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July 27, 2009

Harry M. Boertzel
Hearing Examiner
Commonwealth Public Utilities Commission
P.O. Box 500806
CK, Saipan MP 96950

Re: CDA-CUC Debt Conversion to Preferred Equity—Docket 09-01

Dear Mr. Boertzel:

This letter report responds to your request that Georgetown Consulting Group, Inc. (GCG), review and comment on the petition filed by the Commonwealth Utilities Corporation's (CUC) on May 22, 2009 requesting the Commonwealth Public Utilities Commission's (CPUC) approve and order the conversion of approximately \$45.0 million of existing CUC long-term debt into preferred stock issued to the Commonwealth Development Authority (CDA) pursuant to a Preferred Stock Agreement (the "Agreement") between CUC and CDA. Counsel to GCG, in response to your Third Post Decision Memorandum, has previously provided a report dated March 6, 2009 on certain issues relating to the CDA-CUC preferred stock transaction. That report addressed the scope of CPUC's review of a CDA-CUC preferred stock transaction, as well as other related matters. This report addresses the May 22, 2009 CUC petition for approval of the Agreement and provides GCG's conclusions and findings.

Background

While this matter dates back many years its resolution is critical to the financial viability of CUC and its ability to finance the capital requirements to comply with provisions of the Federal Stipulated Order, and necessary to bring CUC's water and wastewater systems into compliance with Federal Safe Drinking Water and Clean Water Acts. CUC's latest consolidated financial statement indicates that CUC, for all practical purposes, is "insolvent"—liabilities exceed assets by an amount in excess of \$70 million. This deficiency is principally related to CUC's default of the repayment terms associated with prior loans made by CDA to CUC. This default is a major

financial event and until cured prevents CUC's access to traditional short- and long-term credit markets.

After many years of uncertainty the potential resolution of this matter is at hand. The current petition presents an Agreement between CDA and CUC wherein the parties agree to a preferred stock transaction, which is authorized by 4 CMC § 8123 (p) and requires CPUC approval pursuant to 4 CMC § 8123 (r) and 8409 (d). Under the terms of the Agreement the CDA debt would be reduced to an amount of \$45.0 million and converted to preferred stock. Given CUC's urgent need for rehabilitation capital we view this matter as one of the most critical, if not the most critical, issue facing CUC today.

Preferred Stock Agreement

The Agreement once approved by the CPUC will bring to an end past litigation regarding CUC repayment of loans made by CDA to CUC. The Agreement identifies the final terms and conditions under which the CUC debt will be converted to preferred stock—CUC will issue to CDA shares of cumulative, non-convertible and non-transferable preferred stock in the amount of \$45.0 million. The key terms and conditions of the Agreement include:

- 1) CUC to pay CDA dividends fixed at two percent (2%) annually
- 2) Dividends are to be paid CDA quarterly in advance
- 3) Dividends for the first three (3) years are deferred and amortized interest free over a 15-year term
- 4) Dividends are due on the outstanding aggregate value of preferred stock
- 5) CUC can buy-back shares of its preferred stock at par value
- 6) CUC's internally funded investments will be credited under the buy-back provision
- 7) Default provisions in the event of CUC failure to meet Agreement terms
- 8) Preferred shareholder rights are identified, and
- 9) Other rights and remedies, consistent with Commonwealth law, as typically found in shareholder and stock purchase agreements

Discussion of Key Provisions of the Agreement

Debt Conversion to Preferred Stock—The Agreement provides that within thirty (30) days after CPUC approval CUC shall issue cumulative, non-convertible and non-transferable preferred stock naming CDA as the legal and beneficial owner. The total aggregate par value of this preferred stock shall be \$45,000,000. Upon issuance of the preferred stock CUC's debt to CDA is forever cancelled inclusive of the outstanding principal and any accumulated interest and late charges under any and all loan agreements, promissory notes or other evidence of indebtedness now existing. This conversion is very favorable to CUC. It is estimated that at the close of the last fiscal year CUC had approximately \$61.0 million in principal due to CDA and accelerated interest payable on outstanding principal of \$116.0 million resulting in a total obligation in excess of \$177.0 million. The reduction in the principal amount from the current \$61.0 million to \$45.0 million is an effective \$16.0 million waiver of previous outstanding loans for sewer and

water projects. CUC's current default status is a major financial event and until cured prevents CUC access to traditional short-and long-term credit markets. The proposed preferred stock conversion is advantageous and in time will allow CUC access to traditional tax-exempt security markets.

Financial Terms—the Agreement contains favorable annual dividends, quarterly payment provisions, and the deferral of the first three years of dividends, subject to the interest free amortization of the deferred dividends over a 15-year term. The three-year dividend deferral period is designed to allow CUC ample time for fiscal recovery—including establishing electric rates at their full cost-of-service. Under these terms CUC during the first three-years following approval of the Agreement would be obligated to make no dividend payments to CDA, in year four (4) through year 18 quarterly dividends of \$270,000 would be due, and in year 19 and beyond quarterly dividends of \$225,000 would be due CDA.

Buy-back Provisions—the Agreement contains two types of buy-back provisions. The first is a standard buy-back provision that allows CUC to buy back, in whole or in part, any of the then outstanding preferred stock. Subject to dividend payments being current the preferred stock can be repurchased at anytime by CUC at par value without incurring any penalties or other charges. In addition, the Agreement contains a second and rather unique buy-back provision by which CUC may offset up to \$16.2 million of the then outstanding preferred stock by using internally generated funds to make capital investments in the electric, water, or wastewater system assets through a "dollar for dollar" offset against outstanding preferred stock held by CDA, as further provided in Section 10 of the amended MOA (Exhibit B of the Agreement). Since electric, water, and wastewater operations by their nature are capital intensive this second buy-back provision represents, when exercised, essentially a future grant of "free" capital to CUC—a very favorable provision. There are a number of near-term CUC capital improvement projects that are eligible for buy-back consideration under this provision of the Agreement.

Default Provisions—The Agreement contains a default provision which is reasonable (i.e., CDA may five (5) calendar days after the "second" failure of CUC to make proper and timely payments of dividends declare a default). Upon declaration of default CDA may seek immediate CUC board action to stop any further default. While CDA shall have all remedies available to it as a preferred stock holder it will not have priority over CUC creditors; only over common stock holders, if any. This latter default provision should not present a barrier to CUC's critical access to traditional tax-exempt security markets for the purpose of funding its future capital projects.

CDA Participation in CUC Governance—There are two potential governance matters related to the Agreement that warrant some discussion. The first matter relates to the provision of the Agreement that allows for a CDA board member to participate in CUC's governance. However, currently no CUC Board exists and the authority of the CUC Board has been delegated to the CUC Executive Director. Counsel to GCG indicates that in their opinion until the CUC Board is fully constituted by the Governor—making the required appointments and the Senate confirming—there is no Board in which a CDA member could participate in CUC's governance.

The second matter relates to whether the CDA Board member that would be assigned to participate in CUC governance is in addition to or the same as the CDA chairman, who is made a member of the CUC Board under 4 CMC Section 8131(a) (1). GCG counsel is of the opinion the Agreement must be consistent with PL 16-17. Section 8131(a) (1) as enacted by PL 16-17 makes the CDA Board chair an automatic member of the eight-person CUC Board. A plain reading of the references on pages 2-4 of the Agreement to the CDA Board member would construe them as referring to the CDA chair's membership on the CUC Board. Counsel is of the opinion that the Agreement does not create another seat for CDA on the CUC Board in addition to the one seat the CDA chair's membership enjoys on the CUC Board.

Further Legislative Approval—The Agreement incorporates by reference the 2002 and 2004 Memorandums of Agreement (MOA) between CDA and CUC as Exhibit A and B respectively. While these earlier MOA's (sections 5, 11 and 12 of Exhibit A and sections 5 and 12 of Exhibit B) reference the need for Legislative approval of the Agreement, counsel to GCG is of the opinion the references in these MOA's to Legislative approval concerns Legislative authorization of CUC to issue preferred stock to CDA. The 2002 MOA (Exhibit A of the Agreement) was signed on November 21, 2002, before the approval of PL 13-36 on December 10, 2002. Referencing the 2002 MOA, PL 13-36 authorized CUC to issue preferred stock to CDA. PL 13-36 appears to be the Legislative approval of the 2002 MOA. Likewise, as to the 2004 MOA (Exhibit B of the Agreement), PL 16-17 apparently constitutes Legislative approval of the 2004 MOA. Counsel is of the opinion that Legislative approval of the Agreement is not necessary unless there is a term in the Agreement that requires a change in statute. That does not appear to be the case with respect to this Agreement.

Release and Satisfaction of Judgment—The Agreement is silent on the requirement that CDA file a release and satisfaction of judgment in Superior Court Civil Action 01-0149 concurrent with the issuance of preferred stock to CDA and the conversion of CUC's debt to preferred debt. However, consistent with paragraph 9 of Exhibits A and B to the Agreement, paragraph 5 of the Agreement expressly provides for the full waiver and release of any claims arising from any existing CUC debt to CDA which should be interpreted to include the amount in dispute in Civil Action 01-0149. A filing in Superior Court Civil Action 01-0149 of a release and satisfaction of judgment would appear to be the logical step to close the matter.

Miscellaneous Provisions—There are a number of other provisions of the Agreement that deserve some discussion. These include:

Department of Interior (DOI) Notification: There is a requirement in section 12 of Exhibit B to the Agreement that DOI must be apprized by the CNMI Executive Branch after Legislative approval of Exhibit B (the Amended MOA) and prior to entering into the Agreement. It is unknown whether the DOI notification has been provided by the Executive Branch; however, this would appear to be a ministerial requirement—notice only in contrast to a substantive requirement in which DOI approval could be considered a condition precedent that if not carried out would bar the effectiveness of the transaction. Nonetheless, it would appear prudent that CUC ensure DOI has been formally informed of the Agreement and pending approval by the CPUC.

CNMI Utility Bills: Section 3 of Exhibit B to the Agreement among other things requires CUC to waive fifty percent (50%) of the CNMI Government's unpaid utility billings outstanding as of March 31, 2002. This section further requires CUC and the CNMI Government will negotiate a mutually acceptable payment plan for the remaining fifty percent (50%). In section 3 of Exhibit B CDA agrees to waive all accrued interest owed by CUC. Further section 5 of the Agreement forever cancel and discharge the indebtedness of CUC to CDA under any and all loan agreements, promissory notes or other evidence of indebtedness existing between the parties. As for the requirement that CUC waive fifty (50) percent of the unpaid CNMI Government utility billings as of March 31, 2002, we are unaware of whether CUC ever waived 50 percent of the unpaid CNMI Government accounts or reached any agreement on the payment for the remaining amounts. We do note that CUC's regulatory counsel has advised us that this matter was resolved by CUC and the CNMI Government in the 2005-06 timeframe.

Fuel Tax Waiver: Section 11 of Exhibit B to the Agreement states that the continued waiver of the fuel tax for CUC must be and is made an integral part of Exhibit B. Counsel to GCG has noted that the reference to the fuel tax waiver is in the excise tax provision of the CNMI Revenue and Tax Code. The section which remains in effect exempts the imposition of the tax on liquid fuel sales to CUC to be used for power generation, provided CUC complies with a section 8141(h) of its statute. It should be noted that Section 8141(h) has been repealed and that PL 16-17 does not contain a provision comparable to Section 8141(h). The repealed section required CUC to reserve the "savings" from the tax waiver in a special account to be used for power plant maintenance and repair (similar to the current LEAC lock box),¹ among other things. At the time Exhibit B to the Agreement was executed Section 8141(h) was still in effect. Regulatory counsel for CUC concurs that the tax exemption on liquid fuel remains in effect for CUC.

Stock Certificate(s): Exhibit C to the Agreement presents a copy of the preferred stock certificate that CUC proposes be delivered to CDA. The Agreement indicates that preferred

¹ 4 CMC Section 8141 (h): The Corporation shall place 15 cents from its general revenues into a special reserve account for each gallon of liquid fuel purchased, at the time of each such purchase of liquid fuel. As used in this subsection, "liquid fuel" means fuel exempted from taxation by 4 CMC § 1403(c). In addition, the Corporation shall upon receipt place into the special reserve account a portion of its general revenues equal to the average percentage of revenues spent during fiscal years 1994, 1995 and 1996 on the purposes for the fund herein specified. Funds from this account shall be expended only for the following purposes and not including payroll:

- 1) Overhaul of generating equipment;
- 2) Power plant preventive maintenance;
- 3) Procurement of service vehicles and heavy equipment;
- 4) Replacement of obsolete or damaged equipment, including procurement of replacement parts;
- 5) Procurement of additional generating capacity;
- 6) Replacement of power poles and power lines; and
- 7) Maintenance and upgrade of transmission and distribution systems, including transformers, insulators, substations, and related parts, equipment, and facilities.

In the event the Corporation fails to comply with the requirements of this subsection, it shall pay into the Commonwealth general fund an amount equal to any funds which it failed to place in the special reserve account or which, having been placed in the reserve account, were improperly spent. The Public Auditor shall monitor compliance with this subsection.

shares issued to CDA shall be evidenced in one or more stock certificates in substantially the same form as the form of stock certificate attached hereto as Exhibit C to the Agreement. Given the preferred stock redemption applicable to the buy-back provision resulting from future CUC capital improvements it would seem prudent that multiple certificates be issued to CDA. For administrative purposes, certificates for approximately \$16.0 million redeemable in the short-term upon CUC making capital improvements could be issued in smaller denominations—something in the order of \$500,000 may be reasonable.

Privatization: The Agreement requires that any purchase money from CUC privatization activities be applied to CUC obligations and then to redeeming the CDA shares, subject to CPUC approval. It further requires that the CDA board member, serving on the CUC Board, shall actively participate in the CUC Board's review of invitations to bid, pre-qualifying bidders and in the selection of the winning bidder for any form of performance management contract, franchise agreement, private sector assistance agreement or the sale of CUC assets. We do not believe these provisions to represent any impediment to CUC in exploring various privatization activities. We would note that it is important that CDA understand that certain privatization activities such as performance management contracts would not be expected to result in any purchase money to CUC.

Conclusions and Findings

We find the Agreement to be consistent with the earlier memorandums of agreement between CDA and CUC. Further we are of the opinion that the Agreement is fair and equitable to CUC and beneficial to CUC's ratepayers. Accordingly, we recommend that the CPUC consider the following:

1. Approval of the Agreement and the proposed Preferred Stock Certificate
2. Authorizing CUC to issue preferred stock to CDA in an amount of \$45.0 million under the stated terms and conditions of the Agreement; and
3. Requiring CUC inform DOI of the Agreement and pending approval by the CPUC
4. Requiring CUC in the development its Business Plan, pursuant to CUC Docket No. 09-01 (2008), Stipulation of Dec. 12, 2008, identify the long-term rate, financial, and other implications of the Agreement.
5. Requiring CUC to track all internally funded electric, water, or wastewater system CIP investments for the purpose of offsetting up to \$16.2 million of the outstanding preferred stock through the "dollar for dollar" offset contained in the Agreement. The tracking system used by CUC shall be provided to the CPUC for review and approval.
6. Requiring CUC to annually prepare a report for CPUC review on its internally funded CIP investments.
7. As a condition to approving the Agreement requiring CDA to file in Superior Court Civil Action 01-0149 a full release and satisfaction of judgment against CUC.

If you wish to discuss the above matters, please do not hesitate to call.

Harry M. Boertzel, Hearing Examiner
July 27, 2009
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Best regards,

A handwritten signature in black ink, appearing to read "L. Gawlik". The signature is fluid and cursive, with the first letter "L" being particularly large and stylized.

Larry Gawlik

cc: Jim Madan, GCG
Tony Muna, CUC
Alan Barak, Esq.
Rob Torres, Esq.