

**POHNPEI UTILITIES CORPORATION  
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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**FINANCIAL STATEMENTS AND  
ADDITIONAL INFORMATION AND  
INDEPENDENT AUDITORS' REPORT**

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**YEARS ENDED SEPTEMBER 30, 2008 AND 2007**

**POHNPEI UTILITIES CORPORATION**  
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Years Ended September 30, 2008 and 2007

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## 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 State of Pohnpei, as of September 30, 2008 and 2007, 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 PUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

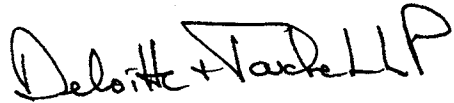
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan 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, the financial statements referred to above present fairly, in all material respects, the financial position of the Pohnpei Utilities Corporation as of September 30, 2008 and 2007, and the changes in its net assets 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 through 6 is not a required part of the basic financial statements but is supplementary information required by the *Governmental Accounting Standards Board*. This supplementary information is the responsibility of PUC's management. We have applied certain limited procedures to such information, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of PUC taken as a whole. The additional information on pages 22 through 24 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 our audit of the basic financial statements for the year ended September 30, 2008 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 8, 2009, on our consideration of PUC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of 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 + Tuck LLP". The signature is written in a cursive, stylized font.

January 8, 2009

**POHNPEI UTILITIES CORPORATION**  
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Management Discussion and Analysis  
Years Ended September 30, 2008 and 2007

The following discussion and analysis of the financial performance and activities of the Pohnpei Utilities Corporation (PUC) is to provide an introduction and understanding of the basic financial statements of the PUC for the years ended September 30, 2008 and 2007. 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.

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 PUC.

PUC has an installed generation capacity of 15.46 MW while the power demand is 6.2 MW in 2008 and 6.6 MW in 2007. PUC generated 36,106 MWh and 38,333 MWh and sold 28,935 and 31,328 MWh to customers in 2008 and 2007, respectively. This resulted in total power revenue of \$12.6 million and \$10.1 million to PUC in 2008 and 2007, respectively. The increase in sales revenue in 2008 is mainly the result of increases in fuel tariff from an average of \$0.2319/kWhr in 2007 to \$0.3428/kWhr in 2008. The number of households being serviced by the PUC is 6,363 (6,052 using cash power meters and 311 using conventional meters) in 2008 and 6,459 in 2007. The service coverage is about 96% of the population.

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 2.3 million gallons per day. PUC produced 779 million and 1.4 billion gallons and sold 590 million and 640 million gallons to customers in 2008 and 2007, respectively, which resulted in total revenue to PUC of \$1.1 million and \$1.2 million, respectively. The PUC services 3,511 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 2008, 2007 and 2006:

Assets:	<u>2008</u>	<u>2007</u>	<u>2006</u>
Utility plant, net	\$ 26,257,924	\$ 28,391,763	\$ 29,912,393
Current assets	3,480,902	4,521,252	5,602,827
Other non-current assets	<u>516,621</u>	<u>494,401</u>	<u>487,516</u>
	<u>\$ 30,255,447</u>	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>
<b>Liabilities and Net Assets:</b>			
Notes payable	\$ 100,000	\$ 874,825	\$ 643,647
Current portion of long-term debt	199,694	134,922	118,536
Other current liabilities	900,258	1,111,791	1,286,008
Long-term debt, net	<u>3,550,597</u>	<u>3,010,853</u>	<u>2,645,682</u>
<b>Total Liabilities</b>	<u>4,750,549</u>	<u>5,132,391</u>	<u>4,693,873</u>

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	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net Assets:			
Invested in capital assets, net of related debt	22,879,154	24,769,163	26,694,528
Restricted	143,970	139,390	132,505
Unrestricted	<u>2,481,774</u>	<u>3,366,472</u>	<u>4,481,830</u>
Total net assets	<u>25,504,898</u>	<u>28,275,025</u>	<u>31,308,863</u>
	<u>\$ 30,255,447</u>	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>
Revenues, Expenses and Changes in Net Assets:			
Operating revenues	\$ 13,799,835	\$ 11,369,043	\$ 10,071,600
Bad debt expense	(202,600)	-	(81,000)
Operating expenses	<u>(16,238,431)</u>	<u>(14,585,306)</u>	<u>(11,920,059)</u>
Net operating loss	(2,641,196)	(3,216,263)	(1,929,459)
Non-operating (expenses) revenues, net	(128,931)	57,672	226,087
Capital contributions	<u>-</u>	<u>124,753</u>	<u>2,445,371</u>
(Decrease) increase in net assets	(2,770,127)	(3,033,838)	741,999
Net assets at beginning of year	<u>28,275,025</u>	<u>31,308,863</u>	<u>30,566,864</u>
Net assets at end of year	<u>\$ 25,504,898</u>	<u>\$ 28,275,025</u>	<u>\$ 31,308,863</u>

Overall changes in the balance sheet components from September 30, 2007 to 2008 include a decrease in utility plant, net (\$2,133,839), a decrease in current assets (\$1,040,350) and a decrease in current and long term liabilities (\$381,842).

Decreases in utility plant are the result of depreciation, asset dispositions and transfers totaling \$2,133,839. There are no material additions to utility plant in 2008 so the carrying value of utility plant assets is reduced by approximately the same amount as total depreciation, dispositions and transfers. Please see note 6 of the financial statements for additional information on PUC's utility plant.

Decreases in current assets are a result of decreases in cash in banks, investments and accounts receivable. PUC encountered rough times paying the high cost of fuel in 2008 and some of the current asset decreases are required to pay for the increased cost of fuel.

Decrease in current and long term debt from 2007 to 2008 is due to PUC's scheduled loan repayments to FSM Development Bank, U.S. Rural Utility Services, Asian Development Bank and the Bank of the FSM. During the year, notes payable of \$773,122 were converted to long-term debt in the same amount. Additionally, investments of \$476,825 were used to pay off an outstanding note to the investment company. PUC also paid more than it bought on credit to vendors and suppliers in 2008. Please see note 7 of the financial statements for additional information on PUC's financing activities.

The changes in revenue, expenses and changes in net assets statement between fiscal year 2007 and 2008 include an increase in operating revenues before bad debts (\$2,430,792), an increase in operating expenses (\$1,653,125), and a decrease in net operating loss of \$575,067.

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The increase in operating revenues before bad debts is due to increase in average fuel tariff from \$0.2319 per kWh in 2007 to \$0.3426/kWh in 2008 or \$2,534,056, less the decrease in water sales of \$90,545.

The increase in operating expenses is mainly the result of fuel cost increases. The fuel expense this year alone is \$11,515,015, an increase of \$2,549,557 from 2007. Although PUC saved \$896,432 on all other expense categories in 2008, operating expense increased by \$1,653,125 over 2007 because of the cost of fuel. PUC cut costs in all areas in 2008. In administration, expenses were reduced by \$266,107, in water and sewer by \$188,383, in generation by \$384,679 and in distribution by \$77,845. Included in these categories, total salaries, wages and benefits, decreased by \$245,197 from 2007.

PUC incurred a loss of \$2,770,127, an improvement of \$263,711 from 2007. It cost PUC \$.52 to produce and sell one unit of power (kWh) in 2008; however, PUC charged an average of \$.4426 per unit of power or (kWh) in 2008. It also cost PUC \$2.42 to produce and sell one thousand gallons of clean water (1,000 gallons), but PUC charged an average of \$1.80 per the thousand gallons of water sold.

Some of the factors affecting the disparity between actual production cost and the tariff are:

1. PUC does not charge depreciation expense to customers. In 2008, the cost of depreciation expense per unit of power is \$.05 and the cost of depreciation per thousand gallons of water is \$1.05.
2. It should also be noted that the existing tariff was approved in 1996, 12 years ago using the revenue requirements and service levels of those years. Tariff reform is overdue for PUC because of inflation. Costs in 2008 are 40% higher based on the U.S. consumer price index, using 1996 as the base year. In addition, freight and insurance costs have more than doubled because of the worldwide increase in fuel prices. PUC's costs are greatly impacted by freight because PUC relies heavily on imports of its engine parts and distribution, water and sewer supplies and materials.
3. PUC is paying for import taxes which it did not pay in 1996. The average cost of import taxes per year is \$130,000.
4. PUC is supposed to recover the actual cost of fuel by the tariff. However, based on the revenue analysis this year, PUC recovered from customers approximately \$9,913,131 in fuel charges, but spent \$11,515,015 on fuel, a shortfall of (\$1,601,884). PUC diverted funds intended for maintenance and operations to cover the shortfall in fuel revenue in 2008. The reasons for the fuel revenue shortfall are as follows:
  - a. The cost of lubrication oil and solvents has increased significantly and PUC does not include this cost in its fuel-pass-through tariff structure that changes when the cost of fuel changes. PUC spent about \$374,000 in lubrication oil and solvents in 2008.
  - b. The technical and line loss for PUC this year is 20.4 percent. The fuel used to produce the power that is lost is not recovered by the tariff.
  - c. Although there are 311 customers using conventional meters among the total 6,363 power customers, their power consumption averages about 46% of the total annual sales. These customers mainly comprise large commercial customers and government customers. The billing cycle for these customers is 90 days and only on July 1, 2008 was it changed to 45 days. The fuel price is not charged to these customers until 90 and 45 days later and so in times of increasing fuel prices, these customers are charged a cheaper fuel price than the actual cost of fuel, creating a mismatch of current revenue and fuel expense.

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Years Ended September 30, 2008 and 2007

Economic Outlook

The economic outlook for PUC operation next year will potentially be better than this year. PUC is likely to enjoy a reduction in fuel costs as the world oil prices are falling. To illustrate, PUC paid \$5.12 per gallon of diesel when world oil price hit \$147 per barrel in July 2008. As of January 8, 2009, the diesel price to PUC is \$2.84 per gallon. Since the world oil price has fallen below \$40 per barrel, PUC anticipates its price to go down as far more lucrative as \$1.39 per gallon if prices are only influenced by the world market price and the price per barrel remains the same for the rest of the year. PUC can save as much as \$7 to \$8 million next year if this happens. The savings will not affect the PUC balance sheet, because the fuel costs saved are passed on to customers in the tariff. However, because PUC will reduce the cost of power charged to customers, there is a potential for non-fuel revenue sales to increase next year, which is good, because this is what funds PUC operations.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2008.

Management's Discussion and Analysis for the year ended September 30, 2007 is set forth in PUC's report on the audit of financial statements, which is dated June 2, 2008. That Discussion and Analysis explains the major factors impacting the 2007 financial statements and can be viewed at the Office of the Public Auditor's website at [www.fsmpublicauditor.fm](http://www.fsmpublicauditor.fm)



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Statements of Net Assets  
September 30, 2008 and 2007

<u>ASSETS</u>	<u>2008</u>	<u>2007</u>
Current assets:		
Cash and cash equivalents	\$ 198,407	\$ 357,056
Investments	173,030	685,000
Accounts receivable, net	1,866,390	2,167,439
Grants receivable	23,698	23,698
Prepayments	-	10,186
Materials and fuel inventory	<u>1,219,377</u>	<u>1,277,873</u>
Total current assets	<u>3,480,902</u>	<u>4,521,252</u>
Other noncurrent assets:		
Restricted:		
Cash and cash equivalents	150,000	153,881
Time certificates of deposit	221,521	200,000
Investments	143,970	139,390
Interest receivable	<u>1,130</u>	<u>1,130</u>
Total other noncurrent assets	<u>516,621</u>	<u>494,401</u>
Utility plant, at cost:		
Electric plant in service	37,585,666	37,560,131
Water and sewer plant in service	<u>19,357,434</u>	<u>19,307,046</u>
	56,943,100	56,867,177
Less accumulated depreciation	<u>(30,743,463)</u>	<u>(28,638,532)</u>
Depreciable assets	26,199,637	28,228,645
Construction work-in-process	<u>58,287</u>	<u>163,118</u>
Total utility plant	<u>26,257,924</u>	<u>28,391,763</u>
	<u>\$ 30,255,447</u>	<u>\$ 33,407,416</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 100,000	\$ 874,825
Current portion of long-term debt	199,694	134,922
Accounts payable:		
Operations	357,598	463,912
Affiliate	78,317	40,000
Deferred revenue	190,074	312,752
Accrued taxes and other liabilities	183,134	202,694
Employees' annual leave	<u>91,135</u>	<u>92,433</u>
Total current liabilities	1,199,952	2,121,538
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>3,550,597</u>	<u>3,010,853</u>
Total liabilities	<u>4,750,549</u>	<u>5,132,391</u>
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	22,879,154	24,769,163
Restricted	143,970	139,390
Unrestricted	<u>2,481,774</u>	<u>3,366,472</u>
Total net assets	<u>25,504,898</u>	<u>28,275,025</u>
	<u>\$ 30,255,447</u>	<u>\$ 33,407,416</u>

See accompanying notes to financial statements.

**POHNPEI UTILITIES CORPORATION**  
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Statements of Revenues, Expenses and Changes in Net Assets  
Years Ended September 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Operating revenues:		
Electricity sales	\$ 12,638,444	\$ 10,104,388
Water sales	1,089,691	1,180,236
Other sales	<u>71,700</u>	<u>84,419</u>
Total operating revenues before bad debts	13,799,835	11,369,043
Bad debts	<u>(202,600)</u>	<u>-</u>
Total operating revenues after bad debts	<u>13,597,235</u>	<u>11,369,043</u>
Operating and maintenance expenses:		
Production fuel	11,515,015	8,965,458
Depreciation	2,104,930	2,084,348
Administrative and general	1,089,952	1,356,059
Water and sewer	723,005	911,388
Generation	450,447	835,126
Distribution	<u>355,082</u>	<u>432,927</u>
Total operating expenses	<u>16,238,431</u>	<u>14,585,306</u>
Operating loss	<u>(2,641,196)</u>	<u>(3,216,263)</u>
Nonoperating (expenses) revenues:		
Interest expense, net	(128,931)	(58,056)
Grants and subsidies	-	99,140
Spurline projects	-	16,363
Other income	<u>-</u>	<u>225</u>
Total nonoperating (expenses) revenues	<u>(128,931)</u>	<u>57,672</u>
Net loss before capital contributions	(2,770,127)	(3,158,591)
Capital contributions:		
Grants passed through from the United States Department of the Interior	<u>-</u>	<u>124,753</u>
Change in net assets	(2,770,127)	(3,033,838)
Net assets at beginning of year	<u>28,275,025</u>	<u>31,308,863</u>
Net assets at end of year	<u>\$ 25,504,898</u>	<u>\$ 28,275,025</u>

See accompanying notes to financial statements.

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Statements of Cash Flows  
Years Ended September 30, 2008 and 2007

	2008	2007
Cash flows from operating activities:		
Cash received from customers	\$ 13,775,606	\$ 11,801,682
Cash payments to suppliers for goods and services	(12,430,488)	(10,296,963)
Cash paid to employees	(1,697,207)	(1,886,308)
Net cash used for operating activities	(352,089)	(381,589)
Cash flows from investing activities:		
Payments to self insurance fund	(4,580)	(6,885)
Retirement of scholarship fund	3,881	-
Increase in time certificates of deposit	(21,521)	(47,494)
Decrease in internally restricted investments	35,145	62,622
Net cash provided by investing activities	12,925	8,243
Cash flows from noncapital financing activities:		
Proceeds from notes payable to bank	475,122	208,000
Advance from affiliate	38,317	40,000
Operating grants received	-	99,140
Spurline projects	-	16,363
Interest expense	(128,931)	(120,678)
Net cash provided by noncapital financing activities	384,508	242,825
Cash flows from capital and related financing activities:		
Repayments of long-term debt	(168,606)	(118,443)
Acquisition of utility plant	(35,387)	(772,926)
Proceeds from long-term debt	-	500,000
Proceeds from note payable to investment company	-	23,178
Capital contributions	-	334,005
Net cash used for capital and related financing activities	(203,993)	(34,186)
Net change in cash and cash equivalents	(158,649)	(164,707)
Cash and cash equivalents at beginning of year	357,056	521,763
Cash and cash equivalents at end of year	\$ 198,407	\$ 357,056
<u>Reconciliation of operating loss to net cash</u>		
<u>used for operating activities:</u>		
Operating loss	\$ (2,641,196)	\$ (3,216,263)
Adjustments to reconcile operating loss to net cash		
<u>used for operating activities:</u>		
Depreciation	2,104,930	2,084,348
Write off of construction work-in-progress	64,296	209,208
Bad debts	202,600	-
Other income	-	225
(Increase) decrease in assets:		
Accounts receivable	98,449	438,298
Prepayments	10,186	(10,186)
Materials and fuel inventory	58,496	326,998
Increase (decrease) in liabilities:		
Accounts payable	(106,314)	(249,137)
Deferred revenue	(122,678)	(5,884)
Accrued taxes and other liabilities	(19,560)	25,084
Employees' annual leave	(1,298)	15,720
Net cash used for operating activities	\$ (352,089)	\$ (381,589)

Supplemental information of noncash investing and financing activities:

During the year ended September 30, 2008, notes payable of \$773,122 were converted to long-term debt in the same amount. Additionally, investments of \$476,825 were used to pay off an outstanding note to the investment company.

See accompanying notes to financial statements.

**POHNPEI UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2008 and 2007

(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 Accounting 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: 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.

Cash and Cash Equivalents: Cash and cash equivalents include cash on hand, demand deposits, and short-term investments with maturity dates 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.

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Notes to Financial Statements  
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets. 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, 2008 approximates \$232,000.

Net Assets: Net assets represent the residual interest in PUC's assets after liabilities are deducted and consist of three sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable, and unrestricted. Net assets invested in capital assets, net of 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, 2008 and 2007, 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. There were no federal grants received during the year ended September 30, 2008. At September 30, 2007, grants, subsidies and capital contributions received from Pohnpei State amounted to \$223,893.

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.

Reclassification: Certain reclassifications have been made to the 2007 financial statements to correspond with the 2008 presentation.

New Accounting Standards: During fiscal year 2008, PUC implemented GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The implementation of this statement did not have a material effect on the financial statements of PUC.

**POHNPEI UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In May 2007, GASB issued Statement No. 50, *Pension Disclosures-an Amendment of GASB Statements No. 25 and 27*, which amends applicable note disclosure and RSI requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27 *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and Statement No. 45 *Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions*. The provisions of this statement are effective for periods beginning after June 15, 2007. Management does not believe the implementation of this statement will have a material effect on the financial statements of PUC.

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

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Notes to Financial Statements  
September 30, 2008 and 2007

(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 of Directors 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 PUC's name;
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in 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 in 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, 2008 and 2007, the carrying amount of PUC's total cash and cash equivalents and time certificates of deposit was \$569,928 and \$710,937, respectively, and the corresponding bank balances were \$709,860 and \$776,617, respectively. Of the bank balances, \$569,156 and \$710,165, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2008 and 2007, 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. PUC has not experienced any losses on such accounts and management believes it is not exposed to any significant credit risk on its deposits.

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Notes to Financial Statements  
September 30, 2008 and 2007

(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;
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in 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, 2008 and 2007, investments in mutual funds at fair value are \$317,000 and \$824,390, 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, 2008 and 2007.

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, 2008 and 2007.

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 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 PUC. As of September 30, 2008 and 2007, the carrying amount of the fund is \$143,970 and \$139,390, respectively, which is presented as a restricted investment in the accompanying statements of net assets.



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Notes to Financial Statements  
September 30, 2008 and 2007

(3) Self Insurance Fund and Risk Management, Continued

At September 30, 2007, PUC carried life insurance on behalf of its employees and maintained a comprehensive business policy and workmen's compensation insurance. During the year ended September 30, 2008, these policies lapsed and have not been renewed. As a result, PUC is self-insured for all losses such as torts; theft or damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Management is of the opinion that no material losses have been sustained as a result of this practice during the past three years.

(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. At September 30, 2007, the carrying amount of the fund is \$3,881, which is presented as restricted cash and cash equivalents in the accompanying statements of net assets. During the year ended September 30, 2008, PUC terminated the program and as such, fund balance was released back as unrestricted cash and cash equivalents in the accompanying statements of net assets.

(5) Accounts Receivable

In 2007 and most of 2008, bills are issued to customers near mid-month approximately one month subsequent to providing utilities services. Effective July 1, 2008, PUC changed its policy and reads meters on the 1<sup>st</sup> day following the month that the services were provided. Therefore, approximately thirty days and forty-five days of service, respectively, is accrued at September 30, 2008 and 2007, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2008 and 2007, are summarized as follows:

	<u>2008</u>	<u>2007</u>
Accounts receivable - electrical:		
Residential	\$ 1,259,841	\$ 1,451,662
Commercial	547,457	532,895
Government	167,377	184,560
Unbilled	<u>523,921</u>	<u>573,426</u>
	<u>2,498,596</u>	<u>2,742,543</u>
Accounts receivable - water and sewer:		
Residential	1,455,065	1,246,901
Commercial and government	126,826	118,659
Unbilled	<u>111,991</u>	<u>147,606</u>
	<u>1,693,882</u>	<u>1,513,166</u>
Installment receivables	<u>91,604</u>	<u>96,962</u>
	4,284,082	4,352,671
Other	<u>106,051</u>	<u>135,911</u>
	4,390,133	4,488,582
Less allowance for doubtful receivables	<u>(2,523,743)</u>	<u>(2,321,143)</u>
	<u>\$ 1,866,390</u>	<u>\$ 2,167,439</u>

**POHNPEI UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2008 and 2007

**(5) Accounts Receivable, Continued**

PUC commenced a prepaid cash power meter system in which a portion of customer payments are used to satisfy balances in arrears. Percentages of collection are applied to arrears at the time of purchase. In April 2007, the policy was to apply 90% of the collection to arrears, but this was reduced to 75% in June 2007, and was further reduced to 50% in October 2007. As of September 30, 2008 and 2007, gross receivables from customers enrolled in the cash power meter system are \$879,178 and \$1,063,534, respectively.

**(6) Utility Plant**

A summary of changes in capital assets for the years ended September 30, 2008 and 2007 is as follows:

	Beginning Balance <u>October 1, 2007</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2008</u>
<b><u>Depreciable assets:</u></b>					
Production plant	\$ 21,750,155	\$ -	\$ -	\$ -	\$ 21,750,155
Distribution plant	14,195,705	25,534	-	-	14,221,239
General plant	<u>1,614,271</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,614,271</u>
Electric plant in service	<u>37,560,131</u>	<u>25,534</u>	<u>-</u>	<u>-</u>	<u>37,585,665</u>
Water production plant	6,357,862	-	-	-	6,357,862
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	6,879,995	-	-	50,388	6,930,383
General plant	<u>556,888</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>556,888</u>
Water and sewer plant in service	<u>19,307,046</u>	<u>-</u>	<u>-</u>	<u>50,388</u>	<u>19,357,434</u>
Total utility plant in service	56,867,177	25,534	-	50,388	56,943,099
Less accumulated depreciation	<u>(28,638,532)</u>	<u>(2,104,930)</u>	<u>-</u>	<u>-</u>	<u>(30,743,462)</u>
	<u>28,228,645</u>	<u>(2,079,396)</u>	<u>-</u>	<u>50,388</u>	<u>26,199,637</u>
<b><u>Non-depreciable assets:</u></b>					
<b>Construction work-in-progress:</b>					
Electric plant	32,706	3,205	-	(22,111)	13,800
Water and sewer plant	<u>130,412</u>	<u>6,648</u>	<u>-</u>	<u>(92,573)</u>	<u>44,487</u>
	<u>163,118</u>	<u>9,853</u>	<u>-</u>	<u>(114,684)</u>	<u>58,287</u>
	\$ <u>28,391,763</u>	\$ <u>(2,069,543)</u>	\$ <u>-</u>	\$ <u>(64,296)</u>	\$ <u>26,257,924</u>
	Beginning Balance <u>October 1, 2006</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2007</u>
<b><u>Depreciable assets:</u></b>					
Production plant	\$ 20,743,497	\$ 1,006,658	\$ -	\$ -	\$ 21,750,155
Distribution plant	13,903,490	292,215	-	-	14,195,705
General plant	<u>1,475,881</u>	<u>138,390</u>	<u>-</u>	<u>-</u>	<u>1,614,271</u>
Electric plant in service	<u>36,122,868</u>	<u>1,437,263</u>	<u>-</u>	<u>-</u>	<u>37,560,131</u>
Water production plant	5,365,165	992,697	-	-	6,357,862
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	6,652,057	227,938	-	-	6,879,995
General plant	<u>556,888</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>556,888</u>
Water and sewer plant in service	<u>18,086,411</u>	<u>1,220,635</u>	<u>-</u>	<u>-</u>	<u>19,307,046</u>

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Notes to Financial Statements  
September 30, 2008 and 2007

**(6) Utility Plant, Continued**

Total utility plant in service	54,209,279	2,657,898	-	-	56,867,177
Less accumulated depreciation	<u>(26,554,184)</u>	<u>(2,084,348)</u>	-	-	<u>(28,638,532)</u>
	<u>27,655,095</u>	<u>573,550</u>	-	-	<u>28,228,645</u>
<b>Non-depreciable assets:</b>					
Construction work-in-progress:					
Electric plant	1,098,520	445,572	(1,511,386)	-	32,706
Water and sewer plant	<u>1,158,778</u>	<u>225,122</u>	<u>(1,253,488)</u>	-	<u>130,412</u>
	<u>2,257,298</u>	<u>670,694</u>	<u>(2,764,874)</u>	-	<u>163,118</u>
	<u>\$ 29,912,393</u>	<u>\$ 1,244,244</u>	<u>\$ (2,764,874)</u>	<u>\$ -</u>	<u>\$ 28,391,763</u>

**(7) Notes Payable and Long-Term Debt**

Notes payable consist of the following at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Notes drawn on a bank line of credit of \$100,000 and \$190,000 as of September 30, 2008 and 2007, respectively (line expiry on December 7, 2008 and March 24, 2008, respectively), interest at time certificate of deposit (TCD) rate plus 2% (6.10% and 5.94% at September 30, 2008 and 2007, respectively), collateralized by TCD.	\$ 100,000	\$ 190,000
Two \$104,000 notes drawn on a bank line of credit of \$850,000 (line expiry May 9, 2008), interest at bank prime rate plus 2% (9.75% at September 30, 2007) due on November 27, 2007 and December 27, 2007, collateralized by TCD and equipment.	-	208,000
Note to an investment company, interest at 9.25%, collateralized by investments.	-	<u>476,825</u>
<b>Total notes payable</b>	<b>\$ <u>100,000</u></b>	<b>\$ <u>874,825</u></b>

Changes in notes payable for the years ended September 30, 2008 and 2007, are as follows:

	<u>Outstanding September 30, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2008</u>
Notes to a bank	\$ 398,000	\$ 475,122	\$ (773,122)	\$ 100,000
Note to an investment company	<u>476,825</u>	<u>-</u>	<u>(476,825)</u>	<u>-</u>
	<u>\$ 874,825</u>	<u>\$ 475,122</u>	<u>\$ (1,249,947)</u>	<u>\$ 100,000</u>

**POHNPEI UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2008 and 2007

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

	<u>Outstanding September 30, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2007</u>
Notes to a bank	\$ 190,000	\$ 208,000	\$ -	\$ 398,000
Note to an investment company	<u>453,647</u>	<u>23,178</u>	<u>-</u>	<u>476,825</u>
	<u>\$ 643,647</u>	<u>\$ 231,178</u>	<u>\$ -</u>	<u>\$ 874,825</u>

The proceeds from the notes payable were used to finance PUC's operating activities.

Long-term debt consists of the following at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</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 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 was paid by the State of Pohnpei during the years ended September 30, 2008 and 2007.	\$ 2,022,848	\$ 2,096,260
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%.	565,803	569,552
Loan payable to FSM Development Bank, 5 year term, interest at 9%, collateralized by a \$150,000 time certificate of deposit, receivables, inventory and property, plant and equipment. Monthly principal and interest installments of \$10,379 commencing July 2007. A member of the PUC Board is also a member of management of the FSM Development Bank.	388,518	479,963
Loan payable to Bank of the Federated States of Micronesia (BoFSM), 5 year term, interest at 9%, collateralized by one unit of diesel power comprehensive generator plant, two units of Daihatsu model 12D532 engines, building and materials, and existing and future receivables. Monthly principal and interest installments of \$9,794 commencing September 15, 2008. First payment was made in October 2008.	<u>773,122</u>	<u>-</u>
Total long-term debt	3,750,291	3,145,775
Less: current portion of long-term debt	<u>199,694</u>	<u>134,922</u>
Long-term portion of long-term debt	<u>\$ 3,550,597</u>	<u>\$ 3,010,853</u>

The proceeds from long-term debt were previously used to acquire utility plant.

**POHNPEI UTILITIES CORPORATION**  
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Notes to Financial Statements  
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(7) Notes Payable and Long-Term Debt, Continued

At September 30, 2008, PUC is not in compliance with several debt covenants contained in the loan agreement with the Bank of the FSM. PUC is in the process of obtaining a waiver from the Bank and is of the opinion that no impact on the accompanying financial statements would result from resolution of this matter.

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>
2009	\$ 199,694	\$ 151,026	\$ 350,720
2010	211,477	129,449	340,926
2011	226,999	113,927	340,926
2012	203,032	97,449	300,481
2013	596,227	84,105	680,332
2014-2018	297,029	197,211	494,240
2019-2023	321,160	173,080	494,240
2024-2028	348,782	145,458	494,240
2029-2033	380,645	113,595	494,240
2034-2038	417,677	76,563	494,240
2039-2043	461,035	33,205	494,240
2044	<u>86,534</u>	<u>806</u>	<u>87,340</u>
	<u>\$ 3,750,291</u>	<u>\$ 1,315,874</u>	<u>\$ 5,066,165</u>

Changes in non-current liabilities for the years ended September 30, 2008 and 2007, are as follows:

	<u>Outstanding September 30, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2008</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 479,963	\$ -	\$ (91,445)	\$ 388,518	\$ 93,373	\$ 295,145
Loan payable to Rural Utilities Service	569,552	-	(3,749)	565,803	6,520	559,283
Loan payable to Bank of the Federated States of Micronesia	-	773,122	-	773,122	52,741	720,381
Loan payable to Asian Development Bank	<u>2,096,260</u>	<u>-</u>	<u>(73,412)</u>	<u>2,022,848</u>	<u>47,060</u>	<u>1,975,788</u>
	<u>\$ 3,145,775</u>	<u>\$ 773,122</u>	<u>\$ (168,606)</u>	<u>\$ 3,750,291</u>	<u>\$ 199,694</u>	<u>\$ 3,550,597</u>
	<u>Outstanding September 30, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2007</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 67,451	\$ 500,000	\$ (87,488)	\$ 479,963	\$ 46,444	\$ 433,519
Loan payable to Rural Utilities Service	578,000	-	(8,448)	569,552	6,234	563,318
Loan payable to Asian Development Bank	<u>2,118,767</u>	<u>-</u>	<u>(22,507)</u>	<u>2,096,260</u>	<u>82,244</u>	<u>2,014,016</u>
	<u>\$ 2,764,218</u>	<u>\$ 500,000</u>	<u>\$ (118,443)</u>	<u>\$ 3,145,775</u>	<u>\$ 134,922</u>	<u>\$ 3,010,853</u>

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Notes to Financial Statements  
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(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 their operation.

(9) Grants, Subsidies and Capital Contributions

Grants, subsidies and capital contributions comprise the following for the year ended September 30, 2007:

	<u>2007</u>
Grants and Subsidies:	
U.S. Department of the Interior:	
Operations and maintenance improvement program:	
Easy power	\$ 50,000
Leak detection	20,000
Training	<u>9,200</u>
	79,200
South Pacific Applied Geoscience Commission:	
Tariff study	<u>19,940</u>
Total grants and subsidies	99,140
Capital Contributions:	
Department of the Interior (DOI)	<u>124,753</u>
	\$ <u>223,893</u>

PUC did not receive any grants, subsidies and capital contributions during the year ended September 30, 2008.

(10) Sinking Fund

During fiscal year 1998, PUC management established a sinking fund 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 mutual funds that have the following asset allocations at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Money market funds	\$ 173,030	\$ 17,355
U.S. Government obligations	-	163,083
Corporate bonds and others	-	140,655
Common stock	<u>-</u>	<u>363,907</u>
	\$ <u>173,030</u>	\$ <u>685,000</u>

During the year ended September 30, 2008, \$476,825 of the investments was liquidated to pay an outstanding note payable to an investment company in the same amount.

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Notes to Financial Statements  
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(11) 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 receive from the FSM Social Security System. The Plan is a contributory, defined contribution 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. In June 2008, PUC discontinued future employer contributions to the Plan until such time that PUC's financial standing improves.

Contributions to the Plan during the years ended September 30, 2008 and 2007 were \$46,292 and \$83,523, respectively. Management is of the opinion that the plan does not represent an asset or liability of PUC. At September 30, 2008 and 2007, plan assets were \$196,274 and \$1,130,264 respectively.

(12) Related Party

At September 30, 2008 and 2007, accounts receivable include amounts owed by the State of Pohnpei and its component units to PUC of \$159,070 and \$59,033, respectively. At September 30, 2008 and 2007, PUC also has a non-interest bearing advance from the PUC Social Club of \$44,817 and \$40,000, respectively. Further, at September 30, 2008, PUC has a non-interest bearing advance from the State of Pohnpei of \$33,500. These advances have no set repayment terms and are classified as current due to the mutual consent of the parties.

(13) Commitment and Contingencies

PUC is involved in various legal actions in the normal course of business, including a variety of legal actions and claims that seek monetary damages or punitive damages. Based on current information, including legal consultation, management believes any ultimate liability that may arise from these actions would not materially affect PUC's financial position, results of operations or cash flows. However, management's evaluation of likely impact of these actions could change in the future and an unfavorable outcome, depending upon the amount and timing, could have a material effect on PUC's results of operations or cash flows in the future period.

**POHNPEI UTILITIES CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Combining Statement of Net Assets  
September 30, 2008  
(With comparative totals as of September 30, 2007)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
<u>Assets</u>	2008	2007		2008	2007
<b>Current assets:</b>					
Cash and cash equivalents	\$ 708,660	\$ (510,253)	\$ -	\$ 198,407	\$ 357,056
Investments	173,030	-	-	173,030	685,000
Accounts receivable, net	1,018,872	847,518	-	1,866,390	2,167,439
Grants receivable	-	23,698	-	23,698	23,698
Prepayments	-	-	-	-	10,186
Fuel and material inventory	784,903	434,474	-	1,219,377	1,277,873
Total current assets	2,685,465	795,437	-	3,480,902	4,521,252
<b>Other noncurrent assets:</b>					
Restricted:					
Cash and cash equivalents	150,000	-	-	150,000	153,881
Time certificates of deposit	221,521	-	-	221,521	200,000
Investments	143,970	-	-	143,970	139,390
Interest receivable	1,130	-	-	1,130	1,130
Total other noncurrent assets	516,621	-	-	516,621	494,401
<b>Utility plant, at cost:</b>					
Electric plant in service	37,585,666	-	-	37,585,666	37,560,131
Water and sewer plant in service	-	19,357,434	-	19,357,434	19,307,046
	37,585,666	19,357,434	-	56,943,100	56,867,177
Less accumulated depreciation	(23,502,396)	(7,241,067)	-	(30,743,463)	(28,638,532)
Depreciable assets	14,083,270	12,116,367	-	26,199,637	28,228,645
Construction work-in-process	13,800	44,487	-	58,287	163,118
Total utility plant	14,097,070	12,160,854	-	26,257,924	28,391,763
	\$ 17,299,156	\$ 12,956,291	\$ -	\$ 30,255,447	\$ 33,407,416
<u>Liabilities and Net Assets</u>					
<b>Current liabilities:</b>					
Notes payable to bank	\$ 100,000	\$ -	\$ -	\$ 100,000	\$ 398,000
Notes payable to investment company	-	-	-	-	476,825
Current portion of long-term debt	146,114	53,580	-	199,694	134,922
Accounts payable:					
Operations	357,598	-	-	357,598	463,912
Affiliate	44,817	33,500	-	78,317	40,000
Deferred revenue	190,074	-	-	190,074	312,752
Accrued taxes and other liabilities	183,134	-	-	183,134	202,694
Employees' annual leave	91,135	-	-	91,135	92,433
Total current liabilities	1,112,872	87,080	-	1,199,952	2,121,538
<b>Noncurrent liabilities:</b>					
FSM Development Bank loan	295,145	-	-	295,145	433,519
RUS Water extension loan	-	559,283	-	559,283	563,318
Bank of the FSM	720,381	-	-	720,381	-
ADB Water extension loan	-	1,975,788	-	1,975,788	2,014,016
Total liabilities	2,128,398	2,622,151	-	4,750,549	5,132,391
<b>Net assets:</b>					
Invested in capital assets, net of related debt	13,306,951	9,572,203	-	22,879,154	24,769,163
Restricted	143,970	-	-	143,970	139,390
Unrestricted	1,719,837	761,937	-	2,481,774	3,366,472
Total net assets	15,170,758	10,334,140	-	25,504,898	28,275,025
	\$ 17,299,156	\$ 12,956,291	\$ -	\$ 30,255,447	\$ 33,407,416

See accompanying Independent Auditors' Report.



**POHNPEI UTILITIES CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Combining Statement of Revenues, Expenses and Changes in Net Assets  
Year Ended September 30, 2008  
(With comparative totals for the year ended September 30, 2007)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2008	2007
Operating revenues:					
Residential	\$ 200,167	\$ 823,312	\$ -	\$ 1,023,479	\$ 1,268,505
Commercial	3,110,859	123,855	-	3,234,714	2,293,352
Government	2,518,941	142,524	-	2,661,465	2,059,615
Cash power	6,808,477	-	-	6,808,477	5,663,152
Intercompany sales	62,650	-	(62,650)	-	-
Other sales	59,523	12,177	-	71,700	84,419
Total operating revenues before bad debts	12,760,617	1,101,868	(62,650)	13,799,835	11,369,043
Bad debts	(202,600)	-	-	(202,600)	-
Total operating revenues after bad debts	12,558,017	1,101,868	(62,650)	13,597,235	11,369,043
Operating and maintenance expenses:					
Production fuel	11,515,015	-	-	11,515,015	8,965,458
Depreciation	1,482,989	621,941	-	2,104,930	2,084,348
Administrative and general:					
Employee benefits	323,680	-	-	323,680	366,554
Salaries and wages	368,058	-	-	368,058	420,631
Vehicle, POL	127,839	-	-	127,839	157,999
General repairs	50,788	-	-	50,788	45,158
Consumables	48,093	-	-	48,093	51,732
Travel	13,394	-	-	13,394	21,461
Communications	58,521	-	-	58,521	48,793
Insurance	-	-	-	-	54,512
Contractual services	40,000	-	-	40,000	176,355
Training and safety	9,985	-	-	9,985	9,108
Customer service and collection	49,594	-	-	49,594	3,731
Legal fees	-	-	-	-	25
Utility	13,653	-	(13,653)	-	-
	1,103,605	-	(13,653)	1,089,952	1,356,059
Generation:					
Salaries and wages	314,720	-	-	314,720	393,498
Repairs and maintenance	129,907	-	-	129,907	426,499
Other production	5,820	-	-	5,820	15,129
	450,447	-	-	450,447	835,126
Water and sewer:					
Salaries and wages	-	527,586	-	527,586	568,339
Repairs and maintenance	-	75,718	-	75,718	91,825
Chemicals	-	30,661	-	30,661	59,391
Employee benefits	-	58,553	-	58,553	62,143
Other production	-	13,984	-	13,984	105,636
Training and safety	-	16,503	-	16,503	24,054
Utility expense	-	48,997	(48,997)	-	-
	-	772,002	(48,997)	723,005	911,388
Distribution:					
Salaries and wages	314,796	-	-	314,796	341,425
Repairs and maintenance	40,286	-	-	40,286	91,502
	355,082	-	-	355,082	432,927
Total operating expenses	14,907,138	1,393,943	(62,650)	16,238,431	14,585,306
Operating loss	(2,349,121)	(292,075)	-	(2,641,196)	(3,216,263)

See accompanying Independent Auditors' Report.

**POHNPEI UTILITIES CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Combining Statement of Revenues, Expenses and Changes in Net Assets, Continued  
Year Ended September 30, 2008  
(With comparative totals for the year ended September 30, 2007)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2008	2007
Nonoperating revenues:					
Interest (expense) income, net	(33,648)	(95,283)	-	(128,931)	(58,056)
Federal grants and subsidies	-	-	-	-	99,140
Spurline projects	-	-	-	-	16,363
Other income	-	-	-	-	225
	<u>(33,648)</u>	<u>(95,283)</u>	<u>-</u>	<u>(128,931)</u>	<u>57,672</u>
Total nonoperating revenues (expenses)					
Net loss before capital contributions	(2,382,769)	(387,358)	-	(2,770,127)	(3,158,591)
Capital contributions:					
Grants passed through from the United States Department of the Interior	-	-	-	-	124,753
	<u>(2,382,769)</u>	<u>(387,358)</u>	<u>-</u>	<u>(2,770,127)</u>	<u>(3,033,838)</u>
Change in net assets					
Net assets at beginning of year	<u>17,553,527</u>	<u>10,721,498</u>	<u>-</u>	<u>28,275,025</u>	<u>31,308,863</u>
Net assets at end of year	<u>\$ 15,170,758</u>	<u>\$ 10,334,140</u>	<u>\$ -</u>	<u>\$ 25,504,898</u>	<u>\$ 28,275,025</u>

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**

Board of Directors  
Pohnpei Utilities Corporation:

We have audited the financial statements of Pohnpei Utilities Corporation (PUC) as of and for the year ended September 30, 2008 and have issued our report thereon dated January 8, 2009. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PUC's internal control over financial reporting.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

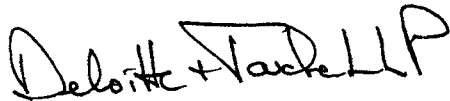
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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 grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of PUC in a separate letter dated January 8, 2009.

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

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

January 8, 2009