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Research:
Many Factors Affecting Credit Quality of Electric Utilities in U.S. Northwest

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The Pacific Northwest's lack of precipitation that reached crisis proportions during the 2001 water year appears to be easing. Water levels in the region, following the second-lowest water year since 1928, have returned to near-normal levels, according to the Northwest River Forecast Center.

As a result, utilities that depend on hydroelectric generation, such as Bonneville Power Administration, Seattle City Light, Tacoma Power, Eugene Water and Electric Board, Puget Sound Energy Inc., and Avista Corp., are considerably more self-sufficient than they were in 2001.

In "Return to Credit Stability Seen For Public Power in the U.S. Northwest," published Dec. 7, 2001, Standard & Poor's noted its expectation of a return to credit stability for the sector in 2002. This, however, depends on a recovery of positive cash flow and overall financial health that these utilities enjoyed before the power crisis began in late 2000. Standard & Poor's is concerned that this expected recovery could be delayed by low market prices, lower-than-expected growth, and pressure on utilities to reduce rates.

Market prices continue to remain very low, at about $20 per megawatt-hour (MWh). A number of utilities, either through participation in Bonneville Power's SLICE product, entrance into long-term contracts, or load reduction as a result of conservation and the economic slowdown, are now long on power. This means that during certain hours of the day, these utilities sell excess energy into the market and use the revenues received to offset fixed costs.

In many cases, such off-system sales have become critical to their prospects for financial recovery. Revenues are needed to repay short-term borrowings, cover large deferred power costs from 2001, replenish depleted cash reserves, and fund delayed capital spending.

A number of Northwest utilities continue to petition the FERC for a review of contracts signed before the federal price cap was established for western markets last June, in hopes of reducing their fixed costs associated with this power. Snohomish County Public Utilities District has taken its case a step further, urging the FERC to modify a specific existing contract with Morgan Stanley that is well above current market prices and requires a burdensome collateral provision.

In addition, Northwest utilities customers are beginning to wonder why their rates remain high while market prices have fallen dramatically. Customers of certain public power entities, who are accustomed to some of the lowest electric rates in the U.S., have faced rate increases approaching 50% to 60%. City councils and boards are challenged to provide rate relief to customers while not further weakening the utilities' financial credit quality.

Utilities are explaining to their customers that rates and market prices will not always move in tandem due to the use of long-term contracts and hedging mechanisms to protect customers from the more volatile price shifts.

Just as most Northwest customers did not see immediate rate increases in late 2000 as energy prices sky-rocketed, neither will customers experience immediate decreases now that those prices have fallen. One notable exception is Tacoma Power. Tacoma was the first utility to raise rates when the power crisis began, adding a hefty 50% rate surcharge in December 2000. As a result, Tacoma's revenues more closely tracked actual power costs incurred by the utility and the company limited its short-term borrowing for operations to $35 million. As market prices came down, Tacoma was able to replace the 50% rate surcharge with a permanent rate increase of only 32% on Oct. 1, 2001. For Tacoma's customers, this was effectively a rate decrease, which contrasted markedly with the rate increases that most Northwest utilities were imposing to pay for the sizable rate hike in wholesale power from Bonneville Power.

The rate pressure felt by public power customers is in contrast to those customers of Avista and Puget Sound Energy, who have not yet felt the full effect of 2001 costs. Avista and the Washington Utilities and Transmission Commission (WUTC) reached a settlement agreement that will implement a 5% interim electric rate increase for customers effective March 15, 2002. The monthly bill for the typical homeowner using 1,000 kilowatt-hours will increase by $2.92 to $55.81, still competitive both regionally and nationally. Puget Sound Energy continues to work with the WUTC to get regulatory support for interim and general rate increases it needs to cover the escalation in power costs.

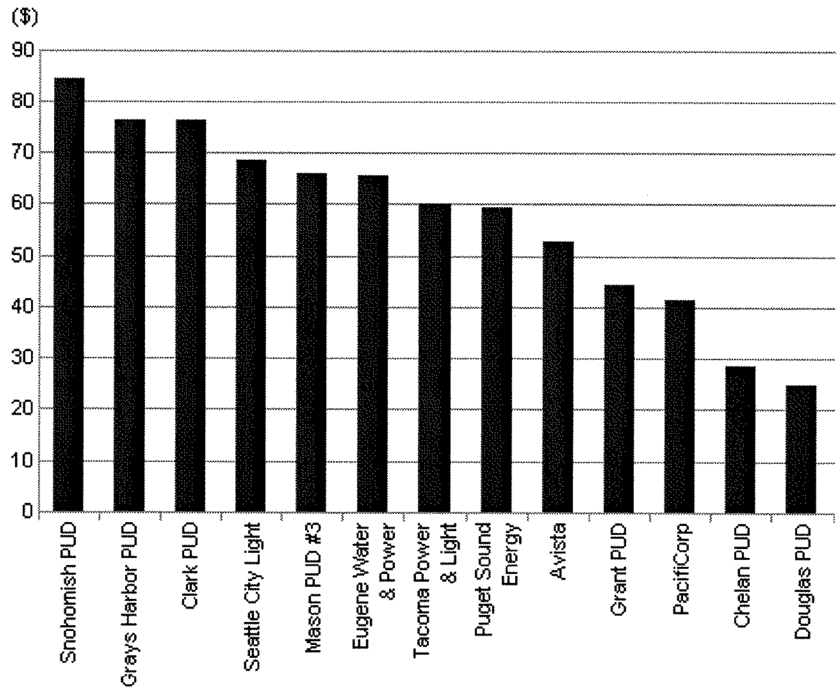
Average Residential Bill (1,000 kWh/month)								
($)	**1/1/1996**	**1/1/1997**	**1/1/1998**	**1/1/1999**	**1/1/2000**	**1/1/2001**	**1/1/2002**	**% change 1996-2002**
Puget Sound Energy	59.95	59.95	58.99	60.04	61.06	62.13	59.57	(0.63)
Avista	45.05	45.05	45.05	45.05	45.05	44.83	52.89	17.40
PacifiCorp (WA)	48.67	48.67	48.67	51.30	51.30	51.46	41.28	(15.18)
Seattle City Light	47.63	50.80	48.62	49.51	50.18	54.18	68.64	44.11
Tacoma Power & Light	45.40	45.40	45.40	45.40	45.40	64.60	60.07	32.31
Snohomish PUD	51.98	51.98	51.46	51.46	54.24	71.50	84.37	62.31
Clark PUD	48.40	48.40	48.40	48.40	53.20	53.20	76.20	57.44
Grant PUD	33.24	37.12	40.35	42.92	44.33	44.33	44.33	33.36
Chelan PUD	27.30	27.30	27.30	28.65	28.65	28.65	28.65	4.95
Grays Harbor PUD	49.70	49.70	49.70	49.70	49.70	59.89	76.40	53.72
Mason PUD #3	57.30	57.30	57.30	57.30	57.30	57.30	65.86	14.94
Eugene Water & Power	45.15	45.15	45.15	45.15	45.15	49.01	65.65	45.40
Douglas PUD	25.00	25.00	25.00	25.00	25.00	25.00	25.00	0.00

Bonneville Power recently announced that the load-based cost recovery adjustment clause (CRAC) would decline to 41% above its base rates during the six months from April through September, five percentage points below the 46% CRAC in effect from October 2001 through March 2002. The decline is the result of the roll-off of some load-reduction contracts, and Bonneville's ability to replace that power in the market at lower cost.

However, many of Bonneville's customers were hoping for a more substantial decrease that they could pass along to ratepayers. Although this should not immediately affect credit quality, it could delay the financial recovery of certain utilities, and customers will likely continue to feel the rate pressure.

The load-based CRAC covers Bonneville's costs to serve its load beyond what its own resources can provide, including load buybacks from customers. A number of the load buybacks were signed when Northwest power prices were higher than current prices, and these costs continue to be reflected in the load-based CRAC. Unfortunately, for Bonneville's wholesale customers, this means their rates will likely continue reflecting these higher costs for the five-year period during which the load-buybacks roll off.

Average Residential Bill Comparison



As of Jan. 1, 2002

Standard & Poor's continues to anticipate a return to credit stability for the overall public power sector in the Northwest, although there are a handful of utilities that have individual negative outlooks, indicating the possibility of further downgrades.

The greatest difficulty will be for those utilities that must now repay large amounts of deferred power costs and debt incurred in 2001 as a result of the power crisis. Rates are well above normal and will likely remain that way for the one- to three-year periods that some of the utilities require to regain financial health. They are in less of a position to withstand future market volatility, counter-party risk, increasing transmission costs, and another low water year.

In 2002, Standard & Poor's will continue to place particular emphasis on positive operating cash flow, the speed with which deferred balances or short-term borrowing can be repaid, support from state regulatory bodies or elected city councils regarding full cost recovery, hedging practices, trading and marketing strategies, including assumptions regarding off-system sales, and policies regarding cash reserves and debt levels.