Exh. DCG-6
Dockets UE-260005, UG-260006 and UE-260113
Witness: David C. Gomez

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**DOCKETS UE-260005 & UG-260006**
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Accounting Order Authorizing the Deferred Accounting Treatment for FERC Interest Associated with Mandatory Transmission Network Upgrades**	**DOCKET UE-260113 (Consolidated)**

EXHIBIT TO

TESTIMONY OF

DAVID C. GOMEZ

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

UE-011570, PSE, Direct Testimony of Howard L. Hiller HLH-1T, 11-26-01

July 28, 2026

EXHIBIT NO. _____ (HLH-1T)
DOCKET NO._____
2001 PSE RATE CASE
WITNESS: HOWARD L. HILLER

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DIRECT TESTIMONY OF HOWARD L. HILLER ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 26, 2001

PUGET SOUND ENERGY, INC.

DIRECT TESTIMONY OF HOWARD L. HILLER

Q: Please state your name, business address, and occupation.

A: My name is Howard L. Hiller. I am a Managing Director in the Fixed Income Capital Markets Group of Salomon Smith Barney Inc. ("Salomon Smith Barney"). My business address is 390 Greenwich Street, New York, New York 10013.

Q: What are your responsibilities in your current position?

A: My responsibilities and my current position are described in Exhibit HLH-2.

Q: What is your educational background?

A: My educational background is described in Exhibit HLH-2.

Q: Please summarize your professional experience.

A: My professional experience is described in Exhibit HLH-2.

Q: Have you or your firm provided investment banking services to Puget Sound Energy ("PSE" or "the Company") during the last 18 months?

A: Yes. This is addressed in Exhibit HLH-2.

Q: Have you acted as a witness in any other utility proceedings?

A: Yes. This is also addressed in Exhibit HLH-2.

I. PURPOSE AND CONCLUSIONS OF TESTIMONY

Q: What is the purpose of your testimony?

A: The purpose of my testimony is to describe the implications of wholesale power market volatility on PSE's financial condition, and upon PSE's ability to access debt capital on reasonable terms. By “reasonable terms” I mean a cost of debt that is consistent with the Company's maintenance of investment-grade credit ratings, and does not require any penalty premium reflecting further risk over and above the rating agencies' assessment.

Q: What are the conclusions of your testimony?

A: My primary conclusion is that establishing a mechanism for ensuring the full and timely recovery of PSE's ongoing power costs is essential to restoring the Company's financial integrity. I believe that the recent changes in the wholesale power markets and the resulting power cost volatility have been of sufficient severity that this type of mechanism is required. Over the past several months, the credit rating agencies and financial markets have exhibited significant concern about PSE's deteriorating financial condition. Absent a mechanism that provides a framework for recovery of power costs, PSE's cost of debt will be significantly above that of comparably-rated investment-grade utilities, and PSE runs the further significant risk of being denied access to capital as the Company's risk profile deteriorates. Such a regulatory mechanism is also needed to send a strong signal to the financial markets that the Commission is aware of the financial challenges facing utilities in Washington State and is willing to address these challenges through a balanced approach to cost recovery.

II. BACKGROUND ON CAPITAL MARKETS

Q: How do investors broadly assess their investment decision in corporate stocks and corporate bonds?

A: Most financial decisions reflect an attempt to balance "risk and reward." The case of stock and bond investment decisions is no exception: Reward is measured by expected return and risk is measured by the variability of those returns.

Stocks and bonds are fundamentally different in terms of their risk/return characteristics. Corporate stocks offer unlimited return (share prices can rise to any level) while corporate bonds, in contrast, have limited upside capped by the payment of interest and the return of principal. Of course, the variability of stock returns is much higher than bond returns.

Another key difference: stock investors tend to focus on *earnings* as a key determinant of valuation, while bond investors focus more on *cash flow*. Equity investors often evaluate earnings as a percentage of share price (actually the inverse – price/earnings ratio – is more common) and fixed-income investors evaluate cash flow as a percentage of total debt.

Q: How have investors broadly assessed their investment decision in corporate stocks and corporate bonds of regulated utilities?

A: The risks and expected returns of investing in the common stock of regulated utilities are viewed somewhat differently from the stocks of other non-regulated companies. In fact, utility stocks are more *bond-like* than the stocks of companies in competitive industries. There are two reasons. First, investors believe that the upside potential of utility stocks is fundamentally limited by the ability of the regulator to lower customer rates if a utility "over-earns," i.e., exceeds its allowed return on equity. Second, utility stocks typically provide investors with a more generous dividend yield that, in part, offsets the perceived limitations in capital appreciation. So utility stocks have some of the income characteristics of a bond.

Utility bonds do not differ dramatically from bonds issued by other companies. In fact, bonds of regulated utilities actually enjoy a "safe-haven" status, reflecting the monopoly status of the utility franchise, the essential nature of the service provided, and the perceived value of the regulatory "safety net" that should protect utilities from financial distress.

Q: How do the rating agencies assess risk for regulated utilities?

A: As Mr. Donald E. Gaines describes in his testimony, the rating agencies examine both the *financial* risk and the *business* risk of the utility. The financial risk is usually measured quantitatively by a number of key ratios like cash flow as a percentage of total debt and total debt as a percentage of total capitalization. The

assessment of business risk usually includes a number of qualitative factors including: regulation, operations, customer profile/concentration, power supply and fuel management, commitment to cost reduction and management's willingness to issue equity to support credit ratings.

These two risk analyses are combined to determine a rating for the utility itself as well as the individual securities that the utility issues. Furthermore, the agencies often provide an evaluation of the long-term or short-term *direction* of the ratings.

Q: What are investment-grade ratings and what is their significance?

A: For S&P, the lowest investment-grade rating is “BBB-”; “BB+” is non-investment-grade. For Moody's, the lowest investment-grade rating is “Baa3;” “Ba1” is non-investment-grade (the different symbols are purely a matter of alternative terminology or ratings scales.) Moving from investment-grade to non-investment-grade is very costly for debt issuers. The differential has historically been at least 100 basis points (bp), but has typically been 200-400 bp, depending on the industry sector and issuer specific considerations. In addition, at times the market for non-investment-grade debt – the so-called high-yield market – is closed for an indefinite amount of time.

Q: Describe how the rating agencies describe ratings "direction"?

A: If there is no trend, the rating outlook is simply called "stable." The *long-term* direction of a rating is usually referred to as a rating "outlook." It can be either positive or negative. If the company faces a near-term credit event (e.g., regulatory decision, acquisition, recapitalization), the rating may have a *short-term* direction of positive, negative or developing (meaning the direction is uncertain) and the rating is said to be "under review for an upgrade/downgrade."

Moody's says the rating is "under review for a possible upgrade/downgrade" and S&P says the rating is "on CreditWatch with positive/negative implications."

Q: You mentioned regulation as part of the rating agency assessment of business risk. Can you describe that in greater detail?

A: Yes. On the topic of regulation, S&P has written: "To be viewed positively, regulatory treatment should be timely and *allow consistent performance from period to period, given the importance of financial stability as a rating consideration*." (*Rating Methodology for Global Power Companies*, Standard & Poor's Rating Services, May 1997, page 6 – italics added for emphasis.) Put another way, regulation should provide predictability of financial performance. If not, even a utility that is well-managed from an operating perspective can experience ratings pressure.

Q: How has the rating agency perspective on utilities changed over the last few years?

A: The liberalization of power markets and the introduction of competitive generation in many states has forced the rating agencies to examine these new forms of risk. Standard & Poor's has commented on the "significant challenge of matching fuel and power supply with demand." (*Rating Methodology for Global Power Companies*, Standard & Poor's Rating Services, May 1997, page 7.) The volatility that was experienced in the western power markets in 2000-2001 has further underscored the challenges that utilities face in effectively managing these risks.

Q: What is the significance of an issuer's rating and ratings status to a regulated utility's ability to attract capital on reasonable terms?

A: The ability of a regulated utility to attract capital on reasonable terms often depends as much on the status of the ratings as on the current level. If both ratings are under review for a downgrade, bond investors will often "assume the

worst" and heavily discount the current ratings. As a consequence, the new issue cost for an investment-grade debt issuer can be comparable to a non-investment-grade issuer if the ratings are under review for downgrades or investors simply perceive the ratings to be at risk. The secondary market trading activity in the debt of Enron Corp. is a recent and very dramatic example of that phenomenon.

III. BACKGROUND ON WHOLESALE POWER MARKETS

Q: Please describe the impact of recent wholesale power market volatility on investor perception of utility stocks and bonds.

A: Competition in wholesale energy markets and industry restructuring has forced the rating agencies and debt and equity investors to fundamentally overhaul their approach to evaluating the risk profile of the electric utility industry. In fact, the Commission comments: "western wholesale power markets have exhibited, over the past eighteen months, prices and price volatility that are *unprecedented in anyone's experience*." (Cause No. UE-010395 – September 2001.)

The energy crisis in California highlighted the challenges of introducing competition into markets where supply was not necessarily in balance with demand. The mismatch between volatile market-driven power prices and a fixed rate structure caused rapid increases in the California utilities' unrecovered power costs – on both an accounting and cash basis. Ultimately, these escalating costs precipitated financial distress and a bankruptcy filing at Pacific Gas & Electric. With respect to the state of Washington, the Commission comments: ". . . it is undisputed that many retail power companies, municipal electric companies, cooperatives, and Public Utility Districts in Washington State face *unprecedented financial needs* as a result of both extreme drought and wholesale power market volatility." (Cause No. UE-010395 – September 2001.)

The Pacific Gas & Electric bankruptcy prompted many investors to focus renewed attention on the ability of utilities around the country to recover power costs from customers. Investors increasingly scrutinized any potential mismatch between utility power costs and existing rate structures. This is confirmed in a recent report from Regulatory Research Associates: "The potential for volatility in wholesale electricity markets . . . has raised investors' level of awareness and concern with regard to the ability of electric utilities to recover increased wholesale power costs and fuel expenses from customers . . . . This pricing instability has raised the specter of unrecoverable wholesale power costs nationwide, and thus has piqued investor interest in the existence of purchased power and fuel cost recovery mechanisms." (RRA Special Report: "*Recovery of Fuel and Wholesale Power Costs: Who Is At Risk and Who Is Not?*" dated February 28, 2001.)

This change was often precipitated by forces outside of the control of the utility and its state regulators. In fact, the Commission itself commented (Cause No. UE-010395 – September 2001, page 3): ". . . the upheaval in the western wholesale power market stems, in large measure, from a misplaced confidence by some government policy-makers – outside of Washington State – that competition in electricity markets would sufficiently discipline the price of wholesale power."

The Commission has also acknowledged that volatile wholesale power markets have created unprecedented risk and uncertainty for utilities. The Commission observed: "Decisions made in California to design and implement new market institutions, and by the Federal Energy Regulatory Commission to regulate those institutions, utterly failed to achieve competition in electricity pricing and supply, and *drastically disrupted power markets throughout the*

interconnected West." (Cause No. UE-010395, September 2001, page 3 – italics added for emphasis.)

Q: Describe the impact of wholesale power price volatility on the market for bank debt and commercial paper.

A: Bank lenders – like stock and bond investors – are concerned about the impact of power cost volatility on credit quality. The availability of credit to the electric utility sector has been constrained, in part, by the experience of the California utilities and by other less draconian situations around the country. Banks may withhold credit from a utility if they believe it is unable to recover its ongoing fuel or purchased power costs from customers on a timely basis. In addition, weakened utility earnings can lead to the violation of bank financial covenants, leading to technical default situations. In addition, if a company's senior unsecured debt ratings fall to Baa3/BBB- (the lowest investment-grade rating), the market for commercial paper is no longer available to it.

Q: What is the financial impact of increased power price volatility on western utilities?

A: Those western utilities that have significant exposure to power cost volatility and do not have a regulatory framework for recovering power costs (like Avista and PSE) will find that their access to capital is challenged, in part due to declining rating profiles, often requiring a cost higher than their ratings would imply. For example, I describe below an Avista debt offering in March 2001 – which occurred before Avista's rating downgrades – that was priced essentially as if the ratings were already non-investment-grade.

Q: In this context, is there an appropriate role for tracker mechanisms?

A: Both equity and debt investors abhor uncertainty. Controlling risk is a fundamental part of their jobs as managers of securities portfolios. As a

consequence, a tracker mechanism is viewed positively by investors since it reduces risks, particularly in the context of increasingly uncertain power markets. From a *shareholder* perspective, it increases the predictability of earnings and earnings are a key driver of share price valuation. Similarly, from a *bondholder* perspective, a tracker mechanism reduces the variability of cash flow, a key driver of credit quality. Absent such a mechanism, the cost of equity and debt to a utility facing a power supply exposure similar to PSE's will be unreasonably high.

Q: How have gas local distribution companies (LDCs) coped with the volatility in natural gas prices?

A: Regulators of LDCs have established frameworks by which these companies can recover the cost of the gas commodity and pass those costs through to consumers. In fact, PSE's purchased gas adjustment (PGA) mechanism is an example of this approach. These structures are designed, in large part, to shield the LDC's earnings from commodity price volatility. In general, the gas cost adjustment mechanisms are viewed very positively by both equity and debt investors, as a vehicle for reducing the riskiness of earnings and cash flow within the LDC sector. In addition, many LDCs also have regulatory weather normalization clauses that further offset the volumetric risks associated with, for example, abnormal winter weather.

Q: What is the current status of fuel and purchased power cost recovery mechanisms for US electric utilities?

A: The RRA report cited above contains a table summarizing which states (including the District of Columbia) have tracker mechanisms. According to RRA, only 16 states (including DC) lack tracker mechanisms. A number of these states – for example: Michigan, New Jersey and Pennsylvania – recently abandoned their trackers in the context of a legislative restructuring process that included a rate

freeze. Many utilities believed that the power cost recovery mechanisms would not be needed in a competitive environment. It was presumed that competition would keep prices relatively stable or the utility's owned supply would hedge price volatility.

The report provides the following summary overview:

"Other utilities in ME, MA, NH, NY, RI, TX, have been authorized to implement new power cost recovery mechanisms that flow through wholesale price adjustments on a timely basis, and essentially leave the utility risk free with respect to wholesale power purchases. Yet, other companies, mostly those that continue to operate under traditional regulation, have maintained their traditional FACs [Fuel Adjustment Clauses] (AL, CO, FL, GA, HI, ID, IL, IN, IA, KS, KY, LA, MN, MS, NC, ND, OK, SC, SD, TN, VA, WI, WY)."

State	Rate Cap	Tracker
AL		✓
AZ	✓	
AR		✓
CA	✓	
CO		✓
CT	✓	
DE	✓	✓
DC	✓	
FL		✓
GA		✓
HI		✓
ID		✓
IL	✓	✓
IN		✓
LA		✓
KS		✓
KY		✓

State	Rate Cap	Tracker
LA		✓
ME		✓
MD	✓	
MA		✓
MI	✓	
MN		✓
MS		✓
MO		
MT	✓	
NV		✓
NH	✓	✓
NJ	✓	
NM		
NY		✓
NC		✓
ND		✓
OH	✓	

State	Rate Cap	Tracker
OK		✓
OR		
PA	✓	
RI		✓
SC		✓
SD		✓
TN		✓
TX		✓
UT		
VT		
VA		✓
WA		
WV		✓
WI		✓
WY		✓

Q. Are utilities in any of the 16 states that lack tracker mechanisms seeking to establish one?

A: Yes. I will discuss several examples in the West: Nevada, Montana, and Oregon.

In Nevada, on April 18, 2001, the legislature passed and the Governor signed into law AB 369. This bill essentially reversed an earlier deregulation

plan, halted divestiture of company-owned power plants and re-established deferred energy cost mechanisms for the utilities within the state. This was an important first step for the utility subsidiaries of Sierra Pacific Resources – Nevada Power and Sierra Pacific Power – to deal with the gap between power supply costs and rates collected from customers. However the recovery of these deferred costs also needs to be addressed.

In Montana, restructuring legislation passed in 1997 required that full customer choice would be implemented on July 1, 2002. As a consequence of the western power market crisis, the state legislature passed a new bill (HB 474) that extended the transition period by five years to July 1, 2007. The new law also required the Montana Public Service Commission to establish a power cost adjustment mechanism that would allow Montana Power, the principal utility in the state, to recover all of its prudently-incurred power supply costs.

"The commission shall use an electricity cost recovery mechanism that ensures that all prudently incurred electricity supply costs are fully recoverable in rates. The cost recovery mechanism must provide for prospective rate adjustments resulting from cost changes, load changes, the time value of money on the differences." (Montana HB 474, 69-8-210(4)(a)).

PacifiCorp has over 30% of its customers in the state of Oregon. In Oregon, PacifiCorp is seeking to establish a permanent power tracker mechanism. In Oregon, the regulators allowed PacifiCorp to put in place a temporary tracker that allows for recovery of a fixed percentage (83%) of power costs. The establishment of a permanent power tracker is expected to be part of a future filing.

Q: Why are some utilities in states that lack a tracker not all actively pursuing this alternative?

A: The need for a tracker mechanism as a risk mitigant depends on the utility's reliance on purchased power; sensitivity to hydro and gas as key fuel sources; and the overall volatility of power prices in the region. Utilities in states that lack tracker mechanisms which are *not* seeking some form of tracker typically are not excessively exposed to the volatility of fuel and power prices.

IV. IMPACT ON PSE'S CAPITAL MARKET ACCESS

Q: Please describe, in your view, the risks presently faced by the Company and the market view of those risks.

A: PSE's earnings and cash flow have suffered from significant exposure to wholesale power prices. In fact, the magnitude of the possible annual impact of power cost uncertainty is substantial. In this regard, I refer you to the direct testimony of William A. Gaines, which provides at page 20 the following statement:

> Puget's exposure to power supply risk going forward is substantial. (For example, an illustrative range of projected annual net power costs of $243 million is presented below in this testimony). PSE's heightened exposure is the result of:
>
> (i) its dependence on regional hydro conditions;
>
> (ii) the increase in the volatility of western region power prices;
>
> (iii) the deterioration in supply/demand conditions in the West precipitated by limited growth in capacity; and
>
> (iv) the uncertain ongoing administrative structure of the western power markets as highlighted by the FERC price caps, imposed in 2001.

Further, as an indicator of this volatility based on actual experience, one need only look at the Company's test year net power costs presented in this case to appreciate the effect of this volatility. In particular, the normalizing adjustments between the Company's actual test year and projected normalized rate year net power costs are approximately $100 million. Because of the previously described changes in the wholesale markets, it must be assumed that this can recur.

Q: What is the current status of PSE's debt ratings?

A: The current status of PSE's debt rating is set forth in the following table:

PSE's Credit Ratings

	S&P (8/1/01)	S&P* (11/15/01)	Moody's (8/1/01)	Moody's** (11/15/01)
First Mortgage Bonds	A-	BBB	Baa1	Baa1
Issuer (Company) Rating	BBB+	BBB-	Baa2	Baa2
Senior Unsecured Debt	BBB	BB+	Baa2	Baa2
Trust Preferred Rating	BBB-	BB	Baa3	Baa3
Preferred Stock Rating	BBB-	BB	Ba1	Ba1
Commercial Paper	A-2	A-3	Prime-2	Prime-2

***Negative outlook on long-term ratings**
****All long term ratings on review for possible downgrade**

As noted in the table, the current ratings of PSE's senior *secured* debt are Baa1 by Moody's and BBB by Standard & Poor's. The Moody's rating of the senior *unsecured* debt is one "notch" lower at Baa2 and the S&P rating is two "notches" lower at BB+. The Moody's ratings remain under review for possible downgrade

and the S&P ratings have a negative outlook. Note that PSE's unsecured debt is no longer investment-grade.

On October 9, 2001, Moody's placed the ratings of PSE under review for possible downgrade. This action followed the Commission's decision on PSE's request for interim rate relief. On October 26, 2001, Moody's commented further: "Although PSE's financial performance is showing the negative effects of the current mismatch between its existing electric rates and the net supply costs it is incurring, we believe that taking immediate action to downgrade the ratings in response to the recent WUTC Orders would be premature. We choose instead to await further developments in the upcoming general rate filing. Moody's will continue to assess PSE's ability to achieve some initial financial relief in the form of an interim rate hike relatively early in the general rate case, or from other actions the state might take within that same near-term horizon. We are cautiously optimistic that PSE can be successful in this regard, which we believe would put it back on track toward achieving financial results more commensurate with its existing ratings."

"Absent this scenario playing out, a rating downgrade would result. Furthermore, given the importance of the final outcome of the general rate proceeding to PSE's prospective credit profile, it would not be inconceivable at that point to leave the ratings on review for possible further downgrade, thereby including the short-term rating as part of the subsequent review process, while awaiting the final WUTC Order in the general rate case."

In the first of two actions, on October 8, 2001, Standard & Poor's lowered the senior secured debt rating of PSE to BBB+ from A- and placed all of its ratings on CreditWatch with negative implications. (The latter action is viewed as equivalent to Moody's "review for possible downgrade.") At the same time, S&P

commented: "As such, without near-term responsive action by the WUTC that addresses PSE's weakened financial position, PSE's corporate credit rating may be lowered by multiple notches . . . Also of concern are the company's increasing power needs over the next several years, rising purchased-power costs and *the absence of a periodic rate adjustment mechanism*." (Italics added for emphasis.)

S&P also states that "PSE's historically above-average business profile is likely to be eroded by a weakening economy and lagging responsiveness by regulators." In my opinion, the "weakening economy" is beyond PSE's control and the "lagging responsiveness" criticism can and should be addressed through appropriate actions on the part of the Commission.

In its second action on October 30, 2001, S&P further lowered the rating on PSE's senior secured debt to BBB from BBB+, removed the ratings from CreditWatch and classified the outlook as negative. S&P comments: "The rating downgrades for Puget Sound Energy and its subsidiaries reflect the absence of immediate rate relief, combined with limited near-term prospects for improved cash flow necessary to stabilize the company's weakened financial position." Commenting specifically on excess power costs, S&P writes: "The company's inability to fully recover these costs in a timely fashion continues to severely pressure the company's strained credit-protection measures."

The deterioration of PSE's credit rating has and will continue to impair PSE's financial strength and access to capital. In this regard, the Commission has recently stated the importance of financial stability to a utility's ability to serve its customers: "We cannot, and we will not, ignore the importance for customers of *maintaining the financial stability of the Company*." (Cause No. UE-010395 – September 2001.)

Q: Please describe the market's view of PSE's current ratings and financial stability.

A: In my opinion, the market is concerned that PSE may face difficulties in obtaining regulatory approval for a tracker mechanism. Most bond investors, therefore, are likely to discount the prices they are willing to pay for the bonds of PSE. Similarly, equity investors are likely to be concerned about the predictability of the earnings of Puget Energy, Inc. ("Puget Energy"), the corporate parent of PSE. This will likely exert downward pressure on the share price of Puget Energy.

Q: What are the specific implications for PSE's cost of debt capital?

A: In my opinion, PSE would pay a penalty spread relative to indicative levels for their current ratings. This penalty spread is an additional cost beyond the typical cost associated with the downgrades the Company has recently experienced. The secured debt issues of investment-grade electric utilities trade within a well-defined range at any particular time. (There are sufficiently many liquid investment-grade debt issues quoted in the secondary market that one can use these as reference points for determining indicative levels.)

Q: Are there specific examples where we can gauge how the debt markets have responded to utilities facing exposures similar to PSE's?

A: Yes. On March 29, 2001, Avista Corp. issued $400 million of seven-year *unsecured* notes. The ratings of the notes (at the time of the offering) were Baa2/BBB. Despite these investment-grade ratings, the coupon rate on the notes was 9.75% (with a yield of 9.875%), reflecting a spread of 492.5 bp over the benchmark Treasury yield. This spread is more reflective of a non-investment-grade rating and is over 3 percentage points (or 300 bp) higher than the cost appropriate for a BBB rating at the time of issuance.

Q: What are the implications of the Avista debt offering?

A: One clear implication of this transaction is that the capital markets will not wait for the rating agencies to reassess their view of the credit quality of an issuer. If the issuer's debt ratings are subsequently lowered, it would confirm the market's judgement, but the penalty that the market imposes on issuance cost will not wait for that confirmation. Market opinions change more quickly than ratings, in the case of a downward trend. In fact, Avista's *unsecured* debt ratings were subsequently lowered by two notches to non-investment-grade ratings: Ba1 by Moody's and BB+ by S&P, in October 2001.

Q: Are there other relevant debt transactions?

A: Yes. On May 22, 2001, Nevada Power, a utility subsidiary of Sierra Pacific Resources, issued $350 million of ten-year *secured* debt at a spread of 287.5 bp over the corresponding benchmark Treasury yield. The credit ratings of the secured notes were Baa1/A-. The estimated generic cost for such an issue at the time was approximately +162.5 bp, so the premium that Nevada Power paid was about 1.25%. In addition, Nevada Power's prior debt offering on June 25, 1999 was *unsecured*, not secured. In my opinion, Nevada Power selected this more investor-friendly structure in order to ensure the completion of the offering and lower its overall cost.

Note that Nevada Power paid a penalty rate for its secured debt issuance even though a deferred energy cost recovery framework had just been signed into law by the Governor on April 18, 2001. If legislation had not been completed, Nevada Power's spread-to-Treasuries would likely have been closer to Avista's, a further two percentage points of incremental cost.

Q: Are there any recent debt transactions from western utilities that enjoy more supportive power cost recovery?

A: Yes. On February 27, 2001, Idaho Power, a utility subsidiary of IDACORP, issued $120 million of 6.60% first mortgage bonds, rated A2 by Moody's and AA- by Standard & Poor's, at a spread of 165 bp over Treasuries. In my judgement, this spread was in line with prevailing spreads at the time, i.e., Idaho Power was not charged a penalty spread premium at all.

Note that Idaho benefits from a Power Cost Adjustment (PCA) mechanism. It is described briefly in the Company's 2000 10-K: "IPC [Idaho Power Company] has a PCA mechanism that provides for annual adjustments to the rates charged to its Idaho retail electric customers. These adjustments, which take effect annually on May 16, are based on forecasts of net power supply costs, and the true-up of the prior year's forecast. The difference between the actual costs incurred and the forecasted costs is deferred, with interest, and trued-up in the next annual rate adjustment."

For example, in May and September of 2001, the Idaho PUC authorized Idaho Power to recover over $200 million of deferred excess power costs.

Q: Mr. Gaines' testimony also describes a capital structure for PSE in which the equity component is increased to 45%? Would you comment on this testimony?

A: Given the extreme debt cost penalties and lack of financial flexibility associated with the loss of investment-grade ratings, building equity to prevent this loss is prudent financial planning.

Q: Describe the response of the capital markets to an unsecured debt offering from PSE versus the secured structure it typically uses?

A: In my opinion, an unsecured debt issue would be significantly more challenging and expensive than a secured debt offering to complete. There are three principal

reasons. First, PSE's unsecured debt rating (at S&P) is no longer investment-grade. Second, investors typically have a strong preference for secured versus unsecured debt when the issuer is experiencing some form of financial distress. (For example, secured utility debt has always fared well in bankruptcy.) Third, substantially all of PSE's outstanding long-term debt issues are first mortgage bonds or are collateralized by first mortgage bonds. As a consequence, unsecured debt would be subordinated to PSE's over $2 billion of outstanding first mortgage bonds. Fixed-income investors would require a significant premium to accept these risks or would decline to participate altogether.

Q: Could you describe the reaction of the equity market to PSE's need for equity under a scenario of ongoing exposure to power prices?

A: Due to ongoing regulatory uncertainty, it is difficult to put a high degree of confidence on any forecast of Puget's earnings. This lack of earnings visibility is unacceptable to most equity investors unless the share price is significantly discounted. As a consequence, a public offering of common stock would likely be challenging and cause further erosion in the share price**.**

Q: Are there any recent market examples of such equity offerings?

A: Sierra Pacific Resources, the utility holding company in Nevada, issued 20.5 million shares at a price of $15 per share on August 10, 2001. The company's book value per share, as of June 30, 2001, was $16.90 per share. Hence the new issue share price was 89% of book value.

V. PSE'S RETAIL RATE PROPOSALS

Q: Does PSE need a tracker (or a hedged rate) in order to attract capital on reasonable terms?

A: Yes. A mechanism for ensuring the full and timely recovery of PSE’s ongoing power costs is essential to restoring the Company’s financial integrity. I believe

that the recent changes in the wholesale power markets and the resulting power cost volatility have been of sufficient severity that this type of mechanism is required. Over the past several months, the credit rating agencies and financial markets have exhibited significant concern about PSE's deteriorating financial condition. Absent a mechanism that provides framework for recovery of power costs, PSE's capital costs will continue to rise, and PSE runs the further significant risk of being denied access to capital as the Company's risk profile deteriorates. Such a regulatory mechanism is also needed to send a strong signal to the financial markets that the Commission is aware of the financial challenges facing utilities in Washington state and is willing to address these challenges through a balanced approach to cost recovery.

Q: Do you have evidence that the rating agencies would view a tracker mechanism constructively?

A: Yes. In Moody's review of Avista's ratings, the agency comments on the importance of a "favorable outcome of the general rate filing" that provides "a power cost adjustment mechanism to create more certainty surrounding recovery of Avista's power supply costs incurred to serve its customers in the Washington jurisdiction."

Similarly, S&P comments in its report: "clearly Avista needs a strong show of regulatory support in the form of a rate order that addresses the current cost under-recovery and provides a supportive regulatory framework that addresses the evolving and volatile nature of the electric utility industry."

Q: Does this conclude your testimony?

A: Yes.

[BA013220.014]

EXHIBIT NO. _____ (HLH-2)
DOCKET NO._____
2001 PSE RATE CASE
WITNESS: HOWARD L. HILLER

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

PROFESSIONAL QUALIFICATIONS OF HOWARD L. HILLER ON BEHALF OF PUGET SOUND ENERGY, INC.

PUGET SOUND ENERGY, INC.

PROFESSIONAL QUALIFICATIONS OF HOWARD L. HILLER

Q: Please state your name, business address, and occupation.

A: My name is Howard L. Hiller. I am a Managing Director in the Fixed Income Capital Markets Group of Salomon Smith Barney Inc. ("Salomon Smith Barney"). My business address is 390 Greenwich Street, New York, New York 10013.

Q: Describe your responsibilities in your current position, your educational background, and your professional experience.

A: In 1986, I joined Citicorp Investment Bank as an Assistant Vice President in the Municipal Finance Group. In July 1987, I joined Salomon Brothers and spent five years as a Vice President in the Financial Strategy Group. During that time, I worked with utility and industrial clients on fundamental financial policy issues, including capital structure, dividend policy, rating agency strategy and debt/liquidity management. In 1992, I moved to Salomon Brothers' Fixed Income Capital Markets Group, focusing on the coverage of our electric, gas and power industry clients from a fixed-income perspective. For example, during the first ten months of 2001, I assisted our utility clients in the issuance of over $7.6 billion of debt and preferred securities in which Salomon Smith Barney acted as a lead-manager. In addition, in 2001 I also worked on $4.7 billion of so-called "stranded cost securitization" transactions involving five utilities, for which Salomon Smith Barney acted as a lead-manager.

Q: Have you or your firm provided investment banking services to Puget Sound Energy ("PSE" or "the Company") during the last 18 months?

A: Yes. On May 18, 2001, Salomon Smith Barney acted as a co-manager on a $200 million offering of Trust Originated Preferred Securities (TOPrS). On November 1, 2000, we acted as a joint lead-manager on a $260 million offering of

11-year medium-term notes. On August 31, 2000, we acted as lead-manager on a $25 million offering of 7-year medium-term notes.

Q: Have you acted as a witness in any other utility proceedings?

A: In August 2001, I submitted direct testimony in support of PSE's petition for interim rate relief, Washington Utilities and Transportation Commission, Cause Nos. UE-011163 and UE-011170.

In July 2000, I submitted direct testimony in Detroit Edison's application for a financing order to issue securitization bonds under the Michigan electric restructuring legislation. I have also participated in two similar filings for PECO Energy's issuance of Transition Bonds during 1997.

In preparing this testimony, I have incorporated parts of my August 2001 testimony in response to the same or similar questions. In so doing, I carefully considered each question, reviewed my prior testimony and, in some cases, supplemented my prior testimony. In particular, I have included recent rating agency announcements concerning both PSE and Avista.

[BA013220.014]