EXHIBIT NO. ___(DEG-1T)
DOCKET NO. UE-11___/UG-11___
2011 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-11____** **Docket No. UG-11____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES ON BEHALF OF PUGET SOUND ENERGY, INC.

JUNE 13, 2011

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES

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PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES

I. INTRODUCTION

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

A. My name is Donald E. Gaines. My business address is 10885 NE Fourth Street, P.O. Box 97034, Bellevue, Washington 98009-9734. I am the co-CFO and Vice President Finance and Treasurer for Puget Sound Energy, Inc. ("PSE").

Q. Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?

A. Yes, I have. It is Exhibit No. ___(DEG-2).

Q. What are your duties as co-CFO and Vice President Finance and Treasurer for PSE?

A. I have overall responsibility for raising capital in the financial markets. I am also responsible for maintaining relations with credit rating agencies as well as commercial and investment banks and other members of the Company's group of lenders. In addition, I oversee PSE's financial planning, budgeting, tax, energy risk control, portfolio structuring and credit activities. I am also Chairman of the

Qualified Plans Committee, which oversees PSE's retirement, 401(k), and health and welfare plans. I also serve as a Trustee and the Treasurer of the Puget Sound Energy Foundation.

Q. Please summarize the purpose of your testimony.

A. This prefiled direct testimony describes PSE's requested capital structure and overall rate of return and is organized as follows:

i. Section I introduces my testimony;

ii. Section II summarizes the overall capital structure and rate of return requested and describes how the benefits of PSE's increased equity ratio far exceed the costs;

iii. Section III describes the return on equity PSE is requesting in this proceeding;

iv. Section IV describes how PSE continues to under-earn;

v. Section V describes the cost components of PSE's requested rate of return of 8.42 percent;

vi. Section VI describes the importance of credit ratings and PSE's recent upgrades by the rating agencies; and

vii. Section VII describes PSE's compliance with all Merger Commitments.

Q. Will you please provide a list of your Exhibits?

A. Yes. My Exhibits are listed below:

- DEG-1T Prefiled Direct Testimony
- DEG-2 Professional Qualifications
- DEG-3 Long-term debt savings
- DEG-4 Test Year Capital Structure
- DEG-5 Moody's Credit Opinion, dated March 17, 2011
- DEG-6 Recently Awarded ROEs and Equity Ratios

1 • DEG-7 Comparable Companies ROEs & Equity Ratios
2 • DEG-8 Earned and Allowed ROE Comparison
3 • DEG-9 Impact of setting rates on less equity than exists
4 • DEG-10 Rate of Return (ROR) requested in this proceeding
5 • DEG-11 S&P Rating Methodology, dated May 27, 2009
6 • DEG-12 Moody's Rating Methodology, dated August 2009
7 • DEG-13 S&P PSE Credit Report, dated February 24, 2011

8 **II. THE COMPANY'S CAPITAL STRUCTURE REQUEST**
9 **AND THE BENEFITS OF PSE'S INCREASED EQUITY RATIO**
10 **FAR OUTWEIGH ITS COST**

11 **Q. What is the capital structure and rate of return the Company is requesting in**
12 **this proceeding?**

13 A. As I will more fully discuss later in my testimony, PSE's requested overall rate of
14 return in this proceeding is 8.42 percent, as shown in Table 1 below:

15 **TABLE 1**
16 **CAPITAL STRUCTURE AND**
17 **OVERALL RATE OF RETURN**

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	4.0%	4.62%	0.18%
Long-term Debt	48.0%	6.37%	3.06%
Common Equity	48.0%	10.80%	5.18%
Overall Rate Of Return	**100%**		**8.42%**

18 **Q. What level of common equity was reflected in rates in the Company's last**
19 **proceeding?**

20 A. In the Company's 2009 general rate case, Docket Nos. UE-090704 and UG-
21 090705, the Commission set rates on a capital structure containing 46 percent
22 equity.

Q. What rationale did the Commission provide for the 46 percent equity ratio in PSE's 2009 general rate case?

A. PSE's current 46 percent equity ratio, approved by the Commission in PSE's 2009 general rate case, is a result of a negotiated settlement agreement that occurred prior to the acquisition of Puget Energy by the investor consortium. The Final Order in PSE's 2009 general rate case states:

- All parties agreed to a capital structure with 46 percent equity prior to the approval of the Puget Holdings transaction and prior to the onset of the financial crisis.
- Disruptions in the capital markets have stabilized at levels similar to pre-crisis conditions.

Q. Is the current 46 percent equity ratio appropriate for this rate proceeding?

A. No, it is not. There are several reasons why it is inadequate. First, the 46 percent ratio was part of an all-party settlement in 2008. Settlements include numerous considerations and generally include trade-offs of multiple rate-impacting drivers to arrive at an overall common ground on which the parties agree. It is difficult to ascertain which trade-offs different parties considered appropriate in arriving at the settlement. It is reasonable to conclude that considerations from 2008 would be different from those of importance today, years later. Therefore, it is reasonable to examine facts relevant to the current proceeding rather than rely on what parties settled upon years ago.

1 Second, relying on a 46 percent equity ratio that was deemed appropriate in the
2 2008 settlement ignores what has happened since that time. Of highest
3 consequence is the $805 million of equity that was contributed to PSE in
4 February of 2009 in conjunction with the close of the merger transaction. In fact,
5 Merger Commitment 35, in part, requires that PSE have an equity ratio of at least
6 50 percent shortly after the Merger. This truly significant amount of equity has
7 been productively invested to the benefit of customers for well over two years and
8 is, in part, one of the reasons for the upgrade in PSE's credit ratings from pre-
9 merger levels. This equity remains in place today; it is not hypothetical. As
10 described in my testimony, customers have benefited, and will continue to benefit
11 well into the future, from that higher level of equity.

12 **Q. Why does the Company have an equity ratio higher than 46 percent?**

13 A. As described in more detail later in my testimony, Merger Commitment 35, in
14 part, required PSE to have a common equity ratio of "not less than 50 percent" as
15 of the closing of the merger transaction, or within sixty (60) days thereof. The
16 equity ratio has decreased from that point to the current 48 percent as the
17 Company targets what it considers to be a reasonable equity level to attract debt
18 investment at a reasonable cost. This strategy has thus far been successful in
19 replacing outstanding long-term debt at very attractive interest rates that will
20 benefit customers for a long time.

21 **Q. What are some of the benefits of the 48 percent equity ratio presently in**

1 **place?**

2 A. There are many benefits, some of which are quantifiable and some of which are
3 not. The most obvious benefit of this increased level of equity is that the
4 Company's credit ratings were increased by both Standard and Poor's and
5 Moody's. Standard and Poor's increased the Company's credit ratings shortly
6 before the close of the merger and Moody's upgraded the Company's credit
7 ratings in March of this year. But debt leverage is only one item of consideration
8 rating agencies examine in determining a regulated utility's credit ratings.
9 Earning a reasonable rate of return provides funds needed to service debt with a
10 comfortable cushion. Reasonable cash interest coverage ratios are needed as
11 well. Higher credit ratings benefit customers by resulting in lower borrowing
12 costs incurred to fund utility operations.

13 **Q. Has the Company quantified the customer benefit of lower borrowing costs**
14 **resulting from the credit ratings upgrade?**

15 A. Yes. Exhibit No. ___(DEG-3) compares borrowing costs associated with the
16 credit ratings in effect prior to the upgrade with those following the credit ratings
17 upgrade. On the few debt issues the Company has made to date since the
18 upgrade, the present value of the benefit to customers exceeds $33 million. These
19 benefits are enduring throughout the long-term while the bonds remain
20 outstanding despite what may happen to the Company's credit ratings or equity
21 ratios in the future. Further, the benefits will continue to increase as the Company

1 continues to issue additional debt to fund investments that provide safe and
2 reliable service to its customers at these current credit ratings. The benefit in
3 reduced long-term debt costs is not the only benefit. Higher credit ratings have
4 many additional benefits that the analysis in Exhibit No. ___(DEG-3) does not
5 reflect. These include, but are not limited to: the benefits of lower short-term debt
6 borrowing costs that come as a result of the Company having ratings-based
7 pricing in its credit facilities; the ability of the Company to more reliably access
8 the commercial paper market and do so at lower borrowing costs; the benefits that
9 accrue from having energy hedging counterparties grant increased trade credit
10 when entering into hedging transactions with PSE; more reliable access to capital
11 in times of uncertainty by remaining investment grade, even in the event that the
12 Company were to receive a one notch downgrade in the future. The benefits are
13 many, and the savings from lower interest costs on long-term fixed rate bonds
14 will continue to accrue to customers for as long as those bonds remain
15 outstanding, regardless of what may happen to credit ratings in the future.

16 The $33 million reduction in long-term debt costs, well exceeds the
17 approximately $12 million[1] incremental cost of reflecting the additional two
18 percentage points of common equity into customer rates. While PSE has not
19 quantified these other benefits, including them would result in even greater
20 benefits.

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[1] *See* Exhibit No. ___(DEG-9), page 2.

1 **Q. What do regulators usually consider when determining an appropriate**
2 **capital structure?**

3 A. In determining the appropriate capital structure for rate setting purposes,
4 commissions strive to find the optimal capital structure that balances "safety and
5 economy" – that is, the safety that results from an equity cushion high enough to
6 absorb losses with the economy of lower cost debt. Because finding that optimal
7 balance is as much art as it is science, commissions sometimes look to a
8 cost/benefit-type analysis to see if the cost of incrementally more equity is more
9 than offset by the incremental benefit. In PSE's case, the answer is clear. The
10 benefits for PSE far outweigh the cost. As a result, it is time to reflect in rates the
11 higher equity ratio that resulted in these customer benefits.

12 **Q. What was PSE's capital structure during the test year?**

13 A. PSE's average capital structure (calculated using an average of the monthly
14 averages methodology, as shown in Exhibit No. ___(DEG-4), during this
15 proceeding's test year included a 48.5 percent equity ratio, as show in Table 2
16 below:

1 **TABLE 2**
2 **ACTUAL TEST YEAR CAPITAL STRUCTURE**

Capital Component	Test Year (Average)
Short-term Debt	2.0%
Long-term Debt	49.5%
Common Equity	48.5%
Total Capitalization	**100.0%**

3

4 **Q. Is that the capital structure upon which PSE is requesting that rates be set in**
5 **this proceeding?**

6 A. No. In PSE's most recent general rate case, Docket Nos. UE-090704 and UG-
7 090705, the Commission was very explicit in stating that costs to be recovered
8 should be limited to those that were prudently incurred during the test year
9 except where different costs are "known and measurable". In light of that, it
10 would be reasonable for PSE to request that rates be set on the test year capital
11 structure.

12 However, PSE is expecting to finance utility operations with a lower equity ratio
13 going forward – a 48 percent equity ratio, as well as a with a higher short-term
14 debt ratio. In addition, in light of the state of the local economy, PSE is sensitive
15 to the impact of rates on customers. As a result, PSE is requesting that rates be
16 set in this proceeding on the targeted 48 percent, not the 48.5 percent outstanding
17 on average during the test year.

1 **Q. Has the Commission ever set rates on a hypothetical capital structure in past**
2 **proceedings?**

3 A. Yes. The Commission has stated it will set rates on a hypothetical capital
4 structure when there is a clear and compelling reason to do so.[2] The
5 Commission approved a hypothetical capital structure in PSE's last general rate
6 case and most recently in the Final Order of PacifiCorp's recent general rate case,
7 in which 49.1 percent equity was determined to be appropriate.[3] In the Final
8 Order of PacifiCorp's 2010 general rate case, the Commission stated that a
9 hypothetical capital structure should be balanced in a way that achieves financial
10 safety while minimizing financial risk so that the company may finance its
11 operations at the least cost.[4]

12 **Q. For what other reasons is PSE targeting an equity ratio that is higher than**
13 **the 46 percent level currently reflected in rates?**

14 A. PSE is targeting a higher equity ratio for several other reasons. First, PSE's credit
15 ratings have been upgraded, in part, as a result of the previously described $805
16 million equity infusion that came with the merger close and "the relative stability
17 in operations observed following the company's buyout in February 2009," as
18 described in the March 17, 2011 Moody's credit opinion. *See* Exhibit

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[2] *See WUTC v. PSE*, Docket Nos. UE-090704 and UG-090705 (consolidated), Order 11 at ¶278 (April 2, 2010), citing *WUTC v. PSE* Docket Nos. UE-060266 and UG-060207 Order 08, (Jan. 5, 2007).

[3] *See WUTC v. PacifiCorp*, UE-100749, Order 06 at ¶373 (March 25, 2011).

[4] *See* i*d.* at ¶21.

1 No. ___(DEG-5). The higher equity ratio that resulted from and since the merger
2 is one of the factors that resulted in PSE's credit ratings upgrade, and PSE would
3 like to maintain or even improve its current credit rating.

4 Second, in PSE's 2009 general rate case, rates were set on a 46 percent equity
5 ratio when PSE was capitalized with over 50 percent equity. That resulted in
6 investors earning a debt-like return on a portion of their investment. As discussed
7 previously, the ability to earn authorized returns is an important element of the
8 ratings process. It is unrealistic to expect investors to maintain an equity
9 investment on which a debt-like return is earned.

10 Third, PSE seeks the financial strength to maintain its current level of ratings and
11 to weather volatility in today's uncertain capital markets. As stated above, a
12 higher equity ratio is one factor that contributed to PSE's credit rating upgrade.

13 Fourth, the 48 percent equity ratio PSE is requesting in this proceeding is lower
14 than what has recently been reflected in customer rates of other regulated utilities.
15 Exhibit No. ___(DEG-6) shows that the average equity ratios for natural gas and
16 electric utilities approved by regulatory bodies during 2010 and the first quarter of
17 2011 was 48.75 percent. This average includes the recently awarded 49.1
18 percent, which the Commission granted PacifiCorp this year.

1 Fifth, PSE's requested 48 percent equity is below the 48.28 percent average of
2 current allowed equity ratios in the capital structures of comparable regulated
3 companies, as discussed later in my testimony.

4 **Q. If the Commission were not to base rates on a hypothetical capital structure,**
5 **on what capital structure should rates be set in this proceeding?**

6 A. If the Commission did not believe it is appropriate to set rates on a hypothetical
7 capital structure, then rates should be based on the capital structure supporting
8 utility operations in place, on average, during the test year, as shown in Table 2.

9 **Q. Why is the capital structure you propose appropriate and reasonable for rate**
10 **setting purposes in this proceeding?**

11 A. The capital structure requested by PSE in this proceeding is appropriate and
12 reasonable for the following reasons:

13 (i) it is consistent with the targeted capital structure that will
14 likely support utility operations during the rate year;

15 (ii) it is similar to, albeit containing slightly less equity than,
16 the actual equity in place during the test year;

17 (iii) 48.0 percent equity in the capital structure is lower than the
18 average equity ratio recently reflected in customer rates of
19 other regulated utilities;

20 (iv) 48.0 percent equity in the capital structure is lower than the
21 average upon which rates were set in comparable
22 companies;

23 (v) the additional equity in place since the merger at least
24 partly contributed to the credit ratings upgrades that

customers are currently benefiting from in the form of lower new debt costs, as described later in this testimony;

(vi) short-term debt (the lowest cost capital component) is higher than was actually in place during the test year and is consistent with a reasonable level that can be expected during the rate year; and

(vii) it appropriately balances the risks and costs of funding PSE's utility operations.

Q. Why does the capital structure requested by PSE in this proceeding appropriately balance the risks and costs of funding PSE's utility operations?

A. I believe the capital structure requested by PSE in this proceeding appropriately balances the risks and costs of funding PSE's utility operations for the following reasons:

(i) the capital structure requested by PSE in this proceeding will allow PSE to attract debt capital necessary to fund PSE's infrastructure and new resource construction program;

(ii) the capital structure requested by PSE in this proceeding will allow PSE to satisfy merger commitments related to capital structure; and

(iii) the capital structure requested by PSE in this proceeding will allow PSE to provide electric and gas service to customers on reasonable terms.

Q. Is the test year capital structure reflected in Table 2 above, calculated in a manner similar to the capital structures calculated in PSE's recent rate proceedings?

A. Yes. The test year capital structure reflected in Table 2 above is calculated in a

manner similar to the capital structures calculated in PSE's recent rate proceedings. This methodology removes non-regulated activities and the balance sheet impact of certain other items from PSE's consolidated capital structure. Specifically, PSE made the following three adjustments:

(i) PSE removed the retained earnings from unregulated activities such as Puget Western, Inc. ("PWI") and Hydro Energy Development Corporation ("HEDC");

(ii) PSE removed the unrealized retained earnings impacts resulting from the marking to market the value of its hedging activities; and

(iii) PSE removed the balance sheet impact from pension accounting.

Q. Please explain why PSE made these three adjustments to retained earnings to determine PSE's consolidated capital structure.

A. PSE removed the retained earnings generated by PWI and HEDC from PSE's consolidated capital structure because the retained earnings generated by these two subsidiaries are non-regulated. PWI is a real estate development and disposition subsidiary, and HEDC is a subsidiary that owns, among other things, a non-regulated small hydro facility, Black Creek Hydro, Inc. HEDC was merged into PSE in May 2010 following its sale of Black Creek Hydro in 2010.

PSE removed the balance sheet impacts of certain derivative valuations that flow through net income or into Other Comprehensive Income ("OCI"), a component of retained earnings, because PSE recovers the commodity costs it incurs, not

1 these non-cash and unrealized mark-to-market amounts, through customer rates.

2 PSE removed the balance sheet impacts of accounting for PSE's pension plan
3 because the pension plan expense is not reflected in rates. Instead, PSE reflects
4 pension plan contributions in rates, averaged over a four year period.

5 **Q. Why does PSE remove the balance sheet impacts of certain derivatives from**
6 **its consolidated common equity?**

7 A. The Commission typically sets PSE's rates in a manner that does not recover
8 through customer rates the accounting income and expense from marking
9 derivatives to their market value. PSE removes the corresponding balance sheet
10 impacts of accounting for the market value of derivates from its consolidated
11 common equity because the expense or income is not recognized in rates. This
12 adjustment removes the variability of the mark to market calculations made for
13 financial reporting purposes. The Commission has not recognized these types of
14 adjustments in setting rates because such adjustments reflect the measurement of
15 a timing difference for financial reporting purposes and do not reflect "cash"
16 transactions.

17 **Q. Why does PSE remove the balance sheet impacts of pension accounting from**
18 **its consolidated common equity?**

19 A. The Commission typically sets PSE's rates in a manner that reflects actual "cash"
20 pension contributions averaged over a period of time, typically four years, not the

financial reporting income and expense related to the pension plan. Therefore, PSE removes the balance sheet impacts of such financial reporting of pension accounting. PSE's treatment of these items in this proceeding is consistent with past practices.

Q. How does the capital structure requested by PSE in this proceeding compare to the average capital structure approved by regulatory bodies during the test year?

A. The capital structure requested by PSE in this proceeding contains less equity than the average of capital structures approved by regulatory bodies during the test year. The average capital structure authorized by regulatory bodies for ratemaking purposes during the test year contained a 48.5 percent equity ratio, or 50 basis points higher than PSE's request in this proceeding. Please see Exhibit No. ___(DEG-6) for a list of the equity ratios and returns on equity authorized by regulatory bodies for the calendar year ending December 31, 2010.

Q. Why is PSE proposing that rates be set on a capital structure with more short-term debt than was outstanding during the test year?

A. In my view, a reasonable level of short-term debt is somewhere in the range of three to five percent of total capital. Test year total capitalization, including short-term debt was approximately $6.7 billion. That results in a range of approximately $200 million to $335 million (three to five percent of approximately $6.7 billion). PSE has working capital credit facilities that

1 provide access to $400 million in liquidity for general corporate purposes. My
2 suggested three to five percent range falls within the size of PSE's liquidity
3 facility, leaving room for financial flexibility. In addition, my suggested range is
4 where I expect PSE to be financed on average during the rate year.

5 **Q. You state that the 48 percent equity ratio is lower than that of comparable**
6 **companies. Please explain your calculations.**

7 A. Dr. Olson selected a set of comparable companies for use in preparing his
8 Prefiled Direct Testimony, Exhibit No. ___(CEO-1T). Capital structures upon
9 which rates were set in rate proceedings of those companies' utility operations
10 were determined by applying data from Regulatory Research Associates (RRA)
11 and other sources. That average was 48.28 percent; see Exhibit No.___(DEG-7).

12 **Q. Are there any additional reasons you have suggested this capital structure?**

13 A. Yes. In addition to the reasons mentioned above, PSE is sensitive to the impact
14 of rates on its customers. Short-term debt is the least expensive form of capital.
15 Setting rates on the targeted level of short-term debt will help to minimize
16 upward pressure on rates while still financing PSE in a prudent manner. This is
17 another reason why I am suggesting that rates be set on 48 percent equity, a
18 lower amount of equity than that which PSE could reasonably request in this
19 proceeding.

20 In addition, customers have been benefiting from the lower interest costs on debt

1 that resulted from the post-merger credit rating upgrades of PSE's debt. It is
2 reasonable that customers pay a fair return on the capital the owners invested
3 that resulted in those lower interest costs.

4 5 ## III. OVERVIEW OF THE RATE OF RETURN PSE IS REQUESTING IN THIS PROCEEDING

6 **Q. What is PSE's requested overall rate of return in this proceeding?**

7 A. PSE's requested overall rate of return in this proceeding is 8.42 percent, as shown
8 in Table 3 below:

9 **TABLE 3**
10 **CAPITAL STRUCTURE AND**
11 **OVERALL RATE OF RETURN**

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	4.0%	4.62%	0.18%
Long-term Debt	48.0%	6.37%	3.06%
Common Equity	48.0%	10.80%	5.18%
Overall Rate Of Return	**100%**		**8.42%**

12 **Q. Does PSE recommend the same overall rate of return for electric and natural**
13 **gas operations?**

14 A. Yes. PSE is an integrated electric and natural gas utility and does not run separate
15 electric and natural gas divisions. Capital acquired to finance PSE's activities is
16 not earmarked for either electric or natural gas operations. Therefore, it is
17 appropriate for the Commission to set rates for PSE based on a single overall rate
18 of return for electric and natural gas operations.

1 Additionally, Dr. Olson's recommended return on equity range is based on PSE's
2 integrated operations without any distinction between electric and natural gas
3 operations.

4 **Q. Is PSE's recommended return on equity of 10.8 percent reasonable?**

5 A. Yes, I believe it is. The average return on equity ("ROE") authorized by
6 regulatory bodies during the calendar year 2010 test year and including the first
7 quarter of 2011 was 10.25 percent, well above PSE's last authorized ROE of
8 10.10 percent. *See* Exhibit No. ___(DEG-6). The average capital structure
9 authorized by regulatory bodies for ratemaking purposes during the calendar year
10 2010 and including the first quarter of 2011 contained a 48.75 percent equity
11 ratio; that equity ratio is 75 basis points higher than the 48 percent equity ratio
12 that PSE is requesting for ratemaking purposes in this proceeding. Given more
13 implied financial risk from a lower equity ratio plus higher relative risks to other
14 utilities from PSE's massive construction program and significant regulatory lag,
15 as discussed in the Prefiled Direct Testimony of Dr. Charles Olson, Exhibit
16 No. ___(CEO-1T), it is reasonable for PSE to have a higher than average ROE.

17 Indeed, PSE's expert witness on ROE, Dr. Olson, suggests that in light of these
18 risks, the Commission should authorize an ROE for PSE within a range of 11
19 percent to 13 percent. Although Dr. Olson recommends an ROE that is higher,
20 PSE is requesting a 10.8 percent ROE because PSE is mindful of the customer
21 impact from the requested rate increases in these difficult economic times. The

1 Company believes it is entitled to recover the costs it prudently incurs as it
2 provides safe and reliable service to customers and to earn a reasonable return on
3 its investments. At the same time, it understands the cost pressures its customers
4 face. The recent increases in gasoline, food and other prices have taken their toll
5 on customers' pocketbooks. The Company is sensitive to these pressures and is
6 requesting an equity return that is slightly below the lower end of Dr. Olson's
7 range.

8 **Q. Why doesn't the Company propose an even lower ROE?**

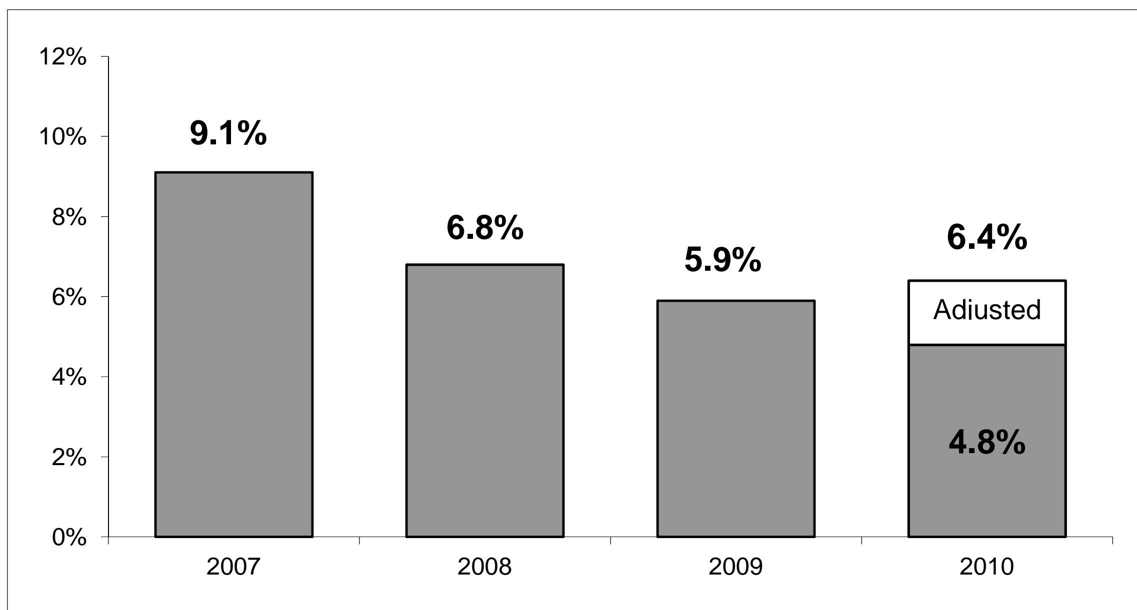
9 A. As I testified earlier, the Company believes it is entitled to earn a reasonable
10 return. There is no "magic number", a return on equity upon which all can agree
11 – that is why considerable pages of testimony are devoted to determining a
12 reasonable "range" of returns. In considering the equity return to request, the
13 Company considers the cost pressures on customers while also looking at: 1) the
14 range to which the Company believes it is entitled based on companies of
15 comparable risk as analyzed by Dr. Olson in his prefiled direct testimony and
16 exhibits; 2) the equity returns utilities granted for utilities in other jurisdictions in
17 our region –because PSE must compete for capital with these national and
18 international firms; and 3) the structural challenges to earning the allowed return I
19 will discussed later in this testimony and knowing the Company is likely to under
20 earn what ever return this Commission selects. Based on the above, PSE's rate of
21 return calculation, of 10.8 percent is a reasonable request.

IV. PSE HAS BEEN UNDER EARNING ITS ROE DESPITE OPERATING EFFICIENTLY

Q. Please describe what return on equity PSE has earned in recent periods.

A. Over the last four years, PSE has dramatically under earned its allowed return on equity. The Company's earned returns from 2007 through 2010 can be seen in the table below.

CHART I
PSE's Earned Equity Returns (ROE)



In 2010, PSE earned a 4.8 percent return on equity compared to the 10.10 percent reflected in rates in the Company's last general rate proceeding. The general trend in PSE's earned returns has been down over the last four years. Calendar year 2010 was a year of warmer than normal temperatures, which further depressed the earned return because a primary use of energy in PSE's service territory is heating. Adjusting for the warmer than normal temperatures, as well

as the impact of conservation and the current economic climate, the Company's earned return was 6.4 percent. Compared to the 10.10 percent authorized return on equity, this represents a gap of 3.7 percent

Earning a reasonable return on equity is a key component of regulated utilities credit ratings. Ratings agencies look not only at the amount of debt leverage employed by a firm, but also at its ability to service that debt which in large part is driven by reasonable returns.

Q. What is the primary cause of the Company's under-earning?

A. The bulk of both electric and natural gas distribution capital expenditures (e.g., pipes, poles and wires) is spent on replacing aging infrastructure. The costs of replacing aging infrastructure have increased, and there is no incremental revenue from such upgrades to the energy delivery system. In addition, the costs to operate and maintain a safe and reliable energy delivery system have also been rising. It is the lack of timely recovery of such costs that comes, in part, from a modified historic test period regulatory framework that creates structural challenges to earning a reasonable return, resulting in a large percentage of the gap between the earned and allowed equity returns.

Q. Has the Company compared its earning returns with those of other utilities?

A. Yes. Exhibit No. ___(DEG-8) contains a comparison of earned and allowed returns of nearly 50 energy companies for calendar year 2010. This comparison

1 shows that in 2010 PSE had the widest gap between its earned and authorized
2 equity returns.

3 **Q. Wouldn't another cause of under earning be costs are increasing faster than**
4 **revenue?**

5 A. Yes. This is why some states have gone to future looking test years or allowed
6 other mechanism so that utilities can have an opportunity to recover their
7 prudently incurred costs. When the infrastructure is more expensive to replace
8 than what is currently built into rates, then revenue growth based on load growth
9 is not likely going to keep up with the increased costs.

10 **Q. Has PSE compared its operating costs with other utilities?**

11 A. For several years, the Company has compared its non-production operating and
12 maintenance costs per customer with other utilities. The results of these
13 comparisons show PSE is a low cost utility. Ms. McLain provides testimony and
14 exhibits showing PSE's costs compared to other utilities. In a comparison of 33
15 combination gas and electric utilities, PSE's non-production operating and
16 maintenance cost per customer was near the most efficient as the fifth (5th) lowest
17 of all the companies. In the comparison, PSE's $272 per customer is about two-
18 thirds of the combination gas and electric average of $398 per customer.

19 **Q. Are their other items that result in PSE under earning its allowed return?**

20 A. Yes. Customers generally pay rates based on the volume of therms or kilowatt

1 hours they use. Those rates are generally set to enable a utility to recover both
2 fixed and variable costs. As a result, all other things being equal, changes in the
3 volume of therms or kilowatt hours used can cause a utility to over or under-
4 recover costs, thereby resulting in over or under earning of the allowed return.

5 Another factor that affects therms and kilowatt hour volumes and thereby causes
6 variability in the recovery of costs is energy efficiency. The Company's energy
7 efficiency programs impact its ability to earn its return. The Commission has also
8 recognized this and, as a result, issued a Report and Policy Statement addressing
9 various mechanisms to remove barriers to conservation. Mr. Piliaris and Mr.
10 DeBoer provide testimony on the Company's Conservation Savings Adjustment
11 rates that would allow PSE to recover costs unrelated to energy supply that go
12 unrecovered due to PSE-sponsored conservation programs

13 Depreciation is another item that can cause under earnings. A company relies on
14 depreciation as a source of cash that recovers the costs associated with capital
15 assets. The amount of depreciation in rates results in cash flow that can be
16 reinvested in new capital assets. When the level of capital investments exceeds
17 this source of cash, the company has to borrow to raise the excess. This increased
18 borrowing further depresses return on equity.

19 Capital structure is another area where under earning occurs. Setting rates on a
20 capital structure with a lower level of equity than is presently in place will result
21 in under earning allowed returns.

1 **Q. Has the rate setting process with respect to capital structure impacted PSE's**
2 **ability to earn its allowed return?**

3 A. Yes. PSE's rates were set on 46 percent common equity when the Company's
4 capital structure contains about 48 percent equity. As previously discussed, the
5 incremental 2 percent equity effectively earns a debt-like return, resulting in an
6 overall lower earned return.

7 Exhibit No. ___ (DEG-9) shows an example of this. In this example, I used the
8 capital structure and cost rates from PSE's 2009 general rate case, Docket Nos.
9 UE-090704 and UG-090705 and applied them to the gas and electric rate base in
10 this proceeding. The example demonstrates that setting rates on a capital
11 structure of 46 percent did not provide sufficient revenues to enable the Company
12 to earn its allowed return on the actual 48 percent of common equity supporting
13 utility operations. The analysis shows that setting rates on 48 percent equity, the
14 level of equity presently in place, rather than 46 percent would have added
15 approximately $12 million to the revenue requirement. This $12 million shortfall
16 resulted in about 25 basis points (0.24 percent) of the gap between the earned and
17 the allowed return.

1 **V. CAPITAL COMPONENTS OF PSE'S REQUESTED**
2 **RATE OF RETURN OF 8.42 PERCENT**

3 **Q. Has PSE prepared an exhibit that demonstrates the projected rate year costs**
4 **that support PSE's requested rate of return of 8.42 percent?**

5 A. Yes. Please see Exhibit No. ___(DEG-10) for the projected rate year cost rates
6 that support PSE's requested rate of return of 8.42 percent.

7 **A. <u>The Cost of Short-term Debt</u>**

8 **Q. Please describe PSE's short-term credit facilities.**

9 A. PSE currently has the following three credit facilities, which total $1.15 billion:

10 (i) a $400 million unsecured revolving credit facility for
11 working capital and general corporate needs;

12 (ii) a $400 million unsecured revolving credit facility, the use
13 of which is limited to funding utility capital expenditures;
14 and

15 (iii) a $350 million unsecured revolving credit agreement to
16 support PSE's energy hedging activities.

17 Each of the above-described credit facilities became effective with the close of
18 the merger in February 2009. Each facility carries a five-year term and expires in
19 February 2014. These short-term credit facilities primarily serve to provide
20 necessary working capital to fund utility operational requirements and the
21 expected variability of such requirements.

Q. Are these three PSE credit facilities the same PSE credit facilities in place during the test year in this case?

A. Yes they are.

Q. Were these facilities in place prior to the merger?

A. No. The facilities described above were in effect throughout the test year and replaced the short-term credit facilities PSE had in place prior to the merger. Absent the merger, PSE's credit facilities during the test year would have been expected to be those in effect prior to the merger, which included:

(i) a $500 million unsecured five-year revolving credit facility that, absent the merger, would have expired in April 2012;

(ii) a $200 million accounts receivable securitization facility that, absent the merger, would have expired in December 2010; and

(iii) a $350 million unsecured revolving credit agreement to support PSE's energy hedging activities that, absent the merger, would have expired in April 2012.

Q. Are the costs associated with the current credit facilities higher or lower than the costs associated with the pre-merger credit facilities?

A. PSE's pre-merger credit facilities were negotiated prior to the commencement of the turmoil in the financial markets at terms that can be considered extremely favorable. Consequently, the costs associated with PSE's pre-merger credit facilities were lower than what PSE could expect to secure if entering 2010

markets to execute new credit facilities. Although the costs associated with the post-merger credit facilities are higher than the costs associated with the pre-merger credit facilities, PSE's current facilities were negotiated in 2007, and their terms are more favorable than those that PSE could otherwise obtain if it were executing new credit facilities in current markets.

Q. Are there any merger commitments that affect the cost of debt PSE seeks to recover in this proceeding?

A. Yes. Merger Commitment Number 24 states:

> Puget Holdings and PSE will not advocate for a higher cost of debt or equity capital as compared to what PSE's costs of debt or equity would have been absent Puget Holdings' ownership.

Q. How did PSE comply with this commitment as it relates to the cost of debt in its most recent general rate proceeding?

A. As described more fully later in my testimony, in its 2009 general rate case, PSE acknowledged that, absent the merger, PSE's pre-merger credit facilities would likely have remained in effect up until their maturities. Therefore, in the 2009 general rate case, PSE requested the lower cost of the pre-merger credit facilities throughout the period they would have remained in effect absent the merger. PSE did not request recovery in rates of any of the costs of the new post-merger credit facilities until the pre-merger facilities would have otherwise expired. After the expiration date of the pre-merger facilities, the higher costs related to PSE's new credit facilities were included for recovery in rates. This same treatment applies

1 to the current costs of today's credit facility supporting energy hedging which are
2 recovered in power costs and which are higher than the pre-merger facility costs
3 requested in the 2009 rate proceeding referred to in the Prefiled Direct Testimony
4 of John H. Story, Exhibit No. __(JHS-1T).

5 **Q. Is the cost of short-term debt PSE seeks to recover in this proceeding**
6 **consistent with the approach in its most recent general rate case?**

7 A. Yes it is. Each of the pre-merger credit facilities would have expired prior to the
8 rate year beginning May 2012. PSE would have needed new credit facilities to
9 replace these facilities had the merger not occurred. Consequently, the current
10 costs of PSE's existing working capital and capital expenditure credit facilities are
11 included in the rate year calculation of the cost of short-term debt while costs for
12 the existing $350 million facility supporting energy hedging are included in
13 energy costs, consistent with prior rate proceedings.

14 **Q. Are you including any costs of the facility supporting energy hedging in the**
15 **cost of capital?**

16 A. No. Because use of the facility is dedicated to providing collateral as needed for
17 gas and electric hedging, the costs are allocated between the PCA and PGA
18 mechanisms as done in prior proceedings.

Q. What else about PSE's short-term liquidity is important to understand?

A. PSE has raised short-term funds in commercial paper ("CP") markets only on a very limited basis since the financial market turmoil of late 2008, which made CP simultaneously more expensive while rendering it a less-than-reliable source of funds for lower-rated issuers like PSE. PSE has for quite some time had a split rating on its CP from the rating agencies, often referred to as "tier 2/tier 3". Tier 1 is the highest rating for CP, tier 2 is a lower or mid-grade rating, while tier 3 is the lowest rating, considered sub-grade by many investors. In difficult market conditions, it can be challenging to attract investors for tier 3 paper.

As a result of PSE's split rating and the turmoil in the liquidity markets, PSE has not had reliable access to CP on competitive terms. Recently however, Moody's March 2011 upgrade of PSE's ratings by one notch improved both long-term debt and CP ratings. Consequently, PSE's CP rating is no longer split rated but is now tier 2. As a result, pricing and reliability of CP issuance success are both expected to be improved, and PSE is planning to enter the CP markets to a limited extent to take advantage of these lower funding rates.

Q. Is the cost of CP included in the projected cost of short-term debt in the rate year?

A. Yes. While PSE realizes that it cannot rely solely on CP to fund its short-term liquidity needs, it has projected some CP issuances and costs, along with borrowings under its credit agreements, into its rate year short-term debt costs.

1 **Q. How does PSE calculate its projected cost of short-term debt during the rate**
2 **year?**

3 A. To calculate the projected cost of short-term debt during the rate year, PSE
4 determines the spread between its short-term borrowing costs and the LIBOR.
5 PSE then applies that spread to a projected LIBOR during the rate year and
6 applies annual commitment fees and the amortization of upfront costs in the
7 projected cost of short-term debt during the rate year. Please see pages 2 and 3 of
8 Exhibit No. ___(DEG-10) for this calculation.

9 **Q. What is the projected cost of PSE's short-term debt during the rate year?**

10 A. The projected cost of PSE's short-term debt during the rate year is 4.62 percent.
11 Please see Exhibit No. ___(DEG-10), at page 2, line 14, column (F).

12 **B. The Cost of Long-term Debt**

13 **Q. Please summarize PSE's calculation of the cost of long-term debt.**

14 A. To calculate the cost of long-term debt, PSE calculates the yield-to-maturity, or
15 cost rate, of each debt issue using the issue date, maturity date, net proceeds to
16 PSE, and coupon rate of that security. Also included in the cost of long-term debt
17 are the costs to reacquire high coupon debt that has been replaced with lower
18 coupon debt. The proportional share that each issue's principal amount represents
19 of the total amount of long-term debt outstanding is then used to weigh these cost

1 rates. This is the same methodology PSE has used in prior proceedings.

2 **Q. Have you prepared an exhibit demonstrating this calculation?**

3 A. Yes. Please see pages 4 and 5 of Exhibit No. ___(DEG-10) for these calculations.

4 **Q. Does PSE project new issues of long-term debt before the end of the rate**
5 **year?**

6 A. Yes, one. PSE issued new long-term debt in March 2011, and PSE's financial
7 plan projects one additional long-term debt issue before the end of the rate year.
8 The projection is for a $250 million senior secured note issue in September 2011.
9 The March 2011 and the projected September 2011 long-term debt issues are
10 included in the cost of long-term debt projected for the rate year.

11 **Q. How does PSE plan to use the proceeds of this new issue of long-term debt?**

12 A. PSE used the March 2011 proceeds to repay short-term debt that had been
13 incurred to temporarily fund the maturity of a February 2011, $260 million, 7.69
14 percent maturing bond. PSE also used the proceeds to pay down short-term debt
15 used to fund capital expenditures. PSE plans to use the proceeds from projected
16 new debt to repay short-term debt incurred to fund PSE's capital expenditures.

1 **Q. How has PSE determined the projected cost of future long-term debt**
2 **expected to be issued by the end of the rate year?**

3 A. PSE has projected the cost of its future long-term debt issue utilizing forecasted
4 yields on benchmark U.S. Treasury securities and adding an estimated credit
5 spread for PSE's long-term debt to derive a projected coupon. Net proceeds,
6 which are a component of the overall bond yield, were derived by averaging the
7 issuance costs of PSE's recent bond issues.

8 **Q. Is this methodology consistent with prior projections of long-term debt costs?**

9 A. Yes. In PSE's 2009 general rate case, bond rates were also based on forecasted
10 U.S. Treasuries benchmark yields plus estimated credit spreads.

11 **Q. What is PSE's projected coupon for the expected future bond issuance?**

12 A. I project that PSE could issue a 30-year bond later this year at a coupon of 6.25
13 percent. That projection is based on indicative quotes of PSE's credit spread from
14 banks with which PSE has capital markets relationships and Moody's Forecasting
15 Service projection of the U.S. Treasury rate on a 30-year bond. Assuming 1) the
16 benchmark 30-year U.S. Treasury rate is 5.15 percent, per Moody's forecast, and
17 2) PSE's credit spreads maintain indicative tight levels at 1.10 percent, the result
18 would be a 6.25 percent coupon. Including estimated issuance costs, the resulting
19 yield would be 6.33 percent. That is lower than the test year current embedded
20 cost of PSE's long-term debt of 6.59 percent. For reasons mentioned previously

in my testimony, I am comfortable including this rate in PSE's projected costs of long-term debt, rather than requesting that rates be set on the embedded cost of long-term debt of 6.59 percent that was outstanding during the test year.

PSE understands that this projection is a hypothetical rate and that there was disagreement in its 2009 general rate case regarding the most appropriate coupon rate for expected future bond issuances. If there is similar disagreement in this proceeding as to the hypothetical rate on its forward looking issuances, PSE recommends looking back to its actual total weighted average long-term debt rate from the test year as the fair and proper methodology.

Q. Are there any issues of PSE long-term debt that will mature or retire between December 31, 2010, and the end of the rate year?

A. Yes. After December 31, 2010, and before April 30, 2013, PSE has one series that will have matured. It is PSE's $260 million, 7.69 percent, senior notes that matured on February 1, 2011. Since these notes will have matured prior to the beginning of the rate year, they have been excluded in the rate year calculation of the cost of long-term debt.

Q. What is the projected cost of PSE's long-term debt during the rate year?

A. The projected cost of PSE's long-term debt during the rate year is 6.37 percent as shown in Exhibit No. ___(DEG-10), at page 4, line 31, column G.

1
2
VI. S&P AND MOODY'S HAVE RECENTLY UPGRADED PSE'S CREDIT RATINGS

3 **Q. What are rating agencies and credit ratings?**

4 A. Rating agencies are independent agencies that assess risks for investors. The two
5 most widely recognized rating agencies are Standard & Poor ("S&P") and
6 Moody's. These rating agencies issue credit ratings to companies and their
7 securities. These ratings provide information to investors regarding risks
8 associated with such companies and their debt securities.

9 **Q. What are PSE's current credit ratings?**

10 A. PSE's current credit ratings are shown in Table 5 below:

11 **TABLE 5**
12 **PSE CREDIT RATINGS**

Security	S&P	Moody's
Corporate credit/issuer rating	BBB	Baa2
Senior Secured Debt	A-	A3
Junior Subordinated Notes	BB+	Baa3
Commercial Paper	A-2	P-2
Bank Facilities	BBB	Baa2

13 **Q. Have the credit ratings of PSE recently changed?**

14 A. Yes. Both S&P and Moody's have upgraded PSE's credit ratings since the merger
15 was approved.

16 After the Commission issued the merger order but before the closing of the

merger, S&P raised several credit ratings of PSE to reflect the improved financial position of PSE that resulted from the merger:

(i) S&P raised the corporate credit rating of PSE from "BBB-" to "BBB";

(ii) S&P raised the senior secured debt rating of PSE from "BBB+" to "A-"; and

(iii) S&P raised the commercial paper rating of PSE from "A-3" to "A-2".

At the same time, S&P removed all of PSE's ratings from CreditWatch with negative implications and stated that PSE's ratings outlook is stable.

Further, in March 2011, Moody's raised PSE's credit ratings, citing, among other things, "the relative stability in operations observed following the company's buyout in February 2009":

(i) Moody's raised the corporate credit rating of PSE from "Baa3" to "Baa2";

(ii) Moody's raised the senior secured debt rating of PSE from "Baa1" to "A3"; and

(iii) Moody's raised the commercial paper rating of PSE from "P-3" to "P-2".

Q. Why are credit ratings important to PSE after the merger?

A. Credit ratings are important post-merger because PSE will be issuing long-term debt securities to finance utility operations going forward. In addition, PSE agreed to continue to be rated by S&P and Moody's going forward in merger Commitment 39.

1 **Q. Why are credit ratings important to customers?**

2 A. Credit ratings are important to customers because they are an overall
3 representation of a company's financial health. As a result, they are a major factor
4 in determining the cost of capital to PSE and ultimately its customers. A low
5 credit rating reflects increased risks for investors, which, in turn, results in a
6 higher cost of capital, which increases the cost of service to customers.

7 **Q. What corporate credit rating is PSE targeting at the present time?**

8 A. In light of PSE's capital spending program, PSE is seeking to at least retain its
9 current senior secured debt ratings of "A-" and "A3" and its corporate ratings of
10 BBB and Baa2 by S&P and Moody's respectively.

11 **Q. Do the rating agencies have targets or guidelines that relate certain credit**
12 **metrics with specific credit ratings?**

13 A. Yes. In a report dated May 27, 2009, S&P revised its ratings criteria. *See* Exhibit
14 No. ___(DEG-11). Under the new criteria, PSE is classified as having a Business
15 Profile of "Excellent" and a Financial Profile of "Aggressive" which suggests a
16 midpoint of a likely ratings range of BBB under the described methodology. In
17 that report, S&P published the following table related to indicative ratios:

1 **TABLE 6**
2 **S&P FINANCIAL RISK INDICATIVE RATIOS - US UTILITIES**

	FFO to Debt	**Debt to EBITDA**	**Debt Ratio**
Modest	45% - 60%	1.5x to 2.0x	25% to 35%
Intermediate	30% to 45%	2.0x to 3.0x	35% to 45%
Significant	20% to 30%	3.0x to 4.0x	45% to 50%
Aggressive	12% to 20%	4.0x to 5.0x	50% to 60%

3 In an August 2009 report revising Moody's rating methodology for regulated gas
4 and electric utilities, Moody's shows benchmark ranges for certain financial
5 metrics associated with its various ratings levels.

6 Table 7 below includes the Moody's benchmark range for certain credit ratings:

7 **TABLE 7**
8 **MOODY'S SELECT KEY RATIOS**

	CFO pre-W/C to Debt	**CFO pre-W/C to Interest**	**Debt Ratio**
"A"	22% to 30%	4.5x to 6.0x	35% to 45%
"Baa"	13% to 22%	2.7x to 4.5x	45% to 55%
"Ba"	5% to 13%	1.5x to 2.7x	55% to 65%

9 **Q. What are PSE's credit metrics?**

10 A. The most recently reported credit metrics are those in the Moody's March 17,
11 2011 report. *See* Exhibit No. ___(DEG-5). For the test year ending December
12 31, 2010, they are:

13 (i) Adjusted cash from operations to debt – 16.4%;
14 (ii) Adjusted cash from operations to interest - 3.6x; and

1 (iii) Debt to total capitalization – 47.8%.

2 As one would expect, the equity infusion and reduction in PSE debt that resulted
3 from the merger improved the metrics. For example, the debt to capitalization
4 metric was 54.5% for the year ending 2008 immediately prior to the merger
5 transaction.

6 Metrics under the S&P methodology for the year ending December 31, 2010 are:

7 (i) Funds from operations to debt – 15.4%;
8 (ii) Debt to EBITDA - 5.6x; and
9 (iii) Debt to total capitalization –56.6%.

10 **Q. What other considerations do the credit rating agencies make when issuing**
11 **credit ratings?**

12 A. The credit rating agencies consider a number of factors which are both
13 quantitative and qualitative in nature. In addition to credit metrics, credit ratings
14 agencies also consider qualitative measures, including, but not limited to,
15 regulation, markets and competition, and operations and management.

16 Moody's revised rating methodology, a copy of which is provided in Exhibit
17 No. ___(DEG-12), bases its ratings on four major factors. These factors, and the
18 weights assigned to each, are shown below:

19 i) Regulatory Framework 25 percent
20 ii) Ability to Recover Costs and Earn Returns 25 percent

1 iii) Diversification 10 percent

2 iv) Financial Strength, Liquidity and Key Metrics 40 percent

3

4 As indicated here, the regulatory framework and the ability to recover prudently-
5 incurred costs and earn allowed returns comprise 50 percent of Moody's ratings
6 considerations. This is one key reason why minimizing the impact of regulatory
7 lag and recovering lost margins from energy efficiency measures is of prime
8 importance.

9 **Q. How do the rating agencies characterize the importance of supportive**
10 **regulation?**

11 A. Supportive regulation is an important component of credit assessment, including
12 support to help with reducing the impact of rate-case lag as noted below by S&P:

> 13 Regulation is the most critical aspect that underlies regulated integrated
> 14 utilities' creditworthiness. Regulatory decisions can profoundly affect
> 15 financial performance. Our assessment of the regulatory environments in
> 16 which a utility operates is guided by certain principles, most prominently
> 17 consistency and predictability, as well as efficiency and timeliness. For a
> 18 regulatory process to be considered supportive of credit quality, it must
> 19 limit uncertainty in the recovery of a utility's investment. <u>They must also</u>
> 20 <u>eliminate, or at least greatly reduce, the issue of rate-case lag, especially</u>
> 21 <u>when a utility engages in a sizable capital expenditure program</u>.[5]

---

[5] Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utilities Industry, March 2010 (emphasis added).

1 **Q. Does PSE expect that its credit ratings will improve during the rate year or**
2 **shortly thereafter?**

3 A. No. The Company does not expect its credit ratings to improve during the rate
4 year or shortly thereafter. Rather, a reasonable expectation is that the ratings
5 could be maintained assuming continuation of the Company's business plan and
6 supportive regulation.

7 I am proposing that the rate year capital structure include 48 percent equity which
8 is slightly below the capital structure in place on average during the test year
9 comprising calendar year 2010. The credit rating agencies would have considered
10 the capital structure during 2010 in their recent ratings assessments including the
11 Moody's upgrade of March 17, 2011. Further, it is not likely that a qualitative
12 measures assessment will be appreciably enhanced over the foreseeable future
13 such that PSE should expect higher credit ratings.

14 PSE desires to at least maintain its current credit ratings to benefit customers with
15 improved debt costs as discussed in this testimony and to provide it with a
16 measure of financial flexibility in difficult economic conditions. It is worthy of
17 note that both agencies have stated that their current credit ratings consider, at
18 least in part, supportive regulation.

19 In the Outlook section of its report dated February 24, 2011, S&P states:

20 > The stable outlook also reflects reasonable and timely rate relief related to
21 > resource additions and changes in power costs at PSE, as well as our

expectation that PSE will internally fund significant capital expenditures.

Supporting the expectation of unlikely upward ratings movement, the following is expressed in the same section of the S&P report: "However, positive ratings momentum is unlikely at this time." *See* Exhibit No. ___(DEG-13) at page 4.

Similarly, Moody's addresses regulatory support in the Collaborative Regulatory Relationships and Credit Supportive Regulatory Practices section of its credit opinion dated March 17, 2011:

> PSE embraces a collaborative regulatory approach in Washington that has been allowing more reasonable rate increases and providing risk-mitigating cost-recovery mechanisms….In our view the PCA and PGA are critical underpinnings of the rating… Although we focus on cash flow, one area of concern has been the under-earning of ROE relative to authorized levels….Going forward we expect the company will seek additional rate increases for both gas and electric operations in mid-2011, providing at least the opportunity to achieve its allowed ROE through revenue growth.

Also, providing some ratings direction looking forward as it relates to the newly increased credit ratings and any potential rate increases, Moody's adds:

> Additionally, we expect the company will seek authorization from the Washington Commission for rate increases at both the electric and gas businesses sometime in 2011 (effective 2012), providing an opportunity for stronger positioning at its current rating category.

Exhibit No. ___(DEG-5) at page 2.

1 **Q. What do credit ratings mean for PSE customers?**

2 A. In general, higher credit ratings result in lower borrowing costs to fund utility
3 capital investments. Costs of long-term debt have been substantially reduced and
4 are reflected in the cost of debt requested in this proceeding. Not only is the cost
5 of long-term debt no higher than it otherwise would have been absent the merger,
6 customers instead will benefit from improved credit ratings in the form of
7 significantly lower interest costs.

8 **Q. Has PSE quantified how its long-term debt costs have been reduced from the**
9 **credit ratings upgrade resulting from the merger?**

10 A. Yes, it has, and the savings are substantial. The benefit of lower pretax interest
11 costs is estimated to exceed $33 million on a present value basis.

12 Since the beginning of 2009, PSE has issued new senior secured notes five times
13 totaling $1.475 billion. These include the following:

14 i. $250 million in January 2009;
15 ii. $350 million in September 2009;
16 iii. $325 million in March 2010;
17 iv. $250 million in June 2010; and,
18 v. $300 million in March 2011.
19

20 PSE estimated the interest savings resulting from a one notch credit rating
21 improvement for each of these issuances.

22 In PSE's 2009 general rate case, I provided an analysis including an estimate for
23 interest savings for the January 2009 bond issuance; it was a range of 12.5 to 32

1 basis points (with a mid-point of 22.3 basis points).[6] Such savings change over
2 time as investors' views of risk change. In order to estimate the benefit in credit
3 spread and related interest savings for its four subsequent 30-year bond issuances,
4 PSE employed a subset of the Barclays Electric Utility Index to determine spread
5 differences of that index's 30-year utility bonds rated A3 and those rated Baa1
6 (one notch lower) at PSE's bond pricing dates. A one notch ratings benefit
7 estimate was derived by taking the weighted average spreads for the population of
8 bonds between the two customized indices. The average spread differential, the
9 mean of which is approximately 17 basis points for the four 30-year bond
10 issuances, was applied as the estimated benefit to the PSE bonds' coupons to
11 generate an estimated interest savings. When the estimated interest savings on
12 the nearly $1.5 billion of bonds is accumulated and discounted it results in over
13 $33 million in savings.

14 **Q. How has PSE's cost of long-term debt changed over time?**

15 A. The cost benefits related to the merger on PSE's most recent issues discussed
16 previously are only part of a considerable overall improvement in the cost of
17 long-term debt over time. Since 2005, PSE's overall cost of long-term debt has
18 fallen well over 100 basis points when comparing PSE's request in this rate
19 proceeding to the allowed cost of debt in effect in 2005 and earlier. This
20 improvement is the result of replacing higher cost debt with lower cost debt over

---

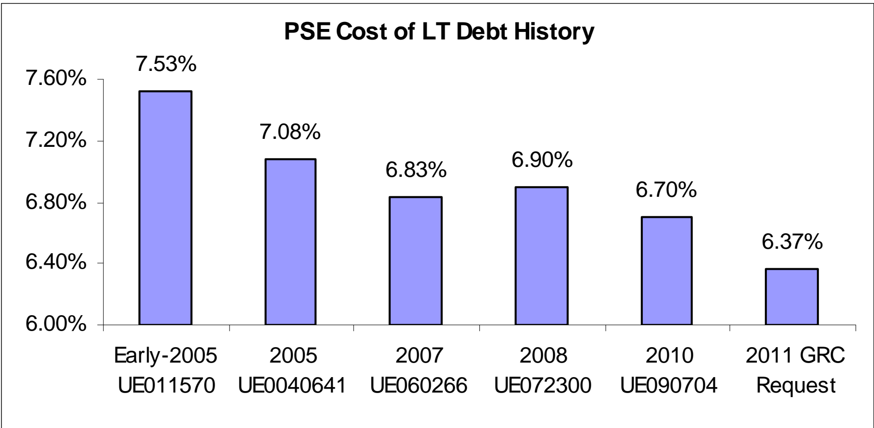
[6] Docket Nos. UE-090704 and UG-090705, Gaines, Exh. No. DEG-1T, at 42:7-9.

1 time.

2 Figure 1 below shows the reduction in the cost of long-term debt component
3 (including the formerly outstanding Trust Preferred and the currently outstanding
4 Junior Subordinated Notes) of the authorized rates of return in prior rate cases up
5 to the cost of long-term debt requested in this rate proceeding.

6 Applying the reduction of 116 basis points (7.53 percent minus 6.37 percent) to
7 the long-term debt in the test year capital structure of approximately $3.3 billion
8 results in a test year interest savings equivalent to approximately $38 million,
9 compared to what it would have been at the cost of long-term debt level from
10 2005.

11 **FIGURE 1**
12 **IMPROVEMENT IN COST OF LONG-TERM DEBT**



13

14 **Q. How does this long-term debt savings relate to PSE's rate request?**

15 A. The significant estimated cost benefits derived from the merger in the form of
16 interest savings on long-term debt, as well as the other improvements over time,

1 are built into PSE's cost of capital request in this and prior rate proceedings.
2 These estimated cost savings are substantial and will continue to benefit
3 customers for years to come.

VII. PSE HAS COMPLIED WITH ALL MERGER COMMITMENTS REGARDING CAPITAL STRUCTURE AND COSTS OF DEBT

Q. Are there merger commitments that relate to PSE's proposed cost of debt or equity in this rate proceeding?

A. As summarized earlier, Merger Commitment 24 prohibits PSE from advocating for a higher cost of debt or equity capital as compared to what PSE's cost of debt or equity capital would have been absent Puget Holdings' ownership:

> Puget Holdings and PSE will not advocate for a higher cost of debt or equity capital as compared to what PSE's cost of debt or equity capital would have been absent Puget Holdings' ownership.[7]

The Eighth Condition of the Merger Order clarified Merger Commitment 24 (among other merger commitments) as follows:

> (a) Determination of PSE's debt and equity costs will be no higher than such costs would have been assuming PSE's credit ratings by S&P and Moody's in effect on the day before the transaction closes and applying those credit ratings to then-current debt and equity markets, unless PSE proves that a lower credit rating is caused by circumstances or developments not the result of financial risks or other characteristics of the transaction.

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[7] *See In re Puget Holdings LLC & Puget Sound Energy, Inc.*, Docket No. U-072375, Order 08, Attachment A at p. 3 (Dec. 30, 2008).

(b) PSE bears the burden to prove prudent in a future general rate case any pre-payment premium or increased cost of debt associated with existing PSE debt retired, repaid, or replaced as a part of the transaction.

(c) Determination of the allowed return on equity in future general rate cases will include selection and use of one or more proxy group(s) of companies engaged in businesses substantially similar to PSE, without any limitation related to PSE's ownership structure.[8]

Q. Are PSE's requested debt and equity costs higher than such costs would have been, assuming PSE's credit ratings by S&P and Moody's in effect on the day before the merger closing and applying those credit ratings to the now-current debt and equity markets?

A. No. PSE's requested debt and equity costs are no higher than such costs would have been assuming PSE's credit ratings by S&P and Moody's in effect before the impact of the merger closing and applying those credit ratings to the now-current debt and equity markets. The Commission's clarification to use the credit ratings in effect "on the day before the transaction closes" assumes the rating agencies would take any action concurrent with the transaction closing when in fact the agencies took action in anticipation of the transaction closing. As discussed in this testimony, PSE is not requesting recovery of any costs of debt capital that are higher than they would have been absent the merger. Further, Dr. Charles Olson, in his analysis on ROE in his prefiled direct testimony, Exhibit No. ___(CEO-

[8] *In re Puget Holdings LLC & Puget Sound Energy, Inc.*, Docket No. U-072375, Order 08, Attachment B (Dec. 30, 2008).

1T), includes selection and use of one or more proxy groups of companies engaged in businesses substantially similar to PSE, without any limitation related to PSE's ownership structure.

In its 2009 general rate case, and following the methodology to this proceeding, PSE has requested costs of short-term debt that would have been in effect absent the merger by applying the costs of the pre-merger facilities up until the time that such facilities would have otherwise expired. The costs of the new credit facilities, which are included as of the expiration dates of the pre-merger facilities, contain spreads that are more favorable than PSE could obtain in today's markets. Additionally, as discussed below, there is evidence to suggest that PSE's costs of long-term debt are substantially lower than they otherwise would have been were it not for the merger.

Q. How does PSE interpret the Eighth Condition of the Merger Order?

A. It is PSE's understanding that the intent of the Commission in the Eighth Condition of the Merger Order was to protect against the possibility that credit ratings agencies would downgrade PSE's credit ratings as a result of the merger. Indeed, the Eighth Condition of the Merger Order does not contemplate the possibility of an upgrade in PSE's credit ratings as a result of the merger.

1 **Q. Did any ratings agency change or affirm its credit ratings for PSE in the**
2 **interim period subsequent to the issuance of the Merger Order and prior to**
3 **the closing of the merger?**

4 A. Yes. S&P and Moody's each changed or affirmed its credit ratings for PSE in the
5 interim period subsequent to the issuance of the Merger Order on December 30,
6 2009, and prior to the closing of the merger on February 6, 2009. S&P upgraded
7 PSE's credit ratings on January 16, 2009, as shown in Table 8, below:

8 **TABLE 8**
9 **S&P CREDIT RATINGS FOR PSE**

Security	Jan. 15, 2009	Jan. 16, 2009
Corporate credit/issuer rating	BBB-	BBB
Senior Secured Debt	BBB+	A-
Junior Subordinated Notes	BB	BB+
Preferred Stock	BB	BB+
Commercial Paper	A-3	A-2

10 Additionally, Moody's affirmed PSE's credit ratings at the time of the merger and
11 increased PSE's credit ratings in March 2011. Therefore, PSE interprets the
12 Commission's reference to PSE's credit ratings in effect "on the day before the
13 transaction closes"[9] as referring to PSE's credit ratings that were in effect on
14 January 15, 2009–the day before S&P upgraded PSE's credit ratings in
15 anticipation of the closing of the merger.

[9] The Eighth Condition of the Merger Order.

1 **Q. Has PSE complied with Merger Commitment 24, as clarified by the Eighth**
2 **Condition of the Merger Order?**

3 A. Yes. PSE's long-term debt costs are no higher than such costs would have been
4 assuming PSE's credit ratings by S&P and Moody's in effect on January 15, 2009
5 and applying those credit ratings to current debt markets. The cost of debt on
6 notes issued post-merger are lower than they would have been absent the merger
7 because they were issued at the higher post-merger credit ratings. The majority of
8 PSE's existing long-term debt issues were issued prior to the Merger Order and
9 the closing of the merger, and the merger did not have an impact on the cost of
10 those issues whatsoever.

11 PSE issued $250 million of 7-year senior secured notes in the interim period
12 subsequent to the issuance of the Merger Order and prior to the closing of the
13 merger. The notes were priced on January 20, 2009, and then subsequently
14 closed on January 23, 2009. As discussed above, S&P upgraded PSE's credit
15 ratings on January 16, 2009, in anticipation of the closing of the merger. As a
16 result of this upgrade, the $250 million of 7-year senior secured notes issued in
17 January 2009 was priced at a lower cost than other secured utility bond issues of
18 companies with credit rating identical to PSE's credit rating on January 15, 2009.

19 **Q. Please describe Merger Commitment 57.**

20 A. Merger Commitment 57 states:

> The objective of [the] Joint Applicants is to refinance the term loan of Puget Energy using medium-term and/or long-term financing. The Joint Applicants will develop a plan to achieve this objective and maintain records of their efforts to achieve such objective. The plan developed by the Joint Applicants pursuant to this Commitment will be available to the Commission and other interested parties, upon request and subject to the protective order in Docket No U-072375.

Q. Has the Company developed and maintained such a plan?

A. Yes. The plan called for Puget Energy to issue a series of four $350 million 10-year note issues, one each per year beginning in 2010 and ending in 2013. The net proceeds of these issues would be used to fully repay the Puget Energy term loan and to partially reduce the drawn portion of the Puget Energy capital expenditure facility. Puget Energy has been implementing this plan.

Q. Does any merger commitment require PSE to maintain a capital structure with a minimum equity ratio?

A. Yes. Merger Commitment 35, in part, requires PSE to maintain a capital structure with a minimum equity ratio:

> as of the closing of the transaction (or within sixty (60) days thereof), PSE will have a common equity ratio of not less than 50 percent. Joint Applicants commit that at all times thereafter, PSE will have a common equity ratio of not less than 44 percent, except to the extent a lower equity ratio is established for ratemaking purposes by the Commission.[10]

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[10] Page 7 of Appendix A (Multiparty Settlement Stipulation) to the Merger Order.

1 **Q. How has the Company complied with the merger commitment to increase its**
2 **equity ratio?**

3 A. Through the merger, the Investor Consortium invested $805 million of equity into
4 PSE resulting in an actual capital structure on March 31, 2009, of 52.9 percent
5 equity ratio. Additionally, PSE's consolidated capital structure on March 31,
6 2010 and March 31, 2011 included regulated equity ratios of 50 percent and 48.5
7 percent, respectively. Now the goal is to maintain that equity ratio so PSE is
8 targeting a 48 percent level of equity in its capital structure, at this time, going
9 forward.

10 **Q. Did PSE have a common equity ratio of not less than 50 percent within sixty**
11 **60 days of the closing of the merger?**

12 A. Yes. PSE's actual capital structure on March 31, 2009 included a 52.9 percent
13 equity ratio. Additionally, PSE's capital structure on December 31, 2010 included
14 a 46.5 percent equity ratio and averaged 48.5 percent throughout 2010. PSE's
15 equity has been above 44 percent since the merger. Therefore, PSE complies with
16 Merger Commitment 35.

17 ## VIII. CONCLUSION

18 **Q. Does that conclude your direct testimony?**

19 A. Yes, it does.