EXHIBIT NO. DEG-11HCT
DOCKET NOS. UE-090704/UG-090705
2009 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

**BEFORE THE**
**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br>Complainant,<br>v.<br>PUGET SOUND ENERGY, INC.,<br>Respondent. | Docket No. UE-090704<br>Docket No. UG-090705 |

# PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF DONALD E. GAINES ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED
VERSION

DECEMBER 17, 2009

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF DONALD E. GAINES**

## CONTENTS

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF DONALD E. GAINES**

## I. INTRODUCTION

**Q. Are you the same Donald E. Gaines who provided in this proceeding prefiled direct testimony, Exhibit No. DEG-1T, on May 8, 2009, and prefiled supplemental direct testimony, Exhibit No. DEG-9T, on September 28, 2009, each on behalf of Puget Sound Energy, Inc. ("PSE")?**

A. Yes.

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

A. First, this rebuttal testimony responds to the direct testimony of each of David C. Parcell, Exhibit No. DCP-1T, witness for the Staff of the Washington Utilities and Transportation Commission ("Commission Staff"), and Stephen G. Hill, Exhibit No. SGH-1HCT, witness for the Public Counsel section of the Washington State Attorney General's Office ("Public Counsel"), with respect to (i) capital structure, (ii) costs of short-term and long-term debt, and (iii) overall rate of return. This rebuttal testimony demonstrates that the Commission should accept the capital structure and rates of return recommended by PSE and reject the capital structures and rates of return proposed by Commission Staff and Public Counsel.

Second, this rebuttal testimony demonstrates that the revenue requirement recommendations of Commission Staff and Public Counsel, if granted by this Commission, would reverse the improvements PSE has been making to its financial condition and would likely result in a credit rating downgrade, which would degrade PSE's ability to raise the capital needed to carry out its public service responsibilities at a reasonable cost.

Third, this rebuttal testimony addresses the positions of Commission Staff, Public Counsel, and the Industrial Customers of Northwest Utilities ("ICNU") with respect to PSE's revised electric load forecast.

## II. CAPITAL STRUCTURE

### A. Common Equity Ratio

**Q. What common equity ratio did PSE recommend in its direct filing in this proceeding?**

A. In its direct filing in this proceeding, PSE recommended a common equity ratio of 48.00%, which is the average common equity ratio that PSE projects will support utility operations during the rate year. *See* Exhibit No. DEG-1T at page 12, lines 6-7.

**Q. Do other parties to this proceeding agree with PSE's common equity ratio recommendation of 48.00%?**

A. No. Commission Staff recommends a common equity ratio of 45.00%. *See* Exhibit No. DCP-1T at page 3, line 4. Public Counsel recommends a common equity ratio of 43.00%. *See* Exhibit No. SGH-1HCT at page 19, Table I.

**1. <u>Commission Staff</u>**

**Q. On what basis does Commission Staff recommend a common equity ratio of 45.00% for PSE?**

A. In an attempt to support its recommended common equity ratio of 45.00% for PSE, Commission Staff asserts that such ratio is "the same capital structure ratios requested by PSE in prior rate cases . . ." and argues that such ratio "is similar to that of the industry-wide electric and combination electric utilities . . . ." Exhibit No. DCP-1T at page 25, lines 11-14. This suggested common equity ratio is, by its very terms, backwards-looking and does not reflect the $805.3 million of equity invested in PSE by Puget Energy, Inc. ("<u>Puget Energy</u>") since the commencement of PSE's last general rate proceeding. PSE used this equity infusion to pay down short-term debt, which resulted in a common equity ratio of over 50% for PSE.

The common equity ratio recommended by Commission Staff, if adopted, would be (i) lower than the common equity ratio approved by the Commission in PSE's last general rate proceeding, (ii) lower than the common equity ratio currently employed by PSE; (iii) lower than the common equity ratio that PSE projects will be employed, on average, during the rate year; and (iv) lower than the average common equity ratio recently approved by state regulatory commissions for ratemaking purposes.

**Q. Should the Commission adopt Commission Staff's invitation to compare the common equity ratio of PSE to the equity ratios of other utilities?**

A. No. The Commission should reject Commission Staff's invitation to compare the common equity ratio of PSE to the equity ratios of other utilities because Commission Staff compares the "per books" capital structures of other utilities to the regulated capital structure of PSE. Indeed, Commission Staff concedes that its comparison is "per books" and reflects "consolidated holding companies". Please see Exhibit No. DEG-12 for a copy of Commission Staff's Response to PSE Data Request No. 007. Many utilities have non-regulated activities or other portions of their book equity that is not included for ratemaking purposes.

A more appropriate comparison would be to compare the common equity ratio requested by PSE in this proceeding (48.00%) to common equity ratios approved by other state regulatory commissions for ratemaking purposes. Exhibit No. DEG-4 demonstrates that the average common equity ratio approved by state regulatory commissions for ratemaking purposes during the period from January 1, 2008 through March 31, 2009 was 49.00%. This average common equity ratio approved for ratemaking purposes is one percent higher than the common equity ratio of 48.00% that PSE recommends in this proceeding.

**Q. Has PSE updated Exhibit No. DEG-4 to include more recent ratemaking orders?**

A. Yes. Exhibit No. DEG-13 provides an update to Exhibit No. DEG-4, using more recent ratemaking orders. As demonstrated in Exhibit No. DEG-13, the average common equity ratio approved by state regulatory commissions for ratemaking purposes during the period from January 1, 2008 through August 31, 2009 was 48.85%. *See* Exhibit No. DEG-13 at the bottom most right figure of the final page.

**Q. Does Commission Staff offer any other rationale for the use of a common equity ratio of 45.00% in lieu of PSE's recommended common equity ratio of 48.00%?**

A. No. Commission Staff offers only two justifications for the use of a common equity ratio of 45.00% in lieu of PSE's recommended common equity ratio of 48.00%:

(i) Commission Staff's unsupported belief that its recommended common equity ratio of 45.00% meets the Commission's "safety and economy" criteria for selecting an appropriate capital structure; and

(ii) the flawed comparison to the "per books" capital structures of other utilities.

*See* Exhibit No. DCP-1T at page 3, lines 4-10. As discussed above, however, PSE's recommended common equity ratio of 48.00% is lower than the ratio of common equity that currently supports PSE's utility operations. PSE's actual regulated common equity ratio has exceeded 51% for each of the available three quarters ending in 2009. PSE's recommended common equity ratio of 48.00% is also lower than the 48.85% average common equity ratio approved for utilities by other regulatory bodies for ratemaking purposes. Furthermore, Commission Staff offers no rationale as to why the Commission should lower the currently approved common equity ratio of 46.00%, particularly when the equity ratio supporting PSE's utility operations is expected to, on average, exceed 46.00% during the rate year.

**Q. Is Commission Staff's suggestion that increases in PSE's common equity ratio following the merger "reflect the decisions of the new owners" and "may give the appearance of capital structure manipulation by PSE's parent company" valid?**

A. No. It is very difficult to understand how there is any "appearance of capital structure manipulation by PSE's parent company" when the capital structure employed by PSE is the very same capital structure that PSE consistently stated would be employed in the merger approval proceeding, Docket No. U-072375. Commission Staff (and most other parties to that proceeding) agreed to a series of merger commitments, including Commitment 35, which states, in part, as follows:

> Joint Applicants commit that as of the closing of the transaction (or within (60) days thereof), PSE will have a common equity ratio of not less than 50 percent. Joint Applicants commit that at all times thereafter, PSE will have a common equity ratio of not less than 44 percent, except to the extent a lower equity ratio is established for ratemaking purposes by the Commission.

After the merger, PSE's regulated common equity ratio was 52.9% on March 31, 2009 and PSE is requesting a common equity ratio of 48.00% (i.e., "not less than 44 percent") in this proceeding. There can be no "appearance of manipulation" when PSE is financed precisely as expected. If anything, it seems disingenuous for Commission Staff to expect PSE to be financed with, and customers to benefit from the safety of such common equity levels, but not expect to reflect those common equity levels in rates. Indeed, no merger commitment required PSE to earn a debt return on a portion of its common equity capital, yet that is what both Commission Staff and Public Counsel propose.

**2. <u>Public Counsel</u>**

**Q. On what basis does Public Counsel recommend a common equity ratio of 43.00% for PSE?**

A. Public Counsel does not offer an explanation as to why it recommends a common equity ratio of 43.00% for PSE other than such common equity ratio is the same recommendation made by Public Counsel in PSE's last general rate proceeding and "is higher than the average common equity ratio Puget has actually used over the last few years . . . ." Exhibit No. SGH-1HCT at page 18, lines 13-14.

The common equity ratio recommended by Public Counsel, if adopted, would also be (i) lower than the common equity ratio approved by the Commission in PSE's last general rate proceeding, (ii) lower than the common equity ratio currently employed by PSE; (iii) lower than the common equity ratio that PSE projects will be employed by PSE, on average, during the rate year; and (iv) lower than the average common equity ratio recently approved by state regulatory commissions for ratemaking purposes.

**Q. Is PSE's common equity ratio recommendation of 48.00% "higher than the average common equity ratio [PSE] has actually used over the last few years"?**

A. Yes. Public Counsel is correct that PSE's common equity ratio recommendation of 48.00% is higher than the average common equity ratio that PSE has used over the past few years. Public Counsel, however, provides no explanation as to the dramatic increases in PSE's common equity ratio over the past few years, starting with the settlement of the 2001 general rate proceeding.

**Q. Has Public Counsel previously recognized PSE's increase in common equity ratio over time?**

A. Yes. In the merger approval proceeding in Docket No. U-072375, Public Counsel attributed the increase, in part, to the settlement of PSE's 2001 general rate proceeding, in which the parties agreed to a hypothetical common equity ratio: "[PSE] strengthened its common equity ratio while ratepayers contributed by paying rates based on a hypothetical common equity ratio." Public Counsel further testified that "in a Commission-approved settlement with Public Counsel, Commission Staff and other parties, PSE agreed to a multi-year 'equity growth tracker' plan to allow [PSE] to build back its financial health." Public Counsel described this activity as "a carefully crafted and successful effort that began in early 2002 under Commission oversight to rebuild [PSE's] financial strength."

In light of this testimony, it seems to me that Public Counsel now seeks to unwind this "carefully crafted and successful effort" by proposing a common equity ratio that is (i) lower than the common equity ratio approved by the Commission in PSE's last general rate proceeding, (ii) lower than the common equity ratio currently employed by PSE; (iii) lower than the common equity ratio that PSE projects will be employed by PSE, on average, during the rate year; and (iv) lower than the average common equity ratio recently approved by state regulatory commissions for ratemaking purposes.

Moreover, Public Counsel, like Commission Staff, ignores the equity infusions that resulted from the completion of the merger earlier this year that resulted in PSE achieving a regulated equity ratio of 52.9% at March 31, 2009.

**Q. Is Public Counsel's assertion correct that, including additional parent company debt, the actual capital structure supporting utility operations of PSE consists of approximately [redacted]?**

A. No. If Public Counsel were correct that, including additional parent company debt, the actual capital structure supporting utility operations of PSE consists of approximately [redacted], then PSE would not be rated "BBB" by Standard & Poor's or "Baa3" by Moody's Investors Service.

There should be no surprise that there is additional third-party debt outstanding at Puget Energy. The joint applicants in the merger approval proceeding (Puget Holdings LLC and PSE) provided details as to the anticipated financing of Puget Energy and PSE. Moreover, it would not be correct to say that the debt at Puget Energy supports utility operations because the Puget Energy debt is non-recourse to PSE. In other words, PSE has no legal obligation to fund that debt service. Indeed, the ring-fencing commitments approved by the Commission in Docket No. U-072375 are intended, in part, to protect PSE and its customers from additional leverage at Puget Energy.

**Q. Have any of the entities above Puget Energy issued third-party debt or had any third-party debt outstanding since the merger?**

A. No. None of the three entities above Puget Energy (Puget Equico LLC, Puget Intermediate Holdings Inc. and Puget Holdings LLC) has issued any third-party debt. At closing of the merger, the Investor Consortium made an investment of $3.4 billion as contemplated. That investment was made in the form of approximately [redacted]. Puget Intermediate Holdings Inc. then indirectly invested approximately $3.4 billion into Puget Energy (through Puget Equico LLC), after paying certain merger costs.

**Q. Is the Public Counsel exhibit that shows an average common equity ratio of 44% for combination gas-electric utilities persuasive?**

A. No. Exhibit No. SGH-5 at page 4 is a list of holding companies that have non-regulated activities, and Public Counsel has made no effort to isolate the common equity ratio supporting regulated activities or the common equity ratios authorized by regulators for ratemaking purposes.

For example, Public Counsel's comparator group average contains firms. such as AES Corporation with a common equity ratio of 16% and CenterPoint Energy with a common equity ratio of 18%. A cursory review of these two company's web sites shows they are holding companies that contain non-regulated activities. AES Corporation is a global company that, among other activities, turns seawater into drinking water. CenterPoint Energy, among other activities, runs a competitive natural gas sales and a field services business that gathers and processes natural gas. Simply removing these two holding company outliers increases Public Counsel's average common equity ratio from 44% to 46%.

In short, the common equity ratios on page 4 of Exhibit No. SGH-5 are not a true comparison of regulated electric and natural gas companies and should not be relied upon by the Commission for establishing rates for PSE in this proceeding.

**B. <u>Long-Term Debt Ratio</u>**

**Q. What long-term debt ratio did PSE recommend in its direct filing in this proceeding?**

A. In its direct filing in this proceeding, PSE recommended a long-term debt ratio of 48.05%, which is the average long-term debt ratio that PSE projects will support utility operations during the rate year. *See* Exhibit No. DEG-1T at page 12, Table 3.

**Q. Do other parties to this proceeding agree with PSE's long-term debt ratio recommendation of 48.05%?**

A. No. Commission Staff recommends a long-term debt ratio of 51.05%. *See* Exhibit No. DCP-3 at page 1. Public Counsel recommends a long-term debt ratio of 53.00%. *See* Exhibit No. SGH-1HCT at page 19, Table I.

**Q. Why do the long-term debt ratio recommendations of Commission Staff and Public Counsel differ from the long-term debt ratio recommendation of PSE?**

A. The long-term debt ratio recommendations of Commission Staff and Public Counsel are greater than the long-term debt ratio recommendation of PSE by an amount approximately equal to the amount by which the common equity ratio recommendations of Commission Staff and Public Counsel are less than the common equity ratio recommendation of PSE. In other words, the long-term debt ratio recommendations of Commission Staff and Public Counsel are wholly dependent on their respective common equity ratios.

Neither Commission Staff nor Public Counsel demonstrates that its long-term debt ratio recommendation is the average long-term debt ratio projected to support utility operations during the rate year. Similarly, neither Commission Staff nor Public Counsel provides evidence to refute the fact that PSE's long-term debt ratio recommendation is the average long-term debt ratio projected to support utility operations during the rate year.

**C. <u>Short-Term Debt Ratio</u>**

**Q. What short-term debt ratio did PSE recommend in its direct filing in this proceeding?**

A. In its direct filing in this proceeding, PSE recommended a short-term debt ratio of 3.95%, which is the mid-point of a reasonable range of projected short-term debt for the rate year. *See* Exhibit No. DEG-1T at page 22, line 16, through page 23, line 1.

**Q. Do other parties to this proceeding agree with PSE's short-term debt ratio recommendation of 3.95%?**

A. Yes. Commission Staff also recommends a short-term debt ratio of 3.95%. *See* Exhibit No. DCP-3 at page 1. Public Counsel recommends a long-term debt ratio of 4.00%. *See* Exhibit No. SGH-1HCT at page 19, Table I.

**Q. Why does the short-term debt ratio recommendation of Public Counsel differ from the short -term debt ratio recommendation of PSE?**

A. Public Counsel does not explain why it recommends a short-term debt ratio of 4.00% in lieu of the short-term debt ratio of 3.95% recommended by PSE. Presumably, Public Counsel simply rounded up PSE's 3.95% requested short-term debt ratio to 4.00%. In any event, the difference between the recommendations is immaterial because the weighted cost of short-term debt of all Commission Staff, Public Counsel, and PSE is the same when rounded to two decimal places—0.10%.

## III. COST OF CAPITAL

### A. Cost of Common Equity

**Q. What cost rate did PSE recommend in its direct filing in this proceeding with respect to its cost of common equity?**

A. In its direct filing in this proceeding, PSE recommended a cost of common equity of 10.80%. *See* Exhibit No. EMM-1CT at page 9, lines 20-22.

**Q. Do other parties to this proceeding agree with PSE's cost of common equity recommendation of 10.80%?**

A. No. Commission Staff recommends a cost of common equity of 10.00%. *See* Exhibit No. DCP-1T at page 4, lines 17-19. Public Counsel recommends a cost of common equity of 9.50%. *See* Exhibit No. SGH-1THC at page 5, lines 13-15.

**Q. Does this rebuttal testimony address Commission Staff's and Public Counsel's respective cost of common equity recommendations for PSE?**

A. No. Please see the Prefiled Rebuttal Testimony of Dr. Roger A. Morin, Exhibit No. RAM-19T, which addresses Commission Staff's and Public Counsel's respective cost of common equity recommendations for PSE.

**Q. Are Commission Staff's and Public Counsel's respective cost of common equity recommendations for PSE consistent with sources relied upon by those parties?**

A. No. Neither Commission Staff's nor Public Counsel's respective cost of common equity recommendations for PSE is consistent with the AUS Utility Reports that each such party uses for its comparable company analyses for capital structure purposes. Please see Exhibit No. DEG-14 for a copy of Commission Staff's Response to PSE Data Request No. 006, which provide copies of the AUS Reports.

The AUS Utility Reports provide the average "Allowed ROE" shown in Table 1 below.

**TABLE 1**
**"ALLOWED ROE" from AUS UTILITY REPORTS**

| Year | Electric Companies | Gas & Electric Companies |
|---|---|---|
| 2003 | 11.47% | 11.30% |
| 2004 | 11.32% | 11.15% |
| 2005 | 11.02% | 10.95% |
| 2006 | 11.00% | 10.85% |
| 2007 | 10.95% | 10.77% |
| 2008 | 10.75% | 10.74% |

See Exhibit No. DEG-14 at pages 2-13. The "Allowed ROE" of 10.74% reported by AUS reports for combination gas and electric companies in 2008 is very close to the cost of common equity of 10.80% recommended by PSE in this proceeding.

In response to PSE Data Request No. 007, Commission Staff states that the use of data in the AUS Utility Reports "is consistent with the dividend yields, growth rates, betas, returns on equity, etc. used in the cost of equity models, such as DCF, CAPM and CE, which are also reflective of the consolidated operations of the publicly-traded entities." Exhibit No. DEG-12. If both Commission Staff and Public Counsel believe these reports appropriate for capital structure comparisons, then the cost of common equity contained therein must also be relevant for comparison to the equity returns recommended in this proceeding.

**Q. What cost rate does PSE now recommend in its rebuttal filing in this proceeding with respect to its cost of common equity?**

A. PSE's cost of common equity recommendation in this proceeding remains 10.80%. *See* Exhibit No. EMM-5T.

## B. Cost of Long-Term Debt

**Q. What cost rate did PSE recommend in its direct filing in this proceeding with respect to its cost of long-term debt?**

A. In its supplemental direct filing in this proceeding, PSE recommended a cost of long-term debt of 6.70%. *See* Exhibit No. DEG-9T at page 14, line 10; *see also* Exhibit No. DEG-10C at page 1, line 9, column (D).

**Q. Do other parties to this proceeding agree with PSE's recommended cost of long-term debt of 6.70%?**

A. Yes. Public Counsel agrees with PSE's cost of long-term debt recommendation of 6.70%. *See* Exhibit No. SGH-1THC at page 19, lines 1-6. Commission Staff, however, recommends a cost of long-term debt of 6.48%. *See* Exhibit No. DCP-1T at page 29, lines 1-2.

Commission Staff revised its cost of long-term debt from 6.45% to 6.48% in Commission Staff's Response to PSE Data Request No. 043. Please see Exhibit No. DEG-15 for a copy of Commission Staff's Response to PSE Data Request No. 043. The revision results from a correction to its earlier testimony in which Commission Staff had unintentionally removed the cost of reacquired debt from its cost of long-term debt calculations.

**Q. How does Commission Staff calculate its recommended cost of long-term debt of 6.48%?**

A. Commission Staff begins with PSE's cost of long-term debt of 6.70% but then makes the following two adjustments:

(i) Commission Staff assumes a 5.757% coupon rate on two future bond issues; and

(ii) Commission Staff uses a 5.757% as the cost rate on the higher ratio of long-term debt that Commission Staff recommends in this proceeding (the difference between PSE's recommended 48% common equity ratio and Commission Staff's recommended 45% common equity).

These two adjustments account for the 22 basis point (0.22%) difference between PSE's and Public Counsel's cost of long-term debt recommendations of 6.70% and Commission Staff's cost of long-term debt recommendation of 6.48%.

**Q. Does PSE agree with Commission Staff's first adjustment to use a cost of long-term debt of 5.757% as the coupon for two future bond issues?**

A. No. PSE disagrees with Commission Staff's use of a cost of long-term debt of 5.757% as the coupon for two future bond issues. The 5.757% rate used by Commission Staff was the interest rate on PSE's most recent senior secured note issue. As far as PSE is aware, this rate represents the lowest coupon that PSE ever received on a 30-year senior secured note issue. PSE has projected coupon rates of 6.72% and 6.86% on the two future bond issues, and these coupon rates are very close to the cost of long-term debt of 6.70%. Future interest rates remain uncertain, and the use of the embedded cost of long-term debt to project coupon rates of future bond issues is much fairer than simply assuming what is believed to be the lowest rate ever realized by PSE for long-term debt with a 30-year term.

**Q. Does PSE agree with Commission Staff's second adjustment to use a cost of long-term debt of 5.757% as the cost of the additional three percent of long-term debt in its recommended capital structure?**

A. No. PSE disagrees with Commission Staff's use of a cost of long-term debt of 5.757% as the cost of the additional three percent of long-term debt in its recommended capital structure. This second adjustment suffers from the same unfair assumption used in the first adjustment because it substitutes the coupon rate from recent bond issues for PSE's embedded cost of long-term debt. In effect, Commission Staff seeks to have customers benefit from a coupon rate of 5.757% from PSE's recent bond issue, which benefited from a higher credit rating resulting from the additional equity infusion into PSE, but ignore the cost of capital that helped provide the low rate.

## C. <u>Cost of Short-Term Debt</u>

**Q. What cost rate did PSE recommend in its direct filing in this proceeding with respect to its cost of short-term debt?**

A. In its direct filing in this proceeding, PSE recommended a cost of short-term debt of 2.47%. *See* Exhibit No. DEG-1CT at page 23, lines 11-12; *see also* Exhibit No. DEG-5C, at page 3, line 16, column (F).

**Q. Do other parties to this proceeding agree with PSE's recommended cost of short-term debt of 2.47%?**

A. Yes. Both Commission Staff and Public Counsel agree with PSE's cost of short-term debt recommendation of 2.47%. *See* Exhibit No. DCP-1T at page 4, lines 6-7; Exhibit No. SGH-1THC at page 19, Table I.

## IV. OVERALL RATE OF RETURN

**Q. What does PSE recommend with respect to capital structure in this rebuttal filing?**

A. PSE's capital structure recommendation has not changed from the direct filing and remains as follows:

**TABLE 2**
**REQUESTED CAPITAL STRUCTURE**

| Capital Component | Ratios |
|---|---|
| Common Equity | 48.00% |
| Long-Term Debt | 48.05% |
| Short-Term Debt | 3.95% |
| **Total Capitalization** | **100.00%** |

**Q. What does PSE recommend with respect to cost rates for common equity, long-term debt, and short-term debt in this rebuttal filing?**

A. PSE's cost rate recommendations have not changed from the direct filing and remain as follows:

**TABLE 3**
**REQUESTED COST RATES**

| Capital Component | Costs |
|---|---|
| Common Equity | 10.80% |
| Long-Term Debt | 6.70% |
| Short-Term Debt | 2.47% |

**Q. What does PSE recommend with respect to the overall rate of return in this rebuttal filing?**

A. PSE's overall rate of return recommendation has not changed from the direct filing and remains as follows:

**TABLE 4**
**OVERALL RATE OF RETURN**

| Capital Component | Capital Structure | Cost Rate | Weighted Cost |
|---|---|---|---|
| Common Equity | 48.00% | 10.80% | 5.18% |
| Long-Term Debt | 48.05% | 6.70% | 3.22% |
| Short-Term Debt | 3.95% | 2.47% | 0.10% |
| **Total Capitalization** | **100.00%** | | **8.50%** |

**Q. Has PSE prepared an exhibit that illustrates the overall rate of return recommended by each party to this proceeding?**

A. Yes. Please see Exhibit No. DEG-16 for an illustration of the overall rate of return proposed by each party to this proceeding. This exhibit illustrates (i) the capital structure, cost rates, and overall rates of return recommended by PSE, Commission Staff, and Public Counsel and (ii) the rate of return granted by the Commission in PSE's last general rate case. Those rates of return are as follows:

**TABLE 5**
**OVERALL RATE OF RETURN**

| | Rate of Return | After-tax |
|---|---|---|
| PSE Recommendation | 8.50% | 7.34% |
| Commission Staff Recommendation | 7.91% | 6.71% |
| Public Counsel Recommendation | 7.73% | 6.46% |
| PSE's Authorized Rate of Return | 8.25% | 7.00% |

## V. COMMISSION STAFF'S AND PUBLIC'S PROPOSED REVENUE REQUIREMENTS, IF GRANTED, WOULD SERIOUSLY WEAKEN PSE's CREDIT METRICS AND COULD RESULT IN A CREDIT RATING DOWNGRADE

**Q. Have Commission Staff and Public Counsel presented any financial metrics that they believe would result if the Commission granted their recommendations?**

A. Yes. Both Commission Staff and Public Counsel present pre-tax interest coverage metrics they purport would result if their recommendations were granted. Commission Staff suggests a 3.03 times pre-tax interest coverage would result from their cost of capital recommendations. *See* Exhibit No. DCP-17. Public Counsel posits a 2.72 times pre-tax interest coverage would result from their cost of capital recommendation. *See* Exhibit No. SGH-16.

**Q. Does PSE agree with these calculations?**

A. No. The pre-tax interest coverages calculated by Commission Staff and Public Counsel simply result from the respective cost of capital recommendations and ignore the various adjustments, and resulting lower rate relief proposed, by other witnesses for Commission Staff and Public Counsel.

PSE asked Commission Staff if a 3.04 times pre-tax interest coverage would result if the Commission were to grant all of Commission Staff's recommendations. Commission Staff's Response to PSE Data Request No. 044 confirmed that the pre-tax interest coverage calculation does not reflect any other adjustment recommended by Commission Staff:

> the 3.04 times interest coverage relates to the implied coverage associated with the cost of capital he is recommending.
> Mr. Parcell's testimony does not offer any calculations as to what rate of return PSE will actually earn in the rate year, as this would require a number of assumptions, which include the impact of "WUTC Staff's recommendations". *See* Exhibit No. DEG-17.

Please see Exhibit No. DEG-17 for a copy of Commission Staff's Response to PSE Data Request No. 044.

PSE also asked Public Counsel if a 2.72 times pre-tax interest coverage would result if the Commission were to grant all of Public Counsel's recommendations. Public Counsel's Response to PSE Data Request No. 011 confirmed that the pre-tax interest coverage calculation does not reflect any other adjustment recommended by Public Counsel:

> It is Mr. Hills testimony that setting the Company's allowed return equal to its cost of equity capital will afford Puget Sound Energy an opportunity, under effective and efficient management, to earn a pre-tax interest coverage ratio of 2.72 times.

Please see Exhibit No. DEG-18 for a copy of Public Counsel's Response to PSE Data Request No. 011. Public Counsel implies the "effective and efficient management" could offset the tens of millions of dollars of adjustments Public Counsel otherwise recommends.

**Q. Is pre-tax interest coverage one of the primary ratios relied upon by credit rating agencies in determining credit rating?**

A. No. Pre-tax interest coverage is no longer one of the primary ratios the credit rating agencies relied upon by credit rating agencies in determining credit ratings. Credit rating agencies focus upon cash flow or funds from operations ("FFO") ratios (FFO interest coverage, FFO to average debt, etc.) and debt leverage ratios in determining credit ratings.

**Q. Has PSE calculated the credit metrics that would likely result in the rate year if the Commission were to grant the recommendations of Commission Staff and Public Counsel?**

A Yes. Exhibit No. DEG-19 illustrates the various credit metrics that would likely result if the Commission were to grant the recommendations of PSE, the recommendations of Commission Staff, and the recommendations of Public Counsel.

**Q. What assumptions did PSE use in the creation of Exhibit No. DEG-19?**

A. PSE used the following assumptions in creating Exhibit No. DEG-19:

(i) Exhibit No. DEG-19 assumes the use of the revised load forecast filed by PSE in its supplemental filing dated September 28, 2009;

(ii) Exhibit No. DEG-19 assumes the rate relief recommended by each of PSE, Commission Staff, and Public Counsel;

(iii) Exhibit No. DEG-19 assumes the capital structure recommended by each of PSE, Commission Staff, and Public Counsel;

(iv) Exhibit No. DEG-19 reflects the projected rate year power costs in PSE's rebuttal filing; and

(v) All scenarios in Exhibit No. DEG-19 reflect PSE's 2010 operating and maintenance and capital expenditure budgets recently approved by PSE's Board of Directors.

Exhibit No. DEG-19 compares the resulting credit metrics to the Standard & Poor's ("S&P") benchmark ranges for PSE's BBB credit. Exhibit No. DEG-19 also compares the resulting credit metrics to the expectations of S&P published in its report dated March 27, 2009. Please see Exhibit No. DEG-20 for a copy of the S&P report, dated March 27, 2009.

**Q. Please describe the "expectations" included in S&P's recent report.**

A. In its report dated March 27, 2009, S&P included a discussion of the approximate levels they would expect PSE's credit metrics to be going forward to support its current credit rating. In its report, S&P stated as follows:

> PSE's financial risk profile is also categorized as 'aggressive' but it will reflect more robust financials metrics post-transaction due to the exclusion of holding company debt and the repayment of some utility debts. Adjusted *FFO to interest coverage is expected to average above 4x*, while *FFO to average total debt is expected to average above 20%. Adjusted debt leverage is expected to be balanced at 50%.*

Exhibit No. DEG-20 (emphasis added).

**Q. Please summarize the results of PSE's analysis.**

A. The results from PSE's recommendations are the only set of credit metrics that come close to S&P's expectations. Commission Staff's and Public Counsel's respective recommendations contain more leverage and lower coverages than what S&P would expect to see to maintain the current credit rating. Specifically, the FFO to interest coverage resulting from Commission Staff's and Public Counsel's recommendations in the rate year are 3.5 times and 3.4 times coverage, respectively. This compares to 4.0 times coverage for the PSE recommendation. These interest coverage metrics not only fall at or below the expected "above 4 times coverage", but also fall below the bottom end of the range of 3.5 times coverage associated with an "aggressive" financial strategy.

The FFO to average total debt numbers from Commission Staff's and Public Counsel's recommendations are 15.8% and 15.4%, respectively. Both are substantially below S&P's expectation associated with the current rating of "above 20%." For purposes of comparison, the FFO to average total debt metric resulting from the PSE recommendation is 19.2%.

The debt leverage ratios, adjusted for imputed debt related to purchased power, resulting from Commission Staff's and Public Counsel's proposals are 56.0% and 58.0%, respectively. This is substantially more leverage than S&P's expected "balanced at 50%". Even with PSE's requested 48.00% equity ratio, the adjusted debt leverage from PSE's proposal is pushing this ratio to 53.2%.

**Q. Given these metrics, does PSE expect that it would retain its current credit rating if the Commission were to grant Commission Staff's or Public Counsel's recommendations in their entirety?**

A. No. Clearly, the metrics resulting from Commission Staff's and Public Counsel's respective proposals are not in line with the expected levels associated with PSE's current credit rating. Beyond the metrics, PSE expects that if the Commission were to grant Commission Staff's or Public Counsel's recommendations, the credit rating agencies would likely interpret such an order as an indication that the Commission was not supportive of maintaining PSE's financial position and credit ratings.

## VI. THE COMMISSION SHOULD ACCEPT THE REVISED LOAD FORECAST FILED BY PSE IN ITS SUPPLEMENTAL FILING DATED SEPTEMBER 28, 2009

**Q. Has PSE provided a revised load forecast in this proceeding?**

A. Yes. PSE filed a revised load forecast in its supplemental filing, dated September 28, 2009, in this proceeding. Please see the Prefiled Supplemental Direct Testimony of Mr. Donald E. Gaines, Exhibit No. DEG-9T, and the supporting exhibit to that testimony, Exhibit No. DEG-10, for details regarding the revised load forecast.

**Q. Has PSE updated the data presented in Table 3 in Exhibit No. DEG-9T, which compared the weather-normalized actual load to the forecasted load for the January 1, 2009, through August 31, 2009, period?**

A. Yes. PSE has updated the data presented in Table 3 in Exhibit No. DEG-9T to reflect an additional three months of data (September 1, 2009, through November 30, 2009). The following Table 6 compares weather-normalized actual loads with forecasted loads for the January 1, 2009, through November 30, 2009, period:

**TABLE 6**
**2009 ACTUAL WEATHER-NORMALIZED & FORECAST ELECTRIC LOADS**

| Loads in GWh | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Apr-Nov Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Actual GPI | 2,431 | 2,068 | 2,209 | 1,832 | 1,711 | 1,621 | 1,777 | 1,698 | 1,644 | 1,871 | 2,027 | 14,182 |
| Normalized GPI | 2,357 | 2,041 | 2,092 | 1,811 | 1,714 | 1,611 | 1,732 | 1,700 | 1,646 | 1,868 | 2,078 | 14,160 |
| F2008 GPI | 2,389 | 2,076 | 2,111 | 1,855 | 1,767 | 1,669 | 1,730 | 1,745 | 1,684 | 1,914 | 2,149 | 14,513 |
| F2008R GPI | | | | 1,810 | 1,724 | 1,628 | 1,687 | 1,703 | 1,643 | 1,867 | 2,096 | 14,157 |
| % Diff Normal vs. F2008 | -1.30% | -1.70% | -0.90% | -2.40% | -3.00% | -3.40% | 0.10% | -2.60% | -2.30% | -2.40% | -3.30% | **-2.40%** |
| % Diff Normal vs. F2008R | | | | 0.10% | -0.60% | -1.00% | 2.70% | -0.10% | 0.20% | 0.10% | -0.90% | **0.00%** |

**Q. Has PSE updated the data presented in Table 4 in Exhibit No. DEG-9T, which compared the actual number of electric customers with the projected number of electric customers for the January 1, 2009, through August 31, 2009, period?**

A. Yes. PSE has updated the data presented in Table 4 in Exhibit No. DEG-9T to reflect an additional three months of data (September 1, 2009, through November 30, 2009). The following Table 7 compares the actual number of electric customers with the projected number of electric customers for the January 1, 2009, through November 30, 2009, period:

**TABLE 7**
**2009 ACTUAL & PROJECTED ELECTRIC CUSTOMERS**

| Customers | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Actual | 1,070,283 | 1,071,244 | 1,071,662 | 1,072,639 | 1,072,583 | 1,072,970 | 1,072,622 | 1,072,832 | 1,073,319 | 1,074,003 | 1,074,284 |
| F2008 | 1,070,735 | 1,072,083 | 1,073,337 | 1,074,569 | 1,075,862 | 1,077,276 | 1,078,821 | 1,080,098 | 1,081,282 | 1,082,550 | 1,083,872 |
| F2008R | 1,070,283 | 1,071,244 | 1,071,662 | 1,072,433 | 1,073,295 | 1,074,264 | 1,075,157 | 1,076,158 | 1,077,211 | 1,078,483 | 1,079,767 |
| % Diff Actual vs. F2008 | 0.00% | -0.10% | -0.20% | -0.20% | -0.30% | -0.40% | -0.60% | -0.70% | -0.80% | -0.80% | -0.90% |
| % Diff Actual vs. F2008R | | | | 0.00% | -0.10% | -0.10% | -0.20% | -0.30% | -0.40% | -0.40% | -0.50% |

**Q. Please summarize how actual weather-normalized electric loads have been tracking projected electric loads.**

A. In the period between April 1, 2009, through November 30, 2009, weather-normalized actual loads were 3 GWh higher than the revised forecast of loads

(F2008R), a variance of 0.0%. In other words, the weather-normalized actuals matched the revised forecast loads. Over that same period, weather-normalized actual loads were 2.4% lower than the original forecast of loads (F2008). In other words, weather-normalized actual loads are much closer to the revised forecast of loads (F2008R) than they are to the original forecast of loads (F2008).

**Q. How does the actual number of electric customers compare to the projected number of electric customers?**

A. In the period between April 1, 2009, through November 30, 2009, the actual number of electric customers is 0.5% lower than the revised projected number of electric customers (F2008R). Over that same period, the actual number of electric customers is 0.9% lower than the original projected number of electric customers (F2008). The actual number of electric customers is much closer to the revised forecast (F2008R) than it is to the original projections. Overall, the number of electrical customers continues to increase slowly, but there is a reduction in load per customer. In other words, usage per customer is declining.

**Q. Has any party to this proceeding accepted the revised load forecast presented by PSE in its supplemental filing dated September 28, 2009?**

A. Yes. The joint testimony of Commission Staff and ICNU accept the revised load forecast presented by PSE in its supplemental filing dated September 28, 2009. Commission Staff and ICNU suggest that PSE also assume no load growth in the AURORA model for Pacific Northwest regional loads and the loads of Southern

California Edison and Pacific Gas & Electric Company for calendar years 2009, 2010, and 2011. *See* Exhibit No. JT-1CT at page 7, lines 13-21. As discussed in the Prefiled Rebuttal Testimony of Mr. David E. Mills, Exhibit No. DEM-12HCT, PSE has accepted this modeling proposal for purposes of this rebuttal filing.

Public Counsel did not analyze the revised load forecast presented by PSE in its supplemental filing dated September 28, 2009. Indeed, Public Counsel neither accepts nor rejects PSE's electric load forecast. *See* Exhibit No. JRD-1CT at page 42, lines 1-6.

**Q. Has any party adjusted the production factor based on the revised load forecast?**

A. Yes. Commission Staff suggests the elimination of the production factor in this proceeding. *See* Exhibit No. MPP-1T at page 18, line 4, through page 20, line 6. In an attempt to support its proposal, Commission Staff makes an unsupported assertion that the production factor "was never contemplated to be an attrition offset for projected load reductions due to reduced economic activity." Exhibit No. MPP-1T at page 19, lines 22-23. Commission Staff then erroneously suggests that production factor is solely "an offset to the pro forma rate base calculation where new production rate base was added outside of the test year to serve increasing loads." Exhibit No. MPP-1T at page 20, lines 1-2.

**Q. Does PSE agree with Commission Staff's proposal to eliminate the production factor in this proceeding?**

A. No. PSE disagrees with Commission Staff's proposal to eliminate the production factor in this proceeding. Please see the Prefiled Rebuttal Testimony of Mr. John H. Story, Exhibit No. JHS-14T, for a discussion of PSE's position with respect to Commission Staff's proposal.

## VII. CONCLUSION

**Q. Please summarize your conclusions.**

A. The Commission should

(i) reject the capital structures proposed by Commission Staff and Public Counsel because they are based on flawed comparisons to other utilities, do not reflect PSE's current or expected capitalization and would seriously weaken PSE's credit metrics;

(ii) reject Commission Staff's cost of long-term debt and adopt the cost of long-term debt proposed by PSE and Public Counsel;

(iii) adopt PSE's proposed cost of short-term debt to which all parties agree;

(iv) set rates on the capital structure and overall rate of return reflected in Table 4 above; and

(v) set rates using a production factor based on PSE's expected rate year load forecast (F2008R).

**Q. Does that conclude your prefiled rebuttal testimony?**

A. Yes.