FITCH AFFIRMS ENERGY NORTHWEST, WA'S WIND PROJECT REV BONDS AT 'A-'; OUTLOOK TO POSITIVE

Fitch Ratings-San Francisco-09 November 2018: Fitch Ratings has affirmed the following Energy Northwest wind project revenue bonds at 'A-':

--Approximately $78.5 million nine canyon wind project revenue and refunding bonds series 2012, 2014 and 2015.

The Rating Outlook is revised to Positive from Stable.

SECURITY

Bonds are secured by a net revenue pledge of the entire nine canyon wind project, which consists of three phases. However, each phase (and bond series) is separately secured by a unique group of municipal power purchasers, although certain purchasers are involved in multiple phases.

KEY RATING DRIVERS

PURCHASER CREDIT QUALITY: The Positive Outlook reflects changes in the credit quality of the largest project participants across the entire project, given the collective payment of project operating and maintenance costs prior to the payment of debt service. The largest participants include: Douglas County public utility district (PUD), Grays Harbor County PUD (A/Negative), Franklin County PUD, Grant County PUD (AA/Stable), and Okanogan PUD.

UNCONDITIONAL TAKE-OR-PAY CONTRACTS: The wind project bonds are secured by payments made pursuant to absolute and unconditional take-or-pay power purchase agreements (PPAs) with 10 Washington-based public utility districts. The PPAs extend for the life of the bonds.

STEP-UP PROVISION: The 25% step-up provision applies only to each of the respective phases of the project and participants within that project. The step-up provides protection to bondholders from a default by one of more project participants that account for 20% or less of the project phase.

CREDIT RISK ACROSS PROJECT: Fitch rates all three series of bonds the same despite the different mix of project participants. Bonds are secured by a pledge of net revenues of the project, which places project participants at risk in the event of non-payment of operating expenses by participants not involved in their separate phase of the project.

ROBUST RESERVES; MODEST MARGINS: Robust reserves, equal to $13.2 million or 799 days cash, help to mitigate the risk of operating costs that would not be fully recovered by the step-up in the event of a default by project participants with a share of any project greater than 20%. Financial margins are typical for a joint action agency project, with Fitch calculated debt service coverage of 1.06x in fiscal year 2018.

RATING SENSITIVITIES

CHANGE IN COUNTERPARTY RATINGS: The long-term rating of the Energy Northwest (ENW) nine canyon wind project bonds will continue to be determined by Fitch's assessment of the credit quality of the purchasing municipal utilities and the magnitude of their obligations. Therefore, material shifts in the rating or credit quality of purchasing utilities below the current rating on the bonds could result in a downgrade. Conversely, shifts in the rating or credit quality of all of the utilities above the current rating on the bonds would result in an upgrade.

CREDIT PROFILE

The Nine Canyon Wind Project was developed by ENW to provide renewable energy to 10 public utility districts in the state of Washington. The project consists of 63 wind turbines totaling 95.9 MW of capacity that were completed in three phases between 2002 and 2008. The turbines are located in Benton County, WA on land that is leased beyond the final repayment of the bonds. Production has been healthy with an average capacity factor of 28% over the last five fiscal years.

UNCONDITIONAL CONTRACTUAL COMMITMENT AND STEP-UP PROVISIONS

The rating on the bonds reflects the security provisions of the long-term PPAs between ENW and each project participant that extend through the life of the bonds. The PPAs for each phase are unconditional. As such, they obligate the purchasers to pay their portion of the debt service regardless of the operational status of any of phases that make up the project. To mitigate participant default risk, the transaction includes a step-up provision (25%) for fixed and variable costs. The bonds are not secured by an ownership interest in the wind turbines.

The PPAs define specific events that allow for the project to be terminated in the event of large cost increases (payment cap) or failure of the project to operate for over one year and agreement by the majority of the project participants to terminate. However, purchasers remain obligated to pay debt service in the event of project termination.

SOLID CREDIT QUALITY OF PARTICIPANTS

The current rating broadly reflects the credit quality of the largest participants. The power purchasers and their overall shares of the Wind System projects in aggregate are as follows:

--Grays Harbor County PUD No. 1 (20.9%; A/Negative);
--Okanogan County PUD No. 1 (16.6%; not rated);
--Grant County PUD No. 2 (12.5%; AA/Stable);
--Franklin County PUD No. 1 (10.5%; not rated);
--Douglas County PUD No. 1 (10.2%; not rated);
--Benton County PUD No. 1 (9.4%; A+/Stable);
--Chelan County PUD No. 1 (8.3%; AA+/Stable);
--Lewis County PUD No. 1 (6.3%; not rated);
--Mason County PUD No. 3 (3.2%; not rated);
--Cowlitz County PUD No. 1 (2.1%; A/Stable).

CREDIT RISK ACROSS PROJECTS

ENW receives revenues from the project participants in accordance with the PPAs that obligate each purchaser for only its share of debt service and operating costs for the phases of the project in which it participates. In the example of Phase III debt service, Okanogan PUD does not pay debt service related to the series 2015 bonds since it is not a participant in Phase III. Operating costs of the project are spread across the three phases.

However, all bondholders have exposure to project participants over 20% of any of the three phases, which includes: Okanogan PUD, Grant PUD, Douglas PUD, Grays Harbor PUD, and Franklin PUD. Given the net revenue pledge that secures bondholders, project participants are subject to the risk in the event of non-payment of operating expenses by participants not involved in their respective phase of the project.

ENW's robust liquidity could mitigate the immediate shortage in revenues to coverage operating and maintenance costs in the event of a participant default. Nonetheless, Fitch rates each phase with one common rating, given the net revenue pledge and risk across phases of a shortfall in operating and maintenance expenses that could necessitate the use of project reserves.

HEALTHY PROJECT OPERATIONS; AVERAGE COST ABOVE MARKET

Generation output at the wind project has been healthy since completion. Availability of the project was 99.1% in fiscal 2018. Production costs remain higher than originally anticipated reflecting the loss of federal renewable energy production incentive payments after fiscal 2010. A strong capacity factor of 31.0% in fiscal 2018 resulted in the lowest average cost per kWh to date for the project of 5.92 cents/kWh.

While project costs of between six and eight cents/kWh are above current energy prices in the region, participants are obligated to pay project costs regardless of operations and market alternatives. The project does, however, provide additional value to certain purchasers given its renewable status. Overall costs are expected to remain level while cost per kWh will vary with annual wind conditions.

ROBUST LIQUIDITY; MODEST DEBT SERVICE COVERAGE

ENW operates the project on a cost basis, collecting rates that are sufficient to pay costs (including debt service). Given very strong cash reserves at the project, it has been ENW's intention to use modest amounts of this cash to pay a portion of costs. Successful cost management has allowed the delay of the planned spend down of reserves. At fiscal year-end 2018, unrestricted cash totaled approximately $13.2 million, or 799 days operating cash.

In fiscal 2018, Fitch calculated debt service coverage was 1.06x. Coverage remained steady despite a 3% rate decrease which was largely driven by savings from both debt refinancing efforts and cost reduction measures. Outstanding debt totaled $22.3 million for Phase I (series 2014), $7.1 million for Phase II (series 2012), and $49.1 million for Phase III (series 2015). The Phase I and II debt matures in 2023 while the Phase III debt matures in 2030. Debt levels continue to exceed the net value of the project, resulting in negative equity levels. This is common for single asset public finance projects financed entirely with debt.

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Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/site/re/864007