Exhibit _____ (LAS-1T)
Docket No. UE-011570 Interim
Witness: Lisa A. Steel

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission,	)	**DOCKET NOS. UE-011570 and UG-011571 (Consolidated)**
Complainant,	)	
v.	)	
Puget Sound Energy, Inc.,	)	
Respondent	)	
____________________________________	)	

TESTIMONY OF
LISA A. STEEL

PUBLIC VERSION

STAFF OF
WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

RE: PUGET SOUND ENERGY PETITION FOR INTERIM RELIEF

January 30, 2002
Revised February 4, 2002

1 **Q. Please state your name and address.**

2 A. My name is Lisa A. Steel. My business address is 1300 S. Evergreen Park Drive S.W.,

3 P.O. Box 47250, Olympia, WA 98504-7250.

4

5 **Q. By whom are you employed and in what capacity?**

6 A. I am employed by the Washington Utilities and Transportation Commission as the

7 Assistant Director for Energy.

8

9 **Q. How long have you been employed by the Commission?**

10 A. Since January 2001.

11

12 **I. QUALIFICATIONS**

13 **Q. Please briefly describe your educational background and experience.**

14 A. I received Bachelor of Science degree in Electrical Engineering from the University of

15 Pittsburgh in 1990. Simultaneously in 1990, I received a Bachelor of Science degree in

16 Microbiology from the University of Pittsburgh. I received a Master of Business

17 Administration degree from Tulane University in 1995. I have attended the 2001 summer

18 session of the Institute of Public Utilities. Prior to joining the Commission, I held private

19 sector positions in engineering, engineering management, finance, and finance

20 management.

21

From 1990-93 as an energy company project engineer, I was assigned to various cost center budget management duties, and project economics responsibilities. These responsibilities were also an important part of my job as an engineering manager in 1993. In 1994, during my studies for an MBA, I worked for an investment company in Russia as its Director of Business Analysis. During my studies, I served as a teaching assistant for Corporate Finance in the MBA program. After completing my MBA studies in 1995, I worked as a corporate credit analyst, then financial analyst and portfolio manager for PNC Bank's energy, mining and utility section. While there, I assisted with the development of Corporate Banking trainees.

Since joining the Staff of this Commission, I have participated in Staff's investigation of interim rate requests by Avista Utilities in Docket No. UE-010395, and Puget Sound Energy (PSE or the "Company") in Docket No. UE-011163.

Q. Please briefly describe your duties as Assistant Director of Energy.

A. I am responsible for management of caseload and budget for a group of 15 professional and professional technical staff. I research, investigate, analyze, and recommend policy and Staff positions on energy filings before the Commission. I also assist the Commission on larger policy issues.

Q. Have you testified previously before the Commission?

A. No. However, on numerous occasions I have participated in the Energy Staff's

1 presentations at open public meetings. I have helped Staff to prepare testimony and
2 exhibits in adjudications.
3

4 **II. SCOPE OF TESTIMONY**

5 **Q. What is the purpose of your testimony?**

6 A. My testimony addresses the following subjects:

7 1. Calculation and assessment of PSE's and Puget Energy's overall financial
8 situation and near-term projections.

9 2. Determination of whether PSE's proposed 21.66% interim surcharge, under
10 Schedule 128, is justified under the Commission's interim relief criteria.

11 3. Presentation of Staff's recommended interim relief in the amount of $42 million
12 with conditions.
13

14 **Q. Do you sponsor any exhibits in support of your testimony?**

15 A. Yes, I sponsor Exhibits ___(LAS-2), ____(LAS-3), ____(LAS-4C), ____(LAS-5),
16 ___(LAS-6), ____(LAS-7C), ____(LAS-8), and ____(LAS-9C), ___(LAS-10C),
17 ____(LAS-11C), ____(LAS-12), and ____(LAS-13), ___(LAS-14C), and ____(LAS-
18 15C).
19
20

1 **Q. Please summarize your conclusions.**

2 A. The Company does not meet all of the traditional Commission criteria for interim rate
3 relief. However, these are unusual times, in recognition of which I recommend interim
4 rate relief under a broad interpretation of the Commission's public interest criterion for
5 interim relief. The Company faces several difficult quarters following an extended
6 period of healthy earnings. Absent interim rate relief, the Company has options, albeit
7 impaired options, to access the financial markets and to continue operations necessary to
8 carry out its public service obligations until the 4th quarter (Q) 2002 when its new general
9 rates will go into effect.

10 Based on corrections and modest modifications to the Company's projections, I
11 recommend an interim surcharge of $42 million to assist the Company with its near-term
12 overall operational cash flow needs. I recommend that the Commission condition the
13 surcharge with a set of regulatory covenants to reduce the utility's near-term financial
14 risk. These regulatory covenants are recommended to ensure that surcharge revenues are
15 used for regulated operations, and that the Company progresses toward the 45% equity
16 ratio it requests in its general rate case filing. I recommend that the Commission allow
17 the Company to choose whether or not to accept the surcharge as conditioned.

18

19

1 **Q. In your analysis of PSE's filing, did you analyze whether any of the costs incurred**
2 **by PSE were prudent, or should be subject to refund?**
3 A. Staff's analysis raises some issues related to both prudence and refunds for the
4 Commission to consider in the interim phase of this docket. Those issues will be
5 addressed by Staff witness Merton Lott. Mr. Lott also addresses the surcharge mechanism
6 for recovery of any interim rate relief the Commission may grant.
7
8 **III. OVERVIEW OF COMPANY PRESENTATION**
9 **Q. What is the annual dollar impact of PSE's requested surcharge?**
10 A. The 21.66% surcharge represents an increase in revenue requirements of $170,727,000
11 over the rates the Company is currently charging. Response to Bench Request 1.1.
12
13 **Q. How does PSE arrive at the $170,727,000 figure?**
14 A. I have summarized this calculation in Exhibit ___(LAS-2). A full description of the
15 calculation is contained in the exhibit.
16
17 **Q. On what basis has PSE sought to justify its request for a 22% surcharge?**
18 A. The Company claims that it requires $280 million in new external financing in 2002,
19 which it cannot obtain on other than "extractive and unreasonable terms." Petition, page
20 4, lines 8-12. The Company identifies $163.1 million in under-recovered power costs
21 over the period, January 1, 2002 through October 31, 2002, and claims that "[w]ithout

1 degrading the quality of the service it provides, PSE has little or no ability to reduce its

2 overall operations costs." Petition, page 5, lines 4-6 and 10-11.

3

4 **Q. Please summarize the Company's testimony in support of its requested interim**

5 **relief.**

6 A. Mr. Hawley states that without interim rate relief: (1) the Company's book equity will

7 continue to erode; (2) the Company will be unable to issue new first mortgage bonds

8 because it will have violated its 2 times (x) interest coverage test by January 2002;

9 (3) unsecured financing will only be available to the Company at "extractive" rates; and

10 (4) the ratings agencies are poised to downgrade the Company without regulatory support

11 evidenced by interim relief. Exhibit ___(RLH-IT) page 1, lines 25-26; page 2, lines 9-11,

12 15-19 and 23-25.

13

14 **Q. Please summarize your concerns with the Company's testimony.**

15 A. The Company ties its entire surcharge to full recovery of a single item: power supply

16 costs in excess of the costs the Company states are embedded in its general rates. The

17 Company does not tie its surcharge to a specific measure of the Company's overall

18 financial health, or to a measure required for the Company to continue to issue debt

19 necessary to carry out its public service obligations.

20 The Company's request, if granted in its entirety, would still result in below

21 investment grade marks in three of the four Key Credit Protection measures it identifies

1 (Funds From Operations to Total Debt, Pre-Tax Interest Coverage, and Total Debt to
2 Average Total Capital). Exhibit ___(RLH-3). The fourth Key Credit Protection
3 measure, Funds From Operations Interest Coverage, would be 3.3x, in excess of Standard
4 & Poor's (S&P) minimum investment grade range of 3.0 for average business position
5 companies. Obtaining minimum investment grade financial ratios or ratings over the
6 near term does not appear to be the object of this interim request.
7 Likewise, the level of the request is not tied to meeting the Company's new
8 indenture first mortgage bond coverage ratio. The Company's request results in a first
9 mortgage bond coverage ratio of 2.6x. This request exceeds the amount of relief required
10 for the Company to meet its 2.0x new indenture first mortgage bond coverage ratio by
11 $102.4 million, using the Company's projections and covenant interpretation. Exhibit
12 ___(RLH-3), Exhibit ___(LAS-3). The minimum surcharge required for a 2.0x new
13 indenture first mortgage bond coverage ratio at October 31, 2002 is $68.3 million, again
14 using the Company's projections.
15 Isolation of the current base level of power supply costs embedded in general
16 rates is difficult: the Company's most recent electric general rate case was in 1992, and
17 its most recent natural gas general rate case was in 1995, both prior to the 1997 merger of
18 the electric and gas utilities. The Company does not volunteer cost savings offsets in
19 other areas that could mitigate higher power supply costs. For example, the Company
20 notes it has reduced operations and maintenance (O&M) costs by $32 per customer
21 between 1995 and 2000, but does not offset these savings against increased power supply

costs. Exhibit ___(GBS-IT), page 2, lines 15-16. The administrative and general components of O&M savings contributed $21.6 million. Exhibit ___(GBS-IT), page 3, lines 15-18.

Q. Has PSE relied on any specific criteria to justify its 22% surcharge request?

A. The Company claims interim relief is in the public interest and consistent with the standards established in *WUTC v. Pacific Northwest Bell Telephone Company*, Cause No. U-72-30 (PNB). Petition, page 5, lines 17-20. The Company lists the six PNB criteria in its petition, but neither analyzes nor applies them in its petition or direct testimony.

Q. Please reiterate the PNB interim rate relief standards.

A. The Commission stated the standards as follows:

> 1. This Commission has authority in proper circumstances to grant interim rate relief to a utility, but this should be done only after an opportunity for adequate hearing.
>
> 2. An interim rate increase is an extraordinary remedy and should be granted only where an actual emergency exists or where necessary to prevent gross hardship or gross inequity.
>
> 3. The mere failure of the currently realized rate of return to equal that approved as adequate is not sufficient standing alone to justify the granting of interim relief.
>
> 4. The Commission should review all financial indices as they concern the applicant, including rate of return, interest coverage, earnings coverage and the growth, stability or deterioration of each, together with the immediate and short term demands for new financing and whether the grant or failure to grant interim relief will have such an effect on financing demands as to substantially affect the public interest.

5. In the current economic climate the financial health of a utility may decline very swiftly and interim relief stands as a useful tool in an appropriate case to stave off impending disaster. However, this tool must be used with caution and applied only in a case where not to grant would cause clear jeopardy to the utility and detriment to its ratepayers and stockholders. That is not to say that interim relief should be granted only after disaster has struck or is imminent, but neither should it be granted in any case where full hearing can be had and the general case resolved without clear detriment to the utility.

6. Finally, as in all matters, we must reach our conclusion with the statutory charge to the Commission in mind, that is to "Regulate in the public interest." This is our ultimate responsibility and a reasoned judgment must give appropriate weight to all salient factors.

WUTC v. Pacific Northwest Bell Telephone Company, Cause No. U-72-30, Second Supplemental Order Denying Petition for Emergency Rate Relief at 13 (October 1972).

IV. STAFF ANALYSIS OF PETITION

Q. Do you believe the Company's petition and testimony meet all of the criteria of the PNB test?

A. No, as I will explain in detail below.

Q. Please provide your analysis of the Company's request under the PNB standards.

A. The first criterion is that the Commission should grant interim relief only after an opportunity for adequate hearing. This matter is set for hearing on February 18, 2002.

Q. What is required by the second PNB criterion?

A. The second criterion states, "An interim rate increase is an extraordinary remedy and should be granted only where an actual emergency exists or where necessary to prevent

1 gross hardship or gross inequity." In this case, PSE asserts an emergency largely due to
2 the impact of higher power costs on its financing terms and availability.
3
4 **Q. Is there evidence of an emergency on an historical basis?**
5 A. No. For the most recent periods available XXXXXXXXXXXXXXXXXXXXXXXX
6 XXX, the Company has been and remains in compliance with all debt covenants. The
7 Company's Corporate Debt Ratings remain investment grade, commonly described as
8 BBB- or better ratings from S&P, and Baa3 or better ratings from Moody's Investor's
9 Services (Moody's). The Moody's ratings are on review for possible downgrade.
10 Several trade creditors re-examined the Company's creditworthiness without a significant
11 negative outcome. The Company continues to finance on reasonable terms during this
12 proceeding. The Company generates sufficient cash flow internally to cover necessary
13 expenses for ongoing operations, and some level of dividend payment. Staff discovered
14 little evidence of cost reductions or other emergency measures, and has discovered
15 evidence inconsistent with a claim of financial hardship on an historical basis.
16
17 **Q. How has the Company performed on its debt agreements?**
18 A. The Company has not defaulted and is not in default on any debt agreements. Response
19 to Staff Data Request 93-I; Response to Staff Data Request 95-I. The Company's debt is
20 governed by only two financial covenants: a debt-to-capitalization ratio on its line of
21 credit, and a coverage ratio on it new first mortgage bond issuances.

1 The Company is required by its $375 million line of credit agreement at the utility

2 level not to exceed a 65% debt-to-capitalization ratio. This debt-to-capitalization ratio is

3 the only financial covenant on the Company's committed line of credit. Response to

4 Staff Data Request 35, Puget Sound Energy Credit Agreement, page 37. For the most

5 recent period provided, September 30, 2001, this ratio improved to 59.4% from 60.7%

6 over the quarter ended September 30, 2000. Response to Staff Data Request 93-I. For all

7 historical periods, the Company has complied with, or would have complied with, this

8 financial ratio. Exhibit ___(LAS-4C), page 1.

9 For all periods through the most recent period for which data is available or an

10 estimate calculated, (December 31, 2001), the Company would have complied with the

11 new 2.0x issuance first mortgage bond coverage ratio. Exhibit ___(LAS-4C), page 2. It

12 is important to note that the Company is not required to meet this covenant *except prior*

13 *to the issuance of new bonded debt*. Response to Staff Data Request 35, $500 Million

14 Prospectus Supplement. This covenant does not affect existing bonds. The Company

15 was able to meet this covenant and issued $40 million 6.25% 2-year medium-term

16 secured notes on January 16, 2002. Exhibit ___(LAS-5).

17

18 **Q. What else is known about this $40 million issuance?**

19 A. On January 14, 2002, Moody's rated the $40 million 6.25% secured notes investment

20 grade (Baa1). On January 17, 2002, S&P also rated these notes investment grade (BBB).

21 Exhibit ___(LAS-6). This new issuance is priced below the Company's total blended

1 cost of medium- and long-term debt of XXXX for the most recent period available

2 6/30/2001. Exhibit ___DEG-4C; Response to Staff Data Request 52-I. The Company's

3 exhibits do not reflect the January 16, 2002 $40 million 6.25% secured note issuance.

4 This issuance reduces short-term borrowing requirements by $39.9 million ($40 million

5 less issuance costs) over the interim period.

6

7 **Q. What has happened with the Company's credit ratings?**

8 A. The Company's senior secured credit ratings are investment grade (BBB and Baa1), and

9 the Company's senior unsecured ratings are split-rated BBB- and Baa2. Response to

10 Public Counsel Data Request 66-I. Both of the split rates are considered investment

11 grade as the term is commonly used: BBB- is considered one notch above speculative

12 grade, Baa2 is considered two notches above speculative grade.

13 The Company identified several potential suppliers who base trade credit

14 extensions on corporate credit ratings. The inquiries reflect differences of opinion about

15 PSE's actual credit ratings and the definition of investment grade. The effect of the

16 Company's October 2001 ratings downgrades are limited to notices and reviews of trade

17 credit extensions by a few counterparties. Indeed, PSE itself has placed a cash and

18 financial exposure credit limits on all its counterparties since 1997. Response to Staff

19 Data Request 86-I, Energy Price Risk Policy, Section 3.4. Enron's collapse and the

20 economic recession are factors that could have prompted counterparty reviews. The only

1 independent assessment provided, PG&E's review, was favorable and has resulted in
2 resumption of trading on the same terms. Response to Staff Data Request 81-I.
3
4 **Q. What is the status of the Company's most recent effort to finance?**
5 A. The Company's financing pattern has been to file $500 million shelf registrations with
6 the SEC, complete them, then file another shelf-registration. In October 2000, PSE filed
7 a $500 million shelf registration from which it then issued $260 million 7.69% (secured)
8 10-year notes on November 9, 2000, $200 million 8.40% 40-year trust preferred stock on
9 May 24, 2001, and $40 million 6.25% 2-year secured notes on January 16, 2002, during
10 the pendency of this interim rate request. These issuances utilized the entire 2000 shelf
11 registration, so the Company must file another shelf registration in order to issue
12 additional debt or equity.
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
14 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
15 Shelf registrations require disclosures of material facts affecting financial risk of the
16 issuances. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
18
19 **Q. Does the Company have sufficient cash flow?**
20 A. The most recent information for 2001 (September 30, 2001) shows that the Company
21 generates sufficient net cash flow to cover its capital expenditures and preferred

1 dividends, excluding common dividends. Exhibit ___(LAS-7C), page 1, Net Cash Flow

2 to Capital Expense Excluding Common Dividend and Exhibit ___ (LAS-7C), page 5.

3 Net cash flow coverage of capital expenditure requirements improved in the 3rd Q2001

4 over 3rd Q2000. The Company generated $102 million more net cash flow in the first 3

5 quarters of 2001 than it generated in the first 3 quarters of 2000. Exhibit ___(LAS-7C),

6 page 1, Net Cash Flow. For the most recent period reported, September 30, 2001, the

7 Company's current ratio has improved over the equivalent quarter of the previous year.

8 The Company had XXXXXX of cash at December 31, 2001, XXX times the cash the

9 Company estimated it would have at December 31, 2001 in its prefiled testimony and

10 exhibits. Response to ICNU Request 1.7, page 2. By these measures, the Company's

11 liquidity has improved.

12

13 **Q. Can you provide examples of steps a utility would typically take during times of**

14 **financial emergency?**

15 A. Specific steps include: hiring freezes, job cuts, discretionary capital expenditure

16 deferrals, bonus restructurings, working capital changes to preserve cash, nonessential

17 asset sales, foregone acquisitions, account factoring, dividend reductions and cash

18 payment substitutions.

19

20 **Q. What steps has the Company taken to prepare for a financial emergency?**

21 A. Staff sought evidence of an historical emergency but found none. Staff asked the

1 Company what specific steps it is taking, beyond filing for emergency relief, to address a
2 financial emergency. The Company's Response to Staff Data Request 54-I, (Exhibit
3 ___(LAS-8)), reveals little evidence of a financial emergency, or steps taken to prepare
4 for one. Response to Staff Data Request 183-I. The Company notes executive bonuses
5 will decline below "target levels of payment" in 2002 absent interim rate relief. The
6 targets used to determine those bonuses are based on XXX results, and were formed in
7 general terms as early as XXX, (Response to Staff Data Request 43-I, 1998 Rating
8 Agency Book, page II-5), rather than formed in response to a current emergency.
9 Response to Staff Data Request 55-I. Discovery has not yet revealed how the grant of
10 interim relief would affect that singular cost reduction.
11
12 **Q. What other evidence inconsistent with a financial emergency exists?**
13 A. Rather than divesting of noncore assets to generate cash, the utility parent company,
14 Puget Energy, rapidly grew its nonregulated ventures. Puget Energy's nonregulated
15 subsidiary InfrastruX assets increased from XX at 2nd Q2000 to XXXXXXXXX at 3rd
16 Q2001. Response to WUTC Staff Data Request 18-IC. On December 7, 2001 InfrastruX
17 purchased Skibeck for XXX million. Response to Staff Data Request 59-I.A. Puget
18 Energy's equity interest in InfrastruX is XXXXXXXX at 3rd Q2001, not inclusive of the
19 Skibeck acquisition. Response to Staff Data Request 18-IC.
20 In addition, Puget Energy helped set up InfrastruX's $150 million line of credit on
21 June 30, 2001 as its guarantor. Staff found no evidence of Puget Energy's or the

1 Company's efforts to increase the regulated utility's $375 million committed line of
2 credit since June 2001. Staff notes that the utility had a larger credit line, $400 million, in
3 1996. Response to Staff Data Request 35-I, Credit Agreement - page 11, and
4 Amendment Number One to Credit Agreement - page 2.
5
6 **Q. Is there evidence of an imminent emergency?**
7 A. Staff's weighing of the net evidence is that absent interim rate relief, the Company is not
8 facing extreme risk, an imminent risk of inability to acquire needed capital, or clear
9 jeopardy to the utility or its ratepayers. Absent interim rate relief, the Company expects
10 no events of default under its existing debt agreements. The Company expects to comply
11 with all debt covenants, except for the *new issuance* first mortgage bond coverage ratio.
12 The Company has not claimed a loss of access to all financing. However, the
13 Company expects to lose access to some financing options during the interim period, and
14 expects to pay higher rates for remaining financing options. The Company's projections
15 show XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
16 XXXXXX. Exhibit ___(LAS-7C), page 5. Staff discovered little evidence of cost
17 reductions or other emergency measures undertaken by the Company, but has discovered
18 evidence inconsistent with a claim of imminent financial hardship. Further, Staff finds
19 evidence of options available to the utility to improve its financial situation which the
20 Company is not implementing or investigating. I will discuss this evidence below.
21

1 **Q. Are projections a part of the analysis for interim rate relief?**

2 A. Yes. The Commission will accept evidence of existing and actual conditions and short-
3 range projections for interim relief. *WUTC v. Washington Water Power*, Cause No. U-
4 80-13 (June 1980). The Company did not provide comprehensive pro-forma financial
5 statement projections in its direct testimony. The Company has provided selected
6 financial ratios, and detailed projections and calculations for certain of its expenses, such
7 as power supply costs. Additional information has been made available through
8 discovery.

9

10 **Q. What do the projections show about the Company's ability to issue new secured**
11 **debt?**

12 A. For the most recent period available, the Company is in compliance with all debt
13 coverage ratios. PSE claims that, absent interim rate relief, it will be "foreclosed from
14 issuing new first mortgage bonds." Exhibit ___(RLH-1T), lines 21-24. By the
15 Company's own testimony, an inability to issue new first mortgage bonds should be of no
16 direct consequence during the interim before the Company's general rate case is decided,
17 since "[t]he Company is not planning to issue any additional long-term debt between the
18 test year (June 30, 2001) and the end of the rate year (September 30, 2003.)" Exhibit
19 ___(DEG-1T), page 23, lines 8-9.

20 Should a need for first mortgage bond issuances emerge, it remains unexplained
21 why the Company has not taken the steps necessary to issue more first mortgage bonds in

1 2001, or even through 1st Q2002, in advance of violating the new issuance first mortgage
2 bond interest coverage requirement. The Company's first mortgage bond terms allow for
3 the calculation of its net earnings available for interest to be made "for a period of 12
4 consecutive calendar months within the 15 calendar months immediately preceding the
5 calendar month" in which it applies for the new bond issuance. Under this indenture
6 agreement, the Company can try to sell first mortgage bonds at least through March 31,
7 2002. Response to Public Counsel Data Request 65-I, Fortieth Supplemental Indenture,
8 Section 1.42; Response to Staff Data Request 142-I.
9 Given the Company's increasing debt burden over the period 4th Q1996 to XX
10 XXXX, it is my opinion that it would not be wise for the Company to choose to issue
11 additional debt except as a bridge to issuance of new equity. Exhibit ___(LAS-4C), page
12 1, Leverage Chart. According to the Company, it plans to issue XXXXXX of common
13 equity in November 2002, and XXXXXXXX additional common equity in 2003. Exhibit
14 ___(DEB-1T), page 18, lines 6-7.
15
16 **Q. How close is the Company to violating its debt-to-capital covenant?**
17 A. The calculation of the Total Debt to Average Total Capital ratio by S&P as shown in
18 Exhibit ___(RLH-3) is different from the calculation of the Total Debt to Total
19 Capitalization ratio for PSE's creditors as shown in Exhibit ___(LAS-9C). Generally, the
20 calculation of Total Debt to Total Capitalization for creditors is lower than the calculation
21 of Total Debt to Average Total Capital for S&P, since S&P imputes some purchased

1 power costs as debt. This distinction is important, since the S&P Total Debt to Average
2 Total Capitalization ratio (64%) in Exhibit ___(RLH-3) appears closer to the 65%
3 revolving credit covenant than the Company's actual covenant ratio XXXXXXXX.
4 According to the Company's projections, the Company will have XXXXXX of cushion
5 above its Total Debt to Total Capitalization covenant requirement at 4th Q2002. The
6 Company is XXXXX to violating this covenant.
7
8 **Q. What other evidence is inconsistent with the existence of an imminent financial**
9 **emergency?**
10 A. The Company's 2002 Capital Budget, approved in early January 2002, XXXXX from
11 XXXXXXX approved in 2001 to XXXXXXXX requested for 2002. Response to Staff
12 Data Request 66-I - Supplement. Included in the 2002 Capital budget is XXXXXX to
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. Response
14 to Staff Data Request 98-I. The Company's December 2001 report shows a cash loss on
15 the existing PEM program since the incremental costs of the program, such as meter
16 reading, are not recovered by the thin spread between peak- and off-peak periods. Staff's
17 understanding of the PEM contract is that XXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXXXXXX.
19 The Company's 2002 Operations and Management budget, approved in early
20 January 2002, XXXXXXXXX from XXXX million in 2001 to XXXX million in 2002 on
21 XXXX 2002 revenues. Response to Staff Data Request 68-I - Supplement. Included

1 among the XXX are an XXXXXXXXXXXX for corporate services, XXXXXX for
2 customer operations center, and XXXXXX for the PEM pilot program. Response to
3 Staff Data Request 98-I. The contract for the PEM pilot is XXXXXXXXXXXXX
4 XXXXXXXXXXXXXXXXX. The Company has proposed to increase the pilot, and
5 thereby lower its earnings.
6
7 **Q. Is there any other evidence inconsistent with a claim of an imminent financial**
8 **emergency?**
9 A. Yes. According to the Company's SEC Form 10Q for the period ended September 30,
10 2001, "The Company is continuing to grow the specialized contracting services business
11 through acquisitions." In the 3rd Q2001, InfrastruX acquired five utility construction
12 companies for a total price of $71.4 million. Since Puget Energy is an important source
13 of financing (through common equity) for both its regulated and nonregulated ventures, a
14 high level of acquisitions is inconsistent with a claim of financial hardship. At
15 September 30, 2001, Puget Energy had XXXXXXX in shareholder equity book value in
16 InfrastruX Group, Inc., which could have been or could be sold to improve liquidity.
17 Response to Staff Data Request 18-IC.
18
19

1 **Q. If InfrastruX is nonregulated, why are its nonregulated acquisitions of concern to**
2 **the regulated utility?**
3 A. The regulated utility continues to provide 100% of the holding company's dividend.
4 Response to Public Counsel Data Request 72, last page. Puget Energy has made no
5 investments in the regulated utility since the holding company was created. Puget
6 Energy's pursuit of higher-risk activities increases its consolidated business risk. Puget
7 Energy's relative investments in the utility and InfrastruX reveal that the parent company
8 assigns a lower priority to the utility's need for capital than for nonregulated venture
9 needs.
10 Staff is concerned about shifting of regulated benefits and opportunities to
11 nonregulated businesses, and shifting of nonregulated costs to the regulated business. For
12 example, Puget Energy allocated XXX Selling, General and Administrative expense
13 (SG&A) to InfrastruX prior to March 31, 2001, during InfrastruX's period of rapid
14 growth. Response to Staff Request 18-IC. The Company states that InfrastruX was part
15 of the utility prior to January 1, 2001; however, this does not explain a XXX allocation of
16 SG&A to InfrastruX. The Company allocated more than XXX of InfrastruX's revenues,
17 net income, and assets when it transferred the subsidiary to Puget Energy. XXXXX
18 executive SG&A should be allocated to InfrastruX. The Company admits that some
19 InfrastruX employees use PSE facilities. Response to Staff Data Request 96-I.
20 Meanwhile, the utility is divesting of the types of utility service businesses that
21 InfrastruX is acquiring. Docket Nos. UE-010526 and UE-010824.

1 **Q. Have the parent Company's nonregulated acquisitions slowed?**

2 A. The December 2001 issue of Electric Light & Power quotes the Company's Chairman
3 and then-CEO Bill Weaver: "Presently, (InfrastruX) has annual revenues of $250 million.
4 And in the next several years it will do a billion dollars worth of business annually."
5 Exhibit ___(LAS-10), Electric Light & Power article. The source of funds for these
6 ventures is unclear. Response to Staff Data Request 103-I.B. The Commission has no
7 assurances that PSE will not use an interim surcharge to increase the amount it pays in
8 dividends to assist the parent company to continue with its nonregulated spending.

9

10 **Q. Is the Company unable to finance?**

11 A. The Company has not identified any specific barrier to its issuance of additional debt
12 except for the new issuance first mortgage bond financial covenant and PSE's statements
13 regarding extractive rates. The Company has not presented evidence that it has fully
14 investigated its financing possibilities. Staff has not discovered any documented
15 evidence that the Company's attempts to issue additional debt have been rebuffed by
16 arrangers and investors. Responses to Staff Data Requests 24-I.B, 30-I, 31-I, 63-I and
17 64-I.

18

19 **Q. Is the Company unable to issue equity?**

20 A. The Company is a publicly traded company that has access to the capital markets. At
21 January 25, 2002, Puget Energy's stock traded at XXXX book value. Exhibit ___(LAS-

1 11C). The Company has the cash required for an arrangement fee should management
2 choose to accelerate its planned November 2002 equity issuance. Response to Staff Data
3 Request 22-IC. The Company regularly issues stock through its dividend reinvestment
4 plan (DRIP), and places no price boundaries on those issuances. Response to Staff Data
5 Request 23-I. The Company claims its stock price is "artificially low" at this time, but
6 the Company has not identified any specific barrier to its issuance of new equity.
7 Response to Staff Data Request 20-I.A and B; Response to Staff Data Request 22-I.A.
8 The Company has not presented evidence that it has fully investigated a near-term
9 equity issuance. Response to Staff Data Request 20-I.C and D; Responses to Staff Data
10 Requests 22-I.B and 24-I.A. As with the debt issuance, Staff has not found any
11 documented evidence that the Company's attempts to issue new equity have been
12 rebuffed by arrangers and investors. Responses to Staff Data Requests24-I.C and 31-I.
13
14 **Q. Why should the Company try to issue new equity?**
15 A. In order to preserve cash and weather its stated financial crisis.
16
17 **Q. What would happen if the Company tried to issue new equity?**
18 A. The Company must issue over $450 million in new equity by the end of the rate year (3rd
19 Q2003), in order to achieve a 45% equity ratio. Exhibit ___(DEG-1T), page 18;
20 Response to Staff Data Request 19-I.B. A 44.76% equity ratio is the pro-forma capital
21 structure of the combined electric and gas company on which PSE's authorized rate of

1 return was based. Response to Staff Data Request 50-I. Accelerating the planned equity
2 issuance could improve the Company's financial risk. My calculation of a new equity
3 issuance of $202 million of common shares on January 25, 2002 would dilute the share
4 price from $22.61 to XXXX, where it would trade at XXXX book value. Exhibit
5 ___(LAS-11C). The Company states that it considers values at or near $20 per share or
6 less "extremely discounted values" but has not provided the basis for that assessment.
7 Exhibit ___(RLH-1T), page 5, line 7; Response to Staff Data Request 26-I.A.
8
9 **Q. Are there other ways the Company could try to preserve cash?**
10 A. Another way for the Company to preserve cash and minimize its financing needs is to
11 issue a partial stock dividend. Response to Staff Data Request 25-I. Sixteen percent of
12 the Company's current investors prefer a stock dividend, but the Company has rejected
13 issuance of a stock dividend to all investors during the requested interim relief period.
14 Response to Staff Data Request 25-I.A and D.
15
16 **Q. Is there anything else you would expect the Company to do to help itself in a**
17 **financial emergency?**
18 A. The Company could reduce its dividend. The Company has not performed financial
19 calculations modeling dividend reduction scenarios. Responses to Staff Data Requests
20 36-I and 104-I; Response to Public Counsel Data Request 54-I. JP Morgan Securities
21 Inc. Equity Research notes that the Company's dividend to earnings "payout ratio is well

1 above industry averages – 83% by [J.P. Morgan's] calculations, versus an industry

2 average of 49%." Response to Staff Data Request 9 in Docket No. UE-011163, May 25,

3 2001 Report. ValueLine notes that the Company has "one of the highest (dividend)

4 yields of any utility equity, at nearly 8%" and that "such a lofty yield frequently suggests

5 the risk of a dividend cut." Response to Staff Data Request 9 in Docket No. UE-011163,

6 August 17, 2001 Report. I agree with the Company's statement in its 1999 Annual

7 Report to Shareholders at page 19 that, "[f]uture dividends will be dependent upon

8 earnings, the financial condition of the Company and other factors." The Company's

9 dividend payout ratio deserves a closer look from the Company's management.

10

11 **Q. Would the grant of immediate rate relief *cause* gross hardship or gross inequity?**

12 A. Possibly. Higher electric bills will cause some customers hardship. The requested

13 surcharge would result in the second highest rates charged by a major Washington

14 electric utility. Exhibit ___(LAS-12). Of particular concern is the impact on the

15 Company's 98,800 commercial customers, some of whom are already facing margin

16 pressures in light of the state's economic downturn.

17

18 **Q. Has the Company provided information that a higher cost of debt in light of a**

19 **downgrade would result in higher cost to the ratepayers as compared to its**

20 **surcharge request?**

1 A. The Company has not shown whether pass-through of higher cost of debt is more or less
2 cost effective to customers than a 21.66% surcharge.
3
4 **Q. Have you evaluated whether granting interim rate relief would cause gross hardship**
5 **or gross inequity?**
6 A. Exhibit ___(LAS-13) quantifies whether higher costs of debt are more or less cost-
7 effective to ratepayers than a 21.66% surcharge. The interest cost calculations are
8 general in nature and subject to error. Yet this analysis is useful to highlight the high
9 hurdle for interim rate relief for a company which claims only increased financing costs,
10 rather than an inability to finance.
11
12 **Q. What is the cost for additional financing in 2002?**
13 A. I agree that the Company will likely have difficulty obtaining capital on terms as
14 attractive as it has in the past. Nevertheless, if the Company is able to obtain interim
15 financing, even on terms it describes as "unreasonable and extractive," and even with
16 noninvestment grade credit, no interim rate relief would cost less to the ratepayers than
17 the grant of interim rate relief.
18 According to the general rate case testimony of Mr. Donald Gaines at page 13,
19 increased costs on the Company's $375 million credit line are $187,000 so far. Also
20 according to the general rate case testimony of Mr. Donald Gaines at page 5, "the
21 Company's cost of debt as reflected in the current spreads over Treasury securities for

10-year debt is 250 basis points, which is 60 basis points higher than the current 190 basis point spread for similarly rated utility debt." Even if the full amount of increased debt costs is passed onto ratepayers, an additional 60 basis points on $240 million of debt costs just $1.44 million per year. Increased debt costs on the surcharge amount will likely cause less hardship to ratepayers than the surcharge and its associated time value of money.

The Company defines "very unfavorable," "extractive and unreasonable" financing terms as 100 basis points (bp) over the interest rate it could have obtained prior to October 2001. Responses to Staff Data Requests 28-I, 29-I and 105-I. $2.8 million is the cost of 100 bp on the entirety of the $280 million of new financing for 2002. Possibly the premium for unsecured debt over secured debt is an additional 40 bp, although that may be included in the 100 bp. Assuming it is not, the additional costs for financing are $3.92 million. My calculations are not precise, and the Company has better access to its true financing options than Staff. Yet, the picture that emerges is that the financing options available to the Company are likely less expensive than the proposed surcharge of over $170 million.

Q. What is your analysis under the third PNB criterion?

A. The third criterion states: "The mere failure of the currently realized rate of return to equal that approved as adequate is not sufficient standing alone to justify the granting of interim relief." The Company's projections show a lagging 12 months average rate of

1 return (ROR) of XXXX for the period January 31 through October 31, 2002, with a nadir
2 at XXXXXXXXXXXXXX Exhibit ___(RLH-1T) page 8; detail shown in Response to
3 Public Counsel Data Request 62-I, page 28. XXXXXXXXXXXXXXXXXXXXXXX
4 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
6 Exhibit ___(LAS-7C), page 1, Return on Equity (ROE). The Company's concern about
7 its return is appropriate, but can be adequately addressed in the general rate case
8 proceeding.
9
10 **Q. What is your analysis under the fourth criterion?**
11 A. The fourth criterion states the Commission will "review all financial indices as they
12 concern the applicant, including rate of return, interest coverage, earnings coverage and
13 the growth, stability or deterioration of each, together with the immediate and short term
14 demands for new financing and whether the grant or failure to grant interim relief will
15 have such an effect on financing demands as to substantially affect the public interest."
16
17 **Q. Which financial indices of PSE are of concern in this case?**
18 A. All of the "Key Credit Protection" measures affect the pricing, but not the availability, of
19 the Company's $375 million committed, unsecured line of credit agreement, since pricing
20 of that debt is tied to the Company's senior secured S&P and Moody's senior secured
21 long-term debt ratings. That line of credit is scheduled to expire if not renewed on

February 13, 2003, several months after the completion of the Company's general rate case.

Q. What is the nature of the covenants the company must satisfy in order to finance as it proposes?

A. The Company is required to comply with the debt-to-capitalization ratio financial covenants under its line of credit agreement. The Company is required to meet a 2.0x interest coverage test prior to the issuance of *new* first mortgage bonds. These are the only financial covenants, aside from general covenants. The Company has no debt agreements at the parent company which are used to finance the regulated utility. The Company expects that it, and every subsidiary (direct and indirect) of Puget Energy, will comply with all covenants absent interim rate relief, excepting the new issuance first mortgage bond coverage covenant. Responses to Staff Data Requests 142-146.

Q. What is the Company's current credit rating?

A. On October 8, 2001, S&P downgraded the Company's senior secured debt from A- to BBB+, and its corporate credit rating from BBB+ to BBB, each with a negative outlook. On October 30, 2001, S&P downgraded the Company's senior secured debt from BBB+ to BBB, its corporate credit rating from BBB to BBB-, and its senior unsecured shelf debt from BBB- to BB+, each with a negative outlook. The BB+ rating was considered speculative rather than investment grade.

1 On October 9, 2000, Moody's placed the Company's debt ratings under review.
2 On October 26, 2000, Moody's noted that it is continuing its review of the Company's
3 ratings. Response to Public Counsel Data Request 66-I. Moody's updated its opinion on
4 January 14, 2002, but did not take any rating action on the Company's existing debt.
5 In summary, the S&P ratings are one to two notches below Moody's, which is
6 called a single and a double split rating, respectively. Often the borrower gets the benefit
7 of the higher rating on a single split, and the median of the ratings that are double split.
8
9 **Q. How is the Company's existing debt affected by its current credit rating?**
10 A. Approximately $2.2 billion, or the vast majority, of the Company's debt is unaffected by
11 its current credit ratings, as it is fixed-rate first mortgage bond debt. The interest rate of
12 the Company's line of credit is slightly affected, but its availability is unaffected.
13 Response to Staff Data Request 172-I. Interest rate, terms and availability of *new* debt
14 and uncommitted debt are affected by the credit ratings, but the impact on cost is small,
15 especially for short-term debt.
16
17 **Q. Is cash interim rate relief required to help the Company's credit ratings?**
18 A. The Company agrees with S&P that, "ratings represent an art as much as a science."
19 Exhibit ___(DEG-1T), page 8. As such, Staff cannot predict what actions ratings
20 agencies will take in response to a grant or denial of interim rate relief. However, on the
21 side of caution, ratings seem to fall faster then they rise.

1 **Q. What do you predict will happen to the Company's debt ratings absent interim rate**
2 **relief?**
3 A. I cannot predict. Moody's ratings of PSE debts are under review for possible downgrade.
4 S&P's ratings of PSE's debt are not on credit watch.
5
6 **Q. What is the trend in the Company's financial ratios?**
7 A. For the discussion that follows, I will focus on the Company's projections presented in its
8 testimony and accompanying workpapers. Exhibit ____ (LAS-7C), page 1 shows that at
9 least two of the Company's four "Key Credit Protection" ratios have been below the
10 minimum investment grade range since 4th Q1997. In addition to these key ratios, the
11 Company's first mortgage bond coverage covenant and net cash flow ratios show
12 important trends.
13 Funds From Operations to Total Debt fell to 11.1% in 4th Q1997, and never
14 recovered to an investment grade level. Over the near term, XXXXXXXXXXXX this
15 ratio to XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
16 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. Exhibit
17 ___(LAS-7C), pages 1 and 2.
18 Funds From Operations Interest Coverage follows a similar trend. This ratio fell
19 to 2.6x in 4th Q1997, recovering partially to just over 3.0x investment grade level. Over
20 the near term, the Company projects that this ratio XXXXXXXXXXXXXXXXXXXX
21 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX Exhibit ___(LAS-7C), pages 1 and
2 3.
3 Pre-Tax Interest Coverage has remained relatively steady, and mostly in the 2.5x
4 to 2.9x range over the historical period. XXXXXXXXXXXXXXXXXXXXXXXXXX
5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. Exhibit
6 ___(LAS-7C), pages 1 and 4.
7 Total-Debt-to-Total-Capital has exceeded S&P's minimum investment grade
8 benchmark since the 4th Q1998, generally trending upward. Exhibit ___(LAS-4C), page 1
9 and ___(LAS-7C), page 1. "Since the merger, the equity component of the Company's
10 capital structure has eroded." Exhibit ___(DEG-1T), page 17. The Company projects
11 S&P's calculation of this ratio to reach XXXX by October 31, 2002. Exhibit ___(RLH-
12 3). XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
14 XXXXXXXXXXXXXXXXX.
15 New issuance first mortgage bonds coverage ratio has not strayed much from 3.2x
16 during the historical period. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXX Exhibit ___(LAS-4C), page 2 and Exhibit ___(LAS-7C), page 1.
19 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
20 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
21 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. The
2 Company's cash flow will be negatively impacted by $117 million in current maturities
3 of long-term debt (CMLTD), which may be difficult to refinance. The NCF ratios do not
4 take into account the CMLTD payments, if refinancing is not available. Exhibit
5 ___(LAS-7C), pages 1 and 5.
6
7 **Q. How have the ratios changed historically versus the recent past?**
8 A. The decline in key ratios started long ago (in 1997), especially Funds From Operations to
9 Total Debt and Total Debt to Average Total Capital. XXXXXXXXXXXXXXXXXX
10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
11
12 **Q. Do the covenants of the recent financings require forward looking coverage**
13 **estimates?**
14 A. Yes.
15
16 **Q. What is your analysis of the Company's projections?**
17 A. Absent interim rate relief, the Company projects it will have XXXXXXXXX outstanding
18 on its line of credit at the end of October 2002, XXXXXXX its $375 million credit limit.
19 Exhibit ___(LAS-14C), page 5. XXXXXXXXXXXXXXXXXXXXXXXXXXX
20 XXXXXXXXXXXXXXXXXXX. What the Company calls short-term debt includes

1 both its line of credit balance and some CMLTD, which is long-term debt due within one
2 year.

3 I recommend modifications to adjust the short-term debt shown on the
4 Company's projected balance sheet to a line of credit balance. The first modification is
5 to remove XXXXXXXX of CMLTD due beyond the surcharge period. This results in
6 XXXXXXXX Company projected short-term debt outstanding at October 31, 2002, XX
7 XXXXXXXXXXXXXXXX.
8
9 **Q. What other modifications to the Company's projections are required?**

10 A. I recommend removal of XXXXX of elective long-term debt redemptions during the
11 surcharge period. These elective redemptions needlessly raise the Company's line of
12 credit balance. Exhibit ___(LAS-14C), page 2 shows the required debt repayments from
13 the Company's 2000 SEC Form 10-K. This page can be cross referenced to Exhibit
14 ___(DEG-4C), page 3 to create the known schedule of required debt repayments.

15 Exhibit ___(LAS-14C), page 3 also from the Company's 2000 SEC Form 10-K
16 confirms that the total mandatory debt long term repayments is $117 million in 2002.
17 Exhibit ___(LAS-14C), page 4 shows the Company's projected "Redemptions of long-
18 term debt" and superimposes required "Redemptions of long-term debt" at the bottom of
19 the page. This page also shows that the Company projects repaying XXXXXX in long-
20 term debt in 2002, XXXXXX of it elective, with XXXXXXXXXX of those elective
21 repayments made during the January through October 2002 surcharge period. After

1 making this second adjustment, the Company's projected line of credit balance is XXX

2 XXXXXXXXXXXXXXXXXXXXXX.

3

4 **Q. What other modifications to the Company's projections are required?**

5 A. I recommend modifying the Company's projections for the actual XXXXXXXXXX

6 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. For

7 example, the Company had projected that it would have only XXXXXX cash at 4th Q

8 2001 as shown in Exhibit ___(LAS-14C), page 5. (Source: Response to Public Counsel

9 Data Request 62, page 22.) Exhibit ___(LAS-14C), page 6 shows that the Company

10 actually had XXXXXXX in cash at 4th Q2001. Adjusting this and the other working

11 capital actuals relative to projected balances results in a XXXXXXXXXX to line of

12 credit outstandings. After this third adjustment, projected line of credit outstandings at

13 October 31, 2002 is XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.

14

15 **Q. Are other modifications to the Company's projections required?**

16 A. I suggest a modest adjustment to projected Capital Expense, and another modest

17 adjustment to projected O&M Expense. As noted earlier, the projections demonstrate

18 minimal to no near-term cost-control efforts in the capital budget and O&M forecasts.

19 The Company's budget does not show much detail, but does show a XXXXXXXX in the

20 capital budget and a XXXXXXXXXX in the O&M budget over the 2001 budget. The

21 Company presented less analysis of its other costs relative to power supply. In light of its

1 request for interim rate relief, XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

2 XXXXXXXXXXXXXXXXXX, is troublesome.

3 I modified the Company's projections as detailed in Exhibit ___(LAS-14C), page

4 7, reducing 2002 2Q-4Q capital expenses by $7.8 million (3%), and 2Q-4Q 2002 O&M

5 by $9.8 million after tax (5%), for a total of $17.6 million after tax cash flow

6 improvement to offset line of credit borrowings. The impact on financial coverage ratios

7 is relatively small, but could serve to mitigate the requested surcharge. These

8 modifications are reasonable XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX After this modification, the

10 projected line of credit outstanding at October 31, 2002 is XXXXXXXXXX.

11

12 **Q. Is that the last modification?**

13 A. No, there is one more required change to deduct $40 million from the line of credit

14 balance for the January 16, 2002 6.25% senior note issuance. That leaves a projected

15 XXXXXXXXX line of credit balance at October 31, 2002, absent interim rate relief.

16

17 **Q. What about contingencies?**

18 A. Not all contingencies are negative. For example, PSE incurred large allowances for

19 doubtful accounts ($41 million at year end 2001) due to California wholesale sales. The

20 Company has a $26.6 million payment overdue from the California ISO and related

21 transaction. Response to Staff Data Request 57-I. XXXXXXXXXXXXXXXXXX

1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
2 Without any positive or negative contingencies, the Company would have an additional
3 XXXXXXXXXXXXXX on its line of credit. Note that this balance assumes that the
4 Company continues to pay all of its dividends as it has projected.
5
6 **Q. Is that enough?**
7 A. Most likely XXXXXXXX is enough, even if the Company does not make a good faith
8 effort to avail itself of its other financing possibilities. However, there is a chance that it
9 may not be enough. During 2nd Q2001, the Company endured a $106 million swing in its
10 working capital, after excluding XXXXXXX for the Schedule 48 settlement payments. It
11 is important to note that a substantial portion of that working capital swing was due to
12 non-core and arbitrage loads.
13 I hope it is unlikely, however, another power market crisis like 2000-2001 would
14 find PSE less prepared. Deducting PSE's XXXXXXXXXXXXXXXXXXXXXXXXX
15 XXXXXXXXXXXXXXXXXXXXXXXXXXXX. Adding another XXXXXXX for
16 contingencies results in my recommended $42 million surcharge as useful insurance
17 against a crisis.
18
19 **Q. Why does the first mortgage bond trend show such a dramatic decline in 2002?**
20 A. The root cause of this year's decline is addressed by Staff witness Merton Lott. From a
21 financial analysis standpoint, sales volumes are down over previous typical years (such as

1 1999), while certain expenses, such as electric fuel for generation, remain high.
2 According to the Company's projections, these expenses will be partly mitigated by year-
3 end.
4
5 **Q. Based on the one factor, first mortgage bond coverage ratio, what level of cash is**
6 **needed to bring the ratio to the required 2.0x?**
7 A. The critical issues are *when* the Company will be required to meet a first mortgage bond
8 coverage ratio, and *whether* it is in the public interest for the Company to issue, or to be
9 able to issue, additional first mortgage bond debt over the near term. The terms of its
10 first mortgage bonds indentures allow the Company to issue new first mortgage bonds
11 prior to March 31, 2002, and such issuances could stabilize the Company's financial risk
12 by replacing its excessive short term debt with longer term financing. Absent deferral
13 accounting and recovery, the Company will be unable to issue first mortgage bonds after
14 April 1, 2002 for at least 12 months, regardless of the amount of cash interim surcharge
15 granted. Since the Company does not plan to issue new debt prior to October, 2003, an
16 inability to issue first mortgage bonds over this period should not be of great
17 consequence. Exhibit ___(DEG-1T), page 23, lines 8-9.
18 Exhibits ___(LAS-3) and ___(LAS-15C) present various calculations of the
19 amount required for the Company to meet this covenant, depending on when it will be of
20 consequence, and whether the Commission accepts the level of my adjustments to the
21 Company's projections. The minimum amount is XXXXXXXX to begin October 1,

1 2002, and end October 30, 2002 when the Company's new general rates will have gone
2 into effect, which would enable the Company to issue first mortgage bonds according to
3 its stated plans. Presumably, the Company's new general rates will provide 11 months of
4 sufficient earnings such that the Company could issue new first mortgage bonds XXXXX
5 XXXXXXXXXXXX, consistent with its plans.
6
7 **Q. Do you recommend an interim surcharge to enable the Company to meet its first**
8 **mortgage bond coverage ratio?**
9 A. No. In general, the ability to issue first mortgage bonds provides liquidity, as it is another
10 source of financing, which may improve the pricing and availability of other debt
11 financing for a company. However, this Company needs equity, not debt, given its
12 particular leverage and trend as shown in Exhibit ___(LAS-4C), page 1.
13
14 **Q. Do you recommend deferral accounting to enable the Company to meet its first**
15 **mortgage bond coverage ratio?**
16 A. No. A deferral and recovery of costs over time could enable the Company to meet its
17 new issuance first mortgage bond coverage covenant, but without clear utility. The grant
18 of a deferral of power supply costs without a recovery mechanism could negatively
19 impair future utility of first mortgage bonds issuances, to the extent that the write-off of
20 costs would be pushed into future periods which could impact actual first mortgage bond
21 issuances. I recommend XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

1 XXXXXXXXXXXXXXXXXXXXX as an effective regulatory covenant to ensure that the

2 Company follows through on its stated plans for equity issuances.

3

4 **Q. Do the financial indices show a need for immediate rate relief?**

5 A. No. The Company has few debt covenants to meet. The Company is not at risk of

6 defaulting XXXXXXXXXXX. The Company should be able to issue bonds through

7 March 31, 2002 with or without interim rate relief. The Company's new issuance first

8 mortgage bond covenant XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

9 XXXXXXX, and it is not advisable to encourage the Company to acquire more debt.

10

11 **Q. What is the fifth PNB criterion?**

12 A. The fifth criterion states "In the current economic climate the financial health of a utility

13 may decline very swiftly and interim relief stands as a useful tool in an appropriate case

14 to stave off impending disaster. However, this tool must be used with caution and

15 applied only in a case where not to grant would cause clear jeopardy to the utility and

16 detriment to its ratepayers and stockholders. That is not to say that interim relief should

17 be granted only after disaster has struck or is imminent, but neither should it be granted in

18 any case where full hearing can be had and the general case resolved without clear

19 detriment to the utility."

20

1 **Q. In your opinion, is the Company facing an impending disaster?**

2 A. The Company has options to avoid financial disaster. XXXXXXXXXXXXXXXX

3 XXXXXXXXXXXXXX, which follow 15 quarters of healthy earnings. Some financing

4 options are not available to the Company at all times, such as XXXXXXXXXXXXX

5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. Other financing options are

6 not as attractively priced as they have been in the past for the Company, and are not

7 likely to be as attractively priced as they would be if ratepayers bear the full cost of the

8 Company's interim surcharge request.

9

10 **Q. What is the Commission's sixth criterion?**

11 A. The sixth, and last, criterion states: "Finally, as in all matters, we must reach our

12 conclusion with the statutory charge to the Commission in mind, that is to 'regulate in the

13 public interest.' This is our ultimate responsibility and a reasoned judgment must give

14 appropriate weight to all salient factors."

15

16 **Q. Are there public interest factors the Commission should consider?**

17 A. Every request for interim relief presents an opportunity to consider whether

18 circumstances exist that are not adequately addressed by existing standards, or ordinary

19 interpretation of those standards. For example, in Docket No. UE-010395, the

20 Commission granted Avista interim rate relief without first requiring a general rate filing.

21 I looked at the circumstances of the Company's financial condition and whether new

1 precedent is required. My conclusion is that the Company does not meet all of the
2 traditional standards regarding interim rate relief and has alternatives to the requested
3 interim rate relief.
4 However, a grant of cash relief is appropriate in view of the serious concerns
5 regarding energy markets. A grant of cash relief could help stabilize the Company's and
6 the region's energy utility financial risk. The Company XXXXXXXXXXXXXXXXXX
7 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX, but has
8 some significant debt maturities. Most importantly, the Company is not financially
9 prepared for another crisis. Other factors, such as the chilling effect of Enron's collapse
10 on some credit markets, a recessionary economic climate, and the impact failure to grant
11 relief could have on the perception of regulatory support for Washington's investor-
12 owned utilities, also support a grant of relief.
13 Therefore, I recommend cash relief of $42 million, based on the Company's
14 sources and uses of funds as shown in Exhibit ___(LAS-14C), page 1. A grant of relief
15 should come with additional temporary conditions, subject to review in the general rate
16 case proceeding. The Company would be free to accept the surcharge with conditions, or
17 reject the surcharge in its entirety.
18 I believe the regulated utility needs immediate insulation from the parent
19 Company's growing non-regulated ventures. Staff believes ratings agencies would view
20 a regulatory equity maintenance requirement on the utility as supportive of the utility's
21 credit quality. Other interim regulatory covenants which would support and insulate the

1 utility's credit quality include a requirement that all debt used to serve the utility remain
2 at the utility level.
3
4 **Q. What are your recommended conditions.**
5 A. I accept as a working hypothesis for the interim period, without prejudice for the general
6 rate case proceeding, the Company's claim that it should have a 45% equity ratio. Exhibit
7 ___(DEG-1T). For the interim period, I consider movement from the current equity ratio
8 of 31% (at September 30, 2001) to a 36% equity ratio significant progress toward that
9 goal. Therefore, I recommend that the Commission condition the Company's surcharge
10 dollars as follows: 1) if the utility's equity ratio equals or exceeds 36% following a
11 proposed dividend payment, then the utility's dividend payment to the parent is
12 unrestricted; and 2) If the utility's equity ratio falls below 36%, then the utility's
13 quarterly *cash* dividend payments to the parent should be restricted to the greater of a)
14 one-quarter of 75% of annualized net income, or b) one quarter of an annualized $100
15 million. Note that $100 million is approximately 75% of Puget Energy's current annual
16 cash dividend level. These conditions are recommended to ensure that surcharge monies
17 are used exclusively to improve the finances of the Company's regulated operations, and
18 to mitigate the risk of future surcharge requests.
19
20 **Q. Should the order permit Puget Sound Energy to continue the deferral cost**
21 **mechanism until the end of the general rate case?**

1 A. No. Staff recommends the deferrals terminate on the interim order date, and that the
2 company amortize these costs in the period incurred. Staff also recommends that any
3 surcharge be granted on the basis of restoring financial stability to the whole of the
4 utility, without attribution of recovery of a specific cost or costs. Those subjects are
5 addressed by Mr. Lott.
6
7 **Q. Does this conclude your direct testimony?**
8 A. Yes.