

MARSHALLS ENERGY COMPANY, INC.

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

YEAR ENDED SEPTEMBER 30, 2007

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, 2007 and have issued our report thereon dated May 16, 2008. 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 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 would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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 entity'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 entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying Schedule of Findings and Responses (pages 3 through 7) as items 2007-1, 2007-2 and 2007-5 to be significant deficiencies in internal control over financial reporting.

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 the 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 the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiencies described above are material weaknesses.

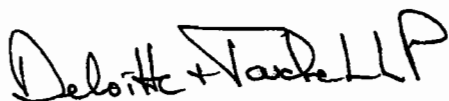
Compliance and Other Matters

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 items 2007-3 and 2007-4.

We noted certain matters that we reported to management of MEC in a separate letter dated May 16, 2008.

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

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.

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

May 16, 2008

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses Year Ended September 30, 2007

Inventory

Finding No. 2007-1

Criteria: Inventory counts are reconciled to inventory records and inventory records are periodically reconciled to the general ledger.

Condition: The spare parts inventory count for fiscal year 2007 was not reconciled to inventory records in a timely manner resulting in adjustments of \$192,171 after year-end.

Cause: The cause of the above condition is the lack of timely and periodic reconciliation of inventory against physical counts.

Effect: The effect of the above condition is a potential misstatement of inventory and expenses.

Recommendation: We recommend that management establish adequate internal control policies and procedures to ensure that inventory counts are reconciled to inventory records in a timely manner.

Auditee Response and Corrective Action Plan: A computer problem caused the delay in the reconciliation process. This has since been rectified and should not happen again.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Journal Entries

Finding No. 2007-2

Criteria: Adequate accounting controls necessitate that journal entries and recorded adjustments be appropriately approved and documented. Further, an independent review of journal vouchers should occur.

Condition: Authorizations of the following journal entries during the year ended September 30, 2007 were not documented:

Journal#'s: 08/08, 08/09, 08/12, 08/15, 08/17 and 10/03

Cause: The cause of the above condition is the lack of adequate internal control policies and procedures to ensure that all manual journal entries to the general ledger are subjected to review and approval of a designated person.

Effect: The effect of the above condition is a potential that unauthorized journal entries may lead to misstatements of general ledger accounts.

Recommendation: We recommend that management adopt policies and procedures to ensure that only authorized journal entries are posted to the general ledger.

Auditee Response and Corrective Action Plan: There is a procedure in place stating that all general ledger journals are to be signed by the authorized officer. Staff have been reminded to comply with this procedure.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Coverage Ratios

Finding No. 2007-3

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, 2007, MEC achieved the following average coverage ratios:

OTIER	=	(7.00)
ODSC	=	(2.95)

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 2006.

Auditee Response and Corrective Action Plan: With approval by the 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 four times during fiscal year 2007 representing increases totaling \$0.055 per KWhr or 22.4% (Government rates).

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Limitations on Additional Indebtedness

Finding No. 2007-4

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 May 25, 2007, MEC obtained a \$12 million, 10-year amortization, 3 year-maturity term loan from a commercial bank that does 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 refinance short-term obligations to a fuel supplier and a commercial bank and 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 ensure compliance with Section 6.13 of the RUS loan contract.

Prior Year Status: Noncompliance with the loan contract limitations as prescribed by Section 6.13 of the RUS loan contract was reported as a finding in the audit of MEC for fiscal year 2006.

Auditee Response and Corrective Action Plan: MEC strongly disagrees with this finding. Please refer to the attached legal opinion provided by the Attorney General to the Bank of Guam concerning the MEC loan, and the legal opinion provided by MEC attorney, which clearly state, among other things, that MEC is empowered to enter into the loan agreement.

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

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Materials and Supplies Management

Finding No. 2007-5

Criteria: Adequate segregation of duties should exist.

Condition: The inventory custodian also records issuances, receipts and adjustments to inventory. The annual physical count is also performed by the same individual.

Cause: Inadequate segregation of duties exists.

Effect: If one individual has responsibility for more than one of the non compatible materials and supplies management functions, that individual could misappropriate assets and conceal the misappropriation.

Recommendation: We recommend that appropriate internal control policies and procedures be established to ensure that responsibility for the following inventory management activities are segregated: (1) custody of inventory, (2) periodic physical inventory and comparisons of counts to inventory records, and (3) processing inventory transactions (e.g., receipt, shipping) and/or adjustments.

Auditee Response and Corrective Action Plan: Agreed. MEC will endeavor to segregate these duties where staff levels permit. Meter readers and senior accounting staff do attend and participate in all stock counts at the power station and other locations.

MARSHALLS ENERGY COMPANY, INC.

Unresolved Prior Year Findings
Year Ended September 30, 2007

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 7).