PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE REPUBLIC OF PALAU)

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2011 AND 2010

Deloitte.

Deloitte & Touche LLP
361 South Marine Corps Drive
Tamuning, GU 96913-3911
USA

Tel: (671)646-3884
Fax: (671)649-4932
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

Board of Directors
Public Utilities Corporation:

We have audited the accompanying statements of net assets of the Public Utilities Corporation (PUC), a component unit of the Republic of Palau, as of September 30, 2011 and 2010, and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of 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 PUC as of September 30, 2011 and 2010, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 11, 2012 on our consideration of the PUC's internal control over financial reporting and on 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.

The Management's Discussion and Analysis on pages 3 through 10 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, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Deloitte & Touche LLP

August 11, 2012

This Management's Discussion and Analysis (MD&A) presents the Public Utilities Corporation's (PUC) financial performance during the fiscal year ended September 30, 2011. Please read it in conjunction with the audited financial statements as of and for the year ended September 30, 2011, which follow this section.

In preparing this MD&A, forward-looking remarks about operational and/or financial matters may be used. Such remarks are usually identified by words such as "expected", "could", etc. Matters discussed in these remarks are subject to risks and changes. The reader should not assume such statements are guarantees.

MISSION AND OPERATIONS

As the electrification arm of the Palau national government, PUC is mandated by law to plan, develop and execute an electrification plan for the entire Republic. To date, PUC has succeeded in meeting its mandate with the exception of the three southern-most islands of Tobi, Sonsorol and Pulo Anna. Due to distance and isolation, electrification of these islands has been slow in developing.

PUC operates five (5) power systems throughout Palau. The two largest systems are located in Koror and Babeldaop (KB), feeding the KB grid that services roughly 95% of Palau's population. The remaining three smaller power systems are located in Peleliu, Angaur and Kayangel servicing less than five hundred people combined. PUC's power generation is fossil fuel driven which makes it vulnerable to spikes in the fuel market. The fuel market had stabilized after the 2008 crisis. However, we continue to see occasional resurgence of that volatility which makes electricity a significant cost in Palau's residential economics.

In step with the National Energy Policy (NEP), PUC has taken a bold step in the pursuit of renewable energy by the establishment of a new division in November 2010, tasked with research, exploration and development of PUC's renewable energy sector. This division, Renewable Energy Division, has already undertaken responsibility for the maintenance of the Ngerulmud Capitol Solar System as well as management and maintenance of PUC's solar system installed at the Palau International Airport. PUC endeavors to achieve the 30/20/20 vision of the NEP, which will yield savings in fuel, sparing PUC and its customers from the market's volatility. To date, PUC has achieved 2% of its goal of renewable energy platform systems.

In addition to energy alternatives, PUC continues its efforts toward fuel efficiency and reduction of energy losses with upgrades to its aging infrastructure and equipment. PUC has successfully installed two 5 megawatt (MW) generators at the Malakal Power Plant that were commissioned on August 11, 2011. PUC has also secured a contract for the purchase of newer, down-sized generators for the outlying states to replace the existing oversized units. Installation of these units is expected to be completed by early fiscal year 2013. Losses from these power systems due to oversized generators and small customer base have netted consistently at around $700K per year.

Shortly after fiscal year end, PUC suffered an unfortunate fire to its Aimeliik Power Plant, effectively decommissioning all four Pielstick generators, an 8MW power system. In collaboration with the national government, PUC promptly purchased and installed a 2MW Caterpillar (CAT) generator at the plant, while plans continue to progress towards a new power plant, which will be equipped with two new 5MW each generators through financial assistance from a foreign grantor agency. Preliminary preparations have commenced with expected construction to commence sometime in 2013.

FINANCIAL HIGHLIGHTS

On the financial side, the net loss this year of $69K is a significant improvement compared to the past several years. The improvement is the result of a combination of a stable fuel market, a responsive fuel rate adjustment mechanism in our tariff, and recovery of prior bad debt of $1.2M. The PUC Board of Directors has recently adopted a revised tariff to take effect October 1, 2012 or the first day of the following month after receipt of subsidy assistance from the national government, whichever occurs first. The new tariff reflects current operating costs and is designed to ensure PUC is able to meet all operating costs within certain constraints created by law.

The following summarizes PUC's financial position and revenues, expenses, and changes in net assets during the year.

Table 1
(Dollars in Thousands)

	Sept 30, 2011	Sept 30, 2010	Sept 30, 2009	Inc (Dec) 2011 to 2010	Inc (Dec) 2010 to 2009
Statement of Net Assets					
Current assets	$ 20,479	$ 17,480	$14,672	$ 2,999	$ 2,808
Other Assets	203	3,804	1,889	(3,601)	1,915
Net Utility Plant	26,262	23,277	25,547	2,985	(2,270)
Total Assets	46,944	44,561	42,108	2,383	2,453
Current Liabilities	10,018	7,057	6,555	2,961	502
Other Liabilities	8,607	9,117	6,616	(510)	2,501
Total Liabilities	18,625	16,174	13,171	2,451	3,003
Invested in Capital Assets	17,346	19,235	21,000	(1,889)	(1,765)
Unrestricted	10,973	9,152	7,937	1,821	1,215
Total Net Assets	$ 28,319	$ 28,387	$ 28,937	$ (68)	$ (550)
Revenues, Expenses, and Changes in Net Assets					
Operating Revenues:					
Electric	$ 25,172	$ 22,811	$ 20,010	$ 2,361	$ 2,801
Others	1,019	677	463	342	214
Recovery of (provision for) bad debts	1,193	(1,146)	(511)	2,339	(635)
Nonoperating Revenues/Expenses	(336)	283	304	(619)	(21)
Total Revenue	27,048	22,625	20,266	4,423	2,359
Operating Expenses:					
Generation fuel	20,130	15,804	15,185	4,326	619
Generation - other costs	2,686	2,614	3,343	72	(729)
Depreciation	1,833	2,614	2,538	(781)	76
Administration	1,104	1,139	921	(35)	218
Distribution and transmission	855	790	828	65	(38)
Engineering	410	324	151	86	173
Renewable energy	98	90	-	8	(90)
Total Operating Expenses	27,116	23,375	22,966	3,741	409
Contribution from ROP	-	200	-	(200)	(200)
Change in Net Assets	(68)	(550)	(2,700)	482	2,150
Beginning Net Assets	28,387	28,937	31,637	(550)	(2,700)
Ending Net Assets	$ 28,319	$ 28,387	$ 28,937	$ (68)	$ (550)

The following is a discussion of significant changes during the year:

- PUC acquired two (2) used 5MW generators with a prepayment made last year of $3.6M. This accounts for the increase in Plant Assets, net of disposals discussed above, and accounts for the decrease in Other Assets.
- In accordance with a Board of Directors resolution, PUC liquidated its investment to finance various capital improvement projects and maintenance/repair works, resulting in a decrease of roughly $2M in cash and cash equivalents.
- PUC's investment in inventory increased significantly because of a new fuel shipment received near year end. This accounts for the increase in inventory and a corresponding increase in current liabilities. Another contributing factor to PUC's current assets was a recovery of approximately $1.2M of bad debt as a result of a settlement entered into with an affiliate shortly after year end. The aggregate of these factors, net of the decrease to cash and equivalents discussed above, accounts for the current year increase in current assets.
- Electric sales increase this year reflects rate changes actuated by fuel price increases. On the expense side, fuel continues to dominate operating costs comprising 74% of total operating expenses (2010 was 68%). The increase in the fuel share of total operating costs is attributed directly to fuel price. Another significant change in operating costs this year was depreciation which decreased by 30% from prior year. During the year, PUC retired two of its three 1.7MW Wartsila generators which had suffered irreparable damages. PUC also fully depreciated all four Pielstick units at the Aimeliik Power Plant due to age, which coincidentally suffered material damage by fire shortly after year-end. All other operating costs remained consistent with the prior year except Engineering Services which increased by 27% as a result of increased professional engineering staff, a move intended to stabilize operations and maintenance planning and improve power quality and supply stability.
- PUC's outstanding long-term debt continues to impact profitability with high dollar interests (over $200K this year). A receivable from a local bank was written down by $167K as recovery proceeds fade with further liquidation of bank assets.

The adoption of the new rates is a positive move and is expected to ensure solvency and corporate preparedness for the ongoing power generation and fuel market challenges.

CAPITAL ASSETS and LONG-TERM DEBT

Capital Assets

Investment in capital assets has been minimal in the past due to tight cash flow. At the end of FY 2011, PUC had invested in a broad range of utility capital assets, including its power generation plants, electric transmission and distribution infrastructure, and general support and administrative equipment. PUC's investment in capital assets increased by $4.6M to $55.7M at the end of this fiscal year. Net of depreciation, capital assets are valued at $26M. Refer below for details of this year's additions.

The following table summarizes PUC's capital assets by category and accumulated depreciation, and the changes therein for the years ended September 30, 2011, 2010, and 2009, respectively.

CAPITAL ASSETS AND ACCUMULATED DEPRECIATION
(Dollars in Thousands)

CAPITAL ASSETS:	Sept 30, 2011	Sept 30, 2010	Sept 30, 2009	Increase (Decrease) 2011 to 2010	Increase (Decrease) 2010 to 2009
Electric Plants:					
Electric Plants, Koror/Aimeliik	$ 29,280	$ 24,874	$ 26,757	$ 4,406	$ (1,883)
Electric Plants, Outlying States	2,378	2,378	2,378	-	-
Total Electric Plants	31,658	27,252	29,135	4,406	(1,883)
Accumulated Depreciation	(17,866)	(16,809)	(16,733)	(1,057)	(76)
Net Electric Plant	13,792	10,443	12,402	3,349	(1,959)
Transmission & Distribution (T&D) System					
T&D System, Koror/Aimeliik	17,263	17,203	17,197	60	6
T&D System, Outlying States	2,090	2,090	2,090	-	-
Total T&D System	19,353	19,293	19,287	60	6
Accumulated Depreciation	(8,775)	(8,226)	(7,674)	(549)	(552)
Net T&D System	10,578	11,067	11,613	(489)	(546)
Administrative Equipment					
Buildings	1,399	917	909	482	8
Heavy Equipment & Vehicles	1,542	1,545	1,521	(3)	24
Tools & Maintenance Equipment	868	1,104	936	(236)	168
Computers & Office Equipment	647	664	622	(17)	42
Total Administrative Equipment	4,456	4,230	3,988	226	242
Accumulated Depreciation	(2,782)	(2,809)	(2,614)	27	(195)
Net Administrative Equipment	1,674	1,421	1,374	253	47
Capital Improvement Projects:					
2MW Caterpillar Generator	218	211	-	7	211
Aimeliik Power Plant Renovation	-	134	-	(134)	134
Pielstick Engine 3 Rehabilitation	-	-	-	-	-
Accounting & Billing Systems	-	-	158	-	(158)
Total Capital Projects in Progress	218	345	158	(127)	187
TOTAL CAPITAL ASSETS	$ 26,262	$ 23,276	$ 25,547	$ 2,986	$ (2,271)

The following major Capital Improvement Projects were completed during the year:

- Two almost new 5MW each Niigata generators $ 4,406K
- Malakal Auxiliary Building $ 178K
- Malakal Control Room $ 100K
- Aimeliik Renovation $ 172K

An ongoing Capital Improvement Project is an acquisition of a used 2MW CAT generator.

PUC's capital improvement plans are based on the master plan developed for PUC in FY2009. The master plan identifies forward-looking strategies based on externally developed assumptions about PUC's demographics and customer demands up to year 2025. The plan includes construction of a new power plant at Aimeliik with installation of six 5MW generators staggered every two years. The plan has been modified internally to include only the first two 5MW units, deferring the remaining units until an updated study can be made of energy demand and renewable energy plans.

Providentially, PUC received confirmation subsequent to fiscal year-end, of approval and award of financial assistance by a foreign development partner for the expansion of the Aimeliik Power Plant with 10MW of additional generation capacity by 2013/14. This is a most welcomed milestone in PUC's development plans and efforts are underway to formalize plans and set things in motion for the project.

PUC is continuing its efforts to augment generation with alternative renewable energy. A 225 (kilowatt) KW system was recently installed at the Palau International Airport parking lot, funded by a grant from a development partner. Transfer of ownership is pending execution of a Memorandum of Understanding with an affiliate, which was the official grant recipient. With this addition to existing third party renewable energy systems connected to the PUC grid, total renewable energy generation capacity add up to 377KW. Studies and plans are being developed for additional solar systems, wind power and hydro systems for the main power grid and hybrid systems for the Outlying States.

Please see note 7 to the financial statements for additional information regarding PUC's utility plant.

Long-Term Debt

At September 30, 2011, PUC's loan portfolio comprised the following:

	Original	Balance at Sept. 30, 2011
International Loan	$ 7,000,000	$ 6,200,000
Domestic Loan	$ 3,000,000	$ 2,925,051
TOTAL	$ 10,000,000	$ 9,125,051

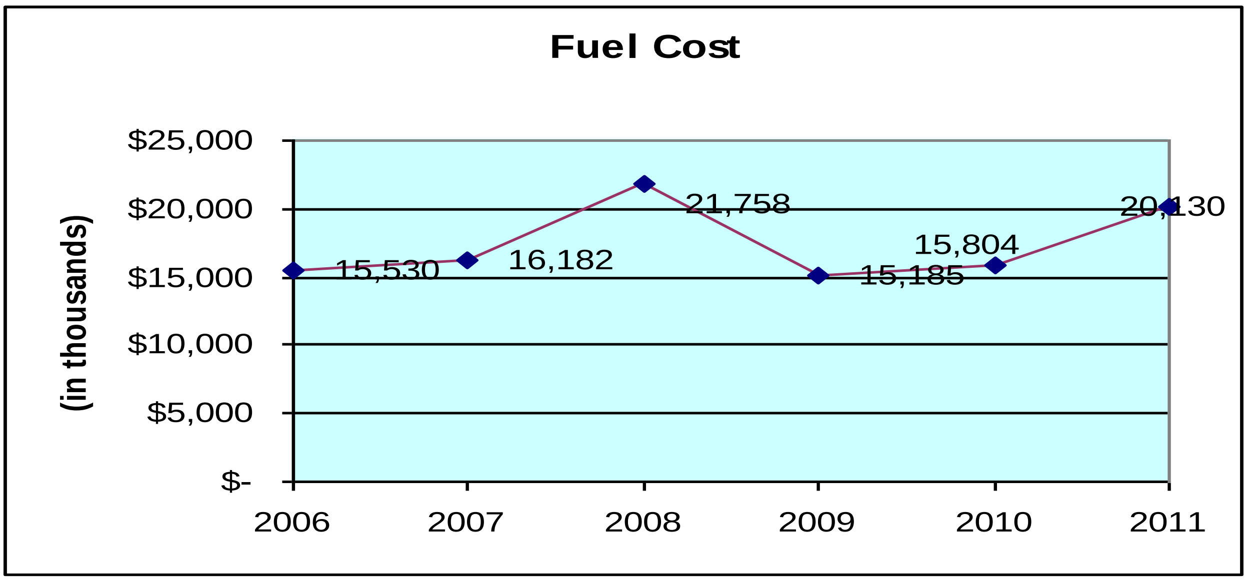
The above debts were acquired to purchase additional generation capacity and to finance major repairs and generation-related equipment. Please see note 8 to the financial statements for additional information regarding PUC's long-term debt.

ECONOMIC FACTORS AND OUTLOOK

Fuel Market

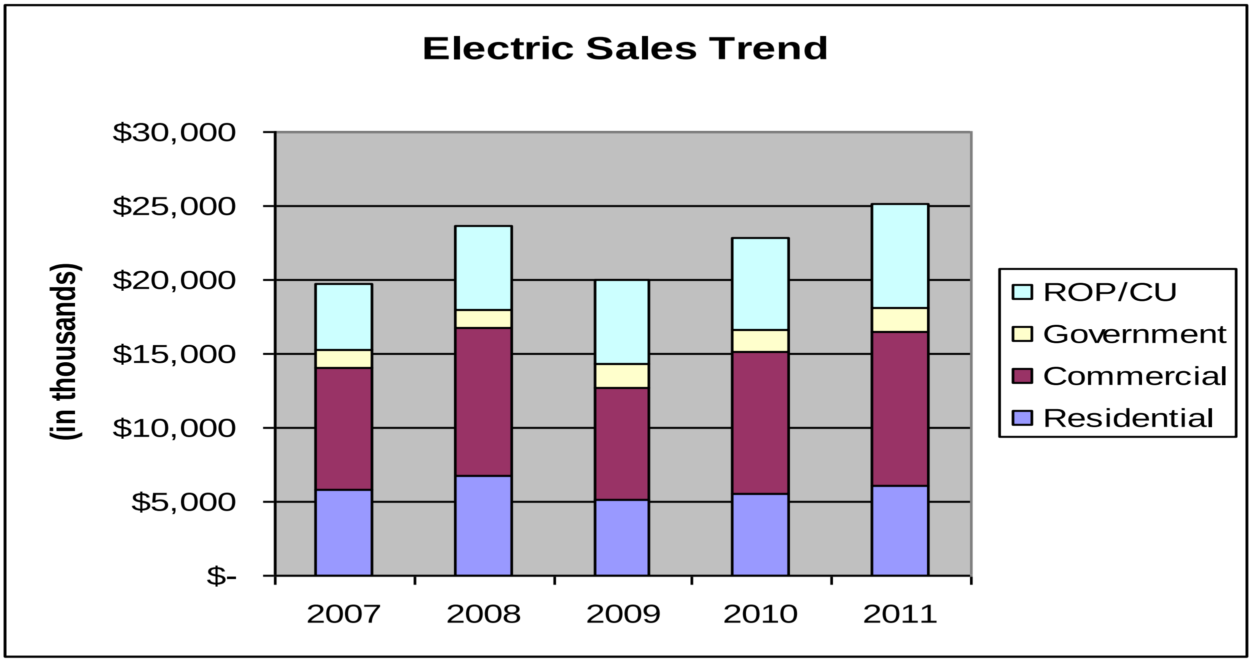
Fuel cost make up over 70% of PUC's operating costs. Due to size and location, PUC's dependence on fossil fuel is likely to continue for several years and price volatility will continue to be a germane factor in PUC's power supply scenario. At present, gasoil price appears steady despite tensions in the Middle East, reportedly due to depressed demand. However, as presented in the chart below, a flattened market is unlikely to remain long-term. PUC's vulnerability is clear and efforts will continue to try and contain this risk.

The cost trend of fuel for the past three years almost mirror the previous three years (see chart below). This movement highlights the volatility of the market and PUC's exposure.

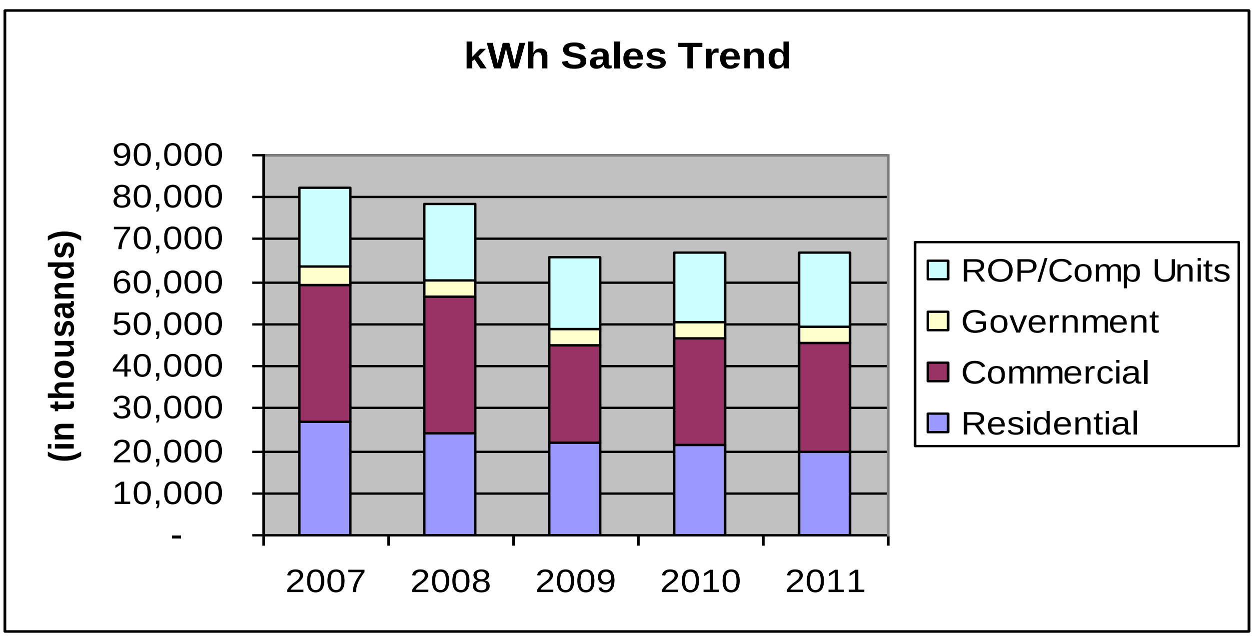


Various factors drive gasoil prices. Unabated tensions in the Middle East and economic outlook of the demand regions are contributing factors. Such factors are unpredictable and the drive for stable electric cost and global temperament towards environmental issues are making renewable energy a relevant, if not a significant, energy source in the future. PUC is continuing its efforts, aided by development partners, to diversify its energy source and reduce dependence on fossil fuel.

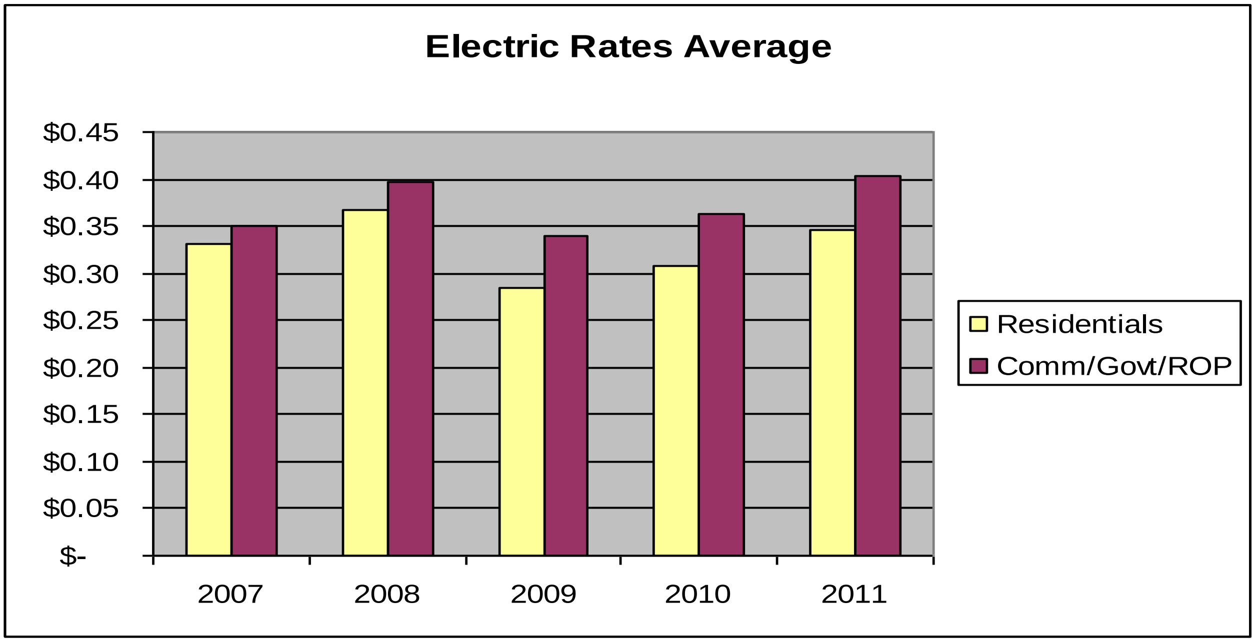
Fuel impact is evident in our sales performance. Sales see-sawed the last five years due to several factors, but primarily fuel price. The steep price spikes in the fuel market in 2008 provoked unforeseen energy conservation efforts which carried throughout 2009, resulting in a drop in sales by 16%. PUC saw steady recovery after 2009 as fuel price stabilized. The charts below illustrate this impact on sales performance.



Sales performance reflects movement in fuel price and energy demand. The 16% drop in 2009 resulted from energy conservation by customers.



Overall kWh unit sales dropped by 16% in 2009 and slightly rebounded in 2010 by 2% with no significant change in 2011.



The above chart reflects the simple average of electric rates of the past five years. Movement parallels actual sales performance. The electric rates are designed with a pass-through mechanism for fuel cost; accordingly, they will rise and fall in tandem with the world fuel market price.

FUTURE OUTLOOK

PUC will continue to exert efforts towards the NEP targets of 30/20/20. Renewable energy continues to attract development partners sympathetic to global warming issues. PUC's efforts should focus on energy diversification and generation upgrades to assure energy supply stability and to benefit from cutting-edge technological advances.

Palau's economic outlook appears fair as we await national elections late in the year and conclusion of the Compact of Free Association (COFA) negotiations. Renewed COFA terms will assure the national government and the local economy of steady capital inflow to sustain current and spur new economic initiatives. This spells a relief to PUC's bad debt problems with the national government being PUC's largest customer as well as the single largest employer on island.

CONTACTING PUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide PUC's rate payers and creditors with a general overview of PUC's finances and to demonstrate PUC's accountability for the money it receives. Management's Discussion and Analysis for the year ended September 30, 2010 is set forth in PUC's report on the audit of financial statements which is dated September 7, 2011. That Discussion and Analysis explains in more detail major factors impacting the 2010 financial statements. If you have questions about this report, or need additional information, contact the PUC Accounting Department at the Palau Public Utilities Corporation, P.O. Box 1372, Koror, Republic of Palau 96940, or e-mail jalexander@PUC.com or call (680) 488-5320.

PUBLIC UTILITIES CORPORATION

Statements of Net Assets
September 30, 2011 and 2010

ASSETS	2011	2010
Utility plant:		
Electric plant	$ 31,658,415	$ 27,251,933
General support equipment	23,279,285	22,746,036
Administrative equipment	529,495	776,907
Utility plant in service	55,467,195	50,774,876
Accumulated depreciation	(29,422,429)	(27,843,879)
Net utility plant in service	26,044,766	22,930,997
Construction in progress	218,055	345,390
Net utility plant	26,262,821	23,276,387
Current assets:		
Cash and cash equivalents	1,909,076	1,876,845
Restricted cash	207,907	1,954,168
Receivables:		
Trade	3,464,861	2,971,231
Affiliate	5,659,741	5,341,536
Contracts	239,115	-
Other	42,482	68,235
	9,406,199	8,381,002
Less allowance for doubtful accounts	(1,368,168)	(2,576,000)
Total receivables, net	8,038,031	5,805,002
Prepaid expenses	521,071	194,948
Inventory, net	9,792,074	7,621,630
Due from grantor agency	10,500	27,756
Total current assets	20,478,659	17,480,349
Other non-current assets:		
Contracts receivable, net of current portion	169,732	-
Receivable from a local bank, net	32,997	200,000
Deposit for new generators	-	3,604,156
Total other non-current assets	202,729	3,804,156
	$ 46,944,209	$ 44,560,892
LIABILITIES AND NET ASSETS		
Net assets:		
Invested in capital assets, net of related debt	$ 17,345,678	$ 19,234,711
Unrestricted	10,973,066	9,152,618
Total net assets	28,318,744	28,387,329
Commitments and contingencies		
Current liabilities:		
Current portion of long-term debt	517,743	483,491
Accounts payable	8,715,741	5,636,593
Accrued expenses	355,048	492,530
Customer deposits	429,625	444,440
Total current liabilities	10,018,157	7,057,054
Long-term debt, net of current portion	8,607,308	9,116,509
Total liabilities	18,625,465	16,173,563
	$ 46,944,209	$ 44,560,892

See accompanying notes to financial statements.

PUBLIC UTILITIES CORPORATION

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

	2011	2010
Operating revenues:		
Power	$ 25,172,146	$ 22,810,549
Other	1,018,950	677,241
Total operating revenues	26,191,096	23,487,790
Recovery of (provision for) uncollectible receivables	1,193,000	(1,145,740)
Net operating revenues	27,384,096	22,342,050
Operating expenses:		
Generation - fuel	20,129,991	15,804,013
Generation - other cost	2,685,605	2,614,425
Depreciation	1,833,162	2,613,498
Administration	1,104,118	1,139,363
Distribution and transmission	855,299	790,065
Engineering services	409,726	323,755
Renewable energy	98,410	89,556
Total operating expenses	27,116,311	23,374,675
Operating income (loss)	267,785	(1,032,625)
Nonoperating revenues (expenses):		
Grants from the United States Government	51,789	83,644
Interest income	1,238	1,159
Net increase in fair value of investments	-	165,376
Other grants from the Japan International Cooperation Agency	-	635,774
Loss on disposal of assets	(1,146)	(260,096)
Writedown of receivable from a local bank	(167,003)	-
Interest expense	(205,234)	(334,321)
Other	(16,014)	(8,806)
Total nonoperating revenues (expenses), net	(336,370)	282,730
Loss before capital contributions	(68,585)	(749,895)
Capital contributions:		
Contribution from the Republic of Palau	-	200,000
Change in net assets	(68,585)	(549,895)
Net assets at beginning of year	28,387,329	28,937,224
Net assets at end of year	$ 28,318,744	$ 28,387,329

See accompanying notes to financial statements.

PUBLIC UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Cash received from customers	$ 24,966,520	$ 19,958,374
Cash payments to suppliers for goods and services	(22,381,750)	(18,522,968)
Cash payments to employees for services	(2,291,895)	(2,143,887)
Net cash provided by (used for) operating activities	292,875	(708,481)
Cash flows from investing activities:		
Net change in restricted cash	1,746,261	(1,190,038)
Interest and dividends on investments and restricted cash	1,238	171,378
Other non-operating	(16,014)	(7,647)
Proceeds from sale and maturities of investment securities	-	15,738,454
Purchase of investment securities	-	(9,241,099)
Net cash provided by investing activities	1,731,485	5,471,048
Cash flows from non-capital financing activities:		
Cash received from grantor agencies	69,045	85,278
Proceeds from short-term borrowings	-	440,000
Payments under a capital lease	-	(113,033)
Principal payment on short-term borrowings	-	(3,107,132)
Interest paid on short-term debt	-	(67,175)
Change in other liabilities	-	(16,147)
Net cash provided by (used for) non-capital financing activities	69,045	(2,778,209)
Cash flows from capital and related financing activities:		
Deposit for new generators	-	(3,604,156)
Proceeds from long-term borrowings	-	3,000,000
Principal payment on long-term debt	(474,949)	(400,000)
Interest paid on long-term debt	(369,639)	(151,642)
Acquisition of utility plant	(1,216,586)	(403,125)
Net cash used for capital and related financing activities	(2,061,174)	(1,558,923)
Net change in cash and cash equivalents	32,231	425,435
Cash and cash equivalents at beginning of year	1,876,845	1,451,410
Cash and cash equivalents at end of year	$ 1,909,076	$ 1,876,845
Reconciliation of operating income (loss) to net cash provided by (used for) operating activities:		
Operating income (loss)	$ 267,785	$ (1,032,625)
Adjustments to reconcile operating income (loss) to net cash provided by (used for) operating activities:		
Depreciation	1,833,162	2,613,498
(Recovery of) provision for uncollectible receivables	(1,193,000)	1,145,740
(Increase) decrease in assets:		
Receivables:		
Trade	(508,462)	(758,191)
Affiliate	(318,205)	(2,660,101)
Contracts	(408,847)	-
Other	25,753	(434)
Prepaid expenses	(326,123)	(67,842)
Inventory	(2,170,444)	(3,031,765)
Increase (decrease) in liabilities:		
Accounts payable	3,079,148	3,194,647
Accrued expenses	26,923	(27,317)
Customer deposits	(14,815)	(84,091)
Net cash provided by (used for) operating activities	$ 292,875	$ (708,481)

See accompanying notes to financial statements.

PUBLIC UTILITIES CORPORATION

Statements of Cash Flows, Continued
Years Ended September 30, 2011 and 2010

Non-cash transactions:

In 2011, deposits of $3,604,156 were applied to utility plant purchases.

PUC recorded a net $165,376 increase in fair value of investments for the year ended September 30, 2010.

PUC recorded noncash contributions of $200,000 and $635,774 representing a generator and various power plant supplies, respectively, at September 30, 2010.

See accompanying notes to financial statements.

(1) Organization

The Public Utilities Corporation (PUC), a component unit of the Republic of Palau (ROP), was created on July 6, 1994, under the provisions of Republic of Palau Public Law (RPPL) 4-13. The law created a wholly-owned government corporation governed by a Board of Directors appointed by the President of the ROP, with the advice and consent of the Senate of the Olbiil Era Kelulau (ROP National Congress). The primary purpose of PUC is to establish and operate electrical utility services within ROP.

PUC's financial statements are incorporated into the financial statements of ROP as a component unit.

(2) Summary of Significant Accounting Policies

Basis of Accounting

The accounting policies of PUC conform to accounting principles generally accepted in the United States of America (GAAP), as applicable to governmental entities, specifically proprietary funds. PUC utilizes the flow of economic resources measurement focus. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. 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 Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989, except those that conflict with a GASB pronouncement. PUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

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 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 other net assets are unrestricted.

Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, demand deposits and time certificates of deposit with original maturities of three months or less.

(2) Summary of Significant Accounting Policies, Continued

Receivables

PUC grants credit, on an unsecured basis, to individuals, businesses and governmental entities situated in the Republic of Palau. The allowance for doubtful accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluation of the collectability of these accounts and prior collection experience. The allowance is established through a provision for uncollectible receivables charged to expense.

Inventory

Inventories of fuel and supplies are stated at the lower of cost (first-in, first-out) or market (net realizable value).

Utility Plant

Utility plant is stated at cost. Donated utility plant is recorded at fair market value at the date of donation or at the donating entity's basis in the asset if donated by ROP or an ROP agency. PUC capitalizes utility plant with a cost of $500 or more. Depreciation is computed using the straight-line method over the estimated useful lives of the respective assets.

Capitalization of Interest

PUC capitalizes interest in order to recognize all costs associated with construction based on PUC's weighted average borrowing rate. During the years ended September 30, 2011 and 2010, $187,263 and $93,180, respectively, of eligible interest was capitalized.

New Accounting Standards

During fiscal year 2011, PUC implemented the following pronouncements:

- GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions.

- GASB Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools.

The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement 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*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method were effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that implementation of this statement will have a material effect on the financial statements of PUC.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements,* which addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus,* which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity,* and No. 34*, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain FASB and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In July 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In July 2011, GASB issued Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions (an amendment of GASB Statement No. 53),* which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The provisions of this statement are effective for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

Sales of Electricity

Sales of electricity are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the most recent cycle billing. Unbilled revenues at September 30, 2011 and 2010 were $1,688,731 and $1,456,870, respectively.

(2) Summary of Significant Accounting Policies, Continued

Retirement Plan

PUC contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing, multiple employer pension plan established and administered by the Republic of Palau.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the Republic of Palau, Republic of Palau State Governments and Republic of Palau agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Normal benefits are the credited total service up to a maximum of thirty years total service. Generally, benefits vest after three years of credited service. Members who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. RPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPL 2-26 at six percent (6%) of total payroll and matched dollar for dollar by the employer. PUC contributed $103,690, $97,503 and $85,865 to the Fund during the fiscal years 2011, 2010 and 2009, respectively, which were equal to the required contributions for the respective years then ended.

Under the provisions of RPPL 2-26, the Fund's Board of Trustees adopted a Trust Fund Operation Plan which has the force and effect of law, and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code. PUC's total payroll, except expatriate workers, for fiscal years 2011 and 2010 is covered by the Fund's plan. The Fund utilizes the actuarial cost method termed "aggregate cost method" with actuarial assumptions used to compute the pension benefit obligation as follows: (a) a rate of return of 8.5% per year on the investment of present and future assets, (b) a 3% increase in employee salaries until retirement, and (c) members are assumed to retire at their normal retirement date.

The pension benefit obligation, which is the actuarial present value of credited projected benefits, is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and any step-rate benefits, estimated to be payable in the future as a result of employment service to date. The measure is intended to assist users to evaluate the Fund's funding status on a going-concern basis, and evaluate progress made in accumulating adequate assets to pay benefits when due.

The Fund's October 1, 2009 actuarial valuation determined the unfunded pension benefit obligation as follows:

Participants in pay status	$ 47,666,805
Active participants	56,060,970
Participants with vested deferred benefits	1,779,610
Total pension benefit obligation	105,507,385
Net assets available for benefits, at market value	(41,254,319)
Unfunded benefit obligation	$ 64,253,066

The Fund issues a publicly available financial report that includes financial statements and required supplemental information. That report may be obtained by writing to the Republic of Palau Civil Service Pension Plan, P.O. Box 1767, Koror, Palau 96940.

(2) Summary of Significant Accounting Policies, Continued

Taxes

Based on enactment of RPPL 4-13, PUC is exempt from all national and state non-payroll taxes or fees.

Compensated Absences

Accumulated unpaid annual leave is accrued when earned and is included in the statements of net assets as an accrued expense. Accumulated unused sick pay benefit is accrued at 25% of the sick leave hours recorded times the employee regular base rate, and is included in the statements of net assets as an accrued expense.

Operating and Non-Operating Revenues and Expenses

Operating revenues and expenses include all direct and administrative revenues and expenses associated with the generation and distribution of electricity to customers in the Republic of Palau.

Non-operating revenues and expenses result from investing and financing activities, including operating and capital grants from other governmental entities.

(3) Cash and Cash Equivalents and Restricted Cash

Cash and Cash Equivalents

GASB Statement No. 3 previously required government entities to categorize cash to give an indication of the level of risk assumed by the entity at year-end. The three categories are described below:

Category 1 Insured or registered with securities held by PUC or its agent in PUC's name;

Category 2 Uninsured and unregistered, but collateralized with securities held by the broker's or dealer's trust department or agent in PUC's name; or

Category 3 Uninsured and unregistered, with securities held by the broker or dealer, or by its trust department or agent but not in PUC's name.

GASB Statement No. 40 amended GASB Statement No. 3 to eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, 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. PUC does not have a deposit policy for custodial credit risk.

(3) Cash and Cash Equivalents and Restricted Cash, Continued

Cash and Cash Equivalents, Continued

As of September 30, 2011 and 2010, cash and cash equivalents and restricted cash were $2,116,983 and $3,831,013, respectively, and the corresponding bank balances were $2,698,460 and $5,574,632, respectively. Of these amounts, $1,461,276 and $2,625,502, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance; while $653,768 and $2,949,130 as of September 30, 2011 and 2010, respectively, are held and administered by investment managers subject to Securities Investor Protection Corporation Insurance. As of September 30, 2011 and 2010, bank deposits of $1,985,211 and $351,239, respectively, were FDIC insured. PUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage and deposits in financial institutions not subject to FDIC coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

Restricted Cash

PUC's restricted cash of $207,907 and $1,954,168 as of September 30, 2011 and 2010, respectively, represent the unspent portion of proceeds from PUC's loan with a foreign bank (see note 8).

(4) Due from Grantor Agency

PUC is a subrecipient of federal grants received by ROP from a U.S. federal agency. Excess grant disbursements over receipts are recognized as due from grantor agencies until funds are received in accordance with grant terms and conditions.

Changes in the due from grantor agency accounts for the years ended September 30, 2011 and 2010, are as follows:

	2011	2010
Balance at beginning of year	$ 27,756	$ 29,390
Additions - program outlays	51,789	83,644
Deductions - cash receipts from grantor agencies	(69,045)	(85,278)
Balance at end of year	$ 10,500	$ 27,756

(5) Receivable from a Local Bank

At September 30, 2011 and 2010, PUC has uninsured deposits of $2,058,378 with a bank that went into receivership on November 7, 2006. These deposits are reflected net of allowances of $2,025,381 and $1,858,378 at September 30, 2011 and 2010 and are recorded as a receivable from a local bank in the accompanying statements of net assets.

(6) Inventory

Inventory at September 30, 2011 and 2010, consists of the following:

	2011	2010
Distribution and power plant supplies	$ 4,565,951	$ 4,194,974
Fuel	5,378,684	3,589,735
Lubricants	21,907	11,389
	9,966,542	7,776,098
Provision for slow moving inventory	(174,468)	(174,468)
	$ 9,792,074	$ 7,621,630

(7) Utility Plant and Construction in Progress

Utility plant and construction in progress consist of the following detailed balances at September 30, 2011 and 2010:

	Estimated Useful Lives	Balance at October 1, 2010	Additions and Transfers	Deletions and Transfers	Balance at September 30, 2011
Depreciable assets:					
Electric plant	3 - 25 years	$ 27,251,933	$ 4,406,482	$ -	$ 31,658,415
General support equipment	2 - 30 years	22,746,036	541,595	(8,346)	23,279,285
Administrative equipment	2 - 10 years	776,907	-	(247,412)	529,495
		50,774,876	4,948,077	(255,758)	55,467,195
Less accumulated depreciation		(27,843,879)	(1,833,162)	254,612	(29,422,429)
		22,930,997	3,114,915	(1,146)	26,044,766
Non-depreciable assets:					
Construction in progress		345,390	4,761,085	(4,888,420)	218,055
		$ 23,276,387	$ 7,876,000	$ (4,889,566)	$ 26,262,821

	Estimated Useful Lives	Balance at October 1, 2009	Additions and Transfers	Deletions and Transfers	Balance at September 30, 2010
Depreciable assets:					
Electric plant	3 - 25 years	$ 29,135,444	$ 115,500	$ (1,999,011)	$ 27,251,933
General support equipment	2 - 30 years	22,708,297	90,389	(52,650)	22,746,036
Administrative equipment	2 - 10 years	565,573	211,334	-	776,907
		52,409,314	417,223	(2,051,661)	50,774,876
Less accumulated depreciation		(27,020,545)	(2,613,498)	1,790,164	(27,843,879)
		25,388,769	(2,196,275)	(261,497)	22,930,997
Non-depreciable assets:					
Construction in progress		158,087	439,117	(251,814)	345,390
		$ 25,546,856	$ (1,757,158)	$ (513,311)	$ 23,276,387

(8) Long-Term Debt

On September 4, 2006, PUC entered into a loan with a foreign bank not to exceed $7,000,000 with interest at 3.5% per annum to finance the purchase of portable generators, a crankshaft assembly and other necessary equipment to facilitate the overhaul of aging generators. The loan is guaranteed by the Republic of Palau and is to be repaid in thirty-five consecutive semi-annual principal installments of $200,000 plus interest; the first installment being repaid on the last day of the thirty-sixth month from the date of the initial advance and thereafter semi-annually on the last day of each successive six-month period, until fully paid.

On April 21, 2010, PUC entered into a loan with a development bank, an affiliated organization, for $3,000,000 to finance the purchase of two generator sets. The loan is collateralized by the generator sets inclusive of auxiliary equipment. The loan bears interest of 7.5% per annum and is to be repaid monthly beginning January 30, 2011 in principal payments of $27,810 plus accrued interest. Payment of interest during the eight month grace period will be spread over twelve months with an equal payment of $12,500 per month starting January 30, 2011.

Principal payments for subsequent years ending September 30 and applicable interest due, are as follows:

Year Ending September 30,	Principal	Interest	Total
2012	$ 517,743	$ 514,520	$ 1,032,263
2013	527,504	404,185	931,689
2014	537,401	380,092	917,493
2015	548,068	355,231	903,299
2016	559,060	330,473	889,533
2017 - 2021	3,003,413	1,229,468	4,232,881
2022 - 2026	3,231,862	424,305	3,656,167
2027	200,000	1,400	201,400
	$ 9,125,051	$ 3,639,674	$ 12,764,725

Movements in long-term liabilities for the years ended September 30, 2011 and 2010, are as follows:

	Balance at October 1, 2010	Additions	Repayments	Balance at September 30, 2011	Balance Due in One Year
Long-term debt	$ 9,600,000	$ -	$ (474,949)	$ 9,125,051	$ 517,743
	$ 9,600,000	$ -	$ (474,949)	$ 9,125,051	$ 517,743

	Balance at October 1, 2009	Additions	Repayments	Balance at September 30, 2010	Balance Due in One Year
Long-term debt	$ 7,000,000	$3,000,000	$ (400,000)	$ 9,600,000	$ 483,491
Other liabilities	16,147	-	(16,147)	-	-
	$ 7,016,147	$3,000,000	$ (416,147)	$ 9,600,000	$ 483,491

(9) Related Party Transactions

Utility services of $7,097,470 and $6,252,423 were rendered to ROP for the years ended September 30, 2011 and 2010, respectively. PUC provides electrical utility services to ROP at the same rates charged to third parties.

Receivables of $5,659,741 and $5,341,536 (gross of allowance for doubtful accounts of $1,056,000 and $2,284,000) are due from ROP as of September 30, 2011 and 2010, respectively. Of these receivables, $3,358,547 and $3,438,847 as of September 30, 2011 and 2010, respectively, have been outstanding for more than ninety days. These long outstanding accounts have been settled subsequently (see note 13).

In October 2007, PUC entered into a Maintenance Agreement with the National Government of Palau for a period of ten years in line with ROP'S utilization of alternative energy technology to reduce dependence on petroleum based fuel products through the installation of solar photovoltaic systems (PV systems). Under the agreement, the National Government shall provide necessary equipment, execute all documents required for receipt of the project resources, and coordinate with the contractor. ROP shall also pay PUC the energy charge produced by the PV systems and PUC shall in turn use the payment in the maintenance, repair and replacement of components of the PV systems. However, any excess cost incurred in the maintenance, repair and replacement of the PV system shall be borne by ROP. For the years ended September 30, 2011 and 2010, the energy charge incurred by ROP was $8,520 and $37,994, respectively.

(10) Commitments

PUC entered into an agreement on October 14, 1999 with the Republic of Palau, State of Koror and Koror State Public Land Authority, in which PUC is granted the use and exclusive possession of real property located in Malakal (on which the Malakal Power Plant is located) for a term of thirty years. PUC is not required to pay rent or fees for its use of the property.

In 2008, PUC entered into commercial supply agreements with two contractors each ending in 2011 in which PUC will purchase production and vehicle fuel and lubricants. Purchase prices are based on movements of the base price for fuel and lubricants. One of the contracts was renewed and is effective until December 31, 2016 with the same basic contract terms while the other contract was extended until September 2011 and on a purchase order basis thereafter until a contract is executed.

In July 2008, PUC entered into a Memorandum of Understanding with one of its fuel contractors for the installation of a mooring buoy system at PUC's Aimeliik power plant. The fuel contractor shall pay and install the mooring buoy system including all costs associated with the purchase of the buoys and mooring equipment and the transportation thereof to the site. The cost of the mooring equipment and related installation is estimated to be $495,000. However, PUC shall reimburse the fuel contractor only for the costs associated with the installation of the buoy system upon presentation of proof of payments which is estimated to be $170,000. The reimbursement shall be payable in eighteen monthly installments commencing on the completion of the buoy system with interest on late payments based on the interest rate provided for under the commercial supply agreement with the fuel contractor. PUC and the fuel contractor shall have the legal title to the buoy system. Further, the fuel contractor shall have the exclusive use and sole responsibility for the maintenance and repair of the buoy system for a term concurrent with the term of the commercial supply agreement or any succeeding future commercial supply agreement. However, upon termination of the commercial supply agreement, PUC shall purchase the buoy system at a price equal to the depreciated value of the buoy system based on a depreciable life of fifteen years. The capital lease liability was paid in full during the year ended September 30, 2010.

(11) Contingencies

As of September 30, 2011, PUC is in noncompliance with certain debt covenants related to its loan with a development bank. The ultimate outcome of such noncompliance is not determinable at September 30, 2011 and, accordingly, no provision or adjustment for the impact of the contingency has been recognized in the accompanying financial statements.

PUC currently does not maintain insurance coverage with respect to its inventory and utility plant. In the event of a loss, PUC will be self insured for the entire amount (see note 13).

Under the provisions of RPPL 4-51, PUC shall credit from future electric utility charges the actual cost, including freight and insurance, incurred by any non-governmental electric utility customer, or incurred by any state government customer prior to the transfer of the Aimeliik Power Plant to PUC, to purchase transformers, cables, and meter bases necessary to connect such customer to the electric power distribution system; provided, however, that the customer is not entitled to such credit unless it has obtained written confirmation from PUC that the types of transformers, cables and meter bases are suitable to connect the customer to the electric power distribution system and that the proposed cost is reasonable. The expected credit from future electric utility charges cannot be presently determined and, accordingly, no provision for any credit has been recognized in the accompanying financial statements.

(12) Risk Management

PUC is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. PUC has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed, except for inventory and utility plant. Settled claims from insured risks have not exceeded commercial insurance coverage in the past three years.

(13) Subsequent Events

In November 2011, the Aimeliik power plant caught fire resulting in damages to several generators and the plant building. In March 2012, PUC decided that the damaged generators will no longer be rehabilitated due to damages sustained. The generators and related utility plant damage amounted to $2.4 million with an estimated net book value of $1.6 million as of March 2012. PUC intends to recover those costs by selling the damaged generators for scrap or for further rehabilitation by interested buyers. The ultimate loss from the fire has not been determined.

In December 2011, PUC entered into an agreement with ROP for the settlement of certain ROP long outstanding receivables. The settlement included payment of $3,200,000 from ROP, plus the offset of receivables against the cost of two generators and assistance provided by ROP to PUC during the Aimeliik fire. PUC recorded a recovery of uncollectible receivables of $1,193,000 at September 30, 2011 as a result of the settlement.