

EXHIBIT NO. ___(DEG-14)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

Docket No. UG-040640
Docket No. UE-040641
(*consolidated*)

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

For an Order Regarding the Accounting
Treatment for Certain Costs of the Company's
Power Cost Only Rate Filing.

Docket No. UE-031471 (*consolidated*)

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

For an Accounting Order Authorizing
Deferral and Recovery of the Investment
And Costs Related to the White River
Hydroelectric Project.

Docket No. UE-032043 (*consolidated*)

FIFTH EXHIBIT TO THE
PREFILED REBUTTAL TESTIMONY OF
DONALD E. GAINES (NONCONFIDENTIAL)
ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 3, 2004

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**Docket Nos. UG-040640 and UE-040641
Puget Sound Energy, Inc.'s General Rate Case
for Gas and Electric Operations**

WUTC STAFF DATA REQUEST NO. 223

WUTC STAFF DATA REQUEST NO. 223:

Please describe the Company's position on the consequences of adopting a "junk bond" level of financial quality for:

- A. Transactions costs for forward deals.
- B. The ability to attract new capital for incremental PPAs and plant ownership.

Your response should include any supporting studies, analyses or other documentation.

Response:

As described in the direct testimony of Mr. Gaines, Exhibit No. ___(DEG-1T) at pages 11-12, it is very important that Puget Sound Energy, Inc. ("PSE") have some cushion in its credit rating above non-investment grade status because of its resource acquisition needs and because PSE needs continuous access to capital markets on reasonable terms. At non-investment grade status, credit spreads can be extremely wide and volatile. At non-investment grade status, PSE would have little if any flexibility to deal with factors such as: (i) credit market events; (ii) fluctuations in power costs; (iii) regulatory and political events; (iv) changes in tax laws; (v) unanticipated wholesale market developments; and (vi) force majeure events. Additionally, under these conditions, access to financial markets is unpredictable and can be quite constrained. Some investors, such as certain institutional investors, would be prohibited from investing in PSE because of its non-investment grade status. As Dr. Cicchetti describes at page 18 of his direct testimony, Exhibit No. ___(CJC-1T), the consequences can be broad ranging: "As debt cost increases and earnings erode, PSE's efforts to acquire resources and improve infrastructure will become more costly to customers, leading to a negative regulatory and financial spiral."

With respect to a utility's future acquisition of physical assets or interests in entities owning physical assets, a junk bond debt rating may adversely affect the ability of the

utility to complete the acquisition and increase the risk and cost of acquisition. At a junk bond rating, the costs of funding the acquisition would be higher than if PSE's rating were investment grade. A junk bond rating may also increase one or more of the transaction costs required to complete the construction or purchase of an asset. Transaction costs related to asset acquisition may include, but are not limited to, these costs: a) engineering services, b) environmental services, c) tax advisory services, d) accounting advisory services, e) legal services with respect to due diligence investigations, negotiation and preparation of letters of intent and terms sheets, negotiation and preparation of definitive purchase agreements and construction agreements and the preparation, filing and prosecution of regulatory filings, f) performance and other bond costs, and g) negotiation and preparation of credit support vehicles such as letters of credit and various pledges of collateral to assure performance.

A company with non-investment grade ratings may have limited access to the capital markets and may well be viewed as having increased potential to become illiquid and/or insolvent and may be viewed as unable to reasonably control or perform on its basic business model in a manner that will allow it to discharge its commercial obligations in the ordinary course of business. In such situations, the number of parties willing to transact with a company may become limited and costs and other terms and conditions may become more onerous because vendors know a company in a downward spiral may have declining control over its finances and operations. As one explains one's credit condition, financial structure, fixed charge obligations, "trigger" conditions in debt and other commercial instruments, and explores a variety of transaction structuring options to try to satisfy the credit concerns of a counterparty, many of the transaction costs noted above are likely to increase significantly. In addition, parties agreeing to work with a non-investment grade company may also require additional compensation in transactions that is not explicitly stated as being an additional cost related to credit concerns to further compensate for perceived risk.

Were an acquisition structured in a way that the developer were wanting payments over time, perhaps during the construction of the resource, then it is likely such a developer would require some form of compensation for the riskiness of the credit rating (e.g., the possibility of non-payment). This could include a premium price, pre-payments or advance funding, etc. In such an agreement, it is unlikely that the construction contractor or counterparty would accept payment risk from a non-creditworthy party and, therefore, would likely require collateral. That collateral may be difficult and expensive for a non-creditworthy utility to obtain.

With respect to acquisition of all or an interest in an operating facility, along the lines of PSE's acquisition from EPCOR of an ownership interest in the Frederickson 1 gas-fired electric generating facility, a principle obligation of the buyer is to make payment at closing upon the satisfaction of certain, defined condition precedents. Each party to the

transaction has a compelling interest in the other party's ability to perform its obligations. In the case of the Frederickson 1 transaction, EPCOR did not require PSE to post any collateral to guarantee PSE's payment obligations. Should PSE's credit rating fall to junk status, it is probable that a seller would require such collateral and such collateral may be difficult and expensive to obtain.

With respect to transaction costs for forward deals, Ms. Ryan's testimony explained that there would be a more significant reduction in credit extended to PSE in the event of a one-notch downgrade from its current corporate credit rating, to a non-investment credit rating. The estimate was \$31 million reduction of financial derivatives credit, \$100 million of gas credit and \$109 million of power credit, making a total of \$240 million. This would be the estimated consequence associated with a single downgrade. This would represent a reduction in open credit of 44% in financial derivatives credit, 67% in physical gas credit and 73% of power credit. The survey upon which the above estimate is based did not assume a rating downgrade lower than one level. But an even greater reduction in credit rating could potentially accelerate the loss of open credit to PSE as well as increase collateral requirements. PSE's ability to hedge with open credit would be greatly diminished.

Even if PSE had the ability to post collateral to meet the types of demands described above, in addition to incurring costs associated with posting of collateral, PSE would find its equity ratio eroding as the collateral posting requirements would likely add debt to PSE's balance sheet. If the amount of debt were significant enough, it could trigger still another downgrade event, which could trigger additional collateral calls.

Supporting documentation is found in the testimonies of Mr. Valdman, Mr. Gaines, Dr. Cicchetti, Mr. Markell and Ms. Ryan and related data request responses.