EXHIBIT NO. ___(BAV-1CT)
DOCKET NO. UE-06___/UG-06___
2006 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-06____ Docket No. UG-06____

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

REDACTED
VERSION

FEBRUARY 15, 2006

PUGET SOUND ENERGY, INC.

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

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

A. My name is Bertrand A. Valdman. My business address is 10885 N.E. Fourth Street Bellevue, WA 98004. 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 and for communicating with the financial community.

Q. What is the nature of your testimony in this proceeding?

A. My testimony addresses the importance of PSE's financial condition to its shareholders and customers. My testimony also provides a current assessment of PSE's financial condition and explains why improving the Company's financial condition beyond existing levels is essential to managing the business and financial risks associated with providing electric and natural gas service to PSE's customers.

II. THE NEED FOR FINANCIAL STABILITY

Q. What is financial stability and why is it important?

A. The Company's financial stability is its ability to raise capital in the financial markets and to engage in energy supply and risk management activities on reasonable terms throughout the economic cycle. This is important because market conditions vary over time as a result of economic events, industry developments, and investor sentiment.

PSE's substantial investment needs and low internal cash flow generation capacity require significant external funding. PSE competes with other entities for this capital--both within and outside the utility sector--and must offer investors and credit counterparties a balanced risk/reward opportunity.

Q. What are your primary concerns about the Company's current financial condition?

A. The Company's recent share price performance has trailed the utility reference index and peers. This tends to reduce the attractiveness of the Company to investors, and thereby threatens the Company's ability to raise equity capital.

In addition, The Company's BBB- credit rating remains one notch above sub-investment grade ratings in spite of an equity ratio of approximately 44% at year-end 2005. This credit rating is too low for a number of reasons, as discussed below. But the Company's credit rating is not likely to be increased absent the rate relief the Company is requesting in this case, as described in the prefiled direct testimony of Mr. Don Gaines, Exhibit No. ___(DEG-1T).

My concerns about the Company's financial stability are not just theoretical. It is particularly important for the Company to be able to maintain a high level of credit and capital market access at the present time because of PSE's current and near-term needs to:

(i) replace the aging components of the Company's electric and gas delivery systems;

(ii) maintain reliability and adequacy of energy supply by acquiring new electric generation resources, thereby minimizing dependence on volatile wholesale energy markets; and

(iii) enter into energy risk management transactions to mitigate energy price volatility and maintain rate stability.

These needs are further described in the prefiled direct testimonies of Ms. Sue McLain (Exhibit No. ___(SML-1CT)), Mr. Eric Markell, (Exhibit No. ___(EMM-1HCT), and Mr. David Mills (Exhibit No. ___(DEM-1CT)).

Q. Has the Company attempted to improve its financial condition prior to seeking rate relief from this Commission?

A. Yes. Since 2001, the Company has improved its equity ratio from a level of 31% to the 44% level achieved at year-end 2005 through: (i) the issuance of 25.4 million additional common shares that generated net proceeds of nearly $527 million, and (ii) by increasing its retention of earnings by lowering its dividend by 46 percent in 2002. The Company has also undertaken the cost control measures described by other witnesses in this case, including Ms. McLain, Mr. Markell, and Mr. Tom Hunt. However, the Company cannot reach the level of financial stability required to serve its customers without rate relief as requested in this case.

III. RISKS TO THE FINANCIAL CONDITION OF THE COMPANY

Q. What are the risks with respect to the company's financial condition?

A. The following risk factors impact the Company's financial condition: (i) increasing capital expenditures; (ii) low internal cash flow as a result of a depreciated asset base and a large percentage of long-term electric power purchase contracts; (iii) exposure to volatile commodity costs; and (iv) inability to actually earn the return on equity ("ROE") that has been authorized by the Commission.

A. <u>Increasing Infrastructure Capital Expenditures Required to Serve Electric and Natural Gas Customers</u>

Q. What level of capital expenditures does the Company anticipate?

A. As described in the direct testimonies of Mr. Markell and Ms. McLain, the Company must make substantial investments over the next several years to meet a growing short energy position and to maintain electric and natural gas system reliability and safety. Over the three year period of 2005-2007 alone, the Company projects investments in the $2 billion[1] range. In addition to these capital investments, the Company has a 2006 funding requirement of $89 million related to the Chelan hydro power contract as described in the direct testimony of Mr. Markell and Mr. Joel Molander, Exhibit No. ___(JLM-1HCT).

[1] PSD 10-Q, dated November 1, 2005, under caption "Utility Construction Program" totals $1.89 billion with additional potential new resources still to be determined.

Q. What is the anticipated magnitude of capital expenditures over the next ten years to meet the needs of PSE's customers?

A. The Company currently projects that between $6 billion and $9 billion in capital expenditures will be required over the next ten years to meet the energy needs of PSE's customers. Another way of looking at these projected amounts is that the Company will incur average annual capital investments of around $600 million to $900 million per year throughout the next decade.

Q. Are these significant infrastructure investments limited to investments in electric generation?

A. No. In fact, a very significant portion of the projected capital expenditures is for investment in energy delivery systems. Of the above projections, approximately $4.6 billion is for energy delivery, with 40% of such amount (approximately $2 billion) for expenditures related to system reliability and safety and 60% of such amount (approximately $3 billion) for expenditures related to system capacity and growth. The importance of investments in energy delivery systems in order to support customer growth and maintain reliable service is discussed in the testimony of Ms. Susan McLain.

Q. How fast is the growth in the Company's customer base?

A. The Company continues to experience strong customer growth in its service territory for both electric and gas customers, and the growth in gas customers has consistently outpaced the growth in electric customers.

Over the three-year period between December 31, 2001, and December 31, 2004, the number of PSE's electric customers increased by 6.4%, from approximately 940,600 to approximately 1,001,200. Over the same three-year period, the number of PSE's gas customers increased by 10.9%, from approximately 606,000 to approximately 672,000. This compares to national growth rates of approximately 4.1% for electric and 3.1% for gas customers over those same periods.

Q. Are the above capital expenditure projections related solely to generation and delivery investments?

A. No, included within the range of 10 year capital expenditures indicated above are a category of "other" investments which include investments in energy supply (existing generation), technology, facilities and environmental. The following chart provides an allocation of the range of projected capital expenditures indicated above:

	Contracted Power Scenario ($ billion)	**%**	**Resource Ownership Scenario** ($ billion)	**%**
New Resources	$[redacted]	5	$[redacted]	40
Energy Delivery	$[redacted]	79	$[redacted]	50
Other	$[redacted]	16	$[redacted]	10
TOTAL	$[redacted]	100	$[redacted]	100

Q. Are the Company's projected capital expenditures outside the range you would expect in the utility industry?

A. It is not unusual for utilities operating in regions with economic and population growth to undertake capital expenditure programs to replace aging infrastructure and address short energy positions.

However, PSE is relatively small compared to others in the utility industry, in terms of net plant, firm value, and operating cash flow. Recent industry consolidations through mergers and acquisitions further dwarfs the Company relative to other utilities in the industry. *See* Exhibit No. ___(BAV-3). The Company's anticipated capital expenditures relative to its size are substantial. To put this in perspective, PSE's net plant at December 31, 2005 was $4.6 billion. This compares to the roughly $2 billion in capital investments projected from 2005 through 2007 referenced earlier.

Q. Are there any practical consequences to your observation that PSE's anticipated capital expenditures are relatively large compared to PSE's size?

A. Yes. As described in the prefiled direct testimony of Dr. Roger Morin, Exhibit No. ___(RAM-1T), investors will demand a higher return to assume the additional risk of executing such a large investment and external financing program in a relatively concentrated period of time, especially given the Company's size.

Credit rating agencies consider size (e.g. assets, equity, diversification, etc.) in their determination of creditworthiness, with larger companies looked upon more favorably. *See* Exhibit No. ___(DEG-5) at 21-22. Retained cash flow in relation to capital expenditures is also an aspect of their quantitative analysis of risk. *See* Exhibit No. ___(BAV-4). Retained cash flow is defined as funds from operations (net income adjusted for non-cash items like depreciation) less dividends.

B. <u>Volatile Commodity Costs</u>

Q. What are the financial risk issues with respect to volatile commodity costs?

A. Commodity costs are the cost of power required to serve electric customers and the cost of natural gas required to serve core gas customers as well as to generate electricity. The cash outlay required to cover such purchases has increased significantly given the Company's short position, volatile natural gas prices, and the increasing presence of financial parties in secondary energy markets that require collateral to mitigate the Company's weak credit position. The Company's credit requirements have steadily increased as a result of these developments. These issues are addressed in greater detail in the testimonies of Mr. David Mills and Mr. Salman Aladin, Exhibit No. ___(SA-1CT).

Q. Do the Company's Power Cost Adjustment ("PCA") and Purchased Gas Adjustment ("PGA") Mechanisms remove the financial risks with respect to such commodity costs?

A. These mechanisms have reduced – but not removed – such financial risks. The PCA and PGA mechanisms have increased the Company's likelihood of recovery of such costs, but the Company must initially finance the cash outlays for such purchases until recovery in rates occurs. As commodity costs have increased, so have the Company's credit requirements. For example, despite increases in both electric and gas customer rates in 2005 through the established PCA and PGA mechanisms, the combined deferred receivable amounts have grown from $19 million at December 31, 2004 to $85 million at December 31, 2005**.** These deferrals must be financed through short term liquidity facilities.

Additionally, the PCA Mechanism, unlike the PGA Mechanism, is not a dollar-for-dollar pass-through of commodity costs. The sharing bands under the current PCA Mechanism subject the Company to a significant amount of financial risk each year with respect to power costs, many of which – such as poor hydro conditions -- the Company cannot control. The cumulative $40 million cap that expires on June 30, 2006 has mitigated power cost variability. After expiration of the cap, however, the Company will be subject to a level of financial risk that will be difficult to sustain.

Q. Why do the existing sharing bands--without the $40 million cap--subject the Company to a level of financial risk that will be difficult to sustain?

A. The Company's analysis of power cost risks under the current PCA Mechanism without a cap suggests that two thirds of the time, the Company could expect up to approximately $[redacted] million in power costs that are higher or lower than the allowed recovery built into electric rates. This is approximately plus or minus [redacted] of annual earnings per share risk. This variability is discussed in the prefiled direct testimony of Mr. Salman Aladin.

That level of power cost variability alone would total approximately 13% of PSE's reported 2005 earnings per share of $1.42 and is roughly 12% to 14% of the current 2006 earnings per share guidance of $1.40 to $1.55. This is a high level of earnings volatility for a fully regulated utility and might, combined with the risks discussed earlier, discourage financial parties from committing capital to the Company.

In a November 4, 2005, report, UBS Investment Research emphasized the Company's power cost volatility as follows:

> Investors should be aware that PSE is short power and purchases a proportion of its power requirement in the spot market. This exposes the utility to volatile power costs – a grave concern given that PSE does not have a complete fuel pass-through. . . .
>
> It is also important to note that PSE relies on hydro for roughly 27% of its total power requirement. While hydro is a cheap fuel source, it comes with a high degree of volatility since it is highly

> dependent on the weather and, more specifically, on stream flow
>
> This introduces fuel cost volatility that forces PSE to purchase electricity in the spot market in the event the Company faces a low hydro year.

Exhibit No. ___(BAV-5) at 37.

C. <u>Inability to Actually Earn the Authorized ROE</u>

Q. Has the financial community raised any issues with respect to the Company's actual ROE in recent years?

A. Yes, investors have expressed a concern regarding the Company's inability to actually earn the ROEs that have been allowed by this Commission. Viewed from an investor's perspective, PSE's actual ROE has consistently and significantly trailed its authorized ROE.

The challenge to earn the allowed ROE has been noted by research analysts who follow the Company's parent, Puget Energy, Inc. ("Puget Energy"). A December 14, 2005, report from KeyBanc Capital Markets initiating coverage on Puget Energy discusses the Company's inability to earn its authorized return as follows:

> While the Company benefits from strong demographics with solid customer growth in an attractive region of the country, this proves to be a double-edged sword. The regulatory framework in Washington State precludes [the Company] from realizing the benefit of this growth on a timely basis. Because the state does not use forward-looking test years in rate cases, the utility faces a

> headwind recovering capital and cost increases between rate cases. This puts the Company in a position of being extremely challenged to earn its authorized return. It also necessitates the frequent filing of rate cases with accompanying regulatory uncertainty.

Exhibit No. ___(BAV-5) at 278. An October 27. 2005, report by JP Morgan also emphasized the Company's inability to earn its authorized rate of return:

> We are maintaining our neutral rating as Puget Energy appears to continue to struggle with regulatory lag and other factors that are preventing its core utility EPS power from emerging.

Exhibit No. ___(BAV-5) at 180.

PSE's inability to earn its allowed ROE is particularly troubling to the financial community in light of the Company's large infrastructure-related capital investment requirements over the next several years. Investors certainly appreciate that these electric generation resources and energy delivery systems are generally approved and ultimately included in ratebase and that the commission has provided PSE with an effective mechanism to recover costs for new resources. However, the fact remains that the Company's full earnings power has not been achieved. . As discussed by Dr. Morin without an adjustment for the risk associated with regulatory lag the Company would be considered a less favorable investment than its peers.

Q. Is the Company proposing any regulatory mechanisms to address its chronic under earning and regulatory lag?

A. Yes. The Company is proposing a Depreciation Tracker to capture and recover depreciation expense as increasing investments are made in the Company's electric and gas transmission and distribution systems, as discussed in Mr. Story's testimony. The Company's proposed natural gas decoupling mechanism addresses the under recovery of fixed costs associated with natural gas service due to decreasing usage per customer and weather variability, as described in Mr. Ron Amen's testimony, Exhibit No. ___(RJA-1T). The Company's proposed revisions to the PCA Mechanism sharing bands, as presented by Mr. Salman Aladin, will more equitably share the power cost variances associated with PSE's electric portfolio and result in more consistent recovery of the commodity costs the Company incurs to serve its electric customers.

IV. MARKET CONDITIONS AND THE COMPANY'S CREDIT RATING

A. Interest Rates

Q. How do interest rates impact investors' views of utilities?

A. Investors generally view utility stocks as bond equivalents. In general, as interest rates increase, investors tend to shift capital out of utilities and into other investment classes.

Q. How would you characterize the interest rate environment over the past three years and its impact on Puget Energy and the industry?

A. Calendar years 2003, 2004 and 2005 saw an extended period of low interest rates. The utility sector benefited from this low rate environment and proved to be one of the best performing sectors for investors over this time period. For example, the Philadelphia Stock Exchange Utility Index[2] increased by 64.63% and the Dow Jones Utility Index[3] increased by 88.28% between January 1, 2003 and December 31, 2005. In calendar year 2005 alone, the Philadelphia Stock Exchange Utility Index increased by 13.83% and the Dow Jones Utility Index increased by 20.96%. This compares to a 2005 increase in the S&P 500 of 3.0%.

While the utility sector showed great strength during this period, Puget Energy's stock performance under performed, with its price of common shares decline of 7.39% over the three years ending December 31, 2005, including a decline of 16.82% in calendar year 2005.

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[2] The Philadelphia Stock Exchange Utility Index is a capitalization-weighted index composed of twenty geographically diverse public utility stocks listed on the New York Stock Exchange.

[3] The Dow Jones Utility Index is a geographically representative index of fifteen utility companies involved in the gas and electric industry that is prepared and published by Dow Jones & Co.

B. Puget Energy's Adjusted Share Price Has Lagged Behind the Sector

Q. Why have Puget Energy's share prices lagged behind the share prices of others in the industry?

A. As discussed above, the Company consistently has been unable to earn its authorized ROE. The fact that actual earnings do not reflect the Company's earnings power is a concern to any existing or potential shareholder. In addition, the Company needs to make considerable capital investments. The regulatory lag associated with recovering this investment is a major concern to investors and is seen as a further barrier to the Company being able to earn its authorized return on equity.

Q. Has Puget Energy's poor share price performance compromised the Company's financing ability?

A. Not yet, but I fear it may at some point as conditions in the financial markets evolve. Importantly, the future financial requirements of the Company must be considered. PSE was able to secure favorable financing terms over the past few years in part due to attractive market conditions: low interest rates, narrow credit spreads, lower utility sector equity capital markets issuances compared to historic levels, and supportive bank markets.

C. Puget Energy's Weak Credit Rating is a Hindrance

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

A. I commonly refer to the Company's corporate credit rating, but the rating agencies rate each of the Company's securities individually. The comprehensive credit ratings of PSE (business position 4), as of January 26, 2005, 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	Stable	Stable

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 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 capital market access would be compromised and its cost of funding would increase.

Another indication of the weakness of the Company's credit rating is demonstrated by comparing PSE's credit rating to those of the companies on its list of approved energy risk management counterparties. *See* Exhibit No. __(DEM-8C). These are the companies with whom PSE regularly does business or may contract with. Of the 128 approved counter parties, 70 are rated A- or above, and another 31 are BBB or BBB+. So 101 of the 128 counter parties, or nearly 80%, are rated more favorably than PSE. In the event of a downgrade, we would expect these parties to limit open credit extended to PSE, and would likely require the Company to post collateral to maintain its activity to enter into energy management transactions.

The testimonies of Mr. Donald Gaines and Mr. Eric Markell emphasize the importance of creditworthiness as it relates to power purchase agreements ("PPAs"). If the Company is a purchaser of energy from a third party in connection with a PPA, the counterparty must have confidence the Company will be able to perform its obligations under the agreement over the long term. In particular, the Company must have the credit capacity to post collateral as may be required as markets move in relation to such purchase obligations.

Q. Could the Company simply increase the size of its credit facilities?

A. If the Company were to obtain larger credit facilities, these larger facilities would only increase the Company's financial risk. Mr. Gaines discusses the risks associated with increasing the size of its credit facilities in his direct filed testimony.

Q. Are there benefits to increasing the Company's credit rating?

A. Absolutely. Besides the obvious benefit of being able to finance with lower interest costs, a credit upgrade sends very positive signals to the market. The Company would be in a stronger position to access the capital markets and could also better weather a market or industry downturn with less risk of a downgrade to non investment grade status. Importantly, a stronger credit rating would have a beneficial impact with risk management and power purchase counterparties.

Q. Are there key components of the Company's requests that would help improve the credit rating?

A. Yes, many components of the Company's requests would address issues that hinder the Company's corporate credit rating. In July 2004, Moody's issued an ROE study of local gas distribution companies. The following excerpts offer some observations from the perspective of a rating agency:

> We found a positive correlation between ROE's and credit ratings. Companies that either met or exceeded their allowed rates of

> equity return (ROE) were more likely to have higher credit ratings, were concentrated in urban areas, and focused their operations in a single-state jurisdiction with more mature customer profiles.
>
> Companies performing well also tended to have formal weather normalization clauses (WNC) in place that have helped to steady their operating performance and credit metrics which resulted in the higher credit ratings.
>
> The single most common determinant as to whether a company met or exceeded its allowed ROE was the degree of regulatory lag and the timeliness of capital expenditure and cost recoveries. Companies growing very quickly or having protracted negotiations with their regulators tended to fare more poorly than those growing more slowly or able to obtain specific provisions for timely rate relief."

Exhibit No. ___(BAV-6). The themes highlighted in the Moody's report support the substance of my testimony:

- it is critical to have the opportunity to earn the allowed ROE;
- during a period of significant capital investment, it is essential to have effective recovery mechanisms to reduce regulatory lag; and
- earnings volatility must be kept at a minimum to assure steady operating performance and stable financial metrics.

Q. To what level is the Company seeking to increase its credit rating?

A. It may be that an "A" level corporate credit rating is ultimately an appropriate goal for the Company, as described in Dr. Morin's testimony. However, given that the Company's corporate credit rating is currently so far below that level, I believe a more realistic short-term goal is to increase the Company's corporate credit rating to "BBB+". It is with this goal in mind that the Company has developed the rate relief requested in this case.

V. CONCLUSION

Q. Please summarize your testimony

A. To maintain PSE's legacy of reliable service to a growing customer base, the Company must make very significant capital investments over the next several years in its gas and electric system infrastructure and in new electric generation resources. As the Chief Financial Officer, it is my responsibility to formulate a strategy that allows the Company to realize its full earnings power and improve its creditworthiness in order to raise the capital that will be required for such investments in external financial markets at the lowest cost to customers. The rate relief requested by the Company in this proceeding supports these objectives.

Q. How does the Company's request for rate relief address the risks identified above?

A. The Company's request for rate relief includes several proposals that would help address the risks identified above and should allow the Company to more closely earn its authorized ROE:

(i) The increase in the Company's current authorized ROE to 11.25%, as proposed by Dr. Morin, on the Company's proposed capital structure of 45%, would support increased retained cash flow and a stronger credit rating;

(ii) the proposed Depreciation Tracker, described in Mr. John Story's testimony, would reduce regulatory lag and improve the Company's ability to actually earn its authorized ROE;

(iii) the proposed revisions to the sharing bands of the PCA Mechanism, as described in the testimony of Mr. Salman Aladin and Mr. John Story, would reduce earnings volatility and improve the Company's ability to actually earn its authorized ROE, making the Company more attractive to equity investors; and

(iv) The Company's proposed gas decoupling mechanism, described in Mr. Ron Amen's testimony, would reduce revenue losses the Company is currently experiencing as natural gas use per customer declines, and thereby improve the Company's ability to actually earn its authorized ROE.

Q. Does that conclude your testimony?

A. Yes, it does.

[BA060420002]