FitchRatings

FITCH RATES ENERGY NORTHWEST, WA'S ELECTRIC REV BONDS 'AA'; OUTLOOK STABLE

Fitch Ratings-Austin-28 March 2017: Fitch Ratings has assigned a 'AA' rating to the following revenue refunding bonds issued by Energy Northwest, Washington (ENW) and secured by payments from the Bonneville Power Administration (Bonneville):

--Approximately $238 million Project 1 series 2017-A&B;
--Approximately $195 million Columbia Generating Station series 2017-A&B;
--Approximately $159 million Project 3 series 2017-A&B.

The bonds are scheduled to price on April 11, 2017, via negotiation. Bond proceeds will refund outstanding debt for all three projects. Proceeds from the Columbia Generating Station bonds will also finance certain capital improvements at the project. The transaction will refinance those maturities out longer as part of ENW and Bonneville's regional cooperation debt plan.

Fitch has also affirmed the 'AA' ratings on debt issued by Port of Morrow and Lewis County Public Utility District, WA, which are similarly secured by payments from Bonneville:

--$841.8 million ENW Project 1 revenue bonds;
--$3.4 billion ENW Columbia Generating Station revenue bonds;
--$1.04 billion ENW Project 3 revenue bonds;
--$811.6 million Port of Morrow transmission facilities revenue bonds, series 2012, 2014, 2015 and 2016-1& 2016-2;
--$78.9 million Lewis County Public Utility District No. 1 Cowlitz Falls hydroelectric project revenue refunding bonds, series 2013.

Fitch has affirmed Bonneville Power Administration's implied revenue obligations at 'AA'.

The Rating Outlook on all ratings is Stable.

Fitch has withdrawn the rating on ENW's Project 3 electric revenue refunding bonds (taxable) series 2014-B as the bonds did not sell. Previous Rating: 'AA'/Outlook Stable.

SECURITY

Bonneville's payments to ENW for debt service on the bonds are unconditional and are made as an operating expense from the Bonneville Fund. These non-federal obligations are paid prior to Bonneville's payments on its borrowings from the U.S. Treasury ($4.8 billion) and federal appropriations debt ($2.9 billion).

The Port of Morrow and Lewis County Cowlitz Falls bonds are payable from Bonneville as absolute and unconditional payment obligations.

KEY RATING DRIVERS

BONNEVILLE'S OBLIGATION SECURES BONDS: The ratings on the ENW, Port of Morrow and Cowlitz Falls bonds reflect the credit quality of Bonneville and its absolute and unconditional obligation to make payments for debt service. Bonneville has pledged the Bonneville Fund, which includes revenues from its power and transmission business lines, to secure its obligation.

REGIONAL POWER AND TRANSMISSION SUPPLIER: Bonneville provides wholesale electricity to a population of more than 12 million in the Pacific Northwest region through a resource portfolio consisting primarily of low-cost hydropower. Transmission services are provided to a similar six-state region but to a broader cast of utilities. Power revenues comprise 73% of total revenues.

DECLINING CASH RESERVES: Bonneville's cash reserves fluctuate given its hydroelectric power supply and the resulting volatility in wholesale energy sales. However, after a $243 million reduction in fiscal 2016, unrestricted cash reserves are at their lowest level since 2007, which is a concern even with the $750 million federal line of credit that provides additional liquidity. Initial results year to date in fiscal 2017 indicate further declines in cash reserves are likely.

RATE INCREASES EXPECTED: Fitch expects power rates will be increased in fiscal 2018 in order to reverse the negative cash trend and include the gradual pursuit of 90 day target financial reserves. The initial 2018-2019 power rate projection of 3.5% could increase prior to final adoption due to revenue pressures and declining reserves. Fiscal 2018 power rates may also include enactment of the cost recovery adjustment clause to restore minimal cash levels.

MEDIUM-TERM POWER SALES CONTRACTS: Bonneville sells net requirements power through power sales contracts, the majority of which are take-and-pay, that recover cost of service from 125 preference customers and federal agencies. However, the contracts expire in 2028 and customers are not obligated to continue to purchase power from Bonneville if new contracts are not signed. Bonneville's ability to offer competitively priced power supply and extend its contracts beyond 2028 will be a key credit factor.

CAPITAL NEEDS KEEP LEVERAGE HIGH: Debt levels are high with Debt/FADS (funds available for debt service) of 11.7x. Planned capital spending to fund aging generation infrastructure and transmission investment in the region are sizable at $4.3 billion over the next five years. Bonneville's overall leverage is expected to remain elevated as a result.

RATING SENSITIVITIES

FAILURE TO REVERSE CASH DECLINES: The failure of Bonneville Power Administration to adopt sufficient rate increases to reverse the decline in cash reserves, given the magnitude of variation in revenues that occurs within the power business line, would result in downward rating pressure.

CREDIT PROFILE

ENW, formerly known as the Washington Public Power Supply System, was created in 1957. ENW has 27 members, consisting of 22 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 Canyon Wind Project. ENW also has financial responsibility for Projects 1 and 3, its terminated nuclear projects.

Bonneville is the largest of the regional federal power marketing agencies within the Department of Energy. Bonneville accounts for approximately 33% of the electricity consumed and 75% of the transmission infrastructure in the region. The majority of Bonneville's revenues are provided by power operations. Transmission revenues accounted for approximately 27% of operating revenues in fiscals 2016.

In recent years the competitive margin between Bonneville's power rates and market alternatives has compressed due to very low natural gas prices, increased generation from renewables, declining energy demands in the region and increasing costs at Bonneville. Bonneville's current power supply contracts expire in 2028. Fitch expects Bonneville to engage in a multi-year process with customers well prior to 2028 to negotiate the next power supply contracts. Most of Bonneville's 125 preference customers receive all of their power supply from Bonneville.

SUFFICIENT POWER SUPPLIES; RELIANCE ON NET SECONDARY REVENUES

Bonneville is statutorily required to provide power to preference customers in the region. Bonneville currently makes power sales to preference customers under contracts that expire in 2028. The contracts limit Bonneville's role to the allocation of the existing federal system (predominantly hydro-electric generation but including CGS) at cost-based (Tier 1) rates, which include environmental costs related to the federal assets. Preference customers can request Bonneville to supply additional power needs above their Tier 1 allocation from the federal system, but the energy is provided at Bonneville's actual costs to secure the power.

For operational planning purposes, Bonneville uses an assumption of water conditions below the 30-year average, referred to as critical water. Bonneville estimates its available generation resources will provide 8,135 annual average megawatts (aMW; an annual average megawatt is equal to 8,760 megawatt-hours) of firm energy under low (or critical) water conditions in 2018. This represents the amount of firm energy (Tier 1) Bonneville plans to have available to divide among its customers, with an estimated demand in 2018 of 7,671 aMW (88% of which is for preference customers). Bonneville's other power sales include small amounts to federal agencies in the region and direct service industrial customers. Power supply in excess of amounts sold to customers is sold into the market.

For ratemaking and financial planning purposes, Bonneville considers the additional energy production available for sale under 'average' water conditions. The federal system is expected to provide 1,891 aMW in 2018 in secondary sales, based on average water conditions. This production in excess of estimated demand is assumed to be sold at forward market prices with revenues used to supplement sales to preference customers. These wholesale sales, netted against market purchases made by Bonneville during certain months of the year to shape the output of the federal system, compose net secondary system revenues. Net secondary revenues have been lower than projected in five of the last seven years due to below average water conditions in certain years and depressed market energy prices.

RESERVE VARIABILITY; DECLINES IN FISCALS 2016 AND 2017

Bonneville's sizable hydro-electric generation fleet requires market sales in some months and market purchases in other months to balance the load demands with actual output of the federal system. Bonneville's risk of revenue variability is managed through its cash reserves.

At the end of fiscal 2015, Bonneville had $845 million in unencumbered reserves, which when combined with its $750 million federal line of credit provided healthy liquidity. Reserves available for risk declined by $243 million to $602 million at the end of fiscal 2016. Bonneville estimates that reserves available for risk could decline another $207 million to $395 million at the end of fiscal 2017. Given the low cash reserves likely at year end and the magnitude of potential declines of $200-$250 million that are possible in a one-year period, downward credit rating action could occur if this trend is not reversed in fiscal 2018. While the line of credit provides short-term borrowing liquidity, it is not designed to compensate for Bonneville's inherent power revenue variability.

Bonneville does not currently have a cash reserve policy other than a cost recovery adjustment mechanism that will trigger only after power business line cash reserves have declined to below zero. Bonneville has proposed a financial reserve policy in its initial 2018-2019 rate proposal.

If approved the policy would establish a target of 90 days cash on hand cash reserves for both the power and transmission business lines, respectively. However, the funding to the target, as proposed, would be phased in over 10 years with a 3% rate pressure limit.

RATE PROPOSAL IN PROGRESS

Bonneville last raised its power rates 7.l% and transmission rates 4.4% on Oct. 1, 2015. The 2018-2019 initial rate proposal estimates a 3.5% rate increase for Tier 1 power rates and a 1.1% increase for transmission rates. However, this power rate increase does not include the CRAC, which could also be triggered in 2018 based on fiscal 2017 operations and low reserve levels. Revenue and cost assumption changes could increase the proposed initial 3.5% power rate increase. Final rates are expected to be announced in July 2017 for implementation on Oct. 1, 2017, the beginning of the 2018 fiscal year. Fitch expects that rate action will reverse declining cash reserve levels.

LARGE CAPITAL INVESTMENTS NEEDED

As with many utilities across the county, Bonneville faces aging infrastructure and delayed capital reinvestment. Capital needs over the next five years are estimated at $4.3 billion, with 58% of the spending (around $2.6 billion) occurring in the transmission business line. These amounts do not include approximately $973 million that ENW estimates will be needed at CGS through 2026. Capital needs will continue to place upward pressure on Bonneville's rates.

Bonneville and its customers face the challenge of funding upgrades and improvements to the valuable fleet of aging hydroelectric facilities. Although the assets are owned by the Bureau of Reclamation and U.S. Army Corps of Engineers, Bonneville makes the decisions regarding the pace and scope of capital reinvestment. Bonneville does not have authority to issue its own debt and has a statutory debt limit with the U.S. Federal Treasury of $7.7 billion ($4.8 million outstanding at year-end fiscal 2016), making capital funding decisions complex. The Port of Morrow or similar lease financing structures provide financing for transmission assets while the regional cooperation debt strategy frees up ongoing treasury capacity as non-federal debt is extended.

REGIONAL COOPERATION DEBT

Bonneville and ENW have agreed to a regional cooperation debt plan that extends the maturity of outstanding ENW debt (CGS and projects 1&3) and uses the revenues made available from lower debt service costs on those projects to prepay higher interest rate debt to the U.S. Treasury. Debt for projects 1&3 is being extended to 2028 and debt for CGS is being extended as far out as 2044. The project operating license expires in December 2043. While this plan effectively accelerates payment of Bonneville's subordinate lien obligations by extending the senior ENW bond maturity, it makes available federal borrowing capacity and provides economic benefit to preference customers, who are the ultimate ratepayers that repay both types of debt. Even with the extensions, only 15% of Bonneville's non-federal debt matures after 2028, when existing power contracts terminate.

RATING NOT BASED ON DIRECT FEDERAL SUPPORT

Fitch's implied rating on Bonneville reflects the credit quality of Bonneville as a self-supporting entity. Bonneville's subordinate obligations to the U.S. Treasury offer a layer of structural support to the Port of Morrow, Lewis County PUD and ENW bonds (non-federal debt), in that Bonneville must defer payment to the Treasury if it has insufficient funds to meet its non-federal debt. This provision provides payment flexibility, but Fitch's rating reflects the expected timely repayment on all Bonneville's obligations.

A linkage with the federal government exists in governance by the DOE, DOE Secretary appointment of the Bonneville Administrator, discretionary congressional review of Bonneville's budget, and the banking and lending relationship with Treasury. Bonneville is in compliance with the federal directive to freeze hiring for 90 days and dovetails with Bonneville's strategic initiative already in process to curtail workforce spending. Recent federal discussions regarding curtailment of federal agency budgets are not expected to materially impact Bonneville. Bonneville's budget is not discretionary and not tax-funded, removing any estimated tax revenue benefit provided by a potential curtailment of Bonneville's budget.

For additional information, see Fitch's report, 'Energy Northwest, WA and Bonneville Power Administration, OR', dated March 17, 2016.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/site/re/750012
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/site/re/864007