Standard & Poor's Document: March 13, 2003

Bonneville Power Administration

Energy Northwest

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Rationale

The outlook on the 'AA-' rating on Energy Northwest**'s** debt, secured by payments from the Bonneville Power Administration, is revised to negative and the rating is affirmed. The outlook revision reflects the increasing likelihood that Bonneville and its customers will decide to use cash savings provided by the debt optimization program, specifically the $315 million cash savings in fiscal year 2003 that is planned to be used for the prepayment of Treasury debt, to finance current operating expenses instead of using the money to pay down more expensive Treasury debt, as originally intended when the debt optimization plan was constructed. Financial pressures on Bonneville resulting from weak hydrology conditions and the high cost of replacement power have culminated in the deterioration of cash reserves to $188 million at the end of fiscal 2002 from $811 million at the end of fiscal 2000. Now that cash reserves have been depleted, ongoing cost pressures are prompting calls from Bonneville's customers to use debt optimization savings to offset the need for additional rate increases rather than to prepay Treasury debt, which would essentially hold the overall debt levels of Bonneville at a stable level. The decision to extend debt instead of using rate increases to cover costs through fiscals 2003-2006 is not reflective of a 'AA' category credit even with the structural advantages afforded to the Energy Northwest bonds by the net billing agreements, which allows for payment of the debt service before any and all operating expenses or other debt obligations of Bonneville.

The preservation of the 'AA-' rating will depend on successful implementation of the Safety-Net Cost Recovery Adjustment Clause (SN CRAC) in the summer of 2003, which is expected to provide additional revenues through a 16% rate increase. This rate increase, in conjunction with approximately $300 million of identified cost reductions and deferrals through fiscal 2006 and the use of cash tools such as the $250 million line of credit, should allow Bonneville to end fiscal 2003 with between $100 million and $200 million in cash reserves. In addition, Bonneville has revised its projections of revenues from wholesale power sales down by $650 million during fiscals 2003-2006, as it had been optimistic due to high projected wholesale prices that were above actual prices being achieved in the market. Although Bonneville's liquidity will remain seriously constrained in fiscal 2003 even with the achieved cost cuts, Bonneville is exploring the optional use of a $250 million federal line of credit to manage its immediate cash flow needs.

The 'AA-' rating on the Energy Northwest debt reflects the following credit strengths:

- Legal payment of the $5.9 billion in Energy Northwest (formerly the Washington Public Power Supply System) obligations as an operating expense of Bonneville through the net billing agreements, which are senior to approximately $7 billion in outstanding Treasury debt and federal obligations. This offers bondholders the assurance of over 2.0x coverage as long as sufficient revenues are collected to meet all of Bonneville's debt obligations, including the Treasury debt;

- Structural advantages offered by the net billing agreements provide that, beginning on July 1 of each year, cash to pay each Bonneville wholesale power bill is sent directly from approximately 100 Energy Northwest participants (all Bonneville customers) to Energy Northwest to pay operating expenses and debt service on the Energy Northwest debt. Only once the Energy Northwest obligations are met do participants begin sending payments to Bonneville to fund Bonneville's operating and remaining debt obligations.
- The presence of rate setting authority in Bonneville's existing contracts, including three separate Cost Recovery Adjustment Clauses (CRACs), and political support to use those CRAC mechanisms that should allow Bonneville to maintain strong debt service coverage on the Energy Northwest debt as well as meet its scheduled Treasury repayments;
- Generation rates remain reasonable and competitive at approximately 3.0-3.4 cents per kilowatt-hour (kWh) as of April 1, 2003, despite low hydrology and the high cost of replacement power. The anticipated SN CRAC increase will raise rates to between 3.2-3.6 cents/kWh as of Oct. 1, 2003;
- Successful implementation of the "Slice" product that allocates 22% of the federal system to purchasers who are obligated to pay a percentage of the system costs in return for a percentage of system output, reducing Bonneville's exposure to low water flow, although Bonneville retains full operational authority over the system. This benefit is mitigated by the increased operating and financial risk that it places on Bonneville's customers who select this product;
- Limited exposure to low water levels, currently around 70% of normal, in the 2003 water year because of Bonneville's current long position resulting from the economic recession in the region and the shutdown of approximately 1,500 MW of industrial load at the aluminum smelters. Lower water is resulting in higher market energy prices in the Northwest, which is increasing the amount of revenues Bonneville receives from wholesale sales.

Rating concerns that could prompt a downgrade include:

- The use of any debt restructuring savings to offset current operating expenses, which would constitute a deferral of the cost recovery needed into future years;
- Failure to implement an adequate SN CRAC, which is needed at 16% absent any additional cost cuts, to keep cash reserves at a minimum operating level; or
- Any "restructuring" of federal Treasury obligations, although Bonneville does have the legal flexibility to "restructure" its federal obligations at any time with minimal financial penalties.

Although Standard & Poor's Ratings Services realizes that Bonneville is under intense financial pressure and that deferring some costs into years beyond 2006, when the "augmentation costs" and the responsibility to serve approximately 1,500 MW of Direct Service Industrial (DSI) load go away, is an attractive option to customers, the use of these short-term solutions are not reflective of a 'AA' credit.

Liquidity.

As mentioned above, Bonneville's liquidity of only $188 million at the end of fiscal 2002 remains seriously constrained, and it has limited liquidity tools available--primarily the $250 million federal line of credit that is not intended to be used for ongoing operations and the anticipated $315 million in cash savings that is expected to be produced by this $1.2 billion debt restructuring. Although the use of the $315 million in 2003 provides some liquidity flexibility, its use would be at the cost of extending existing debt obligations and would be viewed as a negative credit factor. Offsetting liquidity concerns is the real ability of Bonneville to reschedule payments related to its federal obligations, which account for over half of Bonneville's $13 billion in total outstanding debt obligations.

Outlook

The negative outlook reflects concern that the stringent effects of prior rate increases coupled with ongoing revenue shortfalls have prompted Bonneville and its customers to consider solutions to its financial challenges that will avoid rate increases. The solutions under consideration, however, are not supportive of credit quality at the current rating level. Bonneville has announced its intent to trigger the SN CRAC and is proceeding with a rate case that will require final FERC approval. Ongoing revenue shortfalls from wholesale revenues, despite higher prices due to low water conditions, have prompted a discussion of reducing the probability of Treasury repayment, which was previously considered unthinkable by both Bonneville and its customers. Although no party is encouraging missing a payment to Treasury, Bonneville's decimated cash reserves, limited liquidity options, and the time lag between the implementation of the SN CRAC and the collection of the additional revenues make the non-payment of Treasury a real possibility in the next two years. The use of debt restructuring savings for current operations or any delay in the repayment of scheduled Treasury payments would prompt a rating downgrade, even though bondholders have a priority lien on revenues through the net billing agreements.