

IV. FINANCIAL CONSIDERATIONS

A. Overview

This chapter outlines the interrelationship of PSE's financial needs and capabilities and its resource strategies. Compared to previous Least Cost Plans, this plan provides greater information about corporate financial considerations for the following reasons:

- An increased focus on the financial quality of trading partners that determines both access and pricing in power and natural gas markets,
- An increase in the anticipated level of capital requirements needed to fund energy delivery infrastructure growth and replacements in addition to PSE's acquisition of new resources,
- PSE's relatively low credit rating ("BBB-"/"Baa3"),
- Mounting and more stringent financial regulation and accounting requirements, such as the Financial Accounting Standard Board's (FASB) Statements 149 and 133 concerning accounting for derivatives and FASB Interpretation, FIN 46, concerning consolidation of variable interest entities.
- Credit and cost impacts of certain resource structures (e.g. imputed debt and credit needs associated with purchased power agreements)

In support of PSE's overall mission to provide customers with reliable energy at reasonable, stable prices, the Company's financial strategy strives to:

- Ensure continuous access to the capital markets on reasonable terms
- Increase the availability of credit to operate the business
- Expand risk management capabilities to reduce volatility
- Provide competitive return to investors

B. Utility Financial Environment

This section reviews the key financial considerations of energy supply planning and how financial markets view utilities. To some extent, PSE and other electric utilities are still experiencing repercussions from the Western energy crisis of 2000-01. That period of very high and volatile power pricing resulted in several large and well established companies defaulting on obligations.

Energy market participants and the financial markets have since become much more aware of risk and mindful of the energy supply impacts on financial performance.

Key financial considerations for energy supply planning include purchased power and imputed debt costs, credit and risk management:

B.1. Purchased Power and Imputed Debt

Credit rating agencies view electric utility purchased power payments as fixed commitments that impact a company's ability to cover debt. Consequently, the credit agencies calculate (impute) debt associated with the capacity portion of payments made under power purchase agreements. Utilities have used purchase power agreements (PPAs) in the past as an alternative to the risk and expense of new plant development, construction, and operation. However, entering into long-term PPAs create fixed obligations that can increase a utility's market, operating and financial risks.

Both Moody's Investor Service and Standard & Poor's (S&P) use a quantitative methodology to calculate the risk of PPAs and the impact of that risk on the creditworthiness of electric utilities. The methodologies, while different from one another, were designed to make a fair comparison between electric utilities that own and generate power versus those that contract for power.

Generally, because they are not a physical asset and do not have an equity component, PPAs do not contribute to earnings, and the payments related to them are viewed as a fixed obligation, much as the interest on a bond is viewed as a fixed obligation. The rating agency application of imputed debt on PPAs decreases interest coverage ratios and is a negative factor in determining the overall credit rating. Without offsetting this imputed debt with increased equity, the impact is to increase the leverage in the balance sheet and reduce credit quality.

B.2. Credit

In the energy industry, credit risk is defined as the potential loss resulting from a counterparty's failure to perform under one or more agreements for the purchase or sale of an energy service, energy product, or derivative thereof. Credit risk is typically calculated as the sum of amounts currently due and the positive replacement value of the energy under various contracts.

All energy transactions contain credit risk. Parties that transact in the energy markets typically grant a certain level of unsecured credit risk exposure to the other parties. Firms use, among other things, the credit ratings provided by S&P and Moody's to compare the relative creditworthiness of their counterparties and to determine the amount of unsecured credit to grant another party. Firms with higher credit ratings are typically granted more credit and are also able to transact with more counterparties in comparison with lower-rated companies. Transacting with a limited number of counterparties can lead to a concentration of credit risk.

Since lower-rated firms tend to receive relatively small unsecured credit lines, they may be forced to rely upon secured credit lines. Collateral backs a secured credit line so that the creditor will not incur a credit loss if the debtor fails to perform its obligations. Common forms of security used in the energy industry include cash collateral and letters of credit issued by financial institutions such as commercial or investment banks.

Clearly, firms with higher credit ratings are better positioned than firms with lower credit ratings. Firms with higher credit ratings benefit from increased trading liquidity (more counterparties), increased financial liquidity (less funds diverted towards collateral), and lower costs (decreased use of costly letters of credit, for example).

Before the energy crisis, credit was less of an issue, especially for agreements between utilities. Now, credit has attained a much greater importance. Increased concern about credit risk has led to increased credit costs.

B.3. Risk Management

Starting with the Western energy crisis, and continuing through the recent escalation in natural gas prices, energy markets have experienced substantial volatility. Consequently, market participants have taken steps to improve their risk management. This includes taking a more structured approach to managing price exposure, and the use of better modeling tools.

The market offers a variety of fixed priced contracts and financial instruments to hedge a company's price risk exposure.

B.4. Financial Accounting

In June 1998, The Financial Accounting Standards Board (FASB) issued Statement 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*, which established

accounting and reporting standards for derivative contracts and hedging activities. The purpose of FAS 133 is to improve the quality of financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. The impact of FAS 133 is the potential for increased volatility of reported earnings due to the requirement for recording the unrealized gains and losses from derivatives on a company's books. In April 2003, the FASB issued Statement 149, an amendment to FAS 133 that clarified the definition of derivatives and the implementation of this statement for financial instruments.

In December 2003, the Financial Accounting Standards Board issued a revision to Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. Consolidated financial statements are to include subsidiaries in which the enterprise has a controlling financial interest. That requirement has usually been applied to subsidiaries in which an enterprise has a majority voting interest, but in many circumstances the enterprise's consolidated financial statements do not include variable interest entities with which it has similar relationships. The primary objective of FIN 46R is to provide guidance on the identification of and the financial reporting for entities over which control is achieved through means other than voting rights: such entities are known as Variable Interest Entities. The potential impact of FIN 46 on PSE may, depending upon specified criteria, require the consolidation of entities providing long-term power purchase agreements (PPAs). Such consolidation requires PPA suppliers to provide their detailed financial information for determination of applicability of FIN 46 and, if necessary, consolidation of their financial statements. Depending upon the capital structure of the PPA supplier, the consolidation may adversely impact PSE's corporate credit rating and the ultimate cost of the PPA to PSE customers.

C. Financing

Electric utilities are capital-intensive companies and PSE's capital needs for resource additions must be considered in addition to PSE's other financing needs. PSE's specific investment challenges are:

- A growing customer base,
- A growing short resource position,
- Infrastructure expansion, replacements, and improvements,
- A historic high reliance on PPAs, and
- A relatively weak financial position and reliance on external capital markets.

PSE's overall mission is to reliably and safely serve customers and to deliver a fair return to shareholders. To accomplish this mission, the Company is focusing on three general goals: increased self-sufficiency in energy generation through an expanded resource base; minimized power and gas cost volatility through portfolio and risk management initiatives; and investments in delivery infrastructure.

Taking into account PSE's current and projected financial strength, as well as its credit capabilities and other considerations, PSE must determine how it will finance ongoing operations and capital requirements. Financing will come from the Company's capacity to generate funds internally through operating cash flows and from its ability to attract investors in the capital markets. In order to access capital on reasonable terms, PSE must maintain strong credit fundamentals that will be viewed favorably by the rating agencies and investors.

The Company's historic reliance on purchased power does not provide depreciation as a source of cash flow. Without this cash inflow from the recovery of depreciation through rates, PSE is a net borrower. As a net borrower, the Company currently relies on capital markets to fund planned capital investments. After the payment of dividends, which is integral to attracting equity investors, internal operating cash flows are not sufficient to fund near-term planned capital requirements. As a result, PSE must attract capital from the financial markets. This means it is important for PSE to maintain an attractive credit and investment profile to allow for adequate and reasonable external financing options.

Presently, the Company's corporate credit rating ("BBB-"/"Baa3") is the lowest in the investment grade category. Credit rating agencies examine a number of qualitative and quantitative factors in determining a credit rating. While there is no formula for combining assessments of these factors to arrive at a specific credit rating, capital structure, as measured by a debt to total capitalization ratio, and consistent earnings commensurate with a company's business risk, as measured by ratios such as pre-tax interest coverage, are critical factors.

At a credit rating of "BBB-"/"Baa3", the Company's debt costs are higher than they would be at a stronger rating, such as "BBB+"/"Baa1". Higher debt costs represent a burden to customers over time. Furthermore, with a weak rating, access to the financial markets can be limited during periods of economic downturn or market stress. In general, investors are wary of

investing in companies that must undertake large capital projects while rated one step above non-investment grade status.

In addition, the Company's current credit rating provides limited safety or cushion from a potential downgrade to non-investment grade status. There are many risk factors that can lead to downgrades in a company's credit rating. One notch above non-investment grade provides little to no flexibility to deal with the following factors: credit market events, fluctuations in power costs, regulatory and political events, changes in tax laws, unanticipated wholesale market developments, and force majeure events.

Achieving a "BBB+/"Baa1" corporate credit rating, which is three notches above non-investment grade status, is integral to the Company's financial strategy. A higher credit rating results in better access to the capital markets and a lower overall cost of capital. A lower overall cost of capital provides direct benefits to customers through lower rates over time. This is particularly true for PSE, with its significant infrastructure investment requirements. A strong capital structure will also provide PSE with greater ability to access long-term fuel supply contracts, as well as physical and financial hedging products to manage the price volatility associated with its power and natural gas portfolio.

PSE has taken substantial steps to strengthen its capital structure to achieve a higher credit rating. Between September 30, 2001 and December 31, 2004, the Company increased its equity ratio from 31.7 percent to 40 percent. In doing so, the Company has been able to meet the equity structure targets established in the 2002 general rate case settlement with the Washington Utilities and Transportation Commission (WUTC) well ahead of schedule. Puget Energy reduced its common stock dividend, invested earnings in excess of that dividend in PSE, issued common stock to fund the requirements of the dividend reinvestment plan (DRIP), and completed two significant common stock offerings in 2002 and 2003. In total, the Company increased its common equity by more than \$250 million during this period. Furthermore, the Company refinanced its high cost preferred stock and reduced total debt by more than \$300 million.

However, to achieve its "BBB+/"Baa1" target, PSE must do more to improve its financial health. The Company has developed a financial plan that is reasonably expected to result in an improved equity ratio. In its February 18, 2005 order, the WUTC set rates on a 43 percent

equity ratio – a level that PSE plans to achieve. Through a balanced approach to managing its debt portfolio, growth of equity through the sale of stock, and earnings retention, the Company plans to meet the requirements for a higher corporate credit rating. Thus, as it makes new resource acquisitions and funds other operations, PSE will actively strive to maintain this appropriate balance between debt and equity in its financing decisions. The Company's goal is to manage this balance in its capital structure so that it will achieve and maintain at least a "BBB+" rating.

D. Credit and Liquidity

As discussed in section B, PSE has made significant progress in dealing with the challenging times following the Western energy crisis. However, continued careful management of liquidity and effective hedging techniques remain integral aspects of PSE's strategy aimed at shoring up credit quality.

As shown in Exhibit IV-1, PSE's liquidity facilities consist of a \$500 million bank line of credit and an accounts receivable securitization program. Availability of credit through the accounts receivable securitization program varies from \$75 million to \$150 million, depending on the size of the Company's accounts receivable and unbilled revenue balances. These facilities are primarily used to fund PSE's working capital needs. If necessary and if available, these facilities may be used to provide security to PSE's counterparties.

PSE's other source of credit is the unsecured credit limits provided by its trading counterparties. Generally, these credit limits may be increased or decreased at any time. Changes in the Company's credit limits are made in response to changes in the perceived risk of transacting with PSE.

Exhibit IV-1

SOURCES OF CREDIT (representative values in millions of \$)		
Liquidity Facilities (# of counterparties)		\$650
Receivables Securitization	\$150	
Credit Agreement	\$500	
Trading Counterparty Credit		\$444
Gas	\$150	
Power	\$149	
Financial	\$145	
Total Sources		\$1,094

PSE conducted an informal survey of its major counterparties to better understand the relationship between the Company's S&P and Moody's ratings, and the credit lines extended to PSE. A number of surveyed counterparties were not able to indicate the exact amount of the increase or decrease to PSE's credit limits, as they would have to consider the factors causing the credit rating change. Nevertheless, the results of this survey show directionally that an improved credit rating can be expected to expand PSE's ability to enter into hedging transactions. Also of note is that a downgrade to the Company would result in the loss of a substantial amount of unsecured credit. According to the survey results, a downgrade in credit rating is greater than the impact of an increase in credit rating. For physical gas transactions, a downgrade would reduce credit by 60 percent while an upgrade of one rating notch would increase credit by 49 percent. For physical power transactions, a downgrade would reduce credit by 73 percent while an upgrade would increase credit by 67 percent. And for financial power or gas transactions, a downgrade of one notch reduces credit by 49 percent while an upgrade of two notches to BBB+ increases credit by 62 percent.

Credit will be an increasingly important issue for PSE, as a number of PPAs will expire over the next few years. Entering into new PPAs, like any market transaction, requires the use of PSE's credit. The Company's relatively low credit rating coupled with the tighter credit risk standards now common in the industry, should make replacement of the expiring PPAs more expensive than ownership options.

An increase in the Company's credit rating would improve PSE's bargaining position and motivate counterparties to extend higher credit limits to PSE, thereby increasing the company's trading liquidity. Improved credit ratings would also reduce the need to post security, resulting in improved financial liquidity and reduced costs.

Furthermore, a non-investment grade rating would significantly impact the Company's risk management activities. Parties with which the Company currently contracts would constrain open credit extended to PSE, and would likely require the Company to post collateral to maintain its transacting activity. A downgrade would also trigger requirements to post collateral under several financial hedging instruments to which the Company is already a party. While the Company may be able to access additional credit or equity at such a time to cover these cash requirements, it would be forced to do so at the worst time, because its weakened financial condition would significantly increase the cost of such capital.

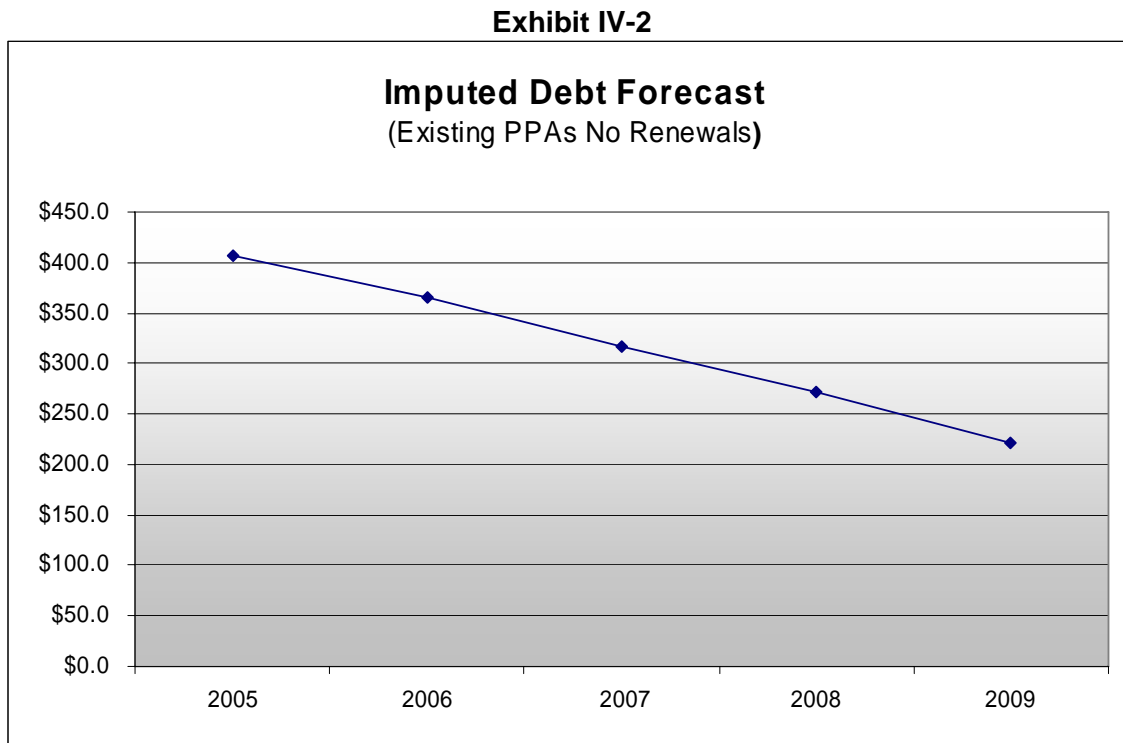
Because of the negative consequences of a potential downgrade, PSE takes a more conservative approach to issues, such as credit policy, than it might if it had a stronger credit rating. For example, PSE must be vigilant to reserve its current credit facilities to meet working capital needs and the variability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

E. Imputed Debt

PSE, like all electric utilities, faces the challenge of maintaining financial strength to attract capital investment. But unlike many other utilities, PSE has the added burden of over \$400 million of imputed debt, using the S&P methodology (see Exhibit IV-2). PSE acquires a majority of its energy and capacity supply from power purchase agreements and thus is subject to significant downward pressure on its credit rating resulting from imputed debt. PSE has been working with the rating agencies since the early 1990s to ensure that they understand the Company's contracts and, in particular, that the imputed debt is mitigated somewhat by the low cost structure of the hydro-based contracts from the Mid-Columbia Public Utility Districts.

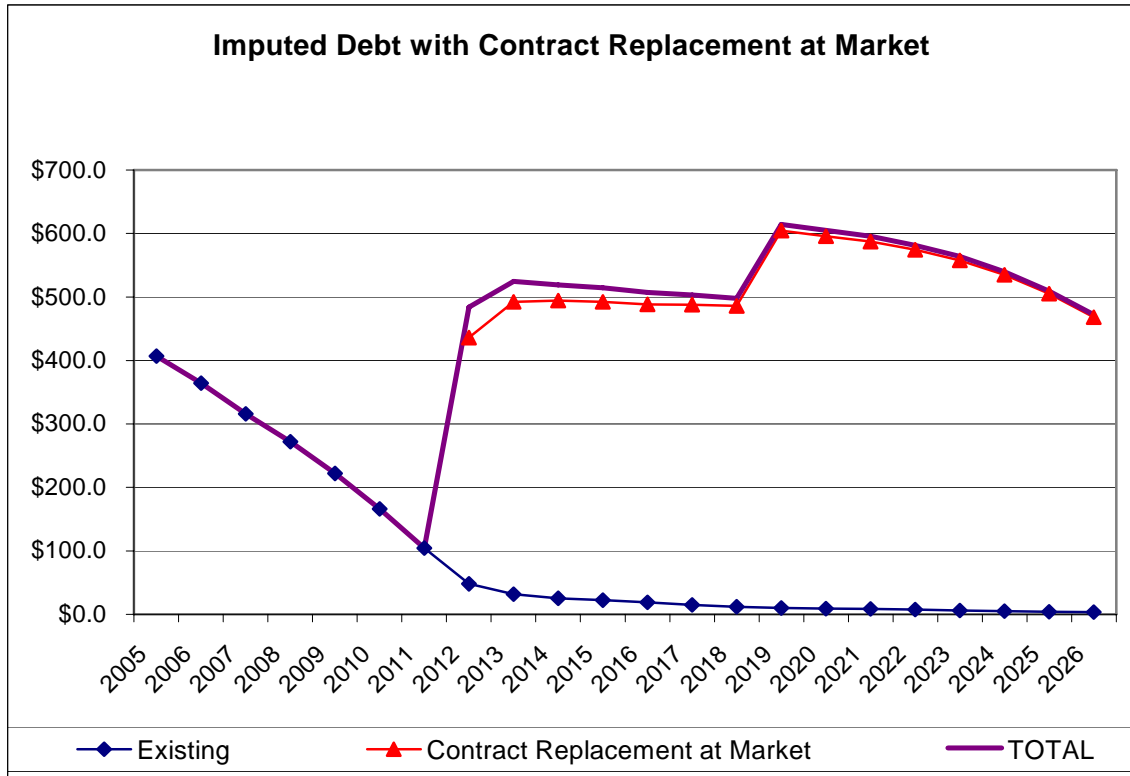
PSE has a number of PPAs outstanding, with termination dates extending from 2006 through 2037. In aggregate, these PPAs result in imputed debt of approximately \$400 million in 2005.

The graph in Exhibit IV-2 reflects existing contracts and excludes the imputed debt associated with possible renewal for a number of PPAs that expire between 2011 and 2019.



PSE has numerous large contracts with Public Utility Districts on the Columbia River and with Non Utility Generators in Northwest Washington that expire between 2011 and 2019. If PSE were to replace these expiring contracts with new 20-year contracts, priced at the Aurora forecast prices, the imputed debt could increase to over \$500 million in 2013 and over \$600 million in 2019. This is likely a low estimate of imputed debt because prices for fixed rate contracts will generally have a forward premium and a credit premium that would increase contract payments. In addition, the estimate may be low because the assumption for replacement of non-utility generator contracts was at 60 percent of existing capability. And finally, the estimate may also be low because it does not include the imputed debt from possible power bridging agreements (PBAs) that may be used to partially fill the resource need in the near term. The chart in Exhibit IV-3 illustrates future imputed debt under these circumstances.

**Exhibit IV-3
Imputed Debt with Selected Contracts Replaced at Market Prices**



Regulatory Treatment of Imputed Debt

Replacing expiring contracts with new long-term PPAs priced at AURORA forecast prices, depicted as “market” in Exhibit IV-3, would place significantly greater downward pressure on PSE’s credit ratings than exists today. Public Utility Commissions in California and Florida have recognized the impact of imputed debt on utility credit ratios.

The Public Utilities Commission of the state of California ruled on the question of imputed debt or debt equivalence of PPAs in Decision 04-12-047 dated December 16, 2004. In that decision it states:

We decline to adopt a formal debt equivalence policy. However, we do recognize that debt equivalence associated with PPAs can affect utility credit ratios, credit ratings, and capital structure. Credit rating agencies have long recognized debt equivalence as a risk factor and we have and will continue to reflect the impact of such risk in establishing a fair and reasonable ROE and in approving a balanced ratemaking capital structure. In that regard, we have identified information that

the utilities should provide in their annual cost of capital applications to enable us to better assess debt equivalence risks. Our goal is to provide the utilities with a fair and reasonable ROE and ratemaking capital structure that, among other matters, support investment-grade credit ratings.

The Florida Public Service Commission, in a decision in March 2004 (Docket 031093-EQ), ruled that it is appropriate for Florida Power and Light to account for imputed debt and make an equity adjustment to reduce the price paid for power purchase from small QFs under PURPA.

We have repeatedly found that consideration of any application of an equity adjustment should be evaluated on a case-by-case basis. We have reviewed FPL's petition, the cited S&P article, and past Commission decisions regarding the application of an equity adjustment in general, and for purposes of determining capacity payments under a Standard Offer Contract, in particular. At our request, FPL provided additional support for its position in the form of a second S&P report dated October 21, 2003. In this report, S&P indicates that it applies a 30% risk factor in its evaluation of purchased power obligations as part of its determination of the consolidated credit profile of FPL Group. Based on the above, we believe it is appropriate in this instance for FPL to make an equity adjustment as stated in the determination of capacity payments in its Standard Offer Contract.

S&P Imputed Debt Methodology

In general, imputed debt is described in the 1994 update of S&P 1992 Corporate Finance Criteria.

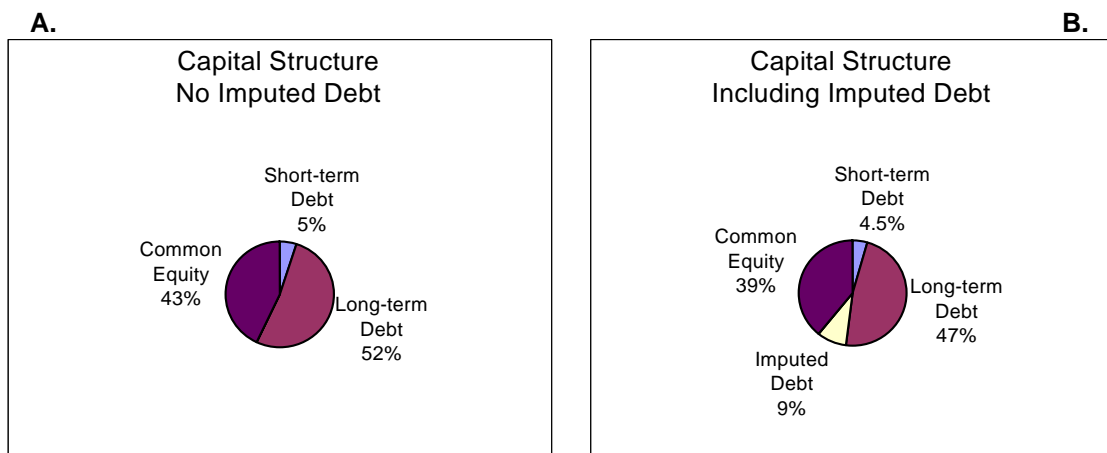
To analyze the financial impact of purchased power, S&P employs the following financial methodology. The net present value of future annual capacity payments (discounted at 10 percent), multiplied by a "risk factor" (which in PSE's case is 30 percent) represents a potential debt equivalent—the off-balance sheet obligation that a utility incurs when it enters into a long-term purchase power contract.

PSE's Least Cost Plan, and screening of potential resource acquisitions, will include a cost of equity to neutralize the reduction in credit quality from imputed debt for all PPAs. As described previously, the debt rating agencies consider long-term take-or-pay and take-and-pay contracts

equivalent to long-term debt; hence there is a cost associated with issuing equity to rebalance the company's debt/equity ratio. Imputed debt in the Least Cost Plan is calculated using a similar methodology to that applied by S&P. The calculation begins with the determination of the fixed obligations that are equal to the actual demand payments, if so defined in the contract, or 50 percent of the expected total contract payments. This yearly fixed obligation is then multiplied by a risk factor. PSE's current contracts have a risk factor of 30 percent, a change that occurred in May 2004. Prior to this recent change, PSE contracts had risk factors between 15 percent and 40 percent. Imputed debt is the sum of the present value, using a 10 percent discount rate and a mid-year cash flow convention, of this risk adjusted fixed obligation. The cost of imputed debt is the equity return on the amount of equity that would be acquired to offset the level of imputed debt to maintain the Company's capital and interest coverage ratios.

Including \$400 million of imputed debt into an illustrative capital structure reduces the equity component from 43 percent to 39 percent. See Exhibit IV-4 for the calculations contained in Exhibits IV-5.1 and IV-5.2.

Exhibit IV-4



**Exhibit IV-5.1
PSE Illustrative Base Case - Excluding Imputed Debt**

Capital Component	Illustrative Amount	Capital Structure	Cost Rate	Pre-tax WACC	WACC	After-tax WACC
Short-term Debt	\$200,000	5.00%	5.00%	0.25%	0.25%	0.16%
Long-term Debt	\$2,080,000	52.00%	7.15%	3.72%	3.72%	2.42%
Imputed Debt						
Common Equity	\$1,720,000	43.00%	10.30%	6.81%	4.43%	4.43%
Total	\$4,000,000	100.00%		10.78%	8.40%	7.01%

**Exhibit IV-5.2
PSE Illustrative Base Case - Including Imputed Debt**

Capital Component	Illustrative Amount	Capital Structure	Cost Rate	Pre-tax WACC	WACC	After-tax WACC
Short-term Debt	\$200,000	4.55%	5.00%	0.23%	0.23%	0.15%
Long-term Debt	\$2,080,000	47.27%	7.15%	3.38%	3.38%	2.20%
Imputed Debt	\$400,000	9.09%	10.00%	0.91%	0.91%	0.59%
Common Equity	\$1,720,000	39.09%	10.30%	6.19%	4.03%	4.03%
Total	\$4,400,000	100.00%		10.71%	8.55%	6.97%

Exhibit IV-6 shows that the financial ratios with imputed debt are eroding PSE's financial strength as measured by the credit rating agencies. The pre-tax interest coverage ratio is reduced from 2.7 to 2.4, and the ratio of debt to capital is increased from 57 percent to almost 61 percent.

Exhibit IV-6

	No <u>Imputed Debt</u>	Includes <u>Imputed Debt</u>
Weighted Return on Equity	4.43%	4.03%
Tax impact	<u>/ 65%</u>	<u>/ 65%</u>
Pre-tax Weighted ROE	= 6.82%	= 6.20%
Cost of Debt	<u>+ 3.97%</u>	<u>+ 4.52%</u>
Pre-tax Cost of Capital	= 10.79%	= 10.72%
Cost of Debt	<u>/ 3.97%</u>	<u>/ 4.52%</u>
Pre-tax Interest Coverage	2.7 x	2.4 x
S&P Benchmark for "BBB" rating	2.2x - 3.3x	2.2x - 3.3x
Ratio Debt to Capital	57.0%	60.9%
S&P Benchmark for "BBB" rating	50% to 60%	50% to 60%

F. Risk Management

PSE must balance numerous risk factors when obtaining energy resources to meet customer load. PSE must analyze these factors to (1) deliver reliable energy when our customers demand it, (2) serve our customers at a reasonably low cost while mitigating price volatility, and (3) enhance the value of PSE's energy resources to reduce power and gas costs. PSE utilizes risk management strategies to reduce volatility in power and gas costs, manage unused capacity, and increase the operational flexibility of assets.

The Company uses a variety of hedging tools to reduce price volatility for power customers. The Company engages in forward market fixed-price purchases (both in physical gas and power purchase contracts and through financial market derivatives) to lock in gas prices, to purchase power as needed and to acquire winter-peaking capacity hedges. In addition, PSE utilizes flexibility in its resources to store hydro energy where possible, to dispatch and displace

generation as market conditions provide economic signals, and to utilize transmission to move energy from resources to load.

PSE's strategic options are constrained by several factors. Market liquidity is one constraint, as there may not be sellers of the hedge transactions sought by the Company. Market conditions may also make certain products very expensive. For example, an option contract such as a call, which is the right, but not the obligation, to purchase energy at a predetermined price, might be very attractive as a means to manage load variability risk. But in volatile markets, the cost of that option might be prohibitive. PSE's strategic options are also constrained by counterparty issues. The Company seeks to enter into transactions with a range of financially strong counterparties to reduce the risk of default by any one counterparty. Finally, as described below, PSE's own credit position can limit its ability to enter into hedging transactions.

If the Company had a higher credit rating, counterparties would extend more open credit to the Company, thereby enabling the utility to expand its hedging capacity for the power and gas portfolios without incurring costs to post collateral and without increasing debt. This benefits customers as the Company has an increased hedging capacity, without additional credit costs. With a better credit rating, PSE anticipates counterparties would be willing to sell more fixed-price supply or other hedge transactions to the Company, thereby expanding PSE's hedging capability. While PSE would continue to develop strategy for hedging linked to price signals, fundamental analysis and risk analysis, when prices were opportunistic, PSE believes it is important to have the capacity and flexibility to hedge more, and further forward in time.

G. Financial Consideration of Resource Types

This chapter has discussed PSE's corporate financial challenges with regard to financial strength, credit, risk management, and imputed debt. In the course of developing its resource strategy, PSE considers how the selected resource portfolio and the individual resources impact the Company's financial situation and conversely whether the Company's financial situation supports the resource choices.

For the generic evaluation considered in least cost planning, resources are compared on the basis of their impact to present value portfolio costs. The overall goal is to include all costs with each resource including not only direct costs like equipment, fuel, and operating costs but also quantification of financial considerations.

Capital Requirements (Financing)

PSE's capital requirements for resource additions need to be combined with the capital requirements for electric and gas infrastructure and other corporate needs to determine the Company's overall financing requirements.

At the expiration of non-utility generator (NUG) contracts in 2011-12, PSE could have a large capital need for resources concentrated over a short period. PSE will need to examine the timing of the acquisitions to determine whether the Company has the financial strength to support rapid-owned resource additions. Also, short-term retail rate impacts are another potential concern.

For this Least Cost Plan, PSE includes the use of short-term PBAs to cover need until long-lead time resources become available. PBAs may also be used to "stagger" resource additions to moderate the year-to-year financing requirements of owned resources.

The least cost planning analysis doesn't explicitly model the timing of regulatory recovery but this will be a consideration for specific resource acquisitions. For long-lead time resources, especially coal and possibly transmission, PSE may pursue recovery of construction work in progress.

Credit

Credit requirements generally apply to power purchase agreements. For this Least Cost Plan, PSE has included a monetized adder of 5 percent of the payments under a power purchase agreement to cover the credit costs for the generic PBAs. The amount is based upon the estimated cost of a letter of credit to cover PSE's credit obligations.

Credit can also apply to the fuel purchase arrangements for a natural gas plant. However, since most fuel purchase arrangements are priced at index, and the risk of non-performance is relatively low for both parties, PSE has not added a credit premium to gas resources.

Although credit is not usually a concern with coal-fueled generation, the coal industry is showing signs of developing a more robust spot price market. If the future coal market more closely resembles the natural gas market model, then credit could become an issue for coal-fueled

resources. For the development model where the coal plant owner also owns the coal reserves, credit would not apply. This Least Cost Plan does not include a credit adder for coal plants.

Price Risk

Price risk management costs apply to resources with high price volatility – primarily index-priced power purchase agreements and natural gas-fired generation. Through the Long-term Risk Management Project, PSE is currently evaluating customer-perceived value in mitigating energy price volatility. PSE plans to use the results of this study to inform its short- and long-term price risk management strategy.

For this Least Cost Plan's generic resource evaluation, both power purchase contracts and natural gas fuel were priced at spot market without a risk management adder. This issue will be re-examined during the evaluation of specific resource acquisitions.

Imputed Debt Cost

Imputed debt is an indirect cost specific to power purchase agreements. PSE computed imputed debt and the associated equity offset cost adder for the generic power bridging agreements analyzed in the portfolios. A similar approach will be applied to the evaluation of specific power purchase agreements in the resource acquisition process.