FitchRatings Corporate Finance

Global Power/North America
New Issue

Energy Northwest

Bonneville Power Administration

Ratings

New Issue

$714 Million Series 2003A and B (taxable and tax-exempt) Project No. 1, Columbia Generating Station and Project No. 3 Refunding Electric Revenue Bonds ....AA–

Outstanding Debt

Security Class	Current Rating	Previous Rating	Date Changed
$5.8 Bil. Rev. Bonds	AA–	AA	3/12/03

Rating Watch..None
Rating Outlook.. Stable

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Profile

Energy Northwest (formerly Washington Public Power Supply System) owns and operates the Columbia Generating Station, previously known as Nuclear Project No. 2. BPA purchases the project power under agreement and markets the power and electricity from 30 federally-owned hydroelectric projects across its high-voltage transmission network throughout the Pacific Northwest. BPA is the largest of the regional federal power marketing agencies.

Key Credit Strengths (BPA)

- Largest provider of electricity and transmission in the Pacific Northwest.
- Energy Northwest debt paid prior to U.S. Treasury payments.
- Improved rate setting flexibility.
- Reasonably priced power.

Key Credit Concerns (BPA)

- Inconsistent financial performance.
- Volatility associated with hydroelectric-based system.
- Substantial increase in rates.
- Political uncertainty.
- Weak economy.

■ Rating Rationale

On March 12, 2003, Fitch Ratings lowered the rating on Energy Northwest's $5.8 billion outstanding electric revenue bonds to 'AA–' from 'AA' and assigned a 'AA–' rating to a proposed $714 million series 2003A and B bond offering. Energy Northwest bonds, which had previously been on a Negative Rating Watch, have been assigned a Stable Rating Outlook. The rating downgrade reflects the less than consistent and weakened financial performance of the Bonneville Power Administration (BPA), which is contractually obligated to pay debt service on the bonds. Below-normal water conditions, a decline in prices received for surplus hydroelectric energy and a softness in the regional economy have negatively affected BPA's creditworthiness. While there remains uncertainty regarding the level of BPA's financial performance, planned cost savings and rate adjustments should be beneficial. Finally, BPA's continued reliance on strategies that bolster near-term financial performance could weaken its longer term credit standing.

Factors that support the new rating include BPA's obligation to pay debt service on the Energy Northwest bonds prior to any U.S. Treasury payments (which provides good coverage protection), the importance of the agency in supplying electricity and transmission service in the Pacific Northwest and recently enacted rate adjustments. The recent implementation of the three-step, cost-adjustment program adds improved rate flexibility and reduces BPA's need to maintain larger reserve positions. Wholesale rates are forecasted to remain competitive for the region but will be above historical levels.

■ Security and New Issue Details

Energy Northwest plans to issue approximately $1.215 billion of series 2003 refunding electric revenue bonds (taxable and tax-exempt) to refund outstanding bonds related to Project No. 1, the Columbia Generating Station and Project No. 3. The 2003 bonds are secured on a subordinated basis to the prior-lien bonds from amounts derived pursuant to net billing agreements with the U.S. Department of Energy (DOE), acting by and through the administrator of BPA from net billing credits and from cash payments from the Bonneville Fund. The prior-lien resolution was previously closed. BPA's obligation to make payments continues notwithstanding suspension or termination of any of the projects. While BPA's commitment under the net billing agreements are not general obligations of the United States and are not secured by the full faith and credit of the federal government, it does come before any payments or repayments of funds to the U.S. Treasury.

Energy Northwest will issue approximately $715 million of series 2003A and B bonds as fixed-rate securities and $500 million series 2003C, D and E bonds as variable-rate demand bonds, including auction reset securities. As of Dec. 31, 2002, Energy Northwest had approximately $5.8 billion of revenue bonds outstanding. Salomon Smith Barney will act as lead manager for the fixed-rate bonds, and pricing is scheduled for March 18, 2003.

Energy Northwest

Energy Northwest is empowered by the state of Washington to finance, acquire, construct and operate facilities for the generation and transmission of electric power. It currently has 17 members, consisting of 14 public utility districts and the cities of Richland, Seattle and Tacoma, Wash. Energy Northwest owns and operates Columbia Generating Station, a nuclear generating station formerly known as Nuclear Project No. 2, with a net design rating of 1,153 megawatts (mw), the Packwood Lake Hydroelectric Project and the Nine Canyon Wind Project.

Since commencing operation, the Columbia Generating Station has operated at a capacity factor of 66.5% and is licensed to operate into 2023. In fiscal-year 2002, the capacity factor set a record for the plant at 92%. Columbia Generating Station's electricity is projected at $27.26 per megawatt-hour (mwh) during fiscal-year 2003, compared with $20.60 per mwh in 2002, due to biannual refueling occurring that year. To increase the value of the plant over time, engineers are working on a proposal to extend its 40-year operating license by 20 years, from 2023 to 2043. Approximately $4.3 million was deposited during fiscal-year 2002 in the decommissioning fund. The plan calls for regular deposits and that the station will be placed in an approximately 60-year safe storage until 2095, at which time decontamination and dismantlement will be completed.

■ Bonneville Power Administration

BPA is the largest of the regional federal power marketing agencies within the DOE. It currently markets electric power from 30 federally-owned hydroelectric projects, most of which are located in the Columbia River Basin, and from several nonfederally-owned and -operated projects, including the Columbia Generating Station. BPA sells and/or exchanges power under contracts with more than 100 utilities in the Pacific Northwest and the Pacific Southwest as well as with several industrial customers. It also owns and operates a high-voltage transmission system comprising approximately 75% of the bulk transmission capacity in the Pacific Northwest. BPA estimates that the electric power sold by it in a 300,000 square-mile service area accounts for about 45% of the electric power consumed in the region. Total population serviced approximates 10 million people.

In 1996, BPA separated its power marketing function from its transmission system operation and electric system reliability functions. BPA remains a single legal entity, but it now conducts its business as separate business lines: the power business line and the transmission business line. BPA receives moneys from the sale of power and the provision of transmission and other services at rates that seek to produce revenues that recover BPA's costs, including its required payment to the U.S. Treasury. Rates are approved by the Federal Energy Regulatory Commission (FERC). 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 the costs necessary to operate and maintain the federal system, including payments of the net billed bonds. Only after these payments are made may BPA make required annual payments to the U.S. Treasury.

BPA met its fiscal-year 2002 U.S. Treasury payment obligation of $1.056 billion in full and on time. Not since 1983 has BPA deferred such payment. In February 2003, Congress enacted and the president signed into law a $700 million increase in BPA's authority to borrow from the U.S. Treasury. The new law increases the principal amount of bonds BPA is authorized to sell to the U.S. Treasury and to have outstanding at any one time to $4.45 billion. Of this amount, $2.77 billion of bonds were outstanding as of Sept. 30, 2002.

As to other power supply agreements, BPA has had certain forward power transactions with Enron Power Marketing Incorporated, but any potential financial risks associated with these contracts for BPA appear to be manageable. BPA entered into certain power sales through the California Power Exchange, for which BPA is due payment but has not yet been paid. Other power sales transactions occurred previously with several other California entities. BPA estimates that its total exposure for sales and exchanges with these California parties, arising since Oct. 1, 2000, is approximately $90 million. Based on its current evaluation, BPA recorded provisions for uncollectible amounts, which management believes are sufficient to cover any potential exposure. In connection with the historically high power prices and volatility in West Coast power markets, FERC has initiated two separate proceedings to address whether certain power sellers charged unjust and unreasonable prices and, therefore, should refund to power purchasers any amounts overcharged. BPA is participating in both proceedings.

BPA's financial success depends on its ability to manage business and financial risks associated with its commercial operations in a changing competitive environment. Most affecting BPA is price risk associated with commodities, natural gas prices and stream flow uncertainty that, in turn, affects the predictability and stability of revenues. In this regard, BPA has adopted a hedging policy, as amended from time to time, to describe the guidelines, controls and management structure when there is a decision to hedge price and revenue risks in financial instruments. In January 2003, BPA entered into two floating- to fixed-rate interest rate swap agreements with an aggregate notional amount of $500 million. The swap agreements were entered in connection with, and are in an aggregate notional principal amount equal to, the principal amount of the series 2003C, D and E bonds. Pursuant to these swap agreements, BPA is required to make fixed-rate payments to each of two swap providers and will receive variable-rate payments from such swap providers. One of the swaps has a term of 10 years, and the other has a term of 15 years.

■ Debt-Optimization Plan

In the spring of 2000, BPA presented its debt-optimization proposal to Energy Northwest. This involved the extension of the final maturity of outstanding Columbia Generation Station refunding revenue bonds from 2012 to 2018 through a series of refunding bond issues. Implementation of the BPA proposal is intended to provide BPA with cash flexibility in funding planned capital expenditures, allow BPA to advance the amortization of its high-interest federal debt and reduce the its overall fixed costs. Energy Northwest, in response to the BPA proposal, developed its 2000 refunding plan, which its executive board formally adopted in October 2000. In September 2001, Energy Northwest adopted an updated refunding plan, including a revision that incorporated the increase in the average life of Nuclear Projects No. 1 and No. 3 net billed bonds as a refinancing program objective for any future refinancing of such bonds. An additional objective is to advance refund outstanding noncallable net billed bonds.

■ BPA Subscription Strategy

Under a power marketing approach begun in 1997, BPA proposed to subscribe access to federal system electric power under long-term contracts to its regional customers for the period after Oct. 1, 2001. Under the subscription strategy, BPA entered into long-term contracts, through which it had agreed to sell all of its available firm power to regional customers for various terms. Pursuant to the subscription strategy, the agency entered into power sales contracts directly or indirectly to provide power to meet loads of approximately 135 preference customers. With the exception of eight contracts that have terms of five years, such agreements have terms of 10 years.

Under the subscription strategy, BPA sells preference customers three basic power products: block sales, under which BPA provides 10-year fixed blocks of power at agreed times on a take-or-pay basis; slice of the system, a form or requirements service in which BPA sells a proportion of federal system output (both firm power and seasonal surplus energy) in return for a promise of the customer to pay a correlative proportion of the cost of the federal system; and partial and full-requirements products. Under these agreements, BPA is obligated to provide approximately 6,300 average mw to meet preference customer loads over the remaining term of the five-year period beginning Oct. 1, 2001. Of this amount, approximately 1,600 average mw are sold as slice of the system, approximately 1,900 average mw are in the form of block sales and the remainder is in the form of requirements products.

BPA also serves six regional investor-owned utilities. Longer term, this load is expected to account for approximately 2,200 average mw of electric power. Lastly, BPA has sold substantial amounts of federal system electrical power to direct service industries (DSIs) that smelt or fabricate aluminum. BPA has contracted to deliver approximately 1,500 average mw to these customers. Under these contracts, the DSI may curtail purchases but retains the take-or-pay requirement. BPA is currently selling almost no power to DSIs, either because BPA agreed to buy back some of its sales obligations and/or suspend some of the DSI purchase obligations or because the DSI has curtailed operations. In addition, two aluminum companies, Kaiser Aluminum and Longview Aluminum, LLC (Longview), have filed for bankruptcy protection under the federal bankruptcy laws. Longview continues to receive both power and transmission services. BPA estimates that Longview is about $17 million in arrears. In view of continued low prices for aluminum relative to the costs of production, and in particular, the price of electric power under the DSI contracts, it is possible that other aluminum companies may seek protection under the bankruptcy laws and reject their power contracts with BPA. Conversely, the loss of these loads could free up more power that could be sold to existing or new customers.

BPA had estimated that its loads for the five years beginning Oct. 1, 2001 (preexisting obligations during such period plus anticipated subscription loads), could exceed federal system generation resources. The aggregate power sales commitments initially undertaken by BPA under these agreements, together with preexisting obligations, exceeded the aggregate amount of power from federal system resources and contract purchases, which was estimated at the time to be between 8,000–9,000 average megawatts, by approximately 3,300 average mw. To meet a portion of this difference, BPA entered into a number of power purchases to augment federal system generation resources (augmentation purchases). Given the very high energy prices prevailing at the time, BPA also negotiated a number of load-reduction agreements with customers, extending through 2006. In view of the augmentation purchases and load-reduction agreements, lowered expectations regarding regional load growth and the poor outlook for the aluminum industry, BPA now believes that its firm resources, including purchases, will be roughly equal to its expected firm load obligations in fiscal-years 2004–2006, but that BPA has more firm resources than it needs for the remainder of fiscal-year 2003.

■ Electric Rates

Coincident with the development of new power sales contracts under the subscription strategy in fiscal-years 2000–2001, BPA developed new power rates for the five-year period beginning Oct. 1, 2001. Under the rate proposal, BPA offered "base rates" that are subject to three intrarate-period rate level adjustments that are triggered upon the occurrence of specified circumstances. While the base rates are low relative to the cost of most other power generation, the triggering of the adjustment mechanisms has had the effect of raising BPA's rates substantially.

Under the first of the rate adjustment mechanisms, the load-based cost recovery adjustment clause (LB-CRAC), BPA makes semiannual adjustments to rate levels tied to the direct cost of certain augmentation purchases and load-reduction agreements entered to address the increment of loads assumed by BPA under the subscription strategy. The LB-CRAC is based on periodic forecasts of BPA's subscription augmentation costs for consecutive six-month periods during the five-year rate period.

The second rate level adjustment, the financial-based cost recovery adjustment clause (FB-CRAC), provides one-year adjustments in rate levels in addition to the LB-CRAC. The FB-CRAC is intended to increase rate levels to obtain limited amounts of revenues in a fiscal year if BPA forecasts that its power business line's accumulated net revenues will be below fiscal-year threshold levels. The amount of revenues BPA can obtain under the FB-CRAC is limited to a maximum of between $90 million–$115 million per fiscal year. The proposed FB-CRAC is designed to restore, on a forecasted basis, BPA's financial reserves to fiscal year-end reserve levels (reserve targets) of $300 million in fiscal-years 2002 and 2003 and $500 million in each of fiscal-years 2004–2006.

The third rate adjustment, the safety net cost recovery adjustment clause (SN-CRAC), allows BPA to increase rate levels to recover costs if, at any time during the rate period, BPA were to forecast a 50% or greater probability of missing a scheduled payment to the U.S. Treasury or other creditor, or miss a scheduled payment to the U.S. Treasury or other creditor. Under the 2002 final power rate proposal, BPA determines the level of the SN-CRAC in a record of decision after a brief formal rate-setting process. Rate level increases under the LB-CRAC and FB-CRAC are currently in effect. BPA also has initiated actions that will lead to the formal process needed to increase rate levels under the SN-CRAC.

■ Transmission

The federal transmission system is composed of approximately 15,000 circuit miles of high-voltage transmission lines and more than 300 substations that are located in Washington, Oregon, Idaho and parts of Montana, Wyoming and northern California. A southern intertie consists of three high-voltage alternating current (AC) transmission lines and one direct current (DC) transmission line that interconnect the electrical systems of the Pacific Northwest and Pacific Southwest. The rated transfer capability of the southern intertie AC in the north-to-south direction is 4,800 mw of capacity and in the south-to-north direction is 3,675 mw. The rated transfer capability of the DC line in both directions is 3,100 mw. BPA is currently considering additional possible transmission investments to ease congestion, integrate new generation and improve reliability. Pursuant to FERC initiatives, BPA and other regional power providers are considering the creation of a regional transmission organization (RTO). The related utilities continue to work on issues raised by FERC in its September 2003 order and the remaining complex issues that need to be resolved to obtain agreement of the parties and obtain FERC approval of the proposal. BPA's current expectations are that RTO West would not begin operating transmission assets until calendar year 2006 or 2007.

■ Fish and Wildlife

Under the Northwest Power Act of 1980, BPA is directed to protect, mitigate and enhance fish and wildlife resources to the extent that 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 effects. The agency estimates that the aggregate total of direct and replacement power costs (the latter included in operational effects) totaled approximately $419 million in fiscal-year 2002. In December 2000, a new biological opinion that superseded all previous opinions was issued concerning the federal system hydroelectric dams. This opinion has been coordinated with a fish and wildlife service biological opinion issued in 2000 relating to certain other species, and they are intended to be mutually consistent. Given the complexity of these and other related issues, BPA can gauge the future costs of these programs, but it can provide no certainty as to the scope or cost of future measures to protect fish and wildlife affected by the federal system and other related parties.

■ BPA's Financial Results

Fiscal-Year 2002

While BPA reported positive net revenues of $9.5 million in fiscal-year 2002, an increase of approximately $347 million more than the $337 million loss of fiscal-year 2001, BPA estimates it had an operating loss of about $308 million in fiscal year 2002 after excluding the positive net revenue effects of extending 2002 maturities of Energy Northwest net billed program debt under the new debt-optimization program. The extra cash flow from the debt restructuring allowed BPA to prepay and amortize ahead of schedule approximately $266 million in relatively high-interest bonds issued by BPA to the U.S. Treasury and appropriated repayment obligations. The low net revenues in fiscal-year 2002 occurred despite a power rate level increase of more than 40%. The 2002 rate increase was under the LB-CRAC and incorporated two semiannual net LB-CRAC adjustments of approximately 46% and 39% of base rates.

The main reason for the low net revenues was lower than expected revenues from seasonal surplus energy sales. A substantial portion of BPA's power sales revenues (in some years up to 25% or more) is derived from the sale of seasonal surplus hydroelectric energy. BPA's rate case projections assumed that the average price it would receive in fiscal-year 2002 for seasonal surplus sales would be approximately 5.7 cents per kilowatt-hour (kwh). Rather, prevailing West Coast wholesale energy prices declined to a range between 2.0–2.5 cents per kwh. In addition, while Columbia River Basin precipitation levels returned from the historically low levels of fiscal-year 2001 to average levels, actual hydroelectric generation was below-average, primarily as a result of the effects of refilling reservoirs. As a result, BPA's discretionary power sales revenues were roughly $670 million lower in fiscal-year 2002 than in BPA's forecast. Other negative factors also occurred.

As a result of the poor financial performance in fiscal-years 2001 and 2002, BPA ended fiscal-year 2002 with financial reserves of approximately $188 million. This compared with financial reserves for fiscal years ended Sept. 30, 2000 and Sept. 30, 2001, of approximately $811 million and $625 million, respectively. BPA's reserves include cash and deferred borrowing from the U.S. Treasury.

Fiscal-Year 2003

The precipitation and snow-packed conditions in the Columbia River Basin, which to a great degree determine the amount of hydroelectric power that the federal system can produce, are at very low levels this fiscal year. Current forecasts indicate that January 2003–July 2003 runoff in the Columbia River Basin, as measured at the Dalles Dam, may be approximately 70% of average period. Therefore, BPA may have only approximately 80% of the seasonal surplus hydroelectric generation that would be expected under normal conditions. BPA now expects that its revenues from power sales for fiscal-year 2003 may be significantly less than what was forecasted in the final stages of developing the 2002 final power rate proposal.

Because of this, BPA has implemented several steps to better assure that its revenues are adequate to meet its costs through the remainder of the rate period. These include cost reductions and the triggering of the FB-CRAC rate level adjustment for all of fiscal-year 2003. This has the effect of raising average rates for those power sales and related contracts, to which the adjustment applies by approximately 11% more than base rates. BPA expects that the FB-CRAC will again be employed in fiscal-year 2004. The rate level increases under the FB-CRAC are in addition to rate level increases in effect under the LB-CRAC. BPA set the net LB-CRAC adjustment at approximately 32% of base rates for the first six months of fiscal-year 2003 and at approximately 39% of base rates for the second six-month period.

Lastly, in February 2003, BPA notified its customers that it will initiate the formal rate procedures to increase rate levels under the SN-CRAC. BPA has indicated that a rate adjustment is probably necessary and is expected to become effective on Oct. 1, 2003. The adjustment could extend for the final three years of the five-year rate period and could be approximately 15% of otherwise applicable rate levels.

BPA estimates that an SN-CRAC adjustment of 15% would increase power revenues by approximately $300 million per year. Assuming an SN-CRAC adjustment in the 15% range greater than the current base rate levels and expected rate level adjustments in fiscal-year 2004 for the FB-CRAC and LB-CRAC, BPA's average power rates would increase to 3.4 cents per kwh from 3.0 cents per kwh for the last half of fiscal-year 2003 and to approximately 3.2–3.6 cents per kwh during the first six months of fiscal-year 2004 before transmission-related charges. In total, such adjustments would exceed the rate levels in effect by more than 50% for like service in fiscal-year 2001, the year preceding the current power rate period.

Some of the cost reductions and deferrals and the commencement in October 2002 of the rate level increase under the FB-CRAC have effects in fiscal-year 2003. Based on certain BPA assumptions, the agency would have net revenues of between positive $40 million and negative $160 million in fiscal year 2003. These numbers exclude $270 million in positive net revenue effects arising from debt-management actions under the debt-optimization program.

Recognizing that BPA could have negative net revenues in the current fiscal year and in view of the low fiscal-year 2003 starting reserve balance of $188 million, BPA intends to manage its finances to assure that the fiscal-year 2003 ending reserve balance will not be lower than $100 million and $200 million. BPA is considering various financial tools for possible use to better assure adequate reserves to meet cash flow needs in early fiscal-year 2004. Under current internal forecasts of future market prices, BPA believes that its subscription power rate levels on average in fiscal-years 2003–2006, as adjusted by the various rate level adjustment mechanisms, will be at or near average market prices for such period based on a similar product.

Financial Summary — Bonneville Power Administration

($ Mil., Years Ended Sept. 30)

	1998	1999	2000	2001	2002
Income Statement					
Total Operating Revenues	2,313	2,619	3,040	4,279	3,534
Total Operating Expenses	1,986	2,140	2,465	4,116	3,172
Operating Income	327	479	575	163	362
Other Income (Expenses)	(376)	(355)	(334)	(500)	(353)
Net Income	(49)	124	241	(337)	9
Adjustments to Operating Income for D/S Coverage	833	960	881	796	565
Income Available for D/S	1,160	1,439	1,456	959	927
Non-Federal Projects Annual D/S*	545	651	561	473	230
BPA Aggregate Annual D/S Including ENW	1,108	1,212	1,104	812	769
Selected Balance Sheet Items					
Unrestricted Cash and Investments	583	685	848	667	235
Restricted Cash and Investments	—	—	—	—	—
Net Plant	15,004	14,754	14,567	14,518	14,838
Total Debt	16,355	16,101	15,817	15,280	15,162
Equity and/or Retained Earnings	(183)	(231)	(108)	132	(221)
Key Ratios					
Nonfederal Projects D/S Coverage (x)	2.13	2.21	2.60	2.03	4.03
BPA Aggregate D/S Coverage(x)	1.05	1.19	1.32	1.18	1.21
Days Cash on Hand	184.6	211.9	195.4	73.3	32.9
Operating Margin (%)	14.1	18.3	18.9	3.8	10.2
Net Margin (%)	(2.1)	4.7	7.9	(7.9)	0.3
General Fund Transfer as % of Revenues	—	—	—	—	—
Short-Term Debt/Total Debt (%)	—	—	—	—	—
Variable Debt/Total Debt (%)	—	—	—	—	—
Net Plant/Net Debt (x)	0.95	0.96	0.97	0.99	0.99
Equity/Capitalization (%)	(1.1)	(1.5)	(0.7)	0.9	(1.5)

*Includes some nonfederal project debt not associated with Energy Northwest. Source: Comprehensive Annual Financial Report. D/S – Debt service. BPA – Bonneville Power Administration. ENW – Energy Northwest. Note: Debt service coverage is calculated as financial coverage, not resolution/indenture coverage.

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