PUBLIC UTILITIES CORPORATION

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2006 AND 2005

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

Tel: +1 671 646 3884
Fax: +1 671 649 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, 2006 and 2005, 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, 2006 and 2005, 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.

As disclosed in note 12 to the financial statements, at September 30, 2006, PUC had approximately $2 million of uninsured and uncollateralized deposits with a bank that went into receivership on November 7, 2006. We are unable to assess the recoverability of such deposits. No provision has been recorded in the financial statements for this uncertainty.

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 (GASB). 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 12, 2007 on our consideration of the PUC's internal control over financial reporting and our tests of its compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte & Touche LLP

June 12, 2007

This Management's Discussion and Analysis (MD&A) presents the Public Utilities Corporation's (PUC) financial performance during the fiscal year ended September 30, 2006. Please read it in conjunction with the audited financial statements as of and for the year ended September 30, 2006, which follow this section.

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

FINANCIAL HIGHLIGHTS

FY2006 witnessed several operational setbacks which hampered services. Loss of top management occurred at the beginning of the fiscal year. These positions were not filled until the last quarter of the year. Unforeseen damages to two base-load generators occurred in July, plunging the nation into rolling blackouts for a month. And throughout the year, negotiations were ongoing with PUC's fuel supplier over differences in interpretation of certain sections of the contract. All these negatively impacted PUC's financial position and results of operations. Highlights are as follows:

- PUC's total assets of $48.5 million decreased by $1.6 million from prior year.
- PUC's net utility plant, stated at $28.7 million, decreased from prior year by $1.9 million.
- At fiscal year end, PUC reported net assets at $41.7 million, of which $13.1 million, or 31%, represents unrestricted net assets. Net reduction to net assets for current year's net loss was $4.0 million, a significant loss compared to prior year's $2.6 million.
- During the fiscal year, operating revenues aggregated to $17.7 million, an increase of 12% from the previous year. This is a result of a combination of rate increases and an enlarged customer base.
- Operating expenses topped $22M exceeding last year's $19M (a 14% increase). This was primarily due to the highest fuel price ever imposed on Palau at exceeding $2.40/gal. Fuel cost alone approximated $15.5M, a 23% increase over prior year's. Other significant cost increases were personnel-related (up by $130K due to the insurance plan in effect during that year), services (up by $237K due to emergency rentals of portable generators), and depreciation (increased by $126K due to a re-evaluation of Aimeliik generators' useful lives).
- Net investment earnings for the year was satisfactory at $0.5 million. Less favorable market conditions is attributed to the 36% decrease from prior year's earnings of $0.8 million. Other significant nonoperating revenues was a $0.2 million interest income from time certificates of deposits.

REQUIRED FINANCIAL STATEMENTS

PUC's basic financial statements aim to present the financial condition of the Company and the results of its operations on a fiscal year basis. These are comprised of the following:

The Statement of Net Assets presents all PUC assets, liabilities, and net assets (difference between assets and liabilities). This provides information about the nature of investments in resources (assets) and obligations of PUC to creditors (liabilities). It also provides the bases for assessing liquidity, leverage, and financial flexibility of PUC. Because of the critical role of plant assets to PUC's operations, plant assets are presented first showing original costs, accumulated depreciation, and net value. For the same reason, net assets is presented first under the Liabilities and Net Assets section. Net assets is subdivided into net assets invested in plant assets and unrestricted net assets.

All of current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Assets. This statement measures the net results of operations (income or loss) during the current fiscal year by presenting major sources of income (operating revenues), major expenses (operating expenses), and nonoperating incidental revenues and expenses. External contributions towards plant expansions, if any, are presented after nonoperating revenues (expenses) as capital contributions. The statement is useful for reviewing PUC's financial performance compared to the prior year, and helps to determine PUC's credit worthiness.

Finally, the Statement of Cash Flows provides information about cash activities during the reporting period. This statement reports cash receipts, cash payments and net changes in cash and cash equivalents resulting from operations, investing activities, and non-capital and capital and related financing activities. Cash and cash equivalents are defined as cash on hand, cash in checking and savings accounts, and time certificates of deposits maturing within three months of issuance.

Notes to the Financial Statements are an integral part of the PUC financial statements. They provide essential information necessary for a fuller understanding of the accounts presented in the basic financial statements. The notes elaborate on off-balance sheet credit risks, commitments, and contingencies not evident on the face of the basic financial statements, as well as identify significant events occurring beyond the scope of the financial statements but which have potential material impact on the reported year's financial picture.

FINANCIAL ANALYSIS OF PUC AS A WHOLE

The following analysis focuses on PUC's net assets (Table 1) and changes in net assets (Table 2) during the year. Our analysis aims to determine whether PUC's financial condition improved or deteriorated as a result of this year's operations, and the underlying reasons for such changes.

Table 1
NET ASSETS
(Dollars in Thousands)

	Sept 30, 2006	Sept 30, 2005	Sept 30, 2004	Increase (Decrease) 2006 to 2005	Increase (Decrease) 2005 to 2004
Current Assets	$ 17,598	$ 19,516	$ 18,958	$ (1,918)	$ 558
Other Assets	2,270	-	-	2,270	-
Net Utility Plant	28,652	30,608	32,750	(1,956)	(2,142)
Total Assets	$ 48,520	$ 50,124	$ 51,708	$ (1,604)	$ (1,584)
Current Liabilities	$ 6,780	$ 4,371	$ 3,355	$ 2,409	$ 1,016
Other Liabilities	16	16	18	-	(2)
Total Liabilities	6,796	4,387	3,373	1,408	1,014
Invested in Capital Assets	28,652	30,608	32,750	(1,956)	(2,142)
Unrestricted	13,072	15,129	15,585	(2,057)	(456)
Total Net Assets	$ 41,724	$ 45,737	$ 48,335	$ (4,013)	$ (2,598)

Under current assets, approximately $2M of investments was liquidated and invested in time certificates of deposit held at a local bank. Shortly after year end, the bank was placed in receivership. Accordingly, the time deposits including interest were reclassified as other receivables pending resolution of receivership. Also included in other receivables is a receivable from PUC's fuel supplier which accumulated from overpayments made due to a dispute in pricing. The controversy over the pricing issue has been adjudicated in court and the net receivable owed by the supplier at year end amounted to approximately $400K.

Decline in plant assets is primarily the result of depreciation. Table 3 below (*Capital Assets and Depreciation*) provides a more detailed analysis of plant assets.

During the year, short-term loans were acquired to finance working capital shortfalls. The outstanding aggregate balance at year end was stated at $4.5 million, an increase of $2.8M from prior year. Of this, $2.2M is collateralized by time certificates of deposit, whose combined value exceed the loan face amounts, and $2.3M is collateralized by investments.

Changes in PUC's net assets serve as indicators of its financial health. To fully evaluate PUC's financial health, consideration should be made of other non-financial factors such as changes in economic conditions, management long-term strategy, community demographics, and legislative mandates. Details of changes to PUC's net assets are discussed in our review of the following condensed schedule *Changes in Net Assets* (Table 2).

Table 2

CHANGES IN NET ASSETS

(Dollars in Thousands)

	FY2006	FY2005	FY2004	Change 2006 to 2005	Change 2005 to 2004
Operating Revenues:					
Electric - Residential	$ 5,477	$ 4,441	$ 3,570	$ 1,036	$ 871
Electric - Commercial	7,303	6,714	4,910	589	1,804
Electric - Government	945	759	-	186	759
Electric – ROP/CU	3,758	3,160	3,259	598	(99)
Other Service Charge	164	352	235	(188)	117
Miscellaneous Revenue	157	62	7	95	55
(Bad debt) Recoveries	(86)	289	(681)	(375)	970
Non-Operating Revenue	673	1,279	572	(606)	707
Total Revenue	18,391	17,056	11,872	1,335	5,184
Operating Expenditures					
Generation Fuel	15,530	12,657	8,404	2,873	4,253
Generation Other Cost	2,355	2,445	1,631	(90)	814
Depreciation Exp	2,507	2,356	2,240	151	116
Administrative Exp	1,059	1,168	880	(109)	288
Transmission & Distribution	787	838	691	(51)	147
Engineering & Control	166	190	198	(24)	(8)
Total Operating Expenses	22,404	19,654	14,044	2,750	5,610
Loss Before Contributed Capital	(4,013)	(2,598)	(2,172)	(1,415)	(426)
Contributed Capital	-	-	445	-	(445)
Change in Net Assets	(4,013)	(2,598)	(1,727)	(1,415)	(871)
Beginning Net Assets	45,737	48,335	50,062	(2,598)	(2,598)
Ending Net Assets	$ 41,724	$ 45,737	$ 48,335	$ (4,013)	$ (3,229)

REVENUES

Operating revenues-electric is comprised of kilowatt-hour (kWh) sales and fuel rate adjustments billed to customers based on kWh usage. Operating revenues showed positive gains in FY2006, with an 8% increase over FY2005, however this was due primarily to factored increases in fuel rates. Customer growth did not perform as expected but only conservatively climbed by 6% over prior year. This decelerated growth, which was probably influenced by the rising utility rates, had a minimal impact on net operating results.

Net non-operating revenue was not as dramatic as prior year's. Investments did not perform as well with net growth at $0.5M compared to $0.8M last year, a 36% decrease. PUC did not realize any grant revenues this year as no externally-funded projects were ongoing.

EXPENDITURES

As already mentioned above, fuel cost rose 23% over prior year's. The extreme volatility of fuel price this year caused hikes at such frequency as to render PUC's fuel cost recovery mechanism inadequate. Management chose not to react impulsively to this by not revising the fuel tariff more frequently. This resulted in this year's prodigious net loss of -$4M. The past three years' losses however merit a re-evaluation of this mechanism to ensure PUC's viability.

As noted earlier, PUC suffered damages to two of its main generators. PUC had to ration available power in a rolling schedule for about a month before emergency rental units could be shipped in to alleviate the situation. Rent of the emergency units bumped service costs to over $500K, a $180K increase over last year. Personnel cost also jumped significantly by $152K as a result of a new insurance plan, which plan was terminated shortly after year end. On the other hand, maintenance cost was actually reduced by $393K, resulting in a net decrease to "generation other costs" by approximately $90K.

The significant reduction in administrative expenses of approximately $109K, or 9.3%, is attributed primarily to reduced payroll and reduced travel expenses. Two top management positions were vacated early in FY2006. These positions were not filled until late in the year. Travel expenses are directly related to management positions.

Decreases in Transmission & Distribution and Engineering & Control divisions are ascribed directly to reduced services. As noted above, customer base grew at a conservative 6% compared to prior year's 25%.

As a result of the matters discussed above, PUC suffered another year of significant net loss amounting to $4 million, which further carved net assets down to $41.7 million. The major setbacks experienced this year have been informally incorporated into management proactive plans to strengthen operations and to ensure reliability of services. Management is optimistic about PUC's viability and delivery of services.

CAPITAL ASSETS

Capital Assets

Investment in capital assets was minimal this year at $0.2M due to operational difficulties mentioned above. At the end of FY 2006, PUC had invested in a broad range of utility capital assets, including its power generation plants, electric transmission and distribution, and general support and administrative equipment a cumulative $48.3 million. Net value after depreciation was $28.7 million, a net decrease of $2 million or 6.4% from last year.

The following table summarizes PUC's capital assets by category and accumulated depreciation, and the changes therein for the year ended September 30, 2006.

Table 3
CAPITAL ASSETS AND ACCUMULATED DEPRECIATION
(Dollars in Thousands)

CAPITAL ASSETS:	Sept 30, 2006	Sept 30, 2005	Increase (Decrease) $	Increase (Decrease) %
Electric Plants:				
Electric Plants, Koror/Aimeliik	$ 22,971	$ 22,972	$ (1)	(0.4%)
Electric Plants, Outlying States	2,378	2,378	-	0.0%
Total Electric Plants	25,349	25,350	(1)	(0.4%)
Accumulated Depreciation	(11,955)	(10,446)	1,509	14.4%
Net Electric Plant	13,394	14,904	(1,510)	(10.1%)
Transmission & Distribution System				
T&D System, Koror/Aimeliik	17,182	17,182	-	0.0%
T&D System, Outlying States	2,090	2,090	-	0.0%
Total T&D System	19,272	19,272	-	0.0%
Accumulated Depreciation	(5,845)	(5,143)	702	13.6%
Net T&D System	13,427	14,129	(702)	(5.0%)
Administrative Equipment				
Buildings	808	716	92	12.8%
Heavy Equipment & Vehicles	1,554	1,379	175	12.7%
Tools & Maint Equipment	787	786	1	0.1%
Computers & Office Equipment	559	583	(24)	(4.1%)
Total Admin Equipment	3,708	3,464	244	7.0%
Accumulated Depreciation	(1,980)	(1,907)	73	3.8%
Net Admin Equipment	1,728	1,557	171	11.0%
Capital Improvement Projects:				
PUC Office Building	-	4	(4)	(100.0%)
PDD Mechanic Shop	103	-	103	100.0%
APP Waste Oil Containment Building	-	14	(14)	(100.0%)
Total Capital Projects in Progress	103	18	85	472.2%
TOTAL FIXED ASSETS	$ 28,652	$ 30,608	$ (1,956)	(6.4%)

In FY2006, PUC completed major Capital Improvement Projects as listed below:

Warehouse Extension-PDD	$ 67,720
APP Waste Oil Containment Building	$ 20,523

On-going projects are as follows:

PDD Mechanic Shop	99% Complete

A project to construct a PUC Office Building was initiated in 2005. The contract has been rescinded and the advance made on the project has been reclassified as a receivable from contractor of $266K at the end of FY2006.

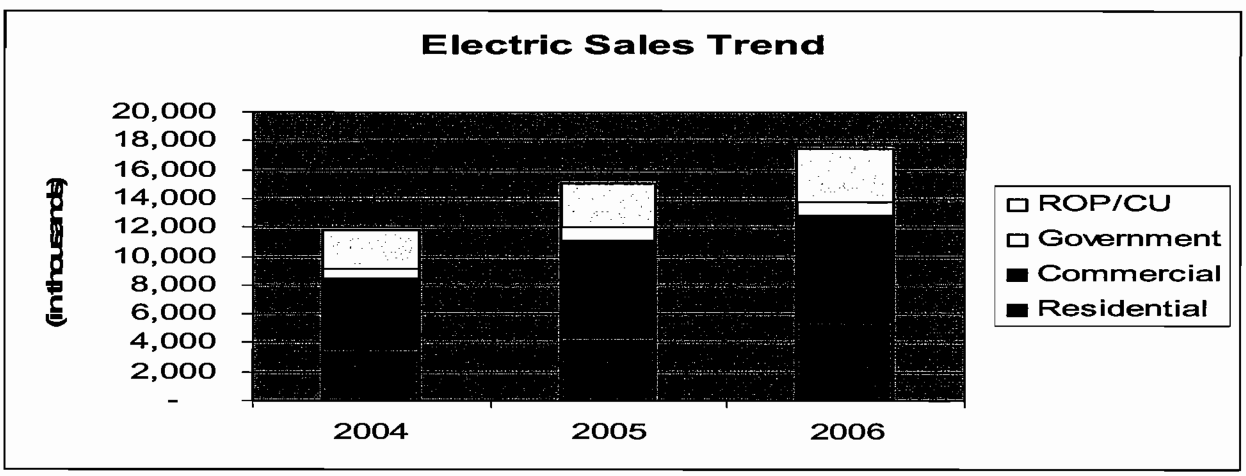
PUC recently acquired a $7M loan to finance a new 5MW generator to supplement the existing but aging 25MW plant. Plans are being developed to seek additional funding to replace or upgrade existing infrastructure in line with a 5-Year Strategic Plan, adopted by the Board of Directors of PUC on October 30, 2003. The plan calls for major capital improvements to its power generating plants, specifically Aimeliik Power Plant, and its power transmission to Koror and the new capitol in Melekeok.

ECONOMIC FACTORS

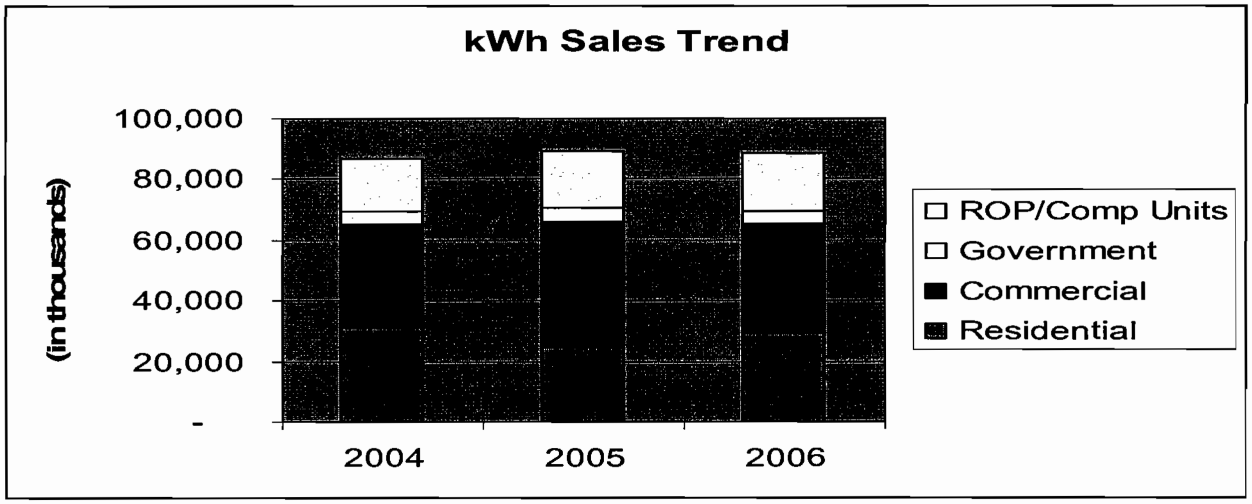
SALES

Electric sales for the past three years has shown a continuous consistent growth trend ranging from 9-28%. With the near completion of the Compact road and the fait accompli of the government move to the new capitol, the big island of Palau is now a magnet for residential settlements and new commercial initiatives. Electric sales are expected to continue to grow at a accelerated rate.

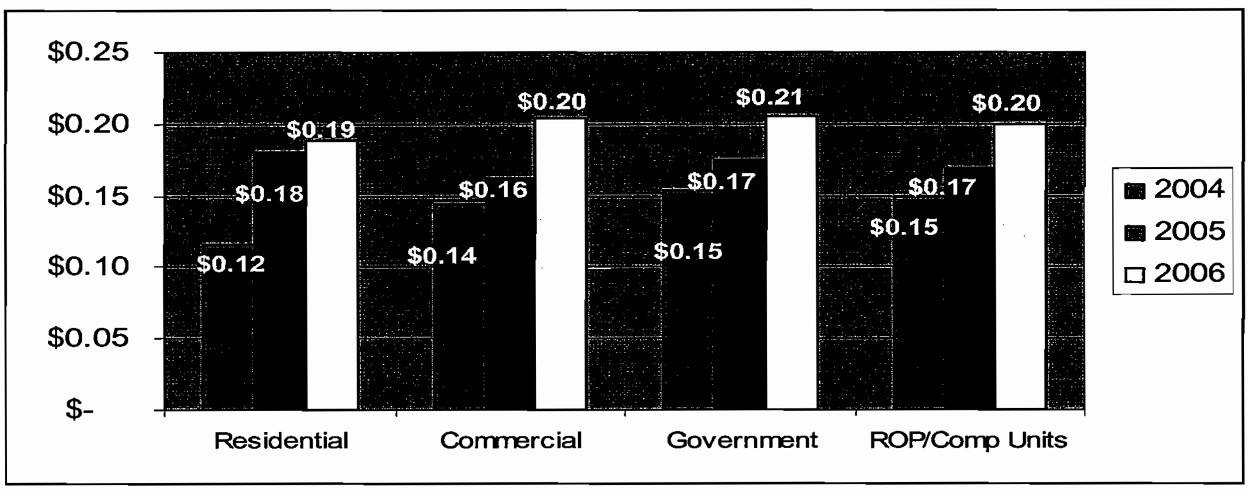
The charts below illustrate the trend of operations by comparing annual electric sales, kWh sales, and rates per kWh over the last three years.



Overall gross sales grew by 9% in 2004, 28% in 2005, and 16% in 2006.



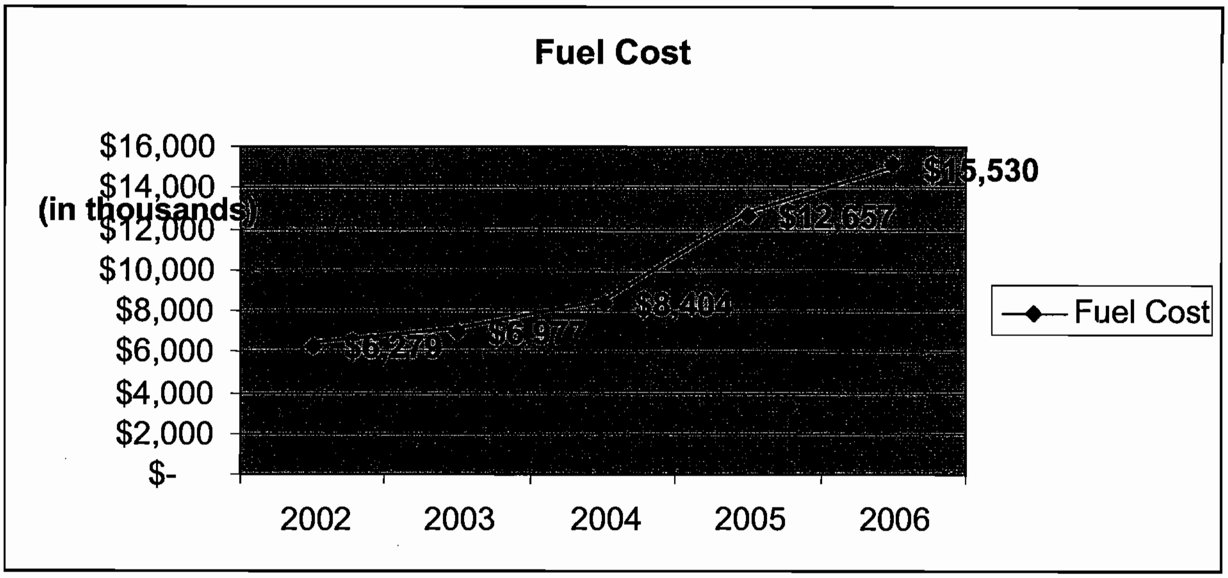
kWh sales remained constant despite the power blackouts in FY2006. Commercial customers were most affected. Major enterprises relied on their own backup power systems during the power rationing period.



Electric rates have steadily grown over the last three years in tandem with rising fuel cost. Because of the automatic fuel price adjustment mechanism that is worked into the PUC electric tariff, the electric rate may continue to fluctuate depending on the world fuel price index.

EXPENSES

Fuel cost now comprises approximately 70% of PUC's operating costs. The trend over the last five years has been mounting as shown in the following chart.



The above trend appears to imply a continuous climb in the future. Management is taking every step possible to minimize loss and maximize efficiency.

INFRASTRUCTURE

As PUC progresses in its plans to upgrade the existing power infrastructure, management believes that operating costs could be curtailed with newer fuel-efficient systems. This, combined with anticipated growth in the big island, gives hope to a strong reliable power system and potential savings to PUC's customers.

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, 2005 is set forth in the report on the audit of PUC's financial statements which is dated May 31, 2006. That Discussion and Analysis explains the major factors impacting the 2005 financial statements. If you have questions about the 2006 or 2005 reports, 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 jacquia@ppuc.com or call 488-5320.

PUBLIC UTILITIES CORPORATION

Statements of Net Assets
September 30, 2006 and 2005

ASSETS	2006	2005
Utility plant:		
Electric plant	$ 25,348,761	$ 25,349,761
General support equipment	22,457,443	22,188,912
Administrative equipment	522,975	547,352
Utility plant in service	48,329,179	48,086,025
Accumulated depreciation	(19,780,665)	(17,496,465)
Net utility plant in service	28,548,514	30,589,560
Construction in progress	103,551	18,666
Net utility plant	28,652,065	30,608,226
Current assets:		
Cash and cash equivalents	949,100	392,539
Time certificates of deposit	1,955,342	2,840,972
Investments	8,107,680	10,423,573
Receivables:		
Trade	2,050,970	1,970,027
Vendor	372,099	-
Affiliate	490,620	637,287
Interest	60,224	18,680
Other	28,925	25,953
	3,002,838	2,651,947
Less allowance for doubtful accounts	(327,000)	(483,976)
Total receivables, net	2,675,838	2,167,971
Prepaid expenses	297,167	67,303
Inventory, net	3,564,635	3,550,951
Due from grantor agency	48,140	72,640
Total current assets	17,597,902	19,515,949
Other assets:		
Receivable from a local bank	2,004,055	-
Receivable from a contractor	265,794	-
Total other assets	2,269,849	-
	$ 48,519,816	$ 50,124,175

LIABILITIES AND NET ASSETS	2006	2005
Net assets:		
Invested in capital assets	$ 28,652,065	$ 30,608,226
Unrestricted	13,071,960	15,129,024
Total net assets	41,724,025	45,737,250
Commitments and contingencies		
Current liabilities:		
Short-term borrowings	4,542,351	1,700,832
Accounts payable	1,428,500	1,895,244
Accrued expenses	270,894	284,098
Payable to affiliate	128,232	128,232
Customer deposits	409,642	362,414
Total current liabilities	6,779,619	4,370,820
Other liabilities	16,172	16,105
Total liabilities	6,795,791	4,386,925
	$ 48,519,816	$ 50,124,175

See accompanying notes to financial statements.

PUBLIC UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2006 and 2005

	2006	2005
Operating revenues:		
Power	$ 17,482,734	$ 15,073,865
Other	321,351	414,559
Total operating revenues	17,804,085	15,488,424
(Bad debts) recoveries	(86,396)	288,788
Net operating reveunes	17,717,689	15,777,212
Operating expenses:		
Generation - fuel	15,530,247	12,656,688
Depreciation	2,506,465	2,356,631
Generation - other cost	2,355,184	2,444,890
Administration	1,059,226	1,165,961
Distribution and transmission	786,834	838,435
Engineering services	166,334	189,640
Total operating expenses	22,404,290	19,652,245
Operating loss	(4,686,601)	(3,875,033)
Nonoperating revenues (expenses):		
Net increase in fair value of investments	535,366	835,756
Grant revenues	-	392,709
Interest income	184,569	35,843
Loss on disposal of assets	(6,525)	(31,349)
Interest expense	(120,796)	(22,150)
Other	80,762	66,076
Total nonoperating revenues (expenses), net	673,376	1,276,885
Change in net assets	(4,013,225)	(2,598,148)
Net assets at beginning of year	45,737,250	48,335,398
Net assets at end of year	$ 41,724,025	$ 45,737,250

See accompanying notes to financial statements.

PUBLIC UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2006 and 2005

		2006		2005
Cash flows from operating activities:				
Cash received from customers	$	16,600,578	$	15,764,700
Cash payments to suppliers for goods and services		(17,999,437)		(15,996,557)
Cash payments to employees for services		(2,189,594)		(2,013,350)
Net cash used for operating activities		(3,588,453)		(2,245,207)
Cash flows from investing activities:				
Linquidation of investments		2,851,259		-
Purchase of time certificates of deposit		(1,118,425)		(632,098)
Interest received		143,025		42,021
Other		80,762		66,076
Net cash provided by (used for) investing activities		1,956,621		(524,001)
Cash flows from non-capital financing activities:				
Proceeds from short-term borrowings		3,516,319		2,300,832
Decrease in bank overdraft		-		(792,999)
Payment of loans		(674,800)		(600,000)
Net cash provided by non-capital financing activities		2,841,519		907,833
Cash flows from capital and related financing activities:				
Cash received from grantor agencies		24,499		374,148
Interest paid		(120,796)		(22,150)
Acquisition of utility plant		(556,829)		(245,917)
Net cash provided by (used for) capital and related financing activities		(653,126)		106,081
Net change in cash and cash equivalents		556,561		(1,755,294)
Cash and cash equivalents at beginning of year		392,539		2,147,833
Cash and cash equivalents at end of year	$	949,100	$	392,539
Reconciliation of operating loss to net cash used for operating activities:				
Operating loss	$	(4,686,601)	$	(3,875,033)
Adjustments to reconcile operating loss to net cash used for operating activities:				
Depreciation		2,506,465		2,356,631
Provision for (recovery of) bad debts		86,396		(288,788)
(Increase) decrease in assets:				
Receivables:				
Trade		(324,314)		(378,981)
Affiliate		146,667		619,654
Vendors		(372,099)		-
Other		(2,972)		(14,458)
Prepaid expenses		(229,864)		34,047
Inventory		(279,478)		(804,863)
Increase (decrease) in liabilities:				
Accounts payable		(466,744)		31,707
Accrued expenses		(13,137)		28,139
Customer deposits		47,228		48,294
Other liabilities		-		(1,556)
Net cash used for operating activities	$	(3,588,453)	$	(2,245,207)

Non-cash transactions:

PUC recorded a net increase in fair value of investments of $535,366 and $835,756 for the years ended September 30, 2006 and 2005, respectively.

PUC recorded noncash contributions of inventories of $366,209 for the year ended September 30, 2005.

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 managed 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

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. 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 Principles 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.

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.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statements of net assets. Proprietary fund operating statements present increases and decreases in net assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

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.

(2) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents and Time Certificates of Deposit

Cash and cash equivalents include cash on hand, demand deposits and time certificates of deposit with original maturities of three months or less. Time certificates of deposit with original maturities greater than three months are separately classified.

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 collectibility of these accounts and prior collection experience. The allowance is established through a provision for uncollectible receivables charged to expense.

Investments

Investments are reported at fair value using quoted market prices. Fair value is the amount at which a financial instrument could be exchanged between willing parties, other than in a forced or liquidation sale.

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. PUC capitalizes utility plant in excess of $500. Depreciation is provided using the straight line method over the estimated useful lives of the respective assets.

New Accounting Standards

During fiscal year 2006, PUC implemented the following pronouncements:

- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which establishes standards for impairment of capital assets when service utility has declined significantly and unexpectedly.

- GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets.

- GASB Statement No. 47, *Accounting for Termination Benefits*, which establishes guidance for state and local governmental employers on accounting and financial reporting for termination of benefits.

- GASB Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefit Expenditures/Expense and Liabilities by Cost-Sharing Employers*, which clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers.

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

The implementation of these pronouncements did not have a material impact on the accompanying 2006 financial statements.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. 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 July 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefit 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, 2008. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of PUC.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. GASB Statement No. 48 establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The Statement also includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. The provisions of this Statement are effective for periods beginning after December 15, 2006. 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, 2006 and 2005 were $945,039 and $188,626, respectively.

Retirement Plan

PUC contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing, multi-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

(2) Summary of Significant Accounting Policies, Continued

Retirement Plan, Continued

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 $161,866, $148,362 and $146,466 to the Fund during the fiscal years 2006, 2005 and 2004, respectively.

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 2006 and 2005 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) an assumption that members retire at the earlier of age 60 or upon attaining 30 years of service.

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, 2005 actuarial valuation determined the unfunded pension benefit obligation as follows:

Participants in pay status	$ 47,711,000
Active participants	33,893,000
Participants with vested deferred benefits	1,565,000
Total pension benefit obligation	83,169,000
Net assets available for benefits, at market value	41,965,000
Unfunded benefit obligation	$ 41,204,000

The actuarial valuation did not provide a breakdown of actuarial present value of vested and non-vested accumulated plan benefits by sponsor or net assets available for benefits by sponsor. Accordingly, no liability has been recorded for any unfunded benefit obligation by PUC.

Taxes

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

(2) Summary of Significant Accounting Policies, Continued

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.

Reclassifications

Certain 2005 balances have been reclassified to conform to the 2006 financial statement presentation.

(3) 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.

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; or

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 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) Deposits and Investments, Continued

Deposits, Continued

As of September 30, 2006 and 2005, cash and cash equivalents and time certificates of deposit were $5,105,869 and $3,233,511, respectively, and the corresponding bank balances were $6,267,984 and $4,530,011, respectively. Of these amounts, $4,257,521 and $4,120,251, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006 and 2005, bank deposits in the amount of $149,610 and $200,000, 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.

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 PUC or its agent in PUC's name;

Category 2 Investments that are uninsured or unregistered for which the securities are held by the counterparty's trust department or agent in PUC's name; or

Category 3 Investments that are uninsured and unregistered with securities held by the counterparty, or by its trust department or agent but not in PUC's name.

GASB Statement No. 40 amended GASB Statement No. 3 to eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks for 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 risk in GASB Statement No. 3.

The following investment policy governs the investment of assets of PUC.

General:

a. Any restrictions set forth by applicable law governing allocation limits, size, or quality of investments, if more stringent than PUC's investment policy, will be the governing restriction.

b. No investment management organization shall have more than 40% of the Capital Investment Reserves Fund.

c. U.S. and non-U.S. common stocks, American Depository Receipts, convertible bonds, preferred stocks, fixed income securities, mutual funds and short-term securities are permissible investments.

d. No individual security of any issuer, other than that of the U.S. Government, shall constitute more than 10% (at cost) of any investment manager's portfolio.

(3) Deposits and Investments, Continued

Investments, Continued

General, Continued

e. The following securities and transactions are not authorized without prior Board approval: letter stock and other unregistered securities; non-negotiable securities; commodities or other commodity contracts; short sales; margin transactions; and options and futures.

Equities:

a. Consistent with the desire to maintain broad diversification, allocations to any economic or industry sector should not be excessive.

b. Equity holdings shall be restricted to readily marketable securities of corporations that are actively traded on major exchanges.

c. Investment managers shall have the discretion to invest a portion of the assets in cash reserves when they deem appropriate. However, the investment managers will be evaluated against their peers on the performance of the total funds under their direct management.

d. Common stock and preferred stock of any institution or entity created or existing under the laws of the United States or any state, district, territory, or any foreign country are permissible investments.

Fixed Income:

a. All fixed income securities held in the portfolio shall have a Moody's or Standard & Poor's credit quality rating of no less than "BBB". U.S. Treasury and Agency securities, while non-rated, qualify for inclusion in the portfolio.

b. No more than 20% of the market value of the portfolio shall be rated less than single "A" quality, unless the manager has specific written authorization. 80% of the fixed income portfolio must be in bonds of credit quality equal to or greater than "A".

c. The total portfolio quality (capitalization weighted) shall maintain an "A" minimum rating.

d. It is the Policy of the Board to place assets in local certificates of deposit (Local CDs) issued by local banking institutions, with the express purpose of making funds available to the local community in the form of loans. While these local CDs are held, they will be included in the "strategic asset allocation" as fixed income investments. However, these local CDs and the local banking institutions must meet the following criteria on an ongoing basis: (1) The local CDs must offer a competitive return relative to alternative issuers; and (2) the local banking institutions must provide quarterly financial statements for Investment Committee review. The Investment Committee is charged with monitoring the financial health of the local banking institutions. Should concerns arise with respect to the financial condition of the local banking institutions, the Investment Committee will immediately notify the Board so that appropriate action can be determined and taken.

(3) Deposits and Investments, Continued

Investments, Continued

Cash and Equivalents:

a. U.S. Government obligations, U.S. Government agency obligations, and U.S. Government instrumentality obligations are permissible.

b. All commercial paper issuers must maintain an "A1" rating by Standard & Poor's and a "P-1" rating by Moody's Investor Service and be issued by corporations domiciled within the United States having total assets in excess of one billion dollars.

c. All certificate of deposit issuers must have a minimum capital of ten million dollars.

d. Repurchase agreements must be collateralized with either: (1) U.S. Treasury or Agency Securities with a market value of 102%, marked to market daily; or, (2) money market instruments which meet the qualifications of the investment policy statement and with a market value of 102%, marked to market daily.

e. Money market funds must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

f. No single issue shall have a maturity of greater than one year.

g. The money market funds must have an average maturity of less than one year.

GASB Statement No. 40 requires entities to provide information about the credit risk associated with their investments by disclosing the credit quality ratings.

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 investment or collateral securities that are in the possession of an outside party. PUC's investments are held and administered by trustees in accordance with negotiated trust and custody agreements. Based on these agreements, all of these investments were held in PUC's name by PUC's custodial financial institutions at September 30, 2006 and 2005.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments.

As of September 30, 2006 and 2005, investments at fair value are as follows:

	2006	2005
Fixed income securities:		
Domestic fixed income	$ 3,639,980	$ 3,541,894
Other investments:		
Domestic equities	4,146,711	4,857,795
Mutual funds	-	2,023,884
Others	320,989	-
	4,467,700	6,881,679
	$ 8,107,680	$ 10,423,573

(3) Deposits and Investments, Continued

Investments, Continued:

As of September 30, 2006, PUC's fixed income securities had the following maturities:

	Investment Maturities (in years)					
Investment Type	Fair Value	Less than 1 year	1 - 5	6-10	More than 10	Rating
U.S. Treasury Notes	$ 1,735,105	$ 106,092	$ 1,270,209	$ 358,804	$ -	AAA
Other obligations of U.S. Government and Agencies	1,256,246	-	197,715	151,143	907,388	AAA
Corporate Bonds	51,412	-	-	51,412	-	AAA
Corporate Bonds	36,717	-	-	36,717	-	AA-
Corporate Bonds	64,419	-	32,468	31,951	-	A+
Corporate Bonds	137,240	-	-	137,240	-	A
Corporate Bonds	71,941	-	36,000	35,941	-	A-
Corporate Bonds	74,037	-	-	74,037	-	BBB+
Corporate Bonds	175,421	-	-	105,429	69,992	BBB
Corporate Bonds	37,442	-	-	37,442	-	BBB-
	$ 3,639,980	$ 106,092	$ 1,536,392	$ 1,020,116	$ 977,380	

As of September 30, 2005, PUC's fixed income securities had the following maturities:

	Investment Maturities (in years)					
Investment Type	Fair Value	Less than 1 year	1 - 5	6-10	More than 10	Rating
U.S. Treasury Notes	$ 2,520,842	$ 48,935	$ 1,959,287	$ 512,620	$ -	AAA
Other obligations of U.S. Government and Agencies	384,266	-	-	-	384,266	AAA
Corporate Bonds	132,388	-	-	132,388	-	A
Corporate Bonds	99,934	-	-	65,822	34,112	A+
Corporate Bonds	31,281	-	31,281	-	-	AA-
Corporate Bonds	52,432	-	-	52,432	-	AAA
Corporate Bonds	148,265	-	-	49,293	98,972	BBB
Corporate Bonds	105,187	-	34,322	70,865	-	BBB-
Corporate Bonds	67,299	-	-	34,496	32,803	BBB+
	$ 3,541,894	$ 48,935	$ 2,024,890	$ 917,916	$ 550,153	

Due From a Local Bank:

At September 30, 206, PUC has uninsured deposits of $2,004,055 with a bank that went into receivership on November 6, 2006. These deposits are reflected as due from local bank in the accompanying statements of net assets.

(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.

(4) Due From Grantor Agency, Continued

Changes in the due from grantor agency accounts for the years ended September 30, 2006 and 2005, are as follows:

	2006	2005
Balance at beginning of year	$ 72,640	$ 420,288
Deductions - cash receipts from grantor agencies	(28,000)	(374,148)
Additions - program outlays	3,500	26,500
Balance at end of year	$ 48,140	$ 72,640

(5) Inventory

Inventory at September 30, 2006 and 2005, consists of the following:

	2006	2005
Distribution and power plant supplies	$ 3,031,274	$ 3,006,551
Fuel	628,456	639,307
Lubricants	7,046	7,234
	3,666,776	3,653,092
Provision for slow moving inventory	(102,141)	(102,141)
	$ 3,564,635	$ 3,550,951

(6) Utility Plant and Construction In Progress

Utility plant and construction in progress consist of the following detailed balances at September 30, 2006 and 2005:

	Estimated Useful Lives	Balance at October 1, 2005	Additions and Transfers	Deletions and Transfers	Balance at September 30, 2006
Electric plant	3 - 25 years	$ 25,349,761	$ -	$ (1,000)	$ 25,348,761
General support equipment	2 - 30 years	22,188,912	493,082	(224,551)	22,457,443
Administrative equipment	2 - 10 years	547,352	31,675	(56,052)	522,975
		48,086,025	524,757	(281,603)	48,329,179
Less accumulated depreciation		(17,496,465)	(2,506,465)	222,265	(19,780,665)
		30,589,560	(1,981,708)	(59,338)	28,548,514
Construction in progress		18,666	103,551	(18,666)	103,551
		$ 30,608,226	$ (1,878,157)	$ (78,004)	$ 28,652,065

	Estimated Useful Lives	Balance at October 1, 2004	Additions and Transfers	Deletions and Transfers	Balance at September 30, 2005
Electric plant	3 - 25 years	$ 25,349,761	$ -	$ -	$ 25,349,761
General support equipment	2 - 30 years	22,023,996	348,412	(183,496)	22,188,912
Administrative equipment	2 - 10 years	428,214	142,970	(23,832)	547,352
		47,801,971	491,382	(207,328)	48,086,025
Less accumulated depreciation		(15,286,585)	(2,356,631)	146,751	(17,496,465)
		32,515,386	(1,865,249)	(60,577)	30,589,560
Construction in progress		234,902	18,666	(234,902)	18,666
		$ 32,750,288	$ (1,846,583)	$ (295,479)	$ 30,608,226

(7) Short-Term Borrowings

PUC entered into a revolving credit line agreement on March 14, 2005 under which a commercial bank will extend credit to PUC in the form of drawings, from time to time until March 14, 2006, in such sums as PUC may request but which shall not exceed $500,000 in the aggregate principal amount for the purpose of financing short-term working capital and to purchase equipment, generator parts, transmission and distribution system parts and any other purchases requiring letters of credit. Interest is subject to rate changes based on the interest rate paid on the deposit account and is payable monthly.

PUC entered into a term loan on December 23, 2004 in the amount of $1,800,000 for the purpose of financing short-term working capital. On October 6, 2005 the loan was refinanced for an additional $600,000 for the purpose of financing property improvements of its new office building. The loan is due on June 23, 2006 including simple interest at a rate of 2.95% per annum and is payable in quarterly $300,000 principal installments plus interest.

The revolving credit line and term loan are collateralized by time certificates of deposit totaling $2,152,714 and $2,524,189 as of September 30, 2006 and 2005, respectively.

PUC entered into a portfolio credit line agreement on May 30, 2006 under which a commercial bank will extend credit to PUC in the form of drawings from time to time in such sums as PUC may request for the purpose of financing short-term working capital. Interest rate is at 7.25% as of September 30, 2006.

Movements in short-term borrowings for the years ended September 30, 2006 and 2005, are as follows:

	Balance at October 1, 2005	Additions	Repayments	Balance at September 30, 2006
Portfolio credit line	$ -	$ 2,396,522	$ (100,000)	$ 2,296,522
Term Loan	1,199,485	850,000	(302,943)	1,746,542
Credit line	501,347	269,797	(271,857)	499,287
	$ 1,700,832	$ 3,516,319	$ (674,800)	$ 4,542,351

	Balance at October 1, 2004	Additions	Repayments	Balance at September 30, 2005
Term Loan	$ -	$ 1,800,000	$ (600,000)	$ 1,200,000
Credit line	-	500,832	-	500,832
	$ -	$ 2,300,832	$ (600,000)	$ 1,700,832

On September 4, 2006, PUC entered into a loan agreement 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 installments in the principal amount 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. As of September 30, 2006, no advance has been made against the loan.

(8) Related Party Transactions

PUC provides electrical utility services to ROP at the same rates charged to third parties. Balances receivable from and payable to ROP consist of the following at September 30, 2006 and 2005:

	2006	2005
Receivables:		
Utility services	$ 490,620	$ 637,287
Payable:		
Lapsed funding	$ 128,232	$ 128,232

(9) 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 any rent or fee for its use of the property.

PUC entered into a commercial supply agreement beginning February 1, 2005 and ending on January 31, 2010 in which PUC will purchase production and vehicle fuel and lubricants from a single contractor at an estimated amount of seven hundred thousand gallons of fuel per month. Purchase prices are based on movements of base price for fuel and lubricants.

PUC entered into an agreement on July 26, 2005 with the Airai State Public Lands Authority (ASPLA) to lease a lot to construct its office building. The lease is for an initial term of fifty years commencing on the date PUC occupies the premises following completion of the construction of its office building. Beginning on the third anniversary of the commencement of the lease term, PUC shall pay ASPLA $15,000 annually for a fifteen-year period. The fees for the remainder of the lease term will be negotiated after the eighteen-year period. Further, throughout the term of the lease, PUC shall provide ASPLA in-kind contributions up to a maximum of $6,000 annually. PUC has not commenced construction of its office building as of September 30, 2006.

(10) Contingencies

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.

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.

(10) Contingencies, Continued

PUC entered into a contract in October 2005 for the construction of an office building. A $265,794 advance payment was made based on the contract provisions. As of September 30, 2006, management decided to put the construction on hold due to certain legalities of the contract. PUC is negotiating with the contractor to recover the advance payment. The amount that will be recovered cannot presently be determined. The advance payment made to the contractor is presented as receivable from a contractor in the accompanying statements of net assets.

PUC is currently in dispute with a vendor related to product pricing and unpaid invoices. The total amount in dispute is $1,156,512. Subsequent to September 30, 2006, the Palau Supreme Court has held that PUC is entitled to recover $372,099, which is recorded as a receivable from vendor at September 30, 2006. However, appeals of the Supreme Court decisions are possible by both PUC and the vendor. The eventual outcome of this matter cannot be reasonably predicted by management and, accordingly, no provision for any liability, potential loss or recovery other than the receivable from vendor of $372,099, that may result from settlement of this dispute has been recorded in the accompanying financial statements.

(11) 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.

(12) Subsequent Events

At September 30, 2006, PUC has time certificates of deposit amounting to $1,982,016 and approximately $22,039 in cash deposits in a banking institution not subject to FDIC insurance. The bank went into receivership on November 7, 2006. It is uncertain if or when PUC will realize these deposits. The TCD and cash deposits are presented as receivable from a local bank in the accompanying statements of net assets.