Kaua'i Island Utility Cooperative

Your Touchstone Energy® Cooperative

*The power of human connections®*

**INDEPENDENT AUDITOR'S REPORT**
**AND**
**FINANCIAL STATEMENTS**

**DECEMBER 31, 2008 AND 2007**

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**INDEPENDENT AUDITOR'S REPORT**

Board of Directors
Kauai Island Utility Cooperative

We have audited the accompanying balance sheet of Kauai Island Utility Cooperative (the Cooperative) as of December 31, 2008 and the related statements of operations, equities and margins and cash flows for the year 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 audit. The accompanying balance sheet of Kauai Island Utility Cooperative as of December 31, 2007 and the related statements of operations, equities and margins and cash flows for the year then ended were audited by other auditors whose report dated April 14, 2008 expressed an unqualified opinion on those statements.

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. 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Cooperative as of December 31, 2008 and the results of its operations and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued a report dated April 28, 2009 on our consideration of the Cooperative's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in conjunction with this report in considering the results of our audit.

Moss Adams LLP

Portland, Oregon
April 28, 2009

**KAUAI ISLAND UTILITY COOPERATIVE**
**BALANCE SHEETS**

## ASSETS

| | DECEMBER 31, 2008 | DECEMBER 31, 2007 |
|---|---|---|
| UTILITY PLANT | | |
| Electric plant in service | $ 369,219,726 | $ 357,806,314 |
| Electric plant acquisition cost | 54,852,453 | 54,852,453 |
| Accumulated depreciation and amortization | (198,671,933) | (186,628,077) |
| Net electric plant in service | 225,400,246 | 226,030,690 |
| Construction work in progress | 14,632,361 | 14,020,468 |
| Net utility plant | 240,032,607 | 240,051,158 |
| OTHER PROPERTY AND INVESTMENTS | | |
| Investments in associated organizations | 307,029 | 281,814 |
| Rural economic development loans | 693,173 | - |
| Other investments | 2,324,455 | 2,125,902 |
| | 3,324,657 | 2,407,716 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | 23,262,767 | 16,608,173 |
| Restricted cash and cash equivalents | 404,007 | 429,855 |
| Accounts and notes receivable, less allowance for doubtful accounts of $1,164,541 and $905,492 in 2008 and 2007, respectively | 9,607,001 | 11,378,102 |
| Accrued unbilled revenue | 7,270,482 | 9,181,212 |
| Energy rate adjustment clause | - | 613,515 |
| Inventories | 13,156,810 | 12,164,292 |
| Other current and accrued assets | 1,119,244 | 1,131,758 |
| Total current assets | 54,820,311 | 51,506,907 |
| DEFERRED DEBITS | 4,420,580 | 5,242,460 |
| | $ 302,598,155 | $ 299,208,241 |


See accompanying notes.

## LIABILITIES AND EQUITIES

| | DECEMBER 31, 2008 | DECEMBER 31, 2007 |
|---|---|---|
| EQUITIES AND MARGINS | $ 46,667,767 | $ 41,323,894 |
| LONG-TERM DEBT, less current maturities | 207,450,282 | 216,394,675 |
| POST-RETIREMENT BENEFIT OBLIGATION | 5,028,600 | 4,003,700 |
| CURRENT LIABILITIES | | |
| Current maturities of long-term debt | 8,487,400 | 8,178,300 |
| Accounts payable | 5,665,381 | 7,605,248 |
| Energy rate adjustment clause | 2,963,597 | - |
| Consumer deposits | 884,009 | 759,866 |
| Accrued employee compensation | 1,841,802 | 1,588,479 |
| Accrued taxes | 10,454,884 | 8,287,200 |
| Other current and accrued liabilities | 90,809 | 179,047 |
| Total current liabilities | 30,387,882 | 26,598,140 |
| DEFERRED CREDITS | 13,063,624 | 10,887,832 |
| | $ 302,598,155 | $ 299,208,241 |

See accompanying notes.

## KAUAI ISLAND UTILITY COOPERATIVE
## STATEMENTS OF OPERATIONS

| | YEAR ENDED DECEMBER 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | | 2007 | | Increase |
| | Amount | % | Amount | % | (Decrease) |
| OPERATING REVENUES | | | | | |
| Residential | $ 67,521,772 | 35.6 | $ 58,823,117 | 36.1 | $ 8,698,655 |
| Irrigation | 415,411 | 0.2 | 344,452 | 0.2 | 70,959 |
| Commercial and industrial | 120,056,369 | 63.3 | 102,429,362 | 62.8 | 17,627,007 |
| Public street and highway lighting | 1,457,504 | 0.8 | 1,286,933 | 0.8 | 170,571 |
| Other operating revenues | 174,072 | 0.1 | 163,931 | 0.1 | 10,141 |
| Total operating revenues | 189,625,128 | 100.0 | 163,047,795 | 100.0 | 26,577,333 |
| OPERATING EXPENSES | | | | | |
| Power cost | 118,523,236 | 62.5 | 93,036,696 | 57.1 | 25,486,540 |
| Transmission - Operation | 325,224 | 0.2 | 566,172 | 0.3 | (240,948) |
| Transmission - Maintenance | 621,943 | 0.3 | 651,558 | 0.4 | (29,615) |
| Distribution - Operation | 1,361,894 | 0.7 | 1,492,154 | 0.9 | (130,260) |
| Distribution - Maintenance | 2,280,171 | 1.2 | 2,049,030 | 1.3 | 231,141 |
| Customer accounts | 2,440,141 | 1.3 | 2,663,936 | 1.6 | (223,795) |
| Customer service and information | 944,753 | 0.5 | 822,573 | 0.5 | 122,180 |
| Administrative and general | 12,186,795 | 6.4 | 11,300,907 | 6.9 | 885,888 |
| Depreciation and amortization | 16,450,486 | 8.7 | 16,207,749 | 9.9 | 242,737 |
| Taxes | 16,026,840 | 8.5 | 13,763,798 | 8.4 | 2,263,042 |
| Total operating expenses | 171,161,483 | 90.3 | 142,554,573 | 87.3 | 28,606,910 |
| OPERATING MARGINS - Before Interest | 18,463,645 | 9.7 | 20,493,222 | 12.7 | (2,029,577) |
| INTEREST ON LONG-TERM DEBT | 9,940,742 | 5.2 | 10,167,302 | 6.2 | (226,560) |
| OPERATING MARGINS | 8,522,903 | 4.5 | 10,325,920 | 6.5 | (1,803,017) |
| NONOPERATING MARGINS | | | | | |
| Interest income | 909,234 | 0.5 | 1,458,820 | 0.9 | (549,586) |
| Capital credits | 58,688 | 0.0 | 67,934 | 0.0 | (9,246) |
| Other nonoperating income | 62,772 | 0.0 | 13,357 | 0.0 | 49,415 |
| Total nonoperating margins | 1,030,694 | 0.5 | 1,540,111 | 0.9 | (509,417) |
| NET MARGINS | 9,553,597 | 5.0 | 11,866,031 | 7.4 | $ (2,312,434) |
| COMPREHENSIVE INCOME | | | | | |
| Unrealized gain on available-for-sale securities | 20,607 | | 63,647 | | |
| Adjustment for FASB Statement No. 158 | (1,217,500) | | (400,300) | | |
| COMPREHENSIVE INCOME | $ 8,356,704 | | $ 11,529,378 | | |



See accompanying notes.

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2008 | 2007 |
| Memberships | | |
| Balance at January 1, | $ 349 | $ 325 |
| Additions | 22 | 24 |
| Balance at December 31, | 371 | 349 |
| Patronage Capital | | |
| Balance at January 1, | 41,674,804 | 32,129,731 |
| Transfer of net margins | 9,553,597 | 11,866,031 |
| Retirement of capital credits, net | (3,037,387) | (2,320,958) |
| Balance at December 31, | 48,191,014 | 41,674,804 |
| Unrealized Gain (Loss) on Available-For-Sale Investments | | |
| Balance at January 1, | 35,135 | (28,512) |
| Gain | 20,607 | 63,647 |
| Balance at December 31, | 55,742 | 35,135 |
| Other Equity | | |
| Balance at January 1, | 16,806 | 2,120 |
| Additions | 24,534 | 14,686 |
| Balance at December 31, | 41,340 | 16,806 |
| Other Comprehensive Loss | | |
| Balance at January 1, | (403,200) | - |
| Loss | (1,217,500) | (403,200) |
| Balance at December 31, | (1,620,700) | (403,200) |
| Total equities and margins | $ 46,667,767 | $ 41,323,894 |

See accompanying notes.

## KAUAI ISLAND UTILITY COOPERATIVE
## STATEMENTS OF CASH FLOWS

| | YEAR ENDED DECEMBER 31, 2008 | 2007 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net margins | $ 9,553,597 | $ 11,866,031 |
| Adjustments to reconcile net margins to net cash from operating activities | | |
| Depreciation and amortization | 16,824,554 | 16,526,454 |
| Capital credits | (58,688) | (67,934) |
| Change in assets and liabilities | | |
| Accounts and notes receivable and unbilled revenue | 3,681,831 | (3,160,130) |
| Energy rate adjustment clause | 3,577,112 | (3,495,624) |
| Inventories and other current and accrued assets | (980,004) | (2,241,766) |
| Deferred debits | 821,880 | 1,325,427 |
| Post-retirement benefit obligation | (192,600) | (158,100) |
| Accounts payable, consumer deposits and accrued expenses | 517,045 | 1,252,095 |
| Deferred credits | 2,175,792 | 240,280 |
| Net cash from operating activities | 35,920,519 | 22,086,733 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Additions to utility plant | (16,806,003) | (19,012,468) |
| Rural economic development loans | (693,173) | - |
| Other property and investments | (144,473) | 2,274,052 |
| Net cash from investing activities | (17,643,649) | (16,738,416) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Payments on long-term debt | (8,635,293) | (5,355,894) |
| Memberships | 22 | 24 |
| Other equity | 24,534 | 14,686 |
| Retirement of patronage capital | (3,037,387) | (2,320,958) |
| Net cash from financing activities | (11,648,124) | (7,662,142) |
| CHANGE IN CASH AND CASH EQUIVALENTS | 6,628,746 | (2,313,825) |
| CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR | 17,038,028 | 19,351,853 |
| CASH AND CASH EQUIVALENTS - END OF YEAR | $ 23,666,774 | $ 17,038,028 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid during the year for: | | |
| Interest on long-term debt | $ 9,940,742 | $ 10,167,302 |
| Income taxes | $ 36,972 | $ 38,250 |



See accompanying notes.

## NOTE 1 - NATURE OF ORGANIZATION AND OPERATIONS

Kauai Island Utility Cooperative (KIUC or the Cooperative), a not-for-profit cooperative association pursuant to the provisions of Chapter 421C of the Hawaii Revised Statutes, was formed to purchase and operate the electric utility on the island of Kauai, Hawaii. KIUC is the exclusive retail electric service provider for the island of Kauai and provides electric generation, transmission and distribution services to approximately 35,000 customers. The Cooperative's headquarters facility is located in Lihue, Hawaii.

On November 1, 2002, the Cooperative acquired substantially all of the assets of Kauai Electric (KE), a division of Citizens Communications Company (Citizens). The aggregate purchase price was approximately $218 million, which included 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.

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of accounting and presentation** - 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).

The accounting records of the Cooperative are maintained in accordance with the Uniform System of Accounts as prescribed by the Federal Energy Regulatory Commission (FERC) for Class A and B electric utilities.

**Regulatory accounting** - Due to regulation of its rates by the HPUC, the Cooperative is subject to the accounting requirements of Financial Accounting Standard No. 71, *Accounting for the Effects of Certain Types of Regulation*. This accounting standard recognizes that the ratemaking process can result in differences in the application of generally accepted accounting principles between regulated and non-regulated businesses. Such differences generally involve the accounting period in which various transactions enter into the determination of net margins. Accordingly, certain costs and income may be capitalized as a regulatory asset or liability that would otherwise be charged to expense or revenues. Regulatory assets and liabilities are recorded when it is probable that future rates will permit recovery and are approved by the HPUC (See Notes 6 and 10). Such balances are amortized over the period specified by the HPUC.

In accordance with an HPUC Decision & Order, KIUC is allowed recovery of depreciation expense not realized due to the early retirement of electric plant destroyed in hurricane Iniki. In 1996, the HPUC approved $7,598,760 as the total amount of Iniki deferred depreciation with an amortization period of 26 years. The annual amortization amount is $292,260 ending in 2022. The Iniki regulatory asset is amortized to depreciation expense and the offsetting Iniki regulatory liability is amortized to accumulated depreciation.

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

**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.

**Patronage capital** - Net margins are assigned to individual Cooperative members' capital credit accounts based upon their pro rata use of total Cooperative electricity provided for the year (See Note 7). Capital credits are returned to members in accordance with the Cooperative's policies. Under the provisions of the mortgage agreements, until the equities and margins equal or exceed 30% of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to 25% of the patronage capital or margins received by the Cooperative in the prior calendar year. KIUC is required to obtain the approval of RUS prior to making a distribution equal to 25% of net margins to members. The equities and margins of the Cooperative represent 15.42% of the total assets at December 31, 2008.

**Electric plant, acquisition cost, depreciation and maintenance** - Electric plant is stated at the original cost of construction, which includes the cost of contracted services, direct labor and materials and overhead items (See Note 3). Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

In accordance with RUS accounting regulations, electric plant acquisition cost represents the difference between the purchase price for the acquisition of KE's assets and the carrying value of those assets. This amount is being amortized over the remaining useful life of the assets acquired which was originally estimated to be 25 years.

Provision has been made for depreciation of electric plant at a straight-line composite rate of approximately 3.9% per annum. During 2004, the Cooperative performed a depreciation study. New depreciation rates were implemented in June 2005. These rates have been approved by the Hawaii Public Utility Commission. Another depreciation study was conducted in March 2009 (See Note 14). Depreciation for the years ended December 31, 2008 and 2007 was $16,824,554 and $16,526,454, respectively, of which $16,450,486 and $16,207,749 was charged to depreciation and amortization expense and $374,068 and $318,705 was allocated to other accounts, respectively.

When property which represents a retirement unit is replaced or removed, the average cost of such property as determined from the continuing property records is credited to electric plant and such cost, together with cost of removal less salvage, is charged to the accumulated provision for depreciation.

Maintenance and repairs, including the renewal of minor items of plant not comprising a retirement unit, are charged to the appropriate maintenance accounts, except that repairs of transportation and service equipment are charged to clearing accounts and redistributed to operating expense and other accounts.

Management assesses impairment and the existence of asset retirement obligations annually and as circumstances warrant.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Investments in associated organizations** - Investments in associated organizations are carried at cost (See Note 4), which approximates fair value, plus capital credits allocated and not retired.

**Rural economic development loans** - The Cooperative has received Rural Economic Development Grants (RED Grant) from the USDA Rural Development (USDA RD) Office in order to provide loans to promote sustainable rural economic development and job creation projects. KIUC is required to match 20% of the RED Grant award. The RED Grant is awarded to KIUC, who in turn loans the funds to the eligible project applicant at 0% interest for a term of up to 10 years. When the loan recipient repays the loan, the loan funds are retained and placed into the Revolving Loan Fund (RLF) and then reused to fund new loans to additional projects (RLF Loans). The RLF Loans are made in accordance with the USDA RD approved Revolving Loan Fund Plan Loan Policies and Procedures Manual. Both the RED Grant loans and the RLF loans are stated at cost (See Note 4).

**Other investments** - KIUC has classified its investments as available-for-sale, which are stated at fair value with unrealized gains and losses included in equities and margins (See Note 4). The cost of investments sold is based on the specific identification method.

**Cash equivalents** - The Cooperative considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

**Restricted cash** - Cash restricted for rural economic development loans.

**Accounts and notes receivable** - Accounts and notes receivable are recorded when invoices are issued and are written off when they are determined to be uncollectible. The allowance for doubtful accounts is estimated considering the Cooperative's historical losses, review of specific problem accounts, existing economic conditions and the financial stability of its customers, currently .01% of monthly operating revenues. Generally, the Cooperative considers accounts receivable past due after 44 days.

**Inventories** - Materials and supplies inventories consist primarily of items for construction and maintenance of electric plant and are valued at average unit cost. Fuel inventories consist of naphtha and diesel fuel for the generation units and are valued at current market. See Note 5

**Accrued vacation** - The Cooperative accrues accumulated unpaid vacation as the obligation is incurred. Compensated absences are included in "accrued employee compensation."

**Customer advances for construction** - Customer advances for construction represent advances for construction jobs that the customer requested, such as line extensions. The customer advance is held in a deferred credit account until the requirements have been met, at which time the advance, or applicable proportion of the advance, is refunded. If the requirements are not met within a 5-year time period, the advance is forfeited by the customer and credited to electric plant.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Overhaul accounting** - In accordance with an HPUC Decision & Order, KIUC accrues for overhaul costs on the generation equipment by charging a proportion of the estimated cost of the overhaul, over the period covered by the overhaul cycle, to maintenance expense. The overhaul cycle for the individual generation units vary based on the type of unit and hours of use. For most generation units, the typical overhaul cycle is every 2 to 5 years. When the overhaul occurs, the actual costs are charged against the overhaul deferred credit (regulatory liability – scheduled plant maintenance), with any leftover being charged to maintenance expense.

**Post-retirement benefits** - KIUC sponsors a Retiree Welfare Benefit Plan (the Plan). The Cooperative accounts for the Plan in accordance with Statement of Financial Accounting Standard (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Post-Retirement Plans – an amendment of FASB Statement No. 87, 88, 106, and 132(R).* SFAS No. 158 requires an employer that sponsors a defined benefit post-retirement plan to report the current economic status (the overfunded or underfunded status) of the plan in its balance sheet, to measure the plan assets and plan obligations as of the balance sheet date and to include enhanced disclosures about the plan (See Note 13).

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

Pursuant to FSP FIN 48-3, management has elected to defer the application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* to fiscal years beginning after December 15, 2008. For 2008 and 2007 the Cooperative has accounted for uncertain tax positions in accordance with FASB Statement No. 5, *Accounting for Contingencies,* whereby the effect of the uncertainty would be recorded if the outcome was considered probable and was reasonably estimatable. As of December 31, 2008 and 2007 the Cooperative had no accrual for uncertain tax positions.

**Electric revenues and unbilled revenue** - KIUC recognizes revenues based on rates (tariffs) authorized by the HPUC including unbilled revenue, revenue from electric power delivered but not yet billed to the customers.

The Cooperative's tariffs for electric service include energy rate adjustment clauses under which billings to customers are adjusted to reflect changes in the cost of fuel. In order to match power costs and related revenues, under-collected or over-collected power costs to be billed or credited to consumers in subsequent periods is recognized as a current asset or current liability and as an increase or decrease of classified operating revenues on the statement of operations.

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

**Marketing expense -** Marketing costs are expensed as incurred.

**Environmental matters -** KIUC is subject to federal, state and local environmental laws. These laws regulate the discharge of materials into the environment and may require KIUC to mitigate the effects of a release of a hazardous substance. Environmental matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. In general, costs related to environmental matters are charged to expense. Environmental costs are capitalized if the costs increase the value of the property and/or prevent or mitigate contamination from future operations. Although the level of future expenditures for environmental matters is difficult to determine, it is management's opinion that such costs when determined will not have a material adverse effect on KIUC's financial condition. Accordingly, no provision has been included in the accompanying financial statements.

**Concentration of credit risk** - Financial instruments that are exposed to concentrations of credit risk consist primarily of cash, including temporary cash investments, and receivables.

The Cooperative maintains its cash in deposit accounts in various financial institutions and its temporary cash investments in highly rated securities. At times these balances exceed federally insured limits. The Cooperative has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents.

Credit is extended to customers generally without collateral requirements; however, the Cooperative requires a deposit from some members upon connection, which is applied to unpaid bills and fees in the event of default. The deposit accrues interest annually and is returned along with accrued interest periodically. In addition, formal shut-off procedures are in place.

**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 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.

**Reclassifications -** Certain 2007 balances have been reclassified to conform with 2008 presentation.

## NOTE 3 - ELECTRIC PLANT IN SERVICE

The major classes of electric plant in service are as follows:

| | 2008 | 2007 |
|---|---|---|
| Production plant | $ 130,864,052 | $ 128,069,014 |
| Transmission plant | 67,918,871 | 66,859,110 |
| Distribution plant | 145,993,701 | 140,281,499 |
| General plant | 24,443,102 | 22,596,691 |
| Electric plant in service | $ 369,219,726 | $ 357,806,314 |

## NOTE 4 - OTHER PROPERTY AND INVESTMENTS

Other property and investments consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Investments in associated organizations (CFC) | | |
| Capital term certificates, interest from 0% to 3% maturing in 2024 or consistent with the related debt | $ 216,607 | $ 206,713 |
| Patronage capital | 88,846 | 74,058 |
| Membership/other | 1,576 | 1,043 |
| | 307,029 | 281,814 |
| Rural economic development loans | | |
| National Tropical Botanical Gardens | 300,000 | - |
| Island School | 300,000 | - |
| Hale Opio | 93,173 | - |
| | 693,173 | - |
| Other investments | | |
| U.S. Government agencies | 963,809 | 463,214 |
| U.S. Treasury obligations | 904,197 | 1,282,695 |
| Corporate bonds and notes | 456,449 | 379,993 |
| | 2,324,455 | 2,125,902 |
| Total other property and investments | $ 3,324,657 | $ 2,407,716 |

## NOTE 4 - OTHER PROPERTY AND INVESTMENTS (Continued)

The Cooperative accounts for its debt securities in accordance with Financial Accounting Standard (FAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. This statement addresses the accounting and reporting for investments in debt and equity securities that have a readily determinable fair value. The Cooperative has classified its debt securities as available-for-sale securities. Fair value was determined in accordance with FAS No. 157, *Fair Value Measurements*, using quoted prices in active markets (Level 1).

Amortized cost and fair value of available-for-sale securities are as follows:

| | Amortized Cost | Fair Value | Unrealized Gain (Loss) |
|---|---|---|---|
| December 31, 2008 | | | |
| U.S. Government agencies | $ 937,427 | $ 963,809 | $ 26,382 |
| U.S. Treasury obligations | 872,354 | 904,197 | 31,843 |
| Corporate bonds and notes | 458,932 | 456,449 | (2,483) |
| | $ 2,268,713 | $ 2,324,455 | $ 55,742 |
| December 31, 2007 | | | |
| U.S. Government agencies | $ 450,864 | $ 463,214 | $ 12,350 |
| U.S. Treasury obligations | 1,252,641 | 1,282,695 | 30,054 |
| Corporate bonds and notes | 387,262 | 379,993 | (7,269) |
| | $ 2,090,767 | $ 2,125,902 | $ 35,135 |

Annual maturities of available-for-sale investments at December 31, 2008 were as follows:

| | Amortized Cost | Fair Value |
|---|---|---|
| Less than one year | $ 448,124 | $ 459,819 |
| After 1 year through 5 years | 1,820,589 | 1,864,636 |
| | $ 2,268,713 | $ 2,324,455 |

## NOTE 5 - INVENTORIES

Inventories consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Materials and supplies | $ 12,090,594 | $ 10,566,922 |
| Fuel | 1,066,216 | 1,597,370 |
| | $ 13,156,810 | $ 12,164,292 |

## NOTE 6 - DEFERRED DEBITS

Deferred debits consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Regulatory asset - Iniki damage | $ 4,018,512 | $ 4,310,772 |
| Regulatory asset - SFAS 106 transition | 275,925 | 344,913 |
| Regulatory asset - demand-side management (DSM) and integrated resource plan (IRP) | (291,130) | 148,365 |
| Preliminary survey and investigation | 302,511 | 283,360 |
| Other deferred debits | 114,762 | 155,050 |
| | $ 4,420,580 | $ 5,242,460 |

## NOTE 7 - PATRONAGE CAPITAL

Patronage capital consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Assigned | $ 51,669,251 | $ 39,803,220 |
| Assignable | 9,553,597 | 11,866,031 |
| | 61,222,848 | 51,669,251 |
| Less: Retired | (13,031,834) | (9,994,447) |
| | $ 48,191,014 | $ 41,674,804 |

## NOTE 8 - LONG-TERM DEBT

The Cooperative has long-term debt due to Rural Utilities Services (RUS), National Rural Utilities Cooperative Finance Corporation (CFC) and the Federal Financing Bank (FFB). Substantially all assets of the Cooperative are pledged as security for the long-term debt and the notes are subject to certain covenants.

Following is a summary of long-term debt:

| | 2008 | 2007 |
|---|---|---|
| Fixed and variable notes payable due to RUS in monthly installments of principal and interest with rates ranging from 3.125% to 4.875%, maturing October 31, 2027. | $ 189,588,095 | $ 196,000,118 |
| Fixed and variable notes payable due to FFB in quarterly installments of principal and interest with rates ranging from 3.167% to 4.305%, maturing December 31, 2023. | 29,219,650 | 30,627,828 |
| Variable notes payable due to CFC in quarterly installments of principal and interest with rates ranging from 4.90% to 6.55%, maturing September 30, 2023. | 6,534,324 | 6,893,366 |
| RUS/FFB advance payments | (9,404,387) | (8,948,337) |
| | 215,937,682 | 224,572,975 |
| Less current portion | (8,487,400) | (8,178,300) |
| | $ 207,450,282 | $ 216,394,675 |

Maturities of long-term debt for the next five years and thereafter are as follows:

| | |
|---|---|
| 2009 | $ 8,487,400 |
| 2010 | 8,832,200 |
| 2011 | 9,221,300 |
| 2012 | 9,625,300 |
| 2013 | 10,036,600 |
| Thereafter | 169,734,882 |
| | $ 215,937,682 |

## NOTE 8 - LONG-TERM DEBT (Continued)

The carrying value for variable rate debt is considered fair value due to the frequency of repricing. The fair market value of the Cooperative's fixed rate long-term debt using currently quoted or offered rates for similar issues of debt is as follows:

| | Carrying Value | Fair Value |
|---|---|---|
| December 31, 2008 | $ 218,807,745 | $ 108,476,707 |
| December 31, 2007 | $ 226,627,946 | $ 185,272,424 |

## NOTE 9 - LINE OF CREDIT

The Cooperative has a perpetual $85,000,000 line of credit for short-term financing with CFC at a variable interest rate. The line is secured by substantially all Cooperative assets and subject to termination provisions and certain covenants. At December 31, 2008 and 2007, the Cooperative had no outstanding balance on this line of credit.

## NOTE 10 - DEFERRED CREDITS

Deferred credits consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Economic development grant | $ 917,114 | $ 309,789 |
| Customer advances for construction | 2,716,184 | 1,690,296 |
| Regulatory liability - Iniki | 4,018,512 | 4,310,772 |
| Regulatory liability - Scheduled plant maintenance | 5,411,814 | 4,576,975 |
| | $ 13,063,624 | $ 10,887,832 |

## NOTE 11 - LITIGATION, COMMITMENTS AND CONTINGENCIES

### Litigation

In March 2007, the Cooperative was notified by the Environment and Natural Resources Division of the U.S. Department of Justice that it was the target of an investigation into the taking of migratory birds. This investigation is being conducted by the U.S. Fish and Wildlife Service in conjunction with the U.S. Department of Justice with the cooperation of the U.S. Attorney's office for the District of Hawaii. At this time it is not determinable what the impact of this investigation will have on the financial statements of the Cooperative. The Cooperative has submitted its plan to protect the endangered wildlife and is awaiting a response from the Department of Justice.

In the normal course of business, the Cooperative is a party to claims and matters of litigation. The ultimate outcome of these matters cannot presently be determined; however, in the opinion of management of the Cooperative, the resolution of these matters will not have a material adverse effect on the Cooperative's financial position, results of operations or liquidity.

### Fuel Contract

As a result of the purchase of KE assets, Citizens assigned to KIUC a fuel supply contract with an international oil refining company that is renewable for 12-month periods unless terminated by KIUC or the supplier. 100% of KIUC's 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. Fuel costs for the years ended December 31, 2008 and 2007 were $98,147,754 and $76,261,688, respectively.

### Power Supply

Most of KIUC's power is generated using diesel and naphtha generating units. In addition, KIUC maintains various power supply agreements to purchase excess power from hydroelectric projects. The terms of the agreements vary and include termination provisions.

In 2007, the Cooperative signed an agreement with Green Energy Team, L.L.C. to purchase power from its proposed 6.4 megawatt biomass-to-energy facility, which is to be completed by 2010. This contract has a term of 20 years.

### Union Contract

KIUC has an agreement with one union. In December 2004, the Cooperative negotiated a new contract with the union. As of December 31, 2008 60% of the positions and 62% of employees were covered by the union contract. The agreement expires in December 2009.

## NOTE 11 - LITIGATION, COMMITMENTS AND CONTINGENCIES (Continued)

### Operating Lease

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, 2008, the future minimum rental commitment under this lease is as follows:

| | |
|---|---|
| 2009 | $ 1,200,000 |
| 2010 | 1,200,000 |
| 2011 | 1,020,000 |
| 2012 | 1,020,000 |
| 2013 | 1,020,000 |
| Thereafter | 7,140,000 |
| | $ 12,600,000 |

In addition to the amounts above, the Cooperative is responsible for common area maintenance costs, real property taxes and other reimbursable operating expenses. Rent expense for the years ended December 31, 2008 and 2007 were $1,306,581 and $1,263,115, respectively.

## NOTE 12 - PENSION BENEFITS

Substantially all employees of the Cooperative participate in the National Rural Electric Cooperative Association (NRECA) Retirement & Security Program (a defined benefit plan) and the 401(K) Savings Plan (a defined contribution plan). The plans are qualified and tax exempt under the Internal Revenue Code. In these multi-employer plans, which are available to all NRECA member cooperatives, the accumulated benefits and plan assets are not determined or allocated separately by the individual employer.

The Cooperative makes monthly contributions to the Retirement & Security Plan equal to the amounts accrued for pension expense. The pension cost for the Cooperative for the years ended December 31, 2008 and 2007 was $1,670,917 and $1,557,061, respectively.

The pension cost for the 401(K) Savings Plan was $370,248 and $386,065 for the years ended December 31, 2008 and 2007, respectively.

## NOTE 13 - POST-RETIREMENT BENEFITS

The KIUC Retiree Welfare Benefit Plan (the Plan) and its associated trust, the KIUC 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, their beneficiaries and covered dependents.

Benefits are paid on behalf of retirees and are a function of medical insurance costs and number of retirees. Benefits paid for the years ended December 31, 2008 and 2007 were $298,578 and $339,210, respectively.

The measurement date for the current valuation is December 31, 2008.

Assumptions:

The weighted-average discount rate used to determine the benefit obligation was 5.5%.

Weighted-average assumptions used to determine the net periodic benefit cost for year ended December 31, 2008:

- Discount rate: 6.0%
- Expected long-term return on plan assets: 4.41% (determined by taking a weighted average based on the market value of each asset and applying the 10-year rate of return for similar assets)
- Health care cost trend rate assumed for next year: 7.5%
- Rate to which the cost trend rate is assumed to decline (the ultimate trend rate): 5.0% in 2014

## NOTE 13 - POST-RETIREMENT BENEFITS (Continued)

| | 2008 | 2007 |
|---|---|---|
| I) Net post-retirement benefit cost | | |
| Service cost | $ 46,900 | $ 44,300 |
| Interest cost | 416,700 | 418,900 |
| Expected return on plan assets | (141,100) | (140,200) |
| Net post-retirement benefit cost | $ 322,500 | $ 323,000 |
| II) Accumulated post-retirement benefit obligation (APBO) | | |
| APBO balance at the beginning of year | $ (7,203,600) | $ (7,189,000) |
| Other | (460,300) | (172,700) |
| Net post-retirement benefit cost | (322,500) | (323,000) |
| Benefits paid | 515,100 | 481,100 |
| Net post-retirement benefit obligation at year end | $ (7,471,300) | $ (7,203,600) |
| III) Reconciliation of funded status | | |
| APBO | $ (7,471,300) | $ (7,203,600) |
| Assets funded | 2,442,700 | 3,199,900 |
| Accrued post-retirement benefit cost | $ (5,028,600) | $ (4,003,700) |
| IV) Accumulated other comprehensive loss | | |
| Unrecognized prior service cost | $ 403,200 | $ - |
| Other comprehensive loss | 1,217,500 | 403,200 |
| Accumulated other comprehensive loss | $ 1,620,700 | $ 403,200 |

**NOTE 13 - POST-RETIREMENT BENEFITS (Continued)**

The following benefit payments, which reflect expected future service as appropriate, are expected to be paid:

| | |
|---|---|
| 2009 | $ 535,300 |
| 2010 | 541,600 |
| 2011 | 550,900 |
| 2012 | 571,300 |
| 2013 | 567,200 |
| 2014-2018 | 2,679,900 |

The Plan has been partially funded as of December 31, 2008. The Plan assets are held in the Trust and are invested in the Central Pacific Bank's Trust Division at December 31, 2008.

The Plan assets are managed by a trustee and are authorized to be held in various equity and fixed income investments and cash equivalents. The trustee is not allowed to invest in real estate or any other investment other than those noted in the investment policy. The investing strategy is long term with a focus on moderate volatility and moderate growth investments. The following table shows the investment allocation for Plan assets.

| | 2008 | | 2007 | |
|---|---|---|---|---|
| Cash and other accrued income | $ 21,800 | 1% | $ 19,200 | 1% |
| Mutual funds | 587,800 | 24% | 945,600 | 29% |
| Bonds | 1,256,500 | 51% | 1,213,100 | 38% |
| Equities | 576,600 | 24% | 1,022,000 | 32% |
| | $ 2,442,700 | | $ 3,199,900 | |

**NOTE 14 - SUBSEQUENT EVENTS**

On March 3, 2009 KIUC filed a notice with the HPUC of its intent to seek a general rate increase in 2009. The amount of the rate increase and the impact on the financial statements of the Cooperative are unknown at this time. KIUC plans to file the formal application with the HPUC in May 2009.

Also in March 2009 KIUC completed a depreciation study. The recommended depreciation rates will result in a decrease in annual depreciation expense compared to existing rates. The decrease in depreciation rates is largely due to the recommended increase in average service lives for many of KIUC's plant assets. The depreciation study has been submitted to RUS for approval and will be submitted to the HPUC as part of the upcoming rate case filing. New depreciation rates will not be implemented until approval is received from both RUS and the HPUC.

# REPORT REQUIRED BY GOVERNMENT AUDITING STANDARDS

**INDEPENDENT AUDITOR'S 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
Kauai Island Utility Cooperative

We have audited the financial statements of Kauai Island Utility Cooperative (the Cooperative) as of and for the year ended December 31, 2008 and have issued our report thereon dated April 28, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**
In planning and performing our audit we considered the Cooperative'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 the Cooperative's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control over financial reporting.

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

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

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

**Compliance and Other Matters**
As part of obtaining reasonable assurance about whether the Cooperative's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to the Cooperative's Board of Directors and management in a separate letter dated April 28, 2009.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties.

Moss Adams LLP

Portland, Oregon
April 28, 2009