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

Fitch Ratings-Austin-01 May 2018: Fitch Ratings has assigned a 'AA' rating to the following electric revenue refunding bonds issued by Energy Northwest, Washington (ENW) and secured by payments from the Bonneville Power Administration (Bonneville):

--Approximately $234 million Columbia Generating Station electric revenue refunding bonds, series 2018-C and taxable series 2018-D;
--Approximately $404 million Project 3 electric revenue refunding bonds, series 2018-C and taxable series 2018-D.

The bonds are scheduled to price on May 9, 2018, via negotiation. Bond proceeds will refund or pay at maturity certain debt obligations and pay costs of issuance.

Fitch has also affirmed the 'AA' ratings on the following bonds, which are similarly secured by parity payments from Bonneville:

--$795.6 million ENW Project 1 revenue bonds;
--$3.5 billion ENW Columbia Generating Station revenue bonds;
--$993.7 million ENW Project 3 revenue bonds (pre-refunding);
--$200.7 million Idaho Energy Resources Authority transmission facilities revenue bonds, series 2017;
--$811.6 million Port of Morrow transmission facilities revenue bonds, series 2012, 2014, 2015 and 2016-1 and 2016-2;
--$75.6 million Lewis County Public Utility District No. 1 Cowlitz Falls hydroelectric project revenue refunding bonds, series 2013.

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

The Rating Outlook on all of the ratings is Negative.

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.

The Idaho Energy Resources Authority and Port of Morrow bonds are payable from lease payments to the respective issuers made by Bonneville as absolute and unconditional payment obligations. Bonneville's lease payments are made as an operating expense from the Bonneville Fund and are on parity with payments to ENW and Lewis County Public Utility District No. 1.

All of the above non-federal obligations are paid prior to Bonneville's payments on its borrowings from the U.S. Treasury ($5.0 billion) and federal appropriations debt ($2.0 billion).

KEY RATING DRIVERS

DECLINING POWER RESERVES: Cash balance continues to decline in the power business line. The relatively moderate 5.4% power rate increase implemented Oct. 1, 2017 reflects increasing competitive pressures at Bonneville and results in a slow reserve replenishment trajectory. The combined impact of these trends, coupled with Bonneville's high leverage position, could result in a rating downgrade, as indicated by the Negative Outlook.

BONNEVILLE'S OBLIGATION SECURES BONDS: The ratings reflect the credit quality of Bonneville and its absolute and unconditional obligation to make payments for debt service. Bonneville's pledged revenues include its power (73% of revenues in fiscal 2017) and transmission (27%) business lines.

REGIONAL POWER AND TRANSMISSION SUPPLIER: Bonneville provides wholesale power to a population of more than 14 million in the Pacific Northwest through a resource portfolio consisting of low-cost hydropower and nuclear generation. Transmission services are provided to a similar six-state region but to a broader cast of utilities.

MEDIUM-TERM POWER SALES CONTRACTS: Bonneville sells wholesale power through take-and-pay power sales contracts with 125 preference customers and federal agencies that expire in 2028. Bonneville's ability to offer competitively priced power supply services will be a key factor during the extension of its power sales contracts.

HYDROELECTRIC DOMINANT POWER SUPPLY: Power supply needs are met through a fleet of 31 hydroelectric projects and one nuclear project. Bonneville's predominantly hydroelectric generation portfolio results in hydrology risk and a variable energy supply. Low market energy prices in the region are placing competitive pressure on Bonneville to keep rate increases as low as possible and have driven wholesale energy revenues lower.

HIGH LEVERAGE: Leverage is high with debt/FADS (funds available for debt service) of 11.0x in fiscal 2017, as compared to the category median of 5.3x, and is expected to remain elevated. Planned capital spending is manageable but reflects the assumed debt financing of all planned capital spending, providing no financial flexibility in the form of rate-funded capital. Bonneville is initiating discussions to design a debt policy that may introduce some level of revenue funding for capital.

RATING SENSITIVITIES

FAILURE TO RESTORE CASH LEVELS: The Negative Outlook reflects the cumulative pressure of declining cash reserve levels combined with Bonneville Power Administration's high debt burden, rate pressures and the financial variability of net secondary revenues for a hydroelectric utility. Failure to implement policies that improve reserve levels on a sustained basis, given the high leverage profile, could prompt a rating downgrade in the near term.

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 key power and transmission agency in the Pacific Northwest, and its role in the region is critical. Bonneville's estimated service area includes 14 million people, and extends across Idaho, Oregon, Washington, and portions of Montana, Wyoming, Nevada, Utah, and California. Bonneville's system accounts for approximately 28% of the electricity sold in the region and 75% of the transmission infrastructure. The majority of revenue is provided by power operations.

NEGATIVE OUTLOOK

Cash reserves play a key role in managing aspects of Bonneville's sizable hydroelectric generation fleet. In addition, robust cash levels could provide financial flexibility in light of Bonneville's high debt levels and increasing competitive pressures from low-cost energy in the region. However, power business lines declined from $395 million at the end of fiscal 2015 to $105 million at the end of fiscal 2017.

The trajectory and pace of the reserve declines prompted Fitch to revise the Outlook to Negative on Aug. 25, 2017. Bonneville's power business line reserves for risk declined sharply in fiscals 2016 and 2017 due to weaker than anticipated wholesale revenues, declines in preference customer and industrial customer firm loads, and regional pressure to keep rates low in order to remain competitive with market alternatives post-2028.

Second-quarter projections released on April 27, 2018 indicate that power reserve levels could end fiscal 2018 at around $46. While this is an improvement over both the first-quarter indication that power reserve levels could fall below $0 and the rate case indication of power reserves at $28 million at the end of fiscal 2018, it highlights the volatility of Bonneville's reserve levels. The variability from one quarter to the next supports the need for Bonneville to build stronger reserves. Downward rating action is likely if structurally stronger and consistent reserve funding is not enacted.

FINANCIAL RESERVE POLICY

As part of the 2018 final rate proposal, Bonneville adopted a financial reserve policy. The policy established a minimum threshold of 60 days reserves for risk at each business line, or $300 million for power and $100 million for transmission. The final power rate increase included funding of $20 million per year until the minimum $300 million threshold is reached (the $20 million accounts for 1% rate increase out of the total 5.4%). Transmission reserves are above the threshold.

The decision to fund the power reserve at this slow pace tempers its value, in Fitch's opinion, until Bonneville is in adherence with the reserve policy. However, Bonneville is going through a process with its stakeholders to consider strengthening its financial reserve policy. Decisions are expected in calendar 2018 regarding a faster pace of reserve funding to reach the $300 million target and a stronger cost recovery adjustment clause (CRAC) that would allow for recovery of reserves above the $0 current threshold. A structural policy change, particularly to the CRAC threshold to protect reserves once accumulated, has the potential to stabilize the rating.

COMPETITIVE PRESSURES ON POWER BUSINESS LINE

Bonneville sells energy produced from 31 hydroelectric plants owned and operated by the U.S. Army Corps of Engineers or the U.S. Bureau of Reclamation. Bonneville has direct-funding agreements with both agencies to pay operating and capex. The direct funding of capital improvements allows Bonneville to direct decision making and prioritization of reinvestment in the hydroelectric fleet. Bonneville also markets energy from nonfederal projects, the largest of which is CGS. CGS is a 1,174 MW nuclear plant (approximately 10% of Bonneville's total power supply).

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.

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 and 3) and uses the revenues made available from not paying debt service costs on those projects to prepay, dollar for dollar, higher interest rate debt to the U.S. Treasury. Debt for projects 1 and 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 16% 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 Idaho Energy Resources Authority, 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 Department of Energy (DOE), DOE Secretary appointment of the Bonneville administrator, discretionary Congressional review of Bonneville's budget, and the banking and lending relationship with Treasury. 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.

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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