MARSHALLS ENERGY COMPANY, INC.

(A COMPONENT UNIT OF THE REPUBLIC OF THE MARSHALL ISLANDS)

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2012

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
Marshalls Energy Company, Inc.:

We have audited the financial statements of Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2012 and have issued our report thereon dated August 14, 2013. 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

Management of MEC is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered MEC'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 MEC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of MEC's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings and Responses (pages 3 through 5), we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

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 a 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. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as item 2012-1 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether MEC'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 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 item 2012-2.

We noted certain matters that we reported to management of MEC in a separate letter dated August 14, 2013.

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

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

Deloitte & Touche LLP

August 14, 2013

Findi ng No. 2012-1

Fuel and Supplies

Criteria: Adequate internal control policies and procedures should be established to require physical verification of supplies inventory and timely reconciliation with the subsidiary ledger and general ledger control accounts to facilitate accurate financial reporting. Policies and procedures should also be established concerning valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

Condition: We noted the following exceptions during our observation of the year-end physical count:

- Inventory written count instructions were not provided to staff prior to the count;
- Inventory locations were not mapped and provided to staff and count teams were not assigned specific locations;
- Issuances were not immediately documented on pre-numbered issue slips; and
- Job order #s are not accurately documented on issue slips.

Stock reports from tank farm, power plant and distribution personnel are not independently verified. Furthermore, approval of adjustments to system quantities and costs are not documented.

The cost of inventory does not include freight and other incidental charges as such are expensed as incurred.

Of eighteen (18) inventory supplies counted, quantities for one item per the final inventory list differed from counted quantities.

Cause: The cause of the above condition is the lack of internal control policies and procedures governing physical verification of supplies inventory, timely reconciliation to subsidiary ledgers and general ledger control accounts, valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

Effect: The effect of the above condition is potential material misstatement of supplies inventory resulting in inaccurate financial reporting.

Recommendation: We recommend that management establish internal control policies and procedures governing physical verification of supplies inventory, timely reconciliation to subsidiary ledgers and general ledger control accounts, valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

Finding No. 2011-1, Continued

Fuel and Supplies, Continued

Auditee Response and Corrective Action Plan:

MEC agrees with this finding and recommendation. Management understands that this continues to be a repeated finding and understands the potential significant impact or risk of the finding as this relates to MEC's internal control over its financial statements.

MEC management has taken necessary steps to resolve the issues and ensure that proper internal control policies and procedures regarding fuel and supplies are established and communicated.

It is the role of the Procurement Manager (for supplies) and the Fuel and Propane Analyst (for fuel and propane) to ensure that all receiving reports and issuances are pre-numbered, completed and reconciled to invoices prior to submission to the Accounts Payable Department for payment. Invoices submitted for payment will not be processed if there are any discrepancies. There will be close coordination and communication between procurement department, operations, and accounts department to ensure timely and accurate recording of invoices.

Furthermore, MEC will develop a template for costing out inventory items to ensure that freight and other incidental charges are included as cost of inventory.

Finding No. 2012-2

Coverage Ratios

Criteria: Section 5.4 of the RUS loan contract requires MEC to establish rates to provide revenue sufficient to meet average coverage ratio requirements as follows:

Times Interest Earned Ratio (TIER)	=	1.50
Operating Times Interest Earned Ratio (OTIER)	=	1.10
Debt Service Coverage (DSC)	=	1.25
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2012, MEC achieved the following average coverage ratios:

TIER	=	0.9
OTIER	=	(1.0)
DSC	=	1.0
ODSC	=	0.2

Cause: The cause of the above condition is that utility rates are not sufficient to provide adequate revenues to comply with the prescribed ratio requirements.

Effect: The effect of the above condition is noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

Recommendation: We recommend that management review MEC's rates to comply with average coverage ratio requirements.

Prior Year Status: Noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract was reported as a finding in the audits of MEC for fiscal years 2000 through 2011.

Auditee Response and Corrective Action Plan:

MEC is in agreement with this finding. As wholly owned government entity, MEC is not able to fully obtain and achieve full cost recovery. However, with the approval by the RMI Cabinet, the tariff pricing template has been revised to allow MEC management the flexibility to increase (and decrease) the electricity tariff based on the variable fuel cost component in line with each shipment received.

Until MEC is allowed to achieve full cost recovery, this finding will continue to be an audit finding. It is essential that RepMar continues to provide financial support to the MEC operations. MEC's Comprehensive Recovery Plan (CRP) is an aggressive plan to revive and sustain the MEC's core and financial operations. The CRP includes goals and objectives towards reducing generation costs through initiatives such as alternative power generation solutions, system efficiencies and energy conservations. The CRP milestones reached and impact to the average coverage ratio requirement required by section 5.4 of the RUS loan will be evident in subsequent audit years.

MARSHALLS ENERGY COMPANY, INC.

Unresolved Prior Year Findings
Year Ended September 30, 2012

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 5).