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Fitch Downgrades PPL Montana, LLC to 'BBB-'; Revises Outlook to Stable

NEW YORK--(BUSINESS WIRE)--Fitch Ratings has downgraded PPL Montana, LLC's (PPLM) pass-through trust certificates due 2020 to 'BBB-' from 'BBB'. The Rating Outlook is revised to Stable from Negative.

The downgrade reflects Fitch's expectation of lower power pricing and a potentially weaker hedging position, which could reduce PPL Montana's flexibility to manage costs as exposure to low merchant market prices increases.

KEY RATING DRIVERS

Base Load Merchant Generation: PPLM manages a diverse portfolio of low cost coal and hydro generation assets and sells energy at market-based prices. The hydro assets benefit from favorable dispatch. The project partially mitigates merchant risk by selling power through medium-term power purchase agreements (PPA) and short-term hedges.

Stable Operations: The project benefits from a history of solid operating performance.

Operating Costs: PPLM maintains a consistent operating cost profile. Exposure to potential increases in coal prices is mitigated by having most of the coal supply coming from a mine mouth facility. Financial pressure from PPLM's $263 million five-year (2012-2016) capital plan is moderated by the pending completion of the Rainbow Dam expansion and the flexibility to delay other capital expenditures. Potential environmental compliance costs, however, could pressure financial performance.

Strong financial performance: Projected financial metrics remain strong, but below the historical levels. Fitch projects FCCRs to average 2.55x based on the roll off of existing financial hedges beginning in 3013. Fixed coverage charge ratios (FCCR) averaged 2.96 times (x) over the last ten years, including 2.71x in 2011.

Hydrology Risk: Hydrology variability is mitigated by management's use of 10 years actual historical water flows, which include drought-like conditions, to project energy production. Persistence of low hydrology, however, could materially erode future cash flow.

Adequate Liquidity: PPLM has adequate liquidity to meet debt obligations. PPLM has a six month rent reserve fund and cash and equivalents of $3 million. Supplemental liquidity is in the form of $100 million line of credit expiring in May 2013, provided by PPL Investment Corp., an affiliate of the corporate parent PPL (rated 'BBB'/Stable Outlook).

WHAT COULD TRIGGER A RATING ACTION

--Continued weakness in the merchant power market.

--Increased exposure to merchant power prices due to an inability to renew contracts (e.g. hedges and PPAs) on favorable terms.

--Persistent reductions in hydrology that materially reduce overall energy production.

--Inability to manage capital expenditures that could materially erode cash flow.

SECURITY

Though security for the rated debt is limited to the owner-lessors' interests in the Colstrip power plant, PPLM's obligation to pay rent is a general unsecured obligation of PPLM. As such, revenue derived from operation of the entire portfolio is available for rent payments.

CREDIT UPDATE

Revenues

The rating downgrade primarily reflects the project's increased exposure to merchant power prices. After wholesale power offtaker Southern Montana Electric (SME) Cooperative filed Chapter 11 Bankruptcy in October 2011, the trustee terminated the power purchase agreement (PPA) between SME and PPL Montana. Loss of the SME contract, which would have accounted for 20% of PPLM's output between 2014 and

2019, exacerbates the project's exposure to merchant power market prices. Further, the amount of power provided to NorthWestern Corp reduces significantly in 2014, adding to the project's merchant market price exposure. PPL Montana continues to seek opportunities for medium and long-term power agreements.

Operating Performance

The hydro and coal units continue to demonstrate solid availability consistent with historical performance. The hydro units achieved overall availability of 93%, while the five coal units achieved availability ranging from 83% to 86%. The decline in power prices, however, has resulted in reduced dispatch for the coal units as reflected in lower capacity factors of 62% to 72%, which are 9% - 16% lower than historical averages. Persistent reductions in generation output in the low power price environment could adversely affect future cash flow.

Operating Expenses

Controlling costs while maintaining well-performing assets continue to be important factors for maintaining the investment grade rating. PPLM reports up-to-date environmental controls installed on its coal units. Capital expenditures of $263 million through 2016, however, could increase if the Environmental Protection Agency imposes additional requirements to reduce emissions of sulfur dioxide and nitrogen oxide on the coal units. A decision could come as early as this summer, while potential compliance requirements could be phased in over a multi-year period. Favorably, upgrades to the Rainbow Dam are on schedule to be completed by mid-2012, resulting in increased energy production for the project. For other expenses, Fitch recognizes that the project has some flexibility to defer non-critical capital expenditures to manage its cost profile.

Financial Performance

Fitch projects operating margins declining beginning in 2016 with increased exposure to low merchant power prices. Although FCCRs average 2.55x under Fitch's financial stress, Fitch project's below investment-grade FCCRs in 2014 and 2016. The project's financial performance is most vulnerable to decline in 2013-2015 as the project implements its capital investment plan and as annual rent service peaks to $40 million - $45 million. A material decline in annual rent service beginning in 2016 to $15 million decreasing to $3 million from 2017 through 2019 provides financial relief, with FCCRs that rebound to over 2.0x under Fitch's financial stress scenario.

PPLM owns, operates and leases a portfolio of 13 hydroelectric and coal-fired generating facilities with an aggregate capacity of 1,239 MW. The PPLM portfolio includes 11 hydro projects, a storage reservoir, the coal-fired Corette facility and the owner-lessors' share of the Colstrip coal facility. The pass-through certificates were issued by a pass-through trust to fund the owner-lessor's acquisition of the leased Colstrip assets, which represent 25% of Colstrip's 1278-MW capacity and 41% of PPLM's total portfolio capacity. Rental payments include equity payments to the owner-lessors and annual debt service on the trust certificates maturing in 2020.

Additional information is available at www.fitchratings.com. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:
--'Rating Criteria for Infrastructure and Project Finance' (Aug. 16, 2011).

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Rating Criteria for Infrastructure and Project Finance
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648832

CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE.

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