Exhibit No. DCP-1T
Dockets UE-090704/UG-090705
Witness: David C. Parcell

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**DOCKET UE-090704** **and** **DOCKET UG-090705** ***(consolidated)***

TESTIMONY

OF

DAVID C. PARCELL

ON BEHALF OF THE STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Cost of Capital

November 17, 2009
Revised November 18, 2009
Revised December 11, 2009

Puget Sound Energy, Inc. ("PSE" or "the Company") in these dockets. I have performed independent studies and am making recommendations of the current cost of capital for PSE.

Q. Have you prepared any exhibits in support of your testimony?

A. Yes, I have. Exhibit No. DCP-2 through Exhibit No. DCP-18 represent the analyses that support my cost of capital recommendation. These exhibits were prepared either by me or under my direction. The information contained in these exhibits is true and correct to the best of my knowledge and belief.

II. RECOMMENDATIONS AND SUMMARY

Q. What is your overall cost of capital recommendation in this proceeding?

A. My overall cost of capital recommendation for PSE is ~~7.89~~ 7.91 percent, as is shown on Exhibit No. DCP-3, and can be summarized as follows:

	Percent	Cost	Return
Short-Term Debt	3.95%	2.47%	0.10%
Long-Term Debt	51.05%	6.4~~5~~**8**%	3.~~29~~**31**%
Common Equity	45.00%	10.00%	4.50%
Total	100.00%		7.~~89~~**91**%

Q. Please compare your ~~7.89~~ 7.91 percent estimate to the Company's proposed cost of capital.

A. PSE requests a return on common equity of 10.8 percent and an overall rate of return of 8.50 percent. My cost of capital recommendation differs from PSE's request in three respects. First, my 10.0 percent cost of equity differs from PSE's 10.8 percent request.

Second, PSE is requesting a hypothetical capital structure with 48.0 percent common equity. I am proposing a 45.0 percent equity ratio. My 45.0 percent equity ratio is more appropriate to use than the Company's proposed capital structure and properly satisfies the Commission's "safety and economy" criteria for selecting an appropriate capital structure. I do not believe the Company's proposed capital structure meets these criteria. In addition, my proposed capital structure is more consistent with the capital structures of other publicly-traded combination electric and gas companies.

Third, PSE is requesting a cost of long-term debt of 6.70 percent. This includes two future debt issues that assume cost rates higher than the recent issue (at 5.757 percent). I have "repriced" these two future issues at a cost of 5.757 percent, and I have also "priced" the differential of common equity (i.e., from 48 percent to 45 percent) and long-term debt at 5.757 percent, which results in a cost of debt of ~~6.45~~ <u>6.48</u> percent.

Q. Please summarize your cost of capital analyses and related conclusions for PSE.

A. This proceeding is concerned with PSE's regulated electric and natural gas distribution utility operations in the State of Washington. My analyses are concerned with the Company's total cost of capital for its regulated operations. The first step I undertake in the determination of PSE's cost of capital is the development of an appropriate capital structure. As I just mentioned, I recommend use of a capital structure with a 45.0 percent equity ratio. This is consistent with prior capital structures used by PSE and approved by this Commission. In my judgment, it reflects a capital structure that meets the Commission's standards of safety and economy.

The second step is a determination of the embedded cost rates of debt. I use a long-term debt cost of ~~6.49~~ ~~6.45~~ 6.48 percent, as described above. I use the 2.47 percent cost of short-term debt contained in the Company's application.

The third step is the estimation of the cost of common equity. I employ three recognized methodologies to estimate the cost of equity for PSE. I apply each of these methodologies to three groups of proxy utilities. These three methodologies and my findings are:

Methodology	Range
Discounted Cash Flow	9.6-11.3%
Capital Asset Pricing Model	7.9-8.2%
Comparable Earnings	9.5-10.5%

Based upon these analyses, I conclude that the cost of common equity for PSE is within a range of 9.5 percent to 10.5 percent. For purposes of this case, I recommend that the Commission authorize a 10.0 percent return on equity, the mid-point of my estimated range. This 10.0 percent return is also consistent with the results of my DCF analyses, which this Commission favors.

Combining these three elements into a weighted cost of capital, results in an overall rate of return of ~~7.89~~ 7.91 percent.

versus 45 percent) at 5.757 percent. The resulting cost of long-term debt is ~~6.45~~ 6.48 percent. This is shown on page 2 of Exhibit No. DCP-3.

VII. COST OF EQUITY

A. Selection of Proxy Companies

Q. How have you estimated the cost of common equity for PSE?

A. PSE is not a publicly-traded company. Consequently, market information is not available for PSE's common stock, and it is not possible to directly apply cost of equity models using that information. Moreover, PSE's parent is not publicly-traded. As a result, it is generally preferable to analyze groups of comparison or "proxy" companies as a substitute for PSE to determine its cost of common equity. The use of proxy companies is also preferable to use of only a single company, because a group of companies provides for a balancing or averaging of statistics for multiple companies deemed to be of similar risk to the subject company.

Therefore, I examined three proxy groups for comparison to PSE. I selected one group of electric utilities similar to PSE using the criteria listed on my Exhibit No. DCP-10. These criteria are as follows:

(1) Net Plant of $1 billion to $10 billion;
(2) Electric revenues 50% or greater;
(3) Common equity ratio 40% or greater;
(4) S&P and Moody's bond ratings of BBB;
(5) S&P stock ranking of B or B+; and,
(6) Has paid dividends for 5 years.

Q. Why are your CAPM results significantly lower than your DCF results?

A. CAPM results are lower than the DCF results, and have been lower than CAPM results in recent years. The two reasons for the lower CAPM results are the current relatively low yields on U.S. Treasury bonds (i.e., risk-free rate) and a lower risk premium that reflects the decline in stock prices in 2008.

Q. Does this mean that CAPM results should be discarded?

A. No. These currently lower CAPM results are only one-half of the impact of recent economic conditions. The other impact is on the DCF results, which are somewhat higher currently due to the higher yields attributable to the decline in stock prices. It would not be proper to disregard the lower CAPM results while not discounting the higher DCF results. This confirms my 10.0 percent cost of equity estimate for PSE.

VIII. TOTAL COST OF CAPITAL

Q. What is the total cost of capital for PSE?

A. PSE's total cost of capital is ~~7.89~~ 7.91 percent. Exhibit No. DCP-3 reflects the total cost of capital for the Company using my proposed capital structure and cost of debt along with the range of common equity costs my DCF analysis supports.

Q. Does your cost of capital recommendation provide the Company with a sufficient level of earnings to maintain its financial integrity?