# MARSHALLS ENERGY COMPANY, INC.

## (A COMPONENT UNIT OF THE REPUBLIC OF THE MARSHALL ISLANDS)

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## FINANCIAL STATEMENTS, ADDITIONAL INFORMATION AND INDEPENDENT AUDITORS' REPORT

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## YEARS ENDED SEPTEMBER 30, 2010 AND 2009

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# INDEPENDENT AUDITORS' REPORT

Board of Directors
Marshalls Energy Company, Inc.:

We have audited the accompanying statements of net deficiency of Marshalls Energy Company, Inc. (MEC), a component unit of the Republic of the Marshall Islands, as of September 30, 2010 and 2009, and the related statements of revenues, expenses and changes in net deficiency and of cash flows for the years then ended. These financial statements are the responsibility of MEC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of MEC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MEC as of September 30, 2010 and 2009, and the changes in its net deficiency and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 10 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of MEC's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of MEC taken as a whole. The accompanying Schedule of Revenues, Expenses and Changes in Net Deficiency by Source for the year ended September 30, 2010 (page 27) is presented for purposes of additional analysis and is not a required part of the basic financial statements of MEC. This schedule is the responsibility of MEC's management. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements for the year ended September 30, 2010 and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 29, 2012, on our consideration of MEC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte + Touche LLP

February 29, 2012

Marshalls Energy Company, Inc. (MEC) herewith presents a discussion and analysis of the company's financial performance for the financial year ended 30th September, 2010. It is to be read in conjunction with the financial statements following this section.

## FINANCIAL HIGHLIGHTS

MEC's net assets decreased by $1.36 million in 2010 compared to an increase in total assets of $1.15 million in 2009. This decrease in net assets is attributed to the following factors:

- Increase in provision for doubtful accounts by $1.30 million
- Increase in fuel prices
- Overall increase in the tariff rates by 22%

In 2010, total net utility operating revenues were $14.97 million, an increase of $0.86 million in comparison to $14.11 million in net utility operating revenues in 2009. The increase in utility revenue is attributable to the increase in tariffs which is a result of the increase in world fuel prices during fiscal year 2010. In March 2010, MEC implemented a new tariff template which resulted in a tariff increase of 22%. The Pricing Template allows MEC to adjust (increase or decrease) the electricity tariffs in line with the movements of published fuel prices and without the need to seek Cabinet's approval. The effect of the increase meant a corresponding increase in electricity revenue of approximately 13%.

Total utility operating expenses were $17.9 million and $16.6 million in 2010 and 2009, respectively. The increase in the amount of $1.30 million is attributed to the fuel cost component and is in line with expectations due to the increase in world fuel prices. The increase in fuel costs to MEC meant an increase in fuel and lubricant costs used for generation. The most significant component of generation operating costs continues to be fuel and lubricants, the cost of which for 2010 represented 63% of total generation costs compared to 59% in 2009.

Total net operating revenues for non-utility operations, fuel sales being the major component, were $19.77 million and $12.95 million in 2010 and 2009, respectively. Total non-utility operating expenses increased by $6.99 million, with $18.50 million and $11.51 million in 2010 and 2009, respectively. This significant increase is a result of an increase in fuel sales by 57%. In addition, this is a positive indicator that MEC is able to maintain pricing competitiveness and increase market share despite stiff competition in the high seas market.

The major contributing factor to MEC's increase in net deficiency is a result of increase in provision for doubtful accounts in 2010. MEC's provisions for doubtful accounts were $1.65 million, for both electric and non-electric accounts in 2010 compared to $0.36 million in 2009.

Furthermore, no operating grants were received by MEC throughout 2010; however, MEC received subsidies of $0.93 million in 2010 compared to operating grants and subsidies of $2.85 million in 2009. Without operating grant funding to prop up MEC's financial position, together with under recovery of cost in its tariff structure, resulted in decrease in total net assets for 2010. Subsidy received during the year from RepMar in the amount of $0.93 million is cost recovery for the operations of Wotje and Jaluit power plants.

It is also important to mention that the audit performed for year ended September 30, 2010 continued to be impacted by several factors:

1.) During the fiscal year ended, MEC used its new fully integrated financial and accounting system which was long overdue. Following are several challenges experienced by MEC management.

- MEC does not have exclusive rights to the software and is leasing the software on a month to month basis.
- The necessary system reconciliations were not completed, thereby resulting in additional workload, process inefficiencies and higher risk of exposure for financial statement misstatement.

Since then, MEC has purchased an accounting and billing software for which it has exclusive rights to. MEC needs to reassess its training needs for the new systems to ensure a smooth transition.

2.) MEC continues to go through its reform efforts with major changes in key management positions throughout 2010.

3.) MEC has also implemented its Comprehensive Recovery Plan – a three year revolving plan, in which its aim is to fundamentally reform MEC.

## FINANCIAL ANALYSIS OF MEC

The Statement of Net Deficiency and the Statement of Revenues, Expenses and Changes in Net Deficiency provide an indication of MEC's financial condition. MEC's net assets (deficiency) reflect the difference between total assets and total liabilities. An increase in net assets over time normally indicates an improvement in financial condition. As illustrated in the figures below, MEC's net assets decreased for the year ended 30th September, 2010.

The Summary Statement of Net Deficiency for MEC is presented below:

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Current and other assets | $ 7,335,348 | $ 11,262,802 | $ 9,153,146 |
| Capital assets | 8,721,864 | 8,840,097 | 9,479,186 |
| Total assets | 16,057,212 | 20,102,899 | 18,632,332 |
| Current liabilities | 13,393,374 | 15,488,339 | 13,221,965 |
| Non-current liabilities | 13,858,805 | 14,445,281 | 16,389,299 |
| Total liabilities | 27,252,179 | 29,933,620 | 29,611,264 |
| Net assets: | | | |
| Invested in capital assets | 2,394,234 | 1,844,155 | 1,855,195 |
| Deficiency | (13,589,201) | (11,674,876) | (12,834,127) |
| Total net deficiency | $ (11,194,967) | $ (9,830,721) | $ (10,978,932) |

Total assets increased from $18.63 million in 2008 to $20.10 million in 2009 but decreased to $16.06 million in 2010. The increase in total assets by $1.47 million (or 8%) from 2008 to 2009 is primarily due to an increase of $3.58 million in Fuel and Supplies for a fuel shipment received in September 2009, a decrease of $1.70 million in net accounts receivable, and $0.64 million decrease in net capital assets due to accumulated depreciation and amortization. The decrease in total assets by $4.04 million (or 20%) from 2009 to 2010 is primarily due to the decrease in Fuel and Supplies by $3.63 million, increase in net accounts receivable of $0.51 million, decrease in cash of $0.81 million and decrease in capital assets of $0.12 million.

Net capital assets decreased from $8.84 million in 2009 to $8.70 million in 2010. Decrease is mainly a result of annual depreciation. During the year, Engine#5 (CAT) was overhauled and restored back online resulting in an increase in net capital assets of $0.19 million. Also, overhaul work began on Engine#6 (Deutz) resulting in an increase in Construction work-in-progress of $0.88 million.

Refer to note #4 to the accompanying financial statements for additional information relating to capital assets.

Total liabilities increased slightly from $29.61 million in 2008 to $29.93 million in 2009 and decreased by $2.68 million to $27.25 million in 2010. The overall decrease of $2.68 million (or 9%) experienced in 2010 is primarily due to decrease in Long-term debt of $0.59 million and decrease in current liabilities of $2.09 million. Current liabilities decreased by $2.09 million as a result of the net effect of increase in short-term debt by $0.95 million, decrease in current portion of long-term debt of $1.06 million, increase of $1.45 million in accounts payable – fuel, increase in accounts payable – other of $0.36 million, decrease in advances from RepMar of $2.54 million due to offsetting of RepMar electricity charges throughout 2010, increase in pPayable to affiliates of $0.13 million, decrease in accrued taxes of $0.03 million, decrease in other accrued liabilities of $0.39 million and decrease in deferred revenue of $0.97 million.

Refer to note #5 to the accompanying financial statements for additional information relating to long-term debt.

A summary of MEC's Statement of Revenues, Expenses and Changes in Net Deficiency is presented below:

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Revenue: | | | |
| Utility revenue | $ 14,965,401 | $ 14,105,966 | $ 18,690,921 |
| Non-utility revenue | 19,766,821 | 12,953,650 | 13,018,799 |
| Total revenue | 34,732,222 | 27,059,616 | 31,709,720 |
| Expenses: | | | |
| Utility expenses | 17,897,398 | 16,626,305 | 21,690,677 |
| Non-utility expenses | 18,495,781 | 11,510,021 | 12,962,924 |
| Total expenses | 36,393,179 | 28,136,326 | 34,653,601 |
| Operating loss | (1,660,957) | (1,076,710) | (2,943,881) |
| RMI subsidy | 926,204 | 937,730 | 355,618 |
| Other grants | - | 1,911,000 | - |
| Payments to RepMar | (165,181) | - | - |
| Loss on write-off of capital assets | (129,914) | - | - |
| Interest expense | (1,118,185) | (1,144,912) | (1,507,841) |
| Capital contributions | 783,787 | 521,103 | - |
| | 296,711 | 2,224,921 | (1,152,223) |
| Change in net deficiency | $ (1,364,246) | $ 1,148,211 | $ (4,096,104) |

The Statements of Revenue, Expenses and Changes in Net Deficiency identify the various revenue and expense items that contributed to the change in net deficiency. MEC's total revenue decreased in 2009 by $4.65 million (or 15%) to a total of $27.10 million compared to $31.71 million in 2008. In 2010, MEC's total revenue increased by $7.67 million (or 28%) to a total of $34.73 million. The decrease in revenue experienced during 2009 is due to the drop in fuel prices where cost savings were passed on to both electricity and fuel customers. In 2010, increase in revenue is mainly due to the increase in world fuel prices and increase in volume of fuel sales.

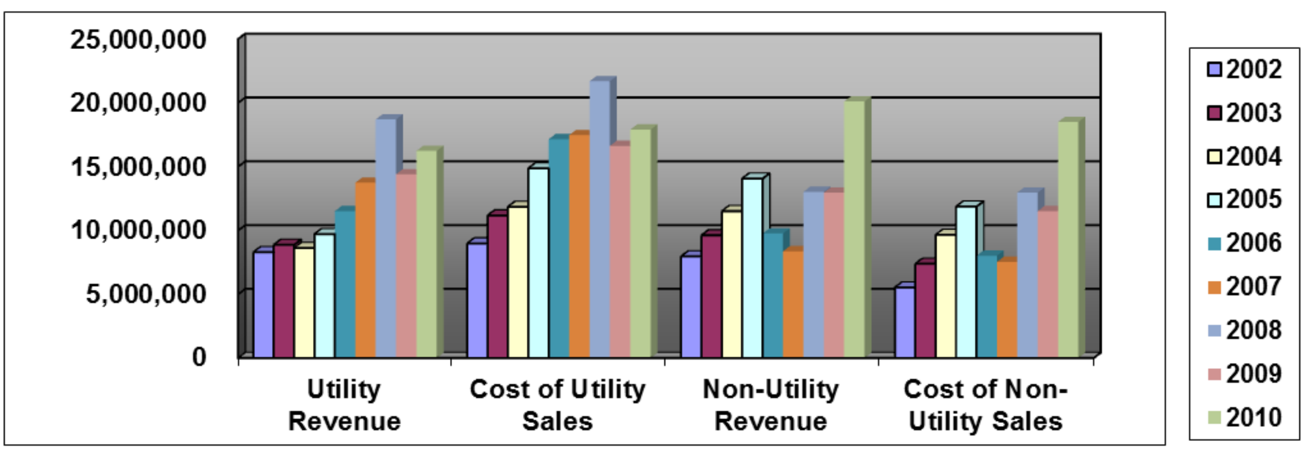
Electricity billings decreased by $4.66 million (or 25%) from $18.69 million in 2008 to $14.03 million in 2009 and increase by $0.87 million (or 6%) in 2010 to $14.90 million, of which $1.32 million pertains to doubtful accounts. Non-Utility revenue is mainly fuel sales. There were no significant changes in non-utility revenue in 2009. In 2010, there was an increase of $6.80 million (or 52%). Increase is due to the increase in fuel volume sales in 2010 compared to 2009.

The operating loss for 2010 was $1.66 million compared to $1.08 million and $2.94 million in 2009 and 2008, respectively. The increase in operating loss by $0.58 million in 2010 is primarily due to the increase in provision for doubtful accounts of $1.65 million, of which $1.32 million being provision for electric accounts and $0.33 million for non-utility revenue.

Capital contributions from RepMar were received by MEC in the amount of $0.78 million in 2010 and used for the refurbishment of engine parts. In 2009, capital contributions were $0.52 million.

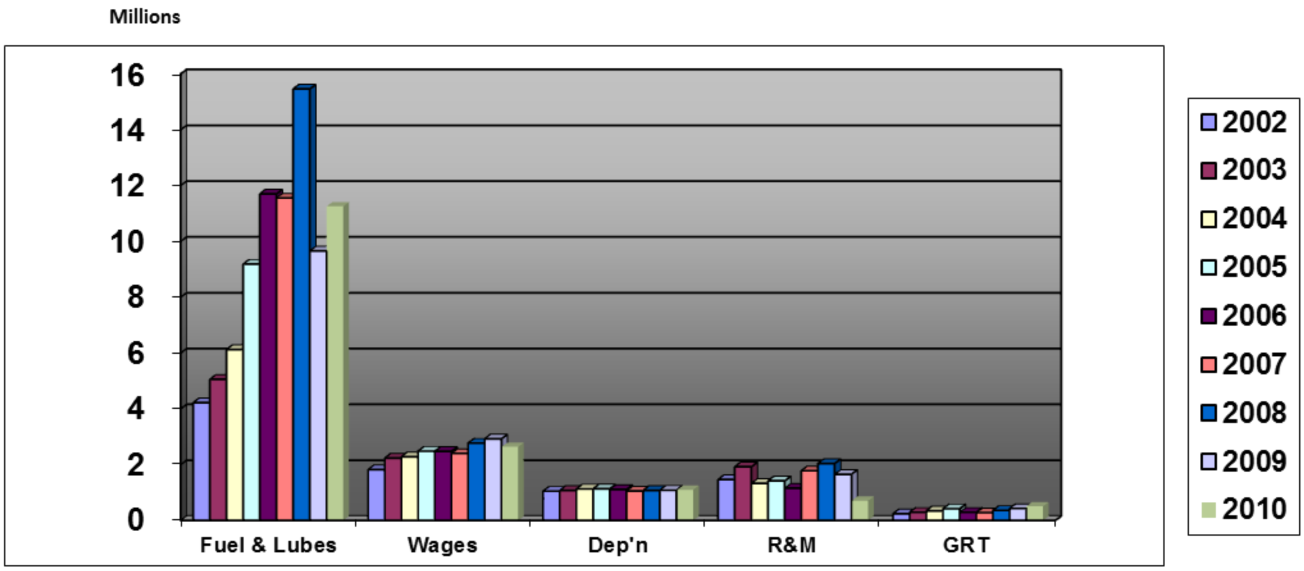
Operating subsidies of $0.93 million were received in 2010 compared to $0.94 million in 2009 and $0.36 million in 2008. Subsidy received during the year is cost recovery for the operations of Wotje and Jaluit power plants.

The graphic below shows the major components of revenue from 2002 through to 2010:




Total expenses decreased from $34.65 million in 2008 to $28.14 million in 2009 and increased to $36.39 million in 2010 due almost entirely to changes in fuel costs. The cost of fuel as a percentage of total generation operating costs declined from 83% in 2008 to 70% in 2009 and increased from 70% in 2009 to 78% in 2010. Total fuel costs for generation did not increase proportionately to the price increases due to the reduction in fuel consumption for generation because of overhaul work done to one of the engines, therefore making power generation more efficient. The cost of fuel and lubricants used for generation increased to $11.25 million in 2010 compared to $9.65 million in 2009 and $15.46 million in 2008.

The following graphic shows the major components of operating expenses, excluding the cost of fuel sold, from 2002 through to 2010:




## CASH FLOW

Net cash provided by operating activities for 2010 was $0.75 million compared to $1.02 million in 2009 and net cash used for operating activities of $6.26 million in 2008. In 2009, the source of cash used for fuel purchases was supplemented by RepMar subsidy and other grant sources (JPNGA) in the amount of $0.70 million and $1.91 million, respectively. In 2010, the source of cash used for fuel purchases was supplemented by RepMar subsidy of $0.93 million.

## FUTURE OUTLOOK ON SUSTAINABILITY

In spite of MEC's net deficiency position, the future outlook on sustainability for MEC is promising, as a wholly state owned entity. With the development and implementation of the Comprehensive Recovery Plan (CRP), MEC anticipates that the road to recovery, both operationally and financially, will be challenging yet achievable. The CRP, a three year roadmap initiated during the year, plays a significant and positive role towards MEC's road to recovery and efforts to secure a viable and sustainable future for MEC. The MEC CRP goals are:

a.) Strengthen MEC and Energy Sector Governance
b.) Improve Organizational Policies, Performance and Capacity
c.) Strengthen and Stabilize Company Finances

Key activities or objectives to support the MEC CRP goals include, but are not limited to, the following:

- Develop and adopt a full cost recovery tariff template and appropriate pricing structures for all goods and services. With the approval of the MEC Tariff Rate template from Cabinet, MEC is authorized to increase/decrease tariff rates in sync with the fluctuating cost of world fuel prices. Although the tariff template does not allow for full cost recovery, at a minimum, MEC is provided with the opportunity to recover the cost of fuel, the main cost driver for producing electricity.

- Renegotiate the terms of the Rural Utilities Services (RUS) loan with the aim of deferring loan servicing payments for at least 3 to 5 fiscal years. On an annual basis, MEC pays approximately $1.10 million towards MEC's debt to RUS. A deferment of the loan will allow for a much needed cash flow injection to rehabilitate the MEC power plant and other operations. As of September 30, 2010, the RUS loan balance is approximately $6.33 million.

- Restructure commercial debt with the Bank of Guam with the aim of securing concessional financing from a development finance institution (preferably the Asian Development Bank) to liquidate the Bank of Guam debt. On an annual basis, MEC pays approximately $1.92 million towards MEC's commercial debt with Bank of Guam. Similar to the RUS deferment program, the concessional financing will increase MEC's cash flow that is needed to rehabilitate the MEC power plant and other operations. In addition, MEC will have the opportunity to recognize cost savings resulting from the lower interest rates of the concessional financing versus the higher interest rates of a commercial loan. On September 8, 2010, MEC entered into a subsidiary loan agreement with RepMar in the amount of $8,542,445. Loan proceeds were used to pay off Bank of Guam loan in October 2010.

- Continue Majuro atoll-wide conversion to pre-paid metering system to improve cash flow and reduce receivables accumulation. As a recipient of grant funding from the US Department of the Interior, MEC will be converting all residential customers to a pre-pay meter. The conversion is expected to be completed within a two-three (2-3) year timeframe. The installation of the pre-pay meters will improve cash flow and reduce MEC's exposure to bad debt. As of September 30, 2010, MEC's Accounts Receivable Balance is $8.15 million, of which residential customers make up $1.70 million in the greater than ninety days (90) aging category and $1.30 million is made up of the customers that have been disconnected from the power grid.

- Conduct full system loss survey to locate and quantify key loss areas/sources. According to the FY 2008 audit report, the overall system loss was around 25%, which is equivalent to $3.2M in revenue loss per annum. The goal is to reduce the system loss to the industry standard of 9%-12%. The result of this exercise will identify losses, where the loss is occurring, and what steps are necessary to mitigate the losses. The survey will also clearly identify technical losses versus non-technical issues.

- Aggressively explore options to reduce generation cost factors, including exploration of alternative fuel sources and grid-connected alternative generation technologies. For FY 2010, 75% of MEC's operating cost was attributed to fossil fuel to run the generators compared to 70% in FY 2009. There is a great need for MEC to identify alternative measures to reduce its complete dependency on fossil fuel to generate electricity. As such, the aim under the CRP is to explore options to reduce power generation cost by venturing into Clean Development Mechanism (CDM) technologies that should reduce the consumption of fossil fuel and increase efficiencies. Other viable options include the implementation of a solar to grid concept and a hybrid system (Solar, Wind, Diesel Generator combined).

- Rehabilitate power plants, prioritizing full rehabilitation of the two Deutz generators. This is one of the most urgent undertakings of the CRP and needs to be highly prioritized. The total megawatt (MW) output from these two generators is 12MW at maximum efficiency. Currently, one of the Deutz engines is out of service and the other engine is yielding only 4.7MW at best. The estimated total cost to fully overhaul both generators will be around $4.5M. It is extremely critical that these two identified generators are overhauled to prolong the life of the asset and power plant to produce electricity. Overhaul work on one of the Deutz engine began during the year. The successful execution and approval of the RUS deferment program is critical to the rehabilitation efforts of the power plant. Any deviation or delays will have adverse impacts and will continue to place strains on MEC's operations and financial position.

- Develop and adopt new financial management and reporting policies. Financial reporting is a key resource that is needed to assist MEC management and the MEC Board of Directors to make appropriate and timely decisions in the best interest of MEC. It is extremely critical that the financial data is accurate, valid, relevant and timely for financial statement reporting and management reporting. MEC must develop and foster a more internally controlled financial environment, identify process gaps/opportunities, and implement process improvement to mitigate the risks. Furthermore, there is a great need for a fully integrated financial and accounting system and required capacity training that will need to be addressed within fiscal year 2011.

  A key accounting policy and procedure that will be a priority for fiscal year 2011 is the general ledger account reconciliations. Initially, a list of the account reconciliations will be compiled and will include the appropriate due dates and frequency. In addition, all reconciliations completed will require a more thorough review and approval process to be performed by MEC management or designee that would require strict adherence and compliance in order for the internal control of reconciliations to be working properly as intended.

In addition to the goals and objectives/key activities set forth by the CRP, MEC will continue to closely monitor operating expenses and maintain tight fiscal constraints and control over utility receivables in order to further improve cash collections and the net asset position. MEC, as a viable going concern, will continue to be dependent on the financial support of RepMar in the form of:

a) Timely payment by RepMar for services provided,
b) Collection of long outstanding utility receivables,
c) Continuing improvements in operations and financial condition.

During fiscal year 2010, there were tariff decreases. These took effect in February 2010 and May 2010, which is in line with the increase in world fuel price trend. Despite the wildly fluctuating world fuel prices, studies indicate that MEC has been able to maintain electricity tariffs at levels which are one of the lowest in the Pacific.

## MEC FOCUS IN THE COMING FISCAL YEAR

The increase in world fuel prices and increase in provision for allowance for doubtful accounts were key factors in MEC's change in net deficiency position of $1.36 million for the year ended September 30, 2010. To improve the company's future sustainability and viability, MEC expects the upcoming fiscal year 2011 to be the start of a challenging and exciting journey to recovery.

MEC's focus in the coming fiscal year includes but not limited to:

- Implement and monitor MEC's CRP. As indicated above, the CRP is an aggressive roadmap in MEC's efforts to revive the company's core operations and financials within a three year timeframe. During the year, various objectives were in stages of progress and completion.

- Improve/increase cash flow to support the CRP goals and objectives through the RUS deferment program. MEC management and MEC Board of Directors must actively lead and pursue the opportunities identified for a favorable outcome and without any further delays.

As MEC works diligently towards securing the RUS deferment and steps to aggressively pursue Accounts Receivable collections is a necessity to sustain MEC's operations in the interim period. Disconnection policy needs to be enforced without delay or prejudice. As long as MEC allows outstanding accounts receivable balances to age, the greater MEC's risk and exposure is to bad debt and continued cash flow constraints.

- Perform timely and accurate reconciliations of the RepMar advance payment in the amount of $6.70 million received in June 2008. Based on consumption rate for the electric accounts eligible to receive the offsetting credit, records indicate that the advance payment from RepMar is expected to be paid in full within the first quarter of fiscal year 2011. This will be a great milestone reached for MEC to fulfill its obligation to repay the $6.70 million. Most importantly, MEC's cash flow position will improve immensely. As such, it is important that reconciliation of the RepMar advance payment is completed timely and accurately to resume normal billing and collection efforts.

- Strengthen financial processes through the promotion of an internally controlled environment, development and adherence to accounting policies, implementation of a new financial and accounting software, and capacity building. MEC's financial processes are crucial to the company's future. Alongside MEC's core operation rehabilitation of the power plant, financial processing is also a key priority area to ensure financial data are recorded accurately, properly and timely for financial statement reporting and management reporting. Management reporting is necessary to ensure that MEC management and Board of Directors are provided the tools and resources to make an informed decision.

- Promote energy efficiency and conservation among consumers. In support of RepMar's National Energy Plan to provide affordable, reliable, clean energy and to sustain quality of life, MEC must start to play an active role in creating awareness and providing consumers with the resources to conserve energy. Although energy conservation will result in decreased annual revenue, the more significant and lasting impact will be the power generation cost savings and social responsibility to educate consumers to be more energy efficient.

Management's Discussion and Analysis for the year ended September 30, 2009 is set forth in the report on the audit of MEC's financial statements dated October 19, 2010. That Discussion and Analysis explains the major factors impacting the 2009 financial statements.

## ADDITIONAL FINANCIAL INFORMATION

This discussion and analysis is designed to provide MEC's customers and other stake holders with an overview of the company's operations and financial condition as at 30th September, 2010. Should the reader have questions regarding the information included in this report, or wish to request additional financial information, please contact the Marshalls Energy Company, Inc. General Manager at P.O. Box 1439, Majuro, Marshall Islands, MH 96960.

## MARSHALLS ENERGY COMPANY, INC.

Statements of Net Deficiency
September 30, 2010 and 2009

| ASSETS | 2010 | 2009 |
|---|---|---|
| Utility plant: | | |
| Electric plant in service | $ 21,066,221 | $ 20,717,527 |
| Construction work in progress | 977,273 | 354,060 |
| Total utility plant | 22,043,494 | 21,071,587 |
| Less accumulated depreciation and amortization | (13,353,446) | (12,270,320) |
| Net utility plant | 8,690,048 | 8,801,267 |
| Other non-current assets: | | |
| Nonutility property | 181,862 | 181,862 |
| Less accumulated depreciation | (150,046) | (143,032) |
| Nonutility property, net | 31,816 | 38,830 |
| Current assets: | | |
| Cash | 650,013 | 1,457,813 |
| Accounts receivable: | | |
| Electricity | 5,332,805 | 4,313,022 |
| Affiliates | 2,296,934 | 1,359,870 |
| Other | 520,651 | 409,066 |
| Total accounts receivable | 8,150,390 | 6,081,958 |
| Less allowance for uncollectible accounts | (4,322,591) | (2,762,012) |
| Net accounts receivable | 3,827,799 | 3,319,946 |
| Fuel and supplies | 2,857,536 | 6,485,043 |
| Total current assets | 7,335,348 | 11,262,802 |
| Total assets | $ 16,057,212 | $ 20,102,899 |

See accompanying notes to financial statements.

## MARSHALLS ENERGY COMPANY, INC.

Statements of Net Deficiency, Continued
September 30, 2010 and 2009

| NET DEFICIENCY AND LIABILITIES | 2010 | 2009 |
|---|---|---|
| Net deficiency: | | |
| Invested in capital assets, net of related debt | $ 2,394,234 | $ 1,844,155 |
| Deficiency | (13,589,201) | (11,674,876) |
| Total net deficiency | (11,194,967) | (9,830,721) |
| Commitment and contingencies | | |
| Long-term debt | 13,858,805 | 14,445,281 |
| Current liabilities: | | |
| Short-term debt | 948,118 | - |
| Current portion of long-term debt | 963,722 | 2,022,622 |
| Accounts payable - fuel | 5,772,944 | 4,319,596 |
| Accounts payable - other | 828,423 | 463,967 |
| Advances from RepMar | 764,961 | 3,303,020 |
| Payable to affiliates | 561,425 | 433,985 |
| Accrued building and engine repairs | 2,140,822 | 2,140,822 |
| Accrued taxes | 293,639 | 324,491 |
| Other accrued liabilities | 92,821 | 482,959 |
| Deferred revenue | 1,026,499 | 1,996,877 |
| Total current liabilities | 13,393,374 | 15,488,339 |
| Total liabilities | 27,252,179 | 29,933,620 |
| Total net deficiency and liabilities | $ 16,057,212 | $ 20,102,899 |

See accompanying notes to financial statements.

## MARSHALLS ENERGY COMPANY, INC.

Statements of Revenues, Expenses and Changes in Net Deficiency
Years Ended September 30, 2010 and 2009

| | 2010 | 2009 |
|---|---|---|
| Utility operations: | | |
| Operating revenues: | | |
| Electricity sales | $ 16,226,770 | $ 14,394,725 |
| Other | 63,503 | 75,344 |
| | 16,290,273 | 14,470,069 |
| Less provision for doubtful accounts | (1,324,872) | (364,103) |
| Total net operating revenues | 14,965,401 | 14,105,966 |
| Operating expenses: | | |
| Cost of power | 14,278,619 | 12,974,260 |
| Administrative and general | 1,283,832 | 1,230,871 |
| Distribution operations | 1,240,687 | 1,350,522 |
| Depreciation and amortization | 1,094,260 | 1,070,652 |
| Total operating expenses | 17,897,398 | 16,626,305 |
| Operating loss from utility operations | (2,931,997) | (2,520,339) |
| Nonutility operations: | | |
| Operating revenues: | | |
| Fuel sales | 19,175,180 | 12,182,844 |
| Propane sales | 629,010 | 543,146 |
| Lubricants sales | 65,511 | 69,188 |
| Other | 230,853 | 158,472 |
| | 20,100,554 | 12,953,650 |
| Less provision for doubtful accounts | (333,733) | - |
| Total net operating revenues | 19,766,821 | 12,953,650 |
| Operating expenses: | | |
| Cost of sales | 17,932,755 | 11,015,891 |
| Other | 563,026 | 494,130 |
| Total operating expenses | 18,495,781 | 11,510,021 |
| Operating income from nonutility operations | 1,271,040 | 1,443,629 |
| Operating loss | (1,660,957) | (1,076,710) |
| Nonoperating income (expense): | | |
| RepMar subsidy | 926,204 | 937,730 |
| Payments to RepMar | (165,181) | - |
| Loss on write-off of capital assets | (129,914) | - |
| Other grants | - | 1,911,000 |
| Interest expense | (1,118,185) | (1,144,912) |
| Total nonoperating income (expense), net | (487,076) | 1,703,818 |
| Capital contributions - RepMar | 783,787 | 521,103 |
| Change in net deficiency | (1,364,246) | 1,148,211 |
| Net deficiency at beginning of year | (9,830,721) | (10,978,932) |
| Net deficiency at end of year | $ (11,194,967) | $ (9,830,721) |

See accompanying notes to financial statements.

## MARSHALLS ENERGY COMPANY, INC.

Statements of Cash Flows

Years Ended September 30, 2010 and 2009

| | 2010 | 2009 |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash received from customers | $ 30,945,612 | $ 27,952,718 |
| Cash payments to suppliers for goods and services | (27,535,409) | (24,439,168) |
| Cash payments to employees for services | (2,662,151) | (2,497,715) |
| Net cash provided by operating activities | 748,052 | 1,015,835 |
| Cash flows from noncapital financing activities: | | |
| Subsidy from RepMar | 874,281 | 937,730 |
| Payments to RepMar | (165,181) | - |
| Net cash advances received from RepMar | - | 1,423,355 |
| Net proceeds from short-term debt | 948,118 | - |
| Interest paid on short-term debt | (89,822) | - |
| Principal paid on long-term debt | (977,064) | (1,246,378) |
| Interest paid on long-term debt | (489,952) | (675,135) |
| Net cash provided by noncapital financing activities | 100,380 | 439,572 |
| Cash flows from capital and related financing activities: | | |
| Acquisition and construction of capital assets | (510,327) | (440,205) |
| Capital contributions received | - | 304,906 |
| Principal paid on long-term debt | (668,312) | (628,049) |
| Interest paid on long-term debt | (477,593) | (469,777) |
| Net cash used for capital and related financing activities | (1,656,232) | (1,233,125) |
| Net change in cash | (807,800) | 222,282 |
| Cash at beginning of year | 1,457,813 | 1,235,531 |
| Cash at end of year | $ 650,013 | $ 1,457,813 |
| Reconciliation of operating loss to net cash provided by operating activities: | | |
| Operating loss | $ (1,660,957) | $ (1,076,710) |
| Adjustments to reconcile operating loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,104,676 | 1,079,294 |
| Provision for doubtful accounts | 1,658,605 | 364,103 |
| (Increase) decrease in assets: | | |
| Accounts receivable: | | |
| Electricity | (2,281,845) | 213,973 |
| Affiliates | (2,011,436) | (1,738,919) |
| Other | (181,556) | 136,734 |
| Fuel and supplies | 3,627,507 | (1,456,374) |
| Prepayments | - | 41,778 |
| Increase (decrease) in liabilities: | | |
| Accounts payable - fuel | 1,453,348 | 1,807,049 |
| Accounts payable - other | 364,456 | (7,348) |
| Payable to affiliates | 127,440 | 39,675 |
| Accrued building and engine repairs | - | (275,060) |
| Accrued taxes | (30,852) | 20,168 |
| Other accrued liabilities | (450,956) | (49,739) |
| Deferred revenue | (970,378) | 1,917,211 |
| Net cash provided by operating activities | $ 748,052 | $ 1,015,835 |

See accompanying notes to financial statements.

**MARSHALLS ENERGY COMPANY, INC.**

Statements of Cash Flows, Continued
Years Ended September 30, 2010 and 2009

| | 2010 | 2009 |
|---|---|---|
| Summary disclosure of noncash activities: | | |
| Off-set of advances from RepMar: | | |
| Electricity receivables | $ 1,234,007 | $ 1,215,278 |
| Receivables from affiliates | 1,304,052 | 1,463,250 |
| Advances from RepMar | (2,538,059) | (2,678,528) |
| | $ - | $ - |
| Contributed fuel and supplies: | | |
| Fuel and supplies | $ - | $ 2,127,197 |
| Other grants | - | (1,911,000) |
| Capital contributions from RepMar | - | (216,197) |
| | $ - | $ - |
| Contributed utility plant: | | |
| Construction work-in-progress | $ 684,751 | $ - |
| Electric plant in service | 99,036 | - |
| Capital contributions from RepMar | (783,787) | - |
| | $ - | $ - |

See accompanying notes to financial statements.

(1) Organization

The Marshalls Energy Company, Inc. (MEC) was granted a corporate charter by the Cabinet of the Republic of the Marshall Islands (RepMar) on February 2, 1984. MEC's principal lines of business are predominantly the generation and transmission of electricity and the buying and selling of petroleum products. Other lines of business include the rental of equipment and accommodation facilities. The principal markets for the generation and transmission of electricity are government agencies, businesses and residential customers located on the atolls of Majuro, Jaluit and Wotje. Petroleum products are sold primarily to foreign and domestic fishing vessels.

An exclusive franchise to construct, maintain and operate a distribution system for furnishing electrical power within Majuro Atoll was granted to MEC by RepMar on March 8, 1983. Simultaneously, RepMar leased to MEC, for a nominal amount, a 12-megawatt power plant, a six million gallon capacity fuel storage facility, electrical transmission systems and related facilities on Majuro Atoll. The term of both the lease and the franchise is for a fifty year period commencing on December 1, 1996.

Pursuant to Cabinet Minute C.M. 162(93), RepMar leased to MEC, for a nominal amount, the right to operate and manage the power generating and distribution system in Jaluit Atoll effective November 1, 1993. The term of the lease is for a fifty year period commencing on December 1, 1996.

Through Cabinet action in October 2000, RepMar contracted MEC to develop, operate and maintain power generation systems on Wotje Atoll.

MEC's financial statements are incorporated into the financial statements of RepMar as a component unit.

(2) Summary of Significant Accounting Policies

The accounting policies of MEC conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. MEC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

MEC considers utility and nonutility revenues and costs that are directly related to utility and nonutility operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Note Disclosures*, establish financial reporting standards for governmental entities, which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements.

(2) Summary of Significant Accounting Policies, Continued

To conform to the requirements of GASB Statement No. 34, equity is presented in the following net asset categories:

- Invested in capital assets - capital assets, net of accumulated depreciation and related debt, plus construction or improvement of those assets.

- Restricted net assets - resources in which MEC is legally or contractually obligated to spend resources in accordance with restrictions either externally imposed by creditors, grantors, contributors, and the like, or imposed by law.

- Unrestricted; net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Revenue Recognition

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. Unbilled revenues are not accrued as the most recent meter reading date approximates the end of the reporting period.

Revenue from fuel and propane sales is billed to customers on a daily basis based on the actual quantity of fuel and propane delivered.

Cash

Custodial credit risk is the risk that in the event of a bank failure, MEC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. MEC does not have a deposit policy for custodial credit risk.

For purposes of the statements of net deficiency and cash flows, cash is defined as cash on hand and cash held in demand accounts. As of September 30, 2010 and 2009, cash was $650,013 and $1,457,813, respectively, and the corresponding bank balances were $619,480 and $1,519,166, respectively, of which $566,774 and $1,516,806, respectively, were maintained in a financial institution subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2010 and 2009, bank deposits in the amount of $250,000 were FDIC insured. MEC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage are uncollateralized. Accordingly, these deposits were exposed to custodial credit risk.

(2) Summary of Significant Accounting Policies, Continued

Receivables

All receivables are due from government agencies, businesses and individuals located within the Republic of the Marshall Islands and are interest free and uncollateralized. The allowance for uncollectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. Management determines the adequacy of the allowance for uncollectible accounts based upon review of the aged accounts receivable. The allowance is established through a provision for bad debts charged to expense.

Fuel and Supplies

Fuel and supplies are valued at the lower of cost (first-in, first-out) or market (net realizable value).

Plant and Nonutility Property

Plant and nonutility property with a cost that equals or exceeds $500 is capitalized. Such assets are stated at cost. Depreciation of plant and nonutility property and amortization of leasehold land and residences are calculated on the straight-line method based on the estimated useful lives of the respective assets. The estimated useful lives of these assets are as follows:

| | |
|---|---|
| Power plant engines | 20 years |
| Plant and machinery | 3 - 10 years |
| Vehicles | 2 - 4 years |
| Leasehold improvements | 20 years |
| Residences | 20 years |
| Fences and seawalls | 10 years |
| Leasehold land | 20 years |
| Solar Power System | 15 years |
| Furniture and fixtures | 3 - 5 years |

Costs pertaining to distribution and line supplies are expensed during the year of installation as MEC considers the estimated useful lives of these supplies to be less than one year.

New Accounting Standards

During fiscal year 2010, MEC implemented the following pronouncements:

- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which addresses whether and when intangible assets should be considered capital assets for financial reporting purposes.

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*, which clarifies the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* for calculating the annual required contribution (ARC) adjustment.

- GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code, and establishes requirements for recognizing and measuring the effects of the bankruptcy process on assets and liabilities, and for classifying changes in those items and related costs.

The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

In March 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of MEC.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of MEC.

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus,* which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of MEC.

Reclassifications

Certain reclassifications have been made to the 2009 financial statements to conform to the 2010 presentation.

## (2) Summary of Significant Accounting Policies, Continued

### Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## (3) Fuel and Supplies

Fuel and supplies at September 30, 2010 and 2009, consist of the following:

| | 2010 | 2009 |
|---|---|---|
| Distribution and power plant supplies | $ 1,490,788 | $ 1,283,969 |
| Fuel | 1,274,157 | 5,064,166 |
| Lubricants | 92,591 | 136,908 |
| | $ 2,857,536 | $ 6,485,043 |

## (4) Capital Assets

Capital asset activity for the years ended September 30, 2010 and 2009 was as follows:

| | 2010 | | | |
|---|---|---|---|---|
| | October 1, 2009 | Additions | Deletions | September 30, 2010 |
| Utility Plant: | | | | |
| Power plant engines | $ 14,720,739 | $ 189,209 | $ - | $ 14,909,948 |
| Plant and machinery | 1,867,713 | 9,255 | - | 1,876,968 |
| Solar power systems | 1,110,417 | - | - | 1,110,417 |
| Vehicles | 884,976 | 156,768 | (18,500) | 1,023,244 |
| Leasehold improvements | 641,012 | - | - | 641,012 |
| Residences | 561,073 | - | - | 561,073 |
| Fences and seawalls | 371,702 | - | - | 371,702 |
| Leasehold land | 330,000 | - | - | 330,000 |
| Furniture and fixtures | 229,895 | 11,962 | - | 241,857 |
| Nonutility Plant: | | | | |
| LPG terminal | 181,862 | - | - | 181,862 |
| | 20,899,389 | 367,194 | (18,500) | 21,248,083 |
| Less accumulated depreciation and amortization | (12,413,352) | (1,104,676) | 14,536 | (13,503,492) |
| | 8,486,037 | (737,482) | (3,964) | 7,744,591 |
| Construction work-in-progress | 354,060 | 926,920 | (303,707) | 977,273 |
| | $ 8,840,097 | $ 189,438 | $ (307,671) | $ 8,721,864 |

## (4) Capital Assets, Continued

| | 2009 | | | |
|---|---|---|---|---|
| | October 1, 2008 | Additions | Deletions | September 30, 2009 |
| Utility Plant: | | | | |
| Power plant engines | $ 14,720,739 | $ - | $ - | $ 14,720,739 |
| Plant and machinery | 1,848,218 | 19,495 | - | 1,867,713 |
| Solar power systems | 1,110,417 | - | - | 1,110,417 |
| Vehicles | 810,987 | 122,064 | (48,075) | 884,976 |
| Leasehold improvements | 641,012 | - | - | 641,012 |
| Residences | 561,073 | - | - | 561,073 |
| Fences and seawalls | 371,702 | - | - | 371,702 |
| Leasehold land | 330,000 | - | - | 330,000 |
| Furniture and fixtures | 224,036 | 5,859 | - | 229,895 |
| Nonutility Plant: | | | | |
| LPG terminal | 181,862 | - | - | 181,862 |
| | 20,800,046 | 147,418 | (48,075) | 20,899,389 |
| Less accumulated depreciation and amortization | (11,382,133) | (1,079,294) | 48,075 | (12,413,352) |
| | 9,417,913 | (931,876) | - | 8,486,037 |
| Construction work-in-progress | 61,273 | 292,787 | - | 354,060 |
| | $ 9,479,186 | $ (639,089) | $ - | $ 8,840,097 |

At September 30, 2010, management determined that certain construction work-in-progress in the amount of $303,707 no longer existed. Accordingly, these capital assets were written off resulting in a loss of $129,914 for the year ended September 30, 2010.

## (5) Long-Term Debt

Long-term debt at September 30, 2010 and 2009 is as follows:

| | 2010 | 2009 |
|---|---|---|
| On November 18, 1997, MEC entered into a loan agreement with the Federal Financing Bank (FFB) in the amount of $12.5 million for the construction of a new power plant, with loan repayments guaranteed by the Rural Utilities Service (RUS). MEC is required to submit drawdown requests to RUS for approval of loan advances. Interest rates are calculated based on the FFB rates at the date of the loan advances and range from 5.49% to 7.25% per annum. Principal and interest are payable in quarterly installments of $273,770 through January 2, 2018. The mortgage notes have been unconditionally guaranteed by RepMar, under which RepMar will make debt service payments to RUS in the event of default by MEC, and have been collateralized by a leasehold mortgage and security agreement over the assets of MEC. These notes are subject to certain coverage ratio requirements. MEC is not in compliance with these ratio requirements as of September 30, 2010 and 2009. | $ 6,327,630 | $ 6,995,942 |

(5) Long-Term Debt, Continued

| | 2010 | 2009 |
|---|---|---|
| On May 25, 2007, MEC obtained a bank loan of $12 million to refinance debts to a fuel supplier and a commercial bank and to finance working capital requirements. This loan was refinanced on June 1, 2010 and is amortized over a period of 10 years and matures in 3 years. Interest is calculated at 1.75% over the bank's reference rate with a minimum rate of 6.5% per annum. As of September 30, 2010 and 2009, interest rate was 6.5% per annum. Principal and interest are payable in monthly equal payments of $99,300 to May 1, 2013. The remaining principal and interest balance are due on June 1, 2013. The loan is guaranteed, unconditionally and absolutely, by RepMar. This loan was paid in full on October 8, 2010 through acquisition of a subsidiary loan executed with RepMar on September 8, 2010 (see note 11). | 8,494,897 | 9,471,961 |
| | 14,822,527 | 16,467,903 |
| Less current installments | (963,722) | (2,022,622) |
| Long-term debt | $ 13,858,805 | $ 14,445,281 |

Changes in long-term debt during the years ended September 30, 2010 and 2009 are as follows:

| | 2010 | | | | |
|---|---|---|---|---|---|
| | Balance October 1, 2009 | Additions | Reductions | Balance September 30, 2010 | Balance due in One Year |
| RUS loan | $ 6,995,942 | $ - | $ (668,312) | $ 6,327,630 | $ 711,396 |
| Commercial bank loan | 9,471,961 | - | (977,064) | 8,494,897 | 252,326 |
| | $16,467,903 | $ - | $ (1,645,376) | $ 14,822,527 | $ 963,722 |

| | 2009 | | | | |
|---|---|---|---|---|---|
| | Balance October 1, 2008 | Additions | Reductions | Balance September 30, 2009 | Balance due in One Year |
| RUS loan | $ 7,623,991 | $ - | $ (628,049) | $ 6,995,942 | $ 668,314 |
| Commercial bank loan | 10,718,339 | - | (1,246,378) | 9,471,961 | 1,354,308 |
| | $18,342,330 | $ - | $ (1,874,427) | $ 16,467,903 | $ 2,022,622 |

## (5) Long-Term Debt, Continued

Annual repayment requirements to maturity for principal and interest are as follows:

| Year ending September 30, | Principal | Interest | Total |
|---|---|---|---|
| 2011 | $ 963,722 | $ 513,709 | $ 1,477,431 |
| 2012 | 898,018 | 340,401 | 1,238,419 |
| 2013 | 1,341,367 | 444,601 | 1,785,968 |
| 2014 | 1,201,783 | 310,406 | 1,512,189 |
| 2015 | 1,260,849 | 251,343 | 1,512,192 |
| 2016-2020 | 4,009,570 | 539,875 | 4,549,445 |
| 2021-2025 | 1,763,647 | 321,833 | 2,085,480 |
| 2026-2030 | 1,900,918 | 184,562 | 2,085,480 |
| 2031-2034 | 1,482,653 | 41,946 | 1,524,599 |
| | $ 14,822,527 | $ 2,948,676 | $ 17,771,203 |

## (6) Short-Term Debt

During the year ended September 30, 2010, MEC obtained three ninety-day or less term loans with interest rates at 7.5% per annum from a financial institution to finance fuel purchases. Short-term debt outstanding as of September 30, 2010 and 2009 was $948,118 and $0, respectively.

Change in short-term debt during the year ended September 30, 2010 is as follows:

| Balance October 1, 2009 | Additions | Reductions | Balance September 30, 2010 |
|---|---|---|---|
| $ - | $ 6,500,000 | $ (5,551,882) | $ 948,118 |

## (7) Employee Retirement Plan

On February 1, 2010, MEC implemented a defined contribution retirement savings plan (the Plan) for its employees. Employees eighteen years and older are eligible upon one year employment with MEC. Plan participants may contribute any amount of their salaries to be matched 100% by MEC up to 5% of base salaries. Withdrawal from the Plan occurs upon termination of employment, death, or financial hardship. Plan assets are held in a trust fund administered by a trustee in accordance with the trust agreement. Management has the authority to establish or amend Plan provisions and contribution requirements. MEC contributed $29,256 to Plan participant accounts during the year ended September 30, 2010.

## (8) Related Party Transactions

MEC is wholly-owned by RepMar and is therefore affiliated with all RepMar-owned and affiliated entities. RepMar subscribes for electricity generated by MEC and is charged for electricity usage at substantially the same rates as those charged to commercial establishments. In addition, RepMar purchases fuel from MEC at the same commercial terms and conditions as afforded to third parties. MEC's receivables from related parties are afforded more favorable payment terms than those extended to unrelated parties.

(8) Related Party Transactions, Continued

Pursuant to the Income Tax Act of 1989, as amended by the Income Tax Amendment Act of 1991, sales of electricity by public utility companies are exempt from gross revenue tax. MEC is therefore required to pay gross revenue tax on all revenue with the exception of electricity sales at the rate of 3%. As of September 30, 2010 and 2009, MEC is liable for gross revenue tax to RepMar amounting to $183,013 and $214,015, respectively.

Pursuant to the Import Duties (MEC Exemption) Act of 2008, enacted on October 6, 2008, MEC is exempt from paying import duty on all types of fuel imported into RepMar, including fuel imported for power generation and for commercial resale. Previously, pursuant to the Import Duties (Amendment) Act, 2005, no import duty was levied on residual fuel oils and diesel fuel imported by MEC solely for the purpose of power generation. MEC was, however, required to pay import duty on diesel fuel imported for commercial resale. As of September 30, 2010 and 2009, MEC is liable for import duties to RepMar amounting to $110,626 and $110,476, respectively, representing import duty owed prior to October 6, 2008.

Transactions for the years ended September 30, 2010 and 2009, and the related receivables from and payables to affiliates, are as follows:

| | 2010 | | | |
|---|---|---|---|---|
| | Revenues | Expenses | Receivables | Payables |
| RepMar | $ 3,625,595 | $ 356,691 | $ 927,932 | $ 331,335 |
| Kwajalein Atoll Joint Utility Resources | 3,920,407 | - | 74,491 | 2,482 |
| Majuro Water and Sewer Company, Inc. | 360,423 | 28,511 | 55,720 | 13,326 |
| Marshall Islands Social Security Administration | 11,817 | 464,134 | - | 152,257 |
| Majuro Resort, Inc. | 397,117 | 6,747 | 845,102 | 4,574 |
| Other | 1,508,051 | 198,663 | 393,689 | 57,451 |
| | $ 9,823,410 | $ 1,054,746 | $ 2,296,934 | $ 561,425 |

| | 2009 | | | |
|---|---|---|---|---|
| | Revenues | Expenses | Receivables | Payables |
| RepMar | $ 2,753,616 | $ 493,622 | $ 537,564 | $ 286,960 |
| Kwajalein Atoll Joint Utility Resources | 2,767,954 | - | 56,168 | - |
| Majuro Water and Sewer Company, Inc. | 371,121 | 2,787 | 40,552 | - |
| Marshall Islands Social Security Administration | 19,083 | 533,304 | 1,335 | 141,213 |
| Majuro Resort, Inc. | 362,966 | 5,272 | 464,885 | - |
| Other | 1,867,701 | 173,648 | 259,366 | 5,812 |
| | $ 8,142,441 | $ 1,208,633 | $ 1,359,870 | $ 433,985 |

Allowance for uncollectable accounts pertaining to receivables from affiliates amounted to $1,031,934 and $452,661 as of September 30, 2010 and 2009, respectively.

(8) Related Party Transactions, Continued

Changes in the advances from RepMar account during the years ended September 30, 2010 and 2009, are as follows:

| | 2010 | 2009 |
|---|---|---|
| Balance at beginning of year | $ 3,303,020 | $ 4,981,548 |
| Advances received | - | 1,000,000 |
| Utility billings offset | (2,538,059) | (2,678,528) |
| | $ 764,961 | $ 3,303,020 |

As of September 30, 2010 and 2009, MEC recorded deferred revenue from Kwajalein Atoll Joint Utility Resources of $242,156 and $786,627, respectively, related to diesel fuel sales paid in advance.

During the years ended September 30, 2010 and 2009, MEC received operating subsidies from RepMar of $926,204 and $937,730, respectively. During the years ended September 30, 2010 and 2009, MEC received capital contributions from RepMar of $783,787 and $216,197, respectively.

During the year ended September 30, 2010, MEC deposited $165,181 into a RepMar bank account in accordance with the terms of a grant passed through RepMar during fiscal year 2009 from an international donor. MEC also received advances of $423,355 passed through RepMar from international donors during fiscal year 2009.

(9) Commitment and Contingencies

Commitment

On June 22, 2006, MEC entered into a five-year fuel supply contract with SK Networks Co., Ltd. commencing January 2007 through December 2011. Under the fuel supply contract, MEC's minimum purchase obligation shall be 13,000,000 U.S. gallons per year.

Contingencies

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplates the continuation of MEC as a going concern. MEC has sustained substantial operating losses during the years ended September 30, 2010 and 2009 of $1,660,957 and $1,076,710, respectively, and has used a substantial amount of working capital in its operations resulting in a working capital deficiency of $6,058,026 at September 30, 2010. Furthermore, at September 30, 2010, total liabilities exceed total assets by $11,194,967. Management acknowledges that it is currently dependent on RepMar for cash advances to fund operations and on its affiliates to pay for actual services rendered in order to maintain MEC as a going concern. Should RepMar and its affiliates choose to discontinue cash advances and payment for services rendered, MEC management may have to consider alternative measures including, among other possibilities, an increase in electricity and fuel rates to maintain MEC as a going concern.

## (9) Commitment and Contingencies, Continued

### Contingencies, Continued

In view of these matters, realization of a major portion of the assets in the accompanying statement of net assets at September 30, 2010, is dependent upon continued operations of MEC, which in turn is dependent upon MEC’s ability to meet its future debt service requirements, and the success of future operations. Management believes that actions presently being taken to revise MEC’s operating requirements, which include entering into new fuel supply contracts with fishing companies, aggressively collecting past due accounts, and maintaining the approved pricing template allowing MEC to automatically adjust tariffs for movements in world oil prices, provide the opportunity for MEC to continue as a going concern.

In the efforts to maintain MEC as a going concern, MEC management implemented its Comprehensive Recovery Plan (CRP) during fiscal year 2010. The CRP is a three (3) year strategic plan or road map designed to a) Strengthen MEC and Energy Sector Governance; (b) Improve Organizational Policies, Performance and Capacity; and (c) Strengthen and Stabilize Company Finances. The objectives of the CRP include but are not limited to MEC’s efforts to renegotiate the terms of the Rural Utilities Services (RUS) loan with the aim of deferring loan servicing payments for at least three (3) to five (5) fiscal years and to restructure MEC’s commercial debt with the Bank of Guam with the aim of securing concessional financing from a development finance institution (preferably the Asian Development Bank) to liquidate the Bank of Guam debt (see note 11).

MEC is a party to several legal proceedings arising from its operations; however, no provision for any liability was made in the accompanying financial statements due to the uncertainty of the legal proceeding outcomes. Although the financial exposure is yet to be determined, MEC's management believes that the provision for any liability will be minimal.

## (10) Risk Management

MEC is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. MEC has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

Insurance proceeds of $3,410,336 received in 2007 for fire damages to MEC’s power plant building and engines were netted against estimated repair costs to put the assets back into service. Accrued building and engine repairs expense as of September 30, 2010 and 2009 amounted to $2,140,822.

## (11) Subsequent Events

On September 8, 2010, MEC entered into a subsidiary loan agreement with RepMar in the amount of $8,542,445. Loan proceeds were used to pay off MEC's $12 million bank loan on October 8, 2010.

On March 24, 2011, MEC borrowed an additional $1 million against the subsidiary loan agreement with RepMar. Loan proceeds were used for working capital purposes.

## MARSHALLS ENERGY COMPANY, INC.

Statement of Revenues, Expenses and Changes in Net Deficiency by Source
Year Ended September 30, 2010

| | Generation | Distribution | Tank Farm | Jaluit | Wotje | Solar | MEC Gas | Admin. | TOTAL |
|---|---|---|---|---|---|---|---|---|---|
| Operating revenues: | | | | | | | | | |
| Fuel, propane and lube sales | $ - | $ - | $ 19,240,691 | $ - | $ - | $ - | $ 629,010 | $ - | $ 19,869,701 |
| Cost of sales | - | - | 17,607,177 | - | - | - | 325,578 | - | 17,932,755 |
| Gross profit on sales | - | - | 1,633,514 | - | - | - | 303,432 | - | 1,936,946 |
| Electric and service billings | 15,440,343 | - | - | 600,181 | 117,013 | 69,233 | - | - | 16,226,770 |
| Service and other income | 11,459 | 49,592 | 57,110 | 4,360 | 48 | 14,247 | 3,433 | 154,107 | 294,356 |
| Less provision for doubtful accounts | (1,081,164) | - | (333,733) | - | - | (243,708) | - | - | (1,658,605) |
| Total electricity sales and other income | 14,370,638 | 49,592 | (276,623) | 604,541 | 117,061 | (160,228) | 3,433 | 154,107 | 14,862,521 |
| Total net operating revenue | 14,370,638 | 49,592 | 1,356,891 | 604,541 | 117,061 | (160,228) | 306,865 | 154,107 | 16,799,467 |
| Operating expenses: | | | | | | | | | |
| Fuel and lubes | 11,074,060 | - | - | 176,144 | - | - | - | - | 11,250,204 |
| Salaries, wages and benefits | 1,094,786 | 609,593 | 149,256 | 207,430 | 141,103 | 77,302 | 37,552 | 630,712 | 2,947,734 |
| Depreciation and amortization | 864,834 | 66,773 | 24,757 | 535 | 1,183 | 56,124 | 10,416 | 80,054 | 1,104,676 |
| Repairs and maintenance | 505,916 | 396,549 | 79,297 | 34,229 | 11,793 | 13,598 | 375 | 36,729 | 1,078,486 |
| Gross revenue tax | 130 | 137 | 482,362 | 179 | - | - | 21,297 | 1,298 | 505,403 |
| Insurance | 131,237 | 16,881 | 67,682 | 6,753 | 6,753 | - | 2,578 | 10,725 | 242,609 |
| Office | 32,910 | 4,376 | 2,597 | - | - | - | 210 | 194,403 | 234,496 |
| Freight and handling | 103,152 | 48,398 | - | 47,904 | 28,609 | 280 | - | 4,126 | 232,469 |
| Auto POL and maintenance | 55,007 | 79,390 | 15,808 | 5,183 | 282 | - | 6,926 | 30,091 | 192,687 |
| Import tax | 146,390 | 40,814 | - | - | - | - | - | - | 187,204 |
| Travel | 47,203 | 4,717 | - | 1,435 | 2,304 | 105 | - | 77,760 | 133,524 |
| Communications | 13,432 | 8,455 | 3,237 | 170 | 150 | - | 779 | 41,580 | 67,803 |
| Utility | - | - | - | 6,263 | - | - | - | 41,677 | 47,940 |
| Professional and consulting fees | - | - | - | - | - | - | - | 39,663 | 39,663 |
| Security services | 13,540 | - | 14,253 | - | - | - | - | 5,702 | 33,495 |
| Staff training | - | - | - | - | - | - | - | 26,106 | 26,106 |
| Equipment rental | 8,754 | 553 | 1,445 | 11,000 | - | 361 | 380 | - | 22,493 |
| Safety and uniforms | 10,362 | 6,364 | 410 | 753 | - | - | - | 1,318 | 19,207 |
| Lease rental | 7,350 | - | - | - | 3,833 | - | - | 6,570 | 17,753 |
| Entertainment | - | - | - | | - | - | - | 15,115 | 15,115 |
| Membership and other fees | - | - | - | - | - | - | - | 12,955 | 12,955 |
| Bank charges | 6,180 | - | - | - | - | - | - | 6,104 | 12,284 |
| Advertising | - | - | - | - | - | - | - | 7,110 | 7,110 |
| Donations | - | - | - | - | - | - | - | 2,652 | 2,652 |
| Miscellaneous | 9,437 | - | 16,618 | - | - | - | - | 301 | 26,356 |
| Total operating expenses | 14,124,680 | 1,283,000 | 857,722 | 497,978 | 196,010 | 147,770 | 80,513 | 1,272,751 | 18,460,424 |
| Operating income (loss) | 245,958 | (1,233,408) | 499,169 | 106,563 | (78,949) | (307,998) | 226,352 | (1,118,644) | (1,660,957) |
| Nonoperating income (expense): | | | | | | | | | |
| RepMar subsidy | - | - | - | 437,141 | 437,141 | - | - | 51,922 | 926,204 |
| Payments to RepMar | - | - | - | - | - | - | - | (165,181) | (165,181) |
| Loss on write-off of capital assets | - | - | - | - | - | (129,914) | - | - | (129,914) |
| Interest expense | (1,117,628) | - | - | - | - | - | - | (557) | (1,118,185) |
| | (1,117,628) | - | - | 437,141 | 437,141 | (129,914) | - | (113,816) | (487,076) |
| Capital contributions - RepMar | 783,787 | - | - | - | - | - | - | - | 783,787 |
| Change in net deficiency | $ (87,883) | $ (1,233,408) | $ 499,169 | $ 543,704 | $ 358,192 | $ (437,912) | $ 226,352 | $ (1,232,460) | $ (1,364,246) |

See accompanying independent auditors' report.