EXHIBIT NO. ___(DEG-1T)
DOCKET NO. UE-09___/UG-09___
2009 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-09____** **Docket No. UG-09____**

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

MAY 8, 2009

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES

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PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES

I. INTRODUCTION

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

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

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

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

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

A. I have overall responsibility for raising capital in the financial markets. I am also responsible for maintaining relations with credit rating agencies, and commercial and investment banks. In addition, I oversee PSE's financial planning, budgeting, tax, and energy risk control and credit activities. I am also Chairman of the Qualified Plans Committee, which oversees PSE's retirement, 401(k), and health and welfare plans. I also serve as a Trustee and the Treasurer of the Puget Sound

Energy Foundation.

Q. Please summarize the purpose of your testimony.

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

(i) Section II describes the current turmoil in the capital markets and the effects of this turmoil on PSE;

(ii) Section III describes PSE's requested capital structure that includes a 48.0% equity ratio;

(iii) Section IV describes the capital components of PSE's requested rate of return of 8.56%;

(iii) Section V describes recent upgrades or affirmations of PSE's credit ratings by Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's"); and

(iii) Section VI describes PSE's compliance with all Merger Commitments made by PSE regarding capital structure and costs of debt in the course of obtaining Commission approval of the merger between PSE's parent company, Puget Energy, Inc., and a subsidiary of Puget Holdings LLC (the "Merger").

II. TURMOIL IN THE CAPITAL MARKETS

Q. Please describe the state of the capital markets.

A. The Commission issued its Order 12 in PSE's last general rate, Dockets UE-072300 & UG-072301, on October 8, 2008. Three weeks prior to the issuance of this order, Lehman Brothers Holdings Inc. ("Lehman Brothers") filed for Chapter 11 bankruptcy protection on September 15, 2008:

> Lehman's slow collapse began as the mortgage market crisis unfolded in the summer of 2007, when its stock began a steady fall from a peak of $82 a share. The fears were based on the fact that the firm was a major player in the market for subprime and prime mortgages, and that as the smallest of the major Wall Street firms, it faced a larger risk that large losses could be fatal.
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> …
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> Lehman's demise set off tremors throughout the financial system. The uncertainty surrounding its transactions with banks and hedge funds exacerbated a crisis of confidence. That contributed to credit markets freezing, forcing governments around the globe to take steps to try to calm panicked markets.[1]

Also in September 2008, the then-largest insurance company in the United States–American International Group Inc. ("AIG")–collapsed under the weight of insured mortgage-backed securities:

> American International Group was the largest insurance company in the United States before it suddenly collapsed in September 2008 under the weight of bad bets it made insuring mortgage-backed securities. The company was bailed out by the Federal Reserve, but even after that $85 billion infusion, losses continued to mount and in November the Treasury announced a new rescue package that brought the total cost to $150 billion.
>
> …
>
> A.I.G.'s problems rest in its London-based financial products unit, part of its financial services group, which is exposed to securities tied to the value of home loans. The financial products group sold credit-default swaps, complex financial contracts allowing buyers to insure securities backed by mortgages. As home values have fallen, the

[1] "Lehman Brothers Holdings Inc.," *The New York Times*, available at http://topics.nytimes.com/topics/news/business/companies/lehman_brothers_holdings_inc/index.html (last visited May 4, 2009).

> value of the underlying mortgages has declined, and A.I.G. has had to reduce the value of the securities on its books.[2]

These two events (and similar troubles at other financial institutions) contributed to credit markets freezing, which forced governments around the globe to take steps to try to calm panicked markets as investors moved funds from equity and corporate debt markets into U.S. Treasury securities in a "flight to safety". This "flight to safety" resulted in a precipitous drop in stock and bond prices, and the yield on U.S. Treasury securities dropped as well. In a U.S. Treasury auction in December 2008, investors accepted a zero percent rate in the auction of $30 billion worth of short-term U.S. Treasury securities that were to mature in four weeks. In fact, for a brief moment, investors were willing to take a small loss (e.g., a negative interest rate) for an already-issued three-month Treasury bill.[3]

Q. How did these events affect PSE?

A. Lehman Brothers Bank, a subsidiary of Lehman Brothers, was a participant bank in PSE's then-existing credit facilities. Specifically, Lehman Brothers Bank had $35 million commitments in PSE's then-existing $500 million credit facility and PSE's then-existing $350 million facility that supported PSE's hedging activities.

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[2] "American International Group Inc.," *The New York Times*, available at http://topics.nytimes.com/topics/news/business/companies/american_international_group/index.html (last visited May 4, 2009).

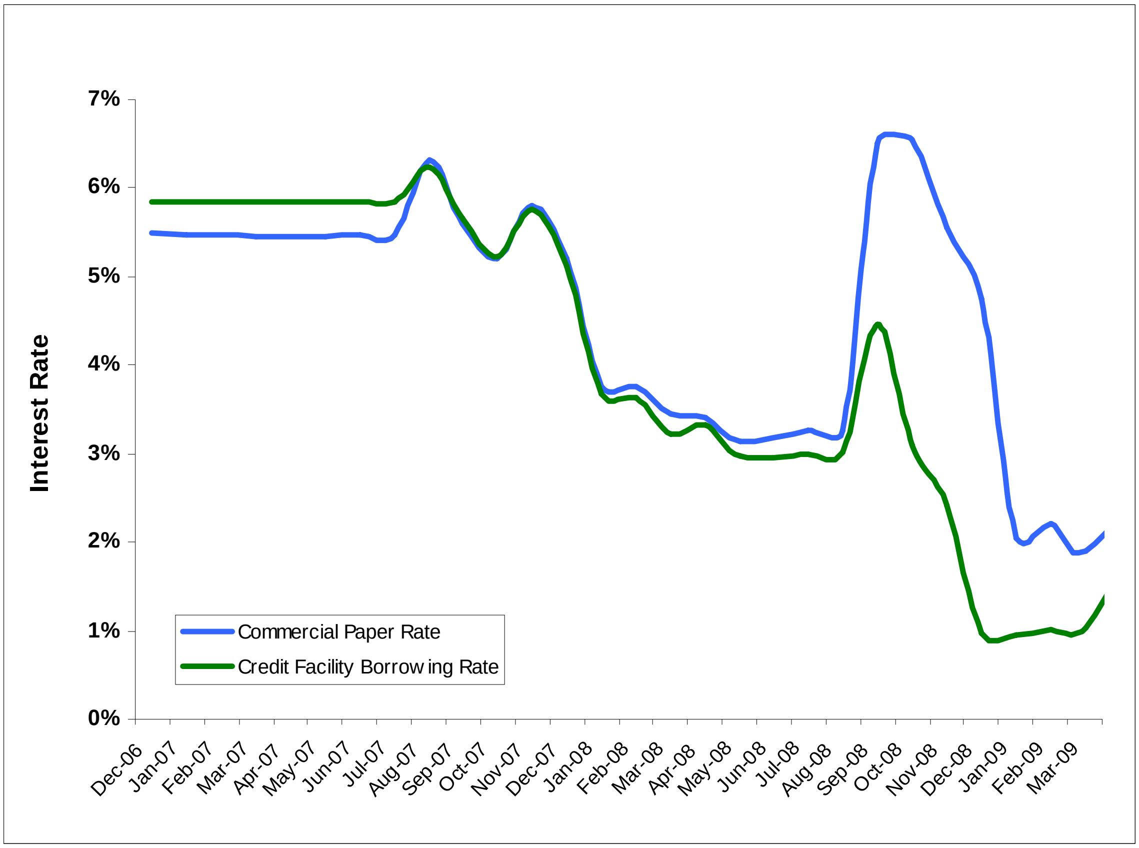
[3] *See, e.g.*, Vikas Bajaj & Michael M. Grynbaum, "Investors Buy U.S. Debt at Zero Yield," *The New York Times* (Dec. 9, 2008), available at http://www.nytimes.com/2008/12/10/business/10markets.html (last visited May 4, 2009).

As a result of the Lehman Brothers filing for Chapter 11 bankruptcy protection, Lehman Brothers Bank informed PSE that the bank would no longer honor PSE's borrowing requests. In effect, this notification reduced the effective size of PSE's then-existing credit facilities. PSE worked with Wachovia, the agent bank for the credit facility, and Lehman Brothers Bank to secure the sale of $25 million of Lehman Brothers Bank's commitment to Sumitomo Mitsui Bank, which reduced Lehman Brothers Bank's commitment to the $500 million facility to $10 million on September 16, 2008.

PSE was concerned that other lenders might follow Lehman Brothers lead, which would affect PSE's liquidity. To mitigate against such a possibility, PSE began borrowing through its credit facilities and holding larger than normal cash balances.

Also during the fall of 2008, the cost of commercial paper—historically a cheaper source of short-term debt than utilizing credit facilities—began to rise dramatically. Chart I below compares the cost of commercial paper with the cost of borrowing under PSE's credit facilities from December 2006 through March 2009:

CHART 1
COMMERCIAL PAPER AND CREDIT FACILITY BORROWING COSTS



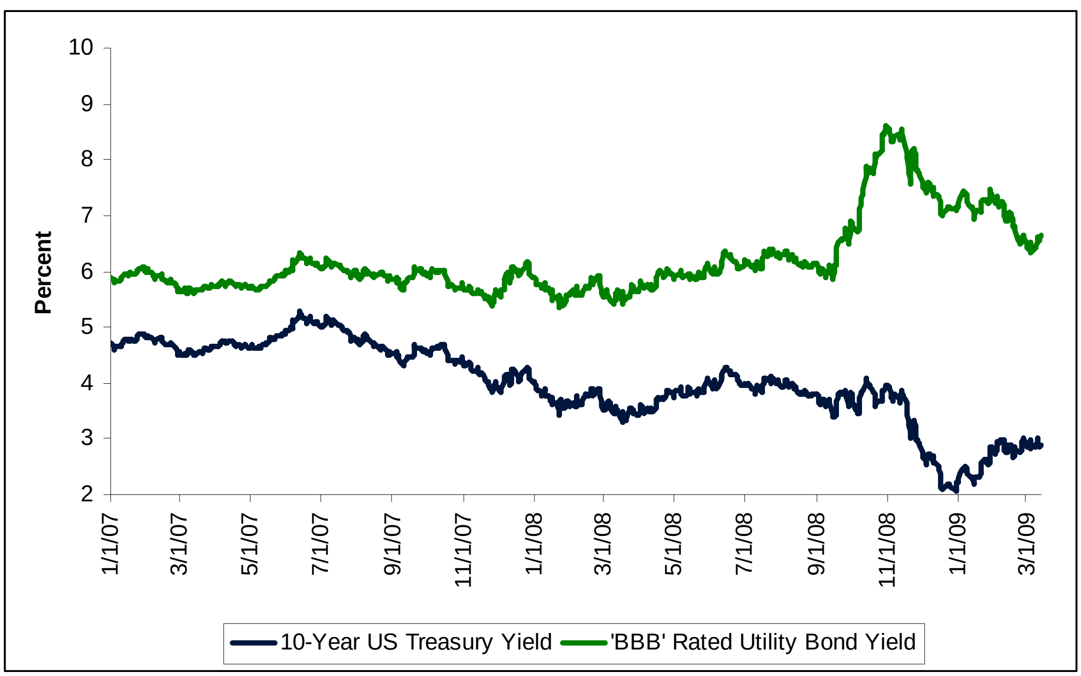
In early 2007, commercial paper rates were thirty-five to forty basis points lower than borrowings under PSE's then-existing credit facilities. By late summer, the rates were comparable. In September 2008, the "flight to safety" caused investors to demand very large credit risk premiums for holding commercial paper. In contrast, PSE's credit facilities, which had been priced earlier when risk premiums were lower, allowed PSE to borrow under its credit facilities at a fixed credit spread of 52.5 basis points over London Interbank Offered Rate ("LIBOR").

With the cost of borrowing under its credit facilities being less expensive than issuing commercial paper, PSE quit issuing commercial paper and relied on its credit facilities and cash balances to meet its liquidity needs. By early November 2008, all previously issued PSE commercial paper had matured. PSE has not issued commercial paper since that time.

Q. Did these events similarly affect PSE's cost of long-term debt?

A. Yes. Rates on utility bonds have increased during this period while, at the same time, the yield on the comparable term U.S. Treasury security has declined. Chart II below compares rates on 10-year "BBB" rated utility first mortgage bonds to the yield on the 10-year U.S. Treasury security for the period January 2007 through March 13, 2009:

CHART II
10-YEAR "BBB" UTILITY RATE vs. 10-YEAR US TREASURY YIELD



During 2007, the credit risk premium or "spread", i.e., the difference between the utility bond rate and the yield on the comparable term U.S. Treasury security, averaged 125 basis points. Since September 16, 2008, the spread has averaged 426 basis points.

PSE issued $250 million of 30-year senior secured notes in June 2006. In September 2006, PSE issued another $300 million of 30.5 year senior secured notes. PSE sold these issues before the credit market crisis, and both issues were 140 basis points over the yield on the 30-year U.S. Treasury bond. In January 2009, PSE issued $250 million of 7-year senior secured note. Although PSE's credit rating was higher in January 2009 than it was in the late summer of 2006, the January 2009 notes were 480 basis points over the yield on the comparable term U.S. Treasury bond.

Q. Was PSE's experience during the credit market crisis unique?

A. No. Although I cannot speak directly to the impact of the credit market crisis on other companies, reports in the trade press suggest that other companies experienced similar increases in cost and, at times, difficulty accessing essential credit. For example, Greenwich Research published a report in October 2008 that stated that the vast majority of companies reported increased costs for revolving credit facilities, term loans, commercial paper, long-term bonds, and other financial products. The report also indicated that the majority of companies reported a decrease in their ability to access these same loans and securities.

Please see Exhibit No. ___(DEG-3C) for a copy of the Greenwich Associates report, dated October 2008, entitled "Credit Market Seizure Deepens and Hits Companies Large and Small".

Q. What conclusions does PSE draw from this period of capital market turmoil?

A. This period of capital market turmoil demonstrates that liquidity can evaporate very quickly and that risk premiums can increase both quickly and substantially. This period highlights the importance of maintaining (i) a strong balance sheet, (ii) substantial cash reserves, and (iii) credit facilities of adequate size to meet funding needs. Additionally, this period demonstrates the benefits of utilizing credit facilities at levels that leave room for additional borrowing as financing needs arise.

III. PSE REQUESTS THAT THE COMMISSION SET RATES ON A CAPITAL STRUCTURE THAT INCLUDES A 48.0% EQUITY RATIO

Q. What factors are typically considered in selecting the appropriate capital structure in ratemaking?

A Selecting the appropriate capital structure involves the balancing of safety and economy. The economy of lower cost debt, on which PSE has an obligation to pay interest, must be weighed against the safety of relatively higher cost common equity, on which PSE does not have a legal obligation to pay a dividend and provide a return.

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

A. PSE's average capital structure (calculated using an average of the monthly averages methodology) during the test year (calendar year 2008) included a 44.67% equity ratio, as show in Table 1 below:

TABLE 1
ACTUAL TEST YEAR CAPITAL STRUCTURE

Capital Component	Dec 31, 2008 Test Year (Average)
Short-term Debt	6.60%
Long-term Debt	48.70%
Preferred Stock	0.03%
Common Equity	44.67%
Total Capitalization	**100.0%**

Q. Is the test year capital structure presented in Table 1 representative of PSE's current capital structure or the capital structure that will likely support utility operations during the rate year?

A No. The test year capital structure presented in Table 1 above is not representative of PSE's current capital structure or the capital structure that is expected to support utility operations during the rate year.

Q. Why is the test year capital structure presented in Table 1 above not representative of PSE's current capital structure?

A. The test year capital structure presented in Table 1 is not representative of PSE's current capital structure because of four factors:

(i) On February 6, 2009, PSE's parent company, Puget Energy, merged with an entity controlled by Puget Holdings. At closing of that transaction, Puget Holdings invested funds into PSE that PSE used to repay existing short-term debt and increase PSE's equity capitalization,

(ii) On March 13, 2009, PSE defeased and called for redemption two small preferred stock issues. Details of this defeasance and redemption are provided in section IV.C., below,

(iii) PSE issued $250 million of 6.75% 7-year senior secured notes in January 2009, and

(iv) PSE's net income, less dividends, has been added to retained earnings, a component of common equity and there have been changes in the level of short-term debt outstanding.

Q. What was PSE's actual capital structure after the four factors that occurred subsequent to the end of the rate year?

A. PSE's actual capital structure on March 31, 2009, included a 52.9% equity ratio, as show in Table 2 below:

TABLE 2
CAPITAL STRUCTURE ON MARCH 31, 2009

Capital Component	**March 31, 2009 (Not Average)**
Short-term Debt	3.1%
Long-term Debt	44.0%
Preferred Stock	0.0%
Common Equity	52.9%
Total Capitalization	**100.0%**

Q. On what capital structure is PSE requesting that rates be set?

A. PSE requests that the Commission set rates in this proceeding on a capital structure that includes a 48.0% equity ratio, as show in Table 3 below:

TABLE 3
REQUESTED CAPITAL STRUCTURE

Capital Structure	Ratios
Short-term Debt	3.95%
Long-term Debt	48.05%
Preferred Stock	0.0%
Common Equity	48.0%
Total Capitalization	**100.0%**

This requested capital structure is consistent with the capital structure that will likely support utility operations during the rate year.

Q. Please describe the primary reasons this capital structure is different from the capital structure that existed on March 31, 2009.

A. PSE's requested capital structure depicted in Table 3 above is different from the PSE's capital structure that existed on March 31, 2009, for a variety of reasons, including, without limitation, the following:

(i) Maturities of existing long-term debt and new long-term securities issued to refinance those and fund capital expenditures,

(ii) Equity investments into PSE from Puget Energy,

(iii) Changes in cash flows resulting in changes in the amount of short-term debt outstanding, and

(iv) Changes to retained earnings resulting from the addition of net income and the payment of dividends.

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

A. Yes. The capital structure requested by PSE in this proceeding appropriately balances the risks and costs of funding PSE's utility operations:

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

(ii) The capital structure requested by PSE in this proceeding will allow PSE to offset imputed debt associated with purchased power agreements;

(iii) The capital structure requested by PSE in this proceeding will allow PSE to satisfy Merger Commitments related to capital structure; and

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

Q. Is the capital structure reflected in Table 3 above calculated in a manner similar to the capital structures calculated in PSE's recent prior proceedings?

A. Yes. The capital structure reflected in Table 3 above is calculated in a manner similar to the capital structures calculated in PSE's recent prior proceedings. This methodology removes non-regulated activities and other comprehensive income ("OCI") from PSE's consolidated capital structure. Specifically, PSE made the following three adjustments:

(i) PSE removed the retained earnings generated by Puget Western, Inc. ("PWI") from PSE's consolidated capital structure;

(ii) PSE removed the retained earnings generated by Hydro Energy Development Corp. ("HEDC") from PSE's consolidated capital structure; and

(iii) PSE removed OCI from PSE's consolidated capital structure.

Q. Please explain why PSE made these three adjustments to remove non-regulated activities and OCI from PSE's consolidated capital structure.

A. PSE made the first two adjustments (the removal of retained earnings generated by PWI and HEDC from PSE's consolidated capital structure) because the retained earnings generated by these two subsidiaries are non-regulated. (PWI is a real estate development and disposition subsidiary, and HEDC is a subsidiary that owns, among other things, a non-regulated small hydro facility, Black Creek Hydro, Inc., that presently sells its energy output to Avista.)

PSE made the third adjustment (the removal of OCI from PSE's consolidated capital structure) because OCI consists of accounting calculations for certain activities not reflected in customer rates. For example, two primary OCI items are (i) balance sheet impacts of certain derivatives that PSE does not recover through customer rates and (ii) balance sheet impacts of accounting for PSE's pension plan.

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

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

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

A. The Commission typically sets PSE's rates in a manner that reflects actual "cash" pension contributions averaged over a period of time, typically four years, not the financial reporting income and expense related to the pension plan. Therefore, PSE removes the balance sheet impacts of such financial reporting of pension accounting. PSE's treatment of these items in this proceeding is consistent with past practices.

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

A. The capital structure requested by PSE in this proceeding contains less equity than the average of capital structures approved by regulatory bodies during the test year. The average capital structure authorized by regulatory bodies for ratemaking purposes during the test year (calendar year 2008) through the first quarter of 2009 contained a 49% equity ratio. In other words, the average capital structure approved by regulatory bodies for ratemaking purposes during the test year (calendar year 2008) contained an equity ratio that was 100 basis points higher than the equity ratio requested by PSE in this proceeding. Please see Exhibit No. ___(DEG-4) for a list of the equity ratios and returns on equity authorized by regulatory bodies from January 2008 through March 2009.

IV. CAPITAL COMPONENTS OF PSE'S REQUESTED RATE OF RETURN OF 8.56%

Q. Has PSE prepared an exhibit that demonstrates the projected rate year costs that support PSE's requested rate of return of 8.56%?

A. Yes. Please see Exhibit No. ___(DEG-5C) for a PSE exhibit that demonstrates the projected rate year costs that support PSE's requested rate of return of 8.56%.

A. The Cost of Debt

1. The Cost of Short-Term Debt

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

A. PSE currently has three credit facilities that totaled $1.05 billion:

(i) a $400 million unsecured revolving credit facility for working capital needs,

(ii) a $400 million unsecured revolving credit facility to fund utility capital expenditures, and

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

Each of the above-described credit facilities carries a five-year term and expires on February 6, 2016. PSE uses these short-term credit facilities primarily to provide necessary working capital to fund utility operational requirements and the expected variability of such requirements.

Q. Are these three PSE credit facilities the same PSE credit facilities in effect during the test year?

A. No. The three credit facilities described above replaced the long-term credit facilities PSE had in place prior to the Merger. During the test year, PSE had three credit facilities that totaled $1.05 billion:

(i) a $500 million unsecured 5-year revolving credit facility that, absent the Merger, would have expired in April 2012,

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

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

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

A. PSE's pre-Merger credit facilities were negotiated prior to the commencement of the turmoil in the financial markets. Therefore, the costs associated with PSE's pre-Merger credit facilities were much lower than what PSE could expect to secure if PSE were executing new credit facilities in today's markets. Although the costs associated with the post-Merger credit facilities are higher than the costs associated with the pre-Merger credit facilities, PSE's new post-Merger credit facilities, which were negotiated in 2007, cost much less than what PSE could otherwise be expected to pay if PSE were executing new credit facilities in today's markets.

Q. Is PSE requesting recovery in rates of the costs of the new post-Merger credit facilities in this proceeding?

A. PSE is not requesting recovery in rates in this proceeding of the costs of the new post-Merger credit facilities during any period in which PSE's prior credit facilities would have been effective.

Absent the Merger, PSE's former two credit facilities would have remained effective during the rate year. The $500 million unsecured 5-year revolving credit facility would not have expired until April 2012—after the expiration of the rate year. The $200 million accounts receivable securitization facility would not have expired until December 2010—three months prior to the expiration of the rate year.

Q. Absent the Merger, would PSE have executed a new credit facility to replace the accounts receivable securitization facility that would have expired prior to the expiration of the rate year?

A. Yes. Absent the Merger, PSE would have needed a new credit facility to replace the accounts receivable securitization facility that would have expired prior to the expiration of the rate year. Therefore, PSE is requesting recovery in rates of a portion of the commitment fees and amortization of the post-Merger credit facilities during the last three months of the rate year.

Q. Why is PSE requesting recovery in rates of a portion of the commitment fees and amortization of the post-Merger credit facilities during the last three months of the rate year?

A. Excluding the $350 million unsecured revolving credit agreement to support PSE's energy hedging activities (the costs of which are recovered through PSE's Power Cost Adjustment and Purchased Gas Adjustment mechanisms), PSE's new post-Merger credit facilities total $800 million. As stated above, the accounts receivable securitization facility that would have expired three months prior to the expiration of the rate year was a $200 million facility. Therefore, PSE is requesting to recover in rates one quarter ($200 million is one quarter of $800 million) of the costs of the post-Merger credit facilities during the last three months of the rate year. In addition, the cost of these facilities is lower than what PSE would incur were it entering into new credit facilities today, with or without the merger, because they were negotiated prior to the recent turmoil in the financial markets.

Q. Are some costs of the post-Merger credit facilities excluded from your calculation? If so, why were these costs excluded?

A. Yes. One cost of the post-Merger credit facilities was a commitment fee payable to banks participating in the new credit facilities from the date the banks agreed to participate (i.e., the date banks had to commit capital) until the closing date of the Merger. These fees, commonly referred to as "ticking fees," were only payable if the Merger closed and covered the period of time that ended with the closing of the Merger.

Q. Is PSE requesting the recovery in rates of "ticking fees" associated with the post-Merger credit facilities?

A. No. PSE is not requesting the recovery in rates of "ticking fees" associated with the new post-Merger credit facilities because the post-Merger credit facilities were not available for use by PSE during the period that "ticking fees" were applicable.

Q. How did PSE calculate the projected amount of short-term debt to be included in the capital structure?

A. PSE determined the amount of short-term debt to be included in the capital structure by projecting the short-term debt level which is expected to be outstanding, on average, during the rate year. Specifically, PSE calculated this amount based on its projected cash flows, financing activities, and requested rate relief. The projected amount of short-term debt is that level needed to keep PSE's sources and uses of cash in balance in light of PSE's financing projections.

Q. Why is PSE not using the average of monthly averages of PSE's short-term debt outstanding during the test year?

A. PSE is not using the average of monthly averages of the short-term debt outstanding during the test year because (i) PSE temporarily maintained a higher level of short-term debt than it normally would maintain during the test year and (ii) PSE is requesting that rates be set reflecting the amount of short-term debt expected to be outstanding during the rate year, as it has done in the past. The average of monthly averages of PSE's short-term debt outstanding during the test year was about $375 million. PSE is expecting that the amount of short-term debt outstanding will average about $285 million during the rate year. *See* Exhibit No. ___(DEG-5C) at page 1, line 7, column (B).

Q. Why did PSE temporarily maintain a higher level of short-term debt than it normally would maintain during the test year?

A. PSE temporarily maintain a higher level of short-term debt than it normally would maintain during the test year for three reasons:

(i) PSE anticipated an equity investment from Puget Energy to pay down short-term debt to a more typical level, and this equity investment was not practicable until after the Commission issued an order in Docket No. U-072375;

(ii) PSE borrowed against its pre-Merger credit facilities to hold a higher cash position to weather the turmoil in the financial markets; and

(iii) PSE planned to issue a first mortgage bond, which subsequently occurred in January 2009.

Q. What would PSE consider to be a reasonable projection of short-term debt for the rate year?

A. PSE would consider a reasonable projection of short-term debt for the rate year to be one that that is well within the size of PSE's working capital facilities. The size of PSE's working capital facilities accommodates volatility in working capital needs and provides reserves for PSE to fund capital expenditures temporarily until PSE can secure long-term funding. PSE considers a reasonable projection of short-term debt for the rate year to be in the range of $200 million to $350 million, or in the range of approximately 3% to approximately 5% of total capitalization. Therefore, PSE requests for recovery in rates a rate of return based on a capital structure that includes a 3.95% short-term debt ratio, or the mid-point of this approximate range.

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

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

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

A. The projected cost of PSE's short-term debt during the rate year is 2.47%. Please see Exhibit No. ___(DEG-5C), at page 3, line 16, column (F).

Q. Has PSE calculated what would be the cost of short-term debt it were requesting recovery of the costs of the new credit facilities?

A. Yes. If PSE were to request recovery of the costs of the new facilities, then the projected cost of short-term debt would be 3.99%, or 152 basis points higher than the cost of short-term debt requested by PSE in this proceeding. Even if PSE were to request recovery of the costs of the new facilities, the projected cost of short-term debt of 3.99% would be lower than the cost of short-term debt of 4.09% requested by PSE upon rebuttal in its prior general rate proceeding.

2. <u>The Cost of Long-term Debt</u>

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

A. To calculate the cost of long-term debt, PSE calculates the yield-to-maturity, or cost rate, of each debt issue using the issue date, maturity date, net proceeds to PSE, and coupon rate of that security. Also included in the cost of long-term debt are the costs to reacquire high coupon debt that has been replaced with lower coupon debt. The proportional share that each issue's principal amount represents of the total amount of long-term debt outstanding is then used to weigh these cost rates. Please see pages 5 and 6 of Exhibit No. ___(DEG-5C) for these calculations.

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

A. Yes. PSE's financial plan projects three long-term debt issues before the end of the rate year:

(i) PSE's financial plan projects a $350 million senior secured note issue in September 2009;

(ii) PSE's financial plan projects a $400 million senior secured note issue in March 2010; and

(iii) PSE's financial plan projects a $375 million senior secured note issue in September 2010.

Q. How does PSE plan to use the proceeds of these three new issues of long-term debt?

A. PSE plans to use the proceeds from these three issues to repay maturing long-term debt and to repay short-term debt incurred to fund PSE's capital expenditures.

Q. Are there any issues of PSE long-term debt that will mature or retire between December 31, 2008, and the end of the rate year?

A. Between December 31, 2008, and March 31, 2011, six series (totaling $650 million) of PSE long-term debt will mature:

(i) a $150 million series of PSE long-term debt matured on March 9, 2009;

(ii) a $3 million series of PSE long-term debt will mature on December 21, 2009;

(iii) a $5 million series of PSE long-term debt will mature on December 22, 2009;

(iv) a $225 million series of PSE long-term debt will mature on February 22, 2010;

(v) a $7 million series of PSE long-term debt will mature on September 13, 2010; and

(vi) a $260 million series of PSE long-term debt will mature on February 1, 2011.

PSE has included the costs of the above issues that will mature before the end of the rate year in the calculation of the cost of long-term debt for only those months during which the bonds will be outstanding.

Q. Did PSE call, redeem or retire any long-term debt as result of the merger?

A. No. The Investor Consortium's original plan was to redeem two long-term debt issues totaling $375 million prior to their natural maturity. PSE was able to achieve its desired post-merger capitalization without redeeming these issues and in the process saved the costs to call these securities which was estimated to be approximately $18 million. One of those issues matured on March 9, 2009 and the other will mature on February 22, 2010.

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

A. The projected cost of PSE's long-term debt during the rate year is 6.82%. Please see Exhibit No. ___(DEG-5C), at page 5, line 37, column G.

B. The Cost of Trust Preferred

Q. Is PSE requesting recovery of the cost of trust preferred in this proceeding?

A. No. PSE redeemed all of its remaining trust preferred in calendar year 2007. PSE issued $250 million of junior subordinated notes, which have equity-like characteristics. As a result, the credit rating agencies consider these junior subordinated notes 50% equity during the first ten years of their term. Although the credit rating agencies consider these securities as equity-like, they are tax deductible like long-term debt. Therefore, PSE includes the cost of these junior subordinated notes in the projected cost of PSE long-term debt during the rate year.

C. <u>The Cost of Preferred Stock</u>

Q. Does PSE have any preferred stock outstanding?

A. No. PSE redeemed both of its remaining preferred stock issues on March 13, 2009.

Q. Please describe the preferred stock that PSE defeased.

A. At January 31, 2009, PSE had two issues of preferred stock outstanding: (i) $431,100 of 4.70% series preferred stock and (ii) $1,458,300 of 4.84% series preferred stock. The series percentages (4.70% and 4.84%, respectively) represent the after-tax dividend rate of the issues. Both issues contained sinking fund requirements that would have resulted in their complete redemption no later than May 15, 2017. The issues could be called upon at least thirty (30) days' notice and with the payment of the redemption price and accrued dividends. The redemption prices were $101 and $102 for the 4.70% and 4.84% series, respectively. These represented call premiums over book value of 1% and 2% for the 4.70% and 4.84% series, respectively.

Q. What is meant by defeasance of the preferred stock?

A. In simple terms, a defeasance is a method of legally removing a financial obligation from a company prior to the normal termination date of the obligation. This is typically accomplished by depositing risk-free funds (cash or Treasury securities) with a trustee sufficient to meet all future interest and principal repayments of the obligation. In the case of PSE's preferred stock, PSE deposited approximately $1.9 million with the paying agent and notified the agent of its intent to call the preferred stock on March 13, 2009. The approximately $1.9 million was the amount necessary to pay the call premiums and to pay accrued dividends through March 13, 2009.

Q. Why did PSE defease and simultaneously call the preferred stock?

A. Under the terms of the Merger, Puget Holdings was to be the sole indirect shareholder of PSE. To accomplish this goal, PSE needed to defease and call the preferred stock. The two step "defease and call" approach removed the preferred stock as a voting class of stock upon closing of the Merger and satisfy the thirty (30) day advance notice requirement for redemption.

Q. Is PSE requesting the recovery of the costs of defeasance and call of the preferred stock?

A. No. PSE is not requesting the recovery of the costs of defeasance and call of the preferred stock in this proceeding because, absent the Merger, PSE likely would not have defeased and called the preferred stock.

D. The Cost of Common Equity

Q. Has PSE prepared an analysis of the projected cost of PSE equity during the rate year?

A. Yes. PSE has retained the services of Dr. Roger A. Morin to prepare an analysis of the projected cost of PSE equity during the rate year. According to Dr. Morin, the projected cost of PSE equity during the rate year lies in the range of 11.0% and 11.5%. Please see Exhibit No. ___(RAM-1T). As discussed in the prefiled direct testimony of Eric M. Markell, PSE is requesting a projected return on equity of 10.8%, which is slightly below Dr. Morin's recommended range. Please see Exhibit No. ___(EMM-1T).

E. The Overall Rate of Return

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

A. PSE's requested overall rate of return in this proceeding is 8.56%, as shown in Table 4 below:

TABLE 4
CAPITAL STRUCTURE AND
OVERALL RATE OF RETURN

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	3.95%	2.47%	0.10%
Long-term Debt	48.05%	6.82%	3.28%
Preferred Stock	0.00%	0.00%	0.00%
Common Equity	48.00%	10.80%	5.18%
Overall Rate Of Return	**100%**		**8.56%**

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

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

Additionally, Dr. Morin's recommended return on equity range is based on PSE's integrated operations without any distinction between electric and gas operations.

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

A. Yes, I believe it is. The average return on equity authorized by regulatory bodies during the test year (calendar year 2008) and into the first quarter of 2009 was 10.39%, well above PSE's last authorized ROE of 10.15%. *See* Exhibit No. ___(DEG-4). The average capital structure authorized by regulatory bodies for ratemaking purposes during the test year (calendar year 2008) contained a 49% equity ratio, which is a full 100 basis points higher than the 48% equity ratio that PSE request for ratemaking purposes in this proceeding. With more financial risk than other utilities, on average, it is reasonable to expect PSE should have a higher than average ROE, all else being equal—but all else is not equal. As discussed in the prefiled direct testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), PSE faces higher relative risks than the average utility because of its massive construction program and significant regulatory lag.

Indeed, Dr. Morin suggests, in light of these risks, that the Commission authorize an ROE for PSE at the high end of his 11% to 11.5% range. Although Dr. Morin's recommends an ROE that is higher, PSE is requesting a 10.8% ROE because the PSE is mindful of the customer impact from the requested rate increases in these difficult economic times. *See* Exhibit No. ___ (EMM-01T).

V. S&P AND MOODY'S HAVE RECENTLY UPGRADED OR AFFIRMED PSE'S CREDIT RATINGS

Q. What are rating agencies and credit ratings?

A. Rating agencies are independent agencies that assess risks for investors. The two most widely recognized rating agencies are S&P and Moody's. These rating agencies issue credit ratings to companies and their securities. These ratings provide information to investors regarding risks associated with such companies and their debt securities.

Q. What are PSE's current credit ratings?

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

TABLE 5
PSE CREDIT RATINGS

Security	S&P	Moody's
Corporate credit/issuer rating	BBB	Baa3
Senior Secured Debt	A-	Baa2
Junior Subordinated Notes	BB+	Ba1
Preferred Stock	BB+	Ba2
Commercial Paper	A-2	P-3

Q. Have the credit ratings of PSE recently changed?

A. Yes. After the Commission issued the Merger order but before the closing of the Merger, S&P raised several credit ratings of PSE to reflect the improved financial position of PSE that result from the Merger:

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

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

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

At the same time, S&P removed all of PSE's ratings from CreditWatch with negative implications and stated that PSE's ratings outlook is stable. Please see Exhibit No. ___(DEG-6) for a copy of the S&P Research Update, dated January 30, 2009, entitled "Puget Energy Term Loan Facility Assigned 'BB+'

Rating; Puget Sound Energy Facilities Assigned 'BBB' Rating".

In taking these actions, S&P stated as follows:

> The ratings actions on PSE and Puget reflect their acquisition led by Macquarie Infrastructure Partners…. The upgrade of PSE and its related securities reflects Standard & Poor's view that plans to place an independent director on the board of directors of the utility company, coupled with other commitments, such as dividend restrictions, provides insulation to the utility company. In addition, the utility company's stand-alone financial metrics are expected to improve post-transaction as some debt is repaid and, on a forward basis, the capital structure is expected to be managed to a more credit supportive level.

On February 3, 2009, Moody's affirmed the long-term ratings of PSE. Please see Exhibit No. ___(DEG-7) for a copy of the Moody's Global Credit Research Credit Opinion, dated February 3, 2009. Moody's stated the following reasons for these actions:

> The impending completion of the purchase of 100% of the common stock of Puget Energy, Inc. by a consortium of infrastructure private equity investors led by Macquarie Infrastructure Partners follows receipt in January 2009 of the final regulatory approval for the transaction from the WUTC. Financing for the transaction includes a significant $3.4 billion equity component from the consortium, which we note has a reputation as a long-term investor.

Moody's further noted:

> PSE's stable rating outlook reflects our view that the utility can sustain its recent financial performance under the impending new ownership, which is increasingly important given the introduction of a significant amount of structurally subordinated debt at the parent. Our expectations assume that PSE maintains conservative financing strategies and receives supportive decisions from the WUTC in future rate cases.

The above statements suggest that both S&P and the Moody's recognize the benefits of the Merger as the main rationale for their actions.

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

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

Q. Why are credit ratings important to customers?

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

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

A. In light of PSE's capital spending program, PSE is seeking to retain its current senior secured debt ratings of "A-" by S&P and "Baa2" by Moody's at this time.

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

A. Yes. In a report dated November 30, 2007, S&P revised its ratings criteria.

Under the new criteria, PSE is classified as having a Business Profile of "Excellent" and a Financial Profile of "Aggressive". In that report, S&P published the following table:

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

	FFO to Debt	FFO Interest Coverage	Debt Ratio
Modest	40% - 60%	4.0x to 6.0x	25% to 40%
Intermediate	25% to 40%	3.0x to 4.5x	35% to 50%
Aggressive	10% to 30%	2.0x to 3.5x	45% to 60%
Highly Leveraged	Below 15%	2.5% or less	Over 50%

In a report dated February 3, 2009, Moody's included "Select Key Ratios for Global Regulated Utilities". Table 7 below includes the Moody's benchmark range for certain credit ratings:

TABLE 7
MOODYS' SELECT KEY RATIOS

	CFO pre-W/C to Debt	CFO pre-W/C to Interest	Debt Ratio
"A" Medium	22% to 30%	3.5x to 6.0x	40% to 60%
"A" Low	12% to 22%	3.0x to 5.7x	50% to 75%
"Baa" Medium	13% to 25%	2.7x to 5.0x	50% to 70%
"Baa" Low	5% to 13%	2.0x to 4.0x	60% to 75%

Q. Has PSE calculated the credit metrics that would likely result if the Commission were to grant PSE's requested rate relief in full?

A. Yes. PSE has calculated the following credit metrics that would likely result if the Commission were to grant PSE's requested rate relief in full: (i) funds from operations ("FFO") interest coverage, (ii) FFO to average debt, and (iii) debt as a percent of total capital. (These ratios are similar to Moody's cash flow from operations ("CFO") pre-working capital ("pre-W/C").)

TABLE 8
SELECT CREDIT METRICS & RELATED S&P BENCHMARKS

	2008	2009	2010	Rate Year
FFO Interest Coverage:				
PSE Projections	**4.4x**	**4.3x**	**4.0x**	**4.1x**
S&P "Aggressive" Range	2.0x-3.5x	2.0x-3.5x	2.0x-3.5x	2.0x-3.5x
Moody's "Baa" Medium Range	2.7x-5.0x	2.7x-5.0x	2.7x-5.0x	2.7x-5.0x
FFO to Average Debt:				
PSE Projections	**20.2%**	**20.8%**	**19.0%**	**19.6%**
S&P "Aggressive" Range	10%-30%	10%-30%	10%-30%	10%-30%
Moody's "Baa" Medium Range	13%-25%	13%-25%	13%-25%	13%-25%
Debt to Total Capital:				
PSE Projections	**62.1%**	**54.6%**	**54.4%**	**54.0%**
S&P "Aggressive" Range	45%-60%	45%-60%	45%-60%	45%-60%
Moody's "Baa" Medium Range	50%-70%	50%-70%	50%-70%	50%-70%

The ratios presented in Table 8 above include imputed debt and treat the $250 million of junior subordinated notes as receiving 50% equity credit.

As can be seen in Table 8, PSE's cash flow interest coverage (FFO Interest Coverage) is higher than the benchmark range and the other two ratios are well within the benchmark ranges. Also, PSE's cash flow to average debt (FFO to Average Debt) and debt to total capital (Debt to Total Capital) ratios show improvement between 2008 and 2009. These financial credit ratios improve largely as a result of the equity infusion that resulted from the Merger.

Q. Do the credit rating agencies issue credit ratings based solely on financial metrics, such as those shown in Table 8 above?

A. No. Credit ratings agencies do not issue credit ratings based solely on financial metrics. Instead, the credit ratings agencies issue credit ratings based on both quantitative and qualitative measures. Table 8 above only shows certain quantitative measures. Credit ratings agencies also consider qualitative measures, including but not limited to regulation, markets and competition, and operations and management.

With respect to regulation, items of importance include weather protection (i.e., stability of cash flows regardless of weather conditions), earnings sharing, and the level of authorized returns on equity (i.e. set at healthy enough levels to attract capital on reasonable terms). PSE benefits from its growing service territory, respected management, and favorable operating statistics. PSE does not, however, have weather protection in either its electric or gas operations.

Q. Does PSE anticipate that its credit ratings would improve during the rate year or shortly thereafter?

A. No. PSE does not anticipate that its credit ratings would improve during the rate year or shortly thereafter. The assessment of qualitative measures is not likely to change sufficiently over the next few years that PSE could expect an increase in its credit ratings. However, both agencies have stated that their current credit ratings are premised on, in part, supportive regulation. S&P states:

> The regulatory environment in Washington and how the company manages its relationship with the WUTC are key drivers of credit quality, especially in light of PSE's high capital needs and commodity price exposure.

Exhibit No. ___(DEG-6) at page 1. Along these same lines, Moody's states in the Ratings Outlook section of their report:

> Our expectations assume that PSE maintains conservative financing strategies and receives supportive decision from the WUTC in future rate cases.

Exhibit No. ___(DEG-7) at page 3.

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

A. <u>PSE's Debt Costs are No higher Than Such Costs Would Have Been Assuming PSE's Credit Ratings by S&P and Moody's in Effect on January 15, 2009, in Compliance with Merger Commitment 24, as Clarified by the Eighth Condition of the Merger Order</u>

Q. Does any Merger Commitment prohibit PSE from advocating for a higher cost of debt as compared to what PSE's cost of debt or equity capital would have been absent Puget Holdings' ownership?

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

> Puget Holdings and PSE will not advocate for a higher cost of debt or equity capital as compared to what PSE's cost of debt or equity capital would have been absent Puget Holdings' ownership.[4]

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

> (a) Determination of PSE's debt and equity costs will be no higher than such costs would have been assuming PSE's credit ratings by S&P and Moody's in effect on the day before the transaction closes and applying those credit ratings to then-current debt and equity markets, unless PSE proves that a lower credit rating is caused by circumstances or developments not the result of financial risks or other characteristics of the transaction.
>
> (b) PSE bears the burden to prove prudent in a future general rate case any pre-payment premium or increased cost of debt associated with existing PSE debt retired, repaid, or replaced as a part of the transaction.
>
> (c) Determination of the allowed return on equity in future general rate cases will include selection and use of one or more proxy group(s) of companies engaged in businesses substantially similar to PSE, without any limitation related to PSE's ownership structure.[5]

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[4] *See* page 3 of Appendix A (Multiparty Settlement Stipulation) to *In re Puget Holdings LLC & Puget Sound Energy, Inc.*, Docket No. U-072375, Order 08 Approving and Adopting Settlement Stipulation; Authorizing Transaction Subject to Conditions, (Dec. 30, 2008) (the "Merger Order").

[5] *In re Puget Holdings LLC & Puget Sound Energy, Inc.*, Docket No. U-072375, Order 08 Approving and Adopting Settlement Stipulation; Authorizing Transaction Subject to Conditions, at page 152 (Dec. 30, 2008) (the "Merger Order").

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

A. No. PSE's requested debt and equity costs are no higher than such costs would have been assuming PSE‘s credit ratings by S&P and Moody's in effect before the impact of the Merger closing and applying those credit ratings to the now-current debt and equity markets. The Commission's clarification to use the credit ratings in effect "on the day before the transaction closes" assumes the rating agencies would take any action concurrent with the transaction closing when in fact the agencies took action in anticipation of the transaction closing. As discussed above, PSE is not requesting recovery of any costs of debt or equity capital that are higher than they would have been absent the Merger.

Q. Is PSE requesting rate recovery in this proceeding for any long-term debt costs that need to be reviewed in light of this commitment?

A. Yes. PSE is requesting recovery of the costs of the $250 million 6.75% senior secured note that was issued in January 2009 in this proceeding.

Q. Please summarize PSE's approach to determine if the cost of this issue was no higher than it would have been absent the Merger.

A. PSE used a "comparable company" approach as contemplated in the Eighth

Condition addressing Merger Commitment 24. In doing so, PSE studied conditions that were "then-current" in the debt capital markets

There were seventeen utility related bond issues between December 1, 2008, and January 20, 2009—the date of pricing of PSE's most-recent long-term debt issuance. Of this group of seventeen utility related bond issues, one was issued by a holding company (FPL Capital Group) and sixteen were issued by utility operating companies. PSE excluded the holding company issuance and selected the three utility operating company issuances (i) of utility operating companies that had the same credit rating as PSE test year credit rating and (ii) that were secured by a first mortgage security interest. Please see Exhibit No. ___(DEG-8) at page 1, lines 37 through 39, for these three issues.

Each of these three issues had a 5-year maturity, which is two years shorter than the PSE issue. The average coupon of these three securities was 7.94%, which reflected a spread, on average, of 634 basis points over the 5-year U.S. Treasury security. PSE's issue had a coupon of 6.75%, which reflected a spread of 480 basis points over the comparable term U.S. Treasury security. Please see Exhibit No. ___(DEG-8) at page 1, line 35, for the coupon rate of the PSE issue. Thus, PSE's issue was priced at a lower spread over a comparable term U.S. Treasury security, was issued with a lower coupon, and will be outstanding for two years longer than these other utility issues.

Q. What does this analysis suggest?

A. This analysis suggests that the Merger likely resulted in a lower cost of long-term debt for this issue. The issue was less expensive, in part, because S&P increased PSE's credit rating as a result of the then-anticipated Merger.

Q. Have the savings associated with the upgrade in the S&P credit ratings for PSE been quantified?

A. Yes. According to an analysis conducted by Barclays Capital, the rating upgrade resulted in a 12.5 to 32 basis point savings attributable to the upgrade to PSE's credit ratings by S&P in anticipation of the Merger. Please see Exhibit No. ___(DEG-8), at pages 2 through 18, for copies of Barclays materials. For this $250 million issue, the 12.5 to 32 basis point savings attributable to the upgrade to PSE's credit ratings by S&P in anticipation of the Merger results in average annual savings of between $312,500 and $800,000. Over the life of the issue, the total savings are between $2.1 million and $5.6 million. Furthermore, it is reasonable to expect that future PSE issues will also be less costly because of the S&P upgrade to PSE's credit ratings attributable to the Merger and because higher rated securities can be expected to be priced at a lower spread than lower rated securities, all else being equal.

Q. How does PSE interpret the Eighth Condition of the Merger Order, which clarifies Merger Commitment 24 (among other Merger Commitments), which relies on PSE‘s credit ratings by S&P and Moody‘s in effect on the day before the transaction closes?

A. It is PSE's understanding that the intent of the Commission in the Eighth Condition of the Merger Order to protect against the possibility that credit ratings agencies would downgrade PSE's credit ratings as a result of the Merger. Indeed, the Eighth Condition of the Merger Order fails to mention the possibility of a possible upgrade in PSE's credit ratings as a result of the Merger.

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

A. Yes. S&P and Moody's each changed or affirmed its credit ratings for PSE in the interim period subsequent to the issuance of the Merger Order on December 30, 2009, and prior to the closing of the Merger on February 6, 2009. S&P upgraded PSE's credit ratings on January 16, 2009, as shown in Table 9 below:

TABLE 9
S&P CREDIT RATINGS FOR PSE

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

Additionally, Moody's affirmed PSE's ratings and improved PSE's ratings outlook from negative to stable on February 3, 2009. Therefore, PSE interprets the reference to PSE's credit ratings in effect "on the day before the transaction closes" in the Eighth Condition of the Merger Order, which clarifies Merger Commitment 24 (among other Merger Commitments), as references to PSE's credit ratings that were in effect on January 15, 2009–the day before S&P upgraded PSE's credit ratings in anticipation of the closing of the Merger.

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

A. Yes. PSE's long-term debt costs are no higher than such costs would have been assuming PSE's credit ratings by S&P and Moody's in effect on January 15, 2009, and applying those credit ratings to current debt markets. All but one issue of PSE's existing long-term debt issues were issued prior to the issuance of the Merger Order and the closing of the Merger. Therefore, the Merger did not have an impact on the cost of those issues whatsoever.

PSE issued $250 million of 7-year senior secured notes in the interim period subsequent to the issuance of the Merger Order and prior to the closing of the Merger. (The notes were priced on January 20, 2009, and the transaction closed on January 23, 2009.) As discussed above, S&P upgraded PSE's credit ratings on January 16, 2009, in anticipation of the closing of the Merger. As a result of this upgrade, the $250 million of 7-year senior secured notes issued in January 2009 was priced at a lower cost than other secured utility bond issues of companies with credit rating identical to PSE's credit rating on January 15, 2009. Please see Exhibit No. ___(DEG-8) for this analysis that demonstrates that PSE's long-term debt costs are no higher than such costs would have been assuming PSE's credit ratings by S&P and Moody's in effect on January 15, 2009, and applying those credit ratings to current debt markets. This analysis demonstrates that PSE has satisfied Merger Commitment 24.

B. PSE's Capital Structure Includes a Common Equity Ratio of Not Less than 50 Percent, in Compliance with Merger Commitment 35

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

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

> as of the closing of the transaction (or within sixty (60) days thereof), PSE will have a common equity ratio of not less than 50 percent. Joint Applicants commit that at all times thereafter, PSE

> will have a common equity ratio of not less than 44 percent, except to the extent a lower equity ratio is established for ratemaking purposes by the Commission.[6]

Q. Did PSE have a common equity ratio of not less than 50 percent within sixty (60) days of the closing of the Merger?

A. Yes. As discussed above and shown in Table 2 above, PSE's actual capital structure on March 31, 2009, included a 52.9% equity ratio. Additionally, PSE's consolidated capital structure, without regulatory adjustments, on March 31, 2009, included a 50.2% equity ratio. Therefore, PSE's capital structure includes a common equity ratio of not less than 50 percent, and PSE complies with Merger Commitment 35.

VII. CONCLUSION

Q. Does that conclude your direct testimony?

A. Yes, it does.

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[6] *See* page 7 of Appendix A (Multiparty Settlement Stipulation) to *In re Puget Holdings LLC & Puget Sound Energy, Inc.*, Docket No. U-072375, Order 08 Approving and Adopting Settlement Stipulation; Authorizing Transaction Subject to Conditions, (Dec. 30, 2008) (the "Merger Order").