Kauai Island Utility Cooperative

Financial Statements
December 31, 2004 and 2003
Together with Report of Independent Public Accountants

Report of Independent Public Accountants

To the Board of Directors of
Kauai Island Utility Cooperative:

We have audited the accompanying balance sheets of Kauai Island Utility Cooperative (the Cooperative) as of December 31, 2004 and 2003, and the related statements of revenues and patronage capital, comprehensive income and change in members' equity and cash flows for the years then ended. These financial statements are the responsibility of the Cooperative'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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kauai Island Utility Cooperative as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of administrative and general and other expenses for the years ended December 31, 2004 and 2003 are presented for purposes of additional analysis and are not a required part of the basic financial statements. These schedules are the responsibility of the Cooperative's management. These schedules have been subjected to the auditing procedures applied in our audits of the financial statements and, in our opinion, are fairly stated in all material respects when considered in relation to the financial statements taken as a whole.

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In accordance with *Government Auditing Standards,* we have also issued our report dated February 25, 2005 on our consideration of the Cooperative's internal control over financial reporting and on our test of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

KMH LLP

KMH LLP

Honolulu, Hawaii
February 25, 2005

Kauai Island Utility Cooperative

Balance Sheets
December 31, 2004 and 2003

Assets

	2004	2003
Utility Plant (Notes 1, 2 and 4):		
Electric plant in service	$ 389,437,082	$ 387,479,962
Construction work in progress	3,300,807	2,266,723
Total utility plant	392,737,889	389,746,685
Accumulated provision for depreciation	(150,099,521)	(138,505,129)
Net utility plant	242,638,368	251,241,556
Investments (Notes 2 and 5):		
Investments in associated organizations	100,994	-
Other investments	8,449,902	3,000,000
	8,550,896	3,000,000
Current Assets:		
Cash and cash equivalents	5,109,132	1,830,940
Accounts receivable:		
Customers	8,043,097	5,715,870
Unbilled	6,499,462	4,751,732
Allowance for doubtful accounts	(79,045)	(86,781)
	14,463,514	10,380,821
Materials and supplies	9,045,208	8,007,996
Prepaid expenses and other	952,874	1,154,036
Total current assets	29,570,728	21,373,793
Deferred Charges (Note 6)	5,751,296	6,010,306
Total assets	$ 286,511,288	$ 281,625,655

The accompanying notes are an integral part of these financial statements.

Kauai Island Utility Cooperative

Balance Sheets
December 31, 2004 and 2003

Equity and Liabilities

	2004	2003
Equity:		
Memberships (Note 2)	$ 279	$ 257
Patronage capital (Note 2)	17,754,491	6,879,907
Net unrealized gain on investments	51,222	-
Total equity	17,805,992	6,880,164
Long-Term Liabilities:		
RUS mortgage notes, less current portion (Note 7)	231,073,284	208,017,055
CFC mortgage notes, less current portion (Note 7)	7,632,313	39,574,000
Postretirement benefit obligations (Note 8)	4,038,498	4,077,104
Customer advances for construction	1,324,965	2,894,114
Deferred credits (Note 6)	8,730,201	7,301,315
Total long-term liabilities	252,799,261	261,863,588
Commitments and Contingencies (Notes 7 and 9)		
Current Liabilities:		
Current portion of long-term debt (Note 7)	5,825,000	2,541,000
Accounts payable	4,010,429	5,479,749
Customer deposits	496,047	432,345
Other current and accrued liabilities	5,574,559	4,428,809
Total current liabilities	15,906,035	12,881,903
Total equity and liabilities	$ 286,511,288	$ 281,625,655

The accompanying notes are an integral part of these financial statements.

Kauai Island Utility Cooperative

Statements of Revenues and Patronage Capital
For the years ended December 31, 2004 and 2003

	2004	2003
Operating Revenues (Note 2)	$ 118,907,802	$ 99,185,257
Operating Expenses:		
Cost of power	55,220,546	41,079,605
Depreciation and amortization (Notes 2 and 4)	17,021,299	16,686,714
Transmission operations	351,065	259,628
Transmission maintenance	322,838	286,685
Distribution operations	1,062,267	1,172,326
Distribution maintenance	1,756,110	1,571,449
Consumer accounts	1,798,833	1,405,921
Consumer service and information	359,718	303,245
Administrative and general	8,784,875	6,658,131
Other	9,800,072	8,614,126
Total operating expenses	96,477,623	78,037,830
Operating margins before interest expense	22,430,179	21,147,427
Interest Expense:		
Long-term debt (Note 7)	10,151,776	8,851,175
Capital lease and other obligations (Note 9)	38,079	6,074,567
Total interest expense	10,189,855	14,925,742
Operating margins	12,240,324	6,221,685
Nonoperating Margins:		
Interest income	339,421	136,035
Other nonoperating expense	(25,267)	(62,124)
Total nonoperating margins	314,154	73,911
Other Capital Credits and Patronage Dividends	40,083	10,533
Net margins	12,594,561	6,306,129
Retirement of patronage capital	(1,719,977)	-
Patronage Capital, beginning of period	6,879,907	573,778
Patronage Capital, end of period	$ 17,754,491	$ 6,879,907

The accompanying notes are an integral part of these financial statements.

Kauai Island Utility

Statements of Comprehensive Income and Change in Members' Equity
For the Years Ended December 31, 2004 and 2003

	2004	2003
Net margins	$ 12,594,561	$ 6,306,129
Other comprehensive income:		
Unrealized gain during the period on available-for-sale investments	51,222	-
Comprehensive income	$ 12,645,783	$ 6,306,129

	Memberships	Patronage Capital	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2002	$ 257	$ 573,778	$ -	$ 574,035
Net margins	-	6,306,129	-	6,306,129
Balance at December 31, 2003	257	6,879,907	-	6,880,164
Net margins	-	12,594,561	-	12,594,561
Change in accumulated other comprehensive income	-	-	51,222	51,222
Membership additions	22	-	-	22
Retirement of patronage capital	-	(1,719,977)	-	(1,719,977)
Balance at December 31, 2004	$ 279	$17,754,491	$ 51,222	$17,805,992

The accompanying notes are an integral part of these financial statements.

Kauai Island Utility Cooperative

Statements of Cash Flows
For the years ended December 31, 2004 and 2003

	2004	2003
Cash Flows From Operating Activities:		
Cash received from customers	$ 114,825,109	$ 99,092,767
Cash paid to suppliers and employees	(77,889,067)	(63,609,481)
Interest received	14,075	35,344
Interest paid	(9,908,435)	(13,964,495)
Net cash provided by operating activities	27,041,682	21,554,135
Cash Flows From Investing Activities:		
Construction of utility plant	(9,721,818)	(11,554,402)
Cost of investments acquired	(6,999,674)	(3,000,000)
Sales of investments	1,500,000	-
(Increase) decrease in:		
Materials and supplies	(1,037,212)	(1,296,107)
Deferred charges-preliminary surveys and investigations	(247,075)	73,101
Net cash used in investing activities	(16,505,779)	(15,777,408)
Cash Flows From Financing Activities:		
Proceeds from long-term debt (Note 7)	32,960,000	41,200,000
Payments on long-term debt (Note 7)	(34,228,240)	-
Payments to cushion of credit (Note 7)	(4,333,218)	(6,067,945)
Payments to line of credit	-	(5,955,400)
Payments to retire capital lease obligation (Note 9)	-	(38,599,792)
Proceeds from memberships issued	22	25
Increase in customer deposits	63,702	5,318
Retirement of patronage capital	(1,719,977)	-
Net cash used in financing activities	(7,257,711)	(9,417,794)
Net increase (decrease) in cash	3,278,192	(3,641,067)
Cash and cash equivalents, beginning of period	1,830,940	5,472,007
Cash and cash equivalents, end of period	$ 5,109,132	$ 1,830,940

The accompanying notes are an integral part of these financial statements.

Kauai Island Utility Cooperative

Statements of Cash Flows
For the years ended December 31, 2004 and 2003

	2004	2003
Reconciliation of Net Margins to Net Cash Provided by Operating Activities:		
Net margins	$ 12,594,561	$ 6,306,129
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	17,021,299	16,686,714
Provision for uncollectible accounts receivable, net	(7,736)	(6,093)
Change in:		
Customer and other accounts receivable	2,173,048	(94,797)
Current and other assets	(4,066,557)	584,133
Accounts payable	(963,298)	(92,741)
Postretirement benefit obligations	(38,606)	(4,759,562)
Current and other liabilities	328,971	2,930,352
Total adjustments	14,447,121	15,248,006
Net cash provided by operating activities	$ 27,041,682	$ 21,554,135

The accompanying notes are an integral part of these financial statements.

1. Summary of Operations

a. Organization

In November 1999, Kauai Island Utility Co-op, a cooperative association pursuant to the provisions of Chapter 421C of the Hawaii Revised Statutes, was formed to purchase and operate the electricity utility on the island of Kauai, Hawaii. In September 2002, the Cooperative changed its name to Kauai Island Utility Cooperative (KIUC or the Cooperative). KIUC is the exclusive retail electric service provider for the island of Kauai and provides electric generation, transmission and distribution services to approximately 33,200 customers.

KIUC is governed by a nine-member board of directors, who serve staggered three-year terms.

b. Membership

In accordance with KIUC's bylaws, all electricity users can elect whether or not to become a member. Each member is entitled to one vote regardless of billing amounts. Membership for all new members at inception was $10. In April 2003, this fee was retroactively reduced to a penny and all excess membership fees paid were refunded to respective members. As of December 31, 2004, there were approximately 27,900 members (23,400 active and 4,500 inactive).

c. Acquisition of Kaua`i Electric

On November 1, 2002, the Cooperative acquired substantially all of the assets of Kaua`i Electric (KE), a division of Citizens Communications Company (Citizens). The acquisition was accounted for as a purchase and, accordingly, KE's results are included in the statements of revenues and patronage capital since the date of the acquisition. The aggregate purchase price was approximately $218 million, which includes transaction costs incurred in the acquisition, and was financed by lines of credit from the National Rural Utilities Cooperative Finance Corporation and loans from the U.S. Government (see Note 7). See further discussion of the utility plant assets at Note 4.

2. Summary of Significant Accounting Policies

a. Basis of Accounting

The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to regulated enterprises, which conform to policies prescribed or permitted by the Hawaii Public Utilities Commission (HPUC) and the United States Department of Agriculture, Rural Utilities Service (RUS). KIUC maintains its accounting records in accordance with the RUS Uniform System of Accounts.

2. Summary of Significant Accounting Policies (continued)

b. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expense during the reporting period. Actual results could differ from those estimates.

c. Revenue Recognition

KIUC recognizes revenues based on rates authorized by the HPUC and include revenues applicable to energy consumed in the accounting period but not yet billed to the customers. Revenues related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. However, the determination of the energy sales to individual customers for billing purposes is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each month, amounts of energy delivered to customers since the date of the last meter reading are estimated and the corresponding unbilled revenue is estimated.

Fuel oil adjustments are included in rates and generally recover all of the prudently incurred fuel costs in accordance with provisions approved by the HPUC. If the actual fuel costs for a given month are more or less than amounts billed to customers for that month, the difference is recorded in deferred charges and any over or under collection is adjusted through a reconciliation mechanism. The balance is periodically filed with the HPUC.

d. Utility Plant

Utility plant is stated at original cost, which includes general overhead, less contributions in aid of construction. Maintenance and repairs are charged to operating expense as incurred. The cost, net of salvage, of routine utility plant dispositions is charged against accumulated depreciation.

Depreciation expense, calculated using the straight-line method, is based upon the estimated service lives of various classifications of property, plant and equipment and represents composite rates of approximately four percent for 2004 and 2003 of the gross depreciable utility plant. See Note 4 for further discussion.

2. Summary of Significant Accounting Policies (continued)

e. Investments

KIUC has classified its investments as available-for-sale, which are stated at fair value with unrealized gains and losses included in members' equity. The cost of investments sold is based on the specific identification method. As of December 31, 2004, the carrying value of the investments approximates their fair market value.

f. Cash equivalents

Cash equivalents include short-term, highly liquid investments with original maturities of three months or less and are stated at cost, which approximates fair value.

g. Materials and Supplies

Inventories of materials and supplies are stated at the lower of average cost or market.

h. Regulatory Assets and Liabilities

KIUC is subject to the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 requires regulated entities to record regulatory assets and liabilities as a result of actions of regulators.

KIUC continuously monitors the applicability of SFAS No. 71. SFAS No. 71 may, at some future date, be deemed inapplicable due to changes in the regulatory and competitive environments and/or a decision by KIUC to accelerate deployment of new technology. If KIUC were to discontinue the application of SFAS No. 71, KIUC would be required to write off its regulatory assets and regulatory liabilities and would be required to adjust the carrying amount of any other assets, including utility plant, which would be deemed not recoverable. KIUC believes its regulated operations continue to meet the criteria for SFAS No. 71 and that the carrying value of its regulated utility plant is recoverable in accordance with established rate-making practices. See Note 6 for further discussion.

2. Summary of Significant Accounting Policies (continued)

i. Impairment of Long-Lived Assets

KIUC reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

j. Taxes

KIUC is exempt under section 501(c)(12) of the Internal Revenue Code from federal income tax for any year in which at least 85 percent of its gross income is derived from members but is responsible for income taxes on certain unrelated business income. KIUC is not exempt under Hawaii Revised Statutes from state income taxes. However, operating margins that are allocated within a specific time period are considered a deduction for state income tax purposes.

For the State of Hawaii, KIUC is assessed a 5.885 percent of gross revenues (PUC Tax) in lieu of general excise taxes and county real property taxes. Also, KIUC is assessed .5 percent of gross revenues (PUC Fee). For the County of Kauai, Hawaii, KIUC is assessed a 2.5 percent franchise fee on gross revenues.

k. Members' Equity

Allocations and distributions of net margins to members are done on a patronage basis. Provisions in KIUC's bylaws further require that 10 percent of net margins be placed in a surplus fund and all distributions be approved by the board of directors. In addition, provisions of RUS loan agreements prohibit distributions until stipulated requirements are met. Furthermore, in accordance with a decision and order by the HPUC, KIUC is required to apply for approval to make a distribution equal to at least 25 percent of net margins to members after each year or reporting period, as applicable, with the RUS. The Cooperative will distribute 25 percent of 2004 net margins subject to receipt of RUS approval in 2005. In addition, the Cooperative will pay a rebate to existing customers as of December 31, 2004 totaling $1.0 million subject to receipt of RUS approval in 2005. The Cooperative plans to treat the rebate as additional patronage capital retirement for members and a reduction of revenue for customers that are not members.

2. Summary of Significant Accounting Policies (continued)

k. Members' Equity (continued)

For the year ended December 31, 2003 and two month period ended December 31, 2002, $1,576,532 and $143,445 of net margins were allocated to members, respectively. Cumulatively, $1,719,977 has been distributed and $2,130 is unpaid at December 31, 2004.

l. Customer Deposits

Customer deposits represent amounts received from utility customers in order to provide service. Deposits are refundable upon the earlier of a customer meeting specified requirements or termination of service. Deposits accrue interest at eight percent which is paid annually.

m. Asset Retirement Obligation

In 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 143, *Accounting for Asset Retirement Obligations*, which provides accounting requirements for the recognition and measurement of liabilities for obligations associated with the retirement of tangible long-lived assets. Retirement obligations are those for which there is a legal obligation under existing or enacted law, statue, written or oral contract, or legal construction. Under the standard, these liabilities will be recognized at fair value as incurred and capitalized as part of the cost of the related asset. Accretion of liabilities due to the passage of time will be expensed.

KIUC may have asset retirement obligations relating to various distribution and transmission assets which are located on property not owned by KIUC. Management believes such obligations are not material to the financial statements at December 31, 2004. In addition, the Cooperative has potential retirement obligations for the dismantlement of power generation facilities. The Cooperative's intent is to maintain these facilities in a manner such that they will be operated indefinitely. The Cooperative cannot estimate any potential retirement obligation associated with these assets and therefore the Cooperative has not recorded an asset retirement obligation as of December 31, 2004.

2. Summary of Significant Accounting Policies (continued)

n. Recently Issued Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which established new standards for classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The statement is effective for certain nonpublic companies for fiscal years beginning after December 15, 2003. In November 2003, the FASB issued FASB Staff Position 150-3, deferring indefinitely the effective date of SFAS No. 150 for nonpublic entities.

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, which is effective for nonpublic enterprises by the beginning of the first annual period beginning after December 15, 2004. This interpretation requires that an enterprise that consolidates a variable interest entity is the primary beneficiary of the variable interest entity. KIUC will adopt FASB Interpretation No. 46 on January 1, 2005, and, based on current circumstances, does not believe that the impact of adoption of this interpretation will have a material impact on KIUC's financial position or results of operations.

3. Concentrations of Risk

KIUC maintains its cash and investment accounts in commercial banks and investment firms. Cash balances in accounts at each bank are insured up to $100,000 per account holder by the Federal Deposit Insurance Corporation (FDIC). Cash and investments held by the investment firms are insured up to $500,000 (with a limit of $100,000 for cash) by the Securities Investor Protection Corporation (SIPC). In assessing its concentration of credit risk related to cash and cash equivalents, the Cooperative places its cash and cash equivalents in various accounts, which may at times exceed FDIC or SIPC insurance limits. As of December 31, 2004, KIUC exceeded these limits by approximately $6.7 million. KIUC believes no significant risk of loss exists with respect to these cash balances.

KIUC received approximately 21 percent of its revenues for the years ended December 31, 2004 and 2003, from its 25 largest customers. The credit risk for accounts receivable is controlled through the collection of deposits from customers and management monitoring procedures.

4. Utility Plant and Depreciation Rates and Procedures

Utility plant consists of the following as of December 31, 2004 and 2003:

	2004	2003
Production plant	$121,818,452	$120,711,204
Transmission plant	64,880,011	64,513,889
Distribution plant	128,613,295	129,381,139
General plant	19,283,390	18,031,796
Plant acquisition adjustment	54,841,934	54,841,934
Electric plant in service	389,437,082	387,479,962
Construction work in progress	3,300,807	2,266,723
Total utility plant	$392,737,889	$389,746,685

In accordance with RUS accounting regulations, the plant acquisition adjustment represents the difference between the purchase price for the acquisition of KE's assets and the carrying value of the electric plant assets acquired. The plant acquisition adjustment is amortized over the remaining estimated useful life of the assets acquired.

Initially, KIUC recorded the difference between the purchase and the net carrying value of the plant assets acquired as goodwill. However, RUS accounting regulations conflicted with management's interpretation of generally accepted accounting principles. In 2003, KIUC requested a waiver for the difference in the accounting treatment with the RUS to keep the accounting treatment consistent with the filings with the HPUC. Management and the board of directors, however, after many discussions with RUS staff, was not able to obtain the waiver and therefore decided to adopt the RUS' interpretation for the accounting of the difference as a plant acquisition adjustment.

4. Utility Plant and Depreciation Rates and Procedures (continued)

The following details the effect the amortization of the plant acquisition adjustment has on net margins:

	2004	2003
Net margins, excluding amortization of plant acquisition adjustment	$ 14,788,238	$ 8,499,806
Amortization of plant acquisition adjustment	(2,193,677)	(2,193,677)
Net margins, as reported	$ 12,594,561	$ 6,306,129

Provision has been made for depreciation of production plant, transmission plant, distribution plant and plant acquisition adjustment at approximate straight-line composite rates of 3.0, 4.0, 4.0 and 4.0 percent per annum, respectively. Approximate general plant depreciation lives have been applied on a straight-line basis as follows

Structures and improvement	3.0%
Office furniture	4.0%
Transportation equipment	10.0%
Power operated equipment	7.0%
Other general plant	7.0%
Communications equipment	5.0%

5. Investments

The following is a detail of amounts recorded as investments in an associated organization as of December 31, 2004:

National Rural Utilities Cooperative Finance Corporation	
Subordinate Certificate	$ 82,400
Patronage Capital	18,594
	$ 100,994

Available for sale investments at December 31, 2004 and 2003 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2004				
US Treasury obligations	$ 776,036	$ –	$ (1,518)	$ 774,518
US Government agencies	664,153	–	(2,732)	661,421
Corporate securities	6,958,491	58,496	(3,024)	7,013,963
	$ 8,398,680	$ 58,496	$ (7,274)	$8,449,902
2003				
Corporate securities	$ 3,000,000	$ –	$ –	$3,000,000
	$ 3,000,000	$ –	$ –	$3,000,000

Annual maturities of the investments at December 31, 2004 are classified as follows:

	Amortized Cost	Fair Value
Less than one year	$ 4,418,004	$ 4,475,369
After 1 year through 5 years	3,980,676	3,974,533
	$ 8,398,680	$ 8,449,902

6. Deferred Charges and Credits

The following is a summary of amounts recorded as deferred charges as of December 31, 2004 and 2003:

	2004	2003
Regulatory asset – Iniki damage	$ 5,187,552	$ 5,479,812
Regulatory asset – SFAS 106 transition	551,877	620,865
Regulatory asset – demand-side management (DSM) and integrated resource plan (IRP)	(568,252)	(423,371)
Preliminary survey investigation costs	580,119	333,000
	$ 5,751,296	$ 6,010,306

The following is a summary of amounts recorded as deferred credits as of December 31, 2004 and 2003:

	2004	2003
Regulatory liabilities – Iniki amortization	$ 5,187,552	$ 5,479,812
Deferred credits – scheduled plant maintenance	3,542,649	1,821,503
	$ 8,730,201	$ 7,301,315

All of the regulatory assets and liabilities identified above have been approved for rate recovery by the HPUC and are being amortized and collected from customers over the period specified by the HPUC. The DSM and the IRP are key components of KIUC's energy conservation efforts. To facilitate the purchase of KE assets, KIUC and Citizens waived their rights to apply for demand side management shareholder incentives available to electricity utilities that meet certain specified energy conservation goals.

Under the DSM program, KIUC recovers from rate payers lost margins, which are estimates of reduced demand resulting from energy conservation efforts. In February 2005, the Cooperative filed an application with the HPUC to remove lost margins from its tariff and also institute new depreciation rates from a study completed in 2004 as of July 1, 2005. If the application is approved, management believes that there will be no material adverse impact to the financial statements.

7. Long-Term Debt

Long-term debt consists of mortgage notes payable to the RUS (RUS Mortgage) and the National Rural Utilities Cooperative Finance Corporation (CFC). The following is a summary of outstanding long-term debt as of December 31, 2004 and 2003:

	2004	2003
RUS, 2.1% Note due October 31, 2027	$ 10,689,000	$ 10,750,000
RUS, 2.8% Note due October 31, 2027	21,388,000	21,500,000
RUS, 3.1% Note due October 31, 2027	21,393,000	21,500,000
RUS, 3.8% Note due October 31, 2027	32,102,000	32,250,000
RUS, 4.4% Note due October 31, 2027	21,409,000	21,500,000
RUS, 4.9% Note due October 31, 2027	107,074,000	107,500,000
RUS, 3.1% Note due March 31, 2009	8,240,000	–
RUS, 3.9% Note due March 31, 2014	8,240,000	–
RUS, 4.3% Note due December 31, 2023	16,480,000	–
	247,015,000	215,000,000
Less: current maturities	(5,789,000)	(942,000)
	$ 241,226,000	$ 214,058,000
CFC, 4.2% Note due September 30, 2023	$ 7,916,000	$ 8,240,000
CFC, 2.6% Note due September 30, 2023	–	32,960,000
	7,916,000	41,200,000
Less: current maturities	(284,000)	(1,626,000)
	$ 7,632,000	$ 39,574,000

As of December 31, 2004, the long-term and current portion of the RUS notes were offset by a cushion of credit that approximated $10,152,000 and $248,000, respectively. As of December 31, 2003, the long-term and current portion of the cushion of credit was approximately $6,041,000 and $27,000, respectively. The cushion of credit represents a voluntary advance payment that remains un-applied until KIUC decides to use it to pay down the RUS notes. In accordance with RUS regulations, this cushion of credit is offset against the RUS long-term debt and a proportionate amount is also offset against currently maturing RUS debt.

7. Long-Term Debt (continued)

KIUC has lines of credit with CFC totaling $85,000,000 which are renewable annually. KIUC had no amounts outstanding on these lines as of December 31, 2004.

The $33 million CFC bridge loan was refinanced with RUS in October 2004. The CFC and RUS notes are payable in quarterly and monthly installments, respectively. The RUS notes have various defined dates at which the interest rates mature and are required to be reestablished based upon available rates and terms from the RUS, up to a maximum of seven percent, as defined in the RUS Mortgage. The CFC note bears interest at a variable rate, as determined by CFC, and was 4.2% and 2.6% at December 31, 2004 and 2003, respectively.

Substantially all assets are pledged as security for the notes and the lines of credit. In addition, the RUS Mortgage and CFC loan agreements require KIUC to maintain certain covenants, including debt service coverage, times interest earned ratio, annual financial reporting to the RUS and compliance with RUS regulations. As of December 31, 2004, KIUC was in compliance with all covenants required by the RUS Mortgage and the CFC loan agreements.

The CFC loan agreement also requires KIUC to purchase loan capital term certificates (LCTC) and subscription capital term certificates (SCTC) at a defined percentage of the commitment amount. KIUC purchased approximately $82,000 and nil of LCTC's and SCTC's, respectively, as of December 31, 2004.

As of December 31, 2004, annual principal maturities of long term debt are as follows:

2005	$ 6,073,000
2006	7,305,000
2007	7,938,000
2008	8,264,000
2009	8,899,000
Thereafter	216,452,000
	$ 254,931,000

8. Pension, Post Retirement Benefit and Compensation Plans

a. 401(k) Plan

KIUC is a participating employer in a multi-employer 401(k) plan sponsored by National Rural Electric Cooperative Association (NRECA) providing for voluntary employee and employer contributions. The administrative expenses of the plan are paid out of earnings of the plan. KIUC contributed approximately $100,000 and $57,000 for bargaining unit employees and approximately $88,000 and $93,000 for non-bargaining unit employees for the years ended December 31, 2004 and 2003, respectively. As of December 31, 2004, KIUC had approximately $8,000 due to the 401(k) plan.

b. Pension Plan

KIUC is a participating employer in a multi-employer pension plan sponsored by NRECA for eligible employees. The accumulated benefits and plan assets are not determined or allocated separately by individual employer. Pension expense for future service contributions for the years ended December 31, 2004 and 2003 were approximately $1,559,000 and $972,000, respectively.

In addition, KIUC assumed a past service liability of approximately $4,780,000 as of November 1, 2002. The past service liability represented the benefits for services rendered prior to November 1, 2002 by Citizens employees that joined KIUC after the acquisition. As of December 31, 2003, the past service liability was fully paid.

c. Fostretirement Benefits Other than Pensions

The Kauai Island Utility Cooperative Retiree Welfare Benefit Plan (the "Plan") and its associated trust, the Kauai Island Utility Cooperative Retiree Welfare Benefit Trust (the "Trust") were adopted effective January 1, 2003. The Plan provides certain non-contributory medical, dental, vision and life insurance benefits for retired employees and their beneficiaries and covered dependents. The following table sets forth the reconciliation of the funded status of KIUC's Plan and the amounts recognized in the financial statements as of December 31, 2004 and 2003.

Kauai Island Utility Cooperative

Notes to Financial Statements
December 31, 2004

8. Pension, Post Retirement Benefit and Compensation Plans (continued)

	2004	2003
Accumulated postretirement benefits obligation:		
a. Retirees and dependents	$ 4,586,900	$ 4,871,900
b. Fully eligible active plan participants	1,869,700	1,508,500
c. Other active plan participants	762,200	615,800
Total	7,218,800	6,996,200
Less: plan assets at fair value:		
Short-term bond fund	2,680,800	2,637,200
Accumulated obligation in excess of plan assets	4,538,000	4,359,000
Unrecognized net (gain)/loss from past experience different from that assumed and from changes in assumptions	(499,502)	(281,896)
Accrued postretirement benefit cost recognized in the balance sheet	$ 4,038,498	$ 4,077,104

8. Pension, Post Retirement Benefit and Compensation Plans (continued)

	2004	2003
Reconciliation of (accrued) postretirement benefit cost:		
a. (Accrued) postretirement benefit obligation	$4,077,104	$4,056,200
b. SFAS 106 expense	301,600	346,400
c. Contribution to assets	–	–
d. Retiree benefits paid	(340,206)	(325,496)
Accrued postretirement benefit cost	$ 4,038,498	$4,077,104
Discount rate	6.00%	6.25%
Return on plan assets	6.00%	6.00%

The Plan assets are invested in short term bonds under the direction of the KIUC board of directors.

A 10.0 percent average annual rate of increase in the per-capita cost of covered health care benefits was assumed for 2004; the rate is assumed to decrease gradually to 5.0 percent per year by 2014 and remain at that level, thereafter.

Estimated future benefit payments:

Year ending December 31	
2005	$ 448,000
2006	470,000
2007	481,000
2008	515,000
2009	535,000
Thereafter	2,785,000
	$ 5,234,000

8. Pension, Post Retirement Benefit and Compensation Plans (continued)

On December 8, 2003, the Federal government enacted the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) into law. The Act introduces a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of qualified retiree health care benefit plans, as defined. The accumulated obligation and net postretirement benefit cost amounts above do not reflect any amount associated with the subsidy because KIUC has not completed its evaluation of whether the benefits provided by the plan are actuarially equivalent to the benefits provided under the Act.

9. Commitments and Contingencies

a. Leases

KIUC leases certain office space under a non-cancelable operating lease which expires in 2020 and contains options to extend the term up to an additional 25 years. The lease also includes an option to purchase the landlord's interest, as defined, in the year 2025. As of December 31, 2004, the future minimum rental commitment under this lease is approximately as follows:

Year ending December 31	
2005	$ 973,000
2006	1,200,000
2007	1,200,000
2008	1,200,000
2009	1,200,000
Thereafter	11,396,000
	$ 17,169,000

In addition to the amounts above, the Cooperative is responsible for common area maintenance costs, real property taxes and other reimbursable operating expenses, as defined. Rent expense for the years ended December 31, 2004 and 2003 approximated $1,377,000 and $1,291,000, respectively.

b. Kaua`i Power Partners (KPP) Purchased Power Agreement

For the majority of 2003, KIUC had a purchase power agreement with KPP, an unrelated third party, to purchase 100 percent of the electricity generated by a recently completed power plant in Lihue, Kaua`i. The plant's capacity is approximately 26.4 megawatts, which represents approximately 22 percent of KIUC's total generation capability. Payments consisted of a fixed (capacity) and variable component. This arrangement was initially classified and recorded as a capital lease.

9. Commitments and Contingencies (continued)

b. Kaua`i Power Partners (KPP) Purchased Power Agreement (continued)

In December 2003, KIUC acquired the generation facility (Facility) and substantially all the assets and certain liabilities from KPP for $40.2 million, adjusted for various amounts as defined in the purchase agreement. The purchase was financed entirely with debt. After deducting the working capital assets acquired in the purchase and the retirement of the capital lease obligation, KIUC was left with approximately $1.4 million in excess costs which were capitalized to the Facility in accordance with RUS accounting regulations. The decision and order that approved the acquisition required KIUC to depreciate the Facility over 16.5 years and provide an equity management plan as an informational filing to the HPUC.

c. Fuel Contract

As a result of the purchase of KE assets, Citizens assigned to KIUC a diesel fuel supply contract with an international oil refining company that is renewable for 12-month periods unless terminated by KIUC or the supplier. 100 percent of KIUC's diesel fuel is obtained through this supply contract. The price is adjusted monthly to equal a published price, as defined, plus other defined costs such as terminal and freight costs. Diesel fuel costs for the years ended December 31, 2004 and 2003 approximated $23,277,000 and $17,032,000, respectively.

d. Employee Agreements

KIUC has agreements with one union. In December 2004, the Cooperative negotiated a new contract with the union which was ratified in December 2004. The agreement expires in December 2009.

KIUC also maintains separate written agreements for certain senior management officials. Each contract has a term of three years.

e. Litigation

KIUC is involved in certain litigation incurred in the normal course of business. In the opinion of management, the ultimate resolution of these matters will not have a material adverse effect on KIUC.

10. Related Party Transactions

KIUC engaged a general legal counsel who is the spouse of a member of senior management. This relationship was fully disclosed to the Board and its members. For the years ended December 31, 2004 and 2003, fees paid to the legal counsel's firm approximated $101,000 and $137,000, respectively.

SUPPLEMENTAL SCHEDULES

Kauai Island Utility Cooperative

Supplemental Schedules of Administrative and General and Other Expenses
For the years ended December 31, 2004 and 2003

	2004	2003
Administrative and General Expenses:		
Salaries and wages	$ 3,293,046	$ 2,489,744
Rent	1,235,107	1,167,705
Outside services	1,084,326	722,996
Office supplies	588,540	528,462
Insurance	490,396	331,107
Maintenance and repairs	65,927	94,367
Miscellaneous	2,027,533	1,323,750
Total administrative and general	$ 8,784,875	$ 6,658,131
Other Expenses:		
PUC tax	$ 6,791,123	$ 3,919,167
Franchise fees	2,884,929	2,455,866
Miscellaneous	124,020	2,239,093
Total other	$ 9,800,072	$ 8,614,126