

Rating Update: Moody's upgrades Guam Power Authority's (GPA) Senior Revenue Bonds to Baa2; Outlook revised to stable

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Approximately \$595 million of debt securities affected

GUAM POWER AUTHORITY
Electric Distribution and Generation
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NEW YORK, September 15, 2015 --Moody's Investors Service has upgraded the rating of Guam Power Authority's approximately \$567 million of senior revenue bonds to Baa2. At the same time, Moody's has upgraded approximately \$27 million of GPA's subordinate revenue bonds to Baa3. The outlook is stable.

SUMMARY RATING RATIONALE

The Baa2 rating on the Senior Bonds and the Baa3 rating on the Subordinated Bonds reflects GPA's monopoly position as the sole provider of electricity and electricity services to the island's customer base, which includes residential, commercial, governmental customers, and the US Navy, the authority's largest customer. The rating action recognizes a recent fire (August 31, 2015) which knocked out two of the authority's most efficient generating plants, but acknowledges a variety of financial and operational mitigants available to the authority to successfully handle the ensuing challenge of repairing or replacing the plants and restoring generation capacity to the island. The rating reflects an adequate debt service coverage metric and above average liquidity profile for the rating as the authority has worked its way through a declining sales environment. Fuel oil almost exclusively powers the island, but management is working toward increasing its fuel diversity through a mix of renewables and construction of a combined cycle unit with dual-fuel capabilities. This plan is spurred on by increasingly stringent EPA requirements, which the authority is currently negotiating. The rating also considers the dependence of the island's economy on historically volatile international tourism.

OUTLOOK

The stable outlook balances currently declining electricity sales with operational efficiencies and longer term changes to the generation portfolio.

WHAT COULD MAKE THE RATING GO UP

- Increased diversity of GPA's resource mix
- Material sales increases on a sustained basis

WHAT COULD MAKE THE RATING GO DOWN

- Debt service coverage levels below 1.1x on a sustained basis
- EPA negotiations result in material fines or burdensome compliance costs
- Sales decline at an accelerated or unexpected pace
- A plant shutdown that would reduce currently strained generation capacity

STRENGTHS

- Monopoly provider of essential service
- Past history of ability and willingness to raise rates
- Diversification of island visitors from Korea, Japan, and China

- Management team prepared to meet challenges of lower sales and distributed generation
- Built in event risk redundancy through self-insurance fund, standby capacity, and relatively low rates

CHALLENGES

- Near total reliance of fuel oil as only form of generating electricity
- Negative net migration coupled with lower sales per customer
- Execution risk with EPA negotiations and LNG strategy
- Recovery from the plant fire on August 31, 2015

RECENT DEVELOPMENTS

On August 31, 2015, Unit 4 of the Cabras Power Plant exploded and spread fire to its neighboring Unit 3. Though the authority has not had the ability to fully investigate the damage caused to the two units, which are among Guam's most efficient generators, it quickly brought on standby generation and was able to avoid shedding any customer load. The fire demonstrates the importance of standby power for island economies, which cannot purchase power in times of crisis. We believe the fire, while costly up front, demonstrates GPA's operational and financial flexibility, as it has the necessary insurance, rate mechanisms, and generation capacity, to handle such an event.

Typhoon Dolphin, a category five tropical storm, reached Guam on May 15, 2015. The island recorded sustained wind speeds of 84 mph and wind gusts of 106 mph. Rainfall totaled 9.3 inches in just 12 hours. Because of the authority's efforts to move more infrastructure underground - currently 60% of electric infrastructure is underground with more being converted - 95% of customers had power within five days of the storm. The authority will continue its storm hardening practices to mitigate its weather event risk.

As a territory of the US, Guam is subject to EPA requirements. In an effort to meet EPA compliance, GPA is working toward a Liquefied Natural Gas (LNG) strategy and is procuring power from renewable sources like solar and wind. Capital spending associated with this strategy will be significant but less than the expected compliance costs required with refurbishing existing fuel oil facilities. While managing its compliance with the EPA, the authority is also examining the possibility of customers switching to solar power further reducing the authority's sales. Though solar customers have been limited in number thus far, the growth rate of solar customers is cause for concern - over 100% annual growth for the last five years. However, Moody's believes the authority is appropriately monitoring and responding to the challenges presented by distributed generation.

In order to meet compliance with EPA requirements and Guam Renewable Portfolio Standard (RPS) targets, the authority is in the process of developing renewable capacity of its own through the recently completed Dandan Solar Project, a 25 MW solar plant that will begin operations in October 2015. The authority is also contemplating another 40 MW of renewable projects that would include solar and wind.

DETAILED RATING RATIONALE

REVENUE GENERATING BASE

GPA serves residential, commercial, and governmental customers in addition to serving the US Navy, its biggest electricity purchaser. Fuel oil almost exclusively powers the island, but management is working toward increasing its fuel diversity through a mix of renewables and a contemplated LNG facility. This plan is spurred on by increasingly stringent EPA requirements, which the authority is currently negotiating. One step the authority has taken to cope with these requirements is cancelling Pruvient's operating contract at the Tanguisson power plant. The early termination required an \$8.1 million payment to Pruvient, which the authority funded through its working capital facility, but management estimates it will save over \$28 million by closing one of its oldest, least efficient plants on the island in a time of declining power sales.

Guam's service area has some vulnerabilities given high (but falling) rates of unemployment, below median family income, and a negative net migration. As a tourist destination, Guam is gaining popularity, especially in Korea; however, the effects of a stronger dollar will mitigate this growth in the near to mid-term. Over the past year, the island has seen the completion of a luxury hotel (419 rooms) and the Guam Regional Medical City, which has 130 beds and provides jobs for over 500 employees. For several years, the US military has planned on relocating its remaining troops at Okinawa, Japan to Guam, but these plans have seen repeated delays, and new estimates of

arriving troops are now lower than they once were. The Navy signed the Record of Decision for the relocation on August 31, 2015 which will begin the process of investment on the island. The estimated 5,000 troops and their dependents arriving will bolster the economy and help alleviate the declines in power sales that have occurred over recent years.

GPA's rates must ultimately be approved by the Public Utility Commission (PUC) of Guam, though the authority has a sound history of achieving its requested rate base increases from its PUC. In the past seven years, the authority has requested changes on five occasions and the PUC has always agreed, at least partially, to every request. In addition to formal rate requests, the authority has a Levelized Energy Adjustment Clause (LEAC) mechanism which adjusts semiannually to changes in fuel oil prices.

GPA's residential rates are lower than most island power providers. As a monopoly, Guam customers cannot switch from GPA to another power provider, but the threat remains that customers could opt to produce their own power via solar panels. The risk of a mass customer exodus to solar is tempered by GPA's lower than average power costs, along with the fact the tax benefits of solar are less valuable in an economy with lower than average incomes.

FINANCIAL OPERATIONS AND POSITION

For an island economy, the authority has performed well in an environment where many utilities are seeing declining electricity sales. Operating revenues of \$437 million in 2014 were down 3.4% from \$452 million in 2013, but total operating expenses also declined to \$359 million in 2014 from \$388 million in 2013, leaving net revenues slightly higher overall in 2014. Management accomplished this task by bringing costs down through reduced headcount and improvements like an automated billings system, while still maintain operational flexibility for the future. The main concern remains that sales will continue to decline, while areas to reduce costs will eventually run dry. That said, management has thus far shown its deftness in handling the challenges it faces.

Debt service (inclusive of the debt service portion of the IPP capital leases) has typically averaged around \$60 million per year, but with the expected 2016 issue to pay for the combined-cycle units, debt service is expected to increase to over \$70 million per year. The authority expects the incremental debt service coverage could be completely offset by the fuel cost savings it would realize from switching off fuel oil and onto natural gas.

Our rating assumes financial metrics will remain at the Baa to A level with days cash on hand at or near the current 82 day three year average, debt service coverage ratios (inclusive of the IPP debt service payments) not dropping below 1.1 times on a sustained basis, and a debt ratio that does not exceed 100%.

The authority pays no taxes or PILOTS to the government of Guam.

Liquidity

Adjusted days liquidity on hand was 88 days in 2014, an increase from 76 days in 2013. Additionally, the authority carries self-insurance in the form of \$20 million, a working capital facility of about \$17 million, and a \$35 million line for letters of credit from which it makes regular draws to cover the costs of fuel payments to its suppliers. Because the line for letters of credit has a MAC clause, however, Moody's does not count the line explicitly in its calculation of adjusted days liquidity on hand.

The repair costs for Cabras facilities may pose a temporary draw on liquidity. However, the authority has approximately \$87 million of restricted bond funds which it could possibly use for repair costs if approved by the PUC. We view this flexibility as key to maintaining adequate liquidity through the repair period and supportive of the rationale for the rating upgrade.

DEBT AND OTHER LIABILITIES

Debt Structure

GPA has over \$594 million of senior and subordinate bonds outstanding. The subordinate bonds have almost fully matured and will completely mature in October 2015. Current debt service calls for about \$60 million in annual principal and interest payments; however, after incorporating expected debt issuances related to the construction of the combined cycle LNG turbines, annual debt service will increase to over \$70 million. The authority has \$73 million of capital leases, which brings Moody's adjusted debt outstanding to \$667 million.

Series 2014A Senior Revenue Bonds \$76,470,000

Series 2012A Senior Revenue Bonds \$340,510,000

Series 2010A Senior Revenue Bonds \$150,440,000

Series 2010A Subordinated Revenue Bonds \$27,300,000

Capital Leases \$73,204,190

Debt-Related Derivatives

In 2000, GPA established a fuel hedging program to mitigate the volatility that results from fluctuating fuel oil prices. The hedging counterparties are Australia and New Zealand Banking Grp. Ltd. (Aa1 (cr)) and Goldman Sachs Group, Inc. (The) (A3/P-2, stable). ISDA agreements do not require margin calls so long as GPA maintains a credit limit of \$15 million.

Pensions and OPEB

The financial impact of unfunded and OPEB obligations of this issuer are minor and thus not currently a major factor in our assessment of its credit profile

MANAGEMENT AND GOVERNANCE

Oversight of the authority was delegated to the five-member CCU in 2001. The CCU is responsible for rate setting, subject to review by the PUC. GPA also has oversight by the Guam Public Utilities Commission (PUC), which must approve all rate increases. As a result of new and increasingly stringent EPA regulations, management is considering adding LNG capacity to the island to not only meet compliance requirements, but also to diversify its fuel mix.

KEY STATISTICS

- Debt Service Coverage, 2014, (by bond ordinance): 3.03x
- Fixed Obligation Charge Coverage (inclusive of IPP debt service payments) , FY 2014: 1.24x
- Operating Ratio, 2014: 82%
- Liquidity days on hand, 2014: 88
- Debt Ratio, 2014: 81%
- Debt Outstanding:
- \$594.72 million in senior and subordinated revenue bonds
- \$73.20 million in capital leases

OTHER CONSIDERATIONS: Mapping to the Grid

Moody's evaluates GPA under the U.S. Public Power Electric Utilities with Generation Ownership Exposure Rating Methodology, and GPA's grid indicated rating under the below depicted grid is Baa1, which is one notch higher than the assigned Baa2 rating for GPA's senior revenue bonds. Factors that limit the assigned rating include GPA's ability to recover from the recent fire, unresolved negotiations with EPA, likely increase in construction costs for LNG and environmental related projects. and longer term, the financial challenges that could result as a move by GPA's customers to distributed generation.

The grid is a reference tool that can be used to approximate credit profiles in the U.S. Public Power Electric Utility Industry in most cases. However, the grid is a summary that does not include every rating consideration. Please see U.S. Public Power Electric Utilities with Generation Ownership Exposure Rating Methodology for more information about the limitations inherent to grids.

PUBLIC POWER RATING METHODOLOGY

Current Rating: Baa2 (Senior Lien), Baa3 (Subordinate Lien)

1. Cost Recovery Framework - (25% weight) (Baa)

2. Willingness to Recover Costs and Maintain Sound Financial Metrics- (25% weight) (A)

3. Management of Generation Risk- (10% weight) (Ba)

4. Rate Competitiveness - (10% weight) (A)

5. Financial Strength:

Sub factor a) Adjusted Days Liquidity on Hand-(10% weight) (Baa) (3 year average, 82 days) (2014, 88)

Sub factor b) Debt Ratio-(10% weight) (Baa) (3 year average, 79.4%) (2014, 80.8%)

Sub factor c) Fixed Obligation Charge or Adjusted Debt Service Coverage (10% weight) (A) (3 year average, 1.10x) (2014, 1.24x)

Notching Factors: No notching

Grid Indicated rating : Baa1

OBLIGOR PROFILE

Guam Power Authority (GPA) is a component unit of the Government of Guam. GPA provides electrical services on the island of Guam to residential, commercial, and governmental customers. GPA is governed by the CCU, an elected five member board and is subject to regulations of the PUC of Guam.

The authority is a retail electric utility that provides electric generation, transmission, and distribution services throughout Guam as the sole monopoly provider of such services. The authority serves the entirety of Guam's 160,000 residents and provides some power services to the US Navy, its largest customer (\$75.3 million of revenue in 2014 and \$84.9 million in 2013). Net capacity totals 429 MW of power coming from 29 substations, 175 miles of transmission lines, and over 645 miles of distribution lines. In 2014, energy sales were 1.5 million MWh. The authority is fully independent from its central government as it does not receive subsidies from the Government of Guam or pay any taxes or PILOTS to it.

LEGAL SECURITY

Senior lien bonds are secured by a pledge of net revenues, subject to the prior application of such revenues for operations and maintenance expenses. GPA covenants to fix rates which will be sufficient to yield 1.3 times debt service coverage on senior lien bonds and 1.2 times coverage on aggregate debt service. Both senior and subordinate bonds feature additional bonds tests that allow inclusion of projected revenues from new projects, in addition to other criteria. Senior and subordinate bonds are secured by a lien specific debt service reserve fund, the total of which is currently cash or investment funded at \$49 million, in excess of maximum annual debt service.

USE OF PROCEEDS

Not applicable.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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