

MARSHALLS ENERGY COMPANY, INC.

REPORT ON THE AUDIT OF
FINANCIAL STATEMENTS IN ACCORDANCE
WITH OMB CIRCULAR A-133

YEAR ENDED SEPTEMBER 30, 2003

MARSHALLS ENERGY COMPANY, INC.

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2003 AND 2002

INDEPENDENT AUDITORS' REPORT

Board of Directors
Marshalls Energy Company, Inc.:

We have audited the accompanying statements of net assets of the Marshalls Energy Company, Inc. (MEC), a component unit of the Republic of the Marshall Islands, as of September 30, 2003 and 2002, and the related statements of revenues, expenses and changes in net assets and 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in note 2 to the accompanying financial statements, MEC adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*.

The Management's Discussion and Analysis on pages 15 and 16 is not a required part of the basic financial statements but is supplementary information required by GASB. 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 Assets by Source for the year ended September 30, 2003 (page 14) 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 the management of MEC. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements 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 a report dated December 18, 2003, on our consideration of MEC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The image shows a handwritten signature in cursive script that reads "Deloitte & Touche".

December 18, 2003

MARSHALLS ENERGY COMPANY, INC.

Statements of Net Assets
September 30, 2003 and 2002

| <u>ASSETS</u> | <u>2003</u> | <u>2002</u> |
|--|------------------------|------------------------|
| Utility plant: | | |
| Electric plant in service | \$ 19,104,392 | \$ 18,675,056 |
| Construction work in progress | <u> -</u> | <u> 20,000</u> |
| Total utility plant | 19,104,392 | 18,695,056 |
| Less accumulated depreciation and amortization | <u>(6,057,348)</u> | <u>(5,053,348)</u> |
| Net utility plant | <u>13,047,044</u> | <u>13,641,708</u> |
| Other assets: | | |
| Nonutility property, net | <u> 69,531</u> | <u> 78,627</u> |
| Current assets: | | |
| Cash and cash equivalents | <u> 713,310</u> | <u> 617,345</u> |
| Accounts receivable: | | |
| Electricity | 3,075,538 | 2,793,137 |
| Affiliates | 1,424,890 | 1,053,766 |
| Other | <u> 358,161</u> | <u> 160,968</u> |
| Total accounts receivable | 4,858,589 | 4,007,871 |
| Less allowance for uncollectible accounts | <u>(2,136,475)</u> | <u>(1,856,023)</u> |
| Net accounts receivable | <u> 2,722,114</u> | <u> 2,151,848</u> |
| Materials and supplies | <u> 1,834,668</u> | <u> 1,784,400</u> |
| Prepayments | <u> 30,381</u> | <u> 39,660</u> |
| Total current assets | <u> 5,300,473</u> | <u> 4,593,253</u> |
| Total assets | <u>\$ 18,417,048</u> | <u>\$ 18,313,588</u> |

See accompanying notes to financial statements.

MARSHALLS ENERGY COMPANY, INC.

Statements of Net Assets, Continued
September 30, 2003 and 2002

| <u>LIABILITIES AND NET ASSETS</u> | | |
|---|----------------------|----------------------|
| | <u>2003</u> | <u>2002</u> |
| Net assets: | | |
| Investment in capital assets, net of related debt | \$ 2,876,974 | \$ 3,054,801 |
| Restricted | <u>2,923,114</u> | <u>2,148,699</u> |
| Total net assets | <u>5,800,088</u> | <u>5,203,500</u> |
| Commitment and contingency | | |
| Long-term debt: | | |
| RUS mortgage notes less current maturities | <u>9,781,020</u> | <u>10,234,294</u> |
| Current liabilities: | | |
| Current maturities of long-term debt | 458,581 | 431,240 |
| Accounts payable | 2,020,733 | 2,120,750 |
| Payable to affiliates | 90,348 | 171,051 |
| Accrued taxes | 175,368 | 82,536 |
| Other current and accrued liabilities | <u>90,910</u> | <u>70,217</u> |
| Total current liabilities | <u>2,835,940</u> | <u>2,875,794</u> |
| Total net assets and liabilities | <u>\$ 18,417,048</u> | <u>\$ 18,313,588</u> |

See accompanying notes to financial statements.

MARSHALLS ENERGY COMPANY, INC.

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2003 and 2002

| | <u>2003</u> | <u>2002</u> |
|---------------------------------|---------------------|---------------------|
| Operating revenues | \$ <u>8,872,780</u> | \$ <u>8,289,970</u> |
| Operating expenses: | | |
| Cost of power | 7,192,439 | 5,722,555 |
| Administrative and general | 1,231,636 | 1,033,773 |
| Distribution operations | 1,083,620 | 748,373 |
| Depreciation and amortization | 1,020,586 | 997,333 |
| Consumer accounts | 282,463 | 329,532 |
| Taxes | 188,505 | 160,058 |
| Distribution maintenance | <u>141,539</u> | <u>144,371</u> |
| Total operating expenses | <u>11,140,788</u> | <u>9,135,995</u> |
| Operating loss | <u>(2,268,008)</u> | <u>(846,025)</u> |
| Nonoperating income (expense): | | |
| Fuel and gas sales | 9,341,838 | 7,660,469 |
| Cost of sales | <u>(7,384,111)</u> | <u>(5,530,080)</u> |
| Gross profit on sales | 1,957,727 | 2,130,389 |
| Compact funding | 1,866,667 | 1,866,667 |
| Interest expense | (669,343) | (764,650) |
| Other, net | <u>(290,455)</u> | <u>(310,287)</u> |
| Total nonoperating income, net | <u>2,864,596</u> | <u>2,922,119</u> |
| Change in net assets | 596,588 | 2,076,094 |
| Net assets at beginning of year | <u>5,203,500</u> | <u>3,127,406</u> |
| Net assets at end of year | \$ <u>5,800,088</u> | \$ <u>5,203,500</u> |

See accompanying notes to financial statements.

MARSHALLS ENERGY COMPANY, INC.

Statements of Cash Flows
Years Ended September 30, 2003 and 2002

| | <u>2003</u> | <u>2002</u> |
|---|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 17,361,889 | \$ 16,135,634 |
| Cash payments to suppliers for goods and services | (15,357,226) | (13,243,530) |
| Cash payments to employees for services | (1,875,632) | (1,636,314) |
| Miscellaneous activities, net | <u>(338,505)</u> | <u>(250,887)</u> |
| Net cash (used for) provided by operating activities | <u>(209,474)</u> | <u>1,004,903</u> |
| Cash flows from noncapital financing activities: | | |
| Cash received from Compact Funds | 1,866,667 | 1,633,334 |
| Net repayment under bank credit line agreement | - | (1,200,000) |
| Interest paid on short-term borrowings | <u>-</u> | <u>(76,455)</u> |
| Net cash provided by noncapital financing activities | <u>1,866,667</u> | <u>356,879</u> |
| Cash flows from capital and related financing activities: | | |
| Acquisition and construction of capital assets | (476,701) | (312,597) |
| Proceeds from disposal of capital assets | 10,749 | - |
| Principal paid on long-term debt | (425,933) | (406,901) |
| Interest paid on long-term debt | <u>(669,343)</u> | <u>(688,195)</u> |
| Net cash used for capital and related financing activities | <u>(1,561,228)</u> | <u>(1,407,693)</u> |
| Net increase (decrease) in cash and cash equivalents | 95,965 | (45,911) |
| Cash and cash equivalents at beginning of year | <u>617,345</u> | <u>663,256</u> |
| Cash and cash equivalents at end of year | \$ <u>713,310</u> | \$ <u>617,345</u> |
| Reconciliation of change in net assets to net cash (used for) provided by operating activities: | | |
| Change in net assets | \$ 596,588 | \$ 2,076,094 |
| Adjustments to reconcile change in net assets to net cash (used for) provided by operating activities: | | |
| Depreciation and amortization | 1,069,713 | 1,044,646 |
| Provision for uncollectible accounts receivable | 282,463 | 329,532 |
| Non-operating Compact funding | (1,866,667) | (1,633,334) |
| Non-operating interest expense | 669,343 | 764,650 |
| (Increase) decrease in assets: | | |
| Accounts receivable: | | |
| Electricity | (284,413) | (362,835) |
| Affiliates | (371,124) | 61,620 |
| Other | (197,193) | 253,077 |
| Materials and supplies | (50,268) | (439,614) |
| Prepayments | 9,279 | (11,860) |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (100,017) | (965,144) |
| Payable to affiliates | (80,703) | (70,576) |
| Accrued taxes | 92,832 | (24,439) |
| Other current and accrued liabilities | <u>20,693</u> | <u>(16,914)</u> |
| Net cash (used for) provided by operating activities | \$ <u>(209,474)</u> | \$ <u>1,004,903</u> |

See accompanying notes to financial statements.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(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 and Jaluit. Petroleum products are sold primarily to foreign and domestic fishing vessels.

MEC's articles of incorporation have authorized the issuance of 100,000 shares of \$1 par value common stock. RepMar owns 75,000 of these shares and MEC retains the remaining 25,000 shares in treasury. These amounts are included in restricted net assets in the accompanying statements of net assets.

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 general purpose 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.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(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.

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.

Cash and Cash Equivalents

For purposes of the statements of net assets and cash flows, cash and cash equivalents is defined as cash on hand, cash held in demand accounts, and time certificates of deposit maturing within ninety days. As of September 30, 2003 and 2002, cash and cash equivalents are \$713,310 and \$617,345, respectively, and the corresponding bank balances are \$1,663,397 and \$1,584,038, respectively. Of the bank balance amount as of September 30, 2003 and 2002, \$1,660,806 and \$1,468,943, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2003 and 2002, bank deposits in the amount of \$100,000 and \$100,994, respectively, are FDIC insured. MEC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage are uncollateralized.

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. The allowance is established through a provision for bad debts charged to expense.

Materials and Supplies

Fuel and supplies are valued at the lower of cost (first-in, first-out) or market (net realizable value). Bulk fuel inventories held on consignment for power plant use and for resale are not reflected in the accompanying statements of net assets.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(2) Summary of Significant Accounting Policies, Continued

Plant and Nonutility Property

Plant and nonutility property 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. 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

GASB has issued 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*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*. These statements 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. MEC is required to adopt GASB Statement No. 34, as amended by GASB Statement No. 37, and certain provisions of GASB Statement No. 38 in fiscal year 2003.

To conform to the requirements of GASB 34, the following changes have been made to MEC's financial statements for fiscal years 2003 and 2002:

- Retained earnings have been reclassified into the following net assets categories:
 - Investment in capital assets; capital assets, net of accumulated depreciation and related debt, plus construction or improvement of those assets.
 - Restricted; all of MEC's assets have been assigned as collateral for the RUS loan (see note 6), and accordingly, classified as restricted. MEC's outstanding common stock and treasury stock are included in this category.
- The statement of cash flows has been presented using the direct method.

(3) Materials and Supplies

Materials and supplies at September 30, 2003 and 2002, consist of the following:

| | <u>2003</u> | <u>2002</u> |
|---------------------------------------|---------------------|---------------------|
| Distribution and power plant supplies | \$ 1,683,194 | \$ 1,602,911 |
| Lubricants | 113,011 | 162,801 |
| Fuel | <u>38,463</u> | <u>18,688</u> |
| | <u>\$ 1,834,668</u> | <u>\$ 1,784,400</u> |

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(4) Utility Plant

Utility plant at September 30, 2003 and 2002, consists of the following:

| | <u>Estimated Useful Lives</u> | <u>2003</u> | <u>2002</u> |
|--|-----------------------------------|----------------------|----------------------|
| Power plant engines | 20 years | \$ 14,720,739 | \$ 14,720,739 |
| Plant and machinery | 3 - 10 years | 1,612,907 | 1,416,381 |
| Vehicles | 2 - 4 years | 785,266 | 781,058 |
| Leasehold improvements | 20 years | 570,964 | 356,059 |
| Residences | 20 years | 548,284 | 548,284 |
| Fences and seawalls | 10 years | 371,702 | 371,702 |
| Leasehold land | 20 years | 330,000 | 330,000 |
| Furniture and fixtures | 3 - 5 years | <u>164,530</u> | <u>150,833</u> |
| | | 19,104,392 | 18,675,056 |
| Less accumulated depreciation and amortization | | <u>(6,057,348)</u> | <u>(5,053,348)</u> |
| | | 13,047,044 | 13,621,708 |
| Construction work in progress | | <u>-</u> | <u>20,000</u> |
| | | <u>\$ 13,047,044</u> | <u>\$ 13,641,708</u> |

(5) Taxes Payable

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. Accordingly, MEC is required to pay gross revenue tax on all revenue with the exception of electricity sales at the rate of 3%. As of September 30, 2003 and 2002, MEC is liable for gross revenue tax to RepMar amounting to \$145,357 and \$60,230, respectively.

Pursuant to the Import Duties Act of 1989, as amended by the Import Duties (Amendment) Act of 1996, no import duty shall be levied on residual fuel oils and diesel oil imported by MEC solely for the purpose of power generation. MEC is, however, required to pay import duty on diesel oil imported for resale subject to certain exemptions. As of September 30, 2003 and 2002, MEC is liable for import duty to RepMar amounting to \$30,011 and \$22,306, respectively.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(6) Notes Payable

| | <u>2003</u> | <u>2002</u> |
|---|---------------------|----------------------|
| 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, 2003 and 2002. | \$ 10,239,601 | \$ 10,665,534 |
| Less current installments | <u>458,581</u> | <u>431,240</u> |
| Long-term debt | \$ <u>9,781,020</u> | \$ <u>10,234,294</u> |

Future repayment commitments are as follows:

| <u>Year ending September 30,</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|--------------------------------------|----------------------|---------------------|----------------------|
| 2004 | \$ 458,581 | \$ 636,517 | \$ 1,095,098 |
| 2005 | 488,979 | 606,115 | 1,095,094 |
| 2006 | 388,124 | 433,196 | 821,320 |
| 2007 | 550,389 | 559,987 | 1,110,376 |
| 2008 | 724,230 | 629,359 | 1,353,589 |
| Thereafter | <u>7,629,298</u> | <u>2,505,642</u> | <u>10,134,940</u> |
| | \$ <u>10,239,601</u> | \$ <u>5,370,816</u> | \$ <u>15,610,417</u> |

(7) 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 based on a tariff rate of \$0.12 cents per kilowatt hour for monthly bills less than 500 kilowatt hours, or \$0.16 cents per kilowatt hour for bills greater than 500 kilowatt hours. 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.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(7) Related Party Transactions, Continued

Total transactions for the years ended September 30, 2003 and 2002, and the related receivables from and payables to affiliates, are as follows:

| | 2003 | | | |
|---|---------------------|-------------------|---------------------|-------------------|
| | <u>Revenues</u> | <u>Expenses</u> | <u>Receivables</u> | <u>Payables</u> |
| RepMar | \$ 1,885,006 | \$ 490,713 | \$ 848,120 | \$ 31,423 |
| Majuro Water and Sewer Company, Inc. | 280,069 | 18,533 | 247,836 | - |
| Marshall Islands Social Security Administration | 34,501 | 244,213 | 2,169 | 58,925 |
| Majuro Resort, Inc. | 289,258 | 8,096 | 50,302 | - |
| Other | <u>790,278</u> | <u>130,691</u> | <u>276,463</u> | <u>-</u> |
| | <u>\$ 3,279,112</u> | <u>\$ 892,246</u> | <u>\$ 1,424,890</u> | <u>\$ 90,348</u> |
| | 2002 | | | |
| | <u>Revenues</u> | <u>Expenses</u> | <u>Receivables</u> | <u>Payables</u> |
| RepMar | \$ 1,547,220 | \$ 487,546 | \$ 589,981 | \$ 101,994 |
| Majuro Water and Sewer Company, Inc. | 201,249 | 3,352 | 171,627 | - |
| Marshall Islands Social Security Administration | 34,880 | 279,128 | 5,550 | 69,057 |
| Majuro Resort, Inc. | 294,211 | 3,635 | 50,465 | - |
| Other | <u>744,347</u> | <u>85,923</u> | <u>236,143</u> | <u>-</u> |
| | <u>\$ 2,821,907</u> | <u>\$ 859,584</u> | <u>\$ 1,053,766</u> | <u>\$ 171,051</u> |

On October 20, 2000, the Cabinet of RepMar approved MEC as the contract manager for the construction of a power plant, power distribution and cable facility on Wotje Atoll in the amount of \$2,023,800. The Cabinet further approved the establishment of an escrow account to facilitate the receipt and disbursement of funds relating to this project. During the year ended September 30, 2002, MEC received \$1,117,850 from RepMar relating to this project. The unexpended amount of \$92,724, payable to RepMar at September 30, 2002, was disbursed during fiscal year 2003.

For the years ended September 30, 2003 and 2002, MEC received Compact Section 214(a) Funding of \$1,866,667 each year, passed through RepMar. Management believes that MEC will not continue to receive such funding after fiscal year 2003.

As of September 30, 2003 and 2002, MEC maintained a demand deposit account with an affiliated financial institution, amounting to \$2,592 and \$115,095, respectively. MEC had a loan payable to an affiliated financial institution amounting to \$1,200,000, which was paid in full on July 4, 2002.

MARSHALLS ENERGY COMPANY, INC.

Notes to Financial Statements
September 30, 2003 and 2002

(8) Commitment and Contingency

Commitment

MEC purchases petroleum products from Mobil Oil Micronesia, Inc. (Mobil) on a consignment basis whereby Mobil continues to hold ownership and title to the product while it is held in storage at the MEC terminal storage tanks. Title and risk on the product remains with Mobil until the product passes the boundary of the MEC terminal. The value of consignment petroleum products as of September 30, 2003 and 2002 is approximately \$2,035,781 and \$2,283,316, respectively. MEC assumes responsibility for the proper and safe storage/handling of the product while under MEC storage. However, MEC carries insurance coverage on such consignment inventories.

Contingency

Management of MEC acknowledges that it is currently dependent on RepMar and 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 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) Risk Management

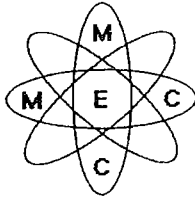
MEC is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions, injuries to employees; and natural disasters. MEC has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed. Settled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

MARSHALLS ENERGY COMPANY, INC.

Schedule of Revenues, Expenses and
Changes in Net Assets by Source
Year Ended September 30, 2003
(With comparative information for the year ended September 30, 2002)

| | Generation | Distribution | Contracts | Tank | Jaluit | Wotje | MEC-Gas | Admin - | Totals | |
|---|-------------|---------------|-----------|-------------|-------------|-----------|------------|---------------|--------------|--------------|
| | | | | Farm | | | | istration | 2003 | 2002 |
| Operating revenues: | | | | | | | | | | |
| Fuel and gas sales | \$ - | \$ - | \$ - | \$8,918,636 | \$ - | \$ - | \$ 423,202 | \$ - | \$ 9,341,838 | \$ 7,660,469 |
| Cost of sales | - | - | - | (7,284,573) | - | - | (99,538) | - | (7,384,111) | (5,530,080) |
| Gross profit on sales | - | - | - | 1,634,063 | - | - | 323,664 | - | 1,957,727 | 2,130,389 |
| Electric and service billings | 8,774,150 | - | - | - | 88,676 | 817 | - | - | 8,863,643 | 8,289,970 |
| Other income | 1,871,357 | 45,281 | 22,200 | 148,187 | 22,813 | 1,980 | 1,538 | 35,592 | 2,148,948 | 2,167,592 |
| Total operating revenues, net | 10,645,507 | 45,281 | 22,200 | 1,782,250 | 111,489 | 2,797 | 325,202 | 35,592 | 12,970,318 | 12,587,951 |
| Operating expenses: | | | | | | | | | | |
| Fuel and lubricants | 4,902,223 | - | - | - | 148,989 | - | - | - | 5,051,212 | 4,215,743 |
| Salaries, wages and benefits | 938,983 | 448,557 | 5,400 | 46,311 | 239,509 | 8,531 | 37,543 | 505,358 | 2,230,192 | 1,815,976 |
| Repairs and supplies | 971,225 | 656,243 | - | 119,564 | 52,961 | 303 | 32,352 | 89,360 | 1,922,008 | 1,462,609 |
| Depreciation and amortization | 810,256 | 102,076 | - | 33,642 | 10,817 | - | 15,485 | 97,437 | 1,069,713 | 1,044,644 |
| Bad debts | 281,949 | - | - | - | - | - | - | 514 | 282,463 | 329,532 |
| Gross revenue tax | - | - | - | - | - | - | - | 288,322 | 288,322 | 234,949 |
| Insurance | 89,241 | 32,368 | - | 27,310 | 4,335 | - | 2,987 | 6,893 | 163,134 | 155,960 |
| Office | 41,189 | 84,298 | - | 532 | 20,041 | 83 | 106,023 | 84,539 | 336,705 | 120,792 |
| Diesel import tax | - | - | - | 102,577 | - | - | - | - | 102,577 | 88,297 |
| Staff training | - | - | - | - | - | - | - | 49,387 | 49,387 | 75,682 |
| Communications | 6,925 | 5,847 | - | 362 | 9,944 | - | 1,714 | 32,074 | 56,866 | 69,486 |
| Other personnel costs | - | - | - | - | - | - | - | - | - | 32,032 |
| Travel | 25,748 | 4,052 | - | - | 170 | 372 | - | 19,216 | 49,558 | 27,880 |
| Laundry and uniforms | 15,076 | 1,540 | - | 140 | 2,874 | - | 230 | 1,525 | 21,385 | 22,246 |
| Professional fees | - | - | - | - | - | - | - | 3,050 | 3,050 | 13,801 |
| Entertainment | - | - | - | - | - | - | - | 26,784 | 26,784 | 12,892 |
| Advertising | - | - | - | - | - | - | - | 10,491 | 10,491 | 990 |
| Miscellaneous | 13,114 | 3,374 | - | 2,473 | - | - | - | 21,579 | 40,540 | 23,696 |
| Total operating expenses | 8,095,929 | 1,338,355 | 5,400 | 332,911 | 489,640 | 9,289 | 196,334 | 1,236,529 | 11,704,387 | 9,747,207 |
| Operating income (loss) before interest expense | 2,549,578 | (1,293,074) | 16,800 | 1,449,339 | (378,151) | (6,492) | 128,868 | (1,200,937) | 1,265,931 | 2,840,744 |
| Interest expense | (669,343) | - | - | - | - | - | - | - | (669,343) | (764,650) |
| Change in net assets | \$1,880,235 | \$(1,293,074) | \$ 16,800 | \$1,449,339 | \$(378,151) | \$(6,492) | \$ 128,868 | \$(1,200,937) | \$ 596,588 | \$ 2,076,094 |

See accompanying independent auditors' report.



MARSHALLS ENERGY COMPANY INC.

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MARSHALLS ENERGY COMPANY, INC.

Management's Discussion and Analysis

This section of the Marshalls Energy Company's (MEC) annual financial report presents our discussion and analysis of MEC's financial performance for the year that ended on September 30, 2003. Please read it in conjunction with the financial statements, which precede this section. The following table summarizes the financial condition and operations of MEC for fiscal years 2003 and 2002.

| Assets | 2003 | 2002 |
|--|----------------------|----------------------|
| Utility plant, net | \$ 13,047,044 | 13,641,708 |
| Current assets | 5,300,473 | 4,593,253 |
| Other assets | 69,531 | 78,627 |
| | <u>\$ 18,417,048</u> | <u>\$ 18,313,588</u> |
| Liabilities and Net Assets | | |
| Long-term debt, net | \$ 9,781,020 | \$ 10,234,294 |
| Current portion of long-term debt | 458,581 | 431,240 |
| Other current liabilities | 2,377,359 | 2,444,554 |
| Net assets | 5,800,088 | 5,203,500 |
| | <u>\$ 18,417,048</u> | <u>\$ 18,313,588</u> |
| Revenues, Expenses, and Changes in Net Assets | | |
| Operating revenues | \$ 8,872,780 | \$ 8,289,970 |
| Operating expenses | 11,140,788 | 9,135,995 |
| Net operating loss | <u>(2,268,008)</u> | <u>(846,025)</u> |
| Other sales, net | 1,957,727 | 2,130,389 |
| Compact funding | 1,866,667 | 1,866,667 |
| Interest expense and other | <u>(959,798)</u> | <u>(1,074,937)</u> |
| Net nonoperating revenue | <u>2,864,596</u> | <u>2,922,119</u> |
| Increase in fund equity | <u>\$ 596,588</u> | <u>\$ 2,076,094</u> |

See Accompanying Independent Auditors' Report.

(Continued)

MARSHALLS ENERGY COMPANY, INC

Management's Discussion and Analysis

Financial Highlight

The operating loss increased \$1,421,983 in FY 2003 compared to FY2002

- Although net operating revenues of \$8.8 million were up 7% from FY-02, operating margins were eroded by historically high fuel costs of \$7.19 million, up 25% from FY-02 fuel costs. The increase in revenues is attributed the first full fiscal year of the tariff increase set in May 2001 for commercial and government customers.

Non-operating revenues increased 22% from FY-02

- Wholesale fuel and gas sales of \$9.34 million compared to FY-02's \$7.66 million. This revenue source represented 51% of MEC's total revenue but skyrocketing fuel costs also eroded gross margins. The gross profit from these sales at \$1.95 million compares to a \$2.13 million gross profit in FY-02.

Accounts Receivable increased 21 % from FY- 02

- Accounts Receivable increased to \$4,858,589 compared to FY-02's \$4,007,871 an increase of 21%. The largest single factor attributed to the increase is the RepMar account which is \$848,120 compared to FY-02's \$589,981 an increase of 44%. Management acknowledges that it is dependent on RepMar and its affiliates to pay for actual services rendered. Should RepMar not pay for services rendered MEC will have to consider discontinuing supplying the service and or increasing the rates charged for electricity and fuel.

See Accompanying Independent Auditors' Report.