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AUTH. NAME AUTHOR AFFILIATION
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MAZUR, D. W. Washington Public Power Supply System
HALVORSON, C. M. Washington Public Power Supply System
RECIP. NAME RECIPIENT AFFILIATION

DENTON, H. R. Office of Nuclear Reactor Regulation, Director (post 851125

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Washington Public Power Supply System
P.O. Box 968 3000 George Washington Way Richland, Washington 99352 (509) 372-5000

Docket Nos: 50-460 - G01-86-0042
50-397 - G02-86-171
50-508 - G03-86-119

February 25, 1986

Mr. Harold R. Denton, Director
Office of Nuclear Reactor Regulation
U. S. Nuclear Regulatory Commission
Washington, D. C. 20555

Dear Mr. Denton:

Subject: NUCLEAR PROJECTS NO. 1, 2 and 3
ANNUAL FINANCIAL REPORT

Enclosed for your information, as required by 10CFR 50.71, are three (3) copies of the Washington Public Power Supply System's 1985 Annual Report. The financial statements of the Supply System's Nuclear Projects are not certified by our auditor (Ernst and Whinney) in view of certain facts discussed in the Annual Report, with which the Nuclear Regulatory Commission is already familiar.

Very truly yours,

G C. Sorensen, Manager
Regulatory Programs

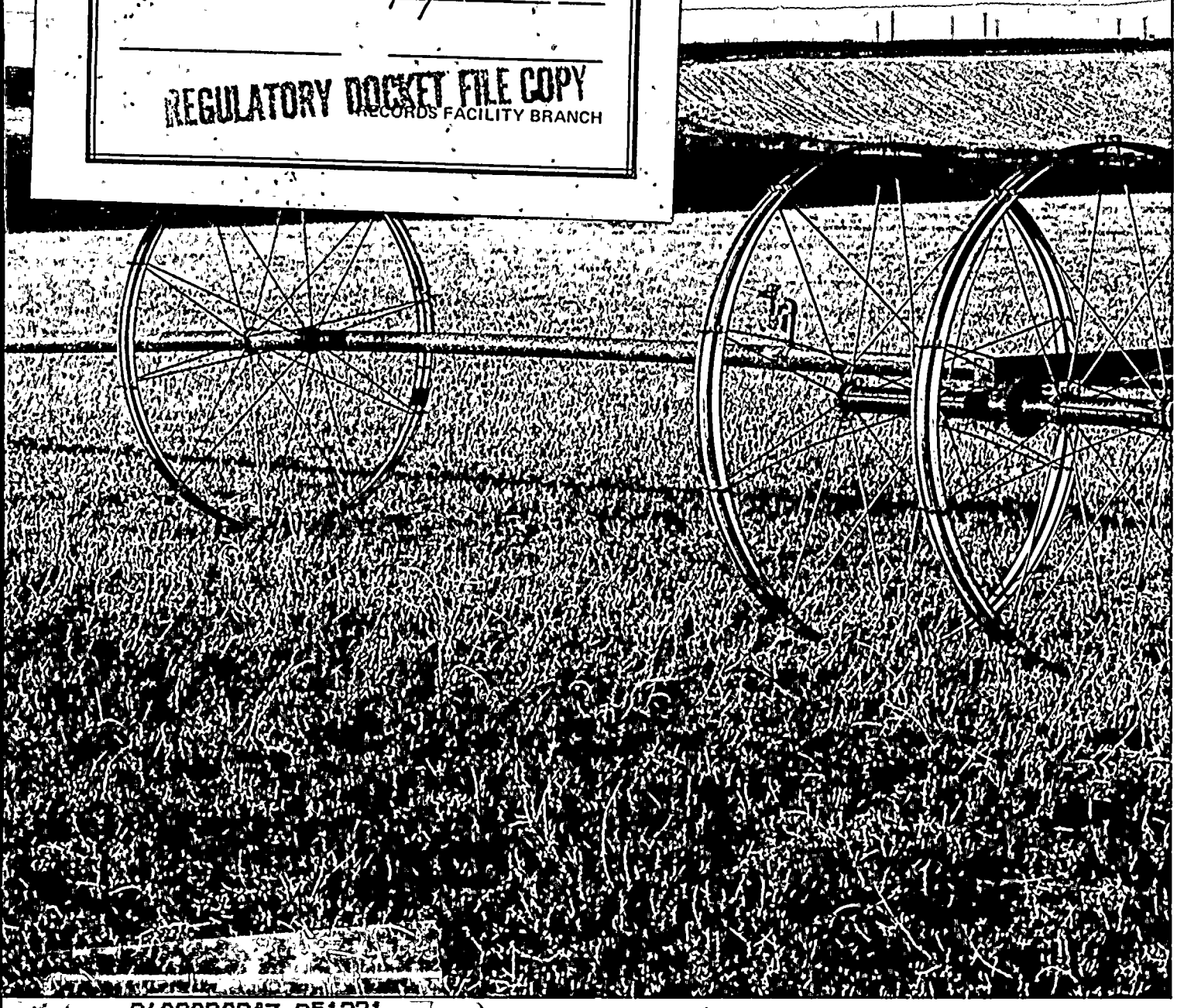
Enclosures

cc: JO Bradfute/NRC
T. Michaels/NRC
RM Boucher/PP&L*
RV Myers/PSP&L*
JR Lewis/BPA*
G. Dick/NRC
NS Reynolds/BLCPR
WL Bryan/WWP*
BD Withers/PG&E*

*Without attachment/copy being sent under separate cover

M004
1/3

1985 Annual Report



On the cover:

Water vapor rises from the cooling towers at the Washington Public Power Supply System's Plant 2 at Hanford. The 1,100-megawatt nuclear power plant sits amid the agricultural environment of Washington State's Columbia Basin, where abundant water and inexpensive electricity have transformed millions of acres of this arid region into productive farmland.

Following completion of the 1985 Annual Report, the U.S. Supreme Court on Jan. 13, 1986 issued an order upholding the validity of the net-billing agreements with the Bonneville Power Administration on Nuclear Projects No.'s 1, 2, and 3.

The order denied a Writ of Certiorari in *DeFazio vs. Washington Public Power Supply System* and finalizes the 9th U.S. Circuit Court of Appeals decision of Feb. 4, 1985 and affirms the May 16, 1983 judgement of the U.S. District Court for Oregon. Those rulings declared that the more than 100 utilities participating in Nuclear Projects No.'s 1, 2, and 3 had the legal authority to enter into the net-billing agreements.

This positive development makes some statements in the Financial Section obsolete, specifically the fourth paragraph on page 14, "Report of Independent Accountants," and the section titled "Net-Billing Agreements" in Note E, pages 32 and 33, which discusses uncertainties in the outcome of the case.

The favorable conclusion of this important litigation removes one of the major impediments to the Supply System returning to the financial markets and clears away some of the uncertainty clouding the future of WNP-1 and WNP-3.

Sincerely,

D.W. Mazur
Managing Director

If 1983 was the most turbulent year in Supply System history, then 1984 was its stabilizing year and 1985 can be considered its turnaround year. With three Supply System plants operating commercially, the focus of its Executive Board has shifted to operations and resolving the preservation and engineering issues at WNP-1 and WNP-3.

It's an important job because the ratepayers already have invested nearly $5 billion in these two unfinished plants. The board members are convinced that growth will occur in our region. It's only a question of how we most reasonably manage the projects in the interim.

In 1986, the Executive Board will be re-evaluating the Supply System's preservation programs—keeping in mind that the power picture could change very rapidly. For example, the Northwest Power Planning Council was created in 1980 to manage a power shortage. By the time it was institutionalized in 1982, it was dealing with a surplus.

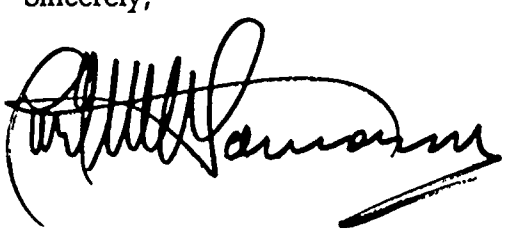
In the 1980s, the Northwest power planners are facing the realization that they had drastically overestimated the region's electrical needs. The natural inclination would be to overcompensate for past errors by using the most conservative projections. But everyone recognizes the jeopardy to the Northwest if we were to pull back too far and fail to maintain adequate cost-effective energy options.

Current economic studies show that the two unfinished Supply System nuclear projects—WNP-1 and WNP-3—meet all the criteria for cost-effectiveness. According to the Power Council, completing these plants would cost less than any new thermal power resource.

We are aware that there are pending legal issues and political actions that make the Supply System's re-entry into financial markets very difficult. But as litigation is concluded and we experience a continued period of stable operation, these obstacles will be eliminated.

The Supply System has a strong and perceptive Executive Board made up of members appointed by Washington State's governor and by the Supply System's Board of Directors. Collectively, the two boards have experience in all facets of the Supply System's business. Working together, our job is to make certain that when our region needs additional power, Supply System resources will be ready to supply that need in an efficient and timely manner.

Sincerely,



Carl M. Halvorson
Chairman, Executive Board

During Fiscal Year 1985, the Supply System exhibited increased strength and corporate maturity and continued to meet performance-based objectives set in the pursuit of excellence.

Due to strong management commitment and a concerted effort by all employees, we were able to complete the year while expending less than 90 percent of the $358 million operating and construction budgets that were authorized by our Executive Board. This significant accomplishment came about through greater efficiencies and the utilization of fewer facilities, equipment and manpower, and demonstrates the commitment and willingness of the Supply System to challenge its own initiatives and motivation in the best interests of the region's electric ratepayers.

Following through on this theme of fiscal responsibility, we developed and implemented a budget for our current 1986 Fiscal Year that is $25 million less than the one for FY 1985.

The major priority for FY 1985, reliable commercial operation of the 1,100-megawatt Plant 2, was accomplished. After completing its first scheduled maintenance outage in May and June, Plant 2 was available (along with our 860-megawatt Hanford Generating Project and the 27.5-megawatt Packwood Lake Hydroelectric Project) to help meet the electrical needs of the region during one of the driest summers in recorded history. At the end of the fiscal year, these three plants had produced a combined lifetime output of over 67 billion kilowatt-hours of electricity—enough power to provide the annual average needs of three million Pacific Northwest all-electric homes.

Meanwhile, preserving the assets of Supply System projects WNP-1 at Hanford and WNP-3 at Satsop continued to be a major concern of the Supply System. The NRC has accepted a pioneering Readiness Review Program, the first in the United States nuclear power industry, which calls for the approval of work already completed at the two plants. Such approval would mean that, when construction resumes, we will have a solid foundation to start from.

That assurance will allow us to direct our full attention to completing the projects.

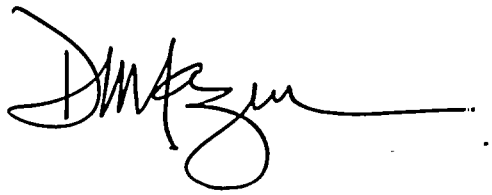
In this area, we are clearly a leader in the industry and lessons that we learn from our readiness review effort will be shared with other utilities in the United States which also have nuclear power plant projects that are in extended construction delays.

An additional benefit of our Readiness Review Program is financial. Its successful completion will eliminate many questions about the eventual licensability of the plants, and should be viewed by the financial community as a strong commitment to future financing and completion of WNP-1 and WNP-3.

Due to the current surplus of electrical supplies in the Pacific Northwest, it is not clear at this time when work will resume on WNP-1 and WNP-3. However, when the Executive Board gives the order to restart construction, efforts already undertaken by the Supply System or scheduled for implementation will assure that these cost-effective facilities will be available to meet the needs of the region.

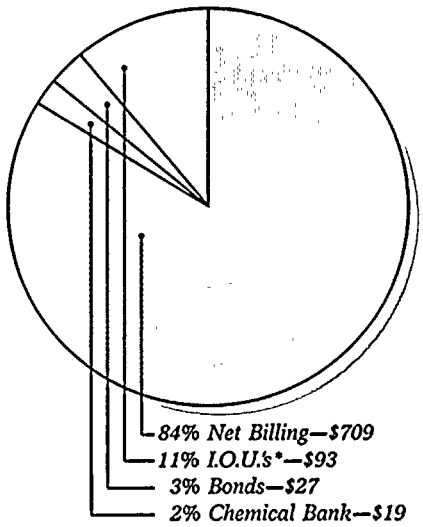
One of our key priorities in 1985 was the possibility of refinancing a portion of the outstanding bonded indebtedness on WNP-1/3 and Plant 2. The region's ratepayers could save hundreds of millions of dollars if we could refinance existing bonds that were issued at higher interest rates. The Supply System presently cannot obtain access to financial markets. In addition, congressional tax simplification initiatives underway could impact tax-exempt financing and advanced refinancing if enacted as written. However, our commitment to the region's ratepayers demands that we work to remove these impediments.

The Supply System had a good year in 1985. We are an organization that is achieving its goals by capitalizing on strong management, fiscal accountability and good people. I look forward to helping guide the Supply System and seeing it grow as one of the nation's best operating utilities, generating needed electricity safely and economically for the Pacific Northwest.

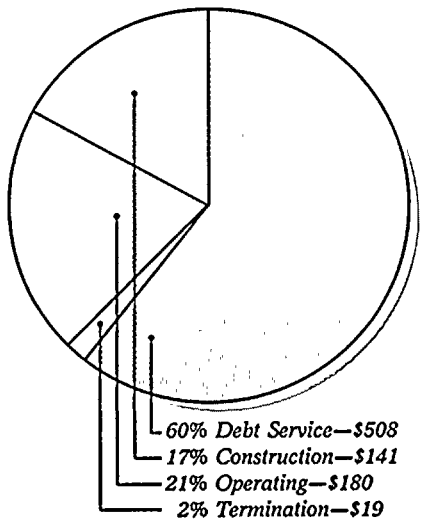


D.W. Mazur
Managing Director

Total FY 1985 Funding Sources
($ in millions)



Total FY 1985 Expenditures
($ in millions)



Total: $848

* *Investor-Owned Utilities*

The Washington Public Power Supply System in 1985 was a stronger organization, better geared to doing its job—supplying reliable, reasonably priced electricity to the ratepayers of the Pacific Northwest.

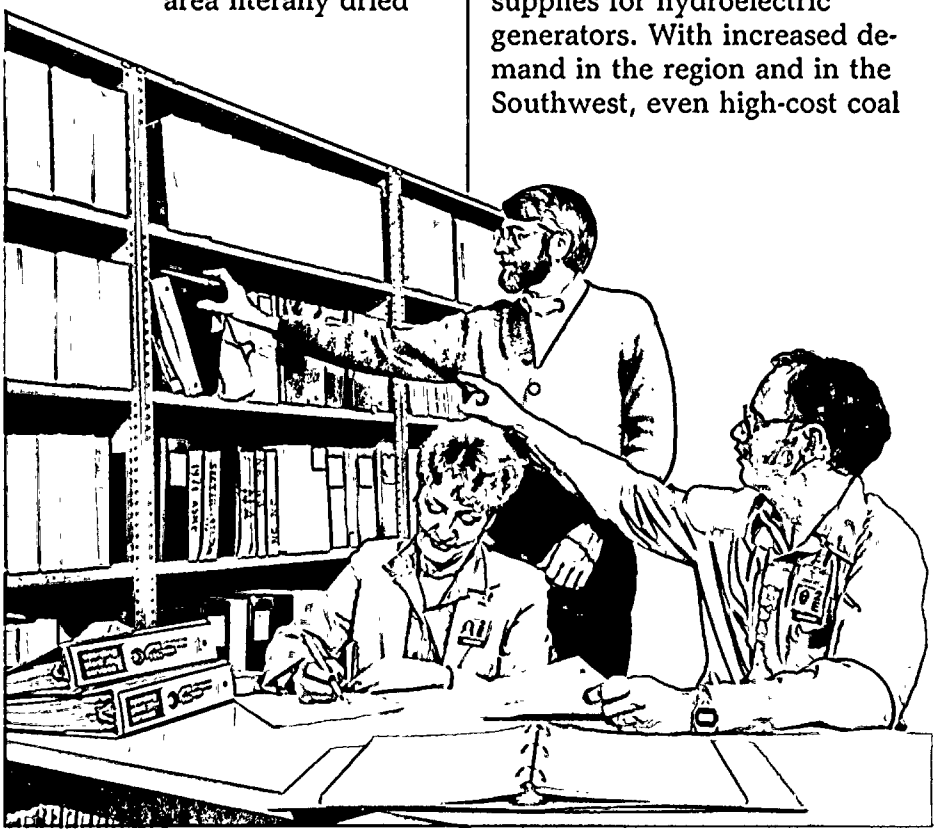
With the commercial operation of Plant 2, the company is now a full-fledged nuclear utility and is living up to its name as a major supplier of electricity in the Pacific Northwest. In fact, the Supply System has the largest generating capacity of any regional public utility.

The addition of Plant 2's 1,100 megawatts of thermal capacity couldn't have come at a more opportune time for the Bonneville Power Administration. An expected power surplus in the federal marketing agency's service area literally dried up when a dry spring and a hot summer combined to shrink normally abundant water supplies for hydroelectric generators. With increased demand in the region and in the Southwest, even high-cost coal plants that had remained idle for years joined Plant 2 in providing base-load capacity to Bonneville, keeping power sales revenue flowing to the agency and paying the costs of operation.

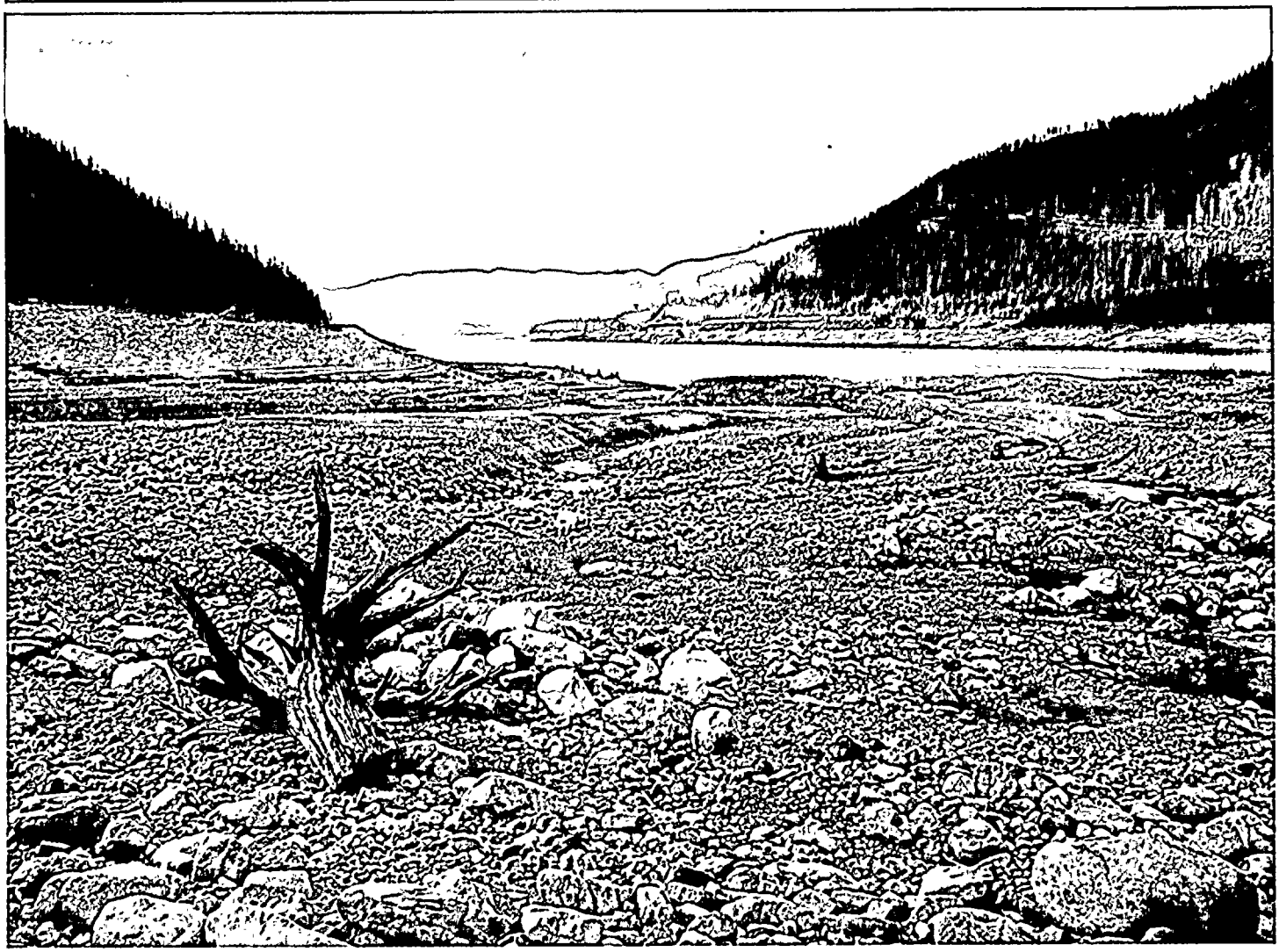
"The summer of 1985 brought dry weather and one of the lowest water years in the Columbia River System. With our hydroelectric system straining to meet power sales obligations, we called on Plant 2 to provide sorely needed generation. This energy saved water in reservoirs and enabled BPA to avoid costly purchases outside of the region to meet power needs."

Peter T. Johnson, Administrator, Bonneville Power Administration

Low water supplies added a sense of urgency to Plant 2's first year of operation. Plant staff was not accorded the luxury of working out the bugs, but rather was challenged to keep the plant on-line as much as possible. The plant's first scheduled maintenance outage began May 3 with a list of problems requiring



□ *The Nuclear Safety Assurance Group works independently from the plant staff, reviewing industry events and site activities and making recommendations to enhance nuclear safety at Plant 2. The group includes (left to right) Sandy Rounds, Herb McGilton and Bob DaValle.*



□ *A Cascade Mountains reservoir shows the effects of this summer's prolonged dry spell.*

troubleshooting. When the outage ended on schedule June 29, the continuing dry spell was placing even more strain on BPA to meet its power commitments.

The first few weeks of operation after the outage were anything but smooth. On its first day back in operation an Unusual Event (the lowest of four emergency classifications maintained by the Nuclear Regulatory Commission) was declared when lubrication oil caught fire following a bearing failure in a reactor feedwater pump. Although the fire was quickly extinguished, the loss of one of the two pumps cut power production by one-half.

The reactor feedwater pump was subsequently repaired and returned to service, but another pump has proved troublesome. One of two reactor recirculation pumps, used to drive a tremendous flow of water through the reactor core continued to vibrate following efforts to repair it during the maintenance outage. Although not a safety problem, both recirculation pumps are needed to produce enough steam for full 1,100-megawatt generation. With only one pump working, Plant 2 has been forced to operate at about 800 megawatts, or about 72 percent of capacity.

A four-to-six week outage to repair the recirculation pump was scheduled for the fall, but it was postponed because of continued dry weather and delays in obtaining needed parts. Repairs will be made during the 1986 annual spring maintenance outage when Plant 2 is shut down at the request of BPA due to abundant hydroelectric supplies. A decision will also be made early in 1986 as to whether Plant 2's first refueling will occur during the outage. About one-quarter of the 764 fuel assemblies would be replaced during refueling, but it may be more cost-effective to delay until the spring outage of 1987.

Despite the recirculation pump, Plant 2 has continued to be a reliable source of electric power for the region. The plant set a generation record on November 12, after operating 100 continuous days without shutting down.

During 1985 the Supply System successfully completed its third annual emergency preparedness exercise at Plant 2. The annual emergency exercise, required under Plant 2's operating license, was conducted in cooperation with local, state and federal agencies to demonstrate that a serious accident can be handled without harm to the public. The U.S. Nuclear Regulatory Commission gave the Supply System good marks for timely notification of the public and for managing the simulated recovery operations.

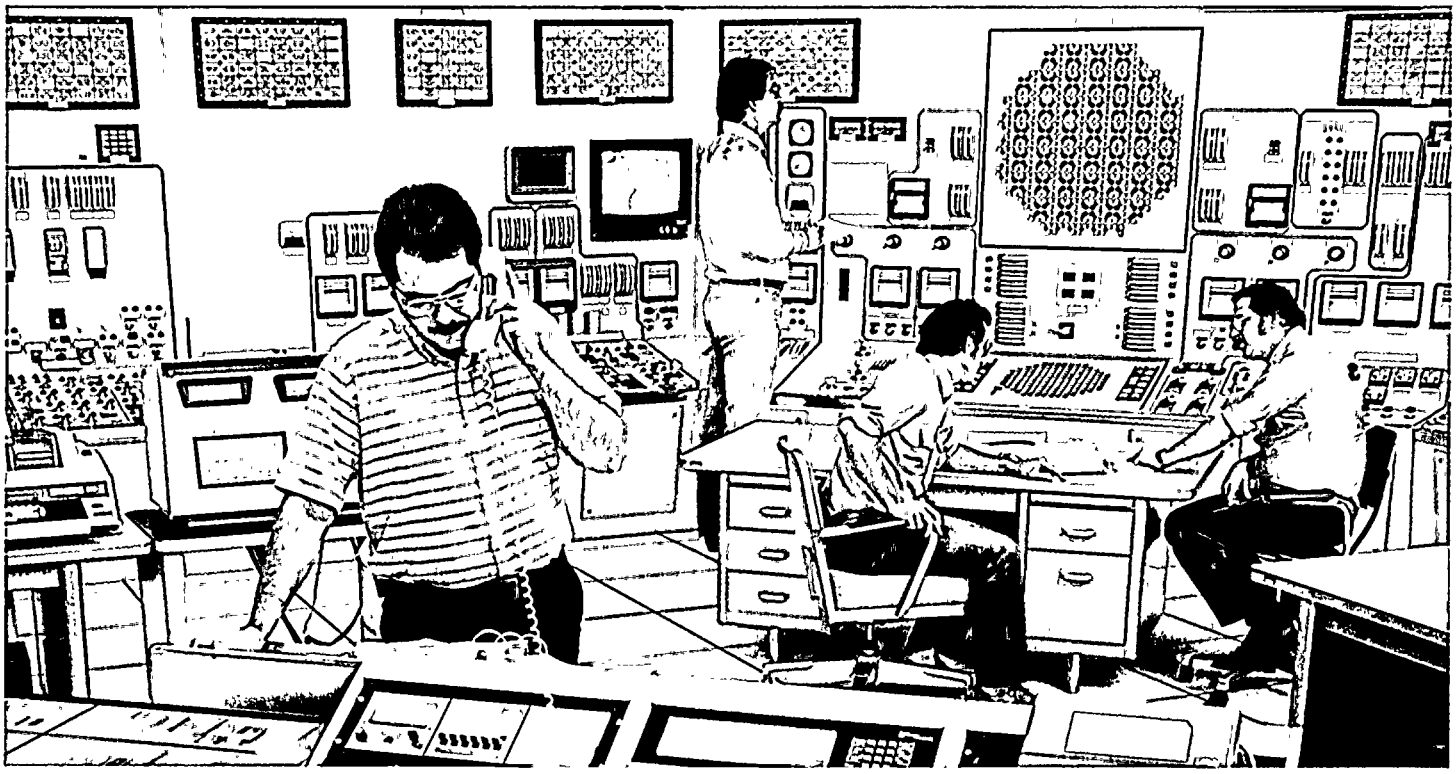
At the Hanford Generating Project a history of reliable low-cost power production continues, as it steadily supplies 860 megawatts of electricity to the BPA transmission system. HGP underwent an annual maintenance outage, beginning in September, when the U.S. Department of Energy's N-Reactor was shut down for refueling and maintenance. The N-Reactor's primary mission is producing special nuclear materials for the government. By-product steam from the nuclear reactor is purchased by the Supply System for generating electricity.

Since beginning operation in 1966, HGP has generated a net total of 62.4 billion kilowatt-hours of electricity, enough to

"Plant 2's operators impressed me as having a professional attitude... if the public had the chance to see them in action, they would have a higher confidence level."

Lando W. Zech, Jr., Commissioner, U.S. Nuclear Regulatory Commission

□ *Noreen Irwin and John Arbuckle are part of the Plant 2 quality assurance organization, charged with enhancing safety and reliability by verifying that activities meet plant procedures and regulatory requirements.*



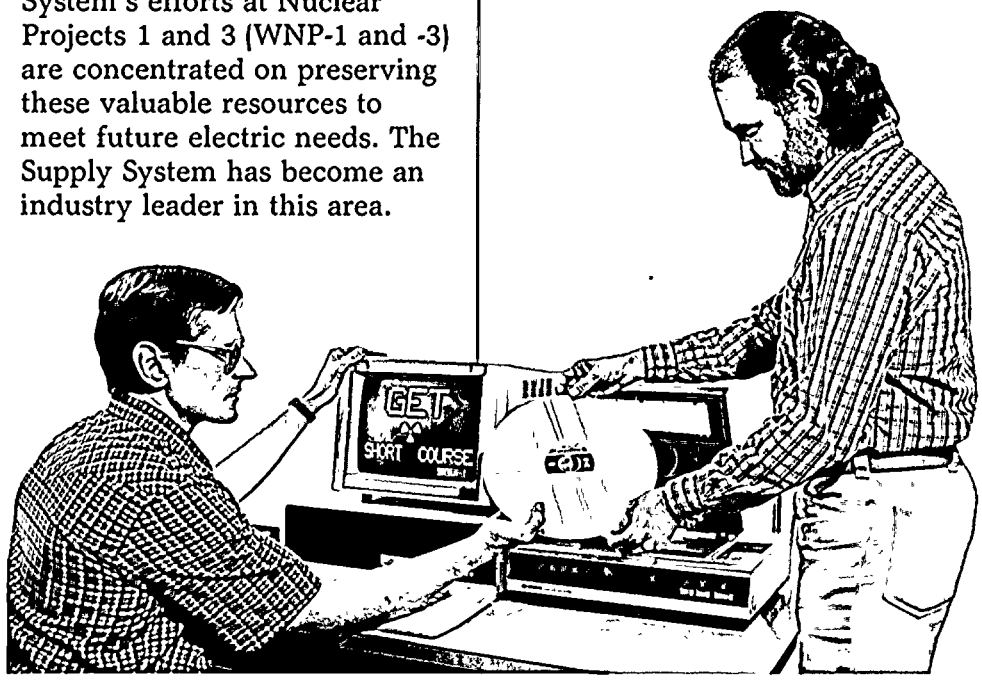
The plant operating crews at Plant 2 are acknowledged to be among the most experienced in the industry. Pictured are Bill Shaeffer (foreground) and left to right Steve Hutchinson, Arlen Herrington and John Dabney.

supply over 3.1 million all-electric homes for a year. With its continued operation assured through 1993 and possibly beyond, HGP will continue to be a source of cheap, reliable electricity for the Pacific Northwest.

The Supply System's oldest generating plant, the 27.5-megawatt Packwood Lake Hydroelectric Project, stayed in operation through the low-water year at reduced capacity, continuing to be a reliable producer of very low-cost electricity.

With construction at a virtual standstill, the Supply System's efforts at Nuclear Projects 1 and 3 (WNP-1 and -3) are concentrated on preserving these valuable resources to meet future electric needs. The Supply System has become an industry leader in this area.

Physical preservation efforts made since WNP-1 was mothballed in 1982 and WNP-3



Steve Rejniak (left) and Ron Utter are developing an interactive computer program to replace the traditional classroom lecture on radiological protection and safety practices.

in 1983 have paid off—research into corrosion rates at the two projects has proved that maintaining equipment and facilities is no longer a major concern.

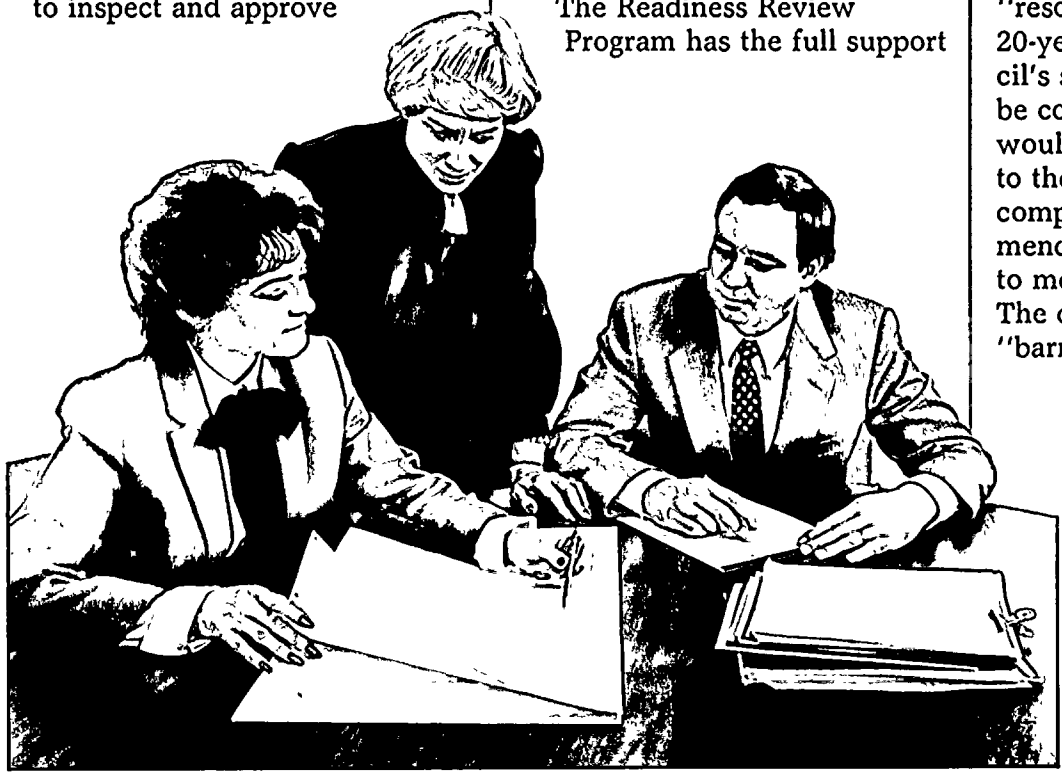
A major milestone was met last fall at WNP-3 when the containment vessel, a steel shell that surrounds the nuclear steam supply system and isolates it from the environment, successfully passed a pressure test. Huge air compressors were used to bring the pressure inside the containment vessel to over 50 pounds per square inch, satisfying regulatory agencies as to the strength and tightness of the structure.

While preservation and testing efforts continued, a new program was instituted at WNP-1 and -3. Called the "Readiness Review Program," it is a joint effort with the Nuclear Regulatory Commission to inspect and approve work done to date at WNP-1 (63 percent complete) and WNP-3 (76 percent complete). The program, expected to take two years or more, will assure that licensing and operation of the plants will not be impacted by quality concerns over construction completed before the delays.

The Readiness Review Program has the full support of the BPA, which is depending on the plants to meet its future generating needs. However, the Northwest Power Planning Council, an advisory group made up of representatives of the four Northwest states, removed WNP-1 and -3 from a list of future "firm resources" and instead listed them as "resource options" in its 20-year energy plan. The council's study found the projects to be cost-effective resources that would pay substantial dividends to the region's ratepayers if completed and strongly recommended that they be preserved to meet future demand. The decision was based on "barriers" to their completion,

"The competence of the Supply System to pull off the preservation of WNP-1 and WNP-3 is not an issue... this organization has impressed the council, more than any utility or rate group in the region, with its honesty, candidness and professionalism."

Charles T. Collins, Former Chairman, Northwest Power Planning Council



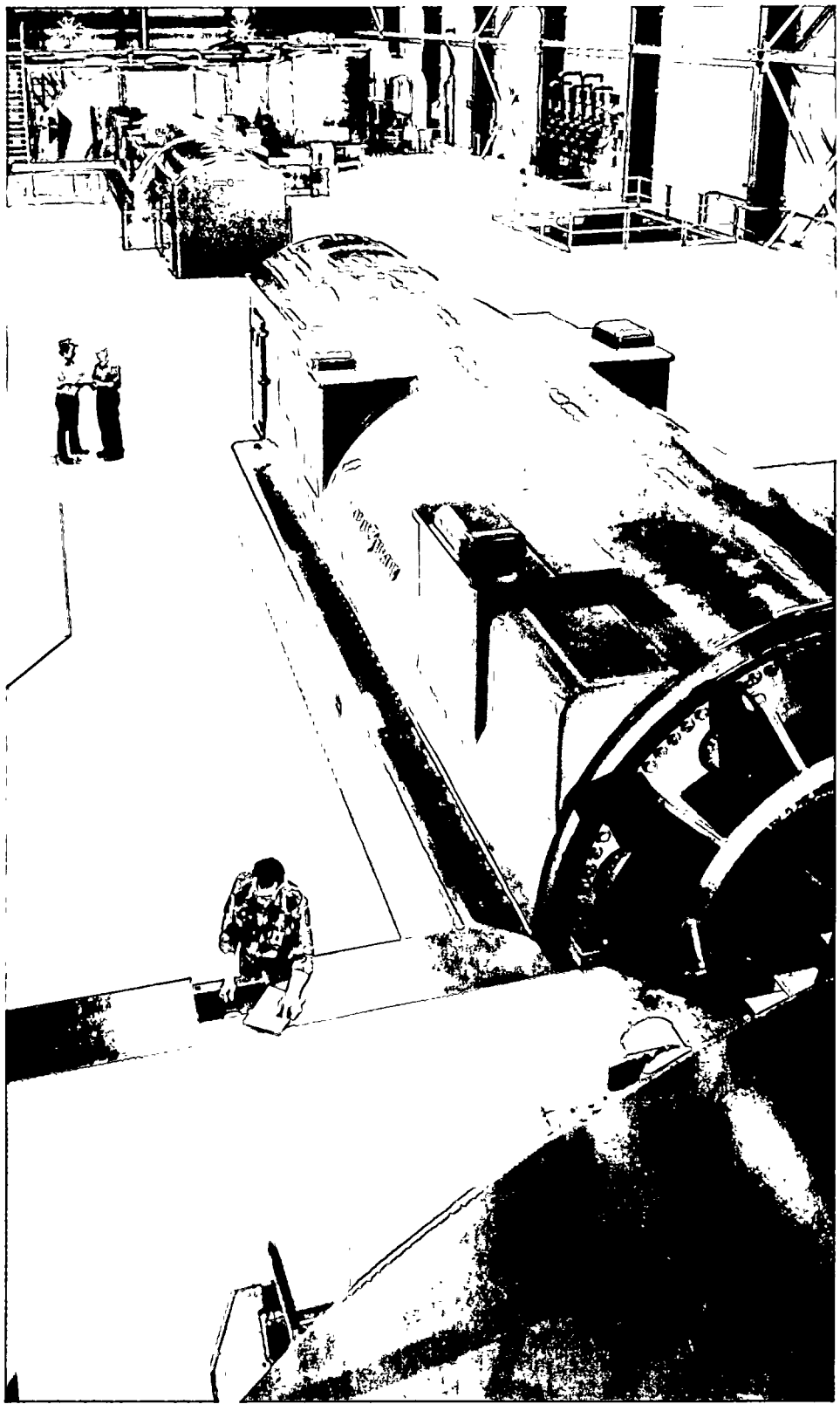
□ *The Human Resources and Legal departments team up to aggressively pursue corporate affirmative action goals. (left to right) Mo Larson, Elna May Akre and Craig Matheson.*

such as litigation and its effect on the Supply System's present inability to finance construction.

The BPA continues to pay through its rates the preservation costs on WNP-3 and the debt service on the $3.7 billion in outstanding bonds on both projects. WNP-1 preservation costs are paid from the project's construction fund with proceeds from the last bond sale in 1982. The BPA has no plans at this time to finance construction through its electric rates. The Supply System's Executive Board is deliberating on when to resume construction.

Meanwhile the WNP-4/5 Termination Program staff continued its efforts to dispose of the salable assets of the two uncompleted projects, which were terminated in 1982. Sales revenue in 1985 exceeded $9 million with proceeds going to Chemical Bank, bond trustee for WNP-4/5. The majority of sales continue to be to other U.S. utilities with operating power plants, with the most significant being the sale of an emergency diesel generator to a Utah utility for about $1.2 million.

Although litigation and its impact on financing continues to influence the direction of the Washington Public Power Supply System, the organization is on a stable foundation and is steering its own course into the future.



☐ *As part of the maintenance team at the Hanford Generating Project, (left to right) Alonzo Maganas, Bill Benson and Frank Schneider keep the turbine generators spinning smoothly.*

Robert E. Berney
Professor of Economics
Washington State University

Donald R. Clayhold
(Assistant Secretary)
Manager
Benton County PUD

Raymond E. Colbert
Commissioner
Okanogan County PUD

Cornelius R. Duffie
(Secretary)
Consultant
Portland, Oregon

Carl M. Halvorson
(Chairman)
President
HalvorsonMason Corporation
Portland, Oregon

*Ronald D. Mayo**
Mayo Associates
Seattle, Washington

Paul J. Nolan
Director
Department of Public Utilities
City of Tacoma

Lois M. Powell
Commissioner
Grays Harbor County PUD

Sydney Steinborn
Consulting Engineer
Seattle, Washington

Frank N. Ward
(Vice Chairman)
Commissioner
Klickitat County PUD

Louis H. Winnard
Senior Management Consultant
Los Angeles, California

**On October 2, 1985, the governor appointed Sam J. Farmer to the Executive Board. He replaced Ronald D. Mayo, whose appointment expired on June 13, 1985.*

Donald R. Clayhold
Manager
Benton County PUD

William D. Scott
Commissioner
Chelan County PUD

Paul L. Runyan
(Assistant Secretary)
Commissioner
Clark County PUD

Larry J. Nickel
Councilman
City of Ellensburg

William G. Kuehne
Commissioner
Ferry County PUD

Kenneth R. Cochrane
(President)
Commissioner
Franklin County PUD

Vera Claussen
(Secretary)
Commissioner
Grant County PUD

Lois M. Powell
Commissioner
Grays Harbor County PUD

Roger C. Sparks
Commissioner
Kittitas County PUD

Frank Ward
Commissioner
Klickitat County PUD

Raymond E. Colbert
Commissioner
Okanogan County PUD

Elmer E. Roloff
Commissioner
Pacific County PUD

Keith Sedore
Energy Services Director
City of Richland

Randall W. Hardy
Superintendent
Seattle City Light

Parker L. Knight
(Vice President)
Commissioner
Skamania County PUD

Paul J. Nolan
Director
Department of Public Utilities
City of Tacoma

David L. Myers
Commissioner
Wahkiakum County PUD

These utilities withdrew their membership in the Supply System during fiscal year 1985, bringing the board to its current 17-member level.

Douglas County PUD
Clallam County PUD
Cowlitz County PUD
Mason County PUD No. 3
Lewis County PUD
Snohomish County PUD

Administrative (Performance) Audit Committee

Functions as the prime working interface between the Executive Board and the Administrative Auditor.

Sydney Steinborn (Chairman)
Paul J. Nolan
Ronald D. Mayo
Frank N. Ward
Carl M. Halvorson (Ex Officio)

Administrative and Public Responsibility Committee

Responsible for personnel matters and matters relating to administration of the Supply System and its relations with the general public, other public agencies and other outside entities.

Paul J. Nolan (Chairman)
Robert E. Berney
Lois M. Powell
Sydney Steinborn
Carl M. Halvorson (Ex Officio)

Audit, Legal and Finance Committee

Responsible for review and oversight of Supply System activities relating to its financial needs, financial management system, finance and investment policies, budget and budget amendments, financial and fiscal auditing activities, real estate activities, insurance activities and legal strategies and policies.

Louis H. Winnard (Chairman)
Robert E. Berney
Donald R. Clayhold
Ronald D. Mayo
Paul J. Nolan
Lois M. Powell
Carl M. Halvorson (Ex Officio)

Construction Committee

Responsible for review and oversight activities of construction of Supply System projects such as budgets, schedules, contracts and change orders, safety, licensing, planning, contracting methods, and design and field engineering.

Donald R. Clayhold (Chairman)
Raymond E. Colbert
Neil R. Duffie
Ronald D. Mayo
Sydney Steinborn
Carl M. Halvorson (Ex Officio)

Operations Committee

Responsible for reviewing activities related directly to the operation of the Supply System power plants such as licensing, safety, operating schedules and plans, and contracts.

Neil R. Duffie, (Chairman)
Raymond E. Colbert
Ronald D. Mayo
Frank N. Ward
Louis H. Winnard
Carl M. Halvorson (Ex Officio)

Financial Section

Executive Board
Washington Public Power Supply System
Richland, Washington

We have examined the individual financial statements, as listed in the financial statements section of the table of contents, of Washington Public Power Supply System's Hanford Generating Project, Packwood Lake Hydroelectric Project, Nuclear Project No. 1, Nuclear Project No. 2, Nuclear Project No. 3, Nuclear Projects No.'s 4 and 5, and the Internal Service Fund for the year ended June 30, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note E to the financial statements, Washington Public Power Supply System Nuclear Projects No.'s 1 and 3 are negotiating with their contractors and suppliers to settle contract claims associated with extended construction delays of those projects. Due to the preliminary status of the settlement process, the ultimate amounts of such costs are not fully determinable at the present time.

As discussed in Note E to the financial statements, Washington Public Power Supply System Nuclear Projects No.'s 1 and 3 are involved in disputes concerning costs shared with Washington Public Power Supply System Nuclear Projects No.'s 4 and 5. Additionally, disputes arising from the extended construction delay of Nuclear Project No. 3 have been tentatively settled; however, such settlement is subject to approval by the court. The ultimate amount of additional costs, if any, to be borne by Nuclear Projects No.'s 1 and 3 due to these matters is not determinable at the present time.

As also discussed in Note E to the financial statements, Washington Public Power Supply System is a party to litigation in which the Springfield ratepayers are challenging the decision of the U.S. District Court for Oregon, rendered on May 16, 1983, that all parties to the net-billing agreements had authority to enter into them. This decision has been appealed to the U.S. Supreme Court. Supply System counsel cannot predict the outcome of this litigation. During August 1984, agreements between Bonneville Power Administration and the Washington Public Power Supply System were executed providing for the assignment of project capability (assignment agreements) of Nuclear Projects No.'s 1 and 2 and 70 percent of Nuclear Project No. 3 to Bonneville Power Administration. Under these agreements, the Washington Public Power Supply System has assigned to Bonneville all rights and interests in the Supply System's ownership share of project capability that the Supply System now has or hereafter may obtain if the courts determine that the net-billing agreements are invalid and project participants are not obligated to pay for any interest in project capability. Bonneville

would pay directly to the Supply System the amounts that would have been payable under the net-billing agreements for such project capability. The validity of the assignment agreements may be challenged in the courts.

As discussed in Note E to the financial statements, creditors of Nuclear Projects No.'s 4 and 5 have threatened to attempt to obtain payment from assets or funds held by other projects of the Supply System or the revenues pledged thereto. This year, except as discussed in Note E to the financial statements, bond counsel has rendered no opinion with respect to the rights of creditors of the Supply System to realize upon the assets, funds, or revenues of Nuclear Projects No.'s 1, 2, 3, the Packwood Project, the Hanford Generating Project, or the Internal Service Fund. Supply System management is of the opinion that creditor claims can only be realized from the assets, funds, or revenues of the projects to which such claims relate. If it is found that creditors are not limited to payment of their claims from the project to which such claims relate, it will have a material adverse impact on the Supply System.

As explained in Note D, participants agreements pertaining to Washington Public Power Supply System Nuclear Projects No.'s 4 and 5 have been held to be invalid. Therefore, the Supply System is unable to recover the costs of Nuclear Projects No.'s 4 and 5 from the participants and has reduced such costs to their estimated recoverable values in the accompanying balance sheets as of June 30, 1985. The ultimate recovery of such estimated amounts cannot presently be determined. In addition, as further discussed in Note D, accrued liabilities have been reflected in the accompanying balance sheets for estimated contract settlement and termination costs. Due to the preliminary nature of the settlement process, the ultimate amounts owing to creditors are not fully determinable at the present time. In addition, as explained in Note E, there are various other matters of litigation for which the outcome is not presently known.

In view of the significance of the matters discussed in the preceding paragraphs, we are unable to express, and we do not express, an opinion on the financial statements of the Supply System's Hanford Generating Project, Packwood Lake Hydroelectric Project, Nuclear Project No. 1, Nuclear Project No. 2, Nuclear Project No. 3, Nuclear Projects No.'s 4 and 5, and the Internal Service Fund referred to above.

Ernst & Whinney

Seattle, Washington
September 13, 1985, except as to the tenth paragraph of Note D as to which the date is October 7, 1985, and as to Note E, the fourth paragraph of Nuclear Projects No.'s 1 and 3 Construction Delay, the date is November 22, 1985, and the fourth paragraph of Nuclear Project No. 3 Claims, the date is September 30, 1985.

BALANCE SHEET

June 30, 1985 ($ in thousands)

Assets	NUCLEAR PROJECT NO. 2	HANFORD GENERATING PROJECT	PACKWOOD LAKE PROJECT	NUCLEAR PROJECT NO. 1	NUCLEAR PROJECT NO. 3	NUCLEAR PROJECTS NOS.4/5	INTERNAL SERVICE FUND
Current Assets—Operating Fund							
Cash and investments	$ 11,724	$ 3,649	$ 1,603	$ 10,129	$ 27,405	$	$18,194
Accounts receivable	36	1	190				502
Prepaid and other	12,767	1,048	19				2,049
Due from participants	1,606	2,139		863	792		
Due from other projects and internal service fund	10,227	164		180			
Due from other funds	48,254	1,631	48	32,182	28,184		
	84,614	8,632	1,860	43,354	56,381		20,745
Restricted Assets Notes B and C							
Special funds (primarily for construction)							
Cash and investments	44,710	3,489	302	149,619	30,836	7,611	
Receivable from joint owners					11,513	1,471	
Advance to internal service fund				825	1,721	222	
Due from other projects				10,596		16,899	
Other assets				252	235	84	
Due from other funds—net					23, 554		
	44,710	3,489	302	161,292	67,859	26,287	
Revenue fund cash						11 *	
Accounts receivable						826	
Chemical Bank fund accounts						31,339 *	
Debt service funds cash and investments	117,195	7,516	660	227,642	181,882	90,076 *	
	161,905	11,005	962	388,934	249,741	148,539	
Utility Plant and Equipment *Note B*							
In service	3,236,122	67,635	12,371	11,242			14,797
Improvements to U.S. government facilities		15,789					
Less allowance for depreciation and amortization	(70,173)	(56,662)	(5,541)	(896)			(8,563)
	3,165,949	26,762	6,830	10,346			6,234
Construction work in progress	5,703						
Construction work in progress—deferred plants				2,219,923	2,373,025		
Costs of terminated plants						2,718,025	
Nuclear fuel and prepaid enrichment services	82,326			258,756	50,972		
Buildings and equipment—net						447	
Less amount charged to joint owners					(608,689)	(88,802)	
Less allowance for estimated unrecoverable cost						(2,622,739)	
	3,253,978	26,762	6,830	2,489,025	1,815,308	6,931	6,234
Other Assets and Deferred Charges							
Unbilled reimbursable costs			2,734				
Unamortized debt expense	3,422	115	22	3,486	2,541		20
Total Assets	$3,503,919	$46,514	$12,408	$2,924,799	$2,123,971	$155,470	$26,999

* *Assets under control of Chemical Bank*

Liabilities	*NUCLEAR PROJECT NO. 2*	*HANFORD GENERATING PROJECT*	*PACKWOOD LAKE PROJECT*	*NUCLEAR PROJECT NO. 1*	*NUCLEAR PROJECT NO. 3*	*NUCLEAR PROJECTS NO.'S 4/5*	*INTERNAL SERVICE FUND*
Current Liabilities—Operating Fund							
Accounts payable and accrued expenses	$ 27,874	$ 4,331	$ 239	$ 49	$ 6	$	$10,196
Advance payments from participants	1,609			2,808	2,891		
Due to other projects and internal service fund	2,800	180					7,883
Amounts due power purchasers	49,331	621	1,506	37,497	26,930		
Amounts due other funds					23,554		
	81,614	5,132	1,745	40,354	53,381		18,079
Liabilities—Payable from Restricted Assets Notes B and C							
Special funds (primarily for construction)							
Accounts payable and accrued expenses	482			12,165	20,636	33,699	
Amounts withheld from contractors				10,574	9,251	7,612	
Due to other projects and internal service fund					16,707	8,005	
Due to other funds—net	41,228	990	22	23,109	18,264		
	41,710	990	22	45,848	64,858	49,316	
Debt service funds							
Accrued bond and note interest payable		366	127	104,105	82,846	410,646	
Due to other funds—net	7,026	642	26	9,073	9,920		
	7,026	1,008	153	113,178	92,766	410,646	
Chemical Bank fund accounts							
Accounts payable and accrued expenses						382	
	48,736	1,998	175	159,026	157,624	460,344	
Debt in Default, Currently Payable							
Revenue bonds payable						2,250,000	
Subordinated revenue notes						67,865	
						2,317,865	
Long-Term Debt Note C							
Revenue bonds payable	2,281,995	34,080	10,469	2,134,200	1,596,535		
Less unamortized discount on bonds—net	(69,286)	(631)	(83)	(52,523)	(38,500)		
	2,212,709	33,449	10,386	2,081,677	1,558,035		
Other Liabilities and Deferred Credits							
Unearned revenue	1,117,612	3,091					
Costs reimbursed under net-billing				640,742	351,931		
Deferred gain on redemption of revenue bonds		1,444	102				
Due to other projects							5,110
Advances and other	43,248	1,400		3,000	3,000		3,810
	1,160,860	5,935	102	643,742	354,931		8,920
Total Liabilities	3,503,919	46,514	12,408	2,924,799	2,123,971	2,778,209	26,999
Deficiency in assets						(2,622,739)	
Total Liabilities and Deficiency in Assets	$3,503,919	$46,514	$12,408	$2,924,799	$2,123,971	$ 155,470	$26,999

STATEMENT OF CHANGES IN FINANCIAL POSITION

For the year ended June 30, 1985 ($ in thousands)

Operating Projects	*NUCLEAR PROJECT NO. 2*	*HANFORD GENERATING PROJECT*	*PACKWOOD LAKE PROJECT*
Source of Funds			
Operations			
Net revenue	$ -0-	$ -0-	$ -0-
Items not affecting working capital:			
Depreciation and amortization	80,559	2,393	258
Decrease in costs reimbursable from power purchasers	86,572	2,099	118
Less gain on redemption of revenue bonds		(129)	(204)
Total from Operations	167,131	4,363	172
Total Source of Funds	$167,131	$4,363	$172
Use of Funds			
Construction and capital	$150,489		
Net improvements		1,142	
Cost of revenue bonds purchased and retired	16,925	3,125	168
Increase (decrease) in restricted assets	(283)	96	4
	167,131	4,363	172
Changes in working capital			
Cash and investments	$5,769	(9,306)	20
Receivables and other	23,598	2,382	(392)
Payables and other	(29,367)	6,924	372
Net increase in working capital	-0-	-0-	-0-
Total Use of Funds	$167,131	$4,363	$172

Non-Operating Projects	*NUCLEAR PROJECT NO. 1*	*NUCLEAR PROJECT NO. 3*	*NUCLEAR PROJECTS NO.'S 4/5*
Source of Funds			
Collected under net-billing	$ 255,287	$203,649	$
Interest income	32,775	17,143	12,167
Charged to joint owners		11,839	(678)
Net decrease in restricted funds	15,942		187,167
Received from sale of fuel	401		
Revaluation of investments	4,818	4,145	1,260
Reduction of estimated cost of termination			2,340
Asset sales			8,880
Other			447
Total Source of Funds	$309,223	$236,776	$211,583
Use of Funds			
Construction costs	33,339	41,154	
Interest expense	208,211	165,692	198,084
Nuclear fuel	(2,167)	25	
Financing, trustee and paying agent expenses	197	228	13,499
Bonds redeemed	9,245	1,785	
Due to participants	9,372	23,502	
Net transfers to Hanford Generating Project	51,026		
Net increase in restricted funds		4,390	
Total Use of Funds	$309,223	$236,776	$211,583

STATEMENT OF OPERATIONS

For the year ended June 30, 1985 ($ in thousands)

	NUCLEAR PROJECT NO. 2	*HANFORD GENERATING PROJECT*	*PACKWOOD LAKE PROJECT*
Operating Revenues	$239,954	$67,761	$824
Operating Expenses			
Nuclear fuel	11,346		
Waste disposal	2,661		
Decommissioning	482		
Reactor availability		62,599	
Depreciation and amortization	67,729	2,326	254
Power production and transmission	27,465	1,833	409
Maintenance	12,834	889	98
Administrative and general	9,606	800	82
Taxes	903		6
	133,026	68,447	849
Net operating revenue/(loss)	106,928	(686)	(25)
Other Income and Expense			
Investment income	13,400	1,867	419
Interest expense and discount amortization	(120,328)	(1,181)	(394)
Net Revenue	$ -0-	$ -0-	$ -0-

OUTSTANDING LONG-TERM DEBT

($ in thousands)

	SERIES	DATE OF SALE	EFFECTIVE INTEREST RATE	OFFERING PRICES	COUPON RATE	SERIAL OR TERM MATURITIES	JUNE 30, 1985
Nuclear Project No. 2							
Revenue Bonds.....	1973	6-26-73	5.66%	(A)	5.00—5.10%	7-1-87/1991	$ 13,600
				100	5.70	7-1-2012	124,400
							138,000
Revenue Bonds.....	1974	7-23-74	7.21	(A)	6.50—6.90	7-1-87/1994	18,000
				100	7.00	7-1-1999	15,000
				100	7.375	7-1-2012	37,000
							70,000
Revenue Bonds.....	1974A	11-26-74	7.67	(A)	7.20	7-1-84/1994	18,000
				100	7.40	7-1-1999	15,000
(excludes $2,500,000 due July 1, 1985)				100	7.75	7-1-2012	78,000
							111,000
Revenue Bonds.....	1975A	3-6-75	6.71	(A)	6.60	7-1-84/1994	18,600
				100	6.60	7-1-1999	15,000
(excludes $3,900,000 due July 1, 1985)				100	6.875	7-1-2012	78,000
							111,600
Revenue Bonds.....	1976	6-3-76	6.63	(A)	5.40—6.25	7-1-84/1998	23,955
				99.25	6.625	7-1-2006	42,300
(excludes $1,095,000 due July 1, 1985)				100	6.75	7-1-2012	49,860
							116,115
Revenue Bonds.....	1976A	11-18-76	5.87	(A)	5.50—5.875	7-1-84/2002	83,140
				100	6.00	7-1-2007	44,815
(excludes $2,950,000 due July 1, 1985)				99.50	6.00	7-1-2012	60,990
							188,945
Revenue Bonds.....	1978	7-11-78	6.71	(A)	5.50—6.60	7-1-84/2000	60,430
				100	6.80	7-1-2006	45,520
(excludes $2,190,000 due July 1, 1985)				100	6.875	7-1-2012	66,230
							172,180
Revenue Bonds.....	1979	3-13-79	6.49	(A)	5.50—6.00	7-1-84/1999	53,735
				100	6.40	7-1-2004	33,490
(excludes $2,490,000 due July 1, 1985)				100	6.75	7-1-2012	83,605
							170,830
Revenue Bonds.....	1979A	10-17-79	7.69	(A)	6.40—7.30	7-1-84/1999	38,275
				100	7.60	7-1-2004	23,050
(excludes $1,800,000 due July 1, 1985)				100	7.75	7-1-2012	57,000
							118,325
Revenue Bonds.....	1980	10-21-80	9.36	(A)	8.90—10.90	7-1-86/1997	35,230
				100	9.30	7-1-2001	23,735
				100	9.60	7-1-2006	46,070
				(A)	9.25	7-1-2011	75,045
				(A)	8.25	7-1-2012	19,920
							200,000
Revenue Bonds.....	1981A	9-4-81	12.44	100	14.375	7-1-2001	30,000
				57.895	8.25	7-1-2003	100,000
				99	14.50	7-1-2006	30,000
				100	13.25	7-1-2012	50,000
							210,000
Revenue Bonds.....	1982A	2-11-82	14.76	100	9.50—13.75	7-1-86/1996	33,335
				100	14.50	7-1-2002	51,665
				99.25	14.75	7-1-2012	215,000
							300,000

	SERIES	DATE OF SALE	EFFECTIVE INTEREST RATE	OFFERING PRICES	COUPON RATE	SERIAL OR TERM MATURITIES	JUNE 30, 1985
Revenue Bonds	1982B	5-20-82	13.82%	100	9.00—13.00%	7-1-86/1996	$ 39,400
				100	13.875	7-1-2012	139,320
							178,720
Revenue Bonds	1982C	5-20-82	13.89	100	13.50	7-1-2002	56,960
				100	13.875	7-1-2012	139,320
							196,280
							$2,281,995
Hanford Generating Project							
Revenue Bonds	1963	5-8-63	3.26	(A)	2.90—3.10	9-1-84/1986	$ 6,495
				98	3.25	9-1-1996	27,585
(includes $3,240,000 due within one year at June 30, 1985)							$ 34,080
Packwood Lake Hydroelectric Project							
Revenue Bonds	1962	3-20-62	3.66	99.425	3.625	3-1-2012	$ 7,929
	1965	11-4-65	3.76	100.5	3.75	3-1-2012	2,540
(includes $175,000 due within one year at June 30, 1985)							$ 10,469
Nuclear Project No. 1							
Revenue Bonds	1975	9-18-75	7.73	(A)	5.75—7.40	7-1-84/2000	$ 37,700
				100	7.70	7-1-2010	58,300
(includes $1,300,000 due July 1, 1985)				100	7.75	7-1-2017	74,700
							170,700
Revenue Bonds	1976A	2-4-76	6.84	(A)	6.00—6.25	7-1-84/1998	31,775
				100	6.90	7-1-2010	66,485
(includes $1,490,000 due July 1, 1985)				100	7.00	7-1-2017	76,495
							174,755
Revenue Bonds	1976B	8-31-76	6.37	(A)	5.00—5.90	7-1-84/1998	35,515
				100	6.50	7-1-2010	66,940
(includes $1,760,000 due July 1, 1985)				99.50	6.50	7-1-2017	71,235
							173,690
Revenue Bonds	1978A	3-21-78	5.69	(A)	5.00—5.50	7-1-84/2002	62,170
				100	5.80	7-1-2010	50,920
(includes $2,210,000 due July 1, 1985)				100	5.875	7-1-2017	64,810
							177,900
Revenue Bonds	1978B	12-5-78	6.61	(A)	5.50—6.00	7-1-84/1998	36,680
				100	6.35	7-1-2003	22,305
(includes $1,770,000 due July 1, 1985)				100	6.60	7-1-2009	38,190
				99.50	6.80	7-1-2017	81,150
							178,325
Revenue Bonds	1979	6-19-79	6.64	(A)	6.00	7-1-84/1998	28,215
				100	6.40	7-1-2003	18,560
(includes $1,255,000 due July 1, 1985)				100	6.70	7-1-2009	32,370
				100	6.80	7-1-2017	69,685
							148,830
Revenue Bonds	1980A	8-5-80	8.87	(A)	7.00—10.00	7-1-86/1995	55,500
				100	9.00	7-1-2002	37,000
				100	9.20	7-1-2005	16,950
				99.00	9.25	7-1-2013	70,550
				(A)	7.75	7-1-2017	30,000
							210,000

(A) Various prices

OUTSTANDING LONG-TERM DEBT

($ in thousands)

	SERIES	DATE OF SALE	EFFECTIVE INTEREST RATE	OFFERING PRICES	COUPON RATE	SERIAL OR TERM MATURITIES	JUNE 30, 1985
Revenue Bonds.....	1981A	4-13-81	11.30%	(A)	11.30—13.00%	7-1-96/2003	$ 28,580
				100	11.625	7-1-2012	91,420
							120,000
Revenue Bonds.....	1981B	4-13-81	11.30	(A)	10.00	7-1-2016	40,000
Revenue Bonds.....	1981C	4-13-81	10.29	100	10.25	7-1-2015	40,000
Revenue Bonds.....	1981D	9-4-81	14.78	100	14.375	7-1-2001	20,000
				57.895	8.25	7-1-2003	30,000
				100	15.00	7-1-2017	265,000
							315,000
Revenue Bonds.....	1982A	2-11-82	14.79	100	10.50—13.75	7-1-88/1996	29,355
				100	14.50	7-1-2002	50,645
				99.25	14.75	7-1-2017	305,000
							385,000
							$2,134,200
Nuclear Project No. 3							
Revenue Bonds.....	1975	12-3-75	7.87	(A)	5.40—7.25	7-1-84/1998	$ 24,280
				100	7.875	7-1-2010	52,695
(includes $1,040,000 due July 1, 1985)				100	7.875	7-1-2018	71,160
							148,135
Revenue Bonds.....	1976	4-13-76	6.48	(A)	5.50—6.00	7-1-84/1998	18,005
				99.625	6.50	7-1-2010	35,100
(includes $865,000 due July 1, 1985)				100	6.60	7-1-2018	45,295
							98,400
Revenue Bonds.....	1977	9-12-77	5.71	(A)	5.00—5.30	7-1-85/2000	59,305
				99.50	5.70	7-1-2009	63,535
(includes $2,620,000 due July 1, 1985)				99.50	5.80	7-1-2018	107,160
							230,000
Revenue Bonds.....	1978	9-12-78	6.27	(A)	5.90—6.00	7-1-85/2004	66,385
				100	6.375	7-1-2010	42,985
(includes $1,650,000 due July 1, 1985)				99	6.40	7-1-2018	90,630
							200,000
Revenue Bonds.....	1981A	2-11-81	10.80	(A)	9.50—12.50	7-1-87/2001	64,375
				100	11.125	7-1-2005	40,535
				99.50	11.125	7-1-2010	80,310
				88.50	9.75	7-1-2017	18,950
				88.50	9.75	7-1-2018	20,830
							225,000
Revenue Bonds.....	1981B	9-4-81	14.80	57.895	8.25	7-1-2003	20,000
				99	14.50	7-1-2006	20,000
				100	15.00	7-1-2018	185,000
							225,000
Revenue Bonds.....	1982A	2-11-82	14.83	100	10.50—13.75	7-1-88/1996	6,055
				100	14.50	7-1-2002	10,445
				99.25	14.75	7-1-2018	148,500
							165,000
Revenue Bonds.....	1982B	5-20-82	13.95	100	10.50—13.00	7-1-88/1996	9,195
				99.50	13.875	7-1-2018	280,925
							290,120
Revenue Bonds.....	1982C	5-20-82	13.63	100	13.50	7-1-2002	14,880
							$1,596,535

(A) Various prices

Note A—Organization

The Washington Public Power Supply System was organized in 1957 as a municipal corporation and joint operating agency of the State of Washington. It is empowered to acquire, construct and operate facilities for the generation and transmission of electric power. On July 1, 1984, its membership consisted of 19 public utility districts and four municipalities that own and operate electric systems within the state of Washington. During fiscal year 1985, six public utility districts withdrew from membership, reducing total membership from 23 to 17. These actions do not affect the rights and obligations of the six utilities and the Supply System under the various contracts executed between the utilities and the Supply System relating to Nuclear Projects No.'s 1, 2, 3, 4, 5, the Hanford Generating Project or the Packwood Lake Hydroelectric Project.

The Supply System constructed and is operating the Packwood Lake Hydroelectric Project, the Hanford Generating Project and Nuclear Project No. 2, which went into commercial operation on December 13, 1984. The Supply System's Nuclear Project No. 1 is in the fourth year of an extended construction delay; Nuclear Project No. 3 is in the third year of an extended construction delay; and Nuclear Projects No.'s 4 and 5 were terminated on January 22, 1982.

Nuclear Projects No.'s 1, 2 and 4 are wholly owned by the Supply System. Nuclear Project No. 3 is jointly owned by the Supply System (70 percent) and four investor-owned utilities (30 percent). Nuclear Project No. 5 is jointly owned by the Supply System (90 percent) and one investor-owned utility (10 percent). Each joint owner is responsible for its own financing costs and share of the costs of construction, operation and termination and is entitled to its ownership share of the projects' operating capability.

The Supply System is currently unable to obtain additional financing through the sale of bonds due to pending litigation. Therefore, construction completion costs for Nuclear Project No. 2 and project maintenance costs for the Supply System's 70 percent share of Nuclear Project No. 3 have been funded since September 1983 and May 1984, respectively, by payments under the net-billing agreements for those projects.

Note B—Summary of Significant Accounting Policies

The Supply System has adopted accounting policies and practices that are in accordance with generally accepted accounting principles applicable to the utility industry. Separate books of account are maintained for each project except for Nuclear Projects No.'s 4 and 5, which are accounted for as a single entity. In addition, the Supply System maintains an internal service fund for payment and accounting of payrolls, administrative and general expenses, and certain common goods and services procured for the projects on a cost-reimbursable basis.

Restricted Funds

In accordance with project bond resolutions and related agreements, separate restricted funds must be established for each of the projects. The assets held in these funds are restricted for specific uses, including construction, termination, debt service and other special reserve requirements. Restricted funds are identified on the balance sheet as Special Funds, Revenue Fund Cash, Accounts Receivable, Chemical Bank Fund Accounts, and Debt Service Funds.

Cash and investments in the Operating Fund of Nuclear Project No. 2 and in Special Funds of Nuclear Projects No.'s 1, 3, 4 and 5 include $30,615,720 retained in escrow for contractors as of June 30, 1985.

Current Assets and Current Liabilities

Assets and liabilities shown as current in the accompanying balance sheets exclude current maturities on revenue bonds and accrued interest because debt service funds are provided for their payment.

Investments

Investments include time certificates of deposit and

United States government and government agencies securities. Investments are stated at cost or amortized cost, as appropriate, and include accrued interest.

Investments held in the Bond Fund Reserve Accounts (included in Debt Service Funds) and Reserve and Contingency Funds (included in Special Funds) are stated at the lower of amortized cost or market as provided by bond resolutions.

The market value of investments (including accrued interest) approximates the carrying value.

Investment Income

Investment income consists of interest earned on investments and gains or losses resulting from the sale of investments. Investment income relating to operating plants is recorded as a credit to operating costs. With respect to Nuclear Projects No.'s 1 and 3, income earned on any construction funds is recorded as a credit to Construction Work in Progress-Deferred Plants shown on the balance sheet, and income earned on all other funds is treated as a reduction of funding required under the net-billing agreements. Investment income relating to Nuclear Projects No.'s 4 and 5 is credited to Costs of Terminated Plants shown on the balance sheet.

Capitalization of Construction Costs and Expenses

During the normal construction phase of a project it is the Supply System's policy to capitalize all costs relating to the project, including interest (net of interest income), general and administrative expense, amortized financing expense and certain other expenses. Interest expense (net) during construction is allocated to nuclear fuel and plant based on cumulative cash utilization. General and administrative expense and overhead expense are allocated to projects primarily on the basis of direct usage or direct salary cost. Financing expense applicable to each project is amortized by the straight-line method over the period of each respective bond issue, to project capital cost or operating cost, as appropriate, during plant construction or operations.

As of July 1, 1984, the Supply System discontinued capitalizing interest expense (net) applicable to Nuclear Project No.'s 1 and 3 because of the extended delay of these projects. The interest expense, which is funded by payments under net-billing agreements, will not be capitalized during the delay. Such net interest expense totaled $188,304,934 and $148,568,714 for Nuclear Projects No.'s 1 and 3, respectively, for the year ended June 30, 1985. Capitalization of interest expense will resume when construction is restarted.

Utility Plant and Equipment—Depreciation and Amortization

Buildings and equipment are depreciated by the straight-line method over their estimated useful lives.

Improvements to U.S. government-owned facilities are being amortized over the period covered by the contract for dual-purpose operation of the U.S. Department of Energy's New Production Reactor.

Revenues

During the construction phase of a project, monies received under net-billing agreements, which are utilized to fund debt service or other project expenditures, are recorded as Unearned Revenues on the balance sheet and are amortized to Revenues over the operating life of the project.

As explained in Note E, there is uncertainty as to when Nuclear Projects No.'s 1 and 3 will be operational. For this reason, monies received under Nuclear Projects No.'s 1 and 3 net-billing agreements previously classified as Unearned Revenues are now classified as Costs Reimbursed Under Net-Billing.

For Nuclear Project No. 2, Hanford and Packwood Projects, the difference between cumulative operating costs, including depreciation and amortization and cumulative payments, including debt service but excluding depreciation and amortization, is reflected as Unearned Revenues or Unbilled Reimbursable Costs, as appropriate.

In accordance with covenants of bond resolutions, the Supply System is authorized to recover actual cash requirements for operations and debt service for each project over the life of the project. Accordingly, the

Supply System records revenues equal to operating costs for each period. No income or loss is realized, and no equity is accumulated.

Nuclear Fuel Cost

Nuclear Project No. 2 capitalized nuclear fuel cost is amortized to nuclear fuel operating expense on the basis of quantity of heat produced for electric generation. Current period nuclear fuel operating expense also includes a charge for future spent nuclear fuel storage and disposal to be provided by the Department of Energy in accordance with the Nuclear Waste Policy Act of 1982. Such charge is based on one mill per kilowatt-hour of energy generated.

Decommissioning

Estimated Nuclear Project No. 2 decommissioning costs are being currently funded under the sinking-fund method. Monthly payments are made into a sinking fund which, with accumulated interest, will be adequate to fund decommissioning costs at the end of the 40-year plant operating life. Sinking-fund requirements are currently based on estimated decommissioning costs of $114 million (1982 dollars). Payments to the decommissioning fund for Nuclear Project No. 2 for fiscal year 1985 aggregated $482,326.

Cost Related to Construction and Termination of Nuclear Power Plants

For Nuclear Projects No.'s 4 and 5, the costs of construction through January 22, 1982, the date of termination, and the costs of termination and other related costs subsequent to that date are shown at their estimated net recoverable value in the accompanying balance sheets as of June 30, 1985, based on Supply System staff estimates. The amount estimated for unrecoverable costs ($2,622,739,057) has been reflected as Allowance for Estimated Unrecoverable Cost and as Deficiency in Assets in the accompanying balance sheets to reduce the capitalized utility plant value to net realizable value.

Retirement Plan

The Supply System participates in the Washington State Public Employees' Retirement System that provides retirement benefits to eligible employees. The cost of the plan to the Supply System is determined by the retirement system's board. The actuarially computed value of pension benefits exceeds the fund assets for the retirement system. However, because the retirement system is a multi-employer system, the amount of any excess that relates to the Supply System is not available. The Supply System's required contribution was $4,187,316 during the period ended June 30, 1985.

Note C—Long-Term Debt

Except for Nuclear Projects No.'s 4 and 5, which were financed together as one utility system, all Supply System projects are financed separately. The revenue bonds issued for each project are payable solely from the revenues of that project.

Outstanding revenue bonds of the various projects as of June 30, 1985, are presented on pages 20 through 22.

Security—Agreements and Contracts

Project participants have purchased the Supply System's ownership share of project capability of Nuclear Project No.'s 1, 2 and 3, and the Hanford Generating Project. The U.S. Department of Energy, acting by and through the Bonneville Power Administration (BPA), has in turn acquired the entire capability from the project participants under various net-billing and exchange agreements. BPA is obligated to pay the participants and the participants are obligated to pay the Supply System their pro rata share of the total annual costs of the projects, including debt service on the bonds, whether or not the projects are completed, operable or operating and notwithstanding the suspension, reduction or curtailment of the projects' output. See Note E for a discussion of the Hanford Generating Project and its relationship to Nuclear Project No. 1.

In connection with the issuance of the generating facilities revenue bonds for Nuclear Projects No.'s 4 and 5, the Supply System pledged the revenues to be derived under participants' agreements with 88

utilities operating principally in the Pacific Northwest. The participants' agreements provided that each participant pay its respective share of annual costs, including debt service on the bonds, whether or not the projects were completed, operable, or operating and notwithstanding the suspension, interruption, interference, reduction or curtailment of the projects' output. Payments from the participants for Nuclear Projects No.'s 4 and 5 termination costs and debt service were due beginning on January 25, 1983. Payments due under the participants' agreements have not been forthcoming (see note D) and an event of default, as defined in the bond resolution, occurred on July 22, 1983, and is continuing. On August 18, 1983, Chemical Bank (Nuclear Projects No.'s 4 and 5 bond fund trustee) declared the principal of all Nuclear Projects No.'s 4 and 5 revenue bonds and accrued interest due and payable immediately. See Note D for a discussion of the termination of Nuclear Projects No.'s 4 and 5, related challenges to the participants' agreements and default on the bonds.

In connection with the issuance of the Nuclear Projects No.'s 4 and 5 subordinated revenue notes ($60,000,000 due July 1, 1984, and $7,865,502 due June 30, 1983), the Supply System pledged to set aside money for payment of such obligations from funds to be accumulated in the Revenue Fund. Payments under the participants' agreements to be accumulated in the Revenue Fund were not made and therefore the subordinated revenue notes were not paid. See Note D for a discussion of default on Nuclear Projects No.'s 4 and 5 subordinated revenue notes.

Note D—Termination of Nuclear Projects No.'s 4 and 5 and Default under Bond Resolution

On January 22, 1982, the Supply System's Nuclear Projects No.'s 4 and 5 were terminated. Construction was 24 and 16 percent complete, respectively, at the time. The Supply System's current estimate of termination costs ($31,917,338), including costs of contract settlements and other termination costs, has been accrued as Accounts Payable and Accrued Expenses in the accompanying balance sheets. Although management of the Supply System is satisfied that its estimates are reasonable, the final settlement for termination costs and the cost of dismantling the projects cannot be determined at this time. Certain physical assets of Nuclear Projects No.'s 4 and 5 are being maintained for a period to maximize their sales value upon disposal.

The participants' agreements (discussed in Note C under Security) provided that each participant pay its respective share of the debt service on the bonds and termination costs beginning January 25, 1983. Payments due under the participants' agreements were not made pending a judicial determination of the participants' authority and obligation to pay. On June 15, 1983, and again on November 6, 1984, the Washington State Supreme Court ruled that Washington municipal utilities did not have statutory authority to enter into the participants' agreements and, thus, that those agreements are invalid as to the cities and public utility districts of the state of Washington, which collectively hold approximately 68 percent of the participants' shares of Nuclear Projects No.'s 4 and 5. In addition, on November 6, 1984 the Washington State Supreme Court also ruled that, because of the invalidity of the participants' agreements entered into by the Washington municipal utilities, all of the remaining participants' agreements are unenforceable as well. Chemical Bank and the Supply System petitioned the U.S. Supreme Court for grant of a writ of certiorari by which the state court decision might be reviewed by that court. Grant of the writ was denied by the U.S. Supreme Court on April 29, 1985.

Since the participants' agreements were ruled invalid, payments due under the agreements were not made and there is a deficiency in the Reserve and Contingency Fund and Bond Fund Interest and Reserve Accounts.

On July 22, 1983, the Supply System acknowledged that it could not meet all Nuclear Projects No.'s 4 and 5 obligations as they became due. This admission represented an event of default under the Nuclear Projects No.'s 4 and 5 bond resolution. A deficiency in the bond fund also existed at this time.

As authorized under Section 11.3 of the bond resolution, Chemical Bank demanded that remaining funds in the Construction Fund ($23,193,264), Construction Trust Account ($723,256) and Revenue Fund ($1,648,568) be transferred to it to the credit of the Washington Public Power Supply System Section 11.3 Account. This transfer was made on July 25, 1983. In addition, on July 1, 1983, Chemical Bank transferred a security with a book value of $8,823,598 from the Bond Fund Reserve Account to a newly established Trustee Legal Fee Escrow Account. The purpose of this transfer was to set aside funds to pay for Chemical Bank's legal fees as well as a portion of Supply System legal fees. Under Section 11.4 of the Nuclear Projects No.'s 4 and 5 bond resolution, Chemical Bank, as bond fund trustee, or a duly constituted bondholders' committee is entitled, to the extent permitted by law, to take possession of the business and properties of Nuclear Projects No.'s 4 and 5. At present, the Supply System is continuing to manage the contract termination and asset disposal activities. Supply System management plans to continue the asset disposal activities through at least June 1986. Chemical Bank disburses the funds for payment of Nuclear Projects No.'s 4 and 5 termination activities in accordance with the payment priorities established in the bond resolution. Since total obligations currently exceed available cash and revenues, certain lower priority obligations (as defined in the bond resolution) are not being paid.

On August 18, 1983, Chemical Bank declared the principal of all Nuclear Projects No.'s 4 and 5 revenue bonds and interest accrued thereon to be due and payable immediately.

Since the participants' agreements have been held to be invalid, the assets of Nuclear Projects No.'s 4 and 5 have been reduced to their estimated net recoverable value, resulting in a deficiency in assets. Such recoverable value is based on Supply System staff estimates. However, the ultimate recoverability cannot presently be determined.

In August 1983, Chemical Bank filed a lawsuit in U.S. District Court, Western District of Washington, which is now pending against the Supply System, all participants in Nuclear Projects No.'s 4 and 5, Supply System member utilities and certain directors, BPA and other individuals. The lawsuit alleges violations of federal and state securities statutes, fraud, misrepresentation, bad faith, negligence, and unjust enrichment, and seeks money damages, rescission and restitution. This suit is currently in the discovery phase.

In addition, numerous lawsuits have been filed against the Supply System and numerous other individuals and entities by individuals purporting to represent classes of bondholders. The lawsuits allege violations of federal and state securities statutes, negligent misrepresentation, common law fraud and deceit, gross negligence, and breach of contract, and seek monetary damages for losses allegedly sustained by the purported classes. These cases have been transferred to the U.S. District Court, Western District of Washington, and most have been consolidated for pretrial purposes. All of these cases are in the discovery phase of litigation.

Another lawsuit, *Haberman v. Washington Public Power Supply System,* has been filed by certain bondholders in King County Superior Court asserting claims substantially similar to those alleged in the other class actions. On October 7, 1985, the court dismissed all claims in the action. The plaintiffs have appealed this decision to the Washington Court of Appeals.

The lawsuits described in the three preceding paragraphs seek to recover the bondholders' investment in the amount of $2.25 billion, plus interest, costs, attorneys fees and damages.

The Supply System cannot predict the outcome of the above litigation.

Pursuant to state law and resolutions of the Supply System's Executive Board, the Supply System has agreed to indemnify its directors for certain of the acts which have been alleged in the complaint. The Supply System is obligated for associated costs (including legal defense costs) to the extent such costs are not covered by directors and officers insurance.

In a recently filed suit, the excess carrier of directors and officers liability insurance for the Supply System seeks an adjudication that it has no liability as a result

of the alleged failure of the Supply System to disclose facts known to it which, if known to the insurer, would have resulted in its not issuing the policy. Although this suit is not for money damages, it could have a serious financial impact on the Supply System.

Note E—Commitments and Contingencies

Hanford Generating Project and its Relationship to Nuclear Project No. 1

The U.S. Department of Energy (DOE) owns and operates the New Production Reactor. This reactor provides by-product steam to the Hanford Generating Project. The Supply System's current agreement with the DOE provides for the continuation of this dual-purpose operation of the reactor through June 1993. In accordance with certain related agreements, the operating costs of the project will be offset by payments from certain public and private utilities in return for the power generated.

It was initially intended that Nuclear Project No. 1 be constructed next to the Hanford Generating Project to provide the energy source to operate the project when the DOE ceased operation of the New Production Reactor. To allow for construction of Nuclear Project No. 1, it would have been necessary to shut down the Hanford Generating Project on October 31, 1977. Because studies at that time indicated that generating resources in the Pacific Northwest would be inadequate in the late 1970s and early 1980s, the Supply System and BPA determined that the Hanford Generating Project should be kept available for power production. Therefore, the Nuclear Project No. 1 net-billing, exchange and project agreements were amended to provide for the separation of Nuclear Project No. 1 from the Hanford Generating Project. The amended agreements provide that Hanford Generating Project costs, to the extent not otherwise provided for, be treated as Nuclear Project No. 1 costs with the Hanford Generating Project having a first claim on the revenues of that project.

The amended agreements provide for the payment of all debt service costs, net of investment income, of the Hanford Generating Project by Nuclear Project No. 1 participants, beginning July 1, 1980, regardless of continued operation of the reactor. If the reactor ceases operations, revenues to the Hanford Generating Project arising from these payments will nevertheless be recorded each year thereafter in amounts that will result in full realization of the carrying value of the plant.

The U.S. government has an option to acquire ownership of the Hanford Generating Project upon congressional approval. If the government exercises its option, it must assume all rights and obligations of the project, including the obligation to pay all revenue bonds.

Under the Hanford Generating Project agreements, public participants were entitled to 50 percent of the output of the project and five investor-owned utilities were entitled to 50 percent. All power was exchanged to BPA for firm power. During fiscal year 1984, three of the five investor-owned utilities withdrew their offer to purchase their entitlement to output from the Hanford Generating Project. The power from the plant is currently being distributed by BPA on the basis of 72 percent to public participants and 28 percent to the remaining two investor-owned utilities.

Nuclear Projects No.'s 1 and 3—Construction Delay

On April 29, 1982, the Supply System, upon the recommendation of BPA, approved an extended construction delay of Nuclear Project No. 1, and on July 8, 1983, the Supply System, also based on BPA's recommendation, approved an extended construction delay of Nuclear Project No. 3. During the construction delay, the Supply System will endeavor to preserve plant assets and maintain project licenses.

On November 1, 1984, BPA released a study of Nuclear Projects No.'s 1 and 3 construction schedule and financing assumptions. The study recommended that 1) BPA should not include funds for construction for Nuclear Projects No.'s 1 and 3 in its budget for fiscal years 1986 and 1987; 2) BPA should use a mid-range estimate of preservation cost in its rates and budgets; 3) BPA should work with the Supply System, the other Nuclear Project No. 3 owners, the Northwest Power Planning Council (council) and other ap-

propriate parties in defining and perfecting preservation plans and restart assumptions; and 4) BPA should perform periodic reviews of Nuclear Projects No.'s 1 and 3 consistent with BPA resource planning and budgeting to assure scheduling is consistent with regional resource requirements.

On August 7, 1985, the council released its 1985 Draft Northwest Conservation and Electric Power Plan (Draft Plan). The final 1985 power plan is scheduled to be completed in February 1986. In the Draft Plan, the council indicated that Nuclear Projects No.'s 1 and 3 are cost effective. However, the council did not include Nuclear Projects No.'s 1 and 3 in its resource portfolio, citing present legal and other barriers. The council does view Nuclear Projects No.'s 1 and 3 as energy options for the future when the current barriers are removed.

On November 22, 1985, BPA released its 1986 Draft Resource Strategy. The Final Resource Strategy is slated for publication in February 1986. The 1986 resource strategy process primarily focused on the proper level of preservation program costs for Nuclear Projects No.'s 1 and 3. The draft BPA report recommends that the Supply System maintain a preservation program that includes a technical program that would allow cost-effective, earned-value work to continue. The Supply System has ongoing detailed programs to physically preserve the equipment at the plants, and a technical program for earned-value work.

The Supply System is currently unable to predict when Nuclear Projects No.'s 1 and 3 will be completed. However, BPA has recommended that for the Supply System's fiscal year 1987 financial planning process, the Supply System assume a restart of construction of one unit in 1994 and restart of construction of the other unit in 1996. BPA further stated there is approximately a one-in-three chance that restart of construction would be needed during or before 1992 for one unit, and approximately a one-in-four chance that restart of construction would be needed during or before 1992 for the second unit to meet regional load growth.

The obligations of BPA and the participants under the net-billing agreements are not affected by the extended construction delays of Nuclear Projects No.'s 1 and 3. See "Nuclear Project No. 3 Claims" for a discussion of the investor-owned utilities' claims of breach of the Ownership Agreement based on the Nuclear Project No. 3 construction delay.

The Supply System's current estimates of costs to settle terminated and delayed contracts for Nuclear Projects No.'s 1 and 3 are $4,777,000 and $5,263,000, respectively, and these costs have been accrued as Accounts Payable and Accrued Expenses in the accompanying balance sheets. The Supply System's management is satisfied that these estimates are reasonable. However, the final settlement costs cannot be determined at this time.

Nuclear Projects No.'s 4 and 5 Subordinated Revenue Notes

In conjunction with the mothballing of Nuclear Projects No.'s 4 and 5, certain project participants, investor-owned utilities and industrial customers of BPA agreed to loan Nuclear Projects No.'s 4 and 5 funds to underwrite a program to preserve the assets of those projects. These loans, called bridge loans, consisted of $60 million in subordinated revenue notes, bearing a stated maturity date of July 1, 1984, and bearing interest to due date at a rate of 15 percent.

Subsequently, when a decision was made to terminate Nuclear Projects No.'s 4 and 5, a number of project participants agreed to loan Nuclear Projects No.'s 4 and 5 funds designed to assist in avoiding an uncontrolled termination of the projects. These loans, called termination loans, consisted of $7,865,502 in subordinated revenue notes bearing a stated maturity date of June 30, 1983, and bearing interest to due date at a rate of 15 percent.

Because Nuclear Projects No.'s 4 and 5 do not have sufficient funds to underwrite payment of the subordinated revenue notes, they have not been redeemed.

Fifteen participants and investor-owned utilities have filed lawsuits against the Supply System for payment of the notes, with Chemical Bank named as codefendant in

several of them. In 12 cases, summary judgments have been rendered against the Supply System, and in certain cases the judgments stated that the obligation to pay the notes was not restricted to the funds of Nuclear Projects No.'s 4 and 5. These cases were subsequently appealed to the Washington State Supreme Court and on September 5, 1985, the court upheld previous rulings that the Supply System must repay the bridge and termination loans, but ruled that repayment must be made only from funds of Nuclear Project No.'s 4 and 5. Motions for reconsideration are now pending.

Nuclear Project No. 5 Ownership Agreement

Under the terms of the ownership agreement with Pacific Power and Light Company (Pacific), Pacific is obligated to fund its respective ownership share of Nuclear Project No. 5 termination costs beginning January 25, 1983, and continuing until all costs of termination have been paid. Ten percent of the funds received from the sale of Nuclear Project No. 5 assets reduce Pacific's obligation for termination costs.

Pacific has stated to the Supply System that it considers the termination of Nuclear Project No. 5 to be a breach of the Nuclear Project No. 5 ownership agreement and has reserved its rights to pursue appropriate remedies with respect to such breach. It is the position of the Supply System that the termination of Nuclear Project No. 5 does not constitute a breach of the Nuclear Project No. 5 ownership agreement and that Pacific is responsible under the Nuclear Project No. 5 ownership agreement for payment of its 10 percent share of the costs of termination of such project.

On June 16, 1983, Pacific advised the Supply System that due to the Washington Supreme Court ruling that certain participants' agreements were invalid (as described in Note D) and other related actions by the Supply System, Pacific would no longer fund 10 percent of the Nuclear Project No. 5 termination costs. Pacific also advised that it would not make further termination cost payments until the Supply System adequately assures that it can re-establish and maintain controlled termination of the project in accordance with the agreements. The Supply System is currently working with Pacific to resolve this matter and resume payments. As stated above, it is the Supply System's position that Pacific is responsible for its 10 percent share of termination costs. Until Pacific resumes payments, the Supply System is withholding Pacific's 10 percent share of revenue received from Nuclear Project No. 5 asset sales. As of June 30, 1985, Pacific's 10 percent share of Nuclear Project No. 5 accrued termination costs was $1,471,588. Of this amount, $449,265 is currently due and has been presented to Pacific for payment. The remaining amount represents the Supply System's estimate of future termination costs.

Pacific has made payments prior to June 16, 1983, under the Nuclear Project No. 5 ownership agreement pursuant to reservations of rights to its potential claim to sue the Supply System for damages for failure to complete the project. Pacific's claim would presumably be about $150,000,000—its investment in the project. Such a claim could be a general claim against the assets of the Supply System.

Inter-Project Claims and Claims Against General Assets

As discussed above, Nuclear Projects No.'s 4 and 5 are currently unable to meet Nuclear Projects No.'s 4 and 5 debts as they become due. Creditors have threatened to attempt to obtain payment from assets or funds held for the benefit of other projects of the Supply System or the revenues pledged thereto. Such creditors include those described in the Notes to Financial Statements and others who may in the future assert claims against the Supply System and/or its projects.

In the opinion of bond counsel, neither the holders of the bonds issued to finance the construction of the Supply System's Nuclear Projects No.'s 4 and 5 nor the creditors of the Supply System whose claims arose from the furnishing of goods or services with respect to Nuclear Projects No.'s 4 and 5 will be able to realize upon monies held in trust by the respective bond fund trustees in the bond funds created by the respective bond resolutions for payment of debt service to the holders of bonds issued by the Supply System to finance the construction of the Supply System's Nuclear Projects No.'s 1, 2 and 3, except to the extent they might obtain rights through a valid exercise of the sovereign police power of the state of

Washington or of the constitutional powers of the United States of America, or by a voluntary bankruptcy of the Supply System.

Bond counsel has not investigated the issues discussed above with respect to the Packwood or Hanford Generating Projects. However, they believe that upon full investigation, the same opinion could be rendered with respect to such monies held in trust by the bond fund trustees in the bond funds created by the respective bond resolutions of the Supply System for the payment of debt service to the holders of bonds issued by the Supply System to finance the construction of such projects.

In the opinion of bond counsel, the Nuclear Projects No.'s 4 and 5 bondholders seeking to recover from the Supply System upon their bonds will be restricted to collecting any amounts in the bond fund for Nuclear Projects No.'s 4 and 5 and will not be able to enforce a judgment against any of the assets, funds or revenues for Nuclear Projects No.'s 1, 2 and 3, except to the extent such holders of bonds might obtain rights through a valid exercise of the sovereign police power of the state of Washington or of the constitutional powers of the United States of America, or by a voluntary bankruptcy of the Supply System.

This year, except as stated in the preceding paragraphs, bond counsel has rendered no opinion with respect to the rights of creditors of the Supply System to realize upon the assets, funds or revenues of Nuclear Project No. 1, Nuclear Project No. 2, Nuclear Project No. 3, the Packwood Project, the Hanford Generating Project, or the Internal Service Fund.

Supply System management is of the opinion that creditor claims can only be realized from the assets, funds or revenues of the projects to which such claims relate. The Supply System will utilize all legal remedies to defend its position. If it is found that creditors are not limited to payment of their claims from the project to which such claims relate, it will have a material adverse impact on the Supply System.

Shared Costs

The termination of Nuclear Projects No.'s 4 and 5 creates an uncertainty as to how certain common services and facilities are to be shared with Nuclear Projects No.'s 1 and 3, respectively. In August 1982, the participants of Nuclear Projects No.'s 4 and 5 presented a claim to Nuclear Projects No.'s 1 and 3 to reimburse Nuclear Projects No.'s 4 and 5 for a portion of the costs of shared services and facilities paid by the projects before July 1, 1981. The claim requested immediate payment of $75,000,000 and $86,000,000 plus interest from Nuclear Projects No.'s 1 and 3, respectively, plus amounts that may be determined in the future. The claim is based on a method of calculating shared costs that is different from the method adopted by the Supply System.

The Supply System has reviewed its cost-sharing policy from inception of the projects to determine if costs were allocated properly. As of June 30, 1985, about $16,962,000 plus interest is due Nuclear Project No. 5 from Nuclear Project No. 3; about $8,000,000 plus interest is due Nuclear Project No. 1 from Nuclear Project No. 4; and about $163,000 plus interest is due Nuclear Project No. 4 from Nuclear Project No. 2 for shared costs. These amounts (excluding accrued interest) have been recorded in the accompanying balance sheets as of June 30, 1985. The results of the aforementioned review are subject to audit by BPA and the investor-owned utilities in Nuclear Projects No.'s 3 and 5. Because of the preliminary nature of the aforementioned findings, the uncertainty over the shared cost policies adopted by the Supply System, and since the matter of proper allocation of shared costs is currently in litigation (as described below), the ultimate allocation of shared costs is uncertain.

On October 26, 1982, the Supply System filed a legal action against BPA, the four investor-owned utilities who are joint owners of Nuclear Project No. 3, the participants of Nuclear Projects No.'s 4 and 5, (the court has since allowed Chemical Bank to intervene in this suit) and the construction fund trustee for Nuclear Project No. 1 seeking a judicial determination of past and future shared costs among Nuclear Projects No.'s 1 and 4 and Nuclear Projects No.'s 3 and 5. (The court has since restructured the case wherein BPA is now the plaintiff and the Supply System and other afore-

mentioned parties are defendants.) Although the lawsuit does not specify the amounts of money that the parties believe should be reallocated, the method used to calculate the aforementioned claim is an issue in the lawsuit.

Nuclear Project No. 3 Claims

In July and August 1983, the four investor-owned utilities who own 30 percent of Nuclear Project No. 3 filed claims in the cost-sharing lawsuits against BPA, the Supply System and Nuclear Project No. 3 participants arising out of the extended construction delay at Nuclear Project No. 3. Included are claims for injunctive and declaratory relief, damages, rescission of the Nuclear Project No. 3 ownership agreement and recovery of the total amount of payments made under the agreement to date. In October 1983, BPA amended its complaint to resolve the Nuclear Project No. 3 dispute.

In November 1984, the court issued an order on the parties' cross-motions for summary judgment holding that the Supply System and BPA violated the terms of their contracts by not continuing construction and including the costs in an annual budget to be paid through net billing. The court reserved for trial the issues of whether the contracts were materially breached and whether the investor-owned utilities remain obligated to pay further Nuclear Project No. 3 costs. The judge on this case subsequently excused himself from the case. On May 16, 1985, the newly appointed judge vacated the summary judgment ruling made in November 1984, but retained the summary judgment motions under advisement.

During the period November 1984 through August 1985, BPA and the four investor-owned utilities negotiated a proposed settlement of the construction delay claims. BPA described the settlement as follows. BPA and the four utilities would enter into an agreement to exchange energy. BPA would exchange an amount of power to be determined by the performance of four surrogate nuclear plants similar in design to Nuclear Project No. 3. If these plants perform as expected, BPA could exchange to the utilities about 193 average megawatts of energy each year. In return, the utilities would provide BPA 1) payments equal to about $700 million (present value) over the life of the agreement based on the costs of operating and maintaining the surrogate plants (or Nuclear Project No. 3 if it is operated); 2) the opportunity to use their combustion turbines if needed; and 3) the opportunity to complete, operate and use their 372-megawatt share of Nuclear Project No. 3 if it is later determined to be both needed and cost-effective.

Final agreements permitting settlement of the construction delay claims were executed by the Supply System on September 13, 1985, and by BPA and the investor-owned utilities on September 17, 1985. Pursuant to those agreements the parties exchanged covenants not to sue and asked the court to enter an order of dismissal of their delay claims. On September 30, 1985, the court entered an order requiring that parties wishing to oppose the settlement file claims to that effect. Briefing will be concluded on January 28, 1986. Upon completion of that schedule, the court will be in a position to rule upon the settlement. In the absence of a settlement, and if the investor-owned utilities were to prevail in their request for an order granting a right to rescind the ownership agreement and a right to recover payments made thereunder, the Supply System could face a loss contingency of some $2 billion plus possible termination of the project. In December 1985, three participant groups filed complaints in the Ninth Circuit Court of Appeals, asking that the settlement be declared illegal and void.

Net-Billing Agreements

On November 15, 1982, the city of Springfield, Oregon, filed a complaint against the Supply System, BPA, the investor-owned utilities owning 30 percent of Nuclear Project No. 3, and all other parties to the net-billing agreements pertaining to Supply System Nuclear Projects No.'s 1, 2 and 3. The complaint alleged that the Lane County Circuit Court's decision in *DeFazio versus Washington Public Power Supply System* had created controversy and uncertainty about the contractual obligations of Oregon public participants and their authority under Oregon law to enter into the net-billing agreements. It also alleged that members of Oregon public utility boards are exposed to personal liability for

any payments of public money not authorized by law. The complaint sought a declaratory judgment that it and other Oregon public participants had legal authority to enter into the net-billing agreements, or if they did not, that BPA is liable to make contract payments. In their responses to the complaint, BPA and the Supply System asked for a declaration that all signatories to the net-billing agreements had legal authority to enter into them. Springfield ratepayers who were parties to *DeFazio* intervened in the action claiming that the plaintiff did not have authority to enter into the net-billing agreements under Oregon law.

The parties to the net-billing agreements are BPA, the Supply System, and the participants. The agreements provide that BPA is obligated to pay the participants, and the participants are obligated to pay the Supply System their pro rata shares of the total annual costs of the projects, including debt service on the bonds, whether or not the projects are completed, operable, or operating, and notwithstanding the suspension, reduction, or curtailment of the projects' output. However, the agreements also provide that they shall not be binding on any of the aforementioned parties if they are not binding on all the parties.

On May 16, 1983, the U.S. District Court for Oregon entered a judgment declaring that all parties to the net-billing agreements had legal authority to enter into them. Its decision was appealed by the ratepayers to the Ninth Circuit Court of Appeals in July 1983 and was argued before the court on May 10, 1984. On February 4, 1985, the Court of Appeals affirmed the judgment of the district court. The court subsequently denied the appellant's petition for rehearing. On August 16, 1985, the appellant filed a petition for writ of certiorari with the United States Supreme Court. It is not known whether or not the United States Supreme Court will accept review of this matter.

During August 1984, agreements between BPA and the Supply System were executed providing for the assignment of project capability (assignment agreements) of Nuclear Projects No.'s 1 and 2 and 70 percent of Nuclear Project No. 3 to BPA. Under these agreements, the Supply System has assigned to BPA all rights and interests in the Supply System's ownership share of project capability that the Supply System now has or hereafter may obtain if the courts determine that the net-billing agreements are invalid and project participants are not obligated to pay for any interest in project capability. BPA would pay directly to the Supply System the amounts that would have been payable under the net-billing agreements for such project capability. The validity of the assignment agreements may be challenged in the courts.

If a final judicial determination were rendered that the net-billing agreements are not enforceable against the parties and that the assignment agreements are not valid, such determination would result in default on Nuclear Projects No.'s 1, 2 and 3, and would have a material adverse impact on the financial condition of the Supply System.

Securities and Exchange Commission Investigation

On January 12, 1984, the Supply System was advised that the Securities and Exchange Commission had started a formal investigation into the circumstances surrounding the default on Nuclear Projects No.'s 4 and 5 revenue bonds. The investigation is continuing and the Supply System cannot predict what further action the commission may take as a result of the investigation.

Other Litigation and Commitments

The Supply System is involved in various claims, legal actions and contractual commitments not mentioned above as both a plaintiff and a defendant and in certain claims and contracts arising in the normal course of business for a large construction program. Although some suits, claims and commitments are significant in amount, final disposition is not determinable. In the opinion of management, the outcome of any such litigation, claims or commitments will not have a material adverse effect on the financial positions of the projects. The estimated cost of the projects may either be increased or decreased as a result of the outcome of these matters.

STATEMENT OF DEBT SERVICE REQUIREMENTS

($ in thousands)

FISCAL YEAR	Nuclear Project No. 2			Hanford Generating Project			Packwood Lake Project		
	PRINCIPAL	INTEREST	TOTAL	PRINCIPAL	INTEREST	TOTAL	PRINCIPAL	INTEREST	TOTAL
1986	$ 23,295	$ 215,015	$ 238,310	$ 3,240	$1,014	$ 4,254	$ 175	$ 383	$ 558
1987	24,925	213,399	238,324	3,255	913	4,168	180	376	556
1988	26,645	211,686	238,331	3,360	806	4,166	190	370	560
1989	28,510	209,818	238,328	3,485	693	4,178	195	363	558
1990	30,555	207,778	238,333	3,455	580	4,035	265	355	620
1991	82,800	205,539	288,339	5,065	425	5,490	275	346	621
1992	35,260	196,455	231,715	5,585	246	5,831	290	336	626
1993	37,980	193,758	231,738	5,835	58	5,893	300	325	625
1994	40,950	190,820	231,770	800	4	804	315	314	629
1995	44,225	187,602	231,827				330	303	633
1996	47,825	184,053	231,878				340	291	631
1997	65,575	180,144	245,719				360	278	638
1998	71,955	173,774	245,729				380	265	645
1999	79,330	166,666	245,996				400	251	651
2000	85,795	159,947	245,742				465	237	702
2001	93,290	152,468	245,758				490	220	710
2002	101,635	144,141	245,776				515	202	717
2003	93,055	134,854	227,909				540	183	723
2004	97,375	127,046	224,421				565	163	728
2005	106,765	117,655	224,420				590	142	732
2006	117,225	107,196	224,421				615	121	736
2007	122,655	95,576	218,231				640	99	739
2008	134,755	83,566	218,321				665	75	740
2009	148,200	70,217	218,417				690	51	741
2010	163,170	55,365	218,535				484	26	510
2011	179,835	38,822	218,657				150	8	158
2012	198,410	20,380	218,790				65	2	67
2013									
2014									
2015									
2016									
2017									
2018									
	$2,281,995	$4,043,740	$6,325,735	$34,080	$4,739	$38,819	$10,469	$6,085	$16,554

Excludes payments of bond principal and interest made on July 1, 1985

FISCAL YEAR	Nuclear Project No. 1 PRINCIPAL	Nuclear Project No. 1 INTEREST	Nuclear Project No. 1 TOTAL*	Nuclear Project No. 3 PRINCIPAL	Nuclear Project No. 3 INTEREST	Nuclear Project No. 3 TOTAL*	Nuclear Projects No.'s 4/5 PRINCIPAL	Nuclear Projects No.'s 4/5 TOTAL
1986	$ 14,855	$ 207,674	$ 222,529	$ 6,530	$ 165,357	$ 171,887	$2,317,865	$2,317,865
1987	15,470	206,652	222,122	8,925	165,001	173,926		
1988	18,055	205,729	223,784	10,555	164,368	174,923		
1989	18,970	204,564	223,534	11,315	163,579	174,894		
1990	21,465	203,320	224,785	12,145	162,761	174,906		
1991	62,560	201,877	264,437	13,050	161,901	174,951		
1992	23,755	196,226	219,981	14,045	160,961	175,006		
1993	25,560	194,547	220,107	15,125	159,932	175,057		
1994	26,985	192,684	219,669	16,310	158,798	175,108		
1995	28,550	190,667	219,217	17,615	157,546	175,161		
1996	30,745	188,480	219,225	19,045	156,163	175,208		
1997	38,080	185,949	224,029	22,595	154,637	177,232		
1998	41,565	182,462	224,027	24,605	152,628	177,233		
1999	45,455	178,573	224,028	26,810	150,427	177,237		
2000	49,465	174,563	224,028	29,020	148,218	177,238		
2001	53,920	170,104	224,024	31,475	145,773	177,248		
2002	58,885	165,142	224,027	34,180	143,068	177,248		
2003	51,135	159,602	210,737	37,095	140,057	177,152		
2004	55,430	155,305	210,735	42,730	136,746	179,476		
2005	60,600	150,137	210,737	45,995	132,503	178,498		
2006	66,320	144,415	210,735	49,615	127,908	177,523		
2007	72,665	138,071	210,736	49,675	122,946	172,621		
2008	79,705	131,031	210,736	54,485	118,136	172,621		
2009	87,525	123,213	210,738	59,810	112,810	172,620		
2010	96,220	114,518	210,738	65,710	106,909	172,619		
2011	105,855	104,883	210,738	72,265	100,355	172,620		
2012	116,610	94,129	210,739	80,365	92,250	172,615		
2013	118,635	82,105	200,740	89,490	83,126	172,616		
2014	127,155	69,605	196,760	99,770	72,846	172,616		
2015	142,820	55,476	198,296	111,370	61,252	172,622		
2016	175,395	39,441	214,836	124,455	48,165	172,620		
2017	194,005	20,831	214,836	139,235	33,382	172,617		
2018				154,950	17,665	172,615		
	$2,124,415	$4,831,975	$6,956,390	$1,590,360	$4,178,174	$5,768,534	$2,317,865	$2,317,865

Refer to Note D—Termination of Nuclear Projects No.'s 4 and 5 and Default Under Bond Resolution, page 26, and Note E—Commitments and Contingencies, page 28.

The Supply System operates two visitor centers for the public, one at Plant 2, about 12 miles north of Richland, and another in Elma, Washington, near the WNP-3 project. Displays in the visitor centers illustrate how plant design, construction and operation have been planned with the public's well-being in mind.

The Plant 2 Visitors Center offers a videotape "arm-chair" tour of the plant, as well as information on nuclear power issues such as radiation, nuclear waste and plant operator training.

Tours of the WNP-3 construction site are offered by appointment by calling (206) 482-4222. Tours of the WNP-1 site are available by appointment by calling (509) 372-5408.