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RESEARCH

Summary: Bonneville Pwr Admin, OR; Utility, Wholesale Electric

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Credit Profile

US$1.02 mil proj 3 elec rev rfdg bnds (Bonneville Pwr Admin) (Taxable) ser 2006-B	AA-
Sale date: 16-MAR-2006	
US$3.31 mil Columbia Generating sta elec rev bnds (Bonneville Pwr Admin) (Taxable) ser 2006-D	AA-
Sale date: 16-MAR-2006	
US$300.815 mil proj 1 elec rev rfdg bnds (Bonneville Pwr Admin) ser 2006-A	AA-
Sale date: 16-MAR-2006	
US$432.295 mil Columbia Generating sta elec rev rfdg bnds (Bonneville Pwr Admin) ser 2006-A	AA-
Sale date: 16-MAR-2006	
US$49.085 mil Columbia Generating sta rev bnds (Bonneville Pwr Admin) ser 2006-C	AA-
Sale date: 16-MAR-2006	
US$5.59 mil Columbia Generating sta elec rev rfdg bnds (Bonneville Pwr Admin) (Taxable) ser 2006-B	AA-
Sale date: 16-MAR-2006	
US$54.53 mil proj 3 elec rev rfdg bnds (Bonneville Pwr Admin) ser 2006-A	AA-
Sale date: 16-MAR-2006	
US$9.495 mil proj 1 elec rev rfdg bnds (taxable) (Bonneville Pwr Admin) ser 2006-B	AA-
Sale date: 16-MAR-2006	

AFFIRMED	
Energy Northwest, Washington	
$165.705 mil. Energy Northwest rfdg elec rev bnds (Bonneville Pwr Admin) (AMBAC)	AAA/AA-(SPUR)
Energy Northwest, Washington	
Energy Northwest, Oregon	
$272.465 mil. Energy Northwest elec rev rfdg (Columbia) (MBIA)	AAA/AA-(SPUR)
$90.860 mil. Energy Northwest elec rev rfdg bnds (1,columbia,3) (FGIC)	AAA/AA-(SPUR)
$606.700 mil. Energy Northwest elec rev rfdg bnds (1,columbia,3) ser 2004AB&C	AA-
$332.885 mil. Energy Northwest elec rev rfdg bnds (AMBAC)	AAA/AA-(SPUR)
Eugene, Oregon	
$58.326 mil. Eugene (Bonneville Pwr Admin) (Trojan Nuclear	

Proj)	AA-
OUTLOOK:	STABLE
AFFIRMED	
Conservation and Renewable Energy Sys, Washington	
$30.320 mil. Conservation & Renewable Energy Sys (Bonneville Pwr Admin) conserv proj	AA-
Bonneville Pwr Admin, Oregon	
Energy Northwest, Oregon	
$186.600 mil. Energy Northwest (Bonneville Pwr Admin) (FSA)	AAA/AA-(SPUR)
$2.380,680 bil. Energy Northwest (Bonneville Pwr Admin) Sub Lien	AA-
Energy Northwest, Washington	
$23.105 mil. Energy Northwest (Bonneville Pwr Admin) (XL Capital Assurance Inc.)	AAA/AA-(SPUR)

Rationale

Standard & Poor's Ratings Services today assigned its 'AA-' rating to the proposed $863.3 million revenue bond issue at Energy Northwest (ENW), Wash. The $806.8 million 2006 tax-exempt series A and series B bonds will refund prior lien bonds and electric revenue bonds. The $56.5 million 2006 series C and D bonds represent new money to finance maintenance capital expenditure at Columbia Generating Station (Columbia). At the same time, Standard & Poor's affirmed its 'AA-' rating on all outstanding bonds at ENW and certain other obligations for which Bonneville Power Administration, Oregon (Bonneville) is the obligor that are junior to the ENW debt but senior to the more than $7 billion in Treasury obligations at Bonneville. The rating is not an issuer credit rating for Bonneville. Bonneville has a 'satisfactory' business profile score ('5' on Standard & Poor's 10-point scale where '1' is 'excellent').

The rating affirmation incorporates the proposed modification to the existing net billing arrangement under which Bonneville's customers have, since inception in 1970-1972, tendered their monthly payments to ENW, rather than to Bonneville. ENW has retained 100% of these payments towards its nuclear program's operating and debt service expenses and remitted customer payments to Bonneville only after all of ENW's annual costs, operating and debt service, were satisfied, usually three to four months into the fiscal year that began on July 1. This payment structure provided an added level of protection to ENW bondholders over Bonneville's underlying credit quality by effectively trapping money needed to meet debt service at ENW. This cash was somewhat akin to an escrow account and Bonneville could not access the cash even if it faced a cash flow shortfall.

Bonneville is moving to a "direct pay" arrangement with ENW. Under direct pay, customers will send cash directly to Bonneville, which will remit funds to ENW to satisfy its operating and debt service budget on a monthly basis. The migration to the new system will improve liquidity at Bonneville and will, thereby, allow it to implement a rate reduction for the 2007-2009 period.

The direct pay arrangement is viewed as removing an important structural credit support feature that protected ENW bondholders. The ongoing debt optimization program at ENW, under which debt without sinking fund requirements refunds ENW debt with sinking fund requirements, further reduces credit protection for ENW bondholders. The Sinking fund provision was less material to credit quality as long as the old net billing arrangement was in effect but would be a supporting factor under the direct pay system. Credit quality is preserved, however, because of Bonneville's decision to return to a 97.5% one-year Treasury payment probability (TPP) for rate-setting purposes, up from 92.8% under the 2003 safety-net cost recovery adjustment clause (CRAC) proposal, and its decision to set aside 30% of its liquid reserves for the transmission business line (TBL) and not consider these while setting rates for the power business line (PBL). The higher TPP target indicates higher confidence that cash flows will be sufficient to meet the ENW obligations that are paid as an operating expense and the subordinated Treasury debt obligations.

Both the TPP and TBL targets were features of the 2002-2006 rate case, but were abandoned during the several years of financial difficulty that Bonneville experienced due to the after effects of the western U.S. power crisis of 2000-01.

When direct pay is implemented, Bonneville's liquidity and cash management will become substantially more important to the rating on the ENW debt, as will the maintenance of the liquidity reserve at the TBL. The target TPP used to set rates at PBL will also be crucial and Bonneville has much lower flexibility to lower its target TPP now than under the net billing arrangement.

The 'AA-' rating also incorporates the following strengths:

- The seniority of the ENW debt with respect to more than $7 billion of Treasury debt, which ensures debt service coverage of at least 2.0x for the ENW bonds;
- A reduction in wholesale market exposure due to a balance between load and resources starting in fiscal 2007;
- Improved prospects for secondary revenues given elevated gas prices;
- A simplified rate adjustment mechanism that still provides sufficient rate flexibility at the 'AA-' rating level;
- Strong and efficient operations of the federal hydro power system; and
- A broad service territory and large number of customers that provide for protection from utility-specific credit risks and also some protection from localized economic downtrends.

Weaknesses include:

- A highly visible and politicized rate-making process;
- Exposure to volatility in wholesale power markets with more than $2 billion in net secondary revenues over the fiscal 2006-2009 period; and
- The need to secure sustainable future sources of capital

Debt service on the $6.49 billion in outstanding ENW debt is legally an operating expense of Bonneville, which results in the debt ranking senior to more than $7 billion in outstanding Treasury debt and federal obligations related to Bonneville's hydro system. This advantaged position offers bondholders the assurance of debt service coverage of at least 2.0x in every year as long as sufficient revenues are collected to meet all of Bonneville's debt obligations, including the Treasury debt. Even during the western U.S. power crisis, coverage of these obligations remained consistently above 2.0x.

Bonneville's exposure to the wholesale markets will change in a meaningful way starting in fiscal 2007. With the loss of the direct service industrial (DSI) load; a settlement with investor-owned utilities that substituted power supply for cash payments; and the expiration of the last of the high-priced supply contracts entered into in 2001, Bonneville's load and resources will be in balance at 8,000 average megawatts (aMW), under critical water conditions. But because Bonneville sets its customer rates assuming significant revenues from wholesale sales (more than $2 billion in 2006-2009) arising from runoff levels above critical water conditions, substantial wholesale exposure remains Bonneville's primary credit risk. The surge in forward power prices generated by high gas prices has partly mitigated this risk. As in most of the country, natural gas sets the marginal price of power in the Northwest. The exception is the second quarter, when hydro runoff is at its peak.

For 2007-2009, Bonneville will set rates to achieve a 97.5% probability of paying ENW and Treasury debt service under a Monte Carlo simulation involving more than 3,000 combinations of primary variables such as water flows, power prices, and load. It is important to note that the probability of meeting just ENW debt service is higher than 97.5% given the substantial amount of subordinated Treasury debt obligations. Bonneville can also legally reschedule treasury debt payments.

Bonneville's rate setting is subject to a lengthy and typically politically charged process involving a host of interested parties, including direct customers, regional economic bureaucracies, environmental agencies, and various other stakeholders. Such a process is currently underway to set rates for the 2007-2009 period and managing this dynamic remains a key credit issue for Bonneville. In fact, the current direct pay proposal is a direct result of pressure from customers to reduce rates. A final proposal is expected by July 2006 for rates that will be implemented Oct. 1, 2006. Bonneville's rate proposal is expected to include the ability to formulaically adjust rates up to $300 million each year to account for wholesale revenue shortfalls, subject to exceptions for potential fish-related issues. The formulaic nature of the adjustment reduces the risks of a public process through 2009.

Efficient operations of the federal hydro system and historically reliable operations at the Columbia generating station have given Bonneville the ability to maintain very competitive wholesale rates for its customers, currently 3 cents per kilowatt-hour (kWh). Moreover, the system's capacity of about 21,000 MW (in January, a low-flow month benchmark) spread over 206 generating units provides for tremendous operational flexibility.

Coverage of ENW debt service was a very strong 7.22x and 6.95x in 2005 and 2004, respectively. These coverage levels can be expected to decline, however, as the debt optimization program is completed by 2009 and non-federal debt service rises. Nevertheless, the ratio is expected to stay above 2.0x. Equity as a percentage of total capitalization improved to 21.5% from about 13% two years ago. Uncertainty of wholesale revenues is the single most important source of cash flow volatility and the expected net wholesale revenues exceed $2 billion from 2006 to 2009. As a risk management measure, Bonneville prudently sells some of its output forward when water flows are reasonably certain and prices are attractive. Standard & Poor's expects Bonneville to exercise its ability to adjust rates as needed to improve liquidity and maintain the target Treasury payment probability.

Liquidity

Bonneville's liquidity management substantially increases in importance with the implementation of the direct pay system and Standard & Poor's will closely monitor cash flows and liquidity reserves going forward. The reserve level at the end of fiscal 2005 (Sept. 30, 2005) stood at a comfortable $554.3 million. This reserve, coupled with a two-year $250 million Treasury note liquidity facility usually reserved for exceptionally cold weather and emergencies, provide sufficient liquidity for Bonneville's operations. Debt optimization funds from ENW could potentially be used to offset operating costs in an emergency rather than to pre-pay Treasury debt. Finally, Bonneville can also alter its federal debt maturity schedule in the event of a crisis.

Outlook

The stable outlook reflects greater confidence in current wholesale revenue projections in light of sustained high gas prices and expectations that management would adjust rates as may be required to cover cash flow shortfalls. Downside risk to the rating is clearly higher under direct pay and Bonneville's liquidity and TPP policies acquire added importance. Given the significant exposure to wholesale markets and the current lofty rating level, upside rating potential is limited.

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.