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, 2009

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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 the Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2009 and have issued our report thereon dated October 19, 2010. 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 6) as items 2009-1 and 2009-2 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 one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in the accompanying Schedule of Findings and Responses as item 2009-3.

We also noted certain matters that we reported to management of MEC in a separate letter dated October 19, 2010.

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

October 19, 2010

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Responses
Year Ended September 30, 2009

Finding No. 2009-1

Account Reconciliations

Criteria: Subsidiary ledgers should be periodically reconciled to the general ledger control accounts in a timely fashion and be independently reviewed and approved.

Condition: Account reconciliations were not periodically performed in a timely fashion during fiscal year 2009, resulting in numerous correcting year-end and audit adjustments affecting electric, fuel, and solar receivables; fuel and supplies inventory; property, plant and equipment; advances from RepMar; accrued taxes; deferred revenue; revenues; expenses; and related party transactions.

Accounts receivable subsidiary ledgers were not reconciled to the general ledger control accounts for the entire year. Further, fuel and solar receivable subsidiary ledgers were maintained concurrently on two separate and unreconciled accounting systems. Additionally, solar revenue collected for the entire year was recorded in the wrong general ledger account. These factors contributed to significant unreconciled variances as of September 30, 2009.

Acct #	Description	General Ledger	S/L per System 1	S/L per System 2
1200	A/R Fuel & Others	$ (336,050)	$ (336,050)	$ 460,868
1230	A/R Electric	$ 6,296,086	N/A	$ 5,178,971
1233	A/R Solar	$ (66,244)	$ 126,231	$ 199,478

Adjustments from receivable account reconciliations performed by management during audit fieldwork reduced the unreconciled variances down to amounts not considered material to the financial statements.

Fuel inventory was understated by $1.7 million as of September 30, 2009 as a result of incorrect entries to reduce inventory and record sales associated with customer advances remaining as of year-end. Audit adjustments were proposed to correct inventory and recognize deferred revenue.

Advances from RepMar for utility (A/c # 2210) was not reconciled with RepMar for the entire year, resulting in an unreconciled variance of $523,666, which was corrected via audit adjustment.

Revenue associated with a significant sale of fuel (400,000 gallons) in October 2008 to an unrelated party was not recorded in the general ledger. An audit adjustment was proposed to record this sale.

Advances from an affiliate for fuel purchases are not reconciled and expenses paid by MEC on behalf of same affiliate are not monitored, billed and collected in a timely fashion. Adjustments from reconciliations performed by management during audit fieldwork were recorded to correct related party balances.

Cause: The cause of the above condition is the lack of established policies and procedures requiring periodic performance of account reconciliations in a timely fashion and the lack of supervisory review.

Effect: The effect of the above condition is potential misstatement of account balances and increased risk of undetected fraud.

Finding No. 2009-1, Continued

Recommendation: We recommend that management establish internal control policies and procedures requiring periodic performance and review of account reconciliations in a timely fashion.

Prior Year Status: Lack of periodic performance of account reconciliations and supervisory review was reported as a finding in the audit of MEC for fiscal year 2008.

Auditee Response and Corrective Action Plan: MEC is in agreement with Finding No. 2009-01 and recommendation. As indicated, lack of periodic performance of account reconciliations and supervisory review was reported as a finding in the audit of MEC for fiscal year (FY) 2008. MEC management understands that this continues to be a repeated finding and further understands the potential significant impact or risk of the finding as it relates to MEC's internal controls over its financial statements. As such, MEC Management is in progress with ensuring that all reconciliations have been completed and documented to include a proper review and approval of reconciliations for fiscal year ending September 30, 2010.

Effective FY 2011, MEC management will establish internal control policies and procedures requiring periodic performance and review of account reconciliations in a timely fashion. At a high level, the reconciliation policies and procedures will include the following:

- Perform monthly reconciliations. Depending on the reconciliation account type, MEC management may identify the frequency of the reconciliation to be performed on a quarterly or annual basis, if appropriate.
- All supporting documentation to include (but not limited to) subsidiary ledger reports, bank statements, General Ledger reports and other forms (i.e. Excel Spreadsheet, Journal Entries, screenshot, invoices, etc.) must be attached to substantiate the reconciliation completed.
- All material variances will be researched and resolved by the following month.
- All variances will be aged using standard aging categories (i.e. current, 30, 60, >90 days aged).
- Variances greater than ninety days (90) aged will be reported/escalated to management
- Supervisory/Manager or designee (someone other than the reconciler) review and approval will be completed (as evident by the existence of a physical signature on the face of the reconciliation worksheet).

As an added goal for FY 2011, a listing of all General Ledger accounts that will be subject to the reconciliation policies and procedures will be compiled to include the reconciliation due dates and frequency.

Finding No. 2009-2

External Financial Reporting

Criteria: General journal entries should be reviewed and adequately supported.

Condition: Discussions with management indicated that adjustments are prepared by the accountants and are reviewed by management prior to posting. However, the number of audit adjustments indicates that the review process may not be effective. Furthermore, a general journal voucher (GJ # 04/10) tested did not include evidence that it was reviewed and approved by management.

Cause: The cause of the above condition is that journal entries are not thoroughly reviewed for accuracy and support.

Effect: The effect of the above condition is possible misstatements of account balances.

Recommendation: We recommend that management thoroughly review all journal entries prior to posting. Furthermore, management should ensure that all transactions are adequately supported.

Auditee Response and Corrective Action Plan: MEC is in agreement with Finding No. 2009-02 and recommendation. MEC Management has noted that evidence of an approval signature is not appropriate if the journal entry is not appropriately supported or properly reviewed by the approver. The journal entry reviewer/approver must perform due diligence and perform the following steps at a minimum:

- Ensure that all supporting documentation is included to substantiate the journal entry
- Verify and validate the amounts, general ledger accounts and purpose of the journal entry
- The journal entry approver must reject any journal entries that have missing or discrepant supporting documentation.

Effective immediately, MEC management will perform due diligence when performing the review and approval process of journal entries, using the guidelines identified above at a minimum.

Finding No. 2009-3

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:

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

Condition: During the year ended September 30, 2009, MEC achieved the following average coverage ratios:

OTIER	=	(5.4)
ODSC	=	(2.0)

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 2008.

Auditee Response and Corrective Action Plan: MEC is in agreement with Finding No. 2009-03. As a 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. During FY 2009, 77% of the power generation cost is attributed to fuel and lubricants.

Until MEC is allowed to achieve full cost recovery, Finding 2009-03 will continue to be an audit finding. It is essential that RepMar continues to provide financial support to the MEC operations. In addition, the development and execution of the MEC Comprehensive Recovery Plan (CRP) in FY 2010 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, 2009

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 6).