EXHIBIT NO. ___(EMM-1CT)
DOCKET NO. UE-09___/UG-09___
2009 PSE GENERAL RATE CASE
WITNESS: ERIC M. MARKELL

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-09____** **Docket No. UG-09____**

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
ERIC M. MARKELL
ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED VERSION

MAY 8, 2009

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
ERIC M. MARKELL

CONTENTS

I. INTRODUCTION 1

II. REQUESTED RELIEF 2

III. THE COMPANY'S TRANSFORMATIONAL ACTIVITIES 11

IV. FINANCIAL CONDITION OF THE COMPANY 15

A. The Company's Need for Additional Capital 15

B. The Challenge of Persistent Under Earning 19

C. The Need for Gradually Improved Financial Strength 22

D. Current Challenges 24

1. Post Merger Financial Challenges 24

2. Capital Expenditure Plans 24

E. Benefits of Investment Grade Creditworthiness 27

V. COST MANAGEMENT AND RATE MITIGATION OPPORTUNITIES 28

A. PSE's Cost Management Philosophy 29

B. Incentive Pay and Executive Compensation 31

C. Other Rate Mitigation Opportunities 33

VI. PENSION PLAN FUNDING 34

VII. SALE OF EXCESS RENEWABLE ENERGY CREDITS 35

VIII. LOW INCOME ASSISTANCE PROGRAMS..38

IX. POST- MERGER UPDATE..38

X. OVERVIEW OF OTHER COMPANY WITNESSES...39

XI. CONCLUSION...45

I. INTRODUCTION

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

A. My name is Eric M. Markell. My business address is 10885 N.E. Fourth Street Bellevue, WA 98004. I am Executive Vice President and Chief Financial Officer for Puget Sound Energy, Inc. ("PSE" or "the Company").

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

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

Q. What are your duties as Executive Vice President and Chief Financial Officer for PSE?

A. My present responsibilities include oversight of the accounting, treasury, financial planning, budgeting, accounting, tax, insurance, portfolio optimization, credit and regulatory functions of the Company.

Q. What is the nature of your testimony in this proceeding?

A. My testimony will: 1) summarize the Company's requested rate relief and the reasons PSE requires rate relief; 2) provide an overview of the Company's ongoing transformational activities; 3) present the financial condition of the Company, including a discussion of the Company's continuing need for access to debt capital and trade credit, the challenge of persistent under earnings, the value of a gradual improvement in PSE's credit standing, and a request for a reasonable allowed return on equity and a sound capital structure; 4) describe rate mitigation opportunities and cost management measures; 5) summarize the Company's pension plan funding contributions; 6) briefly describe the proposed sale of excess renewable energy credits ("RECs"); 7) present a proposal for an increase in funding of low income assistance programs; 8) provide a post-merger update; and 9) provide a brief overview of the testimony presented by the Company's other witnesses in this general rate case.

II. REQUESTED RELIEF

Q. What level of rate increase is the Company requesting in this case?

A. The requested rate increase for electric customers is $148,148,000, an average 7.4% increase over the electric rates set in the Company's 2007 general rate case, Docket No. UE-072300, that became effective on November 1, 2008. The requested rate increase for gas customers is $27,199,000, an average 2.21% increase over the gas rates set in the Company's 2007 general rate case, Docket No. UG-072301, that became effective November 1, 2008.

Q. Please explain why the Company requires the proposed rate relief.

A. There are several factors underlying the Company's need for rate relief. PSE has acquired new resources for electric service in order to meet its customers' needs now and in the future. One such resource is the Mint Farm Generating Station, a combined cycle combustion turbine located in Longview, Washington, which PSE acquired in December 2008, and which provides tens of millions of dollars of net present value benefits to PSE's electric portfolio when compared with the cost of a new combined cycle plant. PSE is also realizing increased costs associated with maintaining reliable gas and electric service for its customers. Even in today's difficult economic times, it is necessary for PSE to move forward with adding resources to meet its customers' energy demands and to maintain a reliable gas and electric system, and the requested rate relief is necessary for PSE to do so.

Q. Has the Company conscientiously addressed cost management opportunities?

A. Yes. The Company is keenly aware of the sensitivity about rate increases and its stewardship obligations in these difficult economic times. The Company is also aware of its duty to balance near term rate pressures with its obligation to the take a long-term view with respect to investing in and managing its system and to comply with the ever growing and increasingly costly demands of various regulations. Accordingly, we look for opportunities to mitigate rate increases while diligently managing our significant capital expenditures, a key determinant of cost of service. Likewise, we try to balance rate pressures with the necessary expenses to recruit and train staff, to refurbish and to expand our systems to provide safe, reliable and adequate service. The Company's cost management efforts include, but are not limited to: working diligently to acquire new resources cost effectively, hedging commodity costs to smooth the impact of large commodity cost swings, procuring materials and construction services competitively, and accessing the debt markets in a fashion that results in reasonably priced debt. Mr. Bertrand A. Valdman, Ms. Kimberly J. Harris and Mr. Donald E. Gaines elaborate on these activities in their respective testimonies. However, even after efforts such as these, the Company's costs to provide service to its customers continue to exceed the revenues it collects under its current rates.

Q. Are there any additional cost mitigation opportunities on the horizon that might be available to the Company during the pendency of this proceeding that might further reduce the amount of requested rate relief?

A. Yes, there are, and some of these may be material in relation to the requested rate relief. I will describe such opportunities later in my testimony and note that the Company advocates, as it has in past proceedings, that the record should remain open to bring forward updates of important cost information so that the most up to date and accurate cost information for material cost items is available to the

Commission when it sets rates for the future rate year.

Q. Why are the costs of serving PSE's electric customers increasing?

A. New plant in rate base is the key cost driver placing upward pressure on electric rates. Although this new plant requires significant initial investment, our analyses demonstrate these facilities benefit the customer over the long-term in serving their electric requirements as compared to the 2007 Integrated Resource Plan lowest reasonable cost portfolio. These facilities help meet growing capacity requirements and provide energy at a cost lower than would otherwise be incurred.

The Company seeks in this case to begin recovering its investments in efficient new generation facilities it has acquired. Further, such investments are consistent with, and meet, the legal requirements of RCW 19.285 (Washington's Energy Independence Act), with respect to the acquisition of renewable energy supplies, and the requirements of RCW 80.80, with respect to the requisite environmental characteristics of the new resources.

Q. Are there other factors causing an increase in PSE's costs to serve electric customers?

A. Other key determinants of increased service costs include: (i) higher operations and maintenance ("O&M") expense, (ii) higher power costs, (iii) higher depreciation expense, and (iv) a stronger capital structure and appropriate cost of capital.

O&M expense has increased due to increasing costs to operate the Company's electric transmission and distribution system and its generation fleet. Higher depreciation expense is related to the addition of new electric plant and is consistent with the plant depreciation lives contained in the Company's December 31, 2006 plant depreciation study and adjustments thereto accepted by the Commission in the Company's last general rate case. Costs of equity capital reflect market forces that have re-priced risk in these turbulent times as Dr. Roger A. Morin and Mr. Gaines illustrate in their prefiled direct testimony.

Q. What is the expected trend in the cost of natural gas service?

A. The delivered cost of gas that is experienced by our customers is composed of two main elements: the cost of the commodity, which PSE buys on the market, and the cost of delivering the commodity to customers. These two elements taken together comprise the actual cost of gas service paid by our customers. Fortunately, the market prices for the commodity are decreasing significantly, and the Company looks forward to being able to lower gas rates for our customers in the months immediately ahead. Indeed, the Company forecasts decreases in delivered natural gas costs to our customers over the balance of 2009 and into the rate year.

Q. Are any of these gas cost reductions to be realized by the customers in the near future?

A. Yes. Commodity cost reductions are material relative to the total delivered cost of gas. Gas commodity cost reductions representing approximately 13% of customers' bills on average will be realized by our customers effective June 1, 2009 via a Purchased Gas Adjustment filing to be made on May 8, 2009. This filing is subject to Commission approval separately from this general rate case filing.

Q. Please explain why the Company is requesting an increase in certain gas rates in this case?

A. The decreased market prices are partially offset by increased costs for delivering natural gas to customers. These increased costs are being determined primarily by the addition of new gas distribution plant to serve a growing customer base and increased O&M costs to maintain the gas system. Mr. Valdman elaborates on these factors in his prefiled direct testimony, Exhibit No. ___(BAV-1T).

Q. Do some increases in the cost of service requested in this case impact both electric and gas customers?

A. Yes. The Company's requested rate relief includes the costs of recognizing an increase in the regulatory equity component of its capital structure and an increase in the allowed return on regulatory equity ("ROE") to 10.8% from 10.15 %.

Q. What is the Company's current regulatory equity ratio?

A. As of March 31, 2009, the regulatory equity ratio was 52.9% as described in the prefiled direct testimony of Mr. Gaines, Exhibit No. ___(DEG-1T).

Q. What do you mean by regulatory equity ratio?

A. The regulatory equity ratio is the equity ratio used for ratemaking and other regulatory purposes. PSE's methodology for determining its regulatory equity ratio in this proceeding is the same methodology PSE used in recent general rate cases, and PSE's regulatory equity ratio is calculated on the same basis as PSE's capital structure for rate making purposes. Please see the prefiled direct testimony of Mr. Gaines for a further discussion of the calculation of PSE's regulatory equity ratio and capital structure.

Q. Have there been changes to the Company's credit ratings since the last general rate case?

A. Yes. As discussed by Mr. Gaines in his prefiled direct testimony, Exhibit No. ___(DEG-1T), on January 16, 2009, Standard & Poor's ("S&P") updated the credit profile of PSE to reflect the approved merger transaction. Specifically, S&P: (1) raised the corporate credit rating on PSE to "BBB" from "BBB-"; (2)

raised the senior secured debt rating to “A-” from “BBB+”; and (3) raised the commercial paper rating to “A-2” from “A-3.” S&P also removed all the ratings from Credit Watch with negative implications and stated that the ratings outlook is stable. Improved credit ratings benefit customers in that they will tend to provide better access to both debt and bank credit markets and make overall cost of debt less costly over time.

Q. Would you briefly describe the relief the Company seeks in this case?

A. The Company seeks Commission approval of the following proposals:

1) Adequate revenue from rates to pay for actual costs already being borne by the Company to serve customers;

2) a capital structure comprised of 48% regulatory equity (a percentage significantly below the actual ratio of 52.9%), which the Company believes is important to (1) maintain and ultimately improve its corporate credit rating, (2) sustain the Company’s ability to access debt markets on reasonable terms as it executes its plans to invest almost $6 billion in capital spending over the next five years, and (3) sustain the Company’s ability to engage in commodity hedging activities to moderate the price and cost volatility in its energy portfolio;

3) a fair, just, reasonable and sufficient rate of return on equity of 10.8%, a level below the range of 11.0 to 11.5% set forth in the prefiled direct testimony of PSE’s cost of equity expert, Dr. Morin; and

4) a pro rata increase in the benefits the Company provides to support the ability of its low income customers to pay for the electric and natural gas services they utilize.

Q. Why does the Company request a return on equity below the level recommended by PSE's cost of equity expert, Dr. Morin?

A. As discussed in Dr. Morin's testimony, investors require a return commensurate with the assumed risk of the investment. For PSE, Dr. Morin recommends an ROE in the upper end of a range of 11.0% to 11.5% due to the slightly above average risks faced by PSE relative to the industry and the highly unstable conditions in the capital markets during the ongoing financial crisis. An authorized ROE at the recommended range would provide the Company with better financial stability and place it in a stronger financial position to access the financial markets on reasonable terms throughout economic and credit cycles. The Company, however, is mindful of the customer impact from the requested rate increases in these difficult economic times. Accordingly, to balance the interest between customer rate increases and the Company's need for a just and reasonable ROE, the Company only asks to increase its authorized ROE to 10.8%, which is below the range recommended by Dr. Morin and below the requested ROE of other regional utilities.

Q. Would approval of the relief the Company requests serve the long-term interests of its customers?

A. Yes. Commission approval of this filing would allow the Company to recover the costs necessary now to provide safe, reliable service to its customers. Further, such relief will provide the financial strength to enable the Company to continue to attract capital to invest in the energy delivery infrastructure, new energy resources and technology needed to provide reliable, cost-effective service to our customers now and into the future.

III. THE COMPANY'S TRANSFORMATIONAL ACTIVITIES

Q. Could you describe some of the major activities and influences now affecting the Company's growth and development?

A. Overall, we are in a period of very significant growth and expansion of Company operations. Our workforce has seen rapid turn over. About 44% of the Company's personnel are new employees within the last six years. This has meant, and continues to mean, we are engaged in a significant employee recruiting, retention, training and integration effort. In addition, our workforce has grown to over 2800 today from about 2200 in 2002 (an average annual increase of about 2.7%), and we have employees stationed at numerous new locations throughout the state.

Q. Has the geographic footprint of the Company's operations changed?

A. Yes, significantly. We now have some distribution, generation and project development activities in sixteen Washington state counties, up from just eleven in 2002. That means we have employees, contractors, community relations needs, communications activities, wind project development and permitting efforts, environmental, customer service and operational activity in many places that we did not just a short while ago.

Q. Could you describe the effects of renewable portfolio standards on the Company?

A. Under current state law and as restated in the Company's 2007 IRP, PSE will need to build additional renewable resources at an estimated cost of approximately $2.0 billion for 1112 MW of capacity by 2027. Emerging federal renewable portfolio standards could increase and accelerate those requirements.

Q. Could you describe the effects on the Company of emerging regulation of green house gasses?

A. It is too soon to know what our investment or operational impacts will be of new federal climate legislation or what operational capabilities we will need to acquire with respect to participation in emerging markets for carbon attributes. We do know that the potential cost of such activities and investments could be significant, and we must monitor legislative and regulatory developments carefully for their potential impacts upon us.

Q. Will the Company need to acquire additional gas transportation and electric transmission capacity?

A. Yes. The growth in the size and diversity of the Company's gas fired generation fleet requires that we add both transmission and gas transportation capacity. Additional gas storage capacity may also prove valuable to system operations. The Company is deeply engaged in commercial dialogues about participation in both regional pipeline and transmission expansion projects.

Q. Does the Company have any plans to rebuild or expand its hydroelectric generation facilities?

A. Yes. The Company is implementing its new FERC license conditions for the Baker and Snoqualmie projects. As part of such license requirements, the Company must re-design and rebuild all four hydroelectric stations in the next four years and, in addition, implement numerous other license conditions within the geographic footprint of those projects.

Q. Are there other factors that have a transformational effect on the Company?

A Yes. Given the increasing number of North American Electric Reliability Corporation ("NERC") reliability standards—currently there are more than 140 new NERC reliability standards with over 1000 requirements and subrequirements—the added costs to the Company to comply and demonstrate compliance with these new and evolving standards have been significant. Additionally, FERC continues to issue orders and proposed rulemakings for the electric and gas industry including new reporting requirements and evolving standards of conduct for transmission providers. The administrative and financial burden on PSE which has grown substantially is only expected to continue, not lessen, as a result of these new requirements.

Q: What specific action is the Company taking to meet these new and evolving standards?

A: The Company has added staff to develop and implement internal compliance processes. While substantial progress has been made in some areas, we continue to look to strengthen those processes with stronger documentation requirements, internal monitoring and detection programs.

Additionally, leveraging PSE's existing software capability, PSE's operations business units have developed an internal compliance monitoring system using the SAP platform. This serves as a repository for all policies and procedures as it relates to PSE's reliability standards requirements.

PSE's trade floor and transmission groups are in the process of strengthening their policies and procedures and will be moving to a new software vendor later this year.

Going forward, PSE is committed to enhancing its compliance environment. Over the next two years, PSE will implement a more rigorous compliance program, which will include significant documentation requirements, audit resources and active monitoring of standards to increase the detection of issues before they become problems and thereby demonstrate strong compliance.

IV. FINANCIAL CONDITION OF THE COMPANY

A. <u>The Company's Need for Additional Capital</u>

Q. Please provide an overview of the cash requirements of the Company over the next several years.

A. PSE continues to execute its capital investment plans as it invests to replace aging infrastructure, obtain new generation, and improve delivery system reliability. Over the next five years, from 2009 to 2013, the Company's rate base is expected to increase approximately 55% to about $8.1 billion from about $5.2 billion in this filing. This increase will result from an estimated $5.9 billion investment in capital projects. After $[redacted] in estimated operating cash flow during the period, the Company will require approximately $[redacted] in total new funds, both debt and equity, such that the Company's total capitalization (defined as total debt and common equity) will be increased by approximately $[redacted] or [redacted]%.

Q. What activities are giving rise to the need for significant sums of investment capital?

A. As described more fully in the direct filed testimony of Ms. Harris and Mr. Valdman, the Company's capital expenditure plans are diverse. These include: reconstruction of existing hydroelectric projects consistent with new FERC licensing requirements; construction and acquisition of new generation facilities; construction of distribution infrastructure to serve new gas and electric customers; expansion of gas and electric system capacity to meet existing and future customer loads; planned reliability projects that are needed to comply with evolving laws and regulations and to maintain reliable gas and electric systems; unplanned reliability projects occasioned by public and worker safety needs and by the need to restore and reduce outage frequency and duration; and finally, relocation projects required of PSE to accommodate public entity infrastructure programs such as road and bridge construction. Of note, the Company's future capital expenditure plans do not reflect the assessment of additional costs associated with facility relocation that might arise in connection with the expenditure of federal stimulus monies in Western Washington, nor do they reflect any possible receipt of federal stimulus funds by the Company.

The $5.9 billion in capital investment included in the Company's multi-year capital expenditure plan for the 2009 to 2013 period is the estimated aggregate cost of many different projects and programs that the Company believes are required to meet its legal requirements and energy planning standards and to provide safe, reliable service to its customers.

Q. How much equity will be needed during this five-year period 2009-2013?

A. PSE forecasts that it will receive from its parent company, Puget Energy, Inc., an estimated $[redacted] of equity during this five-year period in addition to the nearly $809 million of equity that Puget Energy invested in the Company on February 6, 2009. The February 2009 amount was in addition to the $296 million in equity invested in PSE by the investor consortium's purchase of Puget Energy common stock on October 25, 2007.

Q. Please describe the effect on the Company's indebtedness and capital structure as a result of equity contributions made on February 6, 2009?

A. The Company used the proceeds from the $809 million equity contribution made on February 6, 2009 to redeem short-term debt and increase its equity ratio for regulatory purposes to 52.9% as of March 31, 2009. Mr. Gaines discusses PSE's equity ratio in his prefiled direct testimony, Exhibit No. ___(DEG-1T).

Q. Please describe what effect, if any, such equity contribution had on the Company's credit ratings and cost of debt?

A. When the Company issued $250 million principal amount of senior secured notes on January 15, 2009, it received favorable bids for market interest rates and a coupon of 6.75%. The Company's bankers estimate such interest cost was twelve and a half (12.5) to thirty-two (32) basis points lower than had the Company gone to market with its pre-merger senior debt rating of BBB+. That is an annual interest cost savings ranging from $312,500 to $800,000 over the seven year term of that note issue.

Q. What are the Company's incremental debt raising and debt refunding plans during the 2009 to 2013 period?

A. During this five-year period, the Company is scheduled to refund an estimated $665 million in maturing term debt. In addition to refinancing the maturing term debt, an estimated $[redacted] of incremental long-term debt will be obtained to fund the Company's capital plan. The Company's five-year plan also includes $[redacted] in wind farm financing from tax equity investors. This last source of funds addresses the Company's need to monetize PTC's in future wind farms Should the Company have the tax appetite to use the PTC's or monetize them through the ITC grant program established under the Stimulus Plan, the $[redacted] in tax equity financing would likely be replaced with PSE issued debt. Please see Exhibit No. ___(EMM-3C) for additional detail regarding PSE's multi-year plan for 2009-2013.

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Q. Please summarize the Company's anticipated sources of capital over the next five years?

A. The Company's five year financing plan is expected to include these elements: i) $[redacted] in additional equity from both retained earnings and new equity invested by Puget Energy (in addition to the $809 million received on February 6, 2009), ii) $[redacted] in new issue debt, and iii) $[redacted] in funds from tax equity investors.

B. The Challenge of Persistent Under Earning

Q. Has the Company been able to earn its authorized return on equity?

A. No. The Company chronically under-earns its authorized return for regulated equity. Since 2003, the Company has under-earned its authorized rate of return every year. Please see Exhibit No. ___(EMM-4C) for additional detail regarding the Company's failure to earn its authorized rate of return.

Q. Has the Company identified the root causes for such under-earning?

A. Yes. A principal cause is the Company's continuing growth in the number of customers plus the investment in new resources and infrastructure to provide reliable service to all customers. A large portion of the costs used in setting rates are looking backward in time to historic test year costs rather than looking forward to reasonably projected costs, sales and revenues to determine the Company's anticipated revenue requirement during a future rate year. By use of the historic test year, the investment base and operating cost profile used to determine rates is up to seventeen months out of date in relation to the costs actually being incurred in a future rate year.

Q. Is it true that increasing sales and sales margins offset increasing operating costs?

A. It is true that growth in sales and margins help offset *some* of such actual increases in investment and operating costs, but they fall far short in providing the revenue needed to pay for actual costs being incurred to serve customers.

Q. Is this under-earning amount significant?

A. Yes. Due to regulatory lag, the Company's ROE in 2008 was 6.35% rather than the blended 10.28 % level (adjusted for an actual equity ratio of 44.7%) that was approved in the 2006 and 2007 general rate cases. This is a reduction in the projected earned ROE in 2008 of about 38%. Exhibit No. ___(EMM-4C) illustrates an estimate of the regulatory lag effects for 2008 and 2009.

Q. What are the key causes of under-earning?

A. As shown in Exhibit No. ___(EMM-4C), the Company estimates it under-earned by 3.93% or approximately $92 million in 2008 and forecasts to under-earn by approximately $[redacted] in 2009 despite new rates effective November 1, 2008. Sources of under-earning include a lag in recovery of current O&M and depreciation expense. For 2009, the Company estimates the regulatory lag for O&M and depreciation to be approximately $[redacted]. In addition, the Company is financing almost $[redacted] in new electric and gas plant that has already been placed in service for the benefit of customers, but the return on such new plant additions is not yet being recovered in rates. The Company estimates this lag to be approximately $[redacted] in 2009. Rate recovery of the return of (depreciation expense) and return on (capital financing costs) new capital additions made in 2008 for the gas and electric distribution systems will not start to occur until the Company receives the new rates requested in this proceeding. These three costs (O&M, depreciation, and financing costs) in total lower the Company's projected return on regulatory equity in 2009 by over [redacted] percentage points from its authorized level.

Q. Has the Company considered reducing or deferring such unrecoverable expenses?

A. With respect to projected 2009 depreciation expense, the Company has already made the customer-driven capital investments in the distribution system in 2007 and 2008 that drive depreciation expense in 2009 and 2010 well above the levels provided for in the rates that will be in effect in 2009 and the beginning of 2010.

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With respect to projected 2009 O&M expenses and capital expenditures, the Company prepares its annual O&M and capital budgets to authorize the spending that management judges is needed to maintain a reliable, safe generation and distribution system.

The Company's principal expenditure plans are further described in the prefiled direct testimonies of Ms. Harris, Exhibit No. ___(KJH-1CT), Mr. Valdman, Exhibit No. ___(BAV-1T), and Mr. David E. Mills, Exhibit No. ___(DEM-1CT).

In short, we endeavor to take a long and moderate business view and do the right thing by our customers by committing capital and spending appropriately over time to support a safe and reliable system and to meet the Company's many federal, state and local community requirements..

C. The Need for Gradually Improved Financial Strength

Q. Why is improving financial strength important?

A. The Company's financial strength is its ability to raise capital and secure credit in the financial markets on reasonable terms and to engage in energy supply and risk management activities on reasonable terms throughout economic and credit cycles. As we read daily in the financial press, the capability to access credit and capital is the lifeblood of many businesses, particularly capital intensive businesses such as the utility industry.

To access debt and hybrid capital, PSE must compete with other entities for this capital – both within and outside the utility sector – and must offer investors and financial counterparties a risk adjusted return opportunity consistent with prevailing market requirements.

Q. **What specific steps has the Company taken to strengthen its financial position?**

A. Since 2001, the Company, under a plan worked out with the Commission and other parties, has improved its regulatory equity ratio from a level of about 33% to over 52% as of March 31, 2009. This improvement has been achieved by: (i) the issuance of 25.4 million common shares to the public that generated net proceeds of nearly $527 million, (ii) sale to the Investor Consortium of 12.5 million shares that generated about $296 million of net proceeds, (iii) reducing Puget Energy's common dividend by 46 percent in 2002 and holding its cash dividends unchanged for six years thereby increasing PSE's retention of cash earnings to reinvest in the business, and ultimately, (iv) effecting the merger transaction on February 6, 2009 that resulted in an additional equity investment in PSE by Puget Holdings of approximately $809 million.

D. Current Challenges

1. Post Merger Financial Challenges

Q. What are some of the post-merger financial challenges still facing the Company?

A. Notwithstanding the significant de-leveraging of the Company's balance sheets and the acquisition of committed credit facilities, the Company still faces on-going financial challenges. These include:

1) turbulent credit markets characterized by: (a) numerous troubled financial institutions; (b) severe credit contraction, widening credit spreads to re-price risk; (c) apprehension about government intervention and lack of transparency in the financial system; (d) fewer counterparties with whom to transact to obtain energy supplies and financial hedges; (e) a significantly reduced market for tax equity which adversely affects the development of renewable energy projects; and (f) wary credit rating agencies;

2) significant capital expenditures to maintain an aging system and serve a growing customer base;

3) modest internal cash flow as a result of a relatively small generation asset base and a large portfolio of long-term electric power purchase contracts and market purchases; and

4) inability to actually earn the ROE that has been authorized by the Commission as a consequence of regulatory lag, power cost risk under the PCA mechanism, weather risk, and declining use per customer due to conservation.

2. Capital Expenditure Plans

Q. What level of expenditure is estimated in the Company's multi-year capital

plan?

A. As described above and in the direct testimonies of Ms. Harris and Mr. Valdman, substantial investments are required of the Company over the next several years to meet a growing short energy and capacity position and to maintain electric and natural gas system reliability and safety. As already noted, the Company estimates investments of $5.9 billion over the five-year period of 2009-2013.

Q. Are these investments limited to new electric generating resources?

A. No. In fact, a significant percentage of the estimated capital expenditures is for investment in energy delivery systems. Of the $5.9 billion forecasted capital budget for the period 2009 to 2013, approximately $2.6 billion is for energy delivery: system reliability, increased capacity and future growth. The importance of investments in energy delivery systems in order to maintain reliable service and support customer growth is discussed in the testimony of Mr. Valdman.

Q. Please describe the current pace of the Company's growth in the number of customers served?

A. The Company has experienced a slowing in new customer additions in the last year due to the economic slow down as Mr. Valdman describes in his testimony. However, continued migration to the state supports ongoing customer growth in

PSE’s service territory for both electric and gas customers, and the growth in gas customers has consistently outpaced the growth in electric customers.

Over the three-year period between December 31, 2005 and December 31, 2008 the average number of PSE’s electric customers increased by 5.2%, from approximately 1,011,400 to approximately 1,064,000 customers. Over the same three-year period, the average number of PSE’s gas customers increased by 8.0%, from approximately 683,000 to approximately 737,900. In 2008, the Company added 13,000 electric customers and 14,300 gas customers.

Q. How might the debt capital markets respond to the fact that PSE’s anticipated capital expenditures and external financing needs are relatively large compared to PSE’s size?

A. As part of the rating evaluation, credit rating agencies consider a company’s size (e.g., assets, equity, retained cash flow, credit and liquidity facilities, etc.) relative to its capital program in their determination of creditworthiness. A larger company or company with a higher credit rating is better able to sustain the risks of a larger capital program than a smaller company or less well rated company, and thus will be looked upon more favorably by prospective debt investors.

E. <u>Benefits of Investment Grade Creditworthiness</u>

Q. Are there benefits to maintaining and increasing the Company's credit rating?

A. Yes. Mr. Gaines describes the interest cost savings now available to customers from the recent merger-related ratings upgrade of the Company's senior secured debt. Such ratings upgrades send positive signals to potential investors about the Company's financial strength and attitude toward risk management and its commitment to maintaining a strong capital structure. In these perilous financial times, such a signal is of particular value as investors carefully parse management's financial and risk management practices and operational transparency**.**

Q. To what level is the Company seeking to increase its corporate credit/issuer rating?

A. In consideration of the enormous amount of capital the Company must raise in the years just ahead, it may be that an "A" level corporate credit/issuer rating is ultimately an appropriate long-term goal for the Company. However, given that the Company's corporate credit/issuer rating is presently only BBB a more realistic short-term goal continues to be a "BBB+". The Company's demonstrated efforts to raise equity and reduce its debt leverage combined with the rate relief requested in this case, if approved, will support the Company's continued effort to strengthen its financial position such that it can move closer to reaching a BBB+ corporate credit/issuer rating.

V. COST MANAGEMENT AND RATE MITIGATION OPPORTUNITIES

Q. Has the Company taken steps to contain costs and limit the rate increases to customers?

A. Yes. In general, the Company follows a cost management philosophy by which it continuously looks for opportunities to keep costs as low as possible while still providing safe and reliable electric and natural gas service to its customers at the service quality levels established under the SQI's. Specifically, due to the difficult economic times facing our customers, the Company has taken extra measures to limit cost increases in this case and seek other mitigation of customer rate increases. As discussed in more detail below, these measures include freezing officer salaries and temporarily eliminating the recovery of costs related to the Company's Goals and Incentive Plan as it applies to officers; aggressively pursuing new production tax credit and investment tax credit opportunities that are available under the newly enacted American Recovery and Reinvestment Act of 2009; and negotiating the sale of RECs produced by PSE to generate additional revenues to help mitigates other costs.

A. PSE's Cost Management Philosophy

Q. Please discuss the Company's philosophy about cost management?

A. First, the Company is very sensitive to its cost of service-- both the commodity costs and the costs of delivery. Second, management endeavors to cultivate a culture of keen commercial skills and opportunistic commercial decision-making. Third, management tries to balance the impact of near-term rising costs with the need to invest long-term in plant, people and process to meet the service standards to which we are committed and the safety, reliability and environmental obligations we have undertaken.

Q. Could you elaborate on this philosophy?

A. Management tries to focus its attention on those areas of commercial decision making that can have the biggest long term payoff for customers in terms of cost and risk management and that keep our services competitive. For a highly capital intensive business such as ours, that means keeping a focus on managing the cost of the physical plant we build or procure and managing the cost of capital used to fund such plant. Mr. Valdman and Ms. Harris elaborate on these matters in their respective testimonies.

Q. Can you discuss your approach to managing the cost of energy supplies?

A. Mr. Roger Garratt and Mr. Mills discuss some of these activities in detail in their respective testimonies. But in brief, we believe that a "first mover" strategy in the energy markets in which we participate can be a critical value adder for customers, especially with respect to controlling key resource opportunities. Some examples of the Company's execution of this strategy include:

1) The Company's early re-negotiation to extend its large hydroelectric supply agreement with the Chelan PUD in 2005 has locked in a low cost supply resource. This is a contract that would very likely be unavailable to the Company today given market developments. In addition, we maintained it as a valuable resource to help firm and shape the Company's current wind portfolio;

2) The Company's decision to move quickly in 2004 and 2005 to acquire from distressed developers two wind projects at attractive prices and to obtain from BPA attractive prices associated with transmission and shaping services;

3) The acquisition of the Goldendale Generating Station, a state of the art gas fired plant from a distressed independent power producer in bankruptcy at about one-half replacement cost; and

4) The negotiation of a settlement of litigation with California market participants that includes the sale of excess RECs by PSE that, if approved, will have material rate mitigation value for our customers.

B. <u>Incentive Pay and Executive Compensation</u>

Q. What specific additional steps has the Company taken to limit rate increases during these difficult economic times?

A. The Company is highly sensitive to the current economic situation affecting the country and the communities in its service territory. We are also mindful that customers expect some meaningful indication that the Company is prepared to "go the extra mile" for its customers in terms of keeping costs down during these difficult financial times. Accordingly, Company officer salary costs have been frozen and the annual incentive costs for its officers have been removed from operating expenses in this proceeding, even though the Commission has allowed recovery of incentive costs in past cases. The revenue impact of removing the salary change and incentive costs from the rate year operating expenses in this proceeding is approximately $1.8 million. As discussed in the prefiled direct testimony of Mr. Thomas M. Hunt, PSE believes that these costs should be recoverable in rates but is foregoing recovery in this case in recognition of the difficult economic times facing our customers.

Q. Please discuss PSE's approach to executive compensation.

A. As discussed in the testimony of Mr. Hunt, the Company compensates its executives competitively, using a market comparison group of similarly sized utility companies, and following a pay-for-performance philosophy for executives. As a result, both salary and annual incentive compensation together result in market based pay for executive. Only those portions of executive compensation related to utility operation and management are included in customer rates. Shareholders bear the cost of the Company's Long-term Incentive Plan, a market based pay program that makes up a significant portion of executive compensation.

Q. Do you believe it is appropriate for customers to pay for the portion of executive compensation that is requested for recovery in rates in this proceeding?

A. Yes. While the Company understands that the compensation paid to its executives can be a sensitive issue, we believe it is fair for our customers to pay a portion of executive compensation. As described by Mr. Hunt, the Company's research indicates that it is paying a reasonable level of compensation given the size and complexity of the business being managed and the competition to attract and retain executive personnel for utilities such as PSE.

In addition, the efforts of PSE's executives are focused first and foremost on the operational, financial, and other managerial efforts required to provide high quality, cost effective service to the Company's customers. Customers benefit from strong leadership that promotes long-term customer service, community involvement, and recruits, retains and motivates a capable workforce to provide reliable and efficient operations, and works effectively with the community.

C. Other Rate Mitigation Opportunities

Q. Is the Company pursuing any other rate mitigation opportunities?

A. Yes. As discussed in the prefiled direct testimonies of Ms. Harris and Mr. Mathew R. Marcelia, the recent enactment of the American Recovery and Reinvestment Act provides the Company possible opportunities to utilize production tax credits and investment tax credits to mitigate rate increases for customers in the future.

Q. Please briefly explain the tax incentives provided by the American Recovery and Reinvestment Act.

A. The American Recovery and Reinvestment Act of 2009 was enacted on February 17, 2009. The act extends and expands a number of valuable tax incentives including: (1) an extension for production tax credits for wind generation to December 31, 2012; and (2) for the first time, the possibility of receiving cash grants for qualifying renewable projects.

Q. Is PSE eligible for these tax incentives?

A. PSE has used, and will continue to use, the production tax credits generated from its wind plants to mitigate customer rates. Although the act offers the possibility of converting investment tax credits into cash grants; as explained in Mr. Marcelia's prefiled direct testimony, the U.S. Treasury has not yet promulgated rules or issued guidance on the cash grants. Representatives from PSE will be meeting with the Internal Revenue Service and the U.S. Treasury in early May 2009 to discuss details of the cash grant provision. The goal of the meeting is to encourage the U.S. Treasury to issue guidance that will allow PSE to use these cash grants to mitigate the costs of developing and acquiring renewable resources in a manner that benefits customers.

Q. Is the Company pursuing other rate mitigation opportunities?

A. Yes, as discussed in more detail later in my testimony, the Company has entered into contracts to sell RECs generated from its wind farms, which may, if approved by state and federal regulators, provide a significant benefit to customers in terms of rate mitigation.

VI. PENSION PLAN FUNDING

Q. Has the Company made any contributions to its defined benefit plan and does it have plans to make additional contributions?

A. Yes. In the past year the Company's pension plan has experienced the effects of the decrease in market value after several years of strong increase. As a result of the: (1) reduction in market values; and (2) lower interest rates which increase the plan liability, the Company has gone from a fully funded status to an underfunded status. In December 2008, the Company made a $24.5 million contribution to its pension plan, and pursuant to the funding rules under the Pension Protection Act and recommended funding actions of the Plan's actuary, made an additional contribution of $6 million in April 2009 as a first installment on its 2009 funding plans, which are estimated to be in a range of $18 to $32 million. Please see the prefiled direct testimony of Mr. Hunt, Exhibit No. ___(TMH-1T) for a description of the pension plan assets and the need for these contributions.

VII. SALE OF EXCESS RENEWABLE ENERGY CREDITS

Q. Mr. Markell, you previously mentioned that the Company may be able to partially mitigate customer rate increases and settle ongoing litigation through a sale of RECs. Can you provide additional detail regarding this sale of RECs?

A. Yes. PSE and several California utilities have agreed to settle the ongoing litigation that arose out of the California energy crisis. A key component of the settlement is PSE's sale of excess RECs to California utilities.

Q. Would you please explain how the Company receives RECs and what is meant by excess renewable energy credits?

A. The Company receives RECs for the generation from the Company's qualifying renewable energy facilities. Excess RECs are the RECs the Company has produced that are in excess of the amount required under RCW 19.285.

Q. Could you briefly describe the legal history of the disputes that are being settled?

A. By way of background, PSE has held a California Receivable on its books since early 2001. This receivable reflects unpaid amounts owed to the Company from the California Independent System Operator ("Cal ISO") for power PSE sold to California during the California Energy Crisis. PSE sought recovery of this receivable in the litigation.

The dispute involves numerous parties such as Southern California Edison ("SCE"), Pacific Gas and Electric ("PG&E") and certain other entities represented by the California Attorney General and involves market pricing issues during that turbulent time in the western energy markets. There has been litigation in the courts and numerous proceedings before FERC. After more than seven years of litigation and failed attempts at mediation and settlement, the central issues remain far from resolution, but for the promise of a new settlement concept involving the Company's renewable energy credits.

Q. How does the California Receivable matter relate to the Company's excess renewable energy credit position?

A. On the face of it, these matters seem unconnected. However, over the past year a number of events appeared to be developing in California energy policy and the renewable energy marketplace that we believed held the potential to redirect settlement discussions and monetize the Company's excess RECs for the benefit of customers.

In summary, the legal and regulatory landscape in California appeared to potentially create a market opportunity for the sale of PSE's excess RECs and associated representative energy to facilitate a settlement of the long-running litigation.

Q. What is the current status of the settlement negotiations?

A. The parties have executed settlement agreements that now require approval of FERC and the California Public Utilities Commission.

Q. What disposition of transaction proceeds does the Company propose?

A. Subsequent to the filing of this case, the Company will consider how best to address the disposition of the REC proceeds (either via the pending accounting petition or some other filing), assuming the settlement is ultimately approved by FERC and the California Public Utilities Commission.

Q. Will the Company keep the Commission and this proceeding updated as to developments in this matter during the course of this proceeding?

A. Yes, it will.

VIII. LOW INCOME ASSISTANCE PROGRAMS

Q. Is the Company proposing to increase bill assistance funding to low income customers to help offset the impact of its proposed rate increases in this case?

A. Yes, the Company proposes to increase the annual level of low-income electric and natural gas bill assistance funding by the corresponding percent increases to the residential class that are approved by this Commission. The amount of this percentage increase would be added to the low income tariff in the next program year.

IX. POST- MERGER UPDATE

Q. Please describe briefly the outcomes of the recent merger transaction with the Investor Consortium.

A. On February 6, 2009, Puget Holdings LLC completed its merger with Puget Energy, Inc. Puget Holdings LLC is a consortium of long-term infrastructure investors. As a result of the merger, Puget Energy, Inc. is the direct wholly owned subsidiary of Puget Equico LLC which is an indirect wholly owned subsidiary of Puget Intermediate Holdings, a wholly owned subsidiary of Puget Holdings.

Q. Please describe the status of the Company's obligations under the merger order?

A. On April 1, 2009, the Company filed a report indicating its compliance with each of the merger order conditions.

Q. Does the requested increase in revenue in this case include any recovery of the share price premium that Puget Holdings has paid shareholders of Puget Energy, Inc. or any related transaction costs of Puget Holdings or the Company, or any other cost that is not appropriately a cost of service to be reasonably borne by the customers of PSE?

A. No, it does not. The Company has reviewed its books and records to remove any and all costs not appropriately part of the cost of regulated gas and electric service.

X. OVERVIEW OF OTHER COMPANY WITNESSES

Q. Would you please describe briefly the topics presented by PSE's other witnesses in this case?

A. The following additional witnesses present direct testimony on PSE's behalf:

Mr. Bertrand Valdman, the Company's Executive Vice President and Chief Operating Officer, discusses the Company's work to control costs related to its electric and natural gas systems while providing high quality service and reliability. He also describes the cost pressures the Company is facing to replace and maintain its aging infrastructure and to expand that infrastructure to serve new customers.

Ms. Kimberly J. Harris, Executive Vice President and Chief Resource Officer, presents an overview of the Company's electric and gas supply portfolios. She describes the magnitude of the Company's need to acquire new electric resources for its customers as well as some challenges the Company is facing in making such acquisitions. Ms. Harris then presents an executive summary of the acquisitions for the electric portfolio for which the Company is seeking the Commission's approval in this case. Finally, she provides an update regarding some of the Company's current and former hydroelectric projects.

Mr. Roger Garratt, Director of Resource Acquisition, describes in greater detail than Ms. Harris's executive summary the evaluation and due diligence that the Company undertook prior to acquiring the new and replacement electric resources that are presented for the Commission's approval in this case. Mr. Garratt also demonstrates that the Mint Farm

Generating Station and Sumas are baseload electric generation that comply with the greenhouse gasses emissions performance standard.

Mr. W. James Elsea, Financial Analysis Manager of Energy Resources, describes the modeling tools and quantitative analyses that were utilized by the Company to evaluate the various electric resource alternatives presented for cost recovery in this case.

Mr. Clay Riding, Director, Natural Gas Resources, provides an overview of PSE's natural gas system, describes the gas supply and transportation for PSE's combustion turbine plants, and discusses PSE's efforts to expand its gas in storage for power.

Mr. Ed Odom, Director of Thermal and Wind Resources, describes the routine and major maintenance required for PSE's gas plants and wind plants, and the service contracts for these plants.

Mr. Joey Henderson, CT Compliance Program Manager for PSE, presents testimony regarding the compliance of Mint Farm and Sumas with the greenhouse gasses emissions performance standard.

Mr. Paul Wetherbee, Manager, Hydro contracts at PSE**,** presents more detailed testimony regarding the pending and planned sale of the Company's White River assets.

Mr. Michael L. Jones, Manager, Colstrip Project Operations & Fuels for PSE, discusses the Colstrip coal contract, forced outage rate, line losses, and the settlement of the litigation alleging pond leakage at Colstrip,

Mr. David E. Mills, Director, Energy Supply & Planning, describes the structures and policies the Company has in place to manage the risks and volatility in its electric and natural gas portfolios and the manner in which such policies are implemented. He also describes PSE's activities with respect to renewable energy credits and carbon financial instruments. Finally, Mr. Mills presents the Company's projection of power costs for this case and compares them to those the Commission approved in the 2007 PCORC.

Mr. Donald Gaines, Vice President Finance and Treasurer, describes the Company's recent debt issuance and its requested capital structure and overall rate of return. He also discusses the impact of the merger on the cost of debt and PSE's credit rating and that the Company has met certain merger commitments.

Dr. Roger Morin, Emeritus Professor of Finance at the Robinson College of Business, Georgia State University, Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University, and principal in Utility Research International, presents his appraisal of the just, fair, reasonable and sufficient rate of return on the Company's combined gas and electric utility operations, with particular emphasis on the fair return on the Company's common equity capital committed to that business.

Mr. John Story, Director of Cost and Regulation, presents the electric results of operations and revenue requirement. Mr. Story also presents PSE's change in accounting procedure for major maintenance on turbines, and the appropriateness of the deferred accounting methodology for Mint Farm.

Mr. Mike Stranik, Assistant Controller for PSE, presents the gas results of operations and revenue requirement**,** as well as the allocation of common expenditures between electric and natural gas. Mr. Stranik also discusses the electric and gas merger savings as a result of the merger of Puget Energy with Puget Holdings LLC.

Mr. Matthew Marcelia, Director of Taxes for PSE, presents the adjustment of test year taxes to normal, the impacts of the merger on taxes, property tax issues and the net interest payment made to the Internal Revenue Service in settlement of the simplified service cost method dispute.

Mr. David W. Hoff, Manager, Pricing & Cost of Service, presents the Company's electric cost of service study, and the electric rate spread and rate design proposals.

Ms. Janet K. Phelps, Regulatory Consultant in Pricing and Cost of Service for the Company, presents the Company's gas cost of service study, and the gas rate spread and rate design proposals.

Ms. Lorin Molander, Regulatory Consultant in Pricing and Cost of Service for the Company, presents the Company's electric and gas temperature adjustment methodology and results used to develop the pro forma electric and gas loads for the test year.

Mr. Jon Piliaris, Regulatory Consultant in Pricing and Cost of Service for the Company, presents the classification of the Company's electric production costs within its cost of service analysis and the proposed implementation of a new adjustment to restate weather-normalized test year retail natural gas and electric loads to reflect the phase-in of the Company's conservation programs during the test year in this proceeding.

Mr. Thomas Hunt, Director Compensation and Benefits, describes PSE's compensation and benefits programs and how they are competitive and benefit the Company's customers.

XI. CONCLUSION

Q. Please summarize your testimony

A. The Company must make significant capital investments over the next several years in its gas and electric system infrastructure and in new electric generation resources to continue to implement PSE's commitment to reliable service for a growing customer base. As the Company's Chief Financial and Regulatory Officer, it is my responsibility to formulate means and methods to enable the Company to realize its authorized earnings potential and improve its creditworthiness in order to raise the debt and secure the credit capacity in external financial markets at the lowest cost to customers necessary to manage the business effectively. The rate relief requested by the Company in this proceeding is consistent with these objectives.

Q. How does the Company's request for rate relief address the cost of service recovery issues and under-earnings issues identified above?

A. The Company's request for rate relief merely mitigates the size of the regulatory lag being experienced by the Company, but does not eliminate it. The Company will continue to absorb significant costs to serve its customers even if the rate relief it seeks is granted. The requested relief does not address the persistent and structural problems inherent with the use of a largely historic test year to set rates for a company whose capital investments and growth in related operations and maintenance increase far more rapidly than provided for by sales and margin growth alone. However, the increase in the Company's current authorized ROE to 10.8%, a level below the range supported by the testimony of Dr. Morin, on the Company's proposed capital structure of 48%, will support a modest increase in retained cash flow and a stable credit profile, and thereby support the Company's efforts on behalf of its customers.

Likewise, the largely stable electric and natural gas rate design we propose should help minimize the contentiousness that often accompanies this issue and will result in fair and reasonable rates for customers.

Q. Does that conclude your prepared direct testimony?

A. Yes, it does.