

**MARSHALLS ENERGY COMPANY, INC.**

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

**YEAR ENDED SEPTEMBER 30, 2000**



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL  
CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED  
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Chairman  
Board of Directors  
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2000, and have issued our report thereon dated November 30, 2000. 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.

Compliance

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 grants, 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 no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered MEC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting which we have reported to management of MEC in a separate letter dated November 30, 2000.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, supplemental lenders, the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than these specified parties.

*Deloitte & Touche*

November 30, 2000



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL  
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM  
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Chairman  
Board of Directors  
Marshalls Energy Company, Inc.:

Compliance

We have audited the compliance of the Marshalls Energy Company, Inc. (MEC) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended September 30, 2000. 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 and 7). Compliance with the requirements of laws, regulations, contracts, and grants applicable to its one 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 on MEC's compliance with those requirements.

As described in item 2000-1 in the accompanying Schedule of Findings and Questioned Costs, MEC did not comply with requirements regarding special tests and provisions that are applicable to its Rural Electrification Loan. Compliance with such requirements is necessary, in our opinion, for MEC to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, MEC complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2000.

### Internal Control Over Compliance

The management of MEC is responsible for establishing and maintaining effective internal control over compliance with 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 requirements that could have a direct and material effect on a major federal program in order to determine our 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.

We noted one matter involving the internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect MEC's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying Schedule of Findings and Questioned Costs as item 2000-1.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

### Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of MEC as of and for the year ended September 30, 2000, and have issued our report thereon dated November 30, 2000. 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, the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than these specified parties.

*Deloitte & Touche*

November 30, 2000

MARSHALLS ENERGY COMPANY, INC.

Schedule of Expenditures of Federal Awards  
 Rural Utilities Service Loan Funding (CFDA #10.850)  
 Year Ended September 30, 2000

	Proceeds Approved As Of September 30, 2000	Prior Years Loan Proceeds	Loan Proceeds Received During FY 2000	Interest Income Received During FY 2000	Total Loan Proceeds and Interest Received	Total Disburse- ments On Contracts During FY 2000
Generation	\$ <u>11,874,511</u>	\$ <u>9,920,000</u>	\$ <u>1,937,214</u>	\$ <u>28,775</u> *	\$ <u>11,885,989</u>	\$ <u>1,536,490</u>
						\$ 429,499
						<u>26,939</u>
						\$ <u>456,438</u>

The above loan program is received in a direct capacity through the grantor. The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting.

\* Interest income received during FY 2000 is the result of excess advances from RUS invested in time certificates of deposit.

See Accompanying Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2000

**Part I - Summary of Auditor's Results**

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. No reportable conditions in internal control over financial reporting were identified.
3. No instance of noncompliance considered material to the financial statements was disclosed by the audit.
4. One reportable condition in internal control over compliance with requirements applicable to major federal award programs was identified, which is not considered to be a material weakness.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed a qualified opinion.
6. The audit disclosed one finding required to be reported by OMB Circular A-133.
7. MEC's one major program was:

<u>Name of Federal Program</u>	<u>CFDA Number</u>
Rural Electrification Loan	10.850

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. MEC did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

**Part II - Financial Statement Findings Section**

No financial statement findings were reported for the year ended September 30, 2000.

**Part III - Federal Award Findings and Questioned Costs Section**

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>	<u>Refer Page #</u>
2000-1	Special Tests and Provisions	\$ -	7

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2000

Special Tests and Provisions - Utility Rates

Finding No. 2000-1

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
Debt Service Coverage (DSC)	=	1.25
Operating Times Interest Earned Ratio (OTIER)	=	1.10
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2000, MEC achieved the following average coverage ratios:

TIER	=	1.14
DSC	=	1.38
OTIER	=	(2.68)
ODSC	=	(0.60)

MEC only achieved the DSC average coverage ratio as prescribed by the RUS loan contract.

Cause: The cause of the above condition is that utility rates for utility service furnished are not sufficient to provide adequate revenues to comply with the prescribed rates.

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.

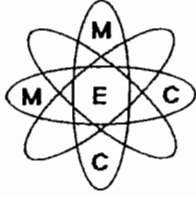
Recommendation: We recommend that management, in accordance with Section 5.4.(e) and (f) of the RUS loan contract, notify RUS in writing of the failure to achieve the prescribed ratios and comply with the requirement that within thirty days of notifying RUS of the noncompliance, a written plan be sent to RUS setting forth the actions to be taken to achieve the required average coverage ratios on a timely basis.

MARSHALLS ENERGY COMPANY, INC.

Summary of Schedule of Prior Audit Findings  
Year Ended September 30, 2000

Findings and Questioned Costs

There are no unresolved findings and questioned costs or matters of noncompliance from prior year audits of MEC.



## **MARSHALLS ENERGY COMPANY INC.**

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Corrective Action Plans to Questioned Costs and Findings included in the Independent Auditors' Reports on Internal Control and on Compliance for the Year Ended September 30, 2000

### **Federal Award Findings and Questioned Cost Section**

#### Special Tests and Provisions - Utility Rates

##### Finding No. 2000-1

The Borrower "Marshalls Energy Company" will report the average coverage ratios when we annually submit the final audit report and management letter to the RUS as agreed in the Loan Contract Article V - Affirmative Covenants Section 5. The non-compliance portion of Section 5.4(e) and corrective plans section 5.4(f) of the loan contract is a retrospective view. The loan contract states in Section 5.4(b) that if the Borrower does not meet the coverage ratios in the two best years out of three, then they must notify the RUS on a retrospective basis, not a current basis. The power plant engines project, which has been funded by a loan from the RUS, has been placed in service December 17, 1999 and has only, received the benefit of this loan for a partial year.