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IMPLICATIONS OF WASHINGTON PUBLIC POWER SUPPLY SYSTEM PROBLEMS ON INVESTOR OWNED UTILITIES IN THE PACIFIC NORTHWEST

LFRUT LOWERS RATINGS ON: PACIFIC POWER, PORTLAND GENERAL, PUGET SOUND AND WASHINGTON WATER POWER

OVERVIEW

As the Washington Public Power Supply System (WPS) #4 and #5 nuclear projects near the brink of default, an assessment must be made concerning the fate of the WPS #3 nuclear plant in which four investor owned utilities (IOUs)--Pacific Power & Light, Portland General, Puget Sound and Washington Water Power--have a cumulative 30% interest. At this juncture, it appears as though project #3 has sufficient funds to continue construction only through the summer. Approximately $1 billion must be raised to complete the plant which was scheduled for mid-1986 commercial operation. But because of the Supply System's highly publicized problems with the #4 and #5 units, along with the Bonneville Power Administration's (BPA) own budgetary and legal difficulties, the future of WPS #3 is in serious jeopardy.

On May 27, 1983 the Supply System instituted an extended work suspension at project #3. A construction slowdown, frequently the first step toward project termination, is dictated by a lack of funds and an inability to access the capital markets until 4 and 5 problems are resolved. About the only things WPS #3 seems to have going for it right now are that: (1) logic would dictate that a project which is 73% complete should proceed, and (2) the Regional Power Act has established a need for the plant. Logic notwithstanding, termination of WPS #3 is a risk which must be addressed as is the IOU's ability to handle a sizeable WPS #3 write-off, especially since it is likely that the Skagit nuclear plant has gone sour and will have to be written-off as well. If project #3 is eventually terminated, all four IOU participants will have to lean very heavily on their respective state commissions in order to maintain their financial integrity. Given the sizeable asset over-hang and regulatory precedents established thus far, the credit impact will not be evenly distributed among the four companies.

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From a credit perspective, the effects of any write-off go beyond reporting "paper" or non-cash losses for a quarter or even the entire year. Rather, reduced financial flexibility, potential indenture violations, as well as significant common equity erosion could result from the cancellation and eventual write-off of the WPS #3 investment. Inasmuch as the current financial health will be an important indicator of the IOU's ability to deal with the write-off stress of Skagit and WPS #3 terminations, in the final analysis, the regulatory recourse available will be the single most critical variable facing each utility. The following table characterizes our view of the financial wherewithal and the regulatory support likely to be provided in the event of a termination for each company, along with the Moody's, S&P, and LFRUT ratings.

	Financial Wherewithall	Regulatory Support	Moody's	S&P	LFRUT
Pacific Power & Light	Favorable	Poor	Baa2	BBB	BBB3
Portland General	Poor	Poor	Baa2	BBB-	BBB3
Puget Sound	Poor	Favorable	Baa2	BBB	BBB3
Washington Water	Poor	Favorable	A3	BBB+	BBB3

While Puget Sound and Washington Water Power could not handle a write-off without some form of offsetting rate recovery, our current view is that the prospect for a regulatory "cure" to the Skagit termination--and possibly WPS--would be forthcoming. We will have some concrete evidence of this in July when the Washington commission prescribes treatment for Puget's investment in the terminated Pebble Springs nuclear plant. Whether or not the July precedent will carry over to other plants is an uncertainty we are taking into consideration at this time by reducing our ratings on Puget and Washington Water from BBB2 to BBB3--and we place them mid-range within the category. The cornerstone of our rating is an expectation that the Washington commission can and will support these companies; however, as events unfold we may have to rethink our position. Pacific Power on the other hand, is a mixed bag--what it lacks in regulatory support is made up for in financial strength. Pacific's better financial resilience and operating diversity give it a decisive edge over the entire group and we consider it strong within the BBB3 category. While we have also revised Portland General's rating to BBB3, it ranks at the very bottom of the grouping, reflecting the inordinate degree of regulatory risk facing the company. In upcoming months we expect the uncertainty surrounding the Pacific Northwest to grow, thereby placing the IOU's under market pressure. At this point, we feel that Pacific Power, Puget Sound, and Washington Water offer the most interesting work-out potential whereas we have less confidence in Portland General's outlook.

The Future of Washington Public Power Supply System Projects

As of this writing, the future of WPS is more uncertain than ever. With WPS #4 and #5 on the brink of default, one cannot help but wonder what the consequences will be for projects #1, #2, and #3 (the net-billed, BPA backed plants). Work on project #1 was suspended last year because of a lower load forecast released by the Bonneville Power Administration (BPA), a distributor of power in the Pacific Northwest and an agency of the federal government. Since the beginning

of 1983, work on units #2 and #3 has been proceeding at a reduced rate, largely as a result of the inability of WPS to market new securities because of the problems at units #4 and #5. The following table summarizes the current status, construction schedules, and estimated financing requirements for each of the five WPS projects.

Project	Capability (Megawatts)	Percent Complete (4/83)	Commercial Operation Date	Bonds Outstanding ($Millions)	Bonds To Be Issued ($Millions)
No.1	1,250	63%	*Mothballed	$2,155	N.A.
No.2	1,100	95	1Q 1984	2,370	$149
No.3	1,240	73	2Q 1986	1,600	961
No.4	1,250	24	Terminated	**2.250	-
No.5	1,240	3	Terminated		-

* Work has been suspended, but the last official service date estimate was 2Q 1986.
** Total bonds outstanding on projects #4 and #5.

The two key projects to focus on are #2 and #3, which require $149 and $961 million, respectively, in order to be completed. At this juncture, it appears as though BPA will put up the money needed to finish unit #2 from its own revenue stream. However, the future of unit #3 is not as bright for two reasons. First, in order for BPA to come up with the $1 billion or so for completion, some form of Congressional legislation would be required in order to give BPA direct access to the capital markets. Although bills will be introduced to give BPA financing authority, we suspect that any resolution would be embroiled in the political process and, as such, we hold little hope that this endeavor will be successful in the near term. A second and more promising option would be to have a new agency created to finance under a different name with BPA throwing its credit behind the entity, thus removing it as far as possible from the "WOOPS" stigma. From a practical standpoint, this seems to be the most feasible means of getting the money to finish unit #3. Yet there is one other stumbling block--namely, in order for a new agency to assume responsibility for finishing unit #3 (in which the investor owned utilities have a 30% cumulative share) the assets must be unbundled from the financial liabilities of projects #4 and #5. This is the case not only because units #3 and #5 share a common site, but because the whole project is held hostage by the WPS financing umbrella. It is unclear at this point what concessions will have to be made in order to effect an asset separation. Moreover, the separation process would be complicated by the as yet unresolved question of allocating common facility charges to unit #3. WPS has indicated that these costs could total $504 million, consisting of $269 million of already incurred expenditures and $235 million of prospective charges on unit #5. The cost-sharing issue is currently in litigation and there exists the possibility that an amount less than $504 million will ultimately be shifted to unit #3. In view of this, the previous cost estimate of $2.6 billion for unit #3 is understated and, as a result, it is likely that the $1 billion of financing needed to complete the unit is also low.

The over-riding observation to be made from the beleaguered WPS situation is that time, and money, are running out. The work slowdown on unit #3 cannot go on indefinitely, a cash infusion would have been needed by this August in order for further work to proceed. Given the tremendous uncertainty surrounding WPS, it does not appear that any financing can be done at this time. Thus, we expected the WPS announcment on May 27, 1983 of an extended construction slow-down on unit #3 and possible mothballing of the plant. The intention behind this action would be to buy time to investigate and work out financing alternatives. However, we believe that this move may only compound the problems facing WPS. Any delay of the in-service date of unit #3 would increase its cost. With a price tag of anywhere from $2.8 to $3.1 billion (depending upon termination cost allocations), and the economics of the plant already in question, it is hard to imagine how the project could make economic sense at higher cost levels. This is particularly important for the investor-owned utilities because their per KW cost of unit #3 is around $4,700 (before cost sharing/termination adjustments), making WPS among the most expensive nuclear plants in the country. The pricing burden is highlighted further when one considers that the incrementally expensive power from WPS will have to be blended with low cost hydro generation.

Finally, there is an added risk that any form of work suspension would be perceived as the first step toward non-completion of project #3. As part of WPS "controlled termination" on units #4 and #5, a work suspension preceded cancellation. Given WPS' poor credibility and the specter of a project #4 and #5 default, a work suspension on unit #3 would merely intensify the uncertainty surrounding its future--a prospect which is equally as unpalatable for the investor owned utilities as it is for the holders of WPS #1, #2 and #3 bonds.

IOUs INVOLVEMENT IN NUCLEAR PROJECTS

A WPS #3 termination would be the largest nuclear plant abandonment in history. But it would not be a first for the investor-owned utilities in the region. Of the two other nuclear projects in the region, Pebble Springs and Skagit, only Pebble Springs has officially been cancelled. Although Skagit is still "officially" a live project, Puget Sound, the sponsor, in February 1983 asked the Nuclear Regulatory Commission (NRC) to suspend certification and licensing proceedings pending adoption of a 20-year Regional Power Plan (a plan which ultimately did not include Skagit but did include WPS #3). In view of this, Pacific Power & Light announced that it was writing off its investment in Skagit for accounting purposes yet not formally withdrawing as a participant. At some point down the road it appears as though Skagit will go the way of Pebble Springs and WPS #4 and #5, eventually being cancelled, making it the fourth nuclear plant in the region to be scrapped. The involvement of the investor owned utilities in planned nuclear projects in the region is detailed below:

	WPS #1	WPS #3	*WPS #4	*WPS #5	*Pebble Springs	Skagit
Pacific Pwr & Lt	None	10%	None	10%	29.4%	20%
Portland General	None	10%	None	None	47.1%	30%
Puget Sound	None	5%	None	None	23.5%	40%
Washington Water	None	5%	None	None	None	10%

* Officially Terminated

The cancellation of Skagit would come as no surprise. For some time now confidence in its completion has been waning on the part of all the participants. In fact, with the exception of Puget, the remaining owners have ceased taking AFDC on the investment--and only Puget continues to accrue AFDC on the plant under special directive from the Washington Utilities and Transportion Commission (WUC). Therefore, it seems to us as though the principal question surrounding Skagit is not whether but, rather, when abandonment will be made official. The timing of a decision regarding Skagit can only be complicated by the very uncertain future of WPS #3. If WPS #3 craters, all four investor owned utilities could be facing substantial write-offs, placing them squarely at the mercy of their regulators. With this in mind and given the recovery treatment accorded other projects, we think PPL's move to write Skagit off early, reducing its nuclear asset exposure, will prove beneficial in the long-run. Nevertheless, all four utilities have a great deal of nuclear investment at stake, as reflected in the following table:

Year-End 1982
Investment in Nuclear Projects
($ Millions)

	WPS#5	Pebble Spring	Skagit	WPS#3	Total
Pacific Pwr & Lt	--------$47	----------------	$ 88.5	$228.3	$316.8
Portland General	None	Written off	135.1	208.9	344.0
Puget Sound	None	$53.5	159.8	96.9	310.2
Washington Water	None	None	38.7	100.0	138.7

While the potential for a write-off of WPS #3 seems unclear at this point, it is nevertheless a possibility which cannot be ignored. With the asset over-hang of both Skagit and WPS #3 so large, the effects--depending upon the regulatory resourse available--could be quite substantial. The asset and earnings exposure of these units is summarized here:

ASSET EXPOSURE
($Millions)

	Total Skagit/WPS#3 Investment	Total Assets (%)	Common Equity (%)	Retained Earnings (%)
Pacific Pwr & Lt	$316.8	$4,412.0 (7.2)	$1,233.4 (25.7)	$326.8 (96.9)
Portland General	344.0	2.323.0 (14.8)	755.5 (45.5)	143.2 (240.2)
Puget Sound	256.7	1,953.8 (13.1)	659.8 (38.9)	167.3 (153.4)
Washington Water	138.7	1,069.2 (13.0)	400.7 (34.6)	85.1 (163.0)

*EARNINGS EXPOSURE
($Millions)

	Annual AFDC Accruals on WPS#3	Net Income	ROE	WPS#3 AFDC/ Net Inc
Pacific Pwr & Lt	$31.0	$157.1	12.7%	19.7%
Portland General	$18.0	97.1	12.9%	18.5%
Puget Sound	$6.5	77.9	11.8%	8.3%
Washington Water	$12.0	48.8	12.2%	24.6%

* With the exception of Puget, each utility has stoped booking AFDC on Pebble Springs. Puget continues to take AFDC under instruction from The Washington commission.

From an earnings standpoint, cessation of AFDC on WPS #3 will not be devastating. In the worst instance (Washington Water Power), net income for common will be reduced by 25% and equity returns, in general, would be shaved from the 12%-13% range to about 10%--respectable levels for Triple-B credits. Yet, whether the utilities involved would be inclined or required to stop taking AFDC on WPS #3 under a mothball/extended construction delay scenario is uncertain. It is likely that each company will have to petition its state commission for a directive on this issue. And there is a precedent---set by Puget on the Pebble Springs plant---allowing AFDC to accrue on projects which have been cancelled.

While the nuclear asset exposure relative to common equity and retained earnings balances is heavy, we do not mean to suggest that WPS #3 will have to be written off against these accounts, or even that these figures will be representative of any write-off levels. Rather, the table is designed to highlight the potential equity risk faced by each utility and, accordingly, the importance of favorable regulatory treatment should WPS #3 be terminated.

Avenues of Regulatory Recourse

The single most important question to be addressed in the Pacific Northwest right now is what regulatory recourse is available for recovery of investments in terminated projects. This is certainly the case for Skagit and it is an issue which must be considered in assessing the overall riskiness of a WPS #3 involvement. While the precedents regarding recovery in the region are by and large discouraging, we believe that the jury is still out. The one glimmer of hope raised thus far comes from the Washington commission which gave Pacific Power & Light a 2.5% added equity kicker to recognize expected investor assessment of increased risk for the termination of WPS #5 and Pebble Springs. The commission denied the company amortization on the grounds that it would be unfair in view of the Oregon and Wyoming rulings denying recovery. Moreover, the commission suggested in the text of the order that amortization was denied only because of Pacific's unique circumstances, rather than due to the commission's opposition and/or statutory inability to recoup terminated plant investment from rate payers. The commission currently has under consideration a request by Puget (as part of a general rate proceeding) for the amortization of its Pebble Springs investment, thereby providing the commission with an ideal opportunity to establish a position on recovery for "domestic" utilities. A ruling is expected by early July, 1983. Based on the overtures made in the Pacific Power & Light case as well as a staff recommendation for Puget providing 5-year amortization, without rate base treatment, for Pebble Springs, we are encouraged about the prospects for recovery of future plant terminations in Washington. Observers close to the Washington commission feel that the commissioners are well aware of the financial consequences of not allowing some form of rate recovery and, although the future turn of events will test the mettle, it is felt that this commission will be supportive. However, we do not mean to imply that whatever treatment is accorded the Pebble Springs investment will carry over to other plants. The over-riding difference is dollars--the Pebble Springs investment relative to Skagit is about one-third. Instead, it is conceivable that the rate-making treatment will be different in future instances. For example, a much longer amortization period could be employed--perhaps 20 years.

On the other hand, the recovery approaches, or lack thereof, established in Oregon for Pacific Power and Portland General are cause for concern. The commission has interpreted the Oregon statutes as precluding recovery of terminated plant through increased rates. Accordingly, in 1982 Pacific wrote off its investments in WPS #5 and Pebble Springs and Portland also cleared Pebble Springs from its books. These extraordinary losses were offset by gains from debt/equity swaps, thereby mitigating the negative effect on earnings and erosion of the equity base. As a practical matter, this "accounting" approach seems to have solved the write-off problem. But we suspect that the technique has limited applicability and future solutions will have to come through regulatory channels. In this regard, the Oregon commission's view is discouraging. While Pacific has requested a declaratory ruling on this issue, a final determination is far more critical for Portland (because sustantially all of its operations are in Oregon) than for Pacific, which derives about 59% of its electric revenues from Oregon.

Finally, in Wyoming, which accounts for 19% of Pacific Power's electric revenues, the commission has also denied recovery of terminated plants through rates. The company has filed for a judicial review of this decision. Menawhile, proceeds from the 1982 debt/equity swap were applied to this jurisdictional write-off. Decisions from the California (4% of revenues) and Montana (3%) commissions are pending, but the outcome of these cases will be less significant for Pacific than those previously discussed.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST