

MARSHALLS ENERGY COMPANY, INC.

**INDEPENDENT AUDITORS'
MANAGEMENT LETTER REPORT**

YEAR ENDED SEPTEMBER 30, 2006

INDEPENDENT AUDITORS' MANAGEMENT LETTER REPORT

Board of Directors
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC) 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, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service (RUS) Borrowers*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of MEC for the year ended September 30, 2006, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

Management is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. 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. We noted one matter involving the internal control over financial reporting and its operation that we consider to be a material weakness, which is described in our 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* dated June 30, 2007.

7 CFR Part 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.33(e)(1), related-party transactions, and depreciation rates. In addition, our audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38-.45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports (other than our Independent Auditors' Report on the Financial Statements, our 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*, and our separate letter regarding recommendations concerning certain matters related to the internal control, all dated June 30, 2007) related to our audit have been furnished to management.

Our comments on specific aspects of internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR Part 1773.33 are presented below.

COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted no matters, except as described in our 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* dated June 30, 2007, regarding MEC's internal control over financial reporting that we consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records;
- The process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts; and
- The materials control.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

Compliance with laws, regulations, contracts, and grants is the responsibility of MEC's management. At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of its property, or for the use of its mortgaged property by others for the year ended September 30, 2006:

1. Inquired with management of the existence of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others, as defined in 7 CFR Part 1773.33(e)(1)(i).
 2. Read Board of Directors' minutes to ascertain whether there are board-approved written contracts, as defined in 7 CFR Part 1773.33(e)(1)(i) entered into during the year ended September 30, 2006.
 3. Noted no contracts that require written RUS approval.
- Procedures performed with respect to the requirement to submit RUS Form 7 or Form 12 to the RUS:
 1. Agreed amounts reported in Form 7 or Form 12 to MEC's accounting records.

The results of our tests indicate that, with respect to the items tested, MEC complied, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirement that:

- The borrower has obtained written approval of the RUS to enter into any contracts for the operation or maintenance of its property, or for the use of mortgaged property by others as defined in 7 CFR Part 1773.33(e)(1)(i); and
- The borrower has submitted Form 7 or Form 12 to the RUS and the Form 7 or Form 12, Financial and Statistical Report, as of September 30, 2006, represented by the borrower as having been submitted to RUS, appears reasonable based upon the audit procedures performed.

(1) Coverage Ratios

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:

$$\begin{aligned} \text{Operating Times Interest Earned Ratio (OTIER)} &= 1.10 \\ \text{Operating Debt Service Coverage (ODSC)} &= 1.10 \end{aligned}$$

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

$$\begin{aligned} \text{OTIER} &= (4.23) \\ \text{ODSC} &= (0.91) \end{aligned}$$

We recommend that management review MEC's rates in order to comply with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

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 are increased five times between 30th of June 2006 and on the 2nd of July 2007 representing increases totaling \$0.085 per KWhr or 41.5% (Government rates).

(2) Limitations on Additional Indebtedness

Section 6.13 of the RUS loan contract limits MEC in 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).

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

(2) Limitations on Additional Indebtedness, continued

We recommend that management ensure 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.

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

COMMENTS ON OTHER ADDITIONAL MATTERS

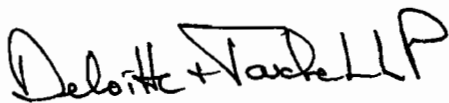
In connection with our audit of the financial statements of MEC, except as set forth below, nothing came to our attention that caused us to believe that MEC failed to comply with respect to:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1);
- The clearing of construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);
- The retirement of plant addressed at 7 CFR Part 1773.33(c)(3) and (4);
- Approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5);
- The disclosure of material related-party transactions, in accordance with Statement of Financial Accounting Standards (SFAS) No. 57, *Related Party Transactions*, for the year ended September 30, 2006, in the financial statements referenced in the first paragraph of this report, addressed at 7 CFR 1773.33(f); and
- The depreciation rates addressed at 7 CFR Part 1773.33(g).

The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773.33(h) and the detailed schedule of investments required by 7 CFR Part 1773.33(i) are not presented as there were no deferred debits, deferred credits or investments reported in the financial statements of MEC as of and for the year ended September 30, 2006.

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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.



June 30, 2007