

POHNPEI UTILITIES CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2005 AND 2004

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Pohnpei Utilities Corporation:

We have audited the accompanying statements of net assets of the Pohnpei Utilities Corporation (PUC), a component unit of the Government of the State of Pohnpei, as of September 30, 2005 and 2004, 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.

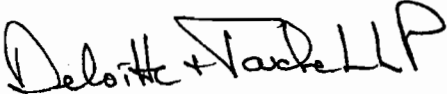
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan 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.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Pohnpei Utilities Corporation as of September 30, 2005 and 2004, 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 18-20 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 June 1, 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 considered in assessing the results of our audit.

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, stylized font.

June 1, 2006

POHNPEI UTILITIES CORPORATION

Management Discussion and Analysis Year Ended September 30, 2005

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, 2005. 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 seven-member Board of Directors that was appointed by the Governor and approved by the Legislature of the 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 2005 and 2004. The PUC generated 39,412 MWh and 40,465 MWh and sold 33,620 and 34,053 MWh to customers in 2005 and 2004, respectively. This resulted in total power revenue of \$7.7 million and \$7 million to PUC in 2005 and 2004, respectively. The number of households being serviced by the corporation increased from 6,399 to 6,496 in 2005, 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 2 million gallons per day. PUC produced 1.4 and 1.3 billion gallons and sold 727 million and 706 million gallons to customers in 2005 and 2004, respectively, which resulted in total revenue to PUC of \$1.2 million and \$1.1 million, respectively. The PUC services 3,428 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 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Assets:		
Utility plant, net	\$ 28,719,385	\$ 28,453,386
Current assets	6,330,689	7,222,309
Total other non-current assets	<u>482,832</u>	<u>329,448</u>
	<u>\$ 35,532,906</u>	<u>\$ 36,005,143</u>
Liabilities and net assets:		
Notes payable	\$ 506,938	\$ 466,938
Long-term debt, net	2,747,515	2,296,089
Current portion of long-term debt	129,918	104,635
Other current liabilities	<u>1,581,671</u>	<u>833,180</u>
Total liabilities	<u>4,966,042</u>	<u>3,700,842</u>
Net assets:		
Invested in capital assets, net of related debt	25,435,014	25,645,724
Restricted	127,821	124,437
Unrestricted	<u>5,004,029</u>	<u>6,534,140</u>
Total net assets	<u>30,566,864</u>	<u>32,304,301</u>
	<u>\$ 35,532,906</u>	<u>\$ 36,005,143</u>

POHNPEI UTILITIES CORPORATION

Management Discussion and Analysis Year Ended September 30, 2005

	<u>2005</u>	<u>2004</u>
Revenues, expenses and changes in net assets:		
Operating revenues	\$ 9,042,447	\$ 8,232,181
Operating expenses	<u>12,599,106</u>	<u>9,591,939</u>
Net operating loss	(3,556,659)	(1,359,758)
Non-operating revenues, net	<u>1,819,222</u>	<u>568,486</u>
Decrease in net assets	(1,737,437)	(791,272)
Net assets at beginning of year	<u>32,304,301</u>	<u>33,095,573</u>
Net assets at end of year	\$ <u>30,566,864</u>	\$ <u>32,304,301</u>

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

Increases in utility plant are mainly the result of construction work in progress for the expansion of the utility's water system. Approximately 32,000 ft of water pipeline was extended from Awak, Uh municipality to Kinakapw, Madolenimw municipality during the year. Four (4) deep water wells and a 500,000 gallon tank were also under construction during the year.

Decreases in current assets are due to increases in allowance for doubtful accounts, which management believes is adequate to absorb possible losses on existing accounts receivable balance should these accounts become uncollectible in the future for any reason.

Increases in total other non-current assets are due to reclassification of time certificate of deposits from current to non-current asset based on restriction of their use.

Increases in long term debt are due to a loan from United States USDA-Rural Utility Service (RUS). This loan portion, \$578,000 is part of the RUS authorized loan/grant funding (total \$2.7 million) to PUC to extend its water pipelines and constructs 4 deep water wells and a 500,000 gallon tank.

Increases in current liabilities are due to 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 increase in non-operating revenue, net and an increase in expenses.

The increase in operating revenue is 10% or \$810,266 compared to last year. The increase is due to increases of power sales (\$658,318) and increases in water sales (\$151,948). The increase in power sales is mainly from increases in fuel tariff, a factor of fuel cost increases passed on to customers. The water sale increase reflects the expanded area of service coverage made possible by the ADB and the RUS water expansion projects.

The increase in non-operating revenue is due to the grant portion of the RUS water expansion funding, which is \$1.5 million received and accrued for 2005.

The increase in operating expense from last year is 31% or \$3,007,167. The increase is due to increases in bad debts of \$1,835,238, increases in cost of fuel of \$1,224,619 and a decrease in other general expense categories (\$52,690).

This concludes the management discussion and analysis of the financial statements for the year September 30, 2005.

POHNPEI UTILITIES CORPORATION

Statements of Net Assets
September 30, 2005 and 2004

<u>ASSETS</u>	<u>2005</u>	<u>2004</u>
Current assets:		
Cash and cash equivalents	\$ 333,314	\$ 327,239
Investments	601,000	551,000
Accounts receivable, net	3,048,181	4,841,003
Grants receivable	825,333	292
Prepayments	-	46,551
Materials and fuel inventory	1,522,861	1,456,224
Total current assets	<u>6,330,689</u>	<u>7,222,309</u>
Other noncurrent assets:		
Restricted:		
Cash and cash equivalents	3,881	3,881
Time certificates of deposit	350,000	200,000
Investment	127,821	124,437
Interest receivable	1,130	1,130
Total other noncurrent assets	<u>482,832</u>	<u>329,448</u>
Utility plant, at cost:		
Electric plant in service	36,013,176	37,211,016
Water and sewer plant in service	14,716,959	14,472,456
Construction work-in-process	2,534,100	1,300,781
	53,264,235	52,984,253
Less accumulated depreciation	<u>(24,544,850)</u>	<u>(24,530,867)</u>
Total utility plant	<u>28,719,385</u>	<u>28,453,386</u>
	<u>\$ 35,532,906</u>	<u>\$ 36,005,143</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 506,938	\$ 466,938
Current portion of long-term debt	129,918	104,635
Accounts payable:		
Fuel oil	482,734	352,759
Operations	745,570	257,073
Deferred revenue	149,417	33,717
Accrued taxes and other liabilities	157,625	148,605
Employees' annual leave	46,325	41,026
Total current liabilities	<u>2,218,527</u>	<u>1,404,753</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>2,747,515</u>	<u>2,296,089</u>
Total liabilities	<u>4,966,042</u>	<u>3,700,842</u>
Contingencies		
Net assets:		
Invested in capital assets, net of related debt	25,435,014	25,645,724
Restricted	127,821	124,437
Unrestricted	5,004,029	6,534,140
Total net assets	<u>30,566,864</u>	<u>32,304,301</u>
	<u>\$ 35,532,906</u>	<u>\$ 36,005,143</u>

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2005 and 2004

	2005	2004
Operating revenues:		
Electricity sales	\$ 7,723,369	\$ 6,949,909
Water sales	1,177,684	1,135,767
Other sales	141,394	146,505
Total operating revenues	9,042,447	8,232,181
Operating and maintenance expenses:		
Production fuel	5,355,411	4,130,792
Depreciation	1,908,540	1,976,598
Administrative and general	3,424,998	1,493,913
Generation	733,713	928,132
Water and sewer	669,478	563,385
Distribution	506,966	499,119
Total operating expenses	12,599,106	9,591,939
Operating loss	(3,556,659)	(1,359,758)
Nonoperating revenues:		
Grants and subsidies	193,459	94,953
Spurline projects	22,930	47,598
Interest income (expense), net	4,039	(5,065)
Other income	50,998	50,000
Total nonoperating revenues	271,426	187,486
Net loss before capital contributions	(3,285,233)	(1,172,272)
Capital contributions:		
Grant from Japanese International Cooperative Agency	-	381,000
Grants from United States Department of Agriculture	1,547,796	-
Change in net assets	(1,737,437)	(791,272)
Net assets at beginning of year	32,304,301	33,095,573
Net assets at end of year	\$ 30,566,864	\$ 32,304,301

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2005 and 2004

	2005	2004
Cash flows from operating activities:		
Cash received from customers	\$ 8,988,958	\$ 7,527,017
Cash payments to suppliers for goods and services	(6,635,717)	(5,660,661)
Cash paid to employees	(1,701,877)	(1,624,060)
Net cash provided by operating activities	651,364	242,296
Cash flows from investing activities:		
Payments to self insurance fund	(3,384)	-
(Increase) decrease in time certificates of deposit	(150,000)	150,000
Increase in internally restricted investments	(50,000)	(27,000)
Net cash (used for) provided by investing activities	(203,384)	123,000
Cash flows from noncapital financing activities:		
Operating grants received	193,459	143,036
Spurline projects	22,930	47,598
Net cash provided by noncapital financing activities	216,389	190,634
Cash flows from capital and related financing activities:		
Proceeds from note payable to investment company	-	406,938
Proceeds from notes payable to bank	40,000	60,000
Repayments of long-term debt	(101,291)	(101,031)
Proceeds from long-term debt	578,000	-
Proceeds from sale of assets	50,998	-
Acquisition of utility plant	(1,948,757)	(979,509)
Capital contributions	722,756	-
Net cash used for capital and related financing activities	(658,294)	(613,602)
Net change in cash and cash equivalents	6,075	(57,672)
Cash and cash equivalents at beginning of year	327,239	384,911
Cash and cash equivalents at end of year	\$ 333,314	\$ 327,239
<u>Reconciliation of operating loss to net cash provided</u>		
<u>by operating activities:</u>		
Operating loss	\$ (3,556,659)	\$ (1,359,758)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	1,908,540	1,976,598
Provision for bad debts	1,962,011	126,773
Other income	4,039	44,935
(Increase) decrease in assets:		
Accounts receivable	(169,189)	(704,453)
Prepayments	46,551	(4,176)
Inventory	(292,420)	(134,910)
Increase (decrease) in liabilities:		
Accounts payable	618,472	344,567
Deferred revenue	115,700	(45,645)
Accrued taxes and other liabilities	9,020	9,350
Employees' annual leave	5,299	(10,985)
Net cash provided by operating activities	\$ 651,364	\$ 242,296

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, 2005 and 2004

(1) Summary of Significant Accounting Policies

The accounting policies of Pohnpei Utilities Corporation (PUC) 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 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.

Cash and Cash Equivalents: Cash and cash equivalents include cash on hand, demand deposits, and short-term investments with a maturity date within three months of the date acquired by PUC. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified on the statement of net assets.

Investments: Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

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.

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

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.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Depreciation expense for each of 2005 and 2004 is approximately 3.8% 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. Accrued sick leave at September 30, 2005 approximates \$180,000.

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.

Revenues: Sales of electricity and water are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2005 and 2004, unbilled revenues are accrued based on the most recent billing cycles.

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

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.

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.

New Accounting Standards: In fiscal year 2004, PUC implemented GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. In fiscal year 2005, PUC implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*. The adoption of these Statements did not have a material effect on PUC's results of operations. In 2006, PUC will implement GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. PUC has yet to assess the impact of the implementation of Statement No. 42.

Reclassification: Certain reclassifications have been made to the 2004 financial statements to correspond with the 2005 presentation.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of PUC are governed by its enabling legislation. The Board is required to engage one or more fund custodians to assume responsibility for the physical possession of the PUC's investments.

A. Deposits:

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 PUC or its agent in PUC'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 the PUC'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 the PUC's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect 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, PUC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The PUC does not have a deposit policy for custodial credit risk.

As of September 30, 2005 and 2004, the carrying amount of the PUC's total cash and cash equivalents and time certificates of deposit was \$687,195 and \$531,120, respectively, and the corresponding bank balances were \$835,575 and \$782,903, respectively. Of the bank balance amounts, \$685,823 and \$529,548, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2005 and 2004, bank deposits in the amount of \$200,000 were FDIC insured. PUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(2) Deposits and Investments, Continued

B. Investments:

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

- Category 1 Investments that are insured or registered, or securities held by the PUC or its agent in PUC's name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in PUC's name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the PUC's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of September 30, 2005 and 2004, investments in mutual funds at fair value are \$728,821 and \$675,437, respectively.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, PUC will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. PUC's investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in PUC's name by PUC's custodial financial institutions at September 30, 2005 and 2004.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for PUC. There was no concentration of credit risk for investments as of September 30, 2005 and 2004.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. PUC does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Self Insurance Fund and Risk Management

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. As of September 30, 2005 and 2004, the carrying amount of the fund was \$127,821 and \$124,437, respectively, and was presented as restricted investment in the accompanying statements of net assets.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(3) Self Insurance Fund and Risk Management, Continued

Additionally, PUC carries life insurance on behalf of its employees and maintains commercial coverage of a comprehensive business policy and workmen's compensation insurance. PUC 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. As of September 30, 2005 and 2004, the carrying amount of the fund was \$3,881 and was presented as restricted cash and cash equivalents in the accompanying statements of net assets.

(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, 2005 and 2004, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2005 and 2004, are summarized as follows:

	<u>2005</u>	<u>2004</u>
Accounts receivable - electrical:		
Residential	\$ 1,919,369	\$ 1,913,216
Commercial	1,027,329	946,581
Government	763,866	648,408
Unbilled	<u>558,547</u>	<u>559,449</u>
	<u>4,269,111</u>	<u>4,067,654</u>
Accounts receivable - water and sewer:		
Residential	1,207,590	1,321,762
Commercial and government	223,261	248,251
Unbilled	<u>127,196</u>	<u>140,085</u>
	<u>1,558,047</u>	<u>1,710,098</u>
Installment receivables	<u>313,537</u>	<u>218,589</u>
	6,140,695	5,996,341
Other	<u>146,269</u>	<u>121,435</u>
	6,286,964	6,117,776
Less allowance for doubtful receivables	<u>(3,238,783)</u>	<u>(1,276,773)</u>
	<u>\$ 3,048,181</u>	<u>\$ 4,841,003</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, 2005 and 2004, gross receivables from customers enrolled in the cash power meter system are \$1,558,652 and \$1,406,370, respectively.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(6) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2005 and 2004 is as follows:

<u>2005</u>	<u>Beginning Balance October 1, 2004</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Ending Balance September 30, 2005</u>
<u>Depreciable assets:</u>				
Production plant	\$ 22,081,519	\$ -	\$ (1,338,022)	\$ 20,743,497
Distribution plant	13,280,522	561,326	-	13,841,848
General plant	<u>1,848,975</u>	<u>23,585</u>	<u>(444,729)</u>	<u>1,427,831</u>
Electric plant in service	<u>37,211,016</u>	<u>584,911</u>	<u>(1,782,751)</u>	<u>36,013,176</u>
Water production plant	5,383,153	-	(17,988)	5,365,165
Sewage collection and treatment plant	5,400,421	48,406	-	5,448,827
Water distribution plant	3,243,801	128,225	-	3,372,026
General plant	<u>445,081</u>	<u>179,678</u>	<u>(93,818)</u>	<u>530,941</u>
Water and sewer plant in service	<u>14,472,456</u>	<u>356,309</u>	<u>(111,806)</u>	<u>14,716,959</u>
Total utility plant in service	51,683,472	941,220	(1,894,557)	50,730,135
Less accumulated depreciation	<u>(24,530,867)</u>	<u>(1,908,540)</u>	<u>1,894,557</u>	<u>(24,544,850)</u>
	<u>27,152,605</u>	<u>(967,320)</u>	<u>-</u>	<u>26,185,285</u>
<u>Non-depreciable assets:</u>				
<u>Construction work-in-progress:</u>				
Electric plant	266,190	421,127	(663,548)	23,769
Water and sewer plant	<u>1,034,591</u>	<u>1,961,571</u>	<u>(485,831)</u>	<u>2,510,331</u>
	<u>1,300,781</u>	<u>2,382,698</u>	<u>(1,149,379)</u>	<u>2,534,100</u>
	<u>\$ 28,453,386</u>	<u>\$ 1,415,378</u>	<u>\$ (1,149,379)</u>	<u>\$ 28,719,385</u>
<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>\$ 2,881,724</u>	<u>\$ (3,878,813)</u>	<u>\$ 28,453,386</u>

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(7) Notes Payable and Long-Term Debt

Notes payable consist of the following at September 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Notes payable drawn on a bank line of credit of \$190,000, interest at time certificate of deposit (TCD) rate plus 2% (3.3% at September 30, 2005 and 2004), collateralized by TCD, due on November 17, 2005.	\$ 100,000	\$ 60,000
Note payable to an investment company, interest at 6.75%, collateralized by investments.	<u>406,938</u>	<u>406,938</u>
Total notes payable	\$ <u>506,938</u>	\$ <u>466,938</u>

Changes in notes payable for the years ended September 30, 2005 and 2004, are as follows:

	Outstanding September 30, <u>2004</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2005</u>
Note payable to bank	\$ 60,000	\$ 360,000	\$ (320,000)	\$ 100,000
Note payable to investment company	<u>406,938</u>	<u>-</u>	<u>-</u>	<u>406,938</u>
	\$ <u>466,938</u>	\$ <u>360,000</u>	\$ <u>(320,000)</u>	\$ <u>506,938</u>
	Outstanding September 30, <u>2003</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2004</u>
Note payable to bank	\$ -	\$ 60,000	\$ -	\$ 60,000
Note payable to investment company	<u>-</u>	<u>406,938</u>	<u>-</u>	<u>406,938</u>
	\$ <u>-</u>	\$ <u>466,938</u>	\$ <u>-</u>	\$ <u>466,938</u>

Long-term debt consists of the following at September 30, 2005 and 2004:

	<u>2005</u>	<u>2004</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 United States Department of Agriculture, Rural Utilities Service, due in monthly installments of \$2,654 commencing October 28, 2006. The loan is collateralized by a revenue bond. The loan bears a fixed interest rate of 4.5%.	578,000	-

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

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. A member of the PUC Board is also a member of management of the FSM Development Bank.

	<u>180,666</u>	<u>281,957</u>
Total long-term debt	2,877,433	2,400,724
Less: current portion of long-term debt	<u>129,918</u>	<u>104,635</u>
Long-term portion of long-term debt	\$ <u>2,747,515</u>	\$ <u>2,296,089</u>

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>
2006	\$ 129,918	\$ 33,517	\$ 163,435
2007	102,195	135,023	237,218
2008	51,063	42,477	93,540
2009	52,889	45,959	98,848
2010	53,659	45,189	98,848
2011-2015	280,536	213,704	494,240
2016-2020	302,920	191,320	494,240
2021-2025	328,449	165,791	494,240
2026-2030	357,779	136,461	494,240
2031-2035	391,724	102,516	494,240
2036-2040	431,293	62,947	494,240
2041-2045	<u>395,008</u>	<u>19,424</u>	<u>414,432</u>
	\$ <u>2,877,433</u>	\$ <u>1,194,328</u>	\$ <u>4,071,761</u>

Changes in non-current liabilities for the years ended September 30, 2005 and 2004, are as follows:

	Outstanding September 30, 2004	Increases	Decreases	Outstanding September 30, 2005	Current	Noncurrent
Loan payable to FSM Development Bank	\$ 281,957	\$ -	\$ (101,291)	\$ 180,666	\$ 129,918	\$ 50,748
Loan payable to Rural Utilities Service	-	578,000	-	578,000	-	578,000
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>2,400,724</u>	\$ <u>578,000</u>	\$ <u>(101,291)</u>	\$ <u>2,877,433</u>	\$ <u>129,918</u>	\$ <u>2,747,515</u>

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

	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>

(8) 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.

(9) Grants, Subsidies and Capital Contributions

Grants, subsidies and capital contributions comprise the following for the years ended September 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Grants and Subsidies:		
U.S. Department of the Interior:		
Operations and maintenance improvement program:		
OMIP single phase prepaid meter	\$ 132,712	\$ 67,288
OMIP three phase prepaid meter	9,224	8,500
Utility development 2001	20,651	-
Utility development 2002	30,872	17,665
Human resources development 2003	<u>-</u>	<u>1,500</u>
Total grants and subsidies	193,459	94,953
Capital Contributions:		
Rural Utilities Service	1,547,796	-
Japanese International Cooperative Agency	<u>-</u>	<u>381,000</u>
	<u>\$ 1,741,255</u>	<u>\$ 475,953</u>

(10) 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.

POHNPEI UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(11) 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 consists of investments in three mutual funds that have the following asset allocations at September 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Money market funds	\$ 20,000	\$ 6,000
U.S. Government obligations	121,000	116,000
Corporate bonds and others	154,000	174,000
Common stock	<u>306,000</u>	<u>255,000</u>
	<u>\$ 601,000</u>	<u>\$ 551,000</u>

(12) Retirement Plan

PUC'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 PUC contributes a matching percentage 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. PUC's comptroller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2005 and 2004 were \$78,657 and \$80,483, respectively. Management is of the opinion that the plan does not represent an asset or liability of PUC. At September 30, 2005 and 2004, plan assets were \$793,108 and \$611,723, respectively.

POHNPEI UTILITIES CORPORATION

Combining Statement of Net Assets
September 30, 2005

(With comparative totals as of September 30, 2004)

<u>Assets</u>	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2005	2004
Current assets:					
Cash and cash equivalents	\$ 1,841,277	\$ (1,507,963)	\$ -	\$ 333,314	\$ 327,239
Investment	601,000	-	-	601,000	551,000
Accounts receivable, net	2,013,978	1,034,203	-	3,048,181	4,841,003
Grants receivable	13	825,320	-	825,333	292
Prepayments	-	-	-	-	46,551
Fuel and material inventory	1,069,183	453,678	-	1,522,861	1,456,224
Total current assets	5,525,451	805,238	-	6,330,689	7,222,309
Other noncurrent assets:					
Restricted:					
Cash and cash equivalents	3,881	-	-	3,881	3,881
Time certificates of deposit	350,000	-	-	350,000	200,000
Investment	127,821	-	-	127,821	124,437
Interest receivable	1,130	-	-	1,130	1,130
Total other noncurrent assets	482,832	-	-	482,832	329,448
Utility plant, at cost:					
Electric plant in service	36,013,176	-	-	36,013,176	37,211,016
Water and sewer plant in service	-	14,716,959	-	14,716,959	14,472,456
Construction work-in-process	23,769	2,510,331	-	2,534,100	1,300,781
	36,036,945	17,227,290	-	53,264,235	52,984,253
Less accumulated depreciation	(19,192,400)	(5,352,450)	-	(24,544,850)	(24,530,867)
Total utility plant	16,844,545	11,874,840	-	28,719,385	28,453,386
	\$ 22,852,828	\$ 12,680,078	\$ -	\$ 35,532,906	\$ 36,005,143
<u>Liabilities and Net Assets</u>					
Current liabilities:					
Notes payable to bank	\$ 100,000	\$ -	\$ -	\$ 100,000	\$ 60,000
Note payable to investment company	406,938	-	-	406,938	406,938
Current portion of notes payable	129,918	-	-	129,918	104,635
Accounts payable:					
Fuel oil	482,734	-	-	482,734	352,759
Operations	275,814	469,756	-	745,570	257,073
Deferred revenue	149,417	-	-	149,417	33,717
Accrued taxes and other liabilities	133,212	24,413	-	157,625	148,605
Employees' annual leave	29,948	16,377	-	46,325	41,026
Total current liabilities	1,707,981	510,546	-	2,218,527	1,404,753
Noncurrent liabilities:					
FSM Development Bank loan	50,748	-	-	50,748	177,322
RUS Water Extension loan	-	578,000	-	578,000	-
ADB Water Extension loan	-	2,118,767	-	2,118,767	2,118,767
Total liabilities	1,758,729	3,207,313	-	4,966,042	3,700,842
Net assets:					
Invested in capital assets, net of related debt	16,256,867	9,178,147	-	25,435,014	25,645,724
Restricted	127,821	-	-	127,821	124,437
Unrestricted	4,709,411	294,618	-	5,004,029	6,534,140
Total net assets	21,094,099	9,472,765	-	30,566,864	32,304,301
	\$ 22,852,828	\$ 12,680,078	\$ -	\$ 35,532,906	\$ 36,005,143

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION

Combining Statement of Revenues, Expenses and Changes in Net Assets
Year Ended September 30, 2005
(With comparative totals for the year ended September 30, 2004)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2005	2004
Operating revenues:					
Residential	\$ 827,450	\$ 901,129	\$ -	\$ 1,728,579	\$ 1,773,195
Commercial	2,190,253	147,239	-	2,337,492	2,318,271
Government	1,789,712	129,316	-	1,919,028	1,930,327
Cash power	2,915,954	-	-	2,915,954	2,063,883
Intercompany sales	64,958	-	(64,958)	-	-
Other sales	131,646	9,748	-	141,394	146,505
Total operating revenues	7,919,973	1,187,432	(64,958)	9,042,447	8,232,181
Operating and maintenance expenses:					
Production fuel	5,355,411	-	-	5,355,411	4,130,792
Depreciation	1,367,006	541,534	-	1,908,540	1,976,598
Administrative and general:					
Bad debts	1,403,175	558,836	-	1,962,011	126,773
Salaries and wages	398,621	-	-	398,621	375,609
Employee benefits	345,939	-	-	345,939	361,162
Vehicle, POL	202,414	-	-	202,414	160,198
General repairs	116,274	-	-	116,274	120,232
Travel	66,012	-	-	66,012	71,369
Consumables	65,517	-	-	65,517	90,340
Contractual services	60,455	-	-	60,455	-
Insurance	60,308	-	-	60,308	59,770
Training and safety	56,370	-	-	56,370	37,008
Customer service and collection	39,870	-	-	39,870	22,568
Communications	39,207	-	-	39,207	59,134
Legal fees	12,000	-	-	12,000	9,750
Utility	15,186	-	(15,186)	-	-
	2,881,348	558,836	(15,186)	3,424,998	1,493,913
Generation:					
Salaries and wages	369,746	-	-	369,746	399,894
Repairs and maintenance	339,803	-	-	339,803	505,313
Other production	24,164	-	-	24,164	22,925
	733,713	-	-	733,713	928,132
Water and sewer:					
Salaries and wages	-	397,398	-	397,398	369,787
Repairs and maintenance	-	116,111	-	116,111	60,881
Chemicals	-	53,147	-	53,147	46,025
Employee benefits	-	52,125	-	52,125	57,310
Other production	-	33,420	-	33,420	22,076
Training and safety	-	17,277	-	17,277	7,306
Utility expense	-	49,772	(49,772)	-	-
	-	719,250	(49,772)	669,478	563,385
Distribution:					
Salaries and wages	354,864	-	-	354,864	390,516
Repairs and maintenance	152,102	-	-	152,102	108,603
	506,966	-	-	506,966	499,119
Total operating expenses	10,844,444	1,819,620	(64,958)	12,599,106	9,591,939
Operating loss	(2,924,471)	(632,188)	-	(3,556,659)	(1,359,758)

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION

Combining Statement of Revenues, Expenses and Changes in Net Assets, Continued
 Year Ended September 30, 2005
 (With comparative totals for the year ended September 30, 2004)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2005	2004
Nonoperating revenues:					
Federal grants and subsidies	193,459	-	-	193,459	94,953
Spurline projects	22,930	-	-	22,930	47,598
Interest (expense) income, net	4,039	-	-	4,039	(5,065)
Other income	50,998	-	-	50,998	50,000
Total nonoperating revenues	271,426	-	-	271,426	187,486
Net earnings (loss) before capital contributions	(2,653,045)	(632,188)	-	(3,285,233)	(1,172,272)
Capital contributions					
Grant from Japanese International Cooperative Agency	-	-	-	-	381,000
Grant from USDA Rural Utilities Service	-	1,547,796	-	1,547,796	-
Change in net assets	(2,653,045)	915,608	-	(1,737,437)	(791,272)
Net assets at beginning of year	23,747,144	8,557,157	-	32,304,301	33,095,573
Net assets at end of year	\$ 21,094,099	\$ 9,472,765	\$ -	\$ 30,566,864	\$ 32,304,301

See accompanying Independent Auditors' Report.

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, 2005, and have issued our report thereon dated June 1, 2006. 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 June 1, 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 + Stack LLP

June 1, 2006

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
WITH REQUIREMENTS APPLICABLE TO EACH MAJOR FEDERAL AWARD
PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE AND ON THE
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

The Board of Directors
Pohnpei Utilities Corporation:

Compliance

We have audited the compliance of the Pohnpei Utilities Corporation (PUC) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended September 30, 2005. PUC's one major federal program is identified in the summary of auditors' results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to its one major federal program are the responsibility of PUC's management. Our responsibility is to express an opinion on PUC's compliance based on our audit.

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

In our opinion, PUC complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2005.

Internal Control Over Financial Reporting

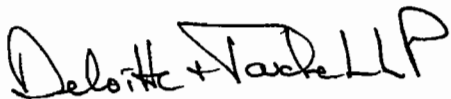
The management of PUC is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing the audit, we considered PUC's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control 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 noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program 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 compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of Pohnpei Utilities Corporation (PUC), as of and for the year ended September 30, 2005, and have issued our report thereon dated June 1, 2006. Our audit was performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. This schedule is the responsibility of the management of PUC. Such information has been subjected to the auditing procedures applied in our audit of the financial statements and, in our opinion, is fairly stated, in all material respects when considered in relation to the financial statements taken as a whole.

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

A handwritten signature in black ink that reads "Deloitte + Stadel LLP". The signature is written in a cursive, stylized font.

June 1, 2006

POHNPEI UTILITIES CORPORATION

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2005

Grantor/Program Title	CFDA No.	Total Authorizations	Receivable at Beginning of Year	Expenditures for the Year Ended Sept. 30, 2005	Cash Receipts for the Year Ended Sept. 30, 2005	Receivable at End of Year
<u>U.S. Department of the Interior:</u>						
Office of Territorial and International Affairs:						
<u>Operations and Maintenance Improvement Programs (OMP):</u>						
	15.875					
Utility Development 2001		\$ 117,668	\$ 292	\$ 20,651	\$ 20,651	\$ 292
OMP Bench		562,500	-	30,872	30,872	-
HR Development 2003		12,500	-	-	-	-
OMIP Single Phase Prepaid Meter		200,000	-	132,712	132,712	-
OMIP Three Phase Prepaid Meter		75,000	-	9,224	9,224	-
OMIP Reimbursement of PUC assistance to CPUC		2,464	-	-	-	-
		<u>970,132</u>	<u>292</u>	<u>193,459</u>	<u>193,459</u>	<u>292</u>
<u>U.S. Department of Agriculture</u>						
Rural Utilities Service						
<u>Water and Waste Disposal Systems for Rural Communities</u>						
	10.760					
Grant		<u>2,761,000</u>	<u>-</u>	<u>2,125,796</u>	<u>1,300,755</u>	<u>825,041</u>
		<u>\$ 2,761,000</u>	<u>\$ -</u>	<u>\$ 2,125,796</u>	<u>\$ 1,300,755</u>	<u>\$ 825,333</u>

Note 1: The grant from RUS includes loan portion of \$578,000 and grant portion of \$2,183,000. Expenditures are first applied to the loan.

Note 2: The schedule of expenditures of federal awards is prepared on the accrual basis of accounting.

Pohnpei Utilities Corporation

Schedule of Findings and Questioned Costs
Year Ended September 30, 2005

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were not identified.
3. No instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal award programs were identified.
5. The Independent Auditors' Report on compliance with requirements applicable to the one major federal awards program expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. PUC's one major federal program is:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
U.S. Department of Agriculture – Rural Utilities Service	10.760

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. The Organization did qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Part II - Financial Statement Findings Section

No matters are reportable.

Part III - Federal Award Findings and Questioned Cost Section

No matters are reportable.