

**BEFORE THE**  
**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND	)	
TRANSPORTATION COMMISSION,	)	
	)	
Complainant,	)	
	)	
v.	)	<b>Docket Nos. UE-072300/</b>
	)	<b>UG-072301 (<i>consolidated</i>)</b>
PUGET SOUND ENERGY, INC.	)	
	)	
Respondent.	)	
_____	)	

**DIRECT TESTIMONY OF**  
**MICHAEL P. GORMAN**  
**ON BEHALF OF**  
**THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES**

**May 30, 2008**

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 **A.** My name is Michael Gorman, and my business address is 1215 Fern Ridge Parkway,  
3 Suite 208, St. Louis, MO 63141-2000.

4 **Q. WHAT IS YOUR OCCUPATION?**

5 **A.** I am a consultant in the field of public utility regulation and a managing principal with  
6 the firm of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

7 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND**  
8 **EXPERIENCE.**

9 **A.** These are set forth on Exhibit No.\_\_(MPG-2).

10 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

11 **A.** I am appearing on behalf of the Industrial Customers of Northwest Utilities (“ICNU”).

12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

13 **A.** I will recommend a fair return on common equity and an overall rate of return for Puget  
14 Sound Energy, Inc. (“PSE” or the “Company”).

15 **Q. PLEASE SUMMARIZE YOUR RATE OF RETURN RECOMMENDATIONS.**

16 **A.** I recommend the Washington Utilities and Transportation Commission (the  
17 “Commission”) award PSE a return on common equity of 10.12% and an overall rate of  
18 return of 8.30%, as shown on Exhibit No.\_\_(MPG-3).

19 My recommended return on equity for PSE is based on a Discounted Cash Flow  
20 (“DCF”), a Risk Premium (“RP”), and a Capital Asset Pricing Model (“CAPM”)  
21 analyses.

22 I demonstrate that my recommended return on equity and proposed capital  
23 structure for PSE will provide PSE with an opportunity to realize cash flow financial  
24 coverages and balance sheet strength that conservatively supports PSE’s current bond

1 rating. Consequently, my recommended return on equity represents fair compensation  
2 for PSE's investment risk, and it will preserve PSE's financial integrity and credit  
3 standing.

4 I respond to PSE witness Dr. Roger Morin's recommended 11.2% return on  
5 equity, which includes a 0.30% flotation cost return add-on. Dr. Morin's recommended  
6 return on equity is excessive and should be rejected.

7 **Q. HOW DOES YOUR PROPOSED RETURN ON EQUITY OF 10.12% COMPARE**  
8 **TO PSE'S LAST AUTHORIZED RETURN ON EQUITY?**

9 **A.** PSE's last authorized return on equity was awarded in January 2007. In that proceeding,  
10 PSE was authorized a return on equity of 10.4% with a hypothetical capital structure  
11 containing a common equity component of 44%. Hence, the capital structure I set forth  
12 below is comparable to the capital structure last authorized for PSE. My recommended  
13 return on equity is approximately 28 basis points lower than PSE's last authorized return  
14 on equity. I believe this is appropriate for the following reasons:

- 15 1. The Order in PSE's last rate case stated that Treasury bond yields during the  
16 last case ranged from 4.97% to 5.30% and averaged 5.14%.<sup>1/</sup> Currently,  
17 Treasury bond yields over the last few months have ranged from about 4.3%  
18 up to about 4.6%. Hence, Treasury bond yields at this time are about 50 basis  
19 points lower than they were during PSE's last rate case.
- 20 2. Treasury bond yield projections two years out are also lower in this case  
21 compared to PSE's last case. In January 2007, the *Blue Chip Financial*  
22 *Forecasts* projected Treasury bonds to increase to 5.1% through the second  
23 quarter of 2008.<sup>2/</sup> As discussed in greater detail below, current projections of  
24 30-year Treasury bond yields two years out are approximately 4.8%. Again,  
25 this is about a 30 basis point reduction to the Treasury bond projections in this  
26 case relative to the last case.
- 27 3. Utility bond yields have been about flat in this case relative to the last case.  
28 During the last six months of 2006 and in January 2007, "Baa" rated utility

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<sup>1/</sup> Docket Nos. UE-060266 and UG-060267, Order at 30.

<sup>2/</sup> *Blue Chip Financial Forecasts*, January 1, 2007 at 2.

1 bond yields ranged from approximately 6.1% up to 6.6%. Currently, “Baa”  
2 rated utility bond yields have ranged from approximately 6.5% up to 6.7%.  
3 Hence, utility bond yields currently are very comparable to the yields that  
4 existed in 2007.

5 Since current and projected interest rates have declined since PSE’s last rate case,  
6 it is appropriate to reflect that cost of capital decline in the authorized return on equity.

## 7 **ELECTRIC UTILITY INDUSTRY MARKET PERSPECTIVE**

### 8 **Q. PLEASE DESCRIBE THE MARKET’S PERCEPTION OF THE ELECTRIC** 9 **UTILITY INDUSTRY OVER THE LAST SEVERAL YEARS.**

10 **A.** The Edison Electric Institute (“EEI”), an electric utility industry trade organization,  
11 provided an assessment of the credit rating history of U.S. electric utilities over the period  
12 2002-2007. EEI’s highlights of its credit rating assessment of the electric power industry  
13 are stated as follows:

#### 14 **Highlights**

- 15 • Industry credit quality improved for the third consecutive year in 2007  
16 as upgrades outnumbered downgrades by a 3:2 ratio.
- 17 • The industry’s average credit rating remained at a solid BBB in 2007  
18 for a fourth consecutive year. The year’s 121 total ratings actions, just  
19 above last year’s 110, were also at a consistent level for a fourth year.
- 20 • Nearly half of the year’s downgrades were tied to regulatory  
21 uncertainty in Texas. TXU received significant downgrades based on  
22 its debt-financed acquisition by a group of private equity investors.
- 23 • As the year progressed, rising capital expenditures and the  
24 accompanying debt were becoming a more frequent concern cited by  
25 the ratings agencies.<sup>3/</sup>

26 Further, Standard & Poor’s (“S&P”) also acknowledges the improving credit  
27 standing of the electric utility industry in its report. S&P states:

#### 28 **Key Credit Trends**

29 The U.S. utility industry demonstrated stable credit quality in the fourth  
30 quarter of 2006, and should continue to do so in 2007 despite increasing  
31 capital spending needs related to reliability enhancements and  
32 environmental requirements. A general refocus by the industry in recent

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<sup>3/</sup> “Q4 2007 Credit Ratings,” EEI Q4 2007 *Financial Update*.

1 years on restoring balance sheet health and selling noncore business  
2 operations has enhanced its ability to withstand the pressure that  
3 substantial capital spending will bring.

4 A credit element during this coming growth phase, however, will be fair  
5 and equitable treatment by state regulators as utilities seek to recover the  
6 capital expenditures they will incur to address declining reserve margins,  
7 aging and increasingly fragile infrastructure, and environmental mandates.  
8 Standard & Poor's Ratings Services expects that most utilities will seek  
9 pre-approval from regulators of any substantial spending program, or at  
10 least a broad understanding of the principles that regulators will apply in  
11 granting recovery. Of comparable significance to supporting credit quality  
12 is regulatory approval for timely recovery of fuel costs, especially in an  
13 environment of elevated commodity prices.<sup>4/</sup>

14 The electric utility industry and utilities in general are currently in a capital  
15 spending cycle that is producing very strong growth in rate base, and in related earnings  
16 and dividends. For the reasons set forth below, the industry is in a very strong growth  
17 period, which is tracking its capital expenditures for meeting growing demand,  
18 environmental compliance, and system upgrades and improvements. This indicates that  
19 the market is providing capital to the industry for significant capital improvements, and  
20 the market is attracted to the safe investment characteristics of regulated utility  
21 companies, which generally receive supportive regulatory treatment in terms of cost  
22 recovery of prudent and reasonable expenses. This is providing a vehicle for strong  
23 growth over at least the next 3 to 5 years.

## 24 **OVERVIEW OF PSE**

### 25 **Q. PLEASE PROVIDE A BRIEF OVERVIEW OF PSE AND ITS INVESTMENT** 26 **CHARACTERISTICS.**

27 **A.** PSE is owned by Puget Energy. Puget Energy has been in the process of divesting  
28 nonregulated investments and focusing on its regulated utility business. PSE's current

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<sup>4/</sup> "Despite Demands For Increased Capital Spending, U.S. Utility Ratings Should Remain Stable," Standard & Poor's *RatingsDirect*, January 12, 2007, at 1.

1 senior secured bond rating from S&P and Moody's is "BBB+" and "Baa2," respectively.  
2 PSE's parent company, Puget Energy's, corporate credit rating from S&P and Moody's is  
3 "BBB-" and "Ba1," respectively.<sup>5/</sup>

4 **PSE'S PROPOSED CAPITAL STRUCTURE**

5 **Q. WHAT CAPITAL STRUCTURE IS THE COMPANY REQUESTING TO USE TO**  
6 **DEVELOP ITS OVERALL RATE OF RETURN FOR ELECTRIC OPERATIONS**  
7 **IN THIS PROCEEDING?**

8 **A.** PSE's proposed capital structure is shown below in Table 1.

Description	Percent of Total Capital
Short-Term Debt	4.93%
Long-Term Debt	50.04%
Preferred Stock	0.03%
Common Equity	<u>45.00%</u>
Total Regulatory Capital Structure	100.00%

Source: Exhibit No. \_\_ (DEG-1T) at 7.

9 **Q. DO YOU BELIEVE PSE'S PROPOSED CAPITAL STRUCTURE IS**  
10 **REASONABLE FOR SETTING RATES?**

11 **A.** Yes. Its capital structure reasonably reflects PSE's actual capitalization mix supporting  
12 its utility operations. Its capital structure reflects the Company's actual capital structure  
13 in the test year reflecting a \$300 million stock issuance in October 2007, and projected  
14 debt issuances through the end of the rate effective year. Further, this capital structure  
15 mix is reasonable given the Company's current bond rating and business risk assessment  
16 by S&P.

<sup>5/</sup> Puget Energy Inc., 2007 Securities and Exchange Form 10K at 53.

1 **Q. DO YOU PROPOSE ANY ADJUSTMENTS TO PSE’S COST OF SHORT-TERM**  
2 **DEBT?**

3 **A.** Yes. PSE’s estimated cost of short-term debt is 5.92% (Exhibit No. \_\_\_(DEG-5C) at 3) .  
4 This cost of debt is based on a projected 3-month LIBOR rate plus a spread for both its  
5 commercial paper, and a separate spread for its accounts receivable balance.

6 The adjustment I propose is an update of the 3-month LIBOR rate. In December  
7 2007, when PSE made its filing, its projected 3-month LIBOR rate was between 5.03%  
8 and 5.29% as shown in Exhibit No.\_\_(DEG-5C), page 4. Since that presentation was  
9 prepared, the Federal Reserve has cut short-term interest rates dramatically. As a result,  
10 the current projected LIBOR rate is 2.58% over the four quarters ending Q32009.  
11 Updating the Company’s cost of commercial paper and accounts receivable lowers the  
12 weighted average cost of short-term debt from the Company’s original filing of 5.92%  
13 down to 2.89%. This revised short-term debt cost is shown on Exhibit No.\_\_(MPG-4).

14 **RETURN ON COMMON EQUITY**

15 **Q. PLEASE DESCRIBE WHAT IS MEANT BY A “UTILITY’S COST OF**  
16 **COMMON EQUITY.”**

17 **A.** A utility’s cost of common equity is the return investors expect, or require, in order to  
18 make an investment. Investors expect to achieve their return requirement from receiving  
19 dividends and stock price appreciation.

20 **Q. PLEASE DESCRIBE THE FRAMEWORK FOR DETERMINING A**  
21 **REGULATED UTILITY’S COST OF COMMON EQUITY.**

22 **A.** In general, determining a fair cost of common equity for a regulated utility has been  
23 framed by two decisions of the U.S. Supreme Court, in Bluefield Water Works &  
24 Improvement Co. v. Public Serv. Commission of West Virginia, 262 U.S. 679 (1923) and  
25 Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

1           These decisions identify the general standards to be considered in establishing the  
2 cost of common equity for a public utility. Those general standards provide that the  
3 authorized return should: (1) be sufficient to maintain financial integrity; (2) attract  
4 capital under reasonable terms; and (3) be commensurate with returns investors could  
5 earn by investing in other enterprises of comparable risk.

6 **Q. PLEASE DESCRIBE THE METHODS YOU HAVE USED TO ESTIMATE THE**  
7 **COST OF COMMON EQUITY FOR PSE.**

8 **A.** I have used several models based on financial theory to estimate PSE's cost of common  
9 equity. These models are: (1) a constant growth Discounted Cash Flow ("DCF") model;  
10 (2) a two-stage growth DCF model; (3) a Risk Premium model; and (4) a Capital Asset  
11 Pricing Model ("CAPM"). I have applied these models to a group of publicly traded  
12 utilities that I have determined reflect similar investment risk to PSE.

13 **Q. PLEASE DESCRIBE THE PROXY GROUP YOU USED TO ESTIMATE PSE'S**  
14 **RETURN ON EQUITY IN THIS PROCEEDING.**

15 **A.** I developed a group of companies that proxy PSE's total investment risk as follows. I  
16 first started with the companies classified by *Value Line* as electric utility companies and  
17 then eliminated companies that failed to meet the following criteria:

- 18           1. S&P's senior secured bond rating in the "BBB" and "lower A-range"  
19           categories, as published in the *AUS Utility Reports*.
- 20           2. Moody's senior secured bond rating in the "Baa" and "lower A-range"  
21           categories, as published in the *AUS Utility Reports*.
- 22           3. Common equity ratios to total capital between 40% and 60% by *Value Line*  
23           and *AUS Utility Reports*.
- 24           4. Had not suspended dividends over the last two years.
- 25           5. Consensus analyst growth rates estimates available from at least two of the  
26           following: Zacks, Reuters and SNL Financial.
- 27           6. No significant divestiture, merger and acquisition activities.



1 7. Classified as “Regulated” or “Mostly Regulated” by the EEI.

2 8. Not exposed to corporate or market restructuring.

3 **Q. HOW DOES YOUR PROXY GROUP’S INVESTMENT RISK COMPARE TO**  
4 **PSE’S INVESTMENT RISK?**

5 **A.** The proxy group is shown on Exhibit No.\_\_\_\_(MPG-5). This proxy group has an average  
6 bond rating from S&P and Moody’s of “BBB+” and “Baa1,” respectively. PSE’s S&P  
7 and Moody’s bond ratings are “BBB+” and “Baa2,” respectively. This proxy group’s  
8 average bond rating is comparable to PSE’s corporate credit ratings from S&P and  
9 Moody’s.

10 The proxy group has an average common equity ratio of 46.2% (including  
11 short-term debt) from AUS and 50.3% (excluding short-term debt) from *Value Line*. The  
12 common equity ratio for PSE is 45.0%, including short-term debt and 47.3%, excluding  
13 short-term debt. As such, the proxy group has comparable financial risk to PSE.

14 The proxy group’s average EEI operating risk assessment is “Regulated.” EEI  
15 rates publicly traded companies based on their relative exposure to regulated and  
16 non-regulated operating risk.<sup>6/</sup> EEI rates publicly traded companies in three categories:  
17 “Regulated,” “Mostly Regulated” and “Diversified.” The proxy group is made up  
18 entirely of “Regulated” and “Mostly Regulated” companies as rated by EEI. There are  
19 no “Diversified” companies included in the proxy group. PSE’s EEI operating risk  
20 assessment is “Regulated.” Hence, the operating risk of the proxy group is comparable to  
21 that of PSE.

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<sup>6/</sup> EEI rates companies that have 80% or more of total assets in regulated operations and designates them as “Regulated” entities. “Mostly Regulated” entities are those companies that have 50% to 80% of total assets in regulated operations. Finally, EEI rates companies with less than 50% of assets in regulated enterprises as “Diversified” companies. EEI Dividends Q1 2008 Financial Update.

1 Based on this assessment, I believe the proxy group has reasonably comparable  
2 total investment risk to PSE.

3 **DISCOUNTED CASH FLOW MODEL**

4 **Q. PLEASE DESCRIBE THE DCF MODEL.**

5 **A.** The DCF model posits that a stock price is valued by summing the present value of  
6 expected future cash flows discounted at the investor's required rate of return ("ROR") or  
7 cost of capital. This model is expressed mathematically as follows:

8 
$$P_0 = \frac{D_1}{(1+K)^1} + \frac{D_2}{(1+K)^2} + \dots + \frac{D_\infty}{(1+K)^\infty}$$
 where (Equation 1)

9  $P_0$  = Current stock price  
10  $D$  = Dividends in periods 1 -  $\infty$   
11  $K$  = Investor's required return  
12

13 This model can be rearranged in order to estimate the discount rate or investor  
14 required return, "K." If it is reasonable to assume that earnings and dividends will grow  
15 at a constant rate, then Equation 1 can be rearranged as follows:

16 
$$K = D_1/P_0 + G$$
 (Equation 2)

17  $K$  = Investor's required return  
18  $D_1$  = Dividend in first year  
19  $P_0$  = Current stock price  
20  $G$  = Expected constant dividend growth rate

21 Equation 2 is referred to as the annual "constant growth" DCF model.

22 **Q. PLEASE DESCRIBE THE INPUTS TO YOUR CONSTANT GROWTH DCF**  
23 **MODEL.**

24 **A.** As shown under Equation 2 above, the DCF model requires a current stock price,  
25 expected dividend, and expected growth rate in dividends.

1 **Q. WHAT STOCK PRICE AND DIVIDEND HAVE YOU RELIED ON IN YOUR**  
2 **CONSTANT GROWTH DCF MODEL?**

3 **A.** I relied on the average of the weekly high and low stock prices over a 13-week period  
4 ended May 2, 2008. An average stock price is less susceptible to market price variations  
5 than is a spot price. Therefore, an average stock price is less susceptible to aberrant  
6 market price movements, which may not be reflective of the stock's long-term value.

7 A 13-week average stock price is short enough to contain data that reasonably  
8 reflects current market expectations, but is not so short a period as to be susceptible to  
9 market price variations that may not be reflective of the security's long-term value.  
10 Therefore, in my judgment, a 13-week average stock price is a reasonable balance  
11 between the need to reflect current market expectations and the need to capture sufficient  
12 data to smooth out aberrant market movements.

13 I used the most recently paid quarterly dividend, as reported in *The Value Line*  
14 *Investment Survey*. This dividend was annualized (multiplied by 4) and adjusted for next  
15 year's growth to produce the D1 factor for use in Equation 2 above.

16 **Q. WHAT DIVIDEND GROWTH RATES HAVE YOU USED IN YOUR CONSTANT**  
17 **GROWTH DCF MODEL?**

18 **A.** There are several methods one can use in order to estimate the expected growth in  
19 dividends. However, for purposes of determining the market required return on common  
20 equity, one must attempt to estimate investors' consensus about what the dividend or  
21 earnings growth rate will be, and not what an individual investor or analyst may use to  
22 form individual investment decisions.

23 Security analysts' growth estimates have been shown to be more accurate  
24 predictors of future returns than growth rates derived from historical data because they

1 are more reliable estimates.<sup>7/</sup> Assuming the market generally makes rational investment  
2 decisions, analysts' growth projections are more likely the growth estimates considered  
3 by the market that influence observable stock prices than are growth rates derived from  
4 only historical data.

5 For my constant growth DCF analysis, I have relied on a consensus, or mean, of  
6 professional security analysts' earnings growth estimates as a proxy for the investor  
7 consensus dividend growth rate expectations. I used the average of three sources of  
8 ratepayer growth rate estimates: Zacks, Reuters, and SNL Financial. All consensus  
9 analysts' projections used were available on May 6, 2008, as reported on-line.

10 Each consensus growth rate projection is based on a survey of security analysts.  
11 The consensus estimate is a simple arithmetic average, or mean, of surveyed analysts'  
12 earnings growth forecasts. A simple average of the growth forecasts gives equal weight  
13 to all surveyed analysts' projections. It is problematic as to whether any particular  
14 analyst's forecast is most representative of general market expectations. Therefore, a  
15 simple average, or arithmetic mean, of analyst forecasts is a good proxy for market  
16 consensus expectations. The growth rates I used in my DCF analysis are shown on  
17 Exhibit No.\_\_(MPG-6).

18 **Q. WHAT ARE THE RESULTS OF YOUR CONSTANT GROWTH DCF MODEL?**

19 **A.** As shown on Exhibit No.\_\_(MPG-7), the constant growth DCF return for the proxy  
20 group is 11.39%.

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<sup>7/</sup> See, e.g., David Gordon, Myron Gordon, and Lawrence Gould, "Choice Among Methods of Estimating Share Yield," The Journal of Portfolio Management, Spring 1989.

1 **Q. DO YOU HAVE ANY COMMENTS CONCERNING THE RESULTS OF YOUR**  
2 **CONSTANT GROWTH DCF ANALYSIS?**

3 **A.** Yes. The constant growth DCF return is not reasonable and represents an inflated return  
4 for PSE at this time. The average 3-5 year growth rate for the proxy group is 6.66%.  
5 This growth rate is far too high to be a rational estimate of the proxy group's long-term  
6 sustainable growth. Because the current 3-5 year growth rates are too high to be  
7 reasonable long-term sustainable growth rate estimates, the constant growth DCF model  
8 is currently producing an inflated DCF return and should not be used in the calculation of  
9 PSE's return on equity.

10 **Q. WHY DO YOU BELIEVE THE PROXY GROUP'S 3-5 YEAR GROWTH RATE**  
11 **IS IN EXCESS OF A RATIONAL ESTIMATE OF LONG-TERM SUSTAINABLE**  
12 **GROWTH?**

13 **A.** The proxy group's 3-5 year growth rate exceeds the growth rate of the overall U.S.  
14 economy. Based on consensus economic projections, as published by *Blue Chip*  
15 *Economic Indicators*, the nominal 5-year and 10-year Gross Domestic Product ("GDP")  
16 growth rate estimate is 5.0% and 4.8%, respectively.<sup>8/</sup> A company cannot grow,  
17 indefinitely, at a faster rate than the market in which it sells its products. The U.S.  
18 economy, or GDP, growth projection represents a ceiling, or high-end, sustainable  
19 growth rate for a utility over an indefinite period of time.

20 **Q. WHY IS THE GDP GROWTH PROJECTION CONSIDERED A CEILING**  
21 **GROWTH RATE FOR A UTILITY?**

22 **A.** Utilities cannot sustain a growth rate that exceeds the growth rate of the overall economy  
23 indefinitely. Utilities' earnings/dividend growth is created by increased utility  
24 investment or rate base. Utility plant investment, in turn, is driven by service area

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<sup>8/</sup> *Blue Chip Economic Indicators*, March 10, 2008 at 15.

1 economic growth and demand for utility service. In other words, utilities invest in plant  
2 to meet sales demand growth, and sales growth in turn is tied to economic growth in their  
3 service areas. The Energy Information Administration (“EIA”) has observed that utility  
4 sales growth is less than U.S. economic growth, as shown on Exhibit No.\_\_(MPG-8).  
5 Utility sales growth has lagged the GDP growth. Hence, nominal GDP growth is a very  
6 conservative, albeit overstated, proxy for electric utility sales growth, rate base growth,  
7 and earnings growth. Therefore, GDP growth is a reasonable proxy for the highest  
8 sustainable long-term growth rate of a utility.

9 **Q. HOW HAS THE PROXY GROUP’S HISTORICAL GROWTH COMPARED TO**  
10 **HISTORICAL NOMINAL GDP GROWTH?**

11 **A.** As shown on Exhibit No.\_\_(MPG-9), the historical growth of the proxy group’s  
12 dividend is substantially lower than the nominal GDP growth. Therefore, the proxy  
13 group’s 3-5 year projected growth rate estimates are considerably higher than historical  
14 growth in relation to nominal GDP growth, and are thus unreasonable.

15 **Q. IS THERE REASON TO BELIEVE THAT THE PROXY GROUP’S GROWTH**  
16 **COULD BE HIGHER GOING FORWARD THAN IT HAS BEEN**  
17 **HISTORICALLY?**

18 **A.** Yes. As shown on Exhibit No.\_\_(MPG-10), the Company’s payout ratio has been  
19 decreasing considerably over the last few years, and is projected to decrease from  
20 approximately 69% in 2007 down to 62% over the next 3-5 years. This reduction in the  
21 dividend payout ratio corresponds to an increase in the earnings retention ratio which  
22 fuels stronger growth because more earnings are retained to invest in utility plant and  
23 grow earnings and dividends.

1 **Q. IS THERE RESEARCH THAT SUPPORTS YOUR CONTENTION THAT OVER**  
2 **THE LONG TERM, A COMPANY’S EARNINGS AND DIVIDENDS CANNOT**  
3 **GROW AT A RATE GREATER THAN THE GROWTH OF THE U.S. GDP?**

4 **A.** Yes. This concept is supported both in published analyst literature and in academic work.  
5 Specifically, in a textbook entitled “Fundamentals of Financial Management,” published  
6 by Eugene Brigham and Joel F. Houston, the authors stated as follows:

7 The constant growth model is most appropriate for mature companies with  
8 a stable history of growth and stable future expectations. Expected growth  
9 rates vary somewhat among companies, but dividends for mature firms are  
10 often expected to grow in the future at about the same rate as nominal  
11 gross domestic product (real GDP plus inflation).<sup>9/</sup>

12 Also, Morningstar’s *Stocks, Bonds, Bills and Inflation 2008 Yearbook Valuation*  
13 *Edition* tracked dividends of the stock market in comparison to GDP growth over the  
14 period 1926 through the end of 2006.<sup>10/</sup> Based on that study, the authors found that  
15 earnings and dividends for the market have historically grown in tandem with the overall  
16 economy. It is important to note that the growth of companies included in the overall  
17 market will normally be higher than that of utility companies. These non-utility  
18 companies achieve higher level of growth because they retain a larger percentage of their  
19 earnings and pay out a much smaller percentage of their earnings as dividends. Retaining  
20 higher percentages of total earnings fuels stronger growth for these non-utility  
21 companies. Since the market in general grows at the overall GDP growth rate, it is very  
22 conservative to assume that utility companies could achieve this same level of sustained  
23 growth without a material reduction in their dividend payout ratios. As such, using the

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<sup>9/</sup> “Fundamentals of Financial Management,” Eugene F. Grigham and Joel F. Houston, Eleventh Edition  
2007, Thomson South-Western, a Division of Thomson Corporation at 298.

<sup>10/</sup> *Stocks, Bonds, Bills and Inflation 2008 Yearbook Valuation Edition* (Morningstar, Inc.) at 92-93.

1 GDP as a maximum sustainable growth rate is a very conservative and high-end estimate  
2 for utility companies.

3 **Q. WHY DO YOU BELIEVE GROWTH RATES FOR ELECTRIC UTILITY**  
4 **COMPANIES ARE PROJECTED TO BE HIGHER OVER THE NEXT**  
5 **3-5 YEARS?**

6 **A.** Electric utility companies are in the midst of major construction programs, which are  
7 significantly increasing their outstanding capital and net plant investment. In the fourth  
8 quarter 2007, EEI published a stock performance assessment for electric utility stocks.  
9 EEI stated the following concerning rate base growth:

10 **Accelerating Regulated Rate Base Growth**

11 U.S. electricity demand is growing slowly but steadily and reserve  
12 margins are shrinking in many power markets nationwide. The utility  
13 industry is in the early stages of a sizeable long-term capital investment  
14 cycle that includes rising spending on emissions control equipment,  
15 transmission and distribution upgrades and, over the longer term, a new  
16 round of baseload generation. Much of this will likely be built in  
17 regulated rate base.

18 EEI's spring 2007 study of industry capital spending based on 10-K data  
19 and discussions with companies indicated that the industry is projecting  
20 \$73.1 billion of capital expenditures in 2007 – a 21.1% rise from the  
21 \$60.3 billion spent in 2006 and 51.1% above the \$48.4 billion in 2005.  
22 Based on current projections, industry capex should reach at least \$75  
23 billion in 2008 and \$75.5 billion in 2009. And Wall Street analysts  
24 forecast strong investment by the industry beyond the end of the decade.  
25 The prospect of carbon regulation adds to the potential longevity of the  
26 current build cycle, should carbon capture and sequestration become the  
27 most economically viable way of complying with likely future carbon  
28 limits.

29 EEI's assessment indicates that annual capital spending will increase through  
30 2009. After that date, the amount of capital expenditures by utilities may stay at a  
31 relatively constant rate, albeit one that is significantly higher than it had been in prior  
32 years. This elevated capital spending level may continue over a relatively long period of



1 time. This indicates that rate base growth will drive earnings growth over the next  
2 3-5 years. Afterward, the relatively high level of capital expenditures and related  
3 increases in rate base and earnings will slow, but stay at an historically high level, near  
4 the GDP growth.

5 **Q. IS THERE A WAY OF TESTING WHETHER IT IS RATIONAL TO EXPECT**  
6 **THAT THE ANALYSTS' 3-5 YEAR EARNINGS GROWTH OUTLOOKS CAN**  
7 **BE A REASONABLE ESTIMATE OF SUSTAINABLE LONG-TERM GROWTH?**

8 **A.** Yes. This can be tested using an internal growth rate calculation for the companies  
9 included in my comparable group using *Value Line's* 3-5 year earnings and dividends  
10 projections, and estimated earned return on equity. An internal growth rate methodology  
11 estimates the sustainable growth rate based on the percentage of the utility's earnings that  
12 are retained in the company and reinvested in utility plant and equipment. These  
13 reinvested earnings then increase the earnings base, and will increase the earned return on  
14 equity as those additional earnings are put into service and the company is allowed to  
15 earn its authorized return on the additional investment.

16 As shown on Exhibit No. \_\_\_ (MPG-11), the average sustainable growth rate for  
17 my proxy group using this internal growth rate model is approximately 4.5%. This  
18 sustainable growth rate could be increased slightly by reflecting the issuance of  
19 additional shares at prices above book value, but that should only modestly increase this  
20 growth rate estimate.

21 In comparison, using the group average growth rate of 6.66%, and a 3-5 year  
22 dividend payout ratio of 62%, would require an earned return on book equity of 13.9%.  
23 In comparison, *Value Line* is projecting a group average return on book equity of 11.0%,  
24 and 10.0% excluding Exelon. I conclude from this estimate of a sustainable growth

1 estimate, and a book return on equity needed to support the analysts' 3-5 year growth rate  
2 estimate, as evidence that the 3-5 year earnings growth rate estimates are much higher  
3 than a reasonable estimate of long-term sustainable growth for these companies. As  
4 such, an expansion of the traditional constant growth DCF model is appropriate in order  
5 to produce a reasonable and reliable DCF return estimate in this proceeding.

6 **Q. SINCE YOU HAVE CONCLUDED THAT THE GROWTH RATES USED IN**  
7 **YOUR CONSTANT GROWTH DCF MODEL ARE HIGHER THAN THE**  
8 **LONG-TERM SUSTAINABLE GROWTH, DO YOU BELIEVE THAT YOUR**  
9 **CONSTANT GROWTH DCF RESULT IS REASONABLE?**

10 **A.** No. My constant growth DCF analysis result is too high because the growth rate used in  
11 this study, 6.66%, is higher than the maximum sustainable growth rate of 4.8% to 5.0%.  
12 As a result, this DCF return is not reliable.

13 However, my constant growth DCF is based on consensus analysts' growth rate  
14 projections, so it is a reasonable reflection of rational investment expectations over the  
15 next 3-5 years. The limitation on the constant growth DCF model is that it cannot reflect  
16 a rational expectation that a period of high/low short-term growth can be followed by a  
17 change in growth to a rate that is more reflective of long-term sustainable growth.  
18 Hence, I performed a two-stage DCF analysis to reflect this outlook of changing growth  
19 expectations.

## 20 **TWO-STAGE DCF MODEL**

21 **Q. PLEASE DESCRIBE YOUR TWO-STAGE DCF MODEL.**

22 **A.** The two-stage DCF growth model reflects the possibility of non-constant growth for a  
23 company over time. The two-stage model reflects two growth periods: (1) a short-term  
24 growth period, which consists of the first 5 years; and (2) a long-term growth period,  
25 which consists of each year starting in year six through perpetuity. For the short-term

1 growth period, I relied on the consensus analysts' growth projections described above in  
2 relationship to my constant growth DCF model. For the long-term growth period, I  
3 assumed each company's growth would converge on the maximum sustainable growth  
4 rate for a utility company as proxied by the consensus analysts' projected growth for the  
5 U.S. GDP.

6 **Q. WHAT STOCK PRICE AND DIVIDEND DID YOU USE IN YOUR TWO-STAGE**  
7 **DCF ANALYSIS?**

8 **A.** I relied on the same 13-week stock price, the most recent quarterly dividend payment,  
9 and consensus analysts' growth rate projections discussed above in my constant growth  
10 DCF model. For the long-term sustainable growth rate starting in year six, I used 4.9%,  
11 the average of the consensus economists' 5-10 year projected nominal GDP growth rate  
12 (5.0% to 4.8%).

13 **Q. WHAT ARE THE RESULTS OF YOUR TWO-STAGE GROWTH DCF MODEL?**

14 **A.** As shown on Exhibit No. \_\_\_ (MPG-12), the two-stage DCF return on equity for the proxy  
15 group is 9.86%.

16 **RISK PREMIUM MODEL**

17 **Q. PLEASE DESCRIBE YOUR BOND YIELD PLUS RISK PREMIUM MODEL.**

18 **A.** This model is based on the principle that investors require a higher return to assume  
19 greater risk. Common equity investments have greater risk than bonds because bonds  
20 have more security of payment in bankruptcy proceedings than common equity and the  
21 coupon payments on bonds represent contractual obligations. In contrast, companies are  
22 not required to pay dividends on common equity, or to guarantee returns on common  
23 equity investments. Therefore, common equity securities are considered to be more risky  
24 than bond securities.

1           This risk premium model is based on two estimates of an equity risk premium.  
2           First, I estimated the difference between the required return on utility common equity  
3           investments and Treasury bonds. The difference between the required return on common  
4           equity and the bond yield is the risk premium. I estimated the risk premium on an annual  
5           basis for each year over the period 1986 through 2007. The common equity required  
6           returns were based on regulatory commission-authorized returns for electric utility  
7           companies. Authorized returns are typically based on expert witnesses' estimates of the  
8           contemporary investor required return.

9           The second equity risk premium method is based on the difference between  
10          regulatory commission-authorized returns on common equity and contemporary  
11          “A” rated utility bond yields. The 1986-2007 time period was selected because over the  
12          period 1986 through 2007, public utility stocks have consistently traded at a premium to  
13          book value. This is illustrated on Exhibit No.\_\_(MPG-13), where the market to book  
14          ratio since 1986 for the electric utility industry was consistently above 1.0. Therefore,  
15          over this time period, regulatory authorized returns were sufficient to support market  
16          prices that at least exceeded book value. This is an indication that regulatory authorized  
17          returns on common equity supported a utility's ability to issue additional common stock,  
18          without diluting existing shares. It further demonstrates that utilities were able to access  
19          equity markets without a detrimental impact on current shareholders.

20          Based on this analysis, as shown on Exhibit No.\_\_(MPG-14), the average  
21          indicated equity risk premium over U.S. Treasury bond yields has been 5.05%. Of the 22  
22          observations, 16 indicated risk premiums fall in the range of 4.40% to 5.89%. Since the  
23          risk premium can vary depending upon market conditions and changing investor risk

1 perceptions, I believe using an estimated range of risk premiums provides the best  
2 method to measure the current return on common equity using this methodology.

3 As shown on Exhibit No.\_\_(MPG-15), the average indicated equity risk  
4 premium over contemporary Moody's utility bond yields was 3.66% over the period  
5 1986 through 2007. The equity risk premium estimates based on this analysis primarily  
6 fall in the range of 3.03% to 4.39% over this time period.

7 **Q. BASED ON HISTORICAL DATA, WHAT RISK PREMIUM HAVE YOU USED**  
8 **TO ESTIMATE PSE'S COST OF EQUITY IN THIS PROCEEDING?**

9 **A.** The equity risk premium should reflect the relative market perception of risk in the utility  
10 industry today. I have gauged investor perceptions in utility risk today on Exhibit  
11 No.\_\_(MPG-16). On that exhibit, I show the yield spread between utility bonds and  
12 Treasury bonds over the last 28 years. As shown on this exhibit, the 2007 utility bond  
13 yield spreads over Treasury bonds for "A" rated and "Baa" rated utility bonds are 1.23%  
14 and 1.49%, respectively. These utility bond yield spreads over Treasury bond yields are  
15 among the lowest yield spreads in the last 28 years, and are below the 28-year average  
16 "A" and "Baa" yield spreads of 1.57% and 1.93%, respectively. The current spread  
17 between spot 30-year Treasury bonds, 4.8%, and "A" rated utility bond yields, 6.2%, is  
18 1.4 percentage points, which is about the average yield spread over the last 28 years.  
19 Hence, this comparison of utility bond yield spreads indicates the market perception of  
20 utility risk to be about average relative to this historical time period.

21 **Q. HOW DID YOU ESTIMATE PSE'S COST OF COMMON EQUITY WITH THIS**  
22 **RISK MODEL?**

23 **A.** I added a projected long-term Treasury bond yield to my estimated equity risk premium  
24 over Treasury yields. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond

1 yield to be 4.9%, and a 10-year Treasury bond yield to be 4.3%.<sup>11/</sup> Using the projected  
2 30-year bond yield of 4.9%, and a Treasury bond risk premium of 4.40% to 5.89%,  
3 produces an estimated common equity return in the range of 9.30% to 10.79%, with a  
4 midpoint estimate of 10.05%.

5 I next added my equity risk premium over utility bond yields to a current 13-week  
6 average yield on “Baa” rated utility bonds for the period ending April 4, 2008 of 6.69%.  
7 This current “Baa” utility bond yield is developed on Exhibit No.\_\_\_\_(MPG-17). Adding  
8 the utility equity risk premium of 3.03% to 4.39% to a “Baa” rated bond yield of 6.69%,  
9 produces a cost of equity in the range of 9.72% to 11.08%, with a midpoint of 10.40%.

10 My risk premium analyses produce a return estimate in the range of 10.05% to  
11 10.40%, with a midpoint estimate of 10.23%.

## 12 CAPITAL ASSET PRICING MODEL

### 13 Q. PLEASE DESCRIBE THE CAPM.

14 A. The CAPM method of analysis is based upon the theory that the market required rate of  
15 return for a security is equal to the risk-free rate, plus a risk premium associated with the  
16 specific security. This relationship between risk and return can be expressed  
17 mathematically as follows:

$$18 \quad R_i = R_f + B_i \times (R_m - R_f) \text{ where:}$$

19  $R_i =$  Required return for stock i

20  $R_f =$  Risk-free rate

21  $R_m =$  Expected return for the market portfolio

22  $B_i =$  Beta - Measure of the risk for stock

23 The stock-specific risk term in the above equation is beta. Beta represents the  
24 investment risk that cannot be diversified away when the security is held in a diversified

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<sup>11/</sup> *Blue Chip Financial Forecasts*, May 1, 2008 at 2.

1 portfolio. When stocks are held in a diversified portfolio, firm-specific risks can be  
2 eliminated by balancing the portfolio with securities that react in the opposite direction to  
3 firm-specific risk factors (e.g., business cycle, competition, product mix and production  
4 limitations).

5 The risks that cannot be eliminated when held in a diversified portfolio are  
6 nondiversifiable risks. Nondiversifiable risks are related to the market in general and are  
7 referred to as systematic risks. Risks that can be eliminated by diversification are  
8 regarded as nonsystematic risks. In a broad sense, systematic risks are market risks, and  
9 nonsystematic risks are business risks. The CAPM theory suggests that the market will  
10 not compensate investors for assuming risks that can be diversified away. Therefore, the  
11 only risk that investors will be compensated for are systematic or nondiversifiable risks.  
12 The beta is a measure of the systematic or nondiversifiable risks.

13 **Q. PLEASE DESCRIBE THE INPUTS TO YOUR CAPM.**

14 **A.** The CAPM requires an estimate of the market risk-free rate, the company's beta, and the  
15 market risk premium.

16 **Q. WHAT DID YOU USE AS AN ESTIMATE OF THE MARKET RISK-FREE**  
17 **RATE?**

18 **A.** *Blue Chip Financial Forecasts'* projected 30-year Treasury bond yield is 4.9%.<sup>12/</sup> The  
19 current 30-year bond yield is 4.4%. I used *Blue Chip Financial Forecasts'* projected  
20 30-year Treasury bond yield of 4.9% for my CAPM analysis.

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<sup>12/</sup> *Blue Chip Financial Forecasts*, May 1, 2008 at 2.

1 **Q. WHY DID YOU USE LONG-TERM TREASURY BOND YIELDS AS AN**  
2 **ESTIMATE OF THE RISK-FREE RATE?**

3 **A.** Treasury securities are backed by the full faith and credit of the United States  
4 government. Therefore, long-term Treasury bonds are considered to have negligible  
5 credit risk. Also, long-term Treasury bonds have an investment horizon similar to that of  
6 common stock. As a result, investor-anticipated long-run inflation expectations are  
7 reflected in both common stock required returns and long-term bond yields. Therefore,  
8 the nominal risk-free rate (or expected inflation rate and real risk-free rate) included in a  
9 long-term bond yield is a reasonable estimate of the nominal risk-free rate included in  
10 common stock returns.

11 Treasury bond yields, however, do include risk premiums related to unanticipated  
12 future inflation and interest rates. Therefore, a Treasury bond yield is not a risk-free rate.  
13 Risk premiums related to unanticipated inflation and interest rates are systematic or  
14 market risks. Consequently, for companies with betas less than 1.0, using the Treasury  
15 bond yield as a proxy for the risk-free rate in the CAPM analysis can produce an  
16 overstated estimate of the CAPM return.

17 **Q. WHAT BETA DID YOU USE IN YOUR ANALYSIS?**

18 **A.** As shown on Exhibit No.\_\_(MPG-18), the proxy group average *Value Line* beta  
19 estimate is 0.85.

20 Based on this data, I will use a beta of 0.85 for my CAPM analysis.



1 **Q. DO YOU RECOMMEND A CAREFUL CONSIDERATION OF A UTILITY**  
2 **BETA FOR USE IN A CAPM STUDY?**

3 **A.** Yes. Utility betas have been increasing over the last 5 years, as shown on Exhibit  
4 No.\_\_(MPG-18), largely because electric utility stocks have outperformed the overall  
5 market. While this increasing beta gives the impression of increasing risk, that  
6 interpretation is incorrect.

7 Indeed, electric utility risk factors have been decreasing as these companies revert  
8 to a back-to-basics investment strategy that lowers their operating risks, and they have  
9 been divesting non-regulated businesses to reduce debt and strengthen balance sheets,  
10 which is lowering risk. *Value Line* notes this in a recent review of the electric utility  
11 industry. *Value Line* states as follows:

12 Better Finances  
13 This decade, utilities have distanced themselves from risky  
14 unregulated business forays, including commodities trading,  
15 foreign energy operations, water services and aircraft leasing.  
16 Currently, *Dominion Resources* plans to sell its oil and gas  
17 production business, *Duke* is spinning its mid-stream gas  
18 operations to shareholders, *Northeast Utilities* is divesting its  
19 merchant power generation business, and *Progress Energy* is  
20 shedding power plant and natural gas assets. Such actions have  
21 improved earnings performance and strengthened capital ratios.  
22 Companies are targeting a nearly equal weighting of debt and  
23 equity on their balance sheets, a goal that should be met by 2009-  
24 2011.<sup>13/</sup>

25 Further, *Value Line* notes an increase in the common equity ratio and fixed charge  
26 coverage ratio over the last 3-5 years. These *Value Line* parameters indicate lower  
27 financial risk and stronger earnings and cash flow coverages of financial obligations.  
28 This reduces utilities' risk and limits the variability to market factors that can inhibit the  
29 utilities' ability to meet investors' earnings and cash flow expectations.

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<sup>13/</sup> *The Value Line Investment Survey*, Electric Utility (East) Industry, December 1, 2006 at 157.

1           These risk reductions have resulted in robust stock return performance for electric  
2 utility stocks, as shown on Exhibit No.\_\_\_\_(MPG-19). As illustrated on this exhibit,  
3 electric utility stocks have outperformed the market over the last 5 years. This utility  
4 stock performance has contributed to an increase in betas and given the impression that  
5 electric utility stock variability is comparable to the overall market, but other risk factors  
6 clearly show this to be a false indication.

7 **Q. HOW DID YOU DERIVE YOUR MARKET RISK PREMIUM ESTIMATE?**

8 **A.** I derived two market risk premium estimates, a forward-looking estimate and one based  
9 on a long-term historical average.

10           The forward-looking estimate was derived by estimating the expected return on  
11 the market (as represented by the S&P 500) and subtracting the risk-free rate from this  
12 estimate. I estimated the expected return on the S&P 500 by adding an expected inflation  
13 rate to the long-term historical arithmetic average real return on the market. The real  
14 return on the market represents the achieved return above the rate of inflation.

15           Morningstar's Stocks, Bonds, Bills and Inflation 2008 Yearbook publication  
16 estimates the historical arithmetic average real market return over the period 1926-2007  
17 as 9.0%. A current consensus analysts' inflation projection, as measured by the  
18 Consumer Price Index, is 2.3%.<sup>14/</sup> Using these estimates, the expected market return is  
19 11.51%.<sup>15/</sup> The market premium then is the difference between the 11.51% expected  
20 market return, and my 4.9% risk-free rate estimate, or 6.61%.

21           The historical estimate of the market risk premium was also estimated by  
22 Morningstar in Stocks, Bonds, Bills and Inflation 2008 Yearbook. Over the period 1926

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<sup>14/</sup> *Blue Chip Financial Forecasts*, May 1, 2008 at 2.

<sup>15/</sup>  $\{ [(1 + 0.090) * (1 + 0.023)] - 1 \} * 100$ .

1 through 2007, Morningstar's study estimated that the arithmetic average of the achieved  
2 total return on the S&P 500 was 12.30%, and the total return on long-term Treasury  
3 bonds was 5.80%. The indicated equity risk premium is 6.50% (12.30% - 5.80% =  
4 6.50%).

5 **Q. WHAT ARE THE RESULTS OF YOUR CAPM ANALYSIS?**

6 **A.** As shown on Exhibit No.\_\_(MPG-20), based on my historical and prospective market  
7 risk premium of 6.50% and 6.61%, respectively, a beta of 0.85 and a risk-free rate of  
8 4.9%, my analysis produces a return range of 10.43% to 10.52%, with a midpoint of  
9 10.47%.

10 **RETURN ON EQUITY SUMMARY**

11 **Q. BASED ON THE RESULTS OF YOUR RATE OF RETURN ON COMMON**  
12 **EQUITY ANALYSES DESCRIBED ABOVE, WHAT RETURN ON COMMON**  
13 **EQUITY DO YOU RECOMMEND FOR PSE?**

14 **A.** Based on my analyses, I estimate PSE's current market cost of equity to be 10.12%.

<b>TABLE 2</b>	
<b>Return on Common Equity Summary</b>	
<b>Description</b>	<b>Results</b>
Two-Stage Growth DCF	9.89%
Risk Premium	10.23%
CAPM	10.47%

15 My recommended return on equity of 10.12% is at the midpoint of my estimated  
16 return on equity range for PSE of 9.89% to 10.35%. The high end of my estimated range  
17 of 10.35% is based on the average of my CAPM, 10.47%, and my risk premium, 10.23%

1 ((10.47% +10.23%)/2). The low end of my estimated range is based on my two-stage  
2 growth DCF analysis.

### 3 **FINANCIAL INTEGRITY**

#### 4 **Q. WILL YOUR RECOMMENDED OVERALL RATE OF RETURN SUPPORT AN** 5 **INVESTMENT GRADE BOND RATING FOR PSE?**

6 **A.** Yes. I have reached this conclusion by comparing the key credit rating financial ratios  
7 for PSE at its proposed capital structure, and my return on equity to S&P's benchmark  
8 financial ratios using S&P's new credit metric ranges. In addition, I compared PSE's key  
9 credit financial ratios to S&P benchmark financial ratios and to the old S&P credit metric  
10 ranges for an "A" rated utility and "BBB" rated utility with a business profile score  
11 ("BPS") of '4,' PSE's S&P rating under S&P's old credit metric benchmarks.

#### 12 **Q. WHY ARE YOU COMPARING YOUR CREDIT METRIC CALCULATIONS TO** 13 **S&P'S NEW AND OLD CREDIT METRIC GUIDELINES?**

14 **A.** S&P's new credit metrics are not as transparent and do not clearly identify utility-specific  
15 credit metric guidance ranges based on S&P business risk assessment. Specifically, S&P  
16 has not published a range, that I am aware of, where it sets out specific credit metric  
17 ranges for a utility with an "Aggressive" financial rating, and a business rating score of  
18 "Strong," PSE's current rating. However, S&P has published guidelines which appear to  
19 be generally reflective of credit metrics at various credit rating levels. In order to more  
20 clearly identify credit metric ranges that are appropriate to support PSE's credit ratings, I  
21 will use both S&P's old and new credit metric benchmarks.

#### 22 **Q. PLEASE DESCRIBE S&P'S USE OF THE FINANCIAL BENCHMARK RATIOS** 23 **IN ITS CREDIT RATING REVIEW.**

24 **A.** S&P evaluates a utility's credit rating based on an assessment of its financial and  
25 business risks. A combination of financial and business risks equates to the overall

1 assessment of PSE's total credit risk exposure. S&P publishes a matrix of financial ratios  
2 that defines the level of financial risk as a function of the level of business risk.

3 S&P publishes ranges for three primary financial ratios that it uses as guidance in  
4 its credit review for utility companies. The three primary financial ratio benchmarks it  
5 relies on in its credit rating process include: (1) funds from operations ("FFO") to debt  
6 interest expense, (2) FFO to total debt, and (3) total debt to total capital.

7 **Q. HOW DID YOU APPLY S&P'S FINANCIAL RATIOS TO TEST THE REASON-**  
8 **ABLENESS OF YOUR RATE OF RETURN RECOMMENDATIONS?**

9 **A.** I calculated each of S&P's financial ratios based on PSE's cost of service for retail  
10 operations. While S&P would normally look at total Puget Energy consolidated financial  
11 ratios in its credit review process, my investigation in this proceeding is to judge the  
12 reasonableness of my proposed cost of capital for rate setting in PSE's utility operations.  
13 Hence, I am attempting to determine whether the rate of return and cash flow generation  
14 opportunity reflected in my proposed utility rates for PSE will support target investment  
15 grade bond ratings and financial integrity.

16 **Q. PLEASE DESCRIBE THE RESULTS OF THIS CREDIT METRIC ANALYSIS**  
17 **FOR PSE.**

18 **A.** The S&P financial metric calculations for PSE are developed on Exhibit  
19 No.\_\_(MPG-21).

20 As shown on Exhibit No.\_\_(MPG-21), page 1, columns 1 and 3, based on an  
21 equity return of 10.12%, PSE will be provided an opportunity to produce an FFO to debt  
22 interest expense of 4.0x. This FFO to interest coverage ratio is within S&P's old

1 benchmark ratio guideline of 4.2x to 3.5x<sup>16/</sup> for an “A” rated utility company with a  
2 business profile score of ‘4,’ and is slightly above (stronger than) S&P’s new guideline  
3 range of 2.5x to 3.5x.<sup>17/</sup> This ratio supports an improvement of PSE’s “BBB” bond  
4 rating to “A.”

5 PSE’s retail operations FFO to total debt coverage at a 10.12% equity return  
6 would be 23%, which is within S&P’s old credit metric guideline range of 20% to 28%  
7 for an “A” bond rating and within the new metric guideline range of 10% to 30%. The  
8 FFO/total debt ratio will support an “A” rated investment grade bond rating, an  
9 improvement to PSE’s current bond rating.

10 Finally, PSE’s total debt ratio to total capital is 58%. This is at about the  
11 midpoint of S&P’s “BBB” rated utility old guideline range of 52% to 62%, and within  
12 the new guideline range of 45% to 60%. This total debt ratio will support a “BBB”  
13 investment grade bond rating.

14 At PSE’s proposed capital structure and my return on equity, PSE’s financial  
15 credit metrics are supportive of a strong “BBB” utility bond rating.

16 **RESPONSE TO PSE WITNESS DR. ROGER MORIN**

17 **Q. WHAT RATE OF RETURN ON COMMON EQUITY IS PSE REQUESTING IN**  
18 **THIS PROCEEDING?**

19 **A.** PSE is requesting a return on common equity of 10.8%. This return on common equity is  
20 at the low end of the range of 10.8% to 11.2% supported by PSE witness Dr. Roger  
21 Morin.

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<sup>16/</sup> Standard & Poor’s: New Business Profile Scores Assigned to U.S. Utilities and Power Companies;  
Financial Guidelines Revised, June 2, 2004.

<sup>17/</sup> Standard & Poor’s: U.S. Utilities Rating Analysis Now Portrayed in the S&P Corporate Ratings Matrix;  
November 30, 2007.

1 **Q. PLEASE DESCRIBE HOW DR. MORIN DEVELOPED HIS RETURN ON**  
2 **EQUITY RANGE FOR PSE.**

3 **A.** Dr. Morin employed a capital asset pricing model and empirical capital asset pricing  
4 model, two risk premium studies, and discounted cash flow studies in support of his  
5 return on equity for PSE. Dr. Morin employed these models to three proxy groups  
6 including: (1) PSE parent company; (2) a group of investment grade integrated utility  
7 companies; and (3) the Moody's Electric Utility Index.

8 Dr. Morin's estimated return on equity for PSE is shown below in Table 3 under  
9 column 1. Under column 2, I show adjustments to Dr. Morin's estimated return for PSE.  
10 These adjustments are described in more detail below.

**TABLE 3**

**Summary of Dr. Morin’s ROE Estimates**

Description	Result (1)	Adjusted Result (2)
CAPM	11.8%	10.25%
ECAPM	12.0%	Reject
<b>Average CAPM</b>	<b>11.9%</b>	<b>10.25%</b>
Historical Risk Premium Electric	10.9%	10.4%
Allowed Risk Premium	10.6%	10.4%
<b>Average Risk Premium</b>	<b>10.8%</b>	<b>10.4%</b>
DCF Puget ( <i>Value Line</i> Growth)	10.7%	Reject
DCF Puget ( <i>Zacks</i> Growth)	10.2%	Reject
DCF Vertically Integrated Utilities ( <i>Value Line</i> Growth)	10.1%	9.54%
DCF Vertically Integrated Utilities ( <i>Zacks</i> Growth)	11.5%	9.78%
DCF Moody’s Electric Utilities ( <i>Value Line</i> Growth)	10.8%	9.44%
DCF Moody’s Electric Utilities ( <i>Zacks</i> Growth)	11.3%	9.51%
<b>Average DCF</b>	<b>10.8%</b>	<b>9.57%</b>

Source: Exhibit No. \_\_\_\_ (RAM-1T) at 57.

1           As described in detail below, Dr. Morin’s ROE estimates should be adjusted as  
 2           shown in Column 2 of Table 3. Based on these adjustments, Dr. Morin’s return on equity  
 3           estimates support a return on equity for PSE in the range of 9.6% to 10.4%. Therefore,  
 4           my recommended return on equity of 10.12% represents a reasonable estimate of fair  
 5           return on equity for PSE.

6   **Q.   IS DR. MORIN’S RECOMMENDED RETURN ON EQUITY OF 10.8% FOR HIS**  
 7   **PROXY GROUP SUPPORTED BY REASONABLE APPLICATIONS OF**  
 8   **FINANCIAL MODELS?**

9   **A.**   No. Dr. Morin’s recommended return of 10.8% is overstated, and his analyses overstate  
 10       a fair return due to his use of inappropriate data and/or adjustments.



1 **Q. PLEASE DESCRIBE DR. MORIN'S CAPM ANALYSIS.**

2 **A.** Dr. Morin used a risk-free rate of 5.0%. This risk-free rate is based on 30-year Treasury  
3 bond yield projected by *Value Line* in September 2007. He used a market risk premium  
4 of 7.1%, and a beta of 0.92. With this data, Dr. Morin derived a CAPM estimate of  
5 11.5%. He then adds 0.3% to his CAPM return estimate for flotation costs, to produce a  
6 an estimate of 11.8%.<sup>18/</sup>

7 **Q. WHAT ISSUES DO YOU TAKE WITH DR. MORIN'S CAPM ANALYSIS?**

8 **A.** Dr. Morin's CAPM analysis return estimate of 11.8% is overstated and unreasonable, due  
9 to his use of an unreasonably high market risk premium of 7.1% and a beta of 0.92.

10 As set forth below, a more reasonable estimate of the market risk premium and  
11 utility beta, and an updated risk-free rate would reduce Dr. Morin's CAPM return  
12 estimate down to 10.5% from 11.8%, excluding flotation costs.

13 As set forth below, Dr. Morin's proposed flotation cost adjustment is  
14 inappropriate and should be rejected. This adjustment should be rejected because it is not  
15 a known and measurable PSE cost, and it is, therefore, not appropriate for setting  
16 regulated utility rates.

17 **Q. WHY IS DR. MORIN'S CAPM ANALYSIS INFLATED DUE TO HIS MARKET**  
18 **RISK PREMIUM ESTIMATE?**

19 **A.** Dr. Morin used a 7.1% market risk premium. Dr. Morin's market risk premium estimate  
20 is a high-end estimate and does not reflect a balanced market risk premium study. Using  
21 multiple reasonable estimates of market risk premiums would indicate that a market risk  
22 premium falls somewhere in the range of 6.2% to 7.1%.

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<sup>18/</sup> Exhibit No. \_\_\_(RAM-1T) at 31.

1 I base this conclusion on several sources including many of those relied on by  
2 Dr. Morin. First, Dr. Morin's reliance on Morningstar data for a market risk premium of  
3 7.1% only considers Morningstar's highest market risk premium estimate. This 7.1%  
4 market risk premium is based on the difference between the total market return on  
5 common stocks (S&P 500) less the income return on Treasury bond investments.  
6 However, Morningstar makes various estimates of the market risk premium with this  
7 same methodology. For example, Morningstar found that if the New York Stock  
8 Exchange (the "NYSE") was used as the market index rather than the S&P 500, that the  
9 market risk premium would be 6.8% and not 7.1%. Further, if only the two deciles of the  
10 largest companies included in the NYSE were considered, the market risk premium  
11 would be 6.35%.<sup>19/</sup>

12 Also, Morningstar found that the 7.1% market risk premium based on the S&P  
13 500 was impacted by an abnormal expansion of price-to-earnings ("P/E") ratios relative  
14 to earnings and dividend growth during the period 1980 through 2001. Morningstar  
15 believes this abnormal P/E expansion is not sustainable. Therefore, Morningstar  
16 proposed an adjustment to this market risk premium estimate to normalize the growth in  
17 the P/E ratio to be more in line with the growth in dividends and earnings. Based on this  
18 alternative methodology, Morningstar published a long-horizon supply-side market risk  
19 premium of 6.2%.<sup>20/</sup>

20 Thus, based on Morningstar data, the market risk premium falls somewhere in the  
21 range of 6.2% to 7.1%.

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<sup>19/</sup> Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. *Ibbotson SBBI 2008 Valuation Yearbook* (Morningstar, Inc.) at 72 and 74.

<sup>20/</sup> *Id.* at 92-98.

1 **Q. DO YOU TAKE ISSUE WITH THE DCF DERIVED MARKET RISK PREMIUM**  
2 **ESTIMATED BY DR. MORIN?**

3 **A.** Yes. Dr. Morin's prospective market risk premium estimate is based on a DCF return of  
4 12.18% less the risk-free rate, 5.0%, producing a market risk premium of 7.18%. The  
5 concern I have with Dr. Morin's DCF derived market risk premium is the growth rate  
6 used in his market DCF return estimate. As part of Dr. Morin's DCF return estimate of  
7 12.18%, he used a growth rate of 10.18%, along with a dividend yield of 1.62%. This  
8 growth rate of 10.18% is not sustainable in the long term. Therefore, his DCF return on  
9 the market is flawed and not reliable. The growth rate in the overall market cannot  
10 sustain a level significantly higher than the U.S. GDP over a prolonged period of time.  
11 Just like utility stocks, companies operating in the general marketplace must compete for  
12 customers in the economies in which they provide their goods and services. It is simply  
13 not rational nor reasonable to expect that the growth rates of these companies can  
14 significantly exceed the growth in the economy in which they operate over a prolonged  
15 period of time. The constant growth version of the DCF model applied to the market is  
16 the same as that applied to utility stocks. The growth rate must be a reasonable estimate  
17 of long-term sustainable growth; otherwise, it will overstate a fair DCF return estimate.

18 **Q. IS THERE ANY EVIDENCE THAT THE GROWTH IN EARNINGS AND**  
19 **DIVIDENDS OF THE S&P 500 TRACK THAT OF THE U.S. GDP?**

20 **A.** Yes. Morningstar found that the dividends and earnings of the S&P 500 generally grew  
21 in tandem with the nominal GDP.<sup>21/</sup> Projections of nominal GDP are in the 5% area over  
22 the next 5-10 years. Hence, Dr. Morin's DCF derived return on the market using a

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<sup>21/</sup> Id. at 92.

1 growth rate of more than twice the nominal GDP resulted in a DCF return that is inflated  
2 and unreliable. Using an inflated DCF return inflated his market risk premium.

3 **Q. WHAT DO YOU CONCLUDE BASED ON YOUR ASSESSMENT OF**  
4 **DR. MORIN'S MARKET RISK PREMIUM STUDY?**

5 **A.** I believe Dr. Morin's use of the market risk premium of 7.1% reflects the high end of  
6 reasonable market risk premium studies. Using Morningstar data, the range of reasonable  
7 market risk premiums is somewhere in the range of 6.2% to 7.1%. The midpoint of that  
8 range is 6.65%.

9 **Q. DO YOU BELIEVE THAT THE BETA OF 0.92 USED BY DR. MORIN IN HIS**  
10 **CAPM STUDY IS REASONABLE?**

11 **A.** No. That beta is derived only from the integrated utility companies included in  
12 Dr. Morin's analysis on his Exhibit No. \_\_\_\_ (RAM-3). Dr. Morin also stated a beta of  
13 0.94 for his Western utility group and a beta of 0.92 for his Moody's Electric Utility  
14 Index group.<sup>22/</sup>

15 Dr. Morin's beta reflected information as of December 2007. Betas at that time  
16 were at abnormally high levels relative to the last 5 years. As shown on Exhibit  
17 No.\_\_(MPG-18), utility betas have been consistently increasing over time largely as a  
18 result of very strong stock performance over the last 5 years – the period over which  
19 betas are measured. The stock performance has given the false impression that utility  
20 risk is increasing when in fact it is actually decreasing as a result of utilities shedding  
21 higher operating risk non-regulated business activities and focusing more on the core  
22 competency of operating regulated utility operations. Utility stock prices have slowed

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<sup>22/</sup> Exhibit No. \_\_\_\_ (RAM-3) through Exhibit No. \_\_\_\_ (RAM-6).

1 down, and betas are now retreating to more normalized levels. This is observable by an  
2 update of Dr. Morin's betas for each of his proxy groups.

3 I have updated Dr. Morin's beta estimates for all three of his proxy groups shown  
4 on Exhibit No. \_\_\_(MPG-22). As shown on this exhibit, the betas previously estimated  
5 by Dr. Morin of 0.92 have now fallen down to an average beta of 0.82. This updated beta  
6 is more reasonable because it reflects more of the low-risk characteristics of regulated  
7 utility betas, and is a more current assessment of the operating risk and beta estimates for  
8 utility companies.

9 **Q. HOW WOULD DR. MORIN'S CAPM STUDY BE IMPACTED IF MORE**  
10 **REASONABLE DATA ARE USED?**

11 **A.** Using an updated beta of 0.82, a market risk premium of 6.65%, which is the midpoint of  
12 the range of market risk premiums estimated by Morningstar, and an updated risk-free  
13 rate of 4.8%, would indicate a CAPM return estimate of 10.25%.

14 **Q. PLEASE DESCRIBE DR. MORIN'S EMPIRICAL CAPM ("ECAPM")**  
15 **ANALYSIS.**

16 **A.** The ECAPM analysis adds two weighted risk premiums to a risk-free rate: a 75%  
17 weighted risk premium based on a 0.92 utility beta, and a 25% weighted risk premium  
18 based on a beta equal to the overall market beta of 1.0. The theory of the ECAPM is that  
19 a beta of less than 1.0 will increase toward the market beta of 1.0 over time, which is  
20 necessary because the risk of securities will be increasing over time.

21 **Q. WHAT ISSUES DO YOU TAKE WITH DR. MORIN'S ECAPM ANALYSIS?**

22 **A.** The ECAPM analysis should be rejected. The practical result of Dr. Morin's ECAPM is  
23 that the CAPM return is based on a beta estimate of 0.94,<sup>23/</sup> instead of the actual *Value*

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<sup>23/</sup> Weighted at 75% utility proxy beta, plus the market beta of 1.0 weighted at 25%.

1 *Line* utility beta of 0.92. Indeed, the ECAPM analysis significantly overstates a utility  
2 company-specific risk premium for use in a risk premium analysis. This is particularly  
3 inappropriate since Dr. Morin relied on a beta estimate that was already significantly  
4 overstated for low-risk regulated utility operations.

## 5 **HISTORICAL RISK PREMIUM**

### 6 **Q. PLEASE DESCRIBE DR. MORIN'S HISTORICAL RISK PREMIUM.**

7 **A.** Dr. Morin estimates the actual achieved return on electric utility stocks relative to that of  
8 long-term Treasury bond securities over the period 1931 through end of year 2005. This  
9 produced an achieved return on electric utility stocks above the achieved return on  
10 Treasury bonds of 5.6%.<sup>24/</sup>

11 Dr. Morin then adds the estimated electric equity risk premium of 5.6% to his  
12 projected yield on long-term Treasury bonds of 5.0%, to arrive at a risk premium  
13 estimated return of 10.6%. Finally, he increased these results by 30 basis points to  
14 include a flotation cost adder that produce a risk premium return of 10.9%.<sup>25/</sup>

### 15 **Q. WHAT ISSUE DO YOU TAKE WITH DR. MORIN'S RISK PREMIUM?**

16 **A.** Dr. Morin's achieved return on utility stocks, compared to Treasury securities, should be  
17 given little weight in this proceeding for several reasons. First, Dr. Morin's analysis has  
18 not been updated for the last two years of data, and it therefore skews the results of this  
19 historical achieved return study. Dr. Morin's study was concluded in 2005. However,  
20 excluding data from 2006 and 2007 likely has an impact on his study. Failing to update  
21 this study diminishes the unbiased nature of the analysis and provides Dr. Morin a means  
22 of misrepresenting this historical achieved return estimate. Excluding a few years from

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<sup>24/</sup> Exhibit No. \_\_ (RAM-7).

<sup>25/</sup> Exhibit No. \_\_ (RAM-1T) at 36.

1 the analysis can make a difference. Hence, eliminating relevant recent information can  
2 skew the results in a meaningful way, as Dr. Morin has done.

3 Second, the achieved return on Treasury securities versus utility securities has  
4 been impacted significantly by the dramatic decrease in interest rates over the last  
5 20 years. Hence, the achieved return on these securities is not as much an assessment of  
6 consistent or varying risk differentials and required return, as it is an assessment of the  
7 impact that declining interest rates and reduced inflation expectations have on stock  
8 versus bond investments.

9 Finally, the estimated risk premium from this methodology is sensitive to the  
10 annual time period selected. Dr. Morin has used December to December as an annual  
11 time period. Had he used different months, for example July through July, his results  
12 may have been very different. More thorough analyses, such as that performed by  
13 Morningstar, consider annual holding periods that can take place throughout the year.  
14 That is, it considers each holding period for each month in the year. Dr. Morin's  
15 estimated equity risk premium may be higher than average for 12-month holding periods  
16 simply by using end-of-year data. Hence, his analysis of an annual holding period's  
17 achieved return is incomplete because it does not reflect the total breadth of possible  
18 12-month holding periods for investments in utility and Treasury securities.

19 **Q. HOW WOULD DR. MORIN'S RISK PREMIUM ANALYSES CHANGE USING**  
20 **MORE RECENT INFORMATION?**

21 **A.** While I take issue with the method of development, just relying on a risk premium over  
22 Treasury bonds of 5.6%, including the current projected Treasury bond yield of 4.8%,  
23 would indicate a return on equity of 10.4%. For the reasons set forth below, I reject the  
24 inclusion of a flotation cost adjustment in this case because Dr. Morin has failed to

1 identify PSE-specific costs that are appropriate for including in its rate of return in this  
2 proceeding.

3 **ALLOWED RISK PREMIUM**

4 **Q. PLEASE DESCRIBE DR. MORIN'S ALLOWED RISK PREMIUM ON**  
5 **ELECTRIC UTILITIES.**

6 **A.** Dr. Morin estimates an equity risk premium by subtracting regulatory commission  
7 authorized returns on equity for U.S. electric utilities from the contemporary Treasury  
8 bond yield. He estimates the average ROE spread of authorized returns on equities over  
9 long-term Treasury yields to be 5.6% during the period 1998 through 2007.

10 Given the current Treasury bond yield of 5.0% and the risk premium of 5.6%  
11 produced an ROE of 10.6%. Dr. Morin did not adjust his ROE estimate for flotation  
12 costs.

13 **Q. PLEASE DESCRIBE THE ISSUES YOU TAKE WITH DR. MORIN'S**  
14 **ALLOWED RISK PREMIUM.**

15 **A.** The only issue I have with Dr. Morin's allowed risk premium is the fact that he added a  
16 long-term Treasury bond yield that is outdated. Adding the most recent projected long-  
17 term Treasury yield of 4.8% to his risk premium of 5.6% will reduce Dr. Morin's return  
18 on equity estimate for PSE from 10.6% to 10.4%.

19 **DCF ANALYSES**

20 **Q. PLEASE DESCRIBE DR. MORIN'S DCF ANALYSES.**

21 **A.** Dr. Morin performed a constant growth DCF analysis on: 1) Puget Energy (PSE's parent  
22 company); 2) a group of integrated electric utilities; and 3) a group of the Moody's  
23 Electric Utilities. Dr. Morin constructed two DCF analyses for each of the utility groups



1 and Puget Energy using an analyst consensus growth rate projection from Zacks for one  
2 DCF analysis and a second DCF analysis using *Value Line*'s projected growth rate.

3 As shown on Exhibit No. \_\_ (RAM-9) and Exhibit No. \_\_ (RAM-14) through  
4 Exhibit No. \_\_ (RAM-17), he relied on growth rate estimates in the range of 5.5% to  
5 6.9% from both *Value Line* and Zacks to produce a DCF cost of equity in the range of  
6 9.9% to 11.2%. He then added a 20-30 basis point flotation cost adjustment to arrive at  
7 adjusted returns on equity in the range of 10.1% to 11.5%, with a midpoint of 10.8%.

8 **Q. PLEASE DESCRIBE THE ISSUES YOU TAKE WITH DR. MORIN'S DCF**  
9 **ANALYSES.**

10 A. I have three major issues with Dr. Morin's DCF model. First, Dr. Morin uses *Value Line*  
11 growth rate estimates that are provided by a single analyst. Second, Dr. Morin's DCF on  
12 a single company (Puget Energy) distorts the fair return on equity for PSE. Finally, he  
13 uses growth rate estimates that are not sustainable in the long run.

14 **Q. WHY IS IT UNREASONABLE TO RELY ON GROWTH RATE ESTIMATES**  
15 **PROVIDED BY VALUE LINE?**

16 A. *Value Line* provides projected 3-5 year growth rates estimated by a single security  
17 analyst. As discussed above, using a source that contains consensus analysts' growth rate  
18 projections supplied by many analysts better reflects the market's growth expectations of  
19 the underlying stock. Hence, Dr. Morin's DCF studies, based on his Zacks growth rate  
20 projections, are superior to those produced from his *Value Line* growth rate projections.

21 Therefore, I recommend that the Commission give primary weight to Dr. Morin's  
22 DCF return estimates based on his Zacks growth rate models, excluding his flotation cost  
23 adjustment.

1 **Q. YOU STATED THAT DR. MORIN'S DCF MODEL ON A SINGLE COMPANY**  
2 **DISTORTS THE FAIR RETURN FOR PSE. PLEASE EXPLAIN.**

3 **A.** The DCF return for Puget Energy does not contain cross-sectional estimates of market  
4 valuations and it might be subject to abnormal events that will impact the Company's  
5 valuation. Indeed, Puget Energy is currently in the process of being acquired by an  
6 investor consortium. Further, using the average growth rate of several companies in a  
7 DCF analysis provides more accurate results because it is subject to smaller measurement  
8 error.

9 Hence, using Dr. Morin's DCF return estimates developed in his Exhibit  
10 No.\_\_(RAM-15) and Exhibit No.\_\_(RAM-17) will produce the most reliable results,  
11 adjusting for more reasonable growth rate estimates and excluding his flotation cost  
12 adjustment.

13 **Q. WHY ARE THE GROWTH RATE ESTIMATES USED IN DR. MORIN'S DCF**  
14 **STUDY NOT REASONABLE?**

15 **A.** Dr. Morin average growth rates from *Value Line* and Zacks fall in the range of 5.5% to  
16 6.9%. These growth rate estimates exceed the projected GDP growth rate of 5.0% and  
17 4.8% for the next 5 and 10 years, respectively. As explained in detail above, the GDP  
18 growth rate can be used as a proxy for long-term sustainable growth rate because it  
19 represents the maximum growth rate of the U.S. economy. The growth rate estimates  
20 used in Dr. Morin's DCF study exceed the projected GDP growth rate of 4.9% (the  
21 average of 5.0% and 4.8%) by 60-200 basis points, and inflate the DCF return on equity  
22 results for PSE.

1 **Q. CAN DR. MORIN'S DCF MODEL BE MODIFIED TO REFLECT MORE**  
2 **REASONABLE GROWTH RATE ESTIMATES?**

3 A. Yes. In order to reflect the current industry environment of abnormal capital investments  
4 that increase utility rate base and impacts analysts' growth rate projections, Dr. Morin's  
5 constant growth DCF model can be modified into a two-stage DCF model that will reflect  
6 a more reasonable growth rate in the second stage.

7 **Q. DID DR. MORIN RECOGNIZE THE PROBLEMS WITH THE CONSTANT DCF**  
8 **MODEL IN THE CURRENT UTILITY INDUSTRY ENVIRONMENT?**

9 A. Yes. At page 42 of Exhibit No. \_\_\_(RAM-1T), Dr. Morin emphasized the fact that the  
10 constant DCF is applicable for mature industries with stable growth rate (utilities in the  
11 past). However, considering the current dynamic industry, this approach is not  
12 reasonable. Specifically, he states:

13 For companies in a mature industry, such as the electric utility industry  
14 had been until recent years, it may be reasonable to assume a constant  
15 growth rate. For companies in a more dynamic evolving industry, such as  
16 the electric utility business today, this assumption may not be  
17 reasonable.<sup>26/</sup>

18 **Q. HOW WILL DR. MORIN'S DCF RESULT CHANGE IF WE APPLY THE TWO-**  
19 **STAGE DCF MODEL?**

20 A. Setting aside the issues I have with Dr. Morin's use of the *Value Line* growth estimates, I  
21 have applied the two-stage DCF model to his return estimates developed on Exhibit No.  
22 (RAM-14) through Exhibit No. \_\_\_(RAM-17). Excluding Dr. Morin's flotation cost  
23 adjustment, the average DCF return will be reduced from 10.8% to 9.57% as shown on  
24 Exhibit No. \_\_\_(MPG-23).

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<sup>26/</sup> Exhibit No. \_\_\_ (RAM-1T) at 42, lines 6-10.

1 **FLOTATION COST ADJUSTMENT**

2 **Q. IS DR. MORIN'S PROPOSED FLOTATION COST ADJUSTMENT REASON-**  
3 **ABLE?**

4 **A.** No. Flotation cost adjustments are a legitimate cost of issuing stock to the public. Actual  
5 book costs, however, should be used for this adjustment so the Commission Staff, and  
6 other interested intervenors, can audit the Company's actual common stock flotation  
7 expenses for reasonableness and amount. Any adjustment to PSE's cost of service for  
8 flotation cost expenses should be based only on known and measurable common stock  
9 flotation expenses.

10 In significant contrast, Dr. Morin's proposed flotation cost adjustment is not  
11 based on PSE's known, measurable, prudent, and reasonable common stock flotation  
12 costs. Rather, it is based on a general study of market flotation costs that may or may not  
13 have any relationship to PSE's actual cost of issuing stock to the public. Indeed,  
14 Dr. Morin acknowledges that PSE is not a publicly traded company, and therefore it is  
15 unclear what, if any, PSE's common stock flotation cost expenses might be. Further,  
16 while PSE receives its incremental equity capital from its parent company, it is not clear  
17 whether that equity capital is being funded by public common stock issuances, debt  
18 issuances, or internally generated funds. Hence, it simply is not known and measurable  
19 what, if any, common stock flotation costs should be properly allocated to PSE and  
20 should be reflected in its cost of service in this proceeding. For these reasons,  
21 Dr. Morin's proposed flotation cost adjustment is not based on known and measurable  
22 expenses and should be rejected.

23 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

24 **A.** Yes.

**BEFORE THE**  
**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND	)	
TRANSPORTATION COMMISSION,	)	
	)	
Complainant,	)	
	)	
v.	)	<b>Docket Nos. UE-072300/</b>
	)	<b>UG-072301 (<i>consolidated</i>)</b>
PUGET SOUND ENERGY, INC.	)	
	)	
Respondent.	)	
_____	)	

**EXHIBIT NO. \_\_\_\_ (MPG-2)**

**QUALIFICATIONS OF MICHAEL P. GORMAN**

**May 30, 2008**

## Qualifications of Michael P. Gorman

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**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

**A.** Michael P. Gorman. My business mailing address is P. O. Box 412000, 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000.

**Q. PLEASE STATE YOUR OCCUPATION.**

**A.** I am a consultant in the field of public utility regulation and a managing principal with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

**Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.**

**A.** In 1983 I received a Bachelor of Science Degree in Electrical Engineering from Southern Illinois University, and in 1986, I received a Master's Degree in Business Administration with a concentration in Finance from the University of Illinois at Springfield. I have also completed several graduate level economics courses.

In August of 1983, I accepted an analyst position with the Illinois Commerce Commission ("ICC"). In this position, I performed a variety of analyses for both formal and informal investigations before the ICC, including: marginal cost of energy, central dispatch, avoided cost of energy, annual system production costs, and working capital. In October of 1986, I was promoted to the position of Senior Analyst. In this position, I assumed the additional responsibilities of technical leader on projects, and my areas of responsibility were expanded to include utility financial modeling and financial analyses.

In 1987, I was promoted to Director of the Financial Analysis Department. In this position, I was responsible for all financial analyses conducted by the staff. Among other things, I conducted analyses and sponsored testimony before the ICC on rate of return, financial integrity, financial modeling and related issues. I also supervised the

1 development of all Staff analyses and testimony on these same issues. In addition, I  
2 supervised the Staff's review and recommendations to the Commission concerning utility  
3 plans to issue debt and equity securities.

4 In August of 1989, I accepted a position with Merrill-Lynch as a financial  
5 consultant. After receiving all required securities licenses, I worked with individual  
6 investors and small businesses in evaluating and selecting investments suitable to their  
7 requirements.

8 In September of 1990, I accepted a position with Drazen-Brubaker & Associates,  
9 Inc. In April 1995 the firm of Brubaker & Associates, Inc. ("BAI") was formed. It  
10 includes most of the former DBA principals and Staff. Since 1990, I have performed  
11 various analyses and sponsored testimony on cost of capital, cost/benefits of utility  
12 mergers and acquisitions, utility reorganizations, level of operating expenses and rate  
13 base, cost of service studies, and analyses relating industrial jobs and economic develop-  
14 ment. I also participated in a study used to revise the financial policy for the municipal  
15 utility in Kansas City, Kansas.

16 At BAI, I also have extensive experience working with large energy users to  
17 distribute and critically evaluate responses to requests for proposals ("RFPs") for electric,  
18 steam, and gas energy supply from competitive energy suppliers. These analyses include  
19 the evaluation of gas supply and delivery charges, cogeneration and/or combined cycle  
20 unit feasibility studies, and the evaluation of third-party asset/supply management  
21 agreements. I have also analyzed commodity pricing indices and forward pricing  
22 methods for third party supply agreements, and have also conducted regional electric  
23 market price forecasts.

1           In addition to our main office in St. Louis, the firm also has branch offices in  
2 Phoenix, Arizona and Corpus Christi, Texas.

3 **Q. HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

4 **A.** Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of service  
5 and other issues before the Federal Energy Regulatory Commission and numerous state  
6 regulatory commissions including: Arkansas, Arizona, California, Colorado, Delaware,  
7 Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Michigan, Missouri,  
8 Montana, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon,  
9 South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia,  
10 Wisconsin, Wyoming, and before the provincial regulatory boards in Alberta and Nova  
11 Scotia, Canada. I have also sponsored testimony before the Board of Public Utilities in  
12 Kansas City, Kansas; presented rate setting position reports to the regulatory board of the  
13 municipal utility in Austin, Texas, and Salt River Project, Arizona, on behalf of industrial  
14 customers; and negotiated rate disputes for industrial customers of the Municipal Electric  
15 Authority of Georgia in the LaGrange, Georgia district.

16 **Q. PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANI-**  
17 **ZATIONS TO WHICH YOU BELONG.**

18 **A.** I earned the designation of Chartered Financial Analyst (“CFA”) from the CFA Institute.  
19 The CFA charter was awarded after successfully completing three examinations which  
20 covered the subject areas of financial accounting, economics, fixed income and equity  
21 valuation and professional and ethical conduct. I am a member of the CFA Institute’s  
22 Financial Analyst Society.