EXHIBIT NO. ___(RCB-1T)
DOCKET NO. UE-132027
WITNESS: ROBERT C. BELLEMARE

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For an Accounting Order Approving the Allocation of Proceeds of the Sale of Certain Assets to Public Utility District #1 of Jefferson County.**	**Docket No. UE-132027**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF
ROBERT C. BELLEMARE
ON BEHALF OF PUGET SOUND ENERGY, INC.

APRIL 22, 2014

PUGET SOUND ENERGY, INC.

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CONTENTS

I. INTRODUCTION 1

II. IMPACT OF THE SALE OF PSE'S JEFFERSON COUNTY SERVICE TERRITORY ON INVESTORS. 4

III. STRANDED COSTS..14

IV. MUNICIPALIZATIONS..16

V. CONCLUSIONS AND RECOMMENDATIONS 18

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I. INTRODUCTION

Q. Please state your name, title, and business address.

A. My name is Robert C. Bellemare. I am employed as Chief Operating Officer of Mykrobel LLC, a consulting firm that focuses on utility related issues including asset and business valuation. My business address is 40 Sandia Haven Drive, Cedar Crest, New Mexico, 87008.

Q. Have you provided an exhibit describing your professional qualifications?

A. Yes, I have. It is Exhibit No. ___(RCB-2). Key to this testimony are my credentials as a Certified Business Appraiser (CBA), Certified Valuation Analyst (CVA), Licensed Professional Engineer in the states of Oklahoma and Texas, and I have nearly 30 years' experience in the electric utility industry in a variety of engineering, operations, management, and consulting roles.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of Puget Sound Energy, Inc. ("PSE") in this proceeding. I have been retained by PSE to review and respond to testimony submitted by WUTC Staff ("Staff"), Public Counsel, and Industrial Customers of Northwest Utilities ("ICNU") in connection with PSE's Petition for an Accounting Order Approving the Allocation of Proceeds of the Sale of Certain Assets to the Public

Utility District #1 of Jefferson County, Docket No.UE-132027. I was also employed by PSE in 2008 to 2011 as a consultant in connection with Jefferson County's attempt to forcibly acquire PSE's Jefferson County service territory by Public Utility District #1 of Jefferson County ("JPUD"). In my then role as Chief Operating Officer of UtiliPoint International, Inc., I was the primary author of a 2008 report entitled "Feasibility Considerations For The Proposed Government Takeover Of Puget Sound Energy's Electric Utility Business Within Jefferson County", referred to in this testimony as the "UtiliPoint Report".

Q. What is the purpose of your rebuttal testimony?

A. My rebuttal testimony responds to the testimony of Edward J. Keating, James R. Dittmer, and Michael P. Gorman submitted on behalf of Staff, Public Counsel, and ICNU, respectively. Each of the allocations of proceeds from the sale of assets and PSE's lost service area in Jefferson County proposed by these parties is inadequate to avoid harm to PSE's investors. In this testimony I provide a calculation of the minimum amount investors would expect to receive in a transaction of this type using a commonly used valuation method. I am also responding to some specific issues raised by these witnesses with respect to the UtiliPoint Report and the number and frequency of "municipalizations" that have occurred across the county over the last 40 years, and whether this risk is reasonably reflected in investor expectations with respect to investor owned utilities.

Q. Please summarize your testimony with respect to these matters.

A. My calculation indicates investors would, at a minimum, reasonably expect to receive at least $75.7 million in compensation before they would even entertain a sale of assets and service area such as PSE's Jefferson County service territory. In fact, the sale of a portion of a system would likely command even higher compensation because typical utility investors are normally interested in long-term consistent earnings, and are not seeking deals to sell off portions of their service area for a short-term, one-time game.

In addition, I disagree with the position forwarded by ICNU page 10, lines 3-7 of Exh. No. ___(MPG-1T), and there is no supporting evidence for the position, that a PUD forming a utility through a hostile taking is incorporated into PSE's currently approved rate of return. As I will further discuss, the hostile taking of an existing service area is an extremely rare event. There are over 3,000 electric utilities in the United States and I can find evidence of only six transactions in the past 40 years that could even be considered to have formed through a hostile process (Jefferson County included). I also do not find supporting evidence that PSE's remaining customers are financially harmed by "stranded costs" incurred as a result of the Jefferson County transaction.

Q. Please summarize your conclusions and recommendations with respect to these matters.

A. PSE's investors should receive at least $75.7 million in compensation from the Jefferson County transaction, plus any additional portion of the gain on sale to be allocated to investors in this proceeding. My testimony does not attempt to allocate gain on sale. Of this $75.7 million, $24.3 million of the amount represents the debt portion of the Jefferson County net book value, and the remaining $51.4 million represents the minimum amount of compensation a PSE shareholder would expect in such a transaction to compensate stock value and transaction costs.

II. IMPACT OF THE SALE OF PSE'S JEFFERSON COUNTY SERVICE TERRITORY ON INVESTORS.

Q. Staff states that shareholders are not harmed by the JPUD sale.[1] Do you agree with this conclusion?

A. No, I do not. As I will demonstrate, share value can be different than the book value approach Staff is utilizing, and PSE's share value is damaged by the loss of current and future earnings that would have been provided by Jefferson County customers. As ICNU stated on page 14 of Exh. No. MPG-1T in Docket Nos. UE-111048/UG-111049, "Investors expect to achieve their return requirement from receiving dividends and stock price appreciation." What is lacking in Staff's, Public Counsel's and ICNU's testimony in this proceeding is consideration of stock appreciation and expected compensation for a sale of service area such as Jefferson County.

Q. How does Staff support or justify its conclusion?

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[1] Exh. No. ___(EJK-1T), 32.

A. Staff and the other parties essentially conclude that investors are only entitled to net book value because investors are not harmed if they are given back what is owed to them of their depreciated original investment.

Q. What is your response to Staff's analysis?

A. Staff's analysis does not include the portion of stock value that is above book value. Investors aren't just losing assets, they are losing customers and all future earnings opportunities from those customers. Therefore, the loss of earnings has a measureable impact on stock value for the corporation. In addition, investors reasonably expect compensation over and above the current stock value in a business sale. Investors would have no financial incentive to engage in a transaction if there was no additional present value compensation above what would otherwise be provided had they retained the business. Investors needs to be fairly compensated for their stock value and require additional compensation if they are to engage in a transaction of this type.

Q. What approach or methodology would you apply to determine the impact to investors of the sale of the JPUD assets? Please explain why your selected methodology is appropriate.

A. The lost earnings from JPUD is estimated and the value of those earnings are calculated using a factor determined by a commonly used valuation formula sometimes referred to as a "constant growth" Discounted Cash Flow ("DCF") model or "Gordon Growth" model. That factor is compared to industry stock price to earnings ("P/E") ratios as a reasonability check. The result is then multiplied by another factor for additional compensation that would reasonably be expected in a voluntary sale of a utility business. The resulting equity value is added on top of the debt component of net book value to arrive at a minimum expected compensation investors would seek for a JPUD-type transaction.

Q. Did the other parties use the DCF model to value lost earnings?

A. No, no other party used the DCF model in this proceeding. ICNU, Public Counsel and WUTC Staff have all testified in past proceedings that the DCF model is an appropriate methodology for calculating PSE's cost of capital.[2] However, each party abandoned this methodology here, when the calculation supports lost opportunity to PSE's shareholders. No party has explained why it is appropriate to embrace the DCF methodology in one instance but reject it when viewed from the perspective of a lost service area.

Q. In response to Staff's assertion that investors are not harmed,[3] have you undertaken an analysis that quantifies harm to investors? If so, please explain your analysis.

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[2] *See, e.g.*, Hill, Exh. No. SGH-1CT, 4:6-10 (on behalf of Public Counsel) in Docket Nos. UE-090704 and UG-090705 (testifying that the DCF model is more reliable than the Capital Asset Pricing Model); *see also* Elgin, Exh. No. KLE-1T, 7:1-12 (on behalf of Staff) in Docket Nos. UE-111048 and UG-111049 ("I strongly support the Commission's policy and practice to use the DCF analysis…"); Gorman, Exh. No. MPG-1T, 16-17 in Docket Nos. UE-111048 and UG-111049, and Parcell, Exh. No. DCP-1T at 30:11-18 (on behalf of Staff) in Docket Nos. UE-090704 and UG-090705 ("The [DCF] model is one of the oldest, as well as the most commonly-used, models for estimating the cost of common equity for public utilities. It is my understanding that the Commission's policy is to place primary reliance on DCF results in setting the cost of capital for the utilities it regulates.").

[3] Exh. No. ___(EJK-1T), 32:18-33:15.

A. Yes, I have analyzed the harm to investors associated with PSE's lost earnings stream from the loss of PSE's Jefferson County service territory and find that at a minimum investors would expect $75.7 million in compensation to even entertain a transaction like the sale of the Jefferson County service territory. This analysis is based on the concept that for investors to be interested in a sale they need to recoup their associated debt, shareholder value, and additional compensation. The steps in the calculation are outlined below.

- All parties to this proceeding appear to agree that Jefferson County had a net book value of $46.7 million.
- The approved capital structure for PSE is 48% equity and 52% debt, which means $46.7 million in Jefferson County associated rate base would be financed using $22.4 million in equity and $24.3 million in debt.
- PSE's authorized equity rate of return is 9.8%. When 9.8% is applied to $22.4 million, Jefferson County would be contributing $2.2 million/year to PSE earnings.
- In a sale of any business, investors would expect to be compensated for the debt obligations plus the value of business earnings plus additional compensation because otherwise there would be no incentive to sell.
- An annual "constant growth" DCF can be utilized to calculate the present stock value of future earnings of a business by determining a "Gordon Growth" factor as follows: (1+ growth)/(discount rate – growth). ICNU refers to this model on pages 16 and 17 of its response testimony in

Docket Nos. UE-111048/UG-111049, Exhibit No. MPG-1T, stating, "the DCF model posits that a stock price is valued by summing the present value of expected future cash flows discounted at the investor's required rate of return or cost of capital."

- Assuming earnings growth is 4% per year and a discount rate equal to the equity return of 9.8%, then the Gordon model would calculate an 18 factor. Note that on page 22 of ICNU's response testimony in Docket Nos. UE-111048/UG-111049, Exhibit No. MPG-1T, Mr. Gorman states, "the average and median sustainable growth rates for the proxy group using this internal growth rate model are 4.93% and 4.87%, respectively." Therefore, the use of a 4% growth rate in this analysis should be viewed as conservative.
- This "factor" or multiplier is an estimate of what PSE's stock price to earnings (P/E) ratio would be if publicly traded. To examine the reasonableness of an 18 multiplier, I examined the P/E ratios for several electric utilities and found they typically range from 16 to 20 and this group's average is 18.7. In other words, if a shareholder wanted to purchase utility stock generating $2.2 million in earnings today, the shareholder would expect to pay around 18.7 x $2.2 million, or $41 million, to acquire such stock. A list of the P/E ratios I examined is provided in Exhibit No. ___(RCB-3). In addition, I examined the subset of utilities that ICNU proposes as PSE's peer group in its calculations of

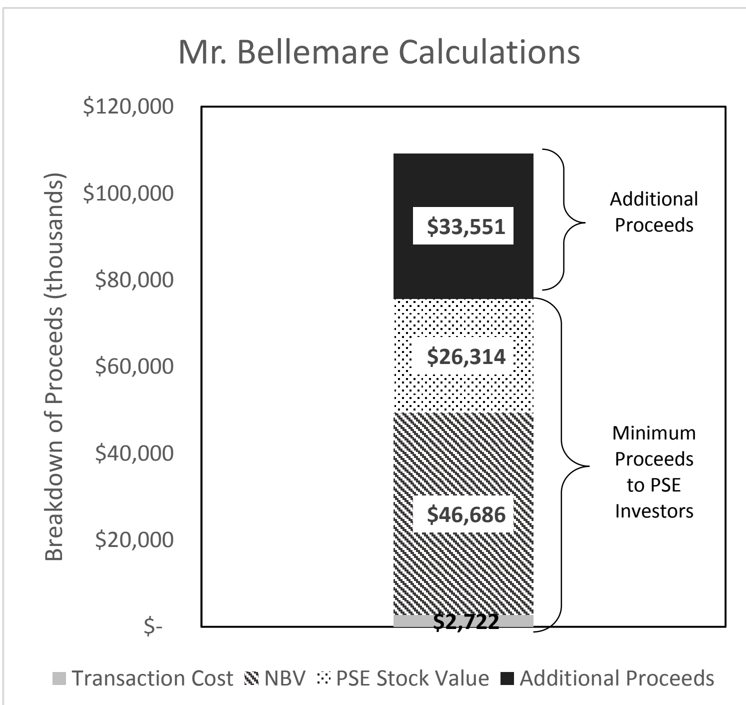
what it believes PSE's allowed return on equity should be in PSE's most recent general rate case, Docket Nos. UE-111048/UG-111049. These utilities, highlighted in Exhibit No. ___(RCB-3), are currently trading with an average 17.5 P/E ratio. I therefore conclude the 18 multiplier of earnings is a reasonable estimate of stock value in PSE's case.

- In addition, a stockholder would expect to receive more than just its "stock value" in a transaction, with 20 to 25% additional compensation not being unusual. A recent example of such a transaction is MidAmerican's 2013 purchase of NV Energy, in which, according to a May 29, 2013 New York Times article (http://dealbook.nytimes.com/2013/05/29/berkshire-unit-in-5-6-billion-deal-for-nevadas-largest-electric-utility/), MidAmerican paid a 23 percent premium for NV Energy. In Puget Holdings, LLC.'s acquisition of PSE in Docket No. U-072375, Puget Holdings paid a 25% premium for the utility. (See Order 08 at ¶ 53). I consider 23% a conservative factor in this case, which involves a partial sale, because utility investors are long-term investors interested in the predictability of earnings; they are not typically interested in selling a portion of their business for a short-term gain.

- So for shareholders in this scenario to consider a transaction involving the loss of $2.2 million/year in earnings, they would normally want at least $2.2*18*1.23, or $48.7 million in compensation plus transaction costs of $2.7 million.

- Therefore, the amount of transaction compensation an investor would require before even considering a transaction under normal circumstances (acting without compulsion) would be $24.3 million (debt obligations) plus $48.7 million (equity), plus transaction costs of $2.7 million for a total of $75.7 million. It is only after this minimum $75.7 million is reached that the Commission should consider any equitable sharing of gain between customers and shareholders.

Below is a chart summarizing the minimum amount of transaction value in a format similar to Staff's.



Q. Does $75.7 million reflect a fair and reasonable allocation of gain on sale in this case?

A. No, and to be clear, I have not attempted to allocate gain on sale in my analysis. We need to be careful in distinguishing "gain" on sale from what I have described as the minimum amount of compensation that investors should receive to avoid harm. My calculations reflect the minimum amount of money that is required to incent someone to even consider selling an asset. It does not determine the purchase price of that asset, or how much "gain on sale" the owner of the asset may be able to realize if it does decide to sell the asset.

These are important distinctions. The purchase price in this case was $109,273,196 and, based upon analysis done by both PSE and JPUD, this amount was determined to be a reasonable reflection of the fair market value of these asset. Fair market value reflects the intersection of what a willing purchaser is willing to pay to acquire an asset, and what a willing seller is willing to accept to sell an asset. My analysis of the minimum amount of money it would take to incent an investor to even consider selling these assets is not a fair market value appraisal, it is simply a reflection of the value of the investment from the standpoint of the investor. Normally the fair market value would be greater than this amount because otherwise there is no financial incentive for an investor to sell a business or asset. And that is true in this case – the resulting actual purchase price is higher than what I concluded is the minimum compensation investors would require before possibly entertaining a transaction of this type.

The "gain on sale" is the excess of the proceeds over the net book value of the asset being sold, less transaction costs. In this case, we know this amount to be

$59.9 million. Normally, gain on sale goes to the owner of the asset that is being sold. However, I understand in this case, PSE has offered to share the gain on sale. So, after accounting for the minimum amount of compensation that investors should receive to avoid harm, which I believe to be $75.7 million, PSE is offering to share the balance, in approximately equal proportions.

Q. Some argue if the shareholder gets net book value they can just reinvest those proceeds back into the business and get the same return.[4] What is your view on this topic?

A. PSE's rate base has been permanently reduced by the departure and loss of Jefferson County assets and customers; therefore, there are no future earnings opportunity to make up for the loss of Jefferson County. The sale of the Jefferson County service territory caused PSE to shrink in size, and there is no new opportunity created for investors by its departure.

Q. Doesn't your analysis reflect an "income approach" to valuing a future revenue stream? If so, why is it the appropriate methodology?

A. Yes, this calculation represents an "income approach," and it is a well-recognized and accepted methodology for assessing the value of a future revenue stream. The income approach is a "general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single

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[4] Exh. No. ___(EJK-1T), 17:7-11. *See also* Exh. No. ___(EJK-1T), 33:11-16; Exh. No. ___(MPG-1T), 2:4-8, and Exh. No. ___(MPG-1T), 8:3-11.

amount."[5] ICNU uses this same methodology in its response testimony in Docket Nos. UE-111048/UG-111049, Exhibit No. MPG-1T. Essentially, it is an approach for valuing a business based on its future ability to generate earnings.

Q. Much is made of Mr. Karzmar' s concerns about using the "income approach" in settlement negotiations with JPUD.[6] Was Mr. Karzmar correct expressing these reservations?

A. Yes, he was, although it appears that the other witnesses misunderstand what Mr. Karzmar was saying. Mr. Karzmar was speaking to methodologies for determining asset value in the context of a threatened condemnation proceeding. He testified that "RCLD and RCNLD were recognized by the experts assisting PSE and JPUD as credible methodologies for determining asset values. PSE was also advised that Washington courts accepted the replacement cost and reproduction cost methods as a proper approach to determining fair market value in this jurisdiction."[7] I agree that RCLD and RCNLD were good tools for settlement negotiations with JPUD and established a clear benchmark to determine the sufficiency of the purchase price of the assets. That does not mean, however, nor is it the point that Mr. Karzmar was making, that the income approach is invalid or deficient for determining the value of a business as a going concern.

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[5] International Glossary of Business Valuation Terms 2001.

[6] Exh. No. KRK-1CT at 9:9-10:6 in Docket No. U-101217.

[7] Exh. No. KRK-1CT at 12:3-7 in Docket No. U-101217.

Q. Do you agree with Staff's statement that the Company did not rely "on going concern damages" in connection with its negotiated settlement with JPUD?

A. No. First, for evaluating JPUD's offer of settlement, Mr. Karzmar' s testimony states that PSE assumed that it might be able to recover going concern damages in the range of $15 million to $20 million.[8] Mr. Karzmar also points to an income approach assessment of the assets, within a range of $91 between $130 million, which compared favorably to PSE's range of $105 million to $136 million derived from a RCNLD/RCLD valuation analysis.[9] Finally, Mr. Karzmar points to the JPUD range of RCNLD valuations, $58 million to $83 million, as compared to the $103 million purchase price, and a downside litigation risk of approximately $45 million had PSE chosen to litigate. When I review all of these numbers, and take into consideration the net book value of $46.7 million for these assets, I think PSE's reliance on going concern damages was cautious, but also prudent, with an offer of $103 million on the table and a significant litigation risk associated with taking these complex questions to a jury.

III. STRANDED COSTS

Q. Public Counsel references the UtiliPoint Preliminary Feasibility Study as a basis to support the argument that PSE's remaining customers incurred "stranded costs" as a result of the sale of the Jefferson county service

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[8] *See* Exh. No. KRK-1TC at 16 in Docket No. U-101217.

[9] *See* Exh. No. KRK-1TC at 16 in Docket No. U-101217.

territory.[10] Do you agree with Public Counsel's reliance on the UtiliPoint Preliminary Feasibility Study in support of this conclusion?

A. No. I was the primary author of the UtiliPoint Study and I authored the section on stranded costs. The report clearly states it did not consider stranded costs or any broader category cost referred to in the report as severance damages in that study.

Q. Why did you not undertake an analysis of stranded costs or severance damages in the UtiliPoint Study?

A. Because at the time I prepared the report, the likely "minimum" price tag for Jefferson County to form a utility was likely to be too expensive, even without quantifying stranded costs. However, since it was a preliminary feasibility analysis, I did point out that such costs or damages may be incurred when one utility acquires the service area of an incumbent utility. An actual analysis, however, of stated costs and severance damages was beyond the scope of this initial report.

Q. Do you know if any such costs or damages were subsequently discovered or incurred in connection with the sale of the JPUD assets?

A. I understand that some costs, of the nature that would fall under the term "severance damages" as used in the UtiliPoint Report, were identified during the three-year transition of the service area. Mr. Sam Osborne speaks to this on pages 10-11 of his prefiled direct testimony, Exhibit No. ___(SSO-1T). PSE apparently

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[10] *See, e.g.*, Exh. No. JRD-1T, 21:13-22:34.

discerned some transition costs (e.g., contract termination and similar types of severance expenses), and expenses associated with accounts receivables and other incidental expenses. According to Mr. Osborne's testimony, these costs were passed on to JPUD.

Q. Are you aware of any other analyses, conditions or circumstances that support or substantiate Public Counsel's argument that PSE incurred any stranded costs or severance damages in connection with the transfer of the Jefferson County service area?

A. No, excepting only the items referred to in Mr. Osborne's testimony, Public Counsel does not provide any such support, although Mr. Dittmer does reference a study authored by D. Hittle and Associates that was prepared about the same time I prepared the UtiliPoint Study. However, like the UtiliPoint Study, the Hittle Report did not undertake an assessment of stranded costs but, unlike the UtiliPoint Study, the Hittle Report offers an opinion that stranded costs in this case "are likely to be zero."[11]

IV. MUNICIPALIZATIONS

Q. ICNU states that the risk of public utility districts condemning PSE's facilities is a known risk in the market place. Do you agree?

A. While it may be a known risk, it is certainly an infrequent risk, and as such, I question that this risk is perceived by many investors or is reflected in the market

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[11] D Hittle & Associates, "Preliminary Feasibility Study Public Utility District No. 1 of Jefferson County Electric System Acquisition," September 15, 2008, p 17.

place. Exhibit No. ___(RCB-4) provides an analysis I prepared of utilities that I am aware of forming since 1973. As you will see, I have found 86 new utilities forming and many of these are very small entities that represent either new communities, such as those in Alaska, or specialty situations such as casinos or former military bases. I only could identify six utilities (in bold text in Exhibit No. ___(RCB-4)) formed through a "hostile" process, and I am including Jefferson County in that total.

Q. Do you agree that the risk of municipalization is built into the equity return?

A. No. Keep in mind there are over 3,000 electric utilities in the United States, with most of these utilities forming in the early to mid-1900's, including most of those in the state of Washington. The formation of a utility through hostile means is an extremely rare occurrence in the electric utility industry, nor is it expected to be a trend in the industry. Therefore, I do not believe municipalization is incorporated into customary risk of the industry. Fitch Ratings came out with an analysis of municipalization on March 15, 2013, in which the analysts concluded they "do not anticipate a material increase in the number of municipalities attempting to purchase an investor-owned utility (IOUs)".

In addition, I would have to believe that a stockholder would reasonably expect if a utility was put in a forced sale position and the company is successful in getting adequate compensation, the stockholder would get more than just its original cost less depreciation back, that it would be compensated in a similar manner as if someone wanted to buy their stock at the stock value plus at least the customary premium involved in a voluntary type sale of a utility.

V. CONCLUSIONS AND RECOMMENDATIONS

Q. Please summarize your recommendations.

A. I conclude that PSE's investors are owed at least $75.7 million in the Jefferson County transaction based on a minimum transaction price an investor would consider engaging in such a transaction, plus any additional portion of the gain on sale to be allocated to investors in this proceeding.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.