EXHIBIT NO. ___(BAV-1T)
DOCKET NO. UE-04____/UG-04____
2004 PSE GENERAL RATE CASE
WITNESS: BERTRAND A. VALDMAN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-04____** **Docket No. UG-04____**

PREFILED DIRECT TESTIMONY OF
BERTRAND A. VALDMAN (NONCONFIDENTIAL)
ON BEHALF OF PUGET SOUND ENERGY, INC.

APRIL 5, 2004

PUGET SOUND ENERGY, INC.

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PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY OF BERTRAND A. VALDMAN

I. INTRODUCTION

Q: Please state your name, business address and present position with Puget Sound Energy, Inc.

A: My name is Bertrand A. Valdman. My business address is 10885 NE 4th Street, P.O. Box 97034, Bellevue, WA 98009-9734. I am the Senior Vice President Finance and Chief Financial Officer for Puget Sound Energy, Inc. ("PSE" or "the Company").

Q: Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?

A: Yes, I have. It is Exhibit No. ___(BAV-2).

Q: What are your duties as Senior Vice President Finance and Chief Financial Officer for PSE

A: I have overall responsibility for the financial management and financial health of PSE.

Q. Please summarize the purpose of your testimony.

A. I address three main items. First, I address the Company's financial strategy and needs. Second, I discuss interests and concerns of investors and the market with regard to the Company. Finally, I discuss the need for the Company's requested rate relief to improve the Company's financial strength.

II. THE COMPANY'S FINANCIAL STRATEGY

Q. What is the Company's financial strategy?

A. The Company's financial strategy is designed to generate stable earnings and cash flow to: (i) make cost-effective investments in energy delivery infrastructure to assure reliable service; (ii) support risk management strategies to manage commodity price volatility and maintain low rates; (iii) execute long-term resource acquisitions to support the energy needs of a dynamic customer base; (iv) realize the Company's authorized return on equity to provide investors with a reasonable return on equity commensurate with risk; and (v) assure access to the capital markets on a competitive basis to support strategic initiatives.

Through the rate relief requested in this case, the Company seeks to attain greater financial stability and flexibility to better serve customers over the long term. A more stable capital structure results in better access to the capital markets and a lower overall cost of capital. A lower overall cost of capital provides direct benefits to customers through lower rates over time. This is particularly true for utilities, such as PSE, with significant infrastructure investment requirements. A strong capital structure will also provide the Company with greater ability to access long-term fuel supply contracts as well as physical and financial hedging products to manage the price volatility associated with PSE's power and natural gas portfolio.

Q. What steps has the Company taken since its last rate case to rebuild its financial strength?

A. The Company has taken substantial steps to improve its financial condition, as discussed in the testimony of Mr. Donald E. Gaines, Exhibit No. ___(DEG-1CT), prior to requesting that the Commission grant the Company additional relief from ratepayers. In doing so, the Company has been able to meet the equity structure targets established in the last rate case well ahead of schedule.

A. Investments to Support Infrastructure Growth, Risk Management, and Long-Term Acquisition Strategies

Q. What is the Company's strategy to provide customers with reliable energy at reasonable, stable prices?

A. To accomplish the goal of providing customers with reliable energy at reasonable, stable prices, the Company is attempting to (i) be more self-sufficient in energy generation by adding to its resource base; (ii) minimize power and gas cost volatility through portfolio and risk management initiatives; and (iii) invest in delivery infrastructure.

<u>1. Attaining Self-Sufficiency in Energy Generation Resources</u>

Q. How does the Company plan to become more self-sufficient in energy generation resources?

A. As PSE's customer load continues to grow and as existing long-term power purchase agreements expire, the Company's current power supply resources will not be adequate to meet anticipated demand. PSE's resource needs are described more fully in the Company's Least Cost Plan filed with the Commission in April 2003 and updated in August 2003.

With the collapse of the merchant energy model, there have been cancellations or delays in power plant construction that were expected to meet the region's supply needs at competitive prices. The Company can no longer exclusively look to outside parties for future power generation requirements. PSE's resource acquisition initiatives are described in the testimony of Mr. Eric Markell, Exhibit No. ___(EMM-1CT). These acquisitions are intended to ensure that PSE has the resources to serve its customers at rates that are less subject to the volatility and risk of wholesale power markets.

Q. Is the Company's current financial health adequate to support its resource acquisition efforts?

A. As discussed in further detail below, the Company's corporate credit rating is BBB-, which is barely investment grade. With a credit rating of BBB-, the Company's debt costs are greater than they would be at a stronger rating, such as

BBB+. Higher debt costs represent a burden to customers over time. Furthermore, at such a rating, market access can be limited during periods of economic or market stress. As described above, we anticipate that the Company will require significant capital to acquire resources to serve customers. In general, investors are wary of investing in companies that must undertake large capital projects while one step away from noninvestment grade status. To the extent that the Company meets resource needs through purchased power agreements, imputed debt attributable to such contracts will need to be offset by additional equity on terms commensurate with investors' risk perceptions.

Q. Could market uncertainties and risks affect the Company's resource acquisition strategies?

A. Yes. There are a number of risks faced by utilities in seeking generation resources. Such risks may result in a delay in acquiring resources and, for PSE, would result in a greater reliance on the types of market purchases discussed in the testimony of Ms. Julia Ryan, Exhibit No. ___(JMR-1T). If PSE must rely on short-term markets because of delays in the resource acquisition process, then the Company would have a greater need to engage in the risk management activities discussed below. Such hedging creates a further need for the Company to be in a stronger financial position to engage in such risk management activities.

2. Supporting Energy Risk Management Activities

Q. Why does the Company engage in energy risk management activities?

A. Risk management activities are designed to increase energy supply reliability and to reduce the Company's power and gas cost volatility. PSE's power supply portfolio contains a diverse mix of resources, as shown in Exhibit No. ___(EMM-5), with widely differing operating and cost characteristics. Power costs within this supply portfolio can be very volatile, primarily because of: (1) streamflow variation affecting the supply of hydroelectric generation; (2) reduced supply due to forced outages of thermal plants; (3) weather uncertainty affecting power usage; and (4) other variations in market conditions, such as wholesale gas and electricity prices.

Q. Is the Company's current financial condition adequate to support risk management activities?

A. No. With a corporate credit rating of barely investment grade (BBB-), the Company's physical and financial hedging capabilities are constrained. Because of the BBB- corporate credit rating, many counterparties providing these services either limit their open credit or request that the Company post collateral as a precondition to entering into transactions. With a stronger credit rating, such as BBB+, the Company believes that counterparties would be more willing to offer the Company physical and financial hedging products at more attractive terms. Furthermore, PSE would be in a much better position to agree to such terms because of the greater financial flexibility and market access provided by a stronger credit rating.

B. Providing Investors with a Reasonable Return on Equity

Q. What is the Company's currently authorized return on equity?

A. In its Ninth Supplemental Order,[1] the Commission adopted the Settlement Stipulation (Attachment A to the Ninth Supplemental Order) reached by the parties to that proceeding. The adopted Settlement Stipulation provided for an 8.76% overall return on capital based on a projected capital structure with an equity component of 40% and an authorized 11% return on common equity.

Q. Is the Company's realizing its authorized return on equity?

A. No, the Company's actual reported return on equity was 7.6% for 2002 and 7.3% for 2003, which is a full 340 and 370 basis points lower than the Company's authorized return on equity for the same time periods.

Q. Why has the Company failed to realize its authorized return on equity?

A. Many factors contributed to this result. For example, the Company has absorbed $40 million of power costs under the PCA mechanism since July 2002. In addition, the following two factors contribute to the Company's failure to realize

[1] Ninth Supplemental Order: Rejecting Tariff Filing; Approving and Adopting Settlement Stipulation; Authorizing and Requiring Compliance Filing, dated March 28, 2002, in Docket Nos. UE-011570 and UG-011571 (consolidated) ("Ninth Supplemental Order").

its authorized return on equity:

- The Company's current rate design does not adequately account for reduced energy usage per customer in its service territory, or for recovery of the Company's fixed costs for the infrastructure required to provide service to customers. Mr. James Heidell testifies regarding the effect of this rate design issue in his testimony, Exhibit No. ___(JAH-1T).

- The Commission's current use of 40-year rather than 60-year hydro data in setting a power cost baseline also contributes to this under-recovery. Dr. Jeffrey Dubin, Director of Statistical and Economic Analysis at Pacific Economics Group and Associate Professor of Economics at the California Institute of Technology, testifies regarding the available historical hydro and generation data in his testimony, Exhibit No. ___(JAD-1T).

III. INVESTOR CONCERNS

Q. Given the Company's needs to access the capital markets, what market factors and investor concerns could affect the Company's ability to strengthen its financial condition?

A. Having worked as an investment banker for J.P. Morgan for sixteen years prior to assuming the CFO position at PSE, I have completed numerous capital markets transactions under a variety of market conditions. Today, primary concerns for utility investors are: (i) the overall state of the economy and outlook for interest rates; (ii) regulatory risk; (iii) liquidity; (iv) earnings growth prospects and dividend stability; (v) commodity price volatility; (vi) required levels of capital investments in infrastructure; and (vii) legislation and litigation. *See, e.g.*, Exhibit No. ___(BAV-3).

A. Overall State of the Economy and Outlook for Interest Rates.

Q. What are current market conditions?

A. Interest rates are at 40-year lows and there is significant spread compression. That is, the debt capital markets are not differentiating between borrowers of varying credit quality to the degree that they have in the past. An increase in interest rates is widely anticipated.

Historically, utilities have underperformed in the equity capital markets during periods of rising interest rates. This relationship has existed because the financial markets historically have viewed utilities as an equity market proxy for a fixed-income investment. For this reason, a number of Wall Street sell-side equity analysts have taken a cautious stance on utility stocks.

B. Regulatory Risk.

Q. What are investors views regarding regulatory risk?

A. Investors perceive significant regulatory uncertainty. A number of utilities are seeking rate relief from their respective public utilities commissions. Investors are concerned that such utilities may not be permitted to recover in rates investments that they have made to build infrastructure or acquire resources.

At the federal level, FERC has also introduced uncertainty by taking a proactive stance on market power and power transmission issues. There is also uncertainty with respect to what business model will prevail--merchant power companies are in financial distress, a number of states have suspended and are reversing deregulation initiatives, and traditional cost of service utilities have significant infrastructure requirements. A number of environmental initiatives could further add to these infrastructure investment requirements.

Another significant regulatory risk at the federal level is the ability to license hydropower projects in an economic manner. Just this year, PSE ceased generation at the White River Project as the conditions attached to the FERC license made it uneconomical, as described in Mr. Eric Markell's testimony.

C. Liquidity.

Q. How are liquidity issues important to investors?

A. The electric industry has become increasingly reliant on gas-fired generation in recent years. Wholesale gas price volatility has also increased. These two factors have led to significantly increased liquidity requirements for utilities dependent on gas-fired generation.

D. Earnings Growth Prospects and Dividend Stability

Q. How are earnings growth prospects and dividend stability important to investors?

A. The market generally rewards publicly-traded companies which have earnings visibility and the financial strength to support dividends with higher price-to-earnings ratios.

E. Commodity Price Volatility.

Q. Are investors concerned about the Company's exposure to wholesale gas and electricity price volatility?

A. Yes, investors are concerned about utilities' exposure to wholesale gas and electricity price volatility. The Western energy crisis had a devastating effect on the utility sector in general, and particularly on utilities that were short and had to purchase gas or power when prices were high.

PSE needs to conduct risk management activities to help protect customers and shareholders against short-term commodity volatility. Furthermore, PSE needs to access capital markets to finance long-term energy resource acquisition programs to reduce the Company's exposure to volatility in the energy markets.

Finally, natural gas prices, a major fuel source for power generation, especially at the margin, have reached new historic highs in terms of price and volatility. No surprise, in light of these developments, that the credit rating agencies are sensitive to business risk in the utility sector, and have tightened their standards and require more conservative capitalization levels.

Q. Has the Company's Power Cost Adjustment Mechanism (PCA Mechanism) reduced the Company's exposure to such market volatility?

A. Yes, the PCA Mechanism helps limit the Company's exposure to power cost variability. In doing so, this mechanism is critical to the Company's efforts to rebuild and maintain its financial strength and earnings visibility. Rating agencies and equity analysts have noted the role of the PCA Mechanism in this effort:

> This is expected to provide Puget with cost stability so that it may rebuild its equity levels to targets that were agreed upon in the settlement with the WUTC Staff and approved by the Commission.

Standard & Poor's Report on PSE (July 23, 2002). Equity analysts have also noted the role of the PCA Mechanism in PSE's efforts to rebuild and maintain its financial strength:

> Puget and the WUTC agreed to the PCA mechanism in part to help Puget improve its capital structure and ROE by limiting its exposure to rising power costs.

Lazard Frères & Co. LLC, *U.S. Equity Research: Puget Energy Inc.* (Mar. 12, 2004). *See* Exhibit No. ___(BAV-3) at page 83. Having absorbed over $40 million in excess power costs, the Company expects to be limited to 1% of power cost variations through June 30, 2006, on a going-forward basis. Both investors and the Company's are relying on the continuation of the limit of the Company's exposure.

F. Condition of Delivery Infrastructure and Required Levels of Capital Investments

Q. What are investor concerns regarding the Company's delivery infrastructure?

A. As discussed in the testimony of Ms. Susan McLain, Exhibit No. ___(SML-1CT), portions of the Company's delivery infrastructure are quite old, sometimes over 100 years old. The Company is planning to make significant capital investments in delivery infrastructure over the next five years. Investors are concerned about the Company's ability to recover its fixed costs when rates are set on a volumetric basis.

G. Legislative and Legal Issues.

Q. What legislative and legal issues are of concern to investors?

A. Among the legal issues of concern to investors are changes in, and compliance with, environmental and endangered species laws, regulations, decisions and policies concerning the environment, natural resources, and fish and wildlife (including the Endangered Species Act).

As the presidential election approaches, the market will be concerned that the dividend tax implemented by the Bush administration could be in jeopardy depending on the outcome of the upcoming election, eliminating the benefits assigned by the market to yield-oriented utilities.

H. Summary of Investor Concerns.

Q. Please summarize what a utility would need to do to address these investor concerns.

A. Investors, both debt and equity, will require a high level of earnings visibility to commit capital on attractive terms. To assure earnings visibility, a utility with a back-to-basics strategy will need:

1. a clear regulatory framework;
2. service territory growth;
3. a strong capital structure; and
4. a well-articulated strategy to address commodity price volatility and support customer growth.

IV. IMPORTANCE OF THE REQUESTED RATE RELIEF

Q. Throughout your testimony, you have frequently referred to the Company's corporate credit rating. Is this the only credit rating?

A. No, in addition to the Company's corporate credit rating, the ratings agencies rate each of the Company's securities. The comprehensive credit ratings of PSE, as of March 8, 2004, are as follows:

	Standard & Poor's	Moody's
Corporate credit/issuer rating	BBB-	Baa3
Senior secured debt	BBB	Baa2
Shelf debt senior secured	BBB	(P)Baa2
Trust preferred securities	BB	Bal
Preferred stock	BB	Ba2
Commercial paper	A-3	P-2
Revolving credit facility	*	Baa3
Ratings outlook	Positive	Stable

Q. What credit ratings do the Company feel are appropriate to meet the Company's demonstrated needs?

A. To meet the Company's financing needs, the Company's corporate credit rating should be at the BBB+ level and the secured debt (senior secured debt and shelf debt senior secured) at the A- level. The Company's peers are largely at these levels.

Q. Is the Company's current credit rating adequate to serve the Company's needs?

A. No. A corporate credit rating of BBB- is the lowest rating in the investment grade category. This credit rating provides limited safety or cushion for the Company from noninvestment grade status. This is problematic for a number of reasons.

If the Company's rating were downgraded, then the Company would fall below investment-grade status, which could result in serious consequences for the Company, and, ultimately, its customers. The Company's cost of funding would increase dramatically, as demonstrated in the testimony of Mr. Donald Gaines. Additionally, some investors, such as certain institutional investors, would be prohibited from investing in the Company because of its noninvestment grade status. As discussed in the testimony of Ms. Julia Ryan, parties with which the Company currently contracts would constrain open credit extended to PSE, and would likely require the Company to post collateral to maintain its transacting activity. A downgrade would also trigger requirements to post collateral under several financial hedging instruments to which the Company is already a party. While the Company may be able to access additional credit or equity at such a time to cover these cash requirements, it would be forced to do so at the worst time, because its weakened financial condition would significantly increase the cost of such capital.

The negative consequences of a potential downgrade require the Company to take a more conservative approach to issues, such as credit policy, than it might if the Company had a stronger credit rating. For example, the Company must be vigilant to reserve its current credit facilities to meet working capital needs and the variability associated with such needs, as discussed in the testimony of Mr. Donald Gaines, rather than using up that credit by posting collateral or letters of credit to support wholesale gas and power market hedging activities.

Q. Could the Company achieve the same result by increasing the size of its credit facilities?

A. Even if the Company obtained larger credit facilities, that would not solve the problem because making use of the larger facilities would only increase the Company's risk. For example, assume that the Company were to pay the premium to double the size of its credit facilities. If the Company were then to use this larger credit facility to post collateral to support risk management activities, then its debt exposure would be significantly greater. At a BBB- corporate credit rating, any credit crisis of the Company could lead to a downgrade to noninvestment grade status, which, in turn, could trigger further collateral calls and exacerbate such credit crisis, as described above.

Q. Would there be benefits to increasing the Company's credit rating to BBB+?

A. Yes, there would be many benefits. For example, with respect to the discussion above regarding credit facilities, at a BBB+ rating the Company would be in a better position to access the market to obtain the credit facilities required to support working capital requirements and credit-backing facilities.

In addition, as described in Ms. Julia Ryan's testimony, at BBB+, the Company would have access to more open credit from counterparties. Such open credit is essentially interest-free float that reduces the need for additional credit facilities.

Q. Does the Company's requested rate relief effectively balance issues of risk and cost?

A. Yes, the Company developed its requested rate relief to optimize the balance between risk and cost by (i) requesting a capital structure consisting of 45% equity and (ii) requesting a return on equity of 11.75%, at the low end of Dr. Cicchetti's reasonable range identified in Exhibit No. ___(CJC-1T). We have chosen this lower return based on the assumption that the Commission will adopt the changes proposed by the Company to reduce the current drags on earnings. This will keep the requested rate increase as low as possible while still placing the Company in a position to achieve a BBB+ corporate credit rating.

Q. You mentioned a return on equity of 11.75%. Did you prepare a study of the appropriate return on equity for the Company?

A. Dr. Charles Cicchetti prepared the Company's analysis of the appropriate return on equity in his testimony.

Q. Do you agree with Dr. Cicchetti's suggested return on equity of 11.75%?

A. Yes, Dr. Cicchetti's suggested return on equity is reasonable. I have relied upon his suggestions in the preparation of my testimony.

V. CONCLUSION

Q. Please summarize your testimony.

A. The requested relief presented in this proceeding is necessary to help the Company to continue to rebuild its financial health. As discussed above, the Company has committed itself to significant resource acquisition program and commodity risk management initiative. The Company needs a return on equity sufficient to attract investors on reasonable terms when conditions in the capital markets are good and when they are bad. With a return of 11.75% on a capital structure comprised of 45% equity, the Company can attract this capital on reasonable terms to implement programs that are, in the long-term, beneficial to customers.

Q. Does that conclude your testimony?

A. Yes, it does.

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