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, 2010

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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 Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2010 and have issued our report thereon dated February 29, 2012. 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 Questioned Costs (pages 6 through 11), 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 Questioned Costs as items 2010-1 through 2010-3 to be 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 Questioned Costs as item 2010-4.

We noted certain matters that we reported to management of MEC in a separate letter dated February 29, 2012.

MEC’s responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs. 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

February 29, 2012

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133 AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Board of Directors
Marshalls Energy Company, Inc.:

Compliance

We have audited Marshalls Energy Company, Inc.'s (MEC) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on MEC's major federal program for the year ended September 30, 2010. MEC's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 6 through 11). Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of MEC's management. Our responsibility is to express an opinion on MEC's compliance based on our audit.

We conducted our audit of compliance 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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about MEC's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of MEC's compliance with those requirements.

In our opinion, MEC complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended September 30, 2010.

Internal Control Over Compliance

Management of MEC is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered MEC's internal control over compliance with the requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of MEC's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be *material weaknesses*, as defined above.

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of MEC as of and for the year ended September 30, 2010, and have issued our report thereon dated February 29, 2012. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule of expenditures of federal awards (page 5) is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of MEC. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

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 those specified parties.

Deloitte & Touche LLP

February 29, 2012

MARSHALLS ENERGY COMPANY, INC.

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2010

Program Title	Program or Award Amount	Funding Available	Expenditures	September 30, 2010 Available Funds
Funds passed through the Republic of the Marshall Islands				
U.S. Department of the Interior				
Compact of Free Association, As Amended: Section 211(d)(1) Public Infrastructure CFDA #15.875				
National Energy Capital Projects	$ 1,000,000	$ 783,787	$ 783,787	$ -
General Technical Assistance, Republic of the Marshall Islands Award #TA-RMI-MEC-2010-4 CFDA #15.875	90,000	90,000	51,923	38,077
	$ 1,090,000	$ 873,787	$ 835,710	$ 38,077

The Schedule of Expenditures of Federal Awards is presented on the accrual basis of accounting.

The above expenditures reconcile to the underlying basic financial statements as follows:

Expenses (included within total operating expenses of $17,897,398)

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Questioned Costs
Year Ended September 30, 2010

PART I - SUMMARY OF AUDITORS' RESULTS SECTION

Financial Statements

1.	Type of auditors' report issued:	Unqualified
	Internal control over financial reporting:	
2.	Material weakness(es) identified?	Yes
3.	Significant deficiency(ies) identified?	None reported
4.	Noncompliance material to financial statements noted?	Yes

Federal Awards

	Internal control over major programs:	
5.	Material weakness(es) identified?	No
6.	Significant deficiency(ies) identified?	No
7.	Type of auditors' report issued on compliance for major programs	Unqualified
8.	Any audit findings disclosed that are required to be reported in accordance with section 510(a) of OMB Circular A-133?	No
9.	Identification of major programs:	

CFDA Numbers	Name of Federal Program or Cluster
	U.S. Department of the Interior:
15.875	Compact of Free Association – Public Infrastructure

10.	Dollar threshold used to distinguish between Type A and Type B Programs:	$300,000
11.	Auditee qualified as a low-risk auditee?	No

PART II- FINANCIAL STATEMENT FINDINGS SECTION

Reference Number	Findings	Refer Page #
2010-1	Account Reconciliations	7
2010-2	Fuel and Supplies	8 - 9
2010-3	External Financial Reporting	10
2010-4	Coverage Ratios	11

PART III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS SECTION

No matters are reportable.

Finding No. 2010-1

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 2010, resulting in numerous correcting year-end audit adjustments affecting all significant accounts. Adjustments from reconciliations performed by management during audit fieldwork reduced variances to amounts not considered material to the financial statements.

Solar monthly billings for the months of October 2009 through January 2010 were not posted to the general ledger until this error was discovered during the reconciliation process performed during audit fieldwork. Further, there is no independent review of the solar billing process.

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.

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 audits of MEC for fiscal years 2008 and 2009.

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. As such, MEC management is in progress with ensuring that all reconciliations have been completed to include a proper review and approval of reconciliations for fiscal year ending September 2011.

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 reconciliations to be performed on a quarterly or an annual basis, if appropriate.
- All supporting documentation include (but not limited to) subsidiary ledger reports, bank statements, general ledger reports and other forms (i.,e excel spreadsheet, journal entries, screenshots, 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
- Variances greater than ninety days (90) aged will be reported/escalated to management
- Variances greater then ninety days aged will be reported and 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.

Finding No. 2010-2

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, which occurred several weeks after year end:

- Inventory locations were not arranged and written count instructions were not provided to staff prior to the count;
- Non-inventory items were not segregated;
- Pre-numbered and pre-listed count sheets were not utilized during the count;
- Inventory locations were not mapped and provided to staff and count teams were not assigned to specific locations;
- Personnel knowledgeable about the inventory parts were not required to attend the count;
- Counts were not independently audited;
- Power plant issuance logs were not pre-numbered;
- Issuances were not immediately documented on pre-numbered issue slips; and
- Job order #s are not accurately documented on issue slips.

Difficulties encountered by accounting personnel in reconciling the results of the year-end physical count prompted another full physical count in June and July 2011. The results of this second count were rolled back to derive quantities as of September 30, 2010 and adjustments were provided by management to reconcile the general ledger control accounts with the results of the count.

Stock reports from tank farm, power plant and distribution personnel are not independently verified. Furthermore, approval of adjustments to inventory quantity and cost in the system is not documented.

Cost of inventory does not include freight and other incidental charges as such are directly expensed when incurred. Additionally, incorrect foreign exchange rates are used to value inventory.

Of seven inventory parts selected for valuation testing, the following errors were noted:

- One part (item # DE0020) was incorrect valued at $7.42/unit instead of $11.25. Furthermore, there were no purchases of this part during fiscal year 2010; however, the quantity on hand increased from 135 at 9/30/2009 to 234 at 9/30/2010.

- No explanation was provided for why the item #s for the following four parts had changed from 2009 to 2010:

Part Description	2009 Item #	2010 Item #
Crimp Lug One Hole #1/0	E0002C1	DE0003
Splice Conn. Copper C-500	E0002H	DE0012
Comp Ya28-2ln #4/0	E0002L	DE0020
Nozzle Ring	TC046A	TC046

Finding No. 2010-2, Continued

Fuel and Supplies, Continued

Of nineteen inventory parts test counted, the following errors were noted:

- One part (Camshaft) is listed in inventory under three different item #s (Item #s DZ115, DZ437, and DZ585).
- One part (Item # DME020) was incorrectly described in the subsidiary ledger as "SL5S Meter 3P" rather than "SL4S Meter 3P".
- Issue slip #s 15144 and 15145 were prepared on 10/22/2010 for issuances prior to 9/30/2010 for one part (Item # DTX130A).

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 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.

Auditee Response and Corrective Action Plan: MEC agrees with this finding and recommendation. Effective immediately, MEC management will take necessary steps to resolve the issues and ensure that proper internal control policies and procedures regarding fuel and supplies are established and communicated.

It will be 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. 2010-3

External Financial Reporting

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

Condition: Discussions with management indicated that adjustments are prepared by accountants and are reviewed by management prior to posting. However, the number of audit adjustments indicates that the review process may not be effective.

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 misstatement 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.

Prior Year Status: Ineffective review and inadequate support of journal entries was reported as a finding in the audit for fiscal year 2009.

Auditee Response and Corrective Action Plan: MEC is in agreement with Finding No. 2010-03 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 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. 2010-4

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, 2010, MEC achieved the following average coverage ratios:

TIER	=	0.1
OTIER	=	(1.4)
DSC	=	0.3
ODSC	=	(0.3)

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 2009.

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, 2010

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Questioned Costs section of this report (pages 6 through 11).