Southern Montana Electric Generation & Transmission Cooperative

Credit Profile

Southern Montana Electric Generation & Transmission Cooperative ICR

| Long Term Rating | BBB/Stable | New |

Rationale

Standard & Poor’s Ratings Services has assigned its ‘BBB’ issuer credit rating (ICR) to Southern Montana Electric Generation & Transmission Cooperative (SMEC or the cooperative). The outlook is stable. SMEC is a generation and transmission cooperative providing service to five Montana-based distribution cooperatives, and the City of Great Falls, Mont.

In our view, the ‘BBB’ ICR reflects:

- Above-average member retail rates for the most part, with upward pressure based on expected rising production and/or wholesales costs relative to declining power supply from the Bonneville Power Administration’s hydro system;
- Execution risk in the cooperatives power supply strategy, given inexperience in operating its own plants and uncertainties regarding the gas-fired generating capacity;
- Limited service area economies. SM EC’s distribution members’ customers are spread over long distances, with little more than 1 customer per line mile; and
- Weak legal covenants in the indenture, with a 1.1x margins-for-interest covenant, which does take into account annual principal payments; and limited restrictions on new debt issuance.

We believe credit strengths include:

- All-requirements contracts with the five member cooperatives, recently amended to expire in 2048 (except for Yellowstone Valley Electric, whose contract expires in 2030). The amended contracts for the four members participating in the SM EC’s Highwood Generating
Station project (HGS) include provisions that all cooperative costs are to be paid, whether or not the plant is completed:

- Financial policy targets for debt service coverage and equity levels that support credit quality, and a financial forecast that indicates adequate 1.25x debt service coverage in the long term;
- SMEC governing board’s ability to set its own rates without state or federal regulation; and
- Decreasing reliance on market purchases, once HGS comes online in 2011-2012, although the cooperative will need to manage fuel-price volatility.

SMEC was formed in 2004 when five of Central Montana Electric Cooperatives decided to exit it. Members include the following distribution cooperatives, all headquartered in Montana:

- Beartooth Electric Cooperative, Inc.
- Fergus Electric Cooperative, Inc.
- Mid-Yellowstone Electric Cooperative, Inc.
- Tongue River Electric Cooperative, Inc.
- Yellowstone Valley Electric Cooperative

In addition, SMEC indirectly serves industrial customers of Great Falls through the power sales contract with the city that obligates the cooperative to use best efforts to obtain wholesale capacity and energy for the city. Indirectly, the cooperative provides power to about 100,000 people in 22 counties in Montana. Yellowstone and Great Falls are not participating in HGS, a proposed 120 megawatt (MW) natural gas generating station consisting of two 40 MW simple cycle units, which should be finished by 2011; and a 40 MW combined cycle steam turbine unit, slated for commercial operation in 2012. We expect the cooperative to obtain long-term financing for the project, which is estimated to cost about $270 million.

**Outlook**

The stable outlook reflects our expectation that SMEC’s operational and financial plans will be implemented. The ICR could face pressure if the projected power supply costs rise meaningfully, or if the cooperative’s board does not achieve financial results consistent with targets.

**Regulation And Management**

Governing SMEC is a board of directors that sets policy, approves budgets, and sets rates. In Montana, there is no rate regulation, nor are the cooperative’s rates subject to federal regulation. We believe this status is favorable, allowing SMEC to recover its costs more readily. One of its distribution members (Beartooth) serves a few customers in Wyoming, which does regulate retail rates, but this does not meaningfully affect the cooperative’s ability to obtain Beartooth’s share of expenses. In addition to this, Montana also has not deregulated retail electricity markets. This benefits SMEC because its distribution members retail customers can not choose alternate retail electricity providers.

A full-time general manager runs day-to-day operations. Management’s financial policies support credit quality. There is a 1.25x debt service coverage target and an equity target of 20%, and management will not remit patronage capital to its members until reaching the equity target. In addition, the board has a policy to review rates annually and set rates such that SMEC will collect revenues to meet all obligations. Member rates similarly pass through purchased power and fuel costs, and account for monthly sales volume fluctuations. During the next couple of years, we expect the cooperative to develop commodity risk management strategies to go along with the increased operating
risk of obtaining fuel supplies and operating the HGS plant. HGS will be SMEC’s first plant that it will own and operate.

**Power Supply**

Historically, power supply consisted of hydro allocations to SMEC’s members of the Western Area Power Administration (WAPA), contract purchases, and since 2001, low-cost power from Bonneville. In 2008, PPL Montana LLC provided 75% of the cooperative’s generation, with Bonneville (15%) and WAPA (10%) providing the balance. The Bonneville arrangement has tapered down dramatically to about 33 MW in 2008, and will expire by 2011. We believe the loss of the low-priced Bonneville hydro power will likely increase power costs. The situation prompted SMEC to seek alternative power supplies, leading to the proposed HGS project. Ownership of 120 MW of gas-fired capacity will limit market exposure for the participating members, while introducing gas-price risk that will need to be effectively hedged. Only four of the cooperative members are participating in HGS, and each of them has signed an amended power sales contract with SMEC extending to 2048. Yellowstone opted to not participate in HGS, and has filed suit to terminate its contract with SMEC, which the cooperative is contesting. With proceedings ongoing, SMEC is nevertheless obligated to serve Yellowstone under an all-requirements contract that expires in 2030, and recently obtained a block of power through a contract with PPL Montana, which will be allocated to Yellowstone’s power requirements.

**Highwood Generating Station**

The HGS project is a 120 MW gas-fired power plant located on SMEC-owned land just outside of Great Falls. The project will consist of two 40 MW simple cycle units, which should be finished by 2011; and a 40 MW combined cycle steam turbine unit, slated for commercial operation in 2012. The site is large enough for further expansions (although none are currently planned), which gives SMEC some flexibility in planning for member demand growth. The cooperative could finance the project in two segments, to reduce capitalized interest costs. We expect the initial financing in mid-2009, and SMEC to obtain 30-year financing for the project, which is estimated to cost about $250 million. All-in cost estimates for the project total about $2,100 per kilowatt. This is well below the per-unit cost of a coal plant, which SMEC had earlier considered. The cooperative might fund some infrastructure components of the project pertaining to water and sewer service through tax-increment financing by local governments, although the project does not depend on that.

Busbar costs of the project are estimated at about $72 in 2012, assuming natural gas prices of $6.50 per million BTU. Estimated fixed capital costs accounting for only one-third of this estimate. The price of fuel, which currently is significantly below the $6.50 estimate, largely influences the busbar cost. However, commodity prices in 2011 and beyond are difficult to predict, and we believe it is reasonable that SMEC has not locked in a price for fuel.

**Low Customer Density**

The four members in HGS collectively serve about 75,000 households and have a total peak demand of about 90 MW. Individually, their respective peak demand ranges from 7 MW to 38 MW. Yellowstone’s peak is 75 MW. Their respective service territories generally cover several counties in the southeastern part of Montana, and are sparsely developed. Only Beartooth averages more than two customers per line mile, which contributes to high distribution costs and hurts the members’ respective
retail rate competitiveness. According to Energy Information Administration data for 2007 (the latest year available), only Tongue River’s average system retail rate is below the state average (at 84%), while the others range from 16%-44% above it. We expect rates to increase by 2012, as the new gas-fired baseload unit replaces lower-cost resources, particularly SMEC’s Bonneville contract. But the relative competitive position will not necessarily decline, as many utilities are facing rising costs.

**Related Research**

“Applying Key Rating Factors To U.S. Cooperative Utilities,” Nov. 21, 2007