BEFORE THE WASHINGTON UTILITIES AND

TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND)
TRANSPORTATION COMMISSION,)
)
Complainant,)DOCKET NO. UE-060266
vs.)DOCKET NO. UG-060267
)
PUGET SOUND ENERGY, INC.,)Volume IV
)Pages 226-431
Respondent.)
________________________________)

A hearing in the above matter was held on September 19, 2006, at 9:30 a.m., at 1300 South Evergreen Park Drive Southwest, Room 206, Olympia, Washington, before ADMINISTRATIVE LAW JUDGE DENNIS MOSS and CHAIRMAN MARK SIDRAN, and COMMISSIONER PHILIP JONES, and COMMISSIONER PATRICK OSHIE.

The parties were present as follows:

THE COMMISSION, by ROBERT D. CEDARBAUM, Assistant Attorney General, 1400 South Evergreen Park Drive Southwest, Post Office Box 40128, Olympia, Washington 98504-0128, Telephone (360) 664-1188, Fax (360) 586-5522, E-mail, bcedarba@wutc.wa.gov.

THE PUBLIC, by SIMON J. FFITCH, Assistant Attorney General, 900 Fourth Avenue, Suite 2000, Seattle, Washington, 98164-1012, Telephone (206) 389-2055, Facsimile (206) 389-2058, E-mail simonf@atg.wa.gov.

Deborah L. Cook, RPR, CSR

Court Reporter

PUGET SOUND ENERGY, by KIRSTIN S. DODGE, Attorney at Law, Perkins Coie, LLP, 10885 Northeast Fourth Street, Suite 700, Bellevue, Washington 98004, Telephone (425) 635-1407, Fax (425) 635-2407, E-Mail kdodge@perkinscoie.com; and by JASON KUZMA, Attorney at Law, Perkins Coie, LLP, 10885 Northeast Fourth Street, Suite 700, Bellevue, Washington 98004, Telephone (425) 635-1407, Fax (425) 635-2407, E-Mail, jkuzma@perkinscoie.com.

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES by S. BRADLEY VAN CLEVE, Attorney at Law, Davison Van Cleve, 1000 Southwest Broadway, Suite 2460, Portland, Oregon, 97205, Telephone, (503) 241-7242, Fax (503) 241-8160, E-mail mail@dvclaw.com

FEDERAL EXECUTIVE AGENCIES, by NORMAN J. FURUTA, Attorney at Law, Department of the Navy, 2001 Junipero Serra Boulevard, Suite 600, Daly City, California, 94014-1976, Telephone (650) 746-7312, Fax (650) 746-7372, E-Mail norman.furuta@navy.mil.

INDEX OF EXAMINATION

INDEX OF EXAMINATION

INDEX OF EXHIBITS

INDEX OF BENCH REQUESTS

PROCEEDINGS

Tuesday, September 19, 2006 at 9:43 AM

JUDGE MOSS: We will go on the record in about two or three minutes.

Good morning everyone. Hope everyone had a pleasant evening.

Let me ask if there are any new appearances. First, Mr. Kuzman.

MR. KUZMAN: Jason Kuzman on behalf of Puget Sound Energy.

JUDGE MOSS: Anyone else wanting to make an appearance on the bridgeline? Hearing none, then we will proceed to our first witness, Mr. Valdman. Welcome.

THE WITNESS: Good morning.

JUDGE MOSS: Ask you to please rise, and raise your right hand.

BERTRAND VALDMAN,

produced as a witness, having been first duly sworn, was examined and testified as follows:

JUDGE MOSS: Thank you. Please be seated.

And I should have asked if there were any preliminary matters before we take our witness.

MR. CEDARBAUM: One preliminary matter with respect to a cross exhibit for Mr. Valdman. Ms. Dodge provided a replacement page, page 1 of Exhibit 465, and apparently there were some errors on what was previously distributed. I don't think that's going to be a problem. I just ask Staff to double-check with the Company as to the source of the changes and reason for the changes, so I'm not expecting that to be an issue.

JUDGE MOSS: We don't have that as of this moment?

MR. CEDARBAUM: You have the corrected version from the Company. It's just a replacement page for page 1.

JUDGE MOSS: It's marked PSE, Corrected Version, correct?

MR. CEDARBAUM: And I want to indicate that when I offer that, I would at least like to -- I haven't had a chance to make sure that Staff understand the reason for the corrections.

JUDGE MOSS: We will consider it with that caveat in mind.

Anything else?

Mr. Valdman has been sworn. Your witness, Ms. Dodge.

DIRECT EXAMINATION

BY MS. DODGE:

Q Mr. Valdman, would you please state your name and title, and spell your name for the court reporter?

A Bertrand A. Valdman, V-a-l-d-m-a-n. My title is senior vice president, finance.

JUDGE MOSS: You need to press your microphone button.

THE WITNESS: My title is senior vice president, finance, and chief financial officer.

Q BY MS. DODGE: Do you have before you what have been marked for identification as Exhibits 451 C through 463?

A I do.

Q Are these your prefiled direct and rebuttal testimonies and related exhibits in this case?

A Yes, they are.

Q Were they prepared on your direction and supervision?

A Yes, they were.

Q Are they true and accurate, to the best of your knowledge and belief?

A Yes.

MS. DODGE: Thank you, Your Honor. Puget Sound Energy offers Exhibits 451 C through 463, and offers Mr. Valdman for cross-examination.

(EXHIBIT OFFERED.)

JUDGE MOSS: Thank you. Hearing no objection, those will be admitted as marked.

(EXHIBIT RECEIVED.)

JUDGE MOSS: Mr. Cedarbaum.

CROSS EXAMINATION

BY MR. CEDARBAUM:

Q Good morning, Mr. Valdman.

A Good morning.

Q Looking at your rebuttal testimony, 456, page 6?

A Okay. Just a minute.

Q And it's Exhibit 457 C, also your Exhibit 7 CT.

A Page No. 6?

Q 6. Do you have that in front of you now?

A I do.

Q And on this page you discuss the topic in your rebuttal testimony concerning the current capital spending needs?

A Yes.

Q And he shows planned expenditures total $850 million?

A Yes. Between delivery and the Wildhorse project, as well as the Chelan contract payment.

Q Is it correct that the Company's construction expenditures will decline in 2007 and 2008 relative to 2006 levels?

A We don't know the answer to that. And let me address it specifically in two components. We have a delivery component, and those go to 500 million, based on our current estimates.

And in terms of new generation, we're in the process of executing the RFP related to our lease cost plan. We have identified six resources, and depending on which resources we're ultimately able to acquire, that will drive the capital expenditures. So it may well be that the capital expenditures are more in 2006. We simply don't know.

And the key factor is resources. But what we do know is delivery and other will be higher in

2006.

Q The key factor being resources. With respect to generation of resources, the Company does have the power cost on the rate case process to address recovery of those costs, doesn't it?

A It does have that six-month process, correct.

Q And would you accept, subject to your check, that in the presentations to the bond rating agencies that Mr. Gaines presents in his Exhibit 13 C, that those presentations show construction outlays to be declining in 2007 and '08, below 2006 levels?

MS. DODGE: Objection; this is not an appropriate subject to check. The witness could be shown to the exhibit.

JUDGE MOSS: Let's provide the witness a copy. Can you do that?

MR. CEDARBAUM: It's Exhibit 143 HC. I don't have an extra copy, if the Company can provide that.

JUDGE MOSS: The Company is searching for that now.

THE WITNESS: (Reading document.)

Q BY MR. CEDARBAUM: Do you have that?

A I have the testimony of Mr. Gaines. Where is the schedule?

Q It's been marked as Exhibit 143 HC. It's page 16 of that exhibit, which is on a confidential yellow piece of paper. And just for clarification purposes, what I have directed your attention to is included in the Company's rating agency presentation for December 2005; is that right? If you look at page 4 of the exhibit.

A That's correct.

Q Now, flipping back to page 16, the line, Capital Expenditures, about the middle of the page -- and, again, without addressing any of the specific numbers, what is shown there for 2007 and 2008 is lower than the amount shown for 2006; is that right?

A That's correct. Though, I would like to point out that this was reviewed with the rating agencies in 2005, and our capital expenditure plans change, and our perspective on future capital expenditures change as well. And, again, the large determinant here of declining CAPX is assumptions related to resources, and those are opportunity driven.

So in December 2005 we would not have

necessarily had the same visibility on resource opportunities as we do today.

Q I am looking at Exhibit 459, which is one of your exhibits. You have included several equity analyst reports regarding Puget; is that right?

A Yes.

Q And am I correct that all of the equity analysts that you have included in your exhibit recommend that their subscribers either hold or buy Puget stock?

A Yes.

Q So none of them recommend that they sell Puget stock?

A Yes. When a stock is undervalued, you can either buy it or hold it. And I think all of these research reports, based on their analysis, would say that we're undervalued; which is, the buy or hold is enough uncertainty for them to recommend a sell.

Q If I could have you look at Exhibit 464, which was one of our cross exhibits of you. Do you recognize this as your response to Staff Data Request No. 398?

A I do.

Q And on the second page of the exhibit, as

your response to part A, you indicate that the above quoted comment, which is sort of a summary section with respect to the Company's opportunity to earn at those rates of return, summarizes later testimony, and refers to utility operations earning the allowed return on equity. Do you see that?
A Yes.
Q So if you were to turn to page 26 of your rebuttal, Exhibit 457 C.
A Hold on.
Q And it's page 26 of your rebuttal testimony.
A Yes.
Q You have a section at the bottom under the heading of earned ROE?
A Yes.
Q And you also reference on line 9 of that page an 8 percent ROE?
A That's correct.
Q And so now if we were to turn to Exhibit 465 --
A (Complies.)
Q Do you recognize Exhibit 465 as your underlying workpaper by which you derive that 8 percent figure in your testimony?

A Yes. Mr. Cedarbaum, you asked earlier to have us clarify the correction we made. Would you like me to do that now?

Q I prefer you to do that off the record, because I prefer Staff to be directly in that --

JUDGE MOSS: Let's pause for half a second.

(Discussion off the record.)

JUDGE MOSS: All right. Mr. Cedarbaum, you can go ahead now.

Q BY MR. CEDARBAUM: Yeah. On the right-hand side of the page the sources for the numbers on the left, to the left of the sources is indicated; is that right?

A Correct, the annual report.

Q So, for example, on page 1 of the exhibit the net income amount for 2005 of 146.7 million would tie to the second to last page of the exhibit on page 5, the last number in the column under 2005?

A Yes. And that would be the net income for Puget Sound Energy.

MR. CEDARBAUM: Thank you.

Your Honor, I would offer, if I haven't already, Exhibit 464. And subject just to the clarification between Staff and the Company on the corrected page 1 of 465, I would offer 465 with the opportunity to just address that later if we can't understand the source of the corrections.

THE WITNESS: And, Mr. Cedarbaum, it's a very minor correction, so it doesn't change at all the substance of what is on this page. And we will be happy to review that with Staff.

Q BY MR. CEDARBAUM: Why don't you go ahead then?

A In the calculations of PSE equity, the $60 million preferred stock was included incorrectly. So what we adjusted was we backed out the 60 million firm equity. So just to flow it through, where you see average the 2.6 percent net earning in the original exhibit, it's now 2.5. It's a 10 basis point difference.

MR. CEDARBAUM: Again, I don't want to belabor this. I just want to consult with Staff.

(EXHIBIT OFFERED.)

JUDGE MOSS: 464 and 465 have been offered. Any objection?

MS. DODGE: No.

JUDGE MOSS: Hearing none, they will be admitted.

(EXHIBIT RECEIVED.)

MR. CEDARBAUM: Those are all of my questions.

JUDGE MOSS: Mr. ffitch, I believe you have some questions for Mr. Valdman.

MR. FFITCH: Yes, thank you, Your Honor. My examination will be shorter because Mr. Cedarbaum covered an area.

CROSS EXAMINATION

BY MR. FFITCH:

Q Good morning, Mr. Valdman.

A Good morning, Mr. ffitch.

Q Could you please take a look at your Exhibit 459, which is BAV 9 to your rebuttal?

A Yes.

Q And look at page 1 after the cover page.

A Is that the J.P. -- Puget Energy, J.P. Morgan Equity Research Report?

Q Yes.

A Yes.

Q Now, on the first bullet point on that page, J.P. Morgan accurately reports the Staff recommendation on revenue requirements, does it not, and refers to a rate decrease relative to the PCORC rates?

A Yes.

Q I used the acronym PCORC, that's the power cost only rate case, correct?

A Yes.

Q Now, if you look at the bullet point at the bottom of the page the report reads, we would expect PSE shares to trade lower off the worse than expected recommendations from the WUTC Staff, correct?

A Yes.

Q And do you know the date the Staff testimony was filed?

A Not off the top of my head, no, sir.

Q It's obviously a matter of record in this case. This report refers to it as being filed -- this report is dated July 26, it refers to it as being filed the day before -- the night before, correct? Is that right?

A I would assume so.

Q Do you know what the Company's closing share price was on the trading day just before this testimony was filed?

A It was higher than 22.33 which was the

date of the report. It was 22.40 and some change.
Q Up?
A So the prognosis that we would expect PSE shares to trade lower was not correct. And I think if you read further in the exhibits you would find that the ** ANOS community appropriately stated that it's not Staff that determines revenue, but the Commission, that it's only the beginning of the process. So that trading behavior would be therefore consistent with the substance of most of these research reports here.
Q And do you know what the closing price on PSE stock was on last Friday, September 15?
A No.
Q Would you --
A But I can tell you that I tracked the share price very closely, and it's not a hard question given that over the last three years Puget has basically traded in the 20 to 50 range, which incidentally is -- trails the Philadelphia Utility Index by about 60 percent.
Q Would you accept, subject to check, that the price at closing on Friday, September 15 was $22.46?
MS. DODGE: I object that this is an

inappropriate subject to check. If Mr. ffitch would like to refer the witness to a document, we can look at it.

JUDGE MOSS: Overruled.

THE WITNESS: That sounds correct.

Q BY MR. FFITCH: So it's correct, as you have acknowledged, that J.P. Morgan was wrong and the stock has traded up and not down since the Staff case was filed?

A It's traded up by 30 cents. And, again, I would like to emphasize a couple of things. One is that the financial community looks at the longer term trading performance. This was dated in July, so it was several months ago. So whether it trades at 22.64 or 22.33 or 22, it's generally within the same trading range.

And, again, the reason that is is because the financial community has correctly stated that it is the Commission, not the Staff, that determines rates in this case, and, therefore, is waiting for a final ruling.

Again, what I would like to emphasize is that if you take a look at a one-year or a three-year or a five-year perspective, and compare Puget's trading performance to its peers, we have consistently underperformed.

Q Can I ask you to turn to page 10 of the same report, please? This is still Exhibit 459, the J.P. Morgan report?

A I only have for that exhibit, Mr. ffitch, the first 4 pages. This is the DA Davidson report.

Q I am sorry. I apologize. You are correct.

A And that's dated July 26?

Q Yes.

A Okay.

Q At the bottom of the page, do you see the statement, very last statement on the page, "At the current price we are maintaining a buy rating"?

A Yes.

Q So this was released after the Staff case was filed, correct?

A Yes. And offers a different perspective.

Q And in the paragraph above that paragraph Davidson refers to the Staff case on the power cost adjustment mechanism, the PCA, correct?

A Yes.

Q Is there anything negative reported about the Staff position in this report on the PCA?

A No. It's really just outlining our

position; in other words, it's factual.

Q I think one more question, Mr. Valdman. Can you tell us what Puget Sound Energy's current book value is per share?

A $18.

Q $18 exactly?

A Yes. Approximately $18.

MR. FFITCH: Thank you. I don't have any further questions, Your Honor.

JUDGE MOSS: Thank you, Mr. ffitch.

MR. FFITCH: I would like to offer Public Cross Exhibits 465 through 470.

(EXHIBIT OFFERED.)

JUDGE MOSS: I have you down as 466. We already have 465 in the record.

MR. FFITCH: You are correct, Judge. 466 through 470, and 771 and 772.

JUDGE MOSS: Any objections? Apparently not, so those will be admitted as marked.

(EXHIBIT RECEIVED.)

JUDGE MOSS: Mr. Van Cleve, you have indicated some cross for this witness.

MR. VAN CLEVE: Thank you, Your Honor.

CROSS EXAMINATION

BY MR. VAN CLEVE:

Q Mr. Valdman, can you refer to page 2 of your rebuttal testimony?

A (Complies.)

Q And if you look at line 10 through 16, you offered three points, I guess, in criticism of Mr. Gorman's ROE recommendation; is that correct?

A Yes, I did.

Q And the first point is that the recommendation is below PSE's authorized current ROE?

A That's correct, by 40 basis points.

Q Would it be appropriate to set ROE lower than current ROE if PSE's cost of capital has declined?

A There's more that needs to be considered. And I believe Dr. Morin will quite thoughtfully address that. But ROE needs to address risk, the ability to earn an actual ROE. So there are a number of other factors that need to be considered when you factor in a portion of ROE.

Q Your second criticism is that Mr. Gorman's recommended ROE is below the average authorized by regulatory commissions since January 1, 2005; is that right?

A And that's correct. And that's 10.5 percent.

Q Now, is the average of all ROE, is that a basis upon which Commission has set ROE in the past?

A I'm not an expert on how this Commission has set ROE, so I can't fully answer that. But what I can tell you is that is one way that the financial community looks at the probability of the ROEs. And my point for putting it in this testimony is just that. And that is, while we have the specific circumstances of what the appropriate ROE is for the Company, and that will be addressed quite thoroughly by Dr. Morin, if you take a look at the financial community, they go to the precedent of other commissions and make their assumptions.

So in the various equity research reports that Mr. ffitch took me through, you will find that a number of the financial analysts from the brokerage firms will make some 2006 assumptions based on ROE. That is largely based on what other commissions have done in combination with what their perception of our risk is.

Q Is it true that the average of all utilities include utilities that have different business risk from Puget's?

A Absolutely. And that's why it's very dangerous to look at averages, and why you have to explore the specific circumstances of the particular utility. And ours are really unique if you consider the commodity price risk, the capital expenditure program, our capitalization of 2.6 billion versus future capital requirements of 2 billion.

If you consider the imputed debt related to the hydroelectric contracts, the seasonality of our business, which we are a winter-peaking utility only. So there are a number of other factors. And you are absolutely right. It's important to consider those.

Q Your third point was that the recommended ROE was below the average of Mr. Gorman's comparable group; is that right?

A Yes.

Q And is it your understanding that ROE is generally determined by taking a simple average of the comparable group?

A Again, it's one measure. I think you earlier correctly identified the appropriate way, and that is really to very carefully consider the business risks and of a particular utility, and factor those in in the calculations of an ROE. And most importantly is a utility's ability to actually earn that ROE. Which is, as you might -- as we discussed yesterday, the substance of our case here.

Q You also criticize ICNU for opposing the Company's proposed revisions to the power cost adjustment mechanism; is that right?

A Yes.

Q Are you aware that Mr. Gorman considered the current state of the power cost adjustment mechanism in determining his recommended ROE?

MS. DODGE: Objection; they are asking the witness to speculate as to what is in Mr. Gorman's mind.

JUDGE MOSS: Well, I would assume if it's not in Mr. Gorman's testimony, the witness couldn't answer it. But since the witness is responding to Mr. Gorman's presentation, I think he can answer so I will overrule the objection.

THE WITNESS: Could you ask the question

again?

Q BY MR. VAN CLEVE: Maybe I can point you to a document and make it easier. That would be helpful.

Let me ask you this first: Would adopting the changes to the PCA mechanism that the Company is proposing reduce the Company's operating risk from what it is today?

A Today we have one level of exposure. I think the PCA adopting it would compare to a -- compared to the proposal, yes, it would address, it would reduce the risk slightly, yes.

Q So that means that keeping the PCA as it is today would not change the Company's current operating risk?

A No, that's not true, because the PCA today does not have a $40 million cap, which the Company has had for the last four years. So the PCA that we have today is a very different type of PCA than we have had in the past. And that has been raised pretty consistently by a lot of the financial research.

And frankly, it's a subject in many of these exhibits that were flagged. It's a subject that the rating agencies address quite thoroughly.

And that is the ability of a utility to be able to recover prudent expenditures with respect to power costs. And then you need to take your judgment in terms of what is the Company's ability to absorb power cost.

And I think I have listed the unique circumstances of Puget. It would be very difficult for us to absorb the full amount, given our current situation.

Q But my question is whether leaving the mechanism as it is today would change current risk.

A Well, the mechanism as it is today is a truncated mechanism. It's not the mechanism that would be in effect on January 1, 2006. So I am struggling with the question.

Q Why wouldn't it be in effect?

A Because for the six months we have less commodity exposure. I guess if you analyze what we have now, it would be the same mechanism, but it doesn't have a cap so it's a very different mechanism than we have had. So it would change our market risk profile, because the market has always understood that we have a $40 million cap in place.

Q But the Company has not had a $40 million cap in place on the PCA since July 1; is that correct?

A But there's the anticipation of something new, that's correct.

Q Would you refer to Exhibit 348, which is an ICNU cross exhibit.

MS. DODGE: Who is the witness for that? Who is it listed under?

JUDGE MOSS: The 300 series is not Mr. Valdman.

MR. VAN CLEVE: It's listed under Dr. Morin.

JUDGE MOSS: Give us a minute.

MS. DODGE: PSE objects to reference to Exhibit 348. This is an ICNU response to a PSE data request. The witness at the bottom of the page is ICNU's cost of capital expert, Michael Gorman. This is introducing supplemental direct testimony into the case by Mr. Gorman.

JUDGE MOSS: Well, Mr. Gorman is not on the stand, so we're having Mr. Valdman's testimony. So let's hear the question first, and then we will see if there's an objection.

So, Mr. Valdman, pause and give your counsel a chance to see if she has an objection to whatever the question is.

Q BY MR. VAN CLEVE: Have you seen this data response?

A No, not until now.

Q In this response to the PSE data request, Mr. Gorman explained that his ROE for PSE is based on PSE's current operating and financial risk. He also stated that the S&P business profile --

MS. DODGE: Objection. Counsel is now reading into the record supplemental direct testimony by Mr. Gorman. That's essentially what this is. Mr. Gorman had the opportunity to support his opinions. The Company then had an opportunity to rebut. This is a subsequent data request response.

JUDGE MOSS: Well, I don't view it the way you view it, Ms. Dodge. It's not supplemental testimony by Mr. Gorman now.

If counsel wishes to introduce this as an exhibit through his witness, I suppose we might give him the opportunity to do that. I don't know. But let's find out what his question is before we find out what the objection is.

He may simply want to ask the witness whether the witness understood Mr. Gorman's testimony that way. This witness does rebut

Mr. Gorman's testimony, so he's entitled to inquire about that.

Go ahead, Mr. Van Cleve, finish the question.

Q BY MR. VAN CLEVE: To tell you where I'm referring to, it's in response to --

JUDGE MOSS: Ask your question without reference to the document, Mr. Van Cleve, and see if the witness understands what it is you are asking about.

Q BY MR. VAN CLEVE: Mr. Gorman stated that "The S&P business profile scores for PSE considers" --

JUDGE MOSS: Is this in his testimony?

MR. VAN CLEVE: No, it's in the data response.

JUDGE MOSS: Well, I asked you to ask your question without reference to the document. Can you do that?

MR. VAN CLEVE: Yes.

Q BY MR. VAN CLEVE: Would you agree that the S&P business profile score for PSE considers current business risk, including regulatory mechanisms like PCA?

A Yes.

Q Would you also agree that a PSE's current business profile score of 4 reflects the current PCA without a cap?

A No.

Q Why is that?

A Because they assign before, when PCA had a cap, very simply. I think that S&P, like Moody's, like many of the other equity research firms are waiting for final ruling in this case. And based on that final ruling, they will go back and reassess their 4 business ratings.

These business ratings, buy and sell, these are constantly reviewed based on new circumstances. And I would argue that we have obviously a new body of information for the financial markets to consider after this case.

Q Wasn't it a new circumstance when the $40 million cap went away in July?

A No, because it was part of this proceeding. Again, rating agencies consider forward looking metrics. The evidence that Mr. Cedarbaum introduced based on our rating agency presentation, what we do with the rating agencies is meet with them annually. We take our most recent 5 and 10 year plan and that is forward looking and review it with them. So rating agencies think of forward looking metrics, and they won't adjust until circumstances have been clarified. This is an important circumstance.

Q Are you aware that the average business profile score for Mr. Gorman's comparable group was 5?

A I was not aware of it, but doesn't surprise me.

Q Does a score of 5 reflect a higher business risk than a score of 4?

A Yes. But, again, as you pointed out, Mr. Van Cleve, the business risk of individual companies seem to be carefully considered. So you could well have a business position 5, and have a different power recovery mechanism than someone who has a business position 4, and no ability to recover power costs or vice versa.

Q If you could refer to page 7 of your rebuttal testimony.

A (Complies.)

Q At line 6 you state, "We're fortunate that borrowing costs are near all-time lows"; is that right?

A Yes.

Q And you also state that the Company's cost to borrow is currently less than 150 basis points over the Federal funds rate?

A Yes.

Q And is the spread between the cost of utility debt a different credit ratings also at a near all-time low?

A It is. And it's an interesting thing to take a look at, because essentially what you are asking and what this is telling us is that right now the market isn't really pricing for risk in the utility sector. That as a BBB minus company you could borrow at spreads of under 150 basis points. If you look at the historic trend, that wasn't always so.

What is very interesting to do, and this is publicly available on Bloomberg, is take a look at the spread between a single A company and a BBB company over time. What you find is that there's tremendous volatility if the companies that are BBB and below in terms of their ability to access low-cost capital in credit spreads. Credit spreads widen and narrow significantly, whereas if you're a stronger credit, credit spreads are more stable. And that is the basis on which we have made our commitment to strengthen our credit rating. That's precisely so we can continue to enjoy low credit spreads when we raise capital for our multi-billion dollar infrastructure program.

Q And do you know what the current spread is between debt cost for a BBB minus utility compared to a BBB?

A I don't know that, but that would be a great question for Mr. Gaines. We were recently in the market, and I am certain he has spread levels for BBB versus a BBB minus. But it continues to be quite attractive compared to historic levels.

And, again, I can tell you this: as a former banker, the financial markets are quite cyclical and you have periods of very tight credit. And during periods of very tight credit, when you are a BBB minus company, it's awful hard to borrow at a low cost. And that's where you want to be, in that BBB plus range where you can assure low cost access through good times and bad, through all sorts of business cycles.

Q Could you refer to page 10 of your rebuttal testimony?

A (Complies.)

Q Now, at lines 6 to 8 you criticize both

Mr. Hill and Mr. Gorman for failing to consider how their recommendations would affect the Company's capital investment program; is that right?

A Yes.

Q And a little later you talk about how they didn't address the Energy Procurement Program, right?

A Could you point me to that reference?

Q Sure. It's page 12, line 5.

A Okay.

Q Would you agree that the Company's credit rating is the most important factor that will affect its ability to make capital investments and continue its energy procurement program?

A It is one important factor. And just to outline both of them, I think the substance of my statement here is that we're doing -- it's in everyone's best interest, especially in the customer's best interest, to make sure we have the lowest cost of capital possible. That is both on the debt side, and on the equity side.

And the danger when you are a utility like ours that has negative cash flow, and billion dollar infrastructure requirements, where you rely on external markets, other people's money, essentially, to fund infrastructure needs that support SQI metrics and reliability, that you are -- you have to incur high prices for equity capital, and high prices for your debt capital.

So that's why you want to target a credit rating that is something that is a little bit better than the last rating before noninvestment grade. And on the equity side, you want to make sure that you trade with your peers and that you offer equity investors an attractive profile for future earnings.

And, again, I always like to say you can either pay for it now in the form of modest rate increases, or you pay for it later as a customer in the form of a very high cost of capital. And it's probably cheaper to pay for it now in thoughtful returns, whether its an ROE, whether it's some of the mechanisms we have proposed.

Q If you can now refer to page 14 of your rebuttal testimony, there's a table at the top of the page.

A (Complies.)

Q Didn't Mr. Gorman recommend an ROE range of 9.6 to 10.45 with a mid point of 9.9?

A I am sorry. You are referring to which page?

Q The table at the top where it purports to show a range that Mr. Gorman recommended.

A I have a low of 7.38 and a high of 12.58 with an average of 10.2.

Q Wasn't his testimony 9.6 to 10.45 with a recommended ROE of 9.9?

A Subject to check, I will have to take your word for it. I don't have his testimony in front of me.

Q So --

A Perhaps Dr. Morin can address this in his testimony, because I know that he --

Q On line 16, on the same page you have a number, 10.20 percent, which you say is the average estimated returns on equity produced by Mr. Gorman's methodology. But didn't he recommend 9.9 percent ROE?

A Well, I do have the backup for my statement on line 16. And his average ROE, based on my calculations here, is -- let me review this for a second -- 10.2. I have --

Q Do you have Mr. Gorman's testimony in front of you?

A Well, I have the summary of Mr. Gorman's

ROE estimates, and this is my Exhibit BAV-8. So again, it's subject to check. We could always check this.

JUDGE MOSS: That's Exhibit 458 that the witness just referred to.

Q BY MR. VAN CLEVE: Do you have Mr. Gorman's testimony, Exhibit 471?

A I am happy -- if someone could hand it to me. I have his testimony.

Q If you could refer to page 22 of Exhibit 471 C, table 3 on page 22.

A (Reading document.) Okay.

Q Doesn't that show the recommended ROE range for Mr. Gorman is 9.6 to 10.4?

A This is something that I would prefer Dr. Morin address, because I'm looking at the table and it says constant growth discounted cash flow. Well, discounted cash flow is a very different measure than return on equity.

So based on this table, I'm not in a position to opine on your question. Again, if we're talking about ROEs, that's one measure, that's essentially a return measure, net income over some form of average over book equity.

If we're talking about discounted cash

flow, that's a very different type of financial measurement that involves future cash flows discounted back at a certain rate.

Q Well, looking at your Exhibit 458, which is BAV-8, the table at the bottom, Summary of Mr. Gorman's ROE Estimates.

A And, again, that's what the table says, Summary. But, again, I'm looking at the lines that say, Constant Growth DCF, so I'm a little stuck.

Q So you don't know where these numbers came from?

A Well, I think they clearly came from Mr. Gorman's testimony. But, again, I don't know if we're talking about ROEs or discounted cash flows.

Q Did you prepare this exhibit?

A It was prepared under my direction.

Q And it says, Summary of Dr. Gorman's ROE Estimates, right?

A Well, the exhibit says 10.2.

Q And you don't know where that came from?

A Well, it clearly came from Mr. Gorman's testimony.

Q Can you point me to where?

A You just pointed me to it.

Q Let's move on to page 18 of your rebuttal testimony.

A (Complies.)

Q If you look at line 16 on page 18, it says that "Mr. Gorman's focus on the average DCF cost of equity for a sample group of utilities understates the average authorized return on equity for those same utilities by 98 basis points."

A Yes. That's essentially the same point I just made, which is he took one financial measure, DCF. But if you take a look at the ROE's of those utilities, it's a different metric. We're talking apples and oranges.

Q Are you saying he performed the DCF calculation inaccurately?

A Not at all. Again, I would refer to Dr. Morin. He's in a better position to opine on whether it's accurate or not. I am just making the representation that it's a different measurement. That's all.

Q Is the purpose of DCF analysis to project the average ROE of the comparable group?

A I don't know what his purpose was.

Q Can you tell us what your experience is in presenting testimony on utility ROE?

A Well, I have presented this testimony -- I have presented testimony before, in our prior rate case. But I'm not -- I'm not the financial witness. Again, my responsibilities are, I am the chief financial officer. So my responsibilities are to fund, to ensure the Company secures funding, to communicate with the investor community.

We have a financial witness for this very reason, who is a specialist in presenting ROE testimony. That's not my function here, Mr. Van Cleve.

Q Referring to page 25 of your rebuttal testimony, you talk about the fact that the Company has issued in excess of $500 million in equity?

A That's right, about 25 million shares.

Q What time period was that issued over?

A From 2003 to the year-end, 2005.

Q And doesn't that demonstrate that the Company can attract capital?

A Well, there is some confidential information that would suggest otherwise. So, yes, we were successfully able to issue 25 million shares. But, frankly, our last issue was a struggle. And, again, that's an exhibit in my testimony that is marked confidential.

MR. VAN CLEVE: Thank you. That's all I have.

JUDGE MOSS: Thank you, Mr. Van Cleve. I think we should proceed. We have Mr. Furuta as the last counsel asking for cross-examination time with this witness, so let's go ahead and do that, and then we will let the witness go --

MR. FURUTA: I will be brief --

JUDGE MOSS: -- after bench questions.

CROSS EXAMINATION

BY MR. FURUTA:

Q Good morning, Mr. Valdman. I'm Norm Furuta for Federal Executive Agencies.

A Good morning, Mr. Furuta.

Q Now, in the Company's last three general rate cases before this Commission, didn't the Commission determine in its order in those cases that the rates set for Puget for both its gas and electric service, that those rates provided Puget with an opportunity to earn its authorized return?

A Could you restate the first part of the question?

Q Are we speaking about the last three

general rate cases of this company?
A Could you restate the question?
Q Is it your understanding that the Commission determined in the orders in those cases that the rates set for Puget for both its gas and electric service provided the Company with an opportunity to earn its authorized rate of return?
A I believe that's the intention.
Q And at the time of the cases Puget did not, and does not now, have a depreciation factor; is that correct?
A That's correct. And we have consistently not earned that rate of return that the Commission granted in the past rate cases.
Q In your rebuttal testimony, Exhibit 457, if we could turn to page 28 --
A (Complies.)
Q I believe at line 19 of that page.
A I am sorry. 457, exhibit --
Q Yes, the rebuttal?
A Let me just -- is it 457 C?
JUDGE MOSS: Yes.
THE WITNESS: What page?
Q BY MR. FURUTA: Page 28, and at line 19 I believe you testified that "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"; is that correct?

A That's correct.

Q I assume that this would apply in the past three general rate cases where the Company did not propose a depreciation factor; is that correct?

A Two points there, Mr. Furuta. One is that we were not able to earn our authorized rate of return after the last rate case. And two, the circumstances are somewhat different. We are looking at significant delivery infrastructure capital requirements. And there's no mechanism to recover the depreciation related to that.

So what we're bringing forward in this case is the fact that we have in rates, currently, $246 million depreciation. Our actual depreciation is 264 or so. Those are estimates for calendar year 2006. We're underrecovering by 18 to 20 million. Those are changed circumstances from the past rate cases. And this will continue, and will -- the underearning will get worse the more we bring in new delivery.

The Novelty Hill substation that my colleague talked about, that substation is currently in service. It was a $23 million capital cost. We're not earning our return, and we're not collecting depreciation in rates on that asset. That translates to roughly $2 million of lost revenue. This is the reason why we're here today in part.

Q If you turn to page 30 of the same exhibit, at lines 8 and 9, I believe you state that "Depreciation expense, when reflected in rates, provides a substantial source of cash flow." Do you see that?

A Yes. Depreciation is added back in the calculations of cash flow, correct.

Q Now, putting aside the depreciation factor for the moment, do you know how much depreciation expense for Puget's electric and gas utility service is being proposed to be reflected in rates in this proceeding by the Company?

A You know, I don't have that number. But what I cited earlier is in calendar year 2006 we're recovering depreciation rates of approximately 245 to 246 million, versus our actual depreciation of 264, so there is a gap.

And in calendar year 2005, we had $233 million of depreciation rates, and our actual expenses were 242. So that's what I can offer.

Q Referring now to page 32 of your rebuttal.

A (Complies.)

Q And looking at the first question and answer on that page, is it my understanding that instead of the depreciation tracker that the Company is agreeable to having the Commission address post-test year plant additions through a known and measurable adjustment to recognize nonrevenue producing, nonexpense reducing net T&D plant additions?

A We have added that as an alternative, yes. I think the key for us is that in some way we recover depreciation on a plant that is in service. And, again, I would like to offer this, and that is if -- I can relate to you, when I sit down and I meet with some of our investors, the question I often get asked is, why don't you ask for both depreciation and return on the new plant?

And, again, we want to be mindful of the impact on our customers. So what we're asking for here is just the depreciation. There still continues to be underearning, because we're not recovering that return on that plant that is in service.

Q And I presume from your testimony that you have read the testimony of our witness, Mr. Smith, about the alternative that he proposes regarding the known and measurable adjustment that he proposes?

A I may have skimmed it. I didn't read it thoroughly. Again, my focus was primarily on the more financial aspects of this case.

Q But I refer to, again, to page 32 of your testimony.

A Correct.

Q Where you refer to his testimony?

A Right. Right.

Q And you are saying that the Company is agreeable to that type of alternative proposal?

A We're open to ways of outside trackers to recover our depreciation. For us, really, it's a question of coming to the right balance between an appropriate ROE that reflects our risk and the ability to actually earn that ROE.

MR. FURUTA: Thank you, Mr. Valdman. I have no further question.

JUDGE MOSS: Thank you, Mr. Furuta. I have one quick question. When you said we're still just asking for the depreciation, were you referring to the depreciation tracker alternative or the additional rate base?

THE WITNESS: We're asking for recovery of depreciation, either through a tracker mechanism or some other mechanism, that would provide us economically a similar result.

JUDGE MOSS: But the alternative, are you asking return of and return on?

THE WITNESS: No. We're not asking for return on.

JUDGE MOSS: What's what I wanted to clarify.

THE WITNESS: We're clearly not asking for that.

JUDGE MOSS: Thank you. Give me just a minute.

(Discussion off the record.)

JUDGE MOSS: We're going to take our morning recess before questions from the bench, so let's take 10 minutes and be back five before the hour.

(Brief recess.)

JUDGE MOSS: Let's be back on the record.

And we're at the point where we have questions from the bench, so we will start with

Commissioner Jones.

EXAMINATION

BY COMMISSIONER JONES:

Q Good morning, Mr. Valdman. I will peer at you over her head.

A Good morning. I will move over.

Q Let me start on the issue of capital spending needs, and I asked some questions yesterday. I don't know if the Company has submitted anything for the record yet, so let me ask you verbally.

Is the most accurate representation of the Company's spending, is the $1.89 billion number, and you approximate that in your rebuttal testimony as $2 billion. Is that the most recent and accurate number for both T&D and resource acquisition?

A Yes, it is, Commissioner. And, in fact, you asked the question yesterday, and I do have a partial answer. And we will submit the completed spreadsheet, but -- is my microphone on?

JUDGE MOSS: I think so.

THE WITNESS: You asked the difference

between our 2004 general rate case and today, and we have an initial response for you. And we will provide the more complete data, but in terms of delivery operations, it is 22 percent higher this rate case versus our 2004 rate case, around say 20 percent.

And in the terms of non-new resource energy supplies, so this is maintenance related to our generation resource plant, it's roughly 90 percent higher. So when you add those two together, and, again, they are disproportionate. There is much more in delivery capital expenditures versus total supply -- it's a total increase of 3 percent versus our last rate case.

Q BY COMMISSIONER JONES: Mr. Cedarbaum asked you some questions on an exhibit that I guess you provided to the analysts in 2005. When was the last time you presented to the analysts on this specific -- well, on the topic I am most interested in is the capital expenditure budget from 2006 to 2008 or 2009?

A The most recent would be roughly two weeks ago I was in New York presenting much to investors in the Lehmann Energy Conference. And I explained in detail our capital expenditure plans, and the

tools we had to recover on those expenditures as well as the thoughts we had that we're proposing in this rate case.
Q When do you file your next 10Q in which you will update these numbers with the SEC? Is that sometime in the next couple of months?
A Yes. That will be -- the Q we'll file related to our third-quarter results.
Q Is it safe to say that the numbers you are quoting to the bench now will not be very different than what you file in the 10Q?
A Yes, that's correct. The number that we're not in a position to take a view on right now is capital expenditures related to resources for calendar year 2007. Again, we will see as we start working through the six projects that have been identified in our RFP process.
Q Thank you. That's it for capital expenditures.
On cash flow, could you give the bench a definition of free cash flow? I think in your rebuttal testimony you talk about a 2005, a negative free cash flow of $432 million. What is the definition of that? Is that funds from operation minus dividends?

A Yes.

Q And why is that -- why is there such a big difference between '03 and '04 going into '05 where, at least in your exhibit, you say you are significantly in the negative cash flow territory?

A A combination of factors. It starts with our ability -- what falls to the bottom line, and what we're not able to earn on. And then there are issues in calendar year 2003, I believe, there was accelerated depreciation, which most corporations were able to enjoy. So there were certain tax legislation impacts that increased cash flow, but these are running off. So here we are with a lower cash flow, so it's a variety of factors. And obviously it's, well --

Q Well, let me stop you there. Is that a new item, the accelerated depreciation?

A No. No.

Q Wasn't that present also in the 2004 rate case?

A No. No. It was present, Commissioner. I think what is new is the overall higher level of CAPX. I mean, that's really --

Q Could you provide for the -- let me ask you this way: I think Mr. Gaines deals with the financial metrics in terms of what you have to deal with Wall Street analysts on in terms of free FFO versus -- what is the proper acronym for FFO?

A Funds from operation.

Q Funds from operation, is a percentage of interest. Have you provided that to us yet on what the rebuttal case -- what your rebuttal case would be with the settlement entered into with the Staff? I think Mr. Gaines has some analysis of the metrics in his.

A I believe it's Mr. Gaines' testimony that addresses this.

Q So that is the most recent financial metrics analysis that we have?

A And, Commissioner Jones, to clarify your question on cash flow, when I meet with investors I frequently use a cash flow number that excludes -- in other words, it's before we pay dividends. So the number -- you just asked the question, when did you last meet with analysts. And in a number of those meetings we have identified our cash flow for calendar year 2006 as roughly $450 million, is the number we have been using. That's an important number because they use that in the total sources and total uses of funds for the Company. And gives some insight in terms of what our funding needs will be.

Q How many analysts cover Puget Energy right now?

A Approximately 10 or so. But what I would say is that a handful cover us very actively. And those are Lehmann Brothers, DA Davidson, J.P. Morgan, Key Bank. So we're very well covered by the financial community.

Q I think in early August you announced the second quarter earnings, did you not?

A Yes.

Q Is it safe to say you exceeded the expectations and estimates of most analysts on Wall Street? It was a good quarter for you, wasn't it?

A It was a very good quarter. And the reason it was a very good quarter is we over recovered power costs.

And I think that's part of the reason we're excited about the proposal we submitted on the PCA. And that is, had we had the proposal to share the first 25 million of 50/50 with customers, customers would have been able to benefit from a favorable hydroenvironment during the second quarter of this year.

Q Is the Company in that earnings conference call that you and the CEO participated in, are you still affirming your earnings guidance, EPS, your earnings per share estimates for calendar year 2006?

A And the guidance we provided was 140 to 150 per share.

Q What does that assume in terms of this Commission's rate case?

A It doesn't assume a thing, because it's for year 2005. We have not provided year guidance for calendar year 2006, although a number of those analysts that covered closely have put their projection out there. But that's not based on anything we have told them.

Q You had a conversation with counsel on DA Davidson's, on Mr. Valesse's (ph) opinion, especially the last paragraph, which covers the EPS estimate, and the valuation of the Company, did you not?

A Yes.

Q Would you agree that his is the majority opinion or the minority opinion in terms of the valuation of the Company in his earnings estimates?

A Well, he is one of the few that has a buy recommendation. Most other people have a more somber outlook.

Q What does somber mean?

A That means it's a hold.

Q In an exchange with, I think, Mr. Van Cleve on market conditions, you stated that market conditions are attractive, and will continue to be attractive based on things like interest rates, relative spread. Is that your statement for the record?

A No. I think marketing conditions have been attractive. We don't know what they will be. I'm certainly -- I wish I did. I would be in a much better position. But anyone in my position can hope they will continue to be as good as they have been, but we don't know.

Q You used to work for J.P. Morgan, did you not?

A Yes, I did.

Q Is there a shortage of investment bankers that are seeking your business, either on the equity side or debt side?

A No, there's not. The question is at what price. And I would prefer it to be a more attractive price to both customers and shareholders.

Q Mr. Gorman in his testimony talks about ways of reducing leverage. And obviously there are various ways, such as increasing retained earnings, issuing more common equity, et cetera. He recommends and talks about, in his testimony, the issuance of preferred securities, which is a lower cost way of issuing equity?

A Yes.

Q Could you respond to his idea?

A It's a good idea, and it's something we're very carefully considering. The issue with preferred securities is they are what we call in the financial community hybrids. Depending on their structure, you have either a little more or a little less equity treatment.

And so before financing with the hybrid, one has to be very careful that one understands the long-term implications of that. Sometimes positions change on structure, and you can end up with something that you thought you got a certain level equity credit, and three years later it's very different.

But the rules have been progressively clarified, and that is a very viable instrument that we're thinking very carefully about. And it would -- obviously we would get some equity credit at the cost of the debt, and that's always very attractive.

Q Mr. Gorman, in his testimony, also talks about off-balance debt risk. Is there any off-balance debt risk associated with the Company?

A Yes. There's imputed debt, and that's related to the hydro contracts. And that's something that is relatively unique for Puget, not that we have imputed debt. Many companies have power purchase agreements. But the level of our imputed debt, which, again, Mr. Gaines can take you through the exact numbers. But it's roughly $400 million.

And that weighs on our credit rating. And that is something, again, by acquiring resources slowly but surely we can address that and reduce our dependence on the PPAs and ultimately eliminate imputed debt.

Q You have been employed as CEO of the Company for how long now?

A Three years.

Q Is it a frustration to you that in spite of the improvements in common equity, reduced leverage and more favorable earnings, that you haven't been able to move the credit rating up from a BBB minus? And why, if you could opine on that, why have the credit agencies, the rating agencies not adjusted your credit rating, in your view?

A It has been frustrating, but I think the rating agencies -- and you see this in the write-ups, the Company has been quite thoughtful. And what they have addressed is some of the key financial ratios in a particular -- the ratios related to cash flow that are on the weaker side.

But more importantly they stepped back and a lot of weight is given to the regulatory recovery mechanisms available to us. And what they acknowledge is, yes, on one hand we have the ability to very efficiently recover on new generation, but on the other hand, we have the specter of increased commodity risk related to power costs. And we don't have the ability to recover on depreciation and environment where we're investing significantly.

So when you take a look at the balance, I think what they are saying is this company has a lot of risk. And therefore, we're not comfortable until we can better understand how the Company will actually recover, and bring some of the risk to the bottom line and will enhance these ratios, we're not comfortable upgrading.

And the other thing I would say is size-wise we're a relatively small company. And size is important to the rating agencies as a metric. You don't see that as a ratio, it's somewhat qualitative. But our firm value, which is our market capitalization plus our debt, is 4.6 -- it's under $5 billion. Which, in this sector, which is consolidating. We're tiny in the scheme of things. And we're a small company with big infrastructure needs, and a growing service territory which I, again, I think the rating agencies consider.

So that's my opinion on why we're where we are. It makes intuitive sense and we're working very hard to address the rating agency concerns. We issued as I mentioned before, we issued 25 million shares to strengthen our capital, our equity capital. So we're able to morph from 31 percent in 2002 to where we are today, which is around 43 percent. But we need to work on some of those other ratios, and some of the mechanisms that we have proposed will address that.

Q But wouldn't you agree that Mr. Valesse with DA Davidson is one of the most informed analysts, at least has been covering the Company for a long time, hasn't he?

A He has been covering the Company, and I have a tremendous amount of respect for Mr. Valesse.

Q And I would like to quote the final paragraph, and he believes the final decision in the rate case will be a compromise between what the Company, what you are asking and what the Staff's proposal -- he's maintaining his EPS estimate. He's valuing your shares at $25. And he's maintaining a buy rating on the Company. So shouldn't that opinion be given some weight?

A Like all opinions, it should be given some weight. And here we are sitting at $22.50, and it warms my heart that Mr. Valesse believes we will get to 25. And if it's through a thoughtful compromise, that's terrific.

COMMISSIONER JONES: Thank you.

JUDGE MOSS: Mr. Oshie, do you have anything?

COMMISSIONER OSHIE: I have no questions.

JUDGE MOSS: Chairman Sidran.

CHAIRMAN SIDRAN: Good morning.

EXAMINATION

BY CHAIRMAN SIDRAN:

Q I noticed in the Exhibit 459 in the first page related to J.P. Morgan -- which did I hear you say you used to work for J.P. Morgan?

A Yes. I started in 1987, and I worked all the way until I left to become a CFO of Puget.

Q We will simply note in the record you don't look old enough to have started with J.P. Morgan in 1987.

A I am very youthful, but thank you for the compliment. I get carded at stores all the time, and that makes me very happy.

Q I take it that refers to purchasing alcohol?

A Yes. Washington State lines. I am supporting the diversified economy of our State.

Q On behalf of the State, we applaud you.

A Thank you.

Q In this J.P. Morgan document it says in the second bullet point, we modeled a 10.5 ROE based on a 44 percent equity component. And given your familiarity with Wall Street and rating agencies, and how they go about things, when they say we modeled a 10.50 ROE based on a 44 percent equity component, what does that mean? When they model something, what are they doing?

A What they are doing is saying you, Puget, we have assumed a rate base of power of 4.2 billion. They are multiplying that 4.2 billion by 10.50 percent, and by the allowed equity of 44 percent. They divide by shares outstanding, and they come up with an earning per share number.

So what they are saying is, we are taking the view that you have asked for "X". Staff recommended Y, and other intervenors, and we're picking 10.5. And there's no surprise where they got the 10.5. They got it the same place I did in my testimony. They took a look, and took an average of what commissions have done across the country, and they came up with that number.

The 44 percent, no accident there. They are basically taking a view on where they think we will be, and came up with that based on where we are today, and what they think our capitalization plans are.

What is interesting here, and this is

highlighted as well in the Lehmann, when Lehmann takes a position on what 2006 earnings are -- and they go through similar calculations -- they assumed a 10.80 ROE. They assumed we earn perfectly on the 10.5. If you go through -- and I didn't do the math for J.P. Morgan, but I did for Lehmann, their 2006 of $1.63 assumes we will earn that 10.8, makes some additional assumptions for additional equity issuance, but that's the philosophy of how they come up with their earnings per share guidance numbers.

Q So do you think they make any assumptions with respect to the shares of the various mechanisms that the Company is proposing here, the depreciation tracker, decoupling, and so on?

A They are assuming that we will be able to earn the ROE, whether it's through mechanisms or whether it's a higher ROE with lag that we have incurred, historic lag. They go at it both ways.

I think what they are taking a view is A, what they believe a fair actual ROE is. And that in this report is 10.5 and Lehmann it's 10.68. But you have it bounded by the ranges of what other commissions have done.

Q And when Wall Street looks at the

companies, do they assume that you are earning your return, or do they actually look at the numbers such as you have presented to the Commission in order to discover that you purportedly are not earning your authorized rate of return?

A Part of our job is to explain why we don't earn our return. Obviously what we want to do is make sure that we're giving an accurate representation of our earnings power, and whether it's through Lehmann conferences or conferences like Lehmann, or whether it's through one-on-one meetings, we meet and we take analysts through why we get to our actual ROE.

And if you take a look at some of my materials that I have used in investor meetings, we break it down, and break it down component by component. So, yes, they understand what all of this is about. And what you are seeing is they are taking a view on what the actual is.

Q You mentioned your range of reasonableness calculations which reflects thoughtful reading of the Commission's prior orders. In that range, which is 10.2 to 10.9, roughly, do you think that where one ends up in that range would depend in part on whether and to what degree the Commission adopts these various mechanisms that the Company is proposing to improve cash flow and reduce risk?

A Yes. Again, I think the view is the assumption is made that within this range of reasonableness, the Company will have an opportunity to actually earn on that.

So if you don't have mechanisms, such as the depreciation tracker, or weather normalization, then the expectation would be that there would be a higher ROE to compensate for that.

Q And the converse would be true if one had those mechanisms?

A Right. As long as it fell into the range of reasonableness, correct.

CHAIRMAN SIDRAN: Thank you. That's all.

JUDGE MOSS: Before we ask about redirect, is there anything clarifying that anyone else wishes to ask?

Mr. Cedarbaum.

FURTHER CROSS EXAMINATION

BY MR. CEDARBAUM:

Q Yes. My follow-up questions have to do with your discussions concerning cash flows. And my question, I guess the preliminary question is, do you -- are you familiar with the accounts receivable arrangement that the Company had with a company called Rainier Receivables?

A Yes. Although I will say it was Mr. Gaines who structured that, but that's something I am familiar with.

Q And that arrangement changed in 2005; is that right?

A Yes, it did.

Q Did that change the arrangement with respect to Rainier Receivables have an impact on the Company's cash flow?

A Yes, it did. And that's one of the reasons the cash flow did change.

Q It changed downward; is that correct?

A Yes. Correct. I would offer --

Q I don't think there was a question pending. Excuse me.

Would you accept, subject to your check, that it's reported in the Company's 2005 10K that that change in the accounts receivable arrangement decreased the Company's cash flow by about $200 million?

A I would have to do it subject to check.

MR. CEDARBAUM: Thank you. Those are all of my questions.

JUDGE MOSS: Nothing further?

Any redirect?

MS. DODGE: Yes, we do, Your Honor.

REDIRECT EXAMINATION

BY MS. DODGE:

Q There are -- I believe, first, that there may be some confusion in the transcript with years that were stated, so I would like to walk through a few of those.

A Sure.

Q You had mentioned that you were -- Commissioner Jones was asking questions about your earnings guidance, and you had mentioned that you had -- were staying with the guidance that had been issued for 2006, and none had yet been issued for 2007. And I believe that was what you meant to say.

A Yes. Correct. We had no earnings guidance for calendar year 2007. And to clarify, Ms. Dodge, in some of the equity research reports that were tagged as exhibits, equity analysts do

offer their view, but that's not the Company's view.
     Q   Then at the beginning of the questioning Mr. Cedarbaum had a question comparing levels of 2006 capital spending with 2007 spending, and I believe one of your ultimate answers was delivery expenses will be higher in 2006. Did you mean to say 2006?
     A   Might have been 2007. Yes, 2007. I apologize.
     Q   I wanted to follow up on Commissioner Jones' discussion about free cash flow, which in his question he asked whether free cash flow was operating cash minus dividends. And you stated yes, but then there was some discussion about subtracting capital expenditures as well. Would you please clarify what free cash flow is?
     A   Free cash flow is what is available to pay equity holders and debt holders.
     Q   Would that be equity cash minus capital expenditures?
          JUDGE MOSS: I would ask that those in the gallery not be signaling the witness. Thank you.
          THE WITNESS: And I apologize for the confusion. Cash flow and free cash flow, they are

used often, and the definitions vary. The definition I use with the financial community is cash flow available to both dividend holders. And if you take a look at most of my presentations to the financial community, again, its sources and uses, I stick with that number consistently.

Q BY MS. DODGE: Mr. Van Cleve walked you through, or pointed you to your rebuttal testimony, Exhibit 457. And if you would turn to that, please.

A (Complies.)

Q Page 14, the table at the top?

A Okay.

Q There was some discussion about the source of your numbers for the line -- Mr. Gorman's line?

A Yes.

Q And the source of your numbers for his low and high on that table?

A Okay.

Q I would like you to turn to Exhibit 477.

A Okay.

Q Mr. Gorman's premarked Exhibit MPG 15?

A Yes. Is it MPG 7?

Q I am sorry, MPG 7.

JUDGE MOSS: So we're on Exhibit 477?

MS. DODGE: Yes. And at the same time we're on 457, page 14.

Q BY MS. DODGE: Can you find, in Mr. Gorman's Exhibit 477, the source of the numbers on the table of your rebuttal, page 14?

A Well, on the low end in my table, that would be 7.38 percent, that is item 10, which is the 7.38 percent of Oklahoma Gas and Electric Energy.

Q And do you see the source of your 12.58 number?

A I do. The 12.58 is the DCF of Pinnacle West Capital.

Q Now, would you please turn to your Exhibit 458. And Mr. Van Cleve also asked you about the bottom table on your Exhibit 458, which the heading is Summary of Mr. Gorman's ROE Estimates.

A Yes.

Q Do you see again the 7.38?

A I do.

Q And 12.58 numbers?

A Yes, I do. That's the low and high on this table.

Q Would the average be 9.6 percent?

A Correct.

Q And looking at Mr. Gorman's Exhibit 4.77, do you see on line 15 his average of 9.6 --
A I'm sorry, Exhibit --
Q Exhibit 477.
A 9.6, yes.
Q Now, turning to Mr. Gorman's testimony, Exhibit 471?
A Is it 471 C?
Q Yes.
A Yeah.
Q And I would like you to look back to your Exhibit 458. On the second line of Mr. Gorman's summary table, the line, the second line, Projected 30-year T-bond Risk Premium. And your table states -- do you have it?
A I am sorry. Where is my --
Q Your table on Exhibit 458.
A Yes.
Q The Mr. Gorman Summary Table at the bottom.
A Right. Yes. 30-year T-bill, 10.3 percent average.
Q Yes. Turning to Mr. Gorman's Exhibit 471, his rebuttal at page 71.
A Yes.

Q Lines 17 through 20.
A Yes.
Q Is this the source of the numbers in your table?
A Yes, it is. I see the 10.3.
Q Turning to page 18 of Mr. Gorman's testimony at the top of the page, would the lines 1 through 3 -- is this number for the BAA utility bond yields the source of the third line of your table?
A Yes. The 10.2, and there's 10.2.
Q I would like to ask you to turn to Mr. Gorman's MPG 15, which is Exhibit 485.
A Yes.
Q Is this the source of the next two lines in your table, the CAPM historical premium, and the CAPM prospective premium?
A Yes, it is. It matches up.
Q And in the end you average all of these numbers to reach your 10.2 percent average?
A Yes, 10.4 -- the average is 10.2.
Q Mr. Van Cleve asked you with respect to page 18 of your rebuttal testimony. That's Exhibit 457, if you would go there.
A (Complies.) Yes.

Q He was asking you about the second half of this page comparing Mr. Gorman's DCF analysis to the authorized ROEs for his sample group.

A Uh-huh.

Q Now, what is your understanding of the relationship between looking at the DCF calculations on the one hand, versus an authorized ROE on the other hand?

A They are two different calculations.

Q In what respect?

A DCF is a measure of future cash flows discounted back. ROE is a measure of a financial return at one point in time.

Q Are state commissions looking at DCF typically as one element of setting an ROE?

A They are. That is one among many, yes.

Q Is it fair to say that your focus here was on looking at what state commissions had actually authorized for ROEs for these companies?

A Yes, that's correct.

Q One more question. You had stated at one point you were not the financial witness in this case. Did you actually mean to state that so broadly?

A It would be difficult to not be the

financial witness as the chief financial officer. To clarify, I'm not the cost of capital witness, which, again, is Dr. Morin. I would hope after the years I spent on Wall Street I could give some perspective on financing and financial matters.

MS. DODGE: I am sorry. I do have one more.

Q BY MS. DODGE: Judge Moss asked whether in the Company's alternative to the Company's depreciation tracker, the known and measurable adjustment, he asked whether the Company was asking for a return on the investment, and you said no; is that correct?

A My understanding -- and I apologize -- was I believe I made the statement that investors keep asking us shouldn't -- why not ask for the full return on and of depreciation on delivery infrastructure in service. And to that, that answer was no. We're only asking for depreciation. I think this mechanism, the alternative where you ask for depreciation and the return on at a point in time does include return on in this other mechanism.

Q But you mean the one time known and measurable adjustment?

A The one time known and measurable adjustment. But that's one point in time. It's not on an ongoing recovery depreciation like the depreciation tracker. And, again, it's not an ongoing recovery for return on. It's just one point in time known and measurable.

The investor community often asks me about an ongoing ability to do both, and that we're not asking. I hope that clarifies the question.

JUDGE MOSS: That does. Thank you very much. If there's nothing further --

MR. CEDARBAUM: Your Honor, I am sorry. It's out of order, but could I ask one clarifying question?

JUDGE MOSS: Sure.

RECROSS EXAMINATION

BY MR. CEDARBAUM:

Q Mr. Valdman, I want to make sure I am not confused about your use of the term cash flow. And it's Exhibit 466, which I think was a cross exhibit from Public Counsel. And that's your most recently filed 10Q; is that right?

A Let me get to it -- yes. I remember

having that.

Q And then turning to page 17.

A Hold on, let me get there. Page 17?

Q Yes.

A (Complies.)

Q Do you have that in front of you?

A Yes.

Q This is a consolidated statement of cash flows of Puget Sound Energy. And I am looking at the column, six months ended June 30 -- actually either column. When you talk about cash flow, which line are you talking about?

A (Reading document.) The line is the 112 and the 309. In other words, I am looking at cash provided by operating activities, cash used by investing activities. Then when I said -- in my discussions with investors, yes.

Q So you are looking at the line entitled net cash used by investing activities?

A No. You need to -- if it's a summation, yes. There's cash provided by operating activities, and then net cash used by investing activities, net cash provided by financing activities. So the deficit -- so it's the 309 and 112.

Q Thank you.

JUDGE MOSS: All right. Then I believe that concludes our examination of you, Mr. Valdman. I appreciate you being here and giving your testimony today. You may step down.

THE WITNESS: Thank you. Thank you.

JUDGE MOSS: I think what we will do is get Dr. Morin on the stand, and we will recess before any cross-examination so we can have our lunch and be efficient when we get back.

(Brief recess taken.)

DR. ROGER MORIN,

produced as a witness, having been first duly sworn, was examined and testified as follows:

THE WITNESS: Yes, I do.

JUDGE MOSS: Thank you. Please be seated.

MS. DODGE: Thank you, Your Honor.

DIRECT EXAMINATION

BY MS. DODGE:

Q Dr. Morin, would you please state your name and title, and spell your name for the court reporter.

A Roger Morin, M-o-r-i-n. And my title is Distinguished Professor of Finance, Robinson College of Business, Georgia State University, Atlanta, Georgia, and Professor of Finance for Regulated Industry at the Center of the Study of Regulated Industry at the same college.

Q Do you have before you what have been marked for identification as Exhibit Nos. 301 through 324?

A I do.

Q Are these your prefiled direct testimony and rebuttal testimony and exhibits in this proceeding?

A Yes, they are.

Q Were these testimonies and exhibits prepared under your direction and supervision?

A Yes, they were.

Q Do you have any additions or corrections to make?

A Yes, I have some minor corrections that are typographical or grammatical in nature. In Cross Exhibit 304, which is an exhibit -- part of my direct testimony -- so Cross Exhibit 304 --

Q Just Exhibit 304?

A And there's a document that discusses the capital asset pricing model, which we will use CAPM as an acronym from now on, for the benefit of the stenographer. On page 8 of that document there is a table in the middle of the document, and the first author that is listed there, his last name was inadvertently omitted. It is Black, comma, Fischer.

So, again, in that table the first author where it says Fischer 1993, it's the famous scholar and finance Fischer Black. So we would have put the word Black in front of Fischer. Same thing on the second line, the word Black should be inserted before the first name Fischer.

Then we go to Exhibit 307. Which again, is an exhibit in my direct testimony. And it is an exhibit which is entitled Combination Gas and Electric Utilities Historical Growth Rates. At the very bottom there is a line denoted Average, and then a second line also denoted Average. That second line should be deleted.

Then we go to the rebuttal, which is Exhibit 315. So rebuttal testimony 315, so the second page of that exhibit, Roman numeral II, at the very bottom of that Table of Contents one sees

Mr. Hill's DCF analysis. It should be Mr. Gorman's DCF analysis. The same is true on the second to last line on that page. It should read Mr. Gorman's CAPM analysis instead of Mr. Hill's.

And then on page 56 of the same exhibit, and that is page 56 on line 13, delete "in which" and insert "the." So the line should read, "pricing model if the market portfolio."

And then the last typo is on page 60, line 8. I will simply read the line, line 8. "A formal recognition of the empirical evidence demonstrating the observed risk return trade-off." I will repeat. Line 8 should read, "A formal recognition of the empirical evidence demonstrating the observed risk return trade-off." And that completes the corrections.

Q With those corrections, are your prefiled direct and rebuttal testimonies and related exhibits true and correct, to the best of your knowledge and belief?

A Yes, they are.

MS. DODGE: PSE offers Exhibits 301 to 324 into evidence, and offers Dr. Morin for cross-examination.

(EXHIBIT OFFERED.)

JUDGE MOSS: Hearing no objection, those will be admitted as marked. And as I mentioned earlier, we will take our recess a few minutes early today.

(EXHIBIT RECEIVED.)

JUDGE MOSS: Let's start back at 1:15. We're in recess.

(Lunch recess taken.)

JUDGE MOSS: Let's be on the record.

Good afternoon, everyone. I hope you all had a pleasant lunchtime.

Dr. Morin has been made available for cross-examination, so unless there's something preliminary, and apparently there is not --

Mr. Cedarbaum.

CROSS EXAMINATION

BY MR. CEDARBAUM:

Q Good afternoon, Dr. Morin.

A Good afternoon, sir.

Q Is it correct that in making your cost of equity recommendations you have relied upon three methods of the CAPM, risk premium, and DCF approaches?

A Yes, sir.

Q Is it correct that both of the CAPM and risk premium method employ a bond yield plus a risk premium approach?

A That's correct.

Q If you could look at page 57 of your direct testimony, which is Exhibit 301.

A I have it.

Q You show the results of all of your analyses in this case; is that right?

A That's correct.

Q Is it correct that each of the numbers that you show in the ROE column include an adjustment for flotation costs of about 30 basis points?

A That is incorrect. The allowed risk premium estimates about halfway through the table do not contain an adjustment for flotation costs, because these are based on actual rate orders by the Commission.

Q So the remaining numbers would include flotation cost adjustments?

A Yes, sir.

Q So other than those two that you pointed out for allowed risk premium, if we wanted to determine the results of your analysis without flotation costs, we would subtract 30 basis points from each of those numbers?

A   As a mathematical proposition, you are correct. But one of the costs of doing business would go unrecovered.

Q   With respect to the CAPM analysis, is it correct that there are three parts to that type of approach? The risk-free rate of interest, the relative risk rate called beta, and a market risk premium?

A   Yes, sir.

Q   If we assume that long-term US Treasury Bonds yield 5 percent, and the market risk premium is 7.5 percent, then a CAPM analysis would indicate a return investors require for the market generally of 12.5 percent; is that right?

A   That's correct for the overall equity market.

Q   So the market risk premium is the return investors require over and above the risk-free rate they would get on the US Treasury Bond in order to invest in the stock market in general.

A   That's correct. The market risk premium is the additional compensation that investors require to make investments in the average risk equity.

Q So now if we were to look at combination gas and electric companies, like Puget, and assume a beta of .8, investors' required return for an investment in that risk class would be below the 12 and a half percent that we have referenced for the market in general?

A That's correct. The utilities are approximately 80 to 90 percent as risky as the average stock in the economy, and that's the meaning of beta. So under your question, if utilities are 80 percent as risky as the average stock, clearly the return forthcoming would be less than the 12 and a half percent, which is the overall market.

Q Now, in your CAPM analysis you have used 7 and a half percent as the market risk premium; is that right?

A That's correct.

Q So if we plug that 7 and a half percent into my example, using a risk-free rate of 5 percent, and a beta of .8, is it correct the CAPM produces a return on equity of 11 percent?

A That is correct.

Q If instead we used a market risk premium of 5 percent, everything else remaining the same, CAPM would produce an ROE of 9 percent; is that right?

A As a mathematical proposition, that is correct. But that is not the correct magnitude of the risk premium.

Q If I could have you turn to Exhibit 327, which is our first cross-examination exhibit for you.

A (Complies.) I have it.

Q Do you recognize this exhibit as a few pages from your 2006 text concerning market risk premium?

A Yes. I do not recognize the figure on the front page, but I do recognize it is book.

Q The mystery man. Turning to page 11 of the exhibit, the second full paragraph up from the bottom, it says -- you say in your text, "Faced with this myriad and often conflicting evidence on the magnitude of the risk premium, the regulator might very well be confused about the correct market risk premium. The author's opinion is that a range of 5 to 8 percent is reasonable for the United States, with a slight preference for the

upper end of the range." Do you see that language?
A Yes, that is my view.
Q And this section of your new textbook was not included in prior editions of your textbook; is that correct?
A That's correct. There's been a lot of controversy concerning the magnitude of the market risk premium. And in the last 10 years an entire cottage industry has developed, both in academia and practical circles on the exact magnitude of this market risk premium. Hence, I felt the need to collate the evidence on the subject, look at all the various studies, and come to the conclusion that you have just read.
Q So I think you anticipated my next question is that, this section of your book does discuss historical market risk premium, research, surveys, and forward looking market risk premium research on the subject matter?
A You are quite right.
Q I would like to turn to some of the market risk premium research that you provided in response to our data requests and that are referenced in your textbook, and some others that are neither in your textbook or your testimony. If you could turn

to Exhibit 328, do you recognize that as your response to Staff Data Request 102?

A Yes.

Q And in that data request we asked if you were aware of new research indicating that expected market risk premiums were lower than indicated by the historical Ibbotson data, and on the second page you discuss in a footnote a list of that type of research; is that correct?

A Yes, sir. Correct.

Q And then turning to --

MR. CEDARBAUM: Actually, Your Honor, at this time, before I forget, I would offer Exhibit 327.

(EXHIBIT OFFERED.)

MS. DODGE: Your Honor, we object at this time to 327, because it's an incomplete excerpt of one chapter of Dr. Morin's book. And the Company may wish to provide the entire chapter, for example, as the exhibit. It depends on where the questioning goes on this.

JUDGE MOSS: I suppose it would be inappropriate to ask for an autographed copy of the book, but under the rule of optional completeness, you would have that opportunity.

But let's admit it for present purposes, and if you wish to supplement it, let us know before the close of the hearing.

THE WITNESS: I would be glad to autograph it, particularly if you suffer from insomnia.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: Turning back to Exhibit 328, we asked you for new research. You discuss and list that new research -- you discuss the research in the response, and then a footnote that research in the footnote's on page 2; is that correct?

A Correct.

Q And is it also correct that in Staff Data Request 208 we asked you to provide copies of the articles that you footnote in the prior data request response?

A It is.

Q And Exhibit 329 is your response to that Staff Data Request, asking for the articles?

A Right, yes.

MR. CEDARBAUM: Your Honor, I would offer Exhibits 328 and 329.

(EXHIBIT OFFERED.)

JUDGE MOSS: Hearing no objection, they

are admitted as marked.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: I will be going back and forth between 328 and 329, so if you can keep those in front of you. One of the papers you footnote in Exhibit 328 is the Dimson Marsh and Staunton paper at page 2?

A Yes.

Q And you state in your response on page 2 of Exhibit 328, "They," referring to the Dimson Marsh and Staunton, "report an average risk premium over long-term bond returns over all countries of 5.6 percent, with the US at 7 percent. The premium was generally higher for the second half of the 20th century, than for the first. For example, the US had 5 percent in the first half of the 20th century compared to 7 percent in the second half." Do you see that?

A Yes.

JUDGE MOSS: I think you misread that. The copy I have says 7.5.

Q BY MR. CEDARBAUM: I meant 7.5. If I misspoke, it is 7.5 percent?

A Yes, it is. Yes.

Q And if we look at page 7 of Exhibit 327, which is your text, basically the same language appears in that middle paragraph just under the heading, Market Risk Premium International Capital Markets?

A That's correct. That's where I obtained the citation. There's also an update to the Dimson Marsh and Staunton study provided by the latest edition of a best-selling textbook by Brealey and Myers, entitled "Corporate Finance," or "Principles of Corporate Finance." And they have updated the Dimson Marsh Staunton, and find slightly higher market risk premiums than the ones we have just quoted in the updated study.

Q You didn't update your response to Staff Data Request 102, which is Exhibit 328; is that right?

A That's correct. I am providing you knew information, for the record.

Q So you believe it's important to provide new information to this Commission as it comes about?

A Well, relevant information is important to point out. The Brealey and Myers edition I was referring to has just been published recently.

Q If you could turn to -- I am still on

Exhibit 329, the Dimson Marsh and Staunton paper that you reference to us in your data request response. Again, at page 42, and if you could turn to page 12 of the article, which is page 53 of the exhibit -- I will let you get there first. Do you have that?

A   Yes, sir. I do.

Q   In the upper -- the right-hand column, the upper side of the page in that first paragraph it says, the second sentence says, "Over the first half of the century, the US equity risk premium had an arithmetic average of 7 and a half percent, whereas second half of the century gave rise to the 9 percent risk premium relative to treasury bills." Do you see that?

A   Yes.

Q   So if we subtract the historical return difference between bills and bonds of 1.5 percent and come up with the 5 and 7 percent range that you cited in your earlier response. That's Exhibit 328?

A   Correct.

Q   Now, what I just quoted to you from the Dimson Marsh and Staunton paper is in a section with the heading "Interpreting History to Estimate

Future Risk Premium"; is that right?

A Yes, sir.

Q And it begins with the sentence, "Clearly history can be no more than a starting point for predicting the equity risk premium." Do you see that?

A Yes, sir.

Q Is it also correct that the next few paragraphs on this page list reasons that the forward looking risk premiums would be lower than historical risk premiums?

A They do, but the actual evidence does not -- is not consistent with that. Generally what we find is that the forward looking market --

Q Dr. Morin, please --

COURT REPORTER: Stop. When you talk at the same time I can't hear anybody. Please repeat the question and answer.

JUDGE MOSS: Let's start with the question again.

MR. CEDARBAUM: I simply asked Dr. Morin if the remaining paragraphs after the paragraph and the sentence that I read, listed reasons that forward looking risk premiums would be lower than historical risk premiums. He answered yes, and that didn't require any more explanation.

JUDGE MOSS: Well, I think this witness is an expert who we ought to give some latitude to explain. We are dealing with academic literature, and I think Dr. Morin can provide useful insights into whether this -- in his opinion, at least, this literature is current, correct, and a current sense. So I am going to give him some latitude to explain his answer.

THE WITNESS: Very briefly, yes, the answer to your question is, there are some reasons that have been offered for the so-called shrinking market risk premium. But the bulk of the evidence on the subject suggests that that has not been observed, the bulk of the evidence.

Q BY MR. CEDARBAUM: The last paragraph on the same page of the exhibit discusses the fact that some of the events that occurred in the past may not reoccur, and the last sentence says --

A What page, please?

Q I'm still on page 53 of the exhibit.

A I have it.

Q That left-hand column. The last sentence of that paragraph at the bottom says, "The financial history of our 12 stock markets has been so variable over time that it is worthwhile exploring this argument further." Do you see that?

A   Yes, sir.

Q   And then continuing to the top of the right-hand column, it says, just before this prior sentence that I read to you, "A comparison between the first and second halves of the 20th century makes the point." Do you see that?

A   Yes. But it makes the point that the risk premium has actually increased in the second half of the century as opposed to the first, so that would be consistent with my original response.

Q   Let me ask you to look at the bottom of the right-hand column of this page, Exhibit 53. Isn't it correct that this article says, To convert from a historical -- excuse me. "To convert from a pure historical estimate of the risk premium into a forward looking projection, we need to reverse engineer the factors that have driven up the stock markets over the last 100 years. This is illustrated conceptually on figure 9, on the next page. The left-hand bar in figure 9 portrays the historical risk premium on the equity market." Do you see that?

A   Yes.

Q And then it goes on, and the last two sentences read, "What remains as an indication of the risk premium demanded by investors today, see the right-hand bar in figure 9, the key qualitative point is that it is lower than the raw historical risk premium." Do you see that?

A Yes. According to these authors, and using the geometric mean as a criterion instead of the arithmetic mean, that would be correct.

Q The authors also say at the bottom of page 54 under that bold heading, "What Returns Can We Expect Over The 21st Century?" They say as follows: "The arguments above all lead in one direction, namely that the historical risk premium is likely to exaggerate investors' current required equity risk premium." Did I read that correctly?

A Yes, you did. One could not help but wonder what these authors would have said after the 2001 debacle of the .com collapse.

Q If you could turn to page 51 of the exhibit, which is page 10 of the article. In the last paragraph on the right-hand side the authors indicate that "For those that are willing to accept that a long-term average market risk premium is a good guide to future risk premiums, the data in the lower bars of figure 7 are the relevant numbers to employ." Figure 7 is actually at the top of the page; is that correct?

A That's correct. And if I look at figure 7 in the middle of that draft where it says US, referring to the United States equity market, the arithmetic market risk premium is 7.7 percent, which is almost identical to what I use. And that's before Dimson Marsh and Staunton updated their study.

Q There's in the -- it's a little hard to read, but in the rest of that bar that you just noticed, discussed, I believe it says 6.8 percent. Is that --

A I can't read it, but I will accept that.

Q Do you know?

A I believe the top number that you see, the 7.7, refers to the arithmetic average. We commonly use arithmetic average, whereas the second number which is barely distinguishable refers to the geometric mean.

Q Figure 7, just above the bars themselves, it says, Equity risk premium versus Bills, referring to Treasury Bills.

A That's correct. And it would be -- the

7.7 would become 6.7 over long-term Treasury Bonds that yield higher returns than short-term Treasury Bills. So I am pretty comfortable with my estimate relative to the authors' statements on the magnitude of market risk premium.

Q Just turning back to Exhibit 327, which was the excerpt from your text, look at page 6.

A I have it.

Q You indicate -- it's the last full paragraph at the bottom, "Because they" -- referring back to Dimson Marsh -- "are referring to the premium over Treasury Bills, which is 1.5 percent greater than the premium over bonds, according to Ibbotson." Do you see that?

A Yes.

Q So if we were to use -- if we wanted to use Treasury Bonds as a risk-free rate, wouldn't we -- we would subtract the 1.5 percent from the T-bill numbers that are on the other exhibit that we discussed?

A That's correct. Although in the last two years, the maturity risk premium has shrunk to virtually a zero. That is, the yield between long-term bonds and short-term Treasury Bills is essentially almost negligible. As we say in the trade, the yield curve is flat. It has flattened considerably. So that 1.5 percent right now would be vastly overstated. Notwithstanding the fact, let's not forget the update of the Dimson Marsh study to include more recent data which shows higher market risk premiums.

Q In Data Request 102, which is, again, Exhibit 328, you refer to the Ivo -- you refer to two studies by Ivo Welch, one in 2000 and one in 2001.

A Yes, I have it at the very bottom of the second page, yes.

Q And then in Exhibit 329, when we ask for you to provide all copies of the articles that you had footnoted in the prior response, is it correct that you only provided those copies of the 2000 Ivo Welch study?

A I couldn't find the other one.

Q Well --

A Hopefully, you did.

Q Well, let's turn to Exhibit 330. That's the copy of the 2001 Ivo Welch study that you footnoted in your Data Request Response 102 to us; is that right?

A Yes, sir.

Q If you would look at page 2, the author there describes that the abstract section has a summary of his findings; is that right?

A Yes.

Q And he says that "The consensus forecast for the one-year equity premium is 3 to 3 and a half percent. The consensus forecast for the 30-year equity premium, arithmetic, is 5 to 5 and a half percent. The consensus 30-year stock market forecast is about 10 percent. These forecasts are considerably lower than those taken just three years ago." Did I read that correctly?

A Yes. It was taken during the heyday of the stock market during the bubble, tech stocks bubble. So I'm not surprised to see a very conservative market risk premium. But I suspect a survey taken after the debacle of the stock market would have indicated higher risk premiums.

Q So a survey taken 2005, 2006 time frame would be more accurate?

A Well, it would be more reflective of more recent capital market conditions. But there are many reasons that I cite in my response to place much less weight on surveys, because these responses are subject to bias. And I think analysts that are being polled, I think, have a tendency to put a lot of weight on recent events and immediate prospects.

Q If I could have you turn to Exhibit 331, so I don't forget as we go along the way here.

A That's the Siegel study?

Q Yes.

MR. CEDARBAUM: Your Honor, I think I have offered 328 and 329?

JUDGE MOSS: They have been admitted.

MR. CEDARBAUM: Okay. I offer Exhibit 330.

(EXHIBIT OFFERED.)

JUDGE MOSS: Hearing no objection, they will be admitted as marked.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: We're looking at Exhibit 331. Do you recognize this as the Jeremy Siegel article that you footnoted in your response to Staff Data Request 102?

A Yes, sir.

MR. CEDARBAUM: I move the admission of Exhibit 331.

(EXHIBIT OFFERED.)

MS. DODGE: Your Honor, is this not

attached to, as part of 329? It appears to be attached to the data request responses.

JUDGE MOSS: That's all right. We will save time. We have it twice. That will be all right.

Any objection? No, it will be admitted.

(EXHIBIT RECEIVED.)

MR. CEDARBAUM: Actually, Ms. Dodge is correct. It's already in Exhibit 329, but let's stick with 331 for this discussion.

Q BY MR. CEDARBAUM: If you could turn to page 3 of the exhibit, is it correct that over this author's entire study period, the arithmetic market risk premium over long-term bonds is 4.7 percent?

A That's correct. If you are looking at the table under arithmetic mean, 1802 to 1998, that was indeed 4.7 percent. There's an article that I have also provided to you by Bill Schwert, S-c-h-w-e-r-t, a professor of the University of Chicago, who has done a lot of research on the adequacy of the data of the 19th century, and has expressed some serious difficulties inherent in the stock market data prior to the Great Depression.

And this is why most analysts concentrate their efforts on 1926 to 1998 where you see the 6.7

percent and 7.3 percent. There's serious issues with stock market data prior to the Great Depression. Very few stocks were trading. They weren't paying dividends. There was wash sales and scandals, and very thinly traded markets. Hence, the focus of most analysts is on the post Depression numbers or data.

Q The Schwert article that you just discussed is part of Exhibit 329; is that right?

A That's correct.

Q And that was written in 1990?

A That's correct. And it's a very complicated article, which essentially tries to reconcile and modernize and correct and decontaminate the data prior to the Depression to make it palatable. So one views the Siegel study prior to the Depression with some suspicion.

Q As you discuss that Schwert discusses data anomalies for pre-1926 data and suggests corrections for those anomalies; is that correct?

A That is well said.

Q And then on page 36 of the exhibit -- and again I am on the Schwert article.

JUDGE MOSS: I have lost track of what exhibit you are on.

MR. CEDARBAUM: It's Exhibit 329.

JUDGE MOSS: What page?

MR. CEDARBAUM: 36.

JUDGE MOSS: Thank you.

THE WITNESS: I have it.

Q BY MR. CEDARBAUM: Is it correct that he says, "When those anomalies are corrected, the economic data from 1802 to 1987 is remarkably homogenous"?

A It is, but that's not the data that was used in the Siegel study, so he has tried to salvage and recuperate the data to make it more consistent with post Depression data.

Q The Siegel paper was written after the Schwert article; is that right?

A That's correct.

Q I don't know that you need to refer back to the text, but -- the textbook, that's in one of the exhibits. But one of the articles that you cite on the references section is the Fama and French article called "The Equity Premium"?

A That is correct.

Q Turning to Exhibit 332. Is that the article that you reference?

A Yes.

MS. DODGE: I'm sorry. Could we have the cite to Exhibit 327 where that cite is found?

MR. CEDARBAUM: It's the last page of the exhibit, page 17.

MS. DODGE: We will see where it goes. Go ahead.

Q BY MR. CEDARBAUM: I think we have established, Dr. Morin, that Exhibit 332 is the Fama and French article that is referenced in your text?

A Yes, it is.

MR. CEDARBAUM: Your Honor, I move the admission of Exhibit 332.

MS. DODGE: Your Honor, the Company objects. And I will tell you the concern with 332 333, 334, 335, these are all articles that Mr. Hill cited in his response testimony, and provided his workpapers but not his exhibits. The prior two articles, the questions by Mr. Cedarbaum established good reason to have them in the record. In one case it was an article that Dr. Morin had not been able to locate, so, of course, that could come in to complete that data request response, as well as the Siegel article.

But now we're getting into articles that are actually Mr. Hill's materials, and there was no question posed on the article. And so we view this as simply supplementing their direct evidence. If there's a question for Dr. Morin, that's fine, but otherwise it's simply supplementing their evidence in this case.

MR. CEDARBAUM: Dr. Morin is being offered for his expertise in this case. He's written a textbook that includes the subject matter that we're discussing, and he references all of these articles that I am discussing with him.

It seems very material and probative on his thinking on the subject to be able to discuss them.

JUDGE MOSS: I agree. The objection is overruled.

MR. CEDARBAUM: I take it that 332 has been admitted?

JUDGE MOSS: Well, it hasn't, but it is now.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: Turning to Exhibit 333 for identification, do you recognize this as an article by Ibbotson and Chen, that is also referenced in your -- in the references section of your textbook that we have discussed earlier?

A Yes.

MR. CEDARBAUM: Your Honor, I would move the admission of 333.

(EXHIBIT OFFERED.)

MS. DODGE: The Company objects to the admission of an article that has no question pending on it. This is not in any way asking Dr. Morin about his professional opinion. It's supplementing the record.

A related concern is that we have an excerpt of Chapter 5, and Mr. Cedarbaum is citing these articles as having been cited by Dr. Morin, but there's no indication that in the excerpt that's been provided there's any discussion of these. So they are simply now stand-alone with no question pending. It's additional evidence.

JUDGE MOSS: Well, it is additional evidence, and it's additional evidence that is useful. It shows the basis for Dr. Morin's material in his textbook, so I can't see that it's in any way objectionable. It's academic literature, and it is what it is.

MS. DODGE: In that case we request that the Company be permitted to supplement the record with other articles that Dr. Morin cited. He took the same practice as Mr. Hill, and cited and provided in workpapers, a good number of articles that would support his opinion in the case. I am worried that we're looking at an overweighting of evidence on one side without counter balancing --

MR. CEDARBAUM: Your Honor, I object to that approach. We asked Dr. Morin in our Staff Data Request 102 for current research. It was a broad question. He could provide whatever he wanted to provide.

What he provided were five articles. I don't think that the Company should be allowed to now supplement the data request response at this stage of the proceeding.

JUDGE MOSS: I need to understand, Mr. Cedarbaum. Are you saying that all of these exhibits that are articles here are ones that were provided to you in response to a data request?

MR. CEDARBAUM: No. What I am saying is that I understood -- Ms. Dodge's proposal is that the Company wants the opportunity to provide additional evidence of market risk premium research. And I am saying we asked the Company for all that they wanted to provide, and what we got is in Data Request 102.

JUDGE MOSS: If the materials that you are now seeking admission of, that is to say some of these articles are ones that were not furnished to you in response to your data request -- which is what I understood you to just say. Am I correct so far?

MR. CEDARBAUM: Some are and some of them aren't.

JUDGE MOSS: Right. It seems to me as a matter of balance, if we're going to have the articles that you wish to include that are part of the references to the chapter that you have included, we have admitted into the record, that in the interest of completeness, if we need all of that background academic literature, then we should allow the Company to supplement as well. So I am going to allow it, if that's what the Company thinks is important to do.

MR. CEDARBAUM: My question then, Your Honor, is what process will that be? Will that happen at a time when the record is closed and we won't be able to inquire of Dr. Morin on any of those articles?

JUDGE MOSS: I would expect it to occur

before the record is closed. Yes? Ms. Dodge is shaking her head in the affirmative as if that can be done.

MS. DODGE: All of the articles we're talking about were provided in Dr. Morin's workpaper. It's a question of our selecting hopefully not an overwhelming number of them to supplement the record, and we can do that tomorrow.

JUDGE MOSS: Let's do keep in mind the hearsay quality of these academic articles. We do have Dr. Morin here, and his book, which relies on these articles.

So it seems to me that that is the key concern we should have in terms of questioning the witness. As far as the backup material is concerned, I'm going to allow it for the reasons I stated, but I would hope that counsel would take into account the weight that might be given that literature.

Go ahead with your questions, Mr. Cedarbaum. Where are we? Did you offer anything beyond 332?

MR. CEDARBAUM: I believe I offered 333.

JUDGE MOSS: Let's dispense with this. Are you going to offer 334 and 335?

(EXHIBIT OFFERED.)

MR. CEDARBAUM: Yes.

JUDGE MOSS: For the reason I have previously stated, even if there is an objection, Ms. Dodge, I am going to admit those.

(EXHIBIT RECEIVED.)

MS. DODGE: Same objection for the record.

JUDGE MOSS: Thank you.

Q BY MR. CEDARBAUM: Looking at Exhibit 333, Dr. Morin, on the right-hand side of the page the paragraph that begins, "In the work reported here, Ibbotson and Chen provide a review of some recent market risk premium work, including the Siegel and Fama articles that we have already discussed, and they refer to three articles offered by Robert R. Known"; is that correct?

A Yes.

Q And all of those articles indicate that the market risk premium is near zero; is that right?

A Not really. Why don't we go to page 10 of that exhibit.

Q If I could -- we will get to that, but let me ask you a question first. If we look at the bottom of page 1 of Exhibit 333, the Arno and Ryan article argued that the forward looking risk premium is actually negative.

Then on the next page it says, "Arno and Bernstein argued similarly that the forward looking equity risk premium is near zero or negative. See also Arno and Asnos." Did I read that correctly?

A Yes, you did, but --

Q Go to page 10, and get your answer.

A You should have paid some attention to the punch line of the article on page 10. The bottom line, if you wish. At the top of that page on the right-hand side, and I quote, "The implication of an estimated equity risk premium being far closer to the historical premium zero or negative is that stocks are expected out perform bonds over the long run." So Ibbotson and Chen are hedging a little bit, and saying history is not such a bad guy after all.

And on the other side of that same page on the left-hand side, line number 4, you see 5.9 or close to 6 percent market risk premium. That is not out of the reasonable range.

Maybe I can save a lot of time here by quoting what you quoted to me --

Q Dr. Morin, I am sorry. I know --

JUDGE MOSS: There's no question pending, Dr. Morin.

MR. CEDARBAUM: Thank you, Your Honor.

THE WITNESS: I was trying to make your life easier.

Q BY MR. CEDARBAUM: I would like to just have you refer to Exhibit 335, which is an article authored by Graham and Harvey. Do you have that?

A Yes.

Q And it indicates there that those two gentlemen are professors at the school of business for Duke University. Do you see that?

A Yes.

Q Is it also correct that they are co-editors of the "Journal of Finance"? Do you know that?

A I am not sure if they still cling to that post.

Q Now, this is -- this article refers to the -- is entitled the Equity Risk Premium in January 2006, "Evidence from the Global CFO Outlook Survey." Do you see that?

A Yes.

Q As part of the survey, is it correct that Graham and Harvey asked the CFOs what market risk premium they expect over treasury bonds over the next 10 years

A Yes.

Q If you will turn to page 6 of the exhibit there's a table that displays survey results beginning in the third quarter of 2000 through the first quarter of 2006; is that right?

A Yes.

Q And the average risk premium column, the average of all of those quarters in their survey is 3.9 percent?

A Yeah. I see that. I am fairly familiar with this survey. The reason I did not include it in my text is because the response rate, as indicated on page 2, is 5 percent. So I -- and it's very, very short term and immediate oriented, if you wish. And I am a little bit leery of surveys that are typically very short-sighted in nature, and reflect current circumstances. But anyway, those are some of my reservations. But it's one source of market risk premium data, certainly not the most reliable.

Q If we look at page 1 of the exhibit in the abstract, it says, "We analyzed the results of the most recent survey." Do you see that?

A Yes.

Q So this is a continuing project of Graham and Harvey, this isn't just a one-time survey they have done this on?

A That's correct. It's periodic, and the response rate is 5 to 8 percent, which is not very convincing, and subject to the well-known biases of surveys.

MR. CEDARBAUM: Your Honor, I am going to offer as a group, Exhibits 336 through 346, which are all complete, I believe, responses to Staff Data Requests by Dr. Morin. I haven't gotten to the last one.

(EXHIBIT OFFERED.)

MS. DODGE: You said through 346?

MR. CEDARBAUM: I'm sorry. 345.

MS. DODGE: In that group the Company does not object to 337 through 345.

JUDGE MOSS: What happened to 336?

MS. DODGE: 336 we would like to note that on page 2, and I believe it was in the production of this data request response, that we made an error in a cross-reference to another data request. And it's going to be quite confusing if we don't correct it.

JUDGE MOSS: Well, I think it should be corrected.

MS. DODGE: So shall I just state that? And this was a law firm error. It's not a Dr. Morin error. Page 2, sub E, it says, "Please see Attachment B to PSE's response to UTC Staff Data Request 363 as well." That's this data request, but there's no attachment. It's meant to refer to the response to Staff Data Request 215.

And it's the same correction in sub H on the same page. And you might note that this Staff Data Request was the Hunt cross-exam exhibit that was admitted into the record yesterday.

JUDGE MOSS: I am sorry. 215.

MS. DODGE: Yeah, of the response to Staff Data Request 215 was admitted into the record yesterday as a cross exhibit for Mr. Hunt.

JUDGE MOSS: That is Exhibit 221 C.

MS. DODGE: Exactly. Sorry for the confusion.

MR. CEDARBAUM: Your Honor, Staff has no objection to those corrections being made on the exhibit.

JUDGE MOSS: We have made them at the bench, so we're in fine shape. We don't need more paper on that. So with that correction, then there's no objection?

MS. DODGE: That's correct.

JUDGE MOSS: Then that one is also admitted.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: I actually have just one more topic to discuss with you, Dr. Morin, and it concerns Exhibit 346.

MR. CEDARBAUM: And, Your Honor, for the record, the first page of this document we believe, and Dr. Morin can confirm, is his response to Staff Data Request 372. The second page of the document was actually not a part of his response. We created that based on some information in his prefiled materials that just related to the same subject matter of 372, so we stapled them together as one exhibit. But I am quite frankly indifferent as to whether or not it's treated as one exhibit or two.

JUDGE MOSS: Is the Company equally indifferent?

MS. DODGE: No, Your Honor. The Company objects to combining these two. The Company has no objection to admission of PSE response to Staff

Data Request 372, which is the first page of 346. We would like to address separately this stand-alone page.

JUDGE MOSS: I will mark it as a separate number, 349.

Q BY MR. CEDARBAUM: Dr. Morin, if I could have you turn to Exhibit 346, which involves Staff Data Request 372. And in that request we asked you to quantify your notion of substantial volatility, and you indicate that establishing a confidence interval of plus 2 and minus 2 standard deviation units gives a sense of how variable the cost of equity result can be. Is that a fair summary of your response?

A It is.

MR. CEDARBAUM: I am sorry, 346 is already in?

JUDGE MOSS: No, you haven't offered it yet.

MR. CEDARBAUM: Move for the admission of 346.

(EXHIBIT OFFERED.)

MS. DODGE: No objection.

JUDGE MOSS: It's admitted.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: Turning to Exhibit 349, do you recognize all of the data in columns -- the small numbers in columns above the mean line as basically being a compilation of the data that was in your Exhibit RAM-5?

A This is a reproduction of my exhibit. Yes, I concur.

Q And RAM-5, and I apologize, I don't have that specific exhibit number, that was your historical risk premium analysis for electric utilities; is that right?

A Yes, sir.

Q And at the bottom of the page in the right-hand column, is it correct that the average risk premium that you use in your analysis is 5.55 percent?

A Well, actually I rounded it up to 5.6 percent. If you add this to the risk-free rate, you get 10.6. So that's the number that I estimate for the risk premium.

Q Now, staying with the data that came from your exhibit, is it correct that the risk premiums over the years that you have studied have ranged from plus 50 percent in 2000, that's the second to bottom line, to a negative 37 percent in 1937?

A Yes. The volatility year-to-year is considerable, but there's no pattern in the data.

Q Would an accurate calculation of the standard deviation for that information from your exhibit be 19.54 percent?

A That seems reasonable.

Q And if we were to create a confidence interval around that 5.5 percent shown on the exhibit, in which we can be 95 percent sure that the risk premium will fall within by adding and subtracting two standard deviations to the mean, the result would be a risk premium range of a negative 33.53 percent to 44.63 percent; is that correct?

A That's correct. The risk premium over time behaves like a random walk essentially oscillating around a mean of 5.6 percent. And that number is consistent with all the other risk premium techniques that I discuss in my testimony, but it is very volatile. And I grant you that, and that's why I use several techniques when trying to measure the cost of the equity.

MR. CEDARBAUM: Your Honor, I would move for the admission of 349.

(EXHIBIT OFFERED.)

MS. DODGE: No objection.

JUDGE MOSS: No objection. It will be admitted as marked.

(EXHIBIT RECEIVED.)

MR. CEDARBAUM: Those are all of my questions. Thank you, Dr. Morin.

JUDGE MOSS: Thank you, Mr. Cedarbaum. I believe the only other party indicating cross for Dr. Morin is ICNU.

So if you go ahead, Mr. Van Cleve.

MR. VAN CLEVE: Thank you, Your Honor.

CROSS EXAMINATION

BY MR. VAN CLEVE:

Q Good afternoon, Dr. Morin.

A Good afternoon.

Q I would like to walk through the portion of your rebuttal testimony that responds to Mr. Gorman's testimony. And I believe that starts at page 69.

JUDGE MOSS: Of Exhibit 315?

MR. VAN CLEVE: Correct, Your Honor.

THE WITNESS: I have it.

Q BY MR. VAN CLEVE: Referring to page 71, the first issue you raise in rebuttal to Mr. Gorman is the flotation cost adjustment. And at page 71, lines 2 through 10, is it fair to say that your position is that a flotation cost adjustment is necessary when an operating subsidiary like PSE raises equity capital through its parent company?

A That's correct. The parent company does raise the capital on behalf of the operating company. And, of course, that capital is not free and has a cost. And it would be unfair to subject the parent company as a shareholder to not compensate them for the flotation cost; whereas a public company would. So it's a question of fairness. So the answer is yes.

Q And would you agree that flotation cost adjustments are needed when legitimate costs of issuing stocks to the public are incurred?

A Absolutely, yes. And this company did issue a considerable amount of stock last year and will continue to do so in the future in an attempt to finance its gargantuan capital spending program over the next 10 years.

Q Did you prepare a flotation cost adjustment study, which I believe is marked as Exhibit 314? I think that's your RAM 14 to your direct testimony.

A Yes, sir. There is a voluminous appendix that deals with the conceptual aspects of the flotation costs, and the empirical evidence on the magnitude of such flotation costs, and why it needs to be compensated for because it's a legitimate cost of doing business. Equity capital is not free.

Q Does Exhibit 314 attempt to measure the costs incurred by PSE for flotation costs?

A I take a broader approach to this. I would rather base a study for academic publication on the large data base. And I have examined myriad studies on flotation costs for electric utility offerings, and those studies are almost unanimous in suggesting a flotation cost of around 5 percent, 3 percent for direct costs and another 2 percent for what we call market pressure. And that is also consistent with the kinds of flotation costs that Puget has incurred in the last issue of common stock last year.

Q You recommend an adjustment to Mr. Gorman's DCF analysis of 30 basis points for flotation costs; is that right?

A That's correct.

Q And is that adjustment based on any actual flotation costs incurred by PSE?

A It's based on all of the studies that are in the appendix on flotation costs that deal with the electric utility stock offerings. And, again, I prefer to depend on the wide variety of sample, if you wish, in order to have reliability and credence to the study. I do not like to depend on one single issue, particularly when it comes to measuring the market pressure.

There's so many things that influence stock prices when a company issues stock. It's -- I think it's preferable to rely on the large, large sample of companies that issue stock in order to quantify flotation costs related to market pressure.

But, again, I think the quick answer to your question is that my results are totally consistent with the actual experience of the Company last year, and its issue of common stock. The flotation costs are about 3 percent -- the direct component, excuse me.

Q So the flotation costs incurred by Puget Energy, the parent company, these are costs that could be tracked and allocated to PSE?

A Yes, absolutely.
Q But that's not what you are proposing?
A I am proposing that the equity capital injected in Puget Sound Energy has a cost of 5 percent.
Q But it's not based on the actual cost incurred?
A It is based on the empirical evidence that strongly suggests that 5 percent is the cost, and that is consistent with the experience of Puget Energy last year.
Q And that is that experience of Puget Energy in the record in this case?
A I don't think it is, no, for the reasons I have indicated earlier.
Q I would like to direct you to page 73 of your rebuttal testimony where you address the DCF growth rates used by Mr. Gorman.
A I have it.
Q I am sorry, page 72, lines 5 to 6. You note that Mr. Gorman's growth forecast is 43 basis points lower than the five-year GDP growth forecast, correct?
A Yes.
Q And you also criticize Mr. Gorman for

comparing his growth rate to the five-year GDP growth rate, correct?

A I am just saying that if you read the question, the growth forecast of 4.77 percent on which Mr. Gorman relies, he qualifies it as being consistent with the economy at 5.2 percent. And I'm not willing to characterize a difference of 43 basis points as being consistent with. I think the growth in the economy is -- 5.2 percent is far in excess of the growth rate forecast that he has utilized.

Q And then at line 11 you say his comparison to the short-term growth rate is inappropriate, right?

A Mr. Gorman is on the right track. What I would have done is I would have compared -- I would have examined the long-term growth rate of the US economy as an excellent proxy for the growth rate that we use in the DCF model. It makes a lot of intuitive sense that over the very long-term utilities will grow at the same pace as the economy.

And all the forecasts of the US economy that I have seen are somewhere 3.5 to 4 percent real growth, plus inflation around 2.5 to 3 percent, that would suggest a nominal growth rate of around 6 percent. So if you are going to go that route, Mr. Gorman should have perhaps used 6 percent, which is the anticipated growth of the US economy over the very long term. That makes a lot of sense to do that.

In fact, I talk about this approach in my book as well.

Q Over the last 20 to 30 years, how is the utility growth rate compared to the growth rate in GDP?

A I don't know. I suspect it was much less because the utility industry was in a profound transformation with lots of restructuring, and write-offs, and mergers and acquisitions and lower allowed returns. So I suspect the last 20 years is not representative of the long-term burning power of the utility industry as it was traversing this period of change.

Q If you refer to page 73 of your testimony, are you aware that Mr. Gorman used an average of growth rate expectations from three sources, Zack's (ph), Reuters, and Thompson Financial?

A Yes, I am.

Q And --

A   And that's okay. There's nothing wrong with that.

Q   But you argue at 73 and 74 of your testimony that an average of the Value Line in Zack's earnings forecasts should apply instead; is that correct?

A   What I am saying on this particular page, is that one should also examine an independent source of growth forecast, notably Value Line. Some people have argued that analysts' forecasts could be overly optimistic. And to guard against that, why not consult a growth forecast of an independent advisor like Value Line. As the case turns out, on the next page, they are identical, 5.2 percent, which gives me great comfort that they both agree.

Q   So Value Line is a single analyst projection?

A   Yes. But it is a widely followed one, a widely used investment service. And it is an independent provider of information, not engaged in stock trading or bond trading.

Q   Do you think it's important to estimate the consensus of investors, rather than the views of individual analysts?

A I agree. I think you should look at both; hence, I take comfort in the fact that they both are 5.2 percent. Both analysts and Value Line do agree on 5.2, and that's significantly higher than Mr. Gorman's 4 point.

Q Now, I would like to return to your response to Mr. Gorman's CAPM analysis. Mr. Gorman relied on the beta estimates of Puget Sound Energy of .8; is that correct?

A That's correct. And that's a radical departure from his past practice.

Q Do you think it's appropriate to use an alternate means to determine beta, when the average beta of the comparable group does not seem reasonable?

A If the group is not reasonable, why did he use it? That's the obvious question. The bottom line on beta is that betas, which is a measure of risk for utilities, for an individual company is fraught with measurement error.

So it's common practice in the field of finance to use a beta of a group of companies to try to alleviate the measurement errors, to get more comfort on the measure of a group, rather than a single estimate based on one company.

And that's what I have always done, and that's what Mr. Gorman has always done, but not in this case. For some reason in this case he used a single company's estimate of namely Puget Sound Energy of .80. And I think that measurement is fraught with measurement error.

Q Can you -- if you could turn to page 77 of your testimony. You, at line 3, you accuse Mr. Gorman of making a false assertion. And then there's a quote where this false assertion allegedly occurred. And can you tell me what about that quote is false?

A Here's the line of reasoning here. Mr. Gorman says, yes, I did deviate from past practice, but why not? Dr. Morin did it once before. Why not me? But I didn't do that. I have never done that. I have always relied on group averages when measuring the betas for utility stocks.

Q Let's talk about the Detroit Edison case that you reference at line 15. You say it's -- starting at line 16, that you relied on the average betas of two groups of utilities; is that right?

A Right. To the best of my recollection, that was awhile ago.

Q And is one of the groups that you relied on the electric industry as a whole?

A Yes. I believe I may have used Moody's Electric Utility Index, or the stocks that comprised the index as a proxy for the industry, yes.

Q And is the other group that you refer to all gas utilities with a market value over $500 million?

A I believe that is correct. As a check on the betas of electric utilities, one can look to the betas of natural gas distributors. They are very, very similar. And so I examined, as a check, the betas of both groups. To the best of my recollection, this is a long time ago.

Q So in that case, you did not base your beta on a group of companies with a comparable risk?

A Yes, I did. I used the betas of Moody's Electric Utility Index as a proxy for Detroit Edison, or DTE Energy it was called.

Q So all the companies in the Moody's index have comparable risk to Detroit Edison?

A It's a good starting point. In this day and age of volatility and turbulence in the industry, I much prefer to rely on a large group of companies and then make risk adjustments if they are warranted.

So on the Detroit Edison case I looked at the average electrical utility industry as proxied by Moody's and made risk adjustments at the end depending on whether they are less risky or riskier than average. I think that's a safer procedure.

Q If you turn to page 81 of your rebuttal testimony.

A I have it.

Q At line 6 you criticize Mr. Gorman's CAPM analysis for using a medium-term inflation forecast. And you argue that a long-term inflation forecast should be used; is that right?

A That's correct. An inflation forecast over the next few years does not marry or match very well with equity common stock that has an infinite life.

So I think one should rely on a very long-term forecast of inflation rather than a shorter-term forecast, because common stock lasts forever.

Q Is a shorter-term forecast of inflation more likely to be accurate than a long-term forecast?

A I think the long-term forecast is probably more accurate, because it evens out the ups and downs, and peaks and valleys over the long term.

Q Which would be more accurate over the short term?

A I guess you will have to say the short term forecast by nature of the beast being one or two years out. But the one that is impounded in security prices, notably long-term bonds and stocks, is obviously the long term forecast because common stock is a long-term instrument.

Q So why not base rates on the more accurate forecast, but allow the Company to come in if the conditions change?

A Oops. You gotta ask me that again. Please rephrase.

Q If the short-term forecast is more accurate over the short term, why not base the rates on that rather than on a long-term forecast that may be more accurate, and the Company can seek rate relief if conditions change?

A Because the cost of equity or bond yields or any of the long-term instruments embody a premium for long-term inflation, not short-term inflation. When you are buying a 20-year bond or an infinite stock, you are worrying about the inflation premium that is embedded in those instruments, which is by nature a very long-term premium for inflation.

So that's why you have to have an apples to apples comparison to match common stock with long-term inflation.

Q If you could please refer to page 87 of that, which is the portion of your rebuttal testimony where you respond to Mr. Gorman's criticisms.

A (Complies.) I have it.

Q Mr. Gorman criticizes your comparable group on the basis that it includes significant nonregulated business risk; is that correct?

A Yes.

Q And at line 6 to 7 on page 87 you admit that several of the companies in your comparable group do have nonregulated business risk; is that right?

A That's correct. No single witness in the proceeding has the luxury of having pure, pure, pure unadulterated electric utilities. The fact of the matter is we're dealing with parent company data that have some unregulated activities. Although, that fraction, that percentage is diminishing rapidly as the industry is becoming much more focused very rapidly and shedding itself of unregulated activities. But the data is such that it cannot be helped. We don't have any pure players.

Q There is a table at the bottom of page 87 with a column labeled Percentage Utility Revenue. What is the purpose of this table?

A It's to show that the criticism that Mr. Gorman directs at me is equally applicable to him, his own group of companies, as 70 percent of its revenue is from utility activities, and therefore, obviously 30 percent from nonutility activities.

So what is good for the goose is good for the gander, is the point I'm trying to make here.

Q Are you aware that half of the utilities listed in the table here, which shows Mr. Gorman's comparable group, are combination gas and electric utilities?

A Yes, they are. And so are mine.

Q And --

A We have a lot of overlap between our two groups.

Q If you refer to Cross Exhibit 325.

A (Complies.)

Q Which is the Company's response to ICNU Data Request 7.144.

A I have it.

Q If you turn to page 3 of that exhibit, does that show the utilities in Mr. Gorman's comparable group that are combination gas and electric?

A Yes, it does. Both Mr. Gorman and myself use the same starting point. We use the list of companies that you see here. The title here is Combination Electric and Gas Companies. And I think we both eliminated noninvestment grade companies, those that have a bond rating of -- about the fifth or sixth column from the right. We eliminated the companies that are not investment grade.

And then focused on the ones that have electric revenues, in my case, in excess of 50 percent. And that's in the -- roughly in the middle of that table there. You see the heading Percent Electric Revenues. So we both are on a very similar path here.

Q Correct. If you look at row 30, for example, for Puget Energy, it shows 61 percent Electric Revenues?

A That's correct.

Q And that's corresponds to the 61 percent that is in your table on page 87 of your rebuttal testimony?

A That's correct.

Q For Puget Energy?

A Yes. But I would say the 61 percent probably understates the proportion of revenues from utility operations because of the vestiture -- of the recent divestiture of one of the subsidiaries of Puget Energy that was not involved in kosher utility operations.

Q So that would make the percentage higher?

A That's correct.

Q And would you agree for combination electric and gas utilities, the total regulated revenue includes both regulated gas and revenues?

A I believe this is how AUS utility reports measures it. The heading on the table probably is a misnomer. It should be Percent Regulated Revenues. So I think you are correct, it's both electric and gas but I would have to check that.

Q So you think on page 3 of Exhibit 325 where it says, Percent Electric Revenue, that that includes gas?

A I have to check that. I honestly don't know. I do know that most of the companies, the vast majority of the revenues from electric operations, including PSE in this case, and there's a lot of data on this page here, allowed returns and so forth, and dividends data. And it's a very good source of information.

Q Well, referring back to page 87 of your rebuttal testimony, at line 11 it says that, "The table lists the revenues attributable to electric utility operations." So I think we need to have that clarified, whether that includes gas revenues or not.

A I would have to check that. Perhaps we should say attributable to utility operations, but I will check on that. If it doesn't include gas utility operations, that would only strengthen both Mr. Gorman's and my case that we have it closer to a pure play utility.

Q Is it fair to compare the regulated gas and electric business risk with unregulated business risk?

A One would have to say the unregulated business risks are higher than the regulated operations on a generic basis. Of course, there are individual cases where a utility can be riskier than a nonregulated company. But I would agree that generally speaking unregulated activities do not benefit from the umbrella or safety net of regulation and are perceived to be riskier by capital markets.

But, again, the industry is becoming increasingly focused on utility operations, and that problem is evaporating quickly.

Q If you could refer to page 94 of your rebuttal testimony.

A I have it.

Q At line 3 it says, "As discussed in the prefiled rebuttal testimony of Donald E. Gaines, PSE has greater purchase power risk than any utility included in my electric proxy group."

A That's correct.

Q Now, isn't it true that Mr. Gaines compared PSE's purchase power risk to the purchase power risk of the industry as a whole?

A You can ask him that, but I believe that's correct.

Q Did you compare PSE's purchase power risk to the risk of your comparable group?
A I relied on Mr. Gaines' data for my assertion here that the Company has significant purchase power risk. And moderating agencies treat that purchase power contractual arrangement as debt like, so they just reinject it into the balance sheet, and for all practical purposes it is debt. So the company is even more leveraged than it appears on the books, if you impute purchase power contracts as debt.
Q I would like to direct you to Exhibit 326, which we had identified as a cross exhibit. This is a response to ICNU's Data Request No. 7.148.
A Yes, I have it.
Q Now, this is a data request that asks for the basis of your statement that Puget has greater purchase power risk than utilities in your comparable group; is that right?
A Yes.
Q And if you could to turn to page 4 of Exhibit 326.
A I am looking at it.
Q And are these -- is this the list of your comparable companies?

A These are the operating companies of the parent companies that we all are using in our groups here, the three witnesses.

There's no market data on operating subsidiaries, so we have to rely on parent company data. So what you are looking at here is the operating company data.

Q And the last column on this table, Percent of Load Met with Power other than Self-Generated Power --

A Yeah.

Q Tell me what that column depicts?

A T&D utilities, meaning transmission and distribution utilities that do not have the power generating function. They are merely intermediaries that buy the power and act as resellers.

Q So is this table the basis upon which you concluded that Puget had more purchase power risk than your comparable group?

A That was one basis. But I think a more solid basis was the statements by the moderating agencies expressing the concern that the Company is too leveraged, meaning it has too much debt, particularly if you take into account purchase power contracts. That was the main basis for my comment.

Q Now, this table doesn't take into account -- it just shows the amount of energy purchased from the FERC Form 1; is that right?

A Yes.

Q And it doesn't account for capacity payments, right?

A It doesn't. But that data would be extremely difficult to get from each individual operating company in the sample. It's aggregate data on purchased power.

Q Is it possible that utilities -- or some utilities displace their generation by buying nonfirm energy, if it's cheaper?

A It is possible.

Q And wouldn't that, in this table, exaggerate the reliance on purchased power?

A It is possible.

Q Do you know what portion of the energy reflected in the table for PSE is related to displacement energy?

A No.

Q Are you aware that the availability of surplus hydro in the Northwest creates a greater opportunity to displace thermo generation than in other parts of the country?

A   Generally speaking, yes. But the Company's reliance on hydro resources also accentuates its risk because of the fluctuations of hydrolicity, if there is such an English word.

Q   Are any of the utilities on page 4 of Exhibit 326, other than Puget, located in the Northwest?

A   No.

Q   Can you describe to us what the S&P methodology is for assessing purchase power risk?

A   Yes. They look at the long-term purchase power contracts that the Company has that exceed three years. They compute what we call in finance, a present value or capitalized value, to bring it down to time zero. And they use a 10 percent rate of return. And they get a number, let's say $100 million. And then they factor in a risk factor which can vary from 30 percent to 50 percent, depending on their perception of the Company's risk.

So let's say it's 30 percent, in the case of Puget, that $100 million would become $30 million. And then they treat the $30 million as debt capital in the Company's capital structure. It's equivalent to debt. To get the real debt ratio, the real balance sheet, so to speak. So that's the procedure.

Q Would you agree that S&P does not capitalize the energy or the fuel component of a purchase power agreement?

A That's correct. The capacity component is the one that is factored in.

Q And did you compare the Puget debt equivalent for purchase power contracts with your comparable group?

A No, I did not. I figured all of this was factored into the moderating of BAA 3 or BBB minus in the case of S&P. And presumably that moderating captures many factors, one of which being purchased power. So the debate is of the companies.

Q If you could refer to page 92 of your rebuttal testimony.

A (Complies.)

MS. DODGE: I am sorry. Would you say that again? I didn't catch that.

MR. VAN CLEVE: 92.

THE WITNESS: I have it.

Q BY MR. VAN CLEVE: There's a chart on this page. Can you explain what the purpose of the chart is?

A Yes. One of my reactions to both Mr. Gorman's and Mr. Hill's testimonies is that they don't talk at all about the big elephant in the room. And the big elephant in the room is the gigantic, almost daunting capital spending program that the Company is contemplating.

Earlier in testimony we heard the figure of $2 billion of capital expenditures. That is the same as the Company's equity account. I mean, let's think about this. The Company is contemplating increasing its equity by 100 percent. They want to invest as much money as they already have in their equity account.

So the capital expenditure burden is absolutely enormous and daunting for this company. And I was trying to say, look, this company is facing all kinds of construction risks. This company is in the middle of changing its business model in favor of one that has its own self-relying generation and abandoning the old ways of depending on somebody else, and on purchase power, and on volatile hydro resources.

So I was trying to make the point here in this table that the ratio of capital expenditures to net plant is 12.6 percent. It is the highest of any company on the list here, compared to the average of 8.89 percent.

But what is the not on this table is the fact that this company is going to invest at least $2 billion in the next several years, which is equal to its market capitalization. It needs support of the Commission.

Q So you would agree that the historic data in this table is really not what is relevant; it's what the expected capital expenditures are?

A Well, it's relevant, because in the recent past it's still the biggest. And we don't have the data on everybody else's intentions with capital spending, but we do know that this company is going to double its equity capital just in the next two years.

And it's going to rely on external capital, because it's internal cash generation is not sufficient to handle the whole construction budget. It has to rely on external financing, bond issues, stock issues. And it has to look good in the financial community. It has to be able to present a competitive profile. And it really

really needs the support of this Commission in order to pull this off.

Q Do the companies in your comparable group have a similar S&P business profile score to Puget?

A Yes. I believe the average is around the middle. On a scale of 1 to 10, I think the average is around 5, and Puget is around 4. But that's a measure of business risk. That does not include financial risk.

From a bond perspective, a business risk scores published by S&P is fine. But from an equity, from a shareholder perspective, there's also financial risk to be reckoned with. And the Company's heroic plan to change its business plan in the future is fraught with risks. Under what conditions will it raise the money on capital markets? Will the Commission be supportive in its rate order? What about demand? You build capacity and nobody shows up. We call that demand risk. There's all kinds of risks associated with construction that are financial in nature, and not reflected in the S&P business risk score.

That's the big elephant in the room, the capital spending. Everybody talks about it, and bond rating reports, stock reports. It's a major,

major concern.

MR. VAN CLEVE: Your Honor, I would request admission of Exhibits 325 and 326. And I have no further questions for the witness.

(EXHIBIT OFFERED.)

JUDGE MOSS: Hearing no objection, those two will be admitted.

(EXHIBIT RECEIVED.)

JUDGE MOSS: Let's go ahead and have questions from the bench. I think we will finish up by about 3:00. So I hope that doesn't press folks too much.

Commissioner Jones.

EXAMINATION

BY COMMISSIONER JONES:

Q Dr. Morin, welcome. I just have a couple of questions.

A Thank you.

Q In your rebuttal testimony, both with Mr. Hill's and Mr. Gorman's testimony, when you criticize their use of the DCF methodology you point out numerous shortcomings in DCF. And you also do that in your textbook.

And I am wondering in general why you included -- based on my reading of that, it seems that DCF in your view is not -- almost an outdated methodology now. Why did you even include a DCF analysis in your testimony?

A DCF is not a dinosaur. It's not obsolete. It's one of the three main frameworks that we use to try to get a handle on investor returns. To me, it has become weaker than in the past, because of the underlying assumptions that you speak of.

The reason that I use it is because it is, indeed, one of the three methods, and also it's been very popular in the utility rate-making, and people are familiar with it. And it's one of the three that I use.

But my major, major concern -- well, before I get into that, I should say that all methods have their own limitations, whether risk premium, or the CAPM, or the DCF method. These are simplifications of reality. They are abstractions of reality so we can better understand it.

So all the models, in a sense, are a simplification of the real world. But when you use the totality of all the models in conjunction with one another as a cross check with one another, I think you have a much more reliable estimate.

The major concern that I have with DCF is that in an age where stocks, electric utility stocks are trading well above book value, the DCF method has a chronic fundamental problem of understating investor returns. And it's a very, very simple thing. It's not a complicated academic thing. If a stock is trading at $100, and an investor wants a 10 percent return, clearly the utility has to generate $10 of revenue.

But if the regulator turns around and applies 10 percent to a $50 common equity base book value, there's only $5 in the pot. So you are never going to meet investors' return if you apply a market base rate of return to a book value rate base. That's the fundamental problem.

And I think regulators recognize that, because in my long experience in this business, allowed returns have systematically exceeded DCF estimates. So I think regulators kind of know this, and -- does that answer the question, or --

Q Well, specifically regarding the other two capital witnesses, is that more of a criticism of Mr. Hill or Mr. Gorman? Because I think Mr. Hill focuses on the market to book, the so-called unity of 1.0. Isn't it true that market caps for the utility industry have been in excess of unity for at least 10 to 20 years?

A Market to book ratios have been well above one since 1981. And, of course, utility stocks and nonutility stocks have been trading well above book for more than two decades.

So to me, market to book is sort of an irrelevant thing. The regulators here do not assess market price. The market sets the market price. You set a fair and reasonable rate of return, and the market will do what it does. It depends on interest rates, on risks, on the economy and inflation and so forth.

So market to book ratios, in my view, are the result of regulation, not the starting point of regulation. And they are largely irrelevant in the minds of investors.

As far as academia is concerned, most textbooks -- I am talking about the leading textbooks in finance, devote a considerable amount of space, in fact, the majority of space to what we call asset pricing models, like CAPM.

And DCF has sort of diminished considerably in the importance of the treatment of methodology in textbooks. But I'm not willing to throw it out. I use it as one of the three, and I have always done it that way for 30 years now: equal weight to DCF, risk premium, CAPM. I have never changed that very much.

Q So your recommendation to the Commission is really, despite your reservations about the DCF methodology, is to look at the abundance of data from the three different methods, CAPM, risk premium method, and DCF. Is that really the point you are trying to make to us?

A The major point I am trying to make to you is look at all the evidence. And don't back yourself into a corner by subscribing to one method by saying, We're a DCF Commission or we're a CAPM Commission, because one day in the future you will regret that. So don't paint yourself into a corner. Look at all of the evidence.

Q My last question is on this 25 basis point adjustment you made for, quote, higher financial risk. Did you read Mr. Gorman's criticism in his testimony of your method of calculating that?

A Yes, I did.

Q How do you respond to that, because it seems that some of the points he's making on the basis of your 25 basis points -- excuse the pun, that your 25 basis point adjustment, there's not much in the record or in economic empirical data to justify that.

A Let me remedy that deficiency, if it is one. The fundamental adjustment of 25 basis points, which I think is conservative, is based on the yield differential between B rated bonds and A rated bonds. I should say, BBB and A to be more accurate. And the spread between these bonds is approximately 40 basis points.

So this company here is BAA 3, the lowest, lowest investment grade. The next step down is junk bond. We don't want that. So the spread between BAA 3 and the average utility bond, which is probably around -- which is BBB plus, is approximately half the distance to 40 basis points, somewhere around 25 basis points. So that's one source.

The other source is if you look at the S&P benchmarks that they assign to various utilities, what they will do is they will assign a utility on a scale of 1 to 10, depending on the business risk. And Puget is, for example, a 4 on a scale of 1 to 10, 10 being very risky, 1 being not risky at all.

And the average utility is around 4 to 5, by definition.

If, for example, you were not to grant some of the requests of the Company, like the depreciation tracker and so forth, it might very well be that S&P will now say, you are now a 5. You are no longer a 4. And that means we want a more robust balance sheet to compensate us for that. We want an extra 2 or 3 percent in equity ratio. And that extra 2 and 3 equity ratio translates into 30 basis points as well. That's the second basis.

The third basis would be, look at the betas of electric utilities, and on average right now they are about .88 or .89, and argue, well, Puget on a stand-alone basis is riskier than average. It might have a beta of .91 or .92, maybe .05 higher. And that .05 higher, using the CAPM formula, translates into 25 to 30 basis points as well.

So I think there's a considerable amount of support for the idea that the risk premium is at least 25 basis points. I mean, that's the way it is. I mean, we're dealing with BAA 3 company that is facing quite a road ahead of itself.

COMMISSIONER JONES: Thank you.

JUDGE MOSS: Anything further from the bench?

Chairman Sidran.

EXAMINATION

BY CHAIRMAN SIDRAN:

Q Good afternoon, Dr. Morin. Did you have an opportunity to hear Mr. Valdman's testimony?

A Yes, sir, I did.

Q What did you think of his range of reasonableness of 10.2 to 10.9 percent?

A I thought it was reasonable. His take was more on the perceptions of analysts and the expectations of the investment community, and I think that range is consistent with the average allowed return, which as of June 2006, midyear this year, is 10.6 percent, not 10.5 percent.

I thought it was a reasonable range. I would have argued for something a little higher because of flotation costs, and because this company is riskier than average. I would probably -- 10.6 or 10.7 would be okay for me for an average risk utility. I would probably go a little bit higher to recognize the tremendous challenges that this company faces.

But it's not just a rate of return here. There's two elephants in the room, one being capital spending. The other elephant, which is closely related to the other one, is the fact that this company has not been allowed to earn its allowed return because of historical test year instead of forward test year, because of rate design issues.

And I think you should seriously consider enhancing somehow the Company's ability to earn that rate of return, and that would eventually translate into a lower cost of capital down the road.

If you want some serious food for thought, think about this: this company is going to raise $2 billion in the next couple of years, half of that externally. Half of that will come from debt. So we're talking about half billion in debt, new debt.

Would we want to raise that at 6 and a half percent, or do we want to raise that at 6 percent over 30 years? That extra 50 basis points that consumers will have to bear over 30 years translates into 30, 40, $50 billion of higher burden for the customers.

So I urge you to adopt some of the proposals the Company has suggested to lower that regulatory lag and possibly reduce it to zero so we can begin the road to an upgrade from BAA 3 to BBB plus. And we all benefit: the Company's customers' costs will go way down over the next 10 years.

If you were to do that, I can assure you that there would be an avalanche of cost reductions that would follow. There would be upgrades, you would be put on Positive Outlook, it would probably upgrade to BBB plus. And all of these new dollars the Company has to raise, huge, huge, amounts of dollars, would be raised at a much lower cost. The cost of the debt would go down. The cost of the equity would go down.

So the point I am trying to make here is that more is less, something I have learned over the last 30 years. Sometimes when you are a little generous with the hour a week, it costs a little bit more today. But the impact is absolutely enormous over the next 10, 15 years on the customers, because of the lower cost that will follow such a rate order.

So a long-winded answer to your question, but I think the range is reasonable. I would go to the top of the range in recognition of the Company's much higher risk, and for all of the reasons I have just described.

Q So let me ask one follow-up question, and you are a professor so you are entitled to be long-winded.

If I take your logic, if the Commission were to accept these mechanisms that are being put forward, would it be your view that that would tend to justify moving toward the lower end, if you will, of that range of reasonableness?

A That's correct. The answer is yes. You have a choice: either compensate the risk or reduce it, or both.

So I think the adoption of some of these mechanisms, particularly the ones that deal with regulatory lag would have a very salutary, positive effect on the risk of the Company. And in some of my responses and in my testimony I am talking about 25 basis points to 50 basis points, depending on which mechanism you accept.

But it's imperative that we deal with this regulatory lag problem. PSE is one of the only utilities in the country that systematically cannot earn its rate of return, because of historical test year, because of regulatory lag. And we need to remedy that, especially now that we are facing probably $10 billion over the next 10 years as the Company changes its business model -- drastically.

Q So given your review of utilities around the country, do most utilities in the United States have power cost only rate cases, and purchase gas or purchase adjustments -- power cost adjustments for decoupling, or the depreciation tracker that is being proposed?

A Three responses. Number one, on the purchase power cost, most is not every utility -- I think I have some data on that in one of my responses -- have some kind of fuel pass-through clause, or fuel adjustment clause, FAC. And most of them, the vast majority, it's one-on-one. Very very few have a partial. And by the way, I agree with having a partial. I think the Company is skimming it, and all that. I don't have a problem with that.

Now, on the second, the power cost only, no, this is unique to here. And this is a very good device that eliminates some of the risk, particularly associated with generation resources. But it does not deal with the fact that the majority of the capital budget as being entertained for the future is for infrastructure for T&D, not generation.

The third item you mentioned, decoupling, we're in new territory. There are only four companies that I know of that have a decoupling mechanism. There are seven or eight that have already filed a case, and I am involved in some of these cases for decoupling mechanisms. That is a new concern in the industry. As the usage per customer diminishes, and as the environmental movement requires us to do something about conservation, we're moving in that direction. But that's new territory.

So on fuel adjustment, most people have one-on-one. For power costs only, that's unique. But on the other hand, in counteracting all of this, most utilities have a forward test year. So it really doesn't solve, but it goes a long way toward solving the regulatory lag issue. And/or a lot of companies have CWIP, construction work in progress, in rate base. So you can earn a return of and on the assets that you are putting into service.

So these are policy issues that the Staff should examine, and think about, and possibly implement.

CHAIRMAN SIDRAN: Thank you. That's all I have.

JUDGE MOSS: Any follow-on questions?

Any redirect?

MS. DODGE: No.

JUDGE MOSS: Dr. Morin, we appreciate you being here and giving your testimony. And you may step down.

THE WITNESS: I appreciate being here and being in the Northwest.

JUDGE MOSS: This would be a good time to take a recess. Let's try to come back about a quarter after or so.

(Discussion off the record.)

(Brief recess taken.)

JUDGE MOSS: Let's be back on the record. We have made arrangements for Mr. Gorman to be on the telephone. Commissioner Jones has a few questions for him.

And can you hear me okay, Mr. Gorman?

THE WITNESS: I can.

JUDGE MOSS: Please be careful to speak up so the court reporter can catch what you say. If we miss something, we will ask you to repeat.

Mr. Gorman, can you give us another sound test?

THE WITNESS: I understand my directions.

JUDGE MOSS: We will have our questions from Commissioner Jones.

COMMISSIONER JONES: Mr. Gorman, this is Commissioner Jones. Good afternoon, how are you?

JUDGE MOSS: Wait, I need to swear Mr. Gorman. Him not being in the room, I neglected that step.

Mr. Gorman, please stand and raise your right hand.

THE WITNESS: I am.

MICHAEL GORMAN,

produced as a witness via Bridgeline, having been first duly sworn, was examined and testified as follows:

THE WITNESS: I do.

JUDGE MOSS: Thank you. Go ahead.

EXAMINATION

BY COMMISSIONER JONES:

Q Mr. Gorman, on flotation costs, I understand from your testimony that you regard Dr. Morin's proposed flotation cost judgment as unwarranted; is that correct?

A That's correct.

Q Have you ever advocated for a flotation cost adjustment in any proceeding in any state?

A I have.

Q And under what conditions would you advocate for a flotation cost adjustment? Would it be under the known and measurable standard?

A It would. It was only instances where the utility has properly accounted for its cost issue of common stock, and shown that they have been reasonable, and shown that there's a proper reasonable allocation of those costs in a regulated utility operation.

Q Would you also object to the -- from your criticism of Dr. Morin's proposal, I understand it also relates to the parent company issuing the stock for the benefit of the subsidiaries. Are there any circumstances under which you could support a flotation cost adjustment where the parent company has issued the stock primarily for the benefit of the regulated utility subsidiary?

A Well, yes. And under those circumstances you just described it's important to recognize that the parent company could issue debt to make equity infusions in the utility subsidiary. And, of course, issuing debt would not entail the cost of issuing stock to the public. So what is necessary is for the utility to demonstrate, first, that it did issue common stock to the public, show the costs it incurred for issuing that stock was reasonable, and show how much of that flotation cost the parent company incurred should be allocated to the utility.

All of those would allow for the Commission Staff and other intervenors to audit the expenses incurred, review the proposed allocation, and demonstrate that those costs are reasonable for use in setting the utility's rates.

Q Moving to the next question on DCF, were you listening to Dr. Morin and the discussion earlier today on your calculation of the 4.77 percent for the infamous G factor?

A I was, yes.

Q He says that is understated and you should look at --

A I am sorry, Commissioner. Somebody just beeped in.

Q I am sorry. I think he objected to your use of the word consistent with GDP, and that would be nominal GDP data.

Do you have any response to that, because the GDP -- I'll state it again.

The nominal GDP data suggests a growth factor of about 5.2 percent, does it not?

A It does. And importantly, Commissioner, I did not testify that the consensus analyst growth projection was equal to the GDP growth factor. What I testified to was the growth factor was reasonably consistent with the expected overall growth of the US economy.

I showed that the growth rate the analysts are now expecting for the utility companies is very high in comparison to historical period, and is consistent with the expected overall growth to the service area economy as brought to you by the GDP group.

It is important to recognize that the utilities historically have not grown as fast as the service area economy which is measured by the GDP. And the reason they don't grow as fast is utilities historically and continue to pay out a majority of their earnings as dividends.

When you pay out a high percentage of your earnings as dividends, you don't reinvest as large a percentage of those earnings in the Company, and that causes your growth to be lower than other companies that do pay out a much smaller portion of their earnings as dividends and reinvest a larger portion.

So it would be reasonable to expect that a nondividend paying company may have long-term sustainable growth equal to the GDP growth rate, but it's not reasonable to expect that the utility or a company that pays out a large percentage of its earnings in dividends would achieve that same level of growth.

And the DCF model, you can get a sense of what the total expected return an investor will receive for making an investment. With utility stocks, the investors get a relatively high dividend yield that is produced by the reality that the utilities pay out a majority of their earnings as dividends. That's part of the compensation to investors.

Another portion of the compensation is the amount of earnings reinvested in the companies which fuels future growth. It's not reasonable to expect a utility can both achieve a high dividend yield relative to overall market average investments. A utility dividend yield today is around 4 and a half to 5 percent, whereas the S&P 500 dividend yield is around 1 to 2 percent. And still the utility can achieve the same kind of growth you would expect from the S&P 500, even though they retain less of their earnings to reinvest for future growth.

Q My last question is on the common equity ratio, in essence the capital structure, both current and proposed for this company.

In Exhibit 475 you list the comparable group of companies, 14 companies. And I just want to verify this data with you, and to understand why your recommendation of 44 percent still stands.

Under the column, Value Line, there's an average common equity ratio of 49 percent. And, again, these are all business profile 5, and I understand that. And for AUS the common equity ratio is 46 percent; is that correct?

A Yeah, that's correct.
Q And you are still recommending a common equity ratio for Puget Sound Energy of 44 percent. Why?
A For two reasons: first, that's their actual common equity ratio. To impute a higher common equity ratio would be tantamount to providing them an equity return on capital for investments that were funded by debt capital, not equity capital. So it's consistent with their actual costs incurred for investing in utility plant.
Second, the overall risk profile of PSE in relationship to its proxy group indicates that the proxy group is a reasonable risk proxy to PSE. The financial risk is one element to the risk; the operating risk is the second.
PSE has lower operating risk, so it can therefore take on greater financial risk and still have a comparable total risk investment profile to that of the proxy group.
Again, total risk is the combination of total risk and operating risks. PSE, as indicated on this schedule, has lower operating risk and greater financial risk, but it has greater total

risk.

COMMISSIONER JONES: Thank you, Mr. Gorman. That's all I have.

JUDGE MOSS: Mr. Cedarbaum, do you have any follow-on to the bench questions.

Ms. Dodge?

MS. DODGE: No.

JUDGE MOSS: Mr. Gorman, we appreciate you making yourself available by telephone to respond to Commissioner Jones' questions. And with that, if you were here, I would tell you to stand down. I believe Mr. Gaines is the last witness for today.

MR. CEDARBAUM: Your Honor, I am sorry. I was just -- the context of the discussion has been with respect to Dr. Morin and Mr. Gorman. And now if the Commissioners have questions of Mr. Hill, we could put him on now to keep the record all together.

JUDGE MOSS: My understanding is they do not. So, Mr. Gaines, raise your right hand.

DONALD E. GAINES,

produced as a witness, having been first duly sworn, was examined and testified as follows:

JUDGE MOSS: Thank you. Please be seated.

THE WITNESS: Judge Moss, may I remove my jacket?

JUDGE MOSS: Yes, you may. This room does get warm, so anybody that wants to remove their jacket, please feel free.

(Discussion off the record.)

DIRECT EXAMINATION

BY MS. DODGE:

Q Please state your name and title, and spell your name for the court reporter.

A My name is Donald E. Gaines. Last name is G-a-i-n-e-s. My title is vice president finance and treasurer.

Q Do you have before you what have been marked for identification as Exhibit Nos. 131 C through 149?

A Yes, I do.

Q Do these exhibits constitute your prefiled direct and rebuttal testimony, and related exhibits in this case?

A Yes, they do.

Q Were they prepared under your supervision and direction?

A Yes.

Q Do you have any additions or corrections to make at this time?

A I do. I submitted an errata sheet with three items on it earlier. And then in double-checking that, I found that the first item was in error. So that should remain as it was originally written. But those second and third items are still accurate.

JUDGE MOSS: And for the record, the errata is in association with the rebuttal testimony, Exhibit 137 C.

Q BY MS. DODGE: With those corrections, are your prefiled direct and rebuttal testimony true and correct to the best of your knowledge?

A They are.

MS. DODGE: Thank you, Your Honor. Puget Sound Energy Exhibits 137 C through 149 in the record, and offers Mr. Gaines for cross-examination.

(EXHIBIT OFFERED.)

JUDGE MOSS: Hearing no objection, those will be admitted as marked.

(EXHIBIT RECEIVED.)

JUDGE MOSS: Mr. Cedarbaum, Mr. Gaines is available to you for cross-examination.

CROSS EXAMINATION

BY MR. CEDARBAUM:

Q Hello, Mr. Gaines.

A Hello, Mr. Cedarbaum.

Q If I could have you turn to Exhibit 150 for identification. And in my questions on this exhibit, I will be asking you page numbers that are in the upper right-hand corner, not the lower right-hand corner.

MS. DODGE: Could we clarify that we're looking at the so-called PSE version?

MR. CEDARBAUM: Yes.

Q BY MR. CEDARBAUM: Do you have that in front of you?

A I do. Some of the pages appear to have the page numbers in the upper left-hand corner, so we might have to bounce around a bit.

Q Well, when I ask you to turn through this document, I will be referring to the page numbers in the upper right. Do you see those?

A Well, the version I have, the very second

page doesn't have a page number in the upper right.
JUDGE MOSS: I think Mr. Gaines has the wrong version, because mine are all numbered in the upper left.
THE WITNESS: I was just handed one with the proper markings. Thank you.
Q BY MR. CEDARBAUM: And do you recognize this document as selected pages from the Company's 10K for the fiscal years ended December 31st, 2002, through 2005, and then the last two pages come from the Company's 10Q for the quarterly period ending June 30, 2006?
A Yes, those are excerpts from those reports.
MR. CEDARBAUM: Your Honor, I would move the admission of Exhibit 150.
(EXHIBIT OFFERED.)
JUDGE MOSS: Hearing no objection, that will be admitted.
(EXHIBIT RECEIVED.)
Q BY MR. CEDARBAUM: If I could have you look at page 2 of the exhibit, there's a line under the common equity section entitled Earnings Reinvested in the Business. Do you see that?
A Yes, I do.

Q Is that essentially retained earnings?

A Yes -- I don't know, though, if that is for -- if that's a cumulative number, or if that is the number for the year.

Q Well, I am trying to get an idea of the trend.

A Okay.

Q And if we look in the 2001 column, there's an amount of $55.3 million which goes up in the 2002 column to 66, just under $67 million; is that right?

A That's correct.

Q And then turning to page 5, the numbers from 2002 to 2003 show an additional increase; is that correct?

A About 34 million, yes.

Q And without belaboring the point, is it correct that throughout the time period shown in this exhibit, earnings reinvested in the business increased over from one year to the next?

A I would think so, Mr. Cedarbaum, because I believe in every one of these years at the utility level, the utility's earnings exceeded its dividends. So a retained earning editions would be positive.

Q If I could have you look at Exhibit 151, and the page numbers in the bottom right-hand corner.

A Okay.

Q Do you recognize this as other pages from the Company's December 31st, 2005, 10K?

A Yes.

Q And if you look at page 3 of the exhibit, under the section, Restrictive Covenants?

A Yes.

Q Does that describe various aspects of the Company's borrowing capacity under the most restrictive tests?

A It does, but as of that date, which is several months ago now, the Company, of course, frequently adds to the amount of its borrowing capacity as it adds more plants. So these numbers grow, and would be higher today.

Q And in the exhibit on page 3, there's a reference to in the first bullet, and in the second bullet, electric -- excuse me, electric bondable property and gas bondable property.

Does that refer to the Company's investment in T&D and generation property on the electric side and delivery property on the gas

side?
A Yes. It excludes things like computers. There are some minor things like that that are excluded, but primarily it's bricks and mortar of the gas-electric business.
Q On page 5 of the exhibit that shows a consolidated statement of cash flows for Puget Energy; is that right?
A Yes.
Q And if we look at the 2005 column under the financing activities section, which is kind of in the lower third, there's a line for issuance of common stock; is that right?
A Yes, there is.
Q And that amount of $317,607,000 is the common stock issuance by Puget Energy in 2005?
A There's a couple of pieces to it. It's primarily the sale we made to Lehmann Brothers in November of 2005, and then some dividends reinvested and so forth.
Q And if you turn back a page in the exhibit to page 4, your reference to the November 2005 sale is discussed in the third full paragraph on the right-hand side of the page?
A That's correct.

Q Is it correct that that additional stock was sold at a per-share price above the per-share book value?

A Yes, it was.

Q Is it correct that Puget Energy took the proceeds from the sale of that stock and invested them in the utility?

A All of it, yes.

Q The last page of the exhibit, which is page 6, again, on the 2005 column under financing activities -- and I guess we should back up. This is a consolidated statement cash flows now for Puget Sound Energy; is that correct?

A Yes, for the utility.

Q Now, turning to the 2005 column under financing activities, there's an entry for issuance of bonds and notes of 400 million. Do you see that?

A Yes, I do.

Q And just to tie that back, two pages in the exhibit, the amounts and timing of those issuances are described in the first two paragraphs of page 4 on the right-hand side, May 2005 and October 2005 bond issuances?

A Yes, that's correct, a 250 million issue and 150 million issue add to the 400.

MR. CEDARBAUM: Your Honor, I would move the admission of Exhibit 151.

(EXHIBIT OFFERED.)

JUDGE MOSS: It will be admitted as marked.

(EXHIBIT RECEIVED.)

Q BY MR. CEDARBAUM: Mr. Gaines, is it correct that the Company recently filed with the Commission a planned issuance of new senior secured notes?

A Yes. That issue, by the way, Mr. Cedarbaum, was completed yesterday morning.

Q Let's just back up for a second. That was an application that came to the Commission on September 12, 2006; is that correct?

A It was dated the 12th. It may have reached the Commission on the 13th.

Q And would you accept, subject to check, that that was given the docket number UE 061543?

MS. DODGE: Objection. If we're going to have questioning on documents in another docket, I prefer to have the witness directed to a copy of that paperwork.

MR. CEDARBAUM: Some of that was

confidential, and I don't have it with me. I have the cover sheet to that. I'm not sure my questions are really that detailed enough.

THE WITNESS: I am unaware of the docket number.

Q BY MR. CEDARBAUM: You indicated -- is it correct in the application the Company was providing notice to the Commission of a plan to sell $300 million of 30-plus year senior secured notes?

A Yes, that's correct. Up to 300 million.

Q And you indicated that issuance closed recently?

A Monday morning, yes. Yesterday morning.

Q What were the final terms in terms of amount and coupon rate?

A The final terms -- we did upsize it to the full 300 million.

MS. DODGE: Could I caution that we're on public record, so if any of this is confidential, and I don't know if it is.

THE WITNESS: We filed an 8K, and so I think we're good. And the term sheet was attached to that 8K, so it's in the public record. But to answer the question, since I know the amounts, we did do the full 300 million. We were successful in pushing the term out beyond 30 years to 30 and a half years, so it would mature March 15, 2037.

And we did that because the issue that we were just talking about, the $250 million issue on page 3, I think it was, would mature in 2036. So we didn't want to double the maturities. The coupon was 6.274 percent.

Q BY MR. CEDARBAUM: If you could now turn to Exhibit 152 for identification.

A (Complies.)

Q And this is obviously a printout from Yahoo Finance, but does this accurately represent the stock price of Puget Energy for the time period that is shown?

MS. DODGE: Objection, Your Honor. This is not -- was not generated by Mr. Gaines.

JUDGE MOSS: If he knows, he can answer.

THE WITNESS: Mr. Cedarbaum, this appears to be a printout from one day of Yahoo Finance, and Yahoo Finance displays stock price and other data. The last trade information here as of this date is $22.13. I have no reason to believe the price was any different on that date, so I would accept that.

Q BY MR. CEDARBAUM: What about the prices, stock prices earlier on this graph? There's a -- for example in the -- well, I guess I am just asking you --

A I do know, Mr. Cedarbaum, that we closed the end of 2004 at $24.70. And that's about where the peak is on the chart as of the January '05 line. So that part, I know, is correct. But I have no reason to believe that this is incorrect.

Q And what was the stock price in November 2005 when the -- that equity issuance was made?

A I am having a tough time trying to remember that, Mr. Cedarbaum. I know we negotiated a discount to the last close on that sale, and I can't remember -- let me check one other document. I may be able to answer that. Let me just check.

Q Let me try this a different way so we can have some flow to these questions, instead of you having to refer to other documents.

But my questions concern the issuance of the 2005 stock relative to the time that the Commission issued its rate case order from the last rate case, which was end of February time frame of 2005.

A Okay.

Q And is it correct that in that order the

Commission set rates using an equity ratio of 43 percent?

A Yes, it did. And in my testimony in that proceeding I showed that we would sell stock -- at that time it was confidential. Since it was completed, it no longer is -- in February of '07. And we moved that up to -- I am sorry, February of '06, and we moved that up to November of '05, and we increased the size.

Q Earlier in the prior exhibit --

JUDGE MOSS: Give us a number.

MR. CEDARBAUM: Okay, Your Honor. Exhibit 151, page 4, shows the -- describes that equity issuance in November 2005.

Q BY MR. CEDARBAUM: Is it correct that for that issuance the Company earned just under $21 per share?

A I see now the nest price that we got. It was $20.80.

Q I say "earned." I should say received.

A It was a discount of the previous close of I want to say 2 or 3 percent.

Q So that would compare to the stock price around the time of the 2004 rate order in February of around $24 per share?

A No. It would be more like 22 something. I think if it was -- I think it was a 2 percent discount. What we sold it at, I believe, was $20.80 per share. So if I take 20.80 and divide it by .98, I would get 21.22. And I could get that price. We have records of that if you would --

Q That price, then, would compare to the stock price at the time of the rate order issued in 2005 of around $24 per share?

A Well, the $24.70 was the end of '04, and what date did you say the order was?

Q Do you know what Puget Sound Energy's stock price traded for at the time of the 2004 rate order?

A I don't know that number off the top of my head, but I could get that if you wanted me to.

Q And you don't know whether what has been marked as Exhibit 152 is an accurate representation of Puget Sound's stock price?

A My testimony was I don't have any reason to believe that it's inaccurate.

MR. CEDARBAUM: Your Honor, I would offer Exhibit 152.

MS. DODGE: Your Honor, we object to this for the same reason. I mean, it's a printout from

Yahoo Finance, but he's talking about dollars and cents stock price, which this is a line graph which doesn't, with very much precision, identify what the stock prices on any given day were. And the questions went to some pretty time-specific inquiries.

MR. CEDARBAUM: Could I make -- maybe it's best to do this by a record requisition if I could have it as an exhibit. And that would be to have the Company provide a list of Puget Energy's stock price for each month beginning January 2005 through January 2006.

JUDGE MOSS: When you say each month, I'm not sure how they do that. Stock prices change daily.

Q BY MR. CEDARBAUM: Then could we have the daily prices?

A We have the daily prices. And what was the ending date, Mr. Cedarbaum?

Q I would say for the calendar year 2005.

JUDGE MOSS: And it would be your proposal to substitute that information provided by the Company as what you have as Exhibit 152?

MS. DODGE: Is this the daily closing?

THE WITNESS: We have a sheet that would

show the high, the low, the close readily available.

MR. FFITCH: Could I ask that the friendly amendment to the record requisition -- we had questions earlier about prices all the way up through the 15th of September of this year. So perhaps if the Company is going to prepare that response, it could include time all the way up until September 15th.

JUDGE MOSS: I understand it's readily available?

THE WITNESS: Yeah.

JUDGE MOSS: So let's do that, so that would lend some precision to the record that does not currently exist.

MR. FFITCH: I asked Mr. Valdman about the closing price as of the 15th, so that would include that. Thank you.

MS. DODGE: Generally the Company objects to this line of inquiry being brought into the record, and the reason for that is that there has been no issue raised by any of the parties in the response testimonies that has anything to do with the Company's issuance of its stock, the discount to that, comparison of the stock prices at various points in time, and how that might relate to anything in this case.

And what I am concerned about is we're now putting evidence in the record that will show up who knows how on brief. The Company will not have had the opportunity to respond to any factual assertions or conclusions that might be made.

JUDGE MOSS: I think if the questions and the responses are in some way relevant material to some issue in the case, then they are. And Staff wants to make some line of argument based on changes in stock prices and so forth, you will deal with that in reply. And, I mean, the stock prices are what they are.

MS. DODGE: Well, I am asserting that they have no relevance to anything in the case that they have raised.

JUDGE MOSS: Then I will be very surprised to see them in a brief. So I am not concerned with this adding too much to the record.

So we will have the record requisition responded to, and we will have that as a substitute for what Mr. Cedarbaum previously tendered as Exhibit 152.

And I think Mr. Gaines said you could

supply that -- could it be supplied, say, tomorrow?
THE WITNESS: I suspect I will be getting off the stand. I can get it tomorrow and PDF it down to the folks tomorrow. Yes.
JUDGE MOSS: Do that, if you can.
Q BY MR. CEDARBAUM: My final question, Mr. Gaines, is to really have you identify Exhibit 749, which is -- if you could identify that as your response to Staff Data Request 409?
A I am sorry. Could you give me that reference again? I'm not familiar with that document by that number.
Q I believe it's been marked --
A My series seems to be 131 through --
JUDGE MOSS: This is marked out of sequence, because we ran out of numbers with the late filed cross-examination exhibits. So it's premarked as Exhibit 749, and it is identified as WUTC Staff Data Request 409 at the top. Do you have that?
THE WITNESS: I do now, thank you.
Q BY MR. CEDARBAUM: And that is your response to the stated data request?
A Yes.
MR. CEDARBAUM: Your Honor, I move for

admission of Exhibit 749.

(EXHIBIT OFFERED.)

MS. DODGE: No objection.

JUDGE MOSS: It will be admitted.

(EXHIBIT RECEIVED.)

JUDGE MOSS: I suppose, Mr. Van Cleve, you have indicated the need to cross.

MR. VAN CLEVE: Yes, Your Honor.

CROSS EXAMINATION

BY MR. VAN CLEVE:

Q Good afternoon, Mr. Gaines.

A Good afternoon.

Q I would like to direct you to page 33 of your rebuttal testimony, which is Exhibit 137 C.

JUDGE MOSS: Could you give me the page again, Mr. Van Cleve?

MR. VAN CLEVE: Page 33.

JUDGE MOSS: Thank you.

THE WITNESS: Yes, I am there.

Q BY MR. VAN CLEVE: You make the statement at line 5, that "If the Commission were to adopt the rate relief proposed by the Staff, that the Company would no longer have the credit metrics necessary to maintain its current credit rating."

A I said they would likely have that, but that's my best guess, yes.

Q And it's your judgment that the rating agencies would reduce the Company's credit rating in that event?

A Absolutely.

Q And --

A In fact, in essence, they have said in my rebuttal -- and I have their quotes in my rebuttal testimony -- that rate relief in this proceeding is a key driver of those metrics going forward.

Q And if you refer to the next page, page 34 of your rebuttal testimony, doesn't the first metric, the FFO, interest coverage show that under the Staff proposal that for this metric the Company would be solidly within the BBB range?

A That's what the metric shows for that chart. But I also provide testimony later that there's things beyond the metrics that are important to the credit rating.

Q If you were to put Mr. Gorman's recommendation in, wouldn't the metric for FFO interest coverage be even higher than the Staff proposal?

A I would think it would fall somewhere in between, because his capital structure and ROE were in between. Therefore, his revenue requirement would be in between. So I picked the low points, which appeared to be the Staff's. So, yes, it should bracket it.

Q And the next metric in the second table on page 34, FFO to average debt, under the Staff case doesn't that show as well that it's solidly within the BBB range?

A That's what that metric shows.

Q And under Mr. Gorman's proposal, would that also be in between the Company and the Staff?

A I would imagine, yes.

Q And finally the third metric debt leverage, doesn't this show, again, that the Staff proposal would put the Company within the BBB range?

A Puts it at B minus, substantially below what the Company is. And it doesn't at all address the other items which rating agencies have said an improved mechanism for commodity cost recovery should also provide positive support. These metrics don't pick up that. There's other things like that that are of equal importance, if not more so, than just these three metrics.

I just picked these three metrics because they are the three for which Standard and Poors publishes benchmarks.

Q Mr. Gaines, I would like to ask you the question I asked Mr. Valdman this morning. And that's whether the S&P business profile score of 4 for the Company accurately reflects PSE's current business risk?

A Well, I would answer it this way. In S&P's view, they assessed our business risk and assign it a score of 4. And that is the present score.

The way you phrased the question, you are trying to have me make my own indication as to whether I think it's 4. I don't have that sort of grading schedule in my mind. So their -- S&P's is 4, certainly, yeah.

MR. VAN CLEVE: Thank you. That's all the questions I have.

JUDGE MOSS: Thank you. Do we have any questions from the bench for Mr. Gaines?

Commissioner Jones.

EXAMINATION

BY COMMISSIONER JONES:

Q Mr. Gaines, would you go back to Exhibit 151 again, please. Mr. Cedarbaum was asking you a question on page 4, and this regards flotation costs?

A Okay.

Q And the stock issuance, is it correct to view the stock issuance in November of 2005, the gross proceeds being 312 million, and the net proceeds being 309.8 million?

A Those are the numbers, yes, Commissioner Jones.

Q Is it correct to say that this 2.2 million is the direct flotation cost for the underwriting of that common stock?

A No. That difference is, I believe, the difference between the net proceeds that we received, which was $20.80 a share, and the price at which it was resold, $20.67. We negotiated a discount to the preceding closing price of the stock, which I believe was around the $21.22 area. It was a 2 or 3 percent discount.

So I imagine that cost, the direct cost we incurred was that discount, which would be 2 to 3 percent. And this looks like it was less than 1 percent.

Q Yes. My calculation is 7 basis points, roughly. Well, would you be so kind as to provide that for the record? What I would like is your best estimate of the direct flotation costs, both with a discount of the stock negotiated with Lehmann Brothers, and that difference between gross and net for that particular issuance in November of 2005.

JUDGE MOSS: That will be Bench Request No. 5.

Ms. Dodge, do you understand the Bench Request?

MS. DODGE: Yes.

(BENCH REQUEST NO. 5.)

Q BY COMMISSIONER JONES: My final question, Mr. Gaines, is have you had a chance to do the financial metrics you just discussed with Mr. Van Cleve over the PSE request case versus the Staff case on the financial metrics, FFO to interest, FFO to debt?

A That's what those charts show, Commissioner Jones. The column on the left is the

Company's proposal as filed, and the column on the right is the Staff proposal as filed.

Q Have you had a chance to run the financial metrics based on the Company's rebuttal case that could incorporate the settlement that was entered into with Staff on some of the adjustments?

A This, it's is my understanding, is the settlement case, but -- I am sorry, is the rebuttal case, but it does not have any settlements that -- possible settlements in it.

Q Would it be possible for you to update that to reflect the settlement that was -- the settlement of the adjustments that were agreed to?

A I am not familiar with those settlements. If there is someone in our company who is, and can provide me the financial impact of those on the revenue requirement, then, yes, we can model that.

MS. DODGE: We can do that.

JUDGE MOSS: We will make that Bench Request No. 6.

(BENCH REQUEST NO. 6.)

MR. CEDARBAUM: If I could ask a clarification, that would include both the Company's bar part of it and Staff's bar part of it?

COMMISSIONER JONES: Correct.

THE WITNESS: I am sorry. I don't understand. Could you repeat that, Mr. Cedarbaum. I don't understand what you are wanting.

MR. CEDARBAUM: I am trying to find the graphs themselves, but --

THE WITNESS: They are on pages 34 and 35 of Exhibit 137 C.

MR. CEDARBAUM: And I was clarifying my understanding of the Bench Request was that you were to rerun these charts entirely, not just the PSE request part, but the Staff proposal part.

THE WITNESS: Well, I thought there was a settlement, which I presume would be all parties, which is one run.

MS. DODGE: There's still some differences. I think we understand the request.

JUDGE MOSS: Okay. Does that complete your questions?

COMMISSIONER OSHIE: No questions.

JUDGE MOSS: Chairman Sidran.

EXAMINATION

BY CHAIRMAN SIDRAN:

Q Good afternoon.

A Good afternoon.

Q If memory serves, Mr. Valdman offered you up to answer a question, which is if you could give us some idea of the difference or the spread between being, say, A rated or A minus or B plus, versus the Company's current rating of BBB minus?

A There's -- I can. I should state that these are not statistics I carry around in my head. So hearing the question, I e-mailed a couple of our banks and got responses from those banks. These are banks that were --

Q I believe that's cheating.

A Well, it's the only source I had.

Q Well, okay.

A If you will admit that, then I can give you the number.

At the time I thought the question was one notch up from our current rating, so I was going from BBB minus to BBB. So that was the answer that I got back.

The one answer was, based on today and

spreads are volatile, of course, that the range would be 3 to 7 basis points -- sorry, 3 to 10 basis points. The other one was 5 to 10 basis points. And since the overlap is in the 5 to 10 range of the two, I would say 5 to 10.

This gets to -- people use this in the estimation of safety in the economy. And when they do that, they forget to look at the value of the safety part. This gets to the economy debt is always cheaper than equity.

The safety part is the value of having this cushion. Our stock price -- our credit rating can change in a day. And likely will be looked at in a day shortly after we get a rate order from this Commission on this proceeding.

The agencies have made it clear on pages 34 and 35 of their views of the importance of this. And it's important, as David Mills said, to have a higher credit rating to support counterparties. The vast majority of our counterparties have higher credit ratings than us.

Mr. Valdman showed nearly three-quarters of the regulated industry has higher credit ratings than us. None of this gets factored into this safety in economy. It's sort of a theoretical discussion.

So when we talk about those spreads, and someone will be tempted to say, well, look, it's only 10 basis points, we have to make sure we look at the value of the cushion of the safety part and not just the economy part.

Q Thank you. And a follow-up question would be, and I don't know if you can do this in your head or not, but can you give us ballpark estimate of the savings given the projected capital expenditures that, let's say, 5 to 10 basis points would mean?

A There's a bunch of pieces to that savings. On -- and by increasing the credit rating, obviously, we're talking about. One is the direct reduction in the amount of financing that we would put forth. And as Dr. Morin said, based on this 2 billion look at capital, a portion of that would be debt and a portion would be equity. The debt piece would be applicable to that spread, the savings would be there.

The company has a credit rating -- I'm sorry, credit facility that has a pricing grid in it. And that pricing grid, the cost that we pay for the availability of the credit changes as the credit rating goes up. The higher the credit rating, the less costly that becomes. So that become a savings as well.

The better credit rating would afford us more credit with our counterparties under our hedging program. There's a value to that. I don't know how much that would increase by, but that value would have to be included in there.

Presumably that increase in the credit rating would have been caused by something, higher equity ratio, supported the rate relief, something along those lines that got more cash in the door. That's value to having this cushion, whatever that cushion was, that would have to be factored in. I can't do that math in my head.

I think what you were asking about is really, roughly what is that first piece? That depends on the amount of debt that we issue. As Mr. Valdman said, that's contingent upon the resources that we select through the RFP process, that has yet to be determined. So I can't do that one.

So there's two parts. There's a lot of pieces to it, and not just one piece. And I can't do any of them as I sit here. It's an excellent question.

CHAIRMAN SIDRAN: Thank you. That's all.

JUDGE MOSS: Any follow-on for the bench questions?

Any redirect?

MS. DODGE: Yes, Your Honor, briefly.

REDIRECT EXAMINATION

BY MS. DODGE:

Q Mr. Gaines, Mr. Van Cleve asked you about S&P's business risk profile for PSE?

A Yes, he did.

Q When S&P last provided a risk profile of 4, was that during a period when the Company was operating under a $40 million cap for the PCA?

A Yes, it was, as Mr. Valdman testified. That's correct. It's not been relooked at since, to my knowledge.

MS. DODGE: Thank you.

JUDGE MOSS: That would appear to complete our questions for you, Mr. Gaines. We appreciate you being here and giving your testimony. You may step down, and that does complete our witnesses for today.

Is there any other business the parties wish to raise while the Commissioners remain on the bench?

MS. DODGE: I have a question, Your Honor. Commissioner Jones referred again today to the information -- his interest in the Company's capital expediture projections in 2004 versus now, and asked whether we had developed paper on it. And we don't have it marked as a Bench Request. We have been treating it that way, because it looks like paper is expected. So I am wondering if we need a number for that, or if we have misunderstood.

JUDGE MOSS: If we didn't give it a number, we should, but I have run out of exhibit numbers, so Commissioner Jones, I'm sorry to disappoint you --

I will take care of it somehow. We will call it Bench Request No. 7.

MS. DODGE: We have a -- sorry.

(BENCH REQUEST NO. 7.)

JUDGE MOSS: Did I make a mistake?

MS. DODGE: No, I did.

JUDGE MOSS: So Bench Request No. 7, and that's how you can furnish the response.

Is that it for the business the Commissioners need to be on the bench for? They are free to go, and we will take care of a few housekeeping matters, and we will all be free to go.

Looking at the schedule, we will have Dr. Dubin first thing in the morning, and followed by Dr. Mariam. So let's be sure those two witnesses are available early, because the indicated cross is fairly brief. And then we move on to Mr. Amen --

MS. DODGE: Mr. Amen.

JUDGE MOSS: And Hoff, and last, Mr. Shirley for tomorrow.

MS. DODGE: And, Your Honor, as I understand it, for Wednesday and Thursday we're going to be progressing through the witnesses as quickly as we can go; is that right?

JUDGE MOSS: Well, the witnesses will appear as scheduled.

MS. DODGE: That's what I --

JUDGE MOSS: So Mr. Gent, for example, will appear on the 21st. I was informed that the schedule of witnesses was a finely-tuned instrument that I should not tinker with, so I elected not to.

MR. FFITCH: Well, Your Honor, with the additional overlay of dates certain for certain witnesses, on Thursday morning we had Mr. Selecky and Mr. Brosch identified as dates-certain, mornings-certain, witnesses for Thursday. So we would ask that given that Mr. Selecky is not showing any cross, that unless the Bench has questions, that Mr. Brosch go first on Thursday.

JUDGE MOSS: What about Mr. Gent?

MR. FFITCH: I don't think there's been any request for him to have a date certain.

JUDGE MOSS: I have down that you requested 15 minutes for Mr. Gent. 15 minutes doesn't seem be an undue amount of time to postpone Mr. Brosch.

MR. FFITCH: That's probably true, Your Honor, now that you put it like that. But I guess I did want --

JUDGE MOSS: There's no question in my mind that we will get to Mr. Brosch on the date indicated, and indeed, early in the morning.

MR. FFITCH: All right.

JUDGE MOSS: I will say that the estimate for Mr. Brosch has been increased to 25 minutes. Anything else?

MR. VAN CLEVE: Your Honor, we do not have any cross for the any of the witnesses the rest of this week, so unless we're needed, I don't plan to be back until Monday.

JUDGE MOSS: We will miss the pleasure of your company, but not a problem for you in terms of your participation for the case.

Anything else? Thank you all very much for your efficient use of time today, and I will look forward to seeing you in the morning at 9:30. We're in recess.

ENDING TIME: 4:15 P.M.