EXHIBIT NO. ___(DEG-13)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

FIFTH EXHIBIT (NONCONFIDENTIAL) TO THE
PREFILED REBUTTAL TESTIMONY OF
DONALD E. GAINES
ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

BEFORE THE WASHINGTON

UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	Docket UG-040640 Docket UE-040641 (Consolidated) Volume IV Pages 377-606
In the Matter of the Petition of PUGET SOUND ENERGY, INC., For an Order Regarding the Accounting Treatment for Certain Costs of the Company's Power Cost Only Rate Filing	Docket UE-031471 (Consolidated)
In the Matter of the Petition of PUGET SOUND ENERGY, INC., For an Accounting Order Authorizing Deferral and Recovery of Investment and Costs Related to the White River Hydroelectric Project.	Docket UE-032043 (Consolidated)

A hearing in the above-entitled matter was held at 9:51 a.m. on Tuesday, December 14, 2004, at 1300 South Evergreen Park Drive Southwest, Olympia, Washington, before Judge DENNIS MOSS, Chairwoman MARILYN SHOWALTER, Commissioner RICHARD HEMSTAD and Commissioner PATRICK OSHIE.

Barbara L. Nelson, CCR

Court Reporter

JUDGE MOSS: Okay. Thank you. All right. Mr. Gaines, it appears that your examination is complete, at least for the time being, and so I'll ask that you step down, and thank you very much for your testimony.

THE WITNESS: Thank you, Judge Moss.

JUDGE MOSS: I believe -- is Mr. Hill next?

MS. DODGE: Yes.

MR. CEDARBAUM: Your Honor, Judge Moss, can we just go off the record for just a second?

JUDGE MOSS: Sure. We're off the record.

(Discussion off the record.)

JUDGE MOSS: Mr. Hill, would you please rise and raise your right hand?

Whereupon,

STEPHEN G. HILL,

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

JUDGE MOSS: Thank you. Please be seated.

D I R E C T   E X A M I N A T I O N

BY MR. FFITCH:

Q. Mr. Hill, could state your full name and spell your last name for the record?

A. Stephen G. Hill, H-i-l-l.

Q. And were you retained by the Public Counsel Office of the State Attorney General to testify regarding cost of capital in this matter?

A. Yes, I was.

Q. Do you have Exhibits 351 through 368 before you? Those are your pre-filed response testimony and exhibits.

A. Yes, I do.

Q. Now, do you have the exhibit numbers marked on those, or should I -- I'd be happy to give you a copy of the exhibit list, so you can cross-reference.

A. I don't have the exhibit numbers marked on them, on my copy.

JUDGE MOSS: Mr. ffitch, while you're getting situated there, I have no objection to your referring to them in both ways if it will make it easier for the witness.

MR. FFITCH: Thank you, Your Honor.

Q. Was this testimony and these exhibits prepared by you, Mr. Hill?

A. They were prepared by me.

Q. Do you have any corrections or changes to the testimony and exhibits?

A. A couple typos. One is on page 55, at line nine. The sentence should read, beginning at line nine, The price of that index of 20 percent dash negative 20 percent growth, not 205 growth.

And then the other one is -- was pointed out by Dr. Cicchetti in his rebuttal, and that's my Exhibit SGH-5, which is Exhibit Number 355, page six of that. And the treasury bond yield in the footnote on that page is incorrect. It should be 5.15, as it is in the body of the testimony and as it is in my exhibits.

Q. Any other corrections or changes?

A. No, sir.

Q. With those corrections and changes, is this testimony and are these exhibits true and correct, to the best of your knowledge?

A. Yes.

Q. If I asked you the questions contained in the testimony today, would your answers be the same?

A. Yes, they would.

MR. FFITCH: Your Honor, I would like to offer Exhibits 351 through 368.

JUDGE MOSS: Any objections? Apparently not. Those will be admitted as marked.

MR. FFITCH: Your Honor, Mr. Hill is available for cross-examination.

JUDGE MOSS: All right. And we have -- Mr.

Van Cleve has pointed out to me that ICNU has five minutes, and Ms. Dodge, do you wish to precede ICNU or follow, since you are the primary adversary here?

MS. DODGE: I would prefer to follow.

JUDGE MOSS: All right. Mr. Van Cleve, why don't you proceed with your questions.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Mr. Hill, can you tell us what your billing rate for this case was?

A. My billing rate for this case is $150 an hour.

Q. And did you pursue this case on a fixed fee arrangement or a billable hour basis?

A. A fixed fee contract arrangement. I made a bid, an original bid of right at 15,000 for the entire case, and due to the complexity of it, I had to recently ask for a $5,000 addendum to that contract.

Q. If you could refer to Exhibit 249, which, if you don't have, I can provide to you.

A. I don't have it. I've seen it, but --

JUDGE MOSS: Who's the witness, Mr. Van Cleve?

MR. VAN CLEVE: Yes, Your Honor.
JUDGE MOSS: What is the witness?
MR. VAN CLEVE: That was from Story.
JUDGE MOSS: Okay. So this is one of Mr. Story's exhibits, Number 249?
MR. VAN CLEVE: Yes, there were some questions about it yesterday.
Q. Mr. Hill, while everyone's finding Exhibit 249, let me ask you when, approximately, you were retained to work on this case?
A. It was the summer. I got the proposal in my computer. I could get an exact date, but it was sometime this summer. There were several cases ongoing in this jurisdiction, and I was contacted -- actually, I was working for the Staff and the consumer advocate on PacifiCorp, and also was asked about a Verizon case, which I was unable to do, because I was too busy, this case, and one other, Northwest Natural, I believe. PacifiCorp and Northwest Natural were settled.
Q. Okay. Do you have Exhibit 249 in front of you?
A. I do.
Q. And even though this is on yellow paper, the company informed us today that it would no longer be

considered confidential. So I'd like to direct your attention, under Pacific Economics Group, that column, which subtitles -- it says cost of capital, and it says $374,160.06. Do you see that?

A. Yes, I do.

Q. And do you think that that is a reasonable expenditure for the company's cost of capital testimony in this case?

A. No, I don't.

MS. DODGE: Objection. There's been no foundation laid that this witness has a basis for giving that opinion.

JUDGE MOSS: You might lay some foundation.

Q. Mr. Hill, how many cases have you testified in regarding cost of capital?

A. I've been testifying on cost of capital since 1980, and about 220 cases, maybe a little more.

Q. And are you familiar with what cost of capital experts generally charge for providing their services?

A. Yes, I am familiar with that.

Q. And why don't you tell us what, on an average basis, you think they generally do charge?

A. The -- my experience is that cost of capital witnesses for companies generally make two to three times what cost of capital witnesses for public advocates make, so that would be in the neighborhood of 25 to 50,000.

Prior to this case, the highest I had seen was for Mr. Hadaway. He had, I believe, a two-year contract with PacifiCorp to do all their testimony in all their jurisdictions for a quarter of a million dollars. I've never seen anything on this scale.

MR. VAN CLEVE: Thank you. I do not have any other questions.

JUDGE MOSS: Thank you. All right. Ms. Dodge.

MS. DODGE: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Hill, please turn to page five of your testimony. It's Exhibit 351.

A. I have it.

Q. Now, in the first Q and A on this page, you note that several regulatory bodies have set the authorized equity return in the single digits, and you cite several cases. And in footnote one on that page, your list includes cases involving a number of water and telephone companies, doesn't it, not just

electric and gas companies?
A. Yes, telephone companies are generally considered --
Q. And I'm sorry --
A. -- to be more risky than gas companies or electric companies.
Q. That was --
JUDGE MOSS: Please don't interrupt the witness. Were you finished with your answer?
THE WITNESS: Yes, sir.
JUDGE MOSS: Did you get that, Ms. Nelson?
THE REPORTER: I did.
JUDGE MOSS: Go ahead, please.
Q. Even with respect to electric or gas companies, you agree, don't you, that the companies involved in the cases you cite were in significantly different positions than PSE with respect to their financial strength and their risk profiles?
A. Well, I believe, as Mr. Valdman said yesterday, it's very difficult to isolate companies that are exactly the same. In fact, I don't think that could be done. The point is that utilities generally have similar risk compared to other investments in the marketplace, and I'm merely showing the Commission, because I believe there's a

real aversion by regulatory bodies to go below the double digit level, i.e., to single digits. I wanted to show the Commission that there have been some regulators in the country that have done that.

Q. Did you review the Commission orders that you cite in your footnote?

A. No, I did not.

Q. Are you aware, from your work in the field, that, for example, in the Connecticut case that you cite, Connecticut Light and Power, the Commission in that case noted that Connecticut Light and Power Company have reduced its operating risk by divesting itself of generation?

A. Yes, I realize some of those companies are wires companies, and I believe I gave an incorrect response to you a moment ago. One of the orders that I cite was the West Virginia water order, and I'm very familiar with that case and I have read the order in that case.

Q. Do you --

A. And although water companies are thought to generally have somewhat less risk than gas and electric companies, they are similar in risk.

Q. Do you recall, with respect to the West Virginia case, that the West Virginia Commission criticized the water company in that case for using a proxy group made up of gas companies to support its requested ROE, and the Commission determined that this was inappropriate because, quote, Natural gas investment is far riskier and not comparable to water?

A. That's what the Commission said, but the Commission in West Virginia has for years rejected other kinds of sample groups that are different than the company being regulated. And the fact that Standard and Poor's gives water utilities and gas distribution utilities similar business position rankings indicates that that's incorrect.

MS. DODGE: I have no further questions.

JUDGE MOSS: Thank you. Do we have any questions from the bench?

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Well, just following up on the last question, I understood Mr. Gaines to say that business position is not the same as credit rating, and I probably would have asked him a follow-up question if I hadn't already had my opportunity, but since you raised it, isn't there a distinction -- or

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what is the distinction, if any, between business position and credit rating?

A. Well, I'm afraid I have to disagree with Mr. Gaines. I believe he informed you that they weren't related. Business position was something different than a bond rating. And while that is true, and I believe there's an exhibit in Mr. Lazar's testimony, which is this new publication by Standard and Poor's, June 2nd, 2004. And the whole focus of the new Standard and Poor's rating paradigm is built around business risk position.

Now, they -- and their rating criteria, their benchmarks are segregated by business risk position. So a company, for example, a wires company or a gas distributor or water company, they generally have business risk positions from one to three.

Q. Well, is that separate or different than what we were talking about, which is -- I thought it was a rating from maybe one to 10, I wasn't sure.

A. Yeah, it does go from one to 10, but I was just -- I was going through the scale to tell you what companies are spread out that way, and then, perhaps if you were able to see the grid, Standard and Poor's lays out a grid with a one to 10 in the left-hand column, and then the benchmarks that are necessary, like the debt leverage, and the debt leverage requirements get to be greater -- I mean, the amount of common equity necessary to achieve a certain bond rating gets greater as the risk increases.

Let me say that again. As the risk increases, as the business position risk goes from one to 10, the amount of equity you need in a capital structure to attain a BBB rating increases. Your business risk increases -- business risk is really a more fundamental measure of your risk than your financial risk, because if you don't have any business risk, you can be capitalized with all debt and have a high bond rating. But the more business risk you have, for example, if you're a marketer, a gas marketer, which is at the top level of business risk, you may need a 70 percent equity ratio to get a BBB rating.

Q. Okay.

A. Okay.

Q. I'm following that. Thank you.

A. So, all right.

MR. FFITCH: Excuse me, Your Honor. Maybe the moment has passed now, but the discussion's about Exhibit 345.

CHAIRWOMAN SHOWALTER: Well, I followed the matrix, if you will.

THE WITNESS: Okay.

Q. Well, I was going to ask you about this same page five and these same companies you cited. First of all, the company has put forth, as peer groups, conceptually, electric or combined electric and gas utilities in fully-regulated states that -- that is, the utilities that are planning or likely to have expansion of infrastructure, or at least that, I think, is how the company would define its peer group.

And I want to ask you, do you think that is conceptually an appropriate peer group?

A. I don't disagree that that should be part of the consideration, or it might be part of the consideration. I'm not sure that the company's -- the company accomplished what it set out to do in that regard, but I think that even though there's been a great deal of discussion about the risk differences between wires companies and fully integrated companies, the cost of capital differences are not that substantial.

For example, I just finished testimony for Bangor Hydro Electric Company in Maine, that's a wires company. There really are very few wires companies out there to assess that are doing well enough to perform a DCF, so one has to use a sample of integrated, fully-integrated electric companies in order to get a sense of what the cost of equity is for electrics, and it's between nine and 10 percent.

Really, the only way you can quantify, then, what the wires company risk is going to be is to put that cost of capital at the lower range of what would be reasonable for a fully-integrated electric.

So while I don't disagree that that could be a consideration for forming a sample group, and I point out that I've also selected combination electric and gas companies in my sample group, I didn't pay attention to whether or not they came from a jurisdiction that was restructured or not, because I don't believe that imparts that much difference in the cost of capital.

And I will also finally note that the return rates that Dr. Cicchetti cites from the jurisdictions that are -- haven't deregulated really are simply jurisdictions that award high returns on equity. For example, he doesn't cite West Virginia. West Virginia hasn't deregulated, and they just awarded a seven percent return to a water company on equity.

Q. You're getting kind of far from my question.
A. Okay, all right.
Q. My question was is it appropriate to select, not why not to select, but is it appropriate to select utilities that are integrated and/or combined with gas in regulated states? Is that a reasonable peer group? I didn't ask you really what might -- what other groups might --
A. Yeah.
Q. -- be reasonable. I just want to know if you think that's a reasonable peer group?
A. And I do think that's a reasonable peer group, and that's the kind of peer group that I put together, as well.
Q. All right. If you had a group of 10 companies, all of which did fit the mold of integrated electric and/or combined gas and integrated electric from regulated states, why wouldn't that group be preferable to a group that included other kinds of states or utilities?
And this begs the question of whether all of the right utilities were included, such as from West Virginia, but wouldn't you want to have that as the core peer group and just make sure it's complete?
A. Well, in theory -- right. In theory, I

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think you want to try to get a group of companies that closely -- as closely as possible matches the company for whom you're trying to calculate the cost of equity. The problem is, in practical application, that's very difficult to do, because -- not only because there are states that have deregulated, some have, some haven't, but there are also companies that own operations, some in states that have deregulated, some in states that haven't.

For example, AEP, they own property in Texas, which are now T and D companies, although they still haven't really separated, while at the same time they own properties in Kentucky and West Virginia, which have not deregulated and have no intention of doing so. So it's very difficult.

There are a few stand-alone wires companies. Other than that, I don't think you can really say honestly that you can choose only companies from states that are deregulated without getting other noise from other issues. Unregulated operations is one, having operations in other states that are regulated or are not -- deregulated, I mean.

So theoretically, I agree with you. Practically, it's very difficult to do that.

Q. Could you look at Exhibit 182? It's one of

Mr. Gaines' exhibits.

A. DEG-12. Is that a part of his direct testimony?

JUDGE MOSS: No, it's part of his rebuttal.

THE WITNESS: All right.

MR. FFITCH: I may be able to assist the witness if I know which -- what was originally labeled for Mr. Gaines.

THE WITNESS: DEG-13 was the original.

MS. DODGE: Twelve.

JUDGE MOSS: No, DEG-12 was Exhibit 182.

THE WITNESS: Oh, I'm sorry. Thank you, sir. I have it.

Q. My question is do you think this is a reasonable set of states to look at, and I think what I mean is every -- do you think that the states and companies that are on here are reasonable ones for us to look at in terms of what commissions did, and that's separate from another question, which is who is not on here. But as far as looking at these companies and what commissions did, is it -- do we gain some guidance by looking at this list?

A. Some guidance, yes. There are problems with this list, one of which is Wisconsin. I have a real problem with the awards that the Wisconsin Commission provides their companies, and you see Wisconsin is entered more times than anything else on this list -- one, two, three, four, five, six -- six times. And for example, they're entered for the electric operations and the gas operations of the same company. So there's another 12 percent ROE that's stuck in the list that really should be one, not two, that drives the cost up.

If you eliminate Wisconsin from this average, the average ROE is 10.58, not 10.9. And also, Madam Chairman, you mentioned Public Utilities Fortnightly the other day, and glad to see that somebody else besides me reads that magazine. You'll know that they just published a ROE awards over the October 2003 through November 2004, and the majority of those returns, the vast majority were between 10 and 10 and a quarter. That's more recent than this list.

Q. And I'm trying to determine what's the right list versus either a list that's inapt or too narrow or too broad. You said you had trouble with Wisconsin. Is that because you disagree with what they did or just this double counting aspect that you mentioned?

A. Both. If you look at a histogram of the equity return awards, either in this Public Utilities Fortnightly article that I mentioned, which is November of this year, or Mr. Gaines' display here, and I've analyzed this before, Wisconsin is beyond the top end of the bell curve. Their numbers are outside of the mainstream of regulatory bodies in the United States. That's the primary reason that I would not include that in my consideration.

Secondarily, these orders in Mr. Gaines' list is between January 2003 and June 2004. It's a little bit different time period than the Public Utilities Fortnightly, but you have to realize, and you understand that the evidence in a hearing comes six months to nine months prior to the decision. These are all decision dates and they're based on a cost of capital that was probably higher than it is now.

So that's another factor. Cost of capital is coming down, so these older studies are based on information that could be as much as two years old here. So that's another consideration. I think the cost of capital is clearly below 10 percent for electrics, and these numbers here show that the average allowed return is from 10 to 10 and a half. I think that's too high.

Q. You said the cost of capital is coming down. It's a present tense. Do you think it is still coming down?

A. It has been, even though the short term --

Q. My question is do you think it still is?

A. Well, the most recent information that I have at my disposal is a cost of equity analysis I did for Bangor Hydro two weeks ago, it's a small wires company in Maine, looking at electric utilities, and again, these are fully-integrated electrics, and the numbers have slipped from nine to 10, and to 8.75 to 9.75, so it's below what I analyzed in this case.

And that seems to be unusual, because the fed is cranking up short-term interest rates. However, if you look at long-term treasury rates, they're not moving. In fact, they're coming down. So that tells me that investors long-term really don't have a lot of faith in this economic expansion to push up interest rates.

Q. On page five of your testimony, you have this list in the footnotes of various utilities where there was an ROE of less than 10 percent?

A. Yes, ma'am.

Q. Is there any combined gas and electric

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integrated utility listed there that's from a state with full regulation? I thought possibly Wyoming, Lower Valley Energy. I don't know what that does or is.
A. I don't know the answer to that question. I can find out.
Q. Well, that's all right. We're here. But maybe -- New York is a deregulated state; correct?
A. That's correct.
Q. New Jersey is a deregulated state; correct?
A. I believe that's correct.
Q. Arkansas is not, but that's a gas company; correct?
A. Yes, ma'am.
Q. Tennessee is not, and that's a water company?
A. Right.
Q. Wyoming, I believe, is not, and that's an energy company. I just don't know what that is.
A. It's probably a gas company.
Q. Colorado is not, but that's a telephone company?
A. Right.
Q. Connecticut is deregulated, I believe. Not certain. I think it is, so that would be an open

question there. Do you know if that's an electric company or a wires company or a gas --

A. Connecticut Light and Power, I believe, is a wires company.

Q. Wires only?

A. I believe, but I have to double check that.

Q. Okay. New Hampshire is a deregulated state, but that's a telecom company, anyway?

A. Right.

Q. All right.

A. Well, just, there's -- never mind.

Q. All right. My broader question to you is the issue of a utility such as Puget, which has already committed -- or committed is maybe too strong a word -- is already definitely planning to expand, and this is pursuant to an integrated resource plan, and they are proceeding along.

And I am trying to think of how that should, if it should, change our thinking when we know a company is about to acquire more resources as distinct from an abstract rate case where you look back and -- look back at the test period, set the rate year as if things are going to go on indefinitely for a while.

A. Mm-hmm.

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Q. I have to say, don't you think that knowing what is about to happen with the company should affect or at least affect our calculation, if not our judgment, about what it will mean to have one credit rating versus another or one picture to Wall Street versus another when they're going out in the relative near term for these new -- this new infrastructure?

A. Well, I think it -- when you say Wall Street, I assume you mean the investment community. It's always good to know more than less if you're an investor. The more certainty you have, the better off you are.

The Commission has provided some certainty to the company through this PCORC mechanism that it will be able to rate base plant additions sooner than a rate case. I don't know many regulatory jurisdictions that have that sort of risk reducing mechanism in place. I do know of one in Connecticut, Yankee Gas Company, I believe, had a similar mechanism where they had a pipeline they had to lay, and the Commission said, as you -- as is confirmed and the construction expenditures are confirmed, we'll put that in the rate base.

Q. But doesn't -- I believe Iowa has a form of, quote, unquote, prior approval and any state that has

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something --
A. Well --
Q. -- kind of like prior approval. I want to use that term loosely.
A. Like IRP, integrated resource plan? I mean, the big question is whether or not the Commission co-opts itself by entering into an IRP and later on can say something's imprudent because they've gotten into the plan. There are states that do have IRPs. Some commissions are actively involved in it and some are not. But I think, my understanding, and I don't have a full understanding of the PCORC situation, but I understand that to be different than an IRP.
Q. Well, in our -- with our terminology, the P is just a plan, and our companies do a plan, but then, after the plan, there is, if necessary, specific --
A. Mechanism.
Q. -- RFPs and other mechanisms for actually acquiring the resource, and it's in that connection that the PCORC arises and in that connection, I think in other states, there are various mechanisms for giving some assurance, short of a rate case many years later --
A. Right.

Q. -- that the company's on the right track.

A. Well, CWIP, for example, didn't really come into existence until the 1980s, and the building of those huge power plants. The companies were looking at huge outlays without getting any return on that, and so construction work in progress became a pretty standard regulatory tool.

Getting back to your question about what kind of risk does the investment community assess to Puget because they have stated that they're going to add plant, I think that it -- if the Commission is -- well, I don't want to say agreeable, but if the Commission is obviously supportive of the utility, which this Commission has been with the PCORC mechanism of plant additions, they recognize that, because of the market price volatility of power supply in the past, that it might be a good idea for this company to get its own generation.

You're sort of pushing the company along with your public statements about why this might be a good idea. Wall Street would see that as a good situation and not a risky situation. Here, the regulators recognize the need for a native generation, and therefore, it's likely that they will be supportive of the company. I think that's a

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positive thing, because, after all, the way utilities grow their earnings and the way they make money is to build plant.

It's the old-fashioned way we used to do things when regulation was going along before people thought of taking it all apart. If you want to grow your earnings, you build plant and you make more money on the billable plant. That's the way you do it.

Q. The problem I see is a chicken-egg thing, which is if the company does go out and secure or propose to secure, say, some wind generation --

A. For example.

Q. -- and then sets it up a la Fredrickson that they want to come in and get our approval, then isn't part of the problem is, when they've gone out to do that or to get it lined up, they have the, quote, old equity ratio and not the kind of new one that might follow, and so how do you get -- how do you or should you be able to get the benefit of the -- there's some Latin phrase, like ex post ante or something, on this, but, basically, if we knew now that we would approve such a thing --

A. Yes.

Q. -- wouldn't we want the benefit of the

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credit rating that would result if Wall Street knew in advance that that's where the equity ratio would be? Am I right or wrong on this? I really pose this as a real question, but it sounds --

A. Well, I think that if you could, simply by a stroke with a pen and allowing this company to earn a return on 45 percent equity, if you could effect a bond rating upgrade from that simple action, that might be a consideration. I frankly don't think that's a reasonable likelihood of that occurring.

I think that if the company wants to raise its equity ratio, it's looking at raising -- someone said $800 million of capital -- that number's gone from five to 800 -- over the next few years, they raise more of it -- the way to raise the equity ratio is they raise more of that capital from the equity market than they do from the debt market.

And then they'll wind up with a 45 percent equity ratio, or whatever they wind up with. Then they come back in here two years from now and say, well, our common equity ratio is 45 percent. We go, well, okay, let's see what your actual cost of capital is.

And what you're suggesting is that the company's position here is that you need to give us a

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45 percent equity ratio so this credit will be loosened up and it will be easier for us to get capital.

But if you look at the way companies are capitalized, you'll see in the list that we had Mr. Gaines read that's in my testimony, those are all holding companies, but that's where they raise the capital. The holding companies issue the equity, and they're capitalized with less than 40 percent equity right now. So -- and they're building plant, they're increasing rate base, and so I don't believe the company needs the 45 percent equity ratio.

I think consumers in this state have done their job, they did their job last time helping the company out by paying rates on 40 percent when they had 30. Now I think it's up to the company to get their own capital structure up to 45.

Q. But that's quite a different rationale just now that you offered. You were saying that the ratepayers were out ahead of the company --

A. Earlier.

Q. -- earlier, and so now, as a compensating factor, the company should be out ahead, so to speak, of the ratepayers, and is that -- I understand the point, but I'm wondering if, in the end, it actually

helps ratepayers? For me --
A. I think it does definitely help ratepayers.
Q. In the short run.
A. And if I gave you the impression that it was a tit-for-tat thing, I'm sorry, that wasn't my intent. It's a normal course of events, when utilities are adding plant, for some of that -- some of those monies will be internally generated monies they don't pay out as dividends, that they retain, some of those monies will come from there. Some will come from short-term debt, small amount. Some will come from preferred stock or debt and some will come from equity.
When companies are expanding, they have to raise capital in the marketplace, and that's why you need to have an investment grade bond rating for a utility. That's important, and I've said that to you in previous Puget rate cases. I think that's important.
But it's a normal course of events for the company to take their own destiny in their hands and determine how they're going to capitalize those operations. If they want a higher equity ratio, then they have to raise more equity from the capital market, and they're certainly in a position to do

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that. Their business position has improved from five to four, they have had a BBB bond rating with much worse common equity ratios and much lower coverages than we're recommending in this proceeding.
So I think -- that's why I hesitate to ask ratepayers once again to step up to the plate, or continue to step up to the plate for the company.

And I think it would be more expensive for ratepayers, let me finally say, because I think that the cost of the common equity ratio difference between 40 and 45 outweighs the benefits.

Q. And by more expensive, surely, in the very short run, it would be more expensive, because it all translates to a higher rate. I think another question, though, is over the long run --

A. Right.

Q. -- is it? And is it also your opinion that, over the long run, assuming that there are going to be some major financings of major infrastructure, is it your opinion that the ratepayers will be better off with the lower equity ratio and the lower ROE that you suggest?

A. Yes, is the short answer to that question. The --

Q. So you're not concerned that if we adopt

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your proposal, that Wall Street would see this as a some kind of negative sign and, say, lower the credit rating or tighten up lending?

A. No, I'm not concerned that Wall Street, the bond rating agencies will lower the credit rating. I believe that the recommendation I've made here on behalf of the Attorney General will maintain the company's credit rating where it is.

Q. Okay. I think I wanted to ask you a couple of questions. Dr. Cicchetti was able to rebut your testimony in his rebuttal, but you haven't had an opportunity to respond to it formally. And I take it you probably read his rebuttal of your testimony pretty carefully?

A. Yes, I did.

Q. If we could turn to Exhibit 206.

JUDGE MOSS: That's his rebuttal testimony?

CHAIRWOMAN SHOWALTER: Right.

THE WITNESS: I'm there.

Q. Well, on page five, lines two to four, or maybe two to eight, he seems to be saying you're only looking at a one-notch difference, not a two, and you should be looking at two. And I wonder what your answer was to that, your response to lines two to eight?

A. Let me read this.
Q. Okay.
A. Oh, my analysis looked at -- first of all, the analysis I did in my testimony looked at the cost of setting rates with a 45 percent equity ratio and, just off the top of my head, it was something like $15 million a year to ratepayers, and the savings were less than a million, about half a million a year, given the $500 million of debt that the one might issue. And I looked at the debt cost differential as the differential between BBB and BBB+.

Now, all the company witnesses, and we heard Dr. Cicchetti here say yesterday that a move from BBB to BBB+ is about all we could expect out of this rate case. He thinks that might be a plateau, that we might move on to something higher later on. But all their testimony is about a one-notch move in the bond rating, because Puget's first mortgage bonds are rated BBB.

The corporate rating, which takes into account the fact that they have unregulated operations, is BBB-, but the first mortgage bonds, the secured debt, senior secured debt of Puget is BBB. That's an important distinction, because this

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has been bandied about quite a bit.

So if the BBB goes up to BBB+, the first mortgage bonds above the BBB+, that's one ratings notch. And that's what I was measuring. That's what they're talking about. But when they rebut my testimony and criticize that analysis, they always talk about two ratings notches.

And if you talk about two ratings notches and you start out talking about a BBB-, then you're into the BB range, and there's a huge cost difference between BBB and BB, and that enables the company to put some numbers in the record that I don't think are accurate.

Q. So is the short answer you are focused on senior secured debt, as distinct from corporate bond rating, is that what you were saying, or corporate credit rating?

A. Yes, ma'am. I was looking at the cost of -- if a company's going to issue long-term debt to build plant, they should issue it as cost effectively as possible and it should be secured debt. It shouldn't be debentures which are not secured.

So I was looking at the cost of how much you could save with issuing $500 million of debt if your bond rating went from BBB to BBB+, and it's about

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half a million dollars a year. But in order to get there, it's going to cost you 15. It doesn't seem like a good trade-off to me.

Q. What about other aspects of a credit -- of a better credit rating, such as dealing with trading partners and things like that? That is, isn't it more focused on the corporate credit rating?

A. That's -- that is more focused on the corporate credit rating, and there are advantages to that. However, I think it was pointed out earlier today that Mrs. Ryan, when she talks about that issue in her testimony, trying to quantify the cost and benefits, she finds the present value of 10 years of those savings and compares that to the one-year cost of those savings. That's really not a fair comparison.

If you want to look at 10 years, then run everything out 10 years and discount it to the present value or just look at one year. Either/or.

Q. All right. But if we were to do that exercise properly, you would say focusing on the corporate credit rating is the place to look at?

A. I think, for that kind of credit that you just discussed, the trade credit and trading partners, yes, I think corporate credit rating is where you should look.

Q. All right. Could you turn to page seven of Dr. Cicchetti's rebuttal?

A. I have it.

Q. He pointed out in his testimony that Pinnacle West is listed here with an A- rating and he thought it should not be included. And after he removed it, he made a calculation, but I wanted to ask you whether you -- whether it should be included and why?

A. I included it because it has a split rating. If you look at my testimony, and it's -- I don't have the exhibit numbers, but I'll give you my exhibit number. It's SGH Exhibit 8.

JUDGE MOSS: That's 358.

THE WITNESS: Thank you, sir. You'll see that the criteria are that the company have a BBB bond rating, and all those I selected have BBB -- at least one BBB bond rating. Pinnacle West has a BBB bond rating from Moody's and a low single A bond rating from Standard and Poor's. Dr. Cicchetti elects to report only one of those bond ratings.

And I wanted to obtain a large enough sample, so I also included the companies that had a split rating, BBB and single A. There's a couple of other of those, by the way. There's -- Cleco is one and -- Cleco Corporation is one, and I think there's one more. Progress Energy.

Q. All right. If we go to Exhibit 358, we'll see the split?

A. Yes, ma'am.

Q. Okay. Thank you. Perhaps you could turn to page 445 of Dr. Cicchetti's rebuttal.

A. I have it.

Q. And on lines five to seven, he says that you ignore the more fundamental issue of whether DCF theory fits PSE's facts. And I would like your response as to whether DCF theory does fit PSE's facts, or whether that matters?

A. It does. It does matter. I think if a company is so unusual that it doesn't pay dividends or the growth rate is highly unusual, I think that the DCF might not be an accurate measure of the cost of equity, but you have to remember here that I'm not just using Puget market data to estimate the cost of equity; I'm using the data of 10 other companies.

And so by using a sample, similar sample group, if there were any abnormalities which might cause a DCF for Puget to be odd, for some reason, then those kind of get washed out in the larger sample group.

Q. Okay. And I apologize. This was specifically about Dr. Wilson, but you were brought into the argument.

A. Well, he has the same false assumptions as I do, apparently, according to Dr. Cicchetti.

CHAIRWOMAN SHOWALTER: All right. That's all the questions I have. Thank you.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. Just pursuing from that same page, page 45 of Dr. Cicchetti's testimony, rebuttal, line 13, 14, Although PSE has positive cash and earnings, it has negative dividend growth. Do you have any comment on that?

A. It doesn't have negative dividend growth. It had negative dividend growth because it reduced its dividend a couple years ago. And in the future, it's expected to continue to grow.

Q. The Chair asked you to comment on Dr. Cicchetti's criticisms of your testimony. Mr. Gaines also directly attacked your testimony and, along with Dr. Wilson, and asserts that the -- overall, I think, paraphrasing it, that the company will be worse off with your capital structure and cost of equity. Do you have any comment on that critique?

A. Well, I'll try to be brief, although I could go on and on, I'm sure. I do not believe that's true. I believe that the capital structure the company now has, which is about 40 percent equity, is a cost-effective capital structure in that it will produce an overall return over the long-term that would be lower than one that's produced by a higher equity ratio. Although you may shave a little bit off of the debt costs, I don't disagree with that, you're going to pay a whole lot more up front for the higher equity.

So from a ratepayer's point of view, it's more cost-effective to be where they are now. They've gotten to -- they've gotten from a very serious equity deficit in the capital structure three or four years ago, down around 30 percent, now to 40 percent. They're in a position to improve their capital structure, and if they do, we could consider a higher equity ratio in the future.

But I think that 40 percent equity ratio is reasonable. Certainly a range between 40 and 45 is reasonable, but I think 40 is more cost effective in the long run.

There is also an issue about short-term debt, which I'm concerned about, and I don't want to take advantage of the Commissioner's question, and I'll just leave it at that. I think there's some questions that have not been answered about the company's short-term debt.

Q. I'll ask the question. What is your concern about the short-term debt?

A. Well, the company has created Rainier Receivables to -- in order to get cheaper short-term debt. The problem is, as I think our cross-examination showed this morning, that the short-term debt is more expensive than long-term debt, because they're piling all of the costs of those facilities on a small amount of debt that appears on Puget's balance sheet when most of the debt is on Rainier Receivables' balance sheet.

So if I'm an analyst at the Commission and I'm directed by the chairman to look at Puget and tell me how much short-term debt they've used over the past year, if I go to Puget's balance sheet, I'm not going to be able to answer that question. All I'm going to see is the short-term debt that appears on Puget's balance sheet, because the other debt that's at Rainier Receivables goes away in consolidation. It appears on the balance sheet of the parent company, but not on Puget's balance sheet.

So from the point of view of a regulator, essentially they've created an entity that has off-balance sheet debt that you're not readily able to track. I have a problem with that.

I also have a problem with the issue of how short-term debt is calculated. If Rainier Receivables is not going to be included, then maybe they ought to pay the cost of that facility and not Puget. Why should the regulated ratepayers pay the cost of it if they're not getting any advantage from the debt. So -- and the debt exists -- the cheapness, quote, unquote, of the debt exists only because of Receivables, an asset that lives at the Puget Sound Energy level.

So Puget enables this facility to happen, but they don't get the advantage of having that short-term debt in their balance sheet. I have concerns about that, and that's one reason, in my capital structure, I make some estimates about levels of short-term debt and cost rates, because I'm not really able to discern what's going on.

Q. Well, let me ask the ultimate question. Do you agree or disagree with Mr. Gaines when he says that arrangement allows Puget to have a lower cost for short-term debt?

A. Well, I have to disagree with that, because, first of all, he's very careful to draw a distinction between the cost of debt and the -- I forget the terminology he used, but the price, the pricing, when all of the factors are rolled into it, you know, he says, Okay, we've got short-term debt that's 1.2 percent, but the cost rate they supplied to Puget is eight percent. Well, if we're having to pay eight percent, then that's what the cost rate is.

So I guess my concern is that I haven't seen that this situation is advantageous for the company. In the projections for the rate year, the company projects so much is short-term debt and so much of it coming from the securitization facility and so much coming from somewhere else. I really don't know if they're considering all of the debt that exists at Puget, some of it, some of it at Rainier Receivables. I just don't know.

So I think that's a problem. That's why I brought it up to the Commission. And yes, our recommendations regarding short-term debt and the cost rate in this case are not that far apart. I mean, we all come to the -- hit the same mark. I merely bring it up to you because I find it troubling that there's stuff going on that's not readily discernible. That's the concern I have.

COMMISSIONER HEMSTAD: Thank you. That's all I have.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Well, that -- you just hit on the follow-up question I want to ask, because I was struggling to, as Commissioner Hemstad put it, struggling to understand all of this earlier with Mr. Gaines, and then he brought me back to Exhibit 179, page three, where the ultimate recommendation is so similar. And are you troubled as a matter of principle, but it doesn't have a real effect in this particular case? Why are we spending so much time on this issue? Of what import is it to the results that we ought to decide here?

A. Because it's important, in my view, and I am troubled on a principle basis and not because, since we're looking forward to the rate year, we can project what we think a reasonable level of short-term debt ought to be, and I don't think four percent is unreasonable, or whatever, 4.36, or whatever my number was.

It's similar, when I look back at Puget in the past, over the past five quarters, they show only about half a percent of short-term debt, but if I roll Rainier Receivables into Puget Sound Energy, then they come up to more short-term debt. And so out of that combination of that analysis, I think four point something is a reasonable amount. And the rate of four percent is less than the company, simply because I think they're overprojecting what the cost is going to be.

But on the long-term basis, we were talking about what was the long-term effect of this. The long-term effect of this is the company has a short-term debt facility that you're not going to be able to track simply by looking at the balance sheet of the regulated utility, and who knows where that short term debt's being used. I don't know where it's being used. And I think that's a concern.

CHAIRWOMAN SHOWALTER: Thank you.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Hill, I want to follow up on some questions that were asked by the Chair, and it really revolves around the discussion that you had regarding the comparable companies in the DCF analysis, and I know that there was a lot of discussion about trying to comp the companies very finely, so that there might be -- only gas and electrics might be considered or you had considered other companies, but I guess my question is, is that really more academic or -- in its import or do investors really parse their investment decisions -- do the majority of investors really parse their investment decisions that finely? Do they only look at electric and gas combos or, of electric companies, those with generation, those without?

A. I don't think that investors parse their investment decisions that finely. There are -- there's a myriad of investment factors. That's one of them. I think that an all electric fully-integrated company and a combination electric-gas company are very similar in risk.

I also, as I've tried to explain to Chairman Showalter earlier, there -- although we talk a lot about the risk differences between wires-only companies and fully-integrated companies, the actual numbers are not that great. The ROE differentials are really not that great.

They're basically, in the utility business, they have franchise service territories. A generation risk is more serious than distribution risk, because you have the very kind of risk we were talking about earlier of you have to construct generation, and unless you add generation in small increments, it's, quote, unquote, lumpy.

You have a big chunk of generation. If anybody's going to build a nuclear plant again, and I think someday, within the next decade, that will happen, but that's a huge investment. And we saw the problem in the 1970s and '80s where an investment like that would almost drown a company. I don't think we're going to see that kind of thing anymore, and there are other mechanisms in place for integrated companies to have pre-approval by regulatory bodies or special rate mechanisms by regulatory bodies.

I think certainly investors have learned and so have company management learned that they need to be protected when they go out and invest in some of these huge projects to build base load generation.

So two answers to your question. One is it's -- I don't deny that different kinds of utilities is a factor in the decision. It's one of many, many factors. And the actual cost of equity differential between those kinds of companies is not as great as we might think it is.

COMMISSIONER OSHIE: All right. Thank you. No further questions.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. I have one follow-up on that. Are you assuming that Puget has a certified franchise territory?

A. Am I assuming that Puget does? No, I'm speaking in generalities about utility operation, traditional utility operation.

Q. That, in general, utilities do?

A. Yes, in general, they do.

Q. Does it matter to you if Puget doesn't?

A. Does it matter that they don't?

Q. Yeah.

A. No, I don't believe it makes a big difference.

Q. Then is having a franchise territory significant?

A. The point I was making was that it's a utility operation that doesn't get much company-on-company competition. In some areas of the country, it's very strict. You can't go within a certain boundary. In West Virginia, it's less strict, because there are interstate pipelines that criss-cross the company -- the country -- the state, and people are able to tap onto those lines and get gas without buying from the local distributor. It's always been a big problem there. So each jurisdiction is different in that regard.

Q. Well, that seems to me that your answer just to Commissioner Oshie points out how different the different states are, that that is one of the problems here, that there are states that have restructured and states that haven't, but whether a state has or hasn't restructured, they may have different degrees of certainty that they provide --

A. Right.

Q. -- either in terms of -- and I'm really not speaking of distribution at all; I'm really speaking on the generation side. So it's difficult to --

A. Assess?

Q. Yeah.

A. Yeah. Well, for example, I'm testifying for the Georgia Public Service Commission and Atlanta Gas Light right now. That is a distribution company,

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obviously, but they have a great deal of protection. The Commission has set up lots of protections with their suppliers and backstops about risk, and the company really has very, very little risk that impinges on them having to do with supply. So they really are just a pipes in the ground kind of company.

And that's different than the arrangement, for example, in Connecticut with Yankee Gas.

CHAIRWOMAN SHOWALTER: Okay. Thank you.

JUDGE MOSS: All right. We didn't get into your area, Mr. Van Cleve, but I'll ask if you have any follow-up, Ms. Dodge?

MS. DODGE: Just a housekeeping matter. I'd like to move to admit Exhibits 369 and 370.

JUDGE MOSS: All right. Those will be admitted as marked. And is there any redirect, Mr. ffitch?

MR. FFITCH: No redirect.

JUDGE MOSS: All right. Well, Mr. Hill, we appreciate you being here and giving your testimony, and you may step down.

THE WITNESS: Thank you, sir.

JUDGE MOSS: Why don't we take our afternoon break while we get Dr. Wilson arranged on the witness