

June 18, 2007

VIA E-MAIL
hboertzel@hotmail.com

Harry M. Boertzel, Esq.
Administrative Law Judge
PUBLIC UTILITIES COMMISSION OF GUAM
Suite 207, GCIC Building
Post Office Box 852
Hagåtña, Guam 96932

RE: BILL NO. 128

Dear Judge Boertzel:

To aid you in preparing testimony for the Guam Public Utilities Commission ("PUC") on Bill No. 128 (The "Honesty in Utility Rate Setting Act"), you have requested that I, on behalf of Georgetown Consulting Group, Inc. ("GCG"), the PUC's independent rate consultant, provide an opinion as to whether the Bill, if enacted into law, would violate certain of the covenants made by the Guam Power Authority ("GPA") and the Guam Waterworks Authority ("GWA") in their respective bond indentures. I submit this letter in response to your request.

Summary of Opinion

It is my opinion that Bill 128, if enacted into law would be found to violate the rate covenants included in GPA's and GWA's bond indentures, as well as the public laws authorizing and approving those indentures. As such, the Bill, if enacted into law, would very probably be deemed an impairment of the contractual rights of the holders of the bonds violating the Contracts Clause of the U.S. Constitution and the Organic Act version of the Contracts Clause.

Analysis

The bond indenture of GPA contains what has been commonly referred to in PUC proceedings as the "rate covenant." In the December 1, 1992 indenture for GPA's 1992 Series A Bonds, the rate covenant is Section 6.20, which states as follows:

Section 6.20. Pledge by Government. The Government hereby pledges to the holders of all Bonds that the Government will not repeal, amend or modify Chapter 12, Title 12, Guam Code Annotated, in any way that would substantially impair the powers, duties or effectiveness of the Public Utilities Commission thereunder in relation to the Authority or its rates. The Authority includes this pledge of the Government in this Indenture as authorized by §8113.3 of the Act [12 GCA §8113.3].

12 GCA §8113.3, referred to in the rate covenant, is the statute that authorizes GPA to incur long-term indebtedness through the issuance of revenue bonds. It provides, in pertinent part, as follows:

Section 8113.3. Long-Term Indebtedness. In order to enable GPA to obtain the best possible price to the territory, and in the best interest of GPA's rate-payers, GPA is authorized to incur long-term indebtedness...payable solely from revenues of GPA. Notwithstanding [12 GCA §8210], without further approval by legislation, but subject to the approval of PUC, the indenture pursuant to which the indebtedness is issued may include any and all covenants described by §8210... The indenture may also include a pledge by the government of Guam not to repeal, amend or modify Chapter 12 of Title 12, Guam Code Annotated, in any way that would substantially impair the powers, duties or effectiveness of the PUC thereunder in relation to GPA and its rates... (Emphasis supplied)

The purpose and intent of the GPA rate covenant is self-evident. Potential purchasers of GPA bonds required an iron-clad assurance that GPA's rates would be set by an independent rate making authority which would be obligated to provide GPA the rates necessary to produce the revenues required by GPA to meet its obligations under the indenture. That is the statutory mandate of the PUC under 12 GCA §12004, which obligates the PUC to establish rates for GPA (and GWA) which "shall be at least adequate to cover the full cost of such service or subject to any contractual agreements of the utilities to the holders of any bonds" and to "increase rates or charges from time to time as may be necessary pursuant to any contractual obligations...".

In other words, the government of Guam made a promise to purchasers of GPA bonds that GPA's rates would be set by an independent rate making authority which would be obliged "to ensure that rates will, at all times, be sufficient to enable the utility to meet its financial obligations, operating expenses, debt service and capital improvement needs." 12 GCA §12004. Politics are to be removed from the rate-making process.

Enactment of Bill 128 would be a breach of the government of Guam's promise. In direct contravention of the clear intent of 12 GCA §8113.3 and GPA's bond indenture (itself approved by the Legislature) Bill 128 would inject the Legislature into the rate-making process. Under it, before GPA or GWA could even seek approval of a base rate increase of four percent or more in any 18-month period, it would be required to first submit its request to the Legislature for its prior approval, which presumably might not be given. The fundamental purpose of the rate covenant would be eviscerated.

To understand the importance of the rate covenant to bond holders and the bond market in general, a bit of historical background is appropriate. Back in the 1970s GPA defaulted on bonds it had issued to raise funds to pay for the Cabras 1 and 2 baseload generators. Following its default, GPA looked to the federal government to bail it out. In 1976 Congress amended the Organic Act of Guam to

authorize the Secretary of the Interior to guarantee for purchase by the Federal Financing Bank bonds and other obligations of GPA. 48 USC 1423a, as amended by P.L. 94-395, 90 Stat. 1199. Due to continuing defaults by GPA, this provision was subsequently amended in 1980 to authorize the Federal Financing Bank to refinance GPA's obligations by purchasing or guaranteeing new ones. P.L. 96-205, Title III, §303, 94 Stat.88. GPA's financial woes continued. As a result, in 1984 Congress again amended the Organic Act to add the following language:

At the request of the Board of Directors of the Guam Power Authority for a second refinancing agreement and conditioned on the approval of the Government of Guam pursuant to the law of Guam, **and conditioned on the establishment of an independent rate-making authority by the Government of Guam, the Secretary may guarantee for purchase...** [GPA obligations].

48 USC 1423a, as amended by P.L. 98-454, Title II, §203, 98 Stat. 1733 (emphasis added).

The PUC, in its present incarnation, is the result of this Congressional mandate.

GPA's obligations to the Federal Financing Bank were paid off by the proceeds of the bonds issued by GPA in 1992, so the Organic Act requirement is now moot. However, to ensure that the new bonds could be sold at favorable prices, GPA's underwriters insisted that the bondholders would similarly be protected by the existence of an independent rate-making authority. They, therefore, insisted that the bond indenture include a covenant of the entire government of Guam that the independence and effectiveness of the PUC would not be substantially impaired. In 1992, the Twenty-First Guam Legislature passed legislation authorizing GPA to issue new bond obligations to pay off the Federal Financing Bank indebtedness. P.L. 21-117. That law added 12 GCA §8313.3 to GPA's enabling legislation. In response to the financial community's concerns, §8313.3 was soon thereafter

amended by P.L. 21-133:1 to authorize GPA to include the rate covenant pledge in its indenture.

The underwriters for GWA for identical reasons insisted on an identical rate covenant in GWA's bond indenture. The importance placed on the government of Guam's pledge to preserve the independence of the PUC is made crystal clear by 12 GCA §14229:

The government of Guam is fully committed to ensuring that [GWA] has the ability to implement the capital improvements authorized to be paid by this [bond] legislation in order to meet the needs of Guam ratepayers for reliable and affordable services. The government also is fully committed to ensuring that bondholders are protected to ensure full and timely repayments of their loans. In order to mirror the previous pledge that allowed Guam Power Authority to successfully reenter the financial markets as found in 12 GCA §8113.3..., the government of Guam hereby pledges that while any bonds of [GWA] issued under this Article remain outstanding and not fully performed or discharged (a) to maintain the rights, powers and duties of the Board and the Guam Public Utilities Commission... (Emphasis added)

This pledge of the government of Guam is incorporated into §6.17 of GWA's bond indenture:

Section 6.17. Pledge of the Government. The Government hereby pledges to the holders of all Bonds the following: while any Bonds remain outstanding and not fully performed or discharged (A) to maintain the rights, powers and duties of the Board and the Guam Public Utilities Commission, or their respective successors in accordance with law, to fulfill the terms of Bonds and this Indenture, (B) to maintain the rights and remedies of Bondholders provided in the Act and this Indenture, (C) to protect the exclusive right of the Authority to operate or

maintain within Guam any water or wastewater system operated by the government or its designees by preventing the acquisition, operation, maintenance or permitting of any instrumentality of the Government or any other public or private agency, entity or person to operate a separate and competitive water and/or wastewater system, and (D) not to transfer any additional non-system operating responsibilities or other unfunded mandates to the Authority without providing for the payment of the costs of such additional responsibilities, with the exception of annual supplemental annuity and COLA contributions paid by the Authority on behalf of retired employees of the Authority (or its lawful predecessors) as may be required by other laws of Guam. **The Authority includes this pledge and agreement of the Government in this Indenture as authorized by §14229 of the Act.** (Emphasis supplied)

Bill 128 would amend GPA's and GWA's enabling legislation, not the statute creating the PUC (Chapter 12 of GCA Title 12). Thus, it might be argued that such an amendment was not a violation of the rate covenant or 12 GCA §8313.3 which refer only to Chapter 12 of Title 12. However, in my opinion a court would give short shrift to such an argument. The Legislature (and the government of Guam) cannot accomplish indirectly what they are prohibited from doing directly. If enacted into law, the provisions of Bill 128 would eviscerate the PUC's independent rate-making authority and hinder and potentially prevent it from fulfilling its statutory obligations.

In the case of Pangelinan v. Gutierrez, 2004 Guam 16, the Guam Supreme Court, set forth the three-step inquiry that governs challenges to legislation based on the Contracts Clause of the Organic Act. 48 USC 1421b(j). Citing the U.S. Supreme Court decision in Energy Reserves Group, Inc. v. Kansas Power and Light Co., 459 U.S. 400, 103 S. Ct. 697 (1983) the court stated that "the threshold inquiry is 'whether the state law has, in fact, operated as substantial impairment of a contractual relationship.'"

The second step of the inquiry is "[i]f the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation..." Finally, "[o]nce a legitimate public purpose has been identified, the next inquiry is whether the adjustment of 'the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption.'" 2004 Guam 16, at ¶39.

In my opinion, Bill 128, if enacted into law, would likely be found to fail each of the elements of this test. First, the obvious intent of the Legislation is to prevent GPA or GWA from seeking a base rate increase from the PUC without first running the gauntlet of the Legislature. The rate covenant included in the bond indenture was precisely intended to prevent this from happening. GPA and GWA, indeed the entire government of Guam (including the Legislature), promised that the government would do nothing that would substantially interfere with the PUC's ability to act or its effectiveness. Bill 128 clearly would do this by erecting an additional, potentially insurmountable obstacle to the ability of GPA and GWA to seek needed rate relief. Such an outcome would unquestionably undermine the effectiveness of the PUC and effectively eliminate the very protection the rate covenant was intended to provide.

Given that there would be a substantial impairment of the bondholders' rights under the indenture, the second step would be to look for a "significant and legitimate purpose" which "guarantees that the State is exercising its police power, rather than providing a benefit to special interests." 2004 Guam 16, at ¶41, quoting Energy Reserves, 459 U.S. at 411-12, 103 S. Ct. at 704-05. Section 1 of Bill 128 sets forth the purported legislative intent (or proposed findings). It states that the Consolidated Commission on Utilities ("CCU") "has failed to represent the interests of the people of Guam in its ongoing governance and supervision of management" of GPA and GWA, "causing inefficiencies, waste and possibly illegal diversion of public resources to be recovered from ratepayers in the form of increased rates for services."

This is an indirect indictment of the PUC, which is the body charged with setting rates, not the CCU.

I cannot speculate as to "possibly illegal diversion of public resources" to which the sponsor of Bill 128 refers or what evidence of such diversion he believes he can present to the Legislature in support of his bill. However, I can comfortably state that there could hardly be any evidence of such diversion with regard to the base rates of GPA, which has not sought a base rate increase for more than 10 years. If such diversions occurred or are ongoing, they would be the subject of possible investigation by the PUC, if and when GPA ever does file for base rate relief.

In my view this bill does not set forth or otherwise establish any "significant and legitimate public purpose" which would justify a substantial impairment of the right of GPA's and GWA's bondholders to have rates for the utilities set by an independent rate-making authority. The concerns expressed in the proposed findings could be addressed in rate proceedings before the PUC.

While I believe there could be no "significant or legitimate public purpose" that would justify the enactment of Bill 128, it is harder to believe that a court would find that the "adjustment" of the bondholders rights was based on reasonable conditions or "of a character appropriate" to the purported public purpose. Requiring GPA or GWA to submit proposed base rate increases first to a politically charged legislative body, answerable only to voters naturally averse to any rate increases, instead of an independent rate-making authority such as the PUC would not be reasonable or appropriate. That is why Congress required the government of Guam to create the PUC when it authorized the GPA bailouts in the 1980s and why the financial community similarly insisted on maintaining an independent PUC when GPA and GWA went to the bond market to borrow funds.

Conclusion

In summary, in my opinion Bill 128, if enacted into law, would be held to violate the Contracts Clause of the Organic Act (48 USC 1421b(j)). Requiring GPA and GWA first to submit requests for base rate relief before they could submit them to the PUC would "substantially impair" the powers and effectiveness of the PUC, in direct violation of the pledge made by the government of Guam in the rate covenants of GPA's and GWA's bond indentures not to do so.

There is no "significant or legitimate public purpose" that would justify such a substantial impairment of the bondholders' rights.

Lastly, the impairment of the bondholders' rights would be neither reasonable nor appropriate. The PUC is already charged with conducting such investigations and hearings as it deems necessary with regard to any proposed rate increase, and no rate increase can be approved unless the utility establishes, by a preponderance of the evidence, that a rate increase is necessary. 12 GCA §12004.

Inasmuch as the test announced by the Guam Supreme Court is based on test pronounced by the U.S. Supreme Court, Bill 128 would also violate the Contracts Clause of the U.S. Constitution.

Very truly yours,

BLAIR STERLING JOHNSON
MARTINEZ & LEON GUERRERO
A Professional Corporation

WILLIAM J. BLAIR

cc: Terrence Brooks, Esq. (via e-mail)
Mr. Jamshed K. Madan (via e-mail)
Mr. Edward R. Margerison (via e-mail)