

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

**INDEPENDENT AUDITORS' REPORT
AND
FINANCIAL STATEMENTS**

**Years Ended
September 30, 2014 and 2013**

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

Years Ended September 30, 2014 and 2013

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Commonwealth Utilities Corporation

Report on the Financial Statements

We have audited the accompanying financial statements of the Commonwealth Utilities Corporation, a component unit of the Commonwealth of the Northern Mariana Islands Government, as of and for the years ended September 30, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the Commonwealth Utilities Corporation's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Commonwealth Utilities Corporation as of September 30, 2014 and 2013, and the changes in net position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Going Concern

The accompanying financial statements have been prepared assuming that the Commonwealth Utilities Corporation will continue as a going concern. As discussed in Note 18 to the financial statements, the Commonwealth Utilities Corporation has suffered recurring losses from operations and has a significant negative unrestricted net position, which raises substantial doubt about its ability to continue as a going concern. Management's plans regarding those matters also are described in Note 18. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to that matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 15 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Commonwealth Utilities Corporation's basic financial statements. The Schedule of Revenues, Expenses and Changes in Net Position on a Divisional Basis is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The Schedule of Expenditures of Federal Awards 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 basic financial statements.

The Schedule of Revenues, Expenses and Changes in Net Position 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 basic financial statements.

Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Schedule of Revenues, Expenses and Changes in Net Position on a Divisional Basis and the Schedule of Expenditures of Federal Awards are fairly stated in all material respects in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated May 26, 2015, on our consideration of the Commonwealth Utilities Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Commonwealth Utilities Corporation's internal control over financial reporting and compliance.



Saipan, Commonwealth of the Northern Mariana Islands
May 26, 2015

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

MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2014

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, 2014 with comparisons to prior fiscal years ended September 30, 2013 and 2012. 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, 2014 were \$132,309,380, a decrease of \$1,022,424 or 0.8% compared to \$133,331,804 in 2013, which increased by \$68,073 or 0.1% compared to \$133,263,731 in 2012. The decrease in 2014 is primarily due to negative operating results for the year.
- Total liabilities at September 30, 2014 were \$76,856,255, an increase of \$3,651,114 or 5.0% from \$73,205,141 (as restated) in 2013, which increased by \$1,312,122 or 1.8% from \$71,893,019 (as restated) in 2012. The increase in 2014 is primarily due to accrual of additional EPA assessments under a stipulated order.
- Total net operating revenues for fiscal year 2014 were \$92,024,791, a \$923,370 or 1.0% increase from \$91,101,421 in 2013, which decreased by \$4,835,580 or 5.0% when compared to fiscal year 2012. The increased net revenue in 2014 is primarily attributable to a reduction in the amount of bad debts recognized as compared to 2013.
- Total operating expenses for fiscal year 2014 were \$96,043,167, a decrease of \$3,903,687 or 3.9% from \$99,946,854 in 2013, which decreased by \$3,710,222 or 3.6% when compared to \$103,657,076 in fiscal year 2012. The decrease in operating expenses in 2014 is primarily due to a reduction in maintenance expenses of \$3.4 million, a reduction of depreciation expense of \$1.1 million, and offset by an increase in general and administrative expense of \$867,116.
- In fiscal year 2014, CUC received \$6,270,224 in capital contributions and federal awards compared to \$11,489,591 in fiscal year 2013 and \$10,407,616 in fiscal year 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.

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

MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2014

Basic Financial Statements

The *Statements of Net Position* present information on assets and deferred outflows of resources, and liabilities and deferred inflows of resources with the difference between them presented as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of CUC is improving or deteriorating.

The *Statements of Revenues, Expenses and Changes in Net Position* report how net position has changed during the year. It compares related operating revenues and operating expenses connected with 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* report 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 Position.
- 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 Schedule of Revenues, Expenses and Changes in Net Position on a Divisional Basis (see pages 48 through 49).

COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2014

ANALYSIS OF BASIC FINANCIAL STATEMENTS

Condensed Statements of Net Position

	2014	2013	\$ Change	% Change
Current and other assets	\$ 47,597,160	\$ 46,292,693	\$ 1,304,467	2.8%
Capital assets, net	<u>84,712,220</u>	<u>87,039,111</u>	<u>(2,326,891)</u>	-2.7%
Total assets	<u>132,309,380</u>	<u>133,331,804</u>	<u>(1,022,424)</u>	-0.8%
Deferred outflows of resources	-	-	-	-
Current and other liabilities	57,043,234	59,321,091	(2,277,857)	-3.8%
Noncurrent liabilities	<u>19,813,021</u>	<u>13,884,050</u>	<u>5,928,971</u>	42.7%
Total liabilities	<u>76,856,255</u>	<u>73,205,141</u>	<u>3,651,114</u>	5.0%
Deferred inflows of resources	<u>2,788,238</u>	<u>3,400,000</u>	<u>(611,762)</u>	-18.0%
Net investment in capital assets	84,712,220	87,039,111	(2,326,891)	-2.7%
Restricted	44,510,907	45,165,364	(654,457)	-1.4%
Deficit	<u>(76,558,240)</u>	<u>(75,477,812)</u>	<u>(1,080,428)</u>	1.4%
Net position	<u>\$ 52,664,887</u>	<u>\$ 56,726,663</u>	<u>\$ (4,061,776)</u>	-7.2%

	2013	2012	\$ Change	% Change
Current and other assets	\$ 46,292,693	\$ 45,136,526	\$ 1,156,167	2.6%
Capital assets, net	<u>87,039,111</u>	<u>88,127,205</u>	<u>(1,088,094)</u>	-1.2%
Total assets	<u>133,331,804</u>	<u>133,263,731</u>	<u>68,073</u>	0.1%
Deferred outflows of resources	-	-	-	-
Current and other liabilities	59,321,091	53,581,914	5,739,177	10.7%
Noncurrent liabilities	<u>13,884,050</u>	<u>18,311,105</u>	<u>(4,427,055)</u>	-24.2%
Total liabilities	<u>73,205,141</u>	<u>71,893,019</u>	<u>1,312,122</u>	1.8%
Deferred inflows of resources	<u>3,400,000</u>	<u>3,400,000</u>	-	0.0%
Net investment in capital assets	87,039,111	85,883,593	1,155,518	1.3%
Restricted	45,165,364	45,093,415	71,949	0.2%
Deficit	<u>(75,477,812)</u>	<u>(73,006,296)</u>	<u>(2,471,516)</u>	3.4%
Net position	<u>\$ 56,726,663</u>	<u>\$ 57,970,712</u>	<u>\$ (1,244,049)</u>	-2.1%

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

MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2014

Highlights of events affecting assets, liabilities, deferred inflows and net position follows.

During fiscal year 2014, total assets decreased by \$1,022,424 or 0.8%. Significant changes in account balances were:

- Current assets which consists primarily of cash and cash equivalents, accounts and notes receivable from utility, regulatory cost for future recovery and inventory increased by \$1,304,467 or 2.8%.
- Cash and cash equivalents increased by \$1,283,514 or 7.1% primarily because the net loss included three large non-cash expenses (bad debts, depreciation, and EPA assessments). CUC was successful in its efforts to fully fund the customer security deposit.
- Accounts receivable net of allowance for uncollectible amounts decreased by \$2,410,519 or 19.4%, primarily attributable to an increase in the allowance for uncollectible amounts. In prior years CUC provided an allowance for bad debts for accounts receivable over 75 days old. Beginning in fiscal year 2013, CUC begun providing an allowance for accounts over 60 days past due.
- Inventory increased by \$1,888,372 or 20.5% due to higher fuel inventory and materials and supplies as of September 30, 2014.
- Other assets increased by \$545,142 or 38.9% primarily due to an increase in other receivables of about \$865,000.
- Changes in capital assets are discussed in a separate section of this MD&A.

Total liabilities increased by \$1,312,122 or 1.8% in 2014. Significant changes in account balances were as follows:

- Current liabilities which consists primarily of accounts payable, customer deposits, stipulated order penalties assessed, current maturities of long-term debt and related interest and dividend payable, decreased \$2,277,857 or 3.8%.
- Accounts payable and accrued expenses decreased by \$2,808,493 or 31.7% due to the decrease in certain operating expenses (such as maintenance) in 2014.
- Security deposits, which includes customer account credit balances and the mandatory deposit upon opening accounts with CUC decreased by \$1,671,389 or 15.5%.

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September 30, 2014

- Current maturities of long term-debt decreased by \$3,531,034 or 58.3%. This is due to the liquidation of the note payable to PMIC for the termination of the power purchase agreement for Power Plant IV.
- Noncurrent liabilities consists primarily of an unearned fuel purchase obligation rebate, due to primary government, long term debt - net of current maturities to Commonwealth Ports Authority (CPA) and retirement contributions payable. The amount increased by \$5,928,971 or 42.7% primarily due to the recognition of a liability for an unearned fuel purchase obligation rebate from CUC's fuel supplier offset by the payment of the PMIC note payable.

Condensed Statements of Revenues, Expenses and Change in Net Position

	<u>2014</u>	<u>2013</u>	<u>\$ Change</u>	<u>% Change</u>
Operating revenues, net	\$92,024,791	\$91,101,421	\$ 923,370	1.0%
Operating expenses	<u>96,043,167</u>	<u>99,946,854</u>	<u>(3,903,687)</u>	-3.9%
Loss from operations	(4,018,376)	(8,845,433)	4,827,057	-54.6%
Nonoperating revenues (expenses), net	(5,857,054)	(5,228,689)	(628,365)	12.0%
Change in recovery of fuel costs	<u>(456,570)</u>	<u>1,340,482</u>	<u>(1,797,052)</u>	-134.1%
Net loss before capital contributions and federal grants	(10,332,000)	(12,733,640)	2,401,640	-18.9%
Capital contributions and federal grants	<u>6,270,224</u>	<u>11,489,591</u>	<u>(5,219,367)</u>	-45.4%
Change in net position	(4,061,776)	(1,244,049)	(2,817,727)	226.5%
Net position, beginning	<u>56,726,663</u>	<u>57,970,712</u>	<u>(1,244,049)</u>	-2.1%
Net position, ending	<u>\$ 52,664,887</u>	<u>\$ 56,726,663</u>	<u>\$ (4,061,776)</u>	-7.2%

	<u>2013</u>	<u>2012</u>	<u>\$ Change</u>	<u>% Change</u>
Operating revenues, net	\$91,101,421	\$95,937,001	\$ (4,835,580)	-5.0%
Operating expenses	<u>99,946,854</u>	<u>103,657,076</u>	<u>(3,710,222)</u>	-3.6%
Loss from operations	(8,845,433)	(7,720,075)	(1,125,358)	14.6%
Nonoperating revenues (expenses), net	(5,228,689)	(6,067,275)	838,586	-13.8%
Change in recovery of fuel costs	<u>1,340,482</u>	<u>3,182,803</u>	<u>(1,842,321)</u>	-57.9%
Net loss before capital contributions and federal grants	(12,733,640)	(10,604,547)	(2,129,093)	20.1%
Capital contributions and federal grants	<u>11,489,591</u>	<u>10,407,616</u>	<u>1,081,975</u>	10.4%
Change in net position	(1,244,049)	(196,931)	(1,047,118)	531.7%
Contract termination loss	-	(7,401,047)	7,401,047	-100.0%
Net position, beginning	<u>57,970,712</u>	<u>65,568,690</u>	<u>(7,597,978)</u>	-11.6%
Net position, ending	<u>\$ 56,726,663</u>	<u>\$ 57,970,712</u>	<u>\$ (1,244,049)</u>	-2.1%

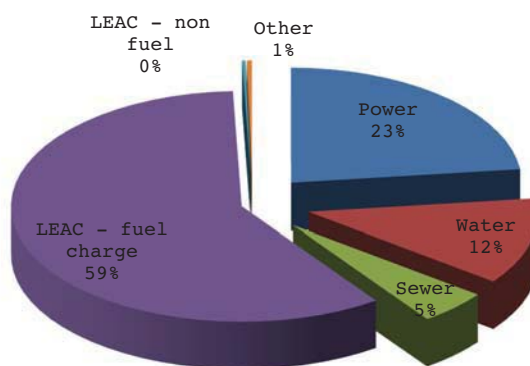
COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
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Operating Revenues

	2014	2013	2012
Power	\$ 22,876,847	\$ 22,342,342	\$ 19,402,752
Water	11,976,163	14,006,882	11,965,121
Sewer	4,853,750	5,873,492	4,723,893
LEAC - fuel charge	58,618,588	58,994,108	57,453,172
LEAC - non fuel	237,824	255,754	334,449
Other	367,979	203,144	2,057,614
Total	\$ 98,931,151	\$ 101,675,722	\$ 95,937,001

The following chart depicts CUC's operating revenues for the year ended September 30, 2014.



In 2014, operating revenues decreased by \$2,744,571 or 2.7% when compared to revenues in 2013, which decreased by about \$4.8 million after considering bad debts when compared to revenues in 2012.

- Power revenues (excluding LEAC) increased by \$534,505 or 2.4% compared to 2013. This is primarily due to an increase in business activity tied to an increase in tourist arrivals.
- Revenues from LEAC charges decreased by \$375,520 or 0.6% compared to 2013 due to decrease in LEAC rates.
- Sewer revenues decreased by \$1,019,742 or 17.4% compared to 2013 due to decreased sales.
- Water revenues decreased by \$2,030,719 or 14.5% compared to 2013 due primarily to decreased sales.

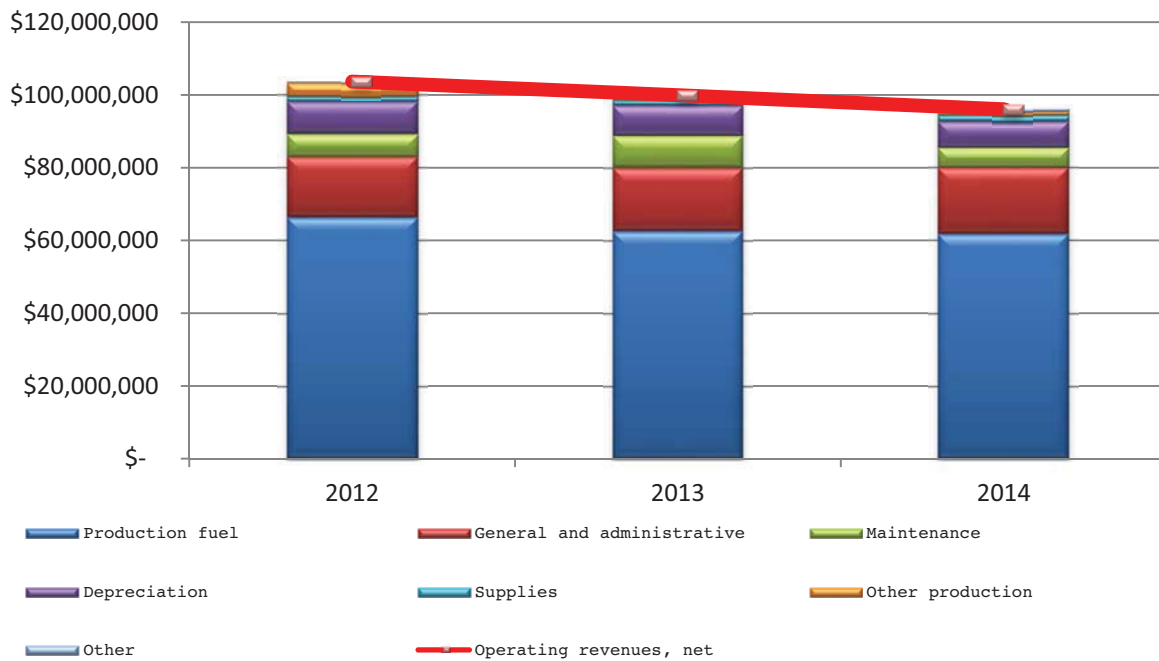
COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
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Operating Expenses

	2014	2013	2012
Production fuel	\$ 61,645,777	\$ 62,570,609	\$ 66,243,015
General and administrative	18,313,501	17,446,385	16,710,015
Maintenance	5,446,343	8,856,541	6,184,390
Depreciation	7,227,734	8,333,369	8,993,041
Supplies	1,609,566	1,365,318	1,265,772
Other production	1,000,912	754,975	3,852,875
Other	799,334	619,657	407,968
	<u>\$ 96,043,167</u>	<u>\$ 99,946,854</u>	<u>\$ 103,657,076</u>

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



In 2014, total operating expenses of \$96,043,167 exceeded operating revenues (net of bad debts) of \$92,024,791 by \$4,018,376 or 4.4%.

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MANAGEMENT'S DISCUSSION & ANALYSIS
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Highlights of events affecting operating expenses follow:

In 2014, production fuel costs totaled \$61,645,777, a decrease of \$924,832 (1.5%) when compared to 2013, which decreased by \$3,672,406 (5.5%) when compared to 2012. Production fuel is the single largest expense of CUC, accounting for 64% of operating expenses in 2014, 63% for 2013 and 64% for 2012.

In 2014, general and administrative expenses, which are primarily personnel costs and related benefits, increased by \$867,116 (5.0%) when compared to 2013, which increased by \$736,370 (4.4%) when compared to 2012.

Maintenance expenses decreased by \$3,410,198 or 38.5% in 2014 primarily due to deferral of necessary maintenance expenses, caused in part by a lack of collections of amounts billed to government sector customers.

Capital Assets

At September 30, 2014, CUC had \$84,712,220 invested in capital assets, net of depreciation where applicable, including electric plant, water plant, sewer plant, administrative equipment and construction in progress.

	2014	2013	2012
Utility plant in service:			
Electric plant	\$ 129,733,086	\$ 128,881,452	\$ 132,337,219
Water plant	67,952,180	67,805,784	70,858,321
Sewer plant	48,315,972	45,730,511	45,839,881
Administrative equipment	3,884,431	3,667,746	5,074,344
	249,885,669	246,085,493	254,109,765
Accumulated depreciation	(180,835,510)	(173,685,835)	(178,157,250)
Depreciable assets, net	69,050,159	72,399,658	75,952,515
Construction work-in progress	15,662,061	14,639,453	12,174,690
Capital assets, net	\$ 84,712,220	\$ 87,039,111	\$ 88,127,205

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
September 30, 2014

Capital Contributions and Federal Grants

CUC received capital contributions and federal grants of \$6,270,224 in fiscal year 2014, which is \$5,219,367 (45.4%) less than the level of support received in fiscal year 2013.

The following is a summary of the CUC's major capital expenditures for 2014:

Federal Assistance

Direct Grants

During fiscal year 2014, the U.S. Environmental Protection Agency (EPA) awarded \$6,764,000 additional funding for the upgrade of sewer and water systems and related equipment. Total cumulative EPA Consolidated Grant funding as of September 30, 2014 was \$40,913,404.

Passed-through Grants

The CNMI government, as a pass-through agency, provided \$733,253 of Covenant 702 funds received from the U.S. Department of the Interior as additional funding for the replacement of the CUC Fuel Line to Power Plant #1. The grant award is dated February 27, 2014.

In sum, active grants funds managed by CUC at September 30, 2014 totaled \$56.8 million

Debt

Long-term debt as of September 30, 2014, 2013 and 2012 are as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Pacific Marine Industrial Corporation	\$ -	\$ 3,902,581	\$ 7,470,468
Commonwealth Ports Authority	<u>3,373,563</u>	<u>3,373,563</u>	<u>3,373,563</u>
	3,373,563	7,276,144	10,844,031
Current maturities	<u>(2,520,963)</u>	<u>(6,051,997)</u>	<u>(5,368,211)</u>
Long-term debt, net of current portion	<u>\$ 852,600</u>	<u>\$ 1,224,147</u>	<u>\$ 5,475,820</u>

The note payable to the Commonwealth Ports Authority (CPA) as of 2012 was restated to reverse the application of utilities receivable from CPA Seaport to the payable to CPA.

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

COMMONWEALTH UTILITIES CORPORATION
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CUC ACCOMPLISHMENTS DURING FISCAL YEAR 2014

Power Division

CUC Power Division Engineers and Mechanics performed various engine maintenance and rehabilitation projects; work was funded through rates.

- Projects include: Major work on power generation engines at Saipan Power Plant 1 (PP1); Engine foundations were repaired and replaced and necessary engine maintenance was accomplished on schedule. Most work was performed in-house with CUC personnel.
- As a measure of the accomplishments of these projects, in 2009 PP1 was producing only 9.0 MW of electricity due to the poor condition of the failing engines. By the end of FY14, the same plant, with rebuilt engines was capable of 62 MW of production, a 688% improvement without purchasing new engines. For the average customer, it means the difference between rolling blackouts in 2009, and 24/7 electricity at their homes and businesses in FY14.

CUC Power Division on Rota completed work began in FY13 also achieved improved service due in part to several grant-funded projects.

- Work on the power transmission system was completed upgrading to a higher voltage, creating better reliability and efficiency. New transformers were procured with grant funds and work was accomplished in house with CUC personnel.

FY14 saw continued improvements in the CUC Power Division toward providing reliable and safe energy to all of the inhabitants of the CNMI, while strides were made toward compliance with Federal Stipulated Order #2.

Water & Wastewater Division

CUC Water and Wastewater Division experienced many improvements during FY14. From FY11 – FY14, CUC received \$40,913,404 in grant funding from US-EPA for the purpose of renovating infrastructure and improving the capability of CUC to comply with the Clean Water Act and the Safe Drinking Water Act of the USA. FY14 saw continued good progress in identifying, designing, procuring and accomplishing the construction of priority projects. Projects are identified by in-house operations personnel and most projects are then designed by and construction management done by in-house CUC engineering staff.

- Projects making good progress during the year include: Several waterline, fire hydrant, and valve replacement projects; an extensive sewer line replacement project; lift station rehabilitation; leak detection and repair; and an island-wide water meter replacement project.

COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2014

Water operations personnel spent untold man-hours performing leak detection on the water distribution system using state of the art equipment purchased with US-EPA grant funds. The resulting conservation of water resulted in a year with improved water supplies to customers.

Customer Service, Accounting, and Administration

CUC Customer Service/Accounting and Administration continued working on improvements during FY14. Accomplishments include:

- CUCgov.org website was vastly improved and enhanced during FY14. The required “Water Quality/Consumer Confidence Report” was issued primarily using the website; saving on postage. Regulatory matters, reports of outages, and other beneficial information for customers are available online.
- Customer Call Center and improved phone services provided customers with 24/7 single-point of contact access to CUC departments.

SUMMARY CONCLUSION REGARDING FY 2014 AND OUTLOOK FOR FY 2015

While CUC had many successes in 2014, including system improvements, reliability, and customer services, improvements can only continue if we recover what it costs to provide these services. Many of the improvement projects were financed by federal grants, rather than by rate payers. Such reliance on federal financial assistance is not sustainable due to future funding uncertainties. Looking forward, the greatest challenge facing the utility is the ballooning size of past-due and delinquent accounts, with the utility’s three largest customers falling further and further in arrears with their accounts. We only have to look back a few short years, to the 2008-2009 timeframe, when a lack of financial investment in system maintenance brought forth by fiscal crisis resulted in rolling brown-outs, sewerage overflows, and regular drinking water boil-order notices. While CUC has been successful in improving the overall quality of services, the continued lack of reinvestment into the utility will increase the chances of again experiencing system failures.

Nevertheless, the outlook for 2015 accomplishments includes:

- Performing an “Integrated Resource Plan & Energy Supply Analysis” to provide a 20 year ‘Master Plan’ for power generation and transmission. (Funded by DOI-OIA grant)
- Beginning of construction to drill for a Geothermal Resource Assessment on Saipan. (Funded by DOI-OIA grant)
- Improved customer outreach and services by new Public Information Officer and by further utilizing website capabilities and further training of personnel.
- Beginning construction of a new buried fuel pipeline from the Mobil facilities at the docks, to Power Plants #1 & #2, in compliance with Stipulated Order #2 (SO2) (Funded by grants from DOI-OIA). Project was halted in FY14 due to contractor compliance.

COMMONWEALTH UTILITIES CORPORATION

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MANAGEMENT'S DISCUSSION & ANALYSIS

September 30, 2014

- Construction of a new fuel storage tank at Power Plant #1 in compliance with SO₂ (Funded by DOI-OIA grants). Project was re-procured in FY14 following the termination of a prior contractor for non-performance.
- Identification of further water and wastewater infrastructure projects, with design and engineering of solutions, and the procurement of contractors to achieve timely completion of such projects. (Funded by US-EPA grant)
- Completion of a Water/Wastewater 20 year Master Plan to provide long range guidance regarding the infrastructure needs & solutions over next two decades.
- Establishing a dedicated crew for leak detection and repairs, resulting in conservation of water and subsequent energy savings. (Partially funded by US-EPA and Bureau of Reclamation grants)
- Building on 2014 successes in sewer line and lift station cleaning and rehabilitation to ensure safe and effective collection and transmission of wastewater to treatment plants.
- Progressive compliance with both Stipulated Orders regarding compliance with the Clean Water Act and Safe Drinking Water Act.
- Expand policies to encourage individuals to implement energy conservation and use of renewable energy sources at their homes and businesses, reducing dependence on fossil fuels.
- Maintain the operation of the power generation system in spite of lack of funds, and the challenge of hiring skilled mechanics and engineers caused in part by immigration restrictions.
- Continued focus on personnel training in all areas involved in the safe and efficient delivery of utility services to the CNMI.

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.

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

Statements of Net Position
September 30, 2014 and 2013

	2014	(Restated) 2013
<u>ASSETS</u>		
Current assets		
Current unrestricted assets		
Cash and cash equivalents	\$ 9,180,020	\$ 7,695,023
Accounts receivable - utility, net	10,039,708	12,450,227
Due from grantor agencies	819,393	116,347
Inventory, net	11,079,929	9,191,557
Regulatory cost for future recovery - fuel	4,140,910	4,597,480
Notes receivable, net	86,855	335,373
Other assets, net	1,947,604	1,402,462
Total current unrestricted assets	37,294,419	35,788,469
Current restricted assets		
Cash and cash equivalents	10,197,517	10,399,000
Total current assets	47,491,936	46,187,469
Noncurrent assets		
Notes receivable, net of current portion	105,224	105,224
Capital assets		
Utility plant in service		
Electric plant	129,733,086	128,881,452
Water plant	67,952,180	67,805,784
Sewer plant	48,315,972	45,730,511
Administrative equipmen	3,884,431	3,667,746
	249,885,669	246,085,493
Accumulated depreciation	(180,835,510)	(173,685,835)
Net utility plant and administrative equipmen	69,050,159	72,399,658
Construction in progress	15,662,061	14,639,453
Total capital assets	84,712,220	87,039,111
Total noncurrent assets	84,817,444	87,144,335
TOTAL ASSETS	132,309,380	133,331,804

See accompanying notes to financial statements.

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

Statements of Net Position, Continued
September 30, 2014 and 2013

	<u>2014</u>	<u>(Restated) 2013</u>
<u>LIABILITIES</u>		
Current liabilities:		
Unrestricted current liabilities:		
Accounts payable and accrued liabilities	6,042,615	8,851,108
Compensated absences	350,675	384,963
Current maturities of long-term debt	2,520,963	6,051,997
Dividends payable	2,340,000	1,260,000
Stipulated order penalties assessed	36,041,000	31,467,000
Interest payable	668,983	555,636
	<u>47,964,236</u>	<u>48,570,704</u>
Restricted current liabilities:		
Security deposits, including accrued interest	9,078,998	10,750,387
	<u>57,043,234</u>	<u>59,321,091</u>
Noncurrent liabilities:		
Long-term debt, net of current maturities	852,600	1,224,147
Due to primary government	6,646,790	6,279,843
Retirement contributions payable	3,387,153	3,388,379
Unearned fuel purchase obligation rebate	6,131,316	-
Dividends payable	2,160,000	2,340,000
Advances from CNMI Government	107,296	107,296
Compensated absences	527,866	544,385
	<u>19,813,021</u>	<u>13,884,050</u>
TOTAL LIABILITIES	<u>76,856,255</u>	<u>73,205,141</u>
<u>DEFERRED INFLOWS</u>		
Rate stabilization (Public Law 16-7)	2,788,238	3,400,000
TOTAL DEFERRED INFLOWS	<u>2,788,238</u>	<u>3,400,000</u>
<u>NET POSITION</u>		
Net investment in capital assets	84,712,220	87,039,111
Restricted for:		
Regulatory expenses	(489,093)	165,364
Preferred stocks	45,000,000	45,000,000
Unrestricted	(76,558,240)	(75,477,812)
NET POSITION	<u>\$ 52,664,887</u>	<u>\$ 56,726,663</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

(A Component Unit of the CNMI Government)

Statements of Revenues, Expenses and Changes in Net Position
For the Years Ended September 30, 2014 and 2013

	2014	(Restated) 2013
Operating revenues		
Power	\$ 22,876,847	\$ 22,342,342
Water	11,976,163	14,006,882
Sewer	4,853,750	5,873,492
LEAC - fuel charge	58,618,588	58,994,108
LEAC - non fuel	237,824	255,754
Other	367,979	203,144
	<u>98,931,151</u>	<u>101,675,722</u>
Bad debts	<u>(6,906,360)</u>	<u>(10,574,301)</u>
Net operating revenues	<u>92,024,791</u>	<u>91,101,421</u>
Operating expenses		
Production fuel	61,645,777	62,570,609
General and administrative	18,313,501	17,446,385
Maintenance	5,446,343	8,856,541
Depreciation	7,227,734	8,333,369
Supplies	1,609,566	1,365,318
Other production	1,000,912	754,975
Other	799,334	619,657
	<u>96,043,167</u>	<u>99,946,854</u>
Loss from operations, carried forward	<u>\$ (4,018,376)</u>	<u>\$ (8,845,433)</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

(A Component Unit of the CNMI Government)

Statements of Revenues, Expenses and Changes in Net Position, Continued
For the Years Ended September 30, 2014 and 2013

	2014	(Restated) 2013
Loss from operations, brought forward	\$ (4,018,376)	\$ (8,845,433)
Non-operating revenues (expenses)		
Interest income	574,488	403,042
Miscellaneous income	213,785	303,236
Amortization of fuel purchase obligation rebate	468,684	-
Regulatory assessments	(960,301)	(172,985)
Settlement expense	(6,558)	(23,760)
Stipulated order penalties	(4,574,000)	(3,881,000)
Contribution to the CNMI government	(366,948)	(417,561)
Interest and distribution expense	(1,206,204)	(1,439,661)
Total non-operating revenues (expenses), net	(5,857,054)	(5,228,689)
Loss before change in recovery of fuel costs	(9,875,430)	(14,074,122)
Change in recovery of fuel costs	(456,570)	1,340,482
Net loss before capital contributions and federal grants	(10,332,000)	(12,733,640)
Capital contributions and federal grants	6,270,224	11,489,591
Change in net position	(4,061,776)	(1,244,049)
Net position, beginning	56,726,663	57,970,712
Net position, ending	\$ 52,664,887	\$ 56,726,663

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, 2014 and 2013

	<u>2014</u>	<u>(Restated) 2013</u>
Cash flows from operating activities		
Cash received from customers	\$ 87,528,952	\$ 96,666,988
Cash payments to suppliers for goods and services	(72,980,805)	(82,205,779)
Cash payments to employees for services	<u>(10,398,452)</u>	<u>(9,777,119)</u>
Net cash provided by operating activities	<u>4,149,695</u>	<u>4,684,090</u>
Cash flows from noncapital financing activities		
Interest paid on outstanding debt	(192,857)	(427,380)
Principal repayment of debt	<u>(3,902,581)</u>	<u>(3,567,887)</u>
Net cash used for noncapital financing activities	<u>(4,095,438)</u>	<u>(3,995,267)</u>
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(4,912,409)	(7,245,275)
Capital contributions received	<u>5,567,178</u>	<u>11,397,840</u>
Net cash provided by capital and related financing activities	<u>654,769</u>	<u>4,152,565</u>
Cash flows from investing activities		
Interest income collected	<u>574,488</u>	<u>16,013</u>
Net cash provided by investing activities	<u>574,488</u>	<u>16,013</u>
Net change in cash and cash equivalents	1,283,514	4,857,401
Cash and cash equivalents at beginning of year	<u>18,094,023</u>	<u>13,236,622</u>
Cash and cash equivalents at end of year	<u>\$ 19,377,537</u>	<u>\$ 18,094,023</u>
Cash and cash equivalents	\$ 9,180,020	\$ 7,695,023
Restricted cash and cash equivalents	<u>10,197,517</u>	<u>10,399,000</u>
	<u>\$ 19,377,537</u>	<u>\$ 18,094,023</u>

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, 2014 and 2013

	<u>2014</u>	<u>(Restated) 2013</u>
Reconciliation of loss from operations to net cash provided by operating activities		
Loss from operations	\$ (4,018,376)	\$ (8,845,433)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation	7,227,734	8,333,369
Provision for bad debts	6,906,358	11,747,212
Loss on disposal of property and equipment	11,565	-
Miscellaneous income	213,785	303,236
Marketing assistance program	468,684	-
Regulatory assessments	(960,301)	(172,985)
Settlement expense	(6,558)	(23,760)
(Increase) decrease in assets:		
Accounts receivable - utility	(4,495,839)	(6,911,860)
Inventory	(1,888,372)	4,705
Notes receivable	248,518	7,409
Other assets	(545,142)	673,030
Increase (decrease) in liabilities		
Accounts payable and accrued liabilities	(2,808,493)	(745,685)
Customer deposits	-	94,143
Compensated absences	(50,807)	(40,877)
Security deposits including accrued interest	(1,671,389)	349,187
Unearned fuel purchase obligation rebate	6,131,316	-
Rate stabilization	(611,762)	-
Retirement contributions payable	(1,226)	(87,601)
Net cash provided by operating activities	<u>\$ 4,149,695</u>	<u>\$ 4,684,090</u>

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2014 and 2013

(1) Organization

The Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI) Government, was established as a Public Corporation by CNMI Public Law 4-47, as amended by Public Law 5-47, effective October 1, 1985 codified as Chapter 1 of Division 8 of Title 4 of the Commonwealth Code, and began operations on October 1, 1987.

Chapter 1 of Division 8 of Title 4 of the Commonwealth Code was repealed and re-enacted by Section 10 of Public Law 16-17.

CUC was given responsibility for supervising the construction, maintenance, operations, and regulation of electric, water and sewage services, provided however, that whenever feasible, CUC shall contract with 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 a proprietary fund to account for its operations. Proprietary funds are accounted for using the “economic resources” measurement focus and the accrual basis of accounting. Accordingly, all assets, deferred outflows of resources, liabilities (whether current or noncurrent), and deferred inflows of resources are included on the *Statement of Net Position*.

The *Statement of Revenues, Expenses and Changes in Net Position* presents increases (revenues) and decreases (expenses) in total net position. Under the accrual basis of accounting, revenues are recognized in the period in which they are earned while expenses are recognized in the period in which the liability is incurred, regardless of the timing of related cash flows.

Operating revenues in the proprietary funds are those revenues that are generated from the primary operations of the fund. All other revenues are reported as non-operating revenues. Operating expenses are those expenses that are essential to the primary operations of the fund. All other expenses are reported as non-operating expenses.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Adopted 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

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.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Recent Pronouncements

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*, which establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term government combinations includes a variety of transactions referred to as mergers, acquisitions, and transfers of operations. This Statement provides specific accounting and financial reporting guidance for combinations in the governmental environment. This Statement also improves the decision usefulness of financial reporting by requiring that disclosures be made by governments about combination arrangements in which they engage and for disposals of government operations. The provisions of Statement 69 are effective for government combinations and disposals of government operations occurring in financial reporting periods beginning after December 15, 2013, and should be applied on a prospective basis. Early application is encouraged.

In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. The requirements of this Statement will enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. This Statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. This Statement also will augment the ability of financial statement users to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee. The provisions of Statement 70 are effective for financial statements for reporting beginning after June 15, 2013. Earlier application is encouraged.

In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to The Measurement Date — An Amendment of GASB Statement No. 68*. The objective of this Statement is to address an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability. The requirements of this Statement will eliminate the source of a potential significant understatement of restated beginning net position and expense in the first year of implementation of Statement 68 in the accrual-basis financial statements of employers and nonemployer contributing entities. This benefit will be achieved without the imposition of significant additional costs. The provisions of this Statement are required to be applied simultaneously with the provisions of Statement 68.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Recent Pronouncements, Continued

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

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 since CUC is financially independent of appropriations by the CNMI Legislature.

Cash and Cash Equivalents

For purposes of the Statements of Net Position 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 Position.

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.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents, Continued

At September 30, 2014 and 2013, cash and cash equivalents were \$19,377,537 and \$18,094,023, respectively, and the corresponding bank balances were \$19,745,738 and \$18,106,069, respectively. Of the bank balance amounts, \$19,734,620 and \$18,071,258, respectively, were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$19,479,529 and \$17,796,241 were in excess of FDIC insurable limits as of September 30, 2014 and 2013, respectively. CUC also has deposits of \$11,118 in 2014 and \$34,811 in 2013 in an uninsured financial institution. CUC's deposits in excess of FDIC insured limits are collateralized by securities in the financial institutions name.

Restricted Cash and Cash Equivalents

The restricted cash and cash equivalents of \$10,197,517 and \$10,399,000 at September 30, 2014 and 2013, respectively, pertains to customer deposits, of which \$7,500,000 in 2013 was held as security pursuant to a standby letter of credit obtained from a financial institution. This letter of credit was canceled in May 2014.

Accounts Receivable and Allowance for Uncollectible 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 collectability 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 sixty (60) days old effective in fiscal year 2013. Prior allowances were based on 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). Materials and supplies inventory is valued at average cost.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Inventory, Continued

Inventory balances at September 30, 2014 and 2013 are as follows:

	2014	2013
Fuel and lubes	\$ 2,944,911	\$ 2,054,390
Materials and supplies	8,827,921	7,834,292
Total	11,772,832	9,888,682
Allowance for obsolescence	(692,903)	(697,125)
Inventory, net	\$ 11,079,929	\$ 9,191,557

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 a deferred fuel cost asset or liability, respectively, in the accompanying Statement of Net Position, and is recovered in or deducted from future billings to customers based on the amendments to Part 24 of the Electric Service Regulations of the CUC adopted on July 20, 2006. Electric fuel rates are computed monthly.

Any difference between the actual fuel costs and the electric fuel rate is accumulated in a deferred account and is 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 approved to extend the effective date of the rate structure until ordered otherwise by the CPUC.

Subsequent approved LEAC rates for 2013 and 2014 are as follows:

Effective Dates	2013
September 6, 2012 to January 6, 2013	\$0.31212
January 7, 2013 to March 4, 2013	\$0.29751
March 5, 2013	\$0.31878
January 1, 2014	\$0.30426
September 1, 2014	\$0.28902

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Fuel Oil Costs, Continued

The regulatory cost for future recovery at September 30, 2014 and 2013 is as follows:

	2014	2013
At beginning of year	\$ 4,597,480	\$ 3,256,998
Change in recovery of fuel costs	(456,570)	1,340,482
At end of year	\$ 4,140,910	\$ 4,597,480

Capital Assets and Depreciation

Capital assets consist of utility plant (including infrastructure), 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 Position. 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.

CUC's current policy is to capitalize items in excess of \$5,000 effective October 1, 2013. The previous limit was \$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 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 was no capitalized interest for the fiscal years ending September 30, 2014 and 2013.

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 a current liability.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Compensated Absences, Continued

The liability at September 30, 2014 and 2013 is as follows:

	2014	2013
Total compensated absences, beginning of year	\$ 929,348	\$ 970,225
Vacation earned	686,584	351,980
Vacation used	(737,391)	(392,857)
Total compensated absences, end of year	878,541	929,348
Current portion	(350,675)	(384,963)
Compensated absences – noncurrent	\$ 527,866	\$ 544,385

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.

Prioritization and Use of Available Resources

When both restricted and unrestricted resources are available for use, it is CUC's policy to use restricted resources first, then unrestricted resources as they are needed, unless there are legal documents or contracts that prohibit doing this, therefore, using other available revenues to fund these ongoing expenditures.

Retirement Plan

CUC contributes to the Northern Mariana Islands Retirement Fund's (the Fund) defined benefit plan (DB Plan) and defined contribution plan (DC Plan), a cost sharing, and multi-employer plan (the Plan) established and administered by the Fund. The Fund 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.

Public Law 17-82, which was signed on September 11, 2012, provided that Class I or Class II members of the DB Plan (active or inactive) may elect to voluntarily terminate membership in the Fund.

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(2) Summary of Significant Accounting Policies, Continued

Retirement Plan, Continued

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. Except as described in the paragraphs below, CUC has complied with GASB Statement No. 45 by recording OPEB expense based on the statutorily determined contribution rate of the Fund. It is the understanding of the management of CUC that the statutorily determined contribution rate of the Fund incorporates both the pension liability and OPEB liability. GASB Statement No. 45 also requires detailed disclosure of information related to the OPEB plan and the management of CUC was unable to obtain this information from the Fund financial report. The management of CUC is unable to obtain the required disclosures and is of the opinion that such information must be obtained from the Fund. It is the position of the management of CUC that the Fund is solely responsible for disclosure of OPEB information.

Defined Benefit Plan (DB Plan)

The DB Plan provides retirement, disability, security and other benefits to employees of the CNMI Government and CNMI agencies, instrumentalities and public corporations and their spouses and dependents. Benefits are based on the average annual salary of the beneficiary over the term of credited service. Public Law No. 6-17, the Northern Mariana Islands Retirement Fund (NMIRF) Act of 1988, is the authority under which benefit provisions are established. Public Law No. 6-17 was subsequently amended by Public Law Nos. 6-41, 8-24, 8-30, 8-31, 8-39, 9-25, 9-45, 10-8, 10-19, 11-9, 11-95, 13-60, 15-14, 15-70, 15-126, 16-2, 16-36, 17-82 and 18-02.

DB Plan members are required to contribute 10.5% and 11% of their annual covered salary for Class I and Class II members, respectively. The actuarially determined contribution rate for the fiscal year ended September 30, 2010 is 72.7215% of covered payroll based on an actuarial valuation as of October 1, 2010 issued in October 2012. The established statutory rate at September 30, 2014 is 72.7215% of covered payroll.

CUC's contribution to the Fund is at accrued 30% of covered payroll. This is based on a Court Order, requiring the CNMI government and its autonomous agencies to remit contributions to the Fund.

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(2) Summary of Significant Accounting Policies, Continued

Defined Contribution Plan (DC Plan)

On June 16, 2006, Public Law No. 15-13 was enacted which created the DC Plan, a multi-employer pension plan and is the single retirement program for all employees whose first time CNMI government employment commences on or after January 1, 2007. Each member of the DC Plan is required to contribute to the member's individual account an amount equal to 10% of the member's compensation. CUC is required to contribute to each member's individual account an amount equal to 40% of the member's compensation. The DC Plan by its nature is fully funded on a current basis from employer and member contributions. Members of the DC Plan, who have completed five years of government service, have a vested balance of 100% of both member and employer contribution plus any earnings thereon. With the passage of Public Law 17-82 in September 11, 2013, the membership to the DC Plan became voluntary.

Settlement Fund

On September 30, 2013, the U.S. District Court approved the Final Settlement Agreement for Case No. 09-000023, creating the Settlement Fund. Active members of the Retirement Fund who did not exercise the option to be excluded from the Settlement Fund became members of the Settlement Fund. Beginning fiscal year 2014, contributions for active members of the Fund are remitted to the Settlement Fund.

CUC's aggregate contributions to the Retirement Fund for the years ended September 30, 2014, 2013 and 2012 were \$351,044, \$418,307 and \$1,621,697, respectively.

The amount CUC recognized as payable to the Retirement Fund prior to the creation of the Settlement Fund totaled \$3,387,153 as of September 30, 2014.

Medical and Life Insurance Benefits

In addition to providing pension benefits, the CNMI Government also ensures that employees are provided with medical and life insurance benefits. The CNMI Government created the Group Health and Life Insurance Trust Fund ("Trust Fund"), 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 to retired CNMI Government employees who retire as a result of length of service, disability or age, as well as their dependents. Life insurance coverage is to be provided by a private carrier. Contributions from employees and employers are based on rates as determined by NMIRF Board of Trustees. Employee deductions are made through payroll withholdings.

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September 30, 2014 and 2013

(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 earnings at September 30, 2014 and 2013 are \$4,392,854 and \$3,581,447, 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.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Contingencies, Continued

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

(3) Accounts Receivable – Utility

Account receivable – utility as of September 30, 2014 and 2013 summarized by location and customer classification are as follows:

By Location	<u>2014</u>	<u>2013</u>
Saipan		
Commercial	\$ 7,589,715	\$ 6,181,799
Residential	10,576,221	11,113,312
Government	<u>18,973,818</u>	<u>17,132,045</u>
	<u>37,139,754</u>	<u>34,427,156</u>
Tinian		
Commercial	663,942	988,681
Residential	364,196	201,001
Government	<u>755,554</u>	<u>424,975</u>
	<u>1,783,692</u>	<u>1,614,657</u>
Rota		
Commercial	202,791	114,385
Residential	275,692	150,174
Government	<u>2,246,032</u>	<u>1,657,157</u>
	<u>2,724,515</u>	<u>1,921,716</u>
Total billed	41,647,961	37,963,529
Unbilled	<u>4,392,854</u>	<u>3,581,447</u>
	<u>\$ 46,040,815</u>	<u>\$ 41,544,976</u>

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(3) Accounts Receivable – Utility, Continued

By Customer Classification	<u>2014</u>	<u>2013</u>
Billed		
Commercial	\$ 8,456,448	\$ 7,284,865
Residential	11,216,110	11,464,487
Government	21,975,403	19,214,177
Unbilled	<u>4,392,854</u>	<u>3,581,447</u>
	46,040,815	41,544,976
Allowance for uncollectible accounts	<u>(36,001,107)</u>	<u>(29,094,749)</u>
Accounts receivable – utility, net	<u>\$ 10,039,708</u>	<u>\$ 12,450,227</u>

(4) Allowance for Uncollectible Accounts

Changes in allowance for uncollectible accounts for the years ended September 30, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Total allowance, beginning of year	\$ 29,871,614	\$ 19,251,221
Provision for uncollectible accounts	6,906,358	11,747,212
Accounts written-off	<u>-</u>	<u>(1,126,819)</u>
Total allowance, end of year	<u>\$ 36,777,972</u>	<u>\$ 29,871,614</u>
Accounts receivable – utility (Note 3)	\$ 36,001,107	\$ 29,094,749
Notes receivable (Note 5)	157,752	157,752
Others assets (Note 6)	<u>619,113</u>	<u>619,113</u>
Total allowance, end of year	<u>\$ 36,777,972</u>	<u>\$ 29,871,614</u>

(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.

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Notes to Financial Statements
September 30, 2014 and 2013

(5) Notes Receivable, Continued

A summary of the outstanding notes receivable as of September 30, 2014 and 2013 is as follows:

	<u>2014</u>	<u>2013</u>
Current portion, net of allowance of \$157,752	\$ 86,855	\$ 335,373
Noncurrent portion	<u>105,224</u>	<u>105,224</u>
	<u>\$ 192,079</u>	<u>\$ 440,597</u>

(6) Other Assets

Other assets as of September 30, 2014 and 2013 consist of the following:

	<u>2014</u>	<u>2013</u>
Prepayments	\$ 705,653	\$ 1,030,172
Temporary facility	51,240	53,319
Employee advances and travel advances	18,903	12,443
Other receivables, net of allowance of \$619,113	<u>1,171,808</u>	<u>306,528</u>
Other assets, net	<u>\$ 1,947,604</u>	<u>\$ 1,402,462</u>

(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 records 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, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Balance at beginning of year	\$ 116,347	\$ 24,596
Adjustments	-	670
Deductions - cash receipts from grantors	(5,054,646)	(11,681,831)
Additions - program outlays	<u>5,757,692</u>	<u>11,772,912</u>
Balance at end of year	<u>\$ 819,393</u>	<u>\$ 116,347</u>

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(8) Capital Assets

A summary of the changes in capital assets activity for the years ended September 30, 2014 and 2013 is as follows:

	Estimated Useful Lives	Balance at October 1, 2013	Acquisitions	Adjustments/ Disposals	Transfers	Balance at September 30, 2014
Utility plant in service						
Electric plant	20 years	\$ 128,881,452	\$ 854,127	\$ (2,493)	\$ -	\$ 129,733,086
Water plant	20 years	67,805,784	146,396	-	-	67,952,180
Sewer plant	20 years	45,730,511	40,066	-	2,545,396	48,315,972
Admin equipment	3-5 years	3,667,746	303,814	(87,130)	-	3,884,431
		246,085,493	1,344,403	(89,623)	2,545,396	249,885,669
Accumulated depreciation		<u>(173,685,835)</u>	<u>(7,227,734)</u>	<u>78,058</u>	<u>-</u>	<u>(180,835,510)</u>
Depreciable assets, net		72,399,658	(5,883,331)	(11,565)	2,545,396	69,050,159
Construction work-in-progress		<u>14,639,453</u>	<u>4,470,373</u>	<u>-</u>	<u>(3,447,764)</u>	<u>15,662,061</u>
Capital assets, net		<u>\$ 87,039,111</u>	<u>\$ (1,412,958)</u>	<u>\$ (11,565)</u>	<u>\$ (902,368)</u>	<u>\$ 84,712,220</u>

	Estimated Useful Lives	Balance at October 1, 2012	Acquisitions	Adjustments/ Disposals	Transfers	Balance at September 30, 2013
Utility plant in service						
Electric plant	20 years	\$ 132,337,219	\$ 560,532	\$ (238,637)	\$ (3,777,662)	\$ 128,881,452
Water plant	20 years	70,858,321	182,371	(102,928)	(3,131,980)	67,805,784
Sewer plant	20 years	45,839,881	476,288	-	(585,658)	45,730,511
Admin equipment	3-5 years	5,074,344	1,227,295	(124,600)	(2,509,293)	3,667,746
		254,109,765	2,446,486	(466,165)	(10,004,593)	246,085,493
Accumulated depreciation		<u>(178,157,250)</u>	<u>(8,333,369)</u>	<u>466,165</u>	<u>12,338,619</u>	<u>(173,685,835)</u>
Depreciable assets, net		75,952,515	(5,886,883)	-	2,334,026	72,399,658
Construction work-in-progress		<u>12,174,690</u>	<u>4,798,789</u>	<u>-</u>	<u>(2,334,026)</u>	<u>14,639,453</u>
Capital assets, net		<u>\$ 88,127,205</u>	<u>\$ (1,088,094)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 87,039,111</u>

Included in utility plant in service adjustments/transfers for fiscal years ended September 30, 2014 and 2013 are completed projects transferred from construction work-in-progress to utility plant in service of \$3,447,764 and \$2,334,026, respectively.

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September 30, 2014 and 2013

(8) Capital Assets, Continued

Depreciation expense for the years ended September 30, 2014 and 2013 is \$7,227,734 and \$8,333,369, respectively.

CUC entered into several construction contracts during fiscal years 2014 and 2013 for improvements, rehabilitation and replacement of facilities, and other capital projects. As of September 30, 2014, CUC had outstanding construction contracts totaling \$8,168,199 that will be financed from operating funds and federal awards.

(9) Security Deposits

Pursuant to 4 CMC § 8143, as amended by Public Law 16-17, CUC shall collect one month security deposits per residential customer account. Such deposits shall be placed in an interest bearing trust fund and shall not be used for any other purpose.

Summarized below is the summary of security deposits including accrued interest as of September 30, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Electric	\$ 7,811,045	\$ 9,492,549
Water	593,130	594,680
Sewer	<u>157,740</u>	<u>121,059</u>
Total security deposits	8,561,915	10,208,288
Accrued interest on security deposits	<u>517,083</u>	<u>542,099</u>
Security deposits, including interest	<u><u>9,078,998</u></u>	<u><u>10,750,387</u></u>
Security deposits, including interest	9,078,998	10,750,387
Restricted cash	<u>10,197,517</u>	<u>10,399,000</u>
Accumulated security deposits used to purchase fuel (Excess restricted cash over liability)	<u><u>\$ (1,118,519)</u></u>	<u><u>\$ 351,387</u></u>

Of CUC's restricted cash, \$7,500,000 as of September 30, 2013 was 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. This letter of credit was canceled in May 2014.

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(10) Long-term Debt

Long-term debt at September 30, 2014 and 2013 is as follows:

	2014	2013
Commonwealth Ports Authority	\$ 3,373,563	\$ 3,373,563
Pacific Marine Industrial Corporation	-	3,902,581
	3,373,563	7,276,144
Current maturities	(2,520,963)	(6,051,997)
Long-term debt, net of current portion	\$ 852,600	\$ 1,224,147

Interest expense on long-term debt for the years ended September 30, 2014 and 2013 was \$306,204 and \$539,661, respectively, and is presented as a component of interest and distribution expense in the accompanying Statements of Revenues, Expenses and Changes in Net Position.

Changes in long-term debt for the fiscal years ended September 30, 2014 and 2013 are as follows:

	Balance at October 1, 2013	Acquisitions	Transfers	Balance at September 30, 2014
Commonwealth Ports Authority	\$ 3,373,563	\$ -	\$ -	\$ 3,373,563
Pacific Marine Industrial Corporation	3,902,581	-	(3,902,581)	-
Total	\$ 7,276,144	\$ -	\$ (3,902,581)	\$ 3,373,563

	Balance at October 1, 2012	Acquisitions	Transfers	Balance at September 30, 2013
Commonwealth Ports Authority	\$ 3,373,563	\$ -	\$ -	\$ 3,373,563
Pacific Marine Industrial Corporation	7,470,468	-	(3,567,887)	3,902,581
Total	\$ 10,844,031	\$ -	\$ (3,567,887)	\$ 7,276,144

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(10) Long-term Debt, continued

A summary of CUC's loans payable to CPA at September 30, 2014 and 2013 is as follows:

	<u>2014</u>	<u>2013</u>
Loan payable to Commonwealth Ports Authority, a component unit of the CNMI Government, principal of \$3,385,131, interest at 6.25% per annum, with a maturity date of October 31, 2017. Principal and interest is due in monthly payments of \$38,008.	\$ 3,373,563	\$ 3,373,563
Current maturities	(2,520,963)	(2,149,416)
Long-term debt, net of current portion	\$ 852,600	\$ 1,224,147

Future repayment commitments of principal and interest are as follows:

Years ending September 30:	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$ 2,520,963	\$ 640,188	\$ 3,161,151
2016	395,446	60,653	456,099
2017	420,882	35,217	456,099
2018	36,272	1,736	38,008
	\$ 3,373,563	\$ 737,794	\$ 4,111,357

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, in 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 without purchasing power from PMIC through Power Plant 4.

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September 30, 2014 and 2013

(10) Long-term Debt, Continued

An analysis by CUC Management of the contract termination follows:

Power purchase commitment at termination date 49 months at \$331,000 per month	\$ 16,219,000
Termination obligation – payable in 27 months	(8,375,916)
Less: assets transferred from PMIC to CUC	<u>974,869</u>
Savings through termination of contract	<u>\$ 8,817,953</u>

As a result of the contract termination, CUC recognized a loan payable to PMIC with a principal balance of \$8,375,916 and bearing interest at 9% per annum. Principal and interest payments are due in monthly payments of \$341,286. The loan balance as of September 30, 2014 and 2013 is \$ 0 and \$3,902,581, respectively. The loan was fully repaid as of September 30, 2014.

(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, 2014 and 2013, CUC recognized an outstanding payable to the CNMI Government in the amount of \$6,646,790 and \$6,279,843, respectively. CUC accrued OPA fees of \$366,948 in 2014 and \$417,561 in 2013. OPA asserts that CUC owes the CNMI government OPA fees of approximately \$9 million as of September 30, 2014 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, 2014.

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 CUC from the monthly utility costs of the government. No application of payments were made as of September 30, 2014.

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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 as 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 Commission.

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 through the execution of the MOA. Dividends payable as of September 30, 2014 and 2013 amounted to \$4,500,000 and \$3,600,000, respectively. CUC is in default of its \$900,000 dividend payment for 2014 and its \$900,000 dividend payment for 2013 and the \$180,000 amortization of deferred dividends.

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

Years ending September 30:	
2015	\$ 2,340,000
2016	180,000
2017	180,000
2018	180,000
2019	180,000
2020 to 2024	900,000
2025 to 2027	<u>540,000</u>
	\$ <u>4,500,000</u>

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(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 does, however, require performance bonds on all of its construction projects.

(14) Commitments and Contingencies

Commitments

At September 30, 2014, CUC had commitments of \$8,168,199 for construction, purchases of inventory, and acquisition of property and equipment, all of which are expected to be incurred in 2015.

Contingencies

Federal Questioned Costs

CUC participates in a number of federally assisted grant programs funded by the United States of America Federal 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, 2014 and 2013.

Public Law 18-19 Public School System Water and Waste Water Rate

Pursuant to Public Law 18-19, CUC should charge the Public School System (PSS) the commercial rate for water and waste water. CUC may recover the decrease in water and waste water rates from other CUC customers paying the government rate for water and waste water but CUC may not increase the residential and commercial rates to recover the PSS rate reduction.

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

Notes to Financial Statements
September 30, 2014 and 2013

(14) Commitments and Contingencies, Continued

Contingencies, Continued

Public Law 18-19 Public School System Water and Waste Water Rate, Continued

Furthermore, Public Law 18-19 states that any late fees or penalties that have been assessed to PSS shall be waived for fiscal year 2013 and any fees that have been collected from PSS in fiscal 2012 and thereafter shall be credited or used to offset PSS utility expenditures in fiscal year 2012, 2013 and 2014.

On September 30, 2014, the CNMI Attorney General issued Legal Opinion Number 2014-02 which concluded that Public Law 18-19 does not require the review and approval of the Commonwealth Public Utilities Commission prior to CUC putting the commercial rate for PSS into effect. CUC intends to comply with this Opinion. However, because of the substantial financial impact of the law on CUC, it is also considering challenging the law in Court.

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 exceed \$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 having these claims dismissed.

As of December 2011, the original Judge assigned to this case recused himself, and the matter has been assigned to another Judge who took it under advertisement on the record on December 29, 2011. CUC has since put this matter on for status conference but has not received further information or decision on this matter to date.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(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.

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 primary 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 accumulated to over \$76 million, but have not been billed to and paid for by CUC, 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. On September 26, 2014, another Stipulated Order was entered into under which the United States and EPA waived all Stipulated Order Two penalties which have accumulated as of September 25, 2014. The amount waived was approximately \$40 million.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(14) Commitments and Contingencies, Continued

Contingencies, Continued

Stipulated Orders, Continued

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 sometime in 2015. The Pipeline design is stalled based on CUC's termination of the primary contractor.

The project will resume under the direction of an Engineering and Environmental Management Company pursuant to the provisions of the Stipulated Order entered on September 26, 2014. Any further penalties and fines are contingent on CUC's performance under both Stipulated Orders One and Two. CUC has chosen to accrue a liability under Stipulated Order one as described in note 17 below.

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. A taxpayer lawsuit was filed in the Superior Court for the purpose of challenging the PPA. CUC is a named Defendant in the case. CUC filed a motion detailing the problems and illegalities with the agreement arguing that the PPA is void ab initio, per a CNMI Attorney General's Opinion. On February 4, 2014 the CNMI Superior Court entered a decision declaring the PPA void ab initio. Accordingly, it appears that liability for CUC will not be an issue. However, there is not yet a final judgment and so there is a possibility of appeal to the CNMI Supreme Court.

SDLLC sued CUC in the US District Court for breach of contract and equitable reimbursement for the PPA at issue in the Superior Court action above. CUC brought a motion to dismiss which was granted by an Order of June 24, 2014, wherein the District Court found exceptional circumstances weighed in favor of abstention and dismissed the complaint with prejudice. SDLLC has appealed this decision to the Ninth Circuit Court of Appeals.

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

Notes to Financial Statements
September 30, 2014 and 2013

(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.

(17) Restatement of Financial Statements

As described in note 14 above, the U.S. EPA has assessed penalties to CUC under Stipulated Order One. The EPA has not enforced collection as of the date of the accompanying financial statements. The EPA has also not waived these penalties. CUC has restated the fiscal year 2013 financial statements to recognize this potential liability. The accumulated penalties as of September 30, 2012 were \$27,586,000. In the accompanying statement of revenues, expenses and changes in net position, the net position at the beginning of the fiscal year ended September 30, 2012 was reduced from \$85,556,712 to \$57,970,712.

Non-operating expenses of \$4,574,000 and \$3,881,000 for the years ended September 30, 2014 and 2013, respectively, were recognized for these penalties.

The cumulative balance payable at September 30, 2014 was \$36,041,000. These penalties continue to accrue on a daily basis.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2014 and 2013

(18) Going Concern

Historically the Corporation has had operating losses, negative cash flows from operations and working capital deficiencies. The unrestricted net deficit as of September 30, 2014 is \$76,558,240 and the net loss for the year ended September 30, 2014 was \$ 4,061,776. Whether, and when, the Corporation can attain a net surplus and positive cash flows from operations is uncertain.

The Corporation will need to increase revenue and improve the collection of revenue in order to fund its operations. This need may be adversely impacted by: continued non-payment of current and past due debts from the CNMI Government and its component units, non-approval of requested rate increases by the Commonwealth Public Utilities Commission (CPUC), legislative decisions, emergency maintenance of power, water and wastewater systems, which are in desperate need of replacement and/or repairs, and debts being called by the Commonwealth Development Authority (CDA), the Commonwealth Ports Authority (CPA) and/or the Environmental Protection Agency (EPA).

Management has concluded that the combination of the above circumstances represents a material uncertainty that casts significant doubt upon the Corporation's ability to continue as a going concern and that, therefore, the Corporation may not be able to realize its assets and discharge its liabilities in the normal course of business. Nevertheless, after making inquiries and considering the uncertainties described above, Management has a reasonable expectation that the Corporation will have adequate resources to continue in some form for the foreseeable future, but the above circumstances could have a significant impact on operational stability. For these reasons, Management continues to adopt the going concern basis of accounting in preparing the annual financial statements.

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

Supplementary Information
Schedule of Revenues, Expenses and Changes in Net Position on a Divisional Basis
For the Year Ended September 30, 2014

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Operating revenues:						
Governmental	\$ 5,729,592	\$ 2,480,999	\$ 1,360,195	\$ -	\$ (2,112,454)	\$ 7,458,332
Commercial	13,118,544	2,670,388	2,343,988	-	-	18,132,920
Residential	6,141,165	6,824,776	1,149,567	-	-	14,115,508
Subtotal	24,989,301	11,976,163	4,853,750	-	(2,112,454)	39,706,760
LEAC - Fuel charge	63,494,004	-	-	-	(4,875,416)	58,618,588
LEAC - Non fuel	237,824	-	-	-	-	237,824
Other	321,494	46,020	465	-	-	367,979
	89,042,623	12,022,183	4,854,215	-	(6,987,870)	98,931,151
Bad debts	(1,964,479)	(3,017,467)	(1,924,414)	-	-	(6,906,360)
Net operating revenue:	87,078,144	9,004,716	2,929,801	-	(6,987,870)	92,024,791
Operating expenses:						
Production fuel	61,645,777	-	-	-	-	61,645,777
General and administrative	8,172,528	3,012,881	1,252,662	5,875,430	-	18,313,501
Maintenance	4,073,775	777,368	472,491	122,709	-	5,446,343
Depreciation	2,456,362	2,228,067	2,058,000	485,305	-	7,227,734
Supplies	512,820	640,825	96,498	359,423	-	1,609,566
Other production	1,126,195	5,339,824	1,213,226	309,537	(6,987,870)	1,000,912
Other	-	-	-	799,334	-	799,334
Total operating expenses	77,987,457	11,998,965	5,092,877	7,951,738	(6,987,870)	96,043,167
Earnings (loss) from operations before allocation of common costs	9,090,687	(2,994,249)	(2,163,076)	(7,951,738)	-	(4,018,376)
Allocation of common cost:	(5,286,822)	(1,719,792)	(945,124)	7,951,738	-	-
Earnings (loss) from operations	\$ 3,803,865	\$ (4,714,041)	\$ (3,108,200)	\$ -	\$ -	\$ (4,018,376)

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 Position on a Divisional Basis
For the Year Ended September 30, 2014

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Earnings (loss) from operations	\$ 3,803,865	\$ (4,714,041)	\$ (3,108,200)	\$ -	\$ -	\$ (4,018,376)
Non-operating revenues (expenses)						
Interest income	343,062	158,115	73,311	-	-	574,488
Miscellaneous income	195,459	14,256	4,070	-	-	213,785
Amortization of marketing assistance	468,684	-	-	-	-	468,684
Regulatory assessments	(721,705)	(123,620)	(114,976)	-	-	(960,301)
Settlement expense	(6,558)	-	-	-	-	(6,558)
Contribution to the CNMI government	(183,638)	(128,811)	(54,499)	-	-	(366,948)
Stipulated order penalties	(4,022,672)	(417,969)	(133,359)	-	-	(4,574,000)
Interest and distribution expense	(1,206,204)	-	-	-	-	(1,206,204)
Total non-operating revenues (expenses), net	(5,133,572)	(498,029)	(225,453)	-	-	(5,857,054)
Loss before change in recovery of fuel cost	(1,329,707)	(5,212,070)	(3,333,653)	-	-	(9,875,430)
Change in recovery of fuel costs	(456,570)	-	-	-	-	(456,570)
Net loss before capital contributions and federal grants	(1,786,277)	(5,212,070)	(3,333,653)	-	-	(10,332,000)
Capital contributions and federal grants	1,758,737	3,017,521	1,493,966	-	-	6,270,224
Change in net position	\$ (27,540)	\$ (2,194,549)	\$ (1,839,687)	\$ -	\$ -	\$ (4,061,776)

See accompanying notes to financial statements.

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

**INDEPENDENT AUDITORS' REPORTS
ON INTERNAL CONTROL
AND ON COMPLIANCE**

**Years Ended
September 30, 2014 and 2013**



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

To the Board of Directors
Commonwealth Utilities Corporation

We have audited, in accordance with the 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, the financial statements of the Commonwealth Utilities Corporation (CUC), as of and for the year ended September 30, 2014, and the related notes to the financial statements, which collectively comprise CUC's basic financial statements and have issued our report thereon dated May 26, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered CUC's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CUC's internal control. Accordingly, we do not express an opinion on the effectiveness of CUC's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and questioned costs, we identified certain deficiencies in internal control that we consider to be material weaknesses and 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 a 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. We consider the deficiency described in Finding No. 2014-001 in the accompanying schedule of findings and questioned costs to be a material weakness.

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. We consider the deficiencies described in Finding Nos. 2014-004 to 2014-005 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 from material misstatement, we 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 our audit, and accordingly, we do not express such an opinion. The results of our 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. 2014-007 to 2014-010.

CUC's Response to Findings

CUC's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. CUC's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.


Saipan, Commonwealth of the Northern Mariana Islands
May 26, 2015

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
FOR EACH MAJOR PROGRAM AND
ON INTERNAL CONTROL OVER COMPLIANCE
REQUIRED BY OMB CIRCULAR A-133**

To the Board of Directors
Commonwealth Utilities Corporation

Report on Compliance for Each Major Federal Program

We have audited CUC's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of CUC's major federal programs for the year ended September 30, 2014. CUC's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of CUC's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our 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; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we 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 we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of CUC's compliance.

Opinion on Each Major Federal Program

In our opinion, CUC, complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended September 30, 2014.

Report on Internal Control Over Compliance


Management of CUC is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered CUC's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program 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, we do not express an opinion on the effectiveness of CUC's internal control over compliance.

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 a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.


Saipan, Commonwealth of the Northern Mariana Islands
May 26, 2015

Commonwealth Utilities Corporation
Schedule of Expenditures of Federal Awards
Year Ended September 30, 2014

Federal Grantor/ Pass Through Grantor/ Program Title	Federal CFDA Number/ Grantor ID No./ Pass Through Grantor's Number	Program or Award Amount	Receivable (Deferred) Revenue) from Grantor at September 30, 2013	Adjustments	Cash Receipt	Expenditures	Receivable (Deferred) Revenue) from Grantor at September 30, 2014
<u>U.S. Environmental Protection Agency</u>							
Direct Program:							
Consolidated Environmental Program	66.600/-/M-00T33711	\$ 40,913,404	\$ 144,096	\$ -	\$ 3,568,196	\$ 3,920,372	\$ 496,272
Subtotal		<u>40,913,404</u>	<u>144,096</u>	<u>-</u>	<u>3,568,196</u>	<u>3,920,372</u>	<u>496,272</u>
<u>U.S. Department of the Interior</u>							
<u>Direct Program</u>							
USGS	15.875/OMIP CUC 2006 -1	12,500	(12,500)	-	-	-	(12,500)
Professional Services Assistance	15.875/CNMI-Water/Wastewater-2011-1	265,800	-	-	529	529	-
Bureau of Reclamation:							
Water Loss Reduction and Energy Savings	15.507/R13AP80017	294,967	-	-	24,349	24,349	-
Passed through the Government of the CNMI:							
<u>Federal Portion</u>							
Geothermal Energy	15.875/CNMI-CIP-2011-3	1,260,000	-	-	232,891	232,891	-
Rehabilitation of Agingan Wastewaer Treatment Facilities	15.875/CNMI-CIP-2009-4	1,443,742	-	-	169,415	169,415	-
Rota Generation Improvements	15.875/CNMI-CIP-2010-2	3,568,830	6,750	-	11,653	4,903	-
Stipulated Order #2	15.875/CNMI-CIP-2010-3	4,050,000	(17,511)	-	-	7,631	(9,880)
New Fuel Tank at PP1 (Tank 102)	15.875/CNMI-CIP-2013-1	350,000	(4,488)	-	22,000	26,488	-
Replacement of 8" Petroleum Pipeline	15.875/CNMI-CIP-2011-2	2,154,000	-	-	371,614	531,926	160,312
Add'l Funding for Replacement of 8" Petroleum Pipeline	15.875/CNMI-CIP-2013-3	1,025,000	-	-	318,000	318,000	-
Add'l Funding for Replacement of 8" Petroleum Pipeline	15.875/CNMI-CIP-2013-6	725,000	-	-	-	185,189	185,189
Add'l Funding for Replacement of 8" Petroleum Pipeline	15.875/CNMI-CIP-2014-2	733,253	-	-	336,000	336,000	-
Subtotal Federal Portion		<u>15,883,092</u>	<u>(27,749)</u>	<u>-</u>	<u>1,486,451</u>	<u>1,837,321</u>	<u>323,121</u>
		<u>\$ 56,796,496</u>	<u>\$ 116,347</u>	<u>\$ -</u>	<u>\$ 5,054,647</u>	<u>\$ 5,757,693</u>	<u>\$ 819,393</u>

See accompanying notes to financial statements.

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

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2014

(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 2014, 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, 2014

(2) Summary of Significant Accounting Policies

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). During the year ended September 30, 2014 CUC's grant award notification and expenditures did not include any ARRA funded programs.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

SECTION I – SUMMARY OF AUDITOR’S RESULTS

Financial Statements

Type of auditor’s report issued: Unmodified

Internal control over financial reporting:

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

Noncompliance material to financial statements noted? yes no

Federal Awards

Internal control over major programs:

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

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

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

Identification of Major Programs:

<u>CFDA No.</u>	<u>Description</u>	
15.875	Economic, Social, and Political Development of the Territories	\$ 1,812,972
66.600	Environmental Protection Consolidated Grants Support	<u>3,920,372</u>
	Total major program expenditures	\$ <u>5,733,344</u>
	Total federal expenditures	\$ <u>5,757,693</u>
	Percentage of federal expenditures tested as major programs	<u>99%</u>

Dollar threshold used to distinguish between
Type A and Type B programs: \$300,000

Auditee qualified as low-risk auditee __yes Xno

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-001 Bank Reconciliations

Criteria:

Pursuant to 34 CFR PART 80 — Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments, §80.20 (b)(3), Internal Control, an effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

In line with this, preparation of monthly reconciliations of cash accounts should be performed on a timely basis and should be properly supported.

Condition:

Monthly account reconciliations were not timely prepared for all bank accounts during fiscal year 2014.

Cause:

During the fiscal year ended September 30, 2013 CUC implemented new Billing and Collection Software and Financial Accounting Software. The integration between the two programs resulted in postings in the cash general ledger of lump-sum amounts that could not be easily traced to the bank statements and from the collection report for the Billing and Collection Software. CUC's accounting department had to request a customized report from the software provider to enable the identification of deposits posted in the general ledger. This problem continued in the fiscal year ended September 30, 2014.

Effect:

Although the cash accounts as of September 30, 2014 were reconciled, interim financial reports may have been misstated for the effects of the un-reconciled bank balances. Financial decisions involving cash could be based on inaccurate information and may have negative consequences. Furthermore, fraud, theft and errors could exist and not be detected.

Prior Year Status:

A similar condition was reported in the prior year audit as Finding 2013-01.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-001 Bank Reconciliations, Continued

Recommendation:

Implementing new software is not an easy endeavor; CUC should have maintained parallel runs of the old and new systems to ensure that financial reporting is timely and accurate.

CUC should ensure bank reconciliations are timely prepared and reviewed.

Finding No. 2014-002 Purchases/Disbursements

Criteria:

Pursuant to § 70-30.3-220 of the Northern Mariana Islands Administrative Code (NMIAC), purchase orders may be utilized for small purchases below \$10,000. Disbursements should be properly supported with an approved purchase order as evidence that the purchase of goods or performance of services is authorized.

Condition:

- a. For 3 or 3% of the 90 purchase order files tested, the vendor invoices show dates that were prior to the date of the purchase order as follows:

<u>No.</u>	<u>Purchase Order Number</u>	<u>Date of Purchase Order</u>	<u>Invoice Number</u>	<u>Date of Invoice</u>	<u>Check Number</u>	<u>Check Amount</u>
1	14-0688	3/12/2014	8831U	2/22/2014	96857	\$ 166
2	14-0838	4/21/2014		4/15/2014	97128	72
			11148	4/15/2014	97128	15
3	14-1400	9/5/2014	MTG081214	8/12/2014	98129	60
						<u>\$ 313</u>

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-002 Purchases/Disbursements, Continued

Cause:

There is a lack of internal control monitoring to ensure compliance with established procurement policies and procedures. CUC failed to ensure the completeness of relevant supporting documentation prior to processing its purchase orders and to ensure that such completed purchase orders are systematically filed for retrieval.

Effect:

The potential exists for unauthorized/invalid expenditures and waste, fraud and abuse that might not be prevented or detected in a timely manner.

Recommendation:

CUC should establish monitoring procedures to ensure that all small purchases below \$10,000 are approved and documented pursuant to § 70-30.3-220 of the NMIAC. Payments should only be made on vendor invoices with reference to an approved purchase order, contract, or other justification as allowed by the procurement policies of CUC and the NMIAC. Administrative procedures should be implemented to ensure all procurements are properly filed for easy retrieval and independent inspection.

Finding No. 2014-003 Reconciliation of Customer Accounts Subsidiary Ledgers to the General Ledger Accounts

Criteria:

Controls should be in place to ensure that all customer billings, collections and adjustments are properly carried forward from the Billings and Collections Software to the Financial Accounting Software.

Condition:

For every customer account in the Billings and Collections software general ledger accounts were assigned to each transaction such as billing, customer adjustments and collection. The software provider designed an interface to upload the transactions to the general ledger. This procedure aims to seamlessly record the transactions from the subsidiary ledgers (which are maintained in the Billings and Collections software) to the general ledger accounts in the Financial Accounting Software.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-003 Reconciliation of Customer Accounts Subsidiary Ledgers to the General Ledger Accounts, Continued

Having this computerized internal control in place, CUC did not conduct monthly reconciliations of the subsidiary ledgers to the general ledger balances. Account reconciliation was only prepared at year-end and such reconciliation disclosed several discrepancies.

Cause:

CUC relied on the computerized controls. Furthermore, the accounting department was not significantly involved in the design and implementation of the Billing and Collection Software from which the significant volume of financial information is generated.

Effect:

Although the accounts receivable balances as of September 30, 2014 were reconciled, interim financial reports may have been misstated for the effects of the unreconciled balances. Financial decisions involving receivables, such as provision for uncollectible accounts, could be based on inaccurate information and may have negative consequences. Furthermore, fraud, theft and errors could exist and not be detected.

Prior Year Status:

A similar condition was reported in the prior year audit as Finding 2013-02.

Recommendation:

In order to make the financial reports generated by the accounting system as meaningful as possible, CUC should reconcile the general ledger accounts for accounts receivable on a monthly basis. A benefit of monthly reconciliations is that errors do not accumulate but can be identified and attributed to a particular period, which makes it easier to perform future reconciliations.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-004 Negative Balances in the Aging of Accounts Receivable

Criteria:

Collections received should be applied to specific billings.

Condition:

The aged listing of accounts receivable as of September 30, 2014 included negative balances totaling more than \$1 million.

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:

A similar condition was cited in Finding Nos. 2013-06, 2012-02, 2011-03, 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. The new Billing and Collection Software is able to summarize such credit balance into customer deposit and advance payments, hence CUC should utilize this to issue refunds for deposits in excess of mandatory deposits and properly apply advances to the appropriate subsequent billings.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-005 Provision for Uncollectible Accounts

Criteria:

Pursuant to CUC policies, an allowance for uncollectible accounts shall be provided for customer accounts over 75 day past due.

Condition:

CUC Billing and Collection Software was configured to age receivable from customers in increments of 30 days, hence the report is unable to generate a summary of customer receivables over 75 days past due.

CUC used the balance over 60 days as the basis for recording the provision for uncollectible accounts.

Cause:

CUC was limited by the Billing and Collection Software's customer receivable aging configuration.

Effect:

CUC uses the rate of uncollectibility as a factor in rate setting. The shorter period used as the basis for providing allowance for uncollectible accounts could result in artificially increasing the provision for bad debts which would be used in making subsequent rate-setting decisions

Recommendation:

CUC should consult its software provider whether or not the aging of customer receivables could be configured to comply with CUC policy.

If CUC believes that the current aging is the more accurate basis for estimating uncollectible accounts, CUC should update its policies accordingly.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding 2014-006 Recalculation of Security Deposits

Criteria:

Pursuant to Title 50 of the CNMI Administrative Code, CUC's Engineering Division shall be responsible for calculating the actual cost of customer's deposit based on a sliding scale of estimated kilowatt usage. Furthermore, it allows customers to request a recalculation of their required security deposit based on actual kilowatt usage rather than the sliding scale provided they had utilized CUC full time for a period of at least one (1) year. In the absence of such direct request from the customers, CUC may also recalculate the security deposit after one year of established use, and annually thereafter. Adjustments necessary on the required security deposit amount based on the new calculation shall be reflected on the customer's monthly bill.

Condition:

The following security deposits are higher than the required amount as of fiscal year ended September 30, 2014:

<u>Customer Number</u>	<u>Deposit Date</u>	<u>Actual Deposit</u>	<u>Recalculated Deposit</u>	<u>Remarks</u>
10935	1/3/2006	246,796.96	-	Closed account
16227	10/27/2011	146,783.92	12,425.77	
50769	1/13/2006	205,243.33	80,268.85	
53017	8/30/2005	165,888.00	31,143.72	

Cause:

CUC has not performed any recalculation of required security deposit amount.

Effect:

CUC is not in compliance with the regulations set forth in the Title 50 of the CNMI Administrative Code and may have customers who are due a refund or owe additional deposit.

Recommendation:

CUC should explore whether or not the new Billing and Collection software is able to keep track of security deposits and recalculate the required amounts to ensure compliance with Title 50 of the CNMI Administrative Code.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

COMPLIANCE AND OTHER MATTERS

Finding No. 2014-007 Procurement

Criteria:

Pursuant to CUC Procurement Regulations §50-50-201, unless otherwise authorized by law or by regulation, all CUC contracts shall be awarded by competitive sealed bidding, except as provided in:

- (a) § 50-50-210 (Small Purchases);
- (b) § 50-50-215 (Sole Source Procurement);
- (c) § 50-50-220 (Emergency Procurement);
- (d) § 50-50-225 (Competitive Sealed Proposals);
- (e) § 50-50-230 (Professional Services);
- (f) § 50-50-305 (Architect-Engineer Services)

Condition:

The Executive Director issued a memorandum authorizing the procurement of materials and parts utilizing a request for quotation instead of competitive sealed bidding. The following contracts were procured using a request for quotation:

<u>Contract No.</u>	<u>Amount</u>
CUC-PG-14-C007	\$ 99,600
CUC-PG-14-C008	165,000
CUC-ADM-14-C004	115,993
CUC-PG-14-C009	81,170
CUC-PG-13-C035	<u>135,070</u>
	<u>\$ 596,833</u>

Effect:

CUC did not comply with its Procurement Regulations.

Prior Year Status:

Similar findings were noted in prior year audit reported as Finding 2013-08.

COMMONWEALTH UTILITIES CORPORATION
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Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

COMPLIANCE AND OTHER MATTERS

Finding No. 2014-007 Procurement, Continued

Cause:

The contracts procured through a request for quotation are for routine repair materials and parts for CUC facilities and plants that have very specific requirements that can often only be provided by the suppliers of the equipment for which the parts reordered are to be used. Oftentimes these suppliers are off-island and would not be monitoring CUC's request for competitive sealed bidding unless CUC sent them a copy of the request. Furthermore, these suppliers often are reluctant in responding to the request for competitive sealed bidding due to the volume of required documentation necessary to be considered responsive bidders.

Recommendation:

CUC should consider updating its Procurement Regulations to include purchase of routine repair materials and parts as an exception to §50-50-201.

Also CUC may designate these suppliers as sole source suppliers and will comply with the CUC's Sole Source Procurement, §50-50-215 of CUC's Procurement Regulation. Furthermore, CUC should consider including a provision for cost analysis in its Sole Source Procurement regulation. Such provision will document CUC's consideration that the cost provided by the sole source vendor is not excessively priced.

Finding 2014-008 Memorandum of Agreement (MOA) with CDA

Criteria:

Pursuant to the MOA between CUC and the Commonwealth Development 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.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

COMPLIANCE AND OTHER MATTERS

Finding 2014-008 Memorandum of Agreement (MOA) with CDA, Continued

Condition:

Outstanding deferred dividends payable as of September 30, 2014 amounted to \$3,600,000. CUC has not established a revolving fund pursuant to the terms of the MOA. In addition to the deferred dividends payable, CUC also has not remitted to CDA the \$900,000 dividend for the year ended September 30, 2014.

Cause:

CUC 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 Nos. 2013,09, 2012-06 and 2011-07 in prior years audits.

Recommendation:

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

Finding 2014-009 Payroll Processing

Criteria:

Employees should be paid pursuant to signed employment contracts and/or an approved notice of personnel action.

Condition:

The rate used in calculating the following payroll was not supported by an approved Notice of Personnel Action (NOPA):

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

COMPLIANCE AND OTHER MATTERS

Finding 2014-009 Payroll Processing, Continued

<u>Employee Number</u>	<u>Pay Period</u>	<u>Payment Date</u>	<u>Rate Used</u>	<u>Rate on NOPA</u>	<u>Effectivity</u>	<u>Remarks</u>
4692	08.24-09.06	9/19/2014	8.30	N/A	N/A	NOPA not provided

Cause:

Not all the NOPA effective for the fiscal year ended September 30, 2014 were provided to the auditor.

Effect:

Although the misstatement does not materially misstate CUC's financial statements, the salaries and wages paid to certain employees might be misstated due to the difference in rates used against the documented Notices of Personnel Action.

Prior Year Status:

A similar condition was reported in the prior year audit as Finding 2013-010.

Recommendation:

The Human Resources Department should ensure that all changes in employee status and/or rates are documented on either properly executed employment contracts or notices of personnel action. Furthermore, they should ensure that each employee timely updates their Form W-4, Employee's Withholding Allowance Certificate and such information is updated on the system used to calculate payroll.

Finding 2014-010 Interest on Security Deposit Refunds

Criteria:

Pursuant to Public Law 16-17 §8143(b), all residential security deposit refunds shall be paid within thirty (30) days after disconnection of utilities with earned interest.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

COMPLIANCE AND OTHER MATTERS

Finding 2014-010 Interest on Security Deposit Refunds, Continued

Condition:

CUC has not yet established procedures for calculating interest accrued on customer deposits, and has not paid interest on security deposits refunded to customers.

Cause:

Conflicting regulations set forth by the Administrative Code and the Commonwealth Code prevented CUC from establishing procedures for calculating interest accrued on customer deposits.

Title 50 of the CNMI Administrative Code (§50-10-435) held CUC liable for all security deposits received and directed CUC to credit each account an amount equal to the average passbook savings interest rate payable during the past year based on rates from at least three local FDIC insured banks. On the other hand, Title 4, Division 8 of the CNMI Commonwealth Code (§8143 (b)) directed CUC to place the security deposits in an interest-bearing trust fund to be established by the Executive Director and to pay security deposit refunds within thirty (30) days after disconnection of utilities with earned interest. This directive, however, is applicable only on residential security deposits.

Effect:

CUC is not in compliance with the provision of Public Law 16-17.

Prior Year Status:

A similar condition was reported in the prior year audit as Finding 2013-011.

Recommendation:

CUC should request guidance as to which regulation prevails, and then explore whether or not the new Billing and Collection software is able to keep track of security deposits and calculate interest on these accounts to ensure compliance with Public Law 16-17.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

PRIOR YEAR FINDINGS AND QUESTIONED COSTS

<u>Finding</u>	<u>Subject Matter</u>	<u>Current Year Status</u>
2013-01	Bank Reconciliations	Unresolved. Refer to Finding 2014-001
2013-02	Reconciliation of Customer Accounts Receivable Subsidiary Ledger to the General Ledger Account	Unresolved. Refer to Finding 2014-003
2013-03	Reconciliation of Vendor Accounts Subsidiary Ledger to the General Ledger Account	Corrective action taken.
2013-04	Use of Journal Entries	Corrective action taken.
2013-05	Accrual of Liabilities	Corrective action taken.
2013-06	Negative Accounts Receivable	Unresolved. Refer to Finding 2014-004
2013-07	Provision for Uncollectible Accounts	Unresolved. Refer to Finding 2014-005
2013-08	Procurement	Unresolved. Refer to Finding 2014-007
2013-09	Memorandum of Agreement (MOA) with CDA	Unresolved. Refer to Finding 2014-008
2013-10	Payroll processing	Unresolved. Refer to Finding 2014-009
2013-11	Interest on Security Deposit Refunds	Unresolved. Refer to Finding 2014-010
2013-12	ARRA Procurement	Corrective action taken.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2014

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, 2014:

Questioned costs as previously reported	\$ -
Questioned costs for fiscal year 2014 Single Audit	<u>-</u>
Unresolved questioned costs at September 30, 2014	<u><u>\$ -</u></u>



Commonwealth Utilities Corporation



June 26, 2015

Mr. David Burger, Partner
Burger Comer Magliari
P.O. Box 504053
Saipan, MP 96950

Subject: Schedule of Findings and Questioned Costs for the year ended September 30, 2014

Dear Mr. Burger:

Please see below CUC's responses to the findings regarding CUC FY 2014 Audit:

Finding 2014-001 Bank Reconciliations

Condition:

Monthly account reconciliations were not timely prepared for all bank accounts during fiscal year 2014.

Recommendation:

CUC should ensure that significant internal control, such as bank reconciliations are timely prepared.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

CUC obtained further customization of the Billing and Collection Software and Financial Accounting Software. CUC is now utilizing the improved customized reporting capabilities to enable accurate monthly reconciliations, with proper supporting documentation, beginning July, 2014. CUC believes this finding has been resolved during FY 2015.

Finding 2014-002 Purchases/Disbursements

Condition:

Several purchases were made wherein the invoice date is prior to the date of the purchase order.

Recommendation:

CUC should establish monitoring procedures to ensure that all small purchases below \$10,000 are approved and documented pursuant to § 70-30.3-220 of the NMIAC. Payments should only be made on vendor invoices with reference to an approved purchase order, contract, or other

justification as allowed by the procurement policies of CUC and the NMIAC. Administrative procedures should be implemented to ensure all procurements are properly filed for easy retrieval and independent inspection.

CUC Response:

CUC agrees with the finding, but feels that the situation was fairly isolated.

Management's Plan of Corrective Action:

CUC will strive to ensure that purchase orders are properly executed and sent to vendors before the purchase transactions are completed.

Finding 2014-003 Reconciliation of Customer Accounts Subsidiary Ledgers to the General Ledger Accounts

Condition:

For every customer account in the Billings and Collections software general ledger accounts were assigned to each transaction such as billing, customer adjustments and collection. The software provider designed an interface to upload the transactions to the general ledger. This procedure aims to seamlessly record each transaction from the subsidiary ledgers (which are maintained in the Billings and Collections software) to the general ledger account in the Financial Accounting Software.

Having this computerized internal control in place; CUC did not conduct monthly reconciliation of the subsidiary ledgers totals to the general ledger balances. Account reconciliation was only prepared at year-end and such reconciliation disclosed several discrepancies.

Recommendation:

In order to make the financial reports generated by the accounting system as meaningful as possible, CUC should reconcile the general ledger accounts for accounts receivable on a monthly basis. A benefit of monthly reconciliations is that errors do not accumulate but can be identified and attributed to a particular period, which makes it easier to perform future reconciliations.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

Customized financial reports were required from the new software to assist the staff in the proper reconciliation and analyses of accounts. The system programmers provided the ability to perform these custom reports beginning mid FY 2014. The CUC accounting staff is working to clear the backlogs on these analyses. Upon completion of all backlogs, CUC staff will be able to fully resolve this finding.

Finding 2014-004 Negative Balances in the Aging of Accounts Receivable

Condition:

The aged listing of accounts receivable as of September 20, 2014 included negative balances totaling more than \$1 million.

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. These negative balances should be reclassified and reported as customer deposits or security deposits. The new software is able to summarize such credit balance into customer deposit and advance payments, hence CUC should utilize this to issue refunds for deposits in excess of mandatory deposit and properly apply advance to the appropriate subsequent billings.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

In fiscal year 2014, more than 2000 accounts were issued security deposit refunds. Billing, Financial Accounts and Management Sections continue to analyze accounts and issue refunds to customers.

Finding 2014-005 Provision for Uncollectible Accounts

Condition:

CUC Billing and Collection Software was configured to age receivable from customer in increments of 30 days, hence the report is unable to generate a summary of customer receivables over 75 days past due. (Pursuant to current CUC policies, allowance for uncollectible shall be provided for customer accounts over 75 day past due.) As dictated by the software configuration, CUC used the balance over 60 days as the basis for recording the provision for uncollectible accounts.

Recommendation:

CUC should consult its software provider whether or not the aging of customer receivable could be configured to comply with CUC policy. If CUC believes that the current aging is the more accurate basis for estimating uncollectible accounts, CUC should update its policies accordingly.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

CUC has implemented directives but have not updated its policies. We will bring this matter to the Board of Directors for their review and decision regarding amending current policy.

Finding 2014-006 Recalculation of Security Deposits

Condition:

There were several security deposit accounts that were higher than the amount required under the CNMI Administrative Code.

Recommendation:

CUC should explore whether or not the new Billing and Collection software is able to keep track of security deposits and recalculate the required amounts to ensure compliance with Title 50 of the CNMI Administrative Code.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

Billing, Financial Accounts and Management Sections continue to analyze accounts and issue refunds to customers.

Finding 2014-007 Procurement

Condition:

The Executive Director issued a memorandum authorizing the procurement of material and parts utilizing request for quotation instead of competitive sealed bidding.

Recommendation:

CUC should consider updating its Procurement Regulations to include purchase of routine repair materials and parts as an exception to §50-50-201. Also CUC may designate some suppliers as sole source suppliers (with justification) and comply with the CUC's Sole Source Procurement, §50-50-215 of CUC's Procurement Regulation. Furthermore, CUC should consider including a provision for cost analysis in its Sole Source Procurement regulation. Such provision will document CUC's consideration that the cost provided by the sole source vendor is not overstated.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

CUC has implemented directives regarding such procurements but have not updated its written policies. We will bring this matter to the Board of Directors for their review of policy.

Finding 2014-008 Memorandum of Agreement with CDA

Condition:

Outstanding deferred dividends payable as of September 30, 2013 amounted to \$3,600,000. CUC has not established a revolving fund pursuant to the terms of the MOA. In addition to the

deferred dividends payable, CUC also has not remitted to CDA the \$900,000 dividend for the year-ended September 30, 2014.

Cause:

CUC has no other available funding source to fund the revolving fund. (CUC comment: Rates do not support and large uncollected accounts receivable from government customers make it impossible to fund)

Recommendation:

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

CUC Response:

CUC agrees with the finding.

*Management's Plan of Corrective Action:*CUC formally requested the Commonwealth Development Authority ("CDA") to suspend for five (5) years all payments, accrual of dividends, and any associated liability for payments of its debt obligation to CDA under 4 CMC § 8123(p) and the 2009 Preferred Stock Agreement between CUC and CDA. CUC is awaiting determination from CDA regarding its request.

If the suspension of all payments, accrual of dividends and any associated liability for payments of its debt obligation to CDA is not approved, CUC will continue to petition for rate increases to include the expense and will work to collect large unpaid accounts.

Finding 2014-009 Payroll Processing

Condition:

The rate used in calculating one employee's payroll was different than the approved Notice of Personnel Action (NOPA) provided to the auditor.

Recommendation:

The Human Resources Department should ensure that all changes in employee status and/or rates are documented on either properly execute employment contracts or notices of personnel action. Furthermore, they should ensure that each employee timely update their Form W-4, Employee's Withholding Allowance Certificate and such information is updated on the system used to calculate payroll.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

CUC will ensure that Notice of Personnel Actions and other pertinent documents are kept current in the employee file and in the software payroll system.

Finding 2014-010 Interest on Security Deposit Refunds

Condition:

CUC has not yet established procedures on calculating interest accrued on customer deposits, hence have not paid interest of security deposits refunded to customers.

Cause:

Conflicting regulations set forth by the Administrative Code and the Commonwealth Code prevented CUC from establishing procedures for calculating interest accrued on customer deposits.

Title 50 of the CNMI Administrative Code (§50-10-435) held CUC liable for all security deposits received and directed CUC to credit each account an amount equal to the average passbook savings interest rate payable during the past year based on rates from at least three local FDIC insured banks. On the other hand, Title 4, Division 8 of the CNMI Commonwealth Code (§8143 (b)) directed CUC to place the security deposits in an interest-bearing trust fund to be established by the Executive Director and to pay security deposit refunds within thirty (30) days after disconnection of utilities with earned interest. This directive, however, is applicable only on residential security deposits.

Recommendation:

CUC should request guidance as to which regulation prevails, and then explore whether or not the new Billing and Collection software is able to keep track of security deposits and calculate interest on these accounts to ensure compliance with Public Law 16-17.

CUC Response:

CUC agrees with the finding.

Management's Plan of Corrective Action:

We will seek guidance on which regulation to follow. The new Billing system is capable of calculating interest however we have yet to work with the programmers to set it up and fully implement procedures.

Please let me know if you have any questions or comments on the above.

Sincerely,



MATTHEW YAQUINTO
Chief Financial Officer