
**Office of the Public
Auditor**

**Commonwealth Utilities Corporation
Organizational Structure**



**OPA Report No.
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Table of Contents

Results in Brief.....	2
Introduction	3
Objective	3
Background	3
Findings	6
Deficiencies in PL 4-47 and Other Laws Weakened CUC’s Autonomy.....	6
Interventions by the Legislature	8
Executive Branch Influence	12
Boards of Directors	13
Various boards of directors did not establish adequate rates.....	14
Various boards pursued major projects despite CUC’s poor financial condition	15
Various boards directly involved themselves in the daily operations of CUC	16
Political influence and intimidation has affected board and management decisions.....	17
Conclusion and Recommendations.....	20
Recommendation.....	20
CUC Response	23
Auditor Response	23
Appendix 1. Scope and Methodology	24
Appendix 2. CUC Response	25
Appendix 3. Status of Recommendations.....	26

Results in Brief

Our audit disclosed that the Commonwealth Utilities Corporation (CUC) has not achieved its purpose to operate as an independent public agency with the legal and political independence to perform as a non-subsidized, autonomous corporation due to interferences by the legislature, various governors, and the boards of directors throughout the history of CUC. While there have been modifications to, and complete changes in, CUC's enabling legislation, and numerous executive orders relating to CUC's operations, none have addressed the overall political nature of CUC's founding and continued operations.

- The legislature, despite requiring CUC to recover all costs through an adequate rate structure, passed laws that did not provide CUC with sufficient autonomy to do so and, on occasion, legislated rate and fee reductions.
- Various governors, through the board appointment process and the use of emergency declarations, have exercised operational control of CUC.
- Absent any enabling or restricting statutes, boards of directors, developed by-laws and regulations allowing their participation in CUC's day-to-day operations instead of focusing on strategic planning, budgeting, and policies.

Introduction

Objective

Given the critical necessity of the Commonwealth Utilities Corporation (CUC) to the Commonwealth and its past and current organizational and fiscal challenges, the Office of the Public Auditor (OPA) conducted a performance audit of CUC. Our objective in this performance audit was to determine:

Did the legislature, in developing CUC's enabling legislations, grant the essential organizational characteristics to ensure long-term autonomy and sustainability, and if not, what are other options?

Background

CUC was established in 1985 as a public corporation of the Commonwealth of the Northern Mariana Islands (CNMI) government. CUC maintains a monopoly on the production and sale of electricity and water and, where applicable, is responsible for wastewater disposal for the islands of Saipan, Tinian, and Rota since operations began in 1987.

As of fiscal year (FY) 2014, CUC's total operating expenses of \$96 million exceeded the combined total operating expenses of the Commonwealth Development Authority (CDA), Commonwealth Ports Authority, Commonwealth Healthcare Corporation, Marianas Public Land Trust, and the Northern Marianas College. This amount is equivalent to 78 percent of the general fund appropriation for that year.

Purpose and the Creation of CUC

After more than 20 years as a trust territory, the people of the Northern Mariana Islands mutually entered into a "Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States" (Covenant) in March 1976. The Covenant granted the CNMI the right to self-governance and outlined its relationship with the United States.

At the time of the Covenant's passage, the CNMI remained heavily dependent on Federal assistance to support government operations. Pursuant to the Covenant, the United States provided economic support through a guaranteed multi-year financial assistance for an initial period of seven years to support local government operations, capital infrastructure improvements, and economic development. During such time, the government's utility operations was a division within the Department of Public Works.

In July 1985, the CNMI and the United States reached a new seven-year agreement that provided more than \$200 million in financial assistance under what was called the "Agreement of the Special Representatives on Future United States Financial Assistance for the Northern Mariana Islands" (Special Agreement). During negotiations, the United States raised concerns regarding the CNMI's unchecked growth in government employment, heavy subsidization of electricity, failing government pension system, lack of capital development, and lack of growth in the private sector. As a result, the Special Agreement subjected funding to the CNMI based on its

fulfillment of various performance standards. The performance standards aimed to promote the following principles within the CNMI government:

- Prioritize capital and economic development over funding of government operations;
- Reduce government operations;
- Continue independent and autonomous regulatory authorities governing utilities, borrowing, and economic development, which will put utilities on a user-fee/pay-as-you-go basis within three years;
- Needed planning to provide for full funding of the government's pension system; and
- Prioritizing the privatization of government services.

CUC was created as a direct response to section 4(e) of the Special Agreement, which required the CNMI government's continuation of an independent public agency that sets rates and fees for public utilities as described in Public Law (PL) 4-47. Such rates and fees are required to fully fund public utility services, including current expenses and long-term debt, without government subsidy.

According to PL 4-47, CUC was established as a public corporation of the CNMI government, consisting of electric power, water services, sewer, and compliance divisions. CUC was created to manage and regulate all utilities while seeking privatization, and to be financially independent of all appropriations by the Commonwealth Legislature.

To achieve considerable operating independence in performing its governmental function, CUC was structured to be governed by a five-member board of directors, managed by an executive director, and was granted all the legal powers of a corporation including the following:

- Prescribe and adopt bylaws;
- Receive and hold funds from various sources;
- Sue and be sued in its corporate name;
- Hold real or personal, tangible or intangible property;
- Secure debt from any private and public sources both within and outside the U.S.;
- Execute contracts;
- Hire employees or engage in independent services;
- Pursue privatization of its functions;
- Assume existing contracts with respect to utility services;
- Regulate other utility services;
- Immediately strengthen existing systems of metering, billing, and collecting fees;
- Review and establish rates and fees; and
- Prepare and submit a budget as a government corporation.

To ensure that CUC continues to be an autonomous agency, independent of all appropriations, the legislature mandated that CUC be managed in a business-like manner with the ability to establish and adjust utility rates to sufficiently recover the full cost of operation and delivery of utility services. PL 4-47 identified such costs to include an adequate financial reserve for debt service and replacements of obsolete or damaged equipment.

After many years of operating as a corporation, CUC was reorganized in 2006 in accordance with the then governor's first and second reorganization plan. The first reorganization located CUC as a division within the Department of Public Works and then reestablished it during the second reorganization as a corporation. According to the second reorganization plan, the executive director assumed all governing authority and the board of directors assumed an advisory role to the executive director. While the then governor's reestablishment of CUC was later declared unconstitutional by the CNMI Supreme Court, the court declared that the then governor's actions had been positively affirmed by the legislature's creation of the Commonwealth Public Utilities Commission (CPUC), an independent regulatory agency.

The legislature reestablished CUC in 2008 through PL 16-17, which incorporated several revisions and restored the governing role of the board of directors. CUC went on to operate without a board of directors until April 2014.

Historically, CUC's cost of operating its water and wastewater divisions has been subsidized by its power division revenues. Insufficient revenues in its power, water, and waste water divisions resulted in inadequacies in its water, wastewater, and fuel storage systems. This led to violations of Federal laws including the Clean Water Act and Safe Drinking Water Act in 2008. These violations resulted in two Stipulated Orders issued by the U.S. District Court. The Stipulated Orders focused on areas of CUC's operations and management structure, with the goal of bringing CUC into compliance.

Findings

According to the Special Agreement, the CNMI ensures continuation of a public agency that sets rates and fees for public utilities as described in PL 4-47 in order to ensure self-sufficiency. PL 4-47 structured CUC to be governed by a board of directors and gave it corporate powers. Both its governance structure and corporate powers were intended to provide CUC with necessary administrative independence and financial flexibility to promote self-sufficiency.

Our audit disclosed that the deficiencies within PL 4-47 and the actions of the legislature, various governors, and boards of directors either directly or indirectly diminished the fundamental characteristics necessary for CUC to succeed.

CUC grew from its initial total revenues of \$7.6 million FY 1988 to \$98.9 million in FY 2014, thus becoming the largest autonomous corporation in the Commonwealth. Despite this impressive revenue growth over 27 years of operations, CUC demonstrated only six fiscal years where operating revenues sufficiently funded its operating costs. CUC's inability to recover its costs and related organizational weaknesses resulted in the following conditions (financial data based on CUC's September 30, 2014 audited financial statements):

- CUC reported a deficit of \$76.5 million, despite a debt for equity swap¹ with CDA of \$170.5 million in 2009, and the receipt of \$135.0 million in Federal grants since 1988;
- For various reasons, governors have kept CUC under emergency declarations since 2005;
- Due to a lack of progress, the Federal Government had oversight of various CUC operations via the Stipulated Orders;
- The CNMI government and related agencies owe CUC in excess of \$20 million;
- Historically, CUC has been unable to pay required dividends to CDA;
- Historically, CUC has not been able to timely hire or retain required management positions; and
- Due to non-compliance, CUC has accumulated court stipulated penalties of \$36 million.

Based on the above conditions, it is evident that CUC did not achieve its purpose to operate as an independent public agency with the legal and political independence to perform as a non-subsidized, autonomous corporation.

Deficiencies in PL 4-47 and Other Laws Weakened CUC's Autonomy

Although CUC was mandated to operate as an independent, businesslike corporation, PL 4-47 contained provisions and lacked others, which, overall, prevented CUC from operating independently.

- Section 8151 designated the Attorney General as legal counsel to CUC and as the approving authority for any other legal counsel to CUC. Given that the Attorney General was appointed by the governor and a cabinet position, Section 8151, as written, imposed

¹ The debt for equity swap involved the forgiveness by CDA of accumulated interest and principal of development loans totaling \$170.5 million, in return for preferred stock issued by CUC to CDA.

a major conflict of interest. Any attempt by CUC to properly carry out its mandate may be short-lived if such an attempt is contrary to the interest of the executive branch. Further, restricting CUC to the advice of the Attorney General as its legal counsel places CUC at a disadvantage if CUC and the CNMI government become involved in a lawsuit.

CUC could not obtain its own legal counsel until PL 10-27 passed in 1996. By this time, however, the CNMI government owed an estimated \$3 million to CUC, according to CUC board minutes.

- Section 8133(a) imposed a salary limit of \$40,000 for CUC's executive director, and Section 8133(c) required CUC to comply with CNMI Civil Service Rules. The limitations imposed by Sections 8133(a) and (c) reduces CUC's ability to competitively recruit and retain qualified individuals for critical positions. The law's reference to the CNMI civil service rules further eliminates CUC's independence in personnel management.

The Department of Interior (DOI) reviewed the CNMI's infrastructure during the 1990s as part of its Operations & Maintenance Improvement Program (OMIP). DOI noted that salary limitations prevented CUC from retaining and recruiting individuals for the comptrollership and repeatedly recommended legislative relief. DOI attributed CUC's serious financial problems and the continued issuance of unfavorable audit opinions by independent auditors to its lack of a comptroller. According to CUC records, the comptroller position remained vacant for three years, then ultimately was filled by four individuals for the period between 1990 and 1996.

PL 8-06 partially corrected the salary limitation of the executive director position in 1992, allowing a ceiling of \$70,000 per year. CUC was finally exempted from both the salary limitation and CNMI Civil Service Rules when PL 10-27 passed in 1996. By this time, revenue had grown from \$7.6 million to more than \$55.1 million. The recruitment and retention of key positions remained a major weakness for CUC, which has had eight different executive directors and comptrollers throughout its 27 years of operations.

- CUC was not exempted from the CNMI's liquid fuel tax, in effect creating additional revenues for the CNMI General Fund at the expense of CUC and its rate payers. As a result, CUC struggled to pay its outstanding balances with its fuel supplier, compelling the CNMI government to make advance utility payments of about \$14 million in 1988 and 1991 to settle its fuel debt. CUC did not receive exemption to the tax until PL 10-36 passed in 1996.
- PL 4-47 did not restrict government employees from being board members and did not guarantee staggered terms of service. In its 1992 OMIP report, DOI described the board of directors as predominantly composed of government employees. DOI recommended that board members serve staggered terms. After repeated recommendations to amend the law, the legislature passed PL 10-8 in 1996 restricting government employees from being board members. Within PL 10-8, the legislature also recognized the importance of reinforcing staggered terms of service and noted that board members did not complete their staggered terms due to the practice of submitting "courtesy resignations." Courtesy

resignations do not comply with the CNMI Constitution's requirement of independence for boards and commissions.

Although PL 10-8 tried to reduce potential conflict of interest, the legislature passed PL 13-9 in 2001, which exempted board appointees from Rota and Tinian from the government's employee restriction.

- In its 1992 OMIP report, DOI reported that board members did not possess the legally required business background and lacked “the expertise to administer a multi-million dollar enterprise.” Therefore, DOI recommended that at least five members possess private sector business or professional background and that all members be college graduates.

Under PL 4-47, initial qualifications for the board of directors required a minimum of five years of managerial or financial experience in business, finance, or utility services. However, PL 10-8 established a less rigorous experience requirement—three years of private sector business or professional background as a minimum, with only an associate of arts degree.

PL 4-47 required CUC to be run in a professional manner and, on occasion, it has been run that way. However, it is imperative that the governing board of directors possess strict professional requirements and related competencies to meet this goal.

- The legislature passed PL 7-02 in 1990, allowing CUC to hire an executive director with professional experience in *public service*. Initial qualifications under PL 4-47 required five years of professional experience in public utility services, business management, or finance. After repeated recommendations by DOI, the legislature restored the qualification requirements provided in PL 4-47 by passing PL 10-27 in 1996. The qualification requirements for the executive director position remained unchanged from 1996 to 2008 when the Federal Stipulated Orders required a higher level of education and experience. By that time, over the course of 12 years from FY 1996 to FY 2008, CUC reported a total of \$89 million of operating losses and only \$22 million of total operating revenues.
- Specific duties of both the board of directors and the executive director are inadequately defined. This has never been corrected and has led to the involvement of various boards in the daily operations of CUC.

Early board minutes indicated that all parties believed CUC would be privatized shortly after incorporation and that the board was only serving in a caretaker role. However, privatization of CUC failed to materialize, and the legislature gradually corrected these deficiencies. These initial weaknesses, combined with CUC's rapid growth, contributed to significant deficits, totaling more than \$40 million in the first ten years.

Interventions by the Legislature

As mandated through its initial enabling legislation of PL 4-47, CUC was designed to possess the powers of a public corporation and operate as a business in order to be independent of all

legislative appropriations. In this way, CUC's decision making and service capability would no longer be limited to the financial constraints of a legislative budgetary process. However, subsequent legislation affected the operations and hindered CUC from achieving self-sustainability.

A review of the laws indicated that the legislative response to the soaring cost of oil during the early 2000s did not focus on the necessity of rate increases. Instead the legislature attempted to undermine any increase in CUC's rate and fee structure, and directly affected its operations through the following:

- The legislature passed PL 12-01 in 2000, mandating CUC pursue its abandoned plan to construct an 80 megawatt power plant under a build-lease-own financial arrangement.

CUC had issued a request for proposals (RFP) to construct the 80 megawatt plant in 1997. However, based on the recommendations of its engineering consultant, it cancelled that RFP, then issued an RFP to construct a 60 megawatt power plant. Due to PL 12-01, CUC issued a conditional award to the highest ranked proposer in May 2000.

Amid negotiations, when its consulting engineer determined that the new power capacity was neither needed, nor in the best interest of CUC, CUC abandoned the project in October 2001. It was later reported that the awarded proposer filed for Chapter 11 bankruptcy protection in December 2001.

- The legislature passed PL 13-35 in 2003 and PLs 13-36, 15-12, and 16-17 in subsequent years to reduce or eliminate CUC's substantial debt to the CDA. Negotiations between CUC and the CDA continued until 2009, resulting in the improvement of CUC's capital structure, for an excess of \$170.5 million.
- CUC faced reduced operating flexibility related to establishing rates following the creation of CPUC in October 2006 through PL 15-35. CPUC was created as an independent regulatory agency within the executive branch of the CNMI government, empowered to regulate all matters pertaining to the formation, operation, and/or direction of a regulated entity.

Now, CUC can no longer implement rates and other charges for utility services without prior approval of CPUC. This also includes procurement contracts. The establishment of CPUC created another layer of difficulty, making it hard for CUC to operate independently.

- In 2007, PL 15-80 reversed CUC's policy of requiring a two-month customer security deposit to one month for utility services. PL 15-80 reduces CUC management's perceived necessary protection against potential delinquencies of customer accounts, increasing the risk of revenue loss. Such losses become transferrable to rate payers who pay their bills on time. PL 15-80 contributed to the long-term effect of increasing CUC's uncollectable accounts.

According to CUC's financial audit reports and other related documents, CUC amended its initial policy of requiring a one-month security deposit to an estimated usage of two

months in 1994 after reporting a bad debt expense² in the amount of \$4.3 million in FY 1993 and \$5 million in FY 1994. Following this amendment, CUC reported substantially lower bad debt expense, with an average of \$467,098 per fiscal year between 1995 and 1999.

CUC's calculated average bad debt expense increased to \$3.3 million per fiscal year from FY 2000 to FY 2007, as world oil prices rose beginning in 2000. Following the passage of PL 15-80, CUC's average bad debt expense increased to \$4.5 million per fiscal year from FY 2008 to FY 2014.

- PL 15-94 prevented CUC from implementing necessary rate increases during FY 2008. CUC initiated its first significant electric rate increase by adopting its amended electric service regulations identified as the Amended Electric Service Regulations, Part 24, during 2006 in response to rising fuel prices that began in early 2000. This rate increase allowed CUC to achieve an operating profit of \$915,798 in FY 2007 for the first time in seven years (since 1999).

However, PL 15-94 effectively reduced the monthly charge, base rates, and froze the fluctuating electric fuel rate of CUC's residential customers. Consequently, CUC experienced substantial monthly revenue shortfalls and fuel supply shortages for the next seven months. In response, the legislature passed PL 16-2 in May 2008, temporarily allowing CUC to apply its previous rates under its Amended Electric Service Regulations. However, CUC reported an operating loss of \$12.8 million for FY 2008.

- PL 15-97 required CUC to allow delinquent residential customers to pay their outstanding balances within one year. This changes its previous repayment policy of three months, affecting the timeliness of CUC's cash flow. Such delay adds to CUC's history of poor cash flow.
- To enhance local employment, the legislature passed PL 15-108 on November 2007, enforcing the preferential hiring of CNMI local and permanent residents. The law temporarily exempted CUC's engineers, mechanics, and technicians until September 2008. CUC's difficulty of complying with PL 15-108 prompted the passage of PL 17-36 in March 2011, extending the exemption to 2012 and allowed the hiring of up to 30 foreign nationals.

In addition to other matters, this restriction prompted the then governor to declare multiple emergency declarations, which enabled direct influence from the executive branch, beginning in 2009. CUC's dependency on foreign workers has not yet been fully resolved.

- The legislature reduced CUC's reconnection fee through PL 15-122 in December 2007 and PL 18-39 in March 2014. In 1994, CUC established a \$150 reconnection fee for its residential and commercial customers. The board reduced its residential reconnection fee

² Bad debt expense represents the anticipated amount of accounts receivable that will be uncollected in a given period. Reduces the amount of reported revenue for a given period. Common business practice recommends adequate levels of security deposits to recover actual revenue losses.

to \$75 in January 1997 through Board Resolution 96-8. A review of the resolution indicated that the legislature's 1996 House Joint Resolution 10-20 partly prompted this reduction.

In 2000, the legislature used House Joint Resolution 12-008 to request a further reduction of its residential reconnection fee to \$25. However, nothing indicates that CUC did this. In 2007, the legislature enacted PL 15-122 to restrict CUC from charging a residential reconnection fee greater than \$60 and, in 2014, enacted PL 18-39 to mandate a \$25 residential reconnection fee and a \$75 commercial reconnection fee.

- In response to CUC's rotating power outages, the legislature passed PL 16-7 in July 2008, earmarking \$3.4 million of future revenues of the Marianas Public Land Trust to enable CUC to procure temporary power services as it rehabilitates its power generation system and to pay for other contractual obligations. CUC was required within 18 months to reduce its electric rates or rebate this amount to residential customers. How this was to be accomplished without an increase in revenues was not addressed.
- In response to CPUC's opposition of unapproved CUC emergency generating contracts, the legislature passed PL 16-9, allowing CUC to procure emergency power contracts without CPUC approval. PL 16-9 enabled CUC to bypass CPUC's regulatory responsibilities.
- The legislature passed PL 16-17 in 2008 in another attempt to privatize CUC power generation at a minimum price of \$250 million. The law also reestablished CUC's board of directors and, with some changes, reestablished the original CUC enabling legislation of PL 4-47. However, an active board of directors was not appointed until 2014, and CUC continued to operate under the then governor's executive orders.
- In September 2013, PL 18-19 required CUC to charge the public school system the commercial water and wastewater rates instead of the higher government rates, despite the public school system's already reduced water rates approved by CPUC in 2012. The law further required CUC's waiver of penalties and late fees assessed to the public school system and the off-set of all collected fees during and after FY 2012 against the public school system's utility expenditures for FYs 2012, 2013, and 2014. The legislature also restricted CUC from recovering the decrease in public school system rates to only increasing other government customer rates.

A review of CUC's financial audit reports showed that the CNMI government had a balance of about \$6.4 million in unpaid utility billings, representing 19 percent of the \$34.4 million due from all customers in FY 2010. As shown in Figure 1 below, the CNMI government's unpaid utility balance rose to \$21.9 million, or 53 percent, of the total \$41.6 million due from all customers in FY 2014.

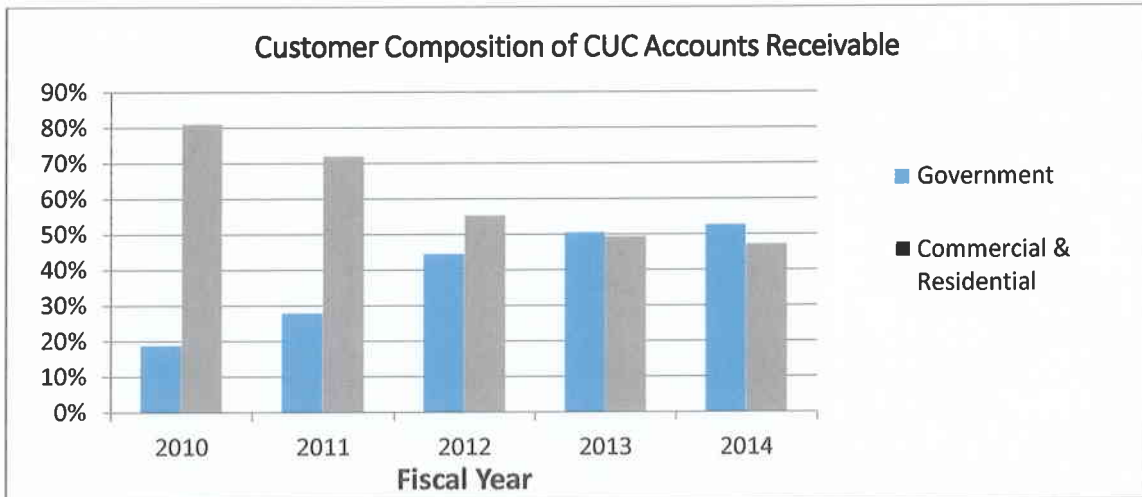


Figure 1. Customer composition of CUC accounts receivable from FY 2010 to FY 2014.
(Source: OPA analysis of CUC Audited Financial Statements.)

Restricting CUC to increasing the rates of only government customers would worsen the CNMI government’s financial hardship and ultimately CUC’s financial condition due to the CNMI government’s inability to pay.

- Anticipating an increase in gross revenue taxes due to the new casino, the legislature passed PL 18-43 in 2014, prioritizing the subsidization of CUC’s fuel cost charged under its Levelized Energy Adjustment Clause (LEAC). This directly conflicts with CUC’s mandate to be financially independent of all legislative appropriations or subsidy. If the government’s subsidizing actually occurs, Federal grant agencies may reassess the need for future capital improvement grants to CUC.

Executive Branch Influence

CUC’s establishment as an autonomous agency under PL 4-47 from its previous status as a division within the Department of Public Works, was intended to enable CUC to operate with greater independence in policy-making. Governance of CUC by a board of directors serving staggered terms whose only removal by the governor is subject to good cause, reduces direct policy control by the governor, thereby insulating CUC from political interference. CUC, however, is not immune from governors exerting direct policy control through the constitutional powers of issuing emergency declarations and executive orders under Article III Sections 10 and 15 of the CNMI Constitution.

The governor, under all enabling legislation, retained the authority to appoint members of CUC’s board of directors, with the terms of appointment deliberately staggered to provide continuity between gubernatorial terms. However, over the years, board members began submitting courtesy resignations upon the election of a new governor. This in effect provided governors with a continuing undue influence on boards of directors, particularly when the central government is both a major consumer and the largest debtor of the utility corporation.

This is further complicated by the governor’s constitutional authority to declare an emergency and issue executive orders. Currently, the issue of executive orders has been upheld by the

courts. We believe it is illogical for declared emergencies to be considered emergencies if they were caused by the actions or inactions of the legislature and governors.

The history of executive orders and emergency declarations began in 1994, with the issuance of Executive Order (EO) 94-3, which generally reorganized executive agencies. Since CUC was an autonomous agency, this had no real impact on it. An emergency was declared in 1995 relating to the quantity and contamination of the island's water supply. Not renewed, this emergency declaration had no consequences.

In 2005, the financial deterioration of CUC, among other reasons, led to the next emergency declaration. CUC's state of emergency continues to present, with the most recent EO 2016-11, which cites CUC's fiscal and technical worker crisis.

The fiscal crisis concerns the unpaid balances owed by government agencies to CUC, an event created by a lack of historical appropriations by governors and the legislature to support the public school system and the Commonwealth Healthcare Corporation. The technical worker crisis was identified and legislated in 2007 through PL 15-108, and is now further complicated by recent actions of the U.S. Citizenship and Immigration Services. In essence, CUC, various governors, and the legislature have had nine years to resolve this issue but made no significant progress. These emergencies are self-created by the actions or inactions of the legislature and governors.

Emergencies have allowed governors to provide emergency infusions of funds to CUC, suspend procurement regulations, override personnel legislation, effectively suspend the board of directors, suspend CPUC's regulating authority, initiate procurement contracts, and appoint CUC's executive director with full authority for CUC. At one point, a Governor's executive order authorized an improper and facially invalid sole source power production contract that would have cost the CNMI \$190 million had it not been ruled void ab initio³ by the Superior Court.

No other CNMI autonomous agency has experienced this degree of legislative and executive branch interference.

Boards of Directors

CUC's board of directors has a responsibility for ensuring that the organization operates in the best interest of the organization and its stakeholders, in accordance with the best practices of effective board governance. The board of directors must also fulfill the following fiduciary duties:

- Duty of care – Board members must exercise reasonable care when making decisions for the organization;
- Duty of loyalty – Board members must act in the best interest of the organization; and
- Duty of obedience – Board members must be faithful to the mission of the organization while adhering to applicable laws.

³ Void ab initio – having no legal force from the beginning.

We based our review of the board of director activity primarily on a review of minutes from February 1990 to January 2016. Although some board minutes were missing, we noted the following based on the minutes reviewed.

Various boards of directors did not establish adequate rates

CUC is mandated to adjust its rate structure so that collections sufficiently recover the cost of operations and delivery of utility services. These rates should include adequate financial reserves for debt service and, if any, the funds to replace obsolete or damaged equipment.

A review of CUC’s revenue performance, shown in Figure 2 below, indicates that utility rate levels have been insufficient to recover the full cost of operations since FY 1988. CUC reported net incomes of \$3.8 million and \$1.8 million for FY 1998 and 1999 respectively; however, these occurred primarily due to the temporary decrease in CUC’s fuel costs.

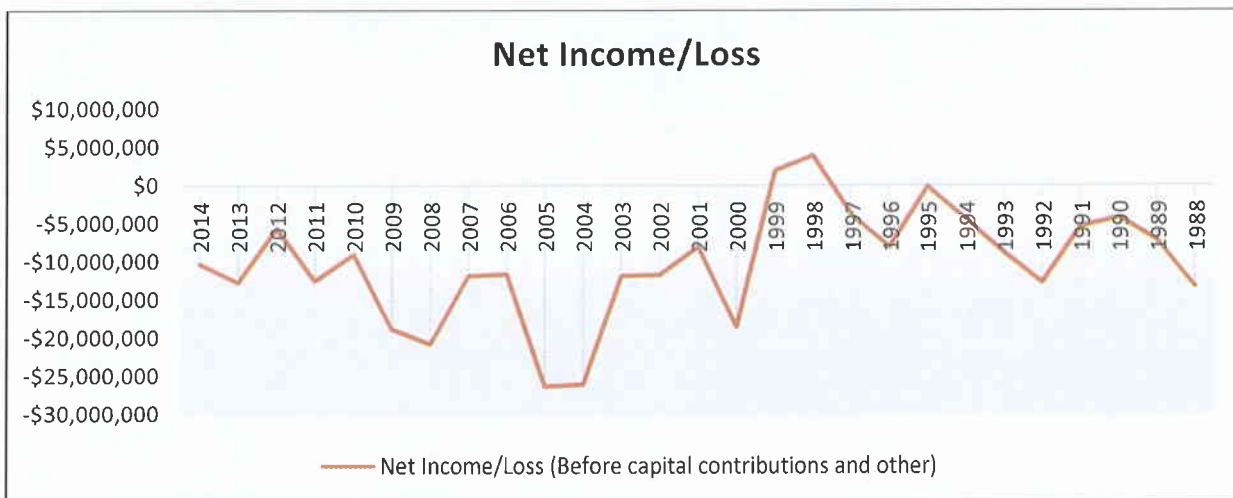


Figure 2. CUC’s reported net income for FY 1988 to FY 2014. (Source: OPA analysis of CUC Audited Financial Statements.)

A review of minutes from 1990 through 2004 indicate that various boards of directors recognize the inadequacy of utility rates as early as 1991. Board minutes note concerns from governors, DOI, and DOI’s Office of Inspector General over CUC’s inadequate rate structure and the repeated requests of its management for rate increases. Additionally, two separate board-commissioned rate studies recommended that CUC establish a fuel charge⁴ in 1993 and a 35.8 percent electric rate increase in 1997, further reinforcing the need for a utility rate increase. Despite these concerns and the apparent need to increase utility rates to adequate levels, none were adopted between FY 1988 and FY 2004.

Since the dissolving of the board of directors in 2005, the executive director temporarily enforced a surcharge rate in 2005, instituted a fuel charge in 2006, and gradually restructured

⁴ Fuel charge is a rate that is charged to utility customers in order to recover the direct cost of fuel used to produce electricity or other utilities. The rate was first used by CUC in 2006 and identified as the Electric Fuel Rate, the LEAC rate, and ultimately the Fuel Adjustment Charge.

utility rates in an effort to recover CUC's operating costs. As a result, CUC eventually reduced its annual operating losses from \$16 million in FY 2005 to \$4 million in FY 2014.

After about nine years, a new board of directors formed in April 2014. According to the board minutes, a majority vote caused board members not to propose a rate hike to recover approximately \$14 million of unpaid LEAC costs, primarily owed by the CNMI government. Board minutes noted that members discussed the then governor's preference and directive not to raise rates prior to rejecting the rate hike proposal. CUC's rate consultant had proposed the need to recapture this cost. The consultant found this amount to result from CUC's inability to reconcile the LEAC rate covering three years due to CPUC's nonfunctioning governing board from 2012 to 2015. The consultant further noted that the failure to recover such cost potentially could lead CUC to underinvest in its infrastructure, thereby affecting service reliability and risking system failure and insolvency.

Various boards pursued major projects despite CUC's poor financial condition

CUC's history of operating losses due to inadequate utility rates, significant customer accounts receivable balances, and its 1993 default of its substantial debt to CDA demonstrates CUC's financial incapability of incurring new debt. However, various boards pursued major projects despite CUC's struggling financial condition. A review of board minutes revealed that past and current boards lack an official strategic plan to guide management in making effective decisions.

In September 1997, the board authorized an RFP for the construction of an 80 megawatt power plant under a lease arrangement. After several procurement protests, CUC contracted an engineering consulting firm in 1998 to re-evaluate the proposals received. CUC finally selected the number one ranked firm and simultaneously directed its consultant to reassess its power supply needs, based on current economic conditions. The results of the reassessment prompted CUC to cancel the 80 megawatt power plant RFP and then issue an RFP to construct a 60 megawatt power plant in January 2000. The legislature later used PL 12-1 to mandate that CUC pursue an 80 megawatt power plant with the initial and immediate construction of 60 megawatts.

CUC ultimately abandoned the project during negotiations after its consultant determined that the new power capacity under the proposed power plant project was neither needed, nor in the best interest of CUC. According to the consultant's recommendation letter, the project would have generated \$336 million of additional debt for CUC, requiring an even larger rate increase. The board of directors initiated another major push for a reverse osmosis unit in May 2002. The RFP, however, was canceled due to multiple instances of improper conduct by the board and formal opposition by the head of CUC's procurement, CUC's legal counsel, the Office of the Public Auditor, and the legislative legal counsel.

In 2014, the current board of directors initiated the development of a Federally funded integrated resource plan. The plan served as a guide to provide CUC with various strategic options leading to the most cost effective, long term energy solution for CNMI consumers. The plan was finalized and presented to the board; however, subsequent to our fieldwork, the board did not adopt any of the options.

In 2016, the board of directors initiated another push for a reverse osmosis system, despite the requirements of the Stipulated Order No. One and contrary to the recommendations of CUC's water and wastewater engineering division. A review of the board minutes and other related documents revealed that a private firm gave an unsolicited presentation suggesting the installation of a reverse osmosis system as a solution to comply with the court orders of the U.S. Environmental Protection Agency in August 2015. As reported in the local newspaper, in May 2016, members of the board attended a dinner meeting, which included the presentation of a \$160 million reverse osmosis system by the same private firm. It was also disclosed that the spokesperson for the private firm was also a consultant to a government official. It was later reported in June 2016 that the board presented their plans for a reverse osmosis system to members of the legislature.

Historically, as in the case of the reverse osmosis project in 2002, board members have received "unsolicited" presentations, which later lead to successful protests of issued and awarded RFPs. Unsolicited presentations by interested third parties may indicate favoritism for one proposer over another. Additionally, any apparent relationship between interested third parties and government officials diminishes the public's trust, complicating future projects.

Various boards directly involved themselves in the daily operations of CUC

According to best practices, a strong and effective board should have a clear understanding of its role in relationship to management. Board members focus mainly on guidance and strategic planning, the selection of the chief executive officer and other senior executives, and adherence to legal requirements. Management implements the business strategy and manages the organization's day-to-day operations, with the goal of increasing long term stakeholder value. Contrary to best practices, however, various boards have involved themselves in the management of CUC creating ineffective relationships, which either led to the removal or departure of key personnel.

In DOI's 1992 OMIP report, it noted CUC's weakening reputation due to the contentious relationship between the board of directors and the executive director. This and subsequent OMIP reports recommended that the board members receive training related to manager relationships, fiduciary responsibilities, and the proper role of a governing body in a public corporation's operations.

According to DOI's 1994 OMIP report, board members who received training in response to the recommendations were replaced by newly appointed members. A review of board minutes and other related documents revealed that the then newly elected governor, solicited courtesy resignations from CUC board members during 1994. There were no indications that subsequent board members received training as recommended by DOI in subsequent years. In 2000, the board minutes noted that the board reversed management's assessment of back charges of a former board member.

Prior to the board's restoration in April 2014, CUC operated under the management of two experienced executive directors and a chief financial officer. Through their management, CUC has increased its electric base rates on three separate occasions; persistently enforced its disconnection policy, thus compelling the CNMI government to address its outstanding balance;

and received its first unqualified audit opinion, commonly known as a clean opinion, in FY 2010 which continued to FY 2014.

During 2014, the newly formed board determined that it would review staffing plans, customer service operations, all billing, and personnel disputes. Within a few months, the new board withdrew management's earlier petition for a proposed standby charge⁵ projected to generate \$2.4 million in additional annual revenues, and a proposed increase of its ineffective late payment charge of one percent to 10 percent.

On June 30, 2014, the chief financial officer reported to the board that CUC was forced to use funds previously allotted to ongoing projects in order to pay for fuel oil after the government did not respond to its letter requesting payment on the outstanding balance owed to CUC. The chief financial officer also stated that CUC should begin disconnecting non-essential services to encourage government payment. A board member responded that efforts to collect from the government had been lax. Based on his discussion with the then governor, he said that the governor agreed to pay some of the government's outstanding balance if CUC were ever to lack funds for its fuel supply. The board directed the executive director to prepare another reminder letter for the governor. Board minutes noted that the chief financial officer had scheduled to officially resign in July 2014.

The board implemented a hiring freeze in May 2014. A month later, the executive director reported several staffing issues and requested approval from the board to fill various vacated budgeted positions. The executive director expressed his hope that the board will allow management to make employment decisions upon the board's approval of a budget plan. It was not until June 2015 that management received full authority to hire replacement employees. The executive director was forced to resign in July 2015 after he reportedly noted in CUC's quarterly report to EPA concerns about CUC's "fiscal and operational constraints and... management's lack of political will to increase utility rates."

In April 2015, the board hired a new chief financial officer who was a certified public accountant with 24 years of experience as a senior financial executive and financial, commercial, and technical consultant in the utilities industry. During a board meeting in September 2015, the newly hired chief financial officer questioned the board's assertion that it needed board members to counter sign disbursement checks, given the existing proper internal controls at CUC's finance department. He further stated that past financial audit reports do not show this as a concern. The chief financial officer was reportedly terminated without cause on June 2016 a day after he reported CUC's dire financial condition to the board.

Political influence and intimidation has affected board and management decisions

A review of the board minutes and other related documents showed that various boards either failed or experienced difficulty upholding their fiduciary duties because of political pressures exhibited through the following:

⁵ Standby charge, as part of CUC's rate petition under Docket 13-01 to CPUC, proposed to charge \$20 per month per kilowatt of generating capacity applicable to large commercial customers who are connected to CUC but consume power on a contingent basis.

- CUC experienced serious financial management problems in its early years, causing delays in the preparation of financial statements and an inability to achieve an unqualified audit opinion. Initial boards were troubled by the lack of accurate and timely financial data, which became a major issue in 1991. This partially led to an aggressive oversight hearing by the legislature, which believed that CUC had deliberately submitted misleading data. The legislature later filed contempt charges against the executive director in 1992.
- Anticipating the pending resignation of the executive director, the board called an executive board meeting in March 1991 to discuss their intention to amend CUC's legislation to give the board authority over personnel management, specifically raising the salaries of key staff to attract competent and qualified individuals regardless of where they were from. The board felt reluctant to do this because of the possible politicization of the executive director position by elected officials.
- The board met again in April 1991 and accepted the executive director's resignation, but requested the executive director to remain with CUC. The executive director agreed to temporarily remain with CUC until the board found a replacement, but not before expressing his frustration with the legislature's disruptive behavior. The then governor, who also attended, insisted that CUC refrain from hiring outsiders, citing that "...it is unfair for our own people [who] can do this job [but] will still be underpaid and underprivileged. And we have to bring in outsiders here and we have to pay all kinds of outrageous benefits."
- In July 1991, the Senate president demanded the resignation of CUC's board members and the executive director, threatening not to reappoint certain board members until the executive director was terminated.
- Per board minutes, in March 1992, the then governor requested the executive director to waive a pending commercial security deposit of about \$40,000 to \$50,000.
- Various boards did not increase utility rates due to the legislature's expressed opposition to any form of increase. Board minutes noted multiple requests by CUC's management to increase rates, the Federal government's concerns over CUC's inadequate rates and multiple board commissioned rate studies recommending rate increases; however, boards continuously deferred action on the issue.
- Although the CNMI Constitution requires boards to be independent, various boards submitted resignation letters both voluntarily and at the request of newly elected governors.
- In the absence of a functioning board and operating under the authority of the governor during 2011, it was publicly reported that CUC reconnected a government agency that was previously disconnected due to its delinquent account at the request of the administration.
- In 2014, the legislature expressed its dissatisfaction with the executive director's management performance through a House Joint Resolution criticizing CUC's rate increases, among other issues. The executive director responded in a letter, which cited

CUC management's legal and fiduciary responsibility according to its mandate. Coincidentally, the executive director, who served CUC since 2012, resigned after learning that the board intended not to renew his contract set to expire in July 2015.

Conclusion and Recommendations

Almost 30 years of history has shown that CUC in its current form is barely sustainable and is obviously inefficient. What we have witnessed is a series of failures, which have ultimately required government bailouts affecting the general fund, Marianas Public Lands Trust, and the CDA, to provide for emergency generation and other operations. These bailouts enabled CUC to continue, but at a major financial cost and disruption of services.

CUC consistently operates as an unsustainable public entity, unable to recover its cost of operations and struggling to retain qualified executive officers. CUC has experienced numerous emergency declarations and executive orders by the executive branch and endured repeated modifications of laws that continually fail to address long term solutions. Additionally, CUC has survived several non-transparent attempts to privatize the production of electricity and water on Saipan, and suffered the intervention of federal authorities in its operations.

With few exceptions, CUC is one of the largest businesses in the Commonwealth. To continue to assume that a politically appointed board of directors whose members are required to have minimal qualifications and who are subject to the orders and influence of the legislature and the governor will lead the corporation to success and sustainability is to ignore the realities of CUC's financial condition and operations.

CUC's sustainability is critical to the future well-being of the Commonwealth; as such its success should not be jeopardized by political patronage and an ineffective corporate model.

Recommendation

OPA recommends the following:

The administration and the legislature promptly and diligently consider a revised corporate form for CUC. There are various proven models which could be considered to replace the current political structure of CUC:

- A. **Cooperatives.** This form calls for the election of a board of directors by the users of the utility and for any profits obtained by the cooperative to be eventually paid back to the users of the utility in the form of dividends. This model also ensures distinct roles for both the board and management. It typically has a rate structure less costly than privatized companies. A regional success story is Hawaii's Kauai electrical cooperative. This would require the sale of assets to the new cooperative. Typically, when cooperatives are chosen, a public utility commission becomes unnecessary since the utility is owned by the users who would prefer lower costs and greater efficiencies.

During our audit we noted that in 2011 a local, private group was formed to explore the concept of a cooperative in the CNMI. This included a survey performed by the National Rural Electrical Cooperative Association released in 2014, which saw the potential of this corporate structure if modified to CNMI's unique Commonwealth status. However,

neither the then governor nor CUC pursued the needed \$300,000 cost for a full study of this type of organization.

- B. **Municipal Corporation.** Somewhat similar to CUC's current legal structure, a municipal corporation allows for the direct election of the corporation's board of directors, which then hires the executive director to run the organization. This concept ensures far greater independence when dealing with debtors. Further, it reduces any external influences and encourages apolitical decision making of management. This model has enjoyed some success in Guam.
- C. **Privatization.** This would involve selling CUC's assets and transferring authority and assets to a private company. This is allowable under the current law; however, the legislative mandated value of the assets appears to be unrealistic at \$250 million.

Historically, privatization has focused solely on the generation of power, with CUC purchasing electricity from the private corporation with a guaranteed rate and minimum quantity. OPA strongly opposes this concept as it places no financial risk on the provider. At a minimum, proper privatization would involve the generation, distribution, operations, maintenance, billings, collections and customer service functions of CUC's power division. This provides both a financial risk and a reward for efficient operations.

A private firm would, as noted in CUC's original enabling legislation, require a return on investment, which would typically create a higher rate structure, unless offset by efficiencies. Unfortunately, CNMI's and CUC's track record of attracting qualified investors and conducting such transfers in a transparent and accountable manner is very uncertain. This model would also require a highly experienced and legally able public utility commission to monitor and regulate the rate structures.

Regardless of which method is determined to best suit the needs of the Commonwealth, a period of time would be needed to research, educate, and have public debate over the best model or hybrid models to adopt. Before the enactment of any legislation, specific questions regarding the actual structure of the new organization would need to be addressed. These questions include:

- What services should be transferred? Should power generation, power distribution, water and wastewater all be included, or, as in most cases, should water and wastewater remain as government services?
- Should Tinian and Rota be allowed to administer and assume responsibility for their own form of ownership and operation? If so, what services should be included?
- Depending on which model is chosen, what are the needs, roles, and responsibilities of the CPUC? What qualities should each board member possess? Would this require members with qualifications not currently possessed by persons within the CNMI?
- What specific assets and liabilities would be transferred to the new entity? What would happen if a cooperative takes over or privatization occurs? What land rights would this ownership inherit?

- In the event of a cooperative or the sale of assets, CDA's current stock holdings would need to be considered. What is its value and how would CDA be reimbursed? Could the new entity buy out the CDA stock?

Whichever model or hybrid model is chosen, for the new entity to be successful it must have the political and financial freedom to chart an independent course in conjunction with oversight from the consumer/electorate. History has clearly shown that a politically appointed board is unable or unwilling to exercise the necessary fiduciary responsibility for CUC to succeed. Financially, history has shown that CUC's best results were achieved without the presence of an active board.

CUC Response

OPA provided a draft copy of the audit report to CUC on March 17, 2017. We did not receive any comments from CUC within the stipulated 30-day response period.

Auditor Response

By law, audited entities are required to submit a response explaining whether the entity agrees or disagrees with OPA's findings. The law further states that recommendations shall be implemented unless otherwise agreed on by the Public Auditor. In this case, CUC is unable to implement the recommendation because a new corporate status requires legislative action.

OPA did not receive comments from CUC for any of the findings or the recommendation. The law requires OPA to report semiannually on the audited entity's compliance with OPA's recommendations. OPA will make contact with CUC again in June and December until the recommendation is resolved.

Appendix 1. Scope and Methodology

The scope of the audit involved a review of the Commonwealth Utilities Corporation's (CUC) legal structure, management practices, financial performance, and other relevant documents from its initial creation in 1985 to present. To achieve our objective, we performed the following:

- Gained an understanding of CUC's purpose as an independent agency by reviewing:
 - Article VII, Sections 701 through 704 of the CNMI Covenant as it relates to the "Agreement by the Special Representatives on Future United States Financial Assistance for the Northern Mariana Islands" of 1985; and
 - CUC's enabling legislation through Public Laws 4-47 and 16-17;
- Gained an understanding of the governor and legislature's constitutional authority as it affects CUC by reviewing related court decisions, legal opinions issued by the Attorney General, and other published information;
- Reviewed various executive orders and emergency declarations issued by governors and public laws affecting CUC's legal structure;
- Reviewed CUC board minutes, newspaper articles, regulations, and other related documents to gain an understanding of CUC's management practices;
- Reviewed CUC's annual financial audit reports and utility rate schedules from fiscal year 1988 to 2014 to analyze CUC's financial performance; and
- Summarized our results.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Appendix 2. CUC Response

OPA provided a draft copy of the audit report to CUC on March 17, 2017. We did not receive any comments from CUC within the stipulated 30-day response period.

Appendix 3. Status of Recommendations

No.	Recommendation	Status
1	The Administration and the legislature promptly and diligently consider a revised corporate form for CUC. There are various proven models which could be considered to replace the current political structure of CUC. OPA's recommended models are provided in detail on pages 21 to 23 of this report.	Unresolved



Commonwealth Utilities Corporation, Organizational Structure
Report No. AR-17-02, April 2017

CONSTITUTIONAL MANDATE

Article III, Section 12 of the CNMI Constitution and the Commonwealth Auditing Act (1 CMC, 2301, 7812 et. seq. of the Commonwealth Code) established the Office of the Public Auditor as an independent agency of the Commonwealth Government to audit the receipt, possession, and disbursement of public funds and to perform such other duties as required by law.

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