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

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2010

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 ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors
Public Utilities Corporation:

We have audited the financial statements of the Public Utilities Corporation (PUC), as of and for the year ended September 30, 2010, and have issued our report thereon dated September 7, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered PUC's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PUC's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described in the accompanying Schedule of Findings and Responses as items 2010- 1 to 2010- 4 that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PUC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed two instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Responses as items 2010- 3 and 2010- 4.

We noted certain matters that we reported to management of PUC in a separate letter dated September 7, 2011.

PUC's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. We did not audit PUC's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the management, the Board of Directors and others within PUC, and the Office of the Public Auditor, and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

September 7, 2011

Procurement

Finding No. 2010-1

Criteria: PUC's Procurement Regulations and Procedures states that all procurements other than emergency procurements shall issue a public notice by (1) placing advertisements in at least one local newspaper of general circulation; (2) posting at Palau Post Office, Palau Supreme Court building, and any other place deemed appropriate; and (3) announcing the invitation for bids on at least one radio or one television station within the Republic at least once a day for seven consecutive days. Further, all contracts must contain the minimum clauses as enumerated in the procurement regulations. Any allowable exceptions must be properly documented and approved in accordance with applicable PUC Procurement Regulations and such approvals shall be documented in the procurement file.

Condition: For one contract (RFP No. PUC09-206), there was no evidence that the request for bid or public notice was advertised in at least one local newspaper of general circulation. We noted a memo from the former Chief Procurement Officer that such documentation was missing either due to documents misfiled or lost.

Cause: The cause of these conditions is weak controls over procurement policies and procedures.

Effect: The effect of the above condition is noncompliance with established procurement regulations.

Recommendation: We recommend that PUC strengthen controls over procurement and demonstrate compliance with established procurement regulations.

Prior Year Status: Controls over procurement regulations and procedures was reported as a finding in the audit of PUC in 2009 and 2008.

Auditee Response and Corrective Action Plan: PUC concurs with the above finding. PUC had implemented, about two years ago, a documentation control docket for each major contract procurement. The new Contract Officer has been charged with ensuring compliance with this control docket.

Name of Contact Person: Doran Inabo, Contract Officer

Proposed Completion Date: February 2011

Inventory

Finding No. 2010-2

Criteria: Adequate inventory controls include accountability over inventory receipts and issuances.

Condition: Our examination of inventory indicated the following:

a. For three items, variances were noted between year-end inventory test counts and the final inventory valuation report.

No.	Item Code	Plant	Per Invty. Valuation Report	Per Physical Count	Diff.	Unit cost	Amount
1	403-WT-0075158009	MPP	-	11	(11)	992.83	$ (10,921)
2	0510-MPP-S40OIL-Z	MPP	-	14	(14)	515.90	(7,223)
3	APP-S40OIL-Z	APP	10	16	(6)	517.00	(3,101)
						Total	$ (21,245)

We were informed that the variances result from missing department codes at e-Req. stage of the procurement process; as such, the Inventory Valuation Report did not pick up the transactions. However, the items are intact in the inventory module.

b. Examination of inventory additions or purchases indicated that three additions pertain to adjustments to record remaining inventory items based on the year-end physical inventory count. The adjustments resulted from inventory items returned but not supported by completed inventory return forms or items that were used after period end and restored to reflect inventory at 09/30/2010.

No.	GL Acct No.	Session ID	Effective date	Amount
1	1331000	<MANADJ20101120>	09/30/10	$ 6,268
2	1331000	<MANADJ20101120>	09/30/10	19,280
3	1331000	<MANADJ20101122>	09/30/10	7,200
			Total	$ 32,748

c. For five expenses pertaining to adjustments to record or remove remaining inventory items based on the year-end physical inventory count, the adjustments were not supported by completed return or issuance forms.

No.	GL Acct No.	GL Date	Reference	GL Amount
1	7160121	9/30/2010	<MANADJ20101112>	$ 16,436
2	7160201	9/30/2010	<MANADJ20101120>	9,872
3	7160201	9/30/2010	<MANADJ20101120>	99,700
4	7160201	9/30/2010	<MANADJ20101120>	96,327
5	7160332	9/30/2010	<MANADJ20101112>	(2,759)
			Total	$ 219,576

Cause: The cause of the above condition is inadequate compliance with inventory controls.

Effect: The effect of the above conditions is potential misstatements of inventory.

Inventory, Continued

Finding No. 2010-2, Continued

Recommendation: We recommend that PUC strengthen controls over inventory. Furthermore, we recommend that PUC continue to resolve variances that resulted from a glitch in the inventory system.

Prior Year Status: Inventory controls and procedures were reported as a finding in the audit of PUC in 2009, 2008 and 2007.

Auditee Response and Corrective Action Plan: We concur with the above finding. The newly implemented accounting software contained technical glitzes with summarization and reporting of inventory transactions. PUC has been working with the software consultant to address a fix to the reporting problems so that the system is able to accurately report on all activities involving inventory. The software supplier has already made several fixes to the inventory system with a final fix due out late June 2011. The fixes are designed to provide redundant integrity checks on all inventory data tables and, therefore; assure PUC of recording and reporting accuracy of inventory records.

Name of Contact Person: Jacqueline Alexander, Chief Financial Officer and Tracy Tellei, Procurement/Inventory Clerk

Proposed Completion Date: October 2011

Loans Payable

Finding No. 2010-3

Criteria: National Development of Bank of Palau (NDBP) loan covenants require that the ratio of accounts receivable to current asset ratio shall not be more than twenty-five percent. Further, as a condition of approval included in the loan offer letter, PUC agreed to implement a tariff note by August 2010 which includes a specific component sufficient to repay the loan.

Condition: At September 30, 2010, the accounts receivable to current asset ratio is more than twenty-five percent. In addition, NDBP asserts that PUC was not able to implement a tariff in August 2010 to include a specific component sufficient to repay the loan. PUC believes that a change in tariff requirement is not included as one of the affirmative covenants or negative covenants of the loan agreement. Further, PUC believes that the tariff change requirement would not be necessary if PUC generates sufficient net income to pay NDBP through other means such as reduction of operating costs by reducing its energy loss and by running fuel efficient engines and/or increase renewal energy penetration on the generation side.

Cause: The cause of the above condition is significant long outstanding accounts with the national government and varying interpretation of the tariff compliance requirements of the loan.

Effect: The effect of the above condition is noncompliance with the requirement of a twenty-five percent accounts receivable to current asset ratio and potential noncompliance with the tariff requirements.

Recommendation: We recommend that PUC consult with NDBP regarding the above.

Auditee Response and Corrective Action Plan: The PUC Board of Directors (Board) rejected the most recent tariff study, which incorporated repayment of the NDBP loan because the proposed tariff failed to meet the following positions of the Board: (1) tariff must be sufficient and equitable, providing electricity at the least cost possible; and (2) electric service must be priced right to support economic growth, promote social progress of the people and most especially help the government meet operating expenditures in providing other essential services. The Board communicated their concern to NDBP and believes that they can work with NDBP to find an alternative that would satisfy the loan covenant.

Please refer to our response to Finding 2010-4 which addresses the ratio of accounts receivable to current ratio.

Name of Contact Person: The PUC Board of Directors

Proposed Completion Date: October 2011

Local Noncompliance

Finding No. 2010-4

Criteria: The Palau National Code (PNC) Chapter 37 Section 302 states that all entities of the national and state governments shall pay all electrical and water utility services consumed, and shall not be given preferential treatment in the handling of their accounts by the agency of the national government responsible for the collection of utility charges.

Condition: As of September 30, 2010, utility receivables from the national government and the state governments amounted to $5,745,383 of which $3,660,406 or 64% is over ninety days.

Cause: The cause of the above condition is that management is reluctant to disconnect government accounts as public services may be disrupted.

Effect: The effect of the above condition is noncompliance with the PNC.

Recommendation: We recommend that PUC comply with the PNC provisions.

Prior Year Status: Noncompliance with PNC Chapter 37 Section 302 was reported as a finding in the audit of PUC for fiscal years 2009, 2008 and 2007.

Auditee Response and Corrective Action Plan: PUC's Electric Service Regulation provides that electric service may not be discontinued when it could "be dangerous to the health" of the customer. Several accounts of the national government directly affect the health of the customers of PUC: water and sewer pumps, the hospital and the airport. These accounts alone make up 70% of the national government's accounts receivables. PUC has endeavored to negotiate with the national government for the full retirement of their arrears. Should negotiations fail, PUC intends to adopt an exception to this policy and to disconnect such government services in order to comply with the law.

Name of Contact Person: Ruth S. Wong, Business Office Manager

Proposed Completion Date: October 2011

PUBLIC UTILITIES CORPORATION

Unresolved Prior Year Findings
Year Ended September 30, 2010

The status of unresolved prior year findings are disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 7).