

POHNPEI UTILITIES CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2004 AND 2003

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Pohnpei Utilities Corporation:

We have audited the accompanying statement of net assets of the Pohnpei Utilities Corporation (PUC), a component unit of the Government of the State of Pohnpei, as of September 30, 2004 and 2003, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the PUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

Because we were not engaged as auditors until after September 30, 2003, we were not present to observe the physical inventory at that date. We have not been able to satisfy ourselves by means of other auditing procedures concerning inventory quantities at September 30, 2003.

In our opinion, except for the effects, if any, of adjustments that may have resulted had we observed the physical inventory at September 30, 2003 as discussed in the previous paragraph, such financial statements present fairly, in all material respects, the financial position of the Pohnpei Utilities Corporation as of September 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis on pages 3 and 4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). This information is the responsibility of PUC's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit of the financial statements was made for the purpose of expressing our opinion on the basic financial statements taken as a whole. The additional information on pages 16-19 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This additional information is the responsibility of the PUC's management. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 5, 2006, on our consideration of PUC's internal control over financial reporting and our tests of its compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte + Touche LLP

January 5, 2006

POHNPEI UTILITIES CORPORATION

Management Discussion and Analysis Year Ended September 30, 2004

The following discussion and analysis of the financial performance and activity of the Pohnpei Utilities Corporation (PUC) is to provide an introduction and understanding of the basic financial statements of the PUC for the year ended September 30, 2004. The discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The PUC is a public corporation of the Pohnpei State Government and is the primary provider of power, water and sewer services for the island. It is under the governance of a seven-member Board of Directors that was appointed by the Governor and approved by the Legislature of Pohnpei State, which has oversight over operation of the power, water and sewer utility services. The General Manager, who is hired by the Board of Directors, oversees the daily operation of the Corporation.

The PUC has an installed generation capacity of 15.46 MW while the power demand is 6.5 MW in 2004 and 6.6 MW in 2003. The PUC generated 40,465 and 39,766 MWh and sold 34,053 and 34,448 MWh to customers in 2004 and 2003, respectively. This resulted in total power revenue of \$7 million to PUC in 2004 and \$6.8 million in 2003. The number of households being serviced by the Corporation increased from 5,567 to 6,399 in 2004, which is equivalent to 96% coverage of Pohnpei.

The PUC also provides clean water to the people of Pohnpei. The PUC has the capacity to produce 4.72 million gallons per day while the daily water demand to existing customers amounts to 1.9 million gallons per day. PUC produced 1,332 and 950 million gallons and sold 706 and 581 million gallons to customers in 2004 and 2003, respectively, which resulted in total revenue to PUC of \$1.1 million and \$1.0 million, respectively. The PUC services 3,490 households, which covers about 1/3 of Pohnpei in area or 53% of the total population.

The following table summarizes the financial condition and operations of the PUC for FY 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Assets:		
Utility plant, net	\$ 28,453,386	\$ 29,450,475
Current assets	7,222,309	6,203,297
Total other assets	<u>329,448</u>	<u>479,448</u>
	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>
Liabilities and net assets:		
Notes payable	\$ 466,938	\$ -
Long-term debt, net	2,296,089	2,407,268
Current portion of long-term debt	104,635	94,486
Other current liabilities	<u>833,180</u>	<u>535,893</u>
Total liabilities	<u>3,700,842</u>	<u>3,037,647</u>
Net assets:		
Invested in capital assets, net of related debt	25,645,724	26,948,721
Restricted	124,437	274,437
Unrestricted	<u>6,534,140</u>	<u>5,872,415</u>
Total net assets	<u>32,304,301</u>	<u>33,095,573</u>
	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>

POHNPEI UTILITIES CORPORATION

Management Discussion and Analysis, Continued
Year Ended September 30, 2004

	<u>2004</u>	<u>2003</u>
Revenues, expenses and changes in net assets:		
Operating revenues	\$ 8,232,181	\$ 8,087,222
Operating expenses	<u>9,591,939</u>	<u>9,378,216</u>
Net operating loss	(1,359,758)	(1,290,994)
Non-operating revenues, net	<u>568,486</u>	<u>542,090</u>
Decrease in net assets	(791,272)	(748,904)
Net assets at beginning of year	<u>33,095,573</u>	<u>33,844,477</u>
Net assets at end of year	\$ <u>32,304,301</u>	\$ <u>33,095,573</u>

Overall changes in the balance sheet components include a decrease in net utility plant, an increase in current assets, a decrease in long-term debt and an increase in current liabilities.

Decreases in utility plant are attributable to insufficient replacement of capital assets that are depreciated over the year. The total depreciation for the year is \$1,976,598, while the Corporation re-invested only \$979,509 in capital assets and construction in progress (CIP). There is a \$3,336,963 reclassification of CIP projects to fixed assets due to the completion of major projects. The major projects completed are an ADB water extension project, (Sekere, Meitik and Awak), five operational wells funded by ADB, installation of prepayment meters and extension of sewer pipelines to Nanpeper community.

Increases in current assets are due to increases in accounts receivable. Although prepaid meters have improved collection of residential and small commercial power customers, government and water accounts remain problematic. Governments, which once used the compact energy grant for utilities, are having difficulty as priorities under Compact II shifted toward health, education and the environment. Energy grants are no longer available, which forces governments to use sectoral grants or local revenue share for their utilities. While customers are focused on paying power through prepaid meters, water accounts are being ignored. There is also a corresponding increase in water accounts receivable as water sales increased during the year.

Decreases in long-term debt are due to payment and reclassification of the currently maturing FSM Development Bank loan.

Increases in current liabilities are due to an increase in PUC's general obligations and purchases of inventory materials for the RUS water pipeline extension project.

The changes in revenue, expenses and changes in net assets statement in comparison with the previous year include an increase in operating revenue and an increase in expenses.

The increase in operating revenue is 2% or \$144,959 compared to last year. The increase is due to increases of power sales of \$77,949 and increases in water sales of \$67,010.

The increase in operating expense from last year is also 2% or \$213,723. The increase is due to increases in the cost of fuel.

This concludes the management discussion and analysis of the financial statements for the year September 30, 2004.

POHNPEI UTILITIES CORPORATION

Statements of Net Assets
September 30, 2004 and 2003

<u>ASSETS</u>	<u>2004</u>	<u>2003</u>
Current assets:		
Cash	\$ 327,239	\$ 384,911
Internally restricted investments	551,000	524,000
Accounts receivable, net	4,841,003	4,263,322
Grants receivable	292	48,375
Prepayments	46,551	42,375
Materials and fuel inventory	1,456,224	940,314
Total current assets	<u>7,222,309</u>	<u>6,203,297</u>
Other noncurrent assets:		
Self insurance fund	124,437	124,437
Scholarship fund	3,881	3,881
Time certificates of deposit	200,000	350,000
Interest receivable	1,130	1,130
Total other noncurrent assets	<u>329,448</u>	<u>479,448</u>
Utility plant, at cost:		
Electric plant in service	37,211,016	36,395,324
Water and sewer plant in service	14,472,456	11,894,096
Construction work-in-process	1,300,781	3,715,324
	<u>52,984,253</u>	<u>52,004,744</u>
Less accumulated depreciation	<u>(24,530,867)</u>	<u>(22,554,269)</u>
Total utility plant	<u>28,453,386</u>	<u>29,450,475</u>
	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 466,938	\$ -
Current portion of long-term debt	104,635	94,486
Accounts payable:		
Fuel oil	352,759	142,134
Operations	257,073	123,131
Deferred revenue	33,717	79,362
Accrued taxes and other liabilities	148,605	139,255
Employees' annual leave	41,026	52,011
Total current liabilities	<u>1,404,753</u>	<u>630,379</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>2,296,089</u>	<u>2,407,268</u>
Total liabilities	<u>3,700,842</u>	<u>3,037,647</u>
Contingencies		
Net assets:		
Invested in capital assets, net of related debt	25,645,724	26,948,721
Restricted	124,437	274,437
Unrestricted	6,534,140	5,872,415
Total net assets	<u>32,304,301</u>	<u>33,095,573</u>
	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2004 and 2003

	2004	2003
Operating revenues:		
Electricity sales	\$ 6,949,909	\$ 6,841,665
Water sales	1,135,767	1,073,760
Other sales	146,505	171,797
Total operating revenues	8,232,181	8,087,222
Operating and maintenance expenses:		
Production fuel	4,130,792	3,678,145
Depreciation	1,976,598	2,105,605
Administrative and general	1,459,474	1,666,977
Generation	929,689	862,886
Water and sewer	563,384	621,243
Distribution	532,002	443,360
Total operating expenses	9,591,939	9,378,216
Operating loss	(1,359,758)	(1,290,994)
Nonoperating revenues:		
Grants and subsidies	94,953	263,352
Spurline projects	47,598	81,811
Interest (expense) income, net	(5,065)	(3,421)
Other income	50,000	10,164
Total nonoperating revenues	187,486	351,906
Net loss before capital contributions	(1,172,272)	(939,088)
Capital contributions:		
Grant from Japanese International Cooperative Agency	381,000	-
Grants from Pohnpei State	-	190,184
Change in net assets	(791,272)	(748,904)
Net assets at beginning of year	33,095,573	33,844,477
Net assets at end of year	\$ 32,304,301	\$ 33,095,573

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2004 and 2003

	2004	2003
Cash flows from operating activities:		
Cash received from customers	\$ 7,527,017	\$ 7,355,711
Cash payments to suppliers for goods and services	(5,660,661)	(5,092,418)
Cash paid to employees	(1,624,060)	(1,724,311)
Net cash provided by operating activities	242,296	538,982
Cash flows from investing activities:		
Payments to self insurance fund	-	(1,047)
Increase in time certificates of deposit	150,000	(250,000)
Increase in internally restricted investments	(27,000)	(49,489)
Net cash provided by (used for) investing activities	123,000	(300,536)
Cash flows from noncapital financing activities:		
Operating grants received	143,036	215,269
Spurline projects	47,598	81,811
Net cash provided by noncapital financing activities	190,634	297,080
Cash flows from capital and related financing activities:		
Proceeds from note payable to investment company	406,938	-
Proceeds from notes payable to bank	60,000	467,091
Repayments of long-term debt	(101,031)	(79,439)
Acquisition of utility plant	(979,509)	(1,354,872)
Capital contributions	-	190,184
Net cash used for capital and related financing activities	(613,602)	(777,036)
Net change in cash	(57,672)	(241,510)
Cash at beginning of year	384,911	626,421
Cash at end of year	\$ 327,239	\$ 384,911
<u>Reconciliation of operating loss to net cash provided</u>		
<u>by operating activities:</u>		
Operating loss	\$ (1,359,758)	\$ (1,290,994)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	1,976,598	2,105,605
Provision for bad debts	126,773	364,013
Other income	44,935	6,743
(Increase) decrease in assets:		
Accounts receivable	(704,453)	(733,002)
Prepayments	(4,176)	(5,812)
Inventory	(134,910)	208,006
Increase (decrease) in liabilities:		
Accounts payable	344,567	11,136
Deferred revenue	(45,645)	(8,673)
Accrued taxes and other liabilities	9,350	(45,870)
Employees' annual leave	(10,985)	(72,170)
Net cash provided by operating activities	\$ 242,296	\$ 538,982

Supplemental disclosure of non-cash financing activity:

During the year ended September 30, 2004, PUC received a grant of generation parts inventory valued at \$381,000 from the Japanese International Cooperative Agency.

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies

The accounting policies of Pohnpei Utilities Corporation conform with accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Auditing Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting", requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. PUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

General: The Pohnpei Utilities Corporation (PUC) is a component unit of the Government of the State of Pohnpei. PUC commenced operations on October 1, 1991, with assets and liabilities of the Division of Public Utilities of the Pohnpei State Department of Public Works transferred as of that date. PUC has adopted the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC). As of October 1, 1993 the assets, liabilities, and operations of the Division of Water and Sewer of the Pohnpei State Department of Public Works were also transferred to PUC as the result of Pohnpei State Law 3L-41-93.

Utility Plant: Utility plant assets were transferred to PUC at the carrying value of the Division of Public Utilities and Division of Water and Sewer of the Pohnpei State Department of Public Works as of October 1, 1991 and 1993, for the electric plant and water and sewer plants, respectively, except as to certain utility plant assets which are stated at estimated net book value in the absence of documents to support cost. The net book value of the electric plant assets transferred was \$17,191,311 as of October 1, 1991, and the net book value of the water and sewer plant assets transferred was \$6,708,112 as of October 1, 1993. PUC capitalizes plant acquisitions with original costs in excess of \$5,000.

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Depreciation expense for 2004 and 2003 is approximately 3.8% and 4.4%, respectively, of the cost of depreciable properties. Estimated useful lives for utility plant assets are 5-40 years for production plant, 5-30 years for distribution plant and 3-20 years for general plant.

Annual and Sick Leave: Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, PUC accrues these benefits in the period earned. It is the policy of PUC to record the cost of sick leave when leave is actually taken and an expense is actually incurred. The accumulated estimated amount of sick leave at September 30, 2004 was \$134,236.

Revenues: Sales of electricity and water are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2004 and 2003, unbilled revenues are accrued based on the most recent billing cycles.

Inventory: Materials and fuel inventory are substantially carried at the lower of cost (weighted average) or market.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

Accounts Receivable and Allowance for Doubtful Accounts: PUC grants credit to companies, individuals and government agencies on an unsecured basis, substantially all of whom are based in Pohnpei. The allowance for doubtful accounts is established through a provision charged to expense. Accounts are charged against the allowance when management believes that the collection of the balance is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing balances that may be uncollectible, based on evaluations of collectibility and prior loss experience.

Net Assets: Net assets represent the residual interest in PUC's assets after liabilities are deducted and consist of four sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable, and unrestricted. Net assets invested in capital assets, net of related 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. All of PUC's restricted net assets are expendable. All other net assets are unrestricted.

Federal Grants and Subsidies: PUC receives federal grants as a subrecipient from Pohnpei State in addition to Pohnpei State Legislature appropriated subsidies and matching funds for federal programs as required.

Cash: For purposes of the balance sheets and statements of cash flows, cash includes cash on hand and cash in banks. Of the cash, up to \$100,000 is covered by the FDIC. PUC does not require collateralization of its deposits. Therefore, the amounts which exceed FDIC insurable limitations are characterized as uncollateralized.

Investments: Investments are carried at market values (see note 10).

Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent 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.

Operating and Non-operating Revenues and Expenses: PUC considers revenues and costs that are directly related to utility operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

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

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(2) Utility Plant, Continued

A summary of changes in capital assets for the years ended September 30, 2004 and 2003 is as follows:

<u>2004</u>	<u>Beginning Balance October 1, 2003</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Ending Balance September 30, 2004</u>
<u>Depreciable assets:</u>				
Production plant	\$ 22,081,519	\$ -	\$ -	\$ 22,081,519
Distribution plant	12,496,638	783,884	-	13,280,522
General plant	<u>1,817,167</u>	<u>31,808</u>	<u>-</u>	<u>1,848,975</u>
Electric plant in service	<u>36,395,324</u>	<u>815,692</u>	<u>-</u>	<u>37,211,016</u>
Water production plant	4,725,907	657,246	-	5,383,153
Sewage collection and treatment plant	5,317,499	82,922	-	5,400,421
Water distribution plant	1,405,609	1,838,192	-	3,243,801
General plant	<u>445,081</u>	<u>-</u>	<u>-</u>	<u>445,081</u>
Water and sewer plant in service	<u>11,894,096</u>	<u>2,578,360</u>	<u>-</u>	<u>14,472,456</u>
Total utility plant in service	48,289,420	3,394,052	-	51,683,472
Less accumulated depreciation	<u>(22,554,269)</u>	<u>(1,976,598)</u>	<u>-</u>	<u>(24,530,867)</u>
	<u>25,735,151</u>	<u>1,417,454</u>	<u>-</u>	<u>27,152,605</u>
<u>Non-depreciable assets:</u>				
<u>Construction work-in-progress:</u>				
Electric plant	707,408	337,475	(778,693)	266,190
Water and sewer plant	<u>3,007,916</u>	<u>1,126,795</u>	<u>(3,100,120)</u>	<u>1,034,591</u>
	<u>3,715,324</u>	<u>1,464,270</u>	<u>(3,878,813)</u>	<u>1,300,781</u>
	<u>\$ 29,450,475</u>	<u>\$ 2,881,924</u>	<u>\$ (3,878,813)</u>	<u>\$ 28,453,386</u>
<u>2003</u>	<u>Beginning Balance October 1, 2002</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Ending Balance September 30, 2003</u>
<u>Depreciable assets:</u>				
Production plant	\$ 22,081,519	\$ -	\$ -	\$ 22,081,519
Distribution plant	12,332,738	163,900	-	12,496,638
General plant	<u>1,817,167</u>	<u>-</u>	<u>-</u>	<u>1,817,167</u>
Electric plant in service	<u>36,231,424</u>	<u>163,900</u>	<u>-</u>	<u>36,395,324</u>
Water production plant	4,725,907	-	-	4,725,907
Sewage collection and treatment plant	5,317,499	-	-	5,317,499
Water distribution plant	1,290,610	114,999	-	1,405,609
General plant	<u>445,081</u>	<u>-</u>	<u>-</u>	<u>445,081</u>
Water and sewer plant in service	<u>11,779,097</u>	<u>114,999</u>	<u>-</u>	<u>11,894,096</u>
Total utility plant in service	48,010,521	278,899	-	48,289,420
Less accumulated depreciation	<u>(20,448,664)</u>	<u>(2,105,605)</u>	<u>-</u>	<u>(22,554,269)</u>
	<u>27,561,857</u>	<u>(1,826,706)</u>	<u>-</u>	<u>25,735,151</u>
<u>Non-depreciable assets:</u>				
<u>Construction work-in-progress:</u>				
Electric plant	283,657	423,751	-	707,408
Water and sewer plant	<u>2,355,694</u>	<u>652,222</u>	<u>-</u>	<u>3,007,916</u>
	<u>2,639,351</u>	<u>1,075,973</u>	<u>-</u>	<u>3,715,324</u>
	<u>\$ 30,201,208</u>	<u>\$ (750,733)</u>	<u>\$ -</u>	<u>\$ 29,450,475</u>

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(3) Self Insurance Fund

In accordance with section 2(5) of State Law 3L-41-93, an amendment to the enabling legislation for the PUC, a self-insurance fund was established to defray costs of any unforeseen accidents or disasters. The funds are accumulated in a restricted self-insurance fund, held by a trustee, in the name of the PUC. PUC also carries life insurance on behalf of its employees. Pohnpei Utilities Corporation is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

(4) Scholarship Fund

The scholarship fund is designated to account for funds to be used for scholarships in exchange for a related term of employment with PUC subsequent to graduation. Funds are provided by voluntary donations.

(5) Accounts Receivable

Bills are issued to customers near mid-month approximately one month subsequent to providing utilities services. Therefore, approximately forty-five days of service is accrued at September 30, 2004 and 2003, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2004 and 2003, are summarized as follows:

	<u>2004</u>	<u>2003</u>
Accounts receivable - electrical:		
Residential	\$ 1,913,216	\$ 1,759,296
Commercial	946,581	737,169
Government	648,408	468,949
Unbilled	<u>559,449</u>	<u>562,128</u>
	<u>4,067,654</u>	<u>3,527,542</u>
Accounts receivable - water and sewer:		
Residential	1,321,762	717,236
Commercial and government	248,251	179,913
Unbilled	<u>140,085</u>	<u>153,111</u>
	<u>1,710,098</u>	<u>1,050,260</u>
Installment receivables	<u>218,589</u>	<u>734,074</u>
Other	5,996,341	5,311,876
	<u>121,435</u>	<u>101,446</u>
	6,117,776	5,413,322
Less allowance for doubtful receivables	<u>(1,276,773)</u>	<u>(1,150,000)</u>
	<u>\$ 4,841,003</u>	<u>\$ 4,263,322</u>

PUC commenced a prepaid cash power meter system in which a portion of customer payments are used to satisfy balances in arrears. Percentages are applied depending on the amount of arrears (45% for arrears \$1,000 and above, 35% for \$500 to \$999 and 25% for under \$500). The cash power meters are primarily installed for residential customers. As of September 30, 2004 and 2003, gross receivables from customers enrolled in the cash power meter system are \$1,406,370 and \$1,369,611, respectively.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(6) Notes Payable and Long-Term Debt

Notes payable consist of the following at September 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Notes payable drawn on a bank line of credit of \$392,000, interest at 3.3%, collateralized by time certificate of deposit, due on December 29, 2004.	\$ 60,000	\$ -
Note payable to an investment company, interest at 4.625%, collateralized by the Corporation's investments.	<u>406,938</u>	<u>-</u>
Total notes payable	\$ <u>466,938</u>	\$ <u>-</u>

Changes in notes payable for the year ended September 30, 2004, are as follows:

	<u>Outstanding September 30, 2003</u>	<u>Increase</u>	<u>Outstanding September 30, 2004</u>
Note payable to bank	\$ -	\$ 60,000	\$ 60,000
Note payable to investment company	<u>-</u>	<u>406,938</u>	<u>406,938</u>
	\$ <u>-</u>	\$ <u>466,938</u>	\$ <u>466,938</u>

Long-term debt consists of the following at September 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Amount drawn on a note payable to the State of Pohnpei, facilitated by an Asian Development Bank loan to the FSM, due in semi-annual installments of \$33,500 commencing February 28, 2007. The loan is ultimately collateralized by a Pohnpei State pledge of Compact of Free Association revenues to the FSM National Government. The State of Pohnpei has not imposed collateralization on PUC and has waived its rights to receive 6.82% in interest. The loan agreement includes a 1% service charge to be added to the principal until installment payments commence. This service charge may be paid by PUC or by the State of Pohnpei.	\$ 2,118,767	\$ 2,118,767
Loan payable to FSM Development Bank, 5 year term, interest at 9%, collateralized by a \$150,000 time certificate of deposit. Pursuant to a loan agreement dated October 26, 2001, PUC is required to make monthly payments of both principal and interest in the amount \$10,379.	<u>281,957</u>	<u>382,987</u>
Total long-term debt	2,400,724	2,501,754
Less: current portion of long-term debt	<u>104,635</u>	<u>94,486</u>
Long-term portion of long-term debt	\$ <u>2,296,089</u>	\$ <u>2,407,268</u>

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(6) Notes Payable and Long-Term Debt, Continued

Future minimum principal and interest payments on all long-term debt for subsequent years ending September 30, are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2005	\$ 104,635	\$ 65,207	\$ 169,842
2006	177,322	35,246	212,568
2007	45,123	19,859	64,982
2008	45,576	21,424	67,000
2009-2013	234,807	100,193	335,000
2014-2018	246,781	88,219	335,000
2019-2023	259,366	75,634	335,000
2024-2028	272,593	62,407	335,000
2029-2033	286,495	48,505	335,000
2034-2038	301,105	33,895	335,000
2039-2043	316,461	18,539	335,000
2044-2046	<u>110,460</u>	<u>3,429</u>	<u>113,889</u>
	\$ <u>2,400,724</u>	\$ <u>572,557</u>	\$ <u>2,973,281</u>

Changes in non-current liabilities for the years ended September 30, 2004 and 2003, are as follows:

	Outstanding September 30, <u>2003</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2004</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 382,987	\$ -	\$ (101,030)	\$ 281,957	\$ 104,635	\$ 177,322
Loan payable to Asian Development Bank	<u>2,118,767</u>	<u>-</u>	<u>-</u>	<u>2,118,767</u>	<u>-</u>	<u>2,118,767</u>
	\$ <u>2,501,754</u>	\$ <u>-</u>	\$ <u>(101,030)</u>	\$ <u>2,400,724</u>	\$ <u>104,635</u>	\$ <u>2,296,089</u>
	Outstanding September 30, <u>2002</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2003</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 462,426	\$ -	\$ (79,439)	\$ 382,987	\$ 94,486	\$ 288,501
Loan payable to Asian Development Bank	<u>1,651,676</u>	<u>467,091</u>	<u>-</u>	<u>2,118,767</u>	<u>-</u>	<u>2,118,767</u>
	\$ <u>2,114,102</u>	\$ <u>467,091</u>	\$ <u>(79,439)</u>	\$ <u>2,501,754</u>	\$ <u>94,486</u>	\$ <u>2,407,268</u>

(7) Contributions

During the year ended September 30, 1995, sole use rights for the Nanpohnmal Power Plant were contributed to PUC by the FSM National Government through the State of Pohnpei. These assets were donated to the FSM National Government through the Japanese Foreign Aid Program. Official title to the ownership of these assets rests with the FSM National Government. However, substantial revenue is generated by PUC from the use of these assets and PUC bears responsibility for all costs associated with the operation of these assets.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(8) Grants, Subsidies and Capital Contributions

Grants, subsidies and capital contributions comprise the following for the years ended September 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Grants and Subsidies:		
U.S. Department of the Interior:		
Operations and maintenance improvement program - electrical year six - apprentice training	\$ -	\$ 7,655
OMIP - water year three	47,500	-
OMIP - water year five	28,288	-
Utility development 2001	-	42,420
Utility development 2002	17,665	205,897
Human resources development 2003	<u>1,500</u>	<u>7,380</u>
Total grants and subsidies	94,953	263,352
Capital Contributions:		
Pohnpei State grants	-	190,184
Japanese International Cooperative Agency	<u>381,000</u>	<u>-</u>
	\$ <u>475,953</u>	\$ <u>453,536</u>

(9) Contingencies

PUC is party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

(10) Sinking Fund

During fiscal year 1998, Pohnpei Utilities Corporation management established a sinking fund. The purpose of this fund is to finance future expansion and upgrade of the power plant and equipment. The goal of PUC is to build this fund to \$2,000,000 in anticipation of certain equipment purchases and upgrades.

The sinking fund is comprised of the following at September 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Money market funds	\$ 6,000	\$ 22,000
U.S. Government obligations	116,000	106,000
Corporate bonds and others	174,000	180,000
Common stock	<u>255,000</u>	<u>216,000</u>
	\$ <u>551,000</u>	\$ <u>524,000</u>

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(11) Retirement Plan

The Corporation's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees received from the FSM Social Security System. The Plan is a contributory plan in which the Corporation contributes a matching percent of the participant's contribution, up to 10% of the participant's annual salary. The participant may contribute three or more percent from his or her annual salary. Participation is optional. The Corporation's comptroller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2004 and 2003 were \$80,483 and \$80,827, respectively. Management is of the opinion that the plan does not represent an asset or liability of the Corporation. For the years ended September 30, 2004 and 2003, plan assets were \$611,723 and \$445,161, respectively.

POHNPEI UTILITIES CORPORATION

Combining Statement of Net Assets
September 30, 2004

(With comparative totals as of September 30, 2003)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2004	2003
<u>Assets</u>					
Current assets:					
Cash	\$ 2,176,940	\$ (1,849,701)	\$ -	\$ 327,239	\$ 384,911
Internally restricted investments	551,000	-	-	551,000	524,000
Accounts receivable, net	3,373,563	1,467,440	-	4,841,003	4,263,322
Grants receivable	13	279	-	292	48,375
Prepayments	46,551	-	-	46,551	42,375
Fuel and material inventory	900,593	555,631	-	1,456,224	940,314
Total current assets	<u>7,048,660</u>	<u>173,649</u>	<u>-</u>	<u>7,222,309</u>	<u>6,203,297</u>
Other noncurrent assets:					
Self insurance fund	124,437	-	-	124,437	124,437
Scholarship fund	3,881	-	-	3,881	3,881
Time certificate of deposit	200,000	-	-	200,000	350,000
Interest receivable	1,130	-	-	1,130	1,130
Total other noncurrent assets	<u>329,448</u>	<u>-</u>	<u>-</u>	<u>329,448</u>	<u>479,448</u>
Utility plant, at cost:					
Electric plant in service	37,211,016	-	-	37,211,016	36,395,324
Water and sewer plant in service	-	14,472,456	-	14,472,456	11,894,096
Construction work-in-process	306,450	994,331	-	1,300,781	3,715,324
	37,517,466	15,466,787	-	52,984,253	52,004,744
Less accumulated depreciation	<u>(19,611,251)</u>	<u>(4,919,616)</u>	<u>-</u>	<u>(24,530,867)</u>	<u>(22,554,269)</u>
Total utility plant	<u>17,906,215</u>	<u>10,547,171</u>	<u>-</u>	<u>28,453,386</u>	<u>29,450,475</u>
	<u>\$ 25,284,323</u>	<u>\$ 10,720,820</u>	<u>\$ -</u>	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>
<u>Liabilities and Net Assets</u>					
Current liabilities:					
Notes payable to bank	\$ 60,000	\$ -	\$ -	\$ 60,000	\$ -
Note payable to investment company	406,938	-	-	406,938	-
Current portion of notes payable	104,635	-	-	104,635	94,486
Accounts payable:					
Fuel oil	352,759	-	-	352,759	142,134
Operations	256,006	1,067	-	257,073	123,131
Deferred revenue	33,717	-	-	33,717	79,362
Accrued taxes and other liabilities	118,884	29,721	-	148,605	139,255
Employees' annual leave	26,918	14,108	-	41,026	52,011
Total current liabilities	<u>1,359,857</u>	<u>44,896</u>	<u>-</u>	<u>1,404,753</u>	<u>630,379</u>
Noncurrent liabilities:					
FSM Development Bank loan	177,322	-	-	177,322	288,501
ADB Water Extension loan	-	2,118,767	-	2,118,767	2,118,767
Total liabilities	<u>1,537,179</u>	<u>2,163,663</u>	<u>-</u>	<u>3,700,842</u>	<u>3,037,647</u>
Net assets:					
Invested in capital assets, net of related debt	17,217,320	8,428,404	-	25,645,724	26,948,721
Restricted	124,437	-	-	124,437	274,437
Unrestricted	6,405,387	128,753	-	6,534,140	5,872,415
Total net assets	<u>23,747,144</u>	<u>8,557,157</u>	<u>-</u>	<u>32,304,301</u>	<u>33,095,573</u>
	<u>\$ 25,284,323</u>	<u>\$ 10,720,820</u>	<u>\$ -</u>	<u>\$ 36,005,143</u>	<u>\$ 36,133,220</u>

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION

Combining Statement of Revenues, Expenses and Changes in Net Assets
Year Ended September 30, 2004
(With comparative totals for the year ended September 30, 2003)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2004	2003
Operating revenues:					
Residential	\$ 906,664	\$ 866,531	\$ -	\$ 1,773,195	\$ 1,698,493
Commercial	2,127,207	191,064	-	2,318,271	2,431,264
Government	1,812,855	117,472	-	1,930,327	2,073,028
Cash power	2,063,883	-	-	2,063,883	1,712,640
Intercompany sales	61,561	-	(61,561)	-	-
Other sales	49,492	97,013	-	146,505	171,797
Total operating revenues	<u>7,021,662</u>	<u>1,272,080</u>	<u>(61,561)</u>	<u>8,232,181</u>	<u>8,087,222</u>
Operating and maintenance expenses:					
Production fuel	4,130,792	-	-	4,130,792	3,678,145
Depreciation	1,406,918	569,680	-	1,976,598	2,105,605
Administrative and general:					
Employee benefits	361,162	-	-	361,162	362,196
Salaries and wages	375,609	-	-	375,609	390,096
Consumables	90,340	-	-	90,340	91,136
General repairs	120,232	-	-	120,232	106,411
Training and safety	46,100	-	-	46,100	39,190
Customer service and collection	22,568	-	-	22,568	44,528
Vehicle, POL	160,198	-	-	160,198	120,014
Legal fees	9,750	-	-	9,750	16,176
Communications	59,134	-	-	59,134	49,024
Travel	71,369	-	-	71,369	79,042
Contractual services	-	-	-	-	2,904
Utility	18,642	-	(18,642)	-	-
Insurance	59,770	-	-	59,770	2,247
Bad debts	126,773	-	-	126,773	364,013
Total administrative and general	<u>1,521,647</u>	<u>-</u>	<u>(18,642)</u>	<u>1,503,005</u>	<u>1,666,977</u>
Generation:					
Salaries and wages	399,894	-	-	399,894	432,630
Repairs and maintenance	505,313	-	-	505,313	392,187
Other production	13,835	-	-	13,835	38,069
Total generation	<u>919,042</u>	<u>-</u>	<u>-</u>	<u>919,042</u>	<u>862,886</u>
Water and sewer:					
Salaries and wages	-	369,787	-	369,787	414,832
Employee benefits	-	57,310	-	57,310	54,859
Repairs and maintenance	-	60,881	-	60,881	43,390
Training and safety	-	7,303	-	7,303	66,864
Chemicals	-	46,025	-	46,025	14,943
Utility expense	-	42,919	(42,919)	-	-
Other production	-	22,076	-	22,076	26,355
Total water and sewer	<u>-</u>	<u>606,301</u>	<u>(42,919)</u>	<u>563,382</u>	<u>621,243</u>
Distribution:					
Salaries and wages	390,516	-	-	390,516	344,632
Repairs and maintenance	108,604	-	-	108,604	98,728
Total distribution	<u>499,120</u>	<u>-</u>	<u>-</u>	<u>499,120</u>	<u>443,360</u>
Total operating expenses	<u>8,477,519</u>	<u>1,175,981</u>	<u>(61,561)</u>	<u>9,591,939</u>	<u>9,378,216</u>
Operating earnings (loss)	<u>(1,455,857)</u>	<u>96,099</u>	<u>-</u>	<u>(1,359,758)</u>	<u>(1,290,994)</u>

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION

Combining Statement of Revenues, Expenses and Changes in Net Assets, Continued
 Year Ended September 30, 2004
 (With comparative totals for the year ended September 30, 2003)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2004	2003
Nonoperating revenues:					
Federal grants and subsidies	94,953	-	-	94,953	263,352
Spurline projects	47,598	-	-	47,598	81,811
Interest (expense) income, net	(5,065)	-	-	(5,065)	(3,421)
Other income	50,000	-	-	50,000	10,164
	<u>187,486</u>	<u>-</u>	<u>-</u>	<u>187,486</u>	<u>351,906</u>
Total nonoperating revenues					
Net earnings (loss) before capital contributions	(1,268,371)	96,099	-	(1,172,272)	(939,088)
Capital contributions					
Grant from Japanese International Cooperative Agency	381,000	-	-	381,000	-
Grants from Pohnpei State	-	-	-	-	190,184
	<u>(887,371)</u>	<u>96,099</u>	<u>-</u>	<u>(791,272)</u>	<u>(748,904)</u>
Change in net assets					
Net assets at beginning of year	<u>24,634,515</u>	<u>8,461,058</u>	<u>-</u>	<u>33,095,573</u>	<u>33,844,477</u>
Net assets at end of year	<u>\$ 23,747,144</u>	<u>\$ 8,557,157</u>	<u>\$ -</u>	<u>\$ 32,304,301</u>	<u>\$ 33,095,573</u>

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2004

Grantor/Program Title	CFDA No.	Total Authorizations	Prior Years' Expenditures	Expenditures for the Year Ended Sept. 30, 2004	Total Program Expenditures
<u>U.S. Department of the Interior:</u>					
Office of Territorial and International Affairs:					
<u>Operations and Maintenance Improvement Programs (OMIP):</u>					
	15.875				
Utility Development 2001		\$ 117,668	\$ 92,813	\$ -	\$ 92,813
OMIP Bench		562,500	440,723	15,201	455,924
HR Development 2003		12,500	7,380	1,500	8,880
OMIP Single Phase Prepaid Meter		200,000	-	67,288	67,288
OMIP Three Phase Prepaid Meter		75,000	-	8,500	8,500
OMIP Reimbursement of PUC assistance to CPUC		2,464	-	2,464	2,464
		<u>\$ 970,132</u>	<u>\$ 540,916</u>	<u>\$ 94,953</u>	<u>\$ 635,869</u>

Note: The schedule of expenditures of federal awards is prepared on the accrual basis of accounting.

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

The Board of Directors
Pohnpei Utilities Corporation:

We have audited the financial statements of the Pohnpei Utilities Corporation (PUC), as of and for the year ended September 30, 2004, and have issued our report thereon dated January 5, 2006, which report was qualified because we were not able to satisfy ourselves concerning inventory quantities at September 30, 2003. We conducted our 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered PUC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted other matters involving the internal control over financial reporting that we have reported to management of PUC in a separate letter dated January 5, 2006.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PUC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended for the information of the Board of Directors and management of PUC, federal awarding agencies, pass-through entities, cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

Deloitte & Touche LLP
January 5, 2006