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Research:

Guam Power Authority; Utility, Retail Electric

Publication date: 11-Feb-2005
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Credit Profile

AFFIRMED	
$436.858 mil. Guam Pwr Auth rev bnds	BB+
$339.948 mil. Guam Pwr Auth rev bnds ser 1999A dtd 05/01/1999 due 10/01/2005-2015 2018 2020 2024	AAA/BB+(SPUR)
OUTLOOK:	NEGATIVE

Rationale

The 'BB+' rating on Guam Power Authority's (GPA) revenue bonds reflects the utility's below-average business profile, adequate debt service coverage, high debt leverage, and high capital requirements. GPA's business profile is characterized by an improved but still uncertain regulatory environment, cyclical markets, heightened operating risk due to dependence on fuel oil and exposure to typhoon damage, and an adequate competitive position.

The rating reflects the following credit concerns:

- Reliance of regulatory approval of rates by Guam's Public Utilities Commission (PUC), and the uncertain prospects for future increases in base rates;
- Ongoing challenges related to the recovery of past due government payments, which accounted for the approximately $24 million in long term receivables as of Sept. 30, 2004;
- A high debt burden with total adjusted debt-to-total capitalization ratio of 77%, which could increase with potential asset write-downs or new debt;
- High capital requirements associated with ongoing repair, reinforcement or replacement of system infrastructure following heavy typhoon damage in 2002; and
- Heavy exposure to oil price volatility, due to the utility's heavy reliance on oil-fired generation, although the utility's fuel adder usually offsets cost variation.

The rating additionally reflects the following credit strengths:

- Improved operational performance at owned and contracted generating stations, resulting in a slight decrease in non-fuel production costs;
- Management's success in reducing payment delinquency by enforcing a strict policy of disconnecting any delinquent customers, including governmental agencies; and
- Adequate debt service coverage (DSC) of 1.5x in fiscal 2004.

Guam Power Authority is a vertically integrated electric utility that provides service to 45,630 customers on the island of Guam, the largest and southernmost island of the Mariana archipelago, approximately 1,500 miles southeast of Tokyo. Guam's tourism-based economy is slowly recovering from a prolonged slump, and increased U.S. military spending on the island has helped to stabilize employment levels. The island of Guam was hit by two major typhoons in the later half of 2002 that left 3,000 people homeless and caused over $300 million in damage, including more than $35 million in damage to GPA plant and equipment.

Outstanding direct debt consisted of $81.4 million in uninsured series 1993 bonds and $333.1 million Ambac-insured series 1999 bonds, as of Sept. 30, 2004. The bonds are secured by a pledge of gross revenues as well as a debt service reserve account (DSRF), funded with $27.4 million in high-investment-grade notes held in trust by investment agent U.S. Bank Trust NA under a long-term investment agreement.

The utility is regulated by the Guam PUC, which sets electricity rates, and is governed by the elected, five-member Consolidated Commission on Utilities (CCU). Regulatory support has improved with the renewed semi-annual adjustment of GPA's fuel adder, but strong political opposition to rate increases makes the prospects for base rate increases uncertain. In September 2003, the PUC approved a 10% increase in the fuel adder, after postponing the rate increase six months earlier. The delay in fuel cost recovery resulted in deferred costs of more than $12 million as of Sept. 30, 2003 and contributed to the deterioration in the utility's financial position in fiscal 2003. The functioning of the fuel cost adjustment clause is essential for timely recovery of fuel costs, which are significant given the utility's dependence on imported fuel oil.

Management's focus on optimizing operating efficiency has helped to offset increases in fuel prices in 2004. GPA improved operations at its baseload generating stations in 2004, resulting in a significant increase in availability factors at the plants and a decrease in non-fuel unit power costs due to reduced utilization of peaking resources. Improved efficiency helped to limit unit production cost increases to 7% in fiscal 2004, versus 19% for unit fuel costs.

GPA management has also made progress in reducing payment delinquencies by both residential and governmental customers, but the utility still carries on its books a significant amount of long-term receivables incurred as a result of chronic payment delinquencies by Government of Guam (GovGuam) agencies prior to fiscal 2004. As of Sept. 30, 2004, GPA had approximately $24 million in long-term receivables, $9 million in past due GovGuam receivables, and $27.4 million in notes receivable, as compared with $226 million in retail revenues. GPA's auditors have repeatedly warned the authority that it may be required to write off a portion or all of the long-term GovGuam receivables if these obligations are not retired immediately or backed with a dedicated revenue stream. In fiscal 2004, two GovGuam agencies issued promissory notes to GPA to retire their portion of the outstanding receivables; GPA is in negotiations with a third agency, the Department of Public Works (DPW) to secure payment on the remainder. As of Oct. 29, 2004, all GovGuam agencies, with the exception of DPW, were current in paying their energy bills and servicing their promissory notes to GPA.

Financial performance improved in fiscal 2004, but was still somewhat weak for the rating given the utility's above-average business risk. The utility achieved debt service coverage of 1.49x in fiscal 2004, versus coverage of less than 1.0x in fiscal 2003. Adjusted debt leverage was high at 77% as of Sept. 30, 2004 and could increase further with the write-down of past due receivables or future indebtedness.

Capital requirements are high, given GPA's plans to relocate much of its transmission and distribution infrastructure underground in an effort to reduce GPA's exposure to future typhoons or other natural disasters. The current five-year capital plan calls for $90.1 million in internally funded capital expenditures to support general plant (26% of revenue funded capital improvements), line extensions (23%), and engineering (50%). The underground transmission and distribution (T&D) conversion initiative could cost as much as $600 million, of which GPA expects to finance about $150 million to $200 million with long-term debt over a five-year period. The financing requirements of the project could increase GPA's debt leverage. GPA applied for and received a Federal Emergency Management Agency (FEMA) grant of $24.4 million to begin planning and design work on the initiative.

Short-term credit factors.

GPA's liquidity is minimally adequate, provided the utility fully passes through fuel costs. GPA's cash reserves improved in fiscal 2004 to $20.4 million, or about 39 days' cash, due largely to an $8 million reimbursement by FEMA for damage caused by Typhoon Paka in 1998. As of Sept. 30, 2004, GPA had no undrawn capacity under its $20 million committed credit agreement with Cathay Bank that supports GPA's commercial paper program. The program is rated 'A-1' based on a letter of credit from the Federal Home Loan Bank of San Francisco ('AAA/A-1') that expires on Oct. 12, 2005. The notes are not subject to redemption of acceleration prior to maturity. The availability of a debt service reserve fund, funded at more than $27 million, mitigates the immediate risk to bondholders of insufficient liquidity at GPA.

In comparison, liquidity requirements are estimated to be at least $20 million to support six months of deferred fuel cost balances (which reached $13 million as of Dec. 31, 2003) and disaster-related cash outlays (which totaled about $10 million to repair damage caused by the Chata'an and Pongsona typhoons). Debt maturities are as follows:

Table 1 Debt Maturities	
Amount Due as of Oct. 1	
2005	5,935,000
2006	6,200,000
2007	6,480,000
2008	6,770,000
2009	7,080,000
2010	7,373,601

According to management, GPA is not subject to any ratings triggers or collateral requirements relating to any of its contracts, including lending agreements fuel supply contracts or hedging contracts.

Guam expects to receive as much as $30 million from GovGuam as payment on past due payment obligations of several of its agencies, but the timing and size of those payments are uncertain and the payment is subject to appropriation risk. Issuance of the GovGuam bonds is contingent on favorable ruling of at the Ninth Circuit U.S. Court of Appeals and on sufficient access to the credit markets by the Government of Guam, whose 'B' rating reflects its severe budget deficit, high debt, and tourist-dependent economy.

Outlook

The negative outlook reflects concerns regarding the adequacy of future debt service coverage, the absence of planned rate relief despite a potentially aggressive capital plan, and challenges related to $49 million in long-term receivables incurred due to past payment delinquencies by territorial governmental customers. Although operating liquidity has improved, emergency and contingency reserves are underfunded relative to potential needs in the event of future typhoons. Any combination of insufficient rate relief, resumed growth in payment delinquencies, inadequate rates, or aggressive capital spending could result in a lowered rating. Violation of bond covenants as a result of write-down of receivables could also result in a ratings downgrade. Ratings stability will require retirement of the GovGuam receivables, consistent application of a fuel adjustment clause to support adequate and timely fuel cost recovery, and a realistic plan to address the system's capital needs while achieving strong and consistent performance at levels at or above those achieved in fiscal 2004.

Business Description

Guam Power Authority is a vertically integrated electric utility that provides service to approximately 45,630 customers on the island of Guam. GPA is an autonomous corporation of the Government of Guam, although GPA shares personnel with other GovGuam agencies and is subject to regulation by the Guam PUC and to governance by an elected governing board. Guam is the largest and southernmost island of the Mariana archipelago, is an unincorporated territory of the United States and its westernmost possession, approximately 6,000 miles west of San Francisco and 1,500 miles southeast of Tokyo.

Business Profile

GPA scores a business profile of '6' on Standard & Poor's 10-point scale, where '1' represents the least business risk. The slightly below-average score is a result of GPA's dependence on the PUC for rate recovery, as well as political pressure against rate increases, GPA's unique competitive position as the sole provider to an island service territory, the higher reserve capacity required by GPA due to its isolation and high load factor, and markets that lack geographic diversity and are concentrated in government, military bases, and tourism.

Regulation

GPA's regulatory environment improved significantly in 2003, but remains challenged due to the utility's multiple levels of external oversight, which can limit the utility's ability to respond rapidly to market or operational difficulties. As with most regulated utilities, GPA is subject to regulation by a utility commission, whose members are appointed by the governor. However, GPA also has an additional layer of oversight through an elected governing board, the CCU. The Guam legislature established the CCU in 2002 to replace the previous governing body in an effort to improve the independence of GPA from GovGuam and minimize political interference. The Guam legislature retains the constitutional authority to modify rates through legislation, adding yet another potential layer of regulation.

GPA's rates, debt issuance, and plant additions are subject to approval by the PUC. GPA has not had a base rate increase since June 1998 despite the steady decline in debt service coverage from 2.66x in 1999 to less than 1.0x in 2003. Implementation of a fuel cost adjustment factor in 1996 had historically allowed GPA to pass through to customers its fuel costs, which account for roughly half of annual operating and maintenance expense. In the late 1990s, the PUC revised the Levelized Energy Adjustment Clause (LEAC) to be adjusted semiannually rather than monthly, but in April 2003, the PUC and GPA agreed to defer adjustment of the LEAC beyond the typical six-month period. The PUC did not adjust the fuel adder until September 2003, when it increased the fuel surcharge by 27%, for an overall rate increase of 10%. The delay resulted in heavy deferred costs that totaled more than $10 million by July 2003. The fuel adder was last adjusted in April 2004, when it was reduced by 2%.

Markets

GPA has the exclusive rights to serve all 45,630 retail electric customers on the island of Guam. Large customer concentration is high, with about 31% of annual revenues derived from the leading 10 customers, including a U.S. Navy base (19%), several GovGuam agencies (9%), and four resort hotels (4%). GovGuam agencies together account for about 17% of annual revenues. Guam's tourism-based economy is slowly recovering from a prolonged slump, and increased U.S. military spending on the island has helped to slow overall job losses. Energy sales rebounded by 9% in fiscal 2004, after consecutive 9% declines in fiscals 2002 and 2003. Among retail customers, the incidence of payment delinquency and energy theft remains relatively high, although GPA management has limited growth in delinquency rates by enforcing a strict disconnection policy to minimize payment delinquencies among all customers, including governmental agencies.

Operations

GPA's operating profile has improved since 2002, but the utility remains subject to above average operating risk due to exposure to typhoons and other natural disasters. GPA completed privatization of operations at its Cabras 3 and 4 generating stations, resulting in a significant increase in availability factors at the plants and a decrease in non-fuel unit power costs due to reduced utilization of peaking resources. Improved efficiency helped to limit unit production cost increases to 7% in fiscal 2004, versus 19% for unit fuel costs. GPA remains exposed to commodity price risk, due to its high dependence on fuel oil for baseload generation. When adjusted on a semi-annual basis as originally intended, the utility's LEAC mechanism helps to significantly offset this exposure. In addition, GPA enters into hedging agreements to limit its downside risk, although the utility's preference for "costless collar" hedges simply converts its downside risk to a low, instead of high, market price scenario. The price of oil represents about one-half of GPA's operating expenses, making control of its price integral to system stability.

Although GPA has casualty insurance on its generating assets, GPA relies on FEMA for casualty insurance for its transmission and distribution facilities. Casualty insurance costs for generating assets are high, after an increase by about $5 million following an explosion at one of its generating stations in 2002. FEMA serves as the provider of last resort of casualty insurance on GPA's T&D system, since casualty insurance coverage from third-party providers is prohibitively expensive. The utility has provided for a relatively small self-insurance reserve to augment FEMA aid. GPA quickly expended its $2.5 million self-insurance reserve following the Chata'an typhoon in 2002, but is replenishing the reserve with a PUC approved surcharge. Given its limited self-insurance reserve, GPA's reliance on FEMA aid can create a liquidity crunch, since the amount and timing of FEMA payments can vary considerably.

Management

GPA is governed by the five-member CCU, whose members are publicly elected. The CCU's independence from GovGuam represents a significant improvement to GPA's governance structure. Following the utility's downgrade in 2003, the commission supported the long overdue adjustment of GPA's fuel adder and approved aggressive steps to secure past due payments from GovGuam agencies, including the shut off of power. John Benavente came out of retirement in 2003 to assume his former post as General Manager, and has since been instrumental in improving operating efficiency of GPA generation resources and in reducing payment delinquencies. GPA management has consistently filed for semi-annual adjustments in the LEAC fuel adder beginning in Sept. 2003.

Financial Policy

GPA's financial policy is considered moderately aggressive, given the utility's reliance on sales growth to offset the need for future rate increases and on FEMA to approve and fund claims for losses related to natural disaster. GPA's forecast assumes a moderately aggressive 4% sales growth in 2005 and a more reasonable 2.5% thereafter. The CCU has established for GPA a debt service target of 1.75x, but future compliance will depend on CCU and PUC support for necessary rate increases or efficiency improvements. The utility has made considerable headway in both respects since July 2003. The utility may consider requesting a base rate increase based on the results of a rate study and review of its capital plan, which it plans to complete in 2005. GPA lacks business interruption or casualty insurance on its transmission and distribution assets, and instead relies on FEMA and a small self-insurance reserve. This policy is considered aggressive, given Guam's heightened natural disaster risk and the unpredictability of FEMA payments. Standard & Poor's considers the current self-insurance reserve target of $2.5 million to be weak relative to the potential cash outlays required to restore electric service following a severe typhoon or other natural disaster.

Financial Profile

In calculating debt service coverage, Standard & Poor's treats all purchase power costs as an operations and maintenance expense payable prior to debt service. Adjusted debt service coverage takes into account off-balance sheet debt obligations, including debt service related to purchase power payments to merchant generators. Adjusted debt leverage also reflects the presence of these off-balance sheet obligations.

Cash Flow Coverage

Financial performance improved in fiscal 2004, but was still somewhat weak for the rating, given the utility's below-average business risk. The utility achieved with debt service coverage of 1.49x, versus the utility's rate covenant of 1.3x. The fiscal 2004 result represents a vast improvement over the prior year, when GPA's debt service coverage dropped below 1x. GPA's financial position in fiscal 2003 was severely challenged by the costs of recent natural disasters, delays in rate relief, and a large receivables burden due to chronic and extended payment delinquencies by GPA's territorial government customers.

Asset/Liability Management

GPA's debt burden is high, with debt leverage of about 71% on an unadjusted basis and 78% on an adjusted basis, after accounting for off-balance sheet obligations related to purchase power contracts. GPA has not yet completed an actuarial study to determine its pension liability under Public Law 26-86, which requires the utility to make lump sum payments of one-half accumulated sick leave to employees upon retirement. GPA plans to use $20 million of the anticipated $30 million payment due from GovGuam to retire its outstanding debt under its $20 million line of credit, used to support its commercial paper program. GPA is also considering the issuance of around $160 million in new debt to provide financing to restructure its purchase power agreements in order to gain cash flow savings. Although the restructuring would not affect GPA's adjusted debt leverage, the transaction would subject GPA to a potentially significant amount of credit risk. As of February 2005, GPA was still planning to pursue the restructuring, but had not yet taken any action.

Financial Flexibility

Financial flexibility is adequate, primarily due to the renewed utilization of GPA's fuel cost adjustment factor. The fuel adder offset the utility's substantial market risk related to its heavy dependence on fuel oil. Without the fuel adder, financial flexibility would be substantially weaker. Access to the capital markets exists, but has been complicated by the downgrade of GPA and GovGuam to noninvestment grade. GPA is able to petition for an adjustment in base rates, but has not successfully done so since 1998. . GPA does have financial flexibility through cost-saving initiatives and through deferring capital expenditures. The utility has already relied heavily on the former over the past two years, making further significant cost savings less likely.

After initially experiencing difficulty in arranging replacement credit facilities in 2003, GPA successfully restructured its short-term credit facilities by November 2004, when it entered into a series of committed credit agreements to support its $20 million commercial paper program (rated 'A-1'). The program is backed by a credit agreement with Cathay Bank, a confirming letter of credit from the Federal Home Loan Bank of San Francisco ('AAA/A-1') and two surety bonds issued by Ambac Assurance Co. ('AAA') to Cathay Bank as beneficiary. Under the program, notes may be sold of up to 270 days in term at a maximum rate of 12%. The notes are not subject to redemption of acceleration prior to maturity. The FHLB LOC is sized at $20 million and expires on Oct. 12, 2005.

Accounting

GPA adheres to the accounting standards of the Governmental Accounting Standards Board (GASB). GPA is in compliance with GASB Statement No. 20, which requires compliance with all FASB statements and interpretations issued through Nov. 30, 1989 (this includes FAS 71, which was issued in 1982). However, GPA has elected to not apply FASB statements and interpretations issued after Nov. 30, 1989. GPA's fiscal year begins Oct. 1 and ends Sept. 30. GPA's auditor is Deloitte & Touche. GPA last changed auditors in 2003.

Deloitte & Touche issued an unqualified opinion on its final audit report for fiscal 2003 based on the expected issuance of notes by the agencies responsible for long-term receivables and timely repayment thereon, and the expectation of a payment by GovGuam for $30 million, which assumes that the government will prevail in its court battle to affirm its legal authority to proceed with a deficit bond issuance.

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