EXHIBIT NO. ___(DEG-7CT)
DOCKET NO. UE-060266/UG-060267
2006 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-060266** **Docket No. UG-060267**

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

REDACTED VERSION

AUGUST 23, 2006

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF DONALD E. GAINES

CONTENTS

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF DONALD E. GAINES

I. INTRODUCTION

Q. Are you the same Donald E. Gaines who submitted prefiled direct testimony in this proceeding on February 15, 2006, on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. First, my prefiled rebuttal testimony responds to assertions regarding capital structure and rate of return made by Mr. Stephen Hill, witness for the Staff of the Washington Utilities & Transportation Commission ("Commission Staff"), and Mr. Michael Gorman, witness for the Industrial Customers of Northwest Utilities ("ICNU"). This testimony demonstrates that the Commission should reject the capital structures proposed by Messrs. Hill and Gorman because such proposals (i) are inconsistent with the methodology this Commission described in its most recent general rate case order for PSE, (ii) ignore the Company's financing plans, and (iii) contain much smaller equity ratios than authorized capital structures set by regulatory commissions, on average, over the past few years.

Second, my prefiled rebuttal testimony demonstrates that the capital structures and resulting rate of return recommendations of Messrs. Hill and Gorman are inappropriate for the Company. My prefiled rebuttal testimony also corrects certain errors and addresses inconsistencies made by Messrs. Hill and Gorman.

Third, my prefiled rebuttal testimony shows that the return calculations prepared by Mr. James Russell, witness for Commission Staff, inaccurately depict the Company's actual earned return--the return with which investors are concerned.

Fourth, my prefiled rebuttal testimony demonstrates the harmful impact on the Company if the Commission were to adopt the rate relief proposed by Commission Staff.

Finally, my prefiled rebuttal testimony comments on the comparison of power cost volatility of PSE and Avista Corporation in the prefiled joint response testimony of Mr. Donald Schoenbeck, on behalf of ICNU, Dr. Yohannes Mariam, on behalf of Commission Staff, and Mr. Jim Lazar, on behalf of Public Counsel, Exhibit No. ___(JOINT-19T).

Q. Does your testimony address the calculation of the appropriate return on equity ("ROE") for the Company?

A. No. Dr. Roger Morin addresses the Company's cost of common equity in his prefiled direct and rebuttal testimonies, Exhibit No. ___(RAM-1T) and Exhibit No. ___(RAM-15T), respectively. However, my prefiled rebuttal testimony and supporting exhibits use Dr. Morin's recommended ROE of 11.25% to calculate the Company's authorized rate of return.

II. CAPITAL STRUCTURE AND RATE OF RETURN

Q. Would you please summarize the capital structure and rate of return proposals of other parties to this proceeding?

A. Yes. Two witnesses provided testimony on capital structure and rate of return: Commission Staff witness Mr. Stephen Hill in Exhibit No. ___(SGH-1CT) and ICNU witness Mr. Michael Gorman in Exhibit No. ___(MPG-1CT). Please see Exhibit No. ___(DEG-8) for a summary of their respective proposals. Exhibit No. ___(DEG-8) also compares and contrasts the proposals of Messrs. Hill and Gorman with the Company's proposal.

Commission Staff proposes a capital structure that contains an equity ratio of 43%--the authorized equity ratio on which Company rates are currently set. ICNU proposes a capital structure that contains an equity ratio of 44%--the actual equity ratio of the Company as of December 31, 2005.[1] The Company proposes a capital structure that contains an equity ratio of 45%--the expected average of the monthly averages for the rate year (calendar year 2007).

The most significant difference among the various proposed rates of return is the

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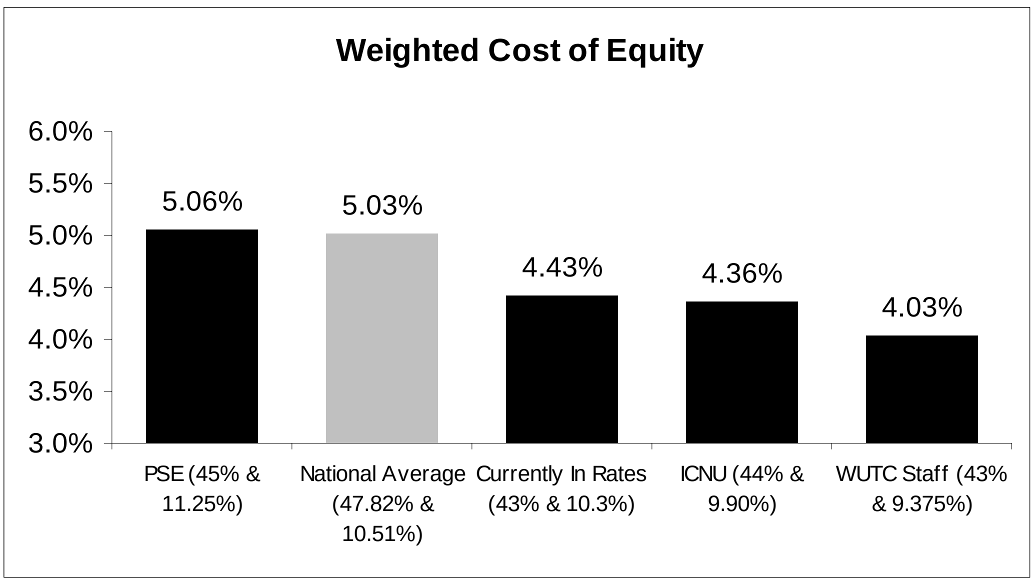
[1] The Company's actual equity ratio as of June 30, 2006 (the end of the most recent quarter) was also 44%.

weighted cost of equity (i.e., the product of the equity ratio and the ROE). The following chart illustrates (i) PSE's proposed weighted cost of equity (5.06%); (ii) the weighted cost of equity authorized by regulatory commissions, on average, since January 1, 2005 (5.03%);[2] (iii) the authorized weighted cost of equity on which PSE's current rates are set (4.43%); (iv) ICNU's proposed weighted cost of equity (4.36%); and (v) Commission Staff's proposed weighted cost of equity (4.03%). This is the result of the relatively wide spread among the ROE's proposed by the various witnesses.



Both Commission Staff and ICNU use the same cost rates for long-term debt, trust preferred and preferred stock. Additionally, ICNU and the Company propose the same cost rate for short-term debt. Commission Staff states that it uses the Company's proposed cost rate for short-term debt but actually proposes a

2 *See* Exhibit No. ___(DEG-9).

cost rate that is slightly lower. In response to PSE Data Request No. 098, Commission Staff has indicated that it accepts the Company's proposed cost rate for short-term debt. *See* Exhibit No. ___(DEG-9).

Q. Have you changed the recommended rate of return included in your prefiled direct testimony based on the response testimony of Messrs. Hill and Gorman?

A. No. The Company remains convinced that the appropriate rate of return for this proceeding is 8.76%.

As I will discuss later, I have updated the Company's financing plan to reflect financings that have occurred since my prefiled direct testimony was submitted. However, those updates did not result in a change in the overall capital structure of the Company or the resulting rate of return.

This proposed rate of return is based on a capital structure that contains an equity ratio of 45%. The components of this rate of return are illustrated in Exhibit No. ___(DEG-10) and are summarized in Table 1 below.

TABLE 1
CAPITAL STRUCTURE & OVERALL RATE OF RETURN

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	2.11%	6.66%	0.13%
Long-term Debt	48.44%	6.64%	3.22%
Trust Preferred	0.70%	8.54%	0.06%
Preferred Stock	3.75%	7.61%	0.29%
Common Equity	45.00%	11.25%	5.06%
Overall Rate of Return	**100.00%**		**8.76%**

Although the Company's proposed overall rate of return is unchanged from that included in my prefiled direct testimony, the mix of short-term and long-term debt has slightly changed to reflect the Company's current financing plans. The increase in long-term debt and reduction in short-term debt results in a slightly higher short-term debt cost rate because the amortization of fixed costs are spread over a lower balance. After these minor changes, the total weighted cost of short-term and long-term debt of 3.35% (0.13% + 3.22%) remains unchanged from that contained in my prefiled direct testimony. The cost rates for long-term debt, trust preferred, preferred stock and ROE also remain unchanged from that contained in my prefiled direct testimony.

Q. What methodology did the Commission use in selecting the appropriate capital structure in the Company's last general rate proceeding?

A. In the final order from the Company's 2004 general rate case, the Commission stated as follows:

> Our goal in this proceeding should be to set the Company's equity ratio at the level that the evidence shows is mostly likely to prevail, on average, over the course of the rate year.[3]

Q. In making their capital structure proposals, do Messrs. Hill and Gorman follow the above-quoted methodology?

A. No. Only the Company proposed a capital structure in a method consistent with the methodology used by the Commission to set PSE's capital structure in the Company's last general rate proceeding. Neither Mr. Hill nor Mr. Gorman proposes a rate year capital structure, and both Mr. Hill and Mr. Gorman ignore the Company's financing plan. Thus, the capital structure proposals of Mr. Hill and Mr. Gorman fail to set the "Company's equity ratio at the level that the evidence shows is mostly likely to prevail, on average, over the course of the rate year."

Commission Staff's proposed capital structure with an equity ratio of 43% is backward looking and simply proposes the capital structure on which the

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[3] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 06: Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent Filing, at page 17, paragraph 40 (Feb. 18, 2005).

Commission set rates in the Company's last proceeding.[4] Mr. Hill's proposed capital structure not only ignores the Company's financing plans as shown in Exhibit No. ___(DEG-10), but his proposed 43% equity ratio is below the Company's equity ratio of 44% that exists today.

ICNU witness Mr. Gorman also proposes a backward-looking capital structure that is set equal to the Company's actual capital structure as of December 31, 2005.[5] That capital structure contained an equity ratio of 44.13%.

III. REBUTTAL OF THE PREFILED RESPONSE TESTIMONY OF MR. HILL

Q. Have you reviewed the prefiled response testimony of Mr. Hill in this proceeding and do you agree with his findings?

A. I have identified the following errors in the prefiled response testimony of Mr. Hill with respect to capital structure and rate of return:

(i) PSE's Current Equity Ratio. Mr. Hill incorrectly identifies the Company's equity ratio as of December 31, 2005, as 42%. In fact, the Company's equity ratio as of that date was 44.13%.

(ii) Equity of Non-regulated Subsidiaries. Mr. Hill improperly calculates the amount of equity by excluding non-regulated subsidiaries.

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[4] *See* Exhibit No. ___(SGH-1CT) at page 37, lines 15-17 ("I believe the 43% common equity ratio selected as reasonable by the Commission in the Company's last proceeding remains a reasonable basis for ratemaking.")

[5] Exhibit No. ___(MPG-1CT) at page 5, lines 4-12 and at page 6, lines 1-3.

(iii) Overstating the Cost of Additional Equity. Mr. Hill incorrectly determines the additional cost to customers of moving from the currently authorized equity ratio of 43% to the proposed equity ratio of 45%.

(iv) Impact of Imputed Debt. Mr. Hill presents an irrelevant comparison of purchased power expense to electric plant and fails to recognize how rating agencies consider the debt-like characteristics of purchased power agreements.

(v) PSE's Equity Ratio vs. Comparable Ratios. Mr. Hill improperly relies upon irrelevant holding company data rather than regulated utility data in asserting that the Company's proposed capital structure contains more common equity than used on average in the electric industry.

(vi) Equity Offerings. Mr. Hill falsely implies that the Company made an equity offering "[o]nly in the eleventh hour, just before the filing of the instant proceeding.…"[6] In fact, my testimony and supporting exhibits in the Company's 2004 rate case demonstrated that the Company planned to issue equity and it did so.

(vii) PSE's Financing Plans. Mr. Hill questions the Company's projected equity ratio at the end of 2006 as somehow reflective of "the Company's willingness to permanently increase its common equity ratio."[7] This statement ignores the Company's long-stated plans and its three recent common equity offerings, in which the Company raised over $500 million in common equity and increased its common equity ratio from a low of about 30% to the current rate of 44%.

(viii) Proceeds from the Sale of InfrastruX. Mr. Hill glosses over the full use of proceeds from the sale of InfrastruX, conveniently ignoring Puget Energy's equity contribution into PSE and instead focusing only on the small portion of the proceeds temporarily lent to the utility.

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6 Exhibit No. ___(SGH-1CT) at page 34, lines 10-11.

7 Exhibit No. ___(SGH-1CT) at page 35, lines 10-11.

(ix) Cost of Short-term Debt. Mr. Hill erroneously identifies the Company's projected cost of short-term debt as 6.19%, when, in fact, the Company proposed a cost of short-term debt of 6.22%.

A. PSE's Current Equity Ratio

Q. Is Mr. Hill correct in his assertion that "the equity capital portion of Puget's capital structure has increased from about 39% of total capital at the end of 2004 to 42% at year-end 2005"?[8]

A. No. The Company's equity ratio as of December 31, 2005, was 44.13%, as shown in Table 2 of my pre-filed direct testimony. Mr. Hill also erroneously states the following with respect to the Company's capital structure at year-end 2005:

> In response to Staff Data Request No. 49, the Company indicates that its capital structure at year-end 2005 consisted of 40.06% common equity, 0.04% preferred stock and the remainder various forms of debt (Trust Preferred, Long-term and Short-term Debt).[9]

The common equity ratio of 40.06% referenced by Mr. Hill is not the "point in time" capital structure on December 31, 2005, but is the average of the monthly averages ("AMA") capital structure. Because the Company issued $310 million of equity in November 2005, that equity issuance is included in only two months of the AMA.

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[8] Exhibit No. ___(SGH-1CT) at page 29, lines 9-10.
[9] Exhibit No. ___ (SGH-1T) at page 29, line 13-16.

<u>B. Equity of Non-Regulated Subsidiaries</u>

Q. Is Mr. Hill's treatment of non-regulated equity consistent with how this issue has been addressed in past rate proceedings?

A. No. The historical approach has been to remove equity of non-regulated subsidiaries from the Company's consolidated equity.

PSE has two unregulated subsidiaries--Puget Western Inc., a real estate subsidiary, and Hydro Electric Development Co. ("HEDC"), a subsidiary that owns development rights to certain potential small hydroelectric sites. As of December 31, 2005, the aggregate amount of equity in those subsidiaries was negative $23.455 million, as shown in page 2 of the workpapers filed with my prefiled direct testimony in this proceeding and in the PSE's Response to Commission Staff Data Request No. 049.

Mr. Hill makes a reference error in locating the number in PSE's Response to Commission Staff Data Request No. 049. Rather than using the total on line 19 in the Dec-05 column, Mr. Hill added lines 17, 18 and 19, which results in a double-counting of the subsidiary retained earnings. Thus Mr. Hill erroneously reports that the equity in these unregulated subsidiaries was negative $46.9 million.[10] In fact, the equity in these unregulated subsidiaries was negative $23.455 million. Mr. Hill subsequently acknowledged his error in Commission Staff's Response to PSE Data Request No. 067. *See* Exhibit No. ___(DEG-11).

As shown in Commission Staff's Response to PSE Data Request No. 067, Mr. Hill deviates substantially from the historical practice of removing equity of non-regulated subsidiaries from the Company's consolidated equity. Rather than simply removing non-regulated subsidiary equity from total common equity, Mr. Hill erroneously subtracts some $150+ million of "unregulated assets" from regulated equity. In that data request response, Mr. Hill reports that his source for the approximate $150+ million of "unregulated assets" is Puget Energy, Inc.'s "Other Property & Investments" of $157.3 million.

Puget Energy, Inc.'s "Other Property & Investments" is an asset, not equity, and includes investments that are related to the utility. In fact, nearly sixty percent of the holding company's "Other Property & Investments" are regulated utility assets, such as the Company's investment in the Bonneville Exchange Power agreement and life insurance owned by PSE. These assets are not from unregulated subsidiaries at all.

In sum, Mr. Hill significantly understates the Company's equity ratio as of December 31, 2005, which was 44.13%. As a result, Commission Staff's proposal would have the Commission set rates on an equity ratio is less than the Company's current equity ratio.

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[10] Exhibit No. ___ (SGH-1T) at page 30, line 3-4.

C. Overstating the Cost of Additional Equity

Q. Do you agree with Mr. Hill's assertion that the cost of an increase in the common equity ratio of 43% to 45% is $14.3 million?[11]

A. No. Mr. Hill's simplistic calculation ignores that a change in the equity ratio would be offset by a comparable change in some other component of the capital structure. In a simplistic capital structure comprised only of debt and equity, adding two percent to the equity ratio would necessitate a reduction of the debt ratio by two percent because the capital structure can never be greater than 100%. In other words, any incremental cost of equity would be offset, in part, by a reduction in the cost of debt. Exhibit No. ___(DEG-12) corrects Mr. Hill's error and shows a corrected amount of $9 million. Mr. Hill makes a similar error in his cost of an increase in the equity ratio by five-percentage points.[12] Exhibit No. ___(DEG-12) also corrects for that error.

Increases in the Company's equity ratio results in an incremental cost increase because equity capital costs more than debt. More expensive equity provides the "safety" and less expensive debt provides the "economy" in the balancing necessary in the selection of an appropriate capital structure.

Whereas Mr. Hill stresses the increased costs associated with an increase in the equity ratio, he ignores the purpose for the Company's projected equity issuances.

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[11] Exhibit No. ___(SGH-1CT) at page 31, line 19, through page 32, line 2.
[12] Exhibit No. ___(SGH-1CT) at page 31, lines 10-18.

As stated in my prefiled direct testimony, the Company must increase its equity ratio to:

(i) attract external capital necessary to fund the Company's infrastructure and new resource construction programs (see the prefiled direct testimonies of Ms. McLain and Mr. Markell);

(ii) engage in energy hedging strategies (see the prefiled direct testimony of Mr. Mills);

(iii) offset the imputed debt from purchased power agreements (see the prefiled direct testimony of Messrs. Markell and Molander); and

(iv) provide electric and gas service to customers on reasonable terms (see the prefiled direct testimony of Ms. Harris).

Mr. Hill's prefiled response testimony discusses the debt-like characteristics of purchased power (which I shall address below) but does not challenge the Company's need to attract external capital necessary to fund the Company's infrastructure and new resource construction programs, engage in energy hedging strategies, or provide electric and gas service to customers on reasonable terms.

D. Impact of Imputed Debt

Q. Is Mr. Hill's comparison of purchased power expenses per dollar of plant an appropriate measure of the purchased power risks of the Company?

A. No. The comparison of purchased power expenses per dollar of plant is an irrelevant measure. Rating agencies only view the *capacity portion of long-term purchased power expenses* as fixed obligations with debt-like characteristics. The data upon which Mr. Hill relied for prefiled response testimony regarding purchased power includes *all* purchased power expenses--short-term spot purchases as well as long-term purchases. The data upon which Mr. Hill relies is from PSE's FERC Form 1, which is net of (has been reduced by) the Bonneville Residential Exchange credit. In short, the data upon which Mr. Hill rests his conclusions is not limited to the *capacity portion of long-term purchased power expenses*.

The true impact of imputed debt on the Company is illustrated in the Company's rating agency presentations, copies of which were provided in PSE's Response to Commission Staff Data Request No. 055 (see Exhibit No. ___(DEG-13) and the Company provided a detailed calculation of imputed debt in PSE's Response to Commission Staff Data Request No. 070 (see Exhibit No. ___(DEG-14). These responses demonstrate that, according to the methodology used by Standard & Poor's ("S&P"), the Company has $[redacted] million of imputed debt.

Ratings agencies consider the $[redacted] million of imputed debt as an additional amount of debt to be included in the Company's capital structure. This $[redacted] million of imputed debt will likely increase as the Company enters into new long-term purchase power agreements to help meet its short position. Therefore, the need to offset imputed debt from purchased power agreements is one of the four reasons listed above supporting the Company's increase in its equity ratio.

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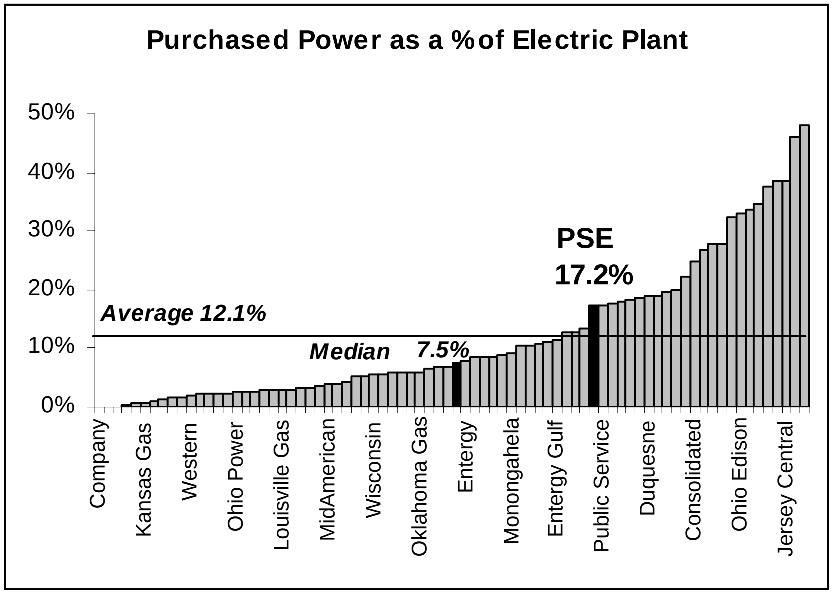
Q. What does the purchased power data from PSE's Response to Commission Staff Data Request No. 059 show?

A. PSE's Response to Commission Staff Data Request No. 059, a copy of which is provided as Exhibit No. ___(DEG-15), includes comparative studies that demonstrate the relative magnitude of the Company's purchased power obligations. The data demonstrates that the Company has more purchased power, relative to electric plant, than the average and median of all utilities.

As discussed above, this comparative study is based on data from PSE's FERC Form 1, which is net of the Bonneville Residential Exchange credit. The Bonneville Residential Exchange credit is a credit PSE receives from the Bonneville Power Administration that is passed through, dollar-for-dollar, to the Company's residential and small farm customers. Only utilities in the Pacific Northwest receive the Bonneville Residential Exchange credit.

To illustrate the impact of "purchased power" relative to plant, one should remove the Bonneville Exchange Credit. The Bonneville Exchange Credit included in the data provided as part of PSE's Response to Commission Staff Data Request No. 059 is $174.5 million. When that one correction is made, PSE is ranked 54th out of the 77 companies (the firm ranked 77th has the highest ratio), with purchased power as a percent of electric plant of 17.2% compared to the average of 12.1%, as shown in the following illustration:



<u>E. PSE's Equity Ratio vs. Comparable Ratios</u>

Q. Do you agree with Mr. Hill's assertion that the "capital structure requested by Puget in this proceeding contains more common equity and less total debt (long- and short-term debt) than is used on average in the electric industry today"?[13]

A. No. To support this statement, Mr. Hill examines the equity ratios of holding companies, not of gas and electric utilities. For example, Mr. Hill's Exhibit No. ___(SGH-8) states that the equity ratio of Pepco Holdings, Inc. is 39%. Pepco Energy Services is an unregulated subsidiary of Pepco Holdings, Inc. and a provider of deregulated energy and energy-related services for residential, small

[13] Exhibit No. ___(SGH-1CT) at page 32, lines 7-9.

business and large commercial customers.[14] Similarly, Exhibit No. ___(SGH-8) includes Puget Energy, Inc., which reflects both PSE and InfrastruX.

A comparison of PSE's proposed equity ratio for ratemaking to equity ratios of holding companies is irrelevant. An accurate comparison would be to the equity ratios of the underlying gas and electric utilities, a study which Mr. Hill stated he had not performed in his response to PSE Data Request No. 116. *See* Exhibit No. ___(DEG-16). I have performed such a study. See Exhibit No. ___(DEG-4) and Exhibit No. ___(DEG-17). These studies show the equity ratios upon which regulatory commissions have authorized rates. The average authorized equity ratio of regulated gas and electric utilities upon which various state commissions have set rates since January 1, 2005, is 47.82%, which is 282 basis points higher than the 45% the Company is requesting in this proceeding.

In sum, the equity ratios on which regulatory commissions have, on average, set rates since January 1, 2005, are considerably higher than the equity ratio proposed by Mr. Hill (47.82% compared to 43%). Additionally, the average ROE authorized by regulatory commissions since January 1, 2005 is also considerably higher than Mr. Hill's proposed ROE in this proceeding (10.51% compared to 9.375%).

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[14] *See* Pepco Holdings Website, http://www.pepco.com/.

F. Equity Offerings

Q. Do you agree with Mr. Hill's characterization that the Company's last equity offering was made "[o]nly in the eleventh hour, before the filing of the instant proceeding?"[15]

A. No. Mr. Hill's statement suggests surprise and falsely implies that the Company issued equity solely to increase its equity ratio for this case. While the recent equity issue did have that effect, the proceeds were used to repay short-term debt incurred to fund the Company's capital expenditures. My prefiled direct and rebuttal testimonies in the Company's 2004 general rate case stated that the Company was planning to issue equity during the rate year for that proceeding. Therefore, Mr. Hill, a cost of capital witness for Public Counsel in the Company's 2004 general rate case, should not have been surprised by that issuance.

Any suggestion that the Company issued equity solely to increase its proposed equity ratio in this proceeding should be disregarded. As discussed in the prefiled direct testimonies of Ms. McLain, Mr. Markell and Mr. Valdman, the Company is making significant capital expenditures to provide electric and natural gas service to its customers. Therefore, the Company must issue equity to help fund these expenditures.

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[15] Exhibit No. ___(SGH-1CT) at page 34, line 10.

G. PSE's Financing Plans

Q. Do you agree with Mr. Hill that the Company's lower equity ratio anticipated at the end of 2006 and the inter-company loan from its parent "provides some guidance with regard to the Company's willingness to permanently increase its common equity ratio"?[16]

A. No. As discussed above, the Company's equity ratio as of December 31, 2005, was 44.13%. At the end of June 2006, the Company's equity ratio was also 44% following a $60 million equity investment from Puget Energy, Inc. from part of the proceeds from the InfrastruX sale. The Company projects an average common equity 45% ratio on average during the rate year (calendar year 2007).

The Company plans to issue debt and perhaps hybrid security (preferred stock, trust preferred, etc.) later in 2006. Following those issues, and prior to the planned stock sale, the Company's equity ratio would naturally decline. This decline in equity ratio is precisely why the Company is planning to issue more equity.

Mr. Hill ignores that the Company has continued to strengthen its equity ratio since 2001, when the Company's equity ratio had eroded to approximately 30%. In the settlement of the 2001 general rate proceeding, the Commission established equity targets for the Company of 34%, 36% and 39% to be achieved by the end of 2003, 2004 and 2005, respectively. The Company achieved those targets far ahead of schedule. The Commission set rates in the Company's last proceeding on an equity ratio of 43%, which the Company has now exceeded.

Since 2001, the Company has issued over $500 million of common stock. The Company projects additional stock issuances for the foreseeable future to finance the Company's planned capital expenditure programs.

The Company's success in rebuilding its equity ratio from 30% to 44% (an amount greater than the 43% upon which current rates are set) is far more indicative of the Company's willingness to permanently increase its equity ratio than the carefully selected snapshots provided by Mr. Hill.

H. Proceeds from the Sale of InfrastruX

Q. Is Mr. Hill's portrayal of the use of the net proceeds from the sale of InfrastruX complete and accurate?

A. No. Mr. Hill states as follows with respect to the proceeds from the sale of InfrastruX:

> While Puget Energy expects to have after-tax net proceeds from the sale of Infrastrux of $85 Million, it currently has $188 Million from the transaction, because not all payments related to the sale have been made. The filings indicate the parent company wants to lend the utility approximately $30 Million on a short-term debt basis.
>
> Those monies represent capital that the parent could use to increase its equity investment in Puget and permanently raise the

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[16] Exhibit No. ___ (SGH-1CT), page 35, lines 10-11.

> Company's common equity ratio. However, it has chosen, instead, to retain most of the monies from the sale and lend a portion to Puget--increasing its short-term debt. In my view this recent action runs counter to the Company's claim that it wants to increase its common equity ratio.[17]

The $85 million referred to by Mr. Hill is within the range of the expected net proceeds the Company included in its Form 8-K filed with the Securities Exchange Commission ("SEC") on May 2, 2006 and in materials provided to the Company's Securities Pricing Committee, the source of Mr. Hill's number. Mr. Hill subsequently corrected his reference to $188 million in proceeds to $118 million in response to PSE Data Request No. 70. *See* Exhibit No. __(DEG-18).

Mr. Hill fails to mention that Puget Energy also planned to make an equity investment into PSE, as shown in the workpapers. Mr. Hill also neglected to mention that (i) the Company filed a notice of the transaction with the Commission, (ii) Commission Staff discussed the transaction with the Company, (iii) Commission Staff did not dispute the loan and (iv) this Commission issued an order related to the transaction.

In fairness to Mr. Hill, Puget Energy, Inc. had not closed the sale of InfrastruX by the time Mr. Hill likely prepared his prefiled response testimony. At closing, the net proceeds from the sale of InfrastruX were $95.9 million, rather than the expected $85 million. Exhibit No. ___(DEG-19) includes a presentation that

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17 Exhibit No. ___(SGH-1CT) at page 35, line 16, through page 36, line 2.

illustrates the sales price of $275 million, the repayment of debt and other transaction related expenses, and the resulting after-tax net proceeds of $95.9 million. Furthermore, Exhibit No. ___(DEG-19) shows that, of the $95.9 million Puget Energy received, $60 million was invested into PSE (an amount four times greater than the planned level shown in my workpapers), $15 million pre-tax ($9.8 million after-tax) was used to fund the creation of the Puget Sound Energy Foundation, and $26.5 million was lent to PSE through the inter-company loan referred to by Mr. Hill:

TABLE 2
USE OF NET PROCEEDS FROM SALE OF INFRASTRUX
(Dollars in Millions)

Net Proceeds from Sale		$95.9
Temporary investment income		0.4
Funds Available		**$96.3**
PE equity investment in PSE		$60.0
PE creation of charitable foundation	$15.0	
Less: tax benefit from contribution	5.2	9.8
PE loan to PSE		26.5
Total Uses		**$96.3**

Q. Why did Puget Energy, Inc. lend $26.5 million to PSE rather than invest this same amount in the utility?

A. As part of the terms of the sale of InfrastruX, Puget Energy, Inc. made certain indemnifications to the buyer. Additionally, some of the payments Puget Energy, Inc. must make related to the sale are to be made over a period of time.

The indemnifications obligate Puget Energy, Inc. to make potential payments to the buyer, capped in amount and limited to certain periods of time, under certain circumstances. Puget Energy, Inc. elected to hold the amounts related to those future payments and potential liabilities so that funds were available in the event Puget Energy, Inc. must indemnify the buyer. In the meantime, Puget Energy, Inc. agreed to support PSE by lending the funds to PSE as an additional source of liquidity.

I. Cost of Short-Term Debt

Q. Does Mr. Hill agree with the Company's proposed cost rate for short-term debt of 6.22%?

A. Mr. Hill states the following with respect to the cost rates of preferred stock, preferred trust securities, long-term debt and short-term debt

> I have reviewed the Company's projected cost rates for preferred stock, preferred trust securities, long-term debt and short-term debt, have found them to be reasonable and will use them for the purpose of determining an overall return.[18]

Exhibit No. ___(SGH-19), however, lists the cost rate of short-term debt as 6.19%, rather than the cost rate of short-term debt of 6.22% proposed by the Company in its initial filing. In response to a data request, Mr. Hill responded

[18] Exhibit No. ___ (SGH-1CT) at page 38, lines 5-7.

that

> [i]f Mr. Gaines' final recommendation for short-term debt costs is 6.22%, and that calculation was made in the same manner as the previous calculation, Mr. Hill will accept that result as the Company's cost rate of short-term debt.[19]

Q. Is the Company's proposed cost rate for short-term debt still 6.22%?

A. No. The Company's initial filing proposed a short-term debt cost rate of 6.22%. Calculated in the same manner--but updated to reflect current borrowing costs and the Company's financing plans--the short-term debt cost rate is now 6.66%, as illustrated in Exhibit No. ___(DEG-10) and in Table 1 above.

Q. Does that conclude your rebuttal of Mr. Hill's prefiled response testimony?

A. Yes it does.

IV. REBUTTAL OF THE PREFILED RESPONSE TESTIMONY OF MR. GORMAN

Q. Have you reviewed the prefiled response testimony of Mr. Gorman in this proceeding and do you agree with his findings?

A. I have identified the following flaws in the prefiled response testimony of Mr. Gorman with respect to capital structure and rate of return:

1. <u>Capital Structure Selection</u>. Like Mr. Hill's, Mr. Gorman's proposed capital structure does not follow the methodology described by the Commission in the Company's last rate

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[19] Exhibit No. ___(DEG-9).

proceeding.

2. Known and Measurable Standard for Capital Structure. Mr. Gorman erroneously suggests the Company's requested capital structure should be rejected because it is not known and measurable and he fails to examine whether the Company needs a higher equity ratio to attract capital on reasonable terms and to achieve an appropriate balance of safety and economy.

3. Capital Funding Plan. Mr. Gorman falsely suggests that the Company has not investigated the use of preferred equity securities.

A. Capital Structure Selection

Q. Did Mr. Gorman select his recommended capital structure using the methodology the Commission described in the Company's last general rate order?

A. No. Mr. Gorman proposes that the Commission set rates on the Company's equity ratio as of December 31, 2005, which was 44.13%. As discussed earlier, the Commission's stated methodology in the 2004 general rate case was to look at the capital structure that the evidence indicates is most likely to prevail on average during the rate year. Mr. Gorman provides no evidence that an equity ratio of 44.13% is the capital structure that is most likely to prevail on average during the rate year.

As discussed above, the average authorized equity ratio of regulated gas and electric utilities upon which various state commissions have set rates since January 1, 2005, is 47.82%, which is 282 basis points higher than the 45% the

Company is requesting in this proceeding.

In sum, the equity ratios on which regulatory commissions have, on average, set rates since January 1, 2005, are considerably higher than the equity ratio proposed by Mr. Gorman (47.82% compared to 44.13%). Additionally, the average ROE authorized by regulatory commissions since January 1, 2005 is also considerably higher than Mr. Gorman's proposed ROE in this proceeding (10.51% compared to 9.90%). *See* Exhibit No. ___(DEG-17).

B. Capital Structure is not Known or Measurable

Q. Why does Mr. Gorman reject the Company's proposed equity ratio of 45%?

A. Mr. Gorman rejects the Company's proposed equity ratio "because it includes adjustments that are not known and measurable."[20]

Q. Do you agree with Mr. Gorman's recommendation that the Company's requested capital structure should be rejected because it is not known and measurable?

A. No. In prior orders, the Commission has stated generally that capital structure is to be set by balancing the safety of equity with the economy of debt. In the final order in the Company's 2004 general rate case, this Commission applied that "balance of safety and economy" standard and concluded that its "goal in this

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[20] Exhibit No. ___(MPG-1CT) at page 4, line 13.

proceeding should be to set the Company's equity ratio at the level that the evidence shows is mostly likely to prevail, on average, over the course of the rate year."[21] To my knowledge, the "known and measurable" test does not apply to establishing capital structures for ratemaking purposes in this state.

The Company has a financing plan that will results in an average equity ratio of 45% during the rate year. Some of the planned financings included in my prefiled direct testimony have already occurred. For example, Puget Energy, Inc. did make an equity contribution into PSE from the proceeds of the sale of InfrastruX. PSE issued senior secured notes in June 2006. PSE also redeemed the $200 million of trust preferred. PSE continues to implement its financing plan, fine tuning it as conditions warrant.

Q. Have you updated the Company's financing plan to account for the Company's financing activities that have taken place since you filed your prefiled direct testimony?

A. Yes. Exhibit No. ___(DEG-10) updates the Company's financing plan to reflect the Company's financing activities that have taken place since the filing of my prefiled direct testimony. That plan continues to show that the Company projects a 45% equity ratio, on average, during the rate year and demonstrates the Company's intention to further strengthen its balance sheet.

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[21] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 06: Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent Filing, at page 17, paragraph 40 (Feb. 18, 2005).

C. Capital Funding Plan

Q. Do you agree with Mr. Gorman's recommendation that "the Commission require PSE to complete a thorough capital funding plan that investigates the cost of all options available to improve its credit rating"?[22]

A. No. The Commission need not require PSE to complete a capital funding plan because the Company already has a capital funding plan in place and has a methodology for developing and updating its plan. The Company's capital funding plan is reflected in my workpapers, the Company's strategic plan and the materials supplied by the Company to credit rating agencies.

Mr. Gorman's recommendation implies that the Company should investigate a greater use of permanent preferred equity securities. The Company agrees that preferred stock is less costly that common equity--this is, in part, why the Company has included a $200 million preferred stock issue in its financing plan. Furthermore, the planned $200 million preferred stock issue is included in the Company's projected capital structure, the same capital structure that Mr. Gorman suggests should be rejected "because it includes adjustments that are not known and measurable."[23] The Company has and will continue to investigate issuance of such hybrid securities to reduce its cost of capital and will issue such securities as reasonable and appropriate.

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[22] Exhibit No. ___(MPG-1CT) at page 7, lines 1-2.

[23] Exhibit No. ___(MPG-1CT) at page 4, line 13.

Q. Does that conclude your rebuttal of Mr. Gorman's prefiled response testimony?

A. Yes it does.

V. REBUTTAL OF THE PREFILED RESPONSE TESTIMONY OF MR. RUSSELL

Q. Have you reviewed the prefiled response testimony of Mr. James Russell?

A. Although I have reviewed the prefiled response testimony of Mr. James Russell, Exhibit No. ___(JMR-1T), my rebuttal is directed to Mr. Russell's depiction of the Company's past returns as shown in Exhibit No. ___(JMR-5). Mr. John Story's and Mr. Karl Karzmar's prefiled rebuttal testimony address other issues presented in Mr. Russell's prefiled response testimony.

Q. Do you believe the calculations presented in Exhibit No. ___(JMR-5) accurately depict the Company's past returns?

A. No. The returns calculated in Exhibit No. ___(JMR-5) appear to be prepared using a combination of (i) Commission Basis Reports and (ii) cost of capital reports supplied by the Company in response to certain data requests. Exhibit No. ___(JMR-5) uses the Company's equity ratios from the data request responses and calculates an earned return on that equity. This calculation, however, ignores the fact that--in the years covered by his analysis--the Commission had set rates on equity ratios in excess of the actual equity capitalization of the Company.

Thus, Exhibit No. ___(JMR-5) erroneously implies that the Company's returns were close to or in excess of those authorized for the years in question.

Q. Can you provide an example of how Exhibit No. ___(JMR-5) erroneously implies that the Company's returns were in excess of those authorized for the years in question?

A. Yes. For example, Exhibit No. ___(JMR-5) shows that the Company's equity ratio was 33.02% in 2002. In the order approving the settlement of the Company's 2001 general rate case, however, the Commission set rates using a 40% equity ratio and an 11.0% ROE, which resulted in a weighted cost of equity of 4.40% (40% x 11.0%). Any comparison using the actual equity ratio needs to reflect the implied return on that equity. The authorized ROE implied by use of the actual equity ratio of 33.02% is 13.33% (4.40% divided by 33.02%). Exhibit No. ___(JMR-5) shows that the Company earned an actual ROE of 9.21% in 2002, which is substantially less than the implied return of 13.33%.

Exhibit No. ___(JMR-5) shows that the Company had an equity ratio of 40.06% at the end of 2005. In the Company's most recent rate case, the Commission set rates on a 43% equity ratio using a 10.30% return on equity, resulting in a weighted cost of equity of 4.43% (43% x 10.30%). Using the calculation described above, the implied return on equity would be 11.06% (4.43% divided by 40.06%). Exhibit No. ___(JMR-5) shows that the Company earned an actual ROE of 9.79%, which is substantially less than the implied ROE of 11.06%.

Q. Are the calculations presented in Exhibit No. ___(JMR-5) the same calculations considered by investors?

A. No. Investors are concerned with the returns that they earn on their investments, not some theoretical returns calculated using reports such as the Commission Basis Reports. Furthermore, investors look at overall returns, not how much of the return is attributable to separate results of gas and electric operations.

Investors considering the purchase of PSE's common stock look to expected returns, and those returns are subject to variability resulting from weather, lag on recovery of infrastructure investments, cost recovery through sharing mechanisms such at the Company's PCA mechanism, and a host of other items that are listed as risk factors in the Puget Energy, Inc.'s Form 10-K filed with the SEC.

More importantly, investors compare expected returns from investments in PSE with returns expected from other investments and invest capital where they expect the greatest return on a risk adjusted basis. The theoretical calculations presented in Exhibit No. ___(JMR-5) do not address the risk factors that prevent the Company from actually earning its authorized return on equity.

Q. Does that conclude your review of Mr. Russell's prefiled response testimony?

A. Yes it does.

VI. IMPACT ON PSE IF COMMISSION STAFF'S PROPOSED RATE RELIEF WERE GRANTED

Q. Have you examined the impact on the Company if the Commission were to grant the rate relief proposed by Commission Staff in this proceeding?

A. Yes I have. If the Commission were to adopt the rate relief proposed by Commission Staff, the Company would likely no longer have the credit metrics necessary to maintain its current credit rating. As a result, credit rating agencies would likely reduce the Company's credit rating.

Furthermore, it is possible that the Company would be unable to attract investors to buy its common stock on reasonable terms if Commission Staff's proposal were adopted. This would likely result in further increases in the Company's leverage and reduce its now stressed credit metrics.

Q. Can you summarize why you believe this would be the result of Commission Staff's proposed relief?

A. Commission Staff proposes that rates be set on an ROE that is substantially below the average ROE authorized by regulatory commissions since January 1, 2005 (9.375% compared to the average 10.51%). Commission Staff then suggests that the mechanisms necessary for the Company to have a reasonable chance of earning its authorized ROE (i.e., the Company's proposed infrastructure tracker, weather decoupling and proposed modifications to the power cost adjustment ("PCA") mechanism) be rejected.

The following charts demonstrate the likely impact on the Company's credit metrics if the Commission were to adopt the Company's and Commission Staff's proposals:

Chart REDACTED as CONFIDENTIAL per Protective Order in WUTC Docket Nos. UE-060266 and UG-060267

Chart REDACTED as CONFIDENTIAL per Protective Order in WUTC Docket Nos. UE-060266 and UG-060267

** "FFO" is an acronym for "Funds From Operations". FFO is calculated by adding depreciation and amortization expenses to earnings.

REDACTED VERSION

Chart REDACTED as CONFIDENTIAL per Protective Order in WUTC Docket Nos. UE-060266 and UG-060267

The above charts demonstrate that the ratios associated with Commission's Staff's proposal are consistently one to two notches below the ratios associated with the Company's proposal.

If the Commission were to adopt Commission Staff's proposed rate reduction, the Company's current ratings would likely drop because of the detrimental effect to the Company's credit quality. For example, S&P stated as follows in its August 2, 2006 report:

> Ratemaking by the Washington Utilities and Transportation Commission (WUTC) remains the key driver of credit quality, especially in light of PSE's high capital needs and commodity price exposure.

In light of S&P's statement, it is reasonable to believe that S&P would consider the adoption of Commission Staff's proposed rate reduction to be a step backwards for the Company.

REDACTED VERSION

Q. Are these ratios the only factors considered when rating agencies establish a Company's credit rating?

A. No. The ratings process is not limited to the examination of various financial measures in one year. Also important is the trend in those measures over time. The credit rating agencies also include qualitative aspects, described further in Exhibit No. ___(DEG-5), particularly in the section titled "Rating Methodology: Industrials & Utilities." One of the qualitative assessments for utilities is regulation.

The Company has had a favorable trend in its credit metrics. A reversal or downward trend in these metrics would not be viewed favorably. S&P also stated as follows in its August 2, 2006 report:

> Consideration of a positive rating outlook will depend on more favorable rate relief in future years (beginning with the forthcoming general rate case), consistently strong cash flow coverage metrics, and Puget's ability to improve its equity capitalization. An improved mechanism for commodity cost recovery could also provide support for a positive outlook.

Q. Why do you believe it would be likely be difficult for PSE to attract investors for its common stock on reasonable terms if the Commission were to adopt Commission Staff's proposal?

A. Commission Staff's proposal would result in a below average authorized ROE, reduced financial strength and flexibility, reduced cash flow and earnings below the dividend at a time when the Company faces the need to fund substantial capital expenditures. The Company has faced challenges in the past selling its securities, even during periods of better financial stability than would likely result if the Commission were to adopt Commission Staff's proposed rate reduction.

VII. PCA MECHANISM

Q. Have you reviewed the Joint Testimony regarding the proposed modifications to the PCA Mechanism?

A. Yes, I have reviewed Exhibit No. ___(JOINT-19T) (the "Joint PCA Testimony").

Q. Do you agree with the proposals in that testimony?

A. No. The Joint PCA Testimony erroneously attempts to compare PSE's and Avista's exposure to power cost volatility. The Joint PCA Testimony assumes that $200 million of power cost volatility for PSE is equivalent to $40 million of power cost volatility for Avista, given the relative size differences between the two companies. For the sake of argument, I will accept the Joint PCA Testimony's quantification of the level of power cost risk of $200 million and $40 million amounts for PSE and Avista, respectively.

The flaw in the Joint PCA Testimony lies in the calculation of the impact of this power cost volatility to shareholders under each company's respective power cost recovery mechanism. When calculated correctly, the impact of the after-tax volatility on the two companies is identical when one compares

(i) the impact to the Company's shareholders under PSE's *proposed* modified PCA Mechanism, with

(ii) the impact to Avista's shareholders under Avista's recently modified mechanism.

Q. Please provide a brief summary of the differences between PSE and Avista.

A. As discussed in the Joint PCA Testimony, PSE is larger than Avista, PSE has a slightly higher credit rating than Avista, and Avista owns more of its generation than PSE. In other words, PSE has relatively higher purchased power expense. As mentioned above, PSE has $[redacted] million of imputed debt using the S&P methodology. In contrast, Avista has $[redacted] million of imputed debt using the S&P methodology. At December 31, 2005, the amount of common equity on the books of PSE and Avista were $2.1 billion and $771 million respectively.

Q. Are there other differences between PSE and Avista?

A. Yes. PSE has over twice the growth rate in the number of customers served. PSE's customer growth has averaged 2.8% between 2003 and 2005, whereas Avista's has averaged 1.3%. PSE also has a much larger capital expenditure program than Avista--according to Value Line, capital expenditures per common share for 2006 are $7.55 and $3.40 for PSE and Avista, respectively. PSE's capital spending is projected to be $850 million during 2006, as shown in its second quarter 2006 SEC Form 10-Q at page 41. Avista's $3.40 per share capital spending is equivalent to about $168 million.

REDACTED VERSION

Q. What is the flaw in the Joint PCA Testimony with respect to the relative impacts on PSE and Avista of power cost volatility?

A. The Joint PCA Testimony attempts to calculate the ability of each company to withstand power cost volatility by looking at the portion of annual earnings per share that exceeds the dividend. They refer to this as "retention" (i.e., the portion of earnings that is not paid out as dividends).

Retention, however, is not the correct measure of the impact on PSE and Avista shareholders of $200 million and $40 million in respective power cost volatility. Instead, the Joint PCA Testimony should have examined the total amount of common equity of each company.

Q. You state the proper comparison of the impact of power volatility is to total common equity and not to earnings retained each year. Why?

A. The "safety" aspect of common equity is that, in theory, common stock does not have the fixed return obligation of a debt instrument. The amount of equity in the capital structure acts as the financial "cushion" that absorbs the risks of the business. That cushion is the total amount of common equity in the business--not just the additions or subtractions to it in any given year.

Q. Does the Joint PCA Testimony examine this?

A. No. The Joint PCA Testimony compares the impact of power cost volatility through a theoretical construct, rather than the practical approach used by investors. The Joint PCA Testimony compares the impact of power cost volatility to what a company could earn under "perfect regulation" (i.e., no earnings lag). As discussed in the prefiled direct and rebuttal testimonies of Mr. Valdman, PSE faces considerable earnings lag that prevent it from earning its authorized ROE. Thus, the use of a theoretical construct that assumes that the utility fully earns its allowed return on all of its book value per share is flawed. Moreover, the Joint PCA Testimony ignores the fundamental premise of cost of service regulation; that investors are supposed to have the opportunity to earn their authorized ROE--not the authorized ROE as reduced by excess power costs.

Q. Do you agree with the Joint PCA Testimony's calculation of the after-tax impact to shareholders of potential power cost volatility?

A. Using the Joint PCA Testimony's assumed power cost volatility of $200 million, the after-tax impact to shareholders is $27.3 million under the Company's existing PCA mechanism. Using that same $200 million of assumed power cost volatility, the after-tax impact to PSE shareholders under the proposed modified PCA mechanism would be $16.9 million. The impact of $40 million of power cost volatility to Avista's shareholders under Avista's recently modified mechanism is $6.5 million.

Table 3 below demonstrates that the impact to shareholders under PSE's proposed modified PCA mechanism and Avista's power cost recovery mechanism are identical.

TABLE 3

Company	Assumed Power Cost Volatility	Impact to Shareholders	Common Equity	Impact / Equity
PSE (existing PCA)	$200 million	$27.3 million	$2,010 million	1.36%
PSE (modified PCA)	$200 million	$16.9 million	$2,010 million	**0.84%**
Avista ($4mm dead-band)	$40 million	$6.5 million	$771 million	**0.84%**

Q. Why did you use total common equity of Avista Corporation and not Avista Utilities?

A. Avista Corporation is not a holding company. PSE is a separate corporation from its parent Puget Energy, Inc., but Avista Utilities is not a separate corporation from Avista Corporation. In a bankruptcy proceeding, Avista Utilities' creditors would have a claim on all equity--not just the equity ascribed to the regulated utility. Likewise, the total amount of equity of Avista Corporation is available to act as a financial cushion for Avista Utilities' risks associated with under-recovery of power costs.

Q. Does the total equity for PSE and Avista Corporation include equity for each company's gas operations?

A. Yes. Use of the total equity of Avista Corporation would also include Avista's gas operations as well as the Corporation's operations outside of the State of Washington. Regarding risks from gas operations, both PSE and Avista have recovery of prudently incurred purchased gas costs through PGA mechanisms; therefore, neither company has risk associated with the under-recovery of prudently incurred purchased gas costs.

Additionally, neither company is organized into separate corporations--one for electric operations and one for natural gas operations. Similarly, Avista Corporation is not organized into separate corporations depending on the state in which it operates. Therefore, all equity is available for creditors from any business line in any state.

Finally, investors look to Avista Corporation for their expected returns. Investors in Puget Energy, Inc. look to PSE for expected returns because the two are virtually identical after the sale of InfrastruX. Investors cannot ascribe their investment decisions to gas or electric operations or one state jurisdiction over another. Investors' investments fund all operations in all states, and they are exposed to the risks from all operations in all states. Therefore, it is total common equity that acts as the cushion for all risks, including the risk from under-recovery of power costs.

Q. What are your conclusions regarding the relative impact of power cost variability on PSE and Avista?

A. The Joint PCA Testimony statement that the impact of power cost volatility to PSE under its current PCA mechanism, without the $40 million cap, is comparable to Avista under its power-cost recovery mechanism is based on a flawed analysis and should be rejected.

Assuming *arguendo* $200 million and $40 million of power cost volatility for PSE and Avista, respectively, the impact on total equity of PSE's proposed modified PCA mechanism and Avista's power-cost recovery mechanism is identical.

Q. Does that conclude your testimony on the PCA mechanism?

A. Yes, it does.

VIII. CONCLUSION

Q. Please summarize your testimony.

A. All of the parties agree on the cost rates for short-term debt, long-term debt, trust preferred and preferred stock. The areas of disagreement as they relate to rate of return are limited to equity ratio and ROE.

Neither Mr. Hill nor Mr. Gorman provides any evidence as to whether his respective proposed capital structure strikes the appropriate balance of safety and economy on a forward-looking basis. Furthermore, the Company's recommended equity ratio of 45% is the only proposed equity ratio determined in accordance with the methodology described in the Commission's final order in the Company's last general rate proceeding.

If the Commission were to adopt Commission Staff's proposed rate reduction, the Company's securities would likely be downgraded and the Company would be challenged in its ability to sell common stock on reasonable terms.

The Company's proposed rate increase is also consistent with improved credit quality, which is crucial in light of the Company's need to attract capital, the impact of imputed debt on its capital structure and credit ratings, its ability to advance its hedging strategy or its ability to provide gas and electric service to customers on reasonable terms.

The Joint testimony comparing the impacts of power cost volatility of PSE and Avista is flawed and should be rejected.

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes, it does.