

**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, 2012 and 2011**

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

Years Ended September 30, 2012 and 2011

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**INDEPENDENT AUDITOR'S REPORT**

The Executive Director  
Commonwealth Utilities Corporation

I have audited the accompanying statements of net assets of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands, as of September 30, 2012 and 2011, and the related statements of revenues, expenses and changes in net assets, and of cash flows for the years then ended. These financial statements are the responsibility of CUC's management. My responsibility is to express an opinion on these financial statements based on my audits.


I conducted my audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that 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 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 audits provide a reasonable basis for my opinion.

In my opinion, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2012 and 2011, and the changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with the *Government Auditing Standards*, I have also issued my report dated July 28, 2013 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 audits.

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis (MD&A) on pages 3 to 15 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Government Accounting Standards Board, who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. I have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to my inquiries, the basic financial statements, and other knowledge I obtained during my audit of the basic financial statements. I do not express an opinion or provide any assurance on the information because the limited procedures do not provide me with sufficient evidence to express an opinion or provide any assurance.

My audits were conducted for the purpose of forming opinion on the CUC's basic financial statements. The Supplementary Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis for the year ended September 30, 2012 on pages 47 and 48 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The accompanying Schedule of Expenditures of Federal Awards on page 53 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is also not a required part of the financial statements. The Supplementary Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis and the Schedule of Expenditures of Federal awards are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In my opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

  
Saipan, Commonwealth of the Northern Mariana Islands  
July 28, 2013

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

MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2012

This discussion and analysis of the Commonwealth Utilities Corporation's (CUC) financial performance provides an overview of CUC's activities for the fiscal year ended September 30, 2012 with comparisons to prior fiscal years ended September 30, 2011 and 2010. We encourage readers to consider the information presented here in conjunction with the financial statements, related notes and supplementary information (pages 16 through 48).

**FINANCIAL HIGHLIGHTS**

- Total assets at September 30, 2012, were \$131,869,056, an increase of \$1,908,980 or 1.5% compared to \$129,960,076 in 2011, which decreased by \$978,675 or 0.7% compared to \$130,938,751 in 2010. The increase in 2012 is primarily due to the increase in deferred fuel cost (the cost of fuel not yet fully recovered by CUC in the form of "levelized energy adjustment clause" (LEAC) rate adjustments).
- Total liabilities at September 30, 2012, were \$42,912,344, an increase of \$4,568,958 or 11.9% from \$38,343,386 in 2011, which decreased by \$2,466,679 or 6.0% from \$40,810,065 in 2010. The increase in 2012 is primarily due to the liability incurred from the early termination of the 49 months remaining term of the Pacific Marine Industrial Corporation (PMIC) power purchase agreement.
- Total net operating revenues for fiscal year 2012 were \$95,937,001, a \$3,656,309 or 3.9% increase from \$92,280,692 in 2011, which increased by \$9,624,542 million or 11.6%, when compared to fiscal year 2010. The increased revenue in 2012 is primarily attributable to the \$2,718,407 or 29% increase in water revenues, \$1,358,789 or 40% increase in sewer revenues and \$600,188 or 41% increase in other revenues offset by the \$1,021,075 or 1% decrease in power and related LEAC revenues.
- Total operating expenses for fiscal year 2012 were \$103,657,076, an increase of \$2,297,341 or 2.3% from \$101,359,735 in 2011, which increased by \$9,294,979 or 10.1% when compared to \$92,064,756 in fiscal year 2010. The increase in operating expenses for 2012 is the result of the \$1,966,596 or 28% increase in depreciation, \$745,832 or 13.7% increase in maintenance expenses and \$354,631 or 0.5% increase in production fuel cost offset by the \$682,162 or 15% decrease in other production expense and \$177,267 or 1.0% decrease in general and administrative expenses.
- In fiscal year 2012, CUC received \$10,407,616 in capital contributions and federal awards compared to \$13,983,886 in fiscal year 2011 and \$5,810,246 in fiscal year 2010.

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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2012

**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 (deficit). Changes in net assets (deficit) 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 (Deficit).
- 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.

*Other Information*

This report also presents certain supplementary information concerning CUC's Statements of Revenues, Expenses and Changes in Net Assets (Deficit) on a divisional basis (see pages 47 through 48).

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**ANALYSIS OF BASIC FINANCIAL STATEMENTS**

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Current assets	\$ 33,162,695	\$ 33,169,917	\$ 35,407,008
Restricted assets	9,194,457	8,324,311	7,709,149
Capital assets, net	88,127,205	87,799,198	87,822,594
Noncurrent notes receivable	<u>1,384,699</u>	<u>666,650</u>	<u>-</u>
Total Assets	<u>131,869,056</u>	<u>129,960,076</u>	<u>130,938,751</u>
Current liabilities	30,219,978	28,808,229	29,809,290
Noncurrent liabilities	<u>12,692,366</u>	<u>9,535,157</u>	<u>11,000,775</u>
Total Liabilities	<u>42,912,344</u>	<u>38,343,386</u>	<u>40,810,065</u>
Net Assets:			
Invested in capital assets, net of related debt	85,883,593	82,116,572	78,554,246
Restricted	48,493,415	50,443,072	58,766,557
Unrestricted	<u>(45,420,296)</u>	<u>(40,942,954)</u>	<u>(47,192,117)</u>
Net Assets	<u>\$ 88,956,712</u>	<u>\$ 91,616,690</u>	<u>\$ 90,128,686</u>
Operating revenues, net	\$ 95,937,001	\$ 92,280,692	\$ 82,656,150
Operating expenses	<u>103,657,076</u>	<u>101,359,735</u>	<u>92,064,756</u>
Loss from operations	(7,720,075)	(9,079,043)	(9,408,606)
Nonoperating revenues(expenses), net	(1,129,275)	(2,083,958)	(1,198,199)
Change in recovery of fuel costs	<u>3,182,803</u>	<u>(1,332,881)</u>	<u>1,536,048</u>
Net loss before capital contributions and federal grants	(5,666,547)	(12,495,882)	(9,070,757)
Capital contributions and federal grants	<u>10,407,616</u>	<u>13,983,886</u>	<u>5,810,246</u>
Change in net assets (deficit) before extraordinary items	4,741,069	1,488,004	(3,260,511)
Contract termination loss	(7,401,047)	-	-
Net assets, beginning	<u>91,616,690</u>	<u>90,128,686</u>	<u>93,389,197</u>
Net Assets, ending	<u>\$ 88,956,712</u>	<u>\$ 91,616,690</u>	<u>\$ 90,128,686</u>

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

During fiscal year 2012, total assets increased by \$1,908,980. Significant changes in account balances were:

- Cash and cash equivalents increased by \$2,341,657 due to collection of accounts receivable.
- Accounts receivable net of allowance for uncollectible decreased by \$2,685,732, primarily attributable to more aggressive collection activities.
- Other assets decreased by \$1,682,226, primarily due to the receipt of off-island purchases of parts and supplies for on-going maintenance programs which were prepaid in 2011.
- Inventory net of allowance for obsolescence decreased by \$1,121,089, due primarily to improved inventory management along with lack of adequate funding for annual typhoon preparedness supplies.
- Deferred fuel costs increased by \$3,182,803 due to LEAC rates consistently lower than actual cost of fuel purchases.
- Changes in capital assets are discussed in a separate section of this MD&A.

Total liabilities increased by \$4,568,958. Significant changes in account balances were as follows:

- Total Long-term debt increased by \$3,766,730. This is related to the early termination of the PMIC power purchase agreement.
- Preferred stocks' deferred dividends payable increased by \$900,000 pursuant to the Memorandum of Agreement between CUC and the Commonwealth Development Authority. Refer to Note 12 in the accompanying Notes to the Financial Statements for.
- Unpaid employer share retirement contribution decreased by \$182,889.

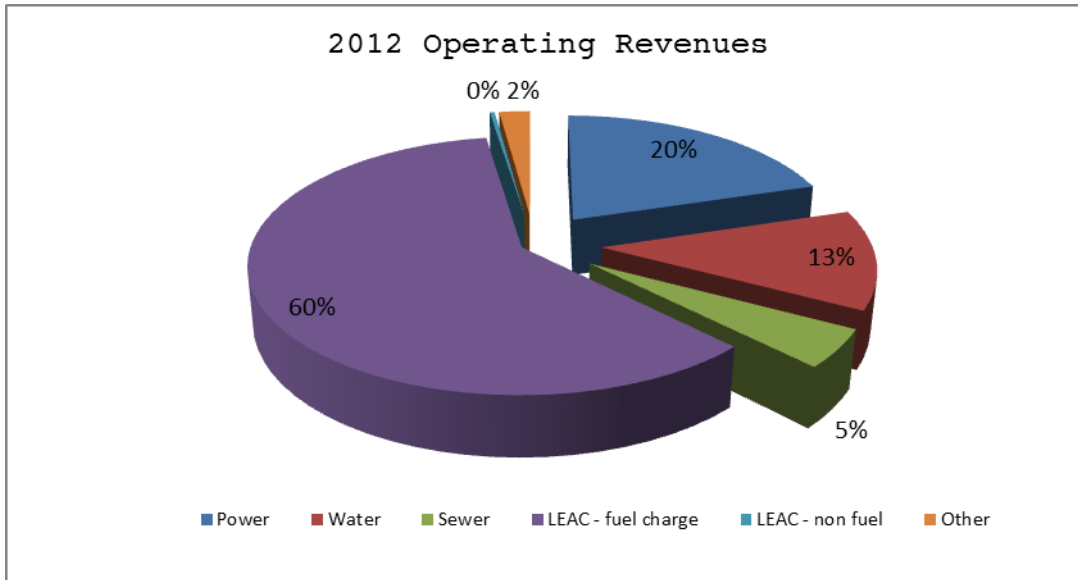


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MANAGEMENT'S DISCUSSION & ANALYSIS  
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Operating Revenues

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Power	\$ 19,402,752	\$ 15,609,742	\$ 17,524,104
Water	11,965,121	9,246,714	9,310,796
Sewer	4,723,893	3,365,104	2,102,383
LEAC - fuel charge	57,453,172	61,837,636	53,341,371
LEAC - non fuel	334,449	764,070	-
Other	<u>2,057,614</u>	<u>1,457,426</u>	<u>377,496</u>
Operating revenues, net	<u>\$ 95,937,001</u>	<u>\$ 92,280,692</u>	<u>\$ 82,656,150</u>



In 2012, operating revenues increased by \$3,656,309 or 4.0% when compared to revenues in 2011, which increased by \$9,624,542 or 11.6% when compared to revenues for 2010.

Power revenues (excluding LEAC) increased by \$3,793,010 or 24.3% compared to 2011. This is primarily due to the full year impact of the \$3,800,000 base rate increase approved by the Commonwealth Public Utilities Commission in June 2011.

Revenues from LEAC charges decreased by \$4,814,085 or 7.7% compared to 2011. This is the result of LEAC charges set at a level below corresponding fuel costs, per a CPUC Order issued in January 2012 to reimburse rate payers for an over-recovery of fuel costs from August 2010 through September 2011.

Sewer revenues increased by \$1,358,789 or 40.4% compared to 2011 due to the full year impact of the 128% rate increase approved by the CPUC in June 2010, improved customer metering, and billing customers with private water wells for sewer.

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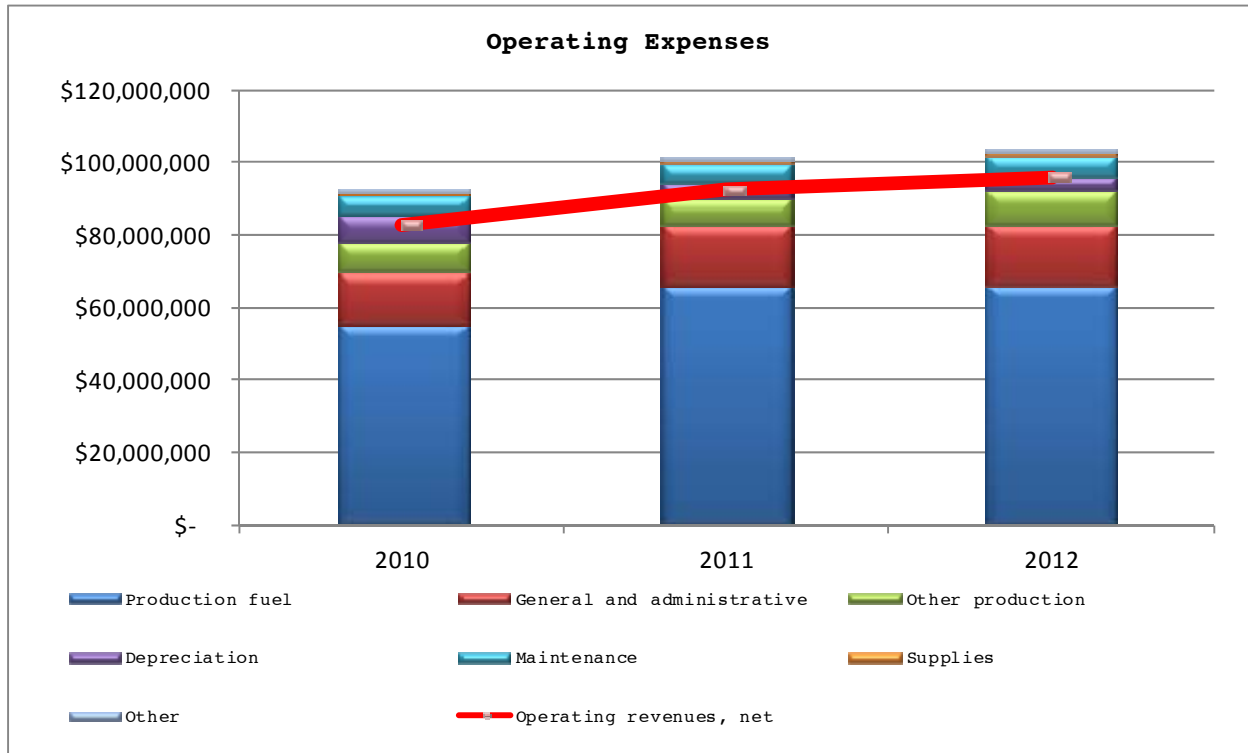
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Water revenues increased by \$2,718,407 or 29.4% compared to 2011 due primarily to improved metering of all water customers and a \$963,000 water rate increase approved by the CPUC in January 2012.

Operating Expenses

	2012	2011	2010
Production fuel	\$ 66,243,015	\$ 65,888,384	\$ 54,877,419
General and administrative	16,710,015	16,887,282	14,921,257
Depreciation	8,993,041	7,026,445	8,164,412
Other production	3,852,875	4,535,037	7,506,477
Maintenance	6,184,390	5,438,558	5,225,928
Supplies	1,265,772	1,229,359	725,217
Other	407,968	354,670	644,046
	<u>\$103,657,076</u>	<u>\$ 101,359,735</u>	<u>\$ 92,064,756</u>

The graph below shows the relationship of the total operating expenses (stacked bar graph) and the total operating revenues (line graph).



In 2012, total operating expenses of \$103,657,076 exceeded operating revenues of \$95,937,001 by \$7,720,075 or 8%.

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Highlights of events affecting operating expenses follow:

In 2012, production fuel costs totaled \$66,243,015, an increase of only \$354,631 (0.5%) when compared to 2011, which increased by \$11,010,965 (20.1%) when compared to 2010. Production fuel is the single largest expense of CUC, accounting for 64% of operating expenses in 2012, 65% for 2011 and 60% for 2010.

In 2012, general and administrative expenses, which are primarily personnel costs and related benefits, decreased by \$177,267 (1%) when compared to 2011, which increased by \$1,966,025 or 13.2% when compared to 2010.

Depreciation expense increased by \$1,966,596 or 28%, while repairs and maintenance increased by \$745,832 or 13.7%. These are related to CUC's efforts to upgrade and maintain its facilities.

Capital Assets

At September 30, 2012, CUC had \$88,127,205 invested in capital assets, net of depreciation where applicable, including electric plant, water plant, sewer plant, administrative equipment and construction in progress.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Utility plant in service			
Electric plant	\$ 132,337,219	\$ 130,656,131	\$ 128,586,476
Water plant	70,858,321	62,897,977	62,436,988
Sewer plant	45,839,881	42,693,604	42,640,713
Administrative equipment	<u>5,074,344</u>	<u>4,623,164</u>	<u>4,475,287</u>
	254,109,765	240,870,876	238,139,464
Accumulated depreciation	<u>(178,157,250)</u>	<u>(169,242,051)</u>	<u>(162,436,969)</u>
Depreciable assets, net	75,952,515	71,628,825	75,702,495
Construction work-in progress	<u>12,174,690</u>	<u>16,170,373</u>	<u>12,120,099</u>
Capital assets, net	<u>\$ 88,127,205</u>	<u>\$ 87,799,198</u>	<u>\$ 87,822,594</u>

For additional information regarding capital asset activity, refer to Note 8 in the accompanying Notes to the Financial Statements.

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MANAGEMENT'S DISCUSSION & ANALYSIS  
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Capital Contributions and Federal Awards

CUC received capital contributions and federal award of \$10,407,616 in fiscal year 2012, which is \$3,576,270 (25.6%) less than the level of support received in fiscal year 2011.

The capital contributions and federal awards, are as follows:

	2012		2011		2010	
	Amount	%	Amount	%	Amount	%
Federal	\$ 10,407,616	100.0	\$ 13,975,408	99.9	\$ 5,810,246	100.0
Local	-	-	8,478	0.1	-	-
Total	<u>\$ 10,407,616</u>	<u>100.0</u>	<u>\$ 13,983,886</u>	<u>100.0</u>	<u>\$ 5,810,246</u>	<u>100.0</u>

The following is a summary of the CUC's major capital expenditures for 2012:

Federal Assistance

*Direct Grants*

During fiscal year 2012, the U.S. Environmental Protection Agency (EPA) provided \$4.1 million for the upgrade of sewer and water systems and related equipment.

*Passed-through Grants*

The CNMI government, as a pass-through agency, provided \$4.9 million of Covenant 702 funds received from the U.S. Department of the Interior for the Saipan Power Plant Improvement and upgrade of sewer and water systems and related equipment for fiscal year 2012. CUC also received through the CNMI Department of Public Works \$1.3 million of the Energy Efficiency and Conservation Block Grant which was used to replace street lights with more energy efficient LED lighting fixtures.

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Debt

Long-term debt as of September 30, 2012, 2011 and 2010 are as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Pacific Marine Industrial Corporation	\$ 7,470,468	\$ -	\$ -
Commonwealth Ports Authority	1,978,888	5,682,626	7,104,452
Marianas Public Land Trust	-	-	245,347
GPPC, Inc.	<u>-</u>	<u>-</u>	<u>1,918,549</u>
	9,449,356	5,682,626	9,268,348
Current maturities	<u>(3,909,993)</u>	<u>(2,382,269)</u>	<u>(3,743,520)</u>
Long-term debt, net of current portion	<u>\$ 5,539,363</u>	<u>\$ 3,300,357</u>	<u>\$ 5,524,828</u>

The early termination of the Pacific Marine Industrial Corp. power purchase agreement is expected to save CUC over \$8.8 million.

For additional information regarding long-term debt activity, refer to Note 10 in the accompanying Notes to the Financial Statements.

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**ECONOMIC FACTORS**

The local economy has been in free fall for the past several years. A report prepared by Dr. Maria Claret M. Ruane, Resident Development Economist at the University of Guam-Pacific Center for Economic Initiatives, stated that the CNMI economy continues to struggle. The CNMI's Gross Island Product (GIP) declined by almost 20% between 2008 and 2009, according to the US Department of Commerce Bureau of Economic Analysis. Per person real income declined by more than 4% annually from 2002 to 2009. The population has decreased 22% from 2000. CNMI's largest remaining industry, tourism, declined 30% from 2005 to 2009, and the decline is accelerating, with tourism down 15% from January to September 2011 when compared to the same period in 2010. A June 2011 study conducted by the U.S. General Accountability Office found employment in all sectors in the CNMI decreased by 13% from 2008 to 2009.

Despite economic difficulties, CUC's operating losses declined from \$9 million in FY2011 to \$8 million in FY2012, an 11% decrease. This can be attributed to management's focus on more efficient operations and the rate increases mentioned above. However, as the losses show, CUC still has not achieved full cost recovery, and has not been able to establish the operating reserves required by statute (4 CMC 8141(c)). The economy continues to struggle, and the local government budget is still insufficient to cover all necessary expenditures. The effects on CUC can be seen in these examples:

- Total kWh sales fell 12% from FY 2011 to FY 2012, after a 9% decline in the prior year. The number of electric customers declined by over 2% from FY2011.
- The number of water customers declined by 3% from FY 2011 to FY 2012, with a corresponding decrease in water sales of 11%, from 1.5 billion gallons in FY 2011 to 1.3 billion gallons in FY2012.
- Wastewater volume actually increased 13%, to 825 million gallons (due to improved billing procedures), even while the total number of customers fell by 5%.
- The amount owed for utilities by the CNMI central government, Public School System and the Commonwealth Health Center increased from \$6.3 million at the end of FY2011 to \$11.9 million at the end of FY 2012.
- The amount of funds tied up in extended payment arrangements with residential customers increased by 72% from FY 2011 to FY 2012, to a total of \$1.6 million.

As the number of accounts and related consumption of utilities continues to decline, CUC's fixed cost of operations must be covered by fewer and fewer billing units. Exacerbating the problem are CUC's aging infrastructure and the new investments mandated by the Federal Court Orders (aka Stipulated Orders). For example, the Water and Wastewater Master Plan completed pursuant to the Federal Court Orders calls for over \$28 million in capital improvements over the next five years. Even if the capital improvements are funded 100% by federal grants, the corresponding increases in operations and maintenance expenses will require rate increases of at least 50% in the next

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MANAGEMENT'S DISCUSSION & ANALYSIS  
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five years. Whether or not adequate rates will be approved, and even if approved, subsequently paid, in the current weak economy is questionable, at best.

**ACCOMPLISHMENTS**

*Operations*

The maintenance of engines at the power plants is at its best or highest levels in years. In 2009, total available capacity at Power Plant 1 was only 9 megawatts and it is now 62 megawatts.

Completed major rehabilitation and upgrades to all engines, including crankshafts, eight new turbochargers, and purchase of new radiators for six engines, rebuilding engine foundations, and carried out preventative maintenance as required.

Installation of 2,375 LED streetlights fixtures, resulting in reduced electrical consumption and saving over \$570,000 annually.

Reached 90% completion of \$2.04 million Water and Wastewater Master Plan. Final completion expected in February 2013. The Master Plan assesses all facets of the water and wastewater systems and programs needed capital improvements over a twenty year planning cycle.

Completed a \$2.48 million rehabilitation of the Sadog Tasi Wastewater Treatment Plant. Completed 95% of a \$4.94 million rehabilitation project for the Agingan Wastewater Treatment Plant.

Repaired 975 water main leaks, saving 1,718,000 gallons of water per day.

Closed 21,515 Customer Service Orders and resolved 1,100 billing disputes. Negotiated the early termination of the PMIC Power Purchase Agreement, which is expected to save CUC customers \$8.8 million.

*Customer Service*

Customer service improvement efforts continued in 2012, including:

- Implementation of a state of the art customer billing and information system.
- Installation of a robust financial management and reporting system.
- Opening of the CUC Customer Care Center, providing a centralized location for payments and customer service and support.
- On-line payment processing.
- On-line appointment scheduling for Customer Care Center services.
- Professionally staffed customer call center and improved phone system, providing customers a 24 hours/day and 7 days/week single point of telephone contact for all CUC departments.

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- CUC web site (cucgov.org) providing payment and appointment portals, along with current information about CUC and its activities (e.g, the 2012 Water Quality/Consumer Confidence Report).

**2013 OUTLOOK**

Provide customers the ability to pay their bills over the telephone.

Installation of state-of-the art Smart prepaid meters.

Improved metering of customer net-metering sites, providing web based reporting of the customer's production and consumption data.

Develop and submit Power, Water, and Wastewater utility rate cases for consideration by the Commonwealth Public Utilities Commission. CUC is currently not recovering the costs of supplying service to consumers in its utility rates as required by CNMI law and Federal Consent Decree.

Perform Renewable Energy Integration Study to determine the loads and locations for introducing renewable energy into CUC transmission and distribution grid. This study will help determine maximum levels of customer supplied net-metering as well as optimal locations for future CUC sponsored projects.

Complete \$2.04 million Water & Wastewater Master Plan. The final draft of this extensive system analysis is scheduled for completion in February 2013.

Reach the goal of supplying water to 100% of Saipan consumers 24 hours/day and 7 days/week. CUC has already reached 95% supply in 2012, following only 50% supply in 2010.

Installation of 1,000 LED Street lights within the distribution system. Completion of all scheduled preventive maintenance and tree-trimming.

Complete installation of six new radiators at Power Plant 1, thereby increasing engine life and efficiency. Completion of all scheduled preventative maintenance.



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

MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2012

**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 [charles\\_warren@cucgov.org](mailto:charles_warren@cucgov.org).

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

Statements of Net Assets  
September 30, 2012 and 2011

	2012	2011
<u>ASSETS</u>		
Current assets		
Current unrestricted assets		
Cash and cash equivalents	\$ 4,042,165	\$ 1,700,508
Accounts receivable - utility, net	14,330,964	17,016,696
Due from grantor agencies	24,596	-
Inventory, net	9,196,262	10,317,351
Deferred fuel costs	3,256,998	74,195
Notes receivable, net	166,098	233,329
Other assets, net	2,145,612	3,827,838
Total current unrestricted assets	33,162,695	33,169,917
Current restricted assets		
Cash and cash equivalents	9,194,457	8,324,311
Total current assets	42,357,152	41,494,228
Noncurrent assets		
Notes receivable, net of current portion	1,384,699	666,650
Capital assets		
Utility plant in service		
Electric plant	132,337,219	130,656,131
Water plant	70,858,321	62,897,977
Sewer plant	45,839,881	42,693,604
Administrative equipment	5,074,344	4,623,164
	254,109,765	240,870,876
Accumulated depreciation	(178,157,250)	(169,242,051)
Net utility plant and administrative equipment	75,952,515	71,628,825
Construction in progress	12,174,690	16,170,373
Total capital assets	88,127,205	87,799,198
Total noncurrent assets	89,511,904	88,465,848
<b>TOTAL ASSETS</b>	<b>\$ 131,869,056</b>	<b>\$ 129,960,076</b>

See accompanying notes to financial statements.

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

Statements of Net Assets, Continued  
September 30, 2012 and 2011

	2012	2011
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities		
Unrestricted current liabilities		
Accounts payable	\$ 9,210,211	\$ 9,244,771
Customer deposits	1,091,039	1,722,155
Accrued liabilities	386,582	288,289
Compensated absences	100,498	222,879
Due to primary government	5,862,282	5,500,008
Current maturities of long-term debt	3,909,993	2,382,269
Interest payable	443,355	334,655
Due to grantor agency	-	167
Total unrestricted current liabilities	21,003,960	19,695,193
Restricted current liabilities		
Security deposits, including accrued interest	9,216,018	9,113,036
Total current liabilities	30,219,978	28,808,229
Noncurrent liabilities		
Long-term debt, net of current maturities	5,539,363	3,300,357
Retirement contributions payable	3,475,980	3,658,869
Dividends payable	2,700,000	1,800,000
Advances from CNMI Government	107,296	107,296
Compensated absences	869,727	668,635
Total noncurrent liabilities	12,692,366	9,535,157
<b>TOTAL LIABILITIES</b>	<b>42,912,344</b>	<b>38,343,386</b>
Commitments and contingencies		
Net assets		
Invested in capital assets, net of related debt	85,883,593	82,116,572
Restricted		
Expendable	93,415	320,917
Non-expendable	48,400,000	50,122,155
Unrestricted deficit	(45,420,296)	(40,942,954)
<b>NET ASSETS</b>	<b>88,956,712</b>	<b>91,616,690</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ 131,869,056</b>	<b>\$ 129,960,076</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 Assets  
For the Years Ended September 30, 2012 and 2011

	2012	2011
Operating revenues, net		
Power	\$ 19,402,752	\$ 15,609,742
Water	11,965,121	9,246,714
Sewer	4,723,893	3,365,104
LEAC - fuel charge	57,453,172	61,837,636
LEAC - non fuel	334,449	764,070
Other	2,057,614	1,457,426
Net operating revenues	95,937,001	92,280,692
Operating expenses		
Production fuel	66,243,015	65,888,384
General and administrative	16,710,015	16,887,282
Depreciation	8,993,041	7,026,445
Other production	3,852,875	4,535,037
Maintenance	6,184,390	5,438,558
Supplies	1,265,772	1,229,359
Other	407,968	354,670
Total operating expenses	103,657,076	101,359,735
Loss from operations	(7,720,075)	(9,079,043)
Non-operating revenues (expenses)		
Interest income	656,645	190,318
Miscellaneous income	421,062	454,242
Regulatory assessments	(561,951)	(469,949)
Settlement expense	(116,000)	(46,861)
Contribution to the CNMI government	(362,275)	(694,759)
Interest expense	(1,166,756)	(1,516,949)
Total non-operating revenues (expenses), net	(1,129,275)	(2,083,958)
Loss before change in recovery of fuel costs	(8,849,350)	(11,163,001)
Change in recovery of fuel costs	3,182,803	(1,332,881)
Net loss before capital contributions and federal grants	(5,666,547)	(12,495,882)
Capital contributions and federal grants	10,407,616	13,983,886
Change in net assets before extraordinary items	4,741,069	1,488,004
Contract termination expense	(7,401,047)	-
Change in net assets	(2,659,978)	1,488,004
Net assets, beginning	91,616,690	90,128,686
Net asset, ending	\$ 88,956,712	\$ 91,616,690

See accompanying notes to financial statements.

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

Statements of Cash Flows  
For the Years Ended September 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	\$ 98,305,092	\$ 97,608,532
Cash payments to suppliers for goods and services	(85,835,727)	(94,229,123)
Cash payments to employees for services	(10,167,137)	(9,543,362)
Net cash provided by (used for) operating activities	2,302,228	(6,163,953)
Cash flows from noncapital financing activities:		
Principal repayment of debt	(118,412)	(245,347)
Net cash used for noncapital financing activities	(118,412)	(245,347)
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(9,321,048)	(7,003,049)
Capital contributions received	10,382,853	15,735,384
Principal repayment of debt	-	(2,708,152)
Interest paid on outstanding debt	(48,841)	(496,351)
Net cash provided by capital and related financing activities	1,012,964	5,527,832
Cash flows from investing activities:		
Interest income	15,023	190,318
Net cash provided by investing activities	15,023	190,318
Net change in cash and cash equivalents	3,211,803	(691,150)
Cash and cash equivalents at beginning of year	10,024,819	10,715,969
Cash and cash equivalents at end of year	\$ 13,236,622	\$ 10,024,819
Cash and cash equivalents	\$ 4,042,165	\$ 1,700,508
Restricted cash and cash equivalents	9,194,457	8,324,311
	\$ 13,236,622	\$ 10,024,819

See accompanying notes to financial statements.

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

Statements of Cash Flows, Continued  
For the Years Ended September 30, 2012 and 2011

	2012	2011
Reconciliation of loss from operations to net cash used for operating activities:		
Loss from operations	\$ (7,720,075)	\$ (9,079,043)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation	8,993,041	7,026,445
Provision for bad debts	3,493,169	3,607,677
Miscellaneous income	421,062	454,242
Regulatory assessments	(561,951)	(469,949)
Settlement expense	(116,000)	(46,861)
(Increase) decrease in assets:		
Accounts receivable - utility	(4,511,175)	(2,665,043)
Inventory	1,121,089	(116,617)
Other assets	1,682,226	(2,990,027)
Increase (decrease) in liabilities:		
Accounts payable	34,861	(797,522)
Customer deposits	(631,116)	186,123
Accrued liabilities	98,293	125,059
Compensated absences	78,711	109,461
Security deposits including accrued interest	102,982	137,164
Retirement contributions payable	(182,889)	(223,242)
Long-term debt	-	(1,421,820)
Net cash provided by (used for) operating activities	<u>\$ 2,302,228</u>	<u>\$ (6,163,953)</u>
Noncash financing and investing activities		
Increase in capital assets and loans payable due to settlement of litigation:		
Noncash increase in capital assets	\$ -	\$ 1,976,232
Noncash increase in long term debt	-	(1,976,232)
	<u>\$ -</u>	<u>\$ -</u>
Payment of MPLT loan by appropriation from CNMI General Fund:		
Decrease in loans payable	\$ -	\$ (1,554,653)
Noncash non-operating revenues	-	1,554,653
	<u>\$ -</u>	<u>\$ -</u>
Offsetting of CPA loans payable with CUC utilities receivable:		
Decrease in loans payable	\$ (3,703,738)	\$ (789,603)
Decrease in utilities receivable	3,703,738	789,603
	<u>\$ -</u>	<u>\$ -</u>
Termination of long-term power purchase agreement:		
Increase in long-term debt	\$ 8,375,916	\$ -
Increase in capital assets	(368,296)	-
Decrease in accounts payable	(606,573)	-
Noncash non-operating loss	(7,401,047)	-
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(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 measurements 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*.

*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.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Adopted Pronouncements*

In November 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. The objective of this Statement is to improve financial reporting by addressing issues related to service concession arrangements (SCAs), which are a type of public-private or public-public partnership. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2011. The provisions of this Statement generally are required to be applied retroactively for all periods presented.

In June 2011, GASB issued Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions—an amendment of GASB Statement No. 53*. The objective of this Statement is to clarify whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider. This Statement sets forth criteria that establish when the effective hedging relationship continues and hedge accounting should continue to be applied. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2011.

The adoption of these Statements does not materially affect CUC financial statements.

*Recent Pronouncements*

In November 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*. The objective of this Statement is to improve financial reporting for a governmental financial reporting entity. The requirements of Statement No. 14, *The Financial Reporting Entity*, and the related financial reporting requirements of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, were amended to better meet user needs and to address reporting entity issues that have arisen since the issuance of those Statements. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2012. Earlier application is encouraged.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The objective of this Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and Interpretations
2. Accounting Principles Board Opinions
3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedures



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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Recent Pronouncements, Continued*

Hereinafter, these pronouncements collectively are referred to as the "FASB and AICPA pronouncements." The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged. The provisions of this Statement generally are required to be applied retroactively for all periods presented.

In June 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This Statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. The requirements of this Statement will improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. It alleviates uncertainty about reporting those financial statement elements by providing guidance where none previously existed. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged.

In March 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. This Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*; and Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*. The requirements of these Statements will improve the decision-usefulness of information in employer and governmental nonemployer contributing entity financial reports and will enhance its value for assessing accountability and interperiod equity by requiring recognition of the entire net pension liability and a more comprehensive measure of pension expense. Decision-usefulness and accountability also will be enhanced through new note disclosures and required supplementary information. These Statements are effective for fiscal years beginning after June 15, 2014.

Management of CUC has not evaluated the effect of these pronouncements on the financial statements of CUC.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*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 but is not legally required to adopt a budget.

*Cash and Cash Equivalents*

For purposes of the Statements of Net Assets 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 Assets.

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 in the depositor government's name 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, 2012 and 2011, cash and cash equivalents were \$13,236,622 and \$10,024,819, respectively, and the corresponding bank balances were \$13,079,327 and \$10,685,992, respectively. Of the bank balance amounts, \$13,037,177 and \$10,154,314, respectively, were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$11,089,045 and \$9,874,161 were in excess of FDIC insurable limits insured as of September 30, 2012 and 2011, respectively. CUC also has deposits of \$42,150 in 2012 and \$26,863 in 2011 in an uninsured financial institution.

CUC's deposits in excess of FDIC insured limits are collateralized by securities in the financial institutions name.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Restricted Cash and Cash Equivalents*

The restricted cash and cash equivalents of \$9,194,457 and \$8,324,311 at September 30, 2012 and 2011, respectively, pertains to customer deposits, of which, \$7,500,000 in 2012 and 2011 is held as security pursuant to a standby letter of credit obtained from a financial institution.

*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 represents 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, 2012 and 2011 are as follows:

	<u>2012</u>	<u>2011</u>
Fuel and lubes	\$ 1,628,855	\$ 1,820,660
Materials and supplies	<u>8,264,532</u>	<u>9,193,816</u>
	9,893,387	11,014,476
Allowance for obsolescence	<u>(697,125)</u>	<u>(697,125)</u>
Inventory, net	<u>\$ 9,196,262</u>	<u>\$ 10,317,351</u>

*Fuel Oil Costs*

Fuel oil costs increase or decrease billings to customers based on price changes 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, 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.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Fuel Oil Costs, Continued*

Any difference between the actual fuel costs and the electric fuel rate is accumulated in a deferred account and subject to annual reconciliation. No interest is charged or paid on any under or over recovery balance in the deferred account.

On April 2, 2009, the Commonwealth Public Utilities Commission (CPUC), adopted a "levelized energy adjustment clause" rate or LEAC rate of \$0.20147 per kWh which was effective from April 3, 2009 until September 30, 2009. On September 3, 2009, CPUC adopted to extend the effective date of the rate structure until ordered by the CPUC.

Subsequent approved LEAC rates are as follows:

<u>Effective Dates</u>	<u>Rate</u>
October 1, 2009 to June 1, 2010	\$0.24446
June 2, 2010 to January 12, 2011	\$0.24446
January 13, 2011 to April 15, 2010	\$0.28125
April 16, 2010 to November 19, 2011	\$0.34426
November 20, 2011 to January 27, 2012	\$0.30791
January 28, 2012 to April 8, 2012	\$0.30550
April 9, 2012 to June 4, 2012	\$0.32910
June 5, 2012 to July 5, 2012	\$0.29569
July 6, 2012 to August 2, 2012	\$0.26373
August 3, 2012 to September 5, 2012	\$0.28168
September 6, 2012 to January 6, 2013	\$0.31212
January 7, 2013 - March 4, 2013	\$0.29751

The deferred fuel costs (excess of electric fuel surcharge over fuel costs) at September 30, 2012 and 2011 are as follows:

	<u>2012</u>	<u>2011</u>
At beginning of year	\$ 74,195	\$ 1,407,076
Change in recovery of fuel costs	<u>3,182,803</u>	<u>(1,332,881)</u>
At end of year	<u>\$ 3,256,998</u>	<u>\$ 74,195</u>

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Capital Assets and Depreciation*

Capital assets consist of utility plant (including infrastructures), 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 cost 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 Assets. 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. CUC capitalizes interest cost on borrowings incurred during the new construction or upgrade of qualifying assets. Capitalized interest is added to the cost of the underlying assets and is amortized over the estimated useful lives of the assets. There were not capitalized interest for the fiscal years ending September 30, 2012 and 2011.

*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 reported as current liabilities. The liability at September 30, 2012 and 2011 are as follows:

	<u>2012</u>	<u>2011</u>
Total compensated absences, beginning of year	\$ 668,635	\$ 782,053
Vacation earned	678,659	617,599
Vacation used	<u>(377,069)</u>	<u>(508,138)</u>
Total compensated absences, end of year	970,225	891,514
Current portion	<u>(100,498)</u>	<u>(222,879)</u>
Compensated absences – noncurrent	<u>\$ 869,727</u>	<u>\$ 668,635</u>

No liability is recorded for non-vesting accumulating rights to receive sick leave 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 the calendar year.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

*Net Assets*

Net assets represent the residual interest in CUC's assets after liabilities while net deficit represents the excess liabilities over assets. Net assets consist of three sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable; and unrestricted. Net assets invested in capital assets, net of debt includes 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.

CUC's restricted net assets as of September 30, 2012 and 2011 are as follow:

	<u>2012</u>	<u>2011</u>
Commonwealth Development Authority equity in CUC (Note 12)	\$45,000,000	\$45,000,000
Restricted for:		
Restricted for customer rebate/ rate reduction per Public Law 16-7	3,400,000	3,400,000
Regulatory assessments	<u>93,415</u>	<u>320,917</u>
	<u>\$48,493,415</u>	<u>\$48,720,917</u>

*Application of Net Assets*

It is CUC's policy to first use restricted net assets, prior to the use of unrestricted net assets, when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
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(2) Summary of Significant Accounting Policies, Continued

*Retirement Plan – Defined Benefit 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, 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.

Based on the actuarial valuation as of October 1, 2010 issued in October 2012, the actuarially determined contribution rate for the fiscal year ended September 30, 2010 was 72.7215% of covered payroll.

The established statutory rate at September 30, 2012 and 2011 were 60.8686% and 37.3909% of covered payroll, respectively.

In fiscal year 2012, CUC's management adopted to follow the 30% employer contribution rate which the CNMI Superior Court ordered CUC to pay the NMIRF as one of the Intervenor's to Civil Action No. 06-0367.

Required contributions and the percentage actually contributed for the current year and for the preceding three 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>
2012	\$1,409,678	30.0000%	\$1,409,678	100%
2011	\$1,811,516	37.3909%	\$1,668,688	93%
2010	\$2,137,963	37.3909%	\$1,061,477	50%

NMIRF issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to the Northern Mariana Islands Retirement Fund, P.O. Box 501247, Saipan, MP, 96950-1247.

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(2) Summary of Significant Accounting Policies, Continued

*Other Postemployment Benefits*

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, requires employers to record other postemployment benefits (OPEB) expense for their contractually required contributions to the OPEB plan. CUC has complied with GASB 45 by recording OPEB expense based on the statutory determined contribution rate of NMIRF. CUC's OPEB liability is incorporated into the contribution amount. It is the understanding of the management of CUC that the statutory determined contribution rate of NMIRF incorporates both the pension liability and the OPEB liability.

*Retirement Plan – Defined Contribution Plan*

The Defined Contribution Plan (DC Plan) is a multi-employer pension plan of the CNMI Government and shall be the single retirement program for all new employees whose employment commences on or after January 1, 2007.

Existing Class I members of the Defined Benefit Plan with less than 10 years of service credit may, upon written election, voluntarily and irrevocably elect membership in the DC Plan. This option shall expire 12 months after enactment of legislation.

CUC's contributions to the DC Plan for the years ended September 30, 2012, 2011 and 2010 are as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Employee contributions	\$ 530,047	\$ 368,891	\$ 285,535
Employer contributions	<u>212,019</u>	<u>142,828</u>	<u>111,689</u>
	<u>\$ 742,066</u>	<u>\$ 511,719</u>	<u>\$ 397,224</u>

*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. Health and life insurance coverage are provided by private carriers through the GHLITF. Employee deductions are made through payroll or pension benefit withholdings.



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(2) Summary of Significant Accounting Policies, Continued

*Revenue and Expense 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 included in current year's earnings at September 30, 2012 and 2011 are \$6,858,994 and \$8,393,695, 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.

*Contingencies*

Certain conditions may exist as of the date the financial statements are issued, which may result in a loss to CUC but which will only be resolved when one or more future events occur or fail to occur. CUC's management and its legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against CUC or unasserted claims that may result in such proceedings, CUC's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in CUC's financial statements. If the assessment indicates that a potentially material loss contingency is not probable, but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed.

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee would be disclosed.

**COMMONWEALTH UTILITIES CORPORATION**  
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(3) Accounts Receivable – Utility

Account receivable – utility as of September 30, 2012 and 2011 summarized by location and customer classification are as follows:

By Location

	2012	2011
Saipan		
Commercial	\$ 4,697,885	\$ 5,846,912
Residential	8,222,248	11,258,213
Government	9,748,895	5,979,231
	22,669,028	23,084,356
Tinian		
Commercial	806,539	975,341
Residential	243,714	444,979
Government	705,018	984,758
	1,755,271	2,405,078
Rota		
Commercial	121,510	231,934
Residential	282,627	587,456
Government	1,163,982	654,414
	1,568,119	1,473,804
Total billed	25,992,418	26,963,238
Unbilled	6,858,994	8,393,695
	\$ 32,851,412	\$ 35,356,933

By Customer Classification

	2012	2011
Billed		
Commercial	\$ 5,625,934	\$ 7,054,187
Residential	8,748,589	12,290,648
Government	11,617,895	7,618,403
Unbilled	6,858,994	8,393,695
	32,851,412	35,356,933
Allowance for uncollectible accounts	(18,520,448)	(18,340,237)
Accounts receivable – utility, net	\$ 14,330,964	\$ 17,016,696

**COMMONWEALTH UTILITIES CORPORATION**  
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(4) Allowance for Uncollectible Accounts

Changes in allowance for uncollectible accounts for the years ended September 30, 2012 and 2011 are as follows:

	2012	2011
Total allowance, beginning of year	\$ 19,250,392	\$ 17,400,040
Provision for uncollectible accounts	3,493,169	3,607,677
Accounts written-off	(3,492,340)	(1,757,325)
Total allowance, end of year	\$ 19,251,221	\$ 19,250,392
Accounts receivable - utility (Note 3)	\$ 18,520,448	\$ 18,340,237
Notes receivable (Note 5)	181,780	181,780
Others assets (Note 6)	548,993	728,375
Total allowance, end of year	\$ 19,251,221	\$ 19,250,392

(5) Notes Receivable

CUC allows customers to settle their outstanding utilities through issuance of promissory notes with terms ranging from 6 months to 10 years at an interest rate of 12% per annum. A summary of the outstanding notes receivable as of September 30, 2012 and 2011 is as follows:

	2012	2011
Current portion, net of allowance for uncollectible of \$181,780 in 2012 and 2011	\$ 166,098	\$ 233,329
Noncurrent	1,384,699	666,650
	\$ 1,550,797	\$ 899,979

**COMMONWEALTH UTILITIES CORPORATION**  
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(6) Other Assets

Other assets as of September 30, 2012 and 2011 consist of the following.

	2012	2011
Prepayments	\$ 1,903,123	\$ 3,521,422
Temporary facility	91,061	91,196
Other receivables	700,421	943,595
	2,694,605	4,556,213
Allowance for uncollectible accounts	(548,993)	(728,375)
Other assets, net	\$ 2,145,612	\$ 3,827,838

(7) Due from (to) Grantor Agencies

CUC is a recipient of direct federal awards and 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 (to) grantor agencies account for the years ended September 30, 2012 and 2011 are as follows:

	2012	2011
Balance at beginning of year	\$ (167)	\$ 1,751,336
Adjustments	-	(754,949)
Deductions - cash receipts from grantor agencies	(10,382,853)	(14,970,584)
Additions - program outlays	10,407,616	13,974,030
Balance at end of year	\$ 24,596	\$ (167)

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(8) Capital Assets

A summary of the changes in capital assets activity for the years ended September 30, 2012 and 2011 is as follows:

	Estimated Useful Lives	Balance at October 1, 2011	Acquisitions	Disposals	Adjustments/ Transfers	Balance at September 30, 2012
Utility plant in service						
Electric plant	20 years	\$130,656,131	\$ 1,473,974	\$ (158,932)	\$ 366,046	\$132,337,219
Water plant	20 years	62,897,977	2,830,486	-	5,129,858	70,858,321
Sewer plant	20 years	42,693,604	174,654	-	2,971,623	45,839,881
Administrative equipment	3-5 years	<u>4,623,164</u>	<u>388,360</u>	<u>(16,151)</u>	<u>78,971</u>	<u>5,074,344</u>
		240,870,876	4,867,474	(175,083)	8,546,498	254,109,765
Accumulated depreciation		<u>(169,242,051)</u>	<u>(8,993,041)</u>	<u>77,842</u>	<u>-</u>	<u>(178,157,250)</u>
Depreciable assets, net		71,628,825	(4,125,567)	(97,241)	8,546,498	75,952,515
Construction work-in-progress		<u>16,170,373</u>	<u>4,453,574</u>	<u>-</u>	<u>(8,449,257)</u>	<u>12,174,690</u>
Capital assets, net		<u>\$ 87,799,198</u>	<u>\$ 328,007</u>	<u>\$ (97,241)</u>	<u>\$ 97,241</u>	<u>\$ 88,127,205</u>
	Estimated Useful Lives	Balance at October 1, 2010	Acquisitions	Disposals	Adjustments/ Transfers	Balance at September 30, 2011
Utility plant in service						
Electric plant	20 years	\$128,586,476	\$ 1,595,613	\$ (309,333)	\$ 783,375	\$130,656,131
Water plant	20 years	62,436,988	460,989	-	-	62,897,977
Sewer plant	20 years	42,640,713	55,520	-	(2,629)	42,693,604
Administrative equipment	3-5 years	<u>4,475,287</u>	<u>144,202</u>	<u>-</u>	<u>3,675</u>	<u>4,623,164</u>
		238,139,464	2,256,324	(309,333)	784,421	240,870,876
Accumulated depreciation		<u>(162,436,969)</u>	<u>(7,026,445)</u>	<u>221,363</u>	<u>-</u>	<u>(169,242,051)</u>
Depreciable assets, net		75,702,495	(4,770,121)	(87,970)	784,421	71,628,825
Construction work-in-progress		<u>12,120,099</u>	<u>4,746,725</u>	<u>-</u>	<u>(696,451)</u>	<u>16,170,373</u>
Capital assets, net		<u>\$ 87,822,594</u>	<u>\$ (23,396)</u>	<u>\$ (87,970)</u>	<u>\$ 87,970</u>	<u>\$ 87,799,198</u>

Included in utility plant in service adjustments/transfers for fiscal years ended September 30, 2012 and 2011 are completed projects transferred from construction work-in-progress to utility plant in service of \$8,449,257 and \$696,451, respectively.

Depreciation expense for the years ended September 30, 2012 and 2011 is \$8,993,041 and \$7,026,445, respectively.

CUC entered into several construction contracts during fiscal year 2012 for improvements, rehabilitation and replacement of facilities, and other capital projects. As of September 30, 2012, CUC had outstanding construction contracts totaling \$4,289,572 that will be financed from operating funds and federal awards.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
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(9) Security Deposits

Pursuant to 4 CMC § 8143, as amended by Public Law 15-80, CUC shall collect one month security deposits per customer account. Such deposits shall be placed in an interest earning trust fund and shall not be used for any other purpose.

On May 3, 2008, 4 CMC § 8143 as established by Public Law 15-80 was amended by Public Law 16-2, which allows CUC to use up to fifty percent (50%) of the security deposit funds to pay for its fuel expenses for fiscal year 2008 with the condition that CUC shall return the funds within three years.

Pursuant to Public Law 16-2, summarized below is the summary of security deposits including accrued interest as of September 30, 2012 and 2011:

	2012	2011
Electric	\$ 8,149,651	\$ 8,203,660
Water	501,438	448,772
Sewer	64,019	9,506
Total security deposits	8,715,108	8,661,938
Accrued interest on security deposits	500,910	451,098
Security deposits, including interest	\$ 9,216,018	9,113,036
Security deposits, including interest	\$ 9,216,018	\$ 9,113,036
Restricted cash	9,194,457	8,324,311
Accumulated security deposits used to purchase fuel	\$ 21,561	\$ 788,725

The restriction on deposits was reinstated by Public Law 16-17.

Of CUC's restricted cash, \$7,500,000 as of September 30, 2012 and 2011, 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. Pursuant to Public Law 16-2, CUC has to return the restricted cash used to purchase fuel by fiscal year 2011. CUC is in default of this provision of the law.

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(10) Long-term Debt

Long-term debt at September 30, 2012 and 2011 is as follows:

	<u>2012</u>	<u>2011</u>
Pacific Marine Industrial Corporation (PMIC)	\$ 7,470,468	\$ -
Commonwealth Ports Authority (CPA)	<u>1,978,888</u>	<u>5,682,626</u>
	9,449,356	5,682,626
Current maturities	<u>(3,909,993)</u>	<u>(2,382,269)</u>
Long-term debt, net of current portion	<u>\$ 5,539,363</u>	<u>\$ 3,300,357</u>

Interest expense on long-term debt for the years ended September 30, 2012 and 2011 was \$314,881 and \$616,949, respectively, is presented as a component of interest expense in the accompanying Statements of Revenues, Expenses and Changes in Net Assets.

Changes in long-term debt for fiscal year ending September 30, 2012 and 2011 are as follows:

	<u>Balance at October 1, 2011</u>	<u>Additions</u>	<u>Repayments</u>	<u>Non-Cash Change</u>	<u>Balance at September 30, 2012</u>
CPA	\$ 5,682,626	\$ -	\$ (3,703,738)	\$ -	\$ 1,978,888
PMIC	<u>-</u>	<u>8,375,916</u>	<u>(905,448)</u>	<u>-</u>	<u>7,470,468</u>
Total	<u>\$ 5,682,626</u>	<u>\$ 8,375,916</u>	<u>\$ (4,609,186)</u>	<u>\$ -</u>	<u>\$ 9,449,356</u>
	<u>Balance at October 1, 2010</u>	<u>Additions</u>	<u>Repayments</u>	<u>Non-Cash Change</u>	<u>Balance at September 30, 2011</u>
CPA	\$ 7,104,451	\$ -	\$ (1,421,825)	\$ -	\$ 5,682,626
GPPC	1,918,550	-	(1,918,550)	-	-
MPLT	<u>245,347</u>	<u>-</u>	<u>(245,347)</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 9,268,348</u>	<u>\$ -</u>	<u>\$ (3,585,722)</u>	<u>\$ -</u>	<u>\$ 5,682,626</u>

**COMMONWEALTH UTILITIES CORPORATION**  
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(10) Long-term Debt, Continued

*Commonwealth Ports Authority (CPA)*

A summary of CUC's loans payable CPA at September 30, 2012 and 2011 is as follows:

	<u>2012</u>	<u>2011</u>
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.	\$ 1,978,888	\$ 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.	<u>-</u>	<u>2,297,495</u>
Current portion	1,978,888 <u>(342,105)</u>	5,682,626 <u>(2,382,269)</u>
Long-term debt, net of current portion	<u>\$ 1,636,783</u>	<u>\$ 3,300,357</u>

Future repayment commitments of principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 342,105	\$ 113,991	\$ 456,096
2014	364,110	91,986	456,096
2015	387,530	68,566	456,096
2016	412,457	43,639	456,096
2017	438,987	17,109	456,096
2018	<u>33,699</u>	<u>175</u>	<u>33,874</u>
	<u>\$ 1,978,888</u>	<u>\$ 335,466</u>	<u>\$2,314,354</u>



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(10) Long-term Debt, Continued

*Pacific Marine Industrial Corporation (PMIC)*

On Sept 23, 1996, CUC entered into a Power Purchase Agreement (PPA) with Pacific Marine and Industrial Corporation (PMIC).

After several contract amendments and renewal, on June 2012 CUC and PMIC agreed to terminate the PPA beginning July 2012 with 4 years and one month (49 months) remaining on the contract. CUC Power Plant 1 power generation is sufficient to provide power to the island even without purchasing power from PMIC through Power Plant 4.

An analysis by CUC Management of the contract termination follows:

Remaining commitment		
Monthly minimum payment	\$	331,000
Remaining term (in months)		<u>x 49</u>
		16,219,000
Termination cost payable in 27 months	\$	8,375,916
Assets transferred to CUC		<u>(974,869)</u>
Contract termination expense		<u>7,401,047</u>
Savings	\$	<u><u>8,817,953</u></u>

As a result of the contract termination, CUC recognized loan payable to PMIC, principal of \$8,375,916 with interest at 9% per annum. Principal and interest payments are due in monthly payments of \$341,286. The loan balance as of September 30, 2012 is \$7,470,468. Future repayment commitments of principal and interest are as follows:

<u>Year ending</u> <u>September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 3,567,888	\$ 527,549	\$ 4,095,437
2014	<u>3,902,580</u>	<u>192,857</u>	<u>4,095,437</u>
	<u>\$ 7,470,468</u>	<u>\$ 720,406</u>	<u>\$ 8,190,874</u>

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(11) Due to Primary Government

Public Law 9-68, enacted on October 19, 1995, requires government agencies to pay the CNMI 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, 2012 and 2011, CUC recognized an outstanding payable to the CNMI Government in the amount of \$5,862,282 and \$5,500,008, respectively. CUC accrued OPA fees of \$362,274 in 2012 and \$694,759 in 2011. OPA asserts that CUC owes the CNMI government OPA fee of approximately \$9 million as of September 30, 2012 based on 1% of CUC's operations budget including fuel costs. CUC's management and OPA have initiated negotiations to reconcile CUC's payable to the CNMI Government for OPA fees; however, no settlement agreement has been formalized as of September 30, 2012. CUC and OPA have differing opinions whether fuel costs should be included in the operations budget which should be used as the basis for the OPA Fee. CUC intends to seek assistance from the CNMI Legislature to resolve this issue. CUC has not made any remittance for OPA fees since fiscal year 2003.

On September 26, 2011, the Appropriations and Budget Authority Act of 2012 (Public Law 17-55) was signed into law. Section 601 of Public Law 17-55 authorizes the CNMI Secretary of Finance to deduct the 1% due to the OPA from the CUC from monthly utility costs of the government. No application of payments were made as of September 30, 2012.

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(12) Preferred Stocks Issued to Commonwealth Development Authority

On October 2, 2008, Public Law 16-17 or the Commonwealth Utilities Corporation Act of 2008 authorized CUC to issue shares of cumulative, non-convertible, non-transferable preferred stock valued at \$45,000,000 to CDA. CUC and CDA may provide by written agreement, subject to the terms and conditions of a Memorandum of Agreement (MOA), such terms and conditions being incorporated herein by reference, for the following:

- (1) Guaranteed annual dividends fixed and payable as agreed;
- (2) Buy-back provisions;
- (3) Default provisions;
- (4) Preferred shareholder rights; and
- (5) Consistent with Commonwealth law, such other rights and remedies are typically found in shareholder and stock purchase agreements.

On May 7, 2009, the MOA was signed by officials of CUC and CDA. The MOA was subsequently approved by the Commonwealth Public Utilities Corporation approved the MOA on September 3, 2009.

Pursuant to the terms of the MOA, the dividend payments for the first three years after issuance of the stocks are to be amortized and interest free over a 15-year period. Although the preferred stock certificates have not been physically issued, CUC is of the opinion that CDA has constructive receipt of the preferred shares though the execution of the MOA. Dividends payable as of September 30, 2012 and 2011 amounted to \$2,700,000 and \$1,800,000 respectively. In 2013, CUC will also be required to pay dividends to CDA amounting to \$900,000.

Future payments of the deferred dividends payable and 2013 dividends are as follows:

<u>Year Ending</u> <u>September 30</u>	
2013	\$ 1,080,000
2014	180,000
2015	180,000
2016	180,000
2017	180,000
2018 to 2022	900,000
2023 to 2027	<u>900,000</u>
	<u>\$ 3,600,000</u>

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Notes to Financial Statements  
September 30, 2012 and 2011

(13) 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. As an autonomous agency, CUC is not required to follow the CNMI government's policy of self-insurance and may insure some of its assets.

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 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 constructions projects.

(14) Commitments and Contingencies

Commitments

At September 30, 2012, CUC had commitments of \$4,289,572 for construction and acquisition of property and equipment, all of which are expected to be incurred in 2013.

Contingencies

*Litigation and Potential Claims*

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.

CUC is a defendant in a class action lawsuit, Superior Court Civil Case No. 09-0410, wherein CUC is alleged to have overcharged its customers from July 22, 2006 to October 24, 2006. The damages sought include a refund of approximately \$4.2 million, in addition to related punitive damages and attorney fees. While the lawsuit was proceeding, the Legislature enacted Public Law 17-3 which sought to clarify the intent of prior Public Laws enabling the Commonwealth Public Utilities Commission (CPUC). The law amends Section 8122 of the Commonwealth Code to give the Executive Director of CUC the power and authority to set rates as of January 27, 2006 and continue until the CPUC's first order setting rates. The second motion to dismiss has now been fully briefed by the parties, including the CNMI, and two former CUC Executive Directors, both represented by the CNMI Attorney General's Office, and was argued on January 19, 2011. CUC believes that it should not be liable for further rate refunds or damages as alleged in this case, and is defending vigorously. If CUC does not prevail, the potential loss could be upward of \$10 million. CUC believes that, with the passage of PL 17-3, which provides that its rate was "legal" during the time period in question, it has a much stronger chance of prevailing and getting these claims dismissed.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(14) Commitments and Contingencies, Continued

Contingencies, Continued

*Litigation and Potential Claims, Continued*

No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

There were also other threatened litigation and claims filed against CUC by Contractors but no formal cases have been filed.

*Federal Questioned Costs*

CUC participates in a number of federally assisted grant programs funded by the United States of America government. These programs are subject to financial and compliance audits to ascertain if federal laws and regulations have been followed. There were no accumulated questioned costs as of September 30, 2012. In the beginning of fiscal year 2011, CUC has accumulated questioned costs of \$1,245,922. CUC believes that no further action is needed to resolved these questioned costs pursuant to OMB Circular A-133 subpart C, §315, *Audit Findings Follow-up*, since (i) two years have passed since the audit report in which the finding occurred was submitted to the Federal Clearinghouse; (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and (iii) a management decision was not issued. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(14) Commitments and Contingencies, Continued

Contingencies, Continued

*Stipulated Orders*

The U.S. Environmental Protection Agency (EPA) sought to force CUC and the CNMI Government to comply with various regulations and requirements. To date there have been two stipulated orders.

Stipulated Order One is intended to ensure that CUC's wastewater and drinking water systems achieve compliance with the Clean Water Act (CWA) and Safe Drinking Water Act (SDWA). The major components of Stipulated Order One are:

1. The reformation of CUC's management, finances and operations;
2. The development of a wastewater and drinking water Master Plan; and
3. The construction of wastewater infrastructure.

CUC is also required to take steps to comply with National Pollution Discharge Elimination System permits and compliance orders, comply with drinking water standards, and to eliminate spills from the wastewater system.

Stipulated Order Two is intended to ensure that CUC's power plant facilities achieve compliance with the CWA. These requirements include requiring CUC to eliminate oil spills, implement appropriate spill prevention measures, implement effective inspection procedures for its oil storage facilities, provide containment for oil storage facilities and prepare appropriate operating plans.

Fines and penalties related to these Stipulated Orders have accrued to over \$40 million, but have not been charged, with the exception of \$29,000 and \$140,000 which were paid by CUC to the United States Department of Justice on January 2010 and July 2010, respectively. CUC has continued to perform its projects and has not been further charged as of September 30, 2012.

The parties appeared for status conferences and signed further stipulations dated August 12, 2010, in which CUC has agreed to specific performance dates for required projects. On the status conference on December 9, 2010, CUC had met its deadlines on 31 out of 33 discrete deliverables, and had made substantial progress on the balance. Pursuant to the March 22, 2011 status conference stipulation, the parties agreed to further deadlines for meter change-outs and the pipeline project. The Federal District Court has expressed its satisfaction with CUC's progress on the water metering project. There have been three major projects of the highest priority to the Federal District Court: the Pipeline, Tank 102, and the Rota Tanks. CUC completed the Rota Tanks in late December, 2012. Tank 102 is progressing with an expected completion date of July 26, 2013. The Pipeline design is progressing as well with a final design underway. CUC is attempting to obtain further federal funding to cover a potential shortfall of \$1.75 million to complete the project. As further penalties and fines are contingent on CUC's performance, and as EPA has not at this time chosen to attempt to collect on the majority of the penalties and fines, it is very difficult to determine future liabilities, therefore, CUC has not accrued any liability in the accompanying Statements of Net Assets.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(14) Commitments and Contingencies, Continued

Contingencies, Continued

*Other Matters*

In August 2012, the then CNMI Governor and Attorney General signed a 25-year power purchase agreement (PPA) with a private company granting exclusive right to develop a diesel-generated electric power plant" on Saipan for a total guaranteed price of \$190 million. CUC filed a motion detailing the problems and illegalities with the agreement. CUC believes that the PPA is void *ab initio*, per an Attorney General Opinion. Given the CNMI Attorney General's Office position on the PPA, CUC believes that no damage will be incurred as the PPA will not go forward. However, there has not yet been a finding by the Superior Court. In addition, the PPA provides for damages if for any reason CUC cancels the contract, so if the PPA is not found to be void or otherwise unenforceable, there may be liability in an amount of 10% of the contract value as lost profits pursuant to PPA section 7.6(a), which CUC believes would be approximately \$7 million.

(15) Liability for Estimated Environmental Remediation Costs

CUC is involved in environmental remediation and ongoing compliance as discussed in Note 14.

On March 10, 2011, CUC received an order from the U.S. EPA, which requires CUC to perform cleanup activities of Power Plants 1 and 2, pursuant to the National Oil and Hazardous Substances Pollution Contingency Plan, which appears at Title 40, CFR Part 300 and paragraphs 12 and 14 of Stipulated Order Two for Preliminary Injunctive Relief. CUC and EPA estimate the cost of remedial activities to range from \$1 million to \$2 million. The accompanying financial statements have not been restated to include accrual of these remedial activities.

(16) Economic Dependency

CUC is dependent on third-party equipment manufacturers, distributors, and dealers for the supply of parts for the utility plants. CUC is dependent on the ability of its suppliers to provide products on a timely basis and on favorable pricing terms. The loss of certain principal suppliers or a significant reduction in product availability from principal suppliers could have a material adverse effect on CUC. CUC believes that its relationships with its suppliers are satisfactory and have not experienced any significant delays due to its major suppliers.

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

Notes to Financial Statements  
September 30, 2012 and 2011

(10) Subsequent Events

On December 3, 2011, the CNMI Legislative House Bill 17-205 was enacted as Public Law 17-62, which authorizes CUC to borrow \$10 million dollars and authorizes CUC's Executive Director to execute a loan in the absence of an organized board of directors. In the course of applying for a \$10 million loan, backed by the United States Department of Agriculture ("USDA"), CUC worked with Independence Bank to secure a loan. There was a provision which provided that CUC would pay an amount of legal fees once USDA approval was received for the loan. CUC was unable to get an Attorney General's Certification it needed to close the loan. In addition, the Attorney General signed a power purchase agreement which effectively took all of CUC's collateral and accounts as security for a different agreement. With these and other financial issues, CUC was unable to go forward with the loan. Independence Bank has made a demand for \$374,866 reimbursement as of January 16, 2013 in connection with the loan application, including a commitment fee, deferred engagement fee, site visit fee, closing costs, lender's local legal fees, and lender's CNMI legal fees. CUC does not believe Independence Bank will be entitled to this amount, although there may be some liability for attorneys' fees.



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

Supplementary Information  
Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis  
For the Year Ended September 30, 2012

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Operating revenues, net:						
Governmental	\$ 5,973,924	\$ 5,343,595	\$ 2,094,836	\$ -	\$ (2,403,017)	\$ 11,009,338
Commercial	12,504,393	2,176,232	1,986,536	-	-	16,667,161
Residential	3,327,452	4,445,294	642,521	-	-	8,415,267
Subtotal	<u>21,805,769</u>	<u>11,965,121</u>	<u>4,723,893</u>	-	<u>(2,403,017)</u>	<u>36,091,766</u>
LEAC - Fuel charge	63,060,212	-	-	-	(5,607,040)	57,453,172
LEAC - Non fuel	334,449	-	-	-	-	334,449
Other	<u>1,751,923</u>	<u>93,346</u>	<u>212,345</u>	-	-	<u>2,057,614</u>
Net operating revenues	<u>86,952,353</u>	<u>12,058,467</u>	<u>4,936,238</u>	-	<u>(8,010,057)</u>	<u>95,937,001</u>
Operating expenses:						
Production fuel	66,243,015	-	-	-	-	66,243,015
General and administrative	6,440,635	3,453,793	1,486,287	5,329,300	-	16,710,015
Depreciation	3,774,977	3,245,198	1,801,797	171,069	-	8,993,041
Other production	3,996,307	5,511,439	2,114,504	240,682	(8,010,057)	3,852,875
Maintenance	4,739,625	720,234	643,743	80,788	-	6,184,390
Supplies	309,898	558,170	130,875	266,829	-	1,265,772
Other	-	-	-	407,968	-	407,968
Total operating expenses	<u>85,504,457</u>	<u>13,488,834</u>	<u>6,177,206</u>	<u>6,496,636</u>	<u>(8,010,057)</u>	<u>103,657,076</u>
Earnings (loss) from operations before allocation of common cost	1,447,896	(1,430,367)	(1,240,968)	(6,496,636)	-	(7,720,075)
Allocation of common costs	<u>(4,056,904)</u>	<u>(1,704,725)</u>	<u>(735,007)</u>	<u>6,496,636</u>	-	-
Loss from operations	<u>\$ (2,609,008)</u>	<u>\$ (3,135,092)</u>	<u>\$ (1,975,975)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (7,720,075)</u>

See accompanying notes to financial statements.

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

Supplementary Information  
Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis  
For the Year Ended September 30, 2012

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Loss from operations	\$ (2,609,008)	\$ (3,135,092)	\$ (1,975,975)	\$ -	\$ -	\$ (7,720,075)
Non-operating revenues (expenses):						
Interest income	549,287	76,175	31,183	-	-	656,645
Miscellaneous income	421,062	-	-	-	-	421,062
Regulatory assessments	(401,605)	(80,173)	(80,173)	-	-	(561,951)
Settlement expense	(116,000)	-	-	-	-	(116,000)
Contribution to the CNMI government	(303,045)	(42,026)	(17,204)	-	-	(362,275)
Interest expense	(1,018,412)	-	(148,344)	-	-	(1,166,756)
Total non-operating revenues (expenses), net	(868,713)	(46,024)	(214,538)	-	-	(1,129,275)
Loss before change in recovery of fuel costs	(3,477,721)	(3,181,116)	(2,190,513)	-	-	(8,849,350)
Change in recovery of fuel costs	3,182,803	-	-	-	-	3,182,803
Net loss before capital contributions and federal grants	(294,918)	(3,181,116)	(2,190,513)	-	-	(5,666,547)
Capital contributions and federal grants	4,089,482	3,002,467	3,315,667	-	-	10,407,616
Change in net assets (deficit) before extraordinary item	3,794,564	(178,649)	1,125,154	-	-	4,741,069
Contract termination expense	(7,401,047)	-	-	-	-	(7,401,047)
Change in net assets (deficit)	\$ (3,606,483)	\$ (178,649)	\$ 1,125,154	\$ -	\$ -	\$ (2,659,978)

See accompanying notes to financial statements.

**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, 2012**



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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**

To the 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, 2012, and have issued my report thereon dated July 28, 2013. 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

Management of CUC, is responsible for establishing and maintaining effective 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 CUC's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of 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 and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings and Questioned Costs, I identified certain deficiencies in internal control over financial reporting that I consider to be material weaknesses and other deficiencies that I consider to be significant deficiencies.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. I consider Finding Nos. 2015-02 and 2012-04 described in the accompanying Schedule of Findings and Questioned Costs to be material weaknesses.

A *significant deficiency* is a deficiency or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. I consider Finding Nos. 2012-03, 2012-05 and 2011-07 described in the accompanying Schedule of Findings and Questioned Costs to be significant deficiencies.


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 Finding Nos. 2012-01 and 2011-06.

I noted certain other matters that I reported to management of CUC in a separate letter dated July 28, 2013.

CUC's responses to the findings identified in my audit are described in the accompanying Schedule of Findings and Questioned Costs. 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. However, this report is also a matter of public record.

  
Saipan, Commonwealth of the Northern Mariana Islands  
July 28, 2013



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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE  
A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON INTERNAL CONTROL  
OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

To the Executive Director  
Commonwealth Utilities Corporation

Compliance

I have audited the Commonwealth Utilities Corporation's (CUC) compliance with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement that could have direct and material effect on each of CUC's major federal programs for the year ended September 30, 2012. 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.

As described in Finding No. 2012-08 in the accompanying Schedule of Findings and Questioned Costs, CUC did not comply with requirements regarding equipment and real property, that is applicable to its Economic, Social, and Political Development of the Territories Grant (CFDA 15.875), Environmental Protection Consolidated Grants Support (CFDA 66.600) and the Energy Efficiency Conservation Block Grant Program (CFDA 81.128 ARRA). Compliance with such requirements is necessary, in my opinion, for CUC to comply with the requirements applicable to these programs.

In my opinion, except for the noncompliance described in the preceding paragraph, 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, 2012.

Internal Control Over Compliance


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 major federal program to determine the auditing procedures for the purpose of expressing my opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, 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 Example Entity's internal control over compliance.

My consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over compliance that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, I identified certain deficiencies in internal control over compliance that I consider to be a material weakness.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is reasonable possibility that material non-compliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. I consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questions costs as Finding No. 2012-08 to be a material weakness.

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. However, this report is also a matter of public record.

  
Saipan, Commonwealth of the Northern Mariana Islands  
July 28, 2013

Commonwealth Utilities Corporation  
Schedule of Expenditures of Federal Awards

Year Ended September 30, 2012

Federal Grantor/ Pass Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
U.S. Environmental Protection Agency		
Direct Programs:		
Environmental Protection Consolidated Grants for the Insular Areas - Program Support	66.600	\$ 3,886,837 *
ARRA - Construction Grants for Wastewater Treatment Works	66.418	124,855
ARRA - Capitalization Grants for Drinking Water State Revolving Funds	66.468	<u>93,252</u>
Subtotal Direct Programs		4,104,944
Indirect Program:		
Passed-through the CNMI Division of Environmental Quality ARRA - State Clean Diesel Grant Program	66.040	<u>70,678</u>
Subtotal U.S. Environmental Protection Agency		<u>4,175,622</u>
U.S. Department of Energy		
Indirect Program:		
Passed-through the CNMI Department of Public Works ARRA - Energy Efficiency and Conservation Block Grant Program (EECBG)	81.128	<u>1,346,643 *</u>
Subtotal U.S. Department of Energy		<u>1,346,643</u>
U.S. Department of the Interior		
Indirect Programs:		
Passed-through the CNMI Government		
CNMI - Water/Wastewater 2009	15.875	41,216
Sadog Tasi Wastewater Treatment Plant Rehabilitation	15.875	53,222
Sadog Tasi Wastewater Treatment Plant Rehabilitation	15.875	247,402
Rehabilitation of Agingan Wastewater Treatment Facilities	15.875	327,929
Water and Wastewater Master Plan Development	15.875	784,439
Grant for Stipulated Order No. 2	15.875	397,974
Power Generation Improvements	15.875	663,782
Rota Generation Improvements	15.875	103,818
Power Generation Improvements	15.875	168,138
Replacement of 8" Petroleum Pipeline	15.875	530,392
Professional Services Assistance	15.875	157,105
Geothermal Energy	15.875	53,501
IT System Upgrade	15.875	601,877
Emergency Assistance for Power Generation and Power Distribution system	15.875	<u>754,556</u>
Subtotal U.S. Department of the Interior		<u>4,885,351 *</u>
Total Federal Programs		<u>\$ 10,407,616</u>
Percentage of Federal Programs expenditures tested		<u>97%</u>

\* Denotes major programs

See accompanying notes to Schedule of Expenditure of Federal Awards.



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

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2012

(1) 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, and 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 2012, CUC had no indirect cost agreement with grantor agencies.

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

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2012

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.

D. American Recovery and Reinvestment Act of 2009 (ARRA)

In February 2009, the Federal Government enacted the American Recovery and Reinvestment Act of 2009 (ARRA). As of September 30, 2012, CUC's grant award notification and expenditures are as follows:

<u>CFDA Number - Program</u>	<u>Grant Amount</u>	<u>Fiscal Year 2012 Expenditures</u>
81.128 ARRA - Energy Efficiency and Conservation Block Grant Program	\$ 4,456,000	\$ 1,346,643
66.418 ARRA - Construction Grants for Wastewater Treatment Works	1,451,700	124,855
66.468 ARRA - Capitalization Grants for Drinking Water State Revolving Funds	1,829,000	93,252
66.040 ARRA - State Clean Diesel Grant Program	<u>70,678</u>	<u>70,678</u>
	<u>\$ 7,807,378</u>	<u>\$ 1,635,428</u>

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

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2012

**SECTION I – SUMMARY OF AUDITOR’S RESULTS**

Financial Statements

Type of auditor’s report issued: Unqualified

Internal control over financial reporting:

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

Noncompliance material to financial statements noted?   X   yes        no

Federal Awards

Internal control over major programs:

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

Type of auditor’s report issued on compliance for major federal programs: Qualified

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

Identification of Major Programs:

<u>CFDA No.</u>	<u>Description</u>
15.875	Economic, Social, and Political Development of the Territories
66.600	Environmental Protection Consolidated Grants Support
81.128	ARRA – Energy Efficiency and Conservation Block Grant Program (EECBG)

Dollar threshold used to distinguish between Type A and Type B programs:        \$   312,228  

Auditee qualified as low-risk auditee        yes   X   no

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

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2012

**SECTION II – FINANCIAL STATEMENT FINDINGS**

**Security Deposits – Liability**

Finding No. 2012-01

**Criteria:**

Pursuant to Public Law 16-02, deposits shall be placed in an interest-earning trust fund to be established by the Executive Director of the Corporation. Such funds shall not be used for any other purpose; except that CUC may use up to fifty percent (50%) of the security deposit funds to pay for its fuel expenses during fiscal year 2008 with the condition that CUC return the said funds within a three-year period. Residential security deposit refunds shall be paid within 30 days after disconnection of such utilities and with earned interest.

The restriction on deposits was reinstated by Public Law 16-17.

**Condition:**

The following were noted during the audit of customer deposits:

- a. Of the \$9,216,018 security deposits, only \$9,194,457 are deposited in interest-earning accounts as of September 30, 2012. CUC did however, reduce the deficiency from \$2,510,880 as of September 30, 2011 to \$21,561 as of September 30, 2012.

Of the cash restricted for customer deposits, \$7,500,000 placed in various time certificates of deposit are 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.

- b. Upon disconnection of customer accounts, security deposits are refunded or applied to outstanding balance without regard to accrued interest earned.

**Cause:**

- a. CUC does not have sufficient cash that can be used as collateral for its letter of credit and to restore the required restricted cash balance.
- b. CUC has not established and implemented procedures to allocate interest earned to individual security deposits.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Security Deposits – Liability, Continued**

Finding No. 2012-01, Continued

**Effect:**

CUC is in violation of its enabling legislation and Public Laws regarding its security deposits.

**Prior Year Status:**

The same condition was cited in Finding Nos. 2011-01, 2010-04, 2009-03, 2008-5, 2007-7 and 2006-15 in prior year audits.

**Recommendation:**

CUC should comply with statutes pertaining to customer deposits.

CUC should ensure that all customer deposits are placed in a restricted interest earning fund and that the related interest earned on the fund be rolled-over to the restricted fund instead of the current practice of transferring interest to the general fund.

CUC should ensure that interests derived from security deposits are given to the customers pursuant to Public Law 16-02.

**Auditee response:**

CUC concurs with this finding. CUC was able to reduce the noncompliance from \$2,510,880 as of September 30, 2011 to \$21,561 as of September 30, 2012.

CUC will review its security deposit refund policy to incorporate the calculation of interest pursuant to the requirements of the public law.

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Year Ended September 30, 2012

**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Negative Balances in the Aging of Accounts Receivable**

Finding No. 2012-02

**Criteria:**

Collections received should be applied to specific billings.

**Condition:**

The aged listing of accounts receivable as of September 30, 2012 included negative balances totaling \$1,091,038.

**Cause:**

The negative balances pertain to advance payments received from customers and security deposits posted as payments. CUC has not established internal control policies and procedures to review and monitor credit balances within the aged listing of accounts receivable.

**Effect:**

The accounts receivable balance is understated by the amount of overpayment.

**Prior Year Status:**

Similar conditions were cited in Finding Nos. 2010-03, 2010-06 and 2009-14 in prior year audits.

**Recommendation:**

Accounts receivable with credit balances should be reviewed periodically. Management should ensure that a separate listing of such credit balances be generated, reviewed and adjusted on a monthly basis. For month-end and year-end financial statement reporting, these negative balances should be reclassified and reported as customer deposits or security deposits.

**Auditee response:**

CUC, in conjunction with its accounting software upgrade, will initiate contact with all customers with credit balances to ascertain the best way to process refunds of credit balances. Refunds will be made as cash flow permits.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Prepayments**

Finding No. 2012-03

**Criteria:**

Recorded prepayments should represent valid assets of an entity. Additionally, a good internal control provides for timely identification and reversal of prepayments upon receipt of goods and or when services are performed.

**Condition:**

An aggregate amount of \$179,356 or 9% of the prepayment balance was for prepayments made from fiscal year 2004 through fiscal year 2009.

**Cause:**

There is the lack of established internal control policies and procedures on monitoring prepayments.

**Effect:**

Potential misstatement exists for prepayments and expenses. Goods or services could have been paid for but not received. Due to lack internal control, errors or fraud could exist and not be prevented or detected in a timely manner.

**Prior Year Status:**

Similar conditions were cited in Finding Nos. 2011-04, 2010-07, 2009-14 and 2008-19 in prior year audits.

**Recommendation:**

CUC should investigate its prepaid expense accounts and determine whether the goods were received or services were performed, then adjust the prepaid asset and related expense accounts accordingly. Internal control policies and procedures should be strengthened to properly monitor all prepayments.

**Auditee response:**

The Accounts Payable Supervisor is investigating the prepayment account. Receiving reports, completion of service and other necessary documentation will be required from the Division involved to close prior years prepayments. The prepayment accounts reconciliation is now prepared monthly. CUC was able to reduce the prior year amounts from \$672,754 to \$179,356.

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Schedule of Findings and Questioned Costs  
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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Utility Plant**

Finding No. 2012-04

**Criteria:**

Capital assets should be physically accounted for at least bi-annually. Adequate presentation and control of capital assets are essential in preparing accurate financial statements. Unless all capital assets are accounted for, the depreciation used in determining utility rates could be misstated.

**Condition:**

CUC has not conducted physical count of capital assets in over 5 years. Since a physical count has not been conducted, the asset listing may still include assets that have been retired, broken, idle, destroyed or stolen.

**Cause:**

Conducting physical count of all of CUC's capital assets would require CUC to pay overtime to its employees who will perform the physical count and CUC does not have the funding to support such an endeavor. With this financial constraint, CUC has not implemented a plan of corrective action for the above condition and this control deficiency has existed since fiscal year 1988.

**Effect:**

The effect of the above condition is a possible misstatement of capital assets. Additionally, a control deficiency exists over the safeguarding of capital assets. Capital assets may be misappropriated, and errors or misstatements may exist and not be detected in a timely manner.

**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 2011.

**Recommendation:**

CUC should perform a physical inventory of all fixed assets on-hand, agree the count with its records and make necessary adjustments. With the financial constraints, CUC may conduct cycle counts per division/location to minimize overtime.

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;



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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Utility Plant, Continued**

**Finding No. 2012-04, Continued**

**Recommendation, Continued:**

- 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 long-lived assets are 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.

**Auditee response:**

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedure. This will be done in conjunction with satisfaction of deliverables required under Stipulated Order No. 1; 61 Water and Wastewater - Development of Geographic Information System. CUC has initiated discussions with contractor providing services for item 61 above to determine cost and resource requirements to extend the inventory and database work to include power division assets. At the same time, CUC's new financial management system (Microsoft Dynamics) will provide for more robust asset tracking on the financial side of the business. Expected completion of inventory and reconciliation to financial records is September 30, 2013.

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Year Ended September 30, 2012

**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Procurement**

Finding No. 2012-05

**Criteria:**

Purchase orders should be approved before actual services are preformed or products are procured. Pursuant to CUC's procurement regulations, CUC may make emergency procurement when there exists a threat to public health, safety or welfare under emergency conditions.

**Condition:**

For 1 or 2% of 60 disbursements selected for testing, services were provided before the purchase orders was executed as follows:

<u>Vendor No.</u>	<u>Purchase Order</u>		<u>Invoice</u>		<u>Amount</u>
	<u>Number</u>	<u>Date</u>	<u>Number</u>	<u>Date</u>	
3571	12-0250	11/15/11	BRS-006820	10/26/11	\$ 10,980

The invoice was for "Risk Management Consulting Services" from July 19, 2011 to September 30, 2011. There was no documentation of the after-the-fact ratification.

**Cause:**

Although there is a centralized procurement office, some departments directly transact with the vendors and may at times override the procurement process.

**Effect:**

CUC is not in compliance with its procurement policies and procedures.

**Prior Year Status:**

Similar conditions were cited in Finding No. 2011-06 in prior year audit.

**Recommendation:**

CUC should ensure that all departments and division heads comply with its procurement policies and procedures.

**Auditee response:**

Notification has been made to all CUC departments that non-compliance with procurement regulations will not be tolerated. Employees initiating procurement actions without proper authorization will be subject to disciplinary actions that may include reimbursing CUC for the improper purchase, suspension, and termination.

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Schedule of Findings and Questioned Costs  
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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Memorandum of Agreement (MOA) with CDA**

Finding No. 2012-06

**Criteria:**

Pursuant to the MOA between CUC and the Commonwealth Ports Authority (CDA), the preferred stocks interest in CUC guarantees annual dividends fixed at two percent (2%) of the total aggregate value of the preferred stock interest, payable quarterly in advance. Dividend payments for the first three years are to be deferred and amortized over a fifteen (15) year period interest-free with the first incremental payment being due simultaneously with the first dividend payment for the fourth year. The guaranteed annual dividend payments shall be deposited into a revolving fund account for the financing of additional revenue producing capital development projects. Interest earned on the revolving fund account before such funds are expended are to be treated as capital development funds and become part of said revolving fund account as principal.

**Condition:**

Outstanding deferred dividends payable as of September 30, 2012 amounted to \$2,700,000. CUC has not established a revolving fund pursuant to the terms of the MOA.

**Cause:**

CUC has operating losses for the years ended September 30, 2012 and 2011 and has no other available funding source to fund the revolving fund.

**Effect:**

CUC is not in compliance with the terms of the MOA.

**Prior Year Status:**

Similar conditions were cited in Finding No. 2011-07 in prior year audit.

**Recommendation:**

CUC should ensure compliance to the terms of the MOA to ensure that CUC is able to pay the dividends accrued and due beginning fiscal year 2013. Unless other funding sources are identified, rate increases might be required to fund the ongoing dividends.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Memorandum of Agreement (MOA) with CDA, Continued**

Finding No. 2012-06, Continued

**Auditee response:**

The MOA with CDA was entered into at about the same time the Commonwealth Public Utilities Commission (CPUC) began its oversight activities of CUC. The CPUC requires that CUC follow generally accepted ratemaking standards. CUC establishes its rates under the cash basis ratemaking standard. Under these standard, CUC is only entitled to recover expenses that it expects to incur throughout the twelve month period following its rate application (known as the "test year"). These expenses include operating expenses, capital outlays, and actual debt principal and interest on both existing obligations and those expected to be incurred in the test year.

CUC filed its first electric base rate application in November 2010. Prior to that time, CUC's base rates were insufficient to fund all of its existing operating and capital expenses. In its application, CUC outlined the expenses that it expected to incur during the test year, fiscal year 2011, and requested that electric base rates be set at a level that would enable CUC to fund all of these expenses. CPUC staff reviewed the petition, and after a series of negotiations, the parties agreed on a compromise rate structure that was eventually adopted by CPUC.

Notably, the rate structure did not include funding for the future dividend requirement of the CDA obligation. The reason was that the first cash payment to the CDA was not due until well after the expiration of the twelve month rate period, or test year. Therefore, under the cash basis ratemaking principles, CUC was not entitled to recover revenues to fund the CDA payment. Establishing a sinking fund would have the effect of penalizing ratepayers by requiring higher base rates before they were necessary.

CUC filed its second electric base rate application in December 2011. This application included funding for the initial CDA payment due in October 2012. CUC and CPUC staff filed a joint stipulation recommending a rate structure that included funding for the CDA payment. CPUC did not approve the rate increase needed for the CDA payment after considering testimony made by a CDA official at the public hearing held to consider CUC's rate application.

CUC will not be able to establish a sinking fund, or pay CDA the amounts due under the MOA, until CPUC approves such amounts be included in CUC's rates.

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Schedule of Findings and Questioned Costs  
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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

Finding No. 2012-07

**Deposit of Collections**

**Criteria:**

Collections should be deposited intact on a timely manner.

**Condition:**

For 10 or 17% of 60 Cashier's Daily Sales Report tested, the collection details in the Daily Sales Report do not agree with the deposit details per bank validated deposit slip.

a. For 9 of the 10 items noted above, the bank validated deposit slips totals agree with the Cashier's Daily Sales Report. However the cash deposited is less than actual cash collection while total checks deposited is greater than the actual check collection. The Daily Sales reports show that cash change were given to some customers who paid with check.

b. For 1 of the 10 items noted above, the check count per Cashier's Daily Sales Report was 28 while actual check count per bank validated deposit slip is 29. A check for \$310 was deposited to replace cash collection.

**Cause:**

CUC does not have a policy prohibiting the issuance of cash change for check payments received. Furthermore, the cash receipts module of CUC's financial management system does not restrict the issuance of change for cash receipts only.

**Effect:**

The lack of policy and the systematic controls open opportunity for fraud to be committed by CUC staff or other parties through CUC.

**Recommendation:**

CUC should adopt internal control policies and procedures restricting the issuance of change only for cash received. If such restriction is not practicable because it is generally accepted in the CNMI for customers to use their payroll checks to pay for services, CUC should have a written policy regarding receipt of endorsed checks as payment.

**Auditee response:**

CUC's Chief Accountant will investigate the frequency of such transactions and will coordinate with the CUC Treasurer on the appropriate policies and procedures to recommend by beginning of fiscal year 2014.

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Schedule of Findings and Questioned Costs  
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**SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS**

**Federal Agencies: U.S. Environmental Protection Agency,  
U.S. Department of Energy, and  
U.S. Department of the Interior**

**Area: Equipment and Real Property Management**

Finding No. 2012-08

<u>CFDA No.</u>	<u>Findings/Noncompliance</u>	<u>Questioned Costs</u>
All Major Programs	<p><u>Criteria:</u> Pursuant to 40 CFR Part 31.32 (2), a physical inventory of the property must be taken and results reconciled with the property records at least once every two years. In accordance with generally accepted accounting principles in the United States of America, long-lived assets should be evaluated for impairment.</p> <p><u>Condition:</u> CUC has not conducted a physical count of capital assets in over 5 years and has no basis to determine if the carrying value of its capital assets is accurate. Since a physical count has not been conducted, the asset listing may include assets that have been retired, broken, idled, destroyed or stolen.</p> <p><u>Cause:</u> Conducting physical count of all of CUC's capital assets would require CUC to pay overtime to its employees who will perform the physical count. CUC does not have the funding to support such an endeavor. With this financial constraint, CUC has not implemented a plan of corrective action for the above condition.</p> <p><u>Effect:</u> CUC is in non-compliance with grant equipment and real property internal control requirements.</p> <p><u>Prior Year Status:</u>  This control deficiency has existed since fiscal year 1988.</p> <p><u>Recommendation:</u> CUC should conduct physical inventory of its capital assets and update its asset listing in accordance with 40 CFR Part 31.</p>	\$ -

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**SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS, CONTINUED**

Finding No. 2012-08, Continued

Auditee response:

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedures. (Refer to responses to Finding 2012-04)

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**SECTION IV – PRIOR YEAR FINDINGS AND QUESTIONED COSTS**

Unresolved Findings

2011-01	Customer Deposits – Liability	Unresolved. Refer to Finding 2012-01.
2011-02	Accounts Receivable/Disconnection	Resolved.
2011-03	Negative Balances in the Aging of Accounts Receivable	Unresolved. Refer to Finding 2012-02.
2011-04	Prepayments	Unresolved. Refer to Finding 2012-03.
2011-05	Utility Plant	Unresolved. Refer to Finding 2012-04.
2011-06	After-the-fact Ratification	Unresolved. Similar condition existing in 2012. Refer to Finding 2012-05.
2011-07	Compliance with Term of the Memorandum of Agreement (MOA) between CUC and CDA	Unresolved. Refer to Finding 2012-06.
2011-08	Compliance with the General Provisions of the Contract and Documentation of Contract Provisions	Resolved.
2011-09	Equipment and Real Property Management	Unresolved. Refer to Finding 2012-07.



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**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, 2012:

Questioned costs as previously reported	\$	-
Questioned costs for fiscal year 2012 Single Audit	_____	-
Unresolved questioned costs at September 30, 2012	\$	<u><u>-</u></u>

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Schedule of Findings and Questioned Costs  
Year Ended September 30, 2012

**SECTION V – MANAGEMENT'S PLAN OF CORRECTIVE ACTION**

CUC's responses are presented as Auditee response on pages 58 through 69.