

Public Power  
New Issue

**Energy Northwest (WA)**  
Bonneville Power Administration

**Ratings**

**New Issues**

\$71,150,000 Series 2010-A Proj. 1 Elec. Rev. Rfdg. Bonds .....	AA
\$279,980,000 Series 2010-A Proj. 3 Elec. Rev. Rfdg. Bonds .....	AA
\$815,000 Series 2010-B Proj. 1 Elec. Rev. Rfdg. Bonds .....	AA
\$16,005,000 Series 2010-B Columbia Generating Stn. Elec. Rev. Rfdg. Bonds .....	AA
\$29,865,000 Series 2010-B Proj. 3 Elec. Rev. Rfdg. Bonds .....	AA
\$75,770,000 Series 2010-C Columbia Generating Stn. Elec. Rev. Rfdg. (Tax BABs) <sup>a</sup> .....	AA

**Outstanding Debt**

\$1.9 Billion Project 1 Bonds .....	AA
\$2.4 Billion Columbia Generating Station Bonds .....	AA
\$1.9 Billion Project 3 Bonds .....	AA

<sup>a</sup>Taxable Build America Bonds.

**Rating Outlook**

Positive

**Analysts**

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**Key Utility Statistics**

(Fiscal Year Ended 6/30/09)

System Type	Wholesale
No. of Members	28 (+4 since 2008)
Population Served	12,257,000
Annual Revenues (\$000)	2.87 billion
Primary Fuel Source	Hydro
ENW Debt Service Coverage (x)	2.17
Total Debt Service Coverage (x)	0.89
Days Operating Cash	261
Equity/Capitalization (%)	16

**Related Research**

- Applicable Criteria**
- *Revenue-Supported Rating Criteria, Dec. 29, 2009*
  - *Public Power Ratings Guidelines, June 11, 2009*

**Rating Rationale**

- The 'AA' rating reflects Bonneville Power Administration's (BPA) obligation to pay debt service on Energy Northwest's (ENW) nuclear project bonds.
- BPA's credit strength is supported by its regional position as the leading provider of electricity and transmission in the Pacific Northwest, with a competitive resource portfolio that provides wholesale electricity and transmission to a population of more than 12 million through its 135 public utility customers.
- The value of BPA's power supply is demonstrated by the signing of new contracts with all preference customers that now extend from 2012 to 2028.
- Favorably, BPA has adjusted its base-rate setting period down to a two-year cycle, which helps stabilize cash flow. Additionally, regulatory oversight by the Federal Energy Regulatory Commission (FERC) is designed to ensure rates are sufficient to recover BPA's total costs.
- BPA's financial performance continues to be tied to hydroelectric variability and market prices, given its reliance on secondary (surplus) sales for approximately 20% of total revenues. Reserves and rate adjustment mechanisms help to mitigate this ongoing variability, the cost implications of which are ultimately passed along to BPA's customers.
- Financial results have considerably improved since the western energy crisis, with cash reserves peaking at \$1.6 billion at fiscal year-end 2008, from just \$188 million at fiscal year-end 2002. However, reserves have since declined to \$1.3 billion at fiscal year-end 2009 and are projected to fall to \$1.09 billion by fiscal year-end 2010, due to considerably lower than projected surplus power sales.
- In 2009, the enactment of the U.S. federal stimulus legislation increased BPA's borrowing authority from the Treasury by \$3.25 billion up to \$7.7 billion. This provides significant near- and long-term relief to BPA's funding requirements related to its capital plan.
- The federal government further augmented BPA's ability to draw on lines of credit from the U.S. Treasury from \$300 million up to \$750 million, increasing BPA's days operating liquidity to 396 days for fiscal year-end 2009.
- With this refunding, ENW will be eliminating remaining variable-rate debt exposure and terminating the related interest rate swaps.

**What Could Trigger an Upgrade?**

- The credit strength of BPA is the key credit driver for ENW. It is Fitch's view that BPA is considerably better positioned, financially and operationally, than ever before. BPA's power price and volume exposure has diminished since the energy crisis in 2001, and it should continue to improve as the new power sales contracts come into effect in late 2011. Hence, Fitch is maintaining its Positive Outlook on ENW, such that if BPA can comfortably weather the current well-below-average hydrological conditions, coupled with depressed market electricity prices and sales,

**ENW's Rating History**

Rating	Action	Outlook/ Watch	Date
AA	Upgraded	Positive	3/04/09
AA-	Affirmed	Positive	3/07/08
	Outlook		
AA-	Revision	Positive	3/09/08
AA-	Affirmed	Stable	3/12/04
	Downgrad		
AA-	Stable	Stable	3/12/03
	Watch	Watch	
AA	Change	Negative	0/9/02
AA	Affirmed	Stable	3/19/02
AA	Upgrade		5/3/00
	Downgrad		
AA-	ed		8/17/95
AA	Affirmed		9/8/92

and still maintain solid financial metrics for fiscal year 2010 and beyond, ENW should be poised for a rating upgrade.

- In particular, Fitch will be monitoring BPA's ability to maintain its strong cash and liquidity position, as cash reserve balances have been rapidly declining since peaking in 2008.

**Credit Summary**

ENW (formerly known as the Washington Public Power Supply System) was created in 1957. ENW's utility membership has grown to 28 (from 24 in Fitch's last credit review and 20 since 2008) and consists of 23 public utility districts and the cities of Centralia, Port Angeles, Richland, Seattle, and Tacoma, WA. ENW owns and operates the Columbia Generating Station (CGS), the Packwood Lake Hydroelectric Project, and the Nine Mile Canyon Wind Project. ENW provides electric service to a population of more than 1.5 million in the region.

BPA utilizes the energy from CGS as part of its overall power supply portfolio (approximately 10% of capacity) and is obligated to pay debt service on the ENW bonds related to CGS, a 1,157 MW operating nuclear plant, and Project 1 and Project 3, nonoperating nuclear plants. The other projects owned by ENW (wind and hydroelectric) are separately secured and not supported by BPA.

BPA is the largest of the regional federal power marketing agencies within the Department of Energy (DOE). BPA was created by Congress in 1937 to market electric power from the Bonneville Dam. Congress has since designated BPA to market power from 31 federally owned hydro projects in the Pacific Northwest. BPA accounts for approximately 33% of the electricity consumed and 75% of the transmission infrastructure in the region. BPA's overall portfolio of resources from which it markets power is approximately 8,863 MW, as estimated under low water conditions.

**New Issue Details**

ENW is issuing approximately \$473.6 million in bonds to fund a portion of capital expenditures at CGS, refund remaining outstanding variable-rate bonds, and free up cash in the Bonneville Fund. The proposed 2010C (\$75.77 million) CGS electric revenue bonds will be issued as taxable, Build America Bonds (BABs), as authorized under the American Recovery and Reinvestment Act of February 2009. The box at the top of page 3 contains pertinent investor information regarding the taxable BABs.

These ENW bonds are issued on behalf of a specific project (CGS or the nonoperating nuclear projects, Project 1 and Project 3), and all enjoy BPA's pledge of payment if revenues from BPA's customers under the net billing agreements should be insufficient. It is important to note, BPA's debt-service payments (including the noted ENW debt) are senior to its payment obligations to the U.S. Treasury (\$2.1 billion outstanding).

Proceeds from the series 2010A and B bonds will refund outstanding variable-rate electric revenue bonds, and the series 2010C bonds will fund a portion of capital expenditures related to CGS. The 2010 bonds and parity revenue/refunding bonds are payable from amounts derived pursuant to net billing agreements with BPA, the Bonneville Fund, and revenues generated from each of the projects (CGS, nuclear Projects 1 and 3).

**Consideration for Taxable Build America Bond Investors – Public Power Bonds**

Public power utility bonds, in most cases, are unsecured debt obligations supported solely by a pledge of net revenues generated by the utility, including other legal structural protections, such as rate covenants, and debt-service reserve fund requirements. Public power utilities (municipal and electric cooperatives) are effectively owned by their customers with a mission to provide essential, reliable, relatively low-cost electric service. The average rating is 'A+', compared with their corporate counterparts' average rating of 'BBB+', with approximately 31% rated at or above 'AA-' and only 8% rated at or below 'BBB+'. A key credit factor supporting public power utilities' higher average rating is their self-regulating authority (local rate setting ability). Municipal utilities are generally not subject to state/federal regulatory oversight, as compared with corporate utilities. This regulatory autonomy provides for timely recovery of costs (operating and debt service) through electric rates and also gives public power issuers the ability to set their own financial and environmental targets. In addition, public power utilities' predominantly residential customer base provides for more stable energy sales and, in turn, more predictable financial performance. Those with below-average ratings or low investment-grade ratings generally have a limited economic base, above-average leverage, and lack of rate and/or financial flexibility.

**Energy Northwest**

ENW is a municipal corporation and joint operating agency of the state of Washington. It operates various projects, of which, only CGS and nonoperating nuclear Projects 1 and 3 are supported by direct payments from BPA.

**Management and Regulatory Oversight**

ENW is governed by a 28-member board of directors, with one board member representing each of ENW's member systems. The board of directors can authorize and terminate projects, determine the salaries of the 11 executive board members (five of which are elected from the board of directors), and elect three of the six outside members on the executive board. The remaining three executive board members are appointed by the governor of Washington State. The CEO of ENW, Vic Parrish, who was selected by the executive board, will be retiring effective July 2010. The executive board is conducting a search for a successor CEO. While Fitch will be monitoring the change in leadership at ENW, this is a credit neutral factor at the present time.

BPA's authority is vested in the secretary of energy, who appoints and acts through the BPA administrator (currently Steve Wright). The Bonneville Fund (where BPA's revenues are deposited and from which its expenditures are paid) is a separate fund within the U.S. Treasury. Congress approves BPA's budget as a component of the U.S. Treasury's budget.

BPA's rates are regulated by FERC. FERC's regulatory oversight is based on a review to ensure that BPA's rates recover costs sufficient to repay its Treasury obligations.

BPA's Treasury obligations (\$2.1 billion outstanding as of fiscal year-end 2009) are paid from net proceeds available in the Bonneville Fund after payment of operating expenditures. Payments due to the U.S. Treasury include the repayment of certain federal investments in transmission and power generation facilities; debt service on bonds issued by BPA and sold to the Treasury; repayments of expenditures incurred by the U.S. Army Corps of Engineers and the Bureau of Reclamation for costs related to the operation and maintenance of the federal hydroelectric projects; and certain costs of irrigation projects that are required to be recovered through power sales.

## Recent Developments

### 20-year Power Supply Contracts Signed

BPA's current power sales contracts with its customers expire on Sept. 30, 2011. After much deliberation and discussions with its customers to determine the terms of new long-term contracts (to begin effective Oct. 1, 2011) in December 2008, BPA signed new power sales contracts with each of its 135 preference customers for the period from 2012 to 2028 (16-year contracts).

The culmination of this process is an important credit development (and a key factor in Fitch's rating upgrade of ENW in early 2009) in that the new contracts provide a more stable source of power sales to cover BPA's fixed costs, and the contract terms are designed to reduce risk to BPA associated with meeting load growth requirements in the region. Instead, the new contracts limit BPA's role as a regional provider to the allocation of the existing federal system at cost-based rates. Importantly, BPA will not be obligated to acquire additional generation and energy to meet growth beyond what can be met through its existing resources, unless specifically requested to do so by individual members at full cost.

Also significant is the understanding that any decline in output or capacity in the federal system, including reductions resulting from operating constraints imposed by the Endangered Species Act (ESA) that could change over time, will result in a corresponding reduction in power available for sale at what are known as Tier 1 rates (see the Rates section on page 8). The new clarification of BPA's role and the tiered rates methodology are credit positives for BPA and were advocated by many of BPA's customers.

While the signed power sales contracts govern the allocation of the federal system at cost-based rates (Tier 1 rates), BPA and its customers more recently signed supplemental Tier 2 contracts. The Tier 2 contracts allow customers to purchase additional power (above the allocation of federal power at Tier 1 rates) from BPA at their option. The Tier 2 rates will reflect the true incremental cost of the additional resources acquired for only those customers that subscribe for Tier 2 power, which is expected to provide timely recovery to BPA of costs incurred and price transparency to customers between the Tier 1 and Tier 2 products. The distinction between Tier 1 and Tier 2 rates is contemplated by policymakers to address regional goals of increased renewable energy and conservation. The majority of the Tier 2 customers opted to fill approximately 80% of their incremental power needs via alternative resources/power providers. The Tiered Rates Methodology section on page 8 contains further details regarding the Tier 1 and 2 rates to be implemented in fiscal year 2012.

### Increased Federal Borrowing Capacity

BPA is authorized to sell bonds directly to the secretary of Treasury, but this authorization had been limited to \$4.45 billion. BPA had \$2.1 billion outstanding in Treasury debt at the end of fiscal 2009. The borrowing cap was a real limitation, given the gradual amortization of the existing debt and BPA's capital needs. Preserving its federal borrowing authority capacity has been an ongoing consideration in BPA's overall capital-funding plan. The recently enacted federal stimulus plan increased BPA's borrowing limit by \$3.25 billion to \$7.7 billion. This provides significant near- and medium-term relief to BPA's funding requirements related to its capital plan.

Additionally, in mid-2009, the U.S. Treasury expanded its line of credit with BPA from \$300 million to \$750 million, more than doubling BPA's access to shorter term capital and adding liquidity. While BPA's days operating cash totaled 261 days at fiscal year-end 2009, including the added liquidity from the U.S. Treasury boosts the number of days operating liquidity to 396.

### **BPA Customers — Power Sales**

The Northwest Power Act (1980) requires BPA to meet certain firm loads in the Pacific Northwest of various preference customers and regional investor-owned utilities (IOUs). Service to these customers is billed at BPA's lowest cost power rate (the preference, or PF, rate). BPA does not have an obligation to meet all firm loads within the region, nor does it have an obligation to provide service to direct-service industrial customers. BPA does have an obligation to meet any load placed on it in the region, even those of the IOUs, but at a true rate, reflecting the marginal cost of acquiring power to meet that load.

Following the western energy crisis in 2000/2001, BPA and its customers began a process in 2002 known as the "Regional Dialogue." The Regional Dialogue had two parts: the first part focused on the five-year period from 2006 to 2011, and the second part focused on the period from 2012 to 2028. The first phase of the Regional Dialogue concluded in 2005 and shaped certain decisions regarding BPA's agreements and rates. The second phase of the Regional Dialogue was completed at the end of 2008 with the signing of the Tier 1 and Tier 2 power supply contracts with BPA's preference customers for the period between 2012–2028.

#### **Preference Customers**

BPA's primary customer base is the preference power customers, which include qualified publicly owned utilities and electric cooperatives within the Northwest region. These customers take priority in terms of purchasing from BPA's federal system power resources at BPA's lower cost rate. Power supply is currently offered to preference customers through three primary products:

- **Load Following (All or Partial Requirements)** — BPA meets any and all requirements of the customer on a real-time basis. (BPA incurs the risk of balancing its resources to meet real-time demand.) In the case of partial requirements, BPA provides power that meets the net requirements beyond other owned resources of the customer. In the event of load loss, BPA will reduce the amount of power provided to the customer.
- **Block Power** — Power is provided in firm amounts per month based on a customer's load profile. Bonneville incurs the risk of firming its resources to meet its monthly block power obligations, but if a customer's load is higher or lower than its fixed block amount, BPA is not financially or operationally responsible for meeting that load.
- **Slice of the System** — The customer pays for and receives a percentage of the federal system based on critical water conditions. The customer takes the risk and receives the benefits of the variability of output of the system based on hydrology and operational performance. No customer is permitted to use the slice product for more than 50% of its overall power supply from BPA.

Under BPA's existing contracts with its preference customers through Sept. 30, 2011, approximately 22.6% is sold as slice of the system product (1,618 average annual MWs), roughly 25.8% is sold as block product (1,880 average annual MWs); and the rest is sold in the form of full or partial requirement products. In addition to the loads of its preference customers, BPA has firm contractual and transfer obligations for another 750 MW–1,050 MW through 2011.

As described earlier, BPA recently signed contracts with its preference customers for the period 2012–2028. In the new power sales contracts, BPA will continue to offer a load following product, but solely for Tier 2 customers. The other two products discussed earlier (slice and block) are maintained in the new contracts. BPA allocated



slightly more of the federal system on a slice basis. The slice product will account for approximately 25% of the output of the federal system in the contracts that begin in 2012, as compared to current contracts that account for 22.6%.

In general, Fitch views the slice product favorably, as it provides BPA greater cost insulation, particularly in low water years, as BPA does not have to provide firming power supply to its customers. Although Bonneville also foregoes the significant upside potential associated with surplus sales, greater stability in its expenses is viewed as a credit positive.

### Residential Exchange Program

The Northwest Power Act established a program (known as the Residential Exchange program [REP]) to extend the benefits of low-cost federal power to residential and small-farm customers in the region that are direct customers of IOUs. The program essentially consists of financial payments to regional IOUs that pass any cost benefit between BPA's cost of power and the IOU's average cost of power along to the IOU's residential and small-farm customers to provide approximately the same rate advantage enjoyed by preference customers of BPA.

The level of benefits provided to the six regional IOUs has been the subject of extensive debate between BPA and its preference customers and the subject of litigation since initially established in 2000. Until fiscal year 2007, BPA had been providing REP payments to the IOUs in excess of \$300 million per year, an added cost passed through to BPA's preference customers. Based on a decision by the U.S. Court of Appeals for the Ninth Circuit Court in May 2007, the REP settlement agreements with BPA were rendered invalid due to an inconsistency of the REP program with provisions of the Northwest Power Act. As a result, BPA suspended all REP payments in that year and subsequently had to estimate the past overpayment of REP benefits to the IOUs (the "lookback amount") between 2002 and 2006.

Bonneville has estimated the remaining lookback amount at \$625 million, as of fiscal year-end 2009, which was overcollected from BPA's preference customers. From an accounting standpoint, a regulatory asset and regulatory liability have been created for the lookback amount that will be repaid to preference customers through 2015 from reduced financial benefits provided to the IOUs over the same period. Fitch views this court decision and repayment requirement as credit neutral, given that it is not expected to materially affect BPA's on a net revenue basis. BPA will recognize the customer refund (lowering revenues) and reduce the residential exchange payment to IOUs (equally reducing expenses) within the same year.

BPA has since replaced the invalidated REP settlement agreements with a combination of short (2009–2011) and longer term agreements (2012–2018) with several of the region's IOUs. BPA anticipates the level of REP benefits will continue to be an issue in its rate cases. The credit impact is minimal since BPA's net revenues essentially remain the same.

### Direct Service Industrial (DSI) Customers

BPA has historically sold power, though it is not statutorily required to do so, to direct service industrial (DSI) customers in the region. These customers are predominantly energy-intensive users, such as aluminum smelters or processing facilities. In the past, DSI load was as high as 2,500 MW. However, most of the region's aluminum industry has ceased to operate. BPA currently only has contracts with two DSIs for 340.1 MW, which terminate in May 2011.

BPA's power sales to DSI customers, and the price at which those sales are made, have been the subject of litigation over the past few years. A legal decision in December

2008 determined that BPA has the authority, but not the obligation, to continue making sales to these customers. However, the ruling determined that the price charged to the DSIs was too low and, therefore, resulted in higher rates for BPA's other customers. While BPA has attempted to address this ruling by amending existing DSI contract terms, the litigation is ongoing. Fitch views the potential financial implications as something that will have a larger impact on rate equity between customer classes rather than bondholders.

### **Power Supply**

To meet its statutory obligations, BPA relies on its many generation resources and power purchases, along with its extensive transmission system. These resources are referred to as the federal system and include federal investments in regional hydro projects and transmission system. These projects were constructed and are operated by the U.S. Army Corp of Engineers or the Bureau of Reclamation. The 31 federal hydroelectric projects account for 79% of BPA's total power supply.

BPA also receives 100% of the power from ENW's CGS, pursuant to net billing agreements. CGS is a 1,157-MW nuclear plant that commenced commercial operation in December 1984. The plant is operating well, with a cumulative capacity factor of 87.1% for the past nine years. Efforts are continuing to relicense CGS for an additional 20 years, from 2023 to 2043. The final Nuclear Regulatory Commission (NRC) relicensing application was submitted on Jan. 19, 2010. The license-renewal process takes approximately 2.5 years to complete.

BPA's resource planning focuses on the need to develop sufficient energy resources to meet firm energy loads. For planning purposes, BPA uses an assumption of below 30-year average water conditions. For fiscal year 2010, BPA estimates that the total federal system will produce 8,612 MW of firm energy under low water conditions. However, the amount of energy that the federal system can produce varies on a number of conditions (weather, rain, storage conditions, fish conservation, etc.). For ratemaking and financial-planning purposes, BPA considers the additional energy that would be generated for sale under average water conditions. For 2010, the federal system is estimated to produce an additional 1,740 average annual MW, based on average water conditions. In very wet years, the surplus generated could be as high as 2,940 average MW, while in very low water years, surplus could be close to zero.

BPA expects the federal system to produce 8,452 average MW between 2010 and 2011. This is nearly sufficient to meet BPA's contractual obligations. A slight deficit (approximately 170 average MW) is estimated for 2011 (related to a scheduled outage at CGS), assuming low water conditions. BPA will likely fill that gap with supplemental generation from the federal system, if water conditions are better; market purchases; or load management/conservation efforts.

### **Environment, Fish, and Wildlife Costs**

BPA is required to protect, mitigate, and enhance fish and wildlife resources to the extent they are affected by federal hydroelectric projects on the Columbia River and its tributaries. BPA's fish and wildlife costs fall into two main categories: direct costs and operational impacts. BPA estimates that the aggregate of these direct and replacement power purchase costs totaled approximately \$602 million in fiscal year 2009 (comparable to 2008), and foregone power revenues were about \$143 million. Overall, about one-third of BPA's priority firm rate is costs related to fish and wildlife.

Operation of the federal system must be in compliance with the ESA. The National Oceanographic and Atmospheric Administration Fisheries (NOAA Fisheries) establishes a "biological opinion" that governs the operations and environmental mitigation efforts in

relation to the federal system. The biological opinion and the environmental impacts in the region are the subject of intense regional and political debate, as well as litigation. The most recent biological opinion was issued in 2008 by the NOAA Fisheries and superseded the previous 2004 opinion that had been invalidated by a court decision. The 2008 biological opinion calls for expanded improvements in fish passage and spill regimen to protect fish species on the Columbia River over the next 10 years. Expanded capital improvements required by the 2008 biological opinion are projected to cost an additional \$500 million, to be funded by BPA. In aggregate, BPA will be spending approximately \$750 million–\$850 million per year, through 2018, to protect fish and wildlife along the Columbia River and its tributaries. Legal challenges to the 2008 biological opinion are pending in Oregon courts.

Important for the credit rating is that spending related to environmental matters is included in BPA's rate to its preference customers and will be included in Tier 1 rates in the new contracts. Legal requirements for increased spending that may be imposed in the future will be included in future rate cases for full recovery from preference customers.

Escalating costs associated with environmental spending remain an ongoing credit consideration. However, the developing momentum behind carbon legislation that is likely to drive future U.S. thermal market energy prices is likely to preserve the competitive pricing of BPA's federal hydroelectric resources, even with additional environmental costs.

Lastly, while the risk of dam breaching surfaces from time to time, Fitch believes the likelihood of it occurring is presently modest. Several factors mitigate this concern: 1) hydroelectricity provides an enormous economic value to the region and it would be very costly to replace; 2) a biological opinion has not called for dam breaching since 2000; 3) in the opinion of BPA's general counsel, federal legislation would be needed to breach any of the dams; and 4) positively, in recent years, endangered fish species on the Columbia and Snake rivers have been returning in numbers not seen in 20 years.

### **Transmission**

The federal transmission system, owned and operated by BPA, is composed of approximately 15,000 circuit miles of high-voltage transmission lines and more than 300 substations that are located in Washington, Oregon, and Idaho and parts of Montana, Wyoming, and northern California. The transmission system is used to deliver federal and nonfederal power resources within the Pacific Northwest, with major interties to the south and west. The rated transfer capability of the southern intertie in the north-to-south direction is 4,800 MW of capacity and in the south-to-north direction is 3,675 MW.

BPA historically manages the federal transmission system to maintain adequate system reliability according to local, regional, and national reliability standards. In recent years, BPA has focused its transmission infrastructure additions on projects needed to interconnect new renewable sources of generation to the transmission grid. BPA operates its transmission business as a separate, self-supporting business line. Transmission rates are established independently from power rates, though they are subject to the same procedures and FERC oversight.

### **Rates**

BPA's rates are reviewed by FERC to ensure BPA's full cost recovery. FERC reviews rates from the standpoint of the ultimate creditor to make sure revenues are sufficient to meet the Treasury payment (the final payment in the flow of funds). After FERC



approval, rates may be reviewed by the U.S. Court of Appeals. Actions seeking such review must be filed within 90 days of a final FERC decision. It is important to note that FERC oversight is to ensure cost recovery for Treasury, not necessarily to protect ratepayers.

BPA has traditionally established rates for multiyear periods to provide cost stability to its customers, though it also had mechanisms within the rate structure to adjust rates more frequently if needed. Favorably, BPA has moved toward shorter rate review periods, given the cost variability in the marketplace, which should add stability to BPA's cash flow.

BPA had to reduce its preference rate in 2009 (the final year of the 2007–2009 rate period), as a result of a court decision regarding the REP, to \$26.90 per MWh. For the proposed two-year rate period (2010–2011), BPA filed its rate case with FERC in August 2009. FERC approved the slightly higher PF rate (a 7% increase to \$28.77 per MWh), on an interim basis, with final approval not likely until mid-2010. It is important to note that BPA's two-year rate-setting period does not eliminate the ability to use a shorter term rate adjustment if certain revenue criteria are met.

BPA's preference rate (for priority firm power deliveries) is very competitive for the region and the nation at \$28.77 per MWh. In most cases, BPA's preference customers maintain competitive retail rates that are below those of their investor-owned counterparts and typically below average for the broader western region. Given BPA's provision of service to so much of the region, with primarily low-cost hydroelectric resources, BPA's cost of generation is generally below the cost of other market alternatives. The cost of BPA's power, which is essentially carbon free, is expected to become even more competitive as momentum builds in individual states and the country for legislation that would require some form of a carbon tax.

### Tiered Rates Methodology

The new contracts that begin in fiscal year 2012 will include what BPA refers to as a "tiered rates methodology." This methodology will allocate the output (and cost recovery) of the federal system resources within Tier 1 rates. These rates will recover costs relating only to operation of the federal system (including fish and wildlife costs) and certain net billed projects (such as CGS, and Nuclear Projects 1 and 3). Tier 1 rates will benefit from BPA's secondary sales of energy derived from the federal system. The allocation of the federal resources to preference customers at Tier 1 rates will be based on each customer's net requirements as a percentage of all preference customers calculated at the end of fiscal 2010 (Sept. 30, 2010).

Any portion of a customer's net requirements that is not met by Tier 1 rates will be billed at Tier 2 rates (generally customer load growth requirements). The purchase of power from BPA on a Tier 2 rate will be made on a take-or-pay basis. Tier 2 rates will recover the marginal cost to BPA of acquiring resources to meet Tier 2 loads. Tier 2 rates will not receive any of the benefits attributable to the federal system, which will be contained solely in the Tier 1 rates. BPA and its customers have indicated a preference for this type of price signal in order to accurately reflect the cost of load growth in the region.

As of Nov. 1, 2009, BPA's preference customers had to commit to the amount of Tier 2 load they would need for the first three fiscal years beginning in 2012. In aggregate, the incremental load BPA will have to procure is very modest, at 20 average MWs in 2012 and increasing to 56.4 MW by 2014. Customers have elected to acquire the majority of their Tier 2 load requirements from alternative providers or develop their own resources. Customers opted to acquire much of their own load growth power needs,

given that BPA would not necessarily provide Tier 2 resources at a cost advantage to any other provider or the market. BPA anticipates developing a Tier 2 product of renewable resources to meet individual customer demands for renewable power.

The Tier 2 rate structure is favorable from a BPA credit perspective, as it passes through the risk of incremental power purchases to the customers requiring the supplemental power resources, as opposed to sharing the costs among all it's the preference customers. It also reduces BPA's exposure to the power price and volume risk associated with historically meeting these customers' load growth.

### **Financials**

BPA's finances have strengthened since the energy crisis. Reserves have improved as a result of rate increases and certain cost-cutting measures. Reserves reached a peak of more than \$1.6 billion at the end of fiscal 2008 but then declined to \$1.3 billion for fiscal year-end 2009 and are projected to fall to \$1.09 billion for fiscal year-end 2010. The primary reason for the decreasing cash reserves is the continued loss in secondary net revenues, which is attributable to the impact of consecutive low water years and economically depressed kWh sales and wholesale electricity market prices.

Despite the overall improvement in financial performance since 2001, BPA continues to face financial pressure related to lower than average hydrological conditions for the past three years and into fiscal 2010. El Niño years have historically produced very low water years, and as of early February 2010, water conditions were at just 74% of the 30 year average, well below average for this current water year.

At the same time that hydro generation levels are down, electricity market prices are being driven lower by reduced kWh sales stemming from the recessed economy. As a result, BPA's secondary (surplus) power sales were considerably down for 2009 and into the first quarter of 2010. Original budget estimates for BPA's net revenues for 2010 were at \$212 million, based on closer to average water conditions. However, due to very poor water conditions thus far, BPA has adjusted its 2010 budget estimate to a net loss of \$13 million, or a shortfall in projected net revenues of \$225 million in total. Positively, BPA has considerable cash reserves to weather this unexpectedly very dry water year and continued depressed (albeit better than last year) wholesale electricity prices. With this added loss in secondary revenues, BPA's cash reserves are currently projected to fall to \$1.089 billion by fiscal year-end 2010, from an initial projection of \$1.3 billion.

Fitch views the volatility inherent in a hydroelectric generation portfolio as a credit consideration that will likely continue to result in variability in BPA's financial performance. However, the financial impact to bondholders is considerably mitigated by various factors, many of which were implemented after the energy crisis:

- Financial projections based upon 95% Treasury payment probability, which in effect builds in extra coverage for senior-lien ENW bonds;
- BPA conservatively projects firm load needs based on critical water conditions; financial projections and rates are based on average water conditions;
- Implementation of the slice contract for a portion of the system, which passes the risks and rewards of hydrological and market price volatility directly to the customers;
- BPA has rate adjustment mechanisms that can be triggered if financial performance significantly falters;
- Healthy cash reserve levels help to offset unexpected cost increases/revenue losses;

- Deferral of all or portion of Treasury payment (approximately \$700 million per year), though BPA has not missed Treasury payment in 26 years;
- Access to \$750 million in lines of credit from the U.S. Treasury; and
- Increased Treasury long-term debt-borrowing capacity from \$4.4 billion to \$7.7 billion.

The direct-pay agreements require payment to ENW prior to BPA's payments to the Treasury. The payment of ENW debt was solid at 2.14x debt-service coverage in fiscal 2009. BPA's coverage of all its obligations from operating cash flow was not sufficient, at 0.89x coverage of total debt service (which includes ENW debt plus treasury obligations). In effect, BPA had to utilize cash reserves to adequately cover operating costs, ENW debt service, and payments on Treasury debt.

While BPA's operating cash flow is below 1.0x for 2009 and potentially for 2010, it is Fitch's view that this is a temporary tightening of financial metrics due to the historically rare combination of very dry water conditions and depressed wholesale electricity prices. Positively, BPA's latest financial projections for 2010 incorporate fairly conservative wholesale electricity prices (in the \$30–\$37 per MWh range) and lower hydroelectric generation, based on only 74% of average water conditions).

### Debt

BPA has a significant debt burden of approximately \$13 billion, consisting of the following:

- \$6.6 billion in ENW debt;
- \$2.1 billion in Treasury debt; and
- \$4.3 billion in federal appropriations repayment obligations.

BPA's leverage ratio, as measured by total debt to funds available for debt service (FADS) rose to 12.1x in fiscal year 2009 (from 9.0x in 2008), as cash flow declined due to losses in secondary net revenues and lower kWh sales to customers resulting from the economic slowdown. This compares less favorably than the 'AA' rating category median of 6.5x debt to FADS (for 2008). Positively, the increase in BPA's leverage ratio was primarily a function of a drop in cash flow (likely temporary), rather than a material increase in debt issuance. Also, the 2009 increase in BPA's federal borrowing authority provides additional debt capacity to fund BPA's ongoing capital needs.

### Capital Plan

BPA has a five-year capital plan estimated at \$3.8 billion (approximately \$800 million per year). Most of the spending will consist of transmission system improvements designed to bring new generation resources on line (particularly wind generation that is being developed in the region) and construction to relieve congestion. BPA's capital spending includes the areas of fish and wildlife, conservation and efficiency, and spending on the federal hydroelectric projects. While BPA has increased borrowing capacity from the U.S. Treasury, it is positively maintaining its existing capital program (rather than scaling it up), and it will likely replace alternative funding sources with more of the U.S. Treasury debt.

### Security Provisions

The series 2010 bonds are payable on a subordinate basis to ENW's outstanding prior-lien bonds. The prior-lien resolution was previously closed. BPA is obligated to pay debt service on the ENW bonds (prior-lien and revenue bonds) before any of its payments to the U.S. Treasury. BPA's obligations are not general obligations of the U.S. government

and are not secured by the full faith and credit of the U.S. There is no debt-service reserve account securing repayment of the 2010 bonds.

BPA receives money from the sale of power and the provision of transmission and other services at rates that are set to recover all of BPA's costs, including its required payment to the U.S. Treasury (at an assumed 95% confidence probability of making the Treasury payment). Rates are approved by FERC to be adequate for full cost recovery. Cash receipts are deposited in the Bonneville Fund, which is a separate fund within the U.S. Treasury. From this fund, BPA must first pay all costs necessary to operate and maintain the federal system, including payments on net billed bonds (i.e., ENW CGS and Projects 1 and 3). Only after these payments are made may BPA make required payments to the U.S. Treasury.

In effect, because of the subordination of the U.S. Treasury debt-service payments, BPA's coverage of debt service on ENW bonds is augmented to more than 2.0x. BPA has not deferred its payment to the U.S. Treasury since 1983.

#### **Direct-Pay Agreements vs. Net Billing Agreements**

BPA has net billing agreements with ENW that have historically required BPA's customers to pay their initial bills in each fiscal year directly to ENW until ENW's expenses related to the nonfederal projects (both operating and debt related) had been satisfied. BPA offered customers a net billing credit, and once the obligation to ENW was satisfied, customers began remitting their bills directly to BPA. This practice had been viewed as a credit strength in that the funds were sent directly to ENW and were typically collected in the first few months of the fiscal years.

In 2006, BPA and ENW entered into direct-pay agreements, which allow BPA to pay ENW directly for the nonfederal projects (CGS, Project 1, and Project 3) instead of BPA customers sending payments directly to ENW in the first few months of the fiscal year. The impact to BPA is more even revenue collections, particularly during the first few months of the fiscal year. The result has improved BPA's reserves and reduced the necessary rate impact to customers in 2007 by between 5%–10%. Fitch does not view this as a material change to the credit even though ENW collections occur over a longer period now. The rating is based on the obligation of BPA to make payments sufficient to pay the ENW debt related to the CGS, Project 1, and Project 3.

**Financial Summary – Bonneville Power Administration**

(\$000, Years Ended Sept. 30)

	2009	2008	2007	2006
<b>Cash Flow (x)</b>				
Nonfederal Project DSC <sup>a</sup>	2.17	2.94	4.28	5.08
Total DSC of Nonfederal and Treasury Obligations <sup>b</sup>	0.89	1.14	1.23	1.38
<b>Liquidity</b>				
Days Cash on Hand	261	370	287	241
Days Liquidity on Hand	396	445	287	278
Increase/(Decrease) BPA Reserves	(254,492)	(10,860)	117,525	241,875
<b>Leverage</b>				
Debt/FADS	12.1	9.0	8.9	7.8
Net Debt/FADS <sup>c</sup>	10.8	7.8	7.9	7.1
Equity/Capitalization (%)	16	17	15	13
Debt/Net Utility Plant (%)	134	137	141	145
<b>Other Ratios</b>				
Debt Service/Operating Expenses (%)	35.1	38.0	34.9	36.0
Average Wholesale Preference Rate (MIL./kWh)	26.6	27.1	27.0	28.3
<b>Balance Sheet</b>				
Unrestricted Cash	1,357,019	1,731,238	1,475,544	1,225,075
Restricted Cash	—	—	—	—
Total Cash	1,357,019	1,731,238	1,475,544	1,225,075
Total Debt	13,091,563	12,910,633	13,129,154	13,320,787
Equity or Retained Earnings	2,556,272	2,664,460	2,402,565	1,945,357
<b>Income Statement</b>				
Operating Revenues	2,870,284	3,036,618	3,268,640	3,419,369
Operating Expenses	2,251,538	2,064,312	2,231,364	2,209,136
Operating Income	618,746	972,306	1,037,276	1,210,233
Depreciation Expense	355,574	358,064	351,787	353,236
Investment Earnings	77,355	80,633	74,460	50,529
Funds Available for Debt Service	1,086,352	1,441,567	1,470,042	1,714,091
Total Annual Debt Service	1,217,907	1,262,731	1,198,469	1,240,091

DSC – Fitch calculated debt-service coverage. BPA – Bonneville Power Administration. FADS – Funds available for debt service. <sup>a</sup>Debt-service coverage of solely ENW debt obligations. <sup>b</sup>Debt-service coverage of ENW and Treasury obligations. <sup>c</sup>Net debt to FADS offsets total debt outstanding by restricted and unrestricted cash reserves.

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