

Washington
State Senate

Energy and Utilities Committee

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MEMORANDUM

DATE: February 26, 1981

TO: Members, Senate Energy and Utilities Committee

FROM: Curtis Eschels, Senior Research Analyst

SUBJECT: Background Material on WPPSS Financing: SB 3302 and SB 3505

This memorandum provides background material in three sections: the symptoms of WPPSS financing problems, the causes of those financial problems, and issues addressed by the bills.

SYMPTOMS OF THE PROBLEM

1. WPPSS bond offerings recently have required a high interest rate -- higher than at any other time in its history. The last offering for a AAA bond, held earlier this month, required a 10.8 percent net interest cost. The last sale for an A-1/A+ rated bond, held in December, 1980 required a 12.4 percent net interest cost. Both of these figures are the highest that WPPSS has had to pay in its financing programs. In addition, they are also substantially higher than the assumed interest cost underlying the construction cost estimates.
2. The most recent offerings of WPPSS bonds have attracted few bids. The last offering held in February for a AAA rated bond attracted only one bidder. Sales of A-1/A+ bonds have attracted only one bidder for over one year.
3. Interest costs which WPPSS has been required to pay at the time of sale have been higher than the average interest paid by other issuers in the same category. A comparison of WPPSS interest costs at the time of sale with the Bond Buyer Index shows that since the beginning of 1977 WPPSS bonds have cost more than comparably rated issues. The differential between WPPSS costs and Moody's Like-Rated Index extends before 1976.

4. WPPSS bonds also trade in the "secondary markets" after the sale is consummated. The price of WPPSS bonds in the secondary market has been discounted more deeply than other comparably rated bonds of other issuers. Comparison of WPPSS bonds with the First Boston Public Power Trading Index shows that since 1978 WPPSS bonds have been discounted more deeply than other issuers of comparable debt.

CAUSES OF WPPSS FINANCIAL PROBLEMS

The causes of WPPSS financial problems underlying the symptoms summarized above fall into two general categories. Some are directly attributable to the character of WPPSS financing program: others are beyond its control.

1. The size of WPPSS debt program in absolute terms is a factor in its financing problems. WPPSS currently has the largest public borrowing program of any single issuer in the country outside of the federal government.

In addition, the size of the WPPSS program is not only increasing but accelerating. The size of the original financing program was \$5.96 billion. At the end of 1980, after having issued \$5.47 billion of bonds, the amount of debt remaining to be issued totaled \$8.83 billion.

2. Because of the large cash flow needs of the WPPSS construction program, it must enter the market very frequently. WPPSS officials testified to the Inquiry Committee that it expected to issue \$200 million of debt every 45 days until its financing program is completed. WPPSS has little bargaining power in the market, because investors know that if the interest cost offered is not sufficiently attractive they can "sit out" that particular sale and wait for the next one.
3. Many of WPPSS' traditional investors have saturated their portfolios with WPPSS bonds. In this case, they are unwilling to invest further in a WPPSS offering. This unwillingness limits the market at a time when WPPSS' demand for capital is high. The problem is particularly acute with respect to the WNP 4/5 bonds.
4. WPPSS is competing in a market which is already crowded with other utilities seeking the same investor dollars.
5. In general, the long-term bond market is deteriorating. Investors are increasingly unwilling to invest their funds at a set interest rate at a time that inflation is high and other investments may prove more attractive. The volatility in the general investment market has affected long-term bonds of all issuers negatively.
6. The foregoing problems have made it more difficult for the underwriters who place WPPSS bonds to quickly complete the transactions. In the underwriting field, time is money. The length of time it has taken underwriters to consummate WPPSS placements recently has resulted in increasing underwriter dissatisfaction with the fee they are paid.

7. The interest on WPPSS bonds is exempt from federal taxation. As such, they are attractive to institutional investors who desire tax-exempt income for their portfolios.

Approximately two-thirds of WPPSS bonds in 1979 were held by fire and casualty companies. At the current time, these companies are in a downward cycle in their revenues. Therefore, they are less interested in tax-exempt income at this time than they were previously. When that cycle turns up again, these investors will become more interested in WPPSS bonds.

8. There is a difference in perspective between WPPSS and its participants regarding WPPSS obligations. The WPPSS bond covenants require that the participants obligate their revenues to repay the WPPSS debt. That obligation competes against uses of the revenues which the participants may wish to pursue.

The contractual relationship between WPPSS and its participants requires that any change in the WPPSS financing program requires 100 percent approval of the participants. Currently, WPPSS has proposed a "balanced financing program" which is awaiting approval of the participants. That program would provide WPPSS more flexibility to overcome the problems listed above. Approval thus far has not been secured.

ISSUES ADDRESSED BY THE BILL

The largest single change which would be allowed by both of these bills is to allow WPPSS to negotiate its issues of debt. Such negotiation would expand the number of avenues and provide flexibility to pursue previously untried financings. There is a perceived need also to protect against the pitfalls of some of the creative financing packages which are possible.

1. Negotiating debt issue versus competitive bidding.

Some of the financing avenues WPPSS wishes to pursue cannot practically be followed in a competitive bid format. Both bills would allow WPPSS to negotiate debt rather than being restricted to advertising for and receiving competitive bids.

On an issue-by-issue basis, it cannot be shown that there will be direct financial savings. Research reported to you by a previous memo shows that higher-rated issues, particularly those which receive more than one bid, cost less when competitively bid than when they are negotiated.

The financial savings which arise from negotiation result from the flexibility which negotiation allows. The savings are caused by the ability to vary the size, terms and timing of the debt issue to suit the market conditions.

WPPSS's financial advisor and others have advised that the financial advisor should serve as a check on the underwriter's spread, the achievement of the underwriter's fee and the selection of the underwriter. Occasional competitive bids would also serve to check the competitive market price of WPPSS issues.

2. Expansion of the types of debt available to WPPSS.

The WPPSS request bill, SB 3302, would allow WPPSS to issue any form of indebtedness. It specifically lists bonds, notes, bond anticipation notes, warrants, certificates of indebtedness, commercial paper and refunding or renewal obligations. However, the last six words of the definition on page 2, lines 1 and 2, remove any restrictions on the debt offerings allowed.

This definition expands the types of debt instruments available to WPPSS. Public utility districts are authorized to issue only several of the types of debt listed in this new definition. Those items that have been added specifically are the bond anticipation notes, commercial paper and refunding or renewal obligation. In addition, the requirement in the FUD law, RCW 54.04.010, that all such issues must be payable from revenues has not been included.

The new language at the bottom of page 2 of SB 3302 allows for creative refinancing by WPPSS. Reference to RCW 54.24.030 would allow WPPSS to issue obligations which include as repayment terms "any other matters of like or different character which relate to any provision or provisions of any resolution adopted pursuant to this section."

3. Partial paydown on rollover.

The Inquiry Committee recommended that if negotiated financing were allowed, all of the interest and a like amount of the principal must be retired by WPPSS and its participants rather than issuing new debt to cover those accounts. This condition is a protection against "snowballing" debt. When WPPSS balanced financing program, WPPSS intends to issue short-term obligations which then would be rolled over until or after commercial operation. Similar programs by others have led to extremely unfavorable reaction from the investment community.

Various financial advisors and investors contacted by the Committee staff have said that the partial paydown recommended by the Committee would be perceived favorably by the financial community. This perception is summarized in a previous memorandum.

There is also evidence that a complete rollover without paydown would be perceived negatively by the financial community. During 1979, WPPSS and BPA proposed issuing subordinated debt rather than beginning to pay WPPSS obligations from BPA revenues. Merrill, Lynch, Pierce, Fenner and Smith observed that that program suggested an unwillingness to test the obligation to raise rates to cover costs under the net billing agreements.

A partial paydown when short-term debt is rolled over differs from the collection of construction work in progress in that WPPSS, as a publicly-owned body, would not receive the profit that an investor-owned utility would by including construction work in progress in the rate base. This does not address the philosophical argument WPPSS has raised about requiring today's ratepayers to pay for tomorrow's energy. Research indicates that in the decade 1980 to 1990 there will be 18.5 percent new residents born in the state. 8.3 percent of the current residents will no longer be living by 1990, and 9.8 percent of the state residents in 1990 will have migrated to the state during the decade.

The Inquiry bill, SB 3505, would require that the interest on short-term obligations and a like amount of principal must be paid at any time a WPPSS short-term obligation is rolled over. It allows for self-determination by the participant as to whether rates would be raised or debt issued in that participant's name.

4. Planning for repayment of short-term debt.

Another condition recommended by the Inquiry Committee was that, if WPPSS is allowed to negotiate debt, each participant must annually examine its plans to repay any debt which comes due before the projects' commercial operation. The Inquiry Committee established that there is a difference of perspective between WPPSS and its participants regarding the balanced financing program. This condition, contained in Section 4 of Senate Bill 3505, would assure that each participant is fully aware of the effect of WPPSS' financing program on its own operations. The bill specifically requires that the participants evaluate the effect on their own financial condition, their customers' rates, and on their other contractual rights and obligations.

5. The Inquiry Committee also recommended that granting the authority to negotiate debt issuance be conditioned by requiring more than one financial advisor. Including this condition was prompted by the size of the WPPSS debt program and the new risks added by entering the shorter-term debt market. Final responsibility to determine which course to follow remains as before with the WPPSS Board of Directors.