

MARSHALLS ENERGY COMPANY, INC.

**INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE**

YEAR ENDED SEPTEMBER 30, 2006

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Board of Directors
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2006 and have issued our report thereon dated June 30, 2007. 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 MEC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect MEC's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described in the accompanying Schedule of Findings (pages 3 through 5) as items 2006-1 and 2006-2.

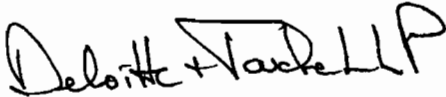
A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 2006-2 as 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 that is required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings as items 2006-3 and 2006-4.

We also noted other matters involving the internal control over financial reporting, which we have reported to management of MEC in a separate letter dated June 30, 2007.

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

A handwritten signature in black ink that reads "Deloitte + Tatchell LLP". The signature is written in a cursive, stylized font.

June 30, 2007

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings
Year Ended September 30, 2006

Billings – Electricity

Finding No. 2006-1

Criteria: Customer bills are calculated using an approved electricity tariff rate.

Condition: MEC electricity tariff was increased effective September 1, 2006 but the rate used in calculation of billings for the month of September was not in accordance with the new rates.

Cause: The cause of the above condition is the lack of adequate internal control to ensure that changes in tariff rates are immediately implemented.

Effect: The effect of the above condition is a potential misstatement of accounts receivable and revenues.

Recommendation: We recommend that management establish adequate internal control policies and procedures to ensure that billings are calculated based on approved rates.

Auditee Response: The tariff increase was advertised to be implemented 1st September 2006. Instead, due to a technical problem, the rate increase was not implemented until 1st October 2006. This situation is not a case of non-compliance with regulation, laws, etc, or financial misstatement, but a case of late implementation of a management decision (tariff increases do not require approval) due to a computer glitch.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings
Year Ended September 30, 2006

Fixed Assets

Finding No. 2006-2

Criteria: Good internal control over fixed asset management and reporting includes periodic counts of fixed assets.

Condition: Periodic physical counts of fixed assets are not performed.

Cause: The cause of the above condition is the lack of internal control policies and procedures to ensure that periodic physical counts of fixed assets are performed.

Effect: The effect of the above condition is a possible misstatement and misuse of fixed assets.

Recommendation: We recommend that policies and procedures be established to ensure controls over the safeguarding of the organization's fixed assets are effective. Management should ensure that fixed assets are counted on a periodic basis and are reconciled to the fixed asset register.

Auditee Response: It is acknowledged that fixed assets were not physically counted during the financial year. Steps have been taken to ensure that policies are followed and assets are counted and checked each year.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings, Continued
Year Ended September 30, 2006

Coverage Ratios

Finding No. 2006-3

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:

Operating Times Interest Earned Ratio (OTIER)	=	1.10
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2006, MEC achieved the following average coverage ratios:

OTIER	=	(4.23)
ODSC	=	(0.91)

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 contract 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 2005.

Auditee Response: With approval by Cabinet of the revised tariff pricing template MEC has managed to increase tariffs to the point where all generation costs are now being covered by the electricity tariffs. Tariffs were increased five times between 30th June 2006 and on 2nd July 2007 representing increases totaling \$0.085 per KWhr or 41.5% (Government rates).

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings, Continued
Year Ended September 30, 2006

Limitations on Additional Indebtedness

Finding No. 2006-4

Criteria: Section 6.13 of the RUS loan contract limits MEC to incurring, assuming, guaranteeing or becoming liable in respect of any debt for borrowed money and restricted rentals other than certain permitted debt, as defined in Section 6.13 (a) to (g).

Condition: On January 13, 2006 MEC obtained a \$2 million 2-year promissory note and a \$3 million letter of credit facility that do not appear to fall within the definition of permitted debt, as defined in Section 6.13 (a) to (g).

Cause: The cause of the above condition is the need to increase working capital to meet operation requirements, especially for the purchase of fuel.

Effect: The effect of the above condition is potential noncompliance with the additional indebtedness limitations as prescribed by Section 6.13 of the RUS loan contract.

Recommendation: We recommend that management ensures compliance with Section 6.13 of the RUS loan contract.

Auditee Response: Section 6.13 (e) of the loan contract refers to "Unsecured indebtedness". The Bank of Guam loan is fully secured/collateralized by RMI's tax revenue in the event of a default by MEC. No assets, future revenue streams or any other items of value owned by MEC have been pledged against the loan; therefore the loan in essence is an RMI loan. A "Finding" should relate to an item or an event that is beyond any doubt, rather than a "potential noncompliance" as it is referred to under the heading "Effect".

Auditor Response: While we appreciate management's response, we recommend that the matter be addressed with RUS.

MARSHALLS ENERGY COMPANY, INC.

Unresolved Prior Year Findings
Year Ended September 30, 2006

The status of unresolved prior year findings is disclosed within the Schedule of Findings section of this report (pages 3 and 4).