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Summary:

Guam Power Authority; Retail Electric

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Credit Profile

Guam Pwr Auth rev bnds

Long Term Rating

BBB/Stable

Affirmed

Rationale

Standard & Poor's Ratings Services affirmed its 'BBB' long-term and underlying rating (SPUR) on the Guam Power Authority's (GPA) outstanding senior-lien revenue bonds and its 'BBB-' long-term rating on the authority's subordinate-lien revenue bonds, which matured on Oct. 1, 2015. The outlook is stable.

The rating reflects our view of the following credit factors:

- GPA's dependence on oil, although fuel diversification, including conversion to dual-fired generation units that burn ultra low sulfur diesel (ULSD) and natural gas, is a key operational focus;
- Extensive damage and outage as a result of a recent fire at its oil-fired Cabras 3 and 4 plants, which have a combined capacity of 79 megawatts (MW), the absence of which constrains GPA's reserve capacity considerably, produces uncertainty and other operational challenges, and could drive up costs;
- Medium- to longer-term challenges related to GPA's capital plan as it converts some units to dual-fired generation, with anticipated base rate increases that would increase the authority's already very high rates; and
- The authority's interdependence with the general government (GovGuam; BB-/Stable general obligation rating), which accounts for about 10% of GPA's operating revenue.

(GovGuam remains current on all department of education and department of public works payments, and overall cash flow and reserves have improved greatly since 2012. However, the general government faces difficult budgetary decisions as it continues to struggle to reduce its general fund deficit and improve other financial metrics.)

Partly offsetting the above strengths, in our view, are:

- Continued support from the Guam Public Utilities Commission (PUC) under the Consolidated Commission on Utilities (CCU) governance structure in terms of its levelized energy adjustment clause (LEAC) fuel adjustment factor, and of recommended base rate adjustments;
- The territory's improved economic stability in recent years, including good tourism growth and favorable prospects for continued growth given economic development initiatives being undertaken as well as the pending military buildup; and
- Substantial completion of redundancy and storm-hardening projects for GPA's transmission and distribution system, and even the introduction of some renewable energy resources, which helps reduce capacity constraints.

We have assigned GPA a business profile score of '6' on a 10-point scale on which '1' is the strongest. The business profile reflects our view of GPA's support from the Guam PUC and CCU for rate adjustments and pass-throughs, high rates, a concentrated and constrained resource portfolio, and adequate management practices and policies.

The senior-lien bonds are secured by a first lien on net revenue of the approximately 48,600-customer vertically integrated electric system. A debt service reserve fund, cash funded at maximum annual debt service, provides additional liquidity. The senior-lien remains GPA's working lien. We have applied our electric and gas utility criteria to determine GPA's general creditworthiness and have applied this rating (BBB) to the senior-lien issues.

Early on the morning of Aug. 31, 2015, an explosion and major fire broke out at GPA's Cabras 3 and 4 oil-fired power plants. The cause of the explosion remains unknown and investigators have had difficulty accessing the site as a result of structural damage posing safety risks. Although no one was injured, the fire resulted in significant damage to both units, especially to Cabras 4, that could be irreparable. GPA aims to get Cabras 3 back on line within six months. Prior to the outage, Cabras 3 and 4 on a combined basis represented a significant 79 MW or 22% of GPA's total system capacity of 354 MW, and GPA's reserve margin was approximately 42% given its peak load of about 250 MW. But as a result of the outage, its reserve capacity immediately declined to a marginal 8% (which is inadequate given the need to perform periodic maintenance on other units) with a total capacity of 276 MW. This slim reserve capacity resulted in GPA having to load shed during peak demand; one such incident was on Sept. 7, when Cabras 1 was offline for repairs. As of Sept. 24, GPA has been able to bring various small diesel generating units on line and has increased the capacity of other combustion turbine units through repairs such that its capacity increased 19 MW to 295 MW, doubling its reserve margin to 16%. We note that any further loss of system baseload capacity or temporary outages of remaining units in service could result in longer or more frequent load shedding during peak energy use periods as well as loss of revenue, which could affect key credit metrics. We do note, however, that GPA's insurance covers \$15 million in expenses related to extra fuel.

GPA paid \$1.1 million in January 2015 to overhaul Cabras 4. The PUC deemed the overhaul necessary to ensure reliability and availability, and wanted to avoid a repeat of the \$4.5 million in extensive repairs to Cabras 3 in 2013, when cracks were found in its rotor shaft.

GPA has considered several near-term measures to mitigate the reduced reserve capacity and to meet peak loads given the outage. Options that GPA is pursuing include:

- Re-energizing its 40-megawatt Dededo plant;
- Delaying major repairs on its 66 MW Cabras 2 plant to January 2016 or later;
- Working with the Navy to dispatch the 18 MW power plant at Orote Point and tap energy from the 6 MW plant at the U.S. Naval Computer and Telecommunications Station (NCTS);
- Leasing 40 to 60 MW of "prepackaged" power generating units;
- Reducing demand through volunteer customer conservation;
- Requesting that its largest customers switch to their own standby generators, where possible, through its recently approved interruptible load program;
- Temporarily switching Guam Waterworks Authority water wells and wastewater treatment plants from GPA-provided power to standby generators; and
- Repairing and restoring the damage to Cabras 3, although management has indicated this could take six months.

Given GPA's reserve restoration plan, total system capacity is projected to increase to 340 MW by October 2015 and to 352 MW by November 2015. From a financial standpoint, according to management, GPA will cover the added costs through a combination of insurance claims and existing bond funds meant for capital improvements. In addition,

savings on operations costs for Cabras 3 and 4 will be used to fund other temporary generation projects, including compensating large customers who use standby generators. Management reports that customer rates will not be affected given the savings provided by a drop in oil prices, with residual fuel oil (RFO) No. 6 now at about \$45 per barrel versus more than \$100 per barrel about a year ago. However, as a result of the outage, customers will likely miss out on an opportunity for rate relief.

GPA's financial performance continues to be good and fairly stable, as various actions in the past several years have improved cash flow certainty, buoyed by supportive rate regulation from the PUC. This includes allowing GPA to recover not just fuel costs but related out-of-the-money hedges and even renewable energy through the LEAC, which is adjusted every six months, as well as the aforementioned surcharge. The most recent LEAC adjustment was effective as of Feb. 1, 2015, and now accounts for 10.4 cents of GPA's average residential rate revenue of about 20 cents per kilowatt-hour (kWh). The average residential rate in fiscal 2014 was about 27 cents per kWh. The PUC's recent ruling also kept in place GPA's plan to boost liquidity to management's eventual goal of 60 days of operating expenses, from 45 days. GPA has also built up its self-insurance fund to \$20 million. The most recent base rate adjustment was in October 2013, when the authority received approval for a 6% increase.

Fixed-charge coverage improved to 1.24x in fiscal 2014, from 1.15x in fiscal 2013 and an inadequate 0.90x in fiscal 2012. Fixed-charge coverage is our internally adjusted debt service coverage (DSC) metric that imputes certain recurring debtlike obligations into the calculation, treating them as if they were long-term debt even if they are operating expenses of the system. The improvement in fiscal 2014 was largely due to a 7% decline in operating expenses given an 8% decline in fuel (oil) costs, while the improvement in fiscal 2013 was due to higher energy sales and reduced debt service requirements. In fiscal 2012, because of the timing of the implementation of the fiscal 2012 base rate increase and the constant challenge of fuel procurement, fixed-charge coverage slipped to a little less than 1x. Fixed-charge coverage also dipped below 1x in fiscal 2009.

GPA's forecast assumes energy sales declines of 4% overall (0.57% annually) through fiscal 2022, RFO prices increasing with inflation, and base rate increases of about 10% in fiscal years 2019 and 2020, and does not incorporate cost mitigation strategies or energy sales growth related to the military buildup discussed below. GPA's financial forecast indicates that fixed-charge coverage will be about 1.16x in fiscal 2015 and range from 1.29x to 1.48x during fiscal years 2016 to 2022, including about 1.3x in fiscal years 2021 and 2022, when debt service requirements related to new gas-fired generation are projected to come on line. Collections and total customer accounts receivable remain very favorable, even from the general government as a customer by way of its schools and street lighting.

Unrestricted cash as of fiscal 2014 was \$56.2 million, or 54 days' cash of operations, but a higher \$73.1 million, or 70 days' cash, when including GPA's self-insurance fund, which could be made available for certain uses upon GPUC approval. To preserve liquidity, GPA has moved to safer fuel hedging arrangements that eliminate margin calls and collateral posting exposure. GPA has a contract in place through August 2018 that supplies nearly all of its RFO and has a \$35 million credit line in place for fuel delivery payment; we believe the LEAC and the relatively lower-risk fuel supply contracts should reduce cash flow volatility.

GPA has already completed the storm hardening of its key transmission and substation assets and most of its distribution system assets. In May 2015, Category 2 Typhoon Dolphin's eye passed just north of Guam, causing strong

and sustained winds reaching 106 mph, and was the largest storm since Super Typhoon Pongsona in 2002 (150 mph winds). However, the GPA system came out relatively well. Although 85% of customers lost power temporarily, almost all power was restored within a few days (and 100% within 10 days) and there was only \$3.5 million in damage and \$1 million in lost revenue (less than 1%).

GPA issued bonds in 2014 to provide funds for pollution control equipment for the authority's internal combustion engines at some of its generation facilities; a portion of the bond proceeds reimbursed GPA for money already spent on these improvements. These reciprocating engines are subject to U.S. federal Clean Air Act requirements. Although GPA will keep some units in service over the long term, the results of its 2013 integrated resources plan (IRP) suggested that a more economic, if initially more expensive, option would be to construct LNG delivery infrastructure such that natural-gas-fired generation could become the primary energy source by decade's end. The IRP also noted that combined cycle facilities together with an LNG facility would initially be more expensive than installing pollution controls at all GPA power plants, many of which are older and have a poorer thermal efficiency. However, the annual fuel expenses could provide operating budget savings. GPA management continues to evaluate all options, but could commit to dual-fired combined cycle within the next year. The GPUC has approved the IRP, and GPA has submitted the resource implementation plan. The next steps would be for GPA to complete the project evaluation and for GPA and the CCU to make a final project decision.

GPA has already received CCU project approval (October 2014) for its plan to install two 60 MW combined-cycle dual fuel plants at an estimated cost of \$350 million. The plants would likely be located near the existing Harmon substation near GWA's wastewater plant. Combined-cycle generation has several benefits, including better efficiency, lower capital cost than installing emission controls on existing units, and promotion of fuel diversity and compliance with regulatory standards. GPA estimates that it would have to spend well over \$475 million on its existing fleet of generation facilities to bring them into compliance with Environmental Protection Agency (EPA) regulations. GPA management believes the PUC's review of GPA's plan will be completed this winter, and GPA's plan anticipates completion of construction by 2020.

GPA's proposed energy plan for the EPA includes several components that will address EPA regulations and allows for transition to new generation and compliant fuel. GPA has already retired two plants in early 2015 (Tanguisson 1 and 2). Other components include the addition of combined-cycle units (that can run on ULSD or natural gas), running RFO on certain baseload oil-fired units under an EPA consent decree, and, in 2020 and beyond, retiring Cabras 1 through 4, completing modifications on MEC 8 and 9 to burn ultra-low-sulfur diesel, and, if economic to do so, install LNG facilities and convert all baseload units to LNG. The energy plan also would allow for GPA to comply with EPA's Clean Power Plan.

GPA has also made progress on renewable energy, with its take-and-pay obligation NRG Energy's 25 MW Dandan Solar Project scheduled for commission in October 2015 and with an additional 40 MW of solar projects being evaluated. A portion of the 2014 bond proceeds will also be used for a 40 MW energy storage project that will be an additional measure in enhancing the entire grid's redundancy.

As of Oct. 2, 2015, GPA had about \$567 million in long-term debt, with no variable-rate debt. Debt service requirements decline from \$61 million in fiscal 2015 to a range of \$45 million to \$50 million during 2016 to 2019 before

debt service is projected to ramp up with the issuance of debt to fund new generation. As of fiscal 2015, total debt to capitalization was a high 81% with debt per customer also high at \$12,925.

GPA is a vertically integrated, 255 MW peak load electric utility that provides service to approximately 160,000 people on the island of Guam, the largest and southernmost of the Mariana archipelago, approximately 1,500 miles southeast of Tokyo. GPA is a statutorily autonomous component unit of the government and, as such, revenue may not otherwise be required to be transferred to GovGuam. Even if the laws were to change to authorize GPA to transfer money out, any use of surplus net revenue to that end would also have to be approved by the CCU and PUC. Otherwise, surplus net revenue stays within GPA's coffers and is not subject to general fund clawback or a payment in lieu of taxes.

Guam's economic activity is largely based on tourism and military spending. Because of this, many of the government's economic development initiatives focus on these pillars, especially tourism. Hotel property owners have invested substantially in hotel renovations and expansions in recent years. Management anticipates that the recent opening of the \$250 million, 400-room Dusit Thani Guam hotel, which also includes a ballroom and banquet rooms with a seating capacity of 2,000, will support increased tourism, especially the high-end luxury market. Various airlines have increased capacity, and new airlines are serving additional markets, including China, from which management anticipates stronger visitor growth. More than 90% of the airport's passenger base consists of international visitors.

The ongoing U.S. military buildup, although still an enormous undertaking, has been scaled back. Originally as many as 8,600 troops and 9,000 dependent were to relocate to the island, mainly from Japan, by 2014 to 2017. Recently, however, the Department of Defense reports that the number would be closer to 5,000 active duty personnel and 1,300 dependents. In July 2015, the Department of Defense released a supplemental environmental impact statement, identifying potential impacts related to the family housing component of this relocation, as well as to the live-fire training range complex. In August 2015 the government received its record of decision, which identified the final locations for additional bases and facilities to accommodate the U.S. Marines. The 2015 final environmental impact statement detailed 13 years of moderate construction followed by a gradual phase-out. There will be about 7,400 additional Guam residents as a result of the military buildup. The government expects that the federal government and Japan will fund most of the costs related to the buildup.

Outlook

The stable outlook reflects our view of GPA's adequate financial capacity to meet its obligations. The rating could come under pressure within our two-year horizon, however, as the utility begins what we anticipate will be a capital-intensive period that could almost double its debt by decade's end and pressure financial margins. We note that the debt will be driven by a fuel-switching project that poses construction risk, even though the long-term benefit could be a drop in high rates. Although the utility could benefit from fuel cost recovery mechanisms, past delays have led to volatile financial performance. Consequently, rating stability is also dependent on timely base rate and LEAC adjustments that preserve GPA's liquidity. The territory will always be vulnerable to volatility in the tourism industry as a result of economic cycles (especially in Asia) and severe weather events, but we would not anticipate that such impacts on the electric load would be long term. We don't anticipate raising the rating over the next two years given

GPA's large capital plan and concentrated and constrained resource portfolio.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric And Gas Utility Ratings, Dec. 16, 2014
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of October 2, 2015)

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|--------------------------|------------------|----------|
| Guam Pwr Auth subord ln | | |
| <i>Long Term Rating</i> | BBB-/Stable | Affirmed |
| Guam Pwr Auth (AGM) | | |
| <i>Unenhanced Rating</i> | BBB(SPUR)/Stable | Affirmed |

Many issues are enhanced by bond insurance.

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