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Ratings

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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
Guam Pwr Auth (AGM)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings affirmed its 'BBB' long-term rating and underlying rating (SPUR) on the Guam Power Authority's (GPA) senior-lien revenue bonds outstanding. The outlook is stable.

The rating reflects our view of the following credit factors:

- GPA's dependence on oil, although fuel diversification is a key operational focus;
- Medium- to longer-term challenges related to GPA's capital plan as it converts some units to dual-fired generation, with increasing debt on the horizon as well as anticipated base rate increases that will likely increase the authority's already very high rates, although rates have declined significantly in recent years;
- Challenges related to being an island-based utility, which introduces capacity and reliability challenges and costs given the lack of a connection to a regional grid;
- The territory's narrow economic base with concentration in military and tourism, which leaves it vulnerable to economic cycles and defense spending;
- Financial projections that indicate a weakening of fixed-charge coverage and liquidity, although we note that these metrics have improved significantly in recent years; and
- The authority's interdependence with the general government (GovGuam; BB-/Stable general obligation rating), which accounts for about 14% 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 exposures, 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;
- Improved fixed-charge coverage and liquidity, partly as a result of cost-cutting initiatives; and
- Substantial completion of redundancy and storm-hardening projects for GPA's transmission and distribution system,

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and even the introduction of some renewable energy resources, which alleviates 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 sometimes 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 49,500-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; the subordinate-lien bonds are not longer outstanding. 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.

Since an explosion and major fire broke out at GPA's Cabras 3 and 4 oil-fired power plants 15 months ago, one of GPA's main challenges has been to quickly restore 78 megawatts (MW; two units at 39 MW each) of lost capacity to its system, given the lack of grid connectivity that most mainland utilities have. Although no one was injured, the fire resulted in significant damage to both units, and Cabras 4 has been determined to be a total loss. While Cabras 3 was initially deemed reparable, GPA and the insurer are evaluating whether to spend considerable funds to repair an old unit (installed in 1995) that also requires additional upgrades to comply with environmental regulations. The forced outage increased GPA's reliance on intermediate power resources as opposed to its typical baseload generation. When the outage occurred, GPA promptly coordinated with large customers to establish about 29 MW of interruptible load programs, fired up some of its older and smaller units, and installed 40 MW of newly acquired temporary generation (Aggreko).

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's having to load shed during peak demand; one such incident was on Sept. 7, 2015, when Cabras 1 was off line for repairs. But over the past 15 months, GPA has been able to bring various small generating units on line and has increased the capacity of other combustion turbine units through repairs such that its capacity increased to 324 MW by April 7, 2016 and to 380 MW by Nov. 15, 2016, giving it a reserve margin of 115 MW versus projected peak load of 265 MW (a comfortable 43%). We also note that GPA had in place a $300 million insurance policy with Lloyd's of London that provided a $50 million cash advance to mitigate the impact of the outage. GPA also used existing bond funds meant for capital improvements. In addition, savings on operations costs for Cabras 3 and 4 were used to fund other temporary generation projects, including compensation of large customers who use standby generators.

GPA filed its updated 2016 integrated resource plan (IRP) with the PUC in July 2016. This updated IRP includes all components of GPA's energy plan, including the installation of 180 MW of dual-fired combined-cycle generation units, retirement of old units (Cabras 1 through 4), the expansion of renewable energy programs, and the installation of an energy storage system. Key factors considered in the revised IRP included environmental compliance cost options, reduction of peak from time-of-use rates, fuel options and strategies, the impact of demand side management and distributed generation, and funding strategies. The 180 MW of combined cycle units would be commissioned no later than Dec. 31, 2020, and would convert 88 MW of oil-fired units to ultralow sulfur diesel (ULSD) within one year of operation of the new combined-cycle units. While the execution of GPA's generation plan has been subject to delays, its temporary power supplies and capacity are sufficient, the costs of future generation projects have declined, and management has been afforded additional time to plan. The Guam PUC approved GPA's generation plan in October 2016 and will review and approve procurement parameters and generation capacity of the projects.

We note that the process of converting to gas or ULSD from oil introduces risk and uncertainty, with regard to such factors as cost overruns and higher debt servicing costs. Combined-cycle generation does, however, offer several benefits, including better efficiency, lower capital cost than installing emission controls on existing units, 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 regulations. GPA has also made progress on renewable energy, with its take-and-pay obligation NRG Energy's 25 MW Dandan Solar Project becoming operational in October 2015 and with an additional 95 MW of solar projects planned. 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. Management anticipates that new combined-cycle units and increased renewable energy resources will eventually account for 75% of GPA's energy supply.

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 took effect Sept. 1, 2016 and now accounts for 8.69 cents of GPA's average residential rate revenue of about 18.1 cents per kilowatt-hour (kWh). The average residential rate in fiscal 2014 was about 27 cents per kWh, and while rates may be competitive versus those of comparable island-based systems, current rates are still well above average rates on the U.S. mainland. A recent PUC 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, and GPA is now comfortably above the revised goal. GPA has also built up its self-insurance fund to over $20 million. The most recent base rate adjustment was in October 2013, when the authority received approval for a 6.0% increase versus the requested 7.3%.

Energy sales increased 2.3% in fiscal 2016 after 0.4% growth in fiscal 2015. Fixed-charge coverage improved again to 1.48x in audited fiscal 2015, from 1.28x in fiscal 2014, 1.15x in fiscal 2013, and an inadequate 0.90x in fiscal 2012. Fixed-charge coverage for unaudited fiscal 2016 (ended Sept. 30, 2016) is estimated to have improved further to 1.83x as a result of declining debt service and independent power producer lease payments. 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. Financial metrics improved in fiscal 2015 as a result of better-than-forecast energy sales, headcount reductions, lower fuel consumption costs, and other operational efficiencies. 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 base revenue will remain near fiscal 2016 levels, but revenue from the LEAC will double by 2020 as debt service requirements ramp up as a result of the financing of new combined-cycle generation. Management anticipates that an increase in rooftop solar panels will offset the increase in demand from population growth. The forecast also assumes expenditure growth of 2.4% annually. GPA's financial forecast indicates that fixed-charge coverage will drop to about 1.28x in fiscal 2017 and range from 1.30x to 1.50x during fiscal years 2018 to 2021, including about 1.30x in fiscal years 2019 and 2020, 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 with regard to the general government as a customer by way of its schools and street lighting.

Unrestricted cash as of audited fiscal 2015 was $56.1 million, or 73 days' cash of operations, but $78.3 million, or 102 days' cash, when including GPA's self-insurance fund, which could be made available for certain uses upon PUC approval. Unrestricted cash improved to $95 million, or 155 days' cash, according to unaudited fiscal 2016 results. 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 residual fuel oil 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. Nonetheless, GPA's forecast indicates unrestricted cash will decline to 60 days by 2021, not including its self-insurance fund or credit line.

As of audited fiscal 2015, GPA had about $612 million in long-term debt, with no variable-rate debt. All subordinate-lien debt has matured. Debt service requirements and capacity payments declined to $65 million in fiscal 2016 from $61 million in fiscal 2015, but these obligations are projected to grow to $59 million by 2019 with the issuance of debt to fund new generation. As of fiscal 2015, total debt to capitalization was a high 88% with debt per customer also high at over $12,000. Capital spending budgeted over the next three years is about $22 million annually. A GPA borrowing for its combined-cycle project could occur as early as 2017, but the specific plan of finance is still being finalized.

GPA is a vertically integrated, 265 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, the CCU and PUC would also have to approve any use of surplus net revenue to that end. 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 renovations and expansions in recent years. Recently added customers include the 400-room Dusit Thani Hotel and Guam Regional Medical City, and more new hotels (over $400 million in developments) are expected in 2020. 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. Unemployment declined to 6.9% as of March 2015, the most recent period for which data are available, from a much higher 13.3% in September 2011, with private sector employment growing 2.6% in 2015. Visitor arrivals were up 11% as of June 2016, on pace for a record year, partly as a result of Guam's hosting of the 12th Festival of Pacific Arts in May 2016. Visitor arrivals continue to diversify, although this is partly due to weakness from the Japan market.

The ongoing U.S. military buildup, while still a large undertaking, has been scaled back. Originally as many as 9,000 troops were to relocate to the island, mainly from Japan, by 2014 to 2017. Three years ago, however, the U.S. Department of Defense (DOD) reported that the number would be closer to 4,700 active duty personnel, along with family members, support and civilian staff, vendors, and suppliers. What was once estimated at a $15 billion economic impact is now estimated at $8 billion. A record of decision, which identifies the final locations for additional bases and facilities to accommodate the marines, was released in August 2015. A 13-year period (revised from seven years) of moderate construction followed by a gradual phase-out is planned. All facets of Guam's government, from the general government to utilities, the port, and airport, have reached a general understanding with DOD that any impact from the relocation would be cost neutral to Guam, even if many of the details are undetermined. Management expects to serve additional large customers through the installation of new military infrastructure.

Outlook

The stable outlook reflects our view of GPA's adequate financial capacity to meet its obligations.

Upside scenario

We don't anticipate raising the rating over the next two years given GPA's large capital plan and concentrated and constrained resource portfolio.

Downside scenario

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 within five years and pressure financial margins. We note that the debt will involve 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.