

**STAFF REPORT ON THE INVESTIGATION
IN THE MATTER OF TRANSACTIONS IN
WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES**



**The Division of Enforcement
United States Securities and Exchange Commission**

September 1988



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20540

September 22, 1988

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
House Committee on Energy and Commerce
2323 Rayburn House Office Building
Washington, D.C. 20515

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: In the Matter of Transactions in Washington
Public Power Supply System Securities

Dear Chairmen Dingell and Proxmire:

I am pleased to transmit a report by the Commission's staff In the Matter of Transactions in Washington Public Power Supply System (WPPSS) Securities. The Staff Report contains a comprehensive discussion of the facts and circumstances that led to the largest default of publicly issued securities in the history of our capital markets.

With the release of the Staff Report, the Commission has determined to close its investigation into transactions in WPPSS securities without initiating any enforcement actions. ^{1/} This decision was made after considering the facts set forth in the Staff Report in the context of applicable legal standards and industry practices, the potential costs and benefits that would be associated with Commission enforcement

^{1/} The decision to terminate the investigation without enforcement action was approved by Commissioner Cox, acting as duty officer, with my concurrence. The other members of the Commission recused themselves from participation in this decision.

action, and the extent to which the WPPSS matter reflects systematic characteristics of the regulatory framework for municipal securities that might be addressed more appropriately by regulatory or legislative initiatives.

The Staff Report discusses several areas in which the disclosures made to investors in WPPSS securities were deficient. As the Staff Report indicates, the parties involved in the WPPSS project and its financing included the Washington Public Power Supply System, financial advisers, engineers, bond counsel, system participants (various participating utilities), the Bonneville Power Administration, underwriters, various unit investment trusts, and rating agencies. In reaching its conclusion to close its investigation, the Commission considered, among other factors, the difficulty of assigning responsibility for disclosure deficiencies in a highly complicated factual situation under the federal securities law antifraud provisions applicable to exempt offerings. In addition, many of the disclosure deficiencies do not relate directly to the precipitating factor in the default, the Washington Supreme Court's decision invalidating contractual agreements between WPPSS and certain public utilities.

The Commission also notes that the WPPSS matter has been the subject of extensive private class action litigation attempting to establish responsibility in this matter. Private class actions and a bond trustee action, which are consolidated in federal multi-district litigation (MDS-551), have been brought against all the major participants in the sale of WPPSS securities. Tentative settlements have been reached with several defendants in this case, and a trial involving the remaining defendants has commenced this month. The pendency of the private litigation means that the issues and claims will be exposed in a judicial forum even without institution of a Commission action.

The private litigation also provides an indication of the extensive resources that might be consumed by a Commission enforcement action in the WPPSS matter. The factual record in the MDL litigation may well be the largest ever compiled in a case brought under the federal securities laws. It has been reported that the attorneys for the bondholders' trustee alone have been paid \$76 million, with the trial having commenced just this month. Without suggesting that the Commission

The Honorable John D. Dingell
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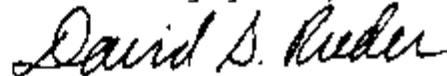
would be required to expend anything approaching that amount, I believe that the Commission's enforcement resources would be more effectively devoted to other matters.

Finally, Commissioner Cox and I determined that the responsibilities of participants in offerings of municipal securities might more effectively be addressed by regulatory measures that would apply to all participants in the municipal securities markets, and not just to the participants in offerings of WPPSS securities. Therefore, I have directed the Commission staff to review the regulatory framework applicable to municipal securities transactions and prepare appropriate recommendations for consideration by the full Commission.

Certain staff recommendations, including rule proposals, will be considered by the full Commission at an open meeting today. Following consideration by the full Commission, I will forward to you the text of any Commission action taken at that meeting, together with a Commission Report that will place these matters in a more complete context.

I believe it extremely important that steps be taken to enhance investor protection in the municipal securities markets, and I believe the Commission is pursuing the course appropriate to accomplishing that goal.

Sincerely yours,



David S. Ruder
Chairman

Enclosure

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PART I

INTRODUCTION AND EXECUTIVE SUMMARY

A. INTRODUCTION

This Staff Report discusses the circumstances of the default on \$2.25 billion of bonds issued by the Washington Public Power Supply System ("Supply System"). The default was the largest non-payment default in municipal bond history. The Supply System, a joint operating agency that is a municipal corporation under Washington State law, issued the bonds to finance the construction of two of five nuclear power generating plants, Washington Public Power Supply System Nuclear Projects Nos. 4 and 5, that the Supply System had undertaken to build on behalf of the publicly-owned utilities in the Pacific Northwest. 1/

Construction of Projects Nos. 4 and 5 began in 1976 and 1977, respectively, and the first long-term bonds to finance the projects were sold in February 1977. Fourteen bond sales averaging \$160 million each were completed over four years from the beginning of 1977 to early 1981. At the time of the last bond sale, in March 1981, Project No. 4 was 16% complete and Project No. 5 was 11% complete. The face value of bonds issued

1/ Approximately \$6.2 billion of bonds were sold to finance the other three projects, Project Nos. 1, 2, and 3. Those bonds were backed by "net-billing" agreements under which the Bonneville Power Administration ("BPA" or "Bonneville") essentially accepted the obligation to pay the bonds out of its revenues. Although only one of these projects was completed and the other two were mothballed, the BPA has continued to meet its commitments under the agreements for all three projects.

to that time, \$2.25 billion, equalled the original estimate of the total cost of both projects.

Increases in the estimates of construction costs announced in late May 1981 led to a moratorium on construction of the two projects. Efforts to provide regional funding to preserve the projects in a suspended state were unsuccessful, and they were terminated in January 1982. Eighty-eight publicly-owned utilities in the Pacific Northwest ("Participants") had entered into agreements ("Participants' Agreements") under which they were obligated to pay the costs of the Supply System's share of the projects ^{2/} regardless of whether the projects were completed. On June 15, 1983, the Washington Supreme Court ruled that certain Washington publicly-owned utilities, whose agreements provided for the payment of more than 68% of the Supply System's share of the projects' cost, lacked the authority to enter into those agreements because they were not to own the projects but were obligated to pay for the projects even if they were never completed (a "take or pay" obligation). Subsequent judicial decisions released the remaining utilities from their obligations.

^{2/} An investor-owned utility owned a 10% share of Project No. 5.

The Commission commenced an investigation into the circumstances of the offers and sales of the bonds. This Staff Report discusses the results of the investigation. ^{3/} Its purpose is to advise Congress of events surrounding the issuance by the Supply System of bonds to finance the construction of Projects Nos. 4 and 5 and the default by the Supply System on those bonds. The Staff Report was prepared based on information gathered in the non-public investigation into this matter. The investigation was not an adjudicatory proceeding of the Commission and it is not intended that the findings or conclusions contained in this Report be used in any adjudicatory proceeding.

^{3/} Private actions related to the default are pending. Class actions and an action by the bond trustee were consolidated as In re Washington Public Power Supply System Securities Litigation, MDL No. 551 (W.D. Wash.). Some settlements were reached in the Federal MDL No. 551 actions. Trial against the non-settling defendants, who include most of the Participants that were Supply System members, the financial advisor to the Supply System and two construction engineer firms, commenced on September 7, 1988.

State actions have also been brought. In Haberman v. WPPSS, No. 84-2-06452-8 (Super. Ct. of St. of Wash. for King County), bondholders sued for fraud and misrepresentation. In Arthur Hoffer v. The State of Washington, No. 84-2-16459-0 (Super. Ct. of St. of Wash. for King County), bondholders sued to recover from the State of Washington principally in connection with the role of the State Auditor and his certification on the bonds and his statements in a letter contained in the Supply System's annual reports. The Washington State Supreme Court reversed lower court dismissals of those actions. Haberman v. WPPSS, 109 Wash. 107, 744 P.2d 1032 (Wash. 1988); Hoffer v. The State of Washington, 110 Wash. 2d 415, 755 P.2d 781 (Wash. 1988).

B. EXECUTIVE SUMMARY

The judicial decisions that invalidated the agreements of the 88 publicly-owned utilities to pay for Projects Nos. 4 and 5 caused the ultimate default on payment of the bonds. This Report takes no position on the merit of those decisions. Rather, the Report examines disclosure issues arising from this matter. The Report first examines developments during the sale of bonds relating to costs, financing, power demand, and Participant support (Part II). The Report next examines the marketing of the bonds during the same period, including the roles of the underwriters, the rating agencies and unit investment trusts (Part III). Finally, the Report examines the extent to which Supply System counsel recognized and disclosed legal problems relating to the validity of those agreements. (Part IV). A summary of the Parts of the Report follows.

1. The Projects (Part II)

a. Cost Estimates (Budgets) for the Projects

The original estimate of the total cost of both Projects Nos. 4 and 5 was \$2.25 billion. The estimate after the last bond sale was almost \$12 billion. The largest increases in cost estimates occurred toward the end of construction. The last increase, announced in May 1981, caused a moratorium on construction. The staff's investigation sought to determine whether the cost estimates made public during the bond sales had understated the anticipated costs.

The Supply System produced annual budgets, reflecting estimates of the costs to complete each of Projects Nos. 1 through 5. The budgets consisted principally of estimates of direct construction costs, the cost of interest on bonds that financed the five projects, and a contingency amount that the Supply System determined. The estimates were included in the official statements, issued in connection with the bond offerings, as establishing the amount of the financing needed for the projects.

The Supply System maintains that it produced detailed, comprehensive, and realistic budgets. The budgets were produced under a "tight but attainable" philosophy to avoid having budget increases become self-fulfilling prophecies. The budgets that resulted from this practice tended to understate the likely costs of the five projects. The practice also sometimes conflicted with the views of the Bonneville Power Administration ("BPA"), a government agency that distributed power from dams in the Pacific Northwest and planned to obtain additional power from Projects Nos. 1, 2, and 3. The BPA desired more inclusive budgets in order to plan rate increases and resource availability. One of the results of the BPA's interest in Projects Nos. 1, 2 and 3 was that the Supply System began performing risk analyses, i.e., analyses of the probability of meeting the budgets. The initial risk analyses, performed in late 1977 and early 1978, indicated that there was little probability that the budgets would be met.

In 1979, when the Supply System adopted a fiscal year that ran from July to June, the budgets were increased, under the influence of the BPA, to a level reflecting a 50% probability, based on the risk analysis, that the projects could be completed within the budgets. These budgets, however, quickly became obsolete because of cost overruns.

The budgets rose again in the summer of 1980 when the fiscal year 1981 budgets were adopted. The budgets as adopted, however, had only a 20% probability of success based on the risk analysis. Management concluded that further increases were not warranted. The budgets also were determined under the "tight but attainable" budget practice. The budgets for the five projects would have had to have been increased by an additional \$1.5 billion in total to reach the 50% probability level. The BPA used budgets at a 50% probability for rate making purposes and requested a mid-year update estimate. No disclosure of the 20% probability was made in the official statement for the next Projects Nos. 4 and 5 bond offering in July 1980, but the BPA obtained disclosure of a low probability level in the fiscal year 1981 budget process in the official statement for the next bond sale, in August 1980, for Project No. 1.

In November 1980, after the conclusion of strikes that had halted construction at three of the five projects from late Spring 1980, a possible increase of \$3 billion in the budgets, including \$1.5 billion to reach the 50% probability level in

the fiscal year 1981 budgets, was discussed as a revised estimate. Senior management discussed acknowledging a portion of the increase then and another portion later. After management was advised that disclosure obligations required that any increase be disclosed at the time that it was determined, management instructed the staff to conduct an overall assessment of the budgets. A rapid one-week reestimate of the budgets was conducted using a modified form of the risk analysis with input about cost increases from the project personnel. This estimate showed a \$4.4 billion increase over the fiscal year 1981 budget for the five projects combined. The Supply System's Managing Director rejected this estimate and its methodology and, instead, adopted cost increases related only to the strike and certain other specific developments, totalling \$1.38 billion. Most of these categories of costs had been expressly excluded from the fiscal year 1981 budget at the time it was adopted, and they did not reflect overall escalation in the budget. The \$4.4 billion increase estimate, in contrast, was a reassessment of the entire budget and reflected overall increases in the budget. The \$4.4 billion increase estimate was never disclosed, even to some of the consultants who helped draft the official statements.

New budgets for fiscal year 1982 were available in early May 1981. These budgets, showing an increase of \$7.8 billion over the fiscal year 1981 budgets for all five projects,

including an increase of \$4.16 billion for Projects Nos. 4 and 5, caused the Supply System management to recommend a temporary moratorium on the construction of the Projects Nos. 4 and 5 when the budgets were disclosed in late May. Construction never resumed.

b. The Financing Program

All costs of the Supply System's share of Projects Nos. 4 and 5, including interest on outstanding bonds, were financed by the sale of bonds to investors. The Supply System financing requirements increased from \$3.4 billion at the start of the bond sales in February 1977 to \$11.1 billion at the time of the construction moratorium. Because the budgets continued to increase, the amount of additional bonds to be sold increased, averaging \$160 million dollars each over four years. The increase in the financing requirements made it less likely that the projects could be successfully financed to completion. Moreover, increasing rates of current actual expenditures decreased the availability of cash to pay for current construction expenses.

In the first two years after the initial bond sale in February 1977, the budgets did not increase significantly and the financing program did not experience serious difficulties. Although the Supply System was not always able to maintain its goal of one to two years cash flow coverage, i.e. the projected time that current expenditures could be paid from funds available, it was near the lower range of the goal.

In 1979, as the budgets began to increase significantly and the general bond market began experiencing the effects of inflation and rapidly rising interest rates, the financing program began to encounter difficulties. The interest rate on the bonds rose and went to a premium even over similar high yielding bonds. Also, the type of investor purchasing the bonds changed. Insurance companies, which had been large investors in the bonds, played a smaller role, and unit investment trusts, which were sold principally to individuals, played an increasingly large role.

In late 1979, the Supply System's financial advisor recommended that the Supply System gain the ability to issue short and intermediate-term debt, in addition to the long-term debt that had been the method of financing. The Participants' Agreements for the projects, however, did not require the Participants to make any payments until the projects were completed or until a date certain in 1988, unless the projects were terminated. In order to issue short or intermediate-term debt that might come due sooner, the Participants were asked to agree to a change in their Agreements. Such a change became increasingly necessary in 1980. Budgets increased significantly, and financing Projects Nos. 4 and 5 to completion became less likely. Also, increased rates of expenditure put the Supply System in the position where it had barely enough cash to meet expenditures from one offering to the next. During this time, the Supply System advised the

Participants that project termination was possible because of the financial problems unless they approved the changes needed for short and intermediate-term debt. Many Participants, however, did not make the needed changes to their Agreements. As a result, in late 1980 and early 1981, the Supply System used financing devices, such as put bonds -- i.e., bonds that the investor could require the Supply System to repurchase after a fixed period of time -- to try to maintain sufficient cash to avoid having to halt construction.

In early May 1981, a planned offering of Projects Nos. 4 and 5 bonds was suspended when the fiscal year 1982 budget figures became available within the Supply System, although that reason was not given in the announcement of the suspension. In late May, the Supply System management announced the budget figures and recommended a moratorium on construction because of the difficulties in continuing the financing program and because of the shortage of cash. The underwriters advised the Supply System that continued financing would be feasible only if the Participants agreed to pay 50% of the interest on the bonds. The Participants did not give the required approval for this change, and the financing program ended.

c. Need for the Projects - Power Supply and Resources

The projects were undertaken based on the projected need for the power that was to be produced by the projects. The need for the power from the projects was depicted prominently

in the official statements in tables and charts of forecasts of future power demand and projected power deficits for both the Pacific Northwest region and the Participants.

During the period of the sales of the Projects Nos. 4 and 5 bonds, each successive forecast showed a smaller increase in power demand. Moreover, the actual demand for power in the years during the sale of bonds was less than even the reduced forecasts. Although the official statements substituted the new forecasts for the old, and deficits were still indicated, they did not show the decline in the forecasts or that the reduced forecasts exceeded actual use. This information would have indicated that the forecasts might be overstated and could continue to decline.

d. Participants' Committee's Reevaluation of Participants' Position

The Participants' interests in the projects were represented by a Participants' Committee. Although the Participants' Committee had certain formal functions and gave certain required approvals, the Supply System effectively controlled the projects, and the Participants' Committee was not actively involved in substantive issues in the early years of the projects.

The Supply System's request that the Participants change their agreements and obligate themselves to pay short and intermediate-term debt if it could not be refinanced caused the Participants' Committee to become more involved. Some Participants formally approved the change. The proposal,

however, ultimately caused a negative reaction in the Participants' Committee. At a Participants' Committee meeting on October 16, 1980, the Committee members reviewed the original aim that Projects Nos. 4 and 5 would be a regional resource and the burdens would be shared by others. Rising project costs and falling power demand forecasts, however, meant that the Participants alone might be left to bear the burden of high cost power from the projects. The Participants discussed possible options, including a slowdown or termination of the projects, if others did not agree to take steps to share some of the burden.

The Committee asked the Supply System to conduct a study of a slowdown or termination of Projects Nos. 4 and 5. They also decided to confront the BPA and its industrial customers to get them to agree to share some of the burdens of the projects, including a BPA commitment to acquire the capacity of the projects and an extension of an industrial customers' agreement to buy power from the projects. They met with the BPA a few days later and stated their position.

The possible adverse consequences to the financing program if these considerations reached the investment community and the need to keep them secret were recognized in the Participants' Committee meeting and in the meeting with the BPA. Although the Supply System knew about these developments, and was represented in these meetings, nothing about the meetings or the considerations was disclosed in the Projects

Nos. 4 and 5 official statements, which continued to describe the Participant's involvement only in positive terms.

The negotiations with the BPA and its industrial customers continued until the moratorium on construction was declared, but the BPA was unable, and the industrial customers were unwilling, to accept more of the burden of the projects. The Supply System conducted a delay and termination study. The study became known to, and was reported in, the news media, but the fact that the study had been requested by the Participants' Committee was not disclosed.

When, after the moratorium, the Participants were requested to agree to pay 50% of the interest on the bonds to permit financing to continue, Participants having a substantial interest in Projects Nos. 4 and 5 stated that they would not agree unless the burdens of the projects were shared regionally. Subsequently, when regional agreement to pay the costs of mothballing Projects Nos. 4 and 5 could not be reached, the projects were terminated.

2. Marketing of Projects Nos. 4 and 5 Bonds (Part III)

a. Role of the Underwriters

Underwriters purchased the bonds from the Supply System and sold them into the market. With the exception of one sale, the underwriters purchased the bonds from the Supply System through a competitive bid procedure, as provided under Washington State law. In a competitive bid sale, the issuer distributes a preliminary official statement and then offers

the bonds for sale to underwriting syndicates, with the best bid, i.e., the bid offering the lowest interest cost, winning the bonds. The other method of public distribution of bonds is a negotiated sale, in which the issuer selects an underwriter in advance of the sale. In a negotiated sale, the underwriter assists the issuer in preparing the official statement and then negotiates the price it will pay and sells the bonds through a syndicate it has formed.

Initially, the Projects Nos. 4 and 5 bonds were sold to two syndicates, each led by two managing underwriters. In early 1980, the managing underwriters of one of the syndicates were unable to form a syndicate capable of bidding on the bonds, and that syndicate joined with the other syndicate in a single bid. Only one bid was received by the Supply System on all the subsequent sales of Projects Nos. 4 and 5 bonds.

In sales of corporate securities, underwriters can be liable to investors under provisions of the federal securities laws for misstatements and omissions in registration statements or prospectuses unless they establish that they made reasonable efforts to determine that there were no misstatements or omissions. Underwriters of corporate securities usually hire underwriters' counsel to conduct an investigation of disclosure items, or a "due diligence" investigation, and to issue an opinion, limited by the scope of the investigation, that proper disclosure has been made. Municipal bonds are expressly excluded from these liability provisions. Underwriters of

municipal bonds are legally liable to investors, however, under the general antifraud provisions of the federal securities laws. They are also subject to market risks in holding the bonds during the time it takes to sell them. Underwriters often retain their own counsel, known as underwriters' counsel, to issue opinion letters on the adequacy of disclosure under the antifraud provisions in negotiated sales of bonds, where the underwriters participate in drafting the official statement.

The underwriters did not conduct due diligence-type investigations to verify the adequacy of disclosure by the Supply System in connection with the sales of Projects Nos. 4 and 5 bonds. During the staff's investigation, the underwriters contended that they had no legal obligation to conduct an investigation and that it was not industry practice to do so in competitive sales of municipal bonds. Although the underwriters met with the Supply System from time to time during the sales of the Projects Nos. 4 and 5 bonds, the discussions were confined largely to the issue of the market for the bonds.

The underwriters were aware, as were many in the investing community, of some problems with the projects from press coverage and other sources. In reports that were circulated internally and to institutional investors, analysts for some of the underwriters noted problems. Also, in bidding on the bonds, the underwriters had to be knowledgeable about the

market for the bonds. One managing underwriter held an internal meeting in 1979 to consider whether to continue bidding on the Supply System's bonds, at which time possible problems with the projects were discussed.

The underwriters became involved in one negotiated offering when, in April 1980, the Supply System rejected the single bid it received and negotiated some of the terms of the underwriting with the lead underwriter it selected. Although in a negotiated bond sale the underwriter typically conducts an inquiry, the Supply System wanted to limit the underwriters' role and proceed quickly with the underwriting. As a result, no significant inquiry was done, and a letter on the adequacy of disclosure was obtained only from the Supply System's bond counsel. After that offering, the underwriters continued the practice of not conducting investigations on the adequacy of disclosure and of not obtaining any underwriters' counsel opinion letters. As a result, there was limited opportunity for the underwriters to discover the November 1980 estimate of a \$4 billion budget increase or the October 1980 Participants' Committee's request for a delay and termination study.

In late 1980 and early 1981, some of the underwriters were consulted on the financing program. The underwriters then supported the Supply System on matters before the Washington state legislature and became involved in matters relating to the short and intermediate-term debt proposal.

In May 1981, the Supply System, through a change in the Washington law, obtained general authority to negotiate underwritings of the bonds of its projects. After the announcement of the fiscal year 1982 budget figures, the underwriters, which were then negotiating the underwritings, advised the Supply System that the Participants needed to agree to begin paying interest on the bonds in order to make further sales of bonds. The Participants did not make the needed change, and no further underwriting was done.

b. The Role of the Rating Agencies

Each offering of the Projects Nos. 4 and 5 bonds was rated by Moody's Investors Service, Inc. and Standard and Poor's Corporation. The initial Moody's rating of A1 and the Standard and Poor's rating of A+ were maintained throughout the four years of bond sales, despite growing problems with the projects. The ratings reassured investors and permitted unit investment trusts, or UITs, to continue purchasing the Projects Nos. 4 and 5 bonds.

The ratings were based in large part on the Participants' obligation to pay and the need for the projects. Some problems with the projects, however, were noted over time, and, after the moratorium recommendation, the ratings were reduced even before the Washington State Supreme Court ruled that the obligations of many of the Participants were invalid.

The rating agencies' publications include disclaimers noting limitations on the use of their ratings. Here, the

rating agencies relied to a large extent on representations by the Supply System and were not told of some significant developments, such as the November 1980 update estimate of a \$4.4 billion budget increase and the request of the Participants' Committee for a slowdown or termination study. Also, although the agencies had analysts with experience in certain areas who could be consulted, they did not have experts to examine and evaluate critical information. The agencies also were not knowledgeable about the market for the bonds. Developments in the market might have suggested some grounds for caution. Finally, it appears the services tended to wait for a major development or decisive confirmation of a trend before changing a rating. Investors who relied only on the ratings were not fully apprised that there were developing problems.

c. The Role of Unit Investment Trusts

UITs are investment companies that issue redeemable securities representing an interest in a portion of a fixed portfolio of securities, which, in the case of tax-exempt trusts, are municipal bonds. The portfolio holdings are diversified as to type of issuer and as to individual bonds. Sponsors, which usually are broker-dealers, purchase bonds and deposit them in the trusts. Units of interests in the trusts are then sold by underwriters, including the sponsors, largely to individual investors.

Sponsors purchased increasingly large amounts of Projects Nos. 4 and 5 bonds for UITs. Ultimately, approximately 25% of all Projects Nos. 4 and 5 bonds were held by UITs, though, because of internal diversification limits, the bonds seldom composed more than 7 1/2% of any individual trust's portfolio. These purchases provided important support to the financing program.

Purchases of Projects Nos. 4 and 5 bonds for the trusts increased even as the problems with the projects were increasing. The sponsors, which usually were also members of the underwriting syndicates, denied that they purchased the bonds at the request of their bond underwriting departments. The purchases, however, helped the market for the bonds and indirectly resulted in a distribution of the bonds to individuals as part of the diversified trust portfolios. The principal immediate cause of the increasingly large purchases appears to have been that the trusts competed intensely on the basis of investment yield. As the yield of the Projects Nos. 4 and 5 bonds went to a premium even over similar high-yielding bonds, the sponsors purchased the bonds for the high yield.

The representations of quality standards in the prospectuses used to sell the trusts generally were not specific. Most stated that the trusts would include only bonds rated A or better by one of the rating services. The sponsors' own quality evaluation procedures varied. One sponsor did not have any direct internal credit approval process, but relied

only on the rating and the fact that the sponsor was also an underwriter of the bonds. Other sponsors had some direct internal approval process. Even where there was a quality approval process, however, it appears that it did not add much to the reliance on ratings in meeting the representation in almost all of the trust prospectuses that one of the factors considered in selection of the bonds was their price in relation to other bonds of comparable quality and maturity. Generally, the sponsors' bond buyer was told only whether the bonds were approved and did not have information, other than the rating service ratings, to compare the quality of bonds and determine relative value.

The problems with the projects did not deter the purchase of the bonds. In the case of one trust, a question was raised within the sponsor in late 1979 about whether to continue purchasing the Projects Nos. 4 and 5 bonds for the trust. Negative developments with the projects were discussed. In the course of deliberations, the person responsible for assembling the portfolios observed that if these premium yield bonds were not purchased, the trusts' own yield might not stay competitive. The person observed further, that if these trusts, which were the largest purchasers of Projects Nos. 4 and 5 bonds, stopped buying, this might be noticed by the market and possibly cause a "slam-out," or collapse, of the Projects Nos. 4 and 5 financing program. The sponsor decided

to continue purchasing relying upon the security of the Participants' obligation to pay.

3. The Opinions and Conduct of the Bond Counsel and Special Counsel Regarding the Validity and Enforceability of the Agreements that Were To Provide Security for the Projects Nos. 4 and 5 Bonds (Part IV)

Prior to the first sale of the Projects Nos. 4 and 5 bonds, the Supply System's bond counsel and special counsel had evaluated the validity and enforceability of the Participants' Agreements, which were to provide security for the bonds. At the closing for each bond sale, bond counsel and special counsel delivered identical opinion letters in which each firm stated that it had examined 72 of the 88 Participants' Agreements and opined that those Agreements were valid and enforceable. A form of these letters was included in the official statement for that bond sale. The investigation considered two issues in connection with conduct of counsel: first, whether it was appropriate to issue, for inclusion in the official statements, unqualified opinions as to the authority of certain participants, i.e., the Washington municipal corporations, to enter into the Agreement; and, second, whether the disclosure about the 16 Participants on whose Agreements the firms did not give a favorable opinion, was adequate.

a. Legal Uncertainties As to the Participation of the Washington State Municipal Corporation Participants

The most significant Participants' Agreements that counsel included in their opinion letters were the Agreements of the Washington State municipal corporation Participants. The Agreements of these 28 Participants, which consisted of municipalities and public utility districts, accounted for the payment of approximately 68% of the Supply System's share of the cost of Projects Nos. 4 and 5. The Washington State Supreme Court's holding that these Agreements were invalid effectively eliminated the security for the projects' bonds.

The court reached its decision as a result of the provision of the Participants' Agreement under which the Participants agreed to pay the Supply System's share of the cost of the projects regardless of the completion of either project or of any performance by the Supply System (the "take-or-pay" provision). The court held that the Washington municipal corporation Participants "simply are not authorized to guarantee another party's ownership of a generating facility in exchange for a possible share of any electricity generated." 4/ The dissenting opinion contended that the Participants' Agreements were valid under Washington State case

4/ Chemical Bank v. Washington Pub. Power Supply Sys., 99 Wash. 2d 772, 799, 666 P.2d 329, 343 (1983), aff'd on rehearing, 102 Wash.2d 874, 691 P.2d 524 (1984), cert. denied, 471 U.S. 1075 (1985).

precedent, and this Report does not take a position on whether the court's decision was to be expected.

The Participants' Agreements represented an untried means of financing in the Pacific Northwest. For the first time, publicly-owned utilities that were not all members of a project's sponsor, and that were not to own the project themselves, agreed to pay the costs of the project regardless of whether it was completed or the sponsor performed. Unlike some other states, Washington had no statute that expressly authorized a municipal corporation to enter into a take-or-pay contract. The Washington statutes authorized municipal corporations to purchase power and to construct, own, and operate electric facilities. The court previously had held that municipal corporations had those powers expressly granted by statute and those necessarily implied from the express powers, but that, in case of doubt about whether a power was granted, the doubt would be resolved by denying the power. The court had never before addressed the validity of take-or-pay arrangements.

The bond counsel and special counsel attorneys contended in testimony that Washington municipal corporations had broad authority to enter into power purchase contracts and to fix the terms of those contracts. They viewed the take-or-pay provision of the Participants' Agreement as merely one term of a power purchase contract that did not change its nature as a power purchase contract. However, at about the time the

Participants' Agreements were signed; representatives of the BPA's industrial customers asserted to the special counsel and others that the inclusion of a take-or-pay provision in an agreement under which those customers were to acquire some of the anticipated output of Projects Nos. 4 and 5 made that agreement a loan guarantee rather than a power purchase agreement. As such, the customers said that their corporate bond indentures prohibited them from participating in Projects Nos. 4 and 5 in that way. Moreover, in connection with preliminary financing proposals for the projects, the special counsel, based on discussions with the bond counsel and others, had prepared a memorandum noting possible legal impediments to the Supply System's issuing notes backed by guarantees of municipal corporations that were not Supply System members.

Despite these indications of legal difficulties with the take-or-pay provisions and the lack of legal precedent on the issue, counsel issued an unqualified opinion without taking action to have the legality of the Participants' Agreement determined. In prior Pacific Northwest power projects in which counsel had issued unqualified opinions, test cases had been brought or legislative changes were sought to resolve legal uncertainties. Counsel testified that they did not even consider bringing a test case to determine the authority of Washington municipal corporations to enter into the Participants' Agreement.

b. Legal Uncertainties as to Other Participants' Authority

In their opinion letters, the bond counsel and special counsel each stated that it had "examined into the validity of" 72 of the utilities' agreements to participate in the Projects. Counsel did not disclose that they had looked into all 88 agreements and were unwilling to opine on 16 of the utilities, accounting for the purchase of 4.06% of the anticipated output of the Projects. Ten of the 16 were excluded because of issues as to their authority to enter into the agreements. Counsel took the position that they believed these Participants had the legal authority to participate but that counsel had not attained the high degree of certainty as to the Participants' authority that was necessary to include the Agreements in their opinion letters.

The ten Participants had been participants in earlier Supply System projects. In connection with earlier projects, where one or both firms identified a question as to a participant's authority to enter into the agreement, the firms made efforts, including seeking amendments to statutes, municipal charters, or by-laws, to have the authority of that participant established expressly. When the efforts were unsuccessful, the firms then excluded the agreements of these participants from the opinions that they had rendered. Some of the participants whose earlier agreements were excluded because of authority issues became Participants in Projects Nos. 4 and 5. The authority issues that had led the firms to exclude

these Participants' earlier agreements were essentially the same as the issues that led the firms to exclude the Participants' Agreements of these Participants from the firms' opinions for Projects Nos. 4 and 5.

It appears that, while the agreements for Projects Nos. 4 and 5 were being drafted, consideration was given to excluding from any involvement in the projects those Participants whose Participants' Agreements the firms later excluded from their opinion letters because of authority issues. These utilities were allowed to participate, however, in part because they were located outside of Washington State and project backers sought broad regional participation in the projects. Regional participation was important because the Participants hoped to obtain legislation in Congress to allow BPA to acquire the anticipated output from the projects. Regional participation, it was believed, would lead to more support in Congress.

Counsel did not disclose the legal uncertainties as to the authority of these Participants. Counsel did not inform the investing public, nor even the utilities themselves, that they were unwilling to opine favorably on the validity and enforceability of these Agreements. Counsel indicated in testimony to the staff that, because of a "step-up" provision in the Participants' Agreement that required non-defaulting Participants to assume the financial responsibilities of a defaulting Participant, any uncertainty about the enforceability of these Participant's Agreements, which covered

approximately 4% of one project's anticipated output, did not have to be disclosed.

Not only did counsel fail to disclose these authority questions, but each official statement included a statement in the section on the security for the bonds, which bond counsel and special counsel prepared, that "[e]ach Participant is obligated to pay the Supply System its share of the total annual cost of the projects" By including that statement, and by stating that they had examined, and could opine favorably upon, 72 of the Participants' Agreements, while stating nothing about the remaining 16 utilities, including the ten whose legal authority was uncertain, counsel provided the investing public with incomplete information.

C. IDENTIFICATION OF PRINCIPAL PARTIES

1. The Washington Public Power Supply System

The Supply System is a municipal corporation and a joint operating agency of the State of Washington. It was organized in 1957 and has the authority to construct and operate electric power generating facilities. At the time of the first offering of Projects Nos. 4 and 5 bonds, its membership consisted of 22 publicly-owned utilities in the State of Washington. ^{5/} Management and control of the Supply System was vested in a Board of Directors composed of representatives of the membership. In addition, the Supply System had an Executive

^{5/} With three exceptions, the Supply System's members also were among the utilities that participated in the Project Nos. 4 and 5.

Committee, composed of seven members of the Board, that handled matters arising between meetings of the Board of Directors.

Unlike the utilities that were Participants in Projects Nos. 4 and 5, the Supply System had no ratepayers and did not make retail sales of power. Rather, the Supply System functioned primarily as an entity for the construction of generating facilities that would provide additional resources to meet the power needs of the region. The first Supply System project, a small hydroelectric facility, was undertaken in 1961. Later, the Supply System built a steam turbine facility that operated from power generated by a United States Government nuclear plant. These were the only facilities constructed by the Supply System before it began a program of building five nuclear power plants in the early 1970's. Only one of the five projects has been completed.

2. Blyth Eastman Dillon & Co.

The investment firm of Blyth Eastman Dillon & Co. ("Blyth") was the Financial Advisor to the Supply System. ^{6/} As Financial Advisor, Blyth advised the Supply System on the marketing of its bonds, acted as liaison with the financial community, and helped draft the official statements. The principal individual from Blyth who advised the Supply System

^{6/} In January 1980, Blyth merged with Paine, Webber, Jackson and Curtis, Inc. The organization within the merged company that performed the financial advisory work was Blyth Eastman Paine Webber. The name of the parent after the merger was Paine Webber Jackson & Curtis Inc., and then PaineWebber, Inc.

during the period of the Projects Nos. 4 and 5 bond sales was Donald E. Patterson. The firm and Mr. Patterson are referred to herein as the Financial Advisor as the context indicates.

3. R.W. Beck and Associates

R.W. Beck and Associates ("R.W. Beck") was the Consulting Engineer on all of the projects. R.W. Beck provided consulting services to the Supply System, helped draft the Supply System's official statements, and provided the Supply System with a letter for inclusion in each official statement in which it opined on the feasibility of the projects and set forth information on the forecasted need for power and projected revenues of the participating utilities. The principal R.W. Beck official responsible for Projects Nos. 4 and 5 bond sales was Winston Peterson.

4. Wood Dawson Love & Sabatine

Wood Dawson Love & Sabatine ("Wood Dawson") ^{1/} is a small New York law firm that acted as the Supply System's bond counsel. Wood Dawson has served as bond counsel for municipal corporations throughout the United States. Wood Dawson helped draft the official statements. Brendan O'Brien was the attorney at Wood Dawson principally responsible for the firm's work in connection with Projects Nos. 4 and 5.

^{1/} The firm now operates under the name of Wood Dawson Smith & Hellman, and, at times relevant to the Staff Report, operated under other names.

5. Houghton Cluck Coughlin & Riley

Houghton Cluck Coughlin & Riley ("Houghton Cluck") 8/ is a Seattle, Washington law firm that acted as special counsel to the Supply System. The firm had been involved in the formation of the Supply System and on a continuing basis thereafter performed a variety of work for it. It helped draft the official statements. Bert L. Metzger, Jr. and Jack R. Cluck were the attorneys at Houghton Cluck principally responsible for the firm's work in connection with the sale of Projects Nos. 4 and 5 bonds.

6. The Participants

Eighty-eight utilities entered into agreements to purchase a share in the Supply System's share 9/ of Projects Nos. 4 and 5. The aggregate amount that the Participants were to pay for that power was to equal the Supply System's share of the cost of the projects. Of the 88 utilities, only 19 were members of the Supply System. 10/ These utilities were to pay for 56% of the Supply System's shares of the projects power.

The Participants consisted of municipal corporations and cooperatives in Washington, Oregon, Idaho, Nevada, Montana, Wyoming and Utah. Some Participants were very small and

8/ The firm now operates under the name of Skellinger Ginsberg & Bender, and, like Wood Dawson, at times relevant to the report, operated under other names.

9/ An investor-owned utility purchased a 10% interest in Project No. 5.

10/ During the period of the sale of bonds one other Participant became a member of the Supply System.

others, such as the City of Tacoma, Washington, were relatively large. All of the Participants were part of a group of publicly-owned utilities that was entitled to preference in access to power by the BPA.

7. The Bonneville Power Administration

The BPA is a federal agency within the Department of Energy. ^{11/} The BPA marketed to the Participants and others inexpensive power from federal dams located on major river systems in the Pacific Northwest. In addition, the BPA agreed to purchase, through differing methods, the anticipated electricity output of projects undertaken by the Supply System, other than Projects Nos. 4 and 5, and by other utilities in the Pacific Northwest. It then incorporated that output into its resource base for sale to its customers. Although the BPA did not have the same involvement in Projects Nos. 4 and 5 as it had in the other Supply System projects, it helped initiate the projects and was knowledgeable about them largely because they were to be built in conjunction with two of the Supply System projects in which the BPA was involved.

8. The Underwriters

The Projects Nos. 4 and 5 bonds were underwritten by two syndicates that bid on the bonds. Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch") and Salomon Brothers Inc. ("Salomon") led one syndicate. Prudential-Bache Securities,

^{11/} Prior to 1977, the BPA was an agency within the Department of Interior.

Inc. ("Bache") and Smith Barney, Harris Upham & Co., Inc. ("Smith Barney") led the other. In early 1980, the Bache/Smith Barney syndicate ceased bidding on the bonds and joined in the bid of the Merrill Lynch/Salomon syndicate.

9. The Unit Investment Trusts

Unit investment trusts, a type of investment company, consist of unmanaged portfolios of securities assembled by sponsoring brokerage firms. Fractional individual interests in the portfolios are sold to investors as units. Sponsors of the trusts increased their purchases of Projects Nos. 4 and 5 bonds dramatically over time to the point where UITs ultimately held approximately 25% of all Projects Nos. 4 and 5 bonds issued.

10. The Rating Services

Moody's Investors Services, Inc. and Standard and Poor's Corporation are rating services that rated the Projects Nos. 4 and 5 bonds.

D. CHRONOLOGY OF SIGNIFICANT EVENTS

Listed below are the dates of some of the events referred to in the Report and of the sales of Projects Nos. 4 and 5 bonds.

<u>Date</u>	<u>Event</u>
	<u>1957</u>
January 19	Supply System organized.

1968

October 23 Program under which the Supply System's Projects Nos. 1, 2, and 3 were undertaken is approved. That Program, known as Phase 1 of the Hydro-Thermal Power Program, provided for the BPA to acquire power from non-federal thermal projects by net billing, which was designed so that, under the project agreements, the BPA would assume the risk of a project's non-completion and of non-performance by a project's sponsor. The power from the Phase 1 projects was to be integrated into the other power the BPA had available to market, and the costs were to be integrated into the rates the BPA charged its customers.

1970

October 7 Legislation enacted authorizing the BPA to acquire by net billing the anticipated output of Projects 1, 2 and 3.

1973

May 30 An organization of customers entitled to preference in obtaining BPA power, the Public Power Council, requests that the Supply System build Project No. 4, which later became Projects Nos. 4 and 5.

June 22 Supply System adopts a Resolution accepting the proposal for it to undertake Project No. 4.

November 15 Houghton Cluck considers preliminary financing alternatives for Project No. 4 and, after discussion of alternatives with Wood Dawson and others, notes possible legal impediments to the Supply System's issuing notes based on guarantees of municipal corporations that are not Supply System members.

December 19 Completion of memorandum describing program, of which Projects Nos. 4 and 5 were considered a part, for the construction of projects in addition to the Phase 1 projects. The program, known as Phase 2 of the Hydro-Thermal Power Program, contemplated that the BPA would acquire power for publicly-owned utilities as their agent and that the entire Pacific Northwest region or interested utilities would share costs caused by any project that was not completed.

1974

- March 20 The Supply System goes forward with the first financing for what became Projects Nos. 4 and 5 by issuing \$2,500,000 of member-backed notes for preliminary work on Project No. 4.
- May Work begins on agreement that later became the Participants' Agreement, and a decision is made to build Projects Nos. 4 and 5.
- August 22 Supply System issues \$15,000,000 of member-backed notes for preliminary work on Projects Nos. 4 and 5.
- November 1974- Wood Dawson and Houghton Cluck conduct majority
February 1975 of their research into authority of BPA preference customers to enter into Participants' Agreement and Option Agreement.
- December 1974- In order to provide time for power allocation
January 1975 issues to be resolved and thereby remove an obstacle to execution of the Participants' Agreements, decision is made for prospective participants in Projects Nos. 4 and 5 each to enter into an Option Agreement, which was developed to provide security for an interim financing for Projects Nos. 4 and 5.

1975

- January 20 Houghton Cluck advises Wood Dawson with regard to Projects Nos. 4 and 5 that Idaho cities "should not be allowed in."
- The BPA advises Wood Dawson that each preference customer should enter into the Option Agreement.
- January 22 Houghton Cluck finalizes summary of Option Agreement, which includes statement that Idaho cities and others would not be parties.
- March 31 Representatives of Idaho cities meet in Portland, Oregon with Houghton Cluck, BPA, Public Power Council attorneys and others to discuss Projects Nos. 4 and 5 agreements. A tentative decision is reached to bring a test case to determine the authority of Idaho cities to participate in Projects Nos. 4 and 5.

April 1-7 Decision made by Houghton Cluck, and possibly Wood Dawson and others, not to go forward with a test case on Idaho cities. Houghton Cluck informs Idaho city attorneys that there is no time for a test case, that Idaho cities have authority, and that, if a court decides otherwise, the Idaho cities simply will not have to pay.

July 22 The signed Option Agreements are given this date.

July 24 The Supply System issues \$100 million of development bonds backed by Option Agreements, for Projects Nos. 4 and 5; 7.04% interest cost; Merrill Lynch lead underwriter.

December Concern that Participants' Agreements will not be executed in time to provide basis for needed financing leads to consideration of a second option agreement to avoid running out of funds and/or spending authority. After it seems that some utilities will not sign, the proposal is abandoned.

1976

April 15 The Participants' Agreement is mailed for signature to Option Participants.

April 16 Certain utilities refuse to sign Participants' Agreement unless they first know what their future allocations of power from the BPA will be. In response, the BPA sends a letter to its preference customers, including utilities that signed Option Agreements, advising that it would be inequitable to use participation in Projects Nos. 4 and 5 as a basis for reducing future allocation of BPA power.

June 24 The BPA issues Notice of Insufficiency to preference customers to the effect that, as of July 1, 1983, the BPA will not guarantee to meet the requirements of its preference customers. The notice thus encourages preference customers to participate in Project No. 4 and 5.

July 14 Previously signed Participants' Agreements are dated as of this date.

1977

- February 23 The Supply System issues first bonds for Projects Nos. 4 and 5 that are backed by Participants' Agreements (Series 1977A); \$145 million; 5.93% interest cost; Smith Barney lead underwriter.
- May 24 Projects Nos. 4 and 5 bond sale (Series 1977B); \$90 million; 6.32% interest cost; Bache lead underwriter.
- July-September BPA questions Supply System about adequacy of cost and schedule projections. Despite reassurances, BPA requests risk analysis on probability of projections.
- September 13 Projects Nos. 4 and 5 bond sale (Series 1979C); \$130 million; 5.96% interest cost; Bache lead underwriter.

1978

- January Risk analysis shows only very low probability on Projects Nos. 1, 2, and 3 budgets and schedules.
- January 31 Projects Nos. 4 and 5 bond sale (Series 1978A); \$150 million; Salomon Brothers lead underwriter.
- May 23 Projects Nos. 4 and 5 bond sale (Series 1978B); \$150 million; 6.86% interest cost; Smith Barney lead underwriter.
- August- Supply System reluctant to acknowledge a schedule September slippage in a net-billed project official statement.
- August 1 Supply System Treasurer complains that 12-24 month cash flow goal is not being met.
- October 12 Projects Nos. 4 and 5 bond sale (Series 1978C); \$170 million; 6.81% interest cost; Bache lead underwriter.

1979

February 12 Merrill Lynch analyst report noting problems with Projects Nos. 4 and 5 issued.

February 14 Projects Nos. 4 and 5 bond sale (Series 1979A); \$175 million; 7.16% interest costs; Merrill Lynch lead underwriter.

June Merrill Lynch meeting on whether to continue underwriting Supply System bonds.

June 20 Financial Advisor warns Supply System of bad market for Projects Nos. 4 and 5 bonds.

July Fiscal year budgets adopted at 50% probability under BPA prodding. First and only budget at that probability.

August 28 Projects Nos. 4 and 5 bond sale (Series 1979B); \$150 million; 7.69% interest costs; Smith Barney lead underwriter.

October 29-
November 2 Supply System Investor Tour at Richland, Washington. After tour, Merrill Lynch UIT analyst recommends reevaluating further purchases of Projects Nos. 4 and 5 bonds; T. Rowe Price analyst rates Projects Nos. 4 and 5 bonds below investment grade and sells holdings.

November Meeting in Merrill Lynch UIT department following analyst's recommendation of reevaluation of Projects Nos. 4 and 5 bonds purchases. Portfolio buyer speculates on possible "slam-out" or collapse of Projects Nos. 4 and 5 market if Merrill Lynch UITs stopped purchasing.

December 11 Projects Nos. 4 and 5 bond sale (Series 1979C); \$200 million; 8.30% interest costs; Smith Barney lead underwriter.

1980

April 24 Board authorizes Supply System to proceed with Balanced Financing Program.

April 29 Only one bid entered on Projects Nos. 4 and 5 bonds. First time only one bid received. Bid rejected and Merrill Lynch subsequently selected as lead underwriter.

May 9 Projects Nos. 4 and 5 bond sale (Series 1980A); \$130 million; 9.23% interest cost; Merrill Lynch lead underwriter.

June Risk analysis on fiscal year 1981 budget. Projects personnel questioned an probability. Budget set by management at 20% probability.

July BPA notifies Supply System that use of low probability means budgets likely understate costs and it will use 50% budget for rate calculations; believe mid-year update will be needed.

July 15 Projects Nos. 4 and 5 bond sale (Series 1980B); \$180 million; 9.5% interest cost; Salomon lead underwriter. Official statement uses fiscal year 1981 budget but does not disclose low probability as indicated by risk analysis.

August A new Managing Director, Robert Ferguson, arrives at Supply System.

August Disclosure first made of low probability of budgets in Project No. 1 official statement at BPA request.

August 26 Ferguson briefed on budgets, including 20% probability of 1981 budget and mid-year review promised to BPA.

September 17 Meeting between large institutional investors and Supply System at Richland. Problems discussed. Utility representatives tell investors that projects will not be cancelled.

September - Smith Barney considers Balanced Financing Program; Smith Barney analyst prepares analysis critiquing program and pointing out some institutional investor resistance to Supply System bonds.

September 23 Projects Nos. 4 and 5 bond sale (Series 1980C); \$180 million; 10.69% interest cost; Merrill Lynch lead underwriter.

- October 13 Additional budget briefing for Ferguson.
- October 16 Participants' Committee meeting. Proposal to issue short and intermediate-term debt creates discussion about Participants' position. Changes in circumstances from original premise of sharing burden of Projects discussed. Discussion of considering slow-down or termination as possible options. Supply System asked to do study on slow-down or termination for Participants' Committee.
- October 21 Participants' Committee representatives meet with BPA Administrator to seek to have BPA and industries share risk. They tell BPA they are looking at possibility of slow-down, sale or termination.
- November 5 Supply System meeting on possible budget update immediately after end of strike. Discussion of possible splitting of recognition of possible budget increase is discussed. Managing Director told that full amount of any increase must be disclosed. He instructs the staff to prepare intensive, quick budget update.
- November 16-17 Meetings to review interim budget estimate. New estimate of \$20.4 billion presented, \$4.4 billion over 1981 budget recently adopted. Basis of estimate discussed. Managing Director orders all figures be kept confidential and rejects estimate and methodology. Only estimated costs of certain specific developments disclosed.
- November 20 Financial Advisor warns Participants' Committee of critical financial condition and possibility of termination if cash shortage. Participants' Committee not told that a budget estimate made four days before indicated a \$4.4 billion budget increase.
- December 9 Projects Nos. 4 and 5 bond sale (Series 1980D, E); \$200 million; 12.44% and 11.83% interest cost; Salomon lead underwriter. Put bonds used for first time.

1981

- February 5 The PNUCC Executive Committee meets and discusses its upcoming 1981 forecast. The BPA indicates that its revised estimate for 1981 will reflect a 500 megawatt reduction for the forecast year 1981 as a result of a study of deviation between forecast and actual usage.
- February 27 The BPA formally transmits its revised load estimate for inclusion in the 1981 PNUCC regional forecast.
- March 17 Projects Nos. 4 and 5 bond sale (Series 1981 A, B); \$200 million; 11.77% and 11.06% interest cost; Merrill Lynch lead underwriter.
- March 18 The PNUCC System Planning Committee meets and discusses its 1981 regional forecast summary, dated March 16, 1981, which projected a drop in forecasted demand for the West Group area of 2,676 average megawatts for the 1981-82 forecast year.
- May 3 Initial fiscal year 1982 budget figures become available at Supply System.
- May 5 May 1981 Projects Nos. 4 and 5 bond offering postponed because fiscal year 1982 budget figures available. Supply System press release of May 5, 1981 does not disclose availability of budget figures.
- May 29 Managing Director announces fiscal year 1982 budget estimate of \$23 billion for all Projects, recommends a moratorium on construction.
- August 27 Participants with 8.2% of shares vote against resolution to require Participants to pay a portion of interest during construction, a condition required by underwriters for any further sales of Projects Nos. 4 and 5 bonds. Participants with 30% of shares indicate they are unlikely to agree to pay interest during construction unless Projects are regionalized.
- December 22 Suit challenging validity of Participant's Agreement of Oregon city filed by residents (Defazio action).

1982

- January 22 Projects Nos. 4 and 5 formally terminated.
- May 18 Trustee for Projects Nos. 4 and 5 bonds files declaratory judgment action in Washington state court to establish validity of Participants' Agreements.
- November 5 Oregon trial court holds Oregon Participants lacked authority to enter into take or pay agreements (Defazio action).
- November 16 Washington State trial court enters order on summary judgment motion that Washington Participants had authority to enter into Participants' Agreements.

1983

- May 13 Supply System fails to pay monthly debt service to Projects Nos. 4 and 5 bond trustee.
- June 15 Washington State Supreme Court rules that Washington municipalities and public utility districts were not authorized to enter into take-or-pay agreements on Projects Nos. 4 and 5.
- September Idaho Supreme Court rules that Idaho cities did not have authority to enter into participants' agreements.

1984

- March 20 Oregon Supreme Court reverses trial court decision and holds that Oregon Participants had authority to enter into take or pay agreements, but does not preclude other defenses to obligation to pay.
- November 6 On rehearing, Washington State Supreme Court affirms its June 15, 1983 decision and relieves all Participants of their obligations.

1985

- April 29 U.S. Supreme Court declines to review Washington State Supreme Court decision.

PART II

THE PROJECTS

A. COST ESTIMATES (BUDGETS) FOR THE PROJECTS

1. Introduction

The official statement for each issue of Projects Nos. 4 and 5 bonds included an estimate of the costs to complete the projects. 12/ The estimates of the costs to complete were produced as part of the Supply System's annual budget process for all five of its projects. The Supply System was obligated to develop a budget for each project each year by agreements that governed the projects. The budgets included updated estimates of the costs to be incurred for each project through completion. 13/ These annually prepared budgets, which were occasionally revised in mid-year, were subject to disapproval by various entities associated with the projects. Therefore, they served as both estimates of, and authorizations for, expenditures by the Supply System.

12/ The estimates were included in a table that established the financing needed for the projects.

13/ The total of the budgets was often referred to as the "budget" for a given year, and such reference is sometimes used here.

a. How The Estimates Were Done

The Supply System's fiscal year began on July 1. ^{14/} The budget process began the preceding December or January, when the Supply System issued instructions to those working on the budgets on how to make and present calculations of costs. One of the important initial steps in the preparation of the budgets was setting the schedules for the projects because the schedules affected the construction cost analysis and the interest cost analysis. The schedules were set by consultation between the Supply System and the companies that were managing the building of the projects.

The costs for building the projects were calculated from the elements of the building process. The direct cost of construction was determined from estimates of construction quantities to be installed, such as yards of concrete in the project, and estimated costs of accomplishing those quantities. The cost of engineering design work was determined by amounts expended and the estimates of design work remaining. Finally, the cost of equipment purchased from outside vendors was estimated based on contract prices or on market prices. Each element of these estimates provided for "escalation" to account for the effect of inflation over the duration of the projects.

^{14/} The Supply System completed a conversion to this fiscal year from a calendar year in 1979.

The assumptions about the rate of inflation for labor and materials were determined by the Supply System.

The Supply System determined and added various "owner's costs," which included administrative overhead. The Supply System also determined and added the cost of the nuclear fuel that was to be acquired before the start of commercial operation of the projects. It also determined and added an overall contingency amount in a Potential Exposure item to encompass anticipated overruns that were not reflected in the contractors' contingency amounts. Finally, the Supply System calculated and added to the budgets the cost of interest to be paid on the bonds issued to finance the construction of the projects before the projects were complete. Interest was a very large item for Projects Nos. 4 and 5 because all the interest payable during the construction of Projects Nos. 4 and 5 was financed by the sale of additional bonds and was part of the budget. ^{15/} Because of this, any schedule delay meant that interest had to be paid on more money over a longer period. This interest factor made any delay very expensive.

The Supply System would generally complete the estimates in May or June and then submit the resulting budgets for each of the

^{15/} Interest was less significant in the Projects Nos. 1, 2 and 3 budgets because after a fixed date the BPA paid the interest on the bonds issued to finance the construction of those Projects.

projects to its Board of Directors and to each of the entities having a contractual right to review and pass on the budgets. In the case of Projects Nos. 1, 2, and 3, the BPA and the Participants' Review Board, composed of representatives of the Participants in those projects, had such a right. In the case of Projects Nos. 4 and 5, the Participants' Committee, composed of representatives of the Participants in those projects, had a similar right. In the case of Projects Nos. 3 and 5, investor-owned utilities that owned a minority portion of the capability of those projects also had such a right. 16/

2. Practices Tending to Cause Understatement of the Budgets

a. Introduction

The Supply System consistently failed to meet construction goals on Projects Nos. 4 and 5. As a result, there were enormous cost increases. The estimated cost to complete Projects Nos. 4 and 5 rose from a combined total of approximately \$2.25 billion at the time of the preliminary estimate to a combined total of approximately \$12 billion when the projects were suspended in 1981. Almost every annual budget showed increases in the estimated cost to complete the projects, but the greatest increases were recognized in the last two

16/ An investor-owned utility purchased a 10% interest in Project No. 5. Other investor-owned utilities purchased 30% of Project No. 3.

budgets. (SEE CHART, NEXT PAGE) 17/

17/ The budget estimates of the cost for Projects Nos. 4 and 5, reflected in the chart on the next page, were:

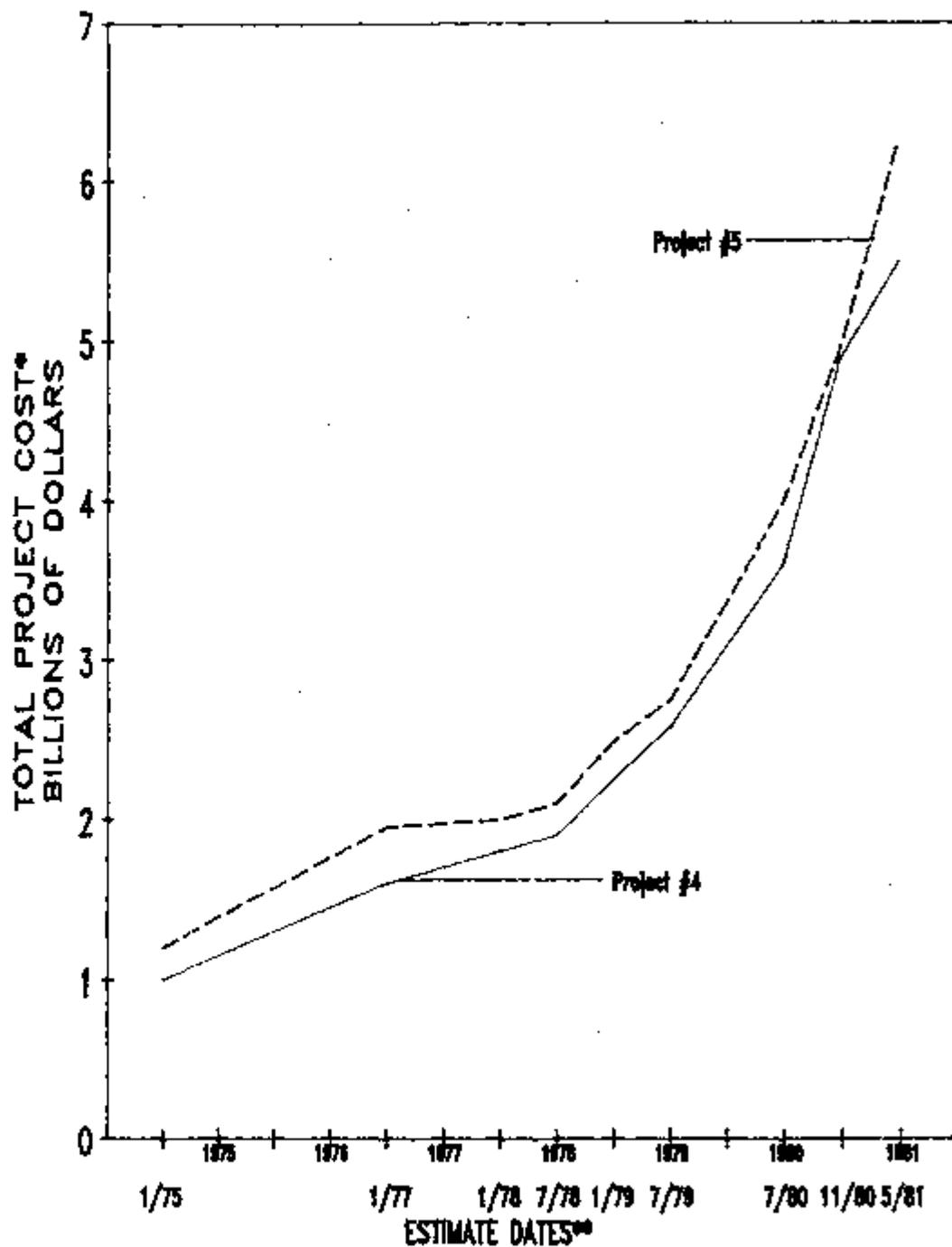
<u>Estimate</u> <u>Date</u>	<u>Cost (millions)</u>	
	<u>Project</u> <u>No. 4</u>	<u>Project</u> <u>No. 5</u>
1/75	\$1,009	\$1,210
1/77	1,610	1,951
1/78	1,870	2,018
7/78	1,915	2,129
1/79	2,251	2,492
7/79	2,580	2,753
7/80	3,614	4,002
11/80*	4,932	4,975
5/81	5,510	6,261

* undisclosed estimate (See SEC Exh. 520 and discussion in text below).

Presentation to R.L. Ferguson (October 13, 1980) (1/75 through 7/80 estimates) (SEC Exh. 493); Project Cost Summary (November 1980 estimate of cost to complete, information presented at November 16, 1980 meeting (SEC Exh. 520); Construction Budgets, 1982 Estimate at Completion, Presentation to Board of Directors (July 24, 1981) (May 1981 estimate of cost to complete) (SEC Exh. 434).

The following abbreviations are used in this Report: Testimony taken by the Commission in its investigation is cited as "SEC tr. at ___ (date)," and exhibits from the Commission's investigation are cited as "SEC Exh. ___". Some information from the private actions was considered by the staff in the investigation. Deposition testimony from the federal court proceeding is cited as "MDL tr. at ___ (date)," and exhibits from those proceedings are cited as "MDL Exh. ___". Deposition testimony from a state court action is cited as "Chemical Bank tr. at ___ (date)," and exhibits are cited as "Chemical Bank Exh. ___".

PROJECT NOS. 4 AND 5
BUDGET HISTORY



*See preceding footnote for figures.

**Estimate for 11/80 is estimate that was not disclosed, see discussion below.

The Supply System believes that the budgets it produced were the result of diligent efforts, were consistent with industry practices, and were realistic. 18/ The budgets were intended to be constrained, however, and were referred to by Supply System personnel as "tight but attainable" or "tight but achievable" budgets. 19/ The Supply System chose to have tight budgets and tight schedules because management believed that larger budget figures or longer schedules would become self-fulfilling prophecies. 20/

Although continuing construction problems caused increases in each new budget, the budgets that were produced tended to understate likely costs because of this desire to keep budgets tight. This often prevented investors from having an accurate perception of the likely costs and put the Supply System in conflict with the BPA, which had its own needs for cost and schedule information on Projects Nos. 1, 2, and 3. The budget increases in the early stages of construction were relatively

18/ See Memorandum of Washington Public Power Supply System in Response to the Staff's Proposed Recommendation That Civil Injunctive Proceedings be Instituted Against the Supply System 85-121 (Apr. 9, 1987) [hereinafter Supply System Memorandum to SEC].

19/ Id.; Frank D. McElwee SEC tr. at 50, 70-71, 86 (Apr. 2, 1985) (Supply System Manager of all the Projects).

20/ Frank D. McElwee SEC tr. at 70 (Apr. 2, 1985) ("[L]oose budgets, loose schedules were self-fulfilling. I believe in tight budgets, and tight schedules. I think the record [bears] that out"); Jerome Read SEC tr. at 59-60 (Feb. 7, 1985).

modest. Understatement in the budgets appears to have become more pronounced in the year before the Supply System management recommended a moratorium on construction of Projects Nos. 4 and 5 in May 1981, as the budgets reached a magnitude that threatened continued financing on the existing basis. The underestimate during this period is reflected particularly in the undisclosed results of a November 1980 update estimate 21/ that indicated that the budgets had grown enormously.

b. Early Practices

Even as bond sales for Projects Nos. 4 and 5 began in early 1977, the Supply System was following practices that tended to cause understatement of cost estimates for the Supply System Projects. By the middle of 1977 the Supply System was having problems maintaining the schedules and cost projections for Projects Nos. 1, 2, and 3, and the BPA held meetings with the Managing Director of the Supply System in July and September to discuss these problems. 22/ The budget and schedule procedures

21/ See discussion, infra.

22/ Letter from S. Munro to N. Strand (Jan. 31, 1978) (letter from BPA Administrator to Supply System Managing Director referring to 1977 meetings). (SEC Exh. 232.)

The BPA had a particular interest in the budgets and schedules for Projects Nos. 1, 2, and 3, because power from those projects was to become part of the BPA's electrical supply. The BPA needed accurate schedule information to make accurate forecasts of when the power from the projects would be available. The BPA also had a keen interest in the budgets because it had to plan rate increases to pay for Projects Nos. 1, 2, and 3, including interest it had to pay during construction. The BPA also had some knowledge about the projects because it had several employees at the sites
(continued...)

for those projects were the same as those for Projects Nos. 4 and 5 as the Projects Nos. 1 and 3 plants were duplicates of the Projects Nos. 4 and 5 plants, respectively. 23/

In those meetings, the Supply System advised the BPA about the Supply System's problems in meeting costs and schedules but told the BPA that there was a 50% probability of meeting the projected September 1980 completion date on Project No. 2, contingent upon an acceleration in construction progress from 1.5% of project completion per month to 2%. 24/ The BPA nonetheless requested in September 1977 that a study of the budgets and schedules be conducted to analyze the probability of meeting the projected budgets and schedules ("risk analysis") for each of Projects Nos. 1, 2, and 3. 25/

By January 1978, the increase in the construction rate projected by the Supply System had not occurred. Further, a risk analysis on Project No. 2 that had been completed in

22/ (...continued)

to help in monitoring Projects Nos. 1, 2, and 3. The Supply System maintains that policy differences and tensions between the Supply System and the BPA affected BPA's position on budget matters. Supply System Memorandum to SEC, supra, at 129-33.

23/ The projects were being constructed at the same sites, with the construction activity on Projects Nos. 4 and 5 following Projects Nos. 1 and 3 by approximately 18 months.

24/ Letter from S. Munro to N. Strand 1 (Jan. 31, 1978) (letter from BPA Administrator to Supply System Managing Director referring to 1977 meetings). (SEC Exh. 232.)

25/ Id. at 2.

December 1977 by a consulting firm hired by the Supply System at the request of the BPA showed that the probability of achieving the existing budget on Project No. 2 was only between 3% and 7% and that the most likely outcome was a budget increase of \$200 to \$300 million and a 12 to 15 month schedule slippage. 26/ The analysis was based on project performance to date, a comparison with other nuclear plants, and an analysis of the critical points in the construction program. BPA officials expressed their concern about the impact of these developments on its resource and rate planning. 27/

A second risk analysis, covering Projects Nos. 1, 2, and 3, was completed in January 1978. This analysis did not use prior experience on the projects or critical construction point analysis because Projects Nos. 1 and 3 were less advanced than

26/ Holmes & Narver, Inc. Risk Analysis (Dec. 1977). (SEC Exh. 213.)

27/ Letter from S. Munro to N. Strand 2 (Jan. 31, 1978) (letter from BPA Administrator to Supply System Managing Director):

As mentioned in our meeting we are very much concerned with the lack of progress over the past 6 months and with your consultant's risk analysis report. It is apparent to us that the current commercial operation date of September 1980 has a very low probability of being achieved.

The current costs of the three net-billed projects have a very substantial impact on our projected rate increase in 1979. Delays in the presently scheduled commercial operation dates and increased project costs will have a significant impact to BPA's resource planning and future rate studies.

(SEC Exh. 232.)

Project No. 2 and sufficient data were not available. A larger industry comparison base, however, was used for the industry comparison. That risk analysis showed a 20% chance of meeting the schedule on Project No. 1, a 0% chance on Project No. 2, and a 6% chance on Project No. 3. 28/

The person who performed the risk analyses for the consulting firm was subsequently hired as an employee by the Supply System to perform additional analyses and to develop additional industry statistics to be used in risk analyses. 29/ Since the risk analysis process was newly developed for the Supply System budgets and schedules, however, it was not initially made a formal part of the budget process. The Supply System continued its "tight but attainable" philosophy even though, as recognized by the Supply System official in charge of the projects, that approach produced budgets and schedules that had less than a 50% chance, in risk analysis terms, of being achieved. 30/

28/ Holmes & Narver, Inc., Risk Analysis of the Schedules of Hanford #1, #2, and #3 Nuclear Projects, and the Development of a Basic Industry Model (Jan. 1978). (SEC Exh. 214.)

29/ In addition to the risk analyses in December 1977 on Project No. 2 and in January 1978 on Projects Nos. 1, 2, and 3, risk analyses on Projects Nos. 1, 2 and 3 were done in January 1979 and in June 1979, and a risk analysis on Projects Nos. 1, 2, 3, 4, and 5 was done in June 1980.

30/ Frank D. McElwee SEC tr. at 71 (Apr. 2, 1985). The conflict between the appropriate probability level for management target goals in contrast to the appropriate probability level for planning financing needs was reflected in the first risk analysis, which expressly
(continued...)

Management practices with respect to the budgets occasionally resulted in conflicts between the Supply System management and the group of consultants that participated in drafting the official statements. The drafting group consisted of the Supply System's Financial Advisor, Special Counsel, Bond Counsel, Consulting Engineer, and, on Projects Nos. 1, 2, and 3 bond sales, the BPA. 31/ On one occasion, involving a Project No. 3 offering in September 1978, information about an event that would likely cause an addition to costs became known to a member of the drafting group. At a drafting session in August 1978 on the official statement for the pending bond offering, the Supply System official in charge of the projects stated that the next budget would "hold the line" on the current budget and would probably show only small increases. 32/ The Financial Advisor, however, questioned the official about the effect on the budget of the fact that the pouring of concrete for the project was to start three months later than the date in the existing schedule:

30/ (...continued)

stated that a 20% probability would be appropriate for a target budget while an 80% probability would be appropriate for a financing budget. Holmes & Narver, Inc. Risk Analysis of the Estimate and Schedule of Hanford #2 Nuclear Project 39 (Dec. 1977). (SEC Exh. 213.)

31/ For identification of the portions involved, see Part I C, supra.

32/ Memorandum from H. Spigal to H. Durocher 1 (Sept. 7, 1978) (memorandum from BPA employee assigned to represent the BPA in the official statement preparation to his supervisor). (SEC Exh. 233.)

Don Patterson [the Financial Advisor] asked why the slippage of 3 months for the WNP No. 3 concrete pour would not affect the new year's budget. McElwee [the Supply System official in charge of all the projects] said that the slippage must be analyzed in connection with the overall schedule. In addition, a 3-month slippage was not a question of disclosure, but a matter of management philosophy. McElwee stated that he did not want to slip the overall WNP No. 3 schedule and create a "self fulfilling prophecy." In response to Patterson's further questions regarding slippage of No. 3 and the impact on budgets for both WNP Nos. 3 and 5, McElwee stated that he was not saying there would be no schedule slippage, but that he did not want to take the slippage at this time. 33/

As the drafting of the official statement proceeded to its final stages in early September, the disagreement over the issue of whether the slippage on Project No. 3 should be disclosed continued. The Supply System was of the opinion that the slippage could be made up, although that would require a rate of progress greatly above the rate achieved to that time. 34/ The debate revolved around the conflict between management's desire for tight budgets and schedules to maintain control over contractors and BPA's interest in having more inclusive budgets and schedules for planning purposes. As noted by the BPA employee who supervised BPA's budget oversight and negotiated with the Supply System on this point:

33/ Id. at 1 (emphasis in original). See also Winston Peterson SEC tr. at 87-91 (Sept. 17, 1985) (testimony of consulting engineer).

34/ In his testimony McElwee did not recall the events of this incident but expressed the view that the estimates could not be made more accurately than three months in any event. Frank McElwee SEC tr. at 57-62 (Apr. 2, 1985).

On August 30 I met with Neil Strand [Supply System Managing Director], Frank McElwee [Head of all the projects] and Jim Perko [chief financial officer] to try to resolve our differences.

It is apparent that WPPSS and BPA have conflicting management philosophies with respect to the need and type of information that should be disclosed. Their [i.e., the Supply System's] view is to put off or postpone as long as possible acknowledgment of delays, because in their view it would have a counter productive impact on their management of the projects. They feel time constraints on the architect/engineer, the construction contractors, and their own staff is necessary throughout the duration of the project. That ultimately, even though there may be schedule extensions, the benefit of the time pressure will produce a lower bottom line cost.

I mentioned to Strand that that philosophy conflicts with our needs from a resource and financial planning standpoint as well as full disclosure to the investors. They acknowledge this difference in views but did not have any suggestion as to how we might resolve it. 35/

Ultimately the BPA prevailed and the official statement was changed to disclose the slippage problem and its possible impact on the schedules and cost estimates in months and dollars.

The difficulties in getting adequate disclosure in the official statements caused the principal BPA representative in the drafting group to comment to his supervisor on the deteriorating participation of certain members of the drafting group

35/ Memorandum from Thomas Wagenhoffer to Files 1 (Sept. 7, 1978) (memorandum from BPA Assistant to the Administrator, Thermal Projects, with copies to the Administrator and other BPA staff members) (SEC Exh. 586). See also Thomas Wagenhoffer SEC tr. at 27-31 (Nov. 8, 1985); Memorandum from H. Spigal to H. Durocher (Sept. 8, 1978) (SEC Exh. 585).

in seeing to disclosure. 36/ A BPA representative was not

36/ Memorandum from H. Spigal to H. Durocher 4-5 (Sept. 8, 1978) (memorandum from BPA representative on the Projects Nos. 1, 2, and 3 drafting group to supervisor):

I believe that the process for drafting official statements has changed significantly during the 2 years I have been involved.

Previously, all members of the financing group took an active role in ferreting out the information necessary to make full disclosure. WPPSS personnel who reported to the financing group regarding project construction, although not eager to pass on information unfavorable to WPPSS, did not systematically avoid revealing such facts. Through the financing group's question and answer process, the facts regarding project construction, completion dates, and costs were determined and disclosed in the official statements.

Recent experience at financing meetings is that WPPSS's bond counsel [Brendan O'Brien of Wood Dawson] is present, but says very little. Retained counsel [Bert Metzger, Jr. of Houghton Cluck] principally limits his participation to discussions of legal issues, disclosure regarding litigation, and similar matters, and avoids participating in discussions of the disclosure to be made about project construction schedules, budgets or related problems. Bert Metzger has advised me that he views his role as that of a lawyer whose obligation to provide legal advice does not extend to recommending what should be disclosed regarding project construction, schedules, or completion dates.

WPPSS's consulting engineer [Winston Peterson of R.W. Beck] has a clearer obligation to dig out the facts which should be disclosed and assure that they are appropriately disclosed. Winn Peterson is obviously uncomfortable with the level of disclosure which WPPSS's management seeks to make, and is clearly concerned about his liability for failure to make full disclosure. However, he seems reluctant to

(continued...)

present in the drafting sessions for the official statements for the Projects Nos. 4 and 5 bond sales; only the other representatives of the drafting group participated with the Supply System in drafting those official statements.

A public event that indicated that budget information in the official statement was inaccurate subsequently caused members of the drafting group to express to the Supply System concern about access to budget information. In early 1979, shortly after a preliminary official statement had been published, a news report described an adverse budget development that the drafting group had not been informed of during the official statement drafting process. Although the incident apparently involved a misinterpretation by the media, it prompted a conference call from some of the members of the drafting group to the managing director of the Supply System to express concern about the flow of information on budget matters:

36/ (...continued)

press WPPSS regarding disclosure matters. In addition, he has advised me that his only real access to information regarding project construction, budgets, and schedules is through Jim Perko, the Assistant Director for Finance. I believe that Jim Perko's access to information is limited, at best.

Only the Supply System's financial advisor [Donald Patterson of Blyth, Eastman Dillon] now takes an active and aggressive role in seeking disclosure of relevant information. Don Patterson has stated that he is concerned about WPPSS' long-term credibility in the financing marketplace.

(SEC Exh. 585.)

He [Donald Patterson, the Financial Advisor] stated that the matter [of access to cost and schedule information] had recently come to head [sic] with respect to financing for the No. 2 Project when information concerning serious problems with certain of the construction contracts for Projects 1 and 4 was not disclosed to the financial consultants but was made public after the sale and prior to the closing, where the information was of a nature which indicated that it had been known to project staff at the time the official statements were prepared. Mr. Patterson, Peterson, O'Brien and Metzger all stated they had serious concerns with the completeness and adequateness of the information flow from project staff to the financing group and indicated that serious action was called for on the part of management to correct the situation or major damage could be done to the credibility of the Supply System in its financing program with consequent serious damage to the financing program itself. 37/

Subsequently, the Supply System's budget review group was moved from the staff of the project manager to the staff of the chief financial officer, who was involved in the preparation of the official statement. 38/

37/ Memorandum from BLM to WPPSS Finance Correspondence File (Apr. 2, 1979) (memorandum of Bert L. Metzger, Jr. on March 30, 1979 conference call from drafting group to Neil Strand and James Perko) (SEC Exh. 6036); see also Winston Peterson SEC Tr. at 452-56 (Sept. 19, 1985). The author of the memorandum, Bert L. Metzger, Jr., testified that, prior to placing the telephone call, it was learned that the news report apparently misinterpreted statements by Supply System personnel. The call was nonetheless made to address increasing problems in getting the project personnel to provide information in light of their preoccupation with project demands. Bert L. Metzger, Jr. SEC tr. at 1964-69 (Nov. 6, 1986).

38/ James Perko MDL tr. at 298-301 (June 4, 1985); Bert L. Metzger, Jr. SEC tr. at 1968-69 (Nov. 6, 1986). Also, Winston Peterson of R.W. Beck, the consulting engineer,
(continued...)

In the beginning of 1979, the Supply System publicly announced schedule extensions for all five projects. 39/ It appears that Supply System management had initially sought to minimize disclosure of the extensions by recognizing only a portion of the extensions at that time and disclosing the rest at a later date. 40/ Ultimately the schedule extensions that were announced were within the general range of a 50% probability

38/ (...continued)

became more involved in the Supply System budget matters: Winston Peterson MDL tr. at 1722 (Oct. 17, 1985); Bert L. Metzger Jr. SEC tr. at 1969 (Nov. 6, 1986).

39/ The completion dates were extended 12 months for Project No. 1; 9 months for Project No. 2; 11 months for Project No. 3; 12 months for Project No. 4; and 11 months for Project No. 5. Washington Public Power Supply System 1980 Project Construction Budgets.

40/ Memorandum from T.V. Wagenhoffer to R. Foleen 2 (Dec. 22, 1978) (memorandum from BPA Assistant to the Administrator and head of the BPA's oversight team to BPA Deputy Administrator):

McElwee [The Supply System official in charge of all the projects] plans to present the Holmes & Narver analysis to the Executive Committee on December 29. He hopes to receive some direction from the Executive Committee on how to address the disclosure of the delays. He mentioned that the staff will be preparing a bond statement for WNP-4&5 during the week of January 2, and that the disclosure of the delays will have to be addressed at that time. He suggested that the Holmes & Narver 10 to 20 percent probability schedule delays be used. This would acknowledge about 50 percent of the delays estimated by both Holmes & Narver and the WPPSS staff. He then proposed that the remaining delay and cost be included in the Fiscal 1980 budget which is due in June 1979.

(SEC Exh. 218.)

of achievement, as reflected in the risk analysis performed at that time. Some budget increases were also recognized as a direct consequence of the schedule extensions. 41/ The fiscal year 1980 budget, prepared in the Spring of 1979 and effective July 1, 1979, was based on the schedule revisions of January 1979. The new cost calculations, however, resulted in higher budget figures than those recognized in January. 42/ It appears that, again, Supply System management initially intended to use budget figures that, under a risk analysis, had less than a 50% probability of achievement, but was induced by the BPA to increase the budgets to a 50% probability. 43/

The fiscal year 1980 budgets were quickly shown to be inadequate. During the balance of 1979 through early 1980,

41/ The total financing cost increased from approximately \$8.7 billion to \$10.2 billion for all five projects and from \$4 billion to \$4.6 billion for Projects Nos. 4 and 5.

42/ The total financing costs for all five projects increased to approximately \$11.5 billion and to \$5.2 billion for Projects Nos. 4 and 5.

43/ Letter from S. Munro to N. Strand 2 (June 12, 1979) (letter from BPA Administrator to Supply System Managing Director):

During a budget review meeting on May 23, my staff was informed that the budget estimates were based upon a 30 percent or less probability level and the project schedules were based upon a 50 percent probability. At the time, we questioned the appropriateness of having both the budget and schedule based upon different probability levels. It is my understanding that all costs and schedules now have been revised and are based on a 50 percent probability.

(SEC Exh. 600); see also Thomas Waggenhoffer SEC tr. at 30-33 (Nov. 8, 1985).

likely increases in costs and likely schedule extensions were identified within the Supply System. 44/ Continuing budget and schedule problems were taking on critical importance to Projects Nos. 4 and 5 because the increasing budgets were becoming a concern to the financial community. 45/

c. Fiscal Year 1981 Budget

The fiscal year 1981 budget, to become effective on July 1, 1980, was prepared in the first half of 1980. For this budget cycle, there was a change in the risk analysis. Up to this time the risk analyses had been based largely on analysis of statistical information. The risk analysis for the fiscal year 1981 budget also involved, for the first time, an intensive effort to obtain evaluations of the reliability of the cost estimates in meetings with the project personnel who created the

44/ See, e.g., Supply System Budget Review Meeting Minutes.

45/ For example, the Moody's rating service report on the August 1979 sale of Projects Nos. 4 and 5 bonds noted in the introductory opinion section of that report, for the first time:

Causes for concern, however, continue to be the higher construction estimates with the resultant impact on additional financing and ultimate higher costs to the participants. Supply System's ability to maintain construction schedules and to contain future cost increases become more significant factors for subsequent evaluations of this enterprise.

Moody's Investor Services, Inc., Municipal Credit Report - Washington Public Power Supply System-Nuclear Projects Nos. 4 and 5 at 1 (Aug. 22, 1979). (SEC Exh. 2323.)

estimates. 46/ The fiscal year 1981 risk analysis involved, in essence, having the persons who had produced the budgets revisit them to assess the likelihood of meeting the budgets. 47/ This risk analysis indicated only a low probability that the budgets would be met. 48/ The Supply System management reviewed the risk

46/ Jeremy Maidment SEC tr. at 105-08 (Aug. 21, 1984). Washington Public Supply System, Risk Analysis of WPPSS Nuclear Projects 1, 2, 3, 4, and 5, at 4 (June 1980):

Since it [the risk analysis on the previous budget] was the first time that this technique [risk analysis] had been used in the Supply System [formal budgets], it was only conducted with senior management at a very limited overview level. It helped to highlight the fact that the base 1980 budgets were significantly underestimated but not to the extent that has now become apparent with more detailed analysis.

This year the members of the Financial Management Controls Division who are responsible for this analysis were present at all project budget reviews so as to build up a background on which to base the final profiles. These profiles were ultimately developed at some 80 hours of open sessions. The participants involved were the estimators and engineers directly responsible for the base figures, senior project and staff management, A-E personnel, BPA representatives, and the staff members conducting the analysis. The profiles finally arrived at constitute a technical consensus of all participants involved.

(SEC Exh. 216(a).)

Also, the risk analysis covered all five projects for the first time.

47/ Jeremy Maidment SEC tr. at 105-08 (Aug. 21, 1984).

48/ Washington Public Power Supply System, Risk Analysis of WPPSS Nuclear Projects 1, 2, 3, 4, and 5, charts 7-12 (June 1980). (SEC Exh. 216(a).)

analysis results and decided to add a small additional amount to the budget contingency category so that the budgets would have an overall probability of approximately 20%. 49/ The total budget at this level of probability was \$15.9 billion for the five projects. 50/ To get the budget to the 50% probability level would have required the addition of a total of approximately \$1.5 billion to the budgets for the five projects. 51/

The Supply System management stated that the risk analysis was only a tool to help evaluate the budgets and, in light of the budget increases and the substantial contingency allowance already in the budget, it decided that further increases to the contingency allowance to bring the budgets to 50% on the risk

49/ James Perko SEC tr. at 345-47 (Oct. 18, 1985).

50/ Even at the relatively low probability level of 20%, the budgets showed sharp increases. The total financing requirements for all five projects increased from approximately \$11.7 billion to \$15.9 billion. The budget was accompanied by schedule extensions of 18 months for Project No. 1, 16 months for Project No. 2, 18 months for Projects No. 3, and 12 months for Projects Nos. 4 and 5. The completion date extensions for Projects Nos. 4 and 5 were less than for their twin plants, Projects 1 and 2, because the Supply System decided to reduce the projected separation time between the two projects from 18 months to 12 months. The completion date changes had been adopted in April 1980 in connection with the initial stages of the budget preparation process. Washington Public Power Supply System, 1981 Project Construction Budgets.

The budgets, moreover, expressly did not include amounts for several major developments, including an ongoing strike that had shut down construction at Projects Nos. 1, 2, and 4, the impact of a crane collapse that had interrupted work on Projects Nos. 3 and 5, and several other matters. Minutes of Board of Directors Meeting 5 (July 25, 1980).

51/ Risk Analysis (June 1980), supra, Chart 12 (SEC Ex. 216(a)); James Perko SEC tr. at 345-347 (Oct. 18, 1985).

analysis was not warranted. 52/ The budget decided upon by management at the 20% probability level was consistent with management's "tight but attainable" budget philosophy. 53/

Some were concerned by the use of a lower than 50% risk analysis probability for the fiscal year 1981 budget. The person representing the City of Seattle on the Board of Directors expressed this concern when the Board was voting on the budgets for all the projects, and he abstained from the vote on approving the budgets as estimates of costs to complete the projects. 54/ The BPA was also concerned about using a contingency allowance that was less than the 50% risk analysis amount. It informed the Supply System that it would use project costs on Projects Nos. 1, 2, and 3 corresponding to 50% probability for its rate calcula-

52/ James Perko SEC tr. at 345-347 (Oct. 18, 1985); Lindy Sandlin SEC tr. at 41-42 (Aug. 21, 1985).

53/ Frank McElwee SEC tr. at 86 (Apr. 2, 1985).

54/ Minutes of the Board of Directors Meeting 8-9 (July 25, 1980). See also memorandum from Dean Sunquist to Joe Recchi Re WPPSS Budget Review Meetings July 1 and 2, 1980 at 5 (July 8, 1980) (Seattle City Light internal memorandum regarding July 1 and 2, 1980 Supply System budget review meeting):

I personally have a problem with accepting a budget which has only a one in five probability of achievement. However the WPPSS staff presents various and asundry [sic] reasons for this approach. Jim Perko always cautions against negative impacts, on the bond market, which inflated budgets could produce.

tions. 55/ The BPA also noted that, because of the potential understatement of the budgets, uncertainties caused by the ongoing strikes, and other matters that had not been included in the budget, a mid-year review of the budget probably would be necessary. 56/

The official statement for the first bond offering after the fiscal year 1981 budget figures were available, a projects Nos. 4 and 5 offering, did not disclose that the risk analysis indicated a low probability that the budgets would be achieved

55/ Letter from S. Munro to N. Strand 2 (July 23, 1980) (SEC Exh. 575.) (letter from BPA Administrator to Supply System Managing Director):

An area of serious concern to us is the change of assumptions on the use of the risk analysis for this year's budget. You have chosen to include amounts in Potential Exposure which reduce the probability of achievement to a range of 10 to 25 percent rather than the midrange 50 percent probability used last year. Because of this, your 1981 budget representing costs to completion has a high probability of being understated. We believe it to be more realistic to use project costs for our rate studies which are based on the 50 percent probability and are higher by an aggregate of \$715 million than your budgeted project costs for WNP-1, 2, and 70 percent of WNP-3.

56/ Id. at 3:

To summarize our position on the 1981 Updated Construction Budgets, we have listed a number of concerns which we believe are significant It is also our belief that because of the many uncertainties and the potential understatement of project costs, it is likely a mid year review will be necessary.

for those projects. 57/ Disclosure of the low probability of the budgets was not made until the next offering, in August, 1980. That offering was a Project No. 1 offering, in which BPA was involved. The BPA wanted disclosure of the risk analysis probability and a brief text reference then was made to the low probability of the budgets. 58/

57/ Official Statement for \$180,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1980B (Nuclear Projects Nos. 4 and 5) (July 15, 1980) (using the fiscal year 1981 budget figures, which were expected to be adopted formally by the Board of Directors shortly).

58/ James Perko SEC tr. at 363-64 (Oct. 18, 1985). The reference in the official statement was:

After estimates of the construction costs have been prepared by the construction engineer and Supply System staff responsible for estimating costs of a specific project, such costs are independently assessed by the Supply System's finance staff. As part of such independent assessment the Supply System applies risk analysis techniques to the construction engineers' and Supply System staff's estimates to determine the probability of constructing the projects within these estimates. To the extent deemed necessary, the Supply System established additional owners' contingencies to enhance this probability in preparing the 1981 project construction budgets. The Supply System increased the cost estimates so as to bring the probability to approximately 25%. In considering the methodology utilized in the risk analysis for the 1981 project construction budgets, the Supply System considers the use of a 25% probability factor to be appropriate.

Official Statement for \$210,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds Series 1980A (Nuclear Project No. 1) 13-14 (Aug. 5, 1980). This statement was then included in the next Projects Nos. 4 and 5 official statement for a September 1980 bond sale.

d. The November 1980 Estimates

In early August 1980, Robert L. Ferguson ("Ferguson"), the new Managing Director for the Supply System, arrived at the Supply System. 59/ At the time of Ferguson's arrival ongoing strikes had shut down work on three of the projects, and a crane accident had disrupted work on the two other projects.

An indication of possible budget and finance problems was provided to him even before he arrived. After he had been selected as the Managing Director in June, 1980, Ferguson requested that senior officials at the Supply System prepare short summaries of the major issues in the areas under their control for his review. The single sheet summary prepared for Ferguson by James Perko, the chief financial officer of the Supply System and the supervisor of the budget review officials, set forth a table of the Supply System's financing needs based on the fiscal year 1981 estimates that had just been made and noted:

This [financing] program [based on the fiscal year 1981 budget] represents the largest municipal financing program in the United States. The current status of project progress would conclude that additional slippages and cost increases will occur, increasing the above requirements perhaps as much as 25-40%. 60/

59/ Neil Strand, the preceding Managing Director, had resigned in February 1979, but remained until a new Managing Director had been selected.

60/ Memorandum entitled Major Issues and Concerns (SEC Exh. 566). See also James Perko SEC tr. at 336-44 (Oct. 18, 1985). Ferguson testified that he received summaries before he arrived pursuant to his request and probably read this summary but he could not specifically recall having read it. Ferguson SEC tr. at 206-53 (June 27, 1985).

After Ferguson arrived at the Supply System he received a briefing on the budget by James Perko and his staff on August 26, 1980. In the briefing, Perko informed Ferguson of the 20% probability of the fiscal year 1981 budget as reflected in the risk analysis. 61/ The concept of a mid-year review, requested by the BPA, was also presented. 62/ Ferguson had already been advised in an introductory meeting with the BPA that it desired a budget update. 63/

On October 13, 1980, Ferguson was more fully briefed on the 1981 budget. The briefing was conducted by Perko and two other top budget officials. Again the risk analysis and the use of a 20% probability factor for the 1981 budget were discussed. 64/

61/ Presentation to Robert L. Ferguson Managing Director (Aug. 26, 1980). (SEC Exh. 487.)

62/ Id.; James Perko SEC tr. at 386, 388-92 (Oct. 18, 1985). The written Presentation outlined a "Streamline Review Effort" concentrating on major variables from the 1981 budget and on conducting a risk analysis.

63/ Robert L. Ferguson SEC tr. at 19-26 (June 26, 1985).

64/ Presentation to: Robert L. Ferguson, Managing Director 1981 Budget Preparation (October 13, 1980) 31-36 (SEC Exh. 493); Lindy Sandlin SEC tr. at 60-63 (Aug. 21, 1985). The staff was under the impression that Ferguson understood and basically agreed with the use of risk analysis in general, but desired a more detailed briefing on its use at the Supply System. Notes by J. Read entitled Action Items, October 13, 1980 Meeting with R.L. Ferguson:

R.L. Ferguson understands methodology of risk analysis; has used the general approach and basically agrees. He believes our problem is in the manner of presentation. A more detailed briefing on risk analysis might be helpful.

(continued...)

Satisfying the BPA's concerns about the low probability factor of the 1981 budget without upsetting the financial community was also addressed. 65/

During the first few days of November 1980, the strike at Projects Nos. 1, 2, and 4 ended. 66/ The Supply System understood that the scheduled distribution of an official statement in late November for a Projects Nos. 4 and 5 offering required disclosure about the current status of the budget. On November 5, 1980, Ferguson met with senior staff personnel. The meeting focused on the budget and whether a new budget that Ferguson could endorse as his first budget could be produced at this time. 67/ The issue of a budget update as requested by the BPA also needed to be addressed, particularly in light of the

64/ (...continued)

(SEC Exh. 502.)

Lindy Sandlin SEC tr. at 66-67 (Aug. 21, 1985). Ferguson testified that based on his prior negative experience with risk analysis he was never interested in risk analysis as it applied to the Supply System budgets. Robert Ferguson SEC tr. at 19, 63 (June 26, 1985).

65/ Action Items, supra, (SEC Exh. 502):

Develop the various scenarios [sic] that would satisfy BPA's concerns without upsetting the financial community until we get a handle on the budget. Get all the numbers down considering prior budget omissions, new items/impacts (labor problem) and additional contingency.

66/ Jerome Read SEC tr. at 365-88 (Feb. 8, 1985); Robert Ferguson SEC tr. at 50 (June 26, 1985).

67/ James Perko SEC tr. at 413-14 (Oct. 18, 1985).

BPA's use of 50% risk analysis probability in its rate calculations.

Budget personnel had compiled figures reflecting the budget impact of certain specific items, including the just-ended strike, recent contract trends, the amount needed to raise the risk analysis probability to 50% in the fiscal year 1981 budget, and certain other developments. These figures showed a "total projected increase" for the costs to complete all five projects of almost \$3 billion over the fiscal year 1981 budget. Roughly half the increase was to raise the 1981 budget to a 50% probability. 68/ The projection was discussed during the November 5, 1980 meeting between Ferguson and the senior staff. 69/ One issue considered in the meeting was whether to recognize the \$3 billion budget increase or to split the increase and publicly acknowledge part then and part later. 70/ Immediately after the meeting, a key aide to the chief finance officer in the bond offering process, who had attended the meeting, prepared an analysis of budget disclosure options for

68/ Chart entitled Update of June 1980 Risk Analysis (Nov. 5, 1980) (SEC Ex. 229(a)); Jerome Read SEC tr. at 379-88 (Feb. 8, 1985); Lindy Sandlin SEC tr. at 78-83 (Aug. 21, 1985).

69/ James Perko SEC tr. at 415-16, 420 (Oct. 18, 1985).

70/ James Perko SEC tr. at 415-16 (Oct. 18, 1985):

There were some things said in that meeting that, at the particular time, I did not -- that went against what I believed in terms of disclosure, especially people saying, "Hey, if it's a \$3 billion increase, we'll take a billion and a half now and a billion and a half in six months."

the chief finance officer's consideration. 71/ The analysis reviewed the options on disclosing the \$3 billion figure, including the advantages and disadvantages of splitting the disclosure and the harm to the financing program that disclosure of the full amount could cause. 72/ The chief financial officer

71/ Handwritten notes entitled 1982 Budget Strategy ["Notes"] (SEC Exh. 494); Stephen Buck SEC tr. 448-49 (Oct. 10, 1985); James Perko SEC tr. at 424-429 (Oct. 18, 1985).

72/ Notes, supra, (SEC Exh. 494). The notes read in part:

1982 BUDGET STRATEGY

3 BILLION COST INCREASE

"NOW MEANS NOVEMBER 19 or 20" [the date of the scheduled rating agency and financial community meetings on the upcoming Projects Nos. 4 and 5 bond sale]

WHY STEP FUNCTION THE COST INCREASES VERSUS ALL NOW?

* * * *

- ° PERCEPTION THAT FINANCIAL MARKETS WILL IMPROVE IN EARLY 1981 FROM THE CURRENT LEVELS - BREAK NEWS IN BETTER MARKETS
- ° POSTURE OF RATING AGENCIES, ESPECIALLY S&P RELATIVE TO COST INCREASES - THREAT OF DOWNGRADING # 4/5 BONDS

* * * *

- ° IF WE ARE DOWNGRADED - WILL WE LOSE MARKET ACCESS BECAUSE WE DON'T YET HAVE: (1) NEGOTIATION OR (2) BALANCED FINANCING PROGRAM? [two changes to financing methods awaiting approval]
- ° IF WE HAVE (1) AND (2) ABOVE, AND
(continued...)

was troubled about splitting disclosure. He felt that the senior management, many of whom were unfamiliar with investor financing, did not understand their disclosure obligations. After the November 5, 1980 meeting, he met with Ferguson and told him that if the budget increase was going to be \$3 billion, the full amount must be disclosed. 72/ Ferguson then instructed the

72/ (...continued)

WE ARE DOWNGRADED, PERHAPS WE
WOULD STILL HAVE MARKET ACCESS!

IF NO MARKET ACCESS (EVEN FOR A
SHORT PERIOD OF TIME) MAY BE
FORCED TO CURTAIL, SUSPEND OR
TERMINATE ONE OR MORE PROJECTS DUE
TO LACK OF CASH!

* * * *

HAZARD TO THIS WHOLE POSTURE:

TREASURY ARGUES FOR "TOTAL
DISCLOSURE", "CREDIBILITY IN
MARKETPLACE", "FREE FLOW OF
INFORMATION" AND YET THEN
CONSIDERS NOT TELLING THE WHOLE
STORY NOW FOR "MARKETING
CONSIDERATIONS".

COULD BE PERCEIVED AS THOUGH
TREASURY IS PROPOSING TO BREAK ITS
OWN "CARDINAL RULES"!

73/ James Perko SEC tr. 416 (Oct. 18, 1985):

I told Mr. Ferguson that what the -- you know, if he knew the budget was going to be \$3 billion, he had to announce that, now. That was the -- simply the disclosure rules that he had to follow, that the important thing was that it had to be right. . . and in conformance with the rules that we were operating under.

Supply System staff to make an all-out effort to quickly review the entire budget. 74/

The senior budget officials to whom the task was assigned understood that their charge was to develop the best current assessment of the budget that could be developed in the short period of time available. 75/ The head of budget reviews used a budget estimate method that utilized risk analysis. 76/ The headquarters budget personnel met with senior management at each project site during the week of November 9, 1980. Changes in major budget items were identified with project personnel at the sites and were evaluated by asking the project personnel to give

74/ Id. at 416-17:

After some discussion along those lines, he did commit to do it right, quote, right. And he, at that time -- I don't know whether it was at that meeting or in the next day or two, he got the staff together, again, said, "I'm going to cause to have happen in the next week an extensive review," and he really put a burden on Mr. Sandlin and his program directors to go out and conduct a most thorough analysis that they possibly could and work in 20 hours a day for six or seven days, straight.

75/ Lindy Sandlin SEC tr. at 83, 86 (Aug. 21, 1985). Jerome Read SEC tr. at 395, 398 (Feb. 8, 1985):

To the best of my recollection the overall purpose would have been for the senior people involved in the activities of the projects to review schedule and cost status, and provide to Mr. Ferguson all facts as they saw them, given the shortness of time, and to come back with, you know, appropriate supporting information regarding the schedules and the estimates. (at 395)

76/ Lindy Sandlin SEC tr. at 83, 86 (Aug. 21, 1985).

their assessments of the probabilities of the costs. 77/ The on-site personnel were told that the goal of the process was to produce the best estimates possible for public disclosure. 78/ Senior officials for each of the projects met that weekend to review the results. 79/

77/ Jerome Read SEC tr. at 389-91, 438-39 (Feb. 8, 1985); Project Schedules/Estimate Evaluation (Nov. 10, 1980) (Jerome Read outline of procedures to be used.) (SEC Exhs. 503, 504); Lindy Sandlin SEC tr. at 86-88 (Aug. 21, 1985); Jeremy Maidment SEC tr. at 17-24, 30-33 (Sept. 12, 1985).

78/ Memorandum by B. J. Casey 1 (Nov. 13, 1980) (memorandum by a senior official for Ebasco Services, Inc., the firm managing construction on Projects Nos. 3 and 5):

On November 11, 1980, a meeting was held to review the WNP-3/5 Project Budget. Ebasco was advised to participate in the meeting by the attached memorandum. The meeting was attended by F.D. McElwee, L.S. Sandlin, J.P. Maidment and W.A. Yatch from the Supply System's Richland Office. In addition, there were various attenders from the Supply System's and Ebasco's Site Office staffs.

Mr. McElwee [Supply System manager of Projects Nos. 3 and 5 at that time] set the tone for the meeting. He stated that Mr. Ferguson would be meeting with Moodys and Standard and Poors [rating agencies] next Tuesday in New York. The objective was, to start today and complete by Sunday evening a review of all five project estimates, to enable Mr. Ferguson to have the best possible estimates for his meetings with the bond rating people.

(SEC Exh. 91). Bernard Casey SEC tr. at 70-75 (July 18, 1984).

79/ Jerome Read SEC tr. at 441, 442-50 (Feb. 8, 1985); cost summary documents compiling the budget and schedule results (SEC Exhs. 514, 515 and 516); Lindy Sandlin SEC tr. at 93-95 (Aug. 21, 1985).

This process produced a budget estimate of \$20.440 billion for all five projects, an increase of \$4.491 billion over the \$15.949 billion fiscal year 1981 budget. 80/ Schedule slippages were estimated at 15 months for Project No. 4 and 6 months for Project No. 5. 81/

80/ Compilation of results, 1 (SEC EX. 520):

PROJECT COST SUMMARY
(\$ in Millions)

	<u>1981 Budget</u>	<u>11/80 Estimate</u>	<u>Variance</u>
WNP-1	2,736	3,589	853
WNP-2	2,467	3,062	595
WNP-3	3,130	3,882	752
WNP-4	3,614	4,932	1,318
WNP-5	<u>4,002</u>	<u>4,975</u>	<u>973</u>
Total	15,949	20,440	4,491

Jerome Read SEC tr. at 456-57 (Feb. 8, 1985).

81/ Compilation of results, 2 (SEC Exh. 520):

SCHEDULE:

	<u>C.O. [commercial operation] Date</u>	<u>Months Slippage</u>
WNP-1	6/86	12
WNP-2	3/84	14
WNP-3	9/86	3
WNP-4	9/87	15
WNP-5	12/87	6

Jerome Read SEC tr. at 456-57 (Feb. 8, 1985).

Bechtel Power Corporation, which Ferguson hired to assist him in evaluating the projects and which then became responsible for some of the projects, participated in the review sessions and prepared its own schedule evaluations
(continued...)

The results of the update were presented at a Sunday meeting at the Supply System headquarters on November 16, 1980. The meeting was attended by the senior Supply System officials and architect-engineers for each of the projects, Supply System budget and finance personnel, personnel from a recently retained construction management firm, a representative from R.W. Beck (the consulting engineer), and a representative from the BPA. 82/ The data from the update process were presented by the budget officials. 83/ An estimate similar to that discussed in the November 5, 1980 meeting, described above, was also presented. 84/

The project officials and others commented on the results of the \$20.4 billion update estimate done over the preceding week, and the person who formulated the risk analysis was called

81/(...continued)

based on their experiences on other nuclear power plant projects. Frank Waterhouse SEC tr. at 113-41; Jerome Read SEC tr. at 393, 394, 425-33 (Feb. 8, 1985); Jerome Read notes, page number stamped 114350 (SEC Exh. 512). Although Bechtel apparently did not produce comprehensive results, the compilation of the Supply System budget update results contains a reference to a Bechtel schedule slippage range. SEC Exh. 520 at 4 ("Bechtel Schedule Slippage Range for Unit #1 - 11 Months to 24 Months"); see also Jerome Read SEC tr. at 471-73 (Feb. 8, 1985).

82/ Lindy Sandlin SEC tr. at 99-102 (Aug. 21, 1985).

83/ Lindy Sandlin SEC tr. at 102-03 (Aug. 21, 1985); compilation of results, supra, (SEC Exh. 520).

84/ Lindy Sandlin SEC tr. at 111-14 (Aug. 21, 1985).

upon to describe the risk analysis process. 85/ Some of the project managers expressed reservations on the limited time for reviewing the results. 86/ Ferguson asked questions about the update process. 87/ The staff responsible for the estimate told Ferguson that this was their best effort and that if they had to adopt a new total budget figure they would focus on this number, although, in light of the limited time that had been available, they couldn't be confident of the figure. 88/ Ferguson stated

85/ Lindy Sandlin SEC tr. at 99-100 (Aug. 21, 1985); Jerome Read SEC tr. at 478 (Feb. 8, 1985).

86/ Sandlin SEC tr. at 99 (Aug. 21, 1985).

87/ James Perko SEC tr. at 461 (Oct. 18, 1985).

88/ James Perko SEC tr. at 457-58 (Oct. 18, 1985):

Q. Well, what did the [budget staff] presentors say that this 11-80 estimate [of \$20.4 billion], here, on the first page of 520 represented?

A. I think they represent -- I believe that they said in the week or so that they had or [-] this was Mr. Sandlin's and his staff working with the Project people, that if they had to buy into an '82 budget increase in November '80, that with the knowledge that they had, a week to do it, that that was a number that they probably would be keying in on
....

Lindy Sandlin SEC tr. at 110-111 (Aug. 21, 1985):

And to the best of my recollection, I had to tell him [Ferguson] that based on the complexity of it and based on the time frame, that I did not have a lot of confidence in that [\$20.4 billion] number; however, I had done my best. So he had -- he was trying to get his arms around these

(continued...)

that he did not find this to be a satisfactory basis for a new fiscal year 1982 budget and that he would use a different method for the fiscal year 1982 budget. 89/ He adjourned the meeting to take up the matter at a smaller meeting the next day. Ferguson instructed the persons present to keep information discussed at the meeting confidential. 90/

A meeting the next day was attended by a limited number of Supply System officials and others. 91/ Ferguson pressed the

88/ (...continued)

five units, and I tried -- as I pointed out to him -- tried to respond as best I could in the different ways that the estimate and schedule could be looked at until such time as his requirement of the bottoms-up [budget] be done by Bechtel and Ebasco.

89/ James Perko SEC tr. at 451-52 (Oct. 18, 1985); see also Lindy Sandlin SEC tr. at 116-17 (Aug. 21, 1985).

As discussed below, the Supply System management was aware of other adverse developments, including financing problems and Participants' Committee reactions to a new financial proposal, including a request from the Participants' Committee for a study of the consequences of slowing down or terminating the Projects, that might have been made worse by the disclosure of the November 1980 budget update estimate.

90/ Frank McElwee SEC Tr. at 129-130 (Apr. 2, 1985):

Bob Ferguson made a statement near the close of that meeting that he would summarily fire anyone who prematurely disclosed anything out of that meeting, and I took that to mean that if anything were taken out of context from that meeting, and I never heard the matter further discussed.

See Winston Peterson SEC tr. at 145-46, 153-55 (Sept. 17, 1985); Robert Ferguson SEC tr. at 531 (July 25, 1985).

91/ Lindy Sandlin SEC tr. at 118-19 (Aug. 21, 1985) (Sandlin recalls Ferguson, Squire, Perko, himself and Peterson of
(continued...))

head of budget reviews about his relative degree of confidence in the different estimates, including the estimates discussed earlier at the November 5, 1980 meeting. The head of budget reviews told Ferguson that he had the most confidence in the estimates of the costs limited to the direct impact of the strike, the crane collapse, and several smaller specific developments, which had constituted a portion of the \$3 billion estimate discussed at the November 5, 1980 meeting. 92/

Ferguson announced that he rejected the use of the risk analysis in the budget process. 93/ He then instructed the budget review staff to prepare cost figures limited to estimates of the direct impact of certain known events. 94/ The budget review staff estimated the costs of the specific developments to be \$1.379 billion. 95/ Most of these developments had been excluded from the fiscal year 1981 budget, and thus the cost

91/ (...continued)

R.W. Beck and Lewis of BPA as attendees). Project directors were called into the meeting as the different projects were discussed.

92/ Id. at 119.

93/ Id.

94/ Lindy Sandlin SEC tr. at 119, 136-37 (Aug. 21, 1985); Jerome Read SEC tr. at 478-84 (Feb. 8, 1985).

95/ The increase included amounts for the strike at Projects Nos. 1, 2 and 4 (\$707 million); accidents at Projects Nos. 3 and 5 (\$249 million); changes in interest rate assumptions (\$223 million); pay increases caused by new labor contracts (\$111 million); additional capitalization of nuclear fuel reload (\$91 million); and a reduction of \$2 million for training simulator. (SEC Ex. 229 at 2, 3); Lindy Sandlin SEC tr. at 123 (Aug. 21, 1985); Jerome Read SEC tr. at 469-91 (Feb. 8, 1985).

estimate was not an estimate of escalation of the 1981 budget. The increase of \$4.491 billion, in contrast, was not limited to specific events but estimated for changes in the entire budget.

On November 21, 1980, Ferguson reported the \$1.379 billion cost estimate for the specific developments to the Executive Committee of the Board. In a prepared statement delivered to the Executive Committee, Ferguson said:

With the resolution of the Hanford labor dispute, the Supply System has undertaken a study of factors which will additionally impact the 1981 budget. During the past two weeks, Supply System personnel have conducted a detailed review of the five projects now underway to identify these known additional costs. As you may recall, I previously committed to provide you with a midyear assessment of the 1981 budget. This evaluation completes that commitment. 96/

No mention was made of the \$4.4 billion overall budget estimate, the result of the only "detailed review" that had been done during the preceding two weeks. A November 24, 1980 Supply System press release also gave the \$1.379 billion as the costs increase without disclosing the \$4.4 billion increase estimate. 97/

96/ Robert Ferguson's Statement at Executive Committee Meeting, 1 (Nov. 21, 1980) (SEC Exh. 557); Robert Ferguson SEC tr. at 84-85 (June 26, 1985).

97/ News Release No. 80-68 (Nov. 24, 1980). (SEC Exh. 230.) The Washington State Senate Committee was conducting an investigation of the Supply System at this time (resulting in a published report in the Spring of 1981), including the costs of the projects. In response to a letter sent by the Committee staff the day after the press release, the Supply System referred to \$1.379 billion increase and to consideration that had been given to doing a review of
(continued...)

The official statement for the pending Projects Nos. 4 and 5 bond sale, which had triggered the need for an updated estimate, disclosed the \$1.379 billion costs for specific developments and stated that preparations for the fiscal year 1982 budget had begun. 98/ The official statement set forth the

97/(...continued)

schedules and budgets without revealing that an estimate actually had been completed or its amount:

Upon conclusion of the Hanford labor strike and in preparation for information meetings pertaining to an upcoming bond sale for WNP-4/5, Mr. Ferguson directed the staff to conduct an immediate review of the project schedules and estimates. Because of their recent involvement with WNP-1, 2 and 4, Bechtel Power Corporation was asked to assist the WPPSS staff in the evaluation of these projects.

After a brief review, it was concluded that substantially more time and effort would be required in order to provide meaningful results. In lieu of a more in-depth evaluation, which time would not allow, the WPPSS staff was then directed to identify any known additions to the 1981 budget. The staff's working papers for this study which resulted in the \$1.379 billion announced at the Executive Committee Meeting of November 21, 1980 are enclosed for your information.

Letter from Al Squire to Terry Husseman (Dec. 1, 1980) (letter from Supply System Deputy Managing Director to Chief Counsel, Washington State Senate Energy Utilities Committee Staff).

98/ Official Statement for \$200,000,000 Washington Public Power Supply System Generating facilities Revenue Bonds, Series 1980D&E (Nuclear Projects Nos. 4 and 5) 24 (Dec. 19, 1980):

A detailed analysis of the construction budgets has begun and will take several months to complete. This analysis will be used in the preparation of the 1982 project

(continued...)

fiscal year 1981 budget without disclosing that an overall budget estimate had been prepared that indicated a \$4.4 billion increase in that budget. Also, the reference in previous official statements to the low probability reflected in the June 1980 risk analysis was deleted.

Although the budget update estimate had been prepared in a short time, it was based on the latest information available from those responsible for the projects. The management of the projects was aware that the purpose of the new estimate was to produce information to be disclosed in connection with the next bond sale. Moreover, the fiscal year 1981 budget had been prepared in the Spring of 1980, and it was unlikely, particularly given the history of the projects, that cost increases over that budget beyond those attributable to the specific developments reflected in the \$1.3 billion increase had not occurred since the time that budget was prepared. 99/ Thus,

98/(...continued)

construction budgets. During the detailed analysis procedure, factors may be identified that would require adjustments to the schedules and costs in addition to those identified above.

99/ See, e.g., Dale Dobson SEC tr. at 37-38 (Aug. 27, 1984) (testimony of a Supply System official who had become Project manager at Projects Nos. 3 and 5 in August 1980):

I was serving in the role of the Project Manager. My major efforts were to attempt to perform against the budget and within the budget. It was a management tool. I am aware that in the fall of 1980 and early 1981 there was a great deal of concern with regard to Units 3 and 5, because we were not

(continued...)

even though the estimate might not have been appropriate for a new formal fiscal year 1982 budget, it was a reasonable indication that the fiscal year 1981 budgets set forth in the official statement were substantially understated. Moreover, the estimate was not revealed to some members of the official statement drafting group, which was responsible for evaluating the need for disclosure of information, including the lawyers and the Financial Advisor. 100/

99/ (...continued)

performing within the budget at all.

We were slipping the schedule and spending, I believe, over that budget. So most of the conversation had to do with the perception that barring a dramatic improvement in the performance, the budget -- or there was a low probability that we would achieve the budget and the schedule.

The fiscal year 1981 budgets had excluded the costs of the strikes and the crane collapse that constituted most of the \$1.379 billion additional costs announced in November. Thus those costs did not reflect increases that may have occurred in the underlying fiscal year 1981 budget.

100/ The Financial Advisor, who was closest to the financial community, testified that he was not told of the budget update estimate. Donald Patterson SEC tr. at 246-55 (July 23, 1985). James Perko, the Supply System's chief financial officer testified that he believed he talked with Patterson about the November 16, 1980 meeting and that, if he did speak with Patterson, he probably would have mentioned the figure. James Perko SEC tr. at 470-72 (Oct. 18, 1985). The two lawyers in the drafting group, the Special Counsel and Bond Counsel, testified that they were not told of the figure. Bert Metzger SEC tr. at 1639-43 (Feb. 25, 1986); Brendan O'Brien SEC tr. at 1031-32 (June 7, 1985).

Winston Peterson of R.W. Beck, the consulting engineer, who was also member of the official statement drafting group, attended the November 16th meeting and the meetings of the
(continued...)

e. The Fiscal Year 1982 Budget

The fiscal year 1982 budget, announced in late May 1981, showed a drastic increase in estimated costs. The budget estimated the cost of all five projects to be \$23.78 billion, an increase of \$7.8 billion over the fiscal year 1981 budget. 101/ These figures exceeded even the November 1980 \$20.4 billion update estimate. The increase in the budget presented cash flow and financing difficulties that compelled Ferguson to recommend on May 29, 1981 that the Board of Directors impose a moratorium on the construction of Projects Nos. 4 and 5. 102/

100/ (...continued)

following day. Peterson testified that he recalled the presentation on the budget update and that Ferguson instructed the attendees that information discussed at the meeting was not to be disclosed without his approval, but he did not remember the \$20 billion figure. Winston Peterson SEC tr. at 152-53 (Sept. 17, 1985).

The BPA was not involved in the drafting of the official statement, which was for a Project Nos. 4 and 5 bond offering. The BPA representative at the November 16, 1980 meeting, who was new to his position as the liaison official, did not recall the meeting. James Lewis SEC tr. at 56-77 (Jan. 10, 1985), at 15-22 (Nov. 5, 1985).

101/ Construction Budget 1982 Estimate at Completion, Presentation to Board of Directors at 4 (July 24, 1981). (SEC Ex. 434.)

The cost of Projects Nos. 4 and 5 was \$11.77 billion, an increase of approximately \$4.16 billion over the fiscal year 1981 budget. Id.

102/ Minutes of May 29, 1981 Special Board of Directors meeting. Robert Ferguson SEC tr. at 346-51 (July 24, 1985):

It [the normal process for the Fiscal Year 1982 budget] would have been to come to the Board on July 24th [for final formal approval of the budget], as we did, but the
(continued...)

The May 29, 1981 budget disclosure and moratorium recommendation marked the public recognition of cost and financing problems that had threatened the continued construction of Projects Nos. 4 and 5. Even in this instance, however, it appears that the Supply System delayed disclosure about the existence of the figures. The budgets were developed during the Spring of 1981. The budget estimate was initially available by the first weekend in May when the final step in totalling the budget, the calculation of interest costs, was

102/ (...continued)

difference was that given the cash that we had on hand, I was very concerned that the Board deal with that issue to ramp down, to preserve the cash and to preserve the projects, while this dialogue was going on, and that's why I recommended a moratorium of up to a year for the region to address this issue. They wanted to ramp down very quickly to preserve the money that we had.

Because, you see, what was happening is that, with a demand of raising \$3 billion [in the next year for all projects] in order to conduct [the] projects on the schedule that we had come up with, and going into the marketplace to raise that money, and at the same time to continue to go forward with the projects and make commitments for which you didn't -- couldn't be assured that there would be money available, I felt, was a terribly irresponsible thing to do, and that's why I went to the Board as soon as I could get to them, and as quickly as I was able to verify the validity of the estimate. (at 349-50.)

The one-year moratorium recommendation, applied only to Projects Nos. 4 and 5 because, among other things, the financing problems were particularly great for these Projects. Minutes of May 29, 1981 Special Board of Directors meeting.

completed. The chief budget review official called the chief financial officer at home on Sunday, May 3, 1981, and told him of the budget results. 103/ The Managing Director was also notified of the results on that Sunday. 104/

At the time the estimates first became available in early May, the Supply System was about to distribute a preliminary official statement for a Projects Nos. 4 and 5 bond offering. The availability of the initial budget results showing enormous increases meant that some disclosure would have to be made if the offering went ahead. When the chief financial officer presented this requirement to the Managing Director, Ferguson decided not to go forward with the offering. 105/ The Supply System announced the postponement of the bond offering on May 5, 1981, citing adverse conditions in the marketplace as the

103/ James Perko SEC tr. at 480 (Oct. 18, 1985).

104/ Robert Ferguson SEC tr. at 351-53 (July 24, 1985).

The Managing Director was shocked by the magnitude of the estimate and asked the budget staff to conduct a sensitivity analysis on the interest portion of the budget to see if changes in assumptions about interest rates would have any effect on the budget. The calculations showed that the interest costs were influenced mostly by schedule extensions and were not significantly affected by changes in interest rate. Thus, even a drop in interest rates would not have a significant impact on the large budget increase. Robert Ferguson SEC tr. at 350, 352-53 (July 24, 1985).

105/ Robert Ferguson SEC. tr. at 378, 385 (July 24, 1985); James Perko SEC tr. at 483-84 (Oct. 18, 1985).

reason. 106/ They repeated this explanation to the Executive Committee of the Board on May 8, 1981. 107/ The budget figures were not disclosed until May 29, 1981, when the normal

106/ Supply System News Release No. 81-30 (May 5, 1981) (SEC Exh. 2783):

Richland--Adverse conditions in the financial marketplace have resulted in the postponement of a Washington Public Power Supply System bond sale, scheduled for the end of May, J.D. Perko, treasurer, said today

The chief financial officer apparently made reference to adverse market conditions when he spoke with the Managing Director about postponing the sale, but the problem about disclosing the preliminary budget figures was the prime cause of the postponement of the bond offering. Ferguson SEC tr. at 378, 385 (July 24, 1985).

107/ Transcript of Regular Executive Committee of the Board meeting 10 (May 8, 1981) (SEC Exh. 2419):

Now, also this last week, we had a situation where on the advice of Jim Perko, after intensive discussions, we decided to postpone the 4-5 bond sale.

Al Squire was in New York ready to meet with the rating agencies, and Jim [Perko] was about ready to go, and Don Claybo [Claybold, a Board member] was caught in at 5 o'clock in the morning before he caught a 6 o'clock airplane. So it was right up to the last minute. But, what happened is the prime rate was raised. The long-term bond market got very sloppy, and Jim can talk some more about this later on, but it just did not seem like a good time to go into the market.

At a Board of Directors meeting on May 15, 1981, the Deputy Managing Director expressly denied the existence of any budget figures. Minutes of Meeting of Board of Directors 9 (May 15, 1981).

schedules for the start of budget reviews with various parties and urgency of the financing situation compelled disclosure.

One study shows a significant, though not precipitous, market-adjusted drop of 5.51% in the value of Projects Nos. 4 and 5 bonds in the ten days surrounding announcement of the new budget figures and of the moratorium. 108/ This suggests the relative importance to the market of Participant commitment to the projects. The weakness of this commitment -- both moral and legal -- 109/ was still not fully known, and the bond prices continued to decline as this commitment publicly unravelled in the months intervening until the Washington Supreme Court's 1983 decision invalidating the take-or-pay requirements.

B. THE FINANCING OF THE PROJECTS

1. Introduction

The Projects Nos. 4 and 5 financing program was a major undertaking. From its inception it was subject to potential difficulties if the budgets increased. Ultimately the large increase in the fiscal year 1982 budget interrupted the financing program, leading finally to the termination of the projects.

108/ J. Peavy and G. Hempel, The Effect on the WPPSS Crisis on the Tax-Exempt Bond Market, 10 J. of Fin. Res. 239, 243 (1987).

109/ See discussion in Part II D and Part IV.

Two problems directly affected the Supply System's ability to finance the Projects Nos. The first was the enormous growth in the total amount of financing needed to complete the projects. The second was the Supply System's need to maintain sufficient cash flow to meet immediate cash needs for construction.

a. Growth of Total Financing Needs

Both the Supply System's construction costs and the bond interest costs on Projects Nos. 4 and 5 were financed solely by the sale of bonds to investors. The Participants were not required to make any payments for the projects until the projects were operating or until 1988, whichever came first, unless the projects were terminated. 110/ Increases in construction costs and extensions in the schedules thus directly increased the total financing needed. The extension of the schedules, in particular, had a great impact on financing needs because the extensions increased the period of time during which interest had to be paid. The combination of increased construction costs and extended schedules meant that more bonds had to be sold to raise more money for a longer time

110/ In the event of termination, the Participants were obligated to begin making payments one year after termination.

period. The amount of total required financing increased even as the proceeds from completed bond sales rose. 111/ (SEE CHART, NEXT PAGE.) Because the Supply System's financing needs increased more rapidly than bond sales financing could be completed, the amount of financing yet to be done, which should

111/ Financing figures for Projects Nos. 4 and 5 at date of each bond sale:

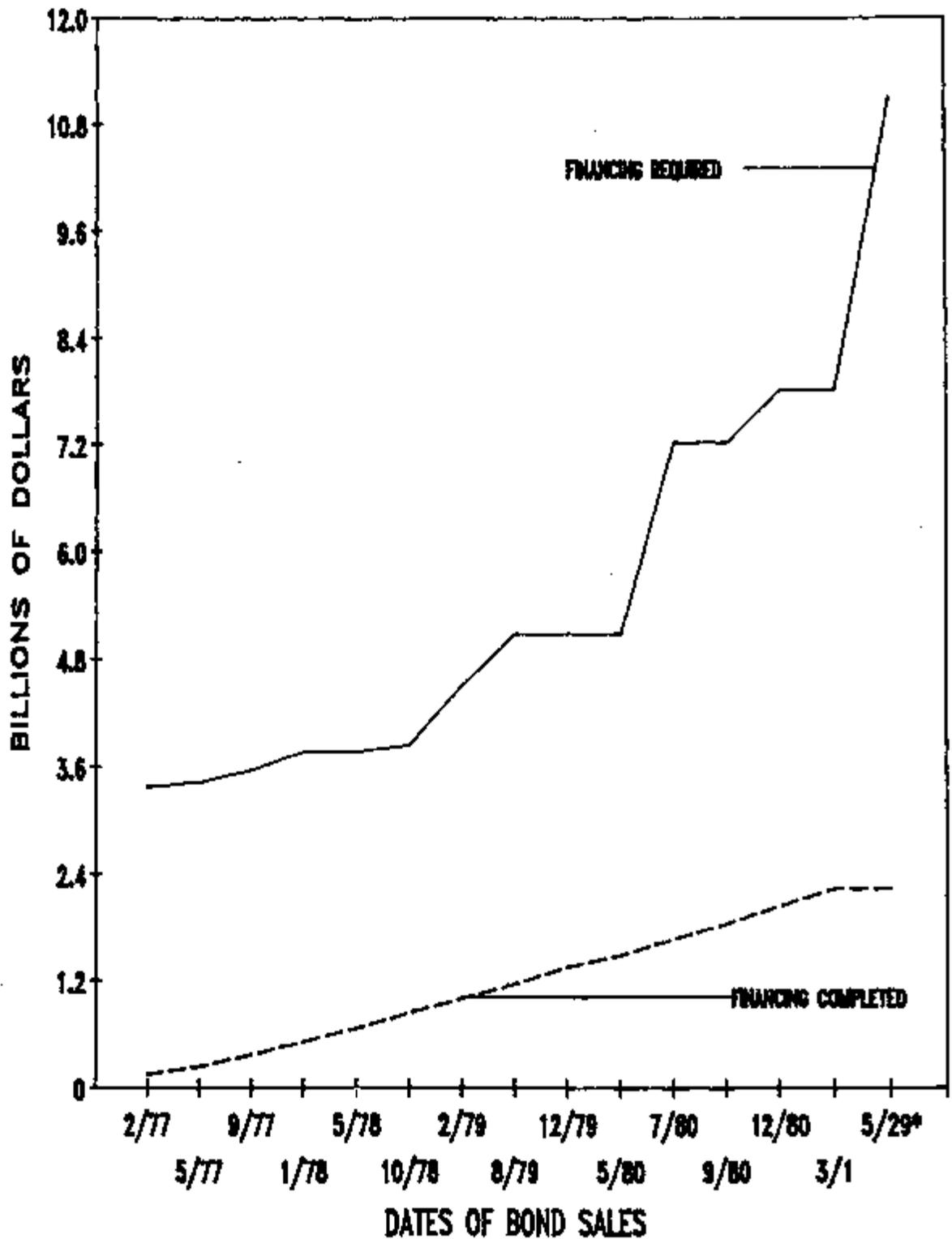
<u>Date of Bond Sales</u>	<u>Total Financing Required (\$ in Billions)*</u>	<u>Funds Obtained to date (including this sale) (\$ in Billions)</u>	<u>Difference (Financing to go) (\$ in Billions)</u>
2/77	3.38	.15	3.23
5/77	3.43	.24	3.19
9/77	3.57	.37	3.20
1/78	3.77	.52	3.25
5/78	3.77	.67	3.10
10/78	3.85	.84	3.01
2/79	4.51	1.01	3.50
8/79	5.08	1.16	3.92
12/79	5.08	1.36	3.72
5/80	5.08	1.49	3.59
7/80	7.23	1.67	5.56
9/80	7.23	1.85	5.38
12/80	7.82	2.05	5.77
3/81	7.82	2.25	5.57
5/29/81**	11.18	2.25	8.93

* Based on published budgets; excludes undisclosed November 1980 estimate, described above.

**Date of announcement of fiscal year 1982 budget.

Source: Official Statements (Estimated Financing Requirements section) and fiscal year 1982 budgets (for 5/29/81 figure).

**FINANCING COMPLETED
AND TOTAL FINANCING NEEDED
FOR PROJECT NOS. 4 AND 5**



*At announcement of moratorium.

See preceding footnote for financing figures.

have been decreasing, actually increased over time. 112/ (SEE CHART, NEXT PAGE.) The financing program, therefore, lost ground despite 14 bonds sales, averaging \$160 million each and totalling \$2.25 billion. 113/

b. Decline in Cash Flow Coverage

The second major financing problem was the risk that cash flow would be insufficient to cover current expenditures. Initially, cash flow was not a serious problem. However, over time, the rate of cash expenditures for construction increased while more rapidly than the rate of bond sales. The Supply System, therefore, was threatened with a cash shortage. By July 1980, the period of cash coverage, i.e., the projected number of months for which available cash could pay construction and interest costs, had decreased to the point where the Supply System consumed all its cash from one offering

112/ Additional financing needed (total financing needed minus amount of financing obtained to date) for Projects Nos. 4 and 5:

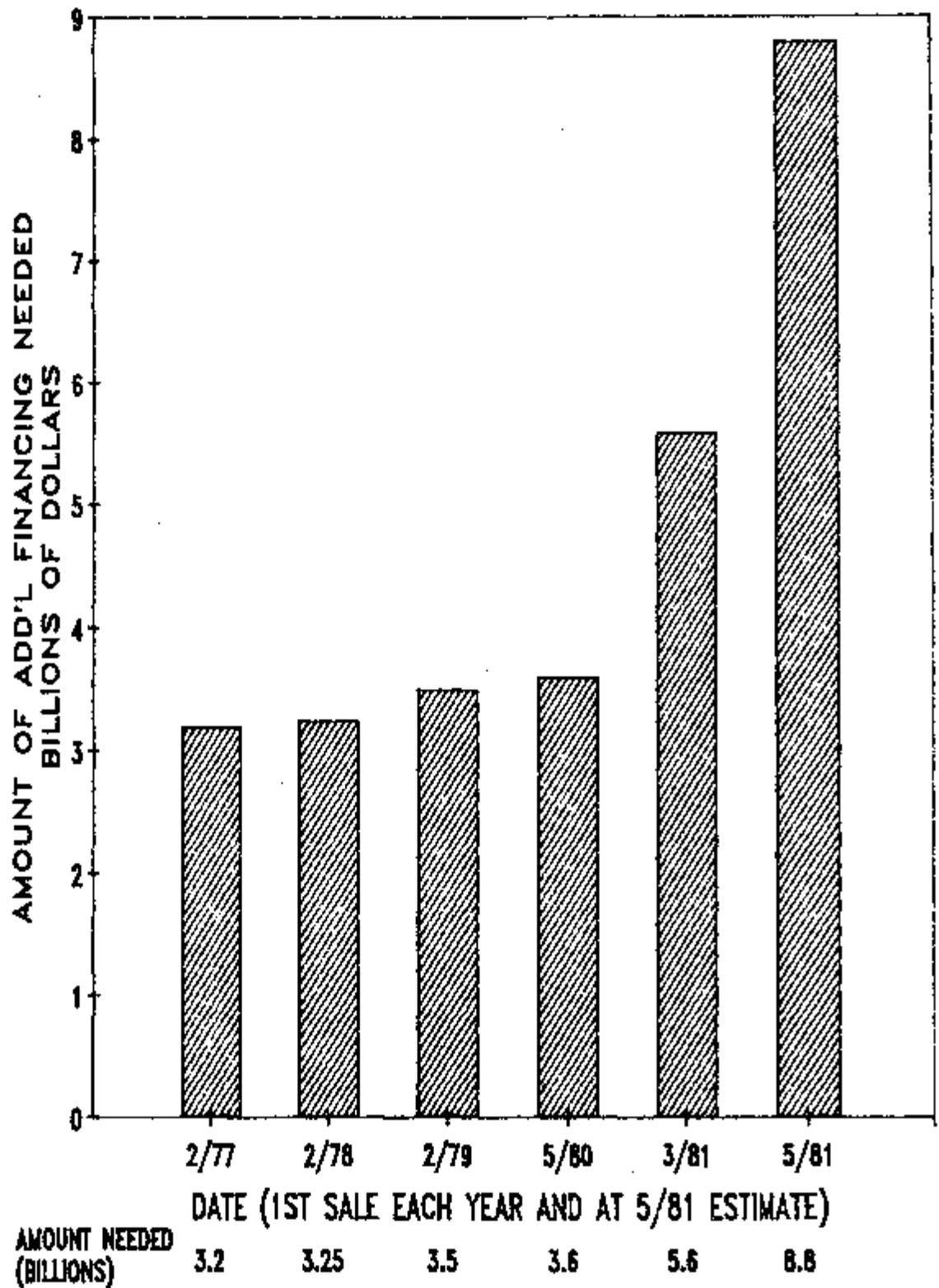
<u>Date (of first bond sale each year)</u>	<u>Amount of additional financing needed (in billions of dollars)</u>
2/77	3.2
1/78	3.25
2/79	3.5
5/80	3.6
3/81	5.6
5/81*	8.9

* At moratorium recommendation.

Source: Official Statements and fiscal year 1982 budget.

113/ The \$2.25 billion of financing that was completed equalled the initial estimate of the total cost of the projects.

ADDITIONAL FINANCING NEEDED FOR PROJECT NOS. 4 AND 5



SOURCE: OFFICIAL STATEMENTS AND 1982 BUDGET

to the next. 114/ (SEE CHART, NEXT PAGE) Any delay in a bond sale could cause suspension of construction.

2. Early Period of the Financing Program

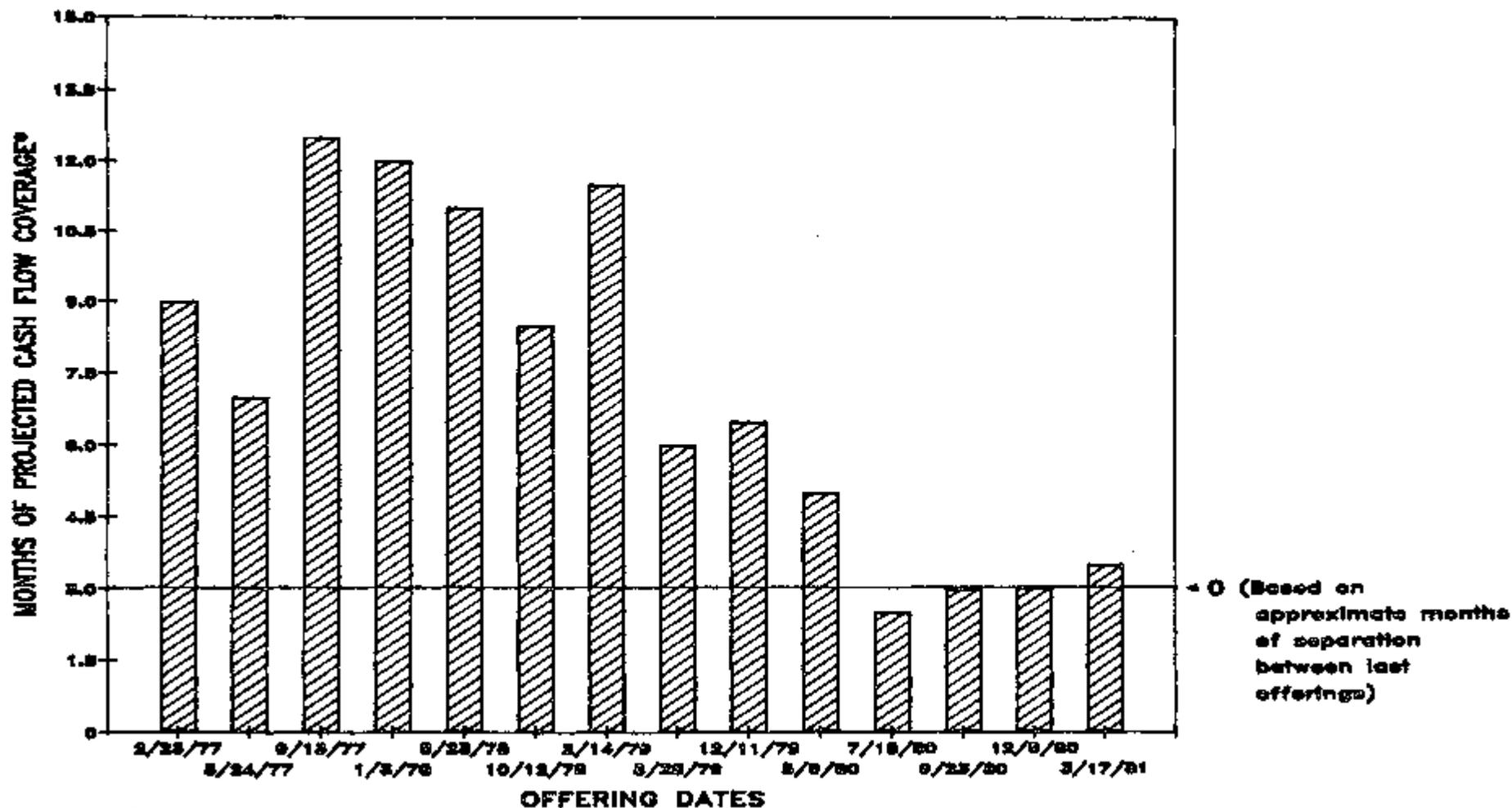
Within weeks after the Participants' Agreements were signed in July 1976, the Projects Nos. 4 and 5 budget increased from \$2.25 billion to more than \$3 billion. Financing problems at the time of the first bond sale in February 1977 were not critical, however, because the financing program was still of manageable size and the bond sales had just begun. Problems began to develop as the financing program proceeded.

114/ The Supply System's projected months of cash coverage for Projects Nos. 4 and 5 at each bond sale:

<u>Dates of Bond Sales</u>	<u>Months of Projected Cash Coverage</u>
2/23/77	9.0
5/24/77	7.0
9/13/77	12.5
1/03/78	12.0
5/23/78	11.0
10/12/78	8.5
2/14/79	11.5
8/28/79	6.0
12/11/79	6.5
5/09/80	5.0
7/15/80	2.5
9/23/80	3.0
12/09/80	3.0
3/17/81	3.5

Source: Official Statements, Estimated Financing Requirements section.

**SUPPLY SYSTEM PROJECTIONS OF MONTHS OF CASH COVERAGE ON
PROJECTS NOS. 4 AND 5 AT THE COMPLETION OF EACH OFFERING (BAR)
AND APPROXIMATE ZERO LEVEL OF CASH COVERAGE
AT TIME OF NEXT OFFERING (LINE)**



*See preceding footnote.

SOURCE: WPPSS Official Statements, Estimated Financing Requirements.

a. Early Interest in Maintaining Adequate Cash Flow

In August 1978 the manager of the Supply System's Treasury Division expressed concern to the Financial Advisor that the financing schedule for all five Supply System projects failed to provide the desired 12 to 24 month cash flow coverage:

The current proposed financing schedule fails to provide the Supply System the ability to achieve its goal of obtaining and maintaining 12 to 24 month cash flow coverage. At best, the current proposed financing schedule provides six to nine months cash flow coverage and, at certain points in time, no coverage at all.

The Supply System wanted the 12 to 24 month coverage to avoid possible disruption of construction from a shortage of funds. 115/ One way to provide greater cash flow was to increase the size of the issues. 116/ The Financial Advisor opposed using larger issues, however, because among other things this would expose the Supply System to the risk of receiving only one bid as the result of the greater capital commitment required of the underwriting syndicate. 117/ This would reduce the Supply System's control over the offering and increase costs. 118/ The drawbacks of larger offerings

115/ Donald Patterson SEC tr. at 569-72 (October 23, 1985).

116/ Id. at 572-75.

117/ Id. at 575.

118/ Id. at 575-76 ("I can't imagine a worse situation than having one competitive bid." (at 575)). As described below in Part III A, the Supply System was required by Washington State law to sell bonds to underwriters by sealed bid auction.

therefore made the desired period of cash coverage impracticable for the Supply System.

b. Early Exploration of Alternative Financing Methods

The Projects Nos. 4 and 5 financing program was based on the sales of long-term bonds. Long-term bonds are the traditional method of financing capital projects. Long-term bonds provide stability and allow the operation of the completed projects to fund the payment of the bonds. The Financial Advisor had suggested on several early occasions that the Supply System consider issuing short or intermediate term debt for Projects Nos. 4 and 5 in order to obtain possible economic benefits through reduced financing costs. The Financial Adviser was told that the use of such debt was contrary to the original understanding of the Participants about financing the projects and that the Participants might not like the proposed change. 119/

119/ Donald Patterson SEC tr. at 679-84. Another issue, the possible risks of short term debt, was raised by the attorneys and the consulting engineer, R.W. Beck, who were members of the official statement drafting group:

- Q. What was the objection from the attorneys and Beck?
- A. They [threw] out New York City. They [threw] out the Housing Finance Agencies [-] that they had experienced problems with short term debt. They were saying [there] was a potential for abuse of using short-term debt. It wasn't something that the participants would like because it was a change. "We don't need it so why do it."

Id. at 683.

By the Summer of 1978, however, the use of shorter-term debt was being considered for Projects Nos. 4 and 5 to reduce interest costs and to protect cash flows on the projects. 120/ The Financial Advisor and the Supply System spoke with a number of banks to ascertain their views with respect to a possible bank line of credit of up to \$500 million dollars. 121/ The Supply System concluded from these discussions that a line of credit would not be feasible because of the practical difficulties. One of the difficulties was that the Participants would have to agree to a change in the Participants' Agreements to provide for the payment of short-term debt because they were not obligated to make payments under the Agreements until 1988 or the completion of the projects. 122/ The Supply System was reluctant to seek this change in the Participant's Agreements unless it was absolutely necessary. 123/

120/ See Memorandum from Thomas Friery to Donald Patterson (June 14, 1978) (memorandum from manager of Supply System Treasury Department) (with chief financial officer's notation under "Purpose": "Overall goal of financing program is to maintain two years cash flow in construction fund. The amount raised by C.P. [commercial paper secured by a bank line of credit] will be a part of that two years."). (SEC Exh. 186.) See also James Perko SEC tr. 202-07 (Oct. 17, 1985).

121/ Donald Patterson SEC tr. at 684 (Oct. 23, 1985); James Perko SEC tr. at 218-19 (Oct. 17, 1985).

122/ Donald Patterson SEC tr. at 685-86 (Oct. 23, 1985).

123/ Id. at 686-87 ("I don't think he [Harlan Kosmata, the Supply System's liaison to the Participants] was looking forward to going out and having to deal with all the Participants again when he didn't see any absolute need, and I couldn't tell him that there was an absolute need for the program." (at 687)).

3. Onset of Serious Problems - 1979

In 1979, serious problems were developing with the financing program. The costs of Projects Nos. 4 and 5 began to increase substantially. Also, the credit markets in general were experiencing unprecedented increases in interest rates and volatility. The interest costs the Supply System had to pay on Projects Nos. 4 and 5 bond sales increased in both absolute amount and relative to the market. 124/ By 1979, the yield on

124/ Net interest cost on Projects Nos. 4 and 5 bond sales (excluding put bonds in December 19, 1980 and March 17, 1981 sales); the Bond Buyer 20 municipal bond index at the nearest weekly fixing; and the spread between the net interest cost and Bond Buyer index in absolute amount and as percentage of net interest cost:

<u>Bond Sales Dates</u>	<u>Net Interest Cost</u> (percent)	<u>BBGO 20 Bond Index* Rates</u> (percent)	<u>Difference Between NIC and BBGO Index</u>	<u>Difference Between NIC and BBGO as Percent of NIC</u>
2/23/77	5.93	5.92	.01	0.0
5/24/77	6.32	5.71	.61	9.6
9/13/77	5.97	5.52	.45	7.5
1/31/78	6.14	5.70	.44	7.2
5/23/78	6.83	6.16	.67	9.8
10/12/78	6.83	6.10	.73	10.7
2/14/79	7.13	6.33	.80	11.2
8/28/79	7.64	6.36	1.28	16.7
12/11/79	8.30	7.26	1.04	12.5
5/09/80	9.23	7.11	2.12	22.9
7/15/80	9.50	8.03	1.47	15.5
9/23/80	10.69	9.18	1.51	14.1
12/09/80	12.44	10.42	2.02	16.2
3/17/81	11.77	9.81	1.96	16.6

* The Bond Buyer 20 Bond Index is an index of yields on twenty year general obligation bonds. The index, which covered the entire period of the sale of Projects Nos. 4 and 5 bonds, was a commonly used index during this period.

Source: Underwriter pricing books and Bond Buyer 20 Bond Index.

Projects Nos. 4 and 5 bonds also were at a premium even over bonds of other power agencies with nuclear projects. 125/ The Supply System noted the increasing interest costs and increasing spread relative to the market and attributed it to external developments, such as problems in the nuclear industry generally following the Three Mile Island nuclear power plant incident, and to internal developments, such as cost increases, schedule extensions and the increased volume of bonds sales for the projects. 126/

By the Summer of 1979, the marketing problems of Projects Nos. 4 and 5 bonds were being noted by the Supply System's Financial Advisor. In a draft letter dated June 20, 1979, that was transmitted to the Supply System, 127/ the Financial Advisor expressed his concerns about the financing program and the marketability of the bonds:

As I have advised the Supply System, the perception of Nuclear Projects Nos. 4 and 5 currently held by investors and the investment banking community is not very positive due primarily to their concern with respect to the Supply System's ability to finance the remaining capital requirements for these projects. The remaining financing requirements for the net billed projects have tended to

125/ See chart, page 233 , infra.

126/ James Perko SEC tr. at 310-12 (Oct. 17, 1985).

127/ Letter from Donald Patterson to Donald Karlberg (June 20, 1979) (the letter was drafted by Patterson and transmitted to the Supply System; a final letter was apparently not sent). (SEC Exh. 2575.) See Donald Patterson SEC tr. at 583-84 (Oct. 23, 1985); Stephen Buck SEC tr. at 119-20 (Oct. 7, 1985).

reinforce this concern, particularly in view of the cost increases which have been recognized with respect to both the net billed projects and Nuclear Projects Nos. 4 and 5. 128/

The Financial Advisor noted that "the indebtedness for Nuclear Projects Nos. 4 and 5 has not been accepted by many of the higher grade portfolios" and that the difference in yield between the Projects Nos. 1, 2, and 3 bonds and the Projects Nos. 4 and 5 bonds had grown from 27 basis points to between 60 and 70 basis points. 129/ Patterson noted that the market for Projects Nos. 4 and 5 bonds was becoming unstable and that bond funds, and what he characterized in his letter as "kinky" investors, were becoming the major buyers:

The movement in the spread differential, we believe, provides some insight into the problem of developing a good sound market for the upcoming issue. There is currently a perception in the marketplace that the bonds for Nuclear Projects Nos. 4 and 5 have less liquidity than the net billed bonds offered in size (\$5 to \$25 million). According to our traders the bid price would move a half or possibly one and a half points [point equals 1% of face value] depending upon the size, and at the present time the major buyers of bonds for Nuclear Projects Nos. 4 & 5 are the funds or

128/ Letter from Donald Patterson to Donald Karlberg 2 (June 20, 1979). (SEC Exh. 2575.) See Donald Patterson SEC tr. at 599-602 (Oct. 23, 1985).

129/ A basis point is one one hundredth of one percent. An interest rate increase from 7% to 7.5% is a 50 basis point increase.

"kinky" investors who are looking for yield and discount bonds. 130/

Indeed, at about this time the market for the Projects Nos. 4 and 5 bonds was changing. Traditional large institutional purchasers of the bonds, particularly insurance companies, were playing a lesser role, while purchases of the bonds by unit investment trusts, which are more yield oriented, were playing a greater role. 131/ The Supply System was aware of the shift. 132/

The Financial Advisor suggested two methods to help deal with the marketing problems. First, he suggested a change in the format of the official statement to help sales,

130/ Letter to Donald Karlberg from Donald Patterson 3 (June 20, 1979). (Exh. 2575.) See Donald Patterson SEC tr. at 604-10 (Oct. 23, 1985).

Patterson does not recall who the "kinky" investors were. Donald Patterson SEC tr. at 610 (Oct. 23, 1985). The term was used by the Blyth traders who supplied Patterson with information on the market. Id.

131/ See Part III C, infra.

132/ See James Perko SEC tr. at 238-258, 280 (Oct. 17, 1985):

Well, again, this is mid-1979, and it, you know, was consistent with earlier testimony, a question you had about, you know, the kind of shift that was beginning to take place to higher yield investors, and I just think that kind of goes along with that same kind of thing.

Bond funds were now beginning to buy more of these securities, more yield, "yield conscious buyers" were -- the spreads were widening. A bigger market was being able to be attracted, which is consistent with what we had discussed earlier about that. (at 280)

particularly in the retail market. 133/ Although the Financial Advisor could not recall the change he suggested, the format of the official statement was changed at this time to bring forward and expand the description of the need for power and move back information about the Supply System and the projects, including their budgets. 134/ Information about the Supply System and the projects was becoming increasingly negative, whereas power demand, at least as presented in the official statement, 135/ was the best remaining selling point.

The other change the Financial Advisor proposed was designed to assist the underwriting syndicates. He proposed that the Supply System change the manner of calculating bids from true interest cost to net interest cost, which would

133/ Letter from Donald Patterson to Donald Karlberg 3 (June 20, 1979) (SEC Exh. 2575):

You are aware of the changes which have been proposed with respect to the format of the Preliminary Official Statement. We believe that these changes will assist in directing investors' attention to areas which should be emphasized in order to develop a strong market desire for this credit. In particular, we see the possibility of this credit being forced into the retail market; the proposed changes are expected to assist the retail salesmen.

Donald Patterson SEC tr. at 610-15 (Oct. 23, 1985).

134/ See James Perko SEC tr. at 281-83 (Oct. 17, 1985).

135/ See discussion about presentation of power demand in Part II C, infra.

permit marketing the bonds as discount bonds. 136/ The Financial Advisor saw discount bonds as being more attractive to some investors and therefore as increasing the underwriters' interest in bidding on the bonds. 137/ The change also would encourage closer bids between syndicates and discourage perfunctory, "sign-off" bids on the sale of bonds by the low-bidding underwriting syndicate. 138/ A non-competitive "sign-

136/ Bids were evaluated on total interest cost derived from weighted interest rates on differing maturities in each offering. The true interest cost calculation takes the future value of money into account in computing the value of a bid. This discourages bids that structure the offering as discount bonds. The net interest cost calculation does not take the future value of money into consideration and thus permits wider use of discounts. See letter from Donald Patterson to Donald Karlberg 3-4 (June 20, 1979) (SEC Exh. 2575); Donald Patterson SEC tr. at 585-89 (Oct. 23, 1985).

137/ Letter sent from Donald Patterson to Donald Karlberg 3 (June 20, 1979) (SEC Exh. 2575):

However it is our opinion that we should do everything possible to develop the interest of the members of the syndicate which will be bidding on these bonds, as well as a marketing process which will entice institutional investors into looking hard at this credit. Potential profit to a syndicate can be a very strong motivating force, and the institutional buyer has consistently shown a preference for obligations offered at a discount.

See Donald Patterson SEC tr. at 588-90, 615-18 (Oct. 23, 1985); James Perko SEC tr. at 269-72 (Oct. 17, 1985).

138/ Letter to Donald Karlberg from Donald Patterson 4 (June 20, 1979) (SEC Exh. 2575):

We believe that this procedure will permit the managers of the two syndicates to interest their members in submitting good

(continued...)

off" bid tends to discourage the entire market for the bonds because it reflects underwriter disinterest in the bonds. 139/

4. Increasing Financing Problems and Critical Cash Situation

a. Further Consideration of the Use of Short and Intermediate-Term Debt - The Balanced Financing Program

In late Fall 1979, the Supply System again considered using short and intermediate-term debt for Projects Nos. 4 and 5 despite its earlier reluctance to seek the Participants' approval for the bank lines of credit. The Financial Advisor testified that he proposed the program because interest rates were rising and he did not wish to have the financing program locked into the high rates through long-term bonds. 140/ It appears, however, that a principal purpose of the program was to expand the market for Projects Nos. 4 and 5 bonds and maintain the cash flow coverage to avoid a possible construction slowdown or project termination.

On April 24, 1980, a proposal for issuing short and intermediate-term debt, known as the Balanced Financing Program, was presented to the Board of Directors. The

138/(...continued)

bids and not sign-off bids. A good cover bid in this financing may very well be as important as the successful bid.

A "sign-off" bid is a bid that is significantly higher in interests costs than the winning bid. Donald Patterson SEC tr. 595-97 (Oct. 23, 1985).

139/ Donald Patterson SEC tr. at 597-98 (Oct. 23, 1985).

140/ Donald Patterson SEC tr. at 687-88 (Oct. 23, 1985).

Financial Advisor firm had prepared a written presentation for the Supply System Board of Directors. The Introduction to the presentation stated that "It is becoming increasingly clear that the Washington Public Power Supply System has entered into a difficult period in its long-term debt marketing program." 141/ The presentation ascribed the difficulty to institutional portfolio saturation in Supply System bonds and increased offerings by other issuers in the market and stated: "Given this supply and demand posture, there is a real possibility that the Supply System might be unable to raise the funds it needs to maintain construction cash flow at acceptable interest rate levels, or at any interest rate level at all." 142/ The Financial Advisor recommended the use of intermediate-term bonds and short-term bond anticipation notes as an integral part of the financing program, with intermediate debt comprising 25% of the financing over the next six years and with short-term debt comprising another 25% of the financing over the next three years. 143/ The Board authorized the program, but the program required the approval of each of

141/ Presentation to Washington Public Power Supply System - A Balanced Financing Program, Introduction (April 1980) (prepared by Public Power Finance Group, Blyth Eastman Paine Webber, Inc.). (SEC Exh. 2369.)

142/ Id. The Supply System staff had reviewed the Introduction containing these statements in draft form. Draft of Introduction with notations (undated) (SEC Exh. 2526); Stephen Buck SEC tr. at 321-23 (Oct. 9, 1985).

143/ Presentation to Washington Public Power Supply System - A Balanced Finance Program at II-1 (April 1980). (SEC Exh. 2369.)

the Participants because their agreement to pay the short term debt was necessary to provide the security for the debt. 144/

b. Only One Bid Received on Bond Sale

In April 1980, the Supply System received only one bid on a Projects Nos. 4 and 5 sale. This was a circumstance feared by the Financial Adviser because it reduced control over the underwriting syndicate. Up to this point, the Supply System had received bids on the Projects Nos. 4 and 5 bonds from two syndicates. 145/ In the offering prior to the April offering, some bonds could not be sold promptly, and the syndicate that had won the bid incurred losses. 146/ At the time of the April bidding on the offering, that syndicate's lead underwriters were unable to organize an effective bid and its members then

144/ As noted above, the Participants were not obligated under the Participants Agreements to make any payments until the projects were in commercial operation or until 1988, whichever came first, or until one year after termination.

At the time the Board authorized the program, the Participants' Committee formally approved the concept, but subsequent consideration of the program, described in Part II D, infra, resulted in a more critical evaluation.

145/ The four leading underwriters were grouped into two syndicates. Smith Barney, Harris Upham & Co. and Prudential Bache Securities, Inc. led one; Merrill Lynch, Pierce, Fenner & Smith, Inc. and Salomon Brothers Inc led the other. It was the practice in each syndicate to have the two lead underwriters in each syndicate rotate the role of leading the syndicate.

For further discussion of the underwriting of the bonds and the events surrounding the rejected bid see Part III A, infra.

146/ Donald Patterson SEC tr. at 623-24 (Oct. 23, 1985).

joined with the other syndicate to submit a single bid. 147/ Only one bid was submitted on each subsequent sale of Projects Nos. 4 and 5 bonds.

c. Consultation on the Balanced Financing Program

After the Board approved the Balanced Financing Program some of the Participants consulted their own financial advisors about the program. Smith Barney, Harris Upham & Co., which was the financial advisor to a number of the larger utilities and also was one of the underwriters of the Projects Nos. 4 and 5 bonds, was one of the advisers that was consulted. 148/ The firm was of the opinion that it was preferable to continue using long term financing for the Projects to the extent feasible and to avoid a programmed issuance of short-term debt as proposed by the Financial Advisor, although a limited use of short-term debt might be acceptable. 149/ At the request of the Supply System, representatives of the Supply System met with representatives of Smith Barney in September 1980, and asked Smith Barney to review the Balanced Financing Program further. A vice president in the firm's public finance department was assigned general responsibility for coordinating Smith Barney's response. An analyst in Smith Barney's research

147/ The members of the Smith Barney-Prudential Bache syndicate joined in the bid submitted by the Merrill Lynch-Salomon Brothers syndicate.

148/ Smith Barney had been a lead underwriter on the December 1979 offering of Project Nos. 4 and 5 bonds that resulted in losses to the syndicate.

149/ James P. Murphy SEC tr. at 111-13, 123 (July 10, 1985).

department, who had written analyst reports on the Supply System bonds, 150/ was asked to look at the Balanced Financing Program and report his ideas. 151/ The analyst had reservations about using short-term debt as a structured part of the financing program because he believed that short-term debt could magnify any financing problems that might exist at the time it became due. 152/ He also believed that short-term debt could expose an issuer to greater risk of interest rate volatility. 153/ The analyst further questioned whether the Balanced Financing Program would solve the "saturation" problem, i.e., the unwillingness of institutional investors to increase their holdings of Supply System bonds, and noted in a memorandum to the coordinator of the Smith Barney review: "The saturation problem is partially credit related, of course, in that many institutions will not buy any WPPSS bonds at all on

150/ Smith Barney's research department had produced and distributed research reports on Supply System bonds. In February 1979, the Smith Barney analyst had lowered his rating on the Projects Nos. 4 and 5 bonds from a 5 on its rating scale (equivalent to Moody's A1) to a 6 (equivalent to Moody's A). Smith Barney Revenue Bond Review-New Issues (Feb. 7, 1979). (SEC Exh. 2129.) The downrating reflected "both the slight deterioration in credit strength created by construction delays and the marketability risks concerning the Phase II [Project Nos. 4 and 5] bonds." Id. at 5.

151/ George D. Friedlander SEC tr. at 66-67 (Apr. 16, 1985).

152/ Id. at 78

153/ Id. at 78.

credit grounds." 154/ The analyst opined, however, that "[i]t is conceivable that the Participants would be well advised to risk a rating reduction, if the Plan, or any substitute plan we may devise, substantially improves the likelihood of Project completion, by ameliorating the saturation problem." 155/

Smith Barney's response to the Financial Advisor and the Supply System was to discourage the "structured" use of intermediate and short-term debt, i.e., using such debt as a scheduled part of the financing plan to replace some of the long term debt, as proposed by the Financial Advisor. Smith Barney proposed that long-term bonds continue to be issued so long as the Supply System could continue to sell them at a reasonable cost. The firm also wanted lower limits on the total amount of short-term debt that could be issued. Smith Barney ultimately wrote a letter to the Supply System that

154/ Memorandum from George D. Friedlander to Morgan Murray 2 (Oct. 10, 1980). (SEC Exh. 2238.) The manager in charge of Smith Barney's West Coast municipal finance office and formerly head of Smith Barney's public finance department had earlier referred one of the analyst's reports to the General Manager of Snohomish County Public Utility District, one of the larger Projects Nos. 4 and 5 Participants, and drawn attention to the saturation issue addressed in the report:

I wish to specifically call your attention to page 4 of this memorandum which points out the possible potential market saturation for major institutional buyers of these [Projects Nos. 4 and 5] revenue bonds.

Letter from Donald R. Larson to W.G. Hulburt Jr. (Feb. 15, 1979). (SEC Exh. 2234.)

155/ Freidlander Memorandum, supra, at 2. (SEC Exh. 2238.)

supported changing the Participants' Agreements to permit issuance of short term debt, but cautioned on the manner and extent of use of such financing. 156/ The letter noted that if the Participants did not amend the Participants' Agreement to permit implementation of the Balanced Financing Program, there could be an adverse affect on the Supply System's ability to finance Projects Nos. 4 and 5 to completion in a timely manner. 157/

d. Marketing Problems

The Supply System was aware that, as noted by Smith Barney, some institutional investors had become more reluctant to purchase Projects Nos. 4 and 5 bonds. 158/ Indeed, in

156/ Letter from Donald Larson and Morgan Murray to James Perko (Feb. 9, 1981) with cover letter to Robert Ferguson from Donald Larson. (SEC Exh. 2413.)

157/ Id. at 8:

The question has been raised as to what would be the effect on Project financing in the event that the proposed Balanced Financing Program is not authorized. In our opinion, failure of the Participants to amend the Participant's Agreements as recommended so as to permit the Balanced Financing Program could affect the ability of WPPSS to complete the financing of the Project in a timely manner. The realities of a remaining \$5 1/2 billion of financing to complete the presently estimated Project construction requirements [of the fiscal year 1981 budgets] within a finite time frame make it imperative that WPPSS be afforded maximum flexibility to meet its responsibilities.

The amounts of financing required referred to in the letter did not include the increase indicated by the undisclosed November 1980 estimate, described in Part II A, supra.

158/ James Perko SEC tr. at 238-49 (Oct. 17, 1985).

September 1980, at the time of the first discussion with Smith Barney about the Balanced Financing Program, the Supply System received information about the deteriorating institutional market for its bonds in a meeting at the Supply System with a group of large institutional investors. 159/ The investors met with Supply System officials, including the Deputy Managing Director and the chief financial officer, and with two Participant representatives. During the meetings, the financing program and the market for Supply System bonds were discussed. The discussions left one of the Participants' representatives with a negative view of the financing situation:

Generally speaking, I was left with the impression that there are serious doubts about the ability to raise the capital to complete the projects, particularly for Projects 4/5. Negative factors include:

1. Portfolios already contain large holdings of WPPSS securities. One substantial investor, Continental Insurance, noted that six percent of their total portfolio was in net billed securities and could go as high as ten percent but not much higher. Continental does not purchase 4/5 bonds.
2. Slow growth in capital funds available for investment.
3. Numerous tax exempt securities are now available which wasn't the case when the WPPSS financing program was undertaken.

159/ These included American Express, Continental Insurance, Crum and Foster Insurance, and Hartford Fire Insurance.

4. The lack of credibility of the Supply System program in the market place based on past cost overruns and schedule slippages (this is probably the largest single negative factor based on informal off the record discussions).
5. Necessity to go to the market too frequently. Investors feel no urgency to buy a particular issue since another will be available in 60 days. 160/

Although beneficial developments might have occurred in the future, such as authority to implement the Balanced Financing Program, authority to negotiate bond sales, and enactment of legislation allowing the BPA to acquire an interest in Projects Nos. 4 and 5, the Participant representative still saw a potential inability to finance the Projects to completion. 161/ The Supply System officials

160/ Memorandum from E.E. Coates to File 1-2 (Sept. 22, 1980) (memorandum of assistant Director, City of Tacoma Department of Public Utilities to file with copies to other Tacoma officials). (SEC Exh. 1344.) With respect to the meeting see also Edward E. Coates SEC tr. at 166-82 (Sept. 30, 1985); Robert E. Patterson (Continental Insurance) SEC tr. at 73-77 (Dec. 12, 1984); Carl P. Jason (Crum and Foster Insurance) SEC tr. at 61-70, 74-79, 96-99 (Nov. 27, 1984); Robert L. Stillson (American Express) SEC tr. at 98-113 (Nov. 20, 1984).

161/ Memorandum from E.E. Coates to file 2 (Sept. 22, 1980) (SEC Exh. 1344):

In summary, the meeting emphasized the need to broaden financing options to the fullest extent but cast some doubt upon the market's ability to absorb the financing required to complete the projects even with the broadened program in place.

recognized the problem of declining interest in the bonds by some institutional investors. 162/

e. Continuing Efforts to Gain Participant Approval of Balanced Financing Program

In late 1980, the Supply System was still trying to get all the Projects Nos. 4 and 5 Participants to approve changing the Participants' Agreement to permit the use of short and intermediate-term debt. By this time, cash coverage had dropped to the minimum needed to continue construction, and the Supply System was acknowledging the difficult cash situation to the press in the Pacific Northwest. 163/ The Supply System and

162/ Jayson (Crum & Foster Insurance) SEC Tr. at 97:

- Q. In connection with that, was there any discussion or anticipation of at some point the welcome would be worn out all together and the market just would not accept the bonds?
- A. I believe that did come up, yes.
- Q. Do you remember what anybody at the Supply System's reaction was, the officers or directors?
- A. The one conversation that we were in a little group with Perko [Supply System's chief financial officer] and he was concerned that they may not be able to market the four, fives, they were running out of buyers.

See also Alexander Squire SEC tr. at 98-99 (July 30, 1985).

163/ This acknowledgement apparently was to help explain to Pacific Northwest ratepayers the record high interest rates the Supply System was being forced to pay and to help win legislative changes, including the right to sell bonds through negotiated sales rather than competitive sales. For example, a Tacoma Washington newspaper
(continued...)

its consultants attended meetings in the region to win support and explained the importance of the short and intermediate-term debt program to the continued financing of the projects. 164/

163/ (...continued)

article, under a headline WPPSS Rocked by 10.7% Interest Bid on Bond Sale, cited statements by the Financial Advisor about the financing problems, including the Supply System's critical cash need, that forced the Supply System to accept a record high interest bid of 10.68% on the Projects Nos. 4 and 5 bonds and about the need for authority for new financing mechanisms, including negotiated sales and shorter term financing. The News Tribune A-15 (Sept. 24, 1980) ("Don Patterson, the system's chief financial adviser, said that had it not been for the Supply System's critical cash need, he would have recommended the bid be rejected."). The December 1980 Projects Nos. 4 and 5 bond sale, at the even higher rate of 12.4%, caused additional coverage and acknowledgement by the Supply System of the necessity of accepting the bid to avoid running out of cash and a request for additional financing authority. Lone Bidder Gets WPPSS Bonds at Record Rate, Seattle Post-Intelligence (Dec. 10, 1980) ("The bid was accepted, in part, because otherwise WPPSS would have run the risk of not having the money needed to continue construction at the two nuclear projects, officials said.").

164/ E.g., Minutes of PUD Association Manager's Section Meeting at Alderbrook Inn (Aug. 7, 1980):

He [Donald Karlberg, Supply System Treasurer] said the reason for the [Balanced Financing] Program was that the long-term bond market has reflected a concern over the volume of financing expected for the projects to completion He [Donald Patterson, Supply System Financial Adviser] explained that implementation of a Balanced Financing Program would relieve some of the pressure in the "long" bond market. This would benefit the Participants by reducing the possibility of an inability to finance the construction of the projects to completion, [that] is to reduce the risk of termination of the projects and the resulting adverse impacts on rates and power supply.

(continued...)

The need for the Program and the possible serious consequences of nonapproval of it were also presented to the Participants' Committee, which was the Participants' formal representative body for Projects Nos. 4 and 5. The effort to persuade the Participants' Committee to approve the Balanced Financing Program was complicated by the fact that the Committee had only recently expressed concern about the Participants' role in the Projects as a result of new payment obligations that would be imposed on the Participants under the Program. 165/

At the November 20, 1980 Participants' Committee meeting, the Supply System's chief financial officer informed the Committee that cash flow coverage was so low that there was almost none at times. He explained that to maintain even minimal cash coverage, the Supply System would have to raise \$1.7 billion through nine to ten bond sales by August of 1981 to finance all the Supply System's projects. He warned the Participants that in considering whether to support the

164/(...continued)

Donald Patterson testified that he did not recall making the statement that the program would reduce the possibility of not being able to finance the Projects to completion and the risks of termination. Donald C. Patterson SEC tr. at 692-94 (Oct. 23, 1985). But see Patterson's tape recorded statements to the Participants Committee, described below.

165/ See description of this development in Part II D, infra.

Balanced Financing program "you have to build in somewhere how bad financing is for 4 and 5 right now." 166/

The Financial Advisor warned the Participants' Committee of the imminent danger that the Projects might be terminated for lack of cash flow:

What we're talking about here is that if we lose one financing that Jim [Perko, the chief financial officer] indicated on that sheet next year we've got a problem. The attorneys have - it's not a question of suspension of the projects, or delaying the projects, we could be forced into a phase of termination [because the bond trustee might take action].

* * * *

I really implore every single one at this table to take a look at this separate from [other considerations] . . . because the risks of exposure to you are so strong, I am personally very concerned about it. 167/

166/ Participants' Committee meeting of November 20, 1980 (Tape 104(a) at 507-509.)

167/ Participants' Committee meeting of November 20, 1980. (Tape 105(a) at 271-74 and 357-59.) With respect to the exposure to risks, the Financial Advisor stated that if the financing program failed and the Projects were terminated it could affect the ratings of the bonds issued by the Participants for their own utilities:

Lose 4 and 5, gentlemen, I think right then you've got a serious problem. Because I think every single one of you are going to be looking at a possible downgrading on your systems. I don't know how far it would go. I don't think it's a half a downgrade. It could be a full grade That's why the balanced financing program was developed. Jim and I didn't feel that the Supply System had any right to expose the members, the 88 participants to the risks that could happen if we lost

(continued...)

In light of the fact that, in connection with its recently expressed concerns about the Participants' role in Projects Nos. 4 and 5, the Participants' Committee had asked the BPA to take steps to acquire the projects' capacity, the Supply System's Special Counsel summed up the need to approve the program so that there would still be projects for the BPA to acquire:

You don't want the house to burn down while
you're trying to get somebody to buy
it. 168/

Despite the statements to the Participants about the need for the Program, the Participants never gave the requisite number of approvals required to implement the Program. 169/

167/ (...continued)
the Projects.

Id. at 304-06, 308-10.

168/ Id. at 365.

169/ James Perko SEC tr. at 645 (Oct. 21, 1985). Although a number of Participants formally approved the needed change in their Participants' Agreements, the reaction of the Participants' Committee, described in Part II D, infra, made the needed unanimous approval of Participants unlikely.

Although the existence of the Balanced Financing Program proposal had been discussed with some in the financial community, such as the rating agencies, the Supply System was apparently concerned about the Participants' Committee's negative reactions to the program becoming known. At the November 20, 1980 Participants' Committee meeting, the chief financial officer urged that a reporter be denied admittance while the Balanced Financing Program was being discussed:

We've told a lot of people that we're
working on this program and that it's

(continued...)

5. End of the Financing Program

Although the Participants did not give the necessary approvals for the Balanced Financing Program, the Supply System began utilizing as an interim measure what was, in effect, intermediate-term debt in the form of \$50 million of ten-year put bonds in the December 1980 Projects Nos. 4 and 5 bond sale. 170/ The use of this intermediate-term debt was necessary to provide additional funding to overcome immediate cash shortages, as the Financial Advisor advised the Participants' Committee:

169/ (...continued)

necessary. We've also been told to wait to solve some of these other considerations that Hank has told me about [the Participant Committee's negative reactions discussed in Part II.D, infra] and we shouldn't open up to the press a wide range of disagreement and let that surface. That won't be good for the participants to have this get back to the financial community - or whatever affect that exists with the regional bill.

Participants' Committee meeting of November 20, 1980. (Tape 104(a) at 465-69.) There was no discussion in the official statements of the Balanced Financing Program or any negative reaction to it.

170/ The intermediate debt could be issued without amendment of the Participants' Agreements because the maturity date of the put feature was after 1988, when the Participants were obligated to start making payments under existing Participants' Agreements. Extensive use of such techniques, however, could present problems under the existing debt repayment schedules. See Standard & Poors Corporation rating sheet for this bond sale at 2 ("We are maintaining the outstanding "A+" but will watch closely for additional put options and other financing techniques which could increase bondholder exposure in the future, and for further labor settlements and associated cost increases."). (SEC Exh. 2437.)

One of the reasons why Jim and I looked at this [the use of \$50 million of put bonds] was - I was basically forced to look at how to get more money for 4 and 5 because of the cash flow. We'd have to be back in January [with another issue of bonds] in order to maintain cash flow. This puts us into the first two weeks in March. 171/

Put bonds were also used in the next, and last, Projects Nos. 4 and 5 offering in March 1981. The Supply System was also increasingly using other expedients, such as shortened maturities and bonds offered as discount bonds.

The tight cash situation continued into 1981, and it was imperative that each offering be made on time to avoid running out of cash to continue construction. 172/ After a Projects Nos. 4 and 5 bond sale in March 1981, a planned bond sale in early May was postponed when the fiscal year 1982 budget

171/ Participants' Committee meeting of November 20, 1980. (Tape 106(a) at 266-67.)

172/ The Supply System's problems, including the financing problems, continued to be a subject in the financial press. See, e.g., The Daily Bond Buyer, Vol. 255, No. 26052 at 1, 22 (Feb. 4, 1981); Fate of Nuclear Power In U.S. Could Depend On Troubled Project, Wall Street Journal (Jan. 8, 1981):

But even as WPPSS is forced to higher rates as it issues more debt, it is also running out of customers for its long-term bonds, according to Blyth Eastman Paine Webber, the investment banking firm that advises the supply system. Most major financial institutions have limits on their investments in certain kinds of bonds from a single source. Consequently, Blyth Eastman warns, "Long-term (WPPSS) debt is reaching saturation levels in institutional portfolios."

figures became available to the Supply System management. 173/
On May 29, 1981, the Supply System announced the budget figure
of \$23.9 billion for the five projects, compared with \$15.9
billion for the fiscal year 1981 budget, to the Board of
Directors. 174/ Because of the difficulty of raising the
enormous amount of financing required by the new budget and
questions about whether the projects were needed, the Managing
Director recommended a one year moratorium on construction of
Projects Nos. 4 and 5 to preserve the limited remaining
cash. 175/

After the moratorium recommendation, the underwriters
informed the Supply System that additional Projects Nos. 4 and
5 bonds could be sold only if the Participants agreed to pay
fifty percent of the interest on the bonds on a current basis. 176/
The necessary Participant approval was not obtained, 177/

173/ See discussion in Part II A, supra.

174/ Minutes of the Washington Public Power Supply System
Special Board of Director's Meeting of May 29, 1981 at 2-3.

175/ Id. at 3-4. See also Part II A 2 e, supra.

176/ Underwriters' memorandum (July 15, 1981) (SEC Exh. 2175);
Underwriters' letter to Robert L. Ferguson (Aug. 21, 1981)

("We also believe that any weakening of the terms and
commitments contained in the Plan would render it
inadequate as a basis for us to undertake the marketing of
such bonds as aforesaid." (at 2)) (SEC Exh. 2176).

177/ The failure to obtain the required Participant approval
and the foreseeability of this outcome is discussed in
Part II D, infra.

further financing was not attempted, and the projects ultimately were terminated. 178/

C. NEED FOR THE PROJECTS - POWER SUPPLY AND DEMAND

1. Introduction

All of the official statements used in the sale of the Projects Nos. 4 and 5 bonds discussed the need for the Projects and anticipated power shortages for the Pacific Northwest region and the Participants. The forecasted power shortages were the reason for the construction of the projects. The need for power in the region was presented prominently in tables and charts showing forecasted increases in regional power demand and regional power deficits into future years. 179/ The

178/ Aside from listing the amount of financing needed, based on the budgets as publicly disclosed, the official statements used to sell the bonds over four years contained only the following description of the state of the financing program:

The Supply System's current cash flow projections indicate that monies currently available together with investment income thereon and the proceeds from [this offering] will be sufficient to continue construction of the Projects until [month and year]. Additional Bonds necessary to complete the financing of the Projects are planned to be issued as the need arises.

E.g., Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1981A&B (Projects Nos. 4 and 5) at 33 (March 17, 1981).

179/ A table presented the figures for the next ten years for estimated requirements, estimated resources and surplus or deficits both in actual amounts and in percentage. E.g., Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, (continued...)

Participants' power needs were also prominently presented in tables and charts showing increases in the Participants' forecasted power demand and forecasted power deficits. 180/

The failure to obtain the forecasted rate of growth in power demand as set forth in the official statements ultimately contributed to the termination of Projects Nos. 4 and 5 and the suspension of construction of Projects Nos. 1 and 3. Even during the period of the sales of Projects Nos. 4 and 5 bonds, each annual forecast showed decreases from prior year forecasts in the projections of power demand, indicating that the forecasts included in the official statements overstated growth in demand. Moreover, during the period when the bonds were being sold, the actual power use was consistently less than had been forecasted for the years in that period. Although the official statements generally presented the new reduced forecasts each year, the historical pattern of

179/(...continued)

Series 1981A&B (Nuclear Projects Nos. 4 and 5) at 10, A-4 (March 17, 1981). The official statements sometimes contained charts showing the resources and deficits in graphic form. E.g., id. at 11, A-5.

180/ Tables presented (1) the historical power requirements for the previous five years in peak demand and total energy with growth from year to year in percent and (2) the Participants' estimated power requirements for the next fifteen years in peak demand and total energy with increases in each year in percent. E.g., Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1980D&E (Nuclear Projects Nos. 4 and 5) at 9-10, A-11 (Dec. 19, 1980). The official statements sometimes contained charts depicting the shortage between supplies of power available to the Participants as calculated under certain conditions and the forecasted power demands. E.g., id. at 18, A-19.

overestimation of demand was not presented. Other negative information also was minimized. 181/

2. Regional Forecasts

a. The PNUCC Forecast

During the period in which the Projects Nos. 4 and 5 bonds were sold, regional load forecasts, 182/ compiled under the auspices of the Pacific Northwest Utilities Conference Committee ("PNUCC") were the forecasts generally used for long range planning purposes in the Pacific Northwest. 183/ The PNUCC was formed in the late 1940's to facilitate advance

181/ The amount of power resources, for example, was presented on critical water period basis, i.e., on the worst historical water shortage conditions experienced in the Northwest over a 42 month period in the past 40 years. See Katz MDL tr. at 214 (June 17, 1986). While this basis is disclosed in the official statements, investors were not provided with information about the magnitude of supply in normal or above normal years, which could bear on the ability to sell power from the projects. The only information in the official statements relating to normal years, in contrast to the tables and charts based on critical water years, is simply a statement that "during most years, substantial secondary energy, resulting from more favorable water conditions is expected to be available." Notably, in average water conditions, an additional 1,500-2,500 megawatts over critical water conditions were available, approximately the power output of Projects Nos. 4 and 5. Winston Peterson SEC tr. at 449 (Sept. 19, 1985). Likewise, references to other forecasts of power demand provided only minimal information about those forecasts, which usually indicated less growth in power demand.

182/ "Load" is a term commonly used in the energy industry to refer to the quantity of power required.

183/ Other regional forecasts were available. Both the Natural Resources Defense Counsel ("NRDC") and the Northwest Energy Power Project ("NEPP") prepared load growth forecasts showing lower growth in demand than the PNUCC forecast, but they were not published annually.

planning on regional electricity matters. The PNUCC membership included representatives from all of the publicly-owned utilities, investor-owned electric utilities, agencies that served the Pacific Northwest region, and the large industrial customers served directly by the BPA. 184/ The PNUCC's major function was to prepare annually a ten and twenty year energy forecast for the Pacific Northwest, which was entitled "West Group Forecast of Power Loads and Resources."

The PNUCC forecast was a "self" forecast in that each utility prepared its own forecast. The PNUCC prepared its annual forecast of energy demand by obtaining forecasts from the various utilities in the region. Large generating utilities submitted their own forecasts directly to the PNUCC. 185/

The BPA prepared the forecasts for non-generating utilities to which it supplied power, including many of the Participants. 186/ In addition, the BPA furnished staff and

184/ Pacific Northwest Utilities Conference Committee, Econometric Model Electricity Sales Forecast, 4 (July 1981). (SEC Exh. 6006.) The PNUCC meetings were open to all interested parties. Paul Nolan SEC tr. at 8 (May 20, 1986). Although the BPA was not an official member of the PNUCC, it had historically been a strong participant, with representation on PNUCC committees and input on decision making. David Hoff SEC tr. at 48 (Sept. 4, 1985); Gerald Garman SEC tr. at 18 (April 24, 1986).

185/ Gerald Lenzen SEC tr. at 25 (Jan. 14, 1986).

186/ Gerald Lenzen SEC tr. at 17 (Jan. 14, 1986). The BPA also provided the PNUCC with the load component of the forecast for the industries served directly by the BPA ("direct service industries" or "DSIs") based on the amounts in the power sales contract between the BPA and the DSIs. The forecast amount for the DSIs was simply the contract
(continued...)

computer time to assist the PNUCC in the preparation of its forecast and assumed responsibility for distributing the PNUCC forecast throughout the region. 187/

The System Planning Committee of the PNUCC received the individual utility forecasts in December or January of each year. 188/ Other than checking for mathematical errors, the PNUCC did not attempt to verify the utility forecasts. 189/ The System Planning Office simply tallied the individual utility forecasts to determine the total load growth for the Pacific Northwest region. The System Planning Committee then presented the forecast to the PNUCC Executive Committee for its approval of the format prior to the general publication of the forecast, which typically occurred in early spring. 190/ The results of this "sum of the utilities" forecast, as it came to

186/ (...continued)

amount. Twenty-five percent of the contract amount was characterized as "interruptible" and was a separate line item in the forecast. The significance of interruptible power was that under certain circumstances, there was no obligation to provide such power to the DSIs, and thus the power could be "interrupted."

187/ Id. at 15, 19.

188/ David Hoff SEC tr. at 34, 43-44 (Sept. 4, 1985); Gerald Garman SEC tr. at 13 (Apr. 24, 1986); Robert McKinney SEC tr. at 19, (May 22, 1986).

189/ David Hoff SEC tr. at 34, 44 (Sept. 4, 1985); Gerald Garman SEC tr. at 13 (Apr. 24, 1986); Robert McKinney SEC tr. at 19 (May 22, 1986).

190/ Gerald Lenzen SEC tr. at 71 (Jan. 14, 1972); Gerald Garman SEC tr. at 25, 27 (Apr. 24, 1986); Paul Nolan SEC tr. at 12 (May 20, 1986); Robert McKinney SEC tr. at 19, 20 (May 22, 1986).

be known, were then presented, in table format, in the Official Statements for Projects Nos. 4 and 5 under the "Power Supply in the Pacific Northwest" section as the regional estimated power demand.

b. The Pattern of Overestimation of the Need for Power

The PNUCC forecasts decreased over time, reflecting diminishing expectations of future growth in demand. Moreover, during the sales of Projects Nos. 4 and 5 bonds, the actual power usage was less than had been forecasted for years in that period, indicating that the forecasts overestimated power demand. 191/ The decreases in the forecasts of demand and the lower actual usage is reflected in the following table of

191/ Although the staff investigation did not attempt to evaluate the methodology of the PNUCC forecasts, certain factors may have contributed to PNUCC forecast inaccuracies. The only written guideline available to many of the smaller utilities was a 1965 load forecasting manual published by the BPA for distribution among the utilities. Winston Peterson SEC tr. at 214 (September 18, 1985); Bonneville Power Administration, Load Estimating Manual (1965) (SEC Exh. 6002). This manual was not replaced until 1982. Gerald Lenzen SEC tr. at 60-61 (Jan. 14, 1986); Bonneville Power Administration, Utilities Studies Section, Utility Load Study Review Guide (draft)(1982) (SEC Exh. 6049). Further, there were wide variances in the forecasting techniques that the utilities used. Some utilities did not consider price elasticity of demand in their calculations. Robert McKinney SEC tr. at 13 (May 22, 1986). Utilities did not necessarily update their forecasts annually. Id. at 23; David Hoff SEC tr. at 40 (Sept. 4, 1985). Moreover, the absence of a region-wide review led to duplicative forecasts in situations where, for instance, an industry may have proposed several sites in different utility districts, and each utility would account for the forecasted need. Gerald Lenzen SEC tr. at 19 (Jan. 14, 1986). The forecasts also included an amount for DSI demand based on the contracted amount, which might not reflect real demand or elasticity.

forecasts made from 1974 through 1981 for the 1978-1979, 1979-80, 1980-81, and 1981-82 consumption periods and the actual usage in those consumption periods:

COMPARISON OF ACTUAL VERSUS ESTIMATED POWER REQUIREMENTS FOR THE PNUCC WEST GROUP AREA (LESS BPA INTERRUPTIBLE) ^{192/}

Average Megawatts ^{193/}

Consumption Period

<u>DATE OF ESTIMATE</u>	<u>1978-79</u>	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>
1974	16,464	17,339	18,257	19,199
1975	16,081	16,883	17,674	18,492
1976	15,756	16,541	17,399	18,234
1977	15,280	16,186	16,978	17,789
1978		15,791	16,611	17,555
1979		15,687	16,460	17,298
1980			16,293	16,993
1981				16,105
Actual Usage	14,716	14,866	14,830	15,105

Thus, for example, the 1974 forecast projected a use of 18,257 average megawatts for the West Group area in 1980-81. By 1980, the forecasted demand for 1980-81 had dropped to 16,293 average megawatts, a 1,964 megawatt drop. The actual use of power in 1980-81 was 14,830 average megawatts - 3,427 megawatts lower than the 1974 estimate and 1463 megawatts lower than the 1980 forecast.

^{192/} Information drawn from SEC Exh. 6010, prepared by BPA - Division of Power Requirements Utility Studies Section, Table 1 (Sept. 30, 1982).

^{193/} Average Megawatts are units of energy measured as the ratio of energy (in megawatt hours) expected to be consumed during the period of time to the number of hours in the period. See Pacific Northwest Utilities Conference Committee, Northwest Regional Forecast of Power Loads and Resources at I-11 (June 1981). (SEC Exh. 6008.)

The regional power demand forecasts were important to investors because they suggested that there would be a strong market for the power and strong regional support for Projects Nos. 4 and 5. As indicated above, although the official statements presented the new forecasts each year, they did not note the decrease in the forecasts or that actual usage was consistently lower than had been forecasted. Forecasted increases in the regional supply of power were also being reduced, but this reduction was relatively less. Thus, the projected deficits decreased. This information might have alerted investors to the tendency of the forecasts to overestimate demand.

c. The 1981 PNUCC Forecast Reduction in the Need for Power

The 1981 PNUCC forecast, publicly disseminated in June 1981, showed a sharp reduction in regional power demand. Specifically, the relevant West Group portion 194/ of the 1981 PNUCC forecast was adjusted downward by approximately 1,736 megawatts or 9.2% for forecast year 1981-82, 195/ decreasing in

194/ The West Group Area System includes BPA, Pacific Power and Light Company, Portland General Electric Company, Puget Power and Light Company, Washington Water Power Company, and the 115 public agency customers of the BPA. (SEC Exh. 6021 at 2.) For comparison purposes, the West Group portion of the load forecast is the relevant forecast because it is the region for which PNUCC forecasts were made until 1981 when the region was expanded to include an East Group.

195/ The 1980 PNUCC West Group forecast projected a load requirement of 18,736 average megawatts for 1981-82. The West Group portion of the 1981 PNUCC forecast projected a
(continued...)

greater amounts for the subsequent forecast years, with a decrease in the 1990-91 forecast year of 2,277 megawatts. 196/ The decrease in the forecast was significant in relation to the expected Projects Nos. 4 and 5 combined generating capacity of approximately 1700 megawatts 197/ and was a factor in the Supply System's recommendation of a suspension of construction of Projects Nos. 4 and 5. 198/

195/ (...continued)

total load requirement of 17,000 average megawatts for 1981-82, resulting in a net decrease of 1,736 average megawatts for the 1981-82 forecast year.

196/ The 1980 PNUCC West Group forecast projected a load requirement of 24,740 average megawatts for 1990-91. The equivalent West Group portion of the 1981 PNUCC forecast predicted a 22,463 average megawatt load for 1990-91, resulting in a net decrease of 2,277 average megawatts for the 1990-91 forecast year.

Although forecasted resources to meet power demand were also reduced in the 1981 forecast, the decrease in forecasted resources was significantly less than the forecasted decrease in demand. Specifically, the projected deficit of power was reduced from 2,314 average megawatts to 1,177 average megawatts for the forecast year 1981-82, a fifty percent reduction in the power deficit. The deficit projected was also adjusted downward in subsequent years, with the decrease in the forecast year 1990-91 at 2,514 average megawatts, a sixty-two percent reduction over the 1980 forecast for the 1990-91 forecast year.

197/ Project No. 4 had a nameplate, or maximum, net generating capacity of 1,250 megawatts and Project No. 5 had a nameplate net generating capacity of 1,240 megawatts: 2,490 megawatts for the two plants. However, the anticipated actual generation aggregated to approximately 1700 megawatts. Coates MDL tr. at 722-723.

198/ Robert Ferguson, managing director of WPPSS, in first recommending a construction slowdown at the May 29, 1981 WPPSS Board of Directors meeting, cited the decline in the PNUCC forecast by the amount of the capacity of Projects
(continued...)

The results of the PNUCC forecast appear to have been known as part of the PNUCC review process as early as February of 1981. On February 5, 1981, the PNUCC Executive Committee met and discussed the 1981 PNUCC load forecast. 199/ The PNUCC 1981 forecast information was nearing final form at approximately the time of this February 5, 1981 meeting. 200/ Also, at that time the BPA power manager indicated that the BPA would reduce its forecast for the small utilities it served by approximately 500 megawatts. 201/ It was agreed at the meeting that the BPA would furnish its revised load estimate for the PNUCC regional forecast. 202/ On March 18, 1981, the PNUCC System Planning Committee met and discussed the results of its 1981 regional load forecast. Summary tables showing the PNUCC West Group forecast, dated March 16, 1981, were distributed at

198/ (...continued)

Nos. 4 and 5 as a factor creating uncertainty about the Projects. Minutes of Board of Directors' Meeting of May 29, 1981 at 3.

199/ Gerald Garman SEC tr. at 39 (Apr. 24, 1986); Paul Nolan SEC tr. at 35 (May 20, 1986). The 1981 West Group Forecast values were available at the time of this February 5, 1981 meeting. Gerald Lenzen SEC tr. at 75 (Jan. 14, 1986).

200/ Gerald Garman SEC tr. at 43 (Apr. 24, 1986).

201/ Gerald Garman SEC tr. at 43 (Apr. 24, 1986); PNUCC Executive Committee Meeting Report for meeting of February 5, 1981 (Feb. 13, 1981) (SEC Exh. 6005).

202/ Gerald Garman SEC tr. at 41 (Apr. 24, 1986); PNUCC Executive Committee Meeting Report for meeting of February 5, 1981 (Feb. 13, 1981) (SEC Exh. 6005).

that meeting. 203/ The tables, which reflected a dramatic drop in forecasted demand, 204/ were identical to the tables summarizing the West Group Area that ultimately appeared in the PNUCC forecast dated in June of 1981. 205/

Although information on the 1981 forecast existed in February 1981 and the forecast figures existed by March 16, 1981, the March 17, 1981 official statement for Projects Nos. 4 and 5 bonds contained only information from the 1980 forecast and made no reference to the additional drastic decline included in the preliminary 1981 forecast. 206/ Although the record does not show that the Supply System or its consulting engineer, R.W. Beck, which was responsible for this portion of the official statement, had the figures, R.W. Beck received forecast information from the PNUCC and attended PNUCC meetings

203/ PNUCC System Planning Committee agenda and attachments (March 18, 1981). (SEC Exh. 6009.)

204/ See discussion supra, for comparison of the 1980 and 1981 forecasts.

205/ Although the figures had not yet been presented to the PNUCC Executive Committee for final formal approval prior to release, as discussed previously, once the individual utility forecasts were tabulated for the PNUCC forecast there was no independent verification process which would be undertaken that would result in changes to the forecast.

206/ The Official Statement discussion of "Regional Power Requirements and Resources" refers to the "Long Range Projection of Power Loads and Resources for Resource Planning" dated September 2, 1980 (the "1980 Blue Book"), as the most current load and resource analysis. Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1981A&B (Nuclear Projects Nos. 4 and 5) 9 (March 17, 1981).

on forecasts from time to time 207/ and could have obtained this information for disclosure in the official statement.

3. Participants' Forecasts

a. General

The official statements also contained projections of power demand for the Participants. These showed substantial projected growth in power demand. The Participants' power demand forecasts were compiled by R.W. Beck from forecasts obtained by R.W. Beck from each of the Participants. Because the forecasts supplied to Beck generally were the same forecasts used in the regional forecasts, they were subject to the same problems that contributed to overstatement of those forecasts. As with the regional forecasts, the Participants' forecasts were dropping and actual usage was lower than the forecasts. Although each year's lowered forecast was substituted for the previous forecast in the official statement, the facts that the forecasts were dropping and that the actual usage was lower than the forecasts were not specifically disclosed. As with the regional forecasts, this information would have suggested that the Participants' forecasts overestimated demand. The following table depicts the pattern of overestimation and the continual drop in Participant forecasts over time:

207/ Winston Peterson SEC tr. at 202, 229-39.

COMPARISON OF PARTICIPANTS' ACTUAL
VERSUS ESTIMATED POWER REQUIREMENTS 208/

Megawatt Hours

Consumption Period

<u>Date of Estimate</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
1976	36,139,300	39,555,640	42,734,880	45,602,880
1977	35,869,790	39,297,660	42,467,990	45,333,890
1978	-----	38,423,540	41,249,890	44,083,450
1979			40,308,898	43,206,083
1980				42,332,625
Actual Usage	34,185,421	35,425,168	38,694,748	39,038,000

As noted above, the BPA had observed in connection with the preparation of the PNUCC 1981 regional forecast that the forecasts the BPA submitted to the PNUCC, which included most of the Participants' forecasts, overstated actual demand. This caused the BPA to make an unprecedented one-time downward adjustment of 6.88% of its portion of the load forecast that it submitted to PNUCC to be used as a component part of the 1981 forecast. This deviation was formally analyzed beginning in 1979. 209/ A possible downward adjustment in the Participants

208/ Source: Official statements for Projects Nos. 4 and 5 bonds Series 1977A (Feb. 23, 1977); 1977C (Sept. 13, 1977); 1978B (May 23, 1978); 1979C (Dec. 11, 1979); 1980B (July 15, 1980); and Draft 1981C (July 1981) (offering not completed). The 1980 estimate, included in the official statements for Projects Nos. 4 and 5 bond series 1980B, dated July 15, 1980, was reduced slightly from the 42,758,216 megawatt hour estimate included in the official statement for Projects Nos. 4 and 5 bond series 1980A dated May 9, 1980.

209/ In the 1970's the BPA became aware that the forecasts it prepared for many of the Participants were consistently
(continued...)

forecasts because of this study appears to have been known to the

209/ (...continued)

higher than the actual load demands experienced by the utilities that it served, including the Participants. In response to this detection of forecast errors, the Power Requirements Section of the BPA initiated a load deviation study in late 1979. Charles Schneider SEC tr. at 7-8 (Jan. 15, 1986); Gerald Lenzen SEC tr. at 36 (Jan. 14, 1986). The load deviation study covered a period from July of 1968 to September of 1978. The study compared the forecast deviation with the actual experience in the first year of each forecast. The 1979 load deviation study culminated in a report, including recommendations for several methods of adjustment to the BPA portion of the PNUCC forecast. Memorandum from George Guinwatt to Hechter Durocher (Dec. 10, 1979). (SEC Exh. 6050.) The study was presented by the staff of the Power Requirements Section to the BPA Power Manager. However, no decision was made at that time to proceed with an adjustment. Charles Schneider SEC tr. at 15-16 (Jan. 15, 1986).

In the fall of 1980, the BPA staff conducted an identical load deviation study. System Load Deviation Study (draft) (SEC Exh. 6045); Gerald Lenzen SEC tr. at 43 (Jan. 14, 1986). In a November 21, 1980 meeting, it was determined that the data be weather adjusted to compare the deviation to the weather as it had actually occurred, not against projected normal weather. System Load Deviation Study (draft) (SEC Exh. 6046); Gerald Lenzen SEC tr. at 47 (Jan. 14, 1986). On January 28, 1981, the BPA completed its revised load estimate, which incorporated the adjustments in the deviation study. System Load Deviation Study (draft) (SEC Exh. 6045); Gerald Lenzen SEC tr. at 43 (Jan. 14, 1986). After making minor weather adjustments, the revised study recommended a 6.88 percent downward adjustment. Gerald Lenzen SEC tr. at 49 (Jan. 14, 1986). The PNUCC was aware of the revised load estimate as soon as the information was developed. *Id.* at 54. On February 27, 1981, BPA formally transmitted to the PNUCC its revised load forecast using the 6.88 percent adjustment. This adjustment accounted for between 45 and 55 percent of the reduction in each of the years of the PNUCC regional forecast. Pacific Northwest Utilities Conference Committee, Northwest Regional Forecast of Power Loads and Resources 6 (June, 1981) (SEC Exh. 6008); Gerald Lenzen SEC tr. at 75 (Jan. 14, 1986).

Participants' Committee and the consulting engineer. 208/

b. Projected Power Deficits for the Participants

The official statements also projected that the Participants would experience a power deficit beginning in the mid-1980's without Projects Nos. 4 and 5, and a deficit in some years even with power from those projects. 209/ The anticipated deficit was the product of power demand increases that had been forecasted and an assumption that the Participants would be unable significantly to increase the amount of power acquired from the BPA after 1983. Although the BPA's power was limited, some additional power beyond that projected for the Participants after 1983 was potentially available. The assumption that the power would not be available to the Participants was based to a large degree on legal and policy questions that, when resolved, could make the power available. 210/ The official statements made reference to some of these issues, but the significance to the power

208/ See Part II D, infra.

209/ See, e.g., Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1980D&E (Nuclear Projects Nos. 4 and 5) at 18 (Dec. 19, 1980). The chart depicting the projected deficit was placed in the main body of the official statements beginning in mid-1979 at the time that power needs information was moved forward in the official statement, as described above in Part II B, supra.

210/ See discussion in Parts II D and IV, infra.

deficit was not presented in a way that would have adequately offset the impression of critical power deficits conveyed by the official statements.

The presentations of need for power by the region and the Participants were based in the official statements on forecasts in general use in the region. The presentations, however, emphasized information about the need for power that was favorable for Projects Nos. 4 and 5 and did not adequately provide information that was negative or that cast doubt on the forecasts. Investors, therefore, were not provided full, balanced information on this important subject.

D. THE PARTICIPANTS' REACTION TO EVENTS AND DEVELOPING DISSENTION

The problems with the budgets, the financing program and declining rates of growth in power demand began affecting the Participants. The growing problems caused the Participants' Committee, the formal representative body of the Participants for the projects, 211/ to seek a sharing of the burdens of the projects and to request a study of the possibility of delaying or terminating the projects approximately seven months before management's moratorium recommendation in May, 1981. Although the issue of the validity and enforceability of the

211/ Under the Participant's Agreements, the Participants' interests were represented through a Participants' Committee composed of up to seven members. Each of the Participants could designate any of the Participant Committee members to represent it.

Participants' Agreements that obligated the Participants to provide funds to pay the bonds issued by the Supply System 212/ was not addressed by the Participants' Committee at the time these deliberations began, the Participants' continued support for the projects was necessary for the success of the projects. After the management's recommendation of a moratorium, the Participants were told that they had to agree to changes in their agreements or further financing would not be feasible. The Participants failed to take the necessary actions and the projects subsequently were terminated. 213/

The official statements consistently portrayed Participant support for the projects as strong. They noted a high degree of regional cooperation and indicated that the Participants needed the projects. 214/ The official statements did not

212/ See discussion in Part IV, infra. on the issue of the validity of the Agreements.

213/ Some of the Participants also ultimately denied the obligation to pay bondholders in the litigation to enforce those obligations.

214/ E.g., Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1980D&E (Nuclear Projects Nos. 4 and 5) at 6 (Dec. 19, 1980):

The power supply facilities in the Pacific Northwest have been operated with a high degree of cooperation for many years.

* * * *

Early in the 1970's, it became apparent that the initial phase of the Ten-year Hydro Thermal Power Program would not provide adequate generating resources to
(continued...)

214/ (...continued)

supply the region's growing demand for electrical power beyond the early 1980's. The cooperation that was established during the development of the Ten-year Hydro Thermal Power Program was continued and additional generating projects were identified. This cooperative planning and scheduling of resources, including the Projects, has resulted in construction and planning of generating facilities by individual utilities and utility groups on a coordinated basis to meet the growing loads of the Pacific Northwest. As part of this power supply program the preference customers [principally the Participants] undertook to provide their own additional generating resources without the acquisition of the capability thereof by Bonneville. At the same time the preference customers have been working with the region's other electric utilities and Bonneville's direct service industrial customers in a cooperative effort to obtain legislation to authorize Bonneville to acquire the resources necessary to meet the region's electric power supply requirements.

The official statements also contained extensive information on the forecasted need for power from the projects. See discussion in Part II C, supra.

The official statements also contained an unqualified statement of the Participants' obligation to pay the costs of the projects, including payment of the bonds. The cover sheet of each official statement, for example, stated:

The Supply System has sold the entire capability of the Projects in shares to the Participants. Each Participant is obligated to pay the Supply System, in the manner and from the sources described herein, its Participant's share of the total annual costs of the Projects, including debt service on the Bonds, whether or not the Projects are completed,

(continued...)

reflect any concern or reservation among the Participants about their role in the projects or any conflict over the projects between the Participants and others in the region.

Prior to 1980, the Participants' involvement in substantive matters relating to the projects had been relatively limited. The Supply System had the operational responsibilities for the projects and problems of costs, decreases in forecasts of power demand, and financing with the projects had not reached critical levels. As the problems became more acute, the Participants were drawn into the worsening situation. Their reaction indicated that their support for the projects, and the regional cooperation, was less than portrayed in the official statements.

1. The Participants' Committee's Reevaluation of the Position of The Participants
 - a. Development of the Conditions Leading to Participant Committee Reevaluation

In 1980, several conditions developed that caused the Participants' Committee to reevaluate the Participants' situation. It began with the Supply System's request that the

214/ (...continued)

operable or operating and notwithstanding the suspension, reduction or curtailment of the Projects' output.

Official Statement for \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1981A&B (Nuclear Projects Nos. 4 and 5) cover page.

The issue of the invalidity of the Participants obligation is described separately in Part IV, infra.

Participants agree to changes in their Participants' Agreements to enable the Supply System to sell short and intermediate-term debt to prevent a possible interruption in funds needed for continued construction. 215/ The proposed change would have exposed the Participants to the risk of having to make payments on the projects before they were completed. The existing Participants Agreements did not require payments until the completion of the projects or 1988, whichever came first. Moreover, many of the Participants had long believed that the costs of the projects would be shared by others in the region and melded with the inexpensive hydro power available from the BPA. 216/ Finally, the projects' soaring costs increased the

215/ See discussion in Part II B, supra.

216/ When the Participants entered into the Agreements, there was substantial uncertainty about the power that might be available to the in future years. At the time Projects Nos. 4 and 5 were initiated, the Participants were statutorily entitled to preference in access to the BPA's hydro power. Some of the power at that time was contracted to the BPA's direct service industry customers ("DSIs"), which did not have statutory preference to the BPA's hydro power. If the Participants were able to obtain this power, it could be used to meet some of their future needs. Because of unsettled issues as to the DSI claims for the BPA power, possible other preference customer claims for the power, and forecasts at that time for very large growth in power demand, the BPA was unwilling, and, because of an obligation to produce an environmental impact statement was unable, to allocate its power supply at that time to the preference customers. The BPA therefore issued a formal "letter of insufficiency" that notified the Participants that it would not be able to assure that it would continue to meet their power growth after 1983. This pressured Participants to join Project Nos. 4 and 5.

Some of the Participants were concerned that they might
(continued...)

differential between the inexpensive BPA power and the cost of Projects Nos. 4 and 5 power. It was beginning to appear that the cost of the power from the projects would be borne by the Participants alone while other power users, such as the BPA's direct service industrial customers, or DSIs, could continue to use the inexpensive BPA power. It further appeared that this problem might not be solved, as had been expected, by federal legislation authorizing the BPA to meet regional power needs by acquiring power from generating facilities owned by others,

216/(...continued)

lose their right to the inexpensive BPA hydro power if they joined Projects Nos. 4 and 5 and the power from those projects were later held to reduce their claim on BPA hydro power. In response to these concerns, the BPA Administrator issued a letter that stated that Participants would not be penalized in future allocations of hydro power because of their participation in Projects Nos. 4 and 5. Also, since the DSIs would benefit from Projects Nos. 4 and 5, their participation in the projects was sought. Original proposals provided for the DSIs to assume part of the dry hole risk on Projects Nos. 4 and 5 for a fixed period of time. The DSIs, however, asserted that the terms of their existing debt obligations prevented them from assuming a dry hole risk. Their obligation was then limited to agreeing to purchase certain amounts of power for a fixed period of time. This obligation was intended to cover the early years of the operation of Projects Nos. 4 and 5 when the Participants might not need the power from the projects.

Finally, there was a possibility of Federal legislation which might provide for the acquisition of the capability of Projects Nos. 4 and 5 by the BPA. This would regionalize the allocation of power and regionalize the risks and costs of Projects Nos. 4 and 5. Indeed, early proposed legislation expressly provided for the acquisition of the capability of Projects Nos. 4 and 5 by the BPA.

such as Projects Nos. 4 and 5. 217/ Thus, the Participants were being asked to assume immediate payment obligations, because of the financing problems, in a situation where they might have to pay for more expensive power from Projects Nos. 4 and 5 while others for whom the projects also had been undertaken might be able to meet their needs with inexpensive BPA power.

There was some Participant support for the short and intermediate-term debt program, which was called the Balanced Financing Program. If the projects were terminated, the Participants would apparently have had to pay for all the bonds issued to that date without receiving power and without any way of forcing the region to share the cost. Also, despite the decreases in the forecasts of power demand, there was still a risk of a regional power shortage that could affect the Participants. The Board of Directors and the Participants' Committee, therefore, approved the concept of the Balanced Financing Program. However, the program could not go forward without each of the 88 Participants agreeing to an amendment of their Participants' Agreements. 218/ The Supply System staff and the Financial Advisor undertook to get the approval of each of the Participants. The Supply System worked with the Participants' Committee to formulate the terms and conditions

217/ The legislation set acquisition priorities based on type of fuel and on cost that might not be met by Projects Nos. 4 and 5.

218/ See discussion in Part II B, supra.

of a supplemental agreement. Initial issues addressed by the Participants' Committee included the maximum amount of short and intermediate-term debt that should be authorized. 219/ There were also discussions about how the Program could be structured to allow the Participants to control the issuance of the short and intermediate-term debt.

b. October 16, 1980 Participants' Committee Meeting

In October 1980, more fundamental issues raised by the short and intermediate-term debt proposal were discussed by the Participants' Committee. At the October 16, 1980 meeting of the Participants' Committee, the manager of a Participant that had one of the largest shares in the projects expressed the view that the Participants had to address the central issue: that the projects had been initiated as a regional resource and that other utilities and the DSIs, for whose benefit the projects had been undertaken, should share some of the burdens

219/ The Participants' Committee was concerned about the adverse impact of a large program, particularly on some of the smaller Participants. See Minutes of Participants' Committee meeting of August 21, 1980. The financial adviser wanted authorization for a large amount of debt and had proposed a figure of \$1.4 billion. The Participants' Committee, working from studies done by R.W. Beck, the Supply System's consulting engineer, on the impact that the Balanced Financing Program would have on the rates of Participants' rate-payers, did not want to exceed \$750 million. The \$750 million amount equated to an average 20% rate increase for the customers of the Participants if the maximum short term debt were issued and could not be rolled over. On the upper end, this would mean an increase of 38% for Pend Oreille, one of the small utilities. One of the Participants' Committee members raised the question of whether some utilities that "have subscribed beyond their own requirements" should "be exposed to the risks of short term bonds." (Id. at 7)

if the 88 Participants were to take on the risk of short term financing:

The question is, when we went into this, the assurances that we had as participants from the Bonneville Administration by letters, by their encouragement, from the DSIs and their corporate headquarters was they were going to remove to the legal extent possible any burdens on our eighty-eight participants.

* * * *

It seems to me that along the line here we have to, as realistic managers and [in] recommendations to our staff, is not lean on the financial advisers as to the methods [of implementing the program] but get right down to the very heart of it. Shouldn't we, if we're taking additional burdens and risks, call in the beneficiaries, and the beneficiaries are the publics [publicly-owned utilities] that are not the eighty-eight, are the DSIs, tremendously the DSIs, who are right now curtailed on their quartile, bring them back to the table, and at least put us back to the same level of protection which they legally could do that we were when we got into this. 220/

Although an extension of the DSIs' commitment to take power would not reduce the risks to Participants arising from the short term debt, it would relieve the Participants of having to take expensive power which they might not need if the projects were completed. 221/ The Participant's concern that

220/ Participants' Committee meeting of October 16, 1980. (Tape 99(a) (S-1) at 190-96, 209-19.) The Participants' Committee meetings were tape recorded.

221/ Participants' Committee meeting of October 16, 1980:

Speaker: The region right now is 1% of what it was a year ago and when
(continued...)

there would be unneeded power from the projects appears to have been based on the Participants' Committee's knowledge that forecasted load growth was declining and that actual usage was lower than had been forecasted, as described above. 222/

221/(...continued)

we started this it looked like 6-7% [growth in power demand] a year. I can visualize with the high rate of prime money and a lot of other things that --

Speaker: You can visualize having [Projects Nos.] 4-5 [power] and no place to market it, right?

Speaker: The reason, Don, is that you're going to have to make some decisions fairly soon on resources and expansion and if you make the decision to expand based on some forecasts in our case that looked at 7-8% growth, load growth, you could easily get caught in a situation of no place to peddle it, or no assured place of peddling it. And that additional ability to assign to the DSIs is from our prospective a real advantage and its gone now, as Bob points out. The delays have basically deteriorated that advantage to zero.

(Tape 99(a) (S-1) at 487-98.)

222/ See discussion in Part II C, supra. The awareness of dropping growth rates also came up later in the meeting when an R.W. Beck representative explained that anticipated drops in power demand growth indicated that the Participants should be concerned about the agreements with the DSIs because there could be more excess power from the projects in certain periods than the industries would be obligated to take under their existing agreements:

(continued...)

The immediate issue that caused the Participants' Committee to revisit the role of the Participants in the projects was the requested change in the Participants' Agreements to permit the sale of short and intermediate-term debt under the Balanced Financing Program. The Participants' Committee was aware that the Balanced Financing Program was

222/ (...continued)

Speaker: Historically what's happening is that every year the loads fall off and off and off and if they fall off an average 400 megawatts in '91, '92, you've got a problem. That's why you need the extension [of the existing DSI agreement to take power].

* * * *

Basically, at this point, based on this analysis, if the total participants loads drop five percent, then the net result is that in '86-'87, '87-'88, and '89-'90 you cannot shove it all to the industries.

* * * *

Right now in '86-'87 the load forecast is 6,058 average megawatts. If you reduce that by 5%, you come up with 5,755 megawatts.

* * * *

Speaker: That's certainly a credible 5% reduction.

Speaker: Yeah.

(Tape 100(a) (S-1) at 553-574.)

important to the continued financing of Projects Nos. 4 and 5. 223/
The Participants' Committee was thus faced with the need to
take on new obligations on troubled projects while others for
whom the projects also were undertaken were not sharing the
burden.

223/ Participants' Committee meeting of October 16, 1980:

Speaker: We're looking at the assessments, I think, of risks all the way along here. You know the only reason - you know one of the main reasons we've come forth with this concept of the Balanced Financing program is that there is a perceived risk to the existing financing program.

Speaker: Well isn't there a question - would this be a fair statement: There is a question raised of the ability to complete both 4 and 5 without a Balanced Financing Program? Somebody has mentioned that that's a possibility, that you might not be able to complete 4 and 5 financing unless we have a balanced financing [program].

Speaker: That's the rationale for the short term [debt program].

Speaker: In fact those comments came from some of the investors themselves, yes.

(Tape 99(a) (S-2) at 014-31).

One of the Participants' Committee members had recent direct knowledge of the financing situation from the meeting on September 17, 1980 with representatives of some of the largest institutional purchasers of Supply System bonds, described above. The member concluded that there was serious doubt about the ability to complete the financing for Projects Nos. 4 and 5. Memorandum from E.E. Coates to Participants' Committee File at 1-2 (Sept. 22, 1980). (SEC Exh. 269.)

In this situation of troubled projects, of the request for new obligations from the Participants, and of a desire to get a sharing of the burden, the Participants' Committee discussed the desirability of considering delaying, selling, or terminating the projects in connection with discussions with the BPA and the DSIs:

Speaker: Are there any benefits for discussion of deferring those projects in connection with our discussions with both BPA and the DSI's?

Speaker: I think there is a lot of benefit in looking at it.

* * * *

Speaker: The other possibility besides delaying the projects is to sell off a portion, that is, actually open up and sell off an additional portion, as many utilities have done, too, on some projects.

Speaker: There's another option: that's cancel it. 224/

Expected reductions in power demand forecasts and financing problems were seen as presenting a situation which might warrant consideration of delay or cancellation of the projects. 225/

224/ Participants' Committee meeting of October 16, 1980.
(Tape 99(a) (S-2) at 123-30, 157-62.)

225/ Participants' Committee meeting of October 16, 1980:

Speaker: Bonneville in their proposed allocation is requiring for the conservation portion of the

(continued...)

225/(...continued)

allocation -- looks at the load forecast. They are talking about the expected load forecast they will have at the end of the year. This raises another concept. If there is 15% conservation possible in the region, then forecasts are going to be changed. They will be reflected. If that's the case, then we're also looking at a change in the need for all the participants for the 4-5 projects. It does seem appropriate that that be addressed in the context of identifying what the needs are; the timing of those needs, particularly in relation to the project delays; the conservation impact and the slowing growth rate, to see if one of these options shouldn't be promoted.

Speaker: Similar to that there are other plants being considered for roughly the same time frame as 4 and 5, on-line basis, such as Creston, Boardman, Idaho Falls. All those things added in, and the uncertainty in financing 4 and 5, or to whatever extent there is an uncertainty, which seems to be a considerable one, and I don't know the answers by any means, but there's enough there that you start worrying a bit, could merit actually termination [sic]. And I'm not advocating it by any stretch of the imagination, but when you start thinking in terms of delays, or of problems of financing, one of the options has to be termination.

Speaker: Obviously when you consider your
(continued...)

The Participants were also concerned that if even the tentative consideration of alternatives, such as slowdown or termination, in negotiations with the DSIs and the BPA became public, it could cause a negative reaction in the financial community. As pointed out by one of the members, however, if the situation could not be resolved favorably to the Participants, the Balanced Financing Program probably would not be approved and the projects would not be completed anyway:

Speaker: We can all agree to that, [dealing with the BPA and the DSI's and raising alternatives], or, if we did all agree to it, the next and hardest question is what do you do, because as soon as you put out anything like what we're suggesting, the repercussions could be horrendous You may do yourself more damage just by publicizing the fact you're considering or analyzing delay, termination or whatever.

Speaker: It could affect your bond rating on the very next issue.

Speaker: Well, if you say to the world that you've got to have balanced financing or the project's dead, and one of the eighty-eight decides it doesn't like the idea, you've done it. 226/

The disclosure of the Participants' deliberations concerning possible courses of action undoubtedly would have caused a

225/(...continued)

options you have to take the whole spectrum.

(Tape 99(a) (S-2) at 163-201.)

226/ Id. at 251-65.

negative reaction in the financial community because the Participants' support for the projects was important. These deliberations were inconsistent with the impression conveyed in the official statements and with the position taken by the Participants in public that the projects were needed and definitely would be completed. 227/

The committee members then considered how they should proceed. They decided to meet with the BPA as part of the effort to get the BPA and the DSIs to share some of the burden of the projects and to ask the Supply System to conduct a secret study of the feasibility of delay or termination. 228/

227/ For example, at a meeting with institutional investors in September, 1980, described above in Part II B, an institutional investor had expressly asked whether there was any possibility of cancelling the Projects and had been told that the Projects would be completed:

- Q. Was cancellation then something you were suggesting to them?
- A. I do not know if I was suggesting it, I was just asking. I thought it was an option that they had.
- Q. What was their reaction?
- A. They said, definitely not, these plants will be completed, there is no question about it. These were the guys from the PUD's [public utility districts].

Carl P. Jayson SEC tr. at 67 (Nov. 27, 1984).

228/ Participants' Committee meeting of October 16, 1980:

Speaker: In answer to Dave's question - I presume that was a question - where do we go from here, I would
(continued...)

The Participants' Committee formed a subcommittee to negotiate with the BPA and the DSIs. Because they wanted to keep their plans confidential, the Committee members drafted the resolution establishing the subcommittee in a way that would not disclose its purpose or the relation of its work to the Balanced Financing Program. The formal motion made was to "establish a subcommittee to work on what the Participants' Committee perceives as problems with the short term sales

228 / (...continued)

think that a meeting with - that a committee or group calling on the Administrator [of the BPA], expressing these concerns in private, not necessarily with the Seattle P.I. [Post-Intelligencer newspaper] present, we might sound out, express the concerns in a very forceful way and maybe get help in approaching the DSI's.

* * * *

Speaker: At the same time I'd sure like to see a staff analysis of some of the things we were looking at [delay and termination] and I don't mean a real detailed -- I mean a very clandestine, hurry-up sort of analysis of the sorts of things we were discussing. Because I think we keep batting these things around but if on the surface of them they don't make sense, then I'd hate to see us surface them. I'd hate to see it come up because of the potential it has for blowing it sky-high.

(Tape 99(a) (S-2) at 273-306.)

agreement [with the DSI's] and other related matters." The vague phrasing was intentional:

Speaker (the person making the motion): We don't have to go public with exactly what we've been saying here today but we could officially get a subcommittee going and we could just let people wonder out there in the world what the hell we're really about by just simply saying this committee is going to work on what we perceive as problems with the short term sales agreement and other matters. 229/

The minutes did not describe the concerns that were expressed or the discussion of available alternatives.

Three members were appointed to the subcommittee. It was agreed that one of them would notify the members of the full committee of the date of the meeting with BPA so that any interested members could attend. 230/ The Participants'

229/ Id. (Tape 99(a)(S-2) at 484-88.)

As to the whole discussion, the minutes state only that "The Committee then entered into a lengthy discussion regarding the Short Term Sales Agreement." This is followed by the intentionally cryptic motion, described above. The omission from the minutes Participants' Committee minutes was unusual because the minutes were customarily exhaustive and were often almost word-for-word accounts and the discussion of these subjects occupied most of the meeting.

230/ It was also suggested that subcommittee members also make telephone calls to the BPA and the DSIs and tell them that this was a serious matter and that the motion had been intentionally written in vague terms to avoid making the matter public:

Speaker: I think Al should feel free to even indicate to these people that the problem was of such a serious nature that we didn't really even -- that's why we

(continued...)

Committee also asked the Supply System employee who also acted as both the Committee's secretary and the Supply System's liaison to the Committee, to have the Supply System develop guidelines for a study which would include options of delay or termination of either or both plants. 231/

c. Meeting of Participants' Committee Members with the BPA

On October 21, 1980, six of the seven members of the Participants' members met with the Administrator of the BPA and other BPA officials. 232/ The BPA was told that a number of alternatives were being discussed. The alternatives included

230/(...continued)

worded the motion rather weakly. We didn't want to surface it to the public at this point in time because we felt it was very, very serious and needed some serious quiet discussion.

Speaker: Yeah, the fact that it is so serious that simply discussing it has a ripple effect -- that it could be uncontrollable.

Id. (Tape 99(a)(S-2) at 531-36.)

231/ Id. (Tape 99(a)(S-2) at 543-55.)

232/ Memorandum from E.E. Coates to WPPSS Participant's File (Oct. 24, 1980) (memorializing the meeting with the BPA, with copies to other utility personnel) ("The meeting was established as a result of actions taken at the last Participants' Committee meeting stemming from concerns expressed by the Participants over WPPSS's ability to complete the financing of the projects."). (SEC Exh. 1217.) See also, Edward Coates SEC tr. at 184-87 (Sept. 30, 1985).

The Supply System employee who was liaison to the Committee and was the Committee's secretary also attended.

greater sharing of the burdens of the projects by the BPA and the DSIs, sale of the projects, and extension or termination of the projects. 233/ BPA representatives were shocked by what they were told and were concerned that such discussions by the Participants could harm the marketability of the bonds. 234/ The Participants' Committee representatives responded that other beneficiaries of the projects had not come forward to

233/ Memorandum from E.E. Coates to WPPSS Participants File at 1-2 (Oct. 24, 1980) (SEC Exh. 1217):

A number of mitigative alternatives were discussed including (1) extension of assignment agreements [with the DSI's], (2) BPA's execution of short-term purchase authority, (3) stretch-out of one or both projects, (4) sale of interest in projects, and (5) mothball and/or terminate projects.

Harlan Kosmata SEC tr. at 412-13 (May 30, 1986); Edward Coates SEC tr. at 187-93 (Sept. 30, 1985).

234/ Notes of David Piper (Oct. 21, 1980) (SEC Exh. 1424):

BPA was very concerned (upset even) when we told our plans for examining the options to the balanced financing program.

- (a) Termination
- (b) Sale
- (c) Delay

Memorandum from E.E. Coates to WPPSS Participants' File at 1 (Oct. 24, 1980) (SEC Exh. 1217):

BPA also appeared taken aback and expressed concern that Participants were even considering stretch out or termination of these needed regional projects and pointed out that such discussions could adversely affect marketability of securities.

Edward Coates SEC tr. at 192-93 (Sept. 30, 1985); Kosmata SEC tr. at 412-13 (May 30, 1986).

assume risk on the projects and that they wanted to look at alternatives. 235/ The tenor of the meeting was confrontational. 236/ The BPA official agreed to approach the

235/ Memorandum from E.E. Coates to WPPSS Participant's File at 1-2 (SEC Exh. 1217):

It was also pointed out that other beneficiaries of the projects have not stepped forward to assume part of the risk. In addition, prudent utility practice dictates that alternatives be examined in the event financing to complete the projects cannot be obtained. Participants' concerns were placed into three general categories:

- (1) the ability to finance the balance of the 4/5 projects with or without balanced financings,
- (2) the ability to market output (short term) from the projects,
- and (3) dry hole risk sharing.

See Harlan Kosmata SEC tr. at 415-17 (May 30, 1986).

236/ Harlan Kosmata SEC tr. at 415-17 (May 30, 1986) (Supply System liaison to the Participants' Committee):

Well, I think again the character of this meeting was a hard ball negotiating meeting. As I remember the mood of the participants, they were just getting absolutely tired of being the only apparent parties in the region who were financially exposed on generation projects. They saw themselves as on the hook for these projects and nobody else was sharing any financial liability.

And yet when they went into these things, everybody was supposed to be sharing the responsibility and the benefits. They clearly saw themselves as being out there by themselves at this point, and they were in this meeting to tell Bonneville that they were tired of Bonneville and the DSIs, who they felt Bonneville had a lot of

(continued...)

DSIs and explore an extension of the short term sales agreement. 237/ They doubted, however, that the DSIs would be willing to amend their agreements because they had no incentive to do so. 238/ The officials also agreed to explore possible short term or long term purchase of the projects' capacity but doubted that it would be feasible. 239/

236/(...continued)

negotiating position to deal with, that neither Bonneville nor the DSIs had any risks in these projects and yet the participants fully were bearing the risk, and that they were getting damn tired of that situation. They just were, in effect, in turning to Bonneville and others, saying it's time that other people step up.

And then in making that discussion and making their points, they went through potential ways in which things might occur, including the list of things said here. But I regarded it again as a negotiating position but, in effect, they were saying if we have to, if you, Bonneville, and if you, DSIs, won't come back into a position of sharing the financial obligations here, we are willing to essentially cut off this. The hell with it. We'll step aside. We will pay off what we owe and let you, Bonneville, decide how you are going to get power to meet your obligations under the act, and you can tell the DSIs how you are going to get them power which you [are] deem[ed] to have.

Now that's the kind of conversation that was going on there.

237/ Memorandum from E.E. Coates to WPPSS Participant's File at 2. (SEC Exh. 1217.)

238/ Id.

239/ The BPA's authority to make short-term purchases of power extended for only 5 years and the Projects might not even
(continued...)

The events at the October 16, 1980 Participants' Committee meeting and the meeting with the BPA were kept confidential because of their possible impact on the financing of the projects. 240/ The Supply System knew of these events because its liaison employee attended the meetings and reported both meetings to his superiors. 241/ No disclosure of the deliberations or actions was made by the Supply System and the affirmative representations in the official statements about the Participants' support were not changed.

d. Efforts to Get Direct Service Industries To Extend Their Agreements and To Get BPA To Buy the Output or Capacity of The Projects

Participants continued to try to get relief through the DSIs and the BPA up to the announcement of the moratorium on May 29, 1981. These efforts were largely unsuccessful because the Participants had little leverage and there were

239/ (...continued)

be completed in that time period. Long-term purchase would require compliance with procedural processes and with a priority scheme that put expensive nuclear projects at the bottom of the acquisition priority. Id.

240/ Id. at 3:

Because of potential impact upon financing of the projects, some of the alternatives discussed are considered confidential and are not reported in Committee minutes.

See also discussion on the October 16, 1980 Participants' Committee meeting, supra.

241/ Harlan Kosmata SEC tr. at 431-32, 442-43, 445-49 (May 30, 1985). See also Supply System Inter Office Memorandum to D.O. Karlberg from S.M. Buck 3-4 (Oct. 20, 1980) (referring to subjects discussed in Oct. 16, 1980 Participants' Committee meeting). (SEC Exh. 2542.)

restrictions on what could be done. The DSIs resisted. They were purchasing extremely cheap power from BPA. The purchase expensive Projects Nos. 4 and 5 power would have increased their costs enormously. 242/ The negotiations with the BPA were ultimately no more productive because the BPA's purchase of the power or capability of the projects was subject to procedural requirements and cost tests.

2. Termination and Slow-down Study

The Supply System complied with the Participants' Committee's request for a delay or termination study. 243/ The memorandum initiating the study was worded in a way that deflected the significance of the fact that the request came from the Participants. It cautioned on the alarm that word of the existence of such a study could cause and spoke of the study as a normal Supply System undertaking to assess changing circumstances, making only an oblique reference to the "needs and special situations which may be confronting our project participants." 244/

242/ See Memorandum from Harlan Kosmata to Distribution (January 30, 1981).

243/ Harlan Kosmata SEC tr. at 431-38, 442-43, 445-49 (Oct. 21, 1986). See also James Perko SEC tr. at 643 (June 13, 1985); Robert Ferguson SEC tr. at 175-77 (June 27, 1985) and at 398-408 (July 24, 1985).

244/ Memorandum from R.L. Ferguson to P.K. Shen, Project Evaluation Analysis (Oct. 31, 1980). (SEC Exh. 1577.) Whether the Supply System also decided to do a study, the study was a result of the Participants' Committee. Harlan Kosmata SEC tr. at 431-32:

(continued...)

The existence of the study itself could not be kept confidential. Several days later newspapers in the Pacific Northwest published articles about the study. The articles appear to have originated from statements by a member of the Board of Directors that the budget committee of the Board had requested information on the costs of delay or termination to enable it to counter critics of the projects. 245/ The Supply System Managing Director is quoted as assuring that the initiation of this study did not have any particular significance. 246/ Neither the Supply System's disclosures to

244/ (...continued)

Q. Was the origin of this request for a study both the participants and the Supply System itself?

[colloquy between counsel]

A. To my recollection it was somewhat simultaneous. It was brought up in a discussion at the Participants' Committee at one of the Committee meetings, and I concurred, believed that it was appropriate to do. I carried that message back to Mr. Squire, Mr. Ferguson, Mr. Shen and essentially we decided to respond in this manner and to initiate these studies.

245/ See, e.g., WPPSS Mulls Mothballing 2 N-Plants, Tacoma News Tribune (Nov. 7, 1980); WPPSS Eyes Cost of Shelving Plants, Seattle Times (Nov. 7, 1980) ("Rather [than a step toward abandonment], Welch [a Board member] said, the board wants to collect accurate cost projections with which to respond to critics who want to close down some of the costly nuclear plant construction projects.").

246/ WPPSS Considers Construction Halt, Daily Olympian (Nov. 8, 1980) ("I don't think the issue is the scrapping of the
(continued...)

the press nor the official statements revealed the critical fact that the Participants' Committee had requested the study as a result of its growing concern about the Participants' role in the projects. As the cash flow and financing problems became critical, the delay and termination studies reflected those problems as well as the Participants' Committee restiveness. 247/ By early December 1980, it had been determined that the study of a slowdown would include analyses

246/(...continued)

two projects,' Ferguson said. 'We're looking at a total range of options, it's just prudent management.' Ferguson confirmed an earlier report that the WPPSS budget committee asked staffers last month to start studying the cost to WPPSS of curtailing work at the two plants."); Construction May Stop At Two Nuclear Plants, Tacoma News Tribune (Nov. 8, 1980); WPPSS Plans To Look At Nuclear Plant Cutbacks, Seattle Post Intelligencer (Nov. 8, 1980).

247/ The critical cash situation had been noted by the head of the delay and termination studies in connection with the December 1980 Projects Nos. 4 and 5 bond sales discussed above in Part II B:

At the Participant's Committee meeting on the following day in conjunction with the [December 1980] bond sale for Projects 4 and 5, I participated in a management discussion regarding options on the bid offer and actively supported the need to accept the full bond issue, pointing out the need for additional time to prepare reasonable alternatives. It was clear in this meeting that the very limited amount of cash still remaining gave us no reasonable option and it was further very evident that there is a real need for carefully prepared corporate analyses of alternatives so that management will be able to exercise some level of control in consideration of future bond offerings.

Memorandum from H.K. Kosmata to P.K. Shen (Dec. 11, 1980).
(SEC Exh. 1582.)

of two approaches in order to protect the cash flow: a slowdown that would try to protect the completion date as much as possible and a "full stop" action where the only continuing activity would be protecting the work site and all other activities would completely stop. 248/

The results of the delay study were announced in March, 1981. 249/ It concluded that delay would involve substantial

248/ Memorandum from H.R. Kosmata to Distribution List (Dec. 4, 1980) (recording meeting of alternative analysis group). (SEC Exh. 1579.)

Information for a termination study was to be gathered along with the information for the delay study but the termination study itself would be done after the slowdown study. The goal for the termination study was to complete it in time for the 1982 fiscal year budget review which would be done in the late spring of 1981. The assumption in the study was a termination date of July 1, 1981. Memorandum from H.R. Kosmata to Distribution List (Dec. 4, 1980) ("It was also noted that a termination analysis needs to be prepared in time for the review of the 1982 construction budget We will take this approach [of gathering information during the slowdown study] with the assumption that termination could commence on July 1, 1981.") (SEC Exh. 1579 at p. 3.) At the time of this planning, the Supply System knew that the November 1980 interim budget estimate, which had not been publicly disclosed, showed a \$4.4 billion increase in the budgets for the five Projects. See Part II A, supra. It would have been reasonable for the Supply System to assume that the 1982 budget could rise at least that much and that, given the financing situation and the rising cost of power from Projects Nos. 4 and 5, the Projects could be subject to possible termination when the 1982 budgets were announced.

249/ The results of the delay study were announced after a report on the Supply System by a Washington State Senate Committee referred to the study. Causes of Cost Overruns and Schedule Delays on the Five WPPSS Nuclear Power Plants, Washington State Senate Energy and Utilities Committee WPPSS Inquiry at 6 (Jan. 12, 1981). (SEC Exh. 1158.) It appears from the report that although the State
(continued...)

extension of the schedules and would thereby cause enormous increases in total costs. The Supply System therefore announced that it had concluded that the cost of any delay would be prohibitively expensive.

3. Lack of Participant Support To Complete the Projects

Nonetheless, the increasing problems with the Projects Nos. 4 and 5, including costs, financing, and questions of need for projects, 250/ forced the Supply System Managing Director on May 29, 1981, to recommend a moratorium on construction of the projects. In response, the underwriters informed the Supply System that further financing could be obtained only if the Participants agreed to pay 50% of the interest on the bonds on a current basis. 251/ This would lessen the amount of financing to be raised and would demonstrate the Participants' commitment to the projects.

When the change, which would have required each of the Participants to amend its Participants' Agreement, came before the Participants' Committee, 14 of the Participants, representing approximately 8% of the shares, voted against the resolution and Participants representing approximately another

249/ (...continued)

Senate conducted an extensive inquiry, the inquiry staff was not told of the events of the Participants' Committee meeting of October 16, 1980 and related events, including the Participants' Committee request for delay and termination studies.

250/ See Part II A, B and C, supra.

251/ See Part II B, supra.

30 percent of the shares indicated that the risks of the projects would have to be shared by other utilities and major customers in the region as a condition to a change in their Participants' Agreements. 252/ The necessary changes to the Participants' Agreements were not made, and no further financings were attempted. Attempts to preserve the projects in a state of suspension through regional financial support failed, and on January 22, 1982, the projects were terminated. On termination, the Participants were called upon to meet the terms of the Participants' Agreements, requiring them to pay for the projects whether or not they were completed. While some Participants indicated that they were willing to pay, when the bond trustee sought a declaratory judgment on the Participants' liability, many of the Participants opposed the liability.

252/ Minutes of the Participants' Committee meeting of August 27, 1981; Official Statement for \$750,000,00 Washington Public Power Supply System Bonds Revenue Projects No. 1 Series 1981D, No. 2 Series 1981A, and No. 3 Series 1981B (Sept. 4, 1981).

PART III

THE MARKETING OF PROJECTS NOS. 4 AND 5 BONDS

A. THE UNDERWRITERS

1. Introduction

a. Role of the Underwriters

Underwriters play a central role in the sale of municipal bonds. They purchase bonds from municipal issuers and sell them into the market. They also distribute the official statement, the key disclosure document in sales of municipal bonds, to their customers. ^{253/}

There are two forms of municipal bond sales by issuers to underwriters, competitive sales and negotiated sales. In a competitive sale, the issuer offers the bonds to underwriters in a sealed bid auction after circulating a preliminary official statement. Underwriting firms form syndicates to bid on the bonds. The syndicate offering the best bid, usually the lowest interest cost to the issuer, wins the bid.

In a negotiated sale, the issuer selects an underwriter to lead the underwriting. The underwriter then helps prepare the official statement and conducts an investigation into the adequacy of disclosure in the official statement. It advises on timing, price and structure for the sale of bonds. When the issuer agrees to offering terms, the underwriter and the

^{253/} Underwriters are required by the Municipal Securities Rulemaking Board rules to supply copies of official statements to their customers when the issuer produces an official statement. Rule G-32 of the Municipal Securities Rulemaking Board.

syndicate it has formed buy the bonds and sell them to the market. All of the Supply System Projects Nos. 4 and 5 bonds were competitively bid, under the requirements of Washington state law, with the exception of the May, 1980 sale, which was partially negotiated. 254/

During the period in which the Projects Nos. 4 and 5 bonds were offered to the public, only two syndicates bid on the offerings. Salomon Brothers Inc. and Merrill Lynch, Pierce, Fenner & Smith, Inc. led one syndicate and Smith Barney, Harris Upham & Co., Inc. and Prudential-Bache Securities, Inc. led the other syndicate. 255/ The syndicate led by Smith Barney and Bache was the successful bidder in seven out of nine offerings prior to the May 1980 offering that was partially negotiated. Thereafter, the Smith Barney and Bache syndicate joined in the bid of the Merrill Lynch and Salomon Brothers syndicate so that the Supply System received only one bid on each of the five subsequent offerings. 256/

254/ See discussion below.

255/ One of the two firms in each group acted as the managing underwriter for each offering.

256/ The winning syndicates, indicated by the senior manager on each Projects Nos. 4 and 5 bond sales, were:

<u>Sale Date</u>	<u>Par Value</u> (Millions)	<u>Managing Underwriter</u>
2/23/77	145	Smith Barney
5/24/77	90	Bache
9/13/77	130	Bache
1/31/78	150	Salomon
5/23/78	150	Smith Barney

(continued...)

The underwriting firms did not have day-to-day involvement with the Supply System. They did not participate in the drafting of the official statements. They did not conduct investigations of the disclosures in the Supply System's official statements as they customarily did in negotiated sales of bonds. Despite the concentration of the bidders into two groups, and finally into what was effectively one group, the underwriters stated that in these competitive offerings they did not know whether they would win the bid until the sale was awarded and thus could not conduct such an investigation. They contended that they evaluated the creditworthiness of the bonds in conformity with their normal business practices but that they were not in a position to verify the disclosures in the official statement and relied instead on the issuer and others who provided information for the official statement and on certificates of adequate disclosure provided to the underwriters at the closings on the bonds. 257/ They contended

256/ (...continued)

10/12/78	170	Bache
2/14/79	175	Merrill Lynch
8/28/79	150	Smith Barney
12/11/79	200	Smith Barney
5/09/80	130	Merrill Lynch
7/15/80	180	Salomon
9/23/80	180	Merrill Lynch
12/09/80	200	Salomon
3/17/80	200	Merrill Lynch

257/ See Submission in Opposition to Issuance of a Staff Report 60-70 (1987) (submission to the SEC by counsel for the lead underwriters of Projects Nos. 4 and 5 bonds).

The final official statement for each offering contained a
(continued...)

that the law does not require them to conduct investigations and that it is not industry practice to perform them in competitive sales. 258/

The staff investigation sought to determine (1) whether the underwriters had knowledge that would indicate that the official statements misrepresented or failed to disclose material information and (2) whether the practices of the underwriters in these sales were consistent with protection of investors. It appears that the underwriters did not know of

257/(...continued)

statement about the role of the underwriters with respect to information in the official statement that stated:

The information contained in this Official Statement has been obtained from the Supply System and other sources deemed reliable. No representation or warranty is made, however, as to the accuracy or completeness of such information, and nothing contained herein is, or shall be, relied upon as a promise or representation of the Underwriters. . . . No dealer, salesman or other person has been authorized to give any information or to make any representations, other than those contained in this Official Statement in connection with the offering of the [this series] Bonds, and if given or made, such information or representation must not be relied upon. The information and expressions of opinion herein are subject to change without notice and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the matters described herein since the date hereof.

Official Statement for \$180,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1980C (Nuclear Projects Nos. 4 and 5) at (i) (September 23, 1980).

258/ See Submission in Opposition to a Staff Report, 60-70 (1987).

significant developments affecting the bonds that were concealed by the Supply System such as the November 1980 estimate of a \$4.4 billion budget increase or the Participants' Committee's request for delay and termination studies. They were, however, aware from information generally available to the financial community that Projects Nos. 4 and 5 were experiencing problems. It appears that the underwriters did not investigate disclosure of the problems as they might have done in a negotiated offering. 259/

b. Underwriter Sources of Information

(1) Organization of Underwriting Firms

Several organizational units in the underwriting firms were involved in collecting information about municipal bonds, including the Supply Systems bonds. The underwriter firms had municipal bond underwriting, or syndication, units that were responsible for acquiring and selling the bonds being issued by the Supply System. They formulated the bid and, if they won the bid, distributed the bonds to the syndicate and to the public through institutional salespersons connected to the unit

259/ See discussion, infra, on May 1980 negotiated offering for a description of underwriting obligations and practices. See also, e.g., Section of Urban, State and Local Government, American Bar Association, Disclosure Roles of Counsel in State and Local Government Securities Offerings (1987) (from a project sponsored by Subcommittee on Municipal and Governmental Obligations, Committee on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, American Bar Association; Section of Urban, State and Local Government Law, American Bar Association; and Committee on Federal Securities Law, National Association of Bond Lawyers) [hereinafter cited as Disclosure Roles of Counsel].

and through the separate retail sales organization of the firm. 260/ The individuals acting as underwriters in the underwriting unit were knowledgeable about the market for bonds, but were less likely to be familiar with substantive information about the issuer.

The underwriting firms also had public finance units that were the investment bankers for municipal bonds. In negotiated bond sales, they solicited business and, if their firm was selected as managing underwriter, worked with the issuer to prepare the offering, including assisting in the preparation of the official statement. In competitive underwritings, the underwriter did not engage in these activities. As a result, the public finance units usually did not develop detailed knowledge of the issuer. Because all but one of the Projects Nos. 4 and 5 bonds offerings were sold competitively, the public finance units were usually not involved in the Supply System and the sale of its bonds. 261/

The underwriting firms also had municipal bond research units that produced research on bonds. 262/ Research reports were sent to potential customers, including institutional investors. The research units also sometimes produced more

260/ A trading desk, also usually connected to the underwriter-syndicate unit, facilitated the sales activity and traded the bonds in the secondary market.

261/ Smith Barney public finance unit officials stated that they were involved, in conjunction with the research department, in reviewing the Supply System bonds.

262/ Salomon did not have a research department.

abbreviated information circulars for the use of the firm's salespersons in offerings of the bonds. When bonds were sold through competitive sales, the research unit was often the unit with the most substantive knowledge about the issuer 263/ and could be called upon by the underwriters for information and opinions. 264/

(2) Sources of Information about the Supply System and its Bonds

The underwriters' information about the Supply System and the Projects Nos. 4 and 5 bonds came from several sources in addition to the official statements. One source was direct contacts with the Supply System that occurred when some of the underwriters occasionally made courtesy or business calls on the Supply System. Personnel from some of the underwriters also occasionally attended luncheons or dinners with Supply System representatives when the latter came to New York to meet with the rating agencies and to make presentations to the investment community in connection with upcoming bond offerings. Also, prior to and during the Projects Nos. 4 and 5 bond offerings, an advisory group composed of representatives of the principal underwriters met with the Supply System from

263/ Research unit analysts also usually learned about market activity for bonds from the firm's institutional salespersons, from the trading desk, and from institutional clients.

264/ The Smith Barney research analyst on the Supply System bonds, for example, was consulted when Smith Barney had to address the Balanced Financing Program. See Part II B, supra. The Merrill Lynch analyst also was called upon for information, as discussed infra.

time to time, usually at the Supply System's request, to discuss the Supply System's financing program. The substance of these various meetings with the Supply System is difficult to establish since there are few notes or memoranda on these meetings and witnesses had only general recollections. It appears, however, that most of the contacts involved discussions of the market for the bonds and not of substantive information about the projects or disclosure issues. It does not appear that in these meetings the Supply System revealed non-public adverse information. Indeed, it appears that information about significant events discussed above was kept from the underwriters. The underwriters, however, appear not to have sought substantive information from the Supply System in these meetings. Some substantive information was obtained by the research analysts in carrying out their research functions. There was also substantial press coverage of problems with the projects. Although much of this press coverage was on the construction problems and did not necessarily inform the underwriters that information was being concealed by the Supply System, it was an indication that there were problems with the projects.

The underwriters also obtained information about the market for the bonds in their role as distributors of, and dealers in, the bonds. Proper pricing and the underwriting

spread 265/ in bids were important because they affected how long it took to sell the bonds and provided a margin of compensation for the relative risk and effort required. Institutional investors were often contacted before bids were submitted to gauge their interest in the bonds. Underwriter firms also had knowledge about pricing and the market for the bonds from their trading in the bonds in the secondary market.

The underwriters have contended that there were no negative indications in the market about the Projects Nos. 4 and 5 bonds. 266/ They contend that the yields, interest rates, and underwriters' spreads on the bonds were not exceptional given the unprecedented rise in interest rates and the great volatility in the general credit markets at that time. They contend, further, that institutional investor

265/ Bonds are usually bid for on the basis of the interest cost to the issuer. The underwriter's interest cost bid equates to a dollar price which is less than the face value of the bonds. The difference between the prices is called the spread or take-down. The syndicate members that sell the bonds receive the take-down. Sales to dealers outside the syndicate are allowed at an established amount less than the face value. This is called a concession and is a portion of the take-down. Investors, usually institutions, that place orders with the syndicate at the face value of the bonds have priority. Institutional investors can also negotiate with syndicate members to buy at concession prices, but then cannot be assured that they will get the bonds. Retail sales by underwriting firms to their individual customers are made at the face value of the bonds, with the account executive getting credit for a portion of the spread.

266/ See Submission in Opposition to Issuance of a Staff Report, supra, 69-87 (1987).

interest remained high 267/ and that the market was unimpaired. They also contend that they did not doubt, while they were selling Projects Nos. 4 and 5 bonds, that the projects could be financed to completion. They contend that the market merely reflected the public information about the bonds and thus would not reveal undisclosed problems. Finally, they contend that information about the market, the state of the financing program or any other information was immaterial because the bonds were secured by the Participants' obligation to pay.

The market for municipal bonds was becoming volatile and interest rates were increasing to unprecedented levels during the sales of Projects Nos. 4 and 5 bonds. This, and the increasing volume of the bonds, explains some of the high interest rates and spreads on the bonds. Also, some of the shift in the types of purchasers was the result of general developments affecting some types of purchasers, such as the decreasing need for tax-free investments by insurance companies. It does appear, however, that the Projects Nos. 4 and 5 bonds were experiencing adverse changes that reflected problems peculiar to those bonds. Supply System bond yields were higher than the yields on bonds issued by other electric power joint operating agencies that were involved in nuclear

267/ Underwriter figures on institutional participation, however, apparently included purchases for unit investment trusts, which are sold largely to individuals, see Part III C, infra, and purchases by intermediaries.

power. 268/ Moreover, the shift to purchases by unit investment trusts occurred to a greater degree than would be expected from the market changes in general. 269/ In addition, the Projects Nos. 1, 2 and 3 bonds, which were backed by the BPA, did not experience the same degree of change in yield, spread, or purchase patterns as did the Projects Nos. 4 and 5 bonds.

It may be that the underwriters did believe, during the time that bonds were being issued, that the projects could be financed to completion because sufficient buyers, individual or institutional, could be found through higher interest rates. Such belief, however, would be reasonable only under favorable conditions. The growing problems, some not disclosed to, or discovered by, the underwriters, were changing the conditions. Indeed, after the recommendation of a moratorium on construction by the Supply System management in May 1981, the underwriters concluded that further financing was not practical under the existing arrangements.

The underwriters may have relied on the existence of Participants' obligations for the payment of the bonds.

268/ See discussion and chart in Part III C, infra. The increase in the volume of the bonds that explained some of the higher yield was caused by the cost overruns that indicated problems with the Projects.

269/ See discussion in Part III C, infra.

Problems with the projects, however, still would be material. 270/ The projects were the reason for the sale of bonds and were expected to generate revenue that could help pay for the bonds. Moreover, the failure of the projects could affect the willingness of the Participants to meet their obligations. The Participants' Agreements, finally, contained untried and untested elements, 271/ although there is no evidence the underwriters realized this.

2. Underwriter Activities

Although the underwriters' contended otherwise, contemporaneous events suggest that the underwriters were aware of and were concerned about problems relating to project costs, power demand and the market for the bonds. 272/

270/ E.g., Edward N. Bennett (insurance company portfolio manager) SEC tr. at 42-43 (Jan. 8, 1985):

We would have no interest in going into a financing if we said, gee, we don't think that project is really feasible and it's probably never going to be completed but who cares because it's a take-or-pay contract. We wouldn't have gone into a financing with an attitude like that. We would have said that doesn't make any sense. (at 43)

271/ See Part IV, infra.

272/ The underwriters assert that even when problems were reflected in observations by the underwriters' own personnel, those observations were contrary to fact. The observations, however, appear to be consistent with the facts.

a. Early Analyst Reports

As noted above, the initial offerings of Projects Nos. 4 and 5 bonds were generally unremarkable. 273/ By 1979, however, budgets had increased, and the bonds were beginning to encounter some investor resistance. Merrill Lynch was expanding its municipal bond research capabilities at that time. An analyst was assigned to report on the Projects Nos. 4 and 5 bonds being sold on February 14, 1979. The report, distributed in the firm and to clients, expressed some concern about the bonds, including the budget increases, the increased cost of power, and potential decreases in energy demand. 274/ It expressed the opinion that the creditworthiness was equivalent to a conditional low-range A rating, in contrast to the unconditional high-range A rating of the rating agencies. 275/ One of the underwriters discussed the contents of the report with the analyst 276/ before Merrill Lynch bid on

273/ See Part II B, supra.

274/ Merrill Lynch Municipal Bond Research Report Washington Public Power Supply System, State of Washington, (Nuclear Projects Nos. 4 and 5) (Feb. 12, 1979). (SEC Exh. 2092.)

275/ Id. at 1:

In our opinion, the credit pledged to the 1979, Series A Bonds financing construction of WPPSS' Nuclear Projects Nos. 4 and 5 is equivalent to a conditional low-range "A." The conditional nature of the rating will be removed and a higher credit level justifiable only upon successful operation of the Project. Downward revision may be necessary unless timely financing and completion of the Projects occur.

276/ Susan M. Linden SEC tr. at 49-59 (Jan. 28, 1985).

the bonds and became the lead underwriter on that offering. On April 17, 1979, the analyst wrote a report on the Projects Nos. 1, 2 and 3 bonds. The report, which was also distributed in the firm and to clients, discussed the problems that were common to Projects Nos. 4 and 5, such as power costs and demand, as well as issues specifically relating to the Projects Nos. 1, 2 and 3 bonds. 277/

The reports provoked a negative reaction from the Supply Systems' Financial Advisor. The Financial Advisor expressed dissatisfaction with the reports to the head of Merrill Lynch's municipal research group. 278/ The head of the municipal research group then reviewed the critical reports by the analyst and concluded that they were accurate. He felt that the reports had touched a nerve, indicating that something was happening that warranted continued research. 279/ The

277/ The creditworthiness was evaluated as equivalent to a mid-range Aa/AA rating, in comparison to the rating services rating of Aaa/AAA.

278/ Leon Karvelis SEC tr. at 111-21 (Feb. 25, 1985).

279/ Id. at 124:

Well, because I viewed it at the time as a personal difference between Mr. Patterson [the Financial Advisor] and myself. Nevertheless, I vowed to continue doing what we were doing because as I indicated before, if we struck such a nerve obviously something was happening. Either we had the truth or the information was grossly distorted[.] [A]fter a review of her report, which I did, and on the basis of the information, as I saw it, I thought she was absolutely accurate and I felt that it

(continued...)

Financial Advisor was aware at this time that difficulties were being encountered and that Projects Nos. 4 and 5 bonds were becoming more difficult to market. 280/

An analyst for Smith Barney also noted some negative factors on the Projects Nos. 4 and 5 bonds during this period. In a February 7, 1979 analyst report, which was distributed within the firm and to clients, he downgraded the bonds from the equivalent of A+ to A. 281/ He cited the recently announced early 1979 budget increases and their likely adverse effect on projected power costs and on the Participants. 282/

279/ (...continued)

was the proper course to continue to do that work.

The meeting between the Supply System and Merrill Lynch apparently occurred in mid to late 1979 during a Supply System financing trip to New York.

The analyst who wrote the reports was also later personally subjected to an intense confrontation with the Financial Advisor in a specially arranged meeting, also attended by Supply System officials and BPA officials, during a Supply System investors tour in late October, 1979. Susan Linden SEC tr. at 75-87 (Jan. 28, 1985).

280/ See discussion in Part II B, supra, on a June 20, 1979 draft letter sent by Patterson to the Supply System.

281/ Smith Barney, Harris Upham & Co., Inc. Revenue Bond Review - New Issues (Feb. 7, 1979). (SEC Ex. 2129.)

282/ Id. at 3-4:

The Phase II [Projects Nos. 4 and 5] bonds, including this issue, are of somewhat greater concern, in that the increasing project costs would place greater pressure on the Participating municipalities in the event of a "dry hole," extended down time, or further lengthy delays in completing the facilities. (at 4)

The analyst also expressed concern about the increased financing that might impede marketability. He commented that while institutional investor portfolio managers might be able to absorb the increase in the higher-rated Projects Nos. 1, 2 and 3 bonds, their purchases of Projects Nos. 4 and 5 bonds might suffer. 283/ He reported that the yields on Projects Nos. 4 and 5 bonds had already increased relative to certain other power issuers. While recognizing the continued "relatively impressive" credit attributes, including the Participants' obligation to pay, the analyst lowered his rating based on creditworthiness and marketability concerns. 284/ He continued the rating in later reports, noting the strengths

283/ Id. at 4:

A Continuing Concern: Potential Market Saturation An additional concern for the Phase II [Projects Nos. 4 and 5] bonds would appear to be the potential for declining marketability Discussions with portfolio managers indicate that they can absorb large amounts of the Phase I [Projects Nos. 1, 2 and 3] bonds, because of the Triple-A creditworthiness. It is conceivable, however, that increased purchases of these bonds including the subordinated debt, if any, could cause some institutional buyers to lessen their purchases of the Phase II bonds, or at least to hold the line in the face of increased financing. (underlining in original)

284/ Id. at 5:

This change reflects both the slight deterioration in credit strength created by construction delays and the marketability risks concerning the Phase II bonds.

embodied in the Participants' obligation to pay and the projected low rates from the melding of hydro and nuclear power, but cautioning that the projects' economic and financing feasibility and the economic pressure on the Participants in the event that the projects were not completed were also relevant factors. 285/

b. A Meeting on Whether To Continue To Underwrite Supply System Bonds, June 1979

In June 1979, Merrill Lynch personnel met to consider the firm's role in future Supply System bond sales. 286/ Merrill

285/ Smith Barney, Harris Upham & Co., Inc., Revenue Bond Review -New Issues 4 (April 25, 1980) (re Projects Nos. 4 and 5 Series 1980A bonds) (SEC Ex. 2131):

The current issue is being sold as part of the financing program for WPPSS Phase II - Projects 4 and 5. A program of this nature and magnitude must be examined from a number of perspectives: I) The financial feasibility of the Projects; II) the economic capability of the Participants to meet their contractual obligations under the "hell or high water" provisions of the Participants Agreements if the Projects are not completed; III) the likelihood that the Projects will be completed and operated in the face of number of potential roadblocks; and IV) the ability of the System to market the massive amounts of bonds required to complete the Projects and the Phase I Projects. In light of these factors, the major weaknesses of the Bonds continue to be 1) possible difficulties in placing the amount of bonds required, 2) the continuing delay in the Commercial Operation dates and the resultant escalation of projected costs, and 3) economic pressure on the Participants in the event of a "dry hole."

286/ Memorandum from Richard J. Ackermann to the attendees of the meeting (June 14, 1979) (SEC Exh. 2019):
(continued...)

Lynch's Supply System analyst had learned at a Supply System pre-sale information luncheon for the investment community on a pending Project No. 1 bond sale that (1) new cost increases for the five projects would be \$1.3 billion; (2) a subordinated debt financing program on Projects Nos. 1, 2 and 3 was cancelled because two of the Participants did not approve the program; and (3) an initiative petition had been placed on the November ballot that would require such stringent environmental controls that, in the Supply System's view, the Supply System's projects could not be operated. 287/ The meeting was attended by the head of the capital markets group and his assistant and by senior personnel in the underwriting and syndication unit, in the public finance unit, and in the research unit.

At the meeting the analyst gave a presentation on the Supply System. She discussed the cost overruns, the additional financing needed, and the construction status. 288/ She also discussed the possible softness in the forecasts of power

286/ (...continued)

As a result of our Power Analyst Sue Linden's attendance at Washington Public Power Supply System information luncheon held June 12, three significant points prompted a meeting . . . to determine the long-range posture of Merrill Lynch's role in future financing.

Leon J. Karvelis SEC tr. at 161-63 (Feb. 21, 1985).

287/ Notes taken by Robert Zipf of conversation with the analyst prior to the meeting at 2-4. (SEC Exh. 2019.)

288/ Leon J. Karvelis SEC tr. at 164 (Feb. 21, 1985).

needs. 289/ The head of the municipal research department commented that he was satisfied with the rate base coverage on Projects Nos. 1, 2 and 3 but was less comfortable with the coverage on Projects No. 4 and 5. 290/ The head of the

289/ Id. at 164:

- Q. Do you remember what she said about the load forecasts?
- A. That the numbers were getting soft.
- Q. What is soft? What did that --
- A. She said that the growth that was anticipated in load for the region, it looked like the engineer's forecasts were not as on target as either the Supply System or anybody else, for that matter, would like.

Notes of Robert Zipf taken at the meeting at 5-6 ("Increase in rates may reduce consumption significantly . . . 90% rate raise in 79 to cover 80 payments."). (SEC Exh. 2019)

See Part II C, supra, on declines on power demand forecasts.

290/ Leon J. Karvelis SEC tr. at 164 (Feb. 21, 1985):

Okay. We -- she went into a bit of an elaboration about declining load forecasts, the fact that construction overruns were continuing, and if anything to generalize the tone of the conversation, it was that we were having -- we were -- we felt a little more uncomfortable with 4 and 5 and we felt very -- we still felt comfortable with 1, 2, and 3.

Notes of Robert Zipf taken at the meeting at 6 ("Karvelis - sufficient rate base to cover #1, 2, 3, but 'antsy' about #4&5.") (SEC Exh. 2019). Leon J. Karvelis SEC tr. at 181 (Feb. 21, 1985):

(continued...)

municipal bond research group also commented that it appeared that institutional investors were growing hesitant about purchasing more Supply System bonds because their portfolios contained too many Supply System bonds and that some institutional investors were moving away from Projects Nos. 4 and 5 bonds to the stronger credit of Projects Nos. 1, 2 and 3 bonds. 291/

290/(...continued)

- Q. Do you recall making such a statement at the meeting?
- A. Well, as I mentioned earlier, I recall being a little more uncomfortable with projects four and five than one, two, and three. It could be that that was somebody's interpretation of those comments.
- Q. Do you remember using the word "antsy"?
- A. I do from time to time. It could well be that I did. That is in my lexicon. (at 181).

291/ Leon J. Karvelis SEC tr. at 165-66 (Feb. 21, 1985):

- Q. Do you recall whether she said anything about any difficulties that the Supply System might have in financing the projects to completion?
- A. No, I -- at one point, I spoke up and mentioned that, as everybody in the room was -- no, I'm sorry. I spoke up and I mentioned that I was sensing a growing hesitance on the part of institutional investors because of the fact that, I believe, that some of the portfolios were near to being filled up with a name. Especially on 4 and 5.

(continued...)

The immediate issue was whether to bid on the Project No. 1 bonds then being put up for sale. The purpose of the meeting was to evaluate the exposure of Merrill Lynch's underwriting position between the time it bought the bonds and the time it sold the bonds in the underwriting distribution. The public finance unit members expressed the view that the Projects Nos. 1, 2 and 3 bonds were "money good" and that Merrill Lynch must maintain a presence in any new financing of Supply System bonds. 292/ The memorandum of the meeting concluded that "We

291/ (...continued)

* * * *

Q. Did you learn from them why there was a distinction between the 4 and 5s and the 1, 2, 3s, in response to their potential purchases, or in connection with the potential purchases?

* * * *

A. Well, what I was finding out was that in being filled up with a name, it meant that they had enough WPPSS bonds to begin with. They felt they didn't want any more exposure in their portfolios, but if they had their druthers, being the conservative people that they are, they prefer to go with the stronger credit as opposed to what they considered, from a rating [point] of view, the weaker credit.

292/ Ackerman Memorandum at 1, supra, (SEC Exh. 2019):

Mr. Moore, Mr. Niebling and Mr. Camp expressed the opinion that the outstanding 1, 2 & 3 Triple A rated bonds and those bonds to be sold on Tuesday, June 19, 1979 were money good and that Merrill Lynch in its syndicate must maintain a
(continued...)

agree to review Nuclear #4 & 5 (Single A Bonds) at the next time they are offered for sale." 293/ It is unclear whether a later review of the Projects Nos. 4 and 5 bonds was made. 294/

c. May 1980 Negotiated Offering

Only one bid was received for an April 29, 1980 Projects Nos. 4 and 5 bond sale. 295/ The Supply System considered the

292/(...continued)

presence in any new financing of this name.

The person taking notes of the meeting stated in an affidavit that the opinion on the bonds being "money good" applied to all five projects.

The public finance group members, however, did not have significant involvement in the Supply System offerings, as they would have had if these had been negotiated offerings. Roger Camp SEC tr. at 67-68 (May 3, 1985) (one of the public finance unit members cited as opining on the bonds being money good):

What I am basically telling you is I told you very early in this discussion that I was in the negotiated area. This was a competitive financing. I had nothing to do with it until they rejected their financing -- their competitive sale in 1980 or '81, whatever the date was.

I mean you had this -- and it was doing competitive sales. I was doing negotiated sales. I didn't have time to do anything else other than negotiate sales.

293/ Ackerman Memorandum at 1, supra. (SEC Exh. 2019).

294/ Roger Camp SEC tr. at 71 (May 3, 1985); Leon J. Karvelis SEC tr. at 177 (Feb. 21, 1985); Robert F. Grimming SEC tr. at 53 (Mar. 21, 1985).

295/ As noted above in Part II B, the Smith Barney-Prudential Bache syndicate joined in the bid of the Merrill Lynch-Salomon Brothers syndicate, in part because of losses experienced by the Smith-Barney-Prudential Bache syndicate in the previous Project Nos. 4 and 5 bond sale.

bid to be too low. Although state law required competitive bidding, it permitted negotiation of bond sales under some circumstances, such as low bids. The Supply System decided to reject the bid. It immediately solicited applications by underwriting firms for selection as the managing underwriter for the offering. Many underwriting firms responded to the solicitation.

It appears from the Supply System interviews of prospective underwriters that the underwriters recognized several troubling aspects of the Projects Nos. 4 and 5 bonds. They recognized that some institutions were avoiding the bonds and that, instead, the bonds were being sold more to retail customers. 296/ The firms told the Supply System that the unit investment trusts they sponsored had become important vehicles

296/ E.g., Stephen Buck notes on Merrill Lynch presentation (SEC Exh. 2100) (emphasis added):

70%-30% Retail/Institutional - Non-Net Billed [Projects Nos. 4 and 5]

70%-30% Institutional/Retail - Net Billed [Projects Nos. 1, 2 and 3] (emphasis added)

Stephen Buck notes on Smith Barney presentation (SEC Exh. 2516 at 5):

Largest order from institutions on Series 1979C bond issue was \$500,000; not one large, key institutional buyer of that deal.

Stephen Buck notes on Bache Halsey Stuart Shields presentation (SEC Exh. 2516 at 7):

Institutional market has been "burned" on WPPSS bonds; can't get any priority institutional business.

for distribution of Projects Nos. 4 and 5 bonds to individuals. 297/
Even those firms that did not sponsor UITs noted their
importance to Projects Nos. 4 and 5 bond offerings and the
access they provided to individual investors. 298/ The losses
on the previous offering by one of the syndicates, which led to

297/ E.g., Stephen Buck notes on Merrill Lynch presentation
(SEC Exh. 2100 at 2):

Unit Investment Trust of M/L as of last
night

. \$125mm A-1/A+
. \$27mm AAA

Stephen Buck notes on John Nuveen & Co presentation (SEC
Exh. 2516 at 10):

Strategy for 1980A issue:

* * * *

Nuveen Bond Fund

. 1st major order 4/29; will be there
again next week; sales activity a[t]
\$1 Billion/year; 7 1/2% of Total
fund in any one name; \$96 million
Total WPPSS - mostly 4/5 unit
investment trust.

298/ E.g., Stephen Buck notes on First Boston presentation (SEC
Exh. 2516 at 3):

Closed End Bond Funds were first orders on
4/29

. 20-30 of them in existence
. at least "A" rated; price the
key investment criteria

Stephen Buck notes on Solomon Brothers presentation (Sec
Exh. 2516 at 1):

Closed End Bond Funds) access individual
Retail Managed Bond Funds) business

only one bid being received from the combined syndicate, were also noted, 299/ as were negative credit perceptions. 300/

Merrill Lynch was selected as the lead underwriter. As this was a negotiated sale, Merrill Lynch was presented with the issue of how to deal with a due diligence type of inquiry that is customarily made in negotiated municipal bond offerings.

(1) Practices in Negotiated Offerings

Section 11 of the Securities Act of 1933, which applies to certain corporate offerings of securities, provides that if a registration statement contains an untrue statement of a material fact or omits to state a material fact needed to make the statements not misleading, certain specified parties, including "every underwriter," are liable to purchasers unless

299/ Stephen Buck notes on Smith Barney presentation (SEC Ex. 2516 at 5):

Rank and file feeling was "pessimistic"!
Another WPPSS underwriting in red ink was
the dreaded thought--gun shy vs. cover bid
of 12/11/79

300/ Stephen Buck notes on Goldman Sachs presentation (SEC Ex. 2516 at 12):

WPPSS Credit (# 4/5)

- . Not a favorable credit (perception)
 - .Nuclear
 - .Cost Escalation
 - .Delays
 - .Weaker credit than the others

- .[Rating] Agencies having a difficult time holding the credit - projects a lowering of the credit.

they had, "after reasonable investigation, reasonable ground to believe and did believe" that the statements in the registration statement were "true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 301/ The inquiry required by the underwriter under the provision is often referred to as "due diligence." Typically, underwriters retain counsel who perform a "due diligence" investigation and issue an opinion letter to the underwriters with negative assurances as to the truthfulness and completeness of the registration statement. Section 11 does not apply to the sale of municipal securities, however, because they are exempted from the registration provisions of the Act. 302/

The sale of municipal securities, however, is not exempt from the antifraud provisions of Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Underwriters of municipal bonds may violate the general antifraud provisions

301/ Securities Act of 1933, § 11(a), (b) [15 U.S.C. 77k(a), (b)]. The standard of "reasonableness is provided in § 11(c) [15 U.S.C. 77k(c)]:

In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

302/ Securities Act of 1933 § 3(a)(2) [15 U.S.C. 77c(a)(2)].

if they participate in fraudulent offerings. Consequently, they will often request a letter, often referred to as a "10b-5 letter," from underwriters' counsel. The 10b-5 letter is similar to the due diligence opinion provided by underwriters' counsel in corporate offerings. The 10b-5 letter states that in the opinion of, or to the knowledge of, underwriters' counsel the official statement does not contain, tracking the language of Rule 10b-5, "any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they [are] made, not misleading." ^{303/} The underwriter's counsel often monitors the performance of other parties, including bond counsel or issuer's counsel, in their respective disclosure roles. ^{304/} Such letters were common in negotiated offerings at the time of the Projects Nos. 4 and 5 offering, but were not, and are not, common in competitive offerings. ^{305/} In the Projects Nos. 4 and 5 bond sales prior to the April 1980 sale, none of the underwriters had requested a 10b-5 letter, no underwriters' counsel was employed, and no "due diligence" type investigations were conducted.

(2) Procedure Used Here

^{303/} See, e.g., Disclosure Roles of Counsel, *supra*, at 105-10.

^{304/} See, e.g., *id.* at 105. See also Homer Schaaf SEC tr. at 38-41 (May 6, 1986) (as underwriters' counsel, often reviews law even when there was a bond counsel opinion).

^{305/} See e.g., Disclosure Roles of Counsel, *supra*, at 18-20.

Although the Supply System's rejection of the competitive bid on April 29, 1980 permitted it to negotiate on the offering, it did not wish to have the offering subject to all the procedures normally followed in negotiated offerings. The Supply System expressly told the prospective underwriters that it intended to limit the work of underwriters' counsel to drafting the underwriting contracts. 306/ Merrill Lynch, however, routinely required 10b-5 opinion letters in negotiated underwritings. 307/ It was agreed within the Merrill Lynch public finance unit that a 10b-5 letter would be required. 308/ The Supply System, through its Financial Advisor, initially questioned the position. 309/ The Supply System then suggested that in-house counsel or its Special Counsel, Houghton Cluck, supply the 10b-5 letter. 310/ Neither counsel was acceptable to Merrill Lynch. Merrill Lynch proposed the use of Wood

306/ Letter from Donald C. Patterson to Roger E. Camp (Apr. 30, 1980) (letter sent to potential underwriters) (SEC Exh. 2279):

In view of the time frame in which this negotiated financing is to be accomplished and given that all the documents have been prepared and circulated, the Supply System would intend to limit underwriters' counsel to review of the underwriting documents. Would this format be acceptable to your firm?

307/ Roger E. Camp SEC tr. at 122 (May 3, 1985) ("And we were in a unique situation here and we always required 10b-5 opinions.").

308/ Id. at 122-123.

309/ Id. at 123.

310/ Id. at 123.

Dawson, bond counsel on the offering, for a 10b-5 opinion letter, drawing on a recent Merrill Lynch experience as precedent. 311/ Wood Dawson was retained to prepare the 10b-5 letter and underwriters' counsel did not supply a 10b-5 letter. Although it is not uncommon for the underwriters to obtain supplemental letters from law firms other than counsel to the underwriters, as they did from Wood Dawson here, it is uncommon for counsel to the underwriters, here Brown, Wood, Ivey, Mitchell & Petty, ("Brown Wood," now known as Brown & Wood) not to provide a 10b-5 letter in a negotiated sale. 312/

Merrill Lynch, the Supply System and its Financial Advisor reached an agreement limiting the role of underwriters' counsel principally to drafting the agreement among underwriters and the purchase contract. The agreement among underwriters sets

311/ In a recent offering of the North Carolina Municipal Power Agency, one of the lawyers in the law firm that was acting as underwriters' counsel had left that firm to join the Wood Dawson firm, which was acting as bond counsel on the offering. Merrill Lynch decided that the individual lawyer's role was so important that it wanted a 10b-5 letter from Wood Dawson. Id. at 123-124. This was taken as precedent for Merrill Lynch's accepting a 10b-5 letter from Wood Dawson in the Supply System offering. Id. at 124. In the North Carolina offering, however, the specific individual who left to join Wood Dawson had been doing due diligence work, and it was his opinion in that capacity that was being sought from his new employer, Wood Dawson. Moreover, in the North Carolina offering, the Wood Dawson 10b-5 letter was a supplemental opinion since a 10b-5 letter was also submitted by underwriters' counsel and by outside counsel to the agency. In the Supply System offering, however, there was no 10b-5 letter from underwriters' counsel.

312/ Id. at 94-97. See also Disclosure Roles of Counsel, supra, at 89, 103, 105-10.

forth the terms of the arrangements among the underwriters. The contract of purchase is the contract between the underwriters and the issuer that delineates the terms of the purchase. Among other things, it sets forth what opinion letters and certificates are to be delivered to the underwriters at closing. Although underwriters in some joint operating agency offerings require participating utilities to certify the truthfulness of various matters in the official statement, the participants in this offering were not required to so. 313/ Nor did the contract of purchase require Houghton Cluck to supply a 10b-5 letter. 314/ The underwriters' counsel raised the question of whether the contract of purchase should include these items and was told that these items were not part of the agreement with the Supply System. 315/

In light of the short time allowed by the Supply System, the investigation done by Merrill Lynch and underwriter's counsel was limited. Merrill Lynch made its presentation to the Supply System for selection as managing underwriter on Thursday, May 1, 1980, and the Supply System interviewed other underwriters through Saturday, May 3, 1980. Merrill Lynch was

313/ Homer Schaaf SEC tr. at 107-109 (May 6, 1986).

314/ Houghton Cluck was Special Counsel to the Supply System and issued bond counsel opinion letters identical to the Wood Dawson letters. Where an issuer has more than one counsel, sometimes additional opinions are obtained from the other counsel. Homer Schaaf SEC tr. at 112-13 (May 6, 1986).

315/ Id. at 107-08, 112-17.

selected as underwriter before the end of the weekend. The lead attorney for Brown Wood learned on Monday that Brown Wood was to be underwriters' counsel. On Tuesday, an associate in Brown Wood's San Francisco office was asked by the New York Office to go to the Supply System headquarters in Richland. The attorney had little municipal bond experience and had never performed a review in connection with an offering of municipal bonds. He arrived in Richland on Wednesday and reviewed board minutes, a Participant's Agreement and several other documents and spoke with several Supply System employees. He also spoke by telephone with the lead Brown Wood attorney in New York. He returned to San Francisco on Thursday afternoon.

In New York, the Brown Wood attorneys worked on drafting the agreement among underwriters and the contract of purchase on Monday and Tuesday, May 5th and 6th. On Wednesday, the lead Brown Wood attorney and a member of Merrill Lynch's public finance unit met with the Wood Dawson lawyer at the printers for the printing of the final official statement. No significant changes were made in the official statement. 316/ The lead Brown Wood attorney on the offering flew to Seattle on Thursday for the formal sale of the bonds, which took place on Friday, May 9, 1980.

d. Subsequent Roles of the Underwriters

After the May 1980 offering, all the remaining Projects Nos. 4 and 5 bond sales were competitively bid. The Supply

316/ Roger E. Camp SEC tr. at 167-72 (May 3, 1985).

System, however, received only one bid on each of these sales. The underwriters did not participate in drafting the official statements and did not conduct negotiated sale type of investigations into the Supply System's disclosures. The underwriters resumed the competitive underwriting role of bidding on the bonds and selling the bonds to the market.

The situation with respect to Projects Nos. 4 and 5 bonds continued to deteriorate during the rest of 1980. The proposed short and intermediate-term debt program, known as the Balanced Financing Program, which was to provide protection for the deteriorating cash flow, provoked the Participants' Committee in October to request a delay or termination study. 317/ Smith Barney became involved in matters relating to the Balanced Financing Program and, in reviewing the situation, the firm's analyst noted some of the problems of marketing the Projects Nos. 4 and 5 bonds. 318/ Although Smith Barney worked with the Supply System on the Balanced Financing Program and communicated with some Participants on the program, Smith Barney and the other underwriters apparently were not aware of the undisclosed Participants' Committee request for a delay or termination study and attempts to get the direct service industries and the BPA to accept more of the burden of the Projects. The underwriters also apparently were unaware of the

317/ See discussion in Part II D, supra.

318/ See discussion in Part II B, supra.

undisclosed November 1980 budget estimate indicating a \$4.4 billion increase in the budget for the five Projects. 319/

At the end of January 1981, the Managing Director and other Supply System representatives, together with BPA officials, came to New York for an extensive series of meetings

319/ See discussion in Part II A, supra. This development probably would have been uncovered in a due diligence type of inquiry. Indeed, the Supply System was concerned that the estimate of \$20 billion might have been revealed to a Merrill Lynch analyst who visited the Supply System in January of 1981 as part of his research for a new, comprehensive report on it. After the analyst completed his visit, the chief financial officer of the Supply System told an employee who worked for him that the analyst had told him that another Supply System employee had said that the fiscal year 1982 budget would be at least \$20 billion, which was approximately the amount of the undisclosed November 1980 estimate. Martin Kuric SEC tr. at 83 (May 2, 1985). Although the employee to whom the statement was attributed denied to the chief financial officer that he had told the analyst of a \$20 billion dollar estimate and the analyst could not recall being told of a \$20 billion budget figure, the figure was known to a number of people at the Supply System and inquiry about estimates in a due diligence type inquiry might have uncovered the estimate.

In connection with his work in preparing a report on the Supply System, the analyst also learned information about the market for the Projects Nos. 4 and 5 bonds. He spoke with the head of the municipal analyst group about possible saturation of institutional portfolios and spoke with the institutional salesmen about the resistance of some institutions to Projects Nos. 4 and 5 bonds. Howard Sitzer SEC tr. at 119-129 (Aug. 2, 1985). He also spoke with a member of the underwriting department about the December 1980 offering. Id. at 121. After his visit to the Supply System, he hypothesized that the BPA might not be able to acquire Projects Nos. 4 and 5, which could cause termination and an excessive burden on the Participants. Id. at 101-102. He expressed this hypothesis to others in the firm, including personnel in the public finance unit. Id. at 100-103. The analyst, however, did not publish a report on the Supply System until after the recommendation for a construction moratorium by the Supply System's management.

with institutional investors, leading Wall Street economists, and an advisory group composed of lead underwriters of the Supply System bonds. The Managing Director, who was inexperienced in investor financing, wanted direct information about the market in which the Supply System was financing its projects. 320/ The issue of the amount of financing required for the Supply System's Projects and its availability was discussed at that meeting. Some of the underwriters expressed the opinion that financing would probably be available, but that it might be expensive, would require other financing options, and would require increasing reliance on the retail market or small institutions and individuals. 321/ They recommended that the Balanced Financing Program be approved promptly. 322/

The underwriters completed a successful sale of Projects Nos. 4 and 5 bonds in March 1981. Another sale, intended for early May 1981, was suspended by the Supply System when the

320/ Robert Ferguson SEC tr. at 632-633 (July 25, 1985).

321/ Memorandum on New York meetings, Part III. (SEC Exh. 220.)

322/ Id. As described above in Part II B, supra, Smith Barney subsequently wrote a letter to the Supply System on the Balanced Financing Program in which it stated:

In our opinion, failure of the Participants to amend the Participants' Agreements as recommended so as to permit the Balanced Financing Program could affect the ability of WPPSS to complete the financing of the Project in a timely manner.

Letter from Donald R. Larson and Morgan J. Murray to James D. Perko 8 (Feb. 9, 1981). (SEC Exh. 2298.)

fiscal year 1982 budget figures became available to it. 323/
The process of selecting managing underwriters, pursuant to the enactment in early May 1981 of legislation permitting negotiated underwritings, was taking place when the Managing Director announced the fiscal year 1982 budget figures and recommended a moratorium on construction of Projects Nos. 4 and 5 bonds on May 29, 1981.

In the Summer of 1981, the underwriters, which were then in a negotiated sale relationship with the Supply System, advised the Supply System that further financing of Projects Nos. 4 and 5 would be feasible only if the Participants agreed to pay 50% of the interest on the Projects. 324/ A substantial portion of the Participants either opposed the change or indicated that the change would be conditioned on regionalization of the burdens of the Projects. No further Projects Nos. 4 and 5 financings were attempted. 325/

The underwriters sold Projects Nos. 4 and 5 bonds to the market. The official statement prepared by the Supply System was the disclosure statement for those sales. The underwriters contend that they were the audience for, rather than the speakers of, the representations made by the Supply System in its official statements. They contend that they were not obligated in these competitively bid sales to verify the

323/ See discussion in Part II A, supra.

324/ See Part II B 5, supra.

325/ See Part II B, supra.

disclosures in the official statements. No underwriters' counsel was employed in connection with the offerings and no investigations of the type employed in negotiated offerings were conducted. This process made it less likely that full and accurate disclosure would be made by the Supply System.

D. THE RATING AGENCIES

The two principal rating agencies that rate municipal bonds are Moody's Investor's Service, Inc. and Standard and Poor's Corporation. Ratings are important to the marketing of municipal bonds. Although large institutional investors can make their own credit evaluations, individual investors and small institutional investors usually do not have the resources or sophistication to do so. Moreover, the UITs that were purchasing the Projects Nos. 4 and 5 bonds, by the criteria set forth in their prospectuses, could buy only bonds with an A or better rating from one of the rating services. Moody's rated Projects Nos. 4 and 5 bonds A1 and Standard and Poor's rated them A+ during the entire period of the bond offerings. 326/

326/ The ratings range downward from strongest to weakest credit rating in alphabetical order. The Moody's ratings are Aaa, Aa, A, Baa, Ba, B, Caa, Ca and C. A "1" can be used as a suffix to indicate a more favorable evaluation within a rating category. The Standard and Poor's ratings are AAA, AA, A, BBB, BB, B, CCC, CC, C (no interest being paid) and D (in default). A "+" or "-" can be use as a suffix to indicate relative standing in a category. The lowest rating for bonds considered to be investment grade is Moody's Baa and Standard and Poor's BBB; bonds below that rating are considered to be in a speculative category. The vast majority of rated bonds have a rating of A or above.

The Commission staff examined the information supplied to the rating agencies by the Supply System and its consultants. It also inquired into the procedures and standards of the rating process. The purpose of the inquiries was to determine whether the ratings were influenced by misrepresentations or non-disclosures by the Supply System and its representatives and whether there were deficiencies in the rating process.

1. The Rating Process

Issuers wishing to obtain a rating apply to the rating agencies. The agencies request written information from the issuer and assign a reviewing analyst, or analysts, to work on the rating. In some cases issuers meet with the reviewing analyst and other rating agency personnel to present information and answer questions. A reviewing committee reviews the rating recommendation of the reviewing analyst. After the committee reaches a decision on the rating, it notifies the issuer of the rating. The issuer is charged a fee by the rating agency. ^{327/} The rating is then stated in the

^{327/} Moody's had a fee range, which increased during the Projects Nos. 4 and 5 bond offerings, based on the size of the offering. The fee within the range could also take into consideration the amount of work involved. Standard and Poor's fees were based on a judgment of the time and effort expended in doing the rating. The fees for the Supply System Projects Nos. 4 and 5 bond ratings were:

	<u>Fees</u>	
<u>Bond Issue</u>	<u>Standard & Poor's</u>	<u>Moody's</u>
1977A	\$5,400	\$4,000 (continued...)

official statement and listed in the agencies' reference works. Standard and Poor's does not publish textual reports on the ratings, but it provides descriptive information from time to time in its periodic publications on municipal bonds. Moody's publishes a Municipal Credit Report on each rating, which is available to subscribers to those reports. The reports express Moody's opinion in summary form, together with a more extensive description of the bonds and other information.

The rating agencies represent their ratings as an assessment of credit quality; 328/ they also represent that

327/(...continued)

1977B	\$1,600	\$2,000
1977C	\$1,650	\$2,000
1978A	\$1,525	\$2,000
1978B	\$1,775	\$7,000
1978C	\$1,900	\$3,500
1979A	\$2,550	\$10,000
1979B	\$2,500	\$12,500
1979C	\$3,200	\$12,500
1980A	\$5,400	\$12,500
1980B	\$3,600	\$12,500
1980C	\$3,600	\$12,500
1980D/E	\$3,600	\$12,500
1981A/B	\$4,200	\$12,500

328/ E.g., Moody's Investor Services, Inc., Municipal and Government Manual, Vol. 1 at v (1987):

Purpose: The purpose. . . is to provide investors with a simple system of gradation by which the relative investment qualities of bonds may be noted.

Standard & Poor's Corporation Creditweek at 1415 (June 27, 1983):

A Standard & Poor's corporate or municipal debt rating is a current assessment of the creditworthiness of an obligor with respect to a specific obligation. This assessment may take
(continued...)

their ratings are not a recommendation to buy or sell and that there may be limitations to the use of the ratings as credit evaluations. 329/ Nevertheless, the ratings have a wide influence on the market for municipal bonds. Less sophisticated investors use them as credit evaluations; UITs use them as a criterion in selecting bonds; and even sophisticated investors use them as reference points.

328/(...continued)

into consideration obligors such as guarantors, insurers or lessees.

329/ E.g., Standard and Poor's Creditweek at 1415 (June 27, 1983):

The debt rating is not a recommendation to purchase, sell, or hold a security, inasmuch as it does not comment as to market price or suitability for a particular investor.

The ratings are based on current information furnished by the issuer or obtained by S&P from other sources it considers reliable. S&P does not perform an audit in connection with any rating and may, on occasion, rely on unaudited financial information. The ratings may be changed suspended, or withdrawn as a result of changes in, or unavailability of, such information or for other circumstances.

Moody's Investors Services, Inc., Municipal Credit Report, Washington Public Power Supply System Nuclear Projects Nos. 4 and 5 at 1 (Dec. 5, 1980):

Moody's rating are opinions, not recommendations to buy or sell, and their accuracy is not guaranteed. A rating should be weighed solely as one factor in an investment decision, and you should make your own study and evaluation of any issuer whose securities or debt obligations you consider buying or selling.

There appear to be significant limitations on the value of the ratings. The ratings are based largely on representations by the issuer. Although the rating agencies' analysts apply their judgment to the representations, they usually do not attempt to conduct independent fact finding. 330/ Also, although the rating agencies can and do utilize analysts who are familiar with the type of issues or subject matter to assist in a rating determination, they generally do not use experts to conduct expertised analyses. 331/ As a result,

330/ E.g., Richard E. Huff SEC tr. at 160-61 (Dec. 4, 1985) (head of Standard and Poor's municipal bond rating department during sale of Projects Nos. 4 and 5 bonds):

- Q. Does Standard & Poor's make an effort to look beyond the representations made to it in official statements or in meetings with the issuer and its representatives about representations that are made?
- A. The very broad comments, I would say yes, we do. We obviously take what's presented to us, read it, analyze it, think about it, and come up with a judgment of our own as to whether what is being represented seems reasonable to us.
- Q. But you don't necessarily -- aside from making a judgment about what seems reasonable and what you are told, you don't make any efforts to actually go beyond and make your own independent fact finding?
- A. No. Most times we wouldn't have the ability, capability or time to do that.

331/ E.g., Richard E. Huff SEC tr. at 160 (Dec. 4, 1985):

- Q. Did Standard & Poor's make any (continued...)

information supplied by the issuer may not be detected as being unreliable. The reliance on information supplied by the issuer is particularly problematic when underwriters do not conduct due diligence type inquiries. 332/

The rating agency analysts also are not knowledgeable about the market for the bonds to the same extent as broker-dealer analysts who have access to market information in their firms. They do not, for example, generally follow the reports of other municipal bond analysts, know the trend of yields in relation to the market, or know what types of purchasers are

331/(...continued)

analysis of the power needs of each of the 88 individual participants in the 4 and 5 Projects?

- A. No, not that I'm aware of. It would have been beyond the scope of their expertise to do so.

Craig Atwater SEC tr. at 83-84 (June 19, 1985) (senior Moody's analyst on Projects Nos. 4 and 5 bonds):

Q. In making your rating determinations with respect to joint operating agencies, do you rely on the conclusions of bond counsel as to the legality of any of the agreements with respect to the undertakings?

A. Yes, we rely on them.

Q. Do you have an independent ability to evaluate the correctness of these opinions?

A. No, I do not believe we do.

332/ See Part III A, supra.

purchasing the bonds. 333/ Although the ratings are not intended to predict the market performance of bonds being rated, such information could be helpful in the evaluation of creditworthiness of bonds. Negative market action could alert the rating agencies that they should examine an issuer more closely. Negative market developments also could translate into negative credit developments, such as possible difficulties in financing a project to completion.

It also appears that rating agencies tend not to change a rating until a major development occurs or a trend is confirmed. 334/ Other analysts, such as broker-dealer analysts

333/ E.g., Craig Atwater SEC tr. at 23-25, 119-21 (June 19, 1985).

334/ E.g., Richard E. Huff SEC tr. at 30-31 (Dec. 4, 1985):

Q. Is there in a sense a bias to not change a rating until something has been observed that is significant, a significant change?

A. Well, this is maybe where the earlier question, the difference between the rating agency at S&P and another analyst on the street. I think we felt that S&P has a responsibility to be sure that the changes you think are coming or going to happen really are permanent changes or that there are confirmation of trends. So you don't tend to make a rating change at the very first indication; whereas, an analyst on the street may well be able because he doesn't have effectively an on-going responsibility for that rating. He may well sound off that this is something that should be lower rated or higher rated, depending. So,

(continued...)

or institutional investor analysts, who attempt to look for credit trends and who have access to market information, may change their ratings or credit evaluations before the rating agencies do. Although a slow response may be prudent in some cases, an investor relying only on rating agency credit ratings may be late in learning of a weakening in creditworthiness.

2. The Projects Nos. 4 and 5 Bond Ratings

The rating agencies assigned a high A rating for the Projects Nos. 4 and 5 bonds at the time of the first bond offering in February, 1977. 335/ The ratings were not changed until the announcement of the fiscal year 1982 budget figures and the moratorium recommendation on May 29, 1981, after the last completed bond offering. After that announcement, the ratings were reduced over time. 336/

334/ (...continued)

I think there is a tendency to be more deliberate at the rating agencies in following a situation and in making changes.

335/ Moody's assigned an A1 rating and Standard and Poor's assigned on A+ rating.

336/ Changes in Projects Nos. 4 and 5 bond ratings after May 29, 1981 (See note 326, supra for rating scale):

Moody's Ratings

<u>Change</u>	<u>Date</u>	<u>Reason for Change</u>
A1 to Baa1	6/10/81	May 29, 1981 50% budget increase announcement and questions about need for the projects raise doubts as to likely completion of projects.

(continued...)

Both Moody's and Standard and Poor's cited the need for the projects and the Participants' obligations to pay as

336/ (...continued)

Suspended	1/07/82	Participant resistance to actions needed to mothball projects raises uncertainty of long term credit standing of bonds.
Caa	6/01/83	Failure of Participants to make required payments as called for in bond resolution.
Withdrawn	6/16/83	Washington Supreme Court decision holding obligations of certain Washington utilities invalid.

Standard and Poor's Ratings

<u>Change</u>	<u>Date</u>	<u>Reason for Change</u>
A+ to A	6/19/81	May 29, 1981 50% budget increase announcement may delay completion dates and cause rate increases.
A to BBB+	1/22/82	Termination occurs and rate increases put financial burden on Participants.
BBB+ to B	11/18/82	Participants' legal challenges and questions of legal validity of Participants' obligations raised.
B to CC	2/28/83	Failure of Participants to make payments to maintain cash flow to pay bonds make default likely.
CC to D	8/24/83	Failure of Participants to pay after 6/15/83 Washington State Supreme Court decision holding obligations of certain Washington utility obligations invalid.

significant factors supporting the initial rating. For the validity of the agreements the agencies relied on the fact that bond counsel was prepared to issue an opinion letter. 337/ The rating was assigned even though the form of the opinion letters on the validity of the Participants' Agreements had blanks for the number of Participants being opined on. 338/

337/ Richard E. Huff SEC tr. at 136-37 (Dec. 4, 1985) (Standard & Poor's):

If I understand your question, I think that would be a valid assumption, that S&P would depend on the main bond counsel's opinion, that it did cover the required issues, and that they had done whatever was appropriate to have been done by bond counsel to enable them to render that opinion. It is similar to an auditor's report saying they had followed whatever the procedures are that auditors follow in order for them to render an opinion on the financial statements of the municipality. We just have to, the rating agency has to assume that bond counsel do what bond counsel are supposed to do.

338/ The senior supervising analyst on the Project Nos. 4 and 5 bonds for Moody's testified that despite the blanks in the Bond Counsel opinion letters, he relied on the reference in the bond counsel opinion letter that Bond Counsel had relied on the opinions of counsel for each of the Participants. Craig W. Atwater SEC tr. at 61-65 (June 19, 1985). Although counsel for each of the Participants did issue opinions, the reference in the Bond Counsel opinion letter to Participants' counsel opinions went only to Bond Counsel's reliance on the Participants' counsel opinions as to local procedural matters and, further, apparently went only to those Participants opined on by Bond Counsel. Later, when the opinion letter referred expressly to the specific number, 72, of the 88 Participants that Bond Counsel was opining on, the rating analyst incorrectly took that to mean that bond counsel had looked into the validity of only 72 Participant's Agreements. See discussion in Part IV, *infra*, on the validity and enforceability of the Participants'

(continued...)

Over the succeeding four years of Projects Nos. 4 and 5 bonds offerings and unchanged ratings, problems with the projects were growing. As described above, the budgets grew despite efforts to keep the published budget figures low; the financing efforts encountered difficulties; the power demand projections were declining; and the Participants' Committee reacted negatively when the Participants were asked to assume additional burdens. 339/ All of these factors could and did lead toward the ultimate default.

During this period, the Supply System, its consultants, and others connected to the projects met with the rating agencies to obtain ratings for each bond offering. They gave reassuring explanations of negative developments. Moreover, they did not provide the rating agencies with some adverse information, including the November 1980 estimate of a \$4.4 billion cost increase for all five projects or the Participants' Committee's October 1980 request for a delay and termination study. The rating agencies appear to have limited their inquiries largely to the issues that were raised by the Supply System or were apparent from information in the official statements.

The rating agencies' publications on the Projects Nos. 4 and 5 bonds did note, after a period of time, concern about the

338/ (...continued)

Agreements and the reason for Bond Counsel's not opining on 16 of the Participants' Agreements.

339/ See discussion in Part II, supra.

rising budgets. The rating agencies, which were receiving explanations and assurances from the Supply System, do not appear, however, to have fully appreciated the deteriorating situation. Although no issue as to the legality of the Participant's obligations to pay arose during the bond offerings, the developments that were occurring could and did have a bearing on the ultimate payment on the bonds. Indeed, as those developments began unfolding in the period after the announcement of the fiscal year 1982 budget and the moratorium recommendation, the rating agencies did downgrade the bonds, even prior to the Washington Supreme Court decision that held the Washington utilities' payment agreements invalid. It appears, however, that some of the limitations of the rating process, described above, contributed to the continuation of the ratings during the sale of bonds.

3. An Analyst's Visit to the Supply System

Some of the limitations of the rating agency evaluations are illustrated by a visit to the Supply System made by an analyst for Moody's. By the middle of 1979, the increase in budgets and schedules was being noticed by Moody's. Before that time, the introductory "Opinion" section of its Municipal Credit Reports referred only to the Participant's obligation, and apparent ability, to pay. In its August 22, 1979 Credit Report on the August 1979 Projects Nos. 4 and 5 bond offering, Moody's added a statement expressing concern about the

increasing cost estimates. 340/ The analyst who prepared the August 22, 1979 report was a senior supervising analyst. A new analyst joined Moody's in March, 1979 and began working on the Supply System ratings. 341/ He rapidly assumed responsibility on the Supply System bonds. 342/ In late 1979, the analyst suggested to his superiors that he be allowed to make trips to

340/ Moody's Investors Services, Inc., Municipal Credit Report Washington Public Power Supply System - Nuclear Projects No. 4 and 5 at 1. (Aug. 22, 1979) (SEC Exh. 2323):

Causes for concern, however, continue to be the higher construction estimates with the resultant impact on additional financing and ultimate higher costs to the participants. Supply System's ability to maintain construction schedules and to contain future cost increases become more significant factors for subsequent evaluations of this enterprise.

341/ Prior to joining Moody's he had no municipal bond analyst experience. The analyst had received a Bachelor's degree in 1965 and subsequently was a student until receiving a PhD in Economics in 1973. He was then a research associate in a firm doing government consulting contracts on manpower, welfare and urban problems for three years. He subsequently was employed in the consumer affairs department of New York City and later worked in the City's energy office where part of his work involved utility oversight. After he left Moody's in June 1980, he went to work at a bank in New York and later left the municipal bond business. Ronald Needleman SEC tr. at 11-27 (December 12, 1985).

342/ The analyst was assigned to be the reviewing analyst on the July 1979 offering of Project Nos. 1 bonds and prepared the published Municipal Credit Report.

The next Supply System offering on which he was the analyst was the December 1979 Projects Nos. 4 and 5 offering. By that time, the analyst had become the principal analyst, under the supervision of the senior analyst, doing the electric revenue bond reviewing at Moody's. Id. at 55.

major issuers. 343/ The Supply System was the first issuer he would visit under this proposal. 344/ Moody's analysts had attended Supply System group tours in 1977 and 1978, but this was the only separate visit of a Moody's analyst to the Supply System.

The Supply System and its Financial Advisor were concerned about the visit. The Financial Advisor understood Moody's to be concerned about the credit of the bonds and to want to conduct a full credit review. 345/ The Supply System's chief financial officer notified the Managing Director of the Supply System of this significant development. 346/ He listed an extensive array of people who should meet with the analyst, including senior management, senior representatives of the contractors, the consulting engineer, board members and Participants' Committee members. A full week's agenda of meetings, presentations and tours was arranged for the analyst.

One of the meetings was to be with representatives of the

343/ Id. at 55.

344/ Id. at 73-74.

345/ Donald C. Patterson SEC tr. at 528-31 (Oct. 22, 1985). This understanding apparently exceeded the purpose and scope of the visit, although concerns about the budgets was one of the purposes of the visit. Craig Atwater SEC tr. at 121-26 (June 19, 1985).

346/ Handwritten note from James Perko to Mr. Strand (June 4, 1980) ("Was informed today that Moody's Investor Service has commissioned a reevaluation of the Supply System's ratings. . . . This reevaluation will review all bond ratings but most important are the 4/5 project ratings.") (SEC Exh. 2571); James Perko SEC tr. at 568-75 (Oct. 21, 1985).

Participants at a Participants' Committee meeting. At a March 6, 1980 Participants' Committee meeting, the Supply System, the Participants' Committee members, and R.W. Beck, the consulting engineer, prepared for a presentation to be made to the analyst at the next Participant's Committee meeting. The presentation focused on the need for power from the projects and the Participants' support for the projects. 347/ The chief financial officer explained that the recent Moody's credit reports had noted concern about the budget and schedules. The possibility of a downrating and the need to make strong presentations were made clear to the Committee. 348/

347/ At the preparatory meeting, the Supply System and the Participants, believing that the analyst was considering a downrating, expressed concern about the fact that the analyst wanted to reduce the length of the trip and that it was only through the Financial Advisor that they got some agenda items restored. Participants' Committee meeting of March 6, 1980. (Tape 53(a) at 454-520.)

348/ Id. (Tape 53(a) at 575-90):

That's the atmosphere we're dealing with and its important to understand that's what this guy is -- I don't know if he's got his mind made up or not yet, but it's important how much of a reduction in the rating occurs, if any, and what kind of report the fellow writes when he decides how far that rating is going to be reduced.

We're now at [Moody's] A1. I'll just use that as a benchmark, it'll apply for the [Standard and Poor's] A+ as well. We can go from A1 down to A or A-, those are the two notches. Blyth [the Financial Advisor] feels that if we move from an A1 to an A, that's probably not too bad. But if we move to an A-, that's going to be much worse. In other words, it's like a

(continued...)

The analyst stopped at the BPA, visited one of the Participants' utilities, and went to the Supply System. At a Participants' Committee meeting, Committee members made strong statements of their need for Projects Nos. 4 and 5 without providing information that qualified their statements and without describing downward trends in power demand

348/(...continued)

geometric progression

Second key point: it's the kind of report this fellow writes. He can write a good report, an indifferent report, or a bad report. . . . A bad one would be that the Supply System is having difficulty in the project management area unique to the

Supply System or, number two, the participants do not have the financial capability to support these projects even at a higher cost. Our attack is going to be to address those two points. . . . The participants then need to come forth that day to show the strength of those projects and their need and the reason why, even at a higher cost, that they are still a valuable resource and still when melded they're a very cheap resource.

forecasts. 349/ The analyst asked few questions and then left

349/ A Participants' Committee member representing some Oregon Participants, for example, stated that they would be short of power in 1984-85 without Projects Nos. 4 and 5:

[We] have needs and we have growth that is scaring us half to death.

* * * *

We're going to be terrifically short in '84-85 without program four [and five].

Participants' Committee meeting of March 13, 1980. (Tape 56(a) at 572-73 and Tape 57(a) at 35-36). Minutes of Participants' Committee meeting March 13, 1980, at 5.

He did not say, however, that his statement was based on the BPA's 1976 letter of insufficiency, which was a contractual notice, and that the actual allocation of BPA power to the Participants had not been resolved. The analyst did not explore this issue with the Participants' Committee:

Q. Did you explain to the representative of Moody's, that -- your statement about the insufficiency in 1984 and 1985 was related to the [letter of insufficiency]--

A. No, I don't think so, because he didn't ask me any questions in particular; he just listened to my discussion.

Q. You weren't speaking, were you, of whether there was enough power in the region or not to supply Central--

A. No, I was only saying that Central Lincoln would be--the Oregon PUD's would be short in 1984.

Q. Solely because of the letter of insufficiency?

A. That's right.

(continued...)

the meeting before its conclusion to fly back to New York.

On the next rating of the Projects Nos. 4 and 5 bonds, the rating was retained and the Opinion section of the Municipal Credit Report was changed to add favorable comments. It now stated that: "The quality of the present schedule and cost estimates, despite their preliminary nature, should afford the Supply System a realistic framework for project completion." It also stated that: "The need for the power from these projects in the Northwest appears greater than ever. The participant's ability to pay for this power, despite its high cost, is a positive factor." Despite this optimistic assessment, the problems in the construction program and increases in the budget estimates continued. ^{350/} Also, the rate of growth in the power demand forecasts was continuing to decline and the relationship between the Participants' role in the Projects and regionalization of the burdens of the Projects was a complicated situation that would become a major issue. ^{351/}

The ratings on the Projects Nos. 4 and 5 bonds were important to the continued sales of the bonds. Investors with

^{349/} (...continued).

Donald DeFreese SEC tr. at 114-115. (Aug. 1, 1985).

The declining trend in power demand projections and deviations between forecasts and actual usage (see discussions in Part II C, supra) also were not discussed.

^{350/} See Part II A, supra.

^{351/} See Part II C, D, supra.

limited sophistication and resources relied on the ratings as the principal guide to creditworthiness. Continued purchases of the bonds by unit investment trusts were also dependent on favorable ratings. The rating agencies, however, depended largely on the representations by the issuer. While the agencies applied their judgment to the facts presented, generally they did not go behind the representations. It also appears that the rating changes tended to follow publicized negative events rather than to reflect negative trends or gradual developments. Those who relied on the ratings alone may not have been fully advised of developing problems. The rating agencies, however, did not represent that the ratings alone should be relied on and did not represent that they conducted due diligence type of investigations.

C. THE UNIT INVESTMENT TRUSTS

1. General

The staff examined the role of unit investment trusts ("UITs") in the marketing of Supply System bonds. UITs ultimately held 25% of all the Projects Nos. 4 and 5 bonds sold by the Supply System. They functioned as marketing vehicles for the bonds since blocks of the bonds were acquired by the trust sponsors and sold indirectly to individuals who invested in the trusts. Some of the trusts also were sponsored by underwriting firms that participated in the primary offerings of Projects Nos. 4 and 5 bonds.

UITs are investment companies that issue redeemable securities, sold mostly to individual investors, in the form of units of the trust. A sponsor, usually a broker-dealer, assembles a portfolio of bonds for inclusion in a trust. The bonds are deposited in the trust and fractional shares of the trust are then sold to investors, typically in units of \$1,000. The units are sold through underwriters. The sponsor also usually acts as an underwriter. The sponsor can profit both by selling bonds to the trust, which are purchased by the sponsor at bid prices and deposited in the trust at offer prices, and by sales commissions, typically 4-5%, paid by investors.

The trusts are not actively managed. Bonds in the original portfolio normally are intended to remain in the portfolio until they mature or are called, at which time the investor receives a return of his investment. The trustee, however, generally has the power to dispose of any of the bonds prior to maturity under appropriate circumstances. Unitholders can have their units redeemed by the trustee at the net asset value of the unit. The sponsors also usually make a secondary market in units of the trusts they sponsor.

The trust sponsors that purchased Projects Nos. 4 and 5 bonds usually stated in the trust prospectuses that the trusts were designed to produce tax-exempt income and to preserve capital. ^{352/} The prospectuses usually stated that all bonds

^{352/} E.g., National Municipal Trust Forty-Eighth Series, prospectus, 4 (April 28, 1981) (sponsored by Thompson (continued...))

placed in the trusts were rated A or better by the rating agencies of Standard & Poor's Corporation or Moody's Investors Service, Inc. Some prospectuses also expressly stated that quality was a consideration in selecting bonds. ^{353/} The prospectuses also stated that bonds were selected on the basis of their price relative to other bonds of comparable quality and maturity. ^{354/} The prospectuses also listed all of the bonds in the trust and the ratings, yields and profit or loss to the sponsor from the deposit of bonds in the trust.

UITs were advertised as benefiting investors through

^{352/}(...continued)
McKinnon Securities, Inc.):

The objectives of the Trust are tax-exempt income and conservation of capital through an investment in a diversified portfolio of municipal bonds. There is, of course, no guarantee that the Trust's objective will be achieved.

(SEC Exh. 247.)

^{353/} *E.g.*, Municipal Investment Trust Fund, One Hundred Thirty-Second Series, prospectus, 6 (May 7, 1980) (sponsored by Merrill Lynch White Weld Capital Markets Group, Bache Halsey Stuart Shields, Inc., Dean Witter Reynolds, Inc., and Shearson Loeb Rhoades, Inc.) ("In selecting Debt Obligations, the following factors, among others, were considered by the Sponsor: (i) the quality of the Debt Obligations and whether they were rated A or better by Standard and Poor's Corporation or Moody's Investors Service, Inc. . . ."). (SEC Exh. 2663.)

^{354/} *Id.* at 7; Nuveen Tax-exempt Bond Fund, Series 155, prospectus, 7 (June 13, 1980) ("In selecting Bonds, the following factors, among others, were considered . . . (ii) the prices of the Bonds relative to other bonds of comparable quality and maturity."). (SEC Exh. 2291.)

diversification and high yield. 355/ Most UITs restricted their holdings in an individual bond to a specific percentage of the trust, frequently 7.5% but slightly higher for some trusts, and also limited holdings of any particular type of bond, such as hospital, housing, or electric utility bonds, to

355/ E.g., Municipal Investment Trust Fund, One Hundred Thirty Second Series, prospectus, supra, insert between 4-5:

HOW DO YOU BUY MUNICIPAL BONDS?

There are many characteristics of municipal bonds that increase their attractiveness. They come in a wide variety of maturities, giving the investor great choice in how long he wants to invest his money. In addition, there are differences in investment quality, geographical origin and yield. To sift this vast exciting field for its most suitable possibilities, many investors obtain experienced, knowledgeable help from their securities brokers.

* * * *

WHY DO INVESTORS BUY MITF?

* * * *

Each MITF portfolio is composed of many different municipal issues, providing buyers professional selection of a diversified group of bonds with different sources, maturities and yields which reduces but does not eliminate the risk of an investment in municipal bonds Since investment quality is a must with MITF, bonds in the portfolio have a rating of A or better by Standard & Poor's or Moody's. We seek the highest yields available among those bonds acceptable to MITF. By purchasing MITF, investors avoid the problem of choosing their municipal bonds themselves.

(SEC Exh. 2663.)

a specific percentage of the trust. Some UITs were also advertised as providing professional selection of bonds from among the vast numbers of municipal bonds with different quality, location, maturities and yield. ^{356/} UIT units are sold mostly to individual investors. ^{357/}

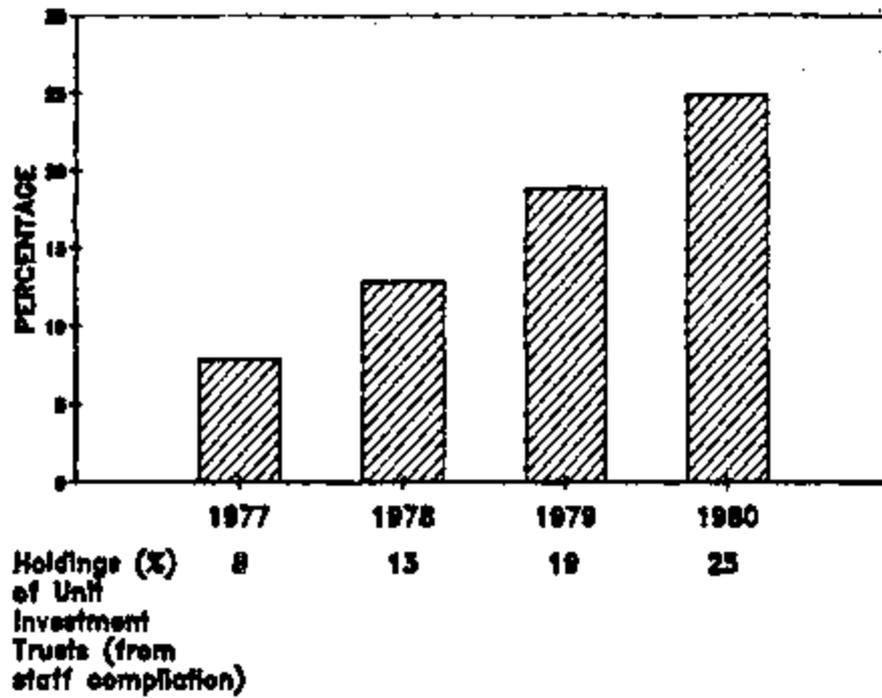
2. Increase in Purchases of Projects Nos. 4 and 5 Bonds by the Trusts and Comparison to an Institutional Investor Portion of Market for the Bonds

Despite the known negative developments that occurred with respect to Projects Nos. 4 and 5, purchases of Projects Nos. 4 and 5 bonds for UITs grew substantially. In the first year that Projects Nos. 4 and 5 bonds were issued, the UITs constituted 8% of the market for the bonds. By May 1981, when Supply System management publicly recommended a construction moratorium, UITs held approximately 24% of all Projects Nos. 4 and 5 bonds: (See chart next page.)

^{356/} E.g., *id.*

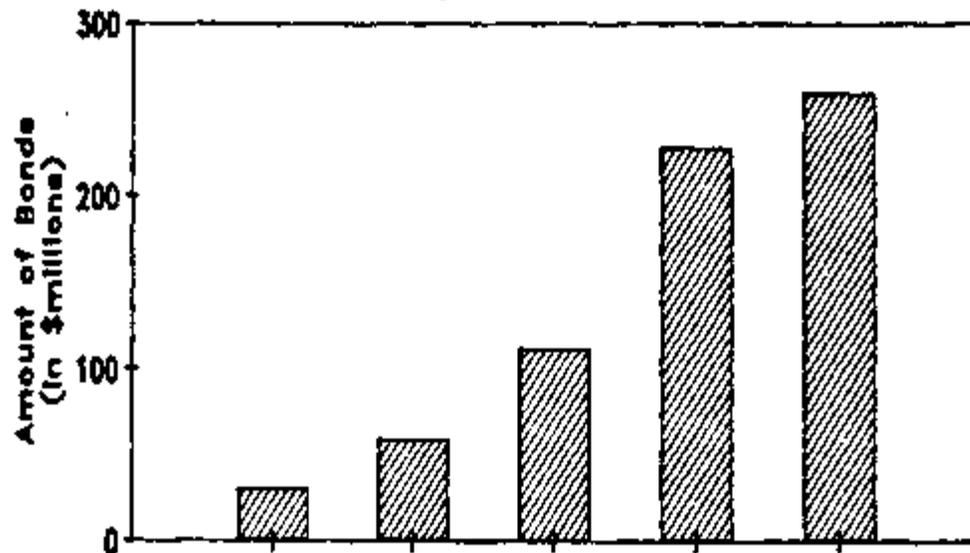
^{357/} William J. Morgan SEC tr. at 27 (Mar. 22, 1985).

**Holdings of Projects Nos. 4 and 5 Bonds
By All Trusts as a Percentage of All Projects
Nos. 4 and 5 Bonds Outstanding**



The volume of purchases of Projects Nos. 4 and 5 bonds by trusts increased even more dramatically:

**Aggregate Volume of Purchases of Projects
Nos. 4 and 5 Bonds By All Trusts in Each Year**



	1977	1978	1979	1980	1981
Purchases (\$millions)	30.97	38.68	112.30	228.24	260.02 as annualized to June 1981 (86.67 actual purchases to end of May, 1981)

Source: Staff compilation of information obtained from UT's; may omit a few small UT's.

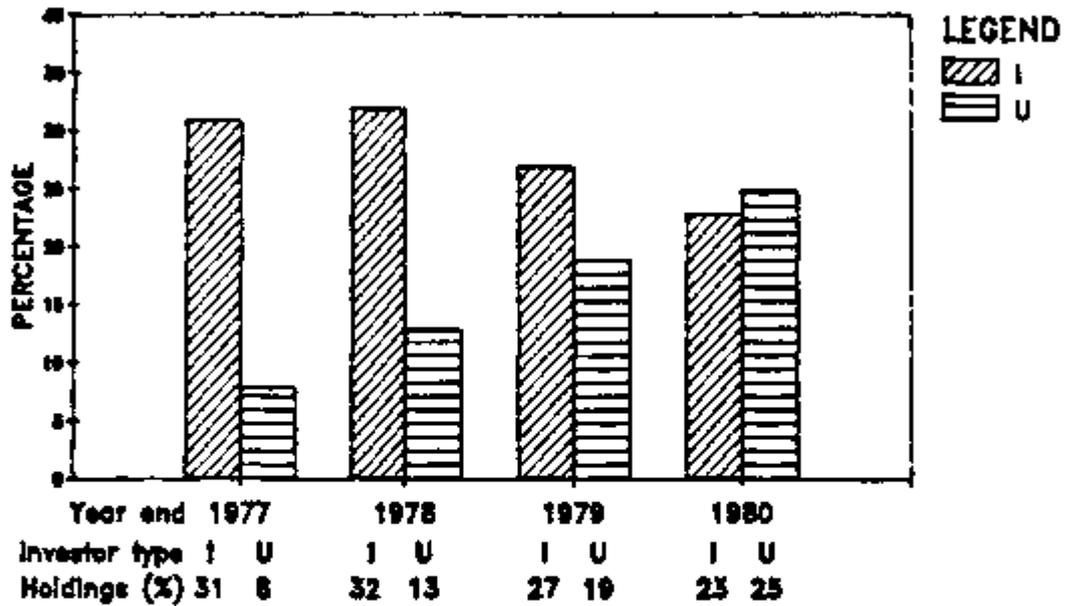
The growth in the purchases of Projects Nos. 4 and 5 bonds for UITs is only partially accounted for by the growth in the UIT industry in general. Although the UIT industry was growing during the period of Projects Nos. 4 and 5 bond sales, the purchases of Projects Nos. 4 and 5 bonds increased faster than the rate of industry growth over this period. 358/

The increase in purchases of Projects Nos. 4 and 5 bonds by the UITs appears to reflect a shift in the market for Projects Nos. 4 and 5 bonds away from institutions purchasing for their own portfolios to a retail market. 359/ In contrast to the increased holdings of Projects Nos. 4 and 5 bonds in UITs as a percentage of all Projects Nos. 4 and 5 bonds outstanding, the holdings by insurance companies, which were the principal institutional purchasers buying the bonds for their own portfolios, were declining as a percentage of all Projects Nos. 4 and 5 bonds outstanding: (See chart next page.)

358/ While the volume of aggregate purchases of Projects Nos. 4 and 5 bonds for UITs increased by approximately 700% from 1977 to 1981, the total industry volume of UITs grew by approximately 200%. The total purchases of all bonds for all UITs were (in millions): 1977 - \$2,284; 1978 - \$2,347; 1979 - \$2,967; 1980 - \$4,376; 1981 - \$5,398. Source: John Nuveen & Co., Inc.

359/ See discussion in Part II A, supra, about contemporaneous observations in shift in the market for Projects Nos. 4 and 5 bonds, including the Financial Advisor's report to the Supply System in June 1979 that major buyers of the Projects Nos. 4 and 5 bonds were becoming "the funds" and "kinky" investors who were looking for yield and discount bonds. See also discussion in Part III A, supra, including references by underwriters in the interview sessions with the Supply System on the selection of a managing underwriter in May, 1980 about market shifts.

**Holdings of Projects Nos. 4 and 5
Bonds as a Percentage of All Projects
Nos. 4 and 5 Bonds Outstanding**

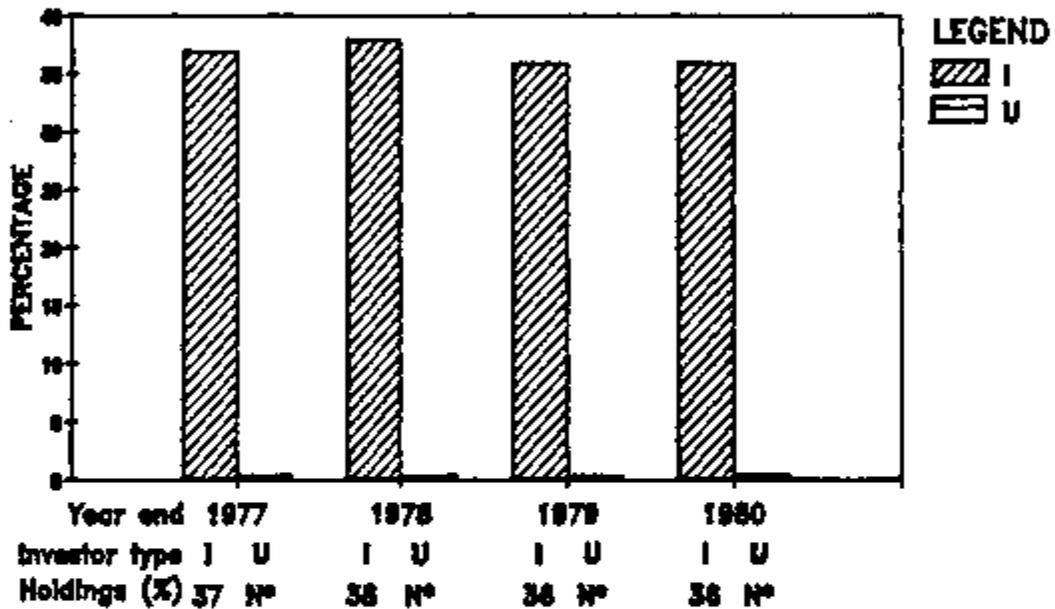


**I = Property & Casualty
Insurance Cos.
(from A.M. Best Co.
published holdings
of insurance companies)**

**U = Unit Investment
Trusts
(from staff
completion)**

Although insurance industry purchases of municipal bonds generally were decelerating in the later period of the Projects Nos. 4 and 5 bond sales because of a diminished need for tax-exempt investments, this development does not appear to account fully for the declining participation in the Projects Nos. 4 and 5 bonds. Indeed, the insurance companies continued their level of holdings of the higher-rated, BPA-backed Projects Nos. 1, 2 and 3 bonds as a percentage of the outstanding bonds of those projects, while the trusts did not increase their nominal purchases: (See chart next page.)

**Holdings of Projects Nos. 1, 2 and 3
Bonds as a Percentage of All Projects
Nos. 1, 2 and 3 Bonds Outstanding**



**I = Property & Casualty
Insurance Cos.
(from A.M. Best Co.
published holdings
of insurance companies)**

**U = Unit investment
Trusts
(from staff
compilation)**

*** Nominal**

3. Reasons for the Increasing Purchases of Projects Nos. 4 and 5 Bonds by Trust Sponsors

Two of the UITs were sponsored by lead underwriters on the Projects Nos. 4 and 5 bond offerings, and most sponsors were members of the underwriting syndicates. The sponsors of the trusts testified that they did not purchase Projects Nos. 4 and 5 bonds at the request of the underwriting departments of the sponsor firms. ^{360/} Although the purchases for the trusts helped the underwriting of the bonds because they absorbed a large amount of bonds at the time when the financing program was experiencing increasing difficulties, ^{361/} it appears that internal considerations of the trusts led to the increasing purchases of the bonds.

The UIT sponsors' increasing purchases of Projects Nos. 4 and 5 bonds during a period when the projects experienced growing problems appear to be explained by the high yields on the bonds. Yield was a principal consideration in purchasing bonds that qualified for purchase. The yields of the UITs were

^{360/} Most purchases for the trusts were from the secondary market, and not from the primary underwriting, because the assembly and sale of individual trusts (often denoted as one of a series) usually did not coincide with a new offering of Projects Nos. 4 and 5 bonds.

^{361/} See, e.g., discussion, *infra*, on speculation of buyer of bonds for the Merrill Lynch sponsored trusts about possible consequence to the Projects Nos. 4 and 5 financing program if Merrill Lynch stopped buying the bonds for its trusts.

important to the sale of trusts to investors. 362/ The portfolio buyers for the UITs were aware that even small differences in yield can affect the competitiveness of a trust with other trusts. 363/ Buyers for the UIT portfolios were supplied by their sales organization with information on yields of competing trusts, sometimes on a daily basis. 364/ Yield was thus a prime consideration for sponsors when purchasing bonds that would constitute the trust portfolio. 365/ Indeed,

362/ E.g., William J. Morgan SEC tr. at 33 (March 22, 1985):

Q. Is it a fair statement to say that's what sells the unit investment trust.

A. Yield?

Q. Yield.

A. Absolutely. Yield and tax exemption.

Thomas D. Van Buskirk SEC tr. at 30-31 21, 1985).

363/ Thomas D. Van Buskirk SEC tr. at 95-96 (May 21, 1985); Robert McNamara SEC tr. at 125 (Nov. 16, 1984); William J. Morgan SEC tr. at 120-121 (Mar. 22, 1985); Robert A. Broman SEC tr. at 37-38 (Dec. 15, 1984) (" . . . And sometimes the difference between the yield in our trust and someone else's may be two or three basis points, just enough to say that, you know, so we can say that we are the best, you know, we have the highest yield. . . .")

364/ Philip G. Milot SEC tr. at 77-78 (Nov. 13, 1985); Thomas D. Van Buskirk SEC tr. at 93 (May 21, 1985); William J. Morgan SEC tr. at 121 (Mar. 22, 1985); James R. Couture SEC tr. at 117 (Mar. 22, 1985); William J. Morgan SEC tr. at 118-20 (Mar. 22, 1985). Portfolio buyers for UITs also usually noted the bonds included in other trusts.

365/ Philip G. Milot SEC tr, at 73 (Nov. 13, 1985); Thomas D. Van Buskirk SEC tr. at 96 (May 21, 1985) (commenting on some competitor's use of bonds with questionable yield-boosting features to get an advantage on yield:

(continued...)

the trust portfolios tended to be composed largely of bonds that were higher yielding, particularly hospital, housing and electric utility bonds. 366/

The Projects Nos. 4 and 5 bonds were attractive to the UIT sponsors. They met the rating criteria for inclusion in the trusts. They had a yield premium over similar bonds. They offered a yield premium even over the bonds of other electric power joint operating agencies with nuclear project exposure. 367/ (SEE CHART, NEXT PAGE)

365/(...continued)

This is a nice product for making money so a lot of people really want to get in the market-place and really when you enter the

marketplace the only thing you've got to sell is yield so that's what they do. They go after yield.).

366/ These tended to be riskier types of bonds that were avoided by some more conservative investors despite their higher yield. Edward N. Bennett SEC tr. at 47-4B (Jan. 8, 1985). The trust prospectuses often contained some general description of possible negative investment aspects of these types of bonds.

367/ E.g., Robert A. Broman SEC tr. at 109-110 (Dec. 15, 1984) (bond buyer for a unit investment trust):

Q. So that one-third [the utility bond portion of the trust] was often most or all nuclear issues.

A. It was all nuclear issues, yes.

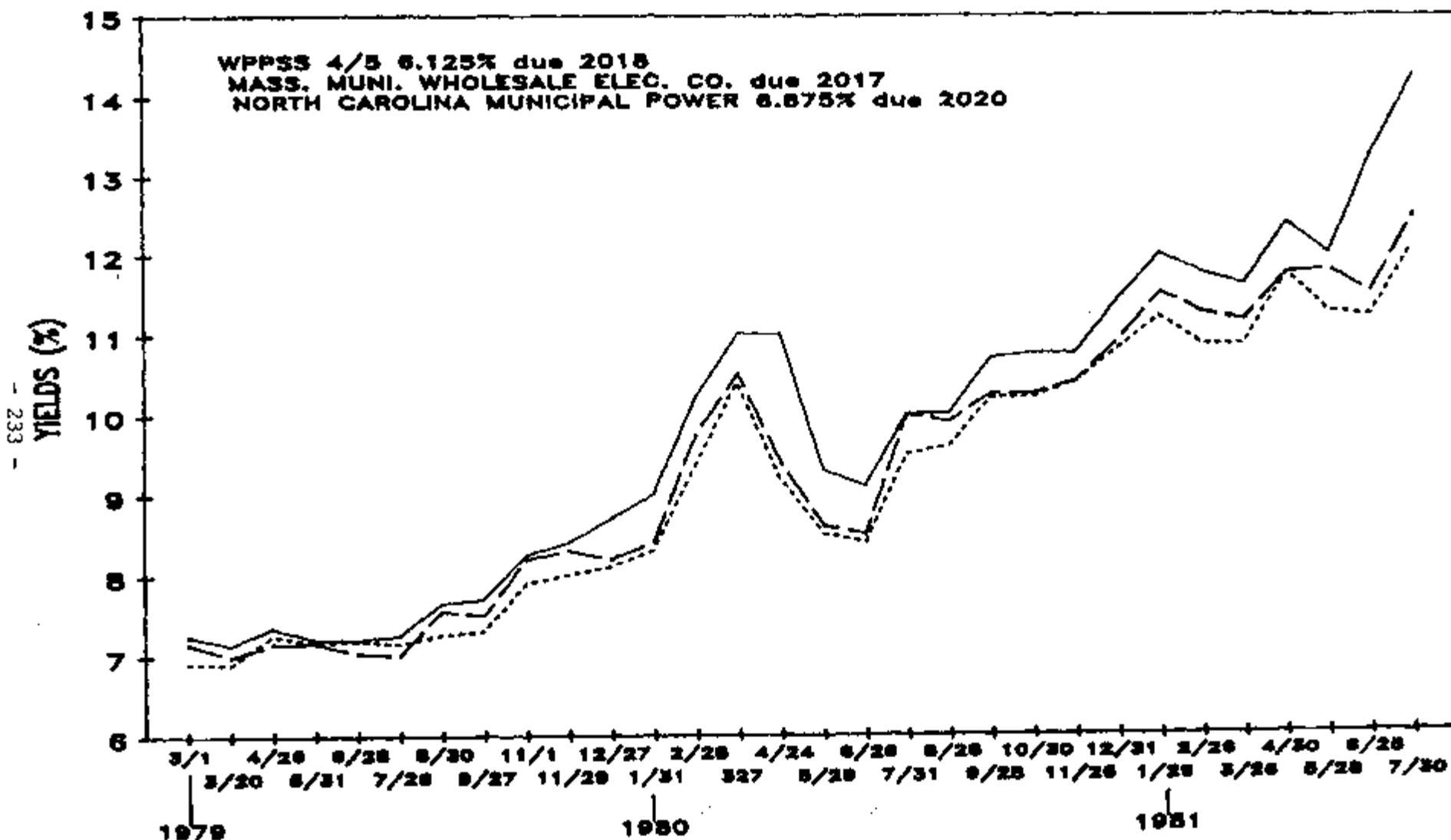
Q. Why was that?

A. Because they have a higher yield and made the trusts more attractive to sell.

Q. Do you remember why that was, or was

(continued on 234)

YIELDS ON BONDS OF PROJECTS NOS. 4&5 AND TWO OTHER JOINT OPERATING AGENCIES



(Text continues on next page)

367/(...continued)

that true for the industry as a whole
then that the nuclear issues paid the
higher yields.

A. That is correct.

Q. They didn't, I guess, then coupling
this back with an earlier statement
that you made that the [Project Nos.]
IV-V issues were often the highest
yielding bond or one of the highest
yielding. Does that mean of the
nuclear issues that the IV-V yields
were the highest -

A. That is correct.

Q. -- among nuclear issues?

A. Yes.

Although yield is of interest to all investors, for some institutional investors purchasing for their own portfolios, yield was not as compelling a factor. It was only one consideration, and the rising yields on the Projects Nos. 4 and 5 bonds did not necessarily make the bonds an attractive purchase. 368/ Concerns about adverse developments could

368/ E.g., Edward N. Bennett SEC tr. at 47-48 (Jan. 8, 1985) (insurance company portfolio manager):

- Q. You weren't attracted to the higher yield of the 4, 5 [bonds]?
- A. Oh, sure they came at a higher yield but we didn't then and we don't now make our decision based upon yield. That's a factor in a decision but it's not the governing factor.

Steven C. Bauer SEC tr. at 95-97 (Aug. 22, 1984) (insurance company portfolio manager):

- Q. Now, I would suppose that your credit evaluation of the issuer is relevant to those determinations [whether a bond is becoming overpriced or underpriced relative to the market].
- A. Certainly. That may be one reason why the relationship is changed. Certainly the relationship of WPPSS bonds in general to the general market changed from the early mid-'70's until the early '80's because the market had a different view of the credit considerations.

So to say that because WPPSS bonds were extraordinarily cheap or looked cheap historically in 1980 was only part of the story. You had to look at what the reason was for why that relationship had changed; and that's basically what my job is all about. (at 96-97).

indicate that even the high yields did not justify the purchase of the bonds. 369/

4. Bond Selection and Creditworthiness Evaluation Process

The high yields on Projects Nos. 4 and 5 bonds might have indicated that extra caution was needed in evaluating the creditworthiness of the bonds and whether they were fairly valued. The fact that the bonds were rated A1 and A+ by the rating services would not alone necessarily constitute a complete quality evaluation or a basis for determining that bonds were properly priced in comparison with other bonds. 370/ Sophisticated institutional investors do not rely solely on

369/ Id., Robert E. Patterson SEC tr. at 57-60, 83-84 (Dec. 12, 1984 (insurance company portfolio manager):

Q. [E]ven in light of the attractive spread, why did you not buy the [Projects Nos. 4 and 5] bonds?

A. Because at that point it became a credit question and a question in my mind for all the things we brought together. It was just a whole host of factors at that point that I was concerned about. Not so much the viability of the project but the credit worthiness or the value orientation of the bonds is the best phrase to use. I was actually right on that. I thought it would deteriorate and I felt the spreads were not properly reflected of the risk that was inherent in the bonds. And unfortunately it really proved to be true. (at 84).

370/ See discussion in Part III B about the limitations of the rating process. See also Richard Huff SEC tr. at 168-69 (Dec. 4, 1985).

ratings in determining the creditworthiness of bonds, 371/ or in determining their relative value. 372/ The rating agencies, moreover, specifically state that their ratings "should be weighed solely as one factor in an investment decision." 373/

In evaluating the price and creditworthiness of bonds being considered for purchase, sophisticated institutional investors review information about the bonds. Official statements are a primary source of information for portfolio

371/ E.g., Carl P. Jayson SEC tr. at 26, 47 (Nov. 27, 1984); Stephen C. Bauer SEC tr. at 25-26 (Aug. 22, 1984); Jeffrey J. Alexopoulos 9-10 (Aug. 15, 1984) ("We do not rely on external rating agencies or external analysts for their opinion, we rely solely upon our own opinion to decide whether or not to own a security or to place it in one of our products."); Edward N. Bennett SEC tr. at 25 (Jan. 8, 1985) ("I always ask what they [ratings] were, but I also emphasized that we wanted to determine what we thought of the credit so that we could make our own credit decision.").

372/ E.g., Edward N. Bennett SEC tr. at 26 (Jan. 8, 1985); Carl P. Jayson SEC tr. at 47-48 (Nov. 27, 1984); Guy E. Wickwire SEC tr. at 26-27 (Aug. 21, 1984); Robert E. Patterson SEC tr. at 18-19 (Dec. 12, 1984).

373/ E.g., Moody's Investors Service, Inc., Municipal Credit Report (Washington Public Power Supply System Nuclear Projects Nos. 4 and 5) 1 (Dec. 6, 1979) (SEC Exh. 2324):

Moody's rating are opinions, not recommendations to buy or sell, and their accuracy is not guaranteed. A rating should be weighed solely as one factor in an investment decision and you should make your own study and evaluation of any issuer whose securities or debt obligations you consider buying or selling.

managers. 374/ Information from brokerage firms, analyst reports, rating agency reports, and financial publications is also often considered. Sometimes information is obtained from the underwriter or the issuer and its consultants. All these sources of information, in addition to the official statements, were available for Projects Nos. 4 and 5 bonds. In evaluating the Projects Nos. 4 and 5 bonds, information about the economic feasibility of the projects being financed was a factor for some institutional investors even though the bonds were secured by the Participants' obligations to pay. 375/ Moreover, although the bond counsel opinion letters supported the legal validity of the Participants' payment obligations, information

374/ E.g., Edward N. Bennett SEC tr. at 24 (Jan. 8, 1985); Robert Patterson SEC tr. at 18 (Dec. 12, 1984) ("The official statement would have been critical in our mind in two factors, one, what was in there; and, two, what was perceived to be missing in the official statement. I guess that would be the leading document....").

375/ E.g., Edward N. Bennett SEC tr. at 42-43 (Jan. 8, 1985) (insurance company portfolio manager):

Whether the project is feasible, sure. We would not want to necessarily be associated with something that didn't seem to be feasible just because it was a take-or-pay contract.

We presume that there is going to be a demand for the product, whatever it is, at the end of the line. You are also assuming that the project would be completed. I mean there's no point -- We would have no interest in going into a financing if we said, gee, we don't think that project is really feasible and it's probably never going to be completed but who cares because it's a take-or-pay contract.

about those obligations and the difficulty of evaluating the willingness and ability of the Participants to pay were considerations for some institutional investors. 376/

The bond selection process for the UITs functioned somewhat differently, in part because of the importance of yield to trust competitiveness. The selection of bonds was usually the responsibility of a bond buyer whose principal function was to seek out the highest yielding bonds that met the trust's criteria so that the trust would be competitive on yield with other trusts. The buyer usually did not have information that would permit him to assess the relative merits of bonds being purchased other than the ratings. Most sponsors maintained that they had some internal credit approval process. This was usually performed by the research units of the sponsoring firms. Even where there was some credit approval

376/ Edward N. Bennett SEC tr. at 49-52; 83-84 (Jan. 8, 1985)(insurance company portfolio manager):

Yes, a lot of them [the 88 participants] were very small and I don't even remember the name of any of the participants right now, but a lot of them were so small you never heard of them and the data was so sketchy that you did have about them that we weren't able to analyze it. It would be almost an act of faith in the sense of investing in them presuming that you could get ongoing data on them to monitor how they're doing and we decided we didn't want to bother with that. (at 83).

See also Jeffrey J. Alexopoulos SEC tr. at 97-98, 119-20 (Aug. 15, 1984).

process, however, the buyer usually was told simply that the bonds were approved for purchase. This did not provide the buyer with information to evaluate the price of the bonds other than on the basis of the rating. 377/ Sophisticated institutional investors assess the creditworthiness and the price apart from the rating. They thus might not purchase bonds that have superior yields if the bonds were not fairly valued in comparison to other bonds. The UITs emphasis on selection based on yield made the selection of the high yielding Projects Nos. 4 and 5 bonds likely. 378/ The selection processes of several trusts are described below.

a. No Direct Quality Approval Procedure

Smith Barney, Harris Upham & Co. sponsored and assembled portfolios for the Tax Exempt Securities Trust. Smith Barney was also one of four firms that acted as a lead underwriter on the Projects Nos. 4 and 5 bonds. The prospectuses for the trusts stated that they invested only in bonds rated A or better by one of the rating agencies; that the objectives of

377/ The trust prospectus usually represented that consideration was given to the prices of the bonds relative to other bonds of comparable quality.

378/ Some trust sponsors maintained that because the bonds were to be held until maturity, the possibility of negative developments was not significant so long as they believed that the interest and principal would be paid. Negative developments could, and here did, ultimately affect payment of principal and interest. Also, negative developments could affect the market price of the bonds and this would affect unitholders who redeemed their units or sold their units in the secondary markets maintained by the sponsors before maturity of the bonds in the trusts.

the trust were "tax-exempt income and conservation of capital"; and that among the factors considered in selecting bonds was that "in the opinion of the Sponsors, the Bonds are fairly valued relative to other bonds of comparable quality and maturity." 379/ A sales brochure included in the prospectus stated that one of the benefits of investment through the trust was professional selection of bonds for the portfolio. 380/ The diversification of bonds and high yields were also cited as benefits. 381/ Smith Barney was a substantial sponsor of UITs,

379/ E.g., Tax Exempt Securities Trust, Series 50, prospectus, 1, 3 (May 20, 1981). (SEC Exh. 2601.)

380/ Id., sales literature insert between 2-3:

- Q. What is the Trust?
- A. It's a way for you to invest in a portfolio of many different bonds - each with its own maturity, yield and rating. All securities in the portfolio are carefully selected by qualified bond professionals. The bonds must have a rating of A or better by Moody's or Standard and Poor's. The face amount of each unit is \$1,000.

381/ Id.:

- Q. How can you be sure of high yields and reasonable safety?
- A. With Tax Exempt Securities Trust, you're not locked into a single bond with the chance, however slight, that the issuer will not be able to pay its debt. Each unit in the Trust represents a share in all the bonds in the portfolio. You're investing in not one, but many bonds. So the Trust can acquire those bonds offering
- (continued...)

and Projects Nos. 4 and 5 Bonds eventually constituted 7.5% of its UIT portfolios, the maximum permitted under its policies.

Smith Barney did not have a UIT research staff to evaluate the quality of the bonds that were purchased for the portfolios, nor did the buyer of bonds for the trusts' portfolios consult with Smith Barney's fixed income research department or read its reports. 382/ The portfolio buyer did not read information that would permit him to form an independent evaluation of the quality of bonds he purchased for the trusts. 383/ As a general practice, the buyer evaluated

381/(...continued)

higher yields and pass the resulting larger returns along to you. (emphasis in the original)

382/ George S. Michinard SEC tr. at 45 (Oct. 28, 1985).

383/ Id. at 43-44:

- Q. Do you normally read the official statements when you're trying to decide what to put into the portfolio?
- A. No.
- Q. Does anybody read them? Anybody involved in the UIT portfolio process?
- A. No.
- Q. Do you normally read anything about the bonds before you make a purchase decision?
- A. No, normally, - -
- Q. Do you read anything in connection with making - -

(continued...)

quality by relying on the ratings given to bonds by the rating agencies and on whether Smith Barney or any of the other sponsors had underwritten the bonds. 384/ If Smith Barney or any of the other sponsors were willing to sell bonds to their clients as underwriters, then the bonds were considered suitable for purchase for the trusts. 385/ In fact, however, Smith Barney purchased bonds for the trusts that had not recently been underwritten by the sponsors, and even purchased bonds that had never been underwritten by any of the sponsors. 386/

The portfolio buyer did not speak with anyone in the underwriting or public finance department about bonds he was buying. 387/ Aside from the rating and underwriting criteria, the portfolio buyer purchased on yield. 388/ The portfolio buyer was aware that other trusts tended to buy many of the same bonds and that the yields of all the trusts would be within a few hundreds of a percent of each other. 389/

383/(...continued)

A. Normally not. No, I don't. There's just not enough time.

384/ Id. at 44-46, 53. Although the portfolio buyer relied on the rating, the unit investment trust department did not subscribe to the rating agency services that publish textual reports on the bonds that are rated. Id. at 90-91.

385/ Id. at 44-46, 53, 57.

386/ Id. at 127-128.

387/ Id. at 44-46, 53, 57.

388/ Id. at 50-53.

389/ Id. at 51-52, 85-86.

In making the determination to purchase the Projects Nos. 4 and 5 bonds, the portfolio buyer followed the general practices described above. He relied on the ratings and the fact that Smith Barney was an underwriter of the Projects Nos. 4 and 5 bonds. 390/ Although the public finance unit of Smith Barney maintained that it reviewed underwritings of Supply System bonds in conjunction with the research department, 391/ the portfolio buyer did not speak with anyone in the research, underwriting, or public finance departments about the Projects Nos. 4 and 5 bonds. 392/ The portfolio buyer did not read the official statements or any other source of substantive information about the Projects Nos. 4 and 5 bonds. 393/ The

390/ Id. at 95.

391/ Morgan J. Murray SEC tr. at 25-39 (July 11, 1985). The Smith Barney research department had noted some investor concerns about the Project Nos. 4 and 5 bonds in the course of reviewing the proposed short-term debt program and Smith Barney's own published research reports pointed out negative developments with respect to the bonds. See Part II B and III A, supra.

392/ George S. Michinard SEC tr. at 95-96 (Oct. 28, 1985).

393/ Id. at 96, 119-22:

Q. Did you have any information about the Supply System bonds when you were making these purchases, as to their credit or quality.

A. Well, we knew the rating was A-1, A+. We knew that Smith Barney approved the name. I didn't have to go any further.

Q. In other words, you didn't read the OS's?

(continued...)

portfolio buyer thus was unable to go beyond the rating or the underwriting by Smith Barney in evaluating the quality of the bonds. Nevertheless, the UIT prospectuses and sales literature state that the bonds were, in the opinion of the sponsor, fairly valued relative to other bonds of comparable quality and that "all securities in the portfolio are carefully selected by qualified bond professionals". 394/

b. Use of Internal Credit Approvals

Some UITs employed a formal creditworthiness approval procedure, usually utilizing a research group within the sponsoring firm. E.F. Hutton, which assembled the E.F. Hutton Tax Exempt Trust, utilized the firm's fixed income research department for credit evaluation. 395/ The portfolio buyer received the reports published by the research department. The portfolio buyer would read the summary portion of the report and note the rating assigned by the analyst. 396/ If the

393/(...continued)

A. No.

Q. You didn't read any analysts reports?

A. No.

Q. You didn't read the Moody's textual descriptions?

A. No. (at 96)

394/ E.g., Tax Exempt Securities Trust, Series 50, prospectus, sales literature between 2-3 (May 25, 1981). (SEC Ex 2601.)

395/ William J. Morgan SEC tr. at 31-35 (Mar. 22, 1985).

396/ Id. at 32, 64.

rating was satisfactory, selection was then based on diversification and highest yield. 397/ The portfolio buyer did not normally talk with the analyst if the report and rating were satisfactory. 398/ The E.F. Hutton analyst reports on the Projects Nos. 4 and 5 bonds noted positive and negative facts. The reports rated the Projects Nos. 4 and 5 bonds as a mid-range A and in August 24, 1979, the classification of "Trend of Underlying Credit Factors" was changed from "Stable" to "Declining". 399/ However, if the rating was satisfactory for bonds for the trust, the trust portfolio buyer was inclined to buy bonds on yield without allowing for smaller differences in quality to affect the purchase decision. 400/ Thus he

397/ Id. at 73.

398/ Id. at 90, 134-36.

399/ E.F. Hutton Fixed Income Research, No. 127 (August 24, 1979). ("In consideration of the mixed influences of significant strengths and weaknesses we are maintaining our Mid-range A rating on WPPSS Projects Nos. 4 and 5 but changing the underlying trend to Declining in response to the continued escalation of costs and related effects." (at 2)). (SEC Exh. 2183.)

400/ William J. Morgan SEC tr. at 81-82 (Mar. 22, 1985):

Q. When you look at a credit and you have two similarly situated issues, both rated, let's, for argument's sake, say A, and one trades at a higher yield than the other. The one with the higher yield is indicated to be by research somewhat less credit worthy than the one with the lower yield. How would that difference affect your decision as to which security to purchase for the unit investment trust, if at all?

(continued...)

continued to purchase Projects Nos. 4 and 5 bonds for the trusts.

Van Kampen Merritt, Inc. utilized a procedure in which an analyst gave credit approval for bonds to be purchased by the trusts it sponsored. Once a bond was approved, the portfolio buyer would not need to resubmit the bond unless he was told the bonds were no longer approved. 401/ The buyer himself did not read sources of substantive information about the bonds, such as official statements, 402/ but would purchase the highest yielding approved bonds. 403/ As a result, purchases of the high yielding Projects Nos. 4 and 5 bonds were made. 404/

400/(...continued)

- A. It probably wouldn't, because if it's still considered to be investment grade, you're getting into shadings of credit rating and as long as I was satisfied that it was investment grade, I'd still probably buy the highest yielding bond.

401/ Robert A. Broman SEC tr. at 18, 26 (Dec. 15, 1984).

402/ Id. at 28-29, 141.

403/ Id. at 69-70.

404/ Robert A. Broman SEC tr. at 69 (Dec. 15, 1984):

It's just a -- it's a yield determination. You know you have [a] vast gam[ut] of bonds to choose from based on credit approval, and what you want to do is: you pick out the highest yielding bonds within certain parameters. We wouldn't want to have a trust of all power bonds or all housing bonds. So we had diversification there as well. WPPSS
(continued...)

The Projects Nos. 4 and 5 bonds were sufficiently attractive on yield that Van Kampen purchased Projects Nos. 4 and 5 bonds for its uninsured trusts after they no longer were eligible for its insured trusts. Some trust sponsors, including Van Kampen, sponsored trusts consisting of bonds where payment of principal and interest was insured by third-party insurers. The American Municipal Bond Assurance Corporation (AMBAC) issued such insurance on Projects Nos. 4 and 5 bonds in UIT portfolios. In the middle of 1979, as purchases of the Projects Nos. 4 and 5 bonds for unit investment trusts were accelerating, AMBAC classified the bonds as ineligible for additional insurance commitments. 405/ The decision to cease issuing insurance on additional Projects Nos. 4 and 5 bonds was based in part on a desire to limit additional exposure in these bonds and in part on quality considerations. 406/

404/ (...continued)

were, you know, the highest yielding bond available with an A or better rating that had been approved. So that is why we generally used some of the Washington Power bonds in our trusts.

405/ See AMBAC underwriting request forms (SEC Exh. 2000.) Some outstanding commitments may not have been exercised until a later time. AMBAC's total commitment on principal and interest on Projects Nos. 4 and 5 bonds was approximately \$70 million.

406/ Vytautas Dudenas SEC tr, at 79, 88-89, 102, 117-118 (Jan. 18, 1985). AMBAC had not reached its legal commitment limit, and, despite subsequent growth in its legal limits and continuing requests for insurance on the bonds, it declined to issue additional insurance. Id. at 79-80, 85-86, 117. AMBAC continued to insure Projects Nos. 1, 2 and 3 bonds into 1981 to a total exposure of more than \$100 million. Id. at 111-112.

Prior to the AMBAC's ceasing to insure the Projects Nos. 4 and 5 bonds, all purchases of these bonds by Van Kampen were for the insured trusts. After AMBAC ceased issuing insurance on the bonds, the bonds were bought for the Van Kampen uninsured trusts, up to the 15% diversification limit of the trusts. 407/

c. Use of Credit Approval Procedure with Other Circumstances

Other firms also employed an analyst approval process. One firm, John Nuveen & Co., sponsored UITs that were major purchasers of Projects Nos. 4 and 5 bonds. 408/ The purchases by the Nuveen sponsored trusts consistently reached the maximum internal limits of 7.5%. Although the portfolio buyer read materials about the Projects Nos. 4 and 5 bonds in the early period of the purchases, the prime responsibility for credit evaluation later shifted to the research department and the portfolio buyer then relied on the research department to advise him of any problems with the bonds. 409/ The portfolio buyer did not seek approval for each purchase or regularly discuss the bonds with the analyst. The analyst's approval was good until withdrawn by the analyst. 410/ The decision on what

407/ The Van Kampen portfolio buyer was not told of any reason for limiting the insurance, but the bonds had been approved and he noted that other trust sponsors continued purchasing the bonds. Robert A. Broman SEC tr. at 114-24 (Dec. 15, 1984).

408/ The purchases of those trusts totalled approximately \$140 million, second in amount only to the trusts sponsored by Merrill Lynch that are discussed below.

409/ Thomas D. Van Buskirk SEC tr. at 85-87 (May 21, 1985).

410/ Id. at 86-87; Jerome Lepinski SEC tr. at 36-37 (May 22, 1985).

bonds were bought among those approved was based on yield. 411/

Nuveen was an underwriter and participated in many of the underwriting syndicates that sold Projects Nos. 4 and 5 bonds, as well as being a sponsor of UITs. One of the assignments of the analyst who approved the bonds for purchase by the UITs was to write reports for bonds that Nuveen might underwrite. 412/ Some shorter reports, or circulars, containing basic sales information, would go principally to Nuveen salesmen. Other, more extensive reports would have a wider distribution to potential customers of the firm, including institutional buyers. The analyst wrote one of these more widely circulated reports on the Supply System during the period in which Projects Nos. 4 and 5 bonds were being issued. In connection with that report, the analyst visited the Supply System in

411/ Thomas D. Van Buskirk SEC tr. at 30-31, 53 (May 21, 1985):

- Q. How would you determine which bonds to buy close to the 7 1/2 percent limit or in quantity and which bonds not to?
- A. Well, you know, we're in a very, very competitive environment, as I'm sure you imagine, and the thing that sells bond funds, regretfully, is current return so what you try to do within the parameters that you operate under is to try to get as much current return as you possibly can for that unit holder.

You would choose then from those bonds that provided the best current return. (at 30-31).

412/ Jerome Lepinski SEC tr. at 8-15 (May 22, 1985).

April, 1979. 413/ At that time, the Supply System's problems were increasing and a number of other reports and comments by analysts and others were beginning to note some of the problems. The analyst told the chief financial officer of the Supply System that Nuveen was trying to offset the negative coverage of the Supply System and possibly to write a positive report:

I explained what Nuveen was trying to do here, that is coming up with some kind of report that, perhaps, is favorable to WPPSS. We would try to offset some of the negative comments coming from the press and other sources in recent days and months. He agreed he is familiar with John Nuveen and respects our firm. 414/

The report that was produced for circulation by Nuveen was, in fact, highly favorable in almost all aspects for the Supply System and its projects. 415/

413/ Id. at 25-35.

414/ The analyst's notes of April 10, 1979 through April 13, 1979 trip at JN--43. (SEC Exh. 2227.)

415/ Nuveen Research Comment, WPPSS -- "Still a Buy?" (June 29, 1979). (SEC Exh. 2201.) The analyst's notes of the visit, although generally favorable, indicate that some of the information learned may not have been as completely favorable as the report. See Analysts Notes, supra, (SEC Exh. 2227) at JN--37 (Participants' commitment: "I asked him if the smaller PUD's and co-ops really understand the cost factors of these Projects. He [Stephen Buck] had to agree with me that they most likely do not realize all the aspects and full implications of the obligations, especially smaller communities or co-ops with 20 to 50 customers."), at JN--36-37 (under normal conditions BPA could provide power "well into the 80's" just from hydro-electric), at JN--48, 54 (board may not have "capability to work with such large responsibilities.").

In May, 1980, Nuveen applied to the Supply System to become a managing underwriter of the sale that was negotiated after the Supply System rejected the competitive bid. 416/ Notes taken by a Supply System employee of the interview with Nuveen indicate that Nuveen was aware of the increasing importance of bond funds to Projects Nos. 4 and 5 bond sales in light of the changing market for the bonds. 417/ It also appears that part of the strategy for the offering included the participation of the Nuveen bond funds, both UITs and a managed

416/ See discussion in Part III A, supra, on the May 1980 negotiated offering.

417/ Stephen Buck notes of May 3, 1980 John Nuveen & Co., Inc. interview (SEC Exh. 2516 at 9-10):

little presale orders [in rejected bid]
 from institutions - \$5 million - momentum
 to dealer accounts, trading accounts - no
 major institutional business - one bond
 fund;

* * * *

Bond Funds) bulk of the deal next
 Individuals) week will come from these

* * * *

<u>Buyer</u>	<u>1980A</u>	<u>1978</u>
Bank's Portfolios	5%	15%
Ins. Co.	20-25%	40-45%
Bond Funds	40-50%	20+%
Trust Dept.	5-10%	10%
Individuals	20-25%	15%

The reference to bond funds probably was principally to unit investment trusts, as reflected in the purchases by unit investment trusts. See charts, supra.

bond fund sponsored by Nuveen, as purchasers. 418/ As part of its continuing purchases, Nuveen purchased \$10.08 million of the bonds issued in that offering for the four trusts it assembled over the next six weeks. 419/ A Nuveen managed bond fund made its first purchase of Projects Nos. 4 and 5 bonds, \$2 million, out of the negotiated offering and later sold the bonds. 420/ A Supply System official subsequently acknowledged

418/ Id. at 10:

Strategy for 1980A issue:

* * * *

- . targets for interest rates = Bonds
Funds and Retail

* * * *

- . Nuveen Bond Fund[s]
 - . 1st major order 4/29; will be there again next week; sales activity \$1 Billion/year; 7 1/2% of Total Fund in any one name; \$96 million Total WPPSS - mostly 4/5 unit investment trust.

419/ Nuveen lists of bonds purchases. (SEC Exhs. 2212, 2290, 2366). The total bond offering was \$130 million. The purchases were up to, or slightly above, the 7.5% internal limit for the trusts.

420/ The Nuveen managed bond fund up until this time had bought Project No. 2 bonds but no Projects Nos. 4 and 5 bonds. List of Nuveen Municipal Bond Fund, Inc. purchases and sales. (SEC Exh. 2228.) The portfolio manager of the managed bond fund did not recall the reasons for the purchase or of having any discussion with the underwriting department. Thomas C. Spaulding, Jr. SEC tr. 29-30 (May 21, 1985). The bond fund sold the bonds approximately a month later.

the role of the Nuveen funds in the offering. 421/ Nuveen continued purchasing Projects Nos. 4 and 5 bonds to the 7.5% limit until shortly after the recommendation of a moratorium on construction in May, 1980.

Merrill Lynch, Pierce, Fenner & Smith, Inc. also sponsored unit investment trusts that purchased Projects Nos. 4 and 5 bonds. 422/ Merrill Lynch also underwrote Projects Nos. 4 and 5 offerings and was a lead underwriter on the syndicate that sold many of the offerings. The Merrill Lynch-sponsored trusts

421/ Memorandum from Paul R. Daniels (Manager of Research Department and supervisor of mutual funds) to members of public finance department (June 9, 1980) (SEC Exh. 2200):

Don Karlberg, who I presume still has the title Treasurer Division Manager of WPPSS, called me last week. . . . I have the feeling that he wanted to either console or conciliate us after we were not included in the [underwriting] management group [on the May 1980 offering].

Don evidently had figures for Nuveen's takedown and/or sales performance and also for the bonds bought by our managed fund. He commented that Nuveen funds were in with both feet. I tried to emphasize the role of Nuveen funds as major WPPSS bondholders and also referred to our research report of last year -- suggesting that some future newsworthy development might trigger a revision of the report.

. . . He did express the belief that there would be more negotiated financing. He also made a rather pointed "off record" comment about Nuveen being given prime consideration in the future.

422/ Co-sponsors of the trusts, the Municipal Investment Trust Fund, during the Project Nos. 4 and 5 offering period were Bache Halsey Stuart Shields, Inc., Dean Witter Reynolds, Inc., and Shearson Loeb Rhoades, Inc. All the operations of the unit investment trusts, including selecting of bonds, however, was done by Merrill Lynch's Bond Fund Division.

contained the largest amount of Projects Nos. 4 and 5 bonds among all the UITs. By June 1981, Merrill Lynch had purchased almost a quarter billion dollars of Projects Nos. 4 and 5 bonds for the UITs it sponsored, more than 10% of all Projects Nos. 4 and 5 bonds issued by the Supply System.

Prior to the first offering of Projects Nos. 4 and 5 bonds, Merrill Lynch had purchased a limited amount of Projects Nos. 1, 2 and 3 bonds for the trusts that it sponsored. When the Supply System began selling Projects Nos. 4 and 5 bonds, Merrill Lynch stopped purchasing the Projects Nos. 1, 2 and 3 bonds for the trusts and began purchasing Projects Nos. 4 and 5 bonds. Purchases of these bonds accelerated, and by 1979 holdings in the trusts were consistently at or near the 7.5% internal limit in each of its trust offerings and continued at that level until the announcement of the recommendation of a construction moratorium in May, 1981.

Merrill Lynch had a Bond Fund Division that assembled the trust portfolios. One person bought bonds for the trust portfolios. The division also had three or four analysts reviewing the bonds that were considered for inclusion in the trusts. The analysts in the Bond Fund Division reviewed the creditworthiness of bonds being considered for purchase. When the buyer wished to purchase a bond that had not been approved recently by an analyst, he asked for a decision by the analyst. The decision was given orally or by a notation of approval or disapproval on a cover page of an official statement. The

reviewing analyst often wrote a brief memorandum to the file about the bonds. The buyer, however, did not know what standards the analysts applied, did not know what factors they considered, and did not read the analyst's memorandum or talk to the analysts about the bonds he was buying. 423/ The buyer did not read official statements or other substantive information about the bonds he purchased. 424/ Subject to the trusts' limitations of 7.5% for any one bond and diversification as to type of bonds, the buyer sought the highest yielding bonds that met the rating criteria and were approved by the bond department analysts. 425/ The buyer was aware on a daily basis of the yields on other trusts with which the Merrill Lynch trusts competed. 426/

The analyst who principally reviewed the Projects Nos. 4 and 5 bonds 427/ produced a limited number of credit memoranda on Projects Nos. 4 and 5 bonds from the beginning of 1977 to

423/ Philip Milot SEC tr. at 56-61 (Nov. 13, 1985).

424/ Id. at 57-61.

425/ Id. at 73-74.

426/ Id. at 57-61.

427/ Kevin Baker SEC tr. at 14, 38 (Dec. 6, 1985).

late 1979. 428/ The bonds were approved for purchase and the holdings in the trusts reached the 7.5% limit.

During this period, problems were developing on the projects. The Supply System's budgets were increasing and its financing program was beginning to experience difficulties. In 1979, Merrill Lynch's Fixed Income Research Department, which was a research department separate from the Bond Fund Division, issued reports on Projects Nos. 4 and 5 bonds that cited negative factors. 429/ Also, the Merrill Lynch municipal bond underwriting department held a meeting in June, 1979 on the question of whether to continue underwriting Supply System bonds. 430/

In late October 1979, the management of the Bond Fund Division suggested to a junior analyst that she go on an investors' tour being given by the Supply System at its facilities. 431/ After the tour, she wrote a memorandum to the

428/ Only two research memoranda on Projects Nos. 4 and 5 were in the files. The first written memorandum was done in October 1978. Another brief, undated handwritten draft was apparently done in 1979. Merrill Lynch has stated that other reports might have been done but missing from the files. Indications of approval were also made on the cover pages of some official statements.

429/ See discussion in Part II B, supra.

430/ See discussion in Part II B, supra.

431/ The analyst had worked for Moody's municipal bond rating service for a little more than a year before joining the Merrill Lynch Bond Fund Division in September 1978. When she started at Merrill Lynch, she reviewed the creditworthiness of bonds that were in existing trusts. At the time of her trip she was reviewing bonds for

(continued...)

head of the Bond Fund Division and the administrative head of the analyst group. 432/ The memorandum listed the current holdings of Supply System bonds by the Merrill Lynch trusts, described the security provisions for Projects Nos. 1, 2, and 3 and Projects Nos. 4 and 5 bonds, listed the additional financing required for the projects, described construction delays and budget increases, and noted a pending 90% BPA rate increase and some opposition to the projects. At the end of the memorandum, she stated that:

The conclusion can be drawn that great uncertainty lies in the ability of a program of this magnitude in the current economic and regulatory environment to completely succeed. While I believe that our position in Projects 1, 2 and 3 is sound, a re-evaluation of our position in respect to Projects 4 and 5 is in order. 433/

431/ (...continued)

prospective purchases as well. She had not been involved in reviewing the Supply System bond purchases. Before she went on the tour, which took place in the last days of October and the first days of November, she read some of the Supply System official statements, including those on Projects Nos. 4 and 5.

432/ Memorandum from Andrea Bozzo to Norman Schevy and Steven Narker (Nov. 11, 1979). (SEC Exh. 2730.)

433/ Id. at 2.

The reevaluation referred to in the memorandum was a reevaluation of the continued purchase of Projects Nos. 4 and 5 bonds for the trusts. Andrea Bozzo SEC tr. at 103 (Apr. 16, 1986).

Another analyst, employed by a managed bond fund, who made the trip reduced his rating to below investment grade as a result of the tour. The analyst felt that the costs of the projects were not ascertainable and only likely to
(continued...)

Several days later, a meeting was held to consider the matters raised in the analyst's memorandum. All four analysts were present, as were the head of the Bond Fund Division, the administrative head of the analyst group and the portfolio buyer. The analyst who had prepared the memorandum explained her analysis. The other analysts expressed their views. One analyst expressed the view that they should stop purchasing any more Projects Nos. 4 and 5 bonds. 434/ He was concerned about the project delays and overruns and about a potential downrating if the pattern continued. 435/ Also, in preparation for the meeting, he had called R. W. Beck, the consulting engineer, and inquired about how it prepared power forecasts for the Participants. He was concerned when he learned that the estimates were obtained from the Participants themselves, a practice that was not satisfactory to him. 436/ A possible

433/ (...continued)

increase; was concerned that the cost increases might affect the ability to market any power that might not be needed by the Participants; and considered the possibility that at least some of the Participants might not have the ability to pay or that political opposition might arise if the take-or-pay agreements had to be used. Jeffrey Alexopoulos SEC tr. at 52, 59, 61, 74-76, 97-98, 119-20, 164. (Aug. 15, 1984). The managed bond fund liquidated its Projects Nos. 4 and 5 bond holdings and did not make any further purchases of the bonds.

434/ Thomas Elmore SEC tr. at 50 (Apr. 18, 1986); Andrea Bozzo SEC tr. at 115 (Apr. 16, 1986); Norman Schvey SEC tr. at 121-122 (Oct. 23, 1986); Kevin Baker SEC tr. at 27-28 (Apr. 18, 1986); Notes by Kevin Baker (SEC Exh. 2744).

435/ Thomas Elmore SEC tr. at 49 (Apr. 18, 1986).

436/ Id. at 74.

overstatement of the forecasts was one of the concerns that heraised at the meeting, and the reviewing analyst on the bonds agreed. 437/ Doubts about the economic feasibility of the facilities being built were also raised. 438/

The portfolio buyer spoke about the competitive consequences of not purchasing more Projects Nos. 4 and 5 bonds. He stated that the Projects Nos. 4 and 5 bonds were the

437/ Id. at 75:

Q. What did you say about it?

A. I said that their methodology was flawed and that more than likely they had overstated it and they had not tested it against any elasticity as should have been done given the cost estimates for the project.

Q. Did anybody respond to that at the meeting?

A. Yes.

Q. What was the response? Who made it?

A. Kevin Baker [the primary analyst on the Supply System] responded.

Q. What did he say?

A. He agreed with my analysis.

Q. Did he say anything further about it?

A. Other than to agree with my analysis that the methodology was not set out the way it ought to have been done and, therefore, the power forecast was probably overstated.

438/ Norman Schvey SEC tr. at 109-10 (Oct. 23, 1986) ("I do have a recollection that there was at the meeting [-] there was expressed a very, very serious reservation as to the economic feasibility of the facility." (at 110)).

highest yielding bonds available in their category and if he did not purchase them it would be difficult for him to assemble a portfolio that would be competitive with other UITs. 439/

439/ Andrea Bozzo SEC tr. at 108 (Apr. 16, 1986). Thomas Elmore SEC tr. at 48-49 (Apr. 18, 1986):

Q. Do you recall anything that Mr. Milot said?

A. I remember Mr. Milot expressed the opinion that it would be very difficult for him to assemble a municipal unit trust, a long-term municipal unit trust, that would be competitive in yield with similar products being sold on the market without including a significant portion, and I would define it[,] a significant portion[,] as our typical portfolio limit of seven and a half percent, a significant portion of Supply System four and five bonds in each unit trust.

Q. Did he say why that was [, what] it was about the bonds?

A. It was two fold, a two fold problem for him and for us. The Supply System four and five bonds had high ratings; that is, above A ratings, they had A+ A1 ratings. Therefore, they were upper middle grade securities which had yields that were significantly higher than comparably rated issues of the same maturity and that he could not find replacement items in the marketplace that would give him that kind of yield.

Q. Did he say anything about whether other unit investment

(continued...)

The portfolio buyer also speculated that if the Merrill Lynch trusts stopped buying Projects Nos. 4 and 5 bonds, the market might notice this development and it might cause a "slam-out" on the bonds, i.e., the Supply System's financing program might collapse because it would not be able to sell any more Projects Nos. 4 and 5 bonds. 440/ Because the Merrill

439/ (...continued)

trusts were purchasing Supply [System] bonds?

- A. He expressed his knowledge that all were purchasing the issue and that any unit trust that did not purchase and use the issue in a long term general fund, general municipal fund, would not have competitive yield.

440/ Handwritten notes by Kevin Baker about meeting (made at a later time) ("Phil Milot [-] if you stop buying become a self fulfilling prophecy because MITF's [Merrill Lynch trusts] withdrawal will cause a slam-out of WPPSS four and five.") (SEC Exh. 2744); Andrea Bozzo SEC tr. at 109 (April 16, 1986); Kevin Baker SEC tr. at 24-27 (Apr. 18, 1986). Thomas Elmore SEC tr. at 63-64 (Apr. 18, 1986):

Q. [D]o you recall his saying anything about what might happen if the UIT stop[ped] buying four and five bonds?

A. I believe that he speculated that if UIT's which have a visible public portfolio page which [is] easily obtained and seen and disseminated that if they ceased their continued purchase of Supply System four and five bonds that it might

create a circumstance whereby the Supply System wouldn't be able to market any more public issues.

(continued...)

Lynch trusts were the largest purchasers of the Projects Nos. 4 and 5 bonds and trust sponsors note purchases by other trusts, and because of the importance of the UIT purchases to the financing program, if Merrill Lynch trusts stopped their purchases, that action could have jeopardized the financing program. 441/

In further discussions at the meeting, the reviewing analyst for the Projects Nos. 4 and 5 bonds expressed the view

440/ (...continued)

Q. Did he say why that might take place?

A. That was his opinion as I stated it, he didn't offer further explanation about his analysis, no.

Q. Did he use the term slam off?

A. Slam out I think he said.

441/ See discussion in Part II B. The role of purchases by the unit investment trusts were mentioned by Merrill Lynch underwriter and public finance personnel during the interview leading to their selection as the lead underwriter on the negotiated May 1980 offering, described in Part III C, supra, as was the importance of the retail market for Projects Nos. 4 and 5 bonds. See Stephen Buck notes of Merrill Lynch interview of May 1, 1980, 4-7 (SEC Exh. 2515):

70%-30% Retail/Inst. - Non-Net-Billed [Projects Nos. 4 and 5]

70%-30% Inst./Retail - Net Billed [Projects Nos. 1, 2 and 3] (emphasis added)

* * * *

Unit Investment Trust of M/L as of last night[:]

- . \$125 MM A-1/A+ [Projects Nos. 4 and 5]
- . \$27 MM AAA [Projects Nos. 1, 2 and 3]

(at 5)

that the Participants' obligations to pay under the take-or-pay agreements provided the security for the bonds and that those agreements had been enforced in Washington State for many years. 442/ The other analysts concurred, 443/ relying in part on the reviewing analyst's representations. 444/ In light of the views on the security provided by the take-or-pay agreements, the head of the Bond Fund Division made the decision to continue purchasing the Projects Nos. 4 and 5 bonds. 445/ After the meeting, one of the analysts suggested to the analyst who had prepared the original report that even if Merrill Lynch did not stop purchasing the bonds, at some point someone else would stop buying them and that might cause the Projects Nos. 4 and 5 financing program to collapse. 446/

442/ Thomas Elmore SEC tr. at 50-51 (Apr. 18, 1986).

443/ Norman Schvey SEC tr. at 111, 121 (Oct. 23, 1986).

444/ The two other senior analysts were experienced and had evaluated issues of entities in the Pacific Northwest, including those with take-or-pay agreements, although they had not read the bond counsel opinions on the Projects Nos. 4 and 5 bonds or noted that bond counsel had not opined on all 88 Participants. Thomas Elmore SEC tr. at 54-60 (Apr. 18, 1986); Walter Tyler SEC tr. at 35-39 (Apr. 16, 1985). There were differences between these take and pay agreements and other take and pay agreements and these agreements were untested. See discussion in Part IV, infra.

445/ Handwritten Notes by Kevin Baker (SEC Exh. 1566); Kevin Baker SEC tr. at 27-28 (Apr. 18, 1986).

446/ Thomas Elmore SEC tr. at 65-66 (Apr. 18, 1986):

(continued...)

In early December, the reviewing analyst on the Projects Nos. 4 and 5 bonds prepared a draft of a memorandum on the pending December 1979 Projects Nos. 4 and 5 bond offering. 447/ The draft memorandum lists "Problems," including problems in

446/(...continued)

Q. What did you say to her in [the] conversation [after the meeting]

A. As I recall I said that there was a likelihood at some point that others if not the unit investment trust or the Merrill [Lynch] bond fund but if others found it in their direct interest they would stop buying the bonds. I believe this is in, you know, in reference to the things that Milot had said about what I believe is stated here, the self-fulfilling prophecy. I believe the way I expressed it to her was that somebody was going to eventually stop buying the bonds for their own reasons, they wouldn't just continue to buy them forever.

Q. Was that in the context of then that might trigger the same thing that Mr. Milot was concerned about?

A. The inability of the Supply System to sell public bonds, yes.

447/ Memorandum, \$200,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1979C (Nuclear Projects Nos. 4 and 5)(Dec. 6, 1979). (SEC Exh. 2707.) The memorandum appears to relate to the memorandum of the analyst who went on the investor tour and contains the statement: "Additions to Andrea Bozzo's memo dated 11/7/79." The memorandum was longer and more detailed than other memoranda on Projects Nos. 4 and 5 bonds.

financing, construction delays, and possible surplus power. 448/ One of the listed items under the "Problems" heading was the Participants' take or pay agreements. 449/ The

448/ Id. at 5-6:

* * * *

2. Possibility plants won't be completed (No. 4 is 12% complete and No. 5 is 7% complete). Major risk is financing risk (need to come back in July 1980), not a material problem as long as ratings are maintained. \$3.7 billion of additional financing required.
3. Construction delays caused by labor strikes, engineering problems, design changes brought about by Kemeny, safety changes.

* * * *

6. Potential for surplus power after plants are on line. BPA building plants, conservation efforts on the part of participants; higher cost of power - participants shifting from high energy intensive crops to lower intensity crops. Surplus agreements with industrial customers only good through 1992.
7. Uncertainties concerning BPA's reallocation of power after 1983. Impacts on rates uncertain.

* * * *

9. Days of cheap power over in region. . . . [citing BPA rate increases, including 90% increase effective December 20, 1979].

449/ Id. at 6:

4. Take or pay contracts of this magnitude have not been tested. Not major population centers. About 25% of Washington & Oregon's population. If a participant defaults, each non-defaulting participant
(continued...)

creditworthiness argument for continued purchase of the Projects Nos. 4 and 5 bonds, despite reservations about the Projects, was the analyst's assertion that the take-or-pay contracts were tested agreements that would assure payment. As the analyst noted in his memorandum, however, take or pay agreements "of this magnitude" had "not been tested". ^{450/} The Projects Nos. 4 and 5 bonds continued to receive purchase approvals and Merrill Lynch continued to purchase the bonds for the trusts up to the 7.5% limit until the construction moratorium recommendation in May, 1981.

The UITs became a major factor in the Projects Nos. 4 and 5 financing program. The trusts purchased the Projects Nos. 4 and 5 bonds despite negative developments. Such trusts were intensely competitive on yield, and the bonds went to a yield premium over similar bonds while maintaining their rating. Moreover, trust diversification policies limited the degree of trust exposure. The bonds became a compellingly attractive purchase at their premium yield. Although the personnel of most trust sponsors who testified maintained that the sponsors had creditworthiness approval procedures, the manner of the approval procedures and the importance of yield resulted in a

^{449/} (...continued)

increases its share up to 25% of its respective original share. Take or pay obligation of utility system only.

^{450/} Id. As noted in Part IV, infra, these agreements contained some untried and untested elements. The analyst stated that he talked to bond counsel about the agreements several times prior to June, 1981.

selection process that did not necessarily lead to a balanced,
independent evaluation of the price and quality of the bonds.

PART IV

THE OPINIONS AND CONDUCT OF BOND AND SPECIAL COUNSEL
REGARDING THE VALIDITY AND ENFORCEABILITY OF THE
AGREEMENTS THAT WERE TO PROVIDE SECURITY FOR THE
PROJECTS NOS. 4 AND 5 BONDS

A. INTRODUCTION

The default by the Supply System on its bonds for Projects Nos. 4 and 5 was triggered by the June 15, 1983 decision of the Washington Supreme Court in Chemical Bank v. Washington Public Power Supply System 451/ ("Chemical Bank I"). There, the court examined whether the Washington municipal corporation Participants -- 7 Washington cities, 2 Washington towns, and 19 Washington public utility districts ("PUDs") -- had the legal authority to enter into the Participants' Agreement, which obligated the Participants to pay the Supply System's share of the cost of the projects "whether or not any of the Projects are completed, operable or operating" and irrespective of the performance of the Supply System. 452/ This provision made the Agreement into what was referred to as a "take-or-pay" or "hell-or-high water" contract, and the risk that the projects would not be completed or operable was known as the "dry hole" risk. The provision was intended to assure payment of the

451/ 99 Wash. 2d 772, 666 P.2d 329 (1983), aff'd on rehearing, 102 Wash. 2d 874, 691 P.2d 524 (1984), cert. denied, 471 U.S. 1075 (1985).

452/ Participants' Agreement § 6(d).

Projects Nos. 4 and 5 bonds and was featured prominently in the official statement of each bond issue. 453/

The court held that the Washington municipal corporation Participants had lacked authority to enter the Participants' Agreement. Those Participants accounted for the disposition of 68.275% of the projects' potential electrical output, referred to in the Participants' Agreement as "Project Capability", 454/ and for the payment of an equivalent percentage of the Supply System's share of the cost of the projects.

The remaining Participants in Projects Nos. 4 and 5 consisted of 1 Washington irrigation district, 7 Oregon cities, 4 Oregon people's utility districts ("PUDs"), 5 Idaho cities, and 43 rural electric cooperatives located in various states in the Pacific Northwest. Following the decision in Chemical Bank I, the Idaho Supreme Court, on September 26, 1983, held that the Participants' Agreement violated the debt limit provision of the Idaho Constitution and that, therefore, the agreements

453/ A description of the provision was one of the few items included on the cover page of each official statement and, in addition, was included in the sections on the security for the bonds and the Participants' Agreements. E.g., Official Statement for \$145,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds, Series 1977A (Nuclear Projects Nos. 4 and 5), at cover page, 2, 26 (Feb. 23, 1977) [hereinafter 1977A Projects Nos. 4 and 5 Official Statement]. (SEC Exhs. 1152, 2740.)

454/ See infra note 468.

of the five Idaho city Participants, accounting for the purchase of 1.876% of the Project Capability, were void. 455/

On March 20, 1984, the Oregon Supreme Court reversed a lower court decision and upheld the authority of the Oregon city and PUD Participants to have entered into their Participants' Agreements, which accounted for the purchase of 8.071% of the Project Capability. 456/ However, the Washington Supreme Court, in a second decision, Chemical Bank v. Washington Public Power Supply System 457/ ("Chemical Bank II"), relieved all Participants of their contractual obligations. The court explained that, in light of their substantial shares, the Washington municipal and PUD Participants were "vital" to the financing, construction, or termination of the Project Nos. 4 and 5. 458/ In view of its decision in Chemical Bank I, which relieved those Participants

455/ Asson v. City of Burley, 105 Idaho 432, 670 P.2d 839 (1983), cert. denied, 469 U.S. 870 (1984). The decision is discussed infra at note 680.

456/ DeFazio v. Washington Pub. Power Supply Sys., 296 Or. 550, 679 P.2d 1316 (1984). At the time the Oregon Supreme Court issued its decision, the Washington trial court already had issued a decision releasing the Oregon city and PUD Participants and all other Participants not covered by the decision in Chemical Bank I from any obligations under their Participants' Agreements. Chemical Bank v. Washington Pub. Power Supply Sys., No. 82-2-06840, typescript op. at 2-3 (Wash. Super. Ct. Aug. 11, 1983), aff'd, 102 Wash. 2d 874, 691 P.2d 524 (1984), cert. denied, 471 U.S. 1075 (1985).

457/ 102 Wash. 2d 874, 691 P.2d 524 (1984), cert. denied, 471 U.S. 1075 (1985).

458/ Id. at 898, 691 P.2d at 538.

of their obligations under the Agreements, the court held that the doctrine of commercial frustration eliminated all other Participants' obligations. 459/ The court eliminated those obligations on the additional ground of mutual mistake and rejected arguments for enforcing the Participants' Agreements based on equitable or federal or state constitutional grounds. 460/

With the Participants' Agreements held invalid, and with Project Nos. 4 and 5 terminated, there was no source of revenue for payment of the Projects Nos. 4 and 5 bonds. The bonds were not general obligations of the Supply System, and the Supply System had not pledged any money derived or to be derived from its other projects to pay the bonds. 461/ Essentially, the bonds were to be paid from the amounts the Supply System received from ownership and operation of its share of the two projects, and the money the Supply System was to receive from that ownership and operation was the money it was to receive pursuant to the Participants' Agreements. 462/

459/ Id., 691 P.2d at 538.

460/ Id. at 899-913, 691 P.2d at 539-46.

461/ See, e.g., 1977A Projects Nos. 4 and 5 Official Statement, supra note 453, at 1-2.

462/ Id. With the exception of Tacoma, each Participant also entered into an agreement entitled "Washington Public Power Supply System Nuclear Projects Nos. 4 and 5 Assignment Agreement" ("Assignment Agreement") with the Supply System, and the Supply System entered into an agreement entitled "Washington Public Power Supply System Nuclear Projects Nos. 4 and 5 Short Term Sales Agreement (continued...)"

Prior to the first sale of the Project Nos. 4 and 5 bonds, the Supply System's bond counsel and special counsel had evaluated the validity and enforceability of the Participants' Agreements. At the closing for each bond sale, bond counsel and the special counsel delivered identical opinion letters in which each firm stated that it had examined into the validity of 72 of the 88 Participants' Agreements and opined that they were valid and enforceable. A form of these letters was included in the official statement for that bond sale. 463/

462/ (...continued)

with Industries" ("Short Term Sales Agreement") with 14 industrial companies in the Pacific Northwest. These Agreements were to assist the Participants in disposing of surplus power or avoiding deficits in the early years of operation of the projects. The Assignment Agreements and Short Term Sales Agreement thus provided the Supply System with an additional source of revenue to provide security for the bonds. Id. Each Assignment Agreement, however, provided that "[t]he Assignor acknowledges that it remains liable under the Participants' Agreement, as therein provided, notwithstanding any provision in this Agreement." Assignment Agreement § 6(d). The Participants, therefore, were relieved of their payment obligations under the Participants' Agreements only to the extent the Supply System collected amounts due from the surplus power the Participants assigned to it.

463/ In relevant part, each firm stated:

We have examined into the validity of seventy-two of the Participants' Agreements, dated July 14, 1976, referred to in the Official Statement of the System dated . . . relating to the Bonds, between the System and certain of the Participants referred to in said Official Statement. Of said seventy-two Participants' Agreements, thirty-six have been executed by municipal corporations and provide for the purchase of an aggregate of not less than 76.15% of the capability of the Projects . . . and

(continued...)

463/ (...continued)

thirty-six have been executed by nonprofit or cooperative corporations and provide for the purchase of an aggregate of not less than 19.79% of the capability of the Projects With regard to the authorization, execution and delivery of said seventy-two Participants' Agreements, we have examined certified copies of proceedings of the System and of the Participants which are parties to said Participants' Agreements authorizing the execution and delivery of said seventy-two Participants' Agreements, and such other documents, proceedings and matters relating to the authorization, execution and delivery of said seventy-two Participants' Agreements by each of the parties thereto as we deemed relevant. In our opinion each of said seventy-two Participants' Agreements has been duly authorized, executed and delivered by each of the parties thereto and constitutes a valid and binding agreement enforceable in accordance with its terms.

* * * *

In rendering this opinion, we have relied upon the opinion of counsel for each of such Participants . . . that the Participants' Agreement . . . to which such Participant . . . is a party has been duly executed and delivered by such Participant . . . and is not in conflict with, or in violation of, and will not be a breach of, or constitute a default under, the terms and conditions of any other agreement or commitment by which such Participant . . . is bound.

E.g., letter from Wood Dawson Love and Sabatine to Board of Directors, Washington Public Power Supply System 1-2 (Mar. 23, 1977) (opinion on agreements) (SEC Exh. 2795); letter from Houghton Cluck Coughlin and Riley to Board of Directors, Washington Public Power Supply 1-2 (Mar. 23, 1977) (opinion on agreements) (MDL Exh. 71841). The opinions also included a statement to the effect that the
(continued...)

This Part of the Staff Report examines the conduct of the Supply System's bond counsel, Wood Dawson, and its special counsel, Houghton Cluck, relating to the disclosures made in the official statements concerning the validity and enforceability of Participants' Agreements. 464/ In Section B, the Report first discusses the Washington court's Chemical I decision, and then examines counsels' position as to why, in their view, the Participants' Agreement had been validly entered into by the Washington municipal corporations. Next

463/ (...continued)

obligations of Participants whose Agreements were included in the opinions and the enforceability of their Participants' Agreements might be subject to judicial discretion, valid bankruptcy laws, and other matters. E.g., letter from Wood Dawson to Board of Directors, Washington Public Power Supply System 2 (May 22, 1980) (opinion on agreements) (MDL Exh. 15206); letter from Houghton Cluck Coughlin & Riley to Board of Directors, Washington Public Power Supply System 2 (May 22, 1980) (opinion on agreements) (MDL Exh. 15207).

The reference in the opinions to opinions of counsel for Participants was to opinions that had been furnished at the request of Wood Dawson. In rendering its opinions on agreements for each of the Supply System projects, as well as for other entities that, like the Supply System, were joint operating agencies, see infra note 467, Wood Dawson required counsel for each of the participating utilities to execute an opinion letter to the effect that the proper procedures with respect to the authorization and execution of the agreement had been followed by the counsel's client, that the agreement did not conflict with or breach any other contract or obligation of that party, and that the agreement was valid and binding on the party. Id. at notes 630 & 700.

464/ Since counsel who issue such opinions are making representations that will be relied upon by investors, their statements are subject to the antifraud provisions of the federal securities laws, creating the possibility of legal sanctions, or civil liability.

the Report examines counsels' conduct leading up to the issuance of opinions favorable to these municipal corporations' authority. The Report then examines counsels' handling of legal uncertainties in connection with prior Supply System and other projects, where counsel brought test cases and/or sought legislative changes to resolve authority issues. Finally, Section B explores possible reasons why similar steps were not taken here.

In Section C, the Report examines a separate issue relating to counsels' role: statements and omissions concerning the Agreements entered into by 16 of the 88 Participants as to which counsel had validity and enforceability concerns. The Report will examine a series of questions related to the legal authority of 10 of these 16 Participants to participate in the projects; counsels' findings and conclusions as to the authority problems; the standard that counsel purportedly employed on whether to render a favorable opinion; the legal and policy reasons why, in view of the problems, these utilities -- which purchased less than 5% of the projects' potential electrical output -- were not simply excluded from participation in the projects or, alternatively, a test case was not brought to resolve the authority problems; why counsel stated in their opinion letters only that they had "examined into" 72 Agreements when, in fact, they had examined all 88 Agreements; and finally what counsel told Participants and

others as to the authority problems and the significance of opening on 72, rather than all 88, Agreements.

B. RECOGNITION AND RESOLUTION OF LEGAL PROBLEMS RELATING TO THE AUTHORITY OF THE WASHINGTON MUNICIPAL CORPORATION PARTICIPANTS.

1. The Court's Decision in Chemical Bank I

The focus of the Washington Supreme Court's decision in Chemical Bank I was on the "take-or-pay" or "dry hole" provision of the Participants' Agreement. The provision obligated each Participant to pay for an assigned portion of the cost of Projects Nos. 4 and 5 even if the projects were never completed or the Supply System failed to perform. 465/ The court acknowledged that the "Washington participants ha[d] explicit statutory authority to buy electricity on behalf of citizens," 466/ and that the cities and PUDs were authorized to

465/ The Agreement provided:

The Participant shall make the payments to be made to Supply System under this Agreement whether or not any of the Projects are completed, operable or operating and notwithstanding the suspension, interruption, interference, reduction or curtailment of the output of either Project for any reason whatsoever in whole or in part. Such payments shall not be subject to any reduction, whether by offset or otherwise, and shall not be conditioned upon the performance or nonperformance by Supply System or any other Participant or entity under this or any other agreement or instrument, the remedy for any non-performance being limited to mandamus, specific performance or other legal or equitable remedy.

Participants' Agreement §6(d) (emphasis added).

466/ 99 Wash. 2d at 782, 666 P.2d at 334.

contract with a joint operating agency, such as the Supply System, "for the purchase and sale of electric energy". 467/

The court, however, concluded that the statutes did not authorize the purchase of a generating plant's possible output, or "Project Capability" as it was termed in the Participants' Agreement. 468/ The court reasoned that the purchase of Project Capability was "essentially an unconditional guaranty of payments on the revenue bonds, secured by a pledge of the participants' utility revenues". 469/ The court held that such

467/ Id. at 783, 666 P.2d at 335 (quoting statute). The Supply System was established as a JOA in 1957 pursuant to legislation passed by the Washington legislature in 1953, Act approved Mar. 23, 1953, ch. 281, § 12, 1953 Wash. Laws 743, 753 (codified as amended at Wash. Rev. Code Ann. §§ 43.52.250-.910 (1983 and Supp. 1988)).

Joint operating agencies, or joint action agencies as they also are known, are found in a number of states. Typically, a JOA is created pursuant to a state statute and is formed by two or more cities, towns, districts, or other municipal corporations and, in general, is deemed to be a body corporate and/or political subdivision of the state. Management and control is usually by a board of directors or commission consisting of representatives of the membership. Although the specific powers of a JOA vary according to statute, it generally has the power to acquire, construct, own, and operate generating and related facilities; to purchase, sell, and exchange electrical energy; and to finance the acquisition and construction of authorized projects.

468/ Project Capability was defined as "the amounts of electric power and energy, if any, which the Projects are capable of generating at any particular time (including times when either or both of the Plants are not operable or operating or the operation thereof is suspended, interrupted, interfered with, reduced or curtailed, in each case in whole or in part for any reason whatsoever), less Project station use and losses". Participants' Agreement § 1(v) (emphasis added).

469/ 99 Wash. 2d at 783, 666 P.2d at 335.

"an agreement to purchase project capability does not qualify as a purchase of electricity." 470/

The court also determined that the Participants' Agreement did not fall within the authority of the Washington municipal and PUD Participants to construct, acquire, and operate generating facilities. The court noted that the bond resolution for Project Nos. 4 and 5 expressly provided that only the Supply System and one investor-owned utility, Pacific Power & Light Company, had any ownership interest in the projects. 471/ The Participants were purchasing only Project Capability, which, together with the provision requiring payment under all circumstances, meant that the Participants merely "unconditionally guaranteed WPPSS bonds with no guaranty of electricity in return". 472/ The court also determined that the Participants also did not retain "sufficient control over the project[s] to constitute the equivalent of an ownership interest". 473/ Although the Participants' committee met periodically to review major items pertaining to the two

470/ Id. at 784, 666 P.2d at 335.

471/ Id. at 785, 666 P.2d at 336. The Supply System, a municipal corporation, see, e.g., Wash. Rev. Code Ann. §43.52.360 (1970), was empowered to generate and sell electric energy, to construct generating facilities, and to negotiate contracts for the sale of electric energy, Act approved May 12, 1975, ch. 37 sec. 1, § 43.52.360 (1), (2), (4), 1975 Wash. Laws Ex. Sess. 254, 254-55 (codified as amended at Wash. Rev. Code Ann. § 43.52.300(1), (2), (4) (1983)).

472/ 99 Wash. 2d at 785-86, 666 P.2d at 336.

473/ Id. at 787, 666 P.2d at 337.

projects, the court concluded that the Participants' Agreement "sets out a procedure for committee consideration of WPPSS proposals that precludes meaningful deliberation on the part of the committee". 474/

The committee's procedures, the court stated, did not "allow sufficient participant involvement in project management to control their risk". 475/ According to the court, the committee "apparently served as a rubber stamp for WPPSS' decisions". 476/ The court, therefore, concluded that the Participants had neither sufficient ownership interests nor sufficient management responsibilities to have acquired a generating facility. 477/

The court also rejected arguments that the Participants had implied authority to enter into the Participants' Agreement. The trustee for bondholders had argued that "the express authority to acquire or construct generating facilities and provide electricity carries with it an implied power to pay for that service." 478/ The court distinguished Municipality

474/ Id., 666 P.2d at 337.

475/ Id. at 788, 666 P.2d at 337.

476/ Id., 666 P.2d at 337.

477/ Id. at 791, 666 P.2d at 339. Apart from the individual statutes authorizing municipalities and PUDs to construct, acquire, and operate generating facilities, the court addressed whether the statute authorizing cities, towns, PUDs, and others jointly to develop thermal facilities could provide a basis for authority. Id. at 795-97, 666 P.2d at 341-42. That statute, inter alia, however, also required participants to have an ownership share in the project to be built. Id. at 795, 666 P.2d at 341.

478/ Id., at 791, 666 P.2d at 339.

of Metropolitan Seattle v. City of Seattle, 479/ the case on which the argument was based, on the ground that, in contrast to the facts of Metropolitan Seattle, the Participants were not assured of service or ownership in exchange for the payments they were required to make. 480/ The court further observed that, subsequent to Metropolitan Seattle, it had "adopted a more stringent test for a municipality seeking to incur indebtedness based upon general grants of authority to provide services" and that, in any event,

a municipal corporation's powers are limited to those conferred in express terms or those necessarily implied. If there is any doubt about a claimed grant of power it must be denied. The test for necessary or implied municipal powers is legal necessity rather than practical necessity. As we stated in Hillis: '[i]f the Legislature has not authorized the action in question, it is invalid no matter how necessary it might be.' 481/

Although the assumption by the Participants of the "dry hole" risk may have been needed to sell the bonds, that type of

479/ 57 Wash. 2d 446, 357 P.2d 863 (1960).

480/ 99 Wash. 2d at 791-92, 666 P.2d at 339. The Supply System's bond counsel testified that Metropolitan Seattle was an important case in arriving at its conclusion that the Washington municipality and PUD Participants had authority to enter into the Participants' Agreements. This case is discussed infra at note 495.

481/ Id. at 792, 666 P.2d at 339-40 (citations omitted). Other Washington cases had established a similar proposition. E.g., Pacific First Fed. Sav. & Loan Ass'n v. Pierce County, 27 Wash. 2d 347, 353, 178 P.2d 351, 354 (1947); Griggs v. Port of Tacoma, 150 Wash. 402, 408, 273 P. 521, 523 (1928); State ex rel. Hill v. Port of Seattle, 104 Wash. 634, 638, 177 P. 671, 673, modified on other grounds, 180 P. 137 (Wash. 1919).

need did not provide legal authority. 482/ The Participants' Agreement, therefore, was not "authorized as an implied power to pay for an admittedly proper municipal service". 483/ In holding that the Washington municipal and PUD Participants lacked authority to enter into the Agreement, the court stated that those Participants "simply are not authorized to guarantee another party's ownership of a generating facility in exchange for a possible share of any electricity generated". 484/

The dissenting opinion criticized the majority's reading of the Participants' authority, stating that the majority imposed "constraints on municipalities not intended by the Legislature". 485/ The dissent relied on Washington case law providing that statutes such as those allowing the Participants to enter into contracts to purchase and sell electricity "are to be liberally construed so as to further their purpose of furnishing power to the people". 486/ According to the dissent, under the "rule of liberal construction," the majority erred by failing to provide municipalities with "the freedom and flexibility to use all advisable means" to provide citizens with electric power. 487/ The dissent maintained that the

482/ 99 Wash. 2d at 794, 666 P.2d at 340.

483/ Id., 666 P.2d at 340.

484/ Id. at 799, 66 P.2d at 343.

485/ Id. at 810, 666 P.2d at 348 (Utter, J., dissenting).

486/ Id. at 811, 666 P.2d at 349.

487/ Id. at 813, 666 P.2d at 350.

means adopted by the municipality should be struck down only when they are "arbitrary and capricious". 488/

2. Position of Counsel as to Why the Agreement Was Valid

Counsel, in testimony before the staff, stated a position that essentially reiterated the view of the dissenting opinion. That position was that the Washington statutes expressly authorized cities, towns, and PUDs to acquire electricity; to own, operate, and manage electric utilities; and to enter into contracts therefor. 489/ The JOA law also authorized cities, towns, and PUDs to contract with JOAs for the purchase and sale of electricity. 490/ Once authorized to run an electric utility system, cities, towns, and PUDs had implied powers necessary to carry out the powers expressly granted. 491/ Moreover, because running an electric utility was a proprietary, rather than a governmental function, the

488/ Id. at 814, 666 P.2d at 350. Some law student commentators also have been critical of the majority's opinion. E.g., Note, Chemical Bank v. Washington Public Power Supply System: The Questionable Use of The Ultra Vires Doctrine to Invalidate Government Take-Or-Pay Obligation, 69 Cornell L. Rev. 1099 (1984); Note, A Cry for Reform in Construing Washington Municipal Corporation Statutes, 59 Wash. L. Rev. 653, 660 (1984).

489/ Bert L. Metzger, Jr. SEC tr. at 1050-51, 1125-26 (Feb. 19 and 20, 1986) (testimony of Houghton Cluck attorney); Brendan O'Brien SEC tr. at 134-138, 155-157 (Apr. 12, 1985) (testimony of Wood Dawson attorney).

490/ Bert L. Metzger, Jr. tr. at 1084-85 (Feb. 19, 1986) (testimony of Houghton Cluck attorney); Brendan O'Brien SEC tr. at 157-58 (Apr. 12, 1986) (testimony of Wood Dawson attorney).

491/ Brendan O'Brien SEC tr. at 134-37, 155-57 (Apr. 12, 1985).

power to act in that area must, in counsels' view, be liberally construed. 492/ According to Brendan O'Brien, the Wood Dawson attorney principally responsible for the firm's work on Projects Nos. 4 and 5, cities, towns, and PUDs, in exercising a proprietary function, were treated like a private corporation. 493/ Under these circumstances, they had authority to enter into power purchase contracts and to fix the terms of those contracts, which terms could include a provision requiring payments to be made even if no power were received. 494/ Bond counsel argued that the Metropolitan Seattle case, which the Chemical Bank I opinion distinguished, supported their position. 495/

492/ Bert L. Metzger, Jr. SEC tr. at 1125 (Feb. 20, 1986) (testimony of Houghton Cluck attorney); Brendan O'Brien SEC tr. at 135-36, 155-57 (Apr. 12, 1985).

493/ Brendan O'Brien SEC tr. at 135-36, 155-57 (Apr. 12, 1985).

494/ Id.; see Bert L. Metzger, Jr. SEC tr. at 1110 (Feb. 20, 1986) (testimony of Houghton Cluck attorney).

495/ Brendan O'Brien SEC tr. at 141, 679 (Apr. 12 and June 6, 1985). Metropolitan Seattle involved a plan that established a metropolitan municipal corporation ("Metro") for the limited purpose of providing sewage disposal service to Seattle and surrounding areas. 57 Wash. 2d at 448, 357 P.2d at 866. Once formed, Metro, which was governed by a fifteen-member board consisting of elected representatives in the area, adopted a sewage disposal plan pursuant to which Metro would process and dispose of sewage for its municipal components. Id. at 449, 453, 357 P.2d at 866, 869. To provide a portion of the sewage disposal service, Metro agreed to pay Seattle a sum of money for the use of some of Seattle's existing disposal facilities. Id. at 449, 357 P.2d at 866. It appears that Metro also was planning to issue bonds to construct additional facilities. See id. at 458, 357 P.2d at 871. Seattle and the surrounding areas were to pay Metro a
(continued...)

This Report does not review the merits of the state court's construction of its law; we take no position on the matter. We note that the take-or-pay provisions of this type

495/ (...continued)

sewage disposal service charge for the services they were to receive. 57 Wash. 2d at 449, 357 P.2d at 866.

One argument the appellants made in Metropolitan Seattle was that Seattle would be exceeding its constitutional debt limit because "the sewage disposal charge to be paid [by Seattle] is not, in substance, a service charge, but, rather, is a means of constructing additional facilities, thereby technically creating a debt on the city of Seattle, and that 'The City is in form the guarantor of Metro's debts but in truth itself the debtor.'" Id. at 458, 357 P.2d at 871 (quoting appellants). The court rejected this argument on the grounds that, as distinguished from payments from general taxes, payments from a "special fund and solely from anticipated service revenue do not constitute a debt with the meaning of the [Washington] constitutional debt limitation provisions". Id. at 459, 357 P.2d at 871. In testimony, O'Brien cited Metropolitan Seattle as a case that "addresses the power of anyone to enter into an unconditional contract to make unconditional payments". Brendan O'Brien SEC tr. at 679 (June 6, 1985). With respect to the existing Seattle facilities, he stated: "If that had been the only facility involved and Seattle simply was agreeing to make payments to Metro Seattle so Metro could return the money to it, issues such as Seattle was guaranteeing the debt of Metro Seattle would not have arisen because there would not have been a Metro Seattle debt to guarantee." Id. at 682. The court in Metropolitan Seattle, however, did not address whether Metro was to issue bonds to construct additional facilities or whether a municipal corporation had authority to enter into a contract requiring it to make unconditional payments.

Moreover, assuming bonds were to be issued for additional sewage disposal facilities that never were built, Seattle and the other municipal components of Metro, unlike the Participants in Projects Nos. 4 and 5, would receive some service in return for their payment of the sewage disposal service charge. And, unlike the Participants in Projects Nos. 4 and 5, the entities that were required to pay the sewage disposal service charge were the municipal components, i.e., the members, of Metro.

were, as will be discussed below, untested by any court in Washington or elsewhere; 496/ the Washington court, as the Chemical Bank I decision made clear, had in certain instances restrictively interpreted the powers of municipal corporations; and the case that bond counsel indicated had facts that were the closest to those surrounding the Participants' Agreement, Metropolitan Seattle, was distinguishable. 497/ Although some states had enacted legislation expressly authorizing municipal corporations to enter into take-or-pay agreements, 498/ no such statute had been enacted in any of the Pacific Northwest states.

496/ See generally S. Feldstein, "Guidelines in the Credit Analysis of General Obligation and Revenue Municipal Bonds," in The Municipal Bond Handbook 116-17 (F. Fabozzi, S. Feldstein, I. Pollack, F. Zarb eds. 1983) (

[T]here are now more non-voter-approved, innovative, and legally untested security mechanisms. These innovative financing mechanisms include . . . take-or-pay power bonds with step-up provisions requiring the participants to increase payments to make up for those that may default What distinguishes these newer bonds from the more traditional general obligation and revenue bonds is that they have no history of court decisions and other case law to firmly protect the rights of bondholders.).

497/ See supra note 495.

498/ E.g., Fla. Stat. Ann. § 163.01(15)(b)(2)(g) (Supp. 1988); Tex. Rev. Civ. Stat. Ann. art. 143a, § 4a(g) (Vernon 1980).

3. How This Financing Arrangement Differed from Financing Arrangements for Previous Pacific Northwest Projects

The Participants' Agreements differed significantly from the arrangements that had been used to support the financings of prior Supply System and other projects in the Pacific Northwest. The distinguishing feature of the arrangement for financing Projects Nos. 4 and 5 was that the Participants were not all members of the Supply System (only 19 of the 88 Participants, accounting for the purchase of 56.607% of the Project Capability, were members) 499/ and were not to be owners of the projects but were required to pay the costs of the projects, including debt service on bonds issued, regardless of whether any of the projects were completed or produced electricity or the Supply System performed. 500/

499/ Between the time the Participants' Agreements were signed and the termination of the projects an additional Participant, accounting for the purchase of .625% of the Project Capability, became a member.

500/ Prior to the first Supply System project, hydroelectric projects were built in Washington along the Columbia River. In connection with those projects, there were agreements under which the owner and sponsor of a project contracted with utilities in the region for the sale of output from the project. For example, in 1956 and 1959 respectively, Public Utility District No. 2 of Grant County, Washington ("Grant PUD") undertook the construction of the "Priest Rapids Hydroelectric Development Project" and the "Wanapum Hydroelectric Development Project". Grant PUD entered into long-term contracts with publicly- and privately-owned utilities in the region for the sale of most of the output from these Projects and, with Wood Dawson as bond counsel, issued revenue bonds to finance construction of the Projects. In contrast to the Participants' Agreement, the agreement(s) for each of these Projects did not require the purchasing (continued...)

Only in the first Supply System Project, the Packwood Hydroelectric Project, undertaken in December 1961, did publicly-owned utility participants assume a dry hole risk. In that relatively small-scale project, the participating utilities agreed to purchase a share of the project's output and, beginning on a fixed date, to pay for that output regardless of whether the project was completed or operable. 501/ Although participating utilities in the Packwood Project therefore assumed the dry hole risk, there was a significant difference between that project and Projects Nos. 4 and 5: in Packwood, all of the participating utilities were Supply System members. Thus under a legal theory known as the alter ego doctrine, the participating utilities could be viewed as agreeing to pay the costs of a project they themselves were to own. 502/ By contrast, Projects Nos. 4 and 5 included as

500/ (...continued)

utilities to make any payments unless and until some or all of the generating units for the Project were completed, tested, and ready for continuous operation. Priest Rapid Power Sales Contract §§ 2(p), 5(d); Wanapum Power Sales Contract §§ 2(q), 5(d). After that, the purchasing utilities were required to make payments regardless of the operational status of the Project. Priest Rapids Power Sales Contract § 5(d); Wanapum Power Sales Contract § 5(d). Under these circumstances, the purchasing utilities did not bear the risk of non-completion or non-performance.

501/ Packwood Lake Hydroelectric Project Power Sales Contract §1(k), 5. (MDL Exh. 105247.)

502/ Cf., e.g., N.C. Gen. Stat. § 159B-12 (1987) (authorizing members of a JOA to enter into take-or-pay contracts with the JOA because the JOA "is an alternative method whereby a municipality [that is a member of the JOA] may obtain
(continued...)

Participants both members and non-members of the Supply System. The Participants' Agreement was structured so that members would have no greater rights with respect to the projects than non-members. 503/ Thus, even member Participants could not be deemed "owners" of the projects.

In none of the projects subsequent to Packwood and prior to Projects Nos. 4 and 5 did publicly-owned utilities that were not project owners assume the "dry hole" risk. Rather, in many such projects, including all of the Supply System's projects, the BPA actually or effectively assumed that risk. The BPA did so in two ways. First, for the next Supply System project after Packwood, the Hanford Electric Generating Project ("Hanford Project"), the Supply System and the BPA entered into an agreement with each participating utility pursuant to which the utility purchased from the Supply System a share of the potential electrical output that it then exchanged with the BPA. 504/ The utility was to begin making its payments to the Supply System on a fixed date, and, regardless of whether the

502/ (...continued)

the benefits and assume the responsibilities of ownership in a project").

503/ See Robert L. McKinney SEC tr. at 125 (July 30, 1985) (testimony of General Manager of Public Utility District No. 1 of Cowlitz County, Washington, a Participant in Projects Nos. 4 and 5 and a Supply System member, that rights particular to a JOA's members with respect to a project undertaken by the JOA were "waived" for Projects Nos. 4 and 5, so that members would have no greater rights than non-members).

504/ Exchange Agreement § 5.

project was operating or operable, the BPA was to begin exchanging electrical energy for the potential output. 505/ The BPA thus had the dry hole risk for the Hanford Project.

For the later Supply System projects prior to Projects Nos. 4 and 5, i.e., Projects Nos. 1, 2, and 3, as well as the Trojan Project, 506/ an arrangement known as net billing was used to finance construction of these projects. Each participating utility in each of these projects purchased a share of the potential electrical output from the project sponsor that it then assigned to the BPA. 507/ Beginning on a fixed date, the utility agreed to pay the sponsor for that potential output regardless of whether the project was completed, operable, or operating and irrespective of any performance by the sponsor, the BPA or any other participating utility. 508/ In turn, the BPA agreed to pay the utility for the assigned potential output, by crediting against the amounts the utility owed the BPA under its power purchase and other contracts with the BPA the amount that the BPA owed for the anticipated output, and to make those payments regardless of whether the project was completed, operable, or operating and irrespective of any performance by the sponsor or any

505/ Id. §§ 5(b), (e).

506/ See infra Part IV B6a.

507/ E.g. Washington Public Power Supply System Nuclear Project No. 2 Agreement (Net Billing Agreement) § 5. (SEC Exh. 1094.)

508/ Id. §§ 5(a), 6(b).

participating utility. 509/ Under this arrangement, the BPA effectively assumed the dry hole risk. 510/

4. Because the BPA Could Not Enter into Additional Net Billing Agreements, An Alternative Financing Mechanism Was Decided Upon, and Counsel Researched the Participants' Authority to Participate in Projects Nos. 4 and 5.

Net billing was not available as a means of financing Project Nos. 4 and 5. A change in Internal Revenue Service regulations, pursuant to which the BPA no longer would be treated as a tax-exempt person, made future bonds issued by the

509/ Id. §§ 5(b), 7.

510/ There was, at most, a remote, theoretical possibility that participants could have some dry hole risk if the BPA could not fully satisfy its net billing obligations to those participants. The net billing agreements, however, included a variety of provisions to keep this from happening. It was contemplated that BPA preference customers might participate in more than one net billed project, and each net billing agreement included a provision that the participating utility would not enter into any agreement that would cause the aggregate amount that the utility owed the BPA under its power purchase and other contracts with the BPA to be less than 115% of the BPA's obligations to that utility under all net billing agreements, id. § 7(d). In the event that the BPA's net billing obligations exceeded the amount the utility owed the BPA, each agreement included provisions for the assignment of some of that utility's share of the potential output. Id. § 7(b), (f). If the assignments were inadequate to enable the BPA to satisfy its obligations, each agreement further provided for the BPA, subject to the availability of appropriations, to pay the balance in cash. Id. § 7(c).

Only in the event that the BPA was unable to satisfy its obligations of net billing, assignment, and cash payment would the participating utility be in the position of ultimately paying for Potential output. Under these circumstances, the utility was entitled to direct that all or part of its share of the potential output limited to the amount for which the BPA was unable to pay, be delivered to it. Id. § 9(a).

Supply System for net billed projects taxable. 511/

Additionally, the BPA was beginning to run out of net billing capacity such that, if another project was undertaken and financed by net billing, individual participants' obligations to the BPA would be less than the 115% of the BPA's net billing obligations to those participants that the existing net billing agreements required. 512/

For these reasons, representatives of utilities in the Pacific Northwest, the Supply System, the BPA, and others began to explore alternative financing arrangements for what became Projects Nos. 4 and 5, as well as other projects. These alternatives included having the BPA obtain legislation authorizing it to purchase power, having the BPA purchase power as the trustee or agent of its preference customers, and having the preference customers supply their own resources without involvement by the BPA. 513/ There also was consideration of

511/ See, e.g., Bert L. Metzger, Jr. SEC tr. at 773-76 (Feb. 13, 1986) (testimony of Houghton Cluck attorney); Robert E. Ratcliffe SEC tr. at 86-87 (Sept. 13, 1985) (testimony of then Regional Solicitor and subsequent Deputy Administrator of the BPA); Brendan O'Brien SEC tr. at 49-51 (Apr. 12, 1986).

512/ See, e.g., Bert L. Metzger, Jr. SEC tr. at 773-76 (Feb. 13, 1986) (testimony of Houghton Cluck attorney); Robert E. Ratcliffe SEC tr. at 86-87 (Sept. 13, 1985) (testimony of then Regional Solicitor and subsequent Deputy Administrator of the BPA); Brendan O'Brien SEC tr. at 49-51 (Apr. 12, 1986).

513/ See, e.g., Bert L. Metzger, Jr. SEC tr. at 776-85 (Feb. 13, 1986) (testimony of Houghton Cluck attorney); Robert E. Ratcliffe SEC tr. at 89-90 (Sept. 13, 1985) (testimony of then Regional Solicitor and subsequent Deputy Administrator of the BPA).
(continued...)

groups of utilities' building and owning their own plants. 514/ The possibility of having the BPA purchase power as trustee or agent -- a possibility to which considerable attention was given -- eventually was abandoned because of an "uncertainty as to whether a generally satisfactory form of a so-called BPA 'agency' contract could be concluded in time to permit the orderly financing of these projects on the accelerated basis requested of the Supply System by the PPC [Public Power Council, an organization of publicly-owned utility customers of the BPA] Executive Committee". 515/ As a result, attention turned to the arrangements contained in what became of the Participants' Agreement, in which the Participants assumed the "dry hole" risk.

Wood Dawson and Houghton Cluck each researched the legal authority for publicly-owned utilities to enter into the

513/ (...continued)

Administrator of the BPA); Robert L. McKinney SEC tr. at 81-83, 85-87 (July 30, 1985) (testimony of General Manager of Public Utility District No. 1 of Cowlitz County, Washington and an active participant in developing proposals for additional facilities).

514/ See, e.g., Alan H. Jones SEC tr. at 61 (Aug. 2, 1985) (testimony of PPC Chairman and General Manager of McMinnville Water and Light Commission of McMinnville, Oregon).

515/ Letter from Norman A. Stoll to R. Ken Dyar 1 (June 13, 1974) (letter from PPC attorney to PPC General Manager) (SEC Exhs. 1261, 1507); see also letter from Jack R. Cluck to LeRoy Love 1 (May 30, 1974) (letter from Houghton Cluck attorney to Wood Dawson attorney stating that "enactment of state statute would be necessary, and [that] it was agreed that the WPPSS No. 4 and No. 5 Projects should be expedited without awaiting attempts to develop such an Agency Agreement").

Participants' Agreement. The utilities that became Participants in Projects Nos. 4 and 5 were required, first for an interim document known as the Option Agreement, 516/ and then for the Participants' Agreement, to furnish a number of documents that Wood Dawson determined were necessary to enable it to render its opinions on agreements. 517/ Wood Dawson and Houghton Cluck each reviewed the documents furnished by the participants. 518/ Each firm also independently researched the authority of all of the participating utilities to enter into the Option and Participants' Agreements. 519/ Most of the research Wood Dawson and Houghton Cluck conducted into the authority of these utilities to enter into the Agreements was completed prior to the mailing in early 1975 of the Option

516/ See infra Part IV B5a.

517/ E.g., letter from Wood Dawson Love & Sabatine to listed persons (July 2, 1976) (letter transmitting document entitled "Memorandum of Transcript Documents - Washington Public Power Supply System Nuclear Projects Nos. 4 and 5 Participants' Agreements and Nuclear Project No. 5 Ownership Agreements"). (Included in SEC Exh. 1141.)

518/ Bert L. Metzger, Jr. SEC tr. at 145 (Feb. 10, 1986) (testimony of Houghton Cluck attorney); Brendan O'Brien SEC tr. at 518 (June 5, 1985).

519/ Bert L. Metzger, Jr. SEC tr. at 152-53 (Feb. 10, 1986) (testimony of Houghton Cluck attorney); see, e.g., Steven I. Turner SEC tr. at 231-35 (May 24, 1985) (testimony of Wood Dawson attorney that, at the request of O'Brien, he researched laws of Washington, Oregon, Idaho, Wyoming, Nevada, and Montana and that O'Brien did not tell him to exclude the authority of any Participant from his research).

Agreement. 520/ After the Option Agreements were mailed, each firm updated its research. 521/

No memorandum exists setting forth the research conducted, the conclusions reached, and the basis for those conclusions. 522/ The only documents that reflect the research conducted by Wood Dawson attorneys consist of compilations of photocopied and typed excerpts of constitutional provisions, statutes, and cases, and citations to and brief descriptions of city charters and articles of incorporation and by-laws of cooperatives 523/ covering several issues that a Wood Dawson attorney assembled at the request of O'Brien. 524/ In addition, there are approximately eleven pages of handwritten notes that O'Brien took wherein he described certain cases and

520/ Bert L. Metzger, Jr. SEC tr. at 1041 (Feb. 19, 1986);
Brendan O'Brien SEC tr. at 96 (Apr. 12, 1985).

521/ Bert L. Metzger, Jr. SEC tr. at 1450 (Feb. 24, 1986);
(testimony of Houghton Cluck attorney); see Brendan
O'Brien SEC tr. at 543 (June 5, 1985); Steven I. Turner
SEC at 234-35 (May 24, 1985) (testimony of Wood Dawson
attorney involved in research pertaining to Projects Nos.
4 and 5 agreements).

522/ Bert L. Metzger, Jr. SEC tr. at 1042-43 (Feb. 19, 1986)
(testimony of Houghton Cluck attorney); Stephen I. Turner
SEC tr. at 254 (May 24, 1985) (testimony of Wood Dawson
attorney).

523/ Document entitled "Memorandum-WPPSS Nuclear Projects Nos.
4 & 5 and Skagit Project" (SEC Exh. 1104); typewritten
citations to and descriptions of state constitutional and
statutory provisions (SEC Exh. 1105); photocopied and
typed excerpts of state statutes and cases (SEC Exh. 1106).

524/ Stephen I. Turner SEC tr. at 253-54 (May 24, 1985)
(testimony of Wood Dawson attorney).

cited to statutes, treatises, digests, and cases pertaining to several subjects. 525/

The only documents that reflect research of attorneys from Houghton Cluck are approximately 15 pages of handwritten notes 526/ made in early 1975 by Bert L. Metzger, Jr., 527/ a principal Houghton Cluck attorney involved with Projects Nos. 4 and 5. Like O'Brien's notes, Metzger's notes consist of descriptions of cases and citations to statutes, constitutional provisions, treatises, and cases pertaining to a number of issues. 528/ In addition, there are a number of files consisting primarily of photocopies of constitutional provisions, cases, and statutes pertinent to municipal corporations and cooperatives in the BPA service area. 529/ These research materials shed little light on counsels' analysis of the "dry hole" or other legal issues.

In testimony Wood Dawson and Houghton Cluck each took the position that, in conducting its research, it viewed the

525/ O'Brien handwritten notes on Projects Nos. 4 and 5 Agreements [hereinafter O'Brien Notes]. (Included in SEC Exh. 1107.)

526/ Metzger handwritten notes for Projects Nos. 4 and 5 Agreements [hereinafter Metzger Notes]. (Included in SEC Exh. 1456.)

527/ See Bert L. Metzger, Jr. SEC tr. at 337-38, 551-54 (Feb. 11 and 12, 1986).

528/ Metzger Notes, supra note 526.

529/ E.g., file entitled "SS - Opinions/Legal Research - Statutes re Authority to Purchase Power - Washington" (SEC Exh. 1455); file entitled "SS - Opinions/Legal Research - Statutes re Authority to Purchase Power - Idaho/Nevada". (SEC Exh. 1487).

Participants' Agreement solely as a power purchase contract. 530/ Both firms, however, were aware that the Participants' assumption of the dry hole risk was a distinguishing feature of the Agreement. 531/ They nevertheless maintained that the take-or-pay provision did not change the nature of the Agreement. 532/

Metzger testified that, in late 1974 and early 1975, he and Jack R. Cluck, a senior partner at Houghton Cluck, looked for "everything that we could find" on the authority of

530/ E.g., Bert L. Metzger, Jr. SEC tr. at 1044 (Feb. 1986); Brendan O'Brien SEC tr. at 599 (June 5, 1985).

531/ See, e.g., Houghton Cluck billing statement to Supply System for January 1975 work 12942197, 12942198 (Feb. 13, 1975) (showing conferences between Cluck and Metzger, telephone conversation between Metzger and O'Brien, and research by Metzger regarding "statutory power to purchase, take or pay" and research by Metzger "regarding loan of credit and statutory problems re take or pay and option") (SEC Exh. 1511); Houghton Cluck billing statement to Supply System for November 1974 work 12939443 (Dec. 13, 1974) (showing research by Cluck and Metzger into authority of Participants "to purchase 'capability,'" which, according to Metzger, was "a shorthand way of saying the term of the purchase was to pay whether the project could be completed or delivered or not," Bert L. Metzger, Jr. SEC tr. at 974-A (Feb. 19, 1986)) (SEC Exh. 1510); Notes on draft agreement referred to as "Washington Public Powers Supply System Nuclear Projects Nos. 4 and 5 Project Agreement" (i) (notes on early draft of Participants' Agreement of whether "1. [p]olitical sub[division]s agreeing to pay unconditionally? Look at Centralia case. Was issue raised?" which a Wood Dawson senior partner wrote, Brendan O'Brien SEC tr. 101 (Apr. 12, 1985)) (included in SEC Exh. 1102).

532/ E.g., Bert Metzger, Jr. SEC tr. at 1512 (Feb. 25, 1986); Brendan O'Brien SEC tr. at 599 (Jun. 5, 1985).

prospective participants to enter into take-or-pay contracts. 533/ According to Metzger, that research included his review of statutes of states outside of the Pacific Northwest "to see if there was any indication in any statute where they treated the purchase of power, where there was an obligation to pay regardless of whether it was delivered differently than a subset of power and energy". 534/ He found no "statute which treated purchases of power, any purchase of power under any form separately from the term power and energy or electricity". 535/ To Metzger, this supported the conclusion that he said he and Cluck reached that the authority to purchase power included "any kind [of power], including take or pay or a contract where the purchaser of power took the risk that it would not be delivered". 536/

Although Metzger testified that the statutes he reviewed supported the conclusion that the authority to purchase power included the authority to enter into take-or-pay contracts, he found no cases that addressed the issue. Metzger said that he looked for cases, including cases in Washington, Oregon, and Idaho, addressing the authority of a municipal corporation to

533/ Bert L. Metzger, Jr. SEC tr. at 976-A to 977 (Feb. 19, 1986).

534/ Id. at 1102 (Feb. 20, 1986); see Metzger Notes, supra note 526, at 12401809 (citing statutes in states outside of the Pacific Northwest) (SEC Exh. 1457).

535/ Bert L. Metzger, Jr. SEC tr. at 1102-04 (Feb. 20, 1986).

536/ Id. at 1103-04.

enter into a take-or-pay agreement for a project of which it was not to be an owner. 537/ He found no such cases. 538/

O'Brien testified that the attorneys at Wood Dawson who worked on Projects Nos. 4 and 5 "understood the provisions of the dry hole risk. We understood their implications. We recognized what they were." 539/ He testified that he conducted a "research effort into what all of the cases were and all of the case law". 540/ He also testified, however, that, prior to starting his research, he and the others at the firm knew from their experience that there were no cases on the laws applicable to Washington municipalities or PUDs upholding contracts with dry hole provisions and that he was unaware of any Washington case specifically upholding such provisions. 541/ O'Brien maintained that he did not feel that the lack of precedent was a critical problem because the principles of law enunciated in cases interpreting the powers of Washington municipalities and PUDs showed that they otherwise had authority to enter into the Agreement. 542/

537/ Id. at 1010, 1104 (Feb. 19 and 20, 1986).

538/ Id. at 1010, 1104-06.

539/ Brendan O'Brien SEC tr. at 697 (June 6, 1985).

540/ Id. at 675.

541/ Id. at 675-77.

542/ Id. at 676.

5. Events Indicating that the Participants' Agreement Might Be Characterized as a Loan Guarantee, Not as a Power Purchase Agreement

Prior to the Participants' Agreement, agreements were drafted to provide a basis for preliminary financing for Projects Nos. 4 and 5. In connection with that work, Houghton Cluck identified as an issue the authority of certain publicly-owned utilities to guarantee loans to the Supply System. Agreements then were drafted to avoid being construed as loan guarantees. At the same time, the agreements contained provisions that were similar to the take-or-pay provision that was later included in the Participants' Agreement. Thereafter, direct service industries, which were BPA customers, informed counsel that the inclusion of such a provision in an agreement they were to sign transformed that proposed agreement into a loan guarantee. The issue these customers raised thus presented the question whether the Participants' Agreement might be subject to the same interpretation.

a. Preliminary Financing Proposals

The loan guarantee issue was first raised when Houghton Cluck attorneys and others were considering methods of financing for studies and preliminary work on Project No. 4. In October and early November 1973, an agreement was drafted whereby prospective participants would advance funds to the Supply System for work they wanted it to perform and the Supply System would reserve them a share of project output or

potential output. 543/ Prospective participants apparently resisted being required to make an actual outlay of cash. 544/ As a partial solution, it was proposed that the Supply System issue notes for a portion of the amount needed secured by agreements, each between the Supply System and a Supply System member, 545/ under which the Supply System would reserve to members shares of the capability or output of the Project. 546/

543/ E.g., draft agreement entitled "Agreement for Rendition of Services and Reservation of Power Capacity or Output (Oct. 23, 1973).

544/ See Special Memorandum from Alan H. Jones to All PPC Members 1 (Nov. 26, 1973) (PPC Chairman stating that, with respect to draft of preliminary financing agreement, "the attorneys working on this problem now think it may be possible to arrange for this financing on a basis which will not require the payment of cash by the preference customers, assuming all goes well on the project" (emphasis in original)) (SEC Exh. 1385); letter from Norman A. Stoll to Robert B. Smith 2 (Nov. 9, 1973) (letter from PPC attorney that "the best we have come up with so far would permit WPPSS members to make an unconditional pledge of credit to secure a WPPSS short-term loan but would require everyone else to raise cash in one way or another. However, you can be sure that we expect to leave no stone unturned to see what can be done to avoid the necessity of laying cash on the line immediately.") (SEC Exh. 1386).

545/ See letter from Norman A. Stoll to Robert B. Smith 2 (Nov. 9, 1973) (letter from PPC attorney that only Supply System members would pledge credit to secure short-term loan to the Supply System) (SEC Exh. 1386); Minutes of Public Power Council Executive Committee Meeting 2 (Nov. 2, 1973) (showing that only Supply System members would execute the agreements securing the notes) (Chemical Bank I Exh. 540).

546/ See, e.g., draft agreement entitled "Washington Public Power Supply System Nuclear Project No. 4 Agreement Between Supply System, Public Power Council and Preference Customer of Bonneville (Project No. 4 Preliminary Agreement)" § 6(b) (Nov. 12, 1973) (providing that the Supply System would reserve to Supply System members the
(continued...)

This avenue was determined to be unavailable to many prospective participants that were not Supply System members because of legal restrictions on their authority to guarantee debt. 547/

A proposal then was advanced under which the Supply System would issue additional notes secured by agreements, each between the Supply System, the PPC, and a prospective participant, pursuant to which the Supply System would perform services and reserve to the prospective participants shares of the project's output or potential output. 548/ Under both this plan and the plan for the Supply System to issue member-backed notes, it was contemplated that the prospective participants, including Supply System members, would not have to make any payments under the agreements unless the Supply System was unable to pay the notes from the proceeds of subsequent note or bond issues. 549/ Thus, the member-backed notes would be paid from the proceeds of the notes secured by the agreements under which the Supply System would perform services and reserve

546/ (...continued)

shares of capability or output reserved to that member in the agreement that was to be security for the member-backed notes). (Included in MDL Exh. 102358.)

547/ See infra Part IV B5a.

548/ See Houghton Cluck Coughlin & Riley, Washington Public Power Supply System Nuclear Project No. 4 Preliminary Financing Alternatives 1 (Nov. 15, 1973) [hereinafter Houghton Cluck Project No. 4 Memorandum]. (SEC Exhs. 1120, 1229, 1495.)

549/ Id. at 2-3.

output or potential output, 550/ and the notes secured by those agreements would be paid from the proceeds of notes secured by the agreements ultimately executed for the purchase of the entire output or potential output of the project. 551/

In mid-November 1973, Cluck prepared a memorandum outlining these various preliminary financing alternatives, 552/ which had been selected after discussions with bond counsel and others. 553/ The principal alternatives set forth in the memorandum were the proposals for the Supply System to issue member-backed notes and then to issue notes backed by agreements with prospective participants under which the Supply System would perform services and reserve output or potential. 554/ In outlining the alternatives, Cluck stated

550/ Id.

551/ See Special Memorandum from Alan H. Jones to All PPC members 1-2 (Nov. 26, 1973). (Memorandum from PPC Chairman) (SEC Exh. 1385.)

552/ Bert L. Metzger, Jr. SEC tr. at 797-98 (Feb. 13, 1986).

553/ Houghton Cluck Project No. 4 Memorandum, supra note 548, at 1.

554/ Id. at 2-3. In the memorandum, Cluck noted that the proposal for the Supply System to issue notes backed by the agreements for the performance of services and the reservation of output or potential output "has not been cleared by bond counsel". Id. at 2. As a result, a proposal for the Supply System to enter into agreements with prospective participants, other than Supply System members that entered into agreements to back Supply System notes, under which the Supply System would perform services and reserve capability or output and the prospective participants would pay the Supply system through the PPC was included as an alternative "to allow direct preference customer financing without the necessity of bond counsel approval". Id.

that one of the assumptions underlying their selection was that "[n]ote financing by Supply System based on loan guarantees of municipal preference customers which are not Supply System members is not available because of legal restrictions." 555/ When asked by the staff to explain that statement, Metzger responded that Supply System members had statutory authority to make loans to the Supply System but that he and Cluck believed that non-members did not have authority simply to loan money to the Supply System. 556/ According to Metzger, "they [the others] were not in the banking business; they were in the power business" 557/ In a subsequent deposition, Metzger stated that the firm had been "unwilling to give an opinion as to the validity" of loan guarantees by non-members of the Supply System. 558/

555/ Id. at 1.

556/ Bert L. Metzger, Jr. SEC tr. at 800 (Feb. 12, 1986). At the time, Wash. Rev. Code Ann. § 43.52.391 (1970) provided that any member of a JOA could "advance or contribute" funds to the JOA. The JOA then was required to repay, with interest, any such advance or contribution from the proceeds of revenue bonds, operating revenues, or other funds of the agency. Id.

557/ Bert L. Metzger, Jr. SEC tr. at 800 (Feb. 12, 1986).

558/ Metzger testified as follows:

- A. My recollection is that a pure guarantee of a Supply System borrowing by such entities, that is, preference customers which were not Supply System members, did not have a sufficient legal support, as I recall, to enable us to obtain loans based on such guarantees.

(continued...)

558/(...continued)

Q. When you talk about us "obtaining loans," do you mean the Supply System?

A. Yes.

* * * *

. . . It isn't just utilities who are non-members or preference customers. It's just municipal preference customers. It's not utilities in general.

* * * *

What I was saying was what I said; was that, as I recall, our firm did not -- that there was a sufficient legal basis to support a pure loan guarantee of a Supply System loan with no other features to such a guarantee, by municipal customers, preference customers of Bonneville.

Q. Who were not members.

A. Who were not members. That's correct. Members of the Supply System.

Q. What do you mean by an insufficient legal basis to support such a loan guarantee?

A. I mean that I think we would have been unwilling to give an opinion as to the validity of such guarantees.

Bert L. Metzger, Jr. MDL tr. at 2614-16 (July 10, 1986).

Metzger and Cluck concluded that, as to members of the Supply System, they would be willing to render an opinion that the members could guarantee loans made to the Supply System, id. at 2626-27, apparently based on the statute described supra at note 556. With respect to municipal corporations that were non-members, however, he said that he recalled "finding that in the light of our knowledge of
(continued...)

Despite the concern about the making of loan guarantees by non-members of the Supply System, Cluck, in his memorandum, made this important point with respect to the proposal for the Supply System to issue notes backed by agreements under which it would perform services and reserve output or anticipated output: he said that the prospective participants would be required "to make payments to the Supply System without regard to the outcome of the work performed by Supply System or to the progress of such work". ^{559/} That provision was incorporated into a draft preliminary financing agreement for Project No. 4. The agreement provided that, if the Supply System otherwise was unable to pay the notes for which the agreements were to be the security, each prospective participant would be required to pay its share of the debt service on the notes "without regard to the outcome or progress of the work or services performed by the Supply System pursuant to this Agreement" and that those payments would "not be . . . conditioned upon the performance or non-performance by PPC, Supply System, Preference Customer or any other Preference Customer under this or any other

^{558/} (...continued)

legal doctrines concerning interpretation of statutes regarding authority of municipal corporations, together with the statutes and charters that we found, that there was not sufficient language in the charters and statutes to satisfy us that there was sufficient legal basis to give an opinion that they had such authority". Id. at 2630-31.

^{559/} Houghton Cluck, Project No. 4 Memorandum, supra note 548, at 2-3.

agreement or instrument" 560/ By virtue of this unconditional commitment, prospective participants might not receive anything in return for their obligations but, regardless of their membership in the Supply System, would guarantee payment of notes that the Supply System issued.

b. Option Agreement

As a result of the adoption of a program known as "Hydro-Thermal Program Phase 2", which included Projects Nos. 4 and 5, work on the draft preliminary financing agreement terminated shortly after the draft agreement was circulated. In 1975, however, the Supply System went forward with an interim financing for Projects Nos. 4 and 5. That financing was backed by Option Agreements, which provided that the Supply System was to perform services and reserve to those signing the Agreement an option to purchase a share of the "Project Capability" 561/ of Projects Nos. 4 and 5. 562/ The Option Agreement authorized the Supply System to issue up to \$100 million of bonds (the "development bonds"). 563/ If the Supply System sold

560/ Draft agreement entitled "Washington Public Power Supply System Nuclear Project No. 4 Agreement Between Supply System, Public Power Council and Preference Customer of Bonneville" § 4 (Draft 2, Nov. 21, 1973). (Included in SEC Exhs. 1385, 2790.)

561/ The definition of Project Capability in the Option Agreement was the same as that in the Participants' Agreement. Compare Option Agreement § 1(k) with Participants' Agreement § 1(v).

562/ Option Agreement §§ 3, 4.

563/ Id. § 5.

development bonds, and subsequently was unable to pay the principal and interest through the issuance of additional bonds, the Agreement further provided that each of the 93 BPA preference customers that signed an Option Agreement ("Option Participant") would pay its share of the debt service on the outstanding bonds regardless of the performance or non-performance by the Supply System. 564/ The Option Agreements were to be security for the development bonds. 565/

The Option Agreement, like the draft preliminary financing agreement, seems to have been drafted to avoid the loan

564/ Id. § 6.

565/ Official Statement for \$100,000,000 Washington Public Power Supply System Generating Facilities Revenue Bonds 9 (July 24, 1975) [hereinafter Development Bonds Official Statement]. (SEC Exh. 1399.) Although the Option Agreement provided for payment by the Option Participants, it also included provisions that would avoid the triggering of the payment provisions. The Agreement obligated the Supply System to deliver the Participants' Agreement by August 1, 1976, and further provided that the Supply System was to use its best efforts thereafter to sell bonds backed by Participants' Agreements. Option Agreement §§ 3(d), 4(a)(3). The proceeds of those bonds would be used to pay the debt service on the development bonds. As long as the Supply System issued additional Projects Nos. 4 and 5 bonds prior to September 1, 1977, the Option Participants would not have to begin making payments under their Option Agreements. See id. § 6(a).

guarantee problem. Wood Dawson's files include the following notes:

Loan of Credit - arg - bilateral K [contract] not loan
Statutory Auth[ority] - Try to structure as purchase of power. 566/

O'Brien testified that he made the notes and that he thought they were notes of a communication from Cluck or Metzger. 567/ In explaining the first line of the notes, O'Brien said it was "expressing the concept that pursuant to the case law that a bilateral contract with mutual obligations does not constitute a loan of credit. To be a loan of credit it has to be unilateral where one person is guaranteeing an obligation for the other private consideration." 568/ With respect to the second line, O'Brien suggested that "somebody is wondering whether you could have the authority to make an option. And the solution to that to be clearly within the statutory authorization would be to structure the arrangement as a take-or-pay contract for the purchase of power" 569/ However, in response to a question whether he had discussed with anyone at Wood Dawson the issue raised in Cluck's 1973

566/ O'Brien handwritten notes made at time of drafting of Option Agreement. (Included in SEC Exh. 1107.) The "arg" in the notes was enclosed in a circle, and O'Brien, who wrote the notes, Brendan O'Brien SEC tr. at 117 (Apr. 12, 1985), testified that he could not read what was written, id. at 123. However, the writing appears to be "arg".

567/ Brendan O'Brien SEC tr. at 117, 122-23, 125 (Apr. 12, 1985).

568/ Id. at 123-24.

569/ Id. at 125.

memorandum, O'Brien further testified that the Option Agreement was "structured" as a services agreement under which the Option Participants would receive consideration for their obligations and that, therefore, the Agreements would not be a grant to the Supply System, which, under Washington's JOA law, was authorized only for members. 570/ Because services were to be provided, O'Brien maintained that the Agreement would not be making a guarantee as such but nevertheless could provide security for bonds. 571/

c. DSI Agreement

Despite these efforts to avoid the loan guarantee problem, representatives of direct service industry customers of the BPA ("DSIs") informed counsel that their efforts on this matter had failed at least with respect to the DSIs. This occurred at about the time that the Supply System signed the Participants' Agreements.

The then current draft of the agreement entitled "Washington Public Power Supply System Nuclear Project Nos. 4 and 5 Short Term Sales Agreement with Industries" ("Short Term Sales Agreement") provided for the sale of surplus Project Capability to DSIs. It exposed the DSIs to a dry hole risk between the time the Projects were to go into operation and

570/ Brendan O'Brien SEC tr. at 357-58 (June 4, 1985). The statute to which O'Brien was referring was the statute described supra at note 556, which authorized members of a JOA to make loans or advances to the JOA.

571/ Id. at 362.

July 1, 1988. 572/ On July 27, 1976, DSI representatives met with Cluck, Metzger, and others and discussed the then current draft of the Agreement. Metzger's notes of that meeting show that the DSI representatives stated that the DSIs' counsel had said that the companies' "debt covenants bar guarantee & STSA [Short Term Sales Agreement] is a guarantee . . . & not a power sales agmt. [agreement]." 573/ Cluck and Metzger responded that the "STSA as are Part. [Participants'] Agmt. [Agreements] must be power sales & can't be & aren't guarantee." 574/

Following the meeting, one of the DSI representatives sent Cluck a letter further explaining why the DSIs viewed the draft agreement as a loan guarantee. 575/ Thereafter, the Short Term

572/ E.g., Memorandum from H.R. Kosmata to Participants in WNP 4/5, at 1-2 (Dec. 22, 1976) (memorandum for Supply System Manager of Planning and Analysis) (SEC Exhs. 1108, 1549).

573/ Document entitled "mtg. - 7/27/76 SS-STSA" 12012938. (Included in SEC Exh. 1545.)

574/ Id. (emphasis in original).

575/ The letter stated:

The problem from the standpoint of the WPPSS contracts is that they would constitute a 'guarantee' by [Company] of the funded debt (borrowings) of the seller.

* * * *

The term 'guarantee' has been ruled to include, in our case, a situation where the buyer purchases goods or services under circumstances in which the buyer must in effect service the debt of the seller whether or not the goods or services are delivered.

(continued...)

Sales Agreement was changed so that the DSIs would not assume any part of the dry hole risk.

Although Metzger's notes show that he linked the loan guarantee provision in the Short Term Sales Agreement with the same provision in the Participants' Agreement, counsel did not explore whether the take-or-pay arrangement in the Participants' Agreement meant that that agreement became a loan guarantee. When asked by the staff in testimony whether, after the meeting, he researched the authority of Washington municipal corporations to guarantee loans, Metzger merely referred to his 1973 research in connection with the Project No. 4 preliminary financing proposals. 576/ He did testify, however, that, after the meeting, he and Cluck discussed whether the dry hole risk put the Participants in the "banking business" rather than the "power business". 577/ He said that he and Cluck came "to the firm conclusion that there was no such effect, that that was not the case where you purchased power". 578/ To Metzger, the Participants' Agreement, with the dry hole provision, was "a purchase of power. It's just

575/ (...continued)

Letter from J. Kenneth Kaseberg to Jack R. Cluck encl. at 1-2 (Aug. 3, 1976) (brackets in original). (SEC Exh. 1548.)

576/ Bert L. Metzger, Jr. SEC tr. at 1508-09 (Feb. 25, 1986).

577/ Id. at 1509-10.

578/ Id.

assigning certain risk to the purchase". 579/ Metzger explained that the DSIs had reached a different conclusion -- that inclusion of take-or-pay provisions would transform their agreements into loan guarantees, based not on legal analysis but, rather, on what their debt covenants provided. 580/ But the DSI position at least raised a question on whether the same conclusion might be reached as a matter of municipal law.

6. Unlike Earlier Projects, Counsel Did Not Seek Judicial or Legislative Resolution of Legal Uncertainties

Despite indications that inclusion of a take-or-pay provision might cause an agreement to be viewed as a loan guarantee and that, therefore, the Participants' Agreement might be invalid as to municipal corporations that were not Supply System members, counsel issued unqualified opinions as to the validity and enforceability of 72 of the Participants' Agreements without seeking a test case or legislation to resolve the uncertainty. In several previous instances, by contrast, counsel resolved legal questions by bringing test

579/ Id. at 1512. No one from Wood Dawson attended the meeting with the DSI representatives, and Metzger did not recall whether he discussed the matter the DSIs had raised with anyone from the firm, Bert L. Metzger, Jr. SEC tr. at 1504-05 (Feb. 25, 1986). However, O'Brien indicated that he was aware of the issue the DSIs had raised. See Brendan O'Brien SEC tr. at 150 (Apr. 12, 1985). In addition, Houghton Cluck's billing statement to the Supply System for the period of time shows that, the day after the meeting, Metzger spoke with O'Brien about the Short Term Sales Agreement and that Cluck also spoke with O'Brien. Houghton Cluck billing statement to Supply System for July 1976 work 12944072 (Aug. 16, 1976).

580/ Bert L. Metzger, Jr. SEC tr. at 1495 (Feb. 25, 1986).

cases, by seeking state or federal legislation, or by structuring the financing arrangements so that they were expressly authorized by statute. These actions were taken where there was no express authority for an entity to enter into a particular agreement or where the agreement contained features that were novel or untested. Significantly, where there were doubts about an entity's authority to assume dry hole risks, these doubts were expressly resolved. In this section, we will first examine these prior cases, and then explore why a similar approach might not have been taken here.

a. Prior Projects

The financing arrangement for the second Supply System Project, the Hanford Project, seems to have been structured so that the BPA, which was to assume the dry hole risk, would have express statutory authority to participate in the project. The Bonneville Project Act, 581/ which set forth the powers of the BPA, did not expressly authorize the BPA to purchase power. The Act did authorize the BPA to contract with public and private utilities "for the mutual exchange of unused excess power upon suitable exchange terms for the purpose of economical operation or of providing emergency or break-down relief". 582/

581/ Ch. 720, 50 Stat. 731 (1937) (codified as amended at 16 U.S.C. §§ 832-832i (1982)).

582/ Id. § 5(b), 50 Stat. at 735 (codified as amended at 16 U.S.C. § 832d(b) (1982)).

It appears that the exchange method was chosen as a result of this provision and that Wood Dawson played a substantial role in the selection of this method. For example, according to a person who, at the time, was a staff attorney in the Portland, Oregon office of the Department of Interior's Office of the Regional Solicitor and later became Regional Solicitor and BPA Deputy Administrator, Wood Dawson was

looking for express authority in the statute and they found express authority for exchange. They did not find express authority for a purchase, although our office was arguing that by implication, Bonneville did have the authority to purchase, but they were unwilling to give a clean opinion on the strength of the purchase concept. 583/

By structuring the exchange agreement as an exchange of project output for power, the BPA was able to acquire all of the project output in a manner that addressed Wood Dawson's concerns regarding the authority of the BPA directly to purchase power. Wood Dawson was therefore willing to opine that exchange agreements to which the BPA was a party were valid and enforceable.

A significant legal issue relating to the authority of municipal corporations also arose in connection with the

583/ Robert E. Ratcliffe SEC tr. at 46 (Sept. 13 1985); see also memorandum entitled "Hanford Project--Exchange Versus Purchase" 1 ("The exchange method was selected in deference to the desire of bond counsel who preferred to base his opinion on the express authority to exchange which is found in section 5(b) of the Bonneville Project Act rather than the authority to purchase which must be implied from other provisions in the act."). (Included in SEC Exh. 1283.)

Centralia Project, which was the first project undertaken as part of the "Ten Year Hydro-Thermal Power Program" for the Pacific Northwest ("Phase 1"). 584/ The publicly-owned utilities were to own the project jointly with investor-owned utilities. Each owner of the Centralia Project was responsible for financing its share of the costs of the project. The publicly-owned utilities planned to finance their respective shares through the issuance of bonds. Tacoma, Washington and PUD No. 1 of Snohomish County, Washington retained Wood Dawson to serve as their bond counsel.

The publicly-owned utilities participated in the project pursuant to a state statute that authorized them to develop, own, operate, and maintain thermal power facilities jointly with investor-owned utilities. 585/ According to the then Tacoma Chief Assistant City Attorney, who later became Tacoma's Director of Utilities, the Centralia Project was the first project built under that statute, and Wood Dawson recommended that a test case be brought to have the authority of the publicly-owned utilities to participate in the project jointly with the investor-owned utilities determined. 586/ Before the

584/ Phase 1 was a program developed by the BPA, publicly-owned and investor-owned utilities in the Pacific Northwest, and DSIs to address anticipated need for power in the region through 1979. Bonneville Power Admin., Dept. of the Int., A Ten Year Hydro-Thermal Power Program for the Pacific Northwest 4 (1969). (MDL Exh. 9741.)

585/ Act approved Mar. 21, 1967, ch. 159, 1967 Wash. Laws 773 (codified as amended at Wash. Rev. Code Ann. §§ 54.44.010-.910 (Supp. 1988)).

586/ Paul J. Nolan SEC tr. at 67, 76 (Oct. 2, 1985).

publicly-owned utilities signed the joint ownership agreement or issued bonds, they brought such a suit. 587/ The Washington Supreme Court ultimately upheld the authority of the utilities jointly to own the project. 588/

The same issue as to the authority of publicly-owned utilities to own generating facilities jointly with investor-owned utilities arose under Oregon law in connection with the next Phase 1 project, the Trojan Project. There, a publicly-owned utility, Eugene, Oregon, was to own a project with two investor-owned utilities. It retained Wood Dawson to serve as its bond counsel. Eugene participated in the Trojan Project pursuant to the Thermal Power Facilities Act, 589/ which authorized certain Oregon cities to own generating facilities jointly with certain publicly-and investor-owned utilities and

587/ Each of the publicly-owned utilities brought its own suit, and the four suits then were consolidated. Id. at 61-62. The issues raised pertained primarily to whether the joint ownership of the project by public and private utilities violated Wash. Const. art. VIII, § 7 prohibiting municipal corporations from lending their credit to individuals, corporations, companies, and associations and from owning stocks or bonds in a corporation, company, or association. See Public Util. Dist. No. 1 v. Taxpayers and Ratepayers, 78 Wash. 2d 724, 725-32, 479 P.2d 61, 62-65 (1971). Additionally, there was an issue whether the assumption by one of the investor-owned utilities of responsibility for managing the construction and operation of the project constituted an unlawful delegation of power by the publicly owned utilities. Id. at 730-31, 479 P.2d at 65.

588/ Public Util. Dist. No. 1 v. Taxpayers and Ratepayers, 78 Wash. 2d 724, 479 P.2d 61 (1971).

589/ Act approved June 20, 1967, ch. 603, 1967 Or. Laws 1454 (codified as amended at Or. Rev. Stat. §§ 225.450-.490, 261.235-.255 (1987)).

to issue revenue bonds therefor. 590/ The Act had been enacted shortly before the project was undertaken, and Wood Dawson again recommended that litigation be brought. 591/ Suit was brought, 592/ and the Oregon Supreme Court upheld the authority of Eugene to be a joint owner with investor-owned utilities. 593/

An additional legal issue arose in connection with the Trojan Project. The BPA was to use the net billing procedure, discussed above, to acquire all of Eugene's share of the generating capability of the project. The net billing agreements into which the BPA entered for this project were to be the principal security underlying the bonds Eugene was to issue to finance its share of the cost of the project. 594/

The BPA was not expressly authorized to engage in the net billing procedure. Wood Dawson recommended that legislation expressly authorizing the BPA to enter into the agreements be

590/ Id. §§ 4, 6, 1967 Or. Laws at 1454, 1555 (codified as amended at Or. Rev. Stat. §§ 225.470, 225.490 (1987)).

591/ Brendan O'Brien SEC tr. 137 (Apr. 11, 1985) (testimony of Wood Dawson attorney).

592/ The subsequently abandoned Eugene Project also was the subject of the suit. The principal issue was whether, by becoming a joint owner with private utilities, Eugene would violate restrictions in Or. Const. art XI, §§ 7, 9 against lending credit to, or becoming a stockholder in, a company, corporation, or association. See Miles v. City of Eugene, 252 Or. 528, 531-37, 459 P.2d 59, 61-64 (1969).

593/ Miles v. City of Eugene, 252 Or. 528, 459 P.2d 59 (1969).

594/ E.g., Official Statement for \$75,000,000 City of Eugene, Oregon Trojan Nuclear Project Revenue Bonds, Series of 1971, at 2 (June 23, 1971).

sought. 595/ Legislation was enacted in the form of a line item in the Public Works for Water, Pollution Control, and Power Development and Atomic Energy Commission Appropriation Act, 1970, 596/ which simply authorized the BPA to enter into net billing agreements for the Trojan Project and the subsequently abandoned Eugene Project. 597/ With the decision in the test case and the enactment of the legislation, Wood Dawson opined that the Trojan Project net billing agreements were valid and enforceable. 598/

The federal legislation authorized the BPA to enter into net billing agreements only for the Trojan Project and the subsequently abandoned Eugene Project. Largely at the urging

595/ Robert E. Ratcliffe SEC tr. at 48 (Sept. 13, 1985) (testimony of then Regional Solicitor and subsequent Deputy Administrator of the BPA).

596/ Pub. L. No. 91-144, 83 Stat. 323 (1969).

597/ In relevant part, the Act provided:

Provided, That not more than \$100,000 of the fund appropriated herein shall be available for preliminary engineering required by the Bonneville Power Administration in connection with the proposed agreements with the Portland General Electric Company and the Eugene Water and Electric Board to acquire from preference customers and pay by net billing for generating capability from non-federally financed thermal generating plants in the manner described in the committee report.

Id. tit. III, 83 Stat. at 333.

598/ E.g., letter from Wood Dawson Love & Sabatine to Eugene Water & Electric Board 2 (Mar. 30, 1977).

of Wood Dawson, additional legislation expressly authorizing the BPA to enter into net billing agreements for the Supply System's Phase 1 projects was sought. 599/ Congress included a line item in the Public Works for Water, Pollution Control, and Development and Atomic Energy Commission Appropriation Act, 1971 600/ authorizing the BPA to enter into net billing agreements for three Supply System projects. 601/ The

599/ See Public Works for Water, Pollution Control, and Power Development and Atomic Energy Commission Appropriation Bill, 1971: Hearings on Pub. L. No. 91-439 Before the Subcomm. on Public Works of the House Comm. on Appropriations, 91st Cong., 2d Sess. 867-68 (1970) (statement of then Special Assistant to the Regional Solicitor of the Department of the Interior that the legislation was necessary because the bond issues were for large amounts of money, and bond counsel and the underwriting bankers, therefore, wanted express authority).

600/ Pub. L. No. 91-439, 84 Stat. 890 (1970).

601/ In relevant part, the Act provided:

Provided, That not more than \$150,000 of the funds appropriated herein shall be available for preliminary engineering required by the Bonneville Power Administration in connection with the proposed agreements relating to three non-federally financed generating plants proposed under the hydro-thermal program to be sponsored jointly or severally by the Washington Public Power Supply System, Seattle City Light, Tacoma City Light, Snohomish County PUD and the Puget Sound Power and Light Company, pursuant to which the Bonneville Power Administration will acquire from preference customers and pay by net billing for generating capability from non-federally financed thermal generating plants in the manner described in the committee report.

Id. tit. III, 84 Stat. at 899.

legislation satisfied Wood Dawson's desire for some form of express authorization for the BPA to enter into the net billing agreements for the Supply System's Projects Nos. 1, 2, and 3. Thereafter, the firm and Houghton Cluck opined on the validity and enforceability of net billing agreements to which the BPA was party. 602/

In the case of Idaho cities that participated in the Supply System's net-billed projects, an opinion of the Idaho Attorney General concluded that these cities lacked the statutory authority to enter into net billing agreements. 603/ As a result, Wood Dawson, Houghton Cluck, and others helped draft legislation that expressly authorized Idaho cities to enter into such agreements. 604/ The legislation, however, was not enacted at the time of the first note issue in a project for which the cities had signed a net billing agreement. As a

602/ E.g., letter from Houghton Cluck Coughlin & Riley to Board of Directors, Washington Public Power Supply System (July 11, 1973) (opinion on Project No. 2 agreements). (SEC Exh. 1484.) As discussed infra at note 649, for each of the Supply System's net billed projects, the firms did not include all of the net billing agreements in the opinions the firms rendered in connection with that project.

603/ Letter from Robert M. Robson to Arthur L. Smith (Oct. 12, 1970) (letter Idaho Attorney General to Idaho Falls, Idaho attorney). (SEC Exh. 1460.) The statutes that were relevant to this issue provided that an Idaho city had authority to sell excess power, i.e., power not needed by the city or its inhabitants. Idaho Code §§ 50-325, -327 (1967). The city could contract for the sale of excess power only with consumers, and no such contract could be for a period of more than five years. Id. § 50-327.

604/ Act of Feb. 20, 1971, ch. 31, § 1, 1971 Idaho Sess. Laws 75 (codified as amended at Idaho Code § 50-342 (Supp. 1987)).

result, these utilities initially were allocated zero percent shares of the project's potential electrical output. 605/ After the legislation was enacted, the Idaho Attorney General issued an opinion that Idaho cities had authority to enter into net billing agreements. 606/ Wood Dawson then issued an opinion concurring in the Attorney General's opinion, 607/ and the shares of the Idaho city participating utilities were increased.

In addition to legislative efforts to establish net billing authority, counsel made efforts to amend city charters and rural electric cooperative by-laws. These efforts were made where one or both law firms identified a question as to the authority of a utility to participate in the project. 608/

605/ See Project No. 2 Washington Public Power Supply System Nuclear Agreement (Net Billing Agreement) Exh. A. (SEC Exh. 1094.)

606/ Letter from W. Anthony Parks to Peter B. Wilson (Aug. 16, 1971) (letter to Bonners Ferry, Idaho attorney). (SEC Exh. 1014.)

607/ Letter from Wood Dawson Love & Sabatine to Board of Directors, Washington Public Power Supply System (Apr. 21, 1972). (SEC Exh. 1473, included in SEC Exh. 1115.)

608/ One amendment, which is significant here because it addressed an authority problem that later arose as to certain Participants in Projects Nos. 4 and 5, see infra note 648, was made to the Bandon, Oregon Charter. There, Bandon's charter provided:

Unless otherwise authorized by the legal voters of the City of Bandon at a special election duly called and held for such purpose, the council shall not contract a voluntary floating indebtedness of said city in excess of the sum of

(continued...)

Outside of the Pacific Northwest, Wood Dawson had been involved in legislative efforts for other publicly-owned utilities. In fact, Wood Dawson had even drafted legislation in North Carolina and Massachusetts that authorized municipal corporations to enter into take-or-pay arrangements. 609/

608/ (...continued)

\$500.00 for general city purposes and the council shall not contract an indebtedness in excess of the sum of \$1,500.00 for the maintenance and operation of its municipal utilities

Bandon, Or. Charter ch. IX, § 34 (Nov. 8, 1940). Prior to the first Project No. 2 note issue, Metzger wrote a letter to Bandon's attorney advising that, because the Project No. 2 net billing agreement provided for the participating utilities to make payments unconditionally, Bandon's charter debt limit could restrict Bandon's authority to enter into the agreement and further advising that applicable law indicated difficulty in opining that Bandon's agreement was valid and enforceable. Letter from Bertram L. Metzger, Jr. to Mr. Spady 1 (Dec. 7, 1970). (SEC Exh. 1606.) Bandon's Attorney drafted a proposed amendment to the City's Charter, which he discussed with Metzger, that made the debt limits inapplicable to the acquisition, ownership, or operation of utility works pertinent to furnishing electric power as provided in the Oregon statutes. Letter from Bertram L. Metzger, Jr. to LeRoy Love 1-2 (Dec. 17, 1970) (letter to Wood Dawson partner in charge for Project No. 2). (SEC Exh. 1255.) The voters of Bandon approved the amendment. Certificate of R.V. Blacklund (Jan. 15, 1971) (Bandon City Recorder certifying approval of amendment). (Chemical Bank Exh. 2236.) With the amendment, Wood Dawson and Houghton Cluck included Bandon's Project No. 2 net billing agreement in their opinions on Project No. 2 agreements. See Bert L. Metzger, Jr. Chemical Bank tr. at 1006-07 (May 9, 1983), and later included Bandon's Projects Nos. 4 and 5 agreements in their opinions on agreements for those projects, see infra Part IV C2.

609/ Brendan O'Brien SEC tr. at 61-65 (Apr. 11, 1985).

b. Possible Reasons Why Similar Actions Were Not Taken To Resolve Legal Uncertainties as to the Authority of the Washington Municipal Corporation Participants

Although counsel had, in the past, resolved authority questions stemming from novel financing arrangements by bringing test cases or seeking legislation, they made no such efforts here. According to O'Brien and Metzger, the firms did not consider seeking to have a test case to determine the authority under existing law, of Washington municipal corporations to enter into the Participants' Agreement. 610/ Likewise, legislation to address authority matters was not sought. The firms took the position in testimony that neither a test case nor legislation was necessary because the existing law was sufficiently clear to establish the authority. 611/

There were a number of factors that may explain why such actions were not taken. There was a real concern about delays and cost increases. The time spent litigating a test case, as well as the possibility that those opposed to the projects, such as environmental groups, might seek to intervene in any litigation or prevent legislation from being enacted, could have increased costs and delayed the projects.

610/ Brendan O'Brien SEC tr. at 418 (June 4, 1985); see, e.g., Bert L. Metzger, Jr. SEC tr. at 1263-64 (Feb. 20, 1986).

611/ E.g., Bert L. Metzger, Jr. SEC tr. at 1334-35 (Feb. 24, 1986); see Brendan O'Brien SEC tr. at 82 (Apr. 12, 1985) (testifying that "[t]he existing statutory authority was plenty sufficient").

From the start of the projects, the Supply System had been concerned about delays. For instance, the Option Agreement provided:

Time is of the essence with respect to the performance of the Agreement as provided herein in order to keep the Projects on a course of construction and acquisition so as to meet the schedules for operation of the Projects. There is a very strong probability that any appreciable delay would cause substantial losses to Supply System and Option Participant due to the inability to deliver power and energy, increases in construction costs and other causes. 612/

Nonetheless, from the start of the projects, delays were encountered. A substantial amount of time was spent in the efforts to arrange for permanent financing for the projects. 613/ Significant delays also were caused by problems relating to allocation of BPA power. 614/ In addition, litigation was brought and further litigation was threatened against certain Option Participants based primarily on alleged failures to comply with environmental requirements. 615/

Two suits also were brought against the BPA seeking to enjoin it from taking any action in connection with Phase 2

612/ Option Agreement preamble.

613/ See supra Part IV B4.

614/ Id. at note 216.

615/ See, e.g., Development Bonds Official Statement, supra note 565, at 28-29; L.G. Hittle, Summary of Lawsuits and Threats of Lawsuits Regarding Execution of the Option and Services Agreement for WPPSS Nuclear Projects Nos. 4, 5 and Skagit Project 1-3 (July 18, 1975) (SEC Exh. 1272).

pending the completion and circulation of an adequate environmental impact statement on Phase 2. 616/ As a result, the sale of the development bonds, which was to have taken place by June 1975, 617/ was delayed one month. 618/

Because of the experience with the Option Agreement, consideration was given to a test case in connection with the Participants' Agreement, 619/ limited, to environmental issues pertaining to Washington municipal corporations, according to O'Brien and Metzger. 620/ However, it was thought that such an action would delay the projects and result in cost

616/ See, e.g., Development Bonds Official Statement, supra note 565, at 19.

617/ See, e.g., letter from Jack R. Cluck to J.J. Stein 1 (Dec. 27, 1974) (letter to Supply System Managing Director that monies then available to the Supply System for Projects Nos. 4 and 5 were to run out by June 1, 1975). (SEC Exh. 1561-1562.)

618/ The sale took place after one suit was dismissed, a threatened suit was resolved, and Wood Dawson and Houghton Cluck opined that the one pending suit against an Option Participant was "without substantial merit" and that no judgment or order rendered in the suits against the BPA would invalidate the development bonds or the Option Agreements. E.g., Development Bonds Official Statement, supra note 565, at 20, 28.

619/ E.g., L.G. Hittle, supra note 615, 3.

620/ Bert L. Metzger SEC tr. at 1108-09 (Feb. 20, 1986), Brendan O'Brien SEC tr. at 418-19 (June 4, 1985); see also, Paul J. Nolan SEC tr. at 142 (Oct. 3, 1985) (testimony of then Deputy City Attorney and subsequent Director of Utilities of Tacoma that the case would have pertained to environmental issues).

increases. 621/ Additionally, there was concern about "difficulty in excluding unwanted intervenors," 622/ i.e., groups opposed to the Projects on environmental grounds. 623/ Ultimately, no test case of any kind was brought. 624/

621/ E.g., L.G. Hittle, supra note 615, at 4 (stating that, with a test case, "Supply System's counsel estimates a delay in the sale of bonds now proposed for the spring of 1976 until January 1977. This delay will cause another one-year delay in plant schedules and add to the cost of the projects an additional \$350 million.").

622/ Inter Office Communication from Paul J. Nolan to File 2 (May 25, 1976) (memorandum of the Deputy City Attorney and subsequent Director of Utilities of Tacoma memorializing meeting of attorneys involved in Projects Nos. 4 and 5 and showing that the unwanted intervenor issue was the reason given why a test case was "determined not presently practicable"). (SEC Exh. 1146.)

623/ Paul J. Nolan SEC tr. at 141 (Oct. 3, 1985) (testimony of then Deputy City Attorney and subsequent Director of Utilities of Tacoma).

624/ Rather than having a test case brought to address environmental issues, the Supply System opted for the Washington municipal corporation Participants to follow a procedure under Washington's environmental laws that limited the period of time during which an action challenging compliance with state environmental laws could be brought. See, e.g., Bert L. Metzger, Jr. SEC tr. at 1163-64 (Feb. 20, 1986). No such action was brought. Id.

Even without litigation, environmental matters caused some delay to the Projects. Seattle informed the Supply System that, because of studies it had agreed to undertake in connection with the dismissal of the environmental suit against it, it would be unable to execute the Participants' Agreement before April 15, 1976. Memorandum from J.J. Stein to All Option Participants Who Have Executed the Option and Services Agreement 1 (June 27, 1975). The Supply System, therefore, extended the schedule for the signing of the Participants' Agreements and the completion of the first financing based on those Agreements from January 1, 1976, to April 15, 1976, for the signing of the Agreements and May 1, 1976, for completion of the financing. Id. at 2.

Although not as conclusive as a test case or legislation, an opinion by the Washington Attorney General would have been another, and perhaps less visible, means of obtaining an independent determination of authority. One possible reason why this option was not pursued was that the firm had a policy that prevented it from giving an opinion that was contrary to a state attorney general's opinion, irrespective of whether the firm agreed with the attorney general's opinion. ^{625/} As such, a negative opinion from the Washington Attorney General on the authority of Washington cities, towns, and PUDs to enter into the Participants' Agreement likely would have prevented the Supply System from going forward with Projects Nos. 4 and 5.

C. COUNSELS' RECOGNITION OF AUTHORITY PROBLEMS OF OTHER PARTICIPANTS AND THEIR FAILURE TO DISCLOSE THOSE PROBLEMS

At the closing for each Projects Nos. 4 and 5 bond issue, Wood Dawson and Houghton Cluck delivered identical opinion letters addressed to the Board of Directors of the Supply System. In those letters, each firm stated that it had "examined into the validity of seventy-two of the Participants' Agreements". ^{626/} Nothing was said about the Agreements of the remaining 16 Participants, which accounted for about 4% of the

^{625/} LeRoy Love SEC tr. at 294-95 (May 14, 1985) (senior partner in Wood Dawson testifying that the "danger of seeking these things" was that the firm "might be able to go ahead and be satisfied we could, but if we asked for the Attorney General and he's a bad Attorney General or he doesn't agree with us, then our policy, which was a very prudent one, would have prevented us from going ahead").

^{626/} See supra note 463.

Project Capability. A form of the letters to be delivered at the closing was included in the official statement for that bond issue. 627/ The letters did not specify the Participants whose Agreements were included in the opinions. Thus, it was not disclosed which of the 72 Agreements were the subjects of the opinions and which of the 16 were not. Nor was it disclosed that the firms had, in fact, looked into the validity and enforceability of the 16 agreements that they did not opine were valid and enforceable. In this section of the Report, we examine the work performed by counsel in connection with the 16 agreements on which they did not opine.

1. Authority Problems Are Discovered Prior to Projects Nos. 4 and 5

The authority problems of five of these 16 Participants -- three Oregon cities (Cascade Locks, Drain, and Milton-Freewater); Vera Irrigation District No.15 ("Vera") of Washington; and the Rural Electric Company ("Rural") of Idaho -- were first noted in connection with the participation of these utilities in the net billed projects. Counsel excluded

627/ The form of opinion letters appearing in the official statements for all but the first bond issue differed from the letters delivered at the closing only in that the forms of letters were undated and unsigned, were not on the respective letterheads of Wood Dawson and Houghton Cluck, and did not contain the date of the other opinion letter Wood Dawson and Houghton Cluck each delivered at each closing, which pertained to the bonds then being issued. The form of opinion letters appearing in the official statement for the first bond issue also had blanks for the number of Participants' Agreements included in the opinions and the percentage of Project Capability those Agreements represented.

at least three of these five utilities from their opinions, just as they would do in their opinions for Projects Nos. 4 and 5. 628/

As was the firm's practice, in connection with rendering its opinions for each of the net-billed projects, Wood Dawson, prior to the first note issue sent a letter to a number of persons, including individuals at Houghton Cluck, the BPA, and the Supply System, requesting the documents it needed to render its opinion on the notes to be issued and its opinions on agreements involved in the project. 629/ The documents requested included those the firm needed to opine on the validity and enforceability of net billing agreements. 630/

628/ It appears that counsel included the agreements of Drain and Milton-Freewater in at least some of their opinions on agreements for the net billed projects. See infra note 648.

629/ E.g., letter from Wood King Dawson Love & Sabatine to listed individuals (Nov. 19, 1970) (letter setting forth documents needed in connection with upcoming Project No. 2 note issue. (SEC Exh. 1376.) For each subsequent note or bond issue, the firm requested documents for its opinion on the notes or bonds then to be issued.

630/ The documents requested included the following: the Participating utility's net billing agreement; the resolution or ordinance authorizing the execution of that agreement; a certificate that the meeting at which the resolution or ordinance was adopted was duly organized; a certified copy of the city charter or by-laws; a certificate as to the accuracy of attached articles of incorporation, the good standing of the utility, and the authority of the utility to do business; and an opinion letter to the utility from its attorney that the agreement was duly authorized, valid, and binding on the utility and was not in conflict with any applicable law, articles of incorporation, by-laws, or agreement. Id. at 5-15.

For many of these, and other documents, Wood Dawson also specified the precise information that it required to be included in the documents. 631/ In addition, the participating utilities were provided with a form for certain documents that essentially enabled the responding person to fill in blanks. 632/ The BPA collected the utilities' documents and transmitted them to the Supply System, Houghton Cluck, and Wood Dawson. 633/

Wood Dawson and Houghton Cluck independently reviewed the participating utilities' documents and researched the authority of participating utilities to enter into net billing agreements. Each firm kept track of the receipt or non-receipt of the utilities' documents, as well as problems pertaining to participating utilities, on check-lists that the firm maintained. 634/

631/ Id. at 14-15 (describing contents of opinion to be given by counsel for each participating utility).

632/ See Bert L. Metzger, Jr. SEC tr. at 135-36, 184-95 (Feb. 10, 11, 1986).

633/ Larry G. Hittle SEC tr. at 69-70 (Sept. 11, 1985) (testimony of BPA official involved in collecting and reviewing documents for net billed projects).

634/ Each check-list generally resembled a spread sheet and consisted of one column under which the names of the participating utilities in the particular project were listed and, next to that column, a separate column for each of the documents to be furnished. E.g., document entitled "Transcript Check-List from Wood King Dawson Love & Sabatine" (Houghton Cluck check-list for Project No. 2 net billing agreement documentation) (SEC Exhs. 1438-1439.)

Wood Dawson and Houghton Cluck each noted problems as to the authority of a number of utilities to enter into net billing agreements. On the firms' lists, the firms' attorneys used such terms as "authority problems," 635/ "authority defects," 636/ "no hope," 637/ and "no statutory

635/ E.g., document entitled "Authority Problems" and "Form Problems" (Houghton Cluck list of certain Project No. 2 participating utilities, with accompanying notations of problems). (SEC Exh. 1444.)

636/ Document entitled "SS #3" at 2 (Houghton Cluck list of certain Project No. 3 participating utilities, with accompanying notations of "defects"). (Included in SEC Exh. 1492.)

637/ Document entitled "SS #2-1973 Permanent financing -- Corres. File" 12990152 (Houghton Cluck list of certain Project No. 2 participating utilities with accompanying notations of issues giving rise to the "no hope" notations) (SEC Exh. 1480); document entitled "List of Participants Not Approved on #2 Note Issues" WD 102141 (Wood Dawson List of Projects No. 2 participating utilities, with accompanying notations of issues giving rise to the "no hope" notations) (SEC Exh. 1116). O'Brien and Metzger maintained that this notation did not mean that there was no hope that the utilities as to which this notation was made had authority but, rather, that there was no hope that the applicable statutory, charter or by-laws provision(s) would be changed so as to enable the firms to include in the firms' opinions the agreements of those utilities. Bert L. Metzger, Jr. SEC tr. at 642 (Feb. 12, 1986); Brendan O'Brien SEC tr. at 731-32 (June 6, 1985).

authority" 638/ in noting authority problems that had been identified. 639/

The authority issue identified with respect to Cascade Locks was its charter debt limit, 640/ which limited to \$2,500 the amount of "voluntary floating indebtedness" and to \$5,000 the amount of "bonded indebtedness" the City could incur 641/.

638/ Document entitled "Participants Not Approved WPPSS Series 1973 Notes" and "Participants Not Approved WPPSS Series 1974 Notes" WD 101748 (Wood Dawson list of certain Project No. 1 participating utilities with accompanying notations). (MDL Exh. 15267.)

639/ Metzger testified that his notations of authority issues on the check-lists and other documents did not reflect that he or anyone else had concluded that the referenced participating utilities lacked authority to enter into the agreement(s) for the project in connection with which the notations were made. See, e.g., Bert L. Metzger, SEC tr. 272-73, 642 (Feb. 11 and 12, 1986). He maintained that he was either identifying issues for review by Cluck or someone else or was identifying the source of the reasons the firm was unwilling to include certain agreements in their opinions on agreements. *Id.* at 226, 770 (Feb. 11 and 13, 1986). Similarly, O'Brien stated that Wood Dawson never reached a belief that any participating utility lacked authority to enter into the agreement(s) for a project into which it entered. Brendan O'Brien MDL tr. at 896-900 (Apr. 14, 1986). Nevertheless, the firms excluded agreements of utilities as to which authority problems were noted from their opinions. See *infra* Part IV C5 (discussing standard each firm maintained it used in deciding whether to include an agreement in its opinions).

640/ E.g., letter from Bert L. Metzger, Jr. to Ron Wendel 2 (July 9, 1974) (letter to BPA attorney setting forth "a recapitulation of items which must be corrected in connection with future financing" for Project No. 1, which, among other things, meant that Cascade Locks' "Charter must be amended to eliminate the debt limitation provision"). (SEC Exh. 1017, included in SEC Exh. 1488.)

641/ Municipal Charter of 1956 for Cascade Locks, Or. ch. X, § 40 (Sept. 12, 1956). The debt limit could be exceeded with the consent of the voters. *Id.* There was no such
(continued...)

The authority issues identified with respect to Vera were two Washington statutes: one provided that, without a vote of the electors, an irrigation district could not enter into a contract for the sale of electrical energy that was to continue for more than ten years; 642/ the other limited the amount of "debt or liability" 643/ an irrigation district could incur. 644/ The authority issue identified with respect to Rural related to its by-laws debt limit, 645/ which provided:

641/ (...continued)

vote held in connection with the City's participation in any of the Supply System's net billed Projects or Projects Nos. 4 and 5. See Gary E. Lockwood SEC tr. at 27-28, 46 (Feb. 20, 1985) (testimony of Cascade Locks attorney).

642/ Act approved Mar. 21, 1967, ch. 206, § 1, 1967 Wash. Laws 1038, 1038-39 (codified as amended at Wash. Rev. Code Ann. § 87.03.015 (Supp. 1988)).

643/ Wash. Rev. Code Ann. § 87.03.475 (1962) (current version at Wash. Rev. Code Ann. § 87.03.475 (Supp. 1988)).

644/ E.g., letter from Bert L. Metzger, Jr. to Joseph Custer (Jan. 25, 1974) (letter to Vera General Manager setting forth "the reason for the necessity of passage" of amendment to the statutes pertaining to irrigation districts and stating that the statutes pertaining to contracts for the sale of energy to last for more than 10 years and to the amount of "debt or liability" an irrigation District could incur "gave rise to questions as to the irrigation districts' legal authority to enter into such [net billing] agreements" and that, therefore, Wood Dawson and Houghton Cluck "were unable to render an unqualified legal opinion as to the validity of the irrigation district's Net Billing Agreement"). (SEC Exh. 1611.)

645/ E.g., letter from Bert L. Metzger, Jr. to Ron Wendel 2 (July 9, 1974) (letter to BPA attorney setting forth "a recapitulation of items which must be corrected in connection with future financing" for Project No. 1, which, among other things, meant that Rural's "by-laws must be amended to eliminate the debt limitation restrictions"). (SEC Exh. 1017, included in SEC Exh. 1488.)

"The board of Directors shall not incur indebtedness in excess of the amount equal to the sum of 40% of the total assets of the association without first obtaining authorization of the members." 646/

Counsel sought to have changes made to the statute, charter, or by-laws provision applicable to the three utilities as to which these problems were uncovered. 647/ These efforts were unsuccessful. As a result, the firms excluded the net billing agreements of these three utilities, as well as those of other utilities as to which problems were noted and outstanding 648/ from the opinions on agreements that they

646/ Rural Electric Company By-Laws art. III, § 5 (revised Mar. 1953, as amended through Jan. 19, 1966). There was no vote taken by Rural's membership with respect to Rural's participation in any of the net billed Projects or Projects Nos. 4 and 5. Larry R. Duff SEC tr. at 44, 109 (Dec. 4 and 5, 1984).

647/ E.g., letter from Bert L. Metzger, Jr. to Ron Wendel (July 9, 1974) (letter to BPA attorney setting forth "a recapitulation of items which must be corrected in connection with future financing" for Project No. 1). (SEC Exh. 1017, included in SEC Exh. 1488.)

648/ Drain and Milton-Freewater were on certain of the lists prepared in connection with the firms' opinions on net billing agreements. E.g., document entitled "Participants Not Approved WPPSS Series 1973 Notes" and "Participants Not Approved WPPSS Series 1974 Notes" WD 101748 (Wood Dawson list prepared in connection with opinions on Project No. 1 net billing agreements listing Drain and Milton-Freewater under the heading of "debt problems"). (MDS Exh. 15267.) It appears that the firms included the net-billing agreements of these cities in at least some of the firms' opinions on net billing agreements. See id. at WD 101747, WD 101748. (MDL Exh. 15267.) Both cities, however, had charter debt limits similar to that of Cascade Locks. Compare Drain Charter of 1954 ch. X § 41; Milton-Freewater Charter ch. X, § 2 with Municipal Charter (continued...)

rendered for the note issue(s) and the bond issues for each project. 649/ In each opinion, each law firm simply stated, as it would do for Projects Nos. 4 and 5, that it had "examined into the validity" of the number of agreements included in the opinion. 650/ The firms did not disclose that they were unwilling to opine that certain additional agreements were

648/ (...continued)

of 1956 for Cascade Locks ch. X, § 40 (Sept. 12, 1956). It is unclear why the agreements of Drain and Milton-Freewater were treated in a manner that was inconsistent with the agreements of Cascade Locks.

649/ Wood Dawson and Houghton Cluck ultimately opined that 84 Project No. 2 net billing agreements, providing for the disposition of 97.638% of the potential electrical output were valid and enforceable. E.g., letter from Houghton Cluck Coughlin & Riley to Board of Directors, Washington Public Power Supply System (July 11, 1973) (opinion on agreements). (SEC Exh. 1484.) The firms ultimately opined that 92 of the No. 1 net billing agreements, as amended (in connection with a decision to change the location of Project No. 1, each Project No. 1 Participant entered into an agreement amending its net billing agreement), providing for the disposition of 65.50% of the potential electrical output through June 30, 1986, 65.53% through June 30, 1996, and 97.04% thereafter, were valid and enforceable. E.g., letter from Houghton Cluck Coughlin & Riley to Board of Directors, Washington Public Power Supply System (Oct. 1, 1975) (opinion on agreements). (MDL Exh. 15172.) (The reason for the different percentages was that the BPA had entered into an exchange agreement with each of five private utilities pursuant to which, prior to July 1996, those utilities were to purchase and exchange portions of potential electrical output). Finally, the firms ultimately opined that 88 of the No. 3 net billing agreements, providing for the disposition of 95.525% of the potential electrical output, were valid and enforceable. E.g., letter from Wood Dawson Love & Sabatine to Board of Directors, Washington Public Power Supply System (Dec. 17, 1975) (opinion on agreements). (MDL Exh. 15173.)

650/ E.g., letter from Wood Dawson Love & Sabatine to Board of Directors, Washington Public Power Supply System (Dec. 17, 1975) (opinion on agreements). (MDL Exh. 15173.)

valid and enforceable or even that they had looked into those agreements. 651/

2. Authority Problems as to 10 of the Participants in Projects Nos. 4 and 5 Whose Agreements the Counsel Excluded from the Opinions

In connection with Projects Nos. 4 and 5, counsel again maintained check-lists and lists of Participants whose Agreements the firms excluded from their opinions. The documents identify the Participants whose Agreements the firms excluded and the issues that led to the exclusions. The firms excluded 10 Agreements because of authority problems and 6 Agreements because of procedural problems. 652/ The 10 Participants whose Participants' Agreements the firms excluded from the opinions they rendered for the sales of the long-term bonds because of authority problems were the five utilities as to which problems had been identified in connection with net

651/ This was not the first time that counsel opined on fewer than all of the agreements and failed to disclose problems as to additional agreements. In 1963, in connection with the Hanford Project, Wood King Dawson and Houghton Cluck opined on the exchange agreements of 25 of the 76 participants in that project. Those 25 agreements accounted for the purchase and exchange of 91.478% of the output of the Hanford Project. Letter from Wood King Dawson & Logan to Board of Directors, Washington Public Power Supply System 1-2 (May 27, 1963) (opinion on agreements) (MDL Exh. 15158); letter from Houghton Cluck Coughlin & Schubat to Board of Directors, Washington, Public Power Supply System 1-2 (May 27, 1963). (MDL Exh. 15159.)

652/ Document entitled "WPPSS #4-5 Participants' Agreement [-] NOT APPROVED" (2) - (3). (SEC Exh. 1551, included, with different page sequence, in SEC Exhs. 1136, 1137). These procedural problems were corrected subsequent to the opinion letters for the first long-term bond issue. Counsel did not amend their letters to reflect this change. See infra Part IV C7 & note 724.

billed projects -- Cascade Locks, Drain, Milton-Freewater, Vera, and Rural -- and the five Idaho cities that participated in the projects. 653/ The Participants whose Agreements were excluded because of procedural problems were six rural electric cooperatives. 654/

As set forth on a list entitled "WPPSS #4-5 Participants' Agreement [-] Not Approved," 655/ which a Wood Dawson attorney prepared, 656/ the Agreements of ten Participants were excluded because of the following authority issues 657/: the Agreements of Cascade Locks, Drain, and Milton-Freewater were excluded because of "Charter debt"; the Agreement of Vera was excluded because of "no Stat[utory]. Auth[ority]"; the Agreement of Rural was excluded because of "bylaw debt limit"; and the

653/ Document entitled "WPPSS #4-5 Participants' Agreement [-] NOT APPROVED" (2)-(3). (SEC Exh. 1551, included, with different page sequence, in SEC Exhs. 1136, 1137.)

654/ Id. at (2).

655/ (SEC Exh. 1551, included, with different page sequence, in SEC Exhs. 1136, 1137.)

656/ Steven I. Turner SEC tr. at 284-85 (May 24, 1985) (testimony of Wood Dawson attorney). Metzger prepared part of the heading on the document. Id. at 285.

657/ Previously, the firms excluded the Option Agreements of these 10 Participants from the opinions on Option Participants that they had rendered in connection with the sale of the development bonds. See, e.g., Wood Dawson Option Agreement check-list WD 101689, WD 101692-94, WD 101702. (SEC Exhs. 1126-27, 1129.)

Agreements of the Idaho cities were excluded because of "Constitution debt". 658/

The Idaho Constitution's debt limit provision, which caused the authority problem for those Participants, limited the amount of "indebtedness, or liability" that municipal corporations could incur, but provided that the limit did not apply to "ordinary and necessary expenses authorized by the general laws of the state". 659/ According to O'Brien, because

658/ Document entitled "WPPSS #4-5 Participants' Agreement [-] NOT APPROVED" (2)-(3). In testimony, O'Brien stated that he thought that Wood Dawson did not want to include Vera's Participants' Agreement simply to be consistent with what had been done with respect to Vera's net billing agreements, see supra Part IV C1. The statute limiting the amount of "debt or liability" an irrigation district could incur, however, would have had a bearing on Vera's authority to participate in Projects Nos. 4 and 5. Moreover, notations for Vera that a Wood Dawson attorney, Stephen I. Turner, made on the list of Participants whose Participants' Agreements were not approved, and on other documents, are inconsistent with O'Brien's testimony. For example, on the Wood Dawson check-list for Option Agreement documentation, Turner wrote next to Vera's name: "Not Approvable - NO STATUTORY AUTHORITY". Wood Dawson Option Agreement check-list WD 101702. (SEC Exh. 1126-27, 1129.) Turner contended that this notation did not represent a conclusion by him but "just represents the questions on their authority". Stephen I. Turner SEC tr. at 191 (May 24, 1985). According to Turner, neither he nor, to his knowledge, anyone else concluded that Vera lacked authority to enter into the Participants' Agreement. Id. at 191-96. He said that questions as to Vera's authority remained, and, because the firms were not required to include all 88 Agreements in their opinions, it was not necessary to reach a conclusion. Id. at 191-94. Turner's explanation is inconsistent with O'Brien's testimony that Vera's Participants' Agreement was excluded just to be consistent with the exclusion of Vera's net billing agreements from the opinions on net billing agreements.

659/ Idaho Const. art VIII, § 3 (1972, amended 1976). In November 1976, this provision was amended, but the
(continued...)

the obligations under the take-or-pay provision of the Participants' Agreement constituted an "indebtedness, or liability," the relevant inquiry for Wood Dawson was whether the obligations of the Idaho city Participants were "ordinary and necessary expenses".

O'Brien testified that he thought that, given the cities' long-standing authority to distribute electricity, together with the forecast of power deficiency, the cases interpreting the "ordinary and necessary expenses" exception supported participation in the projects by Idaho cities. 660/ However, because the cases indicated that the determination whether an expenditure constituted "ordinary and necessary expenses" largely was a question of fact, O'Brien believed the cases "did not reach the state of certainty that would permit us to render an opinion with respect to the Idaho [P]articipants". 661/

Metzger, in his testimony to the staff, stated that Houghton Cluck was confident of the Idaho cities' authority. He stated that Houghton Cluck was prepared to include the Option Agreements of the Idaho city Option Participants in its opinion on Option Agreements and the Participants' Agreements of the Idaho city Participants in its opinions on agreements

659/ (...continued)

portions pertaining to the authority of Idaho cities to participate in the projects were not changed.

660/ Brendan O'Brien SEC tr. at 760-61 (June 6, 1985).

661/ Id. at 760, 768.

for the sales of the long-term bonds. 662/ He testified further that those Agreements were excluded only because Wood Dawson was not prepared to include them in its opinions. 663/

662/ Bert L. Metzger, Jr., SEC tr. at 1175 (Feb. 20, 1986).

663/ Id. To show that Houghton Cluck was prepared to include Agreements of Idaho city Participants in its opinions on Projects Nos. 4 and 5 agreements, Metzger referred to a 1975 letter and two 1976 letters that he wrote to the Supply System's Managing Director. According to Metzger, the letters were to give the Managing Director some assurance that there were Agreements that would support the Supply System's assumption of commitments beyond the funds that were available at the times at which the letters were written. Bert L. Metzger, Jr. SEC tr. at 1458 (Feb. 24, 1986). It appears that the Option Agreements of the Idaho city Option Participants were included in the 1975 letter to the Managing Director. See letter from Bert L. Metzger, Jr. to Washington Public Power Supply System 1-2 (July 22, 1975) (letter to Managing Director that the governing bodies of Option Participants having options to purchase an amount of Project Capability greater than the amount reserved to the Idaho city Option Participants had authority to enter into the Option Agreement) (SEC Exh. 1517); document entitled "No approval Mng. [Manager's] Opin. [Opinion] & Bond Opin. [Opinion]" 12020375 (Houghton Cluck list apparently of Option Participants whose Option Agreements were excluded from the 1975 letter to the Managing Director and the additional Option Participants whose Agreements were excluded from the opinions rendered in connection with the sale of the development bonds) [hereinafter Excluded Option Agreements List] (SEC Exh. 1530).

However, it also appears that the firm included Option Agreements of Option Participants as to which it had identified an authority problem. For example, a list that apparently shows the Option Participants whose Option Agreements were excluded from the letter to the Managing Director and the additional Option Participants whose Agreements were excluded from the opinions rendered in connection the sale of the development bonds, which Metzger prepared, Bert L. Metzger, Jr. SEC tr. at 1364 (Feb. 24, 1986), shows that Metzger included the Option Agreement of Cascade Locks in the letter to the Managing Director, Excluded Option Agreements List, supra note 663, at 12020375. Cascade Locks was an Oregon city whose
(continued...)

However, in prior testimony Metzger, when asked whether, at the time the opinion letters were rendered, he had any reason to believe the Idaho City Participants did not have authority to execute the Participants' Agreements, stated: "We did not conclude that the Idaho Cities did have authority but we reached no conclusion that they didn't have authority We never reached a conclusion on that I never

663/ (...continued)

charter debt limit had caused Houghton Cluck to note a problem with the City's authority to enter into net billing agreements, e.g., Document entitled "SS #3," at (1) (Houghton Cluck list of certain Project No. 3 Participants with reference to Cascade Locks and its charter debt limit under heading of "Authority defects") (included in SEC Exh. 1492), and with the City's authority to enter into the Option Agreement, document entitled "WPPSS Nuclear Projects Nos. 4 and 5 and Skagit Project Check-list" 12020393 (Houghton Cluck Option Agreement check-list with notation of an authority problem for Cascade Locks) (SEC Exh. 1529). Under these circumstances, the 1975 letter to the Managing Director does not establish that Houghton Cluck had concluded that the Idaho city Option Participants had authority to enter into the Option Agreement such that it was prepared to include those cities' Agreements in the firm's opinion for the development bonds sale.

The two 1976 letters to the Managing Director reference the Participants' Agreements of Participants on a list attached to the first of the letters. E.g., Letter from Bert L. Metzger, Jr. to J.J. Stein 1 (July 13, 1976).. (SEC Exh. 1542.) The list, however apparently is no longer in existence. Bert L. Metzger, Jr. SEC tr. at 1459 (Feb. 24, 1986) (statement of counsel for Metzger). Accordingly, even if these letters otherwise could be seen as showing the Participants' Agreements that Houghton Cluck was prepared to include in its opinions for the sales of the long-term bonds, there is no way to determine from the letters whether Houghton Cluck was prepared to include the Agreements of the Idaho city Participants in those opinions.

reached a conclusion one way or the other on the Idaho Cities." 664/ Moreover, on January 17, 1975, Cluck sent a letter to the Supply System's house counsel in which he stated: "We are continuing review of some serious legal questions and further revisions of the [draft Option Agreement] enclosure." 665/ Metzger testified that he had no recollection of what those "serious legal questions" were. 666/ Three days after the letter, however, Metzger had a telephone conversation with O'Brien. 667/ Notes of that conversation, which O'Brien made, 668/ provide:

Jack's thinking - default provision have Wa[shington] & Oreg[on] underwrite each other Co[-]ops - underwrite each other or everybody

Idahos should not be allowed in. 669/

664/ Bert L. Metzger, Jr. Chemical Bank tr. at 18-19 (Aug. 5, 1983).

665/ Letter from Jack R. Cluck to Richard Quigley 1 (Jan. 17, 1975). (SEC Exhs. 113, 1392, 1393). Houghton Cluck's billing statement to the Supply System for this time has entries for Metzger and Cluck for such matters as "[c]onference with Mr. Cluck re analysis of legal problems regarding non-member temporary financing," and "research re Idaho loan of credit restrictions". Houghton Cluck billing statement to Supply System for January 1975 work 12942196, 12942198 (Feb. 13, 1975). (SEC Exh. 1511.)

666/ Bert L. Metzger, Jr. SEC tr. at 1013 (Feb. 19, 1986).

667/ See Houghton Cluck billing statement to Supply System for January 1975 work 12942198. (SEC Exh. 1511.)

668/ Brendan O'Brien SEC tr. at 156 (Apr. 11, 1985).

669/ O'Brien notes of telephone conversation with Metzger (1) (Jan. 20, 1975). (SEC Exh. 1096.)

O'Brien testified that he made these notes in connection with Projects Nos. 4 and 5 and that they seemed to be a report of what Metzger was saying. 670/ To O'Brien, the reference to the Idaho cities "means that he [Metzger or Cluck] does not think that the Idaho municipalit[ies] should be allowed to participate". 671/ Metzger said he did not recall the conversation. 672/

Three days after the telephone conversation with O'Brien, Metzger sent a letter to O'Brien, Love, and representatives of the Supply System and Blyth enclosing a summary of the Option Agreement. 673/ Part of that summary identified who the parties to the Agreement were and were not to be: "Supply System and all preference customers except Idaho cities, Washington irrigation districts, certain co-ops with debt restrictions in bylaws (East End, Farmers, Riverside and Rural Electric) and Cascade Locks (debt restriction in charter)." 674/ Metzger maintained that he had no recollection

670/ Brendan O'Brien SEC tr. at 158 (Apr. 11, 1975).

671/ Id.

672/ Bert L. Metzger, Jr. SEC tr. at 1015-16 (Feb. 19, 1986).

673/ Letter from Bert L. Metzger, Jr. to LeRoy Love, Brendan O'Brien, Richard Quigley, William F. Morgan (Jan. 23, 1975). (SEC Exh. 1121, included in SEC Exh. 151333.) Houghton Cluck's billing statements to the Supply System show that Metzger worked on the summary. Houghton Cluck billing statement to Supply System for January 1975 work 12942199 (Feb. 13, 1975) (SEC Exh. 1511.)

674/ Document entitled "Washington Public Power Supply System Nuclear Projects Nos. 4 and 5 Summary of Preference
(continued...)

whether there was any response to this letter or whether there were discussions on excluding as signatories to the Option Agreement and/or the Participants' Agreement the named preference customers. 675/

The summary of the Option Agreement was distributed at a January 21, 1975 meeting of the PPC Executive Committee, 676/ which Metzger attended, 677/ and then discussed at a January 27 meeting of the PPC Contract Steering Committee 678/. In a subsequent letter to the PPC General Manager, the attorney for the PPC, Norman A. Stoll, noted that the summary had been distributed and discussed and stated:

As pointed out in the above mentioned 'summary', we anticipate that all preference customers will sign, except for certain very small utilities we have identified as being subject to certain legal limitations which made that impossible, and for whom we hope we

674/ (...continued)

Customers' Option and Services Agreement" 1 (Jan. 23, 1975). (SEC Exh. 1179, included in SEC Exhs. 1121, 1513).

675/ Bert L. Metzger, Jr. SEC tr. at 1024-25 (Feb. 19, 1986).

676/ Letter from Norman A. Stoll to R. Ken Dyar 1 (Feb. 7, 1975) (letter from PPC attorney to PPC General Manager). (SEC Exhs. 1176, 1514.)

677/ See Houghton Cluck billing statement to Supply System for January 1975 work 12942199 (Feb. 13, 1975). (SEC Exh. 1511.)

678/ Letter from Norman A. Stoll to R. Ken Dyar 1 (Feb. 7, 1975) (letter from PPC attorney to PPC General Manager). (SEC Exhs. 1176, 1514.)

eventually can somehow make arrangements
for their future power supply. 679/

However, notwithstanding the indication that the Idaho cities
and the others referenced in the summary were to be excluded
because of legal limitations, most of those mentioned in the
summary, the Idaho cities, Vera, Rural, and Cascade Locks,
signed both the Option and Participants' Agreements. 680/

679/ Letter from Norman A. Stoll to R. Ken Dyar 2 (Feb. 7,
1975). (SEC Exhs. 1176, 1514.)

680/ Following termination, the Idaho Supreme Court later
declared the Idaho cities' Participants' Agreements void
in Asson v. City of Burley, 105 Idaho 432, 670 P.2d 839
(1983), cert. denied, 469 U.S. 870 (1984). The court
based its holding on the conclusion that the obligations
of the Idaho cities under the Participants' Agreement did
not fall within the exception to the debt limit provision
for "ordinary and necessary expenses authorized by the
general laws of the state." 105 Idaho at 443, 670 P.2d at
850. In reaching this result, the court reasoned that the
obligations were not "ordinary" because the Participants'
Agreement

was a colossal undertaking, fraught with
financial risk. It was open-ended: the
cities could not have known what their
ultimate debt or liability would be. One
cannot stretch the meaning of 'ordinary' to
include an expense for which there could
not be, until years later, certainty of
limits. The funding agreement left the
Idaho cities with extensive indebtedness --
yet no ownership, and minimal control, and
only the possibility of electricity.

Id., 670 P.2d at 850.

The court further reasoned that execution of the
Participants' Agreement was not authorized by the "general
laws of the state". Idaho cities had the authority to
purchase power and to acquire and construct generating
facilities. Id., 670 P.2d at 850. The court, however,
could

(continued...)

3. Policy Reasons Why the Idaho Cities and Others Were Not Excluded

Despite legal uncertainties and the small amount of the Project Capability purchased by the 10 Participants whose Agreements were excluded because of authority questions, these 10 Participants were not excluded from the projects. The principal reason appears to have been the desire by many of those involved in the projects for regional participation. It was thought that broad regional participation would facilitate Congressional support for federal legislation enabling the BPA to acquire the projects' Project Capability. BPA acquisition would have meant that the costs and risks of the projects could be spread throughout the Pacific Northwest to all of BPA's customers, similar to net-billing, rather than imposing those burdens solely on the Participants.

680/ (...continued)

find no statutory authorization for the purchase of 'project capability' where such purchase comprehends the payment of long-term indebtedness for which no ownership interest is acquired. The municipality is neither acquiring, owning, maintaining, or operating a plant, nor purchasing electrical power.

Id., 670 P.2d at 850. Instead, the Idaho cities simply were "underwriting another entity's indebtedness in return for merely the possibility of electricity". Id., 670 P.2d at 850. This reasoning why execution of the Agreement was not authorized by the "general laws of the state" is similar to the reasoning of the Washington Supreme Court in Chemical Bank I why the execution of the Participants' Agreement by the Washington city, town, and PUD Participants was not authorized by the Washington statutes.

BPA acquisition was expected by major Participants in the projects. The then Regional Solicitor for the Department of the Interior testified that, in 1975, there was discussion "of trying to obtain some additional authority for Bonneville to acquire needed resources". 681/ According to representatives of some of the Participants, "the entire top staff of Bonneville" 682/ had expressed the expectation of being able to acquire the Project Capability of Projects Nos. 4 and 5, which, like the output from the net billed projects, then would become available to serve the needs of the entire region. 683/ In fact, some viewed the Option and Participants' Agreements as an "intermediate step" to the regionalization of the projects, which would require federal legislation. 684/

The Supply System supported the concept of regionalization, and was aware of the need for regional support to

681/ Robert E. Ratcliffe SEC tr. at 110 (Sept. 13, 1985).

682/ Robert L. McKinney SEC tr. at 220 (July 30, 1985) (testimony of General Manager of Public Utility District No. 1 of Cowlitz County, Washington and an active participant in developing proposals for Phase 2, which included Projects Nos. 4 and 5).

683/ E.g., id. at 119-27, 220-21.

684/ Robert L. McKinney SEC tr. at 119-24 (July 30, 1985); see also Paul J. Nolan SEC tr. at 167-69 (Oct. 2, 1985) (testimony of then Deputy City Attorney and subsequent Director of Utilities of Tacoma that "the idea was how can you go into the program and still ultimately get to that solution where Bonneville backs up the projects" and that "the intent was to keep the projects as similar as possible to what had happened before in the pattern of marketing, and ultimately there would be statutory authority for Bonneville to acquire the output").

accomplish that objective. In July 1975, there was a proposal for the BPA to obtain authorization for the "direct purchase of power limited to the current public portion of plants in the WPPSS Phase II [which included Projects Nos. 4 and 5] package". 685/

That proposal was discussed at meetings of a PPC committee established to investigate the measures that would be needed to enable the BPA to purchase power. In a memorandum reporting on those meetings, the Supply System's Manager of Planning and Analysis stated that the BPA officials "stress[ed] it would have to have unified support of all the regional utilities and power users and might even need the blessings of national private power organizations, or at least no active resistance from such groups". 686/ While encouraging continued work on the Participants' Agreement, the Manager of Planning and Analysis advised that "WPPSS has a strong interest in the development of direct purchase as a possible alternative to the direct contract between WPPSS and participants, and that this alternative should be vigorously pursued in order that the participants might have a choice by the end of the year." 687/

Participation in Projects Nos. 4 and 5 by Idaho cities and Oregon cities and PUDs was viewed as essential for the support of the congressional representatives from Idaho and Oregon for

685/ Inter Office Memorandum from H.R. Kosmata to J.J. Stein 1 (July 24, 1975) (memorandum from Supply System Manager of Planning and Analysis).

686/ Id.

687/ Id. at 2.

legislation giving the BPA power purchase authority. Indeed, the General Manager of the Participant that acquired the largest share of Project Capability testified that regional support was so important that, if Idaho utilities had not participated, his utility would not have participated. 688/

4. Counsel Decide Against a Test Case To Determine the Idaho Cities' Authority

A test case could have been brought to resolve the authority questions relating to the Idaho cities. Unlike the situation as to the Washington Municipal Corporation

688/ Robert L. McKinney SEC tr. at 129-30 (July 30, 1985)
(testifying:

It was my feeling, and I would have to judge who was in and who was out at any time, but if I ever determined that we didn't have a broad enough base from which to build a regional consensus, and that means two Senators from Oregon, two Senators from Idaho, two Senators from Montana, two Senators, and then a whole flock of Congressmen -- it's hard for me to think that the State of Idaho's two Senators would get very much concern in a Bonneville legislation if none of their constituency was involved in the projects.

* * * *

Now, if Snohomish and Seattle and Tacoma had dropped out, we would never have signed, even if it added up to 100 percent. If nobody in Oregon signed with two Senators and their Congressmen down there -- if we got no participation in Oregon on 4, 5, we would never have signed.

* * * *

If no one in Idaho had signed, we wouldn't have signed.).

Participants discussed above, consideration was given to the possibility of a test case. Discussion of that option took place at a meeting in Portland on March 31, 1975. Attending that meeting were attorneys representing Bonners Ferry and Idaho Falls, Idaho, representatives of other Idaho cities, and Metzger, Hittle, Stoll, and others. 689/ At that meeting, the participants seem to have decided at least tentatively to bring a test suit. 690/

689/ See memorandum from Peter B. Wilson to All the Cities (Apr. 3, 1975). (MDL Exh. 7247.) Bonners Ferry and Idaho Falls were Participants in Projects Nos. 4 and 5.

690/ See letter from A.L. Smith to Peter B. Wilson 1 (Apr. 7, 1975) (SEC Exhs. 1021, 1270) (letter from Idaho Falls attorney to Bonners Ferry attorney); letter from Norman A. Stoll to R. Ken Dyar 4 (Apr. 4, 1975) (letter to PPC General Manager) (SEC Exh. 1148). Metzger testified that he did not recall the meeting, Bert L. Metzger, Jr. SEC tr. at 1149 (Feb. 20, 1986), but among his notes are notes concerning a test case that he thought he took at the meeting, id. at 552 (Feb. 12, 1986). Those notes provide:

1. Timing question
file after Option financing
for dec[ision]. before perm[anent]. financing
2. issues - Agreements (Part[icipant?]
only[?]
constitutional & legal
3. facts - differ as to under 25 MW [megawatts]
and over 25 MW?
4. Will pendency affect power to finance?
5. Who will prepare 1st draft of
complaints.

Metzger handwritten notes 12401824. (Included in SEC Exh. 1456.)

Despite that decision, Houghton Cluck, and possibly Wood Dawson, apparently decided against a test case. 691/ Houghton Cluck's billing statements for the days following the meeting show that Metzger had "conferences with Mr. Cluck re Idaho cities legal problems," telephone conversations with O'Brien and Stoll on those problems, and telephone conversations with the attorneys for Bonners Ferry and Idaho Falls. 692/ Metzger, O'Brien and Stoll testified that they did not recall those conversations. 693/ The Bonners Ferry attorney, however,

691/ See letter from A.L. Smith to Peter B. Wilson 1 (Apr. 7, 1975) (letter in which Idaho Falls attorney stated to Bonners Ferry attorney: "I know that you have been advised that bond counsel for WPPSS does not want a test case at all during this period of time. This is somewhat at variance with the decision we arrived at tentatively in Portland") (SEC Exhs. 1021, 1270); letter from Norman A. Stoll to R. Ken Dyar 4 (Apr. 4, 1975) (letter to PPC General Manager stating:

I also should advise you that, following the meeting we had the other day with the Idaho representatives, we had some further discussion concerning the possibility of initiating test litigation with respect to the Idaho municipalities. Although I think that all of the lawyers concerned with this matter are very confident as to the likely success of such litigation, for various reasons we have now concluded that it would be inadvisable to embark on this course.).

(SEC Exh. 1148.)

692/ Houghton Cluck billing statement to Supply System for April 1975 work 12942007, 12942008 (May 13, 1975). (SEC Exh. 1516.)

693/ Bert L. Metzger, Jr. SEC tr. at 1153-54, 1165-67, 1211-13 (Feb. 20, 1986); Brendan O'Brien SEC tr. at 743-44 (June 6, 1985); Norman A. Stoll SEC tr. at 280-81 (Jan. 8, 1986).

testified that Metzger told him that the Supply System and the BPA did not want a test case. 694/ The Idaho Falls attorney provided more detailed testimony. He stated that, prior to speaking with Metzger, he had reviewed a draft of the Participants' Agreement and had concerns about the way it might be interpreted and, therefore, suggested that a test case be brought. 695/ He said that, in response,

Bert Metzger said to me then 'No. We don't have time for it. We can't -- it would throw the whole thing into a tailspin,' or words to that effect, that there's no chance. 'You couldn't sell any bonds at all until that gets back from your Supreme Court.'

And I think we discussed how long it took for a case to get back from the Idaho Supreme Court. And at that time it was quite a]while, sometimes two or three years.

And I was told, 'No. We do not need it, and do not do that. Don't get a test case.'696/

According to the Idaho Falls attorney, Metzger further told him that Idaho cities had authority to enter into the Participants' Agreement and that, even if a court subsequently were to decide

694/ Peter B. Wilson SEC tr. at 127 (Feb. 7, 1985); Peter B. Wilson Chemical Bank tr. at 96-97 (Apr. 7, 1983).

695/ Arthur L. Smith SEC tr. at 192 (Feb. 6, 1985).

696/ Id. at 193 (Feb. 6, 1985).

otherwise, the Idaho Falls attorney should not worry because the Idaho city Participants would not have to pay. 697/

The authority issue was also discussed at a May 1, 1975 meeting in Boise that Metzger, attorneys for Idaho cities, and others attended. Metzger said that he recalled that he reviewed provisions of the Option Agreement and/or Participants' Agreement but that he did not recall anything

697/ Id. at 220-21 (testifying:

[H]e kept saying, 'You worry too much,' or words to that effect. 'You have authority. Let's not hold this show up,' or whatever, words to that effect. 'You can't have a test case because it will surely hold the whole thing up.'

And then he finally got into this statement, 'What are you worried about? If you didn't have authority, you wouldn't be liable anyway. So why are you holding the show up?'

And this conversation was in more than -- this was more than once, because I was always asking Bert before the Boise meeting, before we signed the [O]ption [A]greement. And then, of course, later I talked to him before we signed the [P]articipants' [A]greement: 'What do you know, Bert?' You know, What have you heard from the other utilities? Have you heard any reason why we don't have authority or that they don't have authority?'

Always the word came back, 'Art, no; it looks good. You've got authority. We don't need a test case. Just get signed up here.' It was kind of a sales pitch.

And frankly, I guess I worried about it, that he didn't go into it, that he wouldn't get off that theme. But that was the theme he was on.).

else about the meeting. 698/ Attorneys for some of the Idaho cities, however, took notes of the meeting. One of those who took notes was the attorney for Heyburn, Idaho, a Projects Nos. 4 and 5 Participant. In his notes, the attorney wrote: "[e]ven if unenforceable -- WPPSS the lo[]ser because Idaho court hold that couldn't enforce contract -- this leave[s] only individual councilmen liable but if they have studied individually and relied on attorney's opinion they [are] probably safe." 699/ Testifying on his notes, the attorney said that, at the meeting, Metzger stated that

there was no[] Idaho case directly inpoint on the issue. And then he made reference to some cases. And in a couple of occasions he made reference to what those cases involved. And then he had made some reference to the fact that, well even if [the Agreement] were invalid, Washington Public Power Supply would be the loser because under Idaho law if the city has no authority to enter into the agreement, it is invalid and cannot be enforced by other parties. And so therefore, in [e]ffect the inference I drew from what he was saying is why should you be concerned about it. It doesn't make any difference. All we want you to do is give an opinion to your client that says they have authority. They [Metzger] had already reached their own conclusion as to whether or not they had authority so they really weren't interested in our opinion on it. 700/

698/ Bert L. Metzger, Jr. SEC tr. at 1231-34 (Feb. 20, 1986).

699/ Document entitled "Transcription of Notes Pertaining to Heyburn Execution of Power Agreements" TU00003846. (SEC Exh. 299.)

700/ Peter G. Snow SEC tr. at 62-63 (Dec. 7, 1984). One of the documents Wood Dawson requested in connection with its
(continued...)

The attorney's notes also make reference to a discussion of a test case. 701/ The attorney recalled being told that there was insufficient time for such a suit. 702/

700/ (...continued)

opinions on agreements for each note or bond issue was an opinion from the counsel for each participant that the agreement of the counsel's client, inter alia, was valid and enforceable. A sample opinion, essentially enabling the attorney to fill in blanks, then was provided to each participant. See supra Part IV C1. Consistent with this practice, each Option Participant was provided with a sample opinion pertaining to the Option Agreement and each Participant was provided with a sample opinion pertaining to the Participants' Agreement. E.g., memorandum from J.J. Stein to All Parties to the Option and Services Agreement (Apr. 15, 1976) (memorandum from Supply System Managing Director enclosing sample opinion and other Participants' Agreement documents). Counsel for each Option Participant rendered the requested opinion that the Option Agreement of the counsel's client, inter alia, was valid and enforceable, and, likewise, counsel for each Participant rendered the requested opinion that, inter alia, the Participants' Agreement of the counsel's client was valid and enforceable. Compare, e.g., document entitled "Sample Opinion of Counsel (WPPSS Participants' Agreement)" (SEC Exh. 304) with letter from A.L. Smith to City of Idaho Falls, Idaho (July 14, 1976) (opinion letter of Idaho Falls attorney on Idaho Falls' Participants' Agreement) (SEC Exh. 1022). It was these opinions to which the Heyburn attorney apparently was referring in his testimony.

701/ Document entitled "Transaction of Notes Pertaining to Heyburn Execution of Power Sales Agreements" TU00003846. (SEC Exh. 299.)

702/ Peter G. Snow SEC tr. at 68 (Dec. 4, 1984); see also William A. Parsons SEC tr. at 70 (Dec. 6, 1984) (testimony of attorney for Burley, Idaho, another Participant in Projects Nos. 4 and 5, that Idaho city representatives were told there was insufficient time for a test case).

5. Counsels' Testimony as to The Standards for Determining Whether To Include an Agreement in an Opinion

O'Brien maintained that Wood Dawson was willing to include an agreement in its opinions only if it concluded that "the authority was clear and that a reasonable court could not come to another conclusion -- better conclusion," by which he meant that the firm "had reached the conclusion that it was not a doubtful question to anyone having reviewed the law". 703/

Metzger, when asked about the standard by which Houghton Cluck decided whether it would be willing to include an agreement, said that he did not "recall thinking of it as a standard. I just recall that it -- it was so crystal clear is the way I think of it in my own terms that we were willing to give an opinion." 704/ O'Brien and Metzger testified that the firms did not always agree on the agreements that each was

703/ Brendan O'Brien SEC tr. at 463 (June 4, 1985). The standard O'Brien claimed Wood Dawson followed is similar to the standard the National Association of Bond Lawyers has articulated for bond counsel opinions. That standard is: "As to subjects about which the opinion is unqualified, bond counsel should have concluded that it would be unreasonable for a court to hold to the contrary." National Association of Bond Lawyers, The Function and Professional Responsibilities of Bond Counsel 5 (1983).

704/ Bert L. Metzger, Jr. SEC tr. at 680 (Feb. 13, 1986); see also id. at 645 (Feb. 12, 1986) (testifying, with respect to Project No. 2, that the firm would not be willing to give an opinion if Cluck "had decided that the supporting documents and law wasn't crystal clear enough for him to give an opinion on the bonds, a formal, written opinion").

prepared to include in its opinions. 705/ If, however, one firm was prepared to include an agreement and the other firm was not, neither firm included that agreement in its opinion(s). 706/

6. Counsels' Explanation of Why Disclosure Was Not Made of Authority Problems

The language of the Wood Dawson and Houghton Cluck opinions on agreements was identical, with each firm stating only that it has "examined into the validity of" 72 of the Agreements. The firms, however, gave different explanations why each firm did not state that it had "examined into the validity of" all of the Agreements. The position of Wood Dawson was that it states that it has "examined into the validity of" an agreement only when it has examined materials that enable it to reach the conclusion set forth in the opinion. 707/ For example, an attorney who was a senior

705/ Brendan O'Brien SEC tr. at 42 (Apr. 12, 1985); see Bert L. Metzger, Jr. SEC tr. at 1181, 1548-50 (Feb. 20 and 25, 1986).

706/ Brendan O'Brien SEC tr. at 42 (April 12, 1985); Bert L. Metzger, Jr. SEC tr. at 645-46 (Feb. 12, 1986; see id. at 1548-50 (Feb. 25, 1986).

707/ Steven I. Turner SEC tr. 36 (May 23, 1985) (Wood Dawson attorney testifying that, when Wood Dawson states that it has "examined into the validity of" a matter,

it only relates to the examination sufficient to reach the conclusion stated in the opinion. It doesn't relate to examination of other things that are not stated in the opinion.

The opinion only deals with something as to which we've been able to form an

(continued...)

partner at Wood Dawson described the following circumstances under which the firm would not state that it had "examined into the validity of" an agreement:

It may have been possibly we got the proceeding from X, Y, Z Co-op, for instance, and said, 'My God, they didn't have a quorum.' Bang, throw it in the wastebasket [There] is a possibility that in some states there [] may be a threshold question. Throw it in the wastebasket It [the opinion] does not state that we examined one, two, three, and stopped because there was a question, a defect over which we couldn't get. 708/

Similarly, when O'Brien was asked whether Wood Dawson had "examined into the validity of" the Participants' Agreements of the Idaho city Participants, he testified that the firm "did not perform an examination that would enable us to render that opinion. We did not perform an examination that led us to the contrary opinion, either." 709/

707/(...continued)

opinion as to validity or whatever else is referred to in the opinion.);

LeRoy Love SEC tr. 69-70 (May 13, 1985) (senior partner in Wood Dawson testifying that the "[w]e have examined into the validity of" language means that the Wood Dawson attorneys "have made such investigations and have looked into such matters as in our judgment were necessarily desirable to enable us to render the subject opinion made an examination of such facts and information and so on as in your judgment enables [you] to give the opinion.").

708/ LeRoy Love SEC tr. at 72-73 (May 13, 1985).

709/ Brendan O'Brien SEC tr. 466 (June 4, 1985). In a subsequent deposition, O'Brien, when asked whether Wood Dawson had "examined into the validity of" the 16

(continued...)

Metzger's defined the "[w]e have examined into the validity of" language as follows: for Houghton Cluck, "examin[ing] into the validity of" agreements entailed "go[ing] into research and examination of documentation that covered all of the material deemed relevant in connection with the issuance of the opinion on that contract." 710/ That research and review of documentation was conducted by someone at Houghton Cluck for every participating utility in each Supply System project. 711/ Unlike the Wood Dawson attorneys, Metzger, using Houghton Cluck's definition of the language, acknowledged that Houghton Cluck had "examined into the validity of" all 88 Participants' Agreements. 712/ The reason, however, that Metzger gave why Houghton Cluck did not state that it had "examined into the validity of" all of the Agreements was "[b]ecause the opinion letter was not on 88; it was only on the number we opined on." 713/ The opinion "was not to describe

709/ (...continued)

Participants' Agreements excluded from the firm's opinions on agreements gave a similar response: "[W]e examined the constitution and the statutes, relevant law and the proceedings of those 16 [p]articipants We did not examine into the validity to the point that we got to where we were prepared to render a bond counsel opinion with respect to those 16." Brendan O'Brien MDL tr. at 4287-88 (Oct. 30, 1986).

710/ Bert L. Metzger, Jr. SEC tr. at 153 (Feb. 10, 1986).

711/ Id.

712/ Id. at 1532 (Feb. 25, 1982).

713/ Id. at 1533.

anything but the work we had done on the contracts that we were giving an opinion on". 714/

Another reason counsel offered for their approach to this issue was that, in their view, a "step-up" provision in the Participants' Agreement made it unnecessary for the firms to opine that all of the Agreements were valid and enforceable. The step-up provision provided that, in the event of a default of a Participant, the amount of Project Capability purchased by each non-defaulting Participant would be increased, up to a specified maximum amount, to cover the share(s) of Project Capability on which there had been a default. 715/ Metzger said that Cluck had told him that the structure of the contracts for the various projects, i.e., the step-up provision, made it unnecessary to include all of the agreements in the firm's opinions. 716/ O'Brien likewise testified that the firm only needed to include in its opinions sufficient Agreements that, in the opinion of the firm, were valid and enforceable so that, taking into account the step-up provision, 100% of the Project Capability from the Supply

714/ Id.

715/ Participants' Agreement § 17(c), (d). The Agreement distinguished between defaults by municipal corporations and defaults by rural electric cooperatives. If a municipal corporation defaulted, the shares of Project Capability purchased by the non-defaulting municipal corporations would be increased. Id. § 17(c). If a rural electric cooperative defaulted, the shares of Project Capability purchased by non-defaulting rural electric cooperatives would be increased. Id. § 17(d).

716/ Id. at 1392 (Feb. 24, 1986).

System's ownership share of the Projects would be covered. 717/
It is not clear, however, that the step-up provision applied to
the situation where a Participant was found to have lacked the
authority to participate in the projects. 718/

7. What the Participants Were Told About Authority
Problems and Counsels' Opinion Letters

The Participants were not told about authority problems as
to their Agreements. For instance, at the Boise meeting,
Metzger apparently discussed the take-or-pay provisions of the
Option and Participants' Agreements. The Bonners Ferry
attorney testified that he was concerned that the Agreements
"were calling for some kind of guaranty on us", but that
Metzger responded that the Agreements really were power
purchase agreements rather than guarantees. 719/ Similarly,
the Idaho Falls attorney testified that, from what Metzger
said, he understood that the take-or-pay provisions required
payments to be made when the power was delivered, regardless of

717/ Brendan O'Brien SEC tr. at 466 (June 4, 1985).

718/ The Washington trial court held that the step-up provision
applied only to defaults by Participants on their
obligations under the Agreement; therefore, if one or more
Participants lacked authority to enter into the Agreement,
the step-up provision of the Agreements of the remaining
Participants would not be triggered. Chemical Bank v.
Washington Pub. Power Supply Sys., No. 82-2-06840-3,
typescript op. at 3-4 (Wash. Super. Ct. Dec. 15, 1982).
But see Chemical Bank I, 99 Wash. 2d at 796, 666 P.2d at
341 (dictum that "[s]ince the record indicates that from
the statutory outset of the projects there were questions
about the authority of some participants, it seems likely
that the municipalities and PUD's would incur a greater
obligation than they initially contracted for").

719/ Peter B. Wilson Chemical Bank tr. at 46 (Apr. 7, 1983).

whether it was needed and that no one who gave a presentation at the meeting said that payments would have to be made if the projects were not built. 720/ In this regard, he testified:

I did not have any understanding that this would finally be construed as a guarantorship, whether we've got any power or not, that we're going to pay these bonds out. Because of course, obviously everybody knows no one would sign such a thing as that -- not out in the wilds of Idaho they wouldn't. 721/

While there is no indication that Metzger told anyone that the Participants would not be required to make payments if the projects were not built, the Idaho Falls attorney's understanding of the Agreements is consistent with the portrayal by O'Brien and Metzger of the Participants' Agreement simply as a power purchase agreement.

At the time Wood Dawson and Houghton Cluck began to render their opinions in connection with the sales of the long-term bonds, counsel failed to inform Participants that the firms had excluded some of the Participants' Agreements from their opinions because of authority problems. The matter did not arise until an August 7, 1980 Participants' Committee meeting concerning the Balanced Financing Program and the agreement proposed for the Participants to sign to implement that Program. During that meeting, Metzger mentioned that the opinions did not cover all of the Participants' Agreements. A

720/ Arthur L. Smith SEC tr. at 199-200, 235, 239-40 (Feb. 6, 1985).

721/ Id. at 198.

Participants' Committee member then stated that it was the understanding that the opinions did not cover all agreements involved in a project because the firms had not looked into all agreements. In response, Metzger stated that the firms looked into all agreements and excluded certain agreements because of authority or other issues:

Metzger: Well, there's some of the Participants' Agreements which we haven't rendered approving opinions on, for technical reasons, for a questionable authority. There's some of those things. Now, that's true of the net billing agreements too. It's not just the Participants' Agreements. They're just technical reasons that the question -- and just -- there's a small number of them. It's less than 1 percent or 2 percent of the whole amount of the Participants' shares.

If you ever -- if you look at the bond opinion, by the way, as attached as an exhibit in the official statements, you'll notice every one of them for all the net billed sales, it doesn't say 100 percent or all 88. It says we have rendered opinions on so many out of so many of the agreements. This is usually the case. I mean not just with the Supply System. It isn't the authority on behalf of the Supply System, it's on the behalf of the Participant.

Speaker: OK, but the implication, as is always because you have not reviewed them in detail. Now, is that the case or are you saying --

Metzger: No, it's not that we haven't reviewed them in detail. We -- we got all the documentation, but sometimes there's just questions of proceedings that haven't been cleared up and -- or statutory authority that's a little fuzzy for an irrigation district or something, and I -- there was some question. I -- it's been so

long since we did that, we haven't -- there's been no reason to clarify it since we don't need it. We don't have to go through the expense, the legal expense or anything else of doing it.

So we have never attempted to clarify that because it isn't required. It would be required if we didn't have that default provision. That default provision makes it unnecessary because if there ever was a default, that is -- we have it covered. And our -- in our opinion, you'll note the -- I don't have the official statement right here, but the official statement and our -- the opinion attached, and the opinion we rendered on the agreements indicates that these Agreements cover so much of the Participants' share. And read together with the default, it's more than enough to give an opinion on 100% exposure. 722/

There is no indication that, prior to 1980, Wood Dawson or Houghton Cluck advised anyone that the firms were excluding some of the Participants' Agreements from their opinions on agreements because of authority questions. Rather, it seems that the firms conveyed the opposite impression. For example, each of the Participants as to whose documentation one or both firms had identified a procedural or form problem, including some of the 10 Participants as to which there were authority problems, was notified of the procedural or form problem. 723/

722/ Tape of Participants' Committee meeting of Aug. 7, 1980. (Tape 84(a) at 285-304.)

723/ E.g., letter from Nick Mathias to T.H. Church 1 (Feb. 17, 1977) (letter from Houghton Cluck attorney to Heyburn attorney requesting that Heyburn attorney delete from his opinion letter on Heyburn's Participants' Agreement language that provided that the opinion was not intended to be relied upon by third parties because, "in approving (continued...)

The problem then was corrected. 724/ However, in contrast to what had been done in connection with the Supply System's net billed projects, none of the Participants as to which there was an outstanding authority issue was told, prior to termination, that one or both firms had a question as to its authority to enter into the Participants' Agreement. 725/ As a result, none

723/ (...continued)

the Participants' Agreement the bond counsel state expressly that they rely upon the opinions of the attorneys for the individual participants"). (SEC Exh. 305.)

724/ See, e.g., letter from T.H. Church to Heyburn City Council (Mar. 10, 1977) (opinion letter on Heyburn's Participants' Agreement written to correct problem that had given rise to letter cited supra at note 927). After the procedural and form problems were removed, Wood Dawson and Houghton Cluck, following the first issue of long-term bonds, considered changing their opinions to include the six Agreements that they initially had excluded because of procedural defects. See, e.g., Stephen I. Turner SEC tr. at 318-20 (May 24, 1985); draft form of opinion letter from Wood Dawson Love & O'Brien and Houghton Cluck Coughlin & Riley to Board of Directors, Washington Public Power Supply System (Aug. 31, 1977) (opinion on agreements for 1977C bond issue showing a change from 72 to 78 Agreements). (SEC Exh. 1138.) The change would have meant that the firms would have included 78 rather than 72 of the Participants' Agreement in their opinions. The change was not made, however, because, according to Turner, "[i]t wasn't important enough to make the change. It was such a very small percentage." Steven I. Turner SEC tr. at 320 (May 24, 1985).

725/ E.g., Stephen S. Corey SEC tr. at 67-68 (Feb. 22, 1985) (testimony of Milton-Freewater attorney); Donald A. Dole SEC tr. at 74 (Feb. 19, 1985) (testimony of Drain attorney); Thomas H. Church SEC tr. at 132 (Feb. 8, 1985) (testimony of Heyburn attorney); Larry R. Duff SEC tr. at 125-26 (Dec. 4, 1984) (testimony of Rural attorney); Affidavit of Peter B. Wilson ¶¶ 8-9 (Feb. 1, 1983), Chemical Bank v. Washington Pub. Power Supply Sys., No. 82-2-06840-3 (Wash. Super. Ct. Aug. 11, 1983) (Order and Judgment), aff'd, Chemical Bank II (Chemical Bank Exh. 2109). In one deposition, Metzger testified that he

(continued...)

of these Participants knew that Wood Dawson and Houghton Cluck had excluded its Agreement from their opinions.

8. What Persons Other than the Participants Were Told or Led To Believe About Authority Problems

The rating services apparently also were not told that, because of authority issues identified in the course of the firms' research and review, Wood Dawson and Houghton Cluck were unwilling to opine that certain Participants' Agreements were valid and enforceable. For example, the senior supervising analyst at Moody's for the Projects Nos. 4 and 5 bonds testified that no one told him that authority questions were a reason why the firms excluded some of the Agreements. 726/ The person who was the head of the municipal bond department at Standard & Poor's testified that, if issues that could affect the security for the bonds had been found, he would have hoped that those problems would have been brought to the attention of Standard & Poor's. 727/ He "strongly suspect[ed]" that the

725/ (...continued)

recalled generally that someone in his firm notified each of the 16 Participants whose Agreements the firms excluded from their opinions on agreements but that he was not the person in charge of that matter and did not recall how the notifications were made. Bert L. Metzger, Jr. Chemical Bank tr. at 152-55 (Oct. 5, 1982). From the testimony and affidavits discussed and cited supra at Part IV C8 and note 725, however, it appears that no such communications took place.

726/ See Craig W. Atwater SEC tr. at 74 (June 19, 1985).

727/ Richard E. Huff SEC tr. at 137 (Dec. 4, 1985). He was one of the persons who met with Supply System representatives for the first issue of the long-term Projects Nos. 4 and 5 bonds and for subsequent issues.

mention of such a matter would have caught the attention of the service. 728/ Notes taken by Standard & Poor's representatives at meetings in connection with the first long-term bond issue and subsequent bond issues for Projects Nos. 4 and 5 reflect no discussion to the effect that Wood Dawson and Houghton Cluck were going to exclude some Agreements from their opinions because of authority issues. 729/

728/ Id. at 137-38 (Dec. 4, 1985).

729/ See, e.g., document entitled "WPPSS meeting w/ officials" (notes of Frank Ingrasia of Standard & Poor's of meeting on rating for first issue). (SEC Exh. 2606.)

There is testimony from Patterson of Blyth that, in late 1976, in connection with the preparation of the official statement for the first issue of long-term bonds, he discussed with O'Brien and Metzger the firms' opinions on agreements and that they told him that the firms were not going to include certain Participants' Agreements. Donald E. Patterson SEC tr. at 136-41 (July 22, 1985). However, according to Patterson, O'Brien and Metzger told him that the reason certain Agreements were to be excluded did not pertain to substantive legal issues but only to procedural matters. Id. at 139-41, 179 (July 22, 1985). Patterson further testified that the format for the presentations to the rating agencies in connection with the first issue of long-term bonds provided for the attorneys to discuss their opinions, but he said that he did not recall if the opinions actually were discussed. Id. at 183-91 (July 23, 1985).

In a subsequent deposition, however, Patterson testified that, at the meetings with the rating agencies, which took place in early 1977, the attorneys told the rating agency representatives that they then could not say how many Agreements would be included in the opinions but that, most likely, the opinions would not include all of the Agreements. Donald C. Patterson III MDL tr. at 2799-2800, 4285-86 (Apr. 6 and 27, 1987). According to the testimony Patterson gave in this deposition, the reason given was that the firms still were reviewing the documentation of some of the Participants, some documentation was incomplete, and there were "technical" problems with some
(continued...)

Most importantly, the official statements did not inform investors that Wood Dawson and Houghton Cluck had questions as to the authority of certain Participants to enter into the Participants' Agreement. Rather, the official statements

729/(...continued)

of the procedures that had been followed that might prevent the firms from including certain Agreements. Id. at 2800-02, 4286.

Metzger testified that he recalled discussing with Patterson the form of opinions that would be in the official statement for the first long-term bond issue but that he did not recall what was discussed or ever hearing Patterson ask why the firms excluded certain Agreements. Bert L. Metzger, Jr. MDL tr. at 3133-40 (July 15, 1986). Metzger attended the two meetings that were held with each of the rating agencies in connection with the first long-term bond issue, see Houghton Cluck billing statement to Supply System for February 1977 work 12945447 (Mar. 15, 1977) (February 4 entry showing attendance at meetings) (SEC Exh. 1553); Houghton Cluck billing statement to Supply System for January 1977 work 12945446 (Feb. 18, 1977) (January 25 entry showing attendance at meetings) (SEC Exh. 1552), but testified that he also had no recollection whether he discussed the firms' opinion letters with anyone from the ratings agencies, Bert L. Metzger, Jr. SEC tr. at 1556 (Feb. 25, 1986).

O'Brien said he did not recall any discussions with anyone from Blyth regarding the Agreements the firms excluded from their opinions. Brendan O'Brien MDL tr. at 2346-47 (May 13, 1986). He also said that he did not recall whether he attended the meetings with the rating agencies but that it would have been unusual for a JOA to apply for a rating on its first bond issue and not to have bond counsel present. Brendan O'Brien SEC tr. at 54-56 (Apr. 12, 1985). He said he had no understanding of what was discussed at the meetings for the first issue of the long-term bonds for Projects Nos. 4 and 5. Id. at 56.

If the testimony that Patterson gave to the effect that the opinion letters were discussed at the meetings with the rating agencies is correct, it nevertheless is apparent that the rating agency representatives were not told that the firms were excluding certain Agreements from their opinions because of authority questions.

implied that there were no such questions. In addition to the form of opinions on agreements, each official statement included a section describing the security for the bonds that referred to the obligations of "each" Participant. In relevant part, that section stated: "Each Participant is obligated to pay the Supply System its share of the total annual costs of the Projects" 730/

Wood Dawson drafted the section, and Houghton Cluck reviewed and commented on it. 731/ When asked why reference was made to "each" Participant, since the firms' opinion letters covered only 72 of the Agreements, a Wood Dawson attorney who had been involved in the firm's work on Projects Nos. 4 and 5, testified that the statement was merely descriptive of the security for the bonds and that the opinion on the validity and enforceability of Agreements was in the opinion letters, a form of which appeared elsewhere in the official statements. 732/ Metzger maintained that the firms did not want to make the statements in the security section refer to the same number of Agreements included in the firms' opinions because Houghton Cluck and, to his knowledge, Wood Dawson, believed that each Participant was obligated. 733/ As

730/ E.g., 1977A Projects Nos. 4 and 5 Official Statement, supra note 453, at 2.

731/ E.g., Bert L. Metzger SEC tr. at 1517-18 (Feb. 25, 1986).

732/ Stephen I. Turner SEC tr. at 33-34, 39-40 (May 24, 1985).

733/ Bert L. Metzger, Jr. SEC tr. at 1523-24, 1527 (Feb. 25, 1986).

even the statements that Metzger made at the August 7, 1980 Participants' Committee meeting show, however, the firms were not certain that all of the Participants had authority.

The statement made in the security section of each official statement is inconsistent with the opinion on the validity and enforceability of Participants' Agreements that the firms were willing to render. Testifying on the security section, an analyst at a broker-dealer that also sponsored bond funds stated that that section was to provide the information that was in the opinions of counsel and that, if counsel was unwilling to opine that certain Participants' Agreements were valid and enforceable, that fact and the reasons therefor should have been discussed in the security section. 734/ He said that he considered the statement in that section that "each" Participant was required to pay unconditionally to be a "strong" statement and one that did not make him think that anything was out of order. 735/ As a result, he did not look at a form of opinions on agreements. 736/

734/ Jerome Lepinski SEC tr. 21, 97-98 (May 22, 1985); see also Richard E. Huff SEC tr. at 157 (head of municipal bond department at Standard & Poor's testifying that the security section is a summary of the opinions on agreements and that, if counsel had questions as to the validity and enforceability of Participants' Agreements, that fact should have been disclosed both in the opinions and in the security section).

735/ Jerome Lepinski SEC tr. at 96-98 (May 22, 1985).

736/ Id. at 21, 96.

Even if the analyst had read a form of opinions, he would not have known what Wood Dawson and Houghton Cluck had done or the questions they had with respect to the excluded Participants' Agreements. The statements in the forms of opinions may be read to imply that the firms had looked into only 72 of the Agreements. Readers of an official statement could not have known from the statement that the firms actually had looked into all 88 Participants' Agreements and had sufficient doubts as to the authority of 10 of the Participants to enter into the Agreement that they were unwilling to opine that the Agreements of these Participants were valid and enforceable.

PART V

CONCLUSION

A sequence of events led to the defaults on the Project No. 4 and 5 bonds. Cost overruns and schedule delays caused the total cost of the projects to increase greatly. The cost increases put a strain on the financing of the projects, which was obtained solely from the sale of bonds. A number of Participants declined to take on additional obligations needed to continue the financing program, and the projects were terminated. After termination, the Participants' obligations to pay, regardless of whether any of the projects were completed or whether the Supply System performed, were judicially tested. The Washington Supreme Court held that the agreements were unenforceable.

The Report has described the disclosures that were made by persons involved in these projects and in the marketing of the bonds. The Supply System was, of course, at the center of disclosure. It was knowledgeable directly or indirectly about some of the factors leading to the termination of the projects. As the issuer of the bonds, it was responsible for the official statements used to sell the bonds, although others participated in preparing them and providing some information. The Supply System avoided disclosure of negative developments. Most significantly, the Supply System failed to disclose that, in October 1980, Participants, who were concerned about rising projects costs and falling power demands, asked the Supply

System to study a possible slowdown or termination of the projects. In addition, in November 1980, the Supply System failed to disclose a \$4.4 billion estimated budget increase.

The Supply System was not knowledgeable, however, as to an issue of crucial importance to investors -- namely, the validity of the obligations of the Participants to pay even if the Projects were not completed or the Supply System failed to perform. Bond counsel and special counsel were principally responsible for disclosure on this issue through their opinion letters and the disclosure in the text of the official statements. Although opinions on legal issues frequently contain some element of uncertainty, the state of the law was not as clear as those relying on the counsels' opinions might reasonably have assumed. Further, steps were not taken to clarify legal matters. Moreover, counsel failed to disclose in its opinion that it was unwilling to opine on the validity of 10 of the 88 Participants' Agreements, accounting for 4% of the projects' capability, as to which authority problems existed, while the official statements provided that "each" Participant was obligated under the Participants' Agreement.

Several parties in addition to the Supply System, including the financial advisor, the consulting engineer, bond counsel, and special counsel, worked on the official statements for the projects and provided information within their areas of expertise. It appears that these parties did not seek negative information from the Supply System to the degree they might

have, and some information was withheld from them. They also tended to avoid causing full disclosure of negative information in their areas of expertise.

The underwriters also were in a position to discover inadequacies. They did not, however, conduct the kind of investigation in the offerings of these competitively bid bonds that they perform in negotiated municipal bond sales and in corporate securities offerings. The underwriters considered themselves as part of the audience for, rather than the speakers of, disclosure in the official statements and did not attempt to verify disclosure. Thus, this potential check on the adequacy of disclosure was not available in the sale of the bonds.

In addition, although rating services were not involved either in the sale of the bonds or in the official statement disclosure process, these services issued ratings which were used by investors. The rating services obtained information from the Supply System and applied their judgment to the information, but they did not make independent verification of the information and were not aware of some undisclosed negative developments. To be sure, the services do not represent that they perform independent verification. Nevertheless, investors may have relied on the rating services to discover undisclosed information and to reflect that information in their ratings on a timely basis.

Unit investment trusts ultimately came to hold almost a quarter of all Projects Nos. 4 and 5 bonds. The trusts were not

directly part of the Supply System's distribution of the bonds, but they indirectly served as a vehicle for distribution of the bonds as a portion of the trust portfolios. Although the bonds continued to have ratings consistent with the rating criteria set forth in the trust prospectuses and most trust sponsors maintained that they had an internal approval process, the Projects Nos. 4 and 5 bonds were purchased for their premium yield because the trusts were highly competitive on yield. While yield is important to all investors, more conservative investors appear to have been more inclined to weigh yield against the relative quality of the bonds.

Better disclosure practices in the sale of Projects Nos. 4 and 5 bonds would have provided investors with more complete and accurate information on which to base their investment decisions. However, due to the reliance placed upon the supposed Participant guarantees, it cannot reasonably be concluded that additional disclosures about matters other than the guarantees' validity would have prevented offerings from going forward, at least prior to late 1980. Nonetheless, particular investors might have reached different investment decisions, and all investors at least would have had an opportunity to better inform themselves. The experiences in the sale of Projects Nos. 4 and 5 bonds indicate that close attention to disclosure obligations and the use of appropriate disclosure practices are necessary in the sale of municipal bonds.