Financial Considerations

Contents

1. Resource Specific Financial Considerations

Power Purchase Agreement (PPA). As mentioned in Chapter 5, PPAs were not considered in this IRP since the costs and terms of individual PPAs are not know until the time they are offered. However, since PSE expects to receive PPAs during our RFP process, it is important to understand how they will be evaluated. The following section describes what Imputed Debt is, and how it is calculated and used in evaluation.

Imputed Debt Methodologies

Utilities have used 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 creates fixed obligations that can increase a utility's financial risks. Both Moody's Investors 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 vs. utilities that contract for power. In general, imputed debt is described in the 1994 update of S&P 1992 Corporate Finance Criteria:

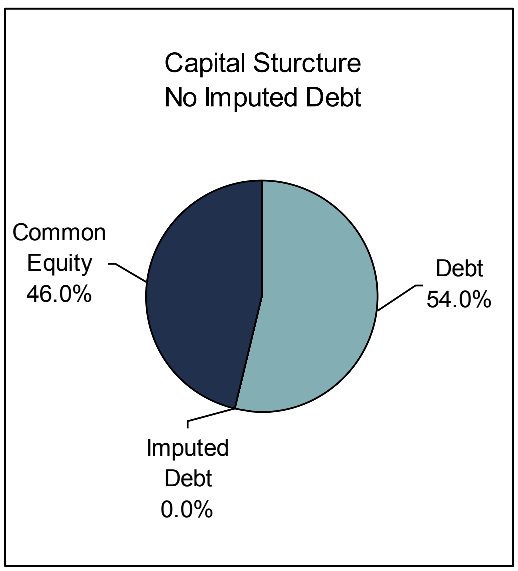
To analyze the financial impact of purchased power, S&P employs the following financial methodology. The net present value of future annual capacity payments (discounted at 10 percent), multiplied by a "risk factor" (which in PSE's case is 30 percent) represents a potential debt equivalent—the off-balance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

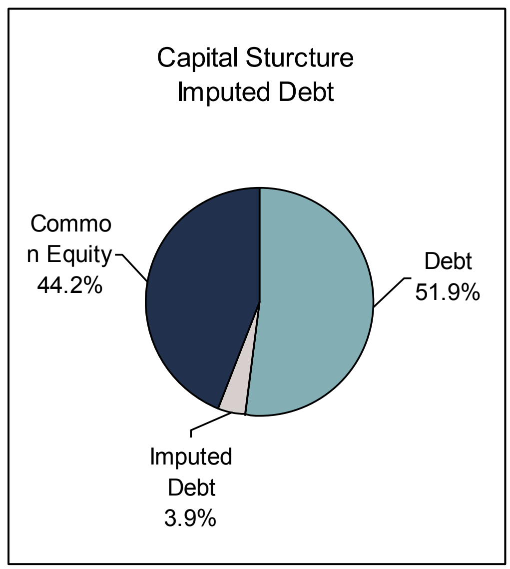
PSE's IRP, and our screening of potential resource acquisitions, includes a cost of equity to neutralize the reduction in credit quality from imputed debt for all PPAs. As described previously, the debt rating agencies consider long-term take-or-pay and take-and-pay contracts equivalent to long-term debt; hence there is a cost associated with issuing equity to rebalance the company's debt/equity ratio. Imputed debt in the IRP 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, as assessed by S&P. Imputed debt is the sum of the present value, using a 6.7 percent discount rate (the company's current average cost of long-term debt), and a midyear cash flow convention of this risk-adjusted fixed obligation. The cost of imputed debt is the 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.

Imputed Debt's Effect on Capital Structure

Figure F-1 shows that the capital structure with imputed debt is eroding PSE's financial strength as measured by the credit rating agencies. Total capitalization is equal to forecast year-end 2010, but the percentage mix of debt and equity is as allowed in the April 2010 General Rate Case order from the Washington Utilities and Transportation Commission (WUTC) in DOCKETS UE-090704 and UG-090705 (consolidated). The level of imputed debt shown in the 2009 IRP was about $300 million. The reduction to about $266 million in the 2011 IRP reflects the roll-off, or shorter remaining term of several large PPAs.

Figure F-1
Capital Structure With and Without Imputed Debt





2. Other Financial Considerations

Discount Rate

PSE uses a discount rate to present value the various portfolio costs in this plan, and the same discount rate to evaluate the present value of portfolio costs and benefits of alternative resources considered for actual acquisition. PSE uses its allowed regulatory return on rate base as the discount rate. The WUTC decided on a capital structure and allowed cost of capital of 8.1 percent in Order 11 to DOCKETS UE-090704 and UG-090705 (consolidated) issued April 2, 2010 (page 93, table 9).

DSR Financial Considerations

Slow economic recovery and the reduction of federal tax incentives and economic stimulus funding may impact PSE's ability to acquire demand-side resources. Lower growth and lower use per customer means less demand-side potential, and lower incomes may reduce the willingness of customers to invest in energy efficiency resources. Also, as a result of the high efficiency tax credits and grants, PSE experienced increases in customer demand for certain energy efficiency equipment. Now that federal tax credits have been reduced significantly and most federal stimulus funds have been allocated, the increased demand for these measures may prove to have been temporary. This could mean that PSE may have to increase incentives, customer education, and promotional efforts to achieve energy efficiency goals. While the increase in energy savings may reduce costs over the long run, customers will continue to face increased rate pressure from higher program costs in the short run. The reduction of revenues due to reduced energy sales from conservation also creates pressure on PSE's financial performance.