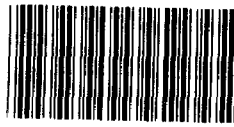




UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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ENERGY AND MINERALS
DIVISION



July 2, 1982

B-208084

119101

The Honorable Jim Weaver
House of Representatives

Dear Congressman Weaver:

Subject: Financial Community's Perceived Impacts Which
Could Result From Default or Successful Legal
Challenge by Participants in Washington Public
Power Supply System Nuclear Project Nos. 4 and
5 (GAO/EMD-82-106)

Your May 3, 1982, letter requested that we review the impacts and consequences of a default or successful legal challenge by Pacific Northwest utilities participating in the construction of Washington Public Power Supply System (Supply System) 1/ Nuclear Project Nos. 4 and 5. In the request, you asked us to include the effects such actions would have on the region's ability to raise capital for public works and other programs, and to carry out the mandate of the Pacific Northwest Electric Power Planning and Conservation Act 2/ (Regional Power Act) (P.L. 96-501) enacted December 5, 1980.

Specifically, you requested that we examine the following three scenarios which would relieve participants of their financial responsibilities with respect to the Supply System Nuclear

1/The Supply System is a municipal corporation and a joint operating agency of the State of Washington, created in 1957. It consists of 19 operating public utility districts and the cities of Ellensburg, Richland, Seattle, and Tacoma, all located in the State of Washington. The Supply System has the authority, among other things, to acquire, construct, and operate plants and facilities for the generation and transmission of electric power and energy.

2/This Act directs the Bonneville Power Administration to give priority to cost-effective conservation and renewable resources in meeting the region's power needs.

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Project Nos. 4 and 5 bonds. First, one or more utilities participating in the projects voluntarily defaulting on their obligations and throwing that class into default. 1 / Second, one or more of the participants being forced into bankruptcy by the debt service obligations and creating a default among the class of participants. 2/ Third, all participants being relieved of their obligations because of a successful court action by rate payers or utilities challenging the "take or pay" 3/ contracts or Supply System construction practices.

OBJECTIVE, SCOPE,
AND METHODOLOGY

Our objective was to gather the views and opinions from financial experts on the possible financial impacts and consequences that a Supply System bond default or successful legal challenge could have on the region's future ability to raise capital. Because of the uncertainties of predicting what could happen, we used as a framework the above three scenarios. Our work was performed in accordance with GAO's current, "Standards for Audit of Governmental Agencies, Activities, and Functions."

In performing our work, we used various documents to develop the chronology of events leading up to the current financial problems with the Supply System's Nuclear Project Nos. 4 and 5. These documents included the bond prospectuses, Participants' Agreement, bond resolution on project Nos. 4 and 5, past GAO reports, engineering and financial reports, and the Regional Power Act.

In addressing the question of how a default or a successful challenge to the "take or pay" contract might impact the Pacific

1/Participants are divided into municipal and non-municipal classes. Each participant has executed an agreement with the Supply System to pay for a share of the project capability. The agreement provides that if a participant fails to make its payments, other participants in the class will have their payments automatically increased to cover the non-paying participant's share. The increase would be in the same proportion as their original share, but cannot exceed 25 percent of their share.

2/Ibid.

3/For the purposes of this report, the "take or pay" contract refers to a provision in the Participants Agreements which obligates each participant to make required payments to the Supply System whether or not the Projects are completed, operable or operating.

Northwest's ability to raise capital for public works and other programs, and to carry out the mandate of the Regional Power Act, we interviewed those financial experts either directly involved with or otherwise considered to be knowledgeable with the Supply System's financial situation. These officials included three financial analysts, five investment bankers, one bond counselor, and two bond rating officers in New York City, and three bond trustees located in New York City, Chicago, and Seattle. We are presenting the consensus obtained from the financial experts even though, in some instances, individual views differed.

POWER DEVELOPMENT
IN THE NORTHWEST

From the late 1930s to 1966, nearly all electric energy needs of the Pacific Northwest were provided by hydroelectric projects. By 1966, projected electricity demand had grown beyond the capability of the hydroelectric system. Consequently, the Bonneville Power Administration (BPA) 1/ and the region's public and private utilities formed the Joint Power Planning Council to study the region's future power needs. In 1969, the Council adopted a plan calling for the construction of several large thermal plants. As a result, the Supply System subsequently agreed to construct Nuclear Project Nos. 1, 2, and 3, which were funded by the net-billing arrangement. 2/

Due to rising construction costs for plants 1, 2, and 3, BPA could not enter net-billing for additional plants. In addition, a 1972 change in U.S. Treasury regulations denied tax exempt status to bonds sold by publicly owned utilities to finance plants if power from the facilities was sold to BPA. This resulted in the Supply System deciding to build two additional nuclear projects, (Nos. 4 and 5) which would be financially backed by participating utilities.

By July 1976, 88 BPA preference customers 3/ and one private utility became participants in acquiring the generating capability

1/BPA was established in 1937 and is an agency of the U.S. Department of Energy. BPA markets power from 30 Federal hydroelectric projects located in the Pacific Northwest.

2/Net-billing is a financial arrangement whereby BPA agrees to purchase part or all of the generating capability of a plant.

3/Bonneville Project Act of 1937 directed that cooperatives and publicly owned utilities of the Pacific Northwest region be given first call on available Federal power resources. They consequently came to be called "preference customers."

from the Supply System Nuclear Project Nos. 4 and 5 (see appendix I for listing of participants and shares owned in plants). These plants were financed through the issuance of municipal tax-exempt bonds by the Supply System and are to be retired from a Bond Fund.

TERMINATION OF NUCLEAR
PROJECT NOS. 4 AND 5

After July 1976, a series of events occurred which resulted in a January 22, 1982, decision to terminate project Nos. 4 and 5. The Supply System's termination decision was based primarily on advice from the financial community that the financial markets' ability to absorb bond financing for all five projects was not possible. At the time of the termination decision, the Supply System estimated the cost of completing the two projects at approximately \$12 billion, which was about \$8.5 billion greater than the original estimate.

By the time the projects were terminated, the Supply System had sold \$2.25 billion in bonds, secured by "take or pay" contracts, on the two projects (No. 4 was approximately 25 percent complete and No. 5 was approximately 14 percent complete). These contracts require the participants to pay off the bonds in the amount of their proportionate share, as shown in appendix I, regardless of whether the plants are ever completed or operated. By the time the \$2.25 billion in bonds are retired in the year 2018, the participants will have paid \$7.2 billion in principal and interest.

Because of the rate increases that will be required to pay off this debt, a number of participants and rate payers have filed lawsuits contesting the validity of "take or pay" and the Supply System's construction practices. In addition, some participants have raised the possibility of defaulting on their debt. Default could occur either through voluntary means, such as participants refusing to pay their debt and/or rate payers refusing to pay their electric bills, or through involuntary means, such as participants being unable to meet their debt obligations.

IMPACTS AND CONSEQUENCES
OF DEFAULT

Investment bankers, bond counselors, bond rating officials, and financial analysts we interviewed generally believe that a default by the participants on the Nuclear Project Nos. 4 and 5 bonds could adversely affect the region's economy and its ability to raise capital in the bond market. Although these officials stated that the full impact of a default is difficult, if not impossible to predict, they generally agreed that a voluntary default could more negatively impact the participants and the region than if the participants were unable to pay due to

bankruptcy or some other form of financial hardship. The predominant opinions of the financial community regarding the situation follow.

Most financial experts predicted that those participants that default could expect to pay higher interest rates for future bond sales. As one financial analyst stated, before the market ever decides to lend any future money to an entity involved in a default, the entity would be expected to pay more and to sign guarantees that it would meet its debt obligation. In effect, investment bankers would have to be satisfied that the entity would not try and renege again on its credit obligations. Moreover, an investment banker pointed out that the defaulting entity could be subject to these higher interest rates for a very long period of time because, as the banker stated, "the market is not very forgiving of those who default." The official cited the example of two municipalities which defaulted on their bonds during the depression. To this day, they are being penalized in the market place with higher interest rates.

Some financial officials also stated that the worst situation that could occur would be a voluntary default on the bonds. Such action could result in the participants being totally excluded from future access to the credit market.

In addition to default adversely affecting participants, financial experts stated that default could also have negative impacts on the region. The most probable impact cited was higher interest rates on future bond sales resulting in added financial expenses. Furthermore, investment bankers voiced concern that a default could impact the region's ability to access the credit market for other power projects, including conservation and renewable resources as provided in the Regional Power Act, and even non-power projects, such as municipal airports and sewage treatment plants.

IMPACT OF SUCCESSFUL
LEGAL CHALLENGE TO TAKE
OR PAY CONTRACTS

Since December 1981, a number of suits have been filed which attempt to relieve participants of their debt obligations. On April 23, 1982, a group of twelve rural electric cooperatives, which are participants in project Nos. 4 and 5, filed a suit alleging that since there is in fact no power to "take" from the terminated plants, they are under no obligation to "pay". Another suit, filed on May 13, 1982, by the utility board of Springfield, Oregon contends that the Supply System breached its contract with the utility board by failing to properly administer the construction and design of project Nos. 4 and 5. The plaintiff is claiming, in effect, that the Supply System did not fulfill its obligation in the contract to build the plants properly; therefore, the

projects' participants are not required to meet their obligation to pay the bill. In addition, a suit was filed on December 22, 1981, by three residents of the City of Springfield, Oregon. The plaintiffs claim that the city illegally signed its contracts with the Supply System and should not be required to pay its share of project Nos. 4 and 5.

In response to the "take or pay" suit, on May 18, 1982, Chemical Bank of New York, bond trustee for Nuclear Project Nos. 4 and 5 bonds, instituted a lawsuit in the Superior Court of King County, Washington. The suit seeks an early determination of the enforceability of "take or pay," and requests a declaration of rights, obligations, and other legal relations of the parties under the bond resolution and Participants' Agreements. An officer of Chemical Bank told us that the suit was brought to avoid the multiplicity of lawsuits being brought against the "take or pay" contracts by obtaining judgment as to the enforceability of the concept as soon as possible.

Although a successful challenge to the "take or pay" contract or construction practices could relieve the participants of their debt obligation, according to financial community officials it also could create difficulties for utility financing because "take or pay" is the traditional method of financing power projects. Financial experts stated that in lieu of "take or pay," no one knows what method of financing could be used. Most of the officials did say, however, that whatever the method, the cost of money will probably be higher because investors will perceive these projects as having more risks associated with them. The projects which would be most directly affected by such a decision are the "joint operating agency" 1/ public power projects. These power projects, located in 14 states, have similar contracts.

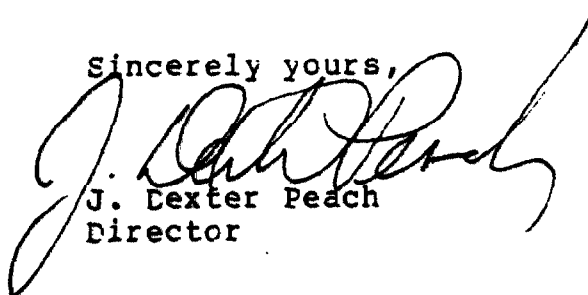
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As requested by your office, we did not obtain agency comments and unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days

1/Joint operation agency is two or more public power supply systems formed jointly to finance the construction of power projects.

from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "J. Dexter Peach". The signature is written in black ink and is positioned above the typed name and title.

J. Dexter Peach
Director

LIST OF PARTICIPANTS AND THEIR SHARE
IN THE SUPPLY SYSTEM'S NUCLEAR
PROJECTS NOS. 4 AND 5

<u>Participant</u>	<u>Participant's Share</u>
<u>Municipal Class</u>	
UTILITY DISTRICTS:	
PUD #1 of Benton County, Wa.....	.05080
Central Lincoln PUD, Ore.....	.02668
PUD #1 of Chelan County, Wa.....	.00642
PUD #1 of Clallam County, Wa.....	.01373
PUD #1 of Clark County, Wa.....	.09858
Clatskanie PUD, Ore.....	.00781
PUD #1 of Cowlitz County, Wa.....	.09132
PUD #1 of Douglas County, Wa.....	.00011
PUD #1 of Franklin County, Wa.....	.02925
PUD #2 of Grant County, Wa.....	.00581
PUD #1 of Grays Harbor County, Wa.....	.04410
PUD #1 of Klickitat County, Wa.....	.00982
PUD #1 of Lewis County, Wa.....	.02021
PUD #1 of Mason County, Wa.....	.00156
PUD #3 of Mason County, Wa.....	.00971
Northern Wasco County PUD, Ore.....	.00324
PUD #1 of Okanogan County, Wa.....	.00681
PUD #2 of Pacific County, Wa.....	.00848
PUD #1 of Pend Oreille County, Wa.....	.00402
PUD #1 of Skamania County, Wa.....	.00257
PUD #1 of Snohomish County, Wa.....	.13051
Tillamook PUD, Ore.....	.00781
Vera Irrigation District #15.....	.00257
PUD #1 of Wahkiakum County, Wa.....	.00123
CITIES:	
Bandon, Ore.....	.00067
Blaine, Wa.....	.00067
Bonnors Ferry, Id.....	.00190
Burley, Id.....	.00190
Canby, Ore.....	.00525
Cascade Locks, Ore.....	.00067
Centralia, Wa.....	.00659
Drain, Ore.....	.00067
Ellensburg, Wa.....	.00625

<u>Participant</u>	<u>Participant's Share</u>
Heyburn, Id.....	.00257
Idaho Falls, Id.....	.00915
McCleary, Wa.....	.00123
McMinnville, Ore.....	.00971
Milton-Freewater, Ore.....	.00056
Port Angeles, Wa.....	.00469
Richland, Wa.....	.01965
Rupert, Id.....	.00324
Springfield, Ore.....	.01764
Steilacoom, Wa.....	.00145
Sumas, Wa.....	.00022
Tacoma, Wa.....	.10696

Non-municipal Class

COOPERATIVES:

Adler Mutual Light Co.....	.00011
Benton Rural Electric Assn. Inc.....	.00670
Big Bend Electric Coop., Inc.....	.00514
Blachly-Lane County Coop. Assn.....	.00458
Central Electric Coop., Inc.....	.00971
Clearwater Power Co.....	.00324
Columbia Basin Electric Coop., Inc.....	.00391
Columbia Rural Electric Assn., Inc.....	.00647
Consumers Power, Inc.....	.01351
Coos-Curry Electric Coop., Inc.....	.00581
Douglas Electric Coop., Inc.....	.00514
Elmhurst Mutual.....	.00581
Fall River Rural Electric Coop., Inc.....	.00648
Glacier Electric Coop.....	.00179
Hood River Electric Coop., Inc.....	.00301
Idaho County Light and Power Coop., Inc.....	.00045
Inland Power & Light Co.....	.02244
Kootenai Electric Coop., Inc.....	.00647
Lane Electric Coop., Inc.....	.00770
Lincoln Electric Coop (Wa.).....	.00190
Lost River Electric Coop., Inc.....	.00134
Lower Valley Power & Light, Inc.....	.00837
Midstate Electric Coop., Inc.....	.00703
Missoula Electric Coop., Inc.....	.00581
Nespelem Valley Electric Coop., Inc.....	.00045
Northern Lights, Inc.....	.00514
Ohop Mutual Light Co.....	.00089
Okanogan County Electric Coop., Inc.....	.00045
Orcas Power and Light Co.....	.00647
Parkland Light & Water Co.....	.00134
Prairie Power Coop., Inc.....	.00089

<u>Participant</u>	<u>Participant's Share</u>
Raft River Rural Electric Coop., Inc.....	.00391
Ravalli County Electric Coop., Inc.....	.00234
Rural Electric Co.....	.00089
Salem Electric.....	.00458
Salmon River Electric Coop., Inc.....	.00084
Tanner Electric.....	.00100
Umatilla Electric Coop. Assn.....	.03573
Unity Light & Power Co.....	.00134
Vigilante Electric Coop., Inc.....	.00290
Wasco Electric Coop., Inc.....	.00134
Wells Rural Electric Co.....	.00045
West Oregon Electric Coop., Inc.....	<u>.00134</u>
Total Participants Shares.....	<u>1.00000</u>