EXHIBIT NO. ___(RAM-20)
DOCKET NO. UE-060266/UG-060267
2006 PSE GENERAL RATE CASE
WITNESS: ROGER A. MORIN

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**

FIFTH EXHIBIT (NONCONFIDENTIAL) TO THE PREFILED REBUTTAL TESTIMONY OF ROGER A. MORIN ON BEHALF OF PUGET SOUND ENERGY, INC.

AUGUST 23, 2006

BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC V. PACIFICORP D/B/A PACIFIC POWER & LIGHT COMPANY

DOCKET NOS. UE-050684 and UE-050412

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1T)

ON BEHALF OF

PUBLIC COUNSEL

November 3, 2005

Also, there are examples in the capital marketplace indicating that investor return requirements are low by historical standards. A recent A.G. Edwards report on the gas utility industry, which is relatively similar in risk to the electric utility industry, shows that market return expectations for gas utility stocks are well below historical earned returns.[8] The report states that, for a sample of 20 large and small gas distributors, the median total return expectation (dividend yield plus expected growth—a DCF-type calculation) is 8.4%.

In addition, in a letter recently published by Public Utilities Fortnightly, an electric industry analyst confirms that investors currently expect single-digit returns from their utility investments:

> "Finally, let's get real about investor expectations, now that investors have begun to get real. Articles on the topic fill the financial journals. They feature variants on this theme: Over time the average equity investment produces an annual total return (dividends plus stock price appreciation) of 6.5 per cent per year in real terms, the bulk of which comes from the dividend component. Add inflation expectations to that number, and you get an 8.5 to 9.5 percent return in nominal terms. The average back-to-basics utility yields about 5 to 6 percent and might grow 3 to 4 percent per year, which adds up to produce a total return expectation of 8 to 10 percent per year, not far from the return the journals posit for the market."

(Hyman, Leonard, Senior Consultant, R.J. Rudden Associates, "Letters to the Editor, *Public Utilities Fortnightly*, August 2004, p. 10).

The "articles in the financial journals," to which the author of the preceding quote refers, relate to recent research involving the market risk premium. The market risk premium is the additional return above the risk-free rate of interest that investors expect to earn by investing in stocks rather than risk-free U.S. Treasury securities. The

[8] A.G. Edwards, "Gas Utilities Quarterly Review," April 4, 2005.

"traditional" view (largely supported by the earned return data over the past 70 years published by Ibbotson Associates[9]) assumes that investors require a risk premium of about 6.5% above the risk-free rate to invest in stocks. With a current long-term T-Bond yield of approximately 5%, that traditional assumption indicates an investor expectation of an 11.5% return for the stock market in general [5% + 6.5% = 11.5%]. Of course, expected utility returns would be lower, because utilities have less investment risk than the stock market generally.

However, the new research referenced in the letter quoted above indicates that Ibbotson data is skewed upward and the actual market risk premium is much, much lower—in the range of 3% to 4.5%.[10] In other words, the recent academic research indicates that current investor return requirements are considerably lower than has been traditionally assumed. Even Roger Ibbotson, whose firm (Ibbotson Associates) is probably the largest purveyor of historical market return data, recently published a paper confirming that risk premium expectations for the future are now below what they were in the past.[11] While Ibbotson's projected risk premium of 4% to 6% for investors, is lower than historical return averages indicate, his estimates are at the upper end of the spectrum produced by the current research. With a current T-Bond yield of about 5%, the new information regarding expected equity risk premiums confirms that investor's stock market return expectations range from approximately 8% to 10%—i.e., single digit equity returns.

The information available to investors in the capital markets confirms that my

[9] Ibbotson Associates is a investor service firm that publishes historical data related to the stock and bond markets from 1926 through the most recent year. The publications are updated each year.

[10] Fama, E., French, K., "The Equity Premium," *The Journal of Finance*, Vol. LVII, No. 2, April 2003, pp. 637-659.

[11] Ibbotson, R, Chen, P., "Long-Run Stock Returns: Participating in the Real Economy," *Financial Analysts Journal*, January/February 2003, pp. 88-89.

8.75%-9.50% equity return range for the electric utility operations under consideration here is reasonable, if not overly conservative (i.e., too high). In addition, those data represent information to which investors are exposed in the equity marketplace for rate-regulated companies and underscore the fact that, currently, investor return requirements for that type of equity investment are low by historical standards.

Q. Are there other indications that capital costs are at historically low levels?

A. Yes. Another indication of the reason investors are willing to buy and hold stocks that offer what seem to be "low" returns is shown in Exhibit No.__(SGH-6), page 1. It depicts Moody's Baa-rated bond yields from 1984 through August 2005. Page 1 of Exhibit No.__(SGH-6) shows that interest rates and capital costs remain very low relative to the interest rate levels that existed in the mid-1980s, and have continued a general downward trend begun in 2000.

Also, page 2 of Exhibit No.__(SGH-6), which presents the year-average Moody's Baa-rated bond yields for each year over the past 37 years (1968-2005), shows that Baa-rated bond yields thus far in 2005 have averaged 5.97%—below the bond yield levels seen in the U.S. in the late 1960s. Also, the most recent average Baa-rated utility bond yield, 5.67%[12], falls below the lower end of the range of interest rates that have existed over the past 40 years. (See Exhibit No.__(SGH-6), page 2) Simply put, a fundamental reason that the current cost of common equity capital for electric utility operations of 8.75% to 9.50% is reasonable is that capital cost rates are lower than they have been in more than thirty years.

The above data indicate that capital costs, even with the recent short-term credit tightening by the Federal Reserve Bank (the Fed), remain at low levels and generally support the efficacy of my range of equity capital costs. However, it is important to note

[12] Value Line *Selection & Opinion*, most recent six weekly editions (6/28/194/05-9/23/05, inclusive), 20/30-year Baa-rated utility bond yield averages.