

**EXHIBIT NO. \_\_\_(DEG-1T)  
DOCKET NO. UE-07\_\_\_/UG-07\_\_\_  
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-07\_\_\_  
Docket No. UG-07\_\_\_**

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

**DECEMBER 3, 2007**

**PUGET SOUND ENERGY, INC.**

**PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF  
DONALD E. GAINES**

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1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF**  
3 **DONALD E. GAINES**

4 **I. INTRODUCTION**

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

7 A. My name is Donald E. Gaines. My business address is 10885 NE Fourth Street,  
8 P.O. Box 97034, Bellevue, Washington 98009-9734. I am the Vice President  
9 Finance & Treasurer for Puget Sound Energy, Inc. (“PSE” or “the Company”).

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

12 A. Yes, I have. It is Exhibit No. \_\_\_(DEG-2).

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

14 A. I have overall responsibility for raising capital in the financial markets. I am also  
15 responsible for maintaining relations with credit rating agencies, commercial and  
16 investment banks. In addition, I oversee the Company’s financial planning,  
17 budgeting, tax and energy risk control and credit activities. I am also Chairman  
18 of the Qualified Plans Committee, which oversees the Company’s retirement,  
19 401(k) and health and welfare plans. I also serve as a Trustee of the Puget Sound

1 Energy Foundation.

2 **Q. Please summarize the purpose of your testimony.**

3 A. My testimony describes the Company's requested capital structure and overall  
4 rate of return. The requested capital structure reflects an equity ratio of 45% and  
5 a 10.8% return on equity, which, when weighted with the other components of the  
6 capital structure, results in a rate of return of 8.60%.

7 The Company's requested capital structure includes a requested 45% equity ratio  
8 which reflects; 1) the test year capital structured adjusted for a "known and  
9 measurable" sale of common stock, and 2) the average amount of equity expected  
10 to be outstanding during the rate year.

11 On October 25, 2007, Puget Energy sold 12.5 million shares of common stock  
12 (approximately \$300 million) to the Macquarie Consortium ("Consortium")  
13 which, when added to the Company's average test year capital structure results in  
14 an equity ratio of 46.35%. Reflecting that sale of stock in the actual, not the  
15 average, capital structure on September 30, 2007 results in a common equity ratio  
16 of 45.59%. This stock sale is not contingent on approval of the merger -- the  
17 Consortium will own those shares whether or not the merger is consummated.  
18 For this general rate filing the Company is requesting that rates be set using a  
19 45% equity ratio, the level that is currently supporting operations, reflecting the  
20 sale of common stock.

1 Approval of the 45% requested equity level, along with a 10.8% return on equity,  
2 the low end of the range recommended by Dr. Roger Morin, will likely enable the  
3 Company to maintain its corporate credit rating at the current “BBB-”/”Baa3”  
4 levels. Such credit ratings, along with the other relief the Company has  
5 requested, should enable the Company to attract the large amount of capital it  
6 needs to invest in new generating resources on behalf of its electric customers and  
7 to invest in its gas and electric system infrastructure, whether or not the  
8 contemplated merger is approved.

## 9 II. CAPITAL STRUCTURE

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

12 A Selecting the appropriate capital structure involves balancing of safety and  
13 economy. The economy of lower cost debt, on which the Company has an  
14 obligation to pay interest, must be weighed against the safety of relatively higher  
15 cost common equity, on which there is no legal obligation to pay a return.

16 In the Company’s last general rate case, Docket Nos. UE-060266 and UG-  
17 060267 (consolidated), (the “2006 general rate case”), the Commission concluded  
18 that rates should be set on the “actual” equity ratio, rather than a “hypothetical”  
19 equity ratio:

20 The record does not demonstrate a compelling reason to approve a

1 capital structure that contains more equity than is actually  
2 supporting the Company's operations, and there is no certainty that  
3 the Company will actually increase its equity share during the rate  
4 year. Consequently, we find an actual rather than hypothetical  
5 capital structure should be used in this case.

6 *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Order 08 Rejecting  
7 Tariff Sheets; Authorizing and Requiring Compliance Filing at ¶78, Docket Nos.  
8 UE-060266 & UG-060267 (consolidated) (Jan. 5, 2007).

9 In this proceeding, the Company is requesting an equity level consistent with the  
10 basis on which the Commission set the capital structure in the 2006 general rate  
11 case which is a capital structure that is actually supporting the Company's  
12 operations.

13 **Q. What is the Company's actual capital structure?**

14 A. The Company's average capital structure for the test year (the twelve months  
15 ended September 30, 2007) is as follows:

16 **TABLE 1**  
17 **ACTUAL TEST YEAR CAPITAL STRUCTURE**

<b>Capital Component</b>	<b>Sept 30, 2007 Test Year (Average)</b>
Short-term Debt	7.00%
Long-term Debt	52.12%
Preferred Stock	0.04%
Common Equity	40.84%
<b>Total Capitalization</b>	<b>100.0%</b>

1 **Q. Why did the Company's equity ratio drop from approximately 44% in the**  
2 **last general rate case to 40.84%?**

3 A. In the last general rate case, the Company had contemplated strengthening its  
4 equity ratio by: 1) retaining net income in excess of dividends, 2) retaining  
5 proceeds from reinvested dividends, and 3) receiving proceeds from an equity  
6 issue in February 2007. While the Company did increase its equity by reinvesting  
7 dividends and net income, the stock sale was made in October 2007 as described  
8 below and closed in early December 2007.

9 **Q. Why is the capital structure presented in Table 1 not representative of the**  
10 **Company's current capital structure?**

11 A Since September 30, 2007, the Company's parent company, Puget Energy, Inc.  
12 ("Puget Energy"), entered into a Stock Purchase Agreement, dated as of  
13 October 25, 2007, with the following entities: Macquarie Infrastructure  
14 Partners A, L.P., Macquarie Infrastructure Partners International, L.P., Macquarie  
15 Infrastructure Partners Canada, L.P., Padua MG Holdings, Inc., Macquarie FSS  
16 Infrastructure Trust, CPP Investment Board (USRE II) Inc., Padua Investment  
17 Trust, PIP2PX (PAD) LTD, and PIP2GV (PAD) LTD (collectively, the  
18 "Consortium"). Please see Exhibit No. \_\_\_\_ (DEG-3) for a copy of the Stock  
19 Purchase Agreement.

20 Pursuant to the Stock Purchase Agreement, Puget Energy sold 12.5 million shares  
21 of common stock to the Consortium at price of \$23.67 per share. Puget Energy

1 will invest the net proceeds from the sale (approximately \$300 million) into PSE  
2 as an equity contribution.

3 **Q. Is the stock sale contingent upon approval by shareholders and the**  
4 **Commission of the merger among Puget Energy, Padua Holdings LLC,**  
5 **Padua Intermediate Holdings Inc. and Padua Merger Sub Inc.?**

6 A. No. The stock sale is not contingent on approval of the merger. The equity  
7 associated with such sale will remain with the Company whether or not the  
8 merger is ultimately consummated.

9 **Q. How does this stock sale affect the Company's test year capital structure?**

10 A As can be seen in Table 2 below, proforming the sale of stock into the Company's  
11 capital structure that existed, on average, during the twelve months ended  
12 September 30, 2007, results in a 46.35% equity ratio:

13 **TABLE 2**  
14 **TEST YEAR CAPITAL STRUCTURE REFLECTING SALE**

<b>Capital Component</b>	<b>Test Year Reflecting Stock Sale</b>
Short-term Debt	1.49%
Long-term Debt	52.12%
Preferred Stock	0.04%
Common Equity	46.35%
<b>Total Capitalization</b>	<b>100.0%</b>



1 The actual capital structure as of September 30, 2007, adjusted to reflect the stock  
2 sale, contains 45.59% equity:

3 **TABLE 3**  
4 **ADJUSTED SEPTEMBER 30, 2007 CAPITAL STRUCTURE**

<b>Capital Component</b>	<b>Sept 30, 2007 Reflecting Stock Sale</b>
Short-term Debt	2.00%
Long-term Debt	52.38%
Preferred Stock	.03%
Common Equity	45.59%
<b>Total Capitalization</b>	<b>100.0%</b>

5 **Q. On what capital structure is the Company requesting that rates be set?**

6 A. The Company is requesting that rates be set on the following capital structure in  
7 this rate proceeding:

8 **TABLE 4**  
9 **REQUESTED CAPITAL STRUCTURE**

<b>Capital Structure</b>	<b>Ratios</b>
Short-term Debt	4.93%
Long-term Debt	50.04%
Preferred Stock	.03%
Common Equity	45.00%
<b>Total Capitalization</b>	<b>100.0%</b>

1 This capital structure reflects the recent sale of stock, includes the maturities of  
2 long-term debt and reflects the anticipated sale of long-term securities through the  
3 rate year. It contains slightly more debt and less equity than the level supporting  
4 operations today, but reflects what is expected to be supporting operations at the  
5 time the rates from this proceeding are in effect.

6 **Q. Notwithstanding the recent stock sale, has the Company issued other**  
7 **securities since it filed the 2006 general rate case?**

8 A. Yes. The Company issued \$250 million and \$300 million of senior secured notes  
9 and a \$250 million junior subordinated note. The Company also redeemed the  
10 remaining 8.231% trust preferred and the 8.40% trust preferred as planned. As a  
11 result of the redemptions, the Company no longer has any trust preferred  
12 outstanding.

13 **Q. Did the Company issue the preferred issue that was discussed in the**  
14 **Company's last general rate case?**

15 A. No. In the last general rate case, the Company planned to issue traditional  
16 preferred stock but stated it was also looking at alternative structures which would  
17 be less costly on an after-tax basis. Rather than issue traditional preferred stock,  
18 the Company issued \$250 million of junior subordinated notes in lieu of the  
19 traditional preferred. Interest on the notes is tax deductible and, like traditional  
20 preferred, the notes receive 50% equity credit from the rating agencies for the first

1 ten years of their term (the amount of equity credit steps down over time). As a  
2 result, the \$250 million junior subordinated notes issue proved to be less costly  
3 than traditional preferred stock.

4 **Q. How does the cost of the junior subordinated notes compare to a comparable**  
5 **mix of traditional debt and equity?**

6 A. The \$250 million of junior subordinated notes have a cost rate of 7.23% and have  
7 a term of 60-years. Because the interest on the notes is deductible when  
8 calculating Federal income taxes, the after-tax cost is 4.70% (65% x 7.23%). The  
9 notes receive 50% equity credit from the rating agencies so, as an alternative, the  
10 Company could have issued \$125 million of debt and \$125 million of equity.  
11 When the notes were issued, the Company could have issued 30-year debt at a  
12 coupon of 6.236% and an after-tax cost of 4.054%. The Commission authorized a  
13 10.4% return on equity in the Company's last general rate case. A 50/50  
14 weighting of the 30-year debt cost and the equity return results in an after-tax cost  
15 of 7.23%. Thus, the comparable mix of debt and equity would have an after-tax  
16 cost that was 253 basis points more than the junior subordinated notes (7.23% -  
17 4.70%).

18 **Q. Where has the Company included the junior subordinated notes in its capital**  
19 **structure and cost of capital calculations?**

20 A. The junior subordinated notes are technically a form of debt and, as a result, are  
21 included in the long-term debt ratio and in the Company's cost of long-term debt.

1 **Q. Does the Company's current capital structure appropriately balance the**  
2 **risks and costs of shareholder and debt funding?**

3 A. Yes, the current capital structure, reflecting the recent common stock sale, should  
4 enable the Company to: (i) attract the capital to fund the Company's  
5 infrastructure and new resource construction program, (ii) offset the imputed debt  
6 from purchased power agreements; and (iii) provide electric and gas service to  
7 customers on reasonable terms.

8 However, it does not reflect the long-term debt that will mature through the rate  
9 year nor the amount of additional financing needed during that time. The capital  
10 structure the Company is requesting reflects these items.

11 **Q. What mix of debt and equity is appropriate for the Company?**

12 A The Company's actual capital structure depends, in part, on its capital spending  
13 plan and energy resource acquisitions, particularly the mix of owned and  
14 contracted resource acquisitions. A heavier weighting towards purchased power  
15 contracts would result in imputed debt that would need to be balanced with  
16 additional equity. At the same time, the Company has already increased its equity  
17 level substantially over the past several years and there are practical limits on how  
18 quickly equity levels can be increased. As Dr. Morin discusses in his testimony, a  
19 company the size of PSE that has a large need for capital to replace infrastructure  
20 and add resources needs a strong equity base to attract debt capitalization.

1 Taken together, the Company believes that a 45% equity level is an appropriate  
2 next step in increasing its equity ratio. That is also the level that is supporting  
3 operations and is thus consistent with the methodology the Commission used in  
4 establishing the appropriate capital structure in the Company's last general rate  
5 case. It is also the amount that is expected to be outstanding during the rate year.  
6 Thus, the Company has used a 45% equity level in its cost of capital calculations.

7 This level of equity, when combined with the regulatory relief requested in this  
8 proceeding and an appropriate return on equity, should enable the Company to  
9 maintain its credit metrics, which, in turn, should enable it to attract capital at  
10 reasonable rates to fund its capital spending program.

11 **Q. How does the capital structure the Company recommends in this proceeding**  
12 **compare to the capital structures approved in general rate proceedings**  
13 **across the country?**

14 A. The average equity ratio approved for ratemaking purposes in general rate  
15 proceedings across the country from January 2006 through September 2007 was  
16 48%, which is 300 basis points higher than the 45% equity ratio requested by the  
17 Company in this proceeding. Please see Exhibit No. \_\_\_(DEG-4) for a table of  
18 results of rate orders in 2006 and 2007.

19 **Q. Are you proposing the same capital structure for gas and electric operations?**

20 A. Yes. PSE is an integrated gas and electric utility. The Company is not run with

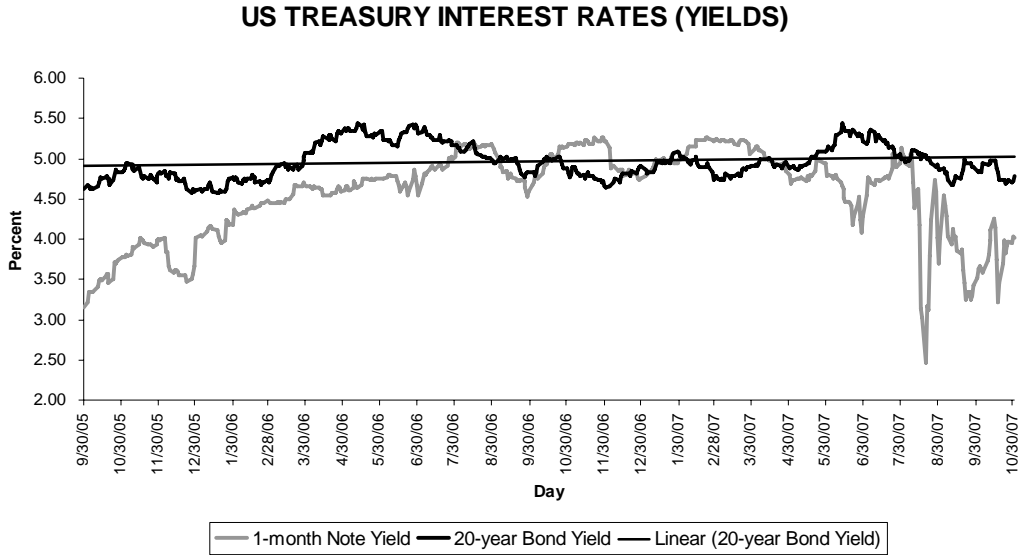
1 separate electric and gas divisions. The capital acquired to finance the Company  
2 is not split between gas and electric operations. The use of proceeds from such  
3 financing is not tied to any one type of commodity. As a result, a single capital  
4 structure is appropriate.

5 **III. CAPITAL COMPONENTS OF THE**  
6 **COMPANY'S REQUEST**

7 **A. Interest Rates**

8 **Q. Please describe the changes in interest rates since the Company's last general**  
9 **rate proceeding.**

10 A. The test year in the last general rate proceeding ended on September 30, 2005.  
11 Below is a chart showing daily yields on the 1-month US Treasury note and 20-  
12 year US Treasury bond from September 30, 2005 through October 31, 2007.



1 As a measure of long-term interest rates, I have shown the yield on the 20-year  
2 bond because the 30-year Treasury bond was not reintroduced until February  
3 2006. I have also included a trend line based on the 20-year Treasury rate. As  
4 can be seen in the trend line, long-term interest rates, while having moved up  
5 and down during the period, have been pretty flat.

6 By comparing the line for the 1-month note yield to the 20-year bond yield, one  
7 can see that the yield curve started the period with a positive slope (short rates  
8 were lower than long-term rates), then the curve flattened during the middle of the  
9 period. Since July of 2007, short-term interest rates declined but have also  
10 become much more volatile.

11 **Q. To what do you attribute the recent volatility in short-term interest rates?**

12 A. The volatility in short-term interest rates that began last summer was the result of  
13 the sub-prime mortgage induced credit crunch. As default rates on sub-prime  
14 mortgages increased, investors began shying away from these investments and  
15 moved their money into more safe short-term Treasury notes. As a result, the  
16 value of mortgage backed securities dropped. There have been several articles  
17 describing the tens of billions of dollars in write downs banks and other investors  
18 have experienced as they marked the value of the investments to the lower market  
19 value. The impact of investors moving to the “safe haven” of short-term Treasury  
20 investments drove prices of those securities up, and their yields down. At the

1 same time, investors started repricing risk -- demanding increased risk premiums  
2 for short-term funds.

3 **Q. What was the impact on the Company during this time?**

4 A. Prior to this time, the Company could issue commercial paper at rates that were  
5 around 15 to 30 basis points over the London Interbank Offered Rate ("LIBOR").  
6 When this event struck, risk premiums went as high over 100 basis points over  
7 LIBOR. To maintain investor interest in commercial paper, the Company would  
8 issue at higher spreads, but not at 100 or 150 basis points over LIBOR.

9 When risk premiums were at such high levels, the Company began borrowing  
10 directly through its credit facilities. The credit facilities were priced earlier this  
11 year during a time of more favorable credit conditions, and as a result, have much  
12 lower risk premiums than presently exist in the market. For example, at its  
13 present credit rating, the Company can borrow through its \$500 million credit  
14 facility at 52.5 basis points over LIBOR. When the Company borrows, it does not  
15 have to pay the 12.5 basis point commitment fee on amount of the borrowing (the  
16 commitment fee is based on the "unused" portion of the facility), resulting in a net  
17 spread (risk premium) of 40 basis points over LIBOR. In the past, spreads on  
18 commercial paper were lower, the Company relied almost exclusively on  
19 commercial paper for its short-term borrowing. As spreads increased, it began  
20 borrowing directly through its credit facilities, while issuing some commercial  
21 paper at reasonable spreads to maintain investor interest.



1 **Q. What conclusions do you draw from this period?**

2 A. During this period, the Company found that liquidity can evaporate very quickly  
3 and risk premiums can increase both quickly and substantially. It also highlights  
4 the value of maintaining credit facilities of adequate size to meet the Company's  
5 funding needs, while also only utilizing them at levels that leave room for  
6 additional borrowing as these needs increase.

7 **B. The Cost of Debt**

8 **1. The Cost of Short-Term Debt**

9 **Q. Please describe the Company's short-term credit facilities.**

10 A. The Company's current short-term credit facilities are used primarily to provide  
11 necessary working capital to fund utility operational requirements and the  
12 expected variability of such requirements. The Company has three credit  
13 facilities: (i) a \$200 million accounts receivable securitization program, (ii) a  
14 \$500 million unsecured revolving credit agreement with a group of banks, and  
15 (iii) a \$350 million unsecured revolving credit agreement to support the  
16 Company's extended energy hedging activities. These facilities carry five-year  
17 terms and expire beyond the end of the rate year.

18 **Q. Is the \$200 million accounts receivable securitization program a new credit**  
19 **facility?**

20 A. No, this is the same \$200 million accounts receivable securitization program

1 discussed in PSE's last general rate case, referred to as "PSE Funding". It is an  
2 on-balance sheet liquidity facility that uses accounts receivable and unbilled  
3 revenues as collateral. Borrowings under the facility are used to fund the  
4 Company's operations until long-term capital is put in place.

5 **Q. Is the \$500 million unsecured revolving credit facility a new credit facility?**

6 A. No, this is the same \$500 million unsecured revolving credit facility discussed in  
7 PSE's last general rate case. This facility was extended for an additional year in  
8 March 2007. The facility was primarily intended for use as a back up for the  
9 issuance of commercial paper, but with the increased cost of commercial paper  
10 resulting from the credit crunch, the Company has funded some of its operations  
11 borrowing directly through the facility. Like the receivable securitization facility,  
12 short-term borrowings under this facility are expected to be repaid with the  
13 proceeds from the sale of long-term securities.

14 **Q. Is the \$350 million unsecured revolving credit facility a new credit facility?**

15 A. Yes, the \$350 million unsecured revolving credit facility is a new credit facility.  
16 In its last general rate proceeding, the Company requested and was granted, the  
17 ability to recover hedging costs, including the costs of the \$350 million credit  
18 facility in its baseline power and gas commodity cost rates. This new credit line  
19 supports an extension of the Company's energy hedging program. Prior to  
20 entering into that facility, the Company did not have adequate liquidity to support  
21 the Company's working capital and energy hedging needs.

1 **Q. What is the purpose of the \$350 million unsecured revolving credit facility?**

2 A. Counterparties that transact with the Company typically make a certain amount of  
3 trade credit available to the Company. As the Company extends its hedging  
4 activities and as energy positions and prices change, the Company's exposure to  
5 these counterparties may exceed the credit made available to the Company, and  
6 these counterparties may ask the Company to provide collateral. The \$350  
7 million credit facility permits the Company to provide cash and/or letters of credit  
8 as collateral without straining the amount of credit available for working capital  
9 needs.

10 For example, assume that the Company needs to buy gas at index but wishes to  
11 fix the price of that gas. The Company could enter into a swap through which it  
12 agrees to pay a counterparty a fixed price for gas in exchange for the counterparty  
13 paying the variable index price for the same quantity of gas. Assume further that  
14 such counterparty has an agreement with the Company through which it will grant  
15 the Company \$10 million in trade credit. The swap is "at market" when it is  
16 entered into so it has a neutral "mark-to-market" value. If the price of gas  
17 subsequently dropped, the value of the swap to the counterparty would increase,  
18 reflecting an increase in credit exposure to the Company. If the credit exposure  
19 remained less than \$10 million, there would be no need to post collateral. If,  
20 however, the credit exposure increased to \$15 million, the counterparty would  
21 likely request that the Company post \$5 million of collateral -- the excess of the  
22 amount of credit exposure over the amount of trade credit granted.

1 **Q. Does the inclusion of hedging costs in the baseline power and gas cost rates**  
2 **affect PSE's cost of capital?**

3 A. No. A credit facility that provides collateral when necessary does not change the  
4 Company's risk profile. The risk profile is determined by the Company's  
5 operations, such as its exposure to the impacts of weather, volatile commodity  
6 prices, its hedging activities, etc. Posting collateral simply exchanges operational  
7 risk for financial risk, in the form of leverage. In the above example, the risk is  
8 that the position moves from neutral value to \$15 million against the Company.  
9 That potential \$15 million exposure exists whether or not the Company posts  
10 collateral. By posting \$5 million of collateral, the Company's risk position is still  
11 \$15 million, but \$10 million is operational risk and \$5 million is financial risk --  
12 additional debt.

13 The Company's commodity costs are recovered through its PCA and PGA  
14 mechanisms. The associated costs to hedge the Company's exposures are also  
15 recovered through these mechanisms. This activity primarily goes to the benefit  
16 of customers, not the Company. All of the benefit goes to gas customers and a  
17 substantial portion goes to electric customers through the sharing bands of the  
18 PCA mechanism. The costs of the liquidity facility that enables the Company to  
19 extend its hedging activities should be recovered in a similar manner. The  
20 Commission recognized this when it granted recovery of the facility through the  
21 base line power cost rate and the gas commodity cost.

1 In summary, the Company's operations, hedging activities, etc. and exposure to  
2 counterparties affects the Company's risk profile -- not the recovery of costs for  
3 collateral through the baseline power and gas cost rates. Therefore, there is no  
4 need to modify the Company's capital structure for the fact that hedging costs are  
5 recovered through the commodity cost rates.

6 **Q. Please describe how the Company determined the amount of short-term debt**  
7 **in the capital structure.**

8 A. The amount of short-term debt included in the capital structure is that which is  
9 expected to be outstanding, on average, during the rate year. This is determined  
10 by projecting the Company's cash flows, financing activities and reflecting the  
11 requested rate relief. The amount of short-term debt is that level needed to keep  
12 the Company's sources and uses of cash in balance in light of these projections.

13 **Q. Why is the Company not using the amount of short-term debt outstanding**  
14 **during the test period?**

15 A. During the test year, the Company temporarily held a higher level of short-term  
16 debt than it normally would. First, the Company anticipated an equity investment  
17 from Puget Energy and would use the proceeds from such an investment to pay  
18 down short-term debt to a more typical level. Second, the Company borrowed to  
19 hold a cash position to protect against the credit crunch resulting from the  
20 summer sub-prime mortgage induced credit crunch. As a result, the Company's  
21 short-term debt during the test year was higher than it would expect to be during

1 the rate year.

2 **Q. What does the Company view as a typical level of short-term debt?**

3 A. A more typical and manageable level of short-term debt would be one that is well  
4 within the Company's \$700 million working capital credit facilities. The \$700  
5 million in working capital credit facilities allows for volatility in working capital  
6 needs and also leaves reserves for the Company to fund capital expenditures  
7 temporarily until long-term funding is put in place. The Company projects that a  
8 more manageable level of short-term debt outstanding would be in the range of  
9 \$200 million to \$400 million, or in the range of 3.3% to 6.7% of total  
10 capitalization. The 4.93% short-term debt ratio requested in this proceeding is  
11 well within this range.

12 **Q. Please summarize your calculation of the cost of short-term debt.**

13 A. To calculate the cost of short-term debt during the rate year, the Company  
14 determines the spread between its short-term borrowing costs and the LIBOR,  
15 then applies that spread to an estimate of LIBOR during the rate year. The  
16 expected cost of the Company's committed credit facilities is also included in the  
17 cost of short-term debt. Please see pages 3 through 5 of Exhibit No. \_\_\_(DEG-  
18 5C) for this calculation. The resulting cost of short-term debt is 5.92%. See  
19 line 16, page 3 of Exhibit No. \_\_\_(DEG-5C).

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**2. The Cost of Long-Term Debt**

**Q. Please summarize your calculation of the cost of long-term debt.**

A. To calculate the cost of long-term debt, the Company calculates the yield-to-maturity, or cost rate, of each debt issue using the issue date, maturity date, net proceeds to the Company and coupon rate of that security. Also included in the cost of long-term debt are the costs to reacquire high coupon debt that has been replaced with lower coupon debt. The proportional share that each issue's principal amount represents of the total amount of long-term debt outstanding is then used to weigh these cost rates. Please see pages 6 and 7 of Exhibit No. \_\_\_(DEG-5C) for these calculations.

**Q. How does the Company treat new issues of long-term debt?**

A. The Company's financial plan includes three long-term debt issues: (i) a \$250 million senior secured note issue in June 2008, (ii) a \$150 million senior secured note issue in January 2009, and (iii) a \$250 million junior subordinated debt issue in July 2009.

The Company plans to use the proceeds from these issues to repay maturing long-term debt and to repay short-term debt incurred to fund the Company's operations.

/////  
  
/////

1 **Q. Are there any issues of long-term debt that will mature or retire between**  
2 **September 30, 2007, and the end of the rate year?**

3 A. Between October 1, 2007 and October 31, 2009, \$329.5 million of the Company's  
4 long-term debt will mature. The costs of the issues that will mature during the  
5 rate year have been included in the calculation of the cost of long-term debt for  
6 only those months during which the bonds will be outstanding.

7 **Q. What is the resulting cost of long-term debt?**

8 A. The embedded cost of long-term debt is 6.90%. See line 35, page 6 of Exhibit  
9 No. \_\_\_(DEG-5C).

10 **C. The Cost of Trust Preferred**

11 **Q. Is the Company requesting recovery of the cost of trust preferred in this**  
12 **proceeding?**

13 A. No. The Company redeemed all of its remaining trust preferred in calendar year  
14 2007. As discussed above, the Company issued \$250 million of junior  
15 subordinated notes, which have equity-like characteristics and, as a result, are  
16 considered 50% equity by the credit rating agencies during the first ten years of  
17 their term. Although the credit rating agencies consider these securities as equity-  
18 like, they are tax deductible like long-term debt and, as a result, are included in  
19 the cost of long-term debt.

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1 **D. The Cost of Preferred Stock**

2 **Q. Does the Company have any preferred stock outstanding?**

3 A. Yes, the Company has two small issues that total less than \$2 million.

4 **Q. How is the cost of preferred stock calculated?**

5 A. The cost of preferred stock includes (i) the dividends on the two outstanding  
6 issues, (ii) issue costs, and (iii) the amortization of costs of reacquiring other  
7 preferred stock issues. The cost is calculated by weighting the cost rate of each  
8 issue by the balance outstanding during the rate year. Please see page 8 of  
9 Exhibit No. \_\_\_\_ (DEG-5C) for the calculation of the embedded cost of preferred  
10 stock. Although the cost rates on the two issues are less than 5%, unamortized  
11 costs remain from the August 2003 redemption of the 7.75% preferred stock that  
12 the Company is amortizing over ten years. Although the annual amortization is  
13 less than \$70,000, with a relatively small balance of preferred stock outstanding,  
14 the cost rate for preferred increases as a result of this amortization. The resulting  
15 cost of preferred stock is 8.61%. See line 9, page 8 of Exhibit No. \_\_\_\_ (DEG-5C).

16 The proportion of preferred stock is so small relative to the other components of  
17 the capital structure, when the cost rate is weighted by the ratio of preferred stock  
18 outstanding, there is no impact on the overall rate of return.

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1 **E. The Cost of Common Equity**

2 **Q. Have you prepared an analysis of the Company's cost of equity?**

3 A. No, I have not. I have relied upon the analysis provided in the prefiled direct  
4 testimony of Dr. Roger A. Morin, Exhibit No. \_\_\_(RAM-1T).

5 **Q. Do you support the cost of equity range recommended by Dr. Morin?**

6 A. Yes, I believe Dr. Morin's proposed range for the cost of equity is reasonable. As  
7 discussed in the prefiled direct testimony of Mr. Eric Markell, Exhibit  
8 No. \_\_\_(EMM-1CT), the Company is recommending the use of the low end of his  
9 range, 10.8%.

10 **Q. Have you performed any tests to support your view that Dr. Morin's cost of  
11 equity range is reasonable?**

12 A. Yes, Exhibit No. \_\_\_(DEG-4) contains a list of all commission decisions in  
13 electric and gas rate cases from January 1, 2006 through September 30, 2007 --  
14 the most recent period for which data is available. The average cost of equity, the  
15 authorized return on equity was 10.29%, on an average equity ratio of 48.01%,  
16 resulting in a weighted cost of equity of 4.95%. It would be inappropriate to set  
17 the Company's cost of equity based on this average since, on average, those firms  
18 have higher equity ratios (48.01% compared to the Company's requested 45%  
19 equity ratio). Dividing the 4.95% weighted cost of equity by the 45% equity ratio  
20 the Company is requesting results in a cost of equity of 11% (4.95% divided by

1 45%). In other words, to have an “industry average” weighted cost of equity, the  
2 Commission would need to set the Company’s cost of equity at 11% on its  
3 requested 45% equity ratio to be comparable to the 10.29% and 48.01% averages.  
4 The 11% is near the high end of the range Dr. Morin is suggesting.

5 **IV. OVERALL RATE OF RETURN**

6 **Q. What is the Company’s requested overall rate of return given the proposed**  
7 **capital structure?**

8 A. The Company is requesting a capital structure comprised of 45% common equity  
9 with a 10.8% return on equity, resulting in an overall rate of return of 8.60%, as  
10 can be seen in Table 4 below:

11 **TABLE 5**  
12 **CAPITAL STRUCTURE AND**  
13 **OVERALL RATE OF RETURN**

<b>Capital Component</b>	<b>Capital Structure</b>	<b>Cost Rate</b>	<b>Weighted Cost</b>
Short-term Debt	4.93%	5.92%	0.29%
Long-term Debt	50.04%	6.90%	3.45%
Preferred Stock	0.03%	8.61%	0.00%
Common Equity	45.00%	10.80%	4.86%
<b>Overall Rate Of Return</b>	<b>100%</b>		<b>8.60%</b>

14 This requested overall rate of return applies the cost rate for each capital  
15 component to the requested capital structure.

1 **Q. Do you propose the same overall rate of return for gas and electric**  
2 **operations?**

3 A. Yes. PSE is an integrated gas and electric company, and the capital structure and  
4 cost of capital are appropriate for the integrated company. Investors purchasing  
5 the Company's securities do not distinguish whether the proceeds are used to fund  
6 gas or electric investments.

7 In addition, the cost of equity range recommended by Dr. Morin is based on the  
8 Company's integrated operations without any distinction between gas and electric  
9 operations.

10 **Q. Does your recommended capital structure or cost of capital include any costs**  
11 **related to the proposed merger with the Consortium?**

12 A. No, it does not. The capital structure and cost rates are those of the Company on  
13 a stand alone basis.

## 14 **V. THE COMPANY'S CREDIT RATINGS**

15 **Q. What are rating agencies and credit ratings?**

16 A. Rating agencies are independent agencies that assess risks for investors. The two  
17 most widely recognized rating agencies are Standard & Poor's ("S&P") and  
18 Moody's Investors Service ("Moody's"). These rating agencies assign a credit  
19 rating to companies and their securities so investors can more easily understand

1 the risks associated with investing in their debt and preferred stock.

2 **Q. What are the Company's current credit ratings?**

3 A. The Company's credit ratings are as follows:

4 **TABLE 6**  
5 **PSE CREDIT RATINGS**

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

6 **Q. Have the Company's credit ratings recently changed?**

7 A. Yes. On October 29, 2007, Moody's (i) moved the Company's issuer rating  
8 outlook from "positive" to "stable" and (ii) placed the Company's commercial  
9 paper rating under review for possible downgrade. Please see Exhibit  
10 No. \_\_\_(DEG-6) for the text of the Moody's statement issued on October 29,  
11 2007. On the same date, Moody's also affirmed the long-term ratings of the  
12 Company. See *id.* Moody's stated the following reasons for these actions:

13 The affirmation of PSE's long-term ratings is conditioned upon  
14 expectations that supportive regulatory treatment will continue

1 despite the change in ownership. The review for possible  
2 downgrade of PSE's short-term rating for commercial paper and  
3 the revision of the outlook to stable from positive for PSE and its  
4 affiliates reflects the high multi-year utility capital spending needs  
5 that may be a drain on liquidity as well as the expected weaker  
6 credit profile of the parent company, Puget Energy.

7 *Id.*

8 Also on October 29, 2007, S&P placed the ratings of the Company on  
9 CreditWatch with negative implications. Please see Exhibit No. \_\_\_\_ (DEG-7) for  
10 the text of the S&P statement issued on October 26, 2007.

11 Both events were made upon the announcement of the proposed merger.

12 **Q. Why are credit ratings important to customers?**

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

19 **Q. What corporate credit rating is the Company targeting?**

20 A. During the rate year of this proceeding, the Company is targeting to (i) strengthen  
21 its credit metrics but likely maintain its current corporate credit ratings and (ii) be  
22 removed from the S&P CreditWatch with negative implications. As the Company

1 proceeds with its ambitious capital spending program, the Company may, in the  
 2 future, target different credit metrics and ratings as described by Mr. Markell.

3 **Q. Have you calculated the credit metrics that would result if the Company’s**  
 4 **request was granted?**

5 A. Yes. Table 7 below shows the three significant credit metrics viewed by the  
 6 rating agencies. These are: 1) funds from operations (FFO) interest coverage, 2)  
 7 FFO to average debt, and 3) debt as a percent of total capital. In calculating these  
 8 ratios, I have included imputed debt and treated the hybrid as receiving 50%  
 9 equity credit by the rating agencies. I have also shown Standard & Poor’s (S&P)  
 10 benchmark range for each metric for companies with a business profile of “4”.

11 **TABLE 7**  
 12 **SELECT CREDIT METRICS & RELATED S&P BENCHMARKS**

	2007	2008	Rate Year	2009
<b>FFO Interest Coverage:</b>				
<b>PSE Projections</b>	<b>3.9x</b>	<b>3.9x</b>	<b>4.1x</b>	<b>4.1x</b>
S&P “A” Benchmark Range	3.5x-4.2x	3.5x-4.2x	3.5x-4.2x	3.5x-4.2x
S&P “BBB” Benchmark Range	2.5x-3.5x	2.5x-3.5x	2.5x-3.5x	2.5x-3.5x
<b>FFO to Average Debt:</b>				
<b>PSE Projections</b>	<b>17.1%</b>	<b>18.8%</b>	<b>20.7%</b>	<b>20.4%</b>
S&P “A” Benchmark Range	20%-28%	20%-28%	20%-28%	20%-28%
S&P “BBB” Benchmark Range	12%-20%	12%-20%	12%-20%	12%-20%
<b>Debt to Total Capital:</b>				
<b>PSE Projections</b>	<b>55.8%</b>	<b>55.2%</b>	<b>55.6%</b>	<b>55.9%</b>
S&P “A” Benchmark Range	45%-52%	45%-52%	45%-52%	45%-52%
S&P “BBB” Benchmark Range	52%-62%	52%-62%	52%-62%	52%-62%

1 As can be seen in Table 7, there is slight improvement in two of the three credit  
2 metrics from 2007 to the end of the rate year, with a more pronounced  
3 improvement in FFO to average debt. While the movement in these metrics is a  
4 step in the right direction, the Company does not believe they would result in an  
5 improvement in the Company's credit ratings.

6 **Q. Are credit ratings based solely on financial metrics such as those shown in**  
7 **Table 7 above?**

8 A. No. Credit metrics are based on both quantitative and qualitative measures.  
9 Table 7 only shows certain quantitative measures. Qualitative measures include  
10 such things as regulation, markets and competition, operations and management.  
11 With respect to regulation, items of importance include weather protection (i.e.  
12 stability of cash flows regardless of weather conditions), earnings sharing, and the  
13 level of allowed equity returns (i.e. set at healthy enough levels to attract capital  
14 on reasonable terms). The Company benefits from having a growing service  
15 territory, respected management and favorable operating statistics. The Company  
16 does not have weather protection in either its gas or electric operations. More  
17 importantly, the assessment of these qualitative measures is not likely to improve  
18 enough over the next few years such that I would expect an increase in the  
19 Company's credit ratings.

20 ////



1 **VI. CONCLUSION**

2 **Q. Does that conclude your testimony?**

3 **A. Yes, it does.**