to the CUC Electric Service Regulation, Part 17, CUC may disconnect past due accounts after 14 calendar days of second disconnection notice, which is sent 45 days after the first disconnection notice. The customer may seek remedy against disconnection by filing a formal dispute or execute a promissory note subject to the CUC approval.

Condition:

From the aging of receivables provided by CUC, I summarized active accounts with over due amounts and noted that 573 accounts totaling \$3,739,242.78, are over 75 days past due. Of these, only 84 accounts totaling \$2,032,515.72 are included in the summary of accounts under dispute and 7 accounts with totaling \$20,715.99, are included in the listing of promissory notes. Therefore, 482 accounts totaling \$1,686,011.07, should have been subject to disconnection.

Cause:

The cause of the above condition is the lack of monitoring to ensure that all accounts that are 75 days past due are disconnected, unless supported by promissory notes or formal customer dispute.

Effect:

The effect of the above condition is the accumulation of past due accounts that are doubtful of collectability and could be bad debts.

Recommendation:

CUC should comply with established policies and procedures for termination/disconnection of service. Furthermore, monitoring should be performed to ensure that accounts that are 75 day past due are timely disconnected, unless supported by promissory notes or formal customer dispute.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNM Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

**Section II - Financial Statement Findings, Continued**

**Inventory**

Finding No. 2006-6

**Criteria:**

Perpetual inventory records should, at all times reflect the total inventory quantity on-hand.

**Condition:**

The inventory valuation report as of September 30, 2006 showed several inventory items with negative quantities on-hand. Although the ending inventory was adjusted to actual physical count, the adjustment of \$455,255.13 may be overstated for these items with credit balances (See Finding No. 2006-7).

**Cause:**

CUC's computer system records inventory when Accounts Payable personnel post vendor invoices into the system. Receiving reports prepared and posted by CUC's warehouse personnel are matched by the system with the corresponding vendor invoices posted. Consequently, if corresponding invoices have not been posted by the Accounting Department or cannot be identified, inventory per books is not adjusted for warehouse receipts. As a result, inventory per books may be zero even though there may be inventory on-hand. Since the computer system allows for issuance even when there is not enough inventory items per books, inventory issuances by warehouse personnel may result in negative inventory per books.

**Effect:**

The effect of the above condition is a possible misstatement of inventory balances resulting in an opinion qualification on the account balance and related expenses.

Furthermore, inaccurate inventory valuation report is not useful to management in making inventory purchase decisions.

**Recommendation:**

CUC should ensure that all inventory transactions are posted timely. A properly functioning perpetual inventory system will help generate more accurate interim financial statements and minimize the likelihood of making large physical inventory adjustments.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the (NMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Inventory Reconciliation

Finding No. 2006-7

Criteria:

A reconciliation of inventory balances between the general ledger and subsidiary ledgers should be performed regularly and discrepancies, if any, should be investigated.

Condition:

For fiscal year ending September 30, 2006, CUC adjusted as a credit to administrative expenses \$455,255.13, for the net understatement of the inventory general ledger balance control account against adjusted inventory valuation report without detailed investigation.

Cause:

The cause of the above condition is the lack of established policies and procedures over inventory reconciliations.

Effect:

The effect of the above condition is a possible misstatement of inventory balances resulting in an opinion qualification on the account balance and related expenses.

Recommendation:

The adjustment should only be made by a responsible person after a reasonable explanation for the discrepancies have been obtained. Thus, before making the adjustment, someone with no access to the inventory should investigate the discrepancies between the inventory valuation report (subsidiary ledger) and physical count and attempt to determine whether they are due to clerical or counting errors, improper purchase and issuance cutoff during the physical count, theft, intentional misstatement of the records or count, etc. Steps should then be taken to address the causes so that they do not recur.

To ensure that the purchase and issuance cutoffs are proper, someone should control purchase and sales invoices received/issued shortly before and after the physical count. This person should determine that the subsidiary ledger as of the physical inventory date include purchase invoices for all goods received before, but not after, the physical count and should exclude issuances for all goods used/transferred before, but not after, the count.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Inventory Reconciliation, Continued

Finding No. 2006-7

Recommendation, Continued:

Monthly inventory reconciliations should be prepared in a timely manner to identify reconciling items between the general ledger and subsidiary ledgers in order to test the accuracy of both systems and, therefore, provide more accurate financial information.

CUC should also consider performing periodic cycle counts of the fast moving inventory items and compare the results with the perpetual records. This will enable CUC to identify inventory shortages and errors on a timely basis.

Prior Year Status:

Lack of established policies and procedures over inventory reconciliations was reported as a finding in the audits of CUC for fiscal years 2002 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Inventory Valuation

Finding No. 2006-8

Criteria:

When the moving average unit cost method of inventory costing is utilized, unit cost is updated for new purchases and issuances are valued based on the most recent average unit cost.

Condition:

Certain inventory items have negative unit costs as of September 30, 2006 and, accordingly, related issuances have negative values. Therefore, operating expenses maybe understated. Furthermore, costs of inventory adjustments were not based on the most recent average unit costs.

Cause:

The cause of the above condition may be due to the following:

- Untimely posting of inventory purchases, receipts and issuances;
- Lack of coordination between accounts payable and warehouse personnel for input of purchases and issuances; and
- Lack of monitoring and review of inventory adjustments.

Effect:

The effect of the above condition is a possible misstatement of inventory resulting in an opinion qualification on the account balance and related expenses.

Recommendation:

CUC should establish policies and procedures to ensure timely posting of inventory purchases, receipts and issuances; establish a formal review process and monitoring procedures for inventory adjustments; ensure coordination between responsible personnel; and ensure that these policies and procedures are strictly adhered to. Even with the bar-coding system that CUC is planning to implement, coordination between Warehouse and Accounts Payable accountant would still be necessary. Although the bar-coding system may facilitate the receiving and issuance function of the warehouse, if the accounts payable section does not timely record the purchases, issuances will still result in credit balances in the inventory valuation report.

Prior Year Status:

Untimely posting of inventory purchases, receipts and issuances, the lack of coordination between Warehouse and Accounts Payable personnel for input of purchases and issuances and monitoring and review of inventory adjustments was reported as a finding in the audits of CUC for fiscal years 2002 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Inventory Obsolescence

Finding No. 2006-9

Criteria:

Inventories should be reviewed regularly for possible obsolescence and generally accepted accounting principles in the United States of America requires inventory to be recorded at lower of cost or net realizable values.

Condition:

Inventory review to determine or identify old, obsolete or overstock was not performed until after fiscal year end.

Cause:

The cause of the above condition is the lack of established policies and procedures for reviewing and monitoring of obsolete and non-moving inventories.

Effect:

The effect of the above condition is a possible misstatement of inventory balances resulting in an opinion qualification on the account balance.

Recommendation:

A periodic inventory turnover analysis or formal obsolescence evaluation throughout the year should be performed to identify slow moving and obsolete items. The timely disposal of these items will eliminate the additional carrying costs associated with inventory.

Carrying costs of slow-moving and obsolete items should be compared with their net realizable value. Should the carrying value exceed net realizable values, CUC should adjust the valuation to reflect the lower of cost or net realizable value.

Prior Year Status:

Lack of established policies and procedures for the review and monitoring of obsolete and non-moving inventories was reported as a finding in the audits of CUC for fiscal years 2002 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Review Inventory Requirements

Finding No. 2006-10

Criteria:

Inventory should be kept at a reasonable level to support operations.

Condition:

Analysis of materials and supplies inventory (except fuels and lubes) is as follows:

|                            |                   |
|----------------------------|-------------------|
| Inventory                  | <u>5,8048,672</u> |
| Issuances:                 |                   |
| Repairs and Maintenance    | \$ 3,812,540      |
| Supplies Expense           | <u>350,495</u>    |
|                            | <u>5,4161,035</u> |
| Average inventory turnover | <u>2 years</u>    |

Cause:

The inventory system is not maintained timely, resulting in having items showing credit balances. Therefore, reported inventory levels may be inaccurate. Furthermore, CUC is experiencing cash flow difficulties and are unable to follow the inventory levels defined in the inventory system.

Effect:

The effect of the above condition is that the CUC sometimes faces unanticipated and undesirable stock-out situations, while levels of other inventory items are too high.

Recommendation:

CUC should evaluate its inventory levels, consider disposing of certain obsolete and slow-moving items.



COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Utility Plant

Finding No. 2006-11

Criteria:

Adequate presentation and control of fixed assets is essential in preparing accurate financial statements. Unless all fixed assets are recorded, depreciation used in determining utility rates could be misstated.

Condition:

CUC has not taken a physical inventory of its capital assets. The following was noted:

- Completed projects are not closed and transferred to capital assets in a timely manner and often remain in construction work-in-progress for several years. These assets, although already in use, are not being depreciated resulting in material misstatements of depreciation expense. This condition contributed to large variances between the net book values of assets tested and net book value derived through calculation of accumulated depreciation based on the respective estimated useful lives. This also resulted to a restatement increasing prior year expenses by \$2,581,732 as a result of the reconciliation of construction work-in-progress subsidiary ledgers and general ledger;
- CUC has not conducted physical count of capital assets in over 4 years and has no basis to determine if the carrying value of its capital assets is recoverable. In accordance with generally accepted accounting principles in the United States of America, long lived assets should be evaluated for impairments. Since a physical count has not been conducted, the asset listing may still include assets that have been retired, broken, destroyed or stolen; and
- Capital assets lapsing schedules and the general ledger balances were reconciled only at year end. This also resulted to a restatement decreasing prior year expenses by \$1,356,840.

Cause:

The causes of the above conditions are as follows:

- No physical count of capital assets has been performed;
- Lack of timely coordination and reconciliations between CUC's departments responsible for project oversight and the accounting department; and
- Lack of timely reconciliations between the general ledger and subsidiary ledgers;

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CHMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Utility Plant, Continued

Finding No. 2006-11

Effect:

The effect of the above conditions is a possible misstatement of capital asset balances resulting in an opinion qualification on the account balance and related depreciation expense. Additionally, a control deficiency exists over the safeguarding of capital assets.

Recommendation:

CUC should perform a physical inventory of all fixed assets on hand, agree the count with its records and make necessary adjustments. CUC should also consider evaluating capital assets for impairments and recoverability of carrying values. An asset should be tested for recoverability if events or changes in circumstances, such as the following among others, indicate that its carrying amount may not be fully recoverable:

- a. Significant adverse change in the asset's use or in its physical condition;
- b. Significant adverse changes in legal factors or business climate, including an adverse action or assessment by a regulator; and
- c. Costs to acquire or construct an asset that significantly exceed original expectations.

When a long-lived asset is tested for recoverability, a review of depreciation or amortization estimates may be required. Any revision to the remaining useful life should then be considered in developing estimates of future cash flows used to test the asset's recoverability.

Prior Year Status:

The lack of control over capital assets was reported as a finding in the audits of CUC for fiscal years 1988 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Insurance Coverage

Finding No. 2006-12

Criteria:

Insurance coverage should be maintained to protect an organization from potential perils and material losses.

Condition:

CUC has not obtained insurance for its capital assets.

Cause:

The CNMI government is a self-insured entity. The government has limited its general liability to individuals to \$100,000 by statute. For this reason, the CNMI government does not maintain any insurance on its buildings, or its employees. CUC follows the CNMI's government of self-insurance policy.

Effect:

The effect of the above condition is the possibility of material losses.

Recommendation:

CUC should implement a policy with respect to required insurance coverage levels.

Prior Year Status:

The lack of insurance coverage was reported as a finding in the audits of CUC for fiscal years 1989 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Obligations under Capital Lease

Finding No. 2006-13

Criteria:

Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, requires that the lessee record a capital lease as an asset and an obligation at an amount equal to the present value of minimum lease payments during the lease term. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and liability shall be fair value.

Emerging Issues Task Force (EITF) Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease", states that in certain circumstances energy-related contracts may represent lease transactions, and the evaluation of whether an arrangement contains a lease within the scope of FASB Statement No. 13 should be based on the substance of the arrangement and whether the use of specific property, plant and equipment is necessary in the fulfillment of the arrangement.

Condition:

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. During this period, the contractor will maintain and operate the power plant and be paid operation, production and maintenance fees in addition to the guaranteed price. The power plant will be turned over to CUC at the end of the ten year period.

CUC determined that this agreement is, in fact, a capital lease and payments made under the agreement are lease payments. As such, CUC recorded \$9,959,000 as Plant and obligations under capital lease.

CUC has been unable to determine whether the guaranteed price of \$9,959,000, constitutes the fair value of the leased property.

Cause:

The cause of the above condition is that CUC's management believes that the guaranteed price approximates fair value; however, a sound basis for determination of fair value such as the actual cost of the power plant or an appraisal report was not obtained.

Effect:

The effect of the above condition is the possible misstatement of obligations under capital lease resulting in an opinion qualification on the account balance.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Obligations under Capital Lease, Continued

Finding No. 2006-13

Recommendation:

CUC should determine the actual cost of the Plant, or obtain an appraisal of the plant for purposes of compliance with the EITF.

Prior Year Status:

The inability to determine whether the recording of the plant and obligation under capital lease are in accordance with PASB No. 13 and EITF No. 01-8 was reported as a finding in the audits of CUC for fiscal years 2000 through 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Accrued Annual Leave

Finding No. 2006-14

Criteria:

CUC's policy on annual leave states that the Section Head or Division Manager may approve advanced annual leave of up to 40 hours per calendar year with the approval of the Executive Director or his/her designee.

Condition:

I noted that there were 7 employees with advanced annual leave over 40 hours amounting to \$4,157.19 as of September 30, 2006.

Cause:

There is a lack of timely review of accrued annual leave.

Effect:

CUC is not in compliance with its policies and procedures for advance annual leave.

Recommendation:

CUC should ensure that advance leave approved for an employee does not exceed 40 hours.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CDMJ Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

**Section II - Financial Statement Findings, Continued**

**Security Deposits**

Finding No. 2006-15

**Criteria:**

Electric Service Regulations Part 6.8, as amended in July 20, 2005 (Commonwealth Register Volume 27 No 06) states that,

- a. The Corporation shall be liable for all security deposits received. The Corporation shall maintain an account indicating customer name, date of security deposit and amount of deposit. Effective January 15 of each year, each account shall be credited an amount equal to the average "passbook" savings interest rate payable during the past year based on rates from at least three local FDIC insured banks.
- b. The Corporation's Comptroller shall prepare for the Board of Directors an annual report in January of each year which explicitly details amounts of deposits received, interest rate to be paid for the previous year and total account liabilities.

**Condition:**

Although annual interest owed on deposits received from customers are calculated annually, CUC did not recognize the liability for such interest in its financial statements.

As of September 19, 2007, the annual report on deposits for calendar year 2006 that is required to be prepared in January of each year was not yet available.

**Cause:**

The cause of the above condition is the lack of timely reconciliation of deposits per subsidiary ledgers to the general ledger balance.

**Effect:**

Although immaterial to CUC's financial statement taken as a whole, CUC's liabilities and expenses may be understated for the interest owed to customers for their deposits.

**Recommendation:**

CUC should accrue its liability for customer deposit interests.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Security Deposits

Finding No. 2006-16

Criteria:

Based on a Memorandum issued September 29, 2005 to all Division Managers by the Executive Director regarding "Assessing Electric Security Deposits":

- a. New customers who apply for service at a location where no prior service was provided, the electric security deposit will be \$268 for residential and \$365 for commercial.
- b. Customers whose security deposits are to be calculated based on actual or estimated usage stated in kilowatt-hours, depending on the applicable circumstances (i.e. certified load calculations provided by the electrical engineer, the 2 highest monthly usage during the past 12-month period, or average monthly usage for the last 6 months for the prior customer), the number of kilowatt-hours shall be multiplied by the applicable electric rate plus the current fuel surcharge fee.

Additional criteria for computation of required deposits from Part 6.4 of the Electric Service Regulations, which states that "after one year of established use and annually thereafter, the CUC may also recalculate security deposit".

Condition:

Of the 49 customer deposits selected for testing 32 or 65% and 24 or 49% have security deposits that are insufficient to the highest usage for the past 12-month period and average monthly usage for the past 6 months, respectively.

Cause:

CUC failed to assess customer security deposits in accordance with its policies and procedures.

Effect:

The effect of this condition is in case certain customers default in paying its billings, CUC does not have enough deposits from these customers to recover its receivable. This may result to potentially high uncollectable accounts.

Recommendation:

CUC should assess customer deposits in accordance with its policies.



COMMONWEALTH UTILITIES CORPORATION  
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Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

Section II - Financial Statement Findings, Continued

Debt

Finding No. 2006-17

Criteria:

Section 7.2 of a loan agreement with a contractor requires CUC to establish and maintain an escrow account of not less than \$360,000 as part of their security agreement.

Condition:

As of September 30, 2006, CUC does not have an escrow fund account pursuant to the loan agreement.

Cause:

The cause of the above condition is lack of sufficient funds and a tight cash flow position.

Effect:

The effect of the above condition is noncompliance with the loan agreement.

Recommendation:

CUC should re-establish the escrow account to ensure compliance with debt requirements.

Prior Year Status:

The lack of escrow fund account was noted as finding for fiscal year 2005.

COMMONWEALTH UTILITIES CORPORATION  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

**Section III - Federal Award Findings and Questioned Costs**

There was no Federal award finding noted for the fiscal year ending September 30, 2006.

**Section IV - Prior Year Findings and Questioned Costs**

**Questioned Costs**

The prior year Single Audit report on compliance with the laws and regulations noted the following costs and comments that were unresolved at September 30, 2006:

|   |                    |
|---|--------------------|
| Questioned cost as previously reported            | \$1,245,922        |
| Questioned costs of fiscal year 2006 Single Audit | <u>          -</u> |
| Unresolved questioned costs at September 30, 2006 | <u>\$1,245,922</u> |

**Unresolved Findings**

The status of unresolved prior year findings is discussed in the Schedule of Findings and Questioned Costs section of this report (pages 48 through 70).

There were no findings on direct funding for the fiscal years ended September 30, 2006 and 2005.

**Section V - Schedule of Findings and Auditee Responses**

CUC will provide a separate letter in response to my findings as discussed in the Schedule of Findings and Questioned Costs section of this report (pages 48 through 70).