

MARSHALLS ENERGY COMPANY, INC.

INDEPENDENT AUDITORS'  
MANAGEMENT LETTER

YEAR ENDED SEPTEMBER 30, 2000



## INDEPENDENT AUDITORS' MANAGEMENT LETTER

Chairman  
Board of Directors  
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC), 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; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service (RUS) Borrowers*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of MEC for the year ended September 30, 2000, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

A description of the responsibility of management for establishing and maintaining the internal control over financial reporting and the objectives of and inherent limitations in such control is set forth in our Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based Upon the Audit Performed in Accordance with *Government Auditing Standards* dated November 30, 2000, and should be read in conjunction with this report.

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 that we consider to be material weaknesses.

7 Part 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.33(e)(1), related party transactions and depreciation rates. In addition, our audit of the financial statements also included the procedures specified in 7 CFR 1773.38-.45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports (other than our Independent Auditors' Report on Financial Statements, our Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based Upon the Audit Performed in Accordance with *Government Auditing Standards*, our 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, and our separate letter regarding recommendations concerning certain matters related to the internal control, all dated November 30, 2000) or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR 1773.33 are presented below.

#### COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted no matters regarding MEC's internal control over financial reporting and its operation that we consider to be a material weakness as previously defined with respect to:

- . The accounting procedures and records;
- . The process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts; and
- . The materials control.

#### COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

Management's responsibility for compliance with laws, regulations, contracts, and grants is set forth in our Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based Upon the Audit Performed in Accordance with *Government Auditing Standards* dated November 30, 2000, and should be read in conjunction with this report. At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- . Procedure performed with respect to the requirement to maintain all funds from loans made or guaranteed by RUS in institutions whose accounts are insured by an agency of the Federal government:
  1. Obtained information from financial institutions with which MEC maintains cash proceeds from loans that indicated that the institutions are insured by an agency of the Federal government.
- . Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended September 30, 2000 of MEC:
  1. Obtained and read a borrower-prepared schedule of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others as defined in 7 CFR 1773.33(e)(1)(ii).
  2. Reviewed Board of Director minutes to ascertain whether board-approved written contracts are included in the borrower-prepared schedule.
  3. Noted the existence of written RUS approval of each contract listed by the borrower.
- . Procedure performed with respect to the requirement to submit RUS Form 7 to the RUS:
  1. Agreed amounts reported in Form 7 to MEC's records.

The results of our tests indicate that, with respect to the items tested, MEC complied, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested include the requirements that:

- . The borrower maintains all funds from loans made or guaranteed by RUS in institutions whose accounts are insured by an agency of the Federal government;
- . The borrower has obtained written approval of the RUS to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others as defined in 7 CFR 1773.33(e)(1)(ii); and
- . The borrower has submitted its Form 7 to the RUS and the Form 7, Financial and Statistical Report, as of December 31, 1999, represented by the borrower as having been submitted to RUS, appears reasonable based upon the audit procedures performed.

#### COMMENTS ON OTHER ADDITIONAL MATTERS

In connection with our audit of the financial statements of MEC, nothing came to our attention, except as noted below, that caused us to believe that MEC failed to comply with respect to:

- . The reconciliation of subsidiary plant records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33(c)(1);

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.33(c)(2);
- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4);
- Sales of plant material, or scrap addressed at 7 CFR 1773.33(c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards No. 57, *Related Party Transactions*, for the year ended September 30, 2000, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR 1773.33(f); and
- The depreciation rates addressed at 7 CFR 1773.33(g).

The detailed schedule of deferred debits and deferred credits required by 7 CFR 1773.33(h) is not presented as there were no deferred debits or credits reported in the financial statements of MEC as of and for the year ended September 30, 2000.

(1) Special Tests and Provisions - Utility Rates

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

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. 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.

Auditee Response: 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.

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

*Deloitte & Touche*

November 30, 2000