Research Department
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FRBSF Weekly Letter

Default for Washington Power?

Last week, government and electric utility officials in the Pacific Northwest reached tentative agreement on a plan that might prevent the Washington Public Power Supply System (WPPSS) from defaulting on $2.25 billion in bonds issued to finance two now-cancelled nuclear power plants. The likelihood that the numerous parties involved will give final approval to the plan appears dim however.

WPPSS officials have warned of an imminent technical default in meeting the monthly payment to its interest account on debt borrowed to finance the two plants. Failure to make that payment could be the first in a series of steps leading to final default in meeting its interest payment to bondholders due January 1, 1984. The implications would be enormous for the Pacific Northwest electric utility industry, its customers, the regional economy and the municipal bond market.

Reviewing the situation

On July 1, WPPSS needs to make a $94-million semi-annual interest payment to holders of the $2.5 billion of municipal bonds issued to finance two cancelled projects, known as plants 4 and 5. As of late March, the agency had $38 million in its interest account and another $42 million in its construction fund. By drawing down the latter account, the agency probably could make the required monthly payments to its interest account through May. But in doing so, it would be in technical default to its contractors. The deficit arises because many of the 88 Pacific Northwest utilities which were to have received power from those plants—the so-called "participants"—are challenging their legal liability in the courts and have refused to make their necessary contributions directly to WPPSS. Some have made payments to an escrow account, but WPPSS probably will not have access to those funds until their liability is established.

The agency can probably still meet its interest payment to bondholders on July 1 by drawing down its Reserve Fund at Chemical Bank—trustee to the bondholders. But unless that fund is replenished in accordance with the bond indenture, WPPSS will be in final default to bondholders by January 1, 1984, when its subsequent semi-annual interest payment comes due.

Institutional framework

The Washington Public Power Supply System is a municipal corporation and a joint operating agency of the State of Washington. Its 23 members include 19 operating public utility districts and the cities of Ellensburg, Richland, Seattle and Tacoma, all located in Washington. In the late 1960s, the agency agreed to become part of a ten-year Hydro-Thermal Power Program entered into by the Bonneville Power Administration (BPA) and over 100 Pacific Northwest utilities to meet the region's projected electrical demands over the 1970–90 period. As part of this effort, WPPSS by 1974 had embarked on an ambitious mission to build five nuclear electric generating plants—three on the Hanford Reservation and two near Satsop, Washington.

WPPSS has sold shares of the output of these plants to its members and other Pacific Northwest utilities. These owners are known as "participants." The agency, acting on behalf of the participants, has sold tax-exempt revenue bonds to finance the nuclear projects. Each participant has entered into agreements with WPPSS with a "take-or-pay" clause that binds them to pay the agency its share of the annual cost of the projects, including debt service on the bonds, *whether or not* the projects are ever completed or operational.

In the case of plants 1, 2 and 70 percent of plant 3, the participants have assigned their shares to the Bonneville Power Administra-

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tion under "net-billing" agreements. Under these agreements, BPA is required by law to meet the obligations to creditors of these plants even if the plants never produce power. Moreover, Bonneville must meet these obligations before making any cash payments to the U.S. Treasury for repayment of Federal investment in the Columbia River Power System.

The purpose of the net-billing arrangement has been to provide security to bondholders of plants 1, 2 and 3. It also has enabled BPA to average the high cost of these projects with other lower-cost BPA hydro-power. In fact, the BPA backing given to plants 1, 2 and 3 obligations has enabled WPPSS to finance those plants to the level of nearly $6 billion and to maintain a Standard and Poor bond rating of AA. In contrast to plants 1, 2 and 3, bonds issued for plants 4 and 5 are secured only by the power sales agreements between WPPSS and the 88 participants.

What went wrong?

WPPSS's financial problems can be traced to cost overruns on its five nuclear plants and the effect these costs have had in raising electricity prices and thereby slowing the growth of electric power consumption in the Pacific Northwest. Higher costs associated with project delays had boosted the total cost of the five plants from $7 billion in the mid-1970s to $24 billion in 1982. As BPA averaged the costs of plants 1, 2 and 3 with its hydroelectric power costs, the average wholesale price of power to its utility and direct industrial customers rose four-fold over the 1979–83 period alone, from 0.3 cents per kilowatt-hour to 1.2 cents per kilowatt-hour. Because Pacific Northwest utilities have passed their costs (including plants 4 and 5) on to final users, the average retail price for electricity in the region has risen over the period from 1.7 cents/kilowatt-hour to 3.2 cents/kilowatt-hour (see chart).

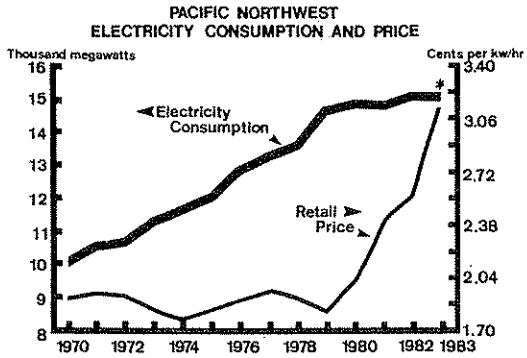
When Northwest utilities developed the Hydro-Thermal plan, they expected regional electrical consumption to continue to grow at an historical average annual rate of 7 percent over the 1970–80 period. Higher prices have since slowed growth to an annual average of 4 percent and forecasts are for 2 percent annual growth for the 1980–2000 period.

When it became evident that the output from plants 4 and 5 would not be needed, WPPSS cancelled further construction of the plants in January 1982. The same circumstances led officials in the spring of 1982 to suspend work on plant 1 (about two-thirds complete) for up to five years, and, in February, to slow construction on plant 3.

Legal challenges

Given the take-or-pay clause in their contracts, cancelling plants 4 and 5 means that the sponsoring utilities will have to pay $7 billion in principal and interest to bondholders over 30 years with no prospect of future income from those facilities. In reaction, numerous utilities have filed lawsuits to challenge the provision, while Chemical Bank—representing the bondholders—is seeking judgment that the 88 utilities are liable for the plant debt. The Chemical Bank case been postponed, but several preliminary decisions already rendered in other lawsuits increase the likelihood of default.

In a possibly precedent-setting case, ratepayers of the Springfield Utility Board in Oregon challenged the authority of their utility to sign the Participants' Agreement. In late October 1982, an Oregon judge ruled in favor of the ratepayers, indicating that the Springfield utility had exceeded its legal authority in entering into the agreement. If upheld, this decision as well as an Idaho ruling could mean that Oregon and Idaho utilities, which account for 10 percent of the ownership of plants 4 and 5, may have no legal obligation to meet debt service on those plants. Moreover, in a pre-trial ruling in mid-December, a Superior Court judge in Washington ruled that participants in that State cannot be forced to "step up" their payments to cover the unpaid shares of non-Washington utilities.



*Consumption is estimated for 1983; price represents current level.

Impacts of default?

Should WPPSS default, the public utilities sponsoring the projects would find it difficult to obtain future financing. Those least affected would face a temporary exclusion from the municipal bond market and subsequently pay high penalty interest rates which would decline over time. Those most heavily involved would be precluded from most types of financing, and some might choose bankruptcy.

The WPPSS joint operating agency might also be forced into bankruptcy or receivership. Bankruptcy might be limited to plants 4 and 5, if State law were changed to permit "selective" bankruptcy. Otherwise, the claim that holders of plants 4 and 5 debt would have on WPPSS' other assets and income could bankrupt the entire WPPSS corporation. (As is, WPPSS has sold $8.5 billion in bonds—more than any other tax-exempt issuer.) In any case, the agency would find it extremely difficult to continue financing plants 1, 2 and 3.

Financial analysts contend that a WPPSS default would make it more costly for other state and local government agencies in the Pacific Northwest to float future debt because the financial market would view the region as being financially irresponsible. A default would have some negative impacts on the municipal bond market generally. In addition, several banks in the Pacific Northwest, heavily invested in plants 4 and 5 and other utility bonds, would stand to lose from default.

Rescue plans

Consultants, brokerage houses and utility associations have put forth a number of proposals to avoid default, or at least to minimize investor losses. The plan utility negotiators tentatively agreed upon seeks to prevent default by relieving the 88 utilities which sponsored plants 4 and 5 from some of their obligation. It calls for "regionalizing" some of the debt by spreading its cost among all Northwest public and investor-owned utilities, whether or not they were sponsors. Specifically, it calls for plants 1 and 3 to assume the full $400 million of shared costs for projects 4 and 5.

A second part of the plan, which would also involve regionalizing part of the debt, would limit the debt obligation of any one utility participating in plants 4 and 5 to an amount that would boost its rates no more than .7 cents per kilowatt-hour. The excess would be distributed to other utilities and ultimately to electric users throughout the Northwest. Bonneville would act as the conduit for the regionalization aspects of this plan by raising its rates to its wholesale customers.

A key question is whether the participants in plants 1 and 3 will agree to this plan, as some of them were not among the 88 utilities sponsoring plants 4 and 5 and do not have any legal financial liability. In addition, Congress would have to pass Federal legislation to enable BPA to incorporate plant 4 and 5 debt into its rate structure.

Unlike some earlier proposals, one benefit of the regionalization approach is that it would not require the taxpayers throughout the nation to subsidize the Northwest by providing low-cost loans. Instead, responsibility for the debt would be contained within the region. Also, the costs incurred by the region's utilities and their retail customers in paying off projects 4 and 5 might be less than the costs they would incur through default. It might be in their mutual interest for the various groups to reach a consensus outside the courts that preserves the region's creditworthiness.

Permitting WPPSS to declare bankruptcy might not be a bad solution, however, in that the courts would then be required to determine which parties really are responsible for the debt. Like all investors, plant 4 and 5 bondholders must have realized there were risks in purchasing those bonds.

Yvonne Levy

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/6/83	Change from 3/30/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	163,684	487	5,072	3.2
Loans (gross, adjusted) — total#	142,640	538	5,286	3.8
Commercial and industrial	45,211	30	2,159	5.0
Real estate	57,098	− 48	142	0.2
Loans to individuals	23,456	0	265	1.1
Securities loans	1,993	− 28	4	0.2
U.S. Treasury securities*	8,180	43	1,890	30.1
Other securities*	12,864	− 94	− 2,104	− 14.1
Demand deposits — total#	43,007	2,975	1,538	3.7
Demand deposits — adjusted	29,552	1,329	484	1.7
Savings deposits — total	66,584	1,318	34,645	108.5
Time deposits — total#	66,791	−1,102	− 23,607	− 26.1
Individuals, part. & corp.	59,608	− 899	− 21,505	− 26.5
(Large negotiable CD's)	20,459	− 776	− 12,640	− 38.2

Weekly Averages of Daily Figures	Week ended 4/6/83	Week ended 3/30/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	111	88	40
Borrowings	14	67	95
Net free reserves (+)/Net borrowed(−)	97	21	− 56

* Excludes trading account securities.

Includes items not shown separately.

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