**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,**<br><br>**Complainant,**<br><br>**v.**<br><br>**PUGET SOUND ENERGY, INC.,**<br><br>**Respondent.** | **Docket No. UE-07____**<br>**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**

**CONTENTS**

**PUGET SOUND ENERGY, INC.**

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

## I. INTRODUCTION

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

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

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

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

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

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

Energy Foundation.

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

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

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

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

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

## II. CAPITAL STRUCTURE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

| Capital Component | Test Year Reflecting Stock Sale |
|---|---|
| Short-term Debt | 1.49% |
| Long-term Debt | 52.12% |
| Preferred Stock | 0.04% |
| Common Equity | 46.35% |
| **Total Capitalization** | **100.0%** |

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

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

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

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

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

**TABLE 4**
**REQUESTED CAPITAL STRUCTURE**

| Capital Structure | Ratios |
|---|---|
| Short-term Debt | 4.93% |
| Long-term Debt | 50.04% |
| Preferred Stock | .03% |
| Common Equity | 45.00% |
| **Total Capitalization** | **100.0%** |

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

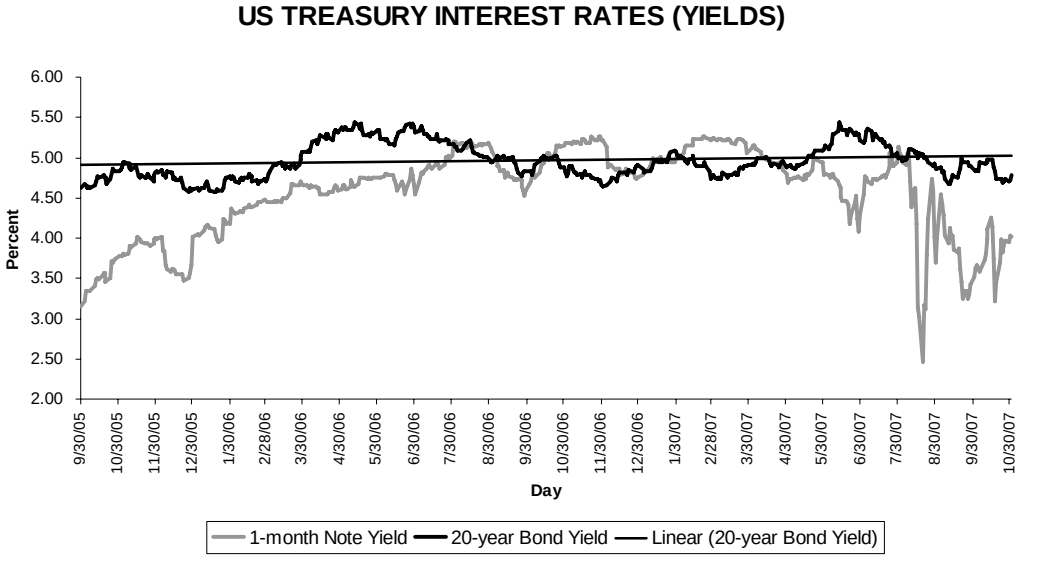
separate electric and gas divisions. The capital acquired to finance the Company is not split between gas and electric operations. The use of proceeds from such financing is not tied to any one type of commodity. As a result, a single capital structure is appropriate.

## III. CAPITAL COMPONENTS OF THE COMPANY'S REQUEST

### A. Interest Rates

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

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



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

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

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

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

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

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

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

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

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

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

## B. The Cost of Debt

### 1. The Cost of Short-Term Debt

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

the rate year.

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

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

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

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

## 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.

/////

/////

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

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

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

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

**C. <u>The Cost of Trust Preferred</u>**

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

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

/////

**D. <u>The Cost of Preferred Stock</u>**

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

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

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

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

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

/////

/////

**E. The Cost of Common Equity**

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

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

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

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

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

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

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

## IV. OVERALL RATE OF RETURN

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

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

**TABLE 5**
**CAPITAL STRUCTURE AND**
**OVERALL RATE OF RETURN**

| Capital Component | Capital Structure | Cost Rate | Weighted Cost |
|---|---|---|---|
| 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% |
| **Overall Rate Of Return** | **100%** | | **8.60%** |

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

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

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

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

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

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

## V. THE COMPANY'S CREDIT RATINGS

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

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

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

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

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

**TABLE 6**

**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 |

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

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

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

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

*Id*.

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

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

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

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

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

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

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

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

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

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

| | 2007 | 2008 | Rate Year | 2009 |
|---|---|---|---|---|
| **FFO Interest Coverage:** | | | | |
| **PSE Projections** | **3.9x** | **3.9x** | **4.1x** | **4.1x** |
| 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 |
| **FFO to Average Debt:** | | | | |
| **PSE Projections** | **17.1%** | **18.8%** | **20.7%** | **20.4%** |
| 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% |
| **Debt to Total Capital:** | | | | |
| **PSE Projections** | **55.8%** | **55.2%** | **55.6%** | **55.9%** |
| 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% |

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

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

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

/////

## VI. CONCLUSION

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

A. Yes, it does.