EXHIBIT NO. ___(BAV-7CT)
DOCKET NO. UE-060266/UG-060267
2006 PSE GENERAL RATE CASE
WITNESS: BERTRAND A. VALDMAN

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 BERTRAND A. VALDMAN ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED VERSION

AUGUST 23, 2006

PUGET SOUND ENERGY, INC.

**PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF
BERTRAND A. VALDMAN**

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PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF BERTRAND A. VALDMAN

I. INTRODUCTION

Q. Are you the same Bertrand A. Valdman 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. Please summarize the purpose of your rebuttal testimony.

A. My rebuttal testimony responds to the assertions made by parties to this rate case, particularly

(i) the prefiled response testimony of Mr. Stephen Hill, cost of capital witness on behalf of Staff for the Washington Utilities and Transportation Commission ("Commission Staff"), Exhibit No. ___(SGH-1CT);

(ii) the prefiled response testimony of Mr. Michael Gorman, cost of capital witness on behalf of the Industrial Customers of Northwest Utilities ("ICNU"), Exhibit No. ___(MPG-1CT); and

(iii) the prefiled joint response testimony of Dr. Yohannes Mariam, witness on behalf of Commission Staff, Mr. Donald Schoenbeck, witness on behalf of ICNU, and Mr. Jim Lazar, witness on behalf of Public Counsel, Exhibit No. ___(JOINT-19T) (the "Joint PCA Testimony").

My prefiled rebuttal testimony responds to the single-digit return on equity

("ROE") recommendations advanced by Messrs. Hill and Gorman. Mr. Hill's recommended ROE of 9.375% is

(i) 92.5 basis points below the Company's current authorized ROE (10.30%);

(ii) 113.5 basis points below the average ROE authorized by regulatory commissions since January 1, 2005; and

(iii) 142.5 and 148.5 basis points below the average authorized ROEs of Mr. Hill's comparable groups of electric utilities (10.80%) and natural gas utilities (10.86%).

Similarly, Mr. Gorman's recommended ROE of 9.90% is

(i) 40 basis points below the Company's current authorized ROE (10.30%);

(ii) 61 basis points below the average ROE authorized by regulatory commissions since January 1, 2005; and

(iii) 98 basis points below the average authorized ROE of Mr. Gorman's comparable group utilities (10.88%).

Furthermore, neither Commission Staff nor ICNU support the Company's proposed mechanisms that would allow the Company an opportunity to actually earn its authorized ROE, such as a revised PCA Mechanism, depreciation tracker, and decoupling. Over the past four years, the Company has, on average, under-earned its authorized ROE by approximately 250 basis points, resulting in an actual ROE of approximately 8%.

A central element of the Company's proposed filing in this proceeding is to balance a competitive *authorized* ROE with recovery mechanisms that provide PSE a fair opportunity to achieve an *actual* ROE that (i) supports the Company's commitment to strengthen its balance sheet and raise capital in the financial markets to fund infrastructure requirements to support service territory growth and (ii) is consistent with the Company's peers in order to raise capital on the most attractive terms in the short and long-term.

II. THE NEED FOR FINANCIAL STABILITY

Q. Would you please summarize your impressions of the Commission Staff and ICNU financial proposals?

A. Yes. At a time when the Company is facing unprecedented capital requirements to fund delivery infrastructure and new electric generation resource needs, Commission Staff and ICNU propose ROEs that are lower than what is currently authorized and, at the same time, parties to the proceeding reject the mechanisms that would provide the Company the opportunity to earn those ROEs. As stated in my prefiled direct testimony, it is particularly important for the Company to be able to maintain a high level of access to capital now and over the next several years to:

(i) replace the aging components of the Company's electric and gas delivery systems;

(ii) maintain reliability and adequacy of energy supply by acquiring new electric generation resources, thereby minimizing dependence on volatile wholesale energy markets; and

(iii) enter into energy risk management transactions to mitigate energy price volatility and maintain rate stability.

No party has disagreed with these needs.

Mr. Donald Gaines stated in his prefiled direct testimony that a higher equity ratio will benefit both ratepayers and shareholders because it will enable the Company to:

(i) attract capital to fund infrastructure and new resource construction programs,

(ii) broaden its energy hedging strategies;

(iii) offset the imputed debt from purchased power agreements; and

(iv) provide electric and gas service to customers on reasonable terms.

No party has disagreed with these needs, yet Messrs. Hill and Gorman have proposed lower ROEs.

A. THE RETURNS ON EQUITY RECOMMENDED BY MESSRS. HILL AND GORMAN FAIL TO IMPROVE THE COMPANY'S FINANCIAL STABILITY

Q. Do you agree with Mr. Hill's assertion that his recommended return on equity would "support and improve the Company's financial position"?[1]

A. No. Mr. Hill's recommended ROE of 9.375% is unlikely to be "sufficient to support and improve the Company's financial position," particularly in light of the Company's significant capital expenditure requirements. If the Commission were to adopt Mr. Hill's recommended return on equity, the Company would likely be unable to even *maintain* its current financial position as described in the rebuttal

[1] Exhibit No. ___(SGH-1CT) at page 5, lines 7-8.

testimony of Mr. Gaines.

Q. Does Mr. Gorman similarly assert that his recommended return on equity would improve the Company's financial position?

A. No. Unlike Mr. Hill, Mr. Gorman does not suggest that his recommendation would be sufficient to improve the Company's financial position. Instead he merely asserts that his recommendation will

> provide PSE an opportunity to realize cash flow financial coverages and a balance sheet strength that conservatively support PSE's current bond rating.[2]

Thus, Mr. Gorman suggests that his recommendation may enable PSE to maintain its current bond rating but will not enable PSE to improve its financial position.

Q. Have witnesses for Commission Staff and ICNU adequately addressed the Company's need for financial stability?

A. No. Both Mr. Hill and Mr. Gorman perform a mechanistic application of financial theory without regard to the practical financing needs of PSE. For example, Mr. Hill fails to acknowledge the Company's significant capital expenditure requirements and the impact of his recommended ROE on the Company's continuing efforts to replace aging infrastructure, procure energy supply and add generation resources to reduce power price volatility.

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[2] Exhibit No. ___(MPG-1CT) at page 2, lines 2-4.

Unlike Messrs. Hill and Gorman, my concerns about the Company's financial stability are not just theoretical. As discussed in my prefiled direct testimony, Exhibit No. ___(BAV-1CT), PSE requires significant external funding to meet its substantial investment needs because its internal cash flow generation is insufficient. PSE must compete with other entities for this capital--both within and outside the utility sector--and must offer investors and credit counterparties a balanced risk/reward opportunity.

B. THE COMPANY'S CAPITAL SPENDING NEEDS

Q. Would you please summarize the Company's capital spending needs?

A. Yes. As described in the Puget Energy, Inc.'s Form 10-Q for the second quarter of 2006, the Company's capital budget for 2006 is $850 million, comprised as follows:

Capital Expenditure Projections

(Dollars in Millions)	2006
Energy delivery, technology and facilities	$444
Wild Horse wind project	$317
Total capital expenditures	$761
Chelan contract payment	$89
Total expenditures	$850

In addition to substantial capita requirements in 2006, the Company plans to spend around $500 million on energy delivery, technology and facilities in 2007, alone. The Company has not yet budgeted 2007 capital expenditures associated with procurement of new resources, but I anticipate them to be substantial, consistent with the resource needs and financial projections described in my prefiled direct testimony, Exhibit No. ___(BAV-1CT) and that of Mr. Eric Markell, Exhibit No. ___(EMM-1HCT).

This level of capital spending is unprecedented in the Company's history. The Company must attract capital on reasonable terms to fund these capital needs. We are fortunate that borrowing costs are near all-time lows. Presently, Treasury bond yields across maturities are lower than the 5.25% Federal funds rate, and the Company's cost to borrow is currently less than 150 basis points over these levels. With supportive regulatory mechanisms and reasonable rate relief, including a reasonable capital structure and authorized ROE, PSE will be able to attract capital to fund capital improvements associated with its generation and delivery systems. Doing so will benefit customers today and in the future.

1. The Company's Projected Costs to Replace Aging Delivery Systems Are Significant and Daunting

Q. Are the projected costs of the Company's transmission and distribution system capital investments for 2006 and 2007 significantly higher than historical levels?

A. Yes. As discussed in the prefiled direct testimony of Ms. Susan McLain, the Company's projected transmission and distribution system capital investments for 2006 and 2007 are significantly higher than historical levels. These increases are driven primarily by adding more gas and electric distribution system capacity, constructing new electric transmission facilities, adding electric substation capacity, programmatic replacement and remediation of aging gas and electric facilities, and relocating existing facilities at the direction of state and local jurisdictions.

Q. How does the Company's projected transmission and distribution system capital investments for 2006 and 2007 compare to historical levels?

A. The Company's projected transmission and distribution system capital investments of $[redacted] million in 2006 and $[redacted] million in 2007 are considerably higher than historical investment levels of $266 million in 2004 and $286 million in 2005.[3] The total transmission and distribution system capital investments for 2006 and 2007 exceeds PSE's 2004 and 2005 total transmission and distribution investments of $552 million by $[redacted] million, or [redacted]%.[4]

The $[redacted] million anticipated investment for 2007, the rate year in this case, is $[redacted] million greater than the test year investments of $228 million. This represents a [redacted]% increase in PSE's transmission and distribution system capital investment.[5]

[3] *See* Exhibit No. ___(SML-4) at 1.
[4] *See* Exhibit No. ___(SML-1CT) at 9.
[5] *See* Exhibit No. ___(SML-1CT) at 9.

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Q. Are the Company's transmission and distribution system operations and maintenance expenditures increasing?

A. Yes. As discussed in Ms. McLain's prefiled direct testimony, the Company faces increases in operations and maintenance expenditures needed to operate PSE's transmission and distribution system. These increases in transmission and distribution system operations and maintenance expenditures are driven primarily by increased gas and electric maintenance requirements, regulatory compliance, vegetation management and locating costs, and Operations & Maintenance Related to Construction cost.[6]

Q. Has the Company quantified its projected transmission and distribution system operations and maintenance expenditures for 2006 and 2007?

A. Yes. The Company projects expenditures (excluding storm costs) of $[redacted] million in 2006 and $[redacted] million in 2007 for transmission and distribution operations and maintenance expenditures. These transmission and distribution operations and maintenance expenditures are considerably higher than historical levels of $88 million in 2004 and $104 million in 2005. During the rate year (2007) alone, PSE expects operations and maintenance expenditures of nearly $[redacted] million for its transmission and distribution systems. This is $[redacted] million greater than the test period expenditures (excluding storm costs) of $92 million and represents a [redacted]%

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[6] *See* Exhibit No. ___(SML-1CT) at 10.

increase.[7]

Q. In making their respective return on equity recommendations, does either Mr. Hill or Mr. Gorman discuss how those recommendations would affect the Company's transmission and distribution system capital investment program?

A. No, neither Mr. Hill nor Mr. Gorman discusses how their respective recommendations would affect the Company's transmission and distribution system capital investment program.

Q. In making their respective return on equity recommendations, does either Mr. Hill or Mr. Gorman discuss how those recommendations would affect the Company's increasing transmission and distribution operations and maintenance expenditures?

A. No, neither Mr. Hill nor Mr. Gorman addresses the issue.

[7] *See* Exhibit No. ___(SML-1CT) at 10.

2. The Company's Projected Costs to Maintain Reliability and Adequacy of Energy Supply are Also Significant and Daunting

Q. Given the recent successes of the Company's energy procurement program (i.e., Frederickson, Hopkins Ridge), does that program continue to require significant capital expenditures?

A. Yes. Although the Company's energy procurement program has made great strides in filling PSE's short position, the Company still faces large investment requirements for energy procurement.

As discussed in the prefiled direct testimony of Mr. Eric M. Markell, the Company projects that it will incur capital costs of as much as $3.7 billion dollars over the next ten years to acquire generating assets to meet the Company's electric resource needs.[8]

To the extent that the Company meets its resource needs through purchase power agreements, the projected capital costs may vary from the estimated $3.7 billion dollars over the next ten years but will still be significant. As discussed in the prefiled direct testimony of Mr. Donald E. Gaines, purchase power agreements with terms longer than two years burden the Company with imputed debt and require equity capital support. Further, the Company must have the financial strength to provide assurance to potential counterparties that it will meet its long-

[8] *See* Exhibit No. ___(EMM-1HCT) at 2.

term obligations under such agreements.[9]

Q. In making their respective return on equity recommendations, does either Mr. Hill or Mr. Gorman discuss how those recommendations would affect the Company's continuing energy procurement program?

A. No, neither Mr. Hill nor Mr. Gorman discusses how their respective recommendations would affect the Company's ongoing energy procurement program.

III. SUMMARY OF RECOMMENDED RETURNS ON EQUITY OF DR. MORIN, MR. HILL AND MR. GORMAN

Q. Could you please summarize Dr. Morin's recommended return on equity?

A. Yes. Dr. Morin has recommended an authorized return on equity for PSE of 11.00%, adjusted upward to 11.25% to account for PSE's higher relative construction, power cost, regulatory and financial risks.[10] Please see Exhibit No. ___(BAV-8) for a summary of Dr. Morin's results for each methodology he employed.

Q. Could you please summarize Mr. Hill's recommended return on equity?

A. Yes. Mr. Hill has recommended an authorized return on equity for PSE of

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9 *See* Exhibit No. ___(DEG-1CT) at 7-8.

10 *See* Exhibit No. ___(RAM-1T) at page 78, lines 6-8; *see also* Exhibit No. ___(RAM-1T) at pages 56-78.

9.375%.[11] Please see Exhibit No. ___(BAV-8) for a summary of Mr. Hill's results for each methodology he employed.

Q. Could you please summarize Mr. Gorman's recommended return on equity and the results of Mr. Gorman's estimated returns on equity for each methodology he employed?

A. Yes. Mr. Gorman has recommended an authorized return on equity for PSE of 9.90%.[12] Please see Exhibit No. ___(BAV-8) for a summary of Mr. Gorman's results for each methodology he employed.

Q. Would you like to comment on the particular methodologies employed by each witness in developing his recommended return on equity?

A. No. Dr. Morin is the witness for the Company with respect to cost of common equity issues, and I believe that his recommended return on equity is reasonable. I also defer to Dr. Morin's expert opinion regarding the merits of the methodologies employed by each of Messrs. Hill and Gorman and any criticism Dr. Morin may have regarding the application of those methodologies by each of Messrs. Hill and Gorman.

I would note, however, that the *ranges* of estimated returns on equities are very wide among the three witnesses:

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[11] *See* Exhibit No. ___(SGH-1T) at page 4, lines 17-21.
[12] *See* Exhibit No. ___(MPG-1CT) at page 1, lines 16-17.

	Low	Average	High
Dr. Morin	7.92%	10.92%	12.85%
Mr. Hill	8.28%	9.23%	11.20%
Mr. Gorman	7.38%	10.20%	12.58%
Nat'l. Avg. Authorized ROE since Jan. 2005		10.51%	

Thus, each of Dr. Morin, Mr. Hill and Mr. Gorman has submitted evidence in this proceeding that demonstrates that purely mechanical financial methodologies support an extremely wide range of estimated returns on equity. This confirms what the Commission stated in its order in PSE's 2004 general rate increase: "[e]stablishing the proper return on equity is not a precise science; it is an exercise in informed judgment."[13] Therefore, each expert witness should exercise his informed judgment to determine where the "range of reasonableness" lies within the wide range of returns on equity estimated by purely mechanical methodologies.

Q. From the wide range of estimated returns on equity summarized above, what would you estimated to be the "range of reasonableness" for returns on equity in this proceeding?

A. Based on my experience in the current regulatory and financial environment, I would assert that the appropriate "range of reasonableness," as viewed by financial markets, would be bounded (i) on the low side by the average of average estimated returns on equity produced by Mr. Gorman's methodologies (10.20%)

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[13] *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 ¶ 80 (Feb. 18, 2005).

and (ii) on the high side by the average of average estimated returns on equity produced by Dr. Morin's methodologies (10.92%).

Q. Is a "range of reasonableness" of 10.20%-10.92% consistent with returns on equity authorized by other regulatory commissions?

A. Yes. Since the beginning of 2005, the average authorized return on equity awarded by regulatory commissions has been approximately 10.5%.[14]

The midpoint of a "range of reasonableness" of 10.20%-10.92% is 10.56%, which is very close to the average authorized return on equity awarded by regulatory commissions in 2005 and 2006.

Q. Is a "range of reasonableness" of 10.20%-10.92% consistent with investor expectations regarding the outcome of this proceeding?

A. Yes. In reports regarding the Company's earnings for the second quarter of 2005, equity analysts have provided projected outcomes regarding the authorized return on equity in this proceeding. *See* Exhibit No. ___(BAV-9). Those reports indicate a range between 10.3% and 10.8% and an average of 10.53%:

Analyst	Projected ROE	Projected Equity Ratio
UBS Investment Research	10.30%	45.00%
Lehman Brothers	10.80%	45.00%
JP Morgan	10.50%	44.00%
AVERAGE	**10.53%**	**44.67%**

14 *See* Exhibit No. ___(DEG-17).

The range of return on equity projections provided above is consistent with a "range of reasonableness" of 10.20%-10.92%. Similarly, the average of return on equity projections provided above (10.53%) is consistent with the midpoint of the above-described "range of reasonableness" and the average authorized return on equity awarded by regulatory commissions since the beginning of 2005 (10.51%).

I would like to underscore that the ROE projections of external financial parties cited above assume that the Company will have the opportunity to actually earn at these levels. Once again, this highlights the importance of pairing a reasonable authorized ROE with mechanisms that allow the Company an opportunity to actually earn its authorized ROE.

IV. THE RETURNS ON EQUITY RECOMMENDED BY MESSRS. HILL AND GORMAN ARE BELOW THE RANGE OF REASONABLENESS

Q. Do you agree with Mr. Hill's assertion at page 6, lines 15-17 of Exhibit No. ___(SGH-1T) that "an equity return of 9.375% for a combination gas and electric utility operation is not only reasonable, but may, in fact, be generous"?

A. No. Mr. Hill's recommended authorized return on equity of 9.375% is far below the reasonable range of returns of equity authorized by other regulatory commissions and required by investors. Mr. Hill's recommended return on equity is well below the approximate 10.5% return on equity authorized by other regulatory commissions, on average, in 2005 and 2006.[15] Indeed, Mr. Hill could not identify a single investor-owned regulated electric utility, natural gas utility or combination electric and natural gas utility with a market capitalization in excess of $1 billion, with an allowed rate of return on common equity that is equal to, or less than, Mr. Hill's recommended return on equity. *See* Exhibit No. ___(BAV-10).

Like Mr. Hill, Mr. Gorman has recommended return on equity of 9.9% that is far below returns on equity authorized by other regulatory commissions, on average, in 2005 and 2006.

Q. What is the average authorized return on equity of Mr. Hill's sample group of electric utilities?

A. Mr. Hill states "that the average DCF cost of equity capital for the entire group of electric utilities is 9.37%."[16] Exhibit No. ___(BAV-11) demonstrates, however, that the average authorized return on equity for that same group of electric utilities is 10.80%.

Thus, Mr. Hill's focus on the average DCF cost of equity for his sample group of electric utilities understates the average authorized return on equity for those same utilities by 143 basis points.

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15 *See* Exhibit No. ___(DEG-4); Exhibit No. ___(DEG-7T).
16 Exhibit No. ___(SGH-1TC) at 49.

Q. What is the average authorized return on equity of Mr. Hill's sample group of natural gas utilities?

A. Mr. Hill states "that the average DCF cost of equity capital for the entire group of . . . gas utilities studied is 9.44%."[17] Exhibit No. ___(BAV-12), however, demonstrates that the average authorized return on equity for that same group of gas utilities is 10.86%.

Mr. Hill's focus on the average DCF analysis underestimates average authorized returns on equity by about 142.5 basis points. If that differential is applied to Mr. Hill's DCF analysis of 9.55% for Puget Energy, then the resulting authorized return on equity for PSE would be 10.975%.

Q. Does Mr. Gorman's DCF analysis also underestimate the average authorized return on equity of Mr. Gorman's sample group of utilities?

A. Mr. Gorman states that the "DCF return for my comparable group is 9.6%."[18] Exhibit No. ___(BAV-13) demonstrates, however, that the average authorized return on equity for that same group of utilities is 10.88%.

Thus, Mr. Gorman's focus on the average DCF cost of equity for his sample group of utilities understates the average authorized return on equity for those same utilities by 98 basis points. If that differential is applied to Mr. Gorman's DCF

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[17] Exhibit No. ___(SGH-1TC) at 49

[18] Exhibit No. ___(MPG-1CT) at 12.

analysis of 10.29% for Puget Energy, then the resulting authorized return on equity for PSE would be 11.27%.

V. THE COMPANY NOT ONLY REQUIRES A FAIR ROE, IT REQUIRES A FAIR OPPORTUNITY TO ACTUALLY EARN ITS AUTHORIZED ROE

Q. You have previously testified that in addition to the Commission granting the Company a fair return on equity, it should also give the Company the opportunity to earn its authorized ROE. What do you mean by this?

A. The Company faces several obstacles to earning its authorized ROE. One obstacle is the volatile and increasing power costs that the Company cannot control, but which the Company is at significant risk of having to absorb under the current PCA mechanism. A second obstacle is the regulatory lag that prevents the Company from timely recovering capital invested in new transmission and distribution system plant. A third obstacle is the fact that when gas usage declines due to warm weather or energy conservation, the Company does not recover its fixed costs because of its current rate structure.

In response to these obstacles, the Company has proposed three mechanisms that will allow it the opportunity to earn its authorized ROE: the revised PCA mechanism, a depreciation tracker and the gas revenue normalization adjustment ("GRNA") decoupling mechanism. The revisions to the PCA mechanism allow the Company to recover excess power costs that are largely outside the Company's control. The depreciation tracker would allow the Company to recover its depreciation expense as plant goes into service, thereby beginning to address the lag on recovery of infrastructure investment. The GRNA decoupling mechanism would allow the Company to recover its fixed costs even as usage declines due to warm weather or energy conservation.

A. <u>THE COMPANY'S PROPOSED MODIFICATIONS TO ITS PCA MECHANISM PROVIDE A FAIR SHARING OF RISK BETWEEN THE COMPANY AND ITS CUSTOMERS</u>

Q. Do you agree with the Testimony of Commission Staff, Public Counsel, ICNU and FEA that the Power Cost Adjustment ("PCA") mechanism should remain unchanged?

A. No. With the expiration of the $40 million cap, the Company will be required to absorb a significant amount of risk related to power costs that are outside the Company's control, if the current PCA Mechanism is not modified. Although the prudently incurred power costs should be passed on to customers, the Company is proposing a fair alternative in which the customer and the Company share risk. PSE's proposed plan is discussed in more detail in the direct and rebuttal testimony of Messrs. Aladin and Story, and its comparison to Avista's recently modified mechanism is addressed by Mr. Gaines.

Q. Do you agree with the Joint Parties' assessment that earnings retention is an important measure of the Company's ability to absorb risk under the PCA methodology?

A. No. It is incorrect to look at retention as setting the power cost risk that the Company can absorb. The earnings that are not paid out as dividends to shareholders should not be viewed as being available to pay power costs that are not recovered in rates. These funds are used to help finance new capital investment, such as infrastructure replacement and other capital expenditures necessary to provide service to customers. The purpose of retention is to build equity in the capital structure so that the Company can have the financial ability to back such investment. This is a long term goal and it is the strength of the capital structure over multiple years that provides the Company the capability to support its ongoing capital investment program. As discussed in the prefiled direct and rebuttal testimonies of Ms. McLain and Mr. Markell, the Company has a great need for capital investment. If retention is not available for these purposes, then the Company must seek additional external financing that will increase customers' costs in the long run.

Further, investors are not just looking for dividends. They are focused on total returns, which includes dividends plus growth through reinvestment of retention. Investors who would only seek the yield provided by dividends could instead invest in risk free government treasuries and at the same time earn returns higher than the yield provided by the Company's stock.

Q. The joint testimony regarding the PCA portrayed the Company's financial health as being substantially better today than at the inception of the PCA mechanism. What are your thoughts on this?

A. The Company has worked hard to improve its financial health over the last several years by growing its equity through issuance of common stock, reducing its dividend nearly 50%, and investing proceeds from the sale of its non-regulated subsidiary into the utility. However, the claims made by the Joint Parties about the Company's health are exaggerated and misleading.

Q. How are the claims made exaggerated and misleading?

A. The Joint Parties state: "The current PCA deadband and sharing bands have not changed, despite significant growth in annual revenues, shareholder equity, and the allowed return." This testimony is posited as evidence of why "…the 'risk' that Puget is exposed to under the PCA is significantly less onerous than when the PCA was adopted" (page 18). I address these claims below.

<u>PCA Risk:</u>

The Joint Parties' statement that the "deadband and sharing bands [of the PCA Mechanism] have not changed" ignores the expiration of the four-year cumulative cap on excess power costs on June 30, 2006. Expiration of the cap shifted significant risk onto PSE from extreme power cost events, as described in the testimony of Mr. Aladin. This risk shifting could undermine the improved financial strength the Company has achieved over the past four years.

Revenues:

The joint testimony on page 19 (lines 2-3) states that "Electric revenues are up 32 percent." This vastly overstates PSE's revenue growth. In fact, the Company's electric retail revenues have increased 13% over the last four years as shown in figure 5 of the joint testimony.

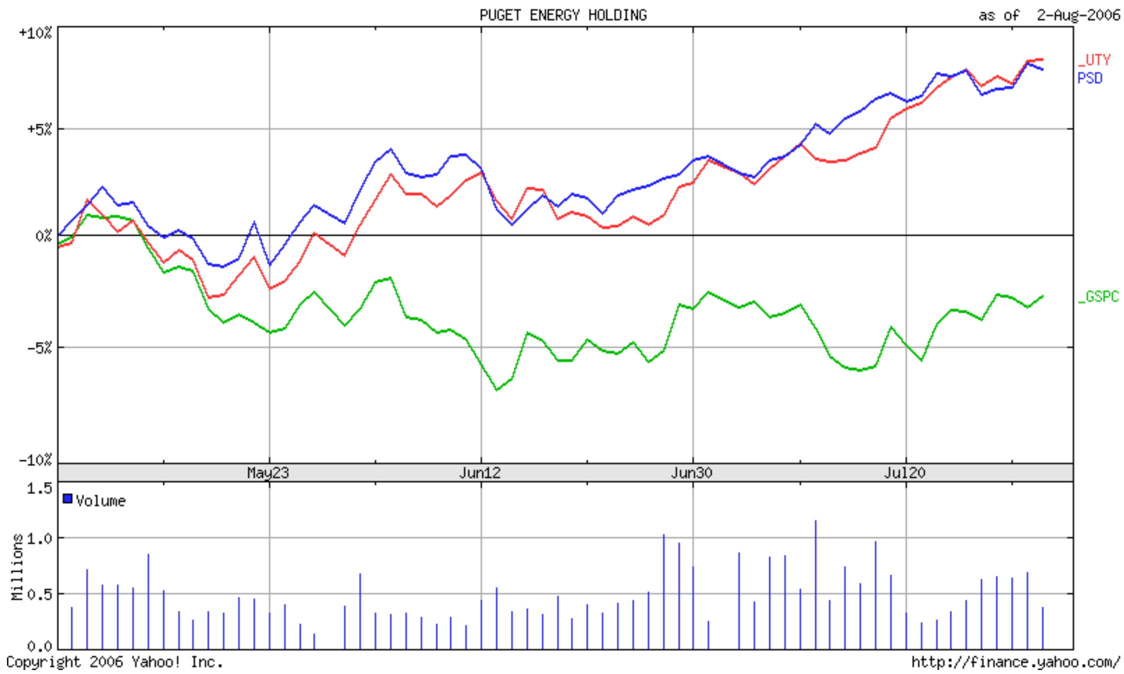
Growth in Allowed Returns:

The claim of significant growth in equity and allowed return ignores PSE's recent issuance of millions of shares of stock. These shares were issued to finance the Company's construction program as described by Ms. McLain and Mr. Markell. However, the additional shares from these issues dilute earnings per share.

Stock Price Performance:

The Joint Parties' conclusion that the market recognizes PSE as healthier is not supported by their comparison of three months of Puget Energy stock performance with the S&P 500 index. *See* Exhibit No. ___(JOINT-19T) at page 20. The Joint Parties use this three-month timeframe even though their testimony is referring to the Company's alleged changes over many years.

Not only is this short timeframe inappropriate in comparing how the Company has changed over many years, had the Joint Parties included the more appropriate utility index as a basis for comparison, it is quite clear that Puget Energy's stock price improvement during the three-month timeframe tracks the industry index. This is reflected in the chart below, which adds the utility index as a benchmark.



In any event, the three month timeframe above is not an appropriate measure and should be disregarded in favor of the stock performance presented below, which covers the full period the PCA has been in effect.

Q. Are there other relevant measures that should be considered with respect to the Company's financial health?

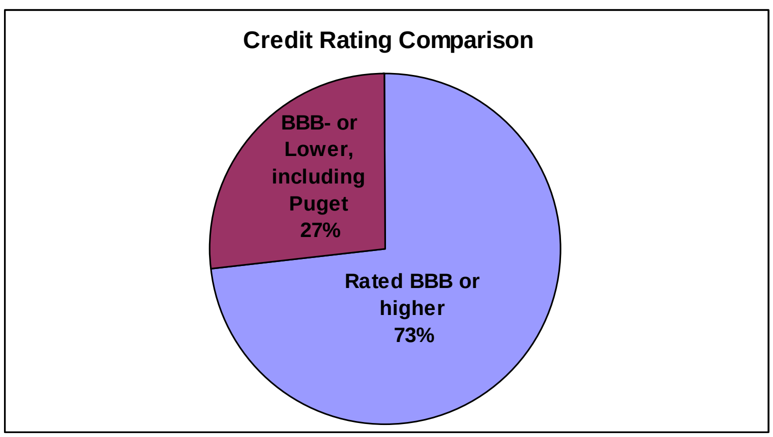
A. Yes, there are several considerations which are relevant to understand the Company's financial health profile.

Credit Rating:

The Company's credit rating reflects an overall risk assessment performed by independent credit rating agencies in order to guide investors on the credit quality of a Company. When the PCA mechanism was implemented in 2002, PSE's

Corporate credit rating from Standard and Poors (S&P) was "BBB-", the lowest level considered investment grade. Despite the Company's sustained efforts to improve its credit rating, including three equity offerings representing over 25 million shares and in excess of $500 million, the Company's credit rating remains "BBB-". Recent comments from S&P state that, "With the recent equity offering, cash flow coverage and debt leverage metrics are now within benchmark levels for the rating".[19]

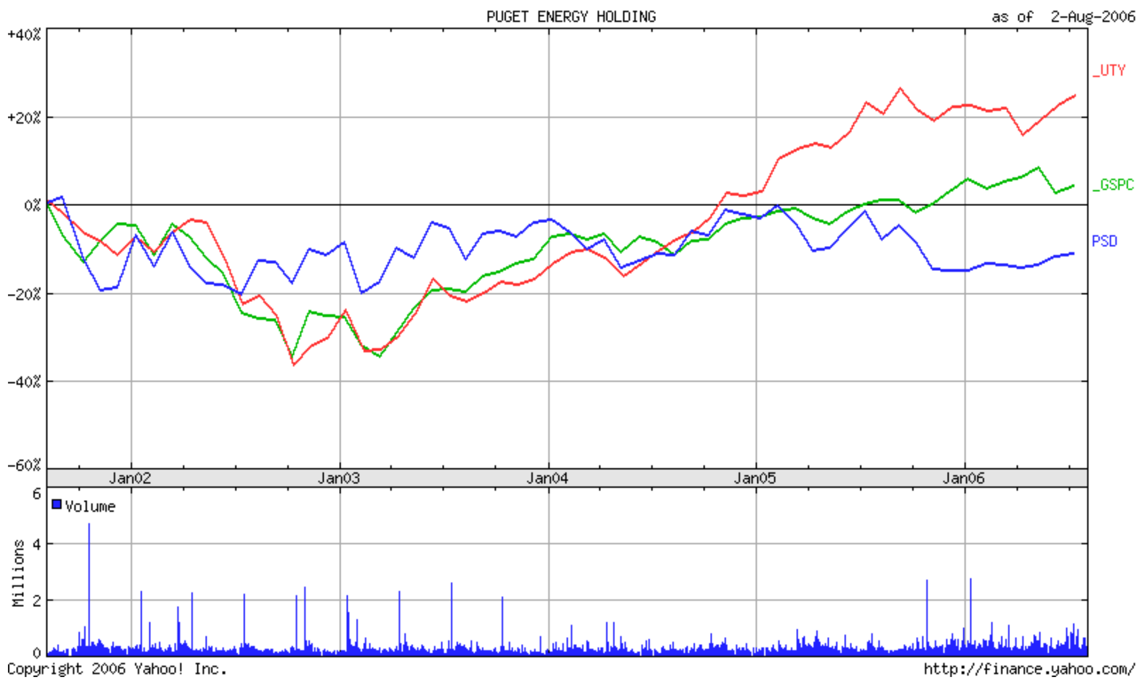
Also, it is important to note that the Company's "BBB-" corporate credit rating is below the industry average. As can be seen in the chart below, nearly three-quarters of regulated utilities have credit ratings above those of PSE. Only 27% of such companies have credit ratings as low as, or lower than, PSE's.



[19] Standard and Poors Research Report; Summary: Puget Energy, Inc.; Publication date: 12-Apr-2006; Primary Credit Analyst: Leo Carrillo.

Stock Performance:

Taking a more appropriate long-term view of the Puget Energy's stock performance in the marketplace, it is clear that the stock price has significantly lagged both the utility index and the broader market S&P index. The chart below reflects this.



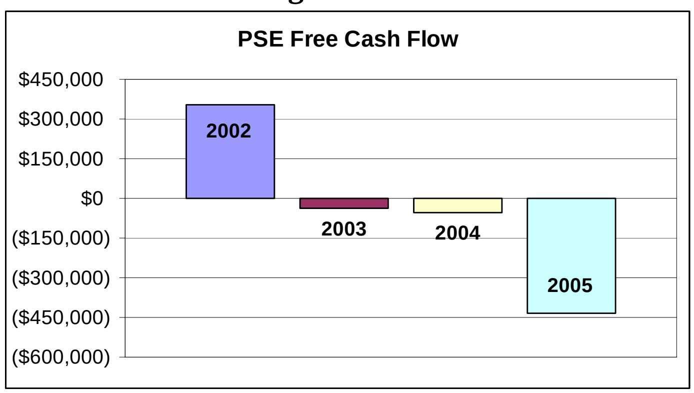
Earned ROE:

The Company continues to under-earn its authorized ROE. Since the inception of the PCA, PSE has earned around an 8% ROE, on average. Recall that this under-earning occurred when the $40 million PCA cap was in place. Compared to the Company's authorized ROE, the 8% earned return represents an average annual under earning of approximately 250 basis points. This is not indicative of financial health.

Increasing Negative Cash Flows:

The Company's internal cash flow generation, after payment of dividends, is insufficient to fund capital expenditures. PSE's free cash flow (cash from operations less dividends and investing activities) has dropped significantly over the last several years. In 2005, free cash flow was negative $432 million as shown below.

PSE Free Cash Flow During Tenure of PCA Mechanism (in 000's)



Q. How would the proposed modified PCA and other mechanisms help improve the Company's financial health?

A. The proposed modified PCA, the proposed depreciation expense tracker and the decoupling proposal would all help narrow the gap between the Company's authorized ROE and its earned ROE. These proposals would also improve cash flow, enabling the Company to finance its investments with less reliance on the capital markets. As Mr. Gaines testifies, the impact of the Staff's proposed rate relief, if granted, would harm PSE and should be rejected.

Q. What are the relevant measures of the Company's ability to absorb risk under the PCA?

A. The relevant measures are actual ROE and cash flow. As described previously, the Company has not been earning its authorized ROE. It is particularly critical at a time of heavy capital investment to have an ability to earn allowed returns in order to effectively fund these investments. The Company is in a significant negative cash flow position since funds from operations are insufficient to cover its investing activities and dividends. The Company's proposals in this rate proceeding are designed to help it achieve internal cash flows that will minimize the need to seek financing from external sources.

B. THE PROPOSED DEPRECIATION TRACKER IS A FAIR MECHANISM THAT WOULD ALLOW THE COMPANY THE OPPORTUNITY TO ACTUALLY EARN ITS AUTHORIZED ROE

Q. Did you review the testimony of Messers. Schoenbeck, Smith, and Higgins regarding PSE's proposed depreciation tracker?

A. Yes.

Q. Do you agree with their recommendation that the Commission should reject the Company's proposed depreciation tracker?

A. No. If the Company is to have a fair opportunity to earn its authorized return on equity, it needs to recover its capital investments in a timely manner. In particular, I disagree with Mr. Schoenbeck's statement that a mechanism such as the depreciation tracker is not necessary "during these times of low inflation and low cost of capital."[20] As discussed in the testimony of Ms. McLain, the condition that necessitates a depreciation tracker today is the high level of capital investment in infrastructure that the Company faces over the next several years, which amplifies the effect of regulatory lag and prevents the Company from earning its authorized return. In addition, as discussed by Ms. McLain, the current low overall rate of inflation is much lower than the inflation rate of the materials PSE must acquire for its delivery system work.

Q. Does the proposed depreciation tracker allow the Company to earn a return on new plant in service without filing a general rate case?

A. No. The depreciation tracker does not allow the Company to earn a return on plant that is placed in service after the test year. It only allows the Company to recover its depreciation expense on this new plant in service.

As Mr. Story explained in his prefiled direct testimony, there are three pieces to the Company's under-recovery of costs that result from capital expenditures and resulting plant growth at a rate in excess of load growth. These three parts are: 1) earning a return on the plant, 2) recovery of the investment (depreciation), and 3) the maintenance of the plant. The depreciation tracker only addresses one of these three pieces -- the recovery of the investment. It is particularly important

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[20] Exhibit No. ___(DWS-1T) at page 4.

for the Company to recover, in a timely manner, its depreciation expense because this expense creates a significant cash issue for the Company.

Q. In disputing the Company's need for a depreciation tracker Mr. Schoenbeck states that depreciation is not an expense that puts any cash strain on the Company. Do you agree with his assertion?

A. No. I do not agree with Mr. Schoenbeck's view that depreciation is purely an accounting expense and does not put any cash strain on the Company. Depreciation expense, when reflected in rates, provides a substantial source of cash flow. That is because the recovery of depreciation in rates is received in cash but, as Mr. Schoenbeck points out, the expense is a non-cash accounting entry. Over the past three years, the recovery of depreciation and amortization expense has been the source of nearly three-quarters of the Company's net cash flow. That provides cash to partially fund the Company's infrastructure improvements and new resource investments, without having to access the capital markets. Contrary to what Mr. Schoenbeck states, the under-recovery of depreciation has a large impact on the Company's cash flow, as well as contributing to PSE's inability to earn its allowed return.

Q. Several of the witnesses for Commission Staff and interveners testify that PSE's proposed depreciation tracker would provide benefits only to shareholders. Do you agree with this assessment of the depreciation tracker?

A. No. The purpose of the depreciation tracker is to support external capital raising necessary to fund the significant capital expenditures to maintain a safe and reliable gas and electric system, as discussed in more detail in the rebuttal testimony of Ms. McLain and Mr. Story. Customers benefit from such a system and benefit from the lower funding costs that will result if PSE can actually earn an ROE that is consistent with its peers.

Q. Do you agree with Mr. Higgins' and Mr. Russell's testimony that the depreciation tracker is not needed because the PGA, PCA and PCORC already address PSE's most critical cost recovery risks between general rate cases?

A. No, I do not. As discussed above, recovery of depreciation expense makes up a significant percentage of the Company's net cash flow. In times such as this, when the Company faces the need to greatly increase its capital expenditures, it is imperative that the Company has the ability to recover its investment in new plant in a timely fashion. These other mechanisms (the PGA, PCA, and PCORC) do not address this.

Q. Mr. Smith testified that, instead of the depreciation tracker, the Commission could address post-test year plant additions through a known and measurable adjustment to recognize non-revenue producing, non-expense reducing transmission and distribution plant additions. Is the Company agreeable to such an alternative proposal?

A. Yes. As discussed in the rebuttal testimony of Ms. McLain, Exhibit No. ___(SML-5CT), PSE has made non-revenue producing investments of approximately $127 million (net of retirements) during the nine-month period subsequent to the test year. As an alternative to the depreciation tracker, the Company requests that the Commission order an adjustment to the revenue requirements to recognize these known and measurable plant additions, as detailed in the rebuttal testimony of Mr. Story Exhibit No. ___(JHS-19T).

C. THE COMPANY'S PROPOSED DECOUPLING PROPOSAL IS A BALANCED PROPOSAL THAT PROVIDES THE COMPANY AN OPPORTUNITY TO RECOVER ITS FIXED COSTS AND SENDS APPROPRIATE PRICE SIGNALS TO CUSTOMERS

Q. Previously you identified the Company's gas decoupling proposal [GRNA] as a mechanism important to the Company's financial strength. Why is the decoupling mechanism important?

A. As discussed in the direct testimony of Mr. Amen decoupling allows the Company to recover its fixed costs, even when temperatures are warmer than normal. Exhibit No. ___(RJA-1T) at page 38-40. Without such mechanisms, in times of load reduction due to warm weather or energy conservation, the Company will experience lower earnings and will not be able to move forward as quickly on, or efficiently finance, proposed infrastructure investments.

Q. In joint testimony, Mr. Lazar, Mr. Schoenbeck and Ms. Steward propose that the Commission reject the Company's decoupling mechanism and increase the residential gas customer charge by $0.75 to $7.00 a month. Does this proposal raise any concerns for you in terms of the Company's plan to fund replacement of its aging delivery system?

A. Yes, I have serious concerns about the additional risk this proposal places on the Company. The increased fixed rate proposed in the Joint Testimony is far below the amount required to recover the Company's fixed costs, as set forth in the rebuttal testimony of Mr. Hoff. Exhibit No. ___(DWH-6T).

Q. You have described the Company's proposed gas decoupling mechanism as a balanced proposal. What do you mean by that?

A. As discussed in the rebuttal testimony of Mr. Hoff, in order for the Company to recover its fixed gas costs through the monthly customer charge, this charge should be set at approximately $29. Exhibit No. ___(DWH-6T) at page 5. The Company is not asking for that relief in this case. Instead, the Company is asking for a gas decoupling measure, and a fixed monthly customer charge of $17.

VI. CONCLUSION

Q. Please summarize your testimony.

A. None of the witnesses dispute the Company's need to replace aging components of the Company's electric and gas delivery systems, maintain a reliable and adequate energy supply by acquiring new electric generation resources, and enter into risk management transactions to mitigate energy price volatility. Yet the parties do not support a financial structure that allows the Company to successfully undertake these activities. The ROE proposed by Mr. Hill and Mr. Gorman are below the Company's current ROE and far below market averages. Even the "comparable groups" of utilities identified by Mr. Hill and Mr. Gorman have a higher authorized ROE, on average, than the ROEs that Mr. Hill and Mr. Gorman have proposed for PSE.

The Company has proposed a balanced ROE and equity ratio, which is consistent with other comparable utilities, and which provides the Company the opportunity for a stronger financial position so that it may attract capital to fund infrastructure and new resource construction programs on competitive terms.

Additionally, the Company should be given the opportunity to earn its authorized ROE. PSE will face considerable earnings lag that will prevent it from earning its authorized ROE. The mechanisms the Company has proposed in this case are designed to put it in a better position to actually earn its authorized ROE. The mechanisms PSE proposes are balanced. PSE is proposing to share power cost risk with customers, not to pass through all power costs in its revised PCA Mechanism. The depreciation tracker provides a fair balance; although it allows the Company to recover its depreciation expense, the Company would not be earning a return on plant that has already been put into service for its customers. Finally, the combined effect of the GRNA and the proposed higher monthly customer charge would provide customers with bills that are lower in the winter than they would otherwise be and correct for over-or under-payment of fixed costs.

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.