

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

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

Years Ended September 30, 2011 and 2010

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

Years Ended September 30, 2011 and 2010

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INDEPENDENT AUDITOR'S REPORT

The Executive Director
Commonwealth Utilities Corporation

I have audited the accompanying statements of net assets of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands, as of September 30, 2011 and 2010, and the related statements of revenues, expenses and changes in net assets, and of cash flows for the years then ended. These financial statements are the responsibility of CUC's management. My responsibility is to express an opinion on these financial statements based on my audits.

I conducted my audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of CUC's internal control over financial reporting. Accordingly, I express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audits provide a reasonable basis for my opinion.

In my opinion, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2011 and 2010, and the changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with the *Government Auditing Standards*, I have also issued my report dated March 21, 2012 on my consideration of CUC's internal control over financial reporting and on my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting, or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of my audits.

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis (MD&A) on pages 3 to 17 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Government Accounting Standards Board, who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. I have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to my inquiries, the basic financial statements, and other knowledge I obtained during my audit of the basic financial statements. I do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

My audits were conducted for the purpose of forming opinion on the CUC's basic financial statements. The Supplementary Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis for the year ended September 30, 2011 on pages 50 and 51 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The accompanying Schedule of Expenditures of Federal Awards on pages 56 and 57 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is also not a required part of the financial statements. The Supplementary Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis and the Schedule of Expenditures of Federal awards are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In my opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.


Saipan, Commonwealth of the Northern Mariana Islands
March 21, 2012

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

MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2011

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, 2011 with comparisons to prior fiscal years ended September 30, 2010 and 2009. We encourage readers to consider the information presented here in conjunction with the financial statements and related notes (pages 18 through 49).

FINANCIAL HIGHLIGHTS

- The fiscal year 2010 and 2009 financial statements have been restated to reflect the issuance of the \$45 million preferred stocks to the Commonwealth Development Authority as equity, presented at face value under the restricted net assets of CUC as opposed to previous presentation as liability presented at net present value. The following analyses were based on the restated values.
- Total assets at September 30, 2011, were \$130 million, a decrease of \$1 million or 0.8% compared to \$131 million in 2010, which decreased by \$547 thousand or 4% compared to \$131.5 million in 2009. The decrease in 2011 is primarily due to the decrease in cash used to payoff the long-term debt to GPPC Construction, Inc. and Marianas Public Land Trust.
- Total liabilities at September 30, 2011, were \$38.3 million, a decrease of \$2.5 million or 6% from \$40.8 million in 2010, which increased by \$2.7 million or 7% from \$38.1 in 2009. The GPPC loan which was recognized in 2010 was subsequently paid in 2011.
- Total net operating revenues for fiscal year 2011 were \$92.3 million, a \$9.6 million or 11.6% increase from \$82.7 million in 2010, which increased by \$8 million or 10.7%, when compared to fiscal year 2009. The increased revenue in 2011 is primarily attributable to a 19% increase fuel related "levelized energy adjustment clause" (LEAC) revenues.
- Total operating expenses for fiscal year 2011 were \$101 million, an increase of \$9.3 million or 10.1% from \$92 million in 2010, which increased by \$1.8 million or 2.8% when compared to \$89.6 million in fiscal year 2009. The increase in operating expenses for 2011 is the result of power plant fuel and lube costs increasing 20% from 2010.
- In fiscal year 2011, CUC received \$14 million in capital contributions and federal awards compared to \$5.8 million in fiscal year 2010 and \$8 million in fiscal year 2009.

COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2011

OVERVIEW OF THE FINANCIAL STATEMENTS

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

Basic Financial Statements

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

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

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

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

Notes to the Financial Statements

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

Other Information

This report also presents certain supplementary information concerning CUC's Statements of Revenues, Expenses and Changes in Net Assets (Deficit) on a divisional basis (see pages 50 through 51).

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September 30, 2011

ANALYSIS OF BASIC FINANCIAL STATEMENTS

	2011	Restated	
	2011	2010	2009
Current assets	\$ 33,169,917	\$ 35,407,008	\$ 32,948,778
Capital assets, net	87,799,198	87,822,594	90,388,841
Noncurrent notes receivable	666,650	-	
Restricted assets	8,324,311	7,709,149	8,148,586
Total Assets	129,960,076	130,938,751	131,486,205
Current liabilities	28,808,229	29,809,290	28,649,595
Noncurrent liabilities	9,535,157	11,000,775	9,447,413
Total Liabilities	38,343,386	40,810,065	38,097,008
Net Assets:			
Invested in capital assets, net of related debt	82,116,572	78,554,246	83,121,399
Restricted	59,556,108	58,766,557	57,334,511
Unrestricted	(50,055,990)	(47,192,117)	(47,066,713)
Net Assets	\$ 91,616,690	\$ 90,128,686	\$ 93,389,197
Operating revenues, net	\$ 92,280,692	\$ 82,656,150	\$ 74,643,224
Operating expenses	101,359,735	92,064,756	89,595,883
Loss from operations	(9,079,043)	(9,408,606)	(14,952,659)
Nonoperating revenues(expenses), net	(2,083,958)	(1,198,199)	552,363
Change in recovery of fuel costs	(1,332,881)	1,536,048	(4,454,066)
Net loss before capital contributions and federal grants	(12,495,882)	(9,070,757)	(18,854,362)
Capital contributions and federal grants	13,983,886	5,810,246	7,983,367
Change in net assets (deficit) before extraordinary items	1,488,004	(3,260,511)	(10,870,995)
Extraordinary gain	-	-	144,175,924
Issuance of preferred stocks	-	-	45,000,000
Net assets, beginning	90,128,686	93,389,197	(84,915,732)
Net Assets, ending	\$ 91,616,690	\$ 90,128,686	\$ 93,389,197

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

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MANAGEMENT'S DISCUSSION & ANALYSIS
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During fiscal year 2011, total assets decreased \$1 million. Significant changes in account balances were:

- Cash and cash equivalents decreased by \$3.6 million due to settlement of long-term debt.
- Accounts receivable decreased by \$943 thousand, primarily attributable to more aggressive collection activities.
- Other receivables increased by \$3 million, primarily due to prepayments made on off-island purchases of parts and supplies for on-going maintenance programs.
- There was no significant fluctuation in inventory level.
- With the increase in LEAC rates in January 2011 (\$0.21825) and April 2011 (\$0.34426) from \$0.24446, the accumulated deferred fuel cost of \$1,407,076 was recovered in fiscal year 2011.
- Changes in capital assets are discussed in a separate section of this MD&A.

Total liabilities decreased by \$2.5 million. Significant changes in account balances were as follows:

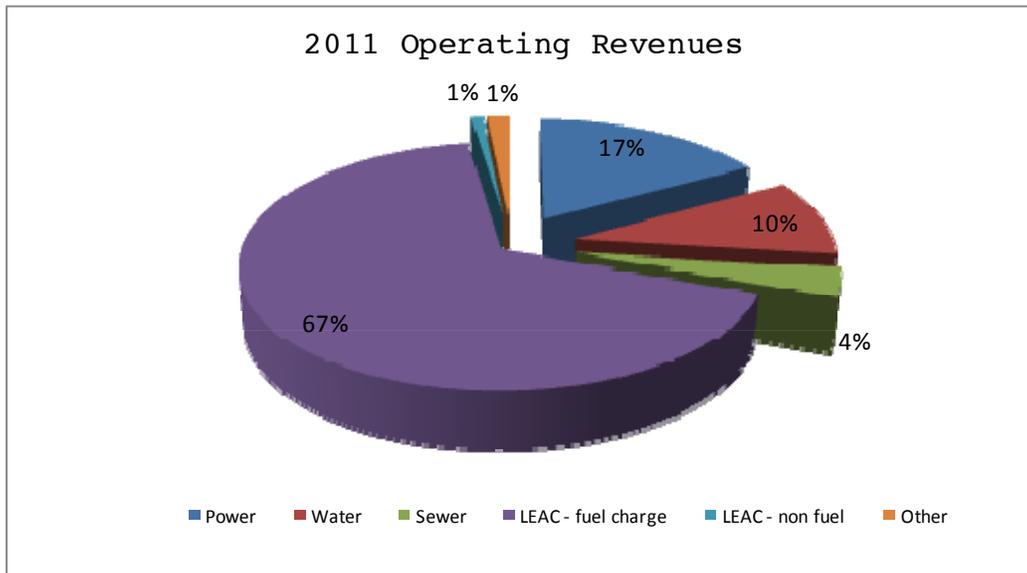
- Accounts payable decreased by \$798 thousand, primarily attributable to increased payments to vendors as utilities receivable were collected.
- Long-term debt decreased by \$3.6 million.
- Preferred stocks' deferred dividends payable increased by \$900 thousand.

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Operating Revenues

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Power	\$ 15,609,742	\$ 17,524,104	\$ 16,282,857
Water	9,246,714	9,310,796	5,094,441
Sewer	3,365,104	2,102,383	1,134,191
LEAC - fuel charge	61,837,636	53,341,371	51,925,018
LEAC - non fuel	764,070	-	-
Other	<u>1,457,426</u>	<u>377,496</u>	<u>206,717</u>
Operating revenues, net	<u>\$ 92,280,692</u>	<u>\$ 82,656,150</u>	<u>\$ 74,643,224</u>



In 2011, operating revenues increased by \$9.6 million or 11.6% when compared to revenues for 2010, which increased by \$8.01 million or 10.7% when compared to 2009.

The majority of the increase was related to LEAC rate increase. In 2011, LEAC increased by \$8.4 million or 15.7% over 2010 due to several LEAC rate adjustments in 2011 to recover power plant fuel and lube fuel costs.

Sewer revenues increased by \$1.3 million or 57% compared to 2010 due to rate increases implemented in June 2010, identification and billing of additional customers and improved volumetric metering.

There was no significant change in water revenues in 2011 compared to 2010.

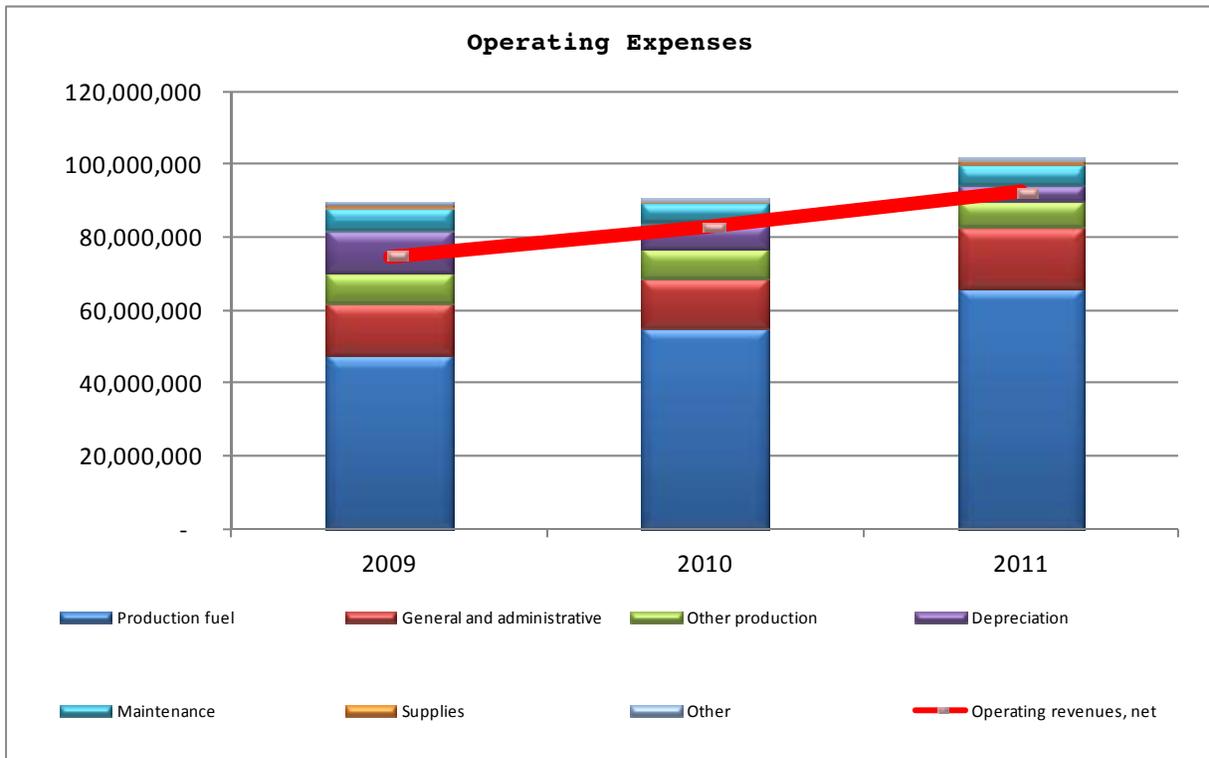
COMMONWEALTH UTILITIES CORPORATION
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Operating Expenses

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Production fuel	\$ 65,888,384	\$ 54,877,419	\$ 47,470,952
General and administrative	16,887,282	14,921,257	14,396,147
Depreciation	7,026,445	8,164,412	8,316,344
Other production	4,535,037	7,506,477	11,802,857
Maintenance	5,438,558	5,225,928	5,708,500
Supplies	1,229,359	725,217	1,104,178
Other	354,670	644,046	796,905
	<u>\$101,359,735</u>	<u>\$ 92,064,756</u>	<u>\$ 89,595,883</u>

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



In 2011, total operating expenses increased by \$9.3 million (10.1%) when compared to expenses for 2010, which increased by \$2.5 million (2.8%) when compared to expenses for 2009.

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Highlights of events affecting operating expenses follow:

In 2011, production fuel was \$65.8 million, an increase of \$11 million (20.1%) when compared to 2010, which increased by \$7.4 million (15.6%) when compared to 2009. Production fuel is the single largest expense of CUC, accounting for 65% of operating expenses in 2011, 60% for 2010 and 53% percent for 2009.

In 2011, general and administrative expenses, which is primarily personnel costs and related benefits, increased by \$2 million (13.2%) when compared to 2010, which increased by \$525 thousand (3.6%) when compared to 2009.

In 2011, other production expense decreased by \$2.9 million (39.6%) when compared to 2010, which decreased by \$4.3 million (36.4%) when compared to 2009. The decrease is attributable to cost of the power purchased from an independent supplier during the rehabilitation of CUC Rota generators. This serviced was no longer required in 2011.

Capital Assets

At September 30, 2011, CUC had \$87.8 million invested in capital assets, net of depreciation where applicable, including electric plant, water plant, sewer plant, administrative equipment and construction in progress.

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Utility plant in service			
Electric plant	\$ 130,656,131	\$ 128,586,476	\$ 127,763,430
Water plant	62,897,977	62,436,988	62,613,268
Sewer plant	42,693,604	42,640,713	37,585,094
Administrative equipment	<u>4,623,164</u>	<u>4,475,287</u>	<u>4,545,784</u>
	240,870,876	238,139,464	232,507,576
Accumulated depreciation	<u>(169,242,051)</u>	<u>(162,436,969)</u>	<u>(154,626,740)</u>
Depreciable assets, net	71,628,825	75,702,495	77,880,836
Construction work-in progress	<u>16,170,373</u>	<u>12,120,099</u>	<u>12,508,005</u>
Capital assets, net	<u>\$ 87,799,198</u>	<u>\$ 87,822,594</u>	<u>\$ 90,388,841</u>

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

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Capital Contributions and Federal Awards

CUC received capital contributions and federal award of \$14 million in fiscal year 2011, which is an increase of \$8 million (140.7%) when compared to \$5.8 million fiscal year 2010.

The capital contributions and federal awards, are as follows:

	2011		2010		2009	
	Amount	%	Amount	%	Amount	%
Federal	\$ 13,975,408	99.9	\$ 5,810,246	100.0	\$ 7,007,294	87.8
Local	8,478	0.1	-	-	976,073	12.2
Total	<u>\$ 13,983,886</u>	<u>100.0</u>	<u>\$ 5,810,246</u>	<u>100.0</u>	<u>\$ 7,983,367</u>	<u>100.0</u>

The following is a summary of the CUC's major capital expenditures for 2011:

Federal Assistance

During fiscal year 2011, the U.S. Department of the Interior provided CUC \$1.6 million for sewer and wastewater system improvements and the U.S. Environmental Protection Agency (EPA) provided \$5.0 million for the upgrade of sewer and water systems and related equipment.

Local Assistance

The CNMI government, as a pass-through agency, provided \$7.3 million of Covenant 702 funds received from the U.S. Department of the Interior for the Saipan Power Plant Improvement and upgrade of sewer and water systems and related equipment.

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MANAGEMENT'S DISCUSSION & ANALYSIS
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Debt

Long-term debt as of September 30, 2011, 2010 and 2009 are as follows:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Commonwealth Ports Authority	\$ 5,682,626	\$ 7,104,452	\$ 7,267,445
Marianas Public Land Trust	-	245,347	1,800,000
GPPC	<u>-</u>	<u>1,918,549</u>	<u>-</u>
	5,682,626	9,268,348	9,067,445
Current maturities	<u>(2,382,269)</u>	<u>(3,743,520)</u>	<u>(2,512,765)</u>
Long-term debt, net of current portion	<u>\$ 3,300,357</u>	<u>\$ 5,524,828</u>	<u>\$ 6,554,680</u>

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

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MANAGEMENT'S DISCUSSION & ANALYSIS
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ECONOMIC FACTORS

Contrary to expectations at the end of fiscal year 2010, the new water and wastewater rates implemented in May 2010, and the electricity rates approved in June 2011 have not provided for full cost recovery, as shown by the \$9 million operating loss for FY 2011, a number essentially unchanged from FY 2010. The cause of the under-recovery of costs is multi-faceted, and include increasing stipulated order compliance costs, a downturn in the general economy (causing businesses to cut costs, including utilities), a significant decline in tax revenues (leading to cut-backs in local government payrolls, which in turn has adversely affected the ability of thousands of CUC customers to pay their bills), and significant out-migration (resulting in a net loss of the number of utility customers served).

The effects of the above can be seen in CUC's operating numbers:

- Total kWh sales fell by 9% from FY 2010 to FY 2011.
- Water accounts have fallen to historic lows, declining from a peak of 13,604 in FY 2005 to an average of approximately 10,421 in FY 2011.
- Water usage has also continued to decline. Water consumption peaked at 2.2 million gallons in FY 2005, and has fallen steadily to about 1.5 million gallons in FY 2011.
- Wastewater accounts at an even greater degree than water accounts, decreasing from 6,059 in FY 2005 to an average of 3,095 in FY 2011.

The end result is that actual revenues about \$10 million less than that contemplated in the rate design. CUC attempted to address this problem in a session with the Commonwealth Public Utilities Commission (CPUC) in January 2012. However, due to the depressed economic conditions, the CPUC approved only a portion of the requested increases.

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

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As the number of accounts and related consumption of utilities continues to decline, CUC's fixed costs of operation must be covered by fewer and fewer billing units. Exacerbating the problem are CUC's aging infrastructure and the new investments mandated by the Federal Court Orders (aka Stipulated Orders). CUC management is working hard to maximize efficiencies and improve worker productivity, but it is still very likely that additional rate increases will be needed to achieve full cost recovery. Whether or not adequate rates will be approved, and even if approved, subsequently paid, in the current weak economy is questionable, at best.

ACCOMPLISHMENTS

Water & Wastewater Divisions

- Increased technical certifications by the licensing of 17 personnel. Conducted over 2,500 contact hours for formalized training in water and wastewater operations, safety, and hazardous materials handling.
- Received \$7,825,000 of funding from EPA under the consolidated water and wastewater grant. Submitted and received approval for six projects. Completed National Environmental Policy Act (NEPA) compliance, commenced design and construction plans.
- Completed 3 American Recovery and Reinvestment Act (ARRA) Projects including the Well Isolation Project, W8 Sewer Lift Station Reroute, and Sadog Tasi Wastewater Rehabilitation Project.
- Hired new Drinking Water and Wastewater Director, Division Manager, Water Manager, Wastewater Manager, Training Coordinator, and Grants Manager. Increased engineering staffing from four to eight engineers.
- Developed grant program for side-sewer installations, providing for no-cost hookups for qualified customers.
- Increased revenues by installing over 2,300 new water meters and accounting for 3,160 unmetered and/or unregistered meter accounts.
- Meet Stipulated Order No. 1 requirements by the submissions of 68 documents, reports, and programs to achieve sustainable utility and business practices in full compliance with Safe Drinking Water and Clean Water Acts.

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Power Generation and Power Transmission & Distribution

- Retrofitted engines 5, 6, 7 and 8 at Power Plant-1 with new MAN TCA55 turbochargers.
- Completed foundation rebuild on engine 6, and replaced failed anchor bolts on engines 2, 3 and 6 (Power Plant-1).
- Installed and commissioned two 1825KW Cummins QSK60 generator sets at Rota power plant. Purchased two new bucket trucks for Rota power distribution.
- Completed major engine overhaul an engine 8 (Power Plant-1).
- Made significant progress on Stipulated Order-2 Requirements.
 - Completed construction of two new secondary containment buildings for used oil and power distribution transformers,
 - Increased secondary containment capacity for fuel service tanks and 34.5kV substation at Power Plant-1,
 - Revision and approval of SPCC and Health & Safety plans,
 - Completed tank 104 cleanout and rehabilitation of tank 105 and 106,
 - Removal and disposal of tanks 107C and 108B, Clean out of Rota fuel tanks R1, R2, R3, R4, R5, and R6.
 - Completed R2 tank repairs.
- Installed 1,200 LED street lights on Saipan, Rota and Tinian.
- Replaced 38 open-delta transformers with 3-winding delta transformers.

FUTURE PLANS

Water & Wastewater Divisions

- To reduce overall energy consumption by 15% by reducing electrical demands for pumping, fleet services, leakage and other non-revenue water losses, increase system operations and maintenance practices.
- To increase the availability of 24/7 water on Saipan from 80% to 100% by the end of calendar year 2012.
- To conduct technical analysis on Rota, Tinian, and Saipan to model and improve infrastructure, including but not limited to water source protection, hydraulic modeling, and engineering analysis for increase operational efficiencies and capital improvement priorities.

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September 30, 2011

- To complete rehabilitation of Agingan Wastewater Treatment Plant, S-8 transient and S-3 terminal lift stations.
- To repair and service all back up power generators; improve overall preventative maintenance so that the incipient failures of the water distribution and sewer collection mains are caught in advance.
- To increase training opportunities and provide for formal apprenticeship programs to expand local workforce opportunities.

Power Generation

- To reduce total line loss from 12.2% to under 8% of total generation. That is including technical and non-technical losses.
- To sign power purchase agreements (in 2012) for the first three renewable energy projects for Saipan and Rota; consisting of:
 - 11.0MW Solar PV,
 - 9.0MW Solar Energy using Solar Concentrated Power and steam turbines, and
 - 1.0MW Gasification
- To move Power Plant-4 electricity production to Power Plant-1, and relegate Power Plant-4 to standby status.
- To improve overall fuel efficiency on Saipan from 13.8kWh per gallon to 14.6kWh/gallon.
- To increase load factor and fuel efficiency on generator sets 1,2,3,7 and 8 at Power Plant-1, by replacing radiator sets on all five engines.
- To rebuild engine 4 at Power Plant-1.
- To install new efficient Alfa Laval SU840 lube oil centrifuge machines on engines 1, 5, 6 and 8 in 2012.
- To install two new oily water separator machines at Power Plant-1 in 2012.

Major goal: to lower the cost of electricity to customers through Renewable Energy Generation (REG) or any other proven technology that is not dependent on fuel oils, without compromising reliability of service.

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

MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2011

Power Transmission & Distribution

- To upgrade Rota distribution feeders 1 and 2 from 4,160V to 13,800V in 2012.
- To replace remaining 475 Form 2S single stator kWh meters with 12S two stator meters. The 2S single stator meters are under-registering energy usage by 25% per meter, when connected to 208V 4W transformer loads.
- To meter all Water and Wastewater facilities.
- To replace all open-delta connected transformers, with three transformer delta connections.

Customer Service

Customer service improvement efforts continued in 2011, including:

- Focused CUC specific customer service training for all CUC employees;
- Implementation of a dedicated dispute resolution department;
- Increased staffing and training in customer service areas; and
- The purchase of improved meter reading equipment.

The second customer service outlet planned for 2011 was deferred to 2012 due to delays encountered in the request for proposal (RFP) for office space. At CUC's main offices in Dandan, customer service operations will expand in 2012, providing a one stop shop for all customers. No longer will customers be asked to navigate through various departments resolve problems or initiate/terminate services.

Evolving technology will allow CUC to adopt improved pre-paid electric meters in 2012 and 2013. These meters will allow customers to recharge their meters on-line or via telephone, thus eliminating the need to wait in line at CUC cashiering offices. An RFP was issued in 2011 for an enhanced billing and customer service data processing system. This system will provide seamless integration of services, including field operations, metering, billing, customer support services, accounting, inventory, and equipment maintenance. This new system will also provide customers the ability to pay their utility bills on-line. Implementation is projected to be complete by the end of calendar year 2012.

COMMONWEALTH UTILITIES CORPORATION
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MANAGEMENT'S DISCUSSION & ANALYSIS
September 30, 2011

REQUESTS FOR INFORMATION

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

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

Or, call (670) 235-7025 through 7032 or email at charles_warren@cucgov.org.

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

Statements of Net Assets
September 30, 2011 and 2010

	2011	2010 Restated
<u>ASSETS</u>		
Current assets		
Current unrestricted assets		
Cash and cash equivalents	\$ 1,700,508	\$ 3,006,820
Accounts receivable - utility, net	17,016,696	17,959,330
Due from grantor agencies	-	1,751,336
Inventory, net	10,317,351	10,200,734
Deferred fuel costs	74,195	1,407,076
Notes receivable, net	233,329	243,901
Other assets, net	3,827,838	837,811
Total current unrestricted assets	33,169,917	35,407,008
Current restricted assets		
Cash and cash equivalents	8,324,311	7,709,149
Total current assets	41,494,228	43,116,157
Noncurrent assets		
Notes receivable, net of current portion	666,650	-
Capital assets		
Utility plant in service		
Electric plant	130,656,131	128,586,476
Water plant	62,897,977	62,436,988
Sewer plant	42,693,604	42,640,713
Administrative equipment	4,623,164	4,475,287
	240,870,876	238,139,464
Accumulated depreciation	(169,242,051)	(162,436,969)
Net utility plant and administrative equipment	71,628,825	75,702,495
Construction in progress	16,170,373	12,120,099
Total capital assets	87,799,198	87,822,594
Total noncurrent assets	88,465,848	87,822,594
TOTAL ASSETS	\$ 129,960,076	\$ 130,938,751

See accompanying notes to financial statements.

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

Statements of Net Assets, Continued
September 30, 2011 and 2010

	2011	2010 Restated
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities		
Unrestricted current liabilities		
Accounts payable	\$ 9,244,771	\$ 10,042,293
Accrued liabilities	288,289	163,230
Compensated absences, current portion	222,879	195,513
Due to primary government	5,500,008	4,805,248
Current maturities of long-term debt	2,382,269	3,743,520
Interest payable	334,655	347,582
Due to grantor agency	167	-
Total unrestricted current liabilities	17,973,038	19,297,386
Restricted current liabilities		
Customer deposits including accrued interest	10,835,191	10,511,904
Total current liabilities	28,808,229	29,809,290
Noncurrent liabilities		
Long-term debt, net of current maturities	3,300,357	5,524,828
Retirement contributions payable	3,658,869	3,882,111
Dividends payable	1,800,000	900,000
Advances from CNMI Government	107,296	107,296
Compensated absences, less current portion	668,635	586,540
Total noncurrent liabilities	9,535,157	11,000,775
TOTAL LIABILITIES	38,343,386	40,810,065
Commitments and contingencies		
Net assets (deficit)		
Invested in capital assets, net of related debt	82,116,572	78,554,246
Restricted		
Expendable	320,917	-
Non-expendable	59,235,191	58,766,557
Unrestricted deficit	(50,055,990)	(47,192,117)
NET ASSETS	91,616,690	90,128,686
TOTAL LIABILITIES AND NET ASSETS	\$ 129,960,076	\$ 130,938,751

See accompanying notes to financial statements.

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

Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended September 30, 2011 and 2010

	<u>2011</u>	<u>2010</u> (Restated)
Operating revenues, net		
Power	\$ 15,609,742	\$ 17,524,104
Water	9,246,714	9,310,796
Sewer	3,365,104	2,102,383
LEAC - fuel charge	61,837,636	53,341,371
LEAC - non fuel	764,070	-
Other	<u>1,457,426</u>	<u>377,496</u>
Net operating revenues	<u>92,280,692</u>	<u>82,656,150</u>
Operating expenses		
Production fuel	65,888,384	54,877,419
General and administrative	16,887,282	14,921,257
Depreciation	7,026,445	8,164,412
Other production	4,535,037	7,506,477
Maintenance	5,438,558	5,225,928
Supplies	1,229,359	725,217
Other	<u>354,670</u>	<u>644,046</u>
Total operating expenses	<u>101,359,735</u>	<u>92,064,756</u>
Loss from operations	<u>(9,079,043)</u>	<u>(9,408,606)</u>
Non-operating revenues (expenses)		
CNMI Government transfers	-	1,554,653
Interest income	190,317	878,122
Miscellaneous income	454,242	206,282
Regulatory assessments	(469,949)	(457,206)
Settlement expense	(46,861)	(54,000)
Contribution to the CNMI government	(694,758)	(694,759)
Interest expense	<u>(1,516,949)</u>	<u>(2,631,291)</u>
Total non-operating revenues (expenses), net	<u>(2,083,958)</u>	<u>(1,198,199)</u>
Loss before change in recovery of fuel costs	(11,163,001)	(10,606,805)
Change in recovery of fuel costs	<u>(1,332,881)</u>	<u>1,536,048</u>
Net loss before capital contributions and federal grants	(12,495,882)	(9,070,757)
Capital contributions and federal grants	<u>13,983,886</u>	<u>5,810,246</u>
Change in net assets	1,488,004	(3,260,511)
Net assets, beginning	<u>90,128,686</u>	<u>93,389,197</u>
Net asset, ending	<u>\$ 91,616,690</u>	<u>\$ 90,128,686</u>

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, 2011 and 2010

	2011	2010 (Restated)
Cash flows from operating activities:		
Cash received from customers	\$ 97,608,532	\$ 86,197,370
Cash payments to suppliers for goods and services	(94,229,123)	(78,596,724)
Cash payments to employees for services	<u>(9,543,362)</u>	<u>(8,521,074)</u>
Net cash used for operating activities	<u>(6,163,953)</u>	<u>(920,428)</u>
Cash flows from noncapital financing activities:		
Principal repayment of debt	<u>(245,347)</u>	<u>(789,603)</u>
Net cash used for noncapital financing activities	<u>(245,347)</u>	<u>(789,603)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(7,003,049)	(3,621,933)
Capital contributions received	15,735,384	6,431,413
Principal repayment of debt	(2,708,152)	-
Interest paid on outstanding debt	<u>(496,350)</u>	<u>(1,153,742)</u>
Net cash provided by capital and related financing activities	<u>5,527,833</u>	<u>1,655,738</u>
Cash flows from investing activities:		
Interest income	<u>190,317</u>	<u>878,122</u>
Net cash provided by investing activities	<u>190,317</u>	<u>878,122</u>
Net change in cash and cash equivalents	(691,150)	823,829
Cash and cash equivalents at beginning of year	<u>10,715,969</u>	<u>9,892,140</u>
Cash and cash equivalents at end of year	<u>\$ 10,024,819</u>	<u>\$ 10,715,969</u>
Cash and cash equivalents	\$ 1,700,508	\$ 3,006,820
Restricted cash and cash equivalents	<u>8,324,311</u>	<u>7,709,149</u>
	<u>\$ 10,024,819</u>	<u>\$ 10,715,969</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, 2011 and 2010

	2011	2010 (Restated)
Reconciliation of loss from operations to net cash used for operating activities:		
Loss from operations	\$ (9,079,043)	\$ (9,408,606)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation	7,026,445	8,164,412
Provision for bad debts	3,607,677	2,928,025
Miscellaneous income	454,242	206,282
Regulatory assessments	(469,949)	(457,206)
Settlement expense	(46,861)	(54,000)
(Increase) decrease in assets		
Accounts receivable - utility	(2,665,043)	(2,398,505)
Inventory	(116,617)	(1,182,898)
Other assets	(2,990,027)	244,323
Increase (decrease) in liabilities		
Accounts payable	(797,522)	(625,085)
Accrued liabilities	125,059	(43,271)
Compensated absences	109,461	117,728
Customer deposits including accrued interest	323,287	(122,607)
Retirement contributions payable	(223,242)	1,142,056
Long-term debt	(1,421,820)	568,924
Net cash used for operating activities	<u>\$ (6,163,953)</u>	<u>\$ (920,428)</u>
Noncash financing and investing activities		
Increase in capital assets and loans payable due to settlement of litigation:		
Noncash increase in capital assets	\$ 1,976,232	\$ 1,976,232
Noncash increase in long term debt	(1,976,232)	(1,976,232)
	<u>\$ -</u>	<u>\$ -</u>
Payment of MPLT loan by appropriation from CNMI General Fund:		
Decrease in loans payable	\$ (1,554,653)	\$ (1,554,653)
Noncash non-operating revenues	1,554,653	1,554,653
	<u>\$ -</u>	<u>\$ -</u>
Offsetting of CPA loans payable with CUC utilities receivable:		
Decrease in loans payable	\$ (789,603)	\$ (162,994)
Decrease in utilities receivable	789,603	162,994
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2011 and 2010

(1) Organization

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

(2) Summary of Significant Accounting Policies

Measurement Focus, Basis of Accounting and Basis of Presentation

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

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

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Accounting Standards

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

Recent Pronouncements

In June 2010, Governmental Accounting Standards Board (GASB) issued Statement No. 59, *Financial Instruments Omnibus*. The Statement updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The Statement is effective for financial statements prepared by state and local governments for periods beginning after June 15, 2010, with earlier application encouraged. The implementation of this Statement does not have a material impact on the financial statements of CUC.

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

In 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.

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Recent Pronouncements, Continued

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 Procedure.

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.

CUC has not yet determined the effect of the implementation of these recent pronouncements to 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.

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents

For purposes of the Statements of Net Assets and Cash Flows, cash and cash equivalents are defined as cash on-hand, cash in checking and savings accounts, and short-term time certificates of deposit with a maturity date within three months of the date acquired. Time certificates of deposit with original dates greater than ninety-days are separately classified on the Statements of Net Assets.

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

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

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

At September 30, 2011 and 2010, cash and cash equivalents were \$10,024,819 and \$10,715,969, respectively, and the corresponding bank balances were \$10,685,992 and \$10,733,133, respectively. Of the bank balance amounts, \$10,154,314 and \$10,729,286, respectively were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$9,874,161 and \$10,212,255 were in excess of FDIC insurable limits insured as of September 30, 2011 and 2010, respectively. CUC also has deposits of \$26,863 in 2011 and \$3,847 in 2010 in an uninsured financial institution.

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

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Restricted Cash and Cash Equivalents

The restricted cash and cash equivalents of \$8,324,311 and \$7,709,149 at September 30, 2011 and 2010, respectively, pertains to customer deposits, of which, \$7,500,000 in 2011 and 2010 is held as security pursuant to a standby letter of credit obtained from a financial institution.

Accounts Receivable and Allowance for Uncollectable Accounts

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

CUC provides utility services to customers within the CNMI and bills for these services on a monthly basis. The accumulated provision for uncollectible accounts is stated at an amount which management represents will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense. Current policy is to provide one hundred percent (100%) of account balances greater than seventy-five (75) days old.

Inventory

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

Inventory as of September 30, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Fuel and lubes	\$ 1,820,660	\$ 1,857,666
Materials and supplies	<u>9,193,816</u>	<u>9,040,193</u>
	11,014,476	10,897,859
Allowance for obsolescence	<u>(697,125)</u>	<u>(697,125)</u>
Inventory, net	<u>\$ 10,317,351</u>	<u>\$ 10,200,734</u>

Fuel Oil Costs

Fuel oil costs increase or decrease billings to customers based on price changes in fuel oil purchased by CUC. Under or over recovery of fuel oil cost is recorded as deferred fuel cost asset or liability, respectively, in the accompanying Statement of Net Deficiency, and are recovered or deducted in future billings to customers based on the amendments to Part 24 of the Electric Service Regulations of the CUC adopted on July 20, 2006. Electric fuel rates are computed monthly.

COMMONWEALTH UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Fuel Oil Costs, Continued

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

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

Subsequent approved LEAC rates are as follows:

<u>Date Approved</u>	<u>Effective Dates</u>	<u>Rate</u>
May 28, 2010	October 1, 2009 to June 1, 2010	\$0.24446
January 12, 2011	January 13, 2011 to April 15, 2010	\$0.28125
April 16, 2011	April 16, 2011 to November 20, 2011	\$0.34426

The deferred fuel cost at September 30, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
At beginning of year	\$ 1,407,076	\$ (128,972)
Change in recovery of fuel cost	<u>(1,332,881)</u>	<u>1,536,048</u>
At end of year	<u>\$ 74,195</u>	<u>\$ 1,407,076</u>

LEAC was subsequently reduced to \$0.30791 on November 19, 2011 to "true-up" the LEAC rate.

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Capital Assets and Depreciation

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

Current policy is to capitalize items in excess of \$1,000. The costs of acquisition and construction of equipment and facilities are recorded as construction-in-progress until such assets are completed and placed in service, at which time the CUC commences recording depreciation expense. CUC capitalizes interest cost on borrowings incurred during the new construction or upgrade of qualifying assets. Capitalized interest is added to the cost of the underlying assets and is amortized over the estimated useful lives of the assets.

Compensated Absences

Compensated absences are accrued and reported as a liability in the period earned. Annual leave to be paid out within the next fiscal year is accrued and is reported as current liabilities. The liability at September 30, 2011 and 2010 are as follows:

	2011	2010
Total compensated absences, beginning of year	\$ 782,053	\$ 664,325
Vacation earned	617,599	607,000
Vacation used	(508,138)	(489,272)
Total compensated absences, end of year	891,514	782,053
Current portion	(222,879)	(195,513)
Compensated absences – noncurrent	\$ 668,635	\$ 586,540

No liability is recorded for non-vesting accumulating rights to receive sick leave benefits. An employee cannot carry over to the following calendar year accumulated annual leave in excess of three hundred sixty (360) hours. However, any annual leave accumulated in excess of 360 hours as of the end of the calendar year can be converted to sick leave on the last day of the calendar year.

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Net Assets (Deficit)

Net assets represent the residual interest in CUC's assets after liabilities while net deficit represents the excess liability over assets. Net assets consist of three sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable; and unrestricted. Net assets invested in capital assets, net of debt include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation.

CUC's restricted net assets as of September 30, 2011 and 2010 are as follow:

	<u>2011</u>	<u>2010</u>
Equity	\$45,000,000	\$45,000,000
Restricted for:		
Customer deposit	10,835,191	10,511,904
Restricted for customer rebate/ rate reduction per Public Law 16-7	3,400,000	3,254,653
Regulatory assessments	<u>320,917</u>	<u>-</u>
	<u>\$59,556,108</u>	<u>\$58,766,557</u>

Application of Net Assets

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

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

Notes to Financial Statements
September 30, 2011 and 2010

(2) Summary of Significant Accounting Policies, Continued

Retirement Plan – Defined Benefit Plan

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

Based on the actuarial valuation as of October 1, 2009 issued in May 2010, the actuarially determined contribution rate for the fiscal year ended September 30, 2009 was 60.8686% of covered payroll.

The established statutory rate at September 30, 2011 and 2010 was 37.3909% of covered payroll.

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

<u>Fiscal Year</u>	<u>Required Contribution</u>	<u>Percentage of Covered Payroll</u>	<u>Actual Contribution</u>	<u>Percentage of Required Contributions Contributed</u>
2011	\$1,811,516	37.3909%	\$1,668,688	93%
2010	\$2,137,963	37.3909%	\$1,061,477	50%
2009	\$2,479,375	37.3909%	\$1,452,227	59%

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

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(2) Summary of Significant Accounting Policies, Continued

Other Postemployment Benefits

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

Retirement Plan – Defined Contribution Plan

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

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

CUC's contributions to the Fund for the years ended September 30, 2011, 2010 and 2009 are as follows:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Employee contributions	\$ 368,891	\$ 285,535	\$ 156,173
Employer contributions	<u>142,828</u>	<u>111,689</u>	<u>62,398</u>
	<u>\$ 511,719</u>	<u>\$ 397,224</u>	<u>\$ 218,571</u>

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(2) Summary of Significant Accounting Policies, Continued

Medical and Life Insurance Benefits

In addition to providing pension benefits, the CNMI Government also ensures that employees are provided medical and life insurance benefits. The CNMI Government created the Group Health and Life Insurance Trust Fund (GHLITF), held in trust and administered by the Northern Mariana Islands Retirement Fund (NMIRF). CUC contributes to the Group Health and Life Insurance program. This is open to active employees who work at least 20 hours per week and retired CNMI government employees who retire as a result of length of service, disability or age, as well as their dependents. Health and life insurance coverage are provided by private carriers through the GHLITF. Employee deductions are made through payroll or pension benefit withholdings.

Revenue and Expense Recognition

CUC defines operating revenues as revenue generated from power, water and sewer sales and services net of provision for uncollectible accounts. Operating expenses are costs incidental to the generation of operating revenues. Revenues and expenses not meeting the above definitions are classified as non-operating revenues and expenses.

Power, water and sewer sales are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the subsequent cycle billing. Unbilled receivables included in current year's earnings at September 30, 2011 and 2010 are \$8,389,020 and \$10,268,375, 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.

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(2) Summary of Significant Accounting Policies, Continued

Contingencies

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

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

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

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(3) Accounts Receivable – Utility

Account receivable – utility as of September 30, 2011 and 2010 summarized by location and customer classification are as follows:

By Location

	2011	2010
Saipan		
Commercial	\$ 7,820,726	\$ 10,626,909
Residential	15,058,787	14,363,121
Government	7,997,713	5,603,782
	30,877,226	30,593,812
Tinian		
Commercial	1,170,642	1,010,524
Residential	534,081	618,027
Government	1,181,946	497,259
	2,886,669	2,125,810
Rota		
Commercial	250,698	510,628
Residential	634,982	820,083
Government	707,358	398,922
	1,593,038	1,729,633
	\$ 35,356,933	\$ 34,449,255

By Customer Classification

	2011	2010
Commercial	\$ 9,242,066	\$ 12,148,061
Residential	16,227,850	15,801,231
Government	9,887,017	6,499,963
	35,356,933	34,449,255
Allowance for uncollectible accounts	(18,340,237)	(16,489,925)
Accounts receivable – utility, net	\$ 17,016,696	\$ 17,959,330

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(4) Allowance for Uncollectible

Changes in allowance for uncollectible accounts for the years ended September 30, 2011 and 2010 are as follows:

	2011	2010
Total allowance, beginning of year	\$ 17,400,040	\$ 15,884,480
Provision for uncollectible accounts	3,607,677	2,928,025
Accounts written-off	(1,757,325)	(1,412,465)
Total allowance, end of year	\$ 19,250,392	\$ 17,400,040
Accounts receivable - utility (Note 3)	\$ 18,340,237	\$ 16,489,925
Notes receivable (Note 5)	181,780	-
Others assets (Note 6)	728,375	910,115
Total allowance, end of year	\$ 19,250,392	\$ 17,400,040

(5) Notes Receivable

CUC allows customers to settle their outstanding utilities through issuance of promissory notes with terms ranging from 6 months to 10 years at an interest rate of 12% per annum. A summary of the outstanding notes receivable as of September 30, 2011 and 2010 is as follows:

	2011	2010
Current portion, net of allowance for uncollectible of \$181,780 in 2011	\$ 233,329	\$ 243,901
Noncurrent	666,650	-
	\$ 899,979	\$ 243,901
Due in:		
2012	\$ 233,329	
2013	554,120	
2014	52,402	
2015	25,638	
2016	16,070	
2017-2020	18,420	
	\$ 899,979	

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(6) Other Assets

Other assets as of September 30, 2011 and 2010 consist of the following.

	2011	2010
Prepayments	\$ 3,521,422	\$ 785,129
Temporary facility	91,196	-
Others	943,595	962,837
	4,556,213	1,747,966
Allowance for uncollectible accounts	(728,375)	(910,155)
Other assets, net	\$ 3,827,838	\$ 837,811

(7) Due from (to) Grantor Agencies

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

Changes in the due from (to) grantor agencies account for the years ended September 30, 2011 and 2010 are as follows:

	2011	2010
Balance at beginning of year	\$ 1,751,336	\$ 2,372,503
Adjustments	(754,949)	(76,289)
Deductions - cash receipts		
from grantor agencies	(14,970,584)	(6,355,125)
Additions - program outlays	13,974,030	5,810,247
Balance at end of year	\$ (167)	\$ 1,751,336

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(8) Capital Assets

A summary of the changes in capital assets activity for the years ended September 30, 2011 and 2010 is as follows:

	Estimated Useful Lives	Balance at October 1, 2010	Acquisitions	Disposals	Adjustments/ Transfers	Balance at September 30, 2011
Utility plant in service						
Electric plant	20 years	\$128,586,476	\$ 1,595,613	\$ (309,333)	\$ 783,375	\$130,656,131
Water plant	20 years	62,436,988	460,989	-	-	62,897,977
Sewer plant	20 years	42,640,713	55,520	-	(2,629)	42,693,604
Administrative equipment	3-5 years	<u>4,475,287</u>	<u>144,202</u>	<u>-</u>	<u>3,675</u>	<u>4,623,164</u>
		238,139,464	2,256,324	(309,333)	784,421	240,870,876
Accumulated depreciation		<u>(162,436,969)</u>	<u>(7,026,445)</u>	<u>221,363</u>	<u>-</u>	<u>(169,242,051)</u>
Depreciable assets, net		75,702,495	(4,770,121)	(87,970)	784,421	71,628,825
Construction work-in-progress		<u>12,120,099</u>	<u>4,746,725</u>	<u>-</u>	<u>(696,451)</u>	<u>16,170,373</u>
Capital assets, net		<u>\$ 87,822,594</u>	<u>\$ (23,396)</u>	<u>\$ (87,970)</u>	<u>\$ 87,970</u>	<u>\$ 87,799,198</u>

	Estimated Useful Lives	Balance at October 1, 2009	Acquisitions	Disposals	Adjustments/ Transfers	Balance at September 30, 2010
Utility plant in service						
Electric plant	20 years	\$127,763,430	\$ 174,213	\$ (44,033)	\$ 692,866	\$128,586,476
Water plant	20 years	62,613,268	84,109	(235,494)	(24,895)	62,436,988
Sewer plant	20 years	37,585,094	22,498	(20,195)	5,053,316	42,640,713
Administrative equipment	3-5 years	<u>4,545,784</u>	<u>39,180</u>	<u>(109,677)</u>	<u>-</u>	<u>4,475,287</u>
		232,507,576	320,000	(409,399)	5,721,287	238,139,464
Accumulated depreciation		<u>(154,626,740)</u>	<u>(8,164,412)</u>	<u>323,472</u>	<u>30,711</u>	<u>(162,436,969)</u>
Depreciable assets, net		77,880,836	(7,844,412)	(85,927)	5,751,998	75,702,495
Construction work-in-progress		<u>12,508,005</u>	<u>5,278,165</u>	<u>(40,561)</u>	<u>(5,625,510)</u>	<u>12,120,099</u>
Capital assets, net		<u>\$ 90,388,841</u>	<u>\$(2,566,247)</u>	<u>\$ (126,488)</u>	<u>\$ 126,488</u>	<u>\$ 87,822,594</u>

Included in utility plant in service adjustments/transfers for fiscal years ended September 30, 2011 and 2010 are completed projects transferred from construction work-in-progress to utility plant in service of \$696,497 and \$5,746,182, respectively.

Depreciation expense for the years ended September 30, 2011 and 2010 is \$7,026,445 and \$8,164,412, respectively.

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(9) Customer Deposits

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

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

Pursuant to Public Law 16-2, summarized below is the summary of customer deposits including accrued interest as of September 30, 2011 and 2010:

	2011	2010
Electric	\$ 8,203,660	\$ 8,203,342
Water	448,772	428,494
Sewer	9,506	346
Total customer deposits	8,661,938	8,632,182
Customer overpayments	1,722,155	1,536,032
Accrued interest on customer deposits	451,098	343,690
	<u>\$10,835,191</u>	<u>\$10,511,904</u>
Customer deposits, including interest	\$10,835,191	\$10,511,904
Restricted cash	8,324,311	7,709,149
Accumulated customer deposits used to purchase fuel	<u>\$ 2,510,880</u>	<u>\$ 2,802,755</u>

Of CUC's restricted cash, \$7,500,000 as of September 30, 2011 and 2010, is held as security pursuant to a letter of credit obtained from a financial institution to secure a \$7,500,000 credit limit for fuel purchases. Pursuant to Public Law 16-2, CUC has to return the restricted cash used to purchase fuel by fiscal year 2011. CUC is in default of this provision of the law.

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(10) Long-term Debt

Long-term debt at September 30, 2011 and 2010 is as follows:

	2011	2010
Commonwealth Ports Authority (CPA)	\$ 5,682,626	\$ 7,104,451
GPPC Construction, Inc. (GPPC)	-	1,918,550
Marianas Public Land Trust (MPLT)	-	245,347
	5,682,626	9,268,348
Current maturities	<u>(2,382,269)</u>	<u>(3,743,520)</u>
Long-term debt, net of current portion	<u>\$ 3,300,357</u>	<u>\$ 5,524,828</u>

Interest expense on long-term debt for the years ended September 30, 2011 and 2010 was \$616,949 and \$1,731,291, respectively, presented as component of interest expense in the accompanying Statements of Revenues, Expenses and Changes in Net Assets.

Changes in long-term debt for fiscal year ending September 30, 2011 and 2010 are as follows:

	Balance at October 1, 2010	Additions	Repayments	Non-Cash Change	Balance at September 30, 2011
CPA	\$ 7,104,451	\$ -	\$ (1,421,825)	\$ -	\$ 5,682,626
GPPC	1,918,550	-	(1,918,550)	-	-
MPLT	245,347	-	(245,347)	-	-
Total	<u>\$ 9,268,348</u>	<u>\$ -</u>	<u>\$ (3,585,722)</u>	<u>\$ -</u>	<u>\$ 5,682,626</u>

	Balance at October 1, 2009	Additions	Repayments	Non-Cash Change	Balance at September 30, 2010
CPA	\$ 7,267,445	\$ -	\$ (162,994)	\$ -	\$ 7,104,451
GPPC	-	-	(57,682)	1,976,232	1,918,550
MPLT	1,800,000	-	(1,554,653)	-	245,347
Total	<u>\$ 9,067,445</u>	<u>\$ -</u>	<u>\$ (1,775,329)</u>	<u>\$ 1,976,232</u>	<u>\$ 9,268,348</u>

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(10) Long-term Debt, Continued

Commonwealth Ports Authority (CPA)

A summary of CUC's loans payable CPA at September 30, 2011 and 2010 is as follows:

	<u>2011</u>	<u>2010</u>
Loan payable to CPA, a component unit of the CNMI, principal of \$3,385,131, interest at 6.25% per annum, with a maturity date of October 31, 2017. Principal and interest payments are due in monthly payments of \$38,008.	\$ 3,385,131	\$ 3,559,068
Loan payable to CPA, principal of \$4,829,895, interest at 6.25% per annum with a maturity date of October 31, 2012. Principal and interest payments are due in monthly payments of \$93,938.	<u>2,297,495</u>	<u>3,545,383</u>
	5,682,626	7,104,451
Current portion	<u>(2,382,269)</u>	<u>(2,783,695)</u>
Long-term debt, net of current portion	<u>\$ 3,300,357</u>	<u>\$ 4,320,756</u>

Future repayment commitments of principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>
2012	\$ 2,382,269	\$ 669,525
2013	1,178,775	255,158
2014	262,444	193,655
2015	279,325	176,774
2016	297,292	158,808
2017-2018	<u>1,282,521</u>	<u>231,163</u>
	<u>\$ 5,682,626</u>	<u>\$ 1,685,083</u>

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(10) Long-term Debt, Continued

GPPC Construction, Inc. (GPPC)

Pursuant to a Memorandum of Understanding between CUC and GPPC signed July 26, 2010, CUC recognized a liability of \$1,976,232 for the unpaid balance for a construction contract between CUC and GPPC. The loan is payable in 25 monthly payments of \$105,000 including interest and one payment of \$95,787, commencing on August 2010 through October 2012. This debt was paid in full in fiscal year 2011.

Marianas Public Land Trust (MPLT)

On August 4, 2008, CUC obtained a \$3,500,000 unsecured loan bearing interest of 7% per annum. Principal and unpaid interest is due on August 4, 2011. Interest is payable in equal monthly installments on each interest payments, payment date beginning September 1, 2008. This debt was paid in full in 2011.

Pursuant to Public Law 16-7, \$3,400,000 shall be expended by CUC for residential rate reduction or a residential customer rebate program within 54 months from July 21, 2008.

(11) Due to Primary Government

Public Law 9-68, enacted on October 19, 1995, requires government agencies to pay the Commonwealth Treasurer an amount not less than the greater of 1% of its total operations budget from sources other than legislative appropriations or pursuant to any other formula, which the CNMI Office of the Public Auditor (OPA) and the agency may agree, to fund the OPA. At September 30, 2011 and 2010, CUC recognized an outstanding payable to the CNMI Government in the amount of \$5,500,008 and \$4,805,248, respectively. CUC accrues OPA fees of \$694,759 annually. OPA asserts that CUC owes the CNMI government OPA fee of \$8,611,903 as of September 30, 2011 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, 2011. 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 is planning on seeking assistance from the CNMI Legislature to resolve this issue. CUC has not made any remittance for OPA fees since fiscal year 2003.

On September 26, 2011, the Appropriations and Budget Authority Act of 2012 (Public Law 17-55) was signed into law. Section 601 of Public Law 17-55 authorizes the CNMI Secretary of Finance to deduct the 1% due to the OPA from the CUC from monthly utility costs of the government.

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(12) Preferred Stocks Issued to Commonwealth Development Authority

On June 6, 2006, the Governor of the CNMI signed Public Law 15-12 which authorized CDA to waive a sum of \$45,500,000, the amount owed by CUC, such amount being the aggregate sum of all outstanding sewer and water project loans given to CUC and referenced in the amended Memorandum of Agreement (MOA) executed in January 2004, by CUC and CDA.

Pursuant to the same amended MOA, CDA is authorized to waive any and all accrued interest owed by CUC on all outstanding loans in accordance with the terms and conditions of the amended MOA. Section 2 of the Public Law 15-12 provides that in the event that the power generation system for the CNMI is privatized and controlled by an independent power producer, \$22,750,000 or fifty percent of the principal amount of \$45,500,000 shall be paid by the independent power producer to CDA.

Section 2 of the Public Law 15-12 was amended by Public Law 15-44, approved by the Governor of the CNMI on January 23, 2007. The amended Section 2 provides that in the event that CUC's power division or any section thereof is privatized, fifty percent or \$22,750,000 of the principal amount of \$45,500,000 shall be rebated to the residential power consumers and the remaining fifty percent shall be waived. The said rebate shall be subject to review and approval by the Public Utilities Commission upon privatization.

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 their MOA, such terms and conditions being incorporated herein by reference, for the following:

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

On May 7, 2009, the MOA was signed by officials of CUC and CDA. The MOA was subsequently approved by the Commonwealth Public Utilities Corporation approved the MOA on September 3, 2009. As a result of the forgoing events, CUC recognized a gain on debt restructuring of \$144,175,924, presented as extraordinary gain in the Statements of Revenues, Expenses and Changes in Net Assets (Deficit) in fiscal year 2009.

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(12) Preferred Stocks Issued to Commonwealth Development Authority

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. Dividends payable as of September 30, 2011 and 2010 amounted to \$1,800,000 and \$900,000 respectively.

Future payments of the deferred dividend payable are as follows:

<u>Year Ending</u> <u>September 30</u>	
2012	\$ -
2013	120,000
2014	120,000
2015	120,000
2016	120,000
2017 to 2021	600,000
2022 to 2016	600,000
2017	<u>120,000</u>
	<u>\$ 1,800,000</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. At some future date, CUC may insure some of its assets, because as an autonomous agency, CUC is not required to follow the CNMI's government of self-insurance.

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

CUC, however, requires performance bonds on all its constructions projects.

(14) Commitments and Contingencies

Commitments

On September 23, 1996, CUC entered into an agreement with a third party for the purchase of electric power and associated services. The agreement provides for a monthly minimum purchase of 7,300,000 kilowatt-hours (kwh) at \$0.033 per kwh after January 1, 1998. Additionally, the agreement provides for periodic adjustment of the prices agreed upon but not to exceed 10% of the price then in effect. The original agreement expired on July 31, 2006 and was subsequently renewed for an additional ten (10) year period to expire on July 31, 2016.

At September 30, 2011, CUC had commitments approximating \$5,000,000 for construction and acquisition of property and equipment, all of which are expected to be incurred in 2012.

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(14) Commitments and Contingencies, Continued

Contingencies

CUC is subject to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its operations, including customer disputes.

CUC is a defendant in a class action lawsuit, Superior Court Civil Case No. 09-410, 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 been fully briefed by the parties, including the CNMI, and two former CUC Executive Directors, both represented by the Attorney General's Office, and is set for oral argument on January 19, 2011. CUC believes that it should not be liable for further rate refunds or damages as alleged in this case, and is defending vigorously. If CUC does not prevail, the potential loss could be upward of \$10 million. CUC believes that, with the passage of PL 17-3, it has a greater likelihood of prevailing and having the claims dismissed. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC is also a party to a labor related complaint with the US Department of Labor and CUC believes that it will prevail on this matter. If CUC does not prevail, the potential loss could be \$105,000. 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.

CUC participates in a number of federally assisted grant programs funded by the United States Government. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of \$1,245,922 have been set forth in CUC's Single Audit Report for the year ended September 30, 2010. The ultimate disposition of these questioned costs can be determined only by final action of the respective grantor agencies. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

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

Notes to Financial Statements
September 30, 2011 and 2010

(14) Commitments and Contingencies, Continued

Contingencies, Continued

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

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

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

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

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

Fines and penalties related to these stipulated orders have accrued to approximately \$40 million, but have not been charged, with the exception of \$29,000 and \$140,000 which were paid by CUC to the United States Department of Justice on January 2010 and July 2010, respectively.

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.

As further penalties and fines are contingent on CUC's performance, and as EPA has not at this time chosen to attempt to collect on the majority of the penalties and fines, it is very difficult to evaluate future liabilities and CUC has not accrued any liability in the accompanying Statements of Net Assets.

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

Notes to Financial Statements
September 30, 2011 and 2010

(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 Number 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

Previously stated 2010 net assets have been restated to correct the presentation of the \$45,000,000 preferred stocks issued to CDA.

The effects on the CUC's previously issued 2010 financial statements are summarized as follows:

	<u>As Previously Stated</u>	<u>Restatement</u>	<u>As Restated</u>
Total assets	\$ 130,938,751	\$ -	\$ 130,938,751
Total liabilities	<u>(58,201,235)</u>	<u>17,391,170</u>	<u>(40,810,065)</u>
Net Assets	<u>\$ 72,737,516</u>	<u>\$ 17,391,170</u>	<u>\$ 90,128,686</u>
Net assets (deficit)			
Invested in capital assets, net of related debt	\$ 59,112,862	\$ 19,441,384	\$ 78,554,246
Restricted	13,766,557	45,000,000	58,766,557
Unrestricted	<u>(141,903)</u>	<u>(47,050,214)</u>	<u>(47,192,117)</u>
Net Assets	<u>\$ 72,737,516</u>	<u>\$ 17,391,170</u>	<u>\$ 90,128,686</u>

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

Notes to Financial Statements
September 30, 2011 and 2010

(17) Restatement, Continued

	As Previously Stated	Restatement	As Restated
Net operating revenues	\$ 82,656,150	\$ -	\$ 82,656,150
Operating expenses	90,776,591	1,288,165	92,064,756
Loss from operations	(8,120,441)	(1,288,165)	(9,408,606)
Non-operating revenues (expenses), net	(1,198,199)	-	(1,198,199)
Change in recovery of fuel costs	1,536,048	-	1,536,048
Net loss before capital contributions	(7,782,592)	(1,288,165)	(9,070,757)
Capital contributions and federal grants	5,810,246	-	5,810,246
Change in net assets	(1,972,346)	(1,288,165)	(3,260,511)
Net assets, beginning	74,709,862	18,679,335	93,389,197
Net asset, ending	<u>\$ 72,737,516</u>	<u>\$ 17,391,170</u>	<u>\$ 90,128,686</u>

(18) Subsequent Events

CUC has evaluated subsequent events from September 30, 2011 through March 21, 2012 the date the financial statements were available to be issued. Summarized below are the significant subsequent events:

On October 27, 2011, the CPUC ratified and confirmed its regulatory support for CUC's effort to obtain external financing to enable it to fund its obligations under the Stipulated Orders cited in Note 14. The final order is pending the passage of House Bill 17-205 into law, by which the authority to review and approve the loan is transferred from the lawmakers to the PCUC.

On December 3, 2011, the CNMI Legislative House Bill 17-205 was enacted as Public Law 17-62, which authorizes CUC to borrow \$10 million dollars and authorizes CUC's Executive Director to execute a loan in the absence of an organized board of directors.

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

Supplementary Information
Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis
For the Year Ended September 30, 2011

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Operating revenues, net:						
Governmental	\$ 3,606,338	\$ 3,198,556	\$ 1,212,947	\$ -	\$ (2,307,269)	\$ 5,710,572
Commercial	11,218,794	2,033,934	1,498,900	-	-	14,751,628
Residential	3,091,879	4,014,224	653,257	-	-	7,759,360
Subtotal	17,917,011	9,246,714	3,365,104	-	(2,307,269)	28,221,560
LEAC - Fuel charge	67,221,265	-	-	-	(5,383,629)	61,837,636
LEAC - Non fuel	764,070	-	-	-	-	764,070
Other	1,395,805	57,242	4,379	-	-	1,457,426
Net operating revenues	87,298,151	9,303,956	3,369,483	-	(7,690,898)	92,280,692
Operating expenses:						
Production fuel	65,888,384	-	-	-	-	65,888,384
General and administrative	7,203,323	3,071,550	1,359,265	5,253,144	-	16,887,282
Depreciation	2,979,531	2,289,211	1,674,308	83,395	-	7,026,445
Other production	4,563,451	5,203,644	2,190,869	267,971	(7,690,898)	4,535,037
Maintenance	4,281,408	852,292	211,854	93,004	-	5,438,558
Supplies	495,159	523,251	85,655	125,294	-	1,229,359
Other	-	-	-	354,670	-	354,670
Total operating expenses	85,411,256	11,939,948	5,521,951	6,177,478	(7,690,898)	101,359,735
Earnings (loss) from operations before allocation of common cost	1,886,895	(2,635,992)	(2,152,468)	(6,177,478)	-	(9,079,043)
Allocation of common costs	(3,790,331)	(1,407,898)	(979,249)	6,177,478	-	-
Loss from operations	\$ (1,903,436)	\$ (4,043,890)	\$ (3,131,717)	\$ -	\$ -	\$ (9,079,043)

See accompanying notes to financial statements.

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

Supplementary Information
Schedule of Revenues, Expenses and Changes in Net Assets (Deficit) on a Divisional Basis
For the Year Ended September 30, 2011

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses	Total
Loss from operations	\$ (1,903,436)	\$ (4,043,890)	\$ (3,131,717)	\$ -	\$ -	\$ (9,079,043)
Non-operating revenues (expenses):						
Interest income	166,190	17,712	6,415	-	-	190,317
Miscellaneous income	454,242	-	-	-	-	454,242
Regulatory assessments	(424,573)	(22,688)	(22,688)	-	-	(469,949)
Settlement expense	(46,861)	-	-	-	-	(46,861)
Contribution to the CNMI government	(606,684)	(64,658)	(23,416)	-	-	(694,758)
Interest expense	(924,849)	-	(592,100)	-	-	(1,516,949)
Total non-operating revenues (expenses), net	(1,382,535)	(69,634)	(631,789)	-	-	(2,083,958)
Loss before change in recovery of fuel cost:	(3,285,971)	(4,113,524)	(3,763,506)	-	-	(11,163,001)
Change in recovery of fuel costs	(1,332,881)	-	-	-	-	(1,332,881)
Net loss before capital contributions and federal grants	(4,618,852)	(4,113,524)	(3,763,506)	-	-	(12,495,882)
Capital contributions and federal grants	7,324,015	2,432,021	4,227,850	-	-	13,983,886
Change in net assets (deficit)	\$ 2,705,163	\$ (1,681,503)	\$ 464,344	\$ -	\$ -	\$ 1,488,004

See accompanying notes to financial statements.

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

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

Year Ended September 30, 2011



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

To the Executive Director
Commonwealth Utilities Corporation

I have audited the financial statements of the Commonwealth Utilities Corporation (CUC), as of and for the year ended September 30, 2011, and have issued my report thereon dated March 21, 2012. I conducted my audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control Over Financial Reporting

In planning and performing my audit, I considered CUC's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CUC's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of CUC's internal control over financial reporting.

My consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be *significant deficiencies* or *material weaknesses*. However, as described in the accompanying Schedule of Findings and Questioned Costs, I identified certain deficiencies in internal control over financial reporting that I consider to be material weaknesses and other deficiencies that I consider to be significant deficiencies.

A *deficiency* in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. I consider Findings 2011-03 through 2011-05 described in the accompanying Schedule of Findings and Questioned Costs to be material weaknesses.

A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. I consider Findings 2011-01, 2011-02, 2011-06 and 2011-08 described in the accompanying Schedule of Findings and Questioned Costs to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CUC's financial statements are free of material misstatement, I performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Questioned Costs as Findings 2011-01, 2011-02, 2011-07 and 2011-08.

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

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


Saipan, Commonwealth of the Northern Mariana Islands
March 21, 2012



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

To the Executive Director
Commonwealth Utilities Corporation

Compliance

I have audited the compliance of Commonwealth Utilities Corporation (CUC) with the types of compliance requirements in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended September 30, 2011. CUC's major federal programs are identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of CUC's management. My responsibility is to express an opinion on CUC's compliance based on my audit.

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

As described in Finding 2011-09 in the accompanying Schedule of Findings and Questioned Costs, CUC did not comply with requirements regarding equipment and real property, that is applicable to its Economic, Social, and Political Development of the Territories Grant (CFDA 15.875), Environmental Protection Consolidated Grants Support (CFDA 66.600) and Capitalization Grants for Drinking Water (CFDA 66.468 ARRA) and compliance with such requirements is necessary, in my opinion, for CUC to comply with the requirements applicable to that program.

In my opinion, except for the noncompliance described in the preceding paragraph, CUC complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2011.

Internal Control Over Compliance

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

My consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, I identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies.

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. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as Finding No. 2011-09 to be material weakness.

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

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


Saipan, Commonwealth of the Northern Mariana Islands
March 21, 2012

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

Schedule of Expenditures of Federal Awards
For the Year Ended September 30, 2011

Federal Grantor/Pass-Through Grantor Program Title	Federal CFDA Number Pass Through Grantor's Number Grant Award Number	Receivable (Deferred Revenue) from Grantor at September 30, 2010	Receipts FY 2011	Adjustments	Expenditures FY 2011	Receivable (Deferred Revenue) from Grantor at September 30, 2011
<u>U.S. Environmental Protection Agency</u>						
Direct Programs:						
Kanat Tabla IMG Tank	66.468	\$ -	\$ (17,362)	\$ -	\$ 17,362	\$ -
As Matuis Waterwell Interconnection	66.468	-	-	-	-	-
Rehabilitation of Existing Slow sand Filter	66.468	-	(3,341)	-	3,341	-
		-	(20,703)	-	20,703	-
ARRA - Wastewater Treatment Construction Programs	66.418 ARRA /-/ 2C-69926301	611,747	(784,740)	-	172,993	-
ARRA - Wastewater Treatment Construction Programs	66.418 ARRA /-/ 2C-69926201	28,644	(209,710)	-	181,066	-
		640,391	(994,450)	-	354,059	-
ARRA - ARRA - Capitalization Grants for Drinking Water	66.468 ARRA /-/ 2F-00T26101	236,735	(1,270,098)	-	1,042,008	8,645
Environmental Protection Consolidated Grants Support	66.600 /-/ M-00T33711	-	(2,970,379)	(627,503)	3,597,882	-
Total U.S. Environmental Protection Agency		877,126	(5,255,630)	(627,503)	5,014,652	8,645
<u>U.S. Department of Homeland Security</u>						
Passed through the Government of the CNMI Public Assistance Grants	97.036	26,857	(55,944)	29,087	-	-
Balance brought forward		\$ 903,983	\$ (5,311,574)	\$ (598,416)	\$ 5,014,652	\$ 8,645

See accompanying notes to schedule of expenditures of federal awards.

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

Schedule of Expenditures of Federal Awards
For the Year Ended September 30, 2011

Federal Grantor/Pass-Through Grantor Program Title	Federal CFDA Number Pass Through Grantor's Number Grant Award Number	Receivable (Deferred Revenue) from Grantor at September 30, 2010	Receipts FY 2011	Adjustments	Expenditures FY 2011	Receivable (Deferred Revenue) from Grantor at September 30, 2011
Balance carried forward		\$ 903,983	\$ (5,311,574)	\$ (598,416)	\$ 5,014,652	\$ 8,645
<u>U.S. Department of the Interior</u>						
<u>Direct Grant</u>						
Meter Maintenance Program	OMIP-CUC-2007-1 /-/-	(13,005)	-	13,005	-	-
Information Technology Upgrade	OMIP-CUC-2007-2 /-/-	(94,964)	-	94,964	-	-
Technical Consultant	OMIP-CUC-2006-1 /-/-	(12,500)	-	-	-	(12,500)
Subtotal Direct Grant		(120,469)	-	107,969	-	(12,500)
<u>U.S. Department of the Interior</u>						
Passed through the Government of the CNMI:						
Renovation and rehabilitation of Saipan Power Plant	15.875 /-/-	156,512	-	(156,512)	-	-
Saipan Power Plant Improvements	15.875 /-/-	325,798	(290,308)	(107,990)	72,500	-
Waste and Wastewater Master Plan	15.875/ CNMI Water Wastewater 2010-1/ GRX0109	-	(1,420)	-	1,420	-
Waste and Wastewater funding	15.875/ CNMI Water Wastewater 2009-1/ GR970179	14,053	(225,655)	-	216,131	4,529
Sadog Tasi Wastewater Treatment Plant Rehabilitation	15.875/ CNMI-CIP-2009-1/ GR97002	202,305	(302,430)	-	100,125	-
Stipulated Order No. 2	15.875 / CNMI-CIP-2009-3/ GR X0115	140,306	(2,003,363)	-	1,863,057	-
Rehabilitation of Agingan Wastewater Treatment Facilities	15.875/ CNMI-CIP-2009-4	(5,440)	(873,694)	-	881,854	2,720
CUC Power Generation Improvements	15.875/ CNMI-CIP-2010-2/ GRX0080	-	(710,593)	-	710,593	-
Rota Power Generation Improvements	15.875/ CNMI-CIP-2010-2/ GRX0081	-	(3,157,703)	-	3,154,142	(3,561)
Sadog Tasi Wastewater Treatment Plant Rehabilitation	15.875/ CNMI-CIP-2010-2/ GRX0082	134,288	(579,977)	-	445,689	-
CUC Power Generation Improvements	15.875/ CNMI-CIP-2011-1/ D11AP0075	-	(1,457,587)	-	1,457,587	-
CUC Used Oil Infrastructure	15.875/ CNMI-CIP-2011-1/D11AP0106	-	(56,280)	-	56,280	-
Subtotal Passed through		967,822	(9,659,010)	(264,502)	8,959,378	3,688
Total U.S. Department of the Interior		847,353	(9,659,010)	(156,533)	8,959,378	(8,812)
Total		\$ 1,751,336	\$ (14,970,584)	\$ (754,949)	\$ 13,974,030	\$ (167)

See accompanying notes to schedule of expenditures of federal awards.

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

Schedule of Programs Selected for Audit
In Accordance with OMB Circular A-133

Year Ended September 30, 2011

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

<u>Original Grantor</u>	<u>CFDA No.</u>	<u>Description</u>	<u>Amount of Expenditures</u>
U.S. Department of the Interior	15.875	Economic, Social, and Political Development of the Territories	\$ 8,959,378
U.S. Environmental Protection Agency	66.600	Environmental Protection Consolidated Grants Support	3,597,882
U.S. Environmental Protection Agency	66.468	ARRA – Capitalization Grants for Drinking Water	<u>1,042,008</u>
Total federal program expenditures			<u>\$ 13,599,268</u>
% of total federal program expenditures tested			<u>97%</u>

Dollar threshold used to distinguish between

Type A and Type B programs: \$ 419,221

Auditee qualified as low-risk auditee yes X no

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

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2011

(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 2011, CUC had no indirect cost agreement with grantor agencies.

C. Matching Requirements

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION I – SUMMARY OF AUDITOR’S RESULTS

Financial Statements

Type of auditor’s report issued: Unqualified

Internal control over financial reporting:

- Material weakness(es) identified? X yes no

- Significant deficiency(ies) identified
that are not considered to be material
weaknesses? X yes none reported

Noncompliance material to financial statements
noted? X yes no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? X yes no

- Significant deficiency(ies) identified
that are not considered to be material
weaknesses? yes X none reported

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

- 15.875 - Equipment and Real Property
- 66.600 - Equipment and Real Property
- 66.468 ARRA - Equipment and Real Property

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS

Customer Deposits – Liability

Finding 2011-01

Criteria:

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

Condition:

The following were noted during the audit of customer deposits:

- a. Of the \$10,835,191 customer deposits only \$8,324,311 are deposited in interest-earning accounts as of September 30, 2011. Of the cash restricted for customer deposits, \$7,500,000 placed in various time certificates of deposit are held as security pursuant to a letter of credit obtained from a financial institution to secure a \$7,500,000 credit limit for fuel purchases.

Customer deposits, including interest	\$10,835,191
Restricted cash	<u>8,324,311</u>
Accumulated customer deposits used to purchase fuel	<u>\$ 2,510,880</u>
Used as collateral for letter of credit	\$ 7,500,000
Used for fuel purchases	<u>2,510,880</u>
Total deposits used by CUC	10,010,880
50% of \$10,835,191 security deposits	<u>5,417,596</u>
Unallowed pursuant to PL 16-02	<u>\$ 4,593,284</u>

CUC have not yet returned to the restricted accounts, customer deposits used to purchase fuel.

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS

Customer Deposits – Liability, Continued

Finding 2011-01, Continued

Cause:

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

Effect:

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

Recommendation:

CUC should comply with statutes pertaining to customer deposits.

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

Auditee response:

CUC concurs with this finding; however, CUC have not established a corrective action plan to restore the restricted cash balance because of the financial condition of CUC.

Prior Year Status:

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Accounts Receivable/Disconnection

Finding 2011-02

Criteria:

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

Condition:

The active accounts with overdue amounts from the aging of receivables were summarized. The listing of active residential and commercial accounts with overdue amounts was compared with the listing of accounts in dispute and accounts with promissory notes. Of the 518 active customer accounts with overdue balance in 2011, 446 customer accounts whose aggregate overdue balance was \$667,053, were not disconnected despite no record of dispute or promissory note. These accounts exclude government and autonomous agencies with past due accounts.

Cause:

There is a lack of internal control monitoring procedures to ensure that all accounts 90-days past due are disconnected pursuant to Part 17 of CUC's Electric Service Regulation.

Effect:

The collectability of the above-mentioned past due customer accounts are doubtful and may represent bad debts. Furthermore fraud could be committed on these accounts and not be detected in a timely manner.

Recommendation:

The above-mentioned past due customer accounts should be investigated pursuant to Part 17 of CUC's Electric Service Regulation. CUC should adhere to its established policies and procedures for termination/disconnection of service. Furthermore, internal control monitoring should be performed to ensure that all accounts 90-days past due are timely disconnected, unless supported by promissory notes or formal customer dispute.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Accounts Receivable/Disconnection

Finding 2011-02, Continued

Auditee response:

All legal attempts will be made to collect the amounts due. All affected customers have been notified to begin paying current charges or they will be subject to disconnection.

Prior Year Status:

Similar conditions were cited in Findings 2010-05, 2009-04, 2008-07, 2007-9 and 2006-5 in prior year audits.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Negative Balances in the Aging of Accounts Receivable

Finding 2011-03

Criteria:

Collections received should be applied to specific billings.

Condition:

The aged listing of accounts receivable as of September 30, 2011 included negative balances totaling \$1,722,155.

Cause:

The negative balances pertain to advance payments received from customers and customer deposits posted as payments.

Effect:

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

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 deferred revenue or properly classified as customer deposits.

Auditee response:

CUC, in conjunction with the planned accounting software upgrade in fiscal year 2012, will initiate contact with all customers with credit balances to ascertain the best way to process refunds of credit balances. Refunds will be made as cash flow permits.

Prior Year Status:

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Prepayments

Finding 2011-04

Criteria:

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

Condition:

An aggregate amount of \$672,754 or 19% of the prepayment balance was for prepayments made from FY 2004 through 2009.

Cause:

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

Effect:

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

Recommendation:

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

Auditee response:

The Accounts Payable Supervisor is investigating the prepayment account. Receiving reports, completion of service and other necessary documentations will be required from Division involved to close prior years prepayments. The prepayment accounts reconciliation is now prepared monthly.

Prior Year Status:

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Utility Plant

Finding 2011-05

Criteria:

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

Condition:

CUC has not conducted physical count of capital assets in over 5 years and has no basis to determine if the carrying value of its capital assets is accurate. In accordance with generally accepted accounting principles in the United States of America, long-lived assets should be evaluated for impairment. Since a physical count has not been conducted, the asset listing may still include assets that have been retired, broken, idle, destroyed or stolen.

Cause:

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

Effect:

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

Recommendation:

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

CUC should also consider evaluating capital assets for impairments and recoverability of carrying values. An asset should be tested for recoverability if events or changes in circumstances, such as the following among others, indicate that its carrying amount may not be fully recoverable:

- a. Significant adverse change in the asset's use or in its physical condition;

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Utility Plant, Continued

Finding No. 2011-05, Continued

Recommendation, Continued:

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

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

Auditee response:

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedures. This will be done in conjunction with satisfaction of deliverables required under Stipulated Order Number. 1; 61 Water and Wastewater – Asset inventory and database, and 62 Water and Wastewater – development of Geographic Information System. CUC has initiated discussions with contractor providing services for 61 and 62 above to determine cost and resource requirements to extend the inventory and database work to include power division assets. At the same time, CUC is installing a new financial management system (Microsoft Dynamics) that will provide for more robust asset tracking on the financial side of the business. Expected completion of inventory and reconciliation of financial records is the end of fiscal year 2013.

Prior Year Status:

The lack of control over capital assets was reported as a finding in the audits of CUC for fiscal years 1988 through 2010.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

After-the-fact Ratification

Finding 2011-06

Criteria:

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

Condition:

For 3 or 5% of 60 disbursements selected for testing, the products and services were provided before the purchase orders (PO) were executed.

<u>Vendor No.</u>	<u>Purchase Order</u>		<u>Invoice</u>		<u>Amount</u>
	<u>Number</u>	<u>Date</u>	<u>Number</u>	<u>Date</u>	
(a) 3422	11-0785	02/22/11	Various	Dec 2010 to Jan 2011	\$ 7,528
(b) 3134	10-2378	09/27/10	6757	09/17/10	1,976
(c) 3134	11-0745	02/15/11	7347	01/28/11	<u>1,575</u>
					<u>\$ 11,079</u>

Finding (a) pertains to payment for radio communication for which the services were included in the contract when CUC acquired the radio equipment. However, the purchase order to acquire the radio equipment did not include the fee for the service agreement. An after-the-fact purchase order was prepared only after the billing was received by CUC.

Findings (b) and (c) pertain to airfare for off-island new hires for which the purchase requisitions and purchase orders were executed after the invoices were received.

For all three instances, there was no documentation of the after-the-fact ratification.

Cause:

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

Effect:

CUC is not in compliance with its procurement policies.

COMMONWEALTH UTILITIES CORPORATION
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Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

After-the-fact Ratification, Continued

Finding 2011-06, Continued

Recommendation:

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

Auditee response:

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Compliance with Term of the Memorandum of Agreement (MOA) between CUC and CDA

Finding 2011-07

Criteria:

Pursuant to the MOA between CUC and the Commonwealth Ports Authority (CDA), the preferred stocks issued by CUC guarantees annual dividends fixed at two percent (2%) of the total aggregate value of the preferred stock, 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 shall be treated as capital development funds and shall become part of said revolving fund account as principal.

Condition:

Outstanding deferred dividends payable as of September 30, 2011 amounted to \$1,800,000. CUC has not established a revolving fund pursuant to the terms of the MOA.

Cause:

CUC has operating losses for the years ended September 30, 2011 and 2010 and has no other available funding source to fund the revolving fund.

Effect:

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

Recommendation:

CUC should ensure compliance to the terms of the MOA to ensure that CUC is able to pay the dividends accrued and due beginning fiscal year 2013.

Auditee response:

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Compliance with Term of the Memorandum of Agreement (MOA) between CUC and CDA

Finding 2011-07, Continued

Auditee response, Continued:

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

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

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

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

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Compliance with the General Provisions of the Contract and Documentation of Contract Provisions

Finding 2011-08

Criteria:

Pursuant to the General Provisions of Contract No. CUC-SD-10-C013, Sadog Tasi Wastewater Treatment Plant Rehabilitation Project, extra work that is within the general scope of the contract shall be covered by written Change Order while extra work that is necessary for acceptable completion of the project but is not within the general scope of the work covered by the original contract, shall be covered by a Supplemental Agreement.

Condition:

Contract No. CUC-SD-10-C013 for Sadog Tasi Wastewater Treatment Plant Rehabilitation Project, with an original contract price of \$1,576,310.28, had three change orders covering extra work which were documented as necessary for the completion of the project. Change Order No. 3 included the following additive costs, which do not appear to be within the general scope of the work covered by the original contract:

1. Miscellaneous office rehabilitation	\$ 70,632
2. Proposed asphalt pavement on driveways and parking	<u>138,982</u>
	<u>\$ 209,614</u>

Article 3 of Contract No. CUC-SD-10-C013 states, "the listed instruments under this article, shall constitute the Contract Documents, all of which are made part of the Contract, and collectively evidence and constitute the Contract between the parties hereto, and they are as fully a part of this Contract as if they were set out verbatim and in full."

The General Provisions, which is listed as contract documents in Article 3 of CUC-SD-10-C013 is therefore part of the Contract even though it was actually attached to the contract.

These addendums should have been procured through a Supplementary Agreement pursuant to the General Provisions and not through a change order. However, CUC's procurement policy does not have provisions regarding Supplementary Agreements.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED

Compliance with the General Provisions of the Contract

Finding 2011-08, Continued

Cause:

For this particular contract, CUC's Procurement Division used the General Provisions used by the CNMI Central Government Procurement Division instead of the of CUC's Mandatory Terms which accurately reflect CUC's procurement regulations.

Furthermore, CUC processed all the extra work for this contract using Change Orders, disregarding the General Provisions, under the premise that the Extra Work terms in the General Provisions do not apply to CUC since it is not subject to the CNMI Procurement Regulations, Northern Mariana Islands Administrative Code 70-30.3-020 which states that it does not apply to a public corporation which has been authorized to conduct its own procurement activities by enabling statute or other law.

Effect:

The processing of the Extra Work stated above, as Change Orders, is not in compliance with the General Provisions of the Contract. Also the General Provisions attached to this Contract, although more restricted, does not comply with CUC's procurement policies.

Recommendation:

CUC should review all Contract Documents referred to in the Contract to ensure that such are in accordance with CUC's procurement policies and procedures. Furthermore, CUC should ensure that all parties to the Contract are in compliance with the General Provisions or Mandatory Terms of the Contract.

Auditee response:

CUC concurs with this finding. Division managers will work closely with CUC's legal counsel to ensure compliance with CUC's procurement policies and procedures and contract terms.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Equipment and Real Property Management

Finding 2011-09

<u>CFDA No.</u>	<u>Findings/Noncompliance</u>	<u>Questioned Costs</u>
15.875, 66.600 and 66.468 ARRA	<p><u>Criteria:</u> Pursuant to 40 CFR Part 31.32 (2), a physical inventory of the property must be taken and results reconciled with the property records at least once every two years.</p> <p><u>Condition:</u> CUC has not conducted physical count of capital assets in over 5 years and has no basis to determine if the carrying value of its capital assets is accurate. In accordance with generally accepted accounting principles in the United States of America, long-lived assets should be evaluated for impairment. Since a physical count has not been conducted, the asset listing may still include assets that have been retired, broken, idle, destroyed or stolen.</p> <p><u>Effect:</u> CUC is in non-compliance with grant equipment and real property internal control requirements.</p> <p><u>Cause:</u> Conducting physical count of all of CUC's capital assets would require CUC to pay overtime to its employees who will perform the physical count; CUC does not have the funding to support such an endeavor. With this financial constraints, CUC has not implemented a plan of corrective action for the above condition and this control deficiency has existed since fiscal year 1988.</p> <p><u>Recommendation:</u> CUC should conduct physical inventory of its capital assets and update its asset listing in accordance with 40 CFR Part 31.</p>	\$ -

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Equipment and Real Property Management

Finding 2011-09, Continued

<u>CFDA No.</u>	<u>Findings/Noncompliance</u>	<u>Questioned Costs</u>
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Auditee response:

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedures. This will be done in conjunction with satisfaction of deliverables required under Stipulated Order #1; 61 Water and Wastewater – Asset inventory and database, 62 Water and Wastewater – development of Geographic Information System. CUC has initiated discussions with contractor providing services for 61 and 62 above to determine cost and resource requirements to extend the inventory and database work to include power division assets. At the same time, CUC is installing a new financial management system (Microsoft Dynamics) that will provide for more robust asset tracking on the financial side of the business. Expected completion of inventory and reconciliation of financial records is the end of fiscal year 2013.

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

Schedule of Findings and Questioned Costs
Year Ended September 30, 2011

SECTION IV – PRIOR YEAR FINDINGS AND QUESTIONED COSTS

Unresolved Findings

Status of prior year findings are discussed in the Schedule of Findings and Questioned Costs section of this report (pages 60 through 76).

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, 2011:

Questioned costs as previously reported	\$1,245,922
Questioned costs that do not warrant further action	(1,245,922)
Questioned cost of fiscal year 2011 Single Audit	<u> -</u>
Unresolved questioned costs at September 30, 2011	<u><u> -</u></u>

The questioned costs were from findings cited in fiscal year 2004 and earlier audits. CUC believes that no further action is needed to resolve these questioned costs pursuant to OMB A-133, Subpart C, § .315 (b), *Audit findings follow-up*, since (i) two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse; (ii) the Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and (iii) a management decision was not issued.



Commonwealth Utilities Corporation



March 21, 2012

J SCOTT MAGLIARI & COMPANY
PMB 297 BOX 10000
Saipan, MP 96950

Dear Mr. Magliari:

We are transmitting herewith our responses to the audit findings and recommendations per your audit report for FY 2011.

We hope that the attached plan of corrective action responses is sufficient to address the audit findings and recommendations.

Sincerely,

A handwritten signature in blue ink, appearing to read "C Warren".

Charles Warren
Chief Financial Officer

cc: CUC Executive Director
file

Auditee Responses and Plan of Corrective Actions:

Finding 2011-01

CUC concurs with this finding; however, CUC have not established a corrective action plan to restore the restricted cash balance because of the financial condition of CUC.

Finding 2011-02

All legal attempts will be made to collect the amounts due. All affected customers have been notified to begin paying current charges or they will be subject to disconnection.

Finding 2011-03

CUC, in conjunction with the planned accounting software upgrade in fiscal year 2012, will initiate contact with all customers with credit balances to ascertain the best way to process refunds of credit balances. Refunds will be made as cash flow permits.

Finding 2011-04

The Accounts Payable Supervisor is investigating the prepayment account. Receiving reports, completion of service and other necessary documentations will be required from Division involved to close prior years prepayments. The prepayment accounts reconciliation is now prepared monthly.

Finding 2011-05

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedures. This will be done in conjunction with satisfaction of deliverables required under Stipulated Order Number. 1; 61 Water and Wastewater – Asset inventory and database, and 62 Water and Wastewater – development of Geographic Information System. CUC has initiated discussions with contractor providing services for 61 and 62 above to determine cost and resource requirements to extend the inventory and database work to include power division assets. At the same time, CUC is installing a new financial management system (Microsoft Dynamics) that will provide for more robust asset tracking on the financial side of the business. Expected completion of inventory and reconciliation of financial records is the end of fiscal year 2013.

Finding 2011-06

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

Finding 2011-07

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

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

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

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

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

Finding 2011-08

CUC concurs with this finding. Division managers will work closely with CUC's legal counsel to ensure compliance with CUC's procurement policies and procedures and contract terms.

Finding 2011-09

CUC will review its Utility Plant policies and procedures and develop a cycle physical inventory counting procedures. This will be done in conjunction with satisfaction of deliverables required under Stipulated Order #1; 61 Water and Wastewater – Asset inventory and database, 62 Water and Wastewater – development of Geographic Information System. CUC has initiated discussions with contractor providing services for 61 and 62 above to determine cost and resource requirements to extend the inventory and database work to include power division assets. At the same time, CUC is installing a new financial management system (Microsoft Dynamics) that will provide for more robust asset tracking on the financial side of the business. Expected completion of inventory and reconciliation of financial records is the end of fiscal year 2013.