

**EXHIBIT NO. ___(EMM-1CT)
DOCKET NO. UE-07 ___/UG-07 ___
2007 PSE GENERAL RATE CASE
WITNESS: ERIC M. MARKELL**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-07 ___
Docket No. UG-07 ___**

**PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
ERIC M. MARKELL
ON BEHALF OF PUGET SOUND ENERGY, INC.**

**REDACTED
VERSION**

DECEMBER 3, 2007

PUGET SOUND ENERGY, INC.

**PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
ERIC MARKELL**

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I. INTRODUCTION

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

A. My name is Eric M. Markell. My business address is 10885 N.E. Fourth Street
Bellevue, WA 98004. I am Executive Vice President and Chief Financial Officer
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. ____ (EMM-2).

Q. What are your duties as Executive Vice President and Chief Financial Officer for PSE?

A. My present responsibilities include oversight of the finance, financial planning, budgeting, accounting, tax, insurance, portfolio optimization and regulatory functions of the Company.

Q. What is the nature of your testimony in this proceeding?

A. My testimony will: 1) summarize the Company's requested rate relief, 2) describe the financial condition of the Company and its need for capital, a reasonable allowed return on equity and capital structure, 3) provide a progress

report on the Power Cost Only Rate Case (“PCORC”) Collaborative and make a related proposal to initiate a rulemaking to consider the use of forward-looking test years in rate cases, 4) introduce the Company’s proposed increases to the gas and electric basic charges, 5) request that the Commission approve a slight revision in the threshold amount for deferral of catastrophic storm costs, 6) summarize the results of a recent study on depreciation rates for the Company’s utility plant, 7) explain in brief why it is reasonable for the Company’s customers to pay the portion of executive compensation requested for inclusion in rates in this case, 8) set forth a proposal to increase assistance to low income customers, and 9) provide a brief overview of the recently announced merger transaction with the Macquarie Consortium and the initial sale of common equity to the members of the Consortium. I also provide a brief overview of the testimonies presented by the Company’s other witnesses in this general rate case.

II. REQUESTED RELIEF

Q. What level of rate increase is the Company requesting in this case?

- A. The total requested rate increase for electric retail customers is \$174,482,512, an average 9.50% increase over the electric rates set in the Company's 2007 PCORC proceeding, Docket No. UE-070565, that became effective on September 1, 2007.

The total requested rate increase for gas customers is \$56,770,992, an average 5.31% increase over the gas rates set in the Company's 2006 general rate case Docket No. UG-060267, that became effective January 13, 2007.

Q. Please explain why the Company needs the proposed rate relief.

- A. The Company is requesting an increase in electric and natural gas rates through this general rate case filing because the costs of providing service to the Company's customers have increased well above levels that existed at the time rates were last determined. The Company has taken steps to manage these cost increases, to the extent possible. However, even after doing what it can to improve efficiencies in its operations and to manage the cost of construction, the Company's costs to provide service to its customers have increased beyond the revenues it collects in its current rates.

Q. Why are the costs of serving PSE's electric customers increasing?

- A. Power cost increases are the largest single category placing upward pressure on electric rates. The rising cost of natural gas for power generation and increased demand for power are main contributors to higher costs of generating power as well as higher costs of purchasing power. The Company is also seeking in this case to begin recovering its investments in new generation facilities. Although these new facilities require significant initial investment, over the longer term these facilities are projected to provide power at a cost lower than would otherwise have been incurred by the Company to serve electric customers.

Other major cost drivers include: (i) storm cost recovery for expenses incurred in 2006 and the beginning of 2007, (ii) higher operations and maintenance (“O&M”) expense, and (iii) higher depreciation expense. O&M expense has increased due

1 to higher costs to operate and maintain the electric transmission, distribution, and
2 generation systems and to serve a growing customer base. Higher depreciation
3 expense is related to the addition of new electric plant as well as higher retirement
4 costs for plant that was installed in the past as determined in a depreciation study
5 completed by the Company this year.

6 **Q. Why are the costs of serving PSE's gas customers increasing?**

7 A. The Company's increased costs for providing natural gas service are being driven
8 primarily by increased depreciation expense, the addition of new gas distribution
9 plant to serve a growing customer base and increased O&M costs to inspect,
10 operate, and maintain the system.

11 **Q. Are there cost increases that impact both electric and gas customers?**

12 A. Yes, the Company's requested rate relief includes the costs of increasing the
13 equity component of its capital structure to 45% from 44% and of increasing
14 PSE's allowed return on equity to 10.8% from 10.4 %. The rate increase
15 resulting from the proposed cost of capital changes amounts to only a small
16 portion of the total requested electric and gas rate increases.

17 Such increase will help better position the Company: (i) to make the significant
18 investments in its electric and natural gas transmission and distribution systems
19 that are required to continue providing quality service to PSE's customers, (ii) to
20 invest in additional generation plant and long-term purchased power agreements

1 to serve the needs of PSE's electric customers, and (iii) to purchase gas and
2 power in the wholesale markets on behalf of the Company's customers.

3 **Q. Would you briefly describe the relief the Company seeks in this case?**

4 A. The Company seeks Commission approval of the following key proposals:

- 5 a) additional revenue in rates to pay for increases in costs the
6 Company incurs to serve customers;
- 7 b) a capital structure comprised of 45% equity, a structure the
8 Company will need to maintain and gradually improve its
9 corporate credit rating, to sustain the Company's ability to access
10 capital markets on reasonable terms as it plans to invest \$ █
11 billion in capital spending over the next 6 years and to sustain the
12 Company's ability to engage in hedging activities to moderate the
13 cost volatility in its energy portfolio;
- 14 c) a fair, just, reasonable and sufficient rate of return on equity of
15 10.8%, a level at the bottom end of the range set forth in the pre-
16 filed direct testimony of PSE's cost of equity expert, Dr. Roger
17 Morin (Exhibit No. ___(RAM-1T)) in order to attract the capital
18 that will be required to invest in infrastructure to serve customer
19 needs;
- 20 d) a revised electric and natural gas rate design to allow the Company
21 to more reliably recover the fixed costs of delivering service to its
22 customers, which will benefit customers by decreasing bill
23 volatility and will benefit PSE by decreasing earnings volatility;
- 24 e) a slightly revised deferral threshold for catastrophic storm costs;
- 25 f) a revised depreciation schedule for electric, gas and common
26 properties to better match the depreciation levels set in rates to the
27 actual useful lives and retirement costs of the Company's operating
28 plant; and
- 29 g) an increase in the benefits provided to support the ability of the
30 Company's low income customers to pay their electric and natural
31 gas bills.

1 Q. **Would approval of the relief the Company is requesting serve the interests of**
2 **its customers?**

3 A. Yes. Such relief will enable the Company to continue investing in the energy
4 delivery infrastructure, energy supplies and technology needed to provide
5 reliable, cost-effective service to our customers.

6 **III. THE FINANCIAL CONDITION OF THE COMPANY AND**
7 **ITS NEED TO ATTRACT CAPITAL TO MAKE INVESTMENTS**
8 **ON BEHALF OF ITS CUSTOMERS**

9 A. **The Company's Significant Need for Additional Capital**

10 Q. **Please provide an overview of the financial forces affecting the Company**
11 **now and over the next several years.**

12 A. PSE is in the midst of a significant capital investment cycle as it invests to replace
13 aging infrastructure, invests in new generation, and invests to provide continuing
14 quality customer service and reliability. Over the next six years, from 2008 to
15 2013, the Company's rate base is expected to increase from about \$ █ billion to
16 about \$ █ billion, an increase of approximately █ %. These increases will be
17 driven by an estimated \$ █ billion investment in capital projects. Retained cash
18 flow from the rates paid by PSE's customers will provide a portion of the \$ █
19 billion, but the Company anticipates needing to raise \$ █ billion in total new
20 capital, both debt and equity, such that the Company's total capitalization
21 (defined as total debt, preferred stock and common equity) will be increased by

1 █%. The Company's six-year business plan, attached as Exhibit No. ___(EMM-
2 3C), which was prepared by Mr. Don Gaines and his staff, provides more detail
3 on the Company's need for significant capital in the coming years.

4 **Q. What is driving this significant capital investment cycle?**

5 A. As described more fully in the prefiled direct testimonies of Ms. Kimberly J.
6 Harris (Exhibit No. ___(KJH-1HCT)) and Ms. Susan McLain (Exhibit
7 No. ___(SML-1CT)), the Company's capital expenditures are being driven by a
8 variety of factors. These include: new energy supply projects; infrastructure to
9 serve new gas and electric customers; expansions of gas and electric system
10 capacity to meet existing and future customer loads; planned reliability
11 improvements and projects needed to comply with various laws and regulations;
12 projects to maintain and strengthen gas and electric systems; and projects to
13 restore and reduce outages; and projects in which PSE is responding to external
14 requirements such as relocating facilities when roads are widened.

15 As described below, the Company carefully considers whether various
16 expenditures need to be made. The \$█ billion in capital spending that the
17 Company is projecting to spend for the 2008 to 2013 period is a portion of the
18 total estimated cost that the Company believes will be necessary to undertake to
19 continue to provide high quality service to its customers.

20 ////

1 **Q. How much external capital will be needed to fund such capital investments?**

2 A. For the six-year period 2008 to 2013, after giving account to retained internally
3 generated funds from operations of about \$ █ billion, an estimated \$ █ billion
4 will be needed to be acquired from the capital markets to fund these capital
5 investments.

6 **Q. What are the primary drivers of increased investment costs?**

7 A. Customer growth and increases in the cost of construction materials, labor, and
8 services are key drivers of rising investment requirements. Given demographic
9 forecasts for our region over the next twenty years, the Company expects
10 customer growth to continue. As discussed by Ms. McLain, customers are also
11 demanding a higher level of service due to telecommuting, the use of home
12 electronic devices and the increasingly electrically intensive nature of the
13 workplace.

14 Further, the cost of construction materials and electrical equipment continues to
15 escalate at rates above the general rate of price increase. This price escalation is
16 being caused by the global demand for such materials and equipment and a
17 relatively weak U.S. dollar, which makes imported materials such as copper and
18 equipment such as wind turbines and towers more costly than just a few years
19 ago. Fortunately, as Mr. Donald E. Gaines explains in his prefilled direct
20 testimony, Exhibit No. ___(DEG-1T), the cost of debt to fund needed investments
21 is relatively stable at present even though construction costs are rising.

1 As explained by Ms. Harris and Ms. McLain, the Company is making every effort
2 to manage costs and keep investments and operating expenditures at a reasonable
3 level while still meeting the customers' expectations.

4 **Q. Will revenues from new customers be sufficient to meet these increasing
5 costs?**

6 A. A portion of these increased revenue requirements will be covered by the
7 revenues associated with new customers. However, revenue growth from
8 increasing sales and payments from customers for line extensions will not cover
9 all of the cost increases associated with adding or replacing aging infrastructure
10 and acquiring new generation resources.

11 **Q. What do you believe the impact on rates will be, due to this increased
12 operations and maintenance and capital expenditures that you discuss?**

13 A. Obviously, with this level of expenditures, there is going to be upward pressure
14 on future rates. As discussed in the Company's May 2007 Integrated Resource
15 Plan, the Company is using its best efforts to plan for and mitigate this rate impact
16 as much as possible as it relates to new gas and power supply and energy
17 efficiency programs. Nevertheless, our multi-year business model forecasts that
18 even with the Company's efforts to manage costs and the assistance of revenues
19 from new customers, the impact on customers rates may exceed somewhat the
20 general rate of inflation and will be "lumpy" as a reflection of the regulatory
21 process.

1 The upward pressure on rates cannot be avoided in the longer term by foregoing
2 maintenance expenditures and capital investments in the shorter term. As
3 discussed by Ms. McLain and Ms. Harris, if the Company delays its efforts to
4 acquire new resources and update infrastructure, the Company and its customers
5 will face increased competition for resources and will face construction cost
6 escalation and increasing prices for resources needed to add to and update
7 existing infrastructure (pipes and wires). Rising construction costs are not a
8 problem unique to PSE and its customers. It is a reality facing utilities and
9 consumers and all whom utilize our nation's aging infrastructure.

10 **Q. How much equity will be needed during this six-year period 2008-2013?**

11 A. PSE will need to acquire an estimated \$█ million of equity during this six-year
12 period in addition to the nearly \$300 million of equity that was recently sold to
13 the Macquarie Consortium (the "Initial Placement") on October 25, 2007.

14 **Q. Is this a significant amount of equity for PSE to raise?**

15 A. Yes. Over the past five years (2002 to 2006), PSE managed to raise \$500 million
16 in equity capital to rebuild its financial strength while at the same time
17 implementing a program to acquire needed power supply resources to meet the
18 Company's current and forecasted load over the next 20 years. Looking beyond
19 the next six years and the Company's estimated \$█ billion capital spending
20 plans, PSE will need to raise █ of equity capital
21 again. Furthermore, the Company's total capitalization is relatively small given

1 the size of its capital spending plans. According to data provided by Morgan
2 Stanley for the period 2007-2009, the Company's six year capital expenditure
3 plan is the largest capital spending program relative to market capitalization
4 compared to 13 specific utilities which were identified for embarking on
5 significant capital spending programs over the next three years. Exhibit
6 No. ____(EMM-4C).

7 **Q. What debt raising and debt refunding plans does the Company have during**
8 **the 2008 to 2013 planning period?**

9 A. During this same six-year period, the Company is scheduled to refund an
10 estimated \$840 million in maturing term debt. In addition to refinancing the
11 maturing term debt, an estimated \$ [REDACTED] billion of incremental term debt will need
12 to be raised to finance new capital investments. The Company's six-year plan
13 also includes \$ [REDACTED] million in new hybrid preferred securities, which are expected
14 to be considered by the rating agencies to have 50% debt and 50% equity
15 weighting for credit rating purposes.

16 **Q. Would you please summarize the Company's anticipated capital needs over**
17 **the next six years?**

18 A. The Company plans to spend about \$ [REDACTED] billion for capital investments between
19 2008 and 2013 and needs to raise \$ [REDACTED] billion in new capital: at least \$ [REDACTED]
20 million in equity beyond the Initial Placement amount and about \$ [REDACTED] billion in
21 new debt and hybrid preferred securities to fund the projected \$ [REDACTED] billion

1 investment.

2 **B. The Problem of Persistent Under-Earning**

3 **Q. Does PSE have an under-earnings problem?**

4 A. Yes. The Company suffers from chronic under-earnings in its regulated business.

5 Since 2003, the Company has under-earned its authorized rate of return every
6 year. Exhibit No. ___(EMM-5C)

7 **Q. Has the Company been able to identify any particular reasons for the
8 earnings shortfall?**

9 A. The cause of under-earning that is of greatest concern to the Company is
10 “regulatory lag”, which is the systemic under recovery of operating costs due to
11 the setting of rates by looking backward in time to historic costs rather than
12 looking forward to reasonably projected costs, sales and revenues to determine
13 the Company’s anticipated revenue requirement during the future rate year.

14 **Q. Have you prepared a schedule illustrating such regulatory lag effects?**

15 A. Yes. Exhibit No. ___(EMM-5C) includes a copy of PSE’s response to Bench
16 Request No. 001 from the 2006 general rate case and provides updated
17 calculations for the years 2006 to 2008. The Company estimates that the impact
18 of regulatory lag for 2007 and 2008 will reduce the Company’s authorized equity
19 return for these years by about █% and █%, respectively. Translated to the

1 return on equity (“ROE”), this is a reduction in the projected earned ROE in 2008
2 of about █%. In other words, due to regulatory lag, the Company’s ROE in
3 2008 is projected to be approximately █% rather than the 10.4% level that was
4 approved in the 2006 general rate case.

5 **Q. What are some of the key causes of under-earning as projected in the**
6 **Company’s 2008 Operating Budget?**

7 A. As shown in Exhibit No. ___(EMM-5C), the Company estimates under recovery
8 of depreciation expense and operating and maintenance (“O&M”) expense in
9 2008 will reduce earnings by about \$_____. In addition, the Company is
10 financing \$_____ in new electric and gas plant that has already been placed
11 in service for the benefit of customers, but the return on such new plant additions
12 is not yet being fully recovered in rates. This delay in recovery creates around
13 \$_____ in regulatory lag. For new capital additions made in 2008, rate
14 recovery of the new investment (depreciation expense and financing capital costs)
15 in the gas and electric transmission and distribution systems will not occur totally
16 until the Company files a general rate case after this current proceeding. As
17 discussed by Ms. McLain in her prefiled direct testimony, line extension
18 payments do not fully offset the costs of new investment and are not designed to
19 recover the upfront costs of adding new customers or the costs for the backbone
20 of the delivery systems. The untimely recovery of these three significant costs
21 (O&M, depreciation, and capital financing) in total are forecasted to lower the
22 Company’s projected return on equity by about █% in 2008.

1 Q. **Did the Company consider reducing or deferring such unrecoverable**
2 **expenses?**

3 A. With respect to projected 2008 depreciation expense, the Company has already
4 made the customer-driven capital investments in the transmission and distribution
5 system in 2006 and 2007 that drive depreciation expense in 2008 far above the
6 levels provided for in the rates that will be in effect in 2008.

7 With respect to projected 2008 O&M expenses and capital spending, the
8 Company carefully prepares its annual O&M and capital budgets to authorize the
9 spending that is needed to maintain reliable and safe generation, transmission and
10 distribution systems. These budgets are also presented to and discussed with the
11 Board of Directors, which approves the final budgets for the year. In this process,
12 the Company seeks to balance spending and cost in a fashion to maintain safe and
13 reliable customer service.

14 As a result of a thorough budget process in the Company, management
15 recommended and the Board approved 2008 O&M and capital budget levels
16 adequate to maintain and enhance the Company's aging delivery systems and
17 generation fleet notwithstanding the significant adverse effects such expenditures
18 will have on earnings in 2008 and 2009. These spending requirements are further
19 described in the prefilled direct testimonies of Ms. Harris, Ms. McLain, and Mr.
20 David E. Mills (Exhibit No. ____(DEM-1CT)).

21 In short, we intend to do the right thing by our customers by spending

1 appropriately to support a safe and reliable system. In this case, the Company
2 requests that the Commission and stakeholders do likewise when setting rates for
3 the Company, such that the long-term interests of our customers are not sacrificed
4 to obtain lower rates in the short-term.

5 **C. The Need for Financial Stability**

6 **Q. What is financial stability and why is it important?**

7 A. The Company's financial stability is its ability to raise capital in the financial
8 markets and to engage in energy supply and risk management activities on
9 reasonable terms throughout the economic and credit cycles. This is important
10 because capital and credit market conditions vary over time as a result of
11 economic events, central bank actions, industry developments, and investor
12 sentiment.

13 As already described, PSE's substantial investment needs, and low internal cash
14 flow generation require significant cash to be accessed from sources external to
15 the Company. PSE competes with other entities for this capital – both within and
16 outside the utility sector – and must offer investors and credit counterparties a risk
17 adjusted return opportunity consistent with its specific business facts and
18 prevailing market requirements.

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1 **Q. Has the Company attempted to improve its financial condition prior to**
2 **seeking rate relief from this Commission?**

3 A. Yes. Since 2001, the Company, with the Commission's support, has improved its
4 equity ratio from a level of 32% to the 45% level that will be achieved at year-end
5 2007 through: (i) the issuance of 25.4 million additional common shares that
6 generated net proceeds of nearly \$527 million, (ii) by contracting with members
7 of the Macquarie Consortium to purchase 12.5 million shares that will generate
8 about \$293 million net of issue costs, and (iii) by increasing PSE's retention of
9 net earnings to reinvest in the business by lowering its dividend by 46 percent in
10 2002 and holding its cash dividends unchanged since that time.

11 PSE also undertakes efforts to keep its operating and investment costs as low as
12 reasonably possible, as described earlier in my testimony as well as in the prefilled
13 direct testimonies of Ms. Harris, Ms. McLain and Mr. Mills. These efforts, in
14 addition to keeping customer rates as low as possible, improve the Company's
15 equity and cash flow generation and minimize, to the extent possible, its need for
16 external capital which in turn enhances the Company's financial stability.

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1 **D. Risks to the Financial Condition of the Company**

2 **1. Increasing Infrastructure Capital Expenditures Required to**
3 **Serve Electric and Natural Gas Customers**

4 **Q. What are the risks with respect to the Company's financial condition?**

5 A. The following are major risk factors which impact the Company's financial
6 condition: (i) increasing capital expenditures to maintain an aging system and
7 serve a growing customer base; (ii) low internal cash flow as a result of a
8 relatively small generation asset base and a large percentage of long-term electric
9 power purchase contracts and market purchases; (iii) exposure to volatile
10 commodity costs; and (iv) inability to actually earn the ROE that has been
11 authorized by the Commission as a consequence of regulatory lag, power cost risk
12 under the PCA mechanism, and weather risk.

13 **Q. What level of capital expenditures does the Company anticipate?**

14 A. As described above and in the direct testimonies of Ms. Harris and Ms. McLain,
15 the Company must make substantial investments over the next several years to
16 meet customer growth and a growing short energy position and to upgrade and
17 maintain electric and natural gas system reliability and safety. As already noted,
18 over the six-year period of 2008-2013 alone, the Company projects investments in
19 the \$ █ billion range.

20 ////

1 **Q. Are these significant infrastructure investments limited to investments in**
2 **electric generation?**

3 A. No. In fact, a large portion of the projected capital expenditures is for investment
4 in energy delivery systems. Of the above projections, approximately \$ █ billion
5 is for energy delivery, with █% of such amount (approximately \$ █) for
6 expenditures related to system reliability and █% of such amount (approximately
7 \$ █) for expenditures related to system capacity and growth. The
8 importance of investments in energy delivery systems in order to support
9 customer growth and maintain reliable service is discussed in the testimony of
10 Ms. McLain.

11 **Q. How fast is the growth in the Company's customer base?**

12 A. The Company continues to experience strong customer growth in its service
13 territory for both electric and gas customers, and the growth in gas customers has
14 consistently outpaced the growth in electric customers.

15 Over the three-year period between December 31, 2003, and December 31, 2006,
16 the average number of PSE's electric customers increased by 6.1%, from
17 approximately 969,000 to approximately 1,028,000 customers. Over the same
18 three-year period, the average number of PSE's gas customers increased by
19 11.0%, from approximately 634,000 to approximately 704,000. This compares to
20 national growth rates of approximately 4.4% for electric and 3.9% for gas
21 customers over those same periods.

1 **Q. Are the Company's projected capital expenditures outside the range you**
2 **would expect in the utility industry?**

3 A. It is typical for utilities operating in regions with economic and population growth
4 to undertake capital expenditure programs to replace aging infrastructure and
5 address short energy positions.

6 However, PSE is relatively small compared to others in the utility industry, in
7 terms of net plant, market capitalization, and operating cash flow. To put this in
8 perspective, PSE's net plant at September 30, 2007 was \$5.5 billion. This is less
9 than the \$ █ billion in capital investments the Company projects it will make in
10 the next six years alone.

11 **Q. How might the capital markets respond to the fact that PSE's anticipated**
12 **capital expenditures are relatively large compared to PSE's size?**

13 A. As described in the prefiled direct testimony of Dr. Morin, equity investors will
14 demand a higher return to assume the additional risk of executing such a large
15 investment and external financing program in a relatively concentrated period of
16 time, especially given the Company's size.

17 Debt investors and counter-parties will look at the expected impact on the
18 Company's credit ratings. As part of the rating evaluation, credit rating agencies
19 consider a company's size (assets, equity, retained cash flow, etc.) relative to its
20 planned capital program in their determination of creditworthiness. A larger

1 company or company with a higher credit rating is better able to sustain the risks
2 of a larger capital program than a smaller company or less well rated company.

3 **2. Volatile Commodity Costs**

4 **Q. What are the financial risks attendant to volatile commodity costs?**

- 5 A. Commodity costs are the cost of power required to serve electric customers and
6 the cost of natural gas required to serve core gas customers as well as to generate
7 electricity. The cash outlay required to cover such purchases has increased
8 significantly given generally rising market prices, the Company's short position,
9 volatile natural gas prices, and the increasing presence of financial parties in
10 secondary energy markets that require collateral to mitigate the Company's weak
11 credit. While PSE's hedging credit facility provides the Company increased
12 flexibility to manage these financial risks, the Company continues to face
13 significant volatilities in its gas and power portfolios due to variables such as
14 hydro, load fluctuations due to weather variations and the measured risk built into
15 the Company's hedging program. Mr. Mills further discusses the volatilities
16 and management of the Company's gas and power portfolios in his prefilled direct
17 testimony.

Q. Do the Company's Power Cost Adjustment ("PCA") and Purchased Gas Adjustment ("PGA") mechanisms remove the financial risks with respect to commodity costs?

A. No. The PCA and PGA mechanisms have increased the Company's likelihood of recovery of its actual costs. The PCA mechanism has mitigated our financial risks by sharing them between customers and shareholders, but has not removed such risks. The PCA Mechanism, unlike the PGA Mechanism, is not a dollar-for-dollar pass through of commodity costs. The sharing bands under the current PCA Mechanism subject the Company to a significant amount of financial risk each year with respect to power costs, many of which – such as poor hydroelectric generating conditions, load variation due to weather and forecast error – the Company can neither control nor hedge.

Q. Please describe the volatility related to variations in hydroelectric supply.

- A. During an average stream flow year, approximately one-third of PSE's electric energy production comes from hydroelectric resources. During poor stream flow conditions, PSE may need to acquire replacement power to serve its customer load. During favorable stream flow conditions, PSE may need to sell surplus power to balance its supply portfolio and mitigate its power costs. These balancing transactions are conducted in the wholesale power markets. Because the market price of power is quite volatile, hydroelectric shortfalls or surpluses can greatly affect PSE's power costs. Further, hydro risk creates an asymmetric

1 risk for shareholders because in a year when hydro is lower than normal, market
2 prices spike higher than they decline when hydro is higher than normal.

3 **Q. What other risks affect the power portfolio?**

- 4 A. In addition to hydro risk described above, the other major drivers of power cost
5 volatility are: (1) weather uncertainty and energy efficiency measures affecting
6 power usage, (2) variations in market conditions such as wholesale gas and
7 electric prices, (3) risk of forced outages, and (4) transmission and gas
8 transportation constraints. All of these factors create load and resource volatility
9 that PSE balances with wholesale market purchases and sales.

10 **Q. What financial risk does the Company bear presently as a result of the
11 current power cost sharing mechanism?**

- 12 A. Analysis conducted by the Company on the current PCA mechanism that was
13 presented in the 2006 general rate case shows that two thirds of the time, the
14 Company can expect up to approximately \$ [REDACTED] in power costs that are
15 higher or lower than the base-line power cost rate built into electric rates. This
16 imbalance represents approximately plus or minus [REDACTED] of annual earnings per
17 share risk.

18 That level of power cost variability alone would total approximately [REDACTED] % of
19 PSE's earnings per share forecast for 2008 of \$ [REDACTED]. This is a high level of
20 earnings volatility for a fully regulated utility and the above average risk is noted

1 and highlighted by the industry analysts in their assessment of the Company's
2 financial profile.

3 In a January 8, 2007, report, Power Insights/Soleil Equity Research emphasized
4 the Company's power cost volatility as follows:

5 We note that in the PCA there is potential upside for PSD shareholders,
6 because in good hydro years the mechanism would likely work in their
7 favor. The problem is that there have been many more bad hydro years
8 than good hydro years in the recent past. The impact of \$20 million in
9 dead band costs is about \$(0.10) per share.

10 Exhibit No. ____(EMM-6) at 3.

11 In a January 8, 2007, report, UBS Investment Research emphasized the
12 Company's power cost volatility as follows:

13 Investors should be aware that PSE is short power and purchases a
14 proportion of its power requirement in the spot market. This exposes the
15 utility to volatile power costs – a grave concern given that PSE does not
16 have a complete fuel pass-through. PSE has a power tracker mechanism in
17 place that shares power costs / savings with customers in a specified
18 manner. It is also important to note that PSE relies on hydro for roughly
19 27% of its total power requirement. While hydro is a cheap fuel source, it
20 comes with a high degree of volatility since it is highly dependent on the
21 weather and, more specifically, on the stream flow. This introduces fuel
22 cost volatility that forces PSE to purchase electricity in the spot market in
23 the event the company faces a low hydro year.

24 Exhibit No. ____(EMM-7) at 2.

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26 ////

1 **3. Inability to Actually Earn the Authorized ROE**

2 **Q. Has the financial community raised any issues with respect to the Company's**
3 **actual ROE in recent years?**

4 A. Yes, investors have expressed a concern regarding the Company's inability to
5 actually earn the ROEs that have been allowed by this Commission. Viewed
6 from an investor's perspective, PSE's actual ROE has consistently and
7 significantly trailed its authorized ROE.

8 The challenge to earn the allowed ROE has been noted by research analysts who
9 follow the Company's parent, Puget Energy, Inc. ("Puget Energy"). A
10 December 14, 2005, report from KeyBanc Capital Markets initiating coverage on
11 Puget Energy discussed the Company's inability to earn its authorized return as
12 follows:

13 While the Company benefits from strong demographics with solid
14 customer growth in an attractive region of the country, this proves
15 to be a double-edged sword. The regulatory framework in
16 Washington State precludes [the Company] from realizing the
17 benefit of this growth on a timely basis. Because the state does not
18 use forward-looking test years in rate cases, the utility faces a
19 headwind recovering capital and cost increases between rate cases.
20 This puts the Company in a position of being extremely challenged
21 to earn its authorized return. It also necessitates the frequent filing
22 of rate cases with accompanying regulatory uncertainty.

23 Exhibit No. ____ (EMM-8) at 1. KeyBanc Capital Markets continued to express
24 such concerns in a January 8, 2007, report on Puget Energy:

25 Traditional regulatory math suggests earnings power of \$1.63 per

1 share. However, the regulatory lag stemming from a level of
2 capex greater than depreciation and inflationary pressures should
3 preclude this level of earnings.

4 Exhibit No. ____(EMM-9) at 1.

5 JP Morgan has also emphasized the Company's inability to earn its authorized
6 rate of return. An October 27, 2005, report by JP Morgan stated:

7 We are maintaining our neutral rating as Puget Energy appears to
8 continue to struggle with regulatory lag and other factors that are
9 preventing its core utility EPS power from emerging.

10 Exhibit No. ____(EMM-10) at 4. This concern was repeated in a January
11 8, 2007, report by JP Morgan:

12 If Puget experiences additional under-earning pressure or is unable to add
13 its planned utility investment to rate base, we would expect EPS, and thus
14 the share price, to come under pressure.

15 Exhibit No. ____(EMM-11) at 3-4.

16 PSE's inability to earn its allowed ROE is particularly troubling to the financial
17 community in light of the Company's large infrastructure-related capital
18 investment requirements over the next several years. Investors appreciate that
19 electric generation resources and energy delivery systems are generally ultimately
20 approved and their costs included in rates via a general rate case or PCORC
21 process. However, the fact remains that regulatory lag in a growing company
22 limits its ability to earn its authorized return. As discussed by Dr. Morin, without
23 an adjustment for the risk associated with regulatory lag the Company will be

1 considered a less favorable investment than its peers.

2 **E. Benefits of Enhanced Creditworthiness**

3 **Q. Are there benefits to increasing the Company's credit rating?**

4 A. Yes. Besides the obvious benefit of being able to finance with lower interest
5 costs (with savings accruing to the benefit of customers over the long-term), a
6 credit upgrade sends positive signals to the potential providers of debt and
7 counterparty credit. With a stronger credit rating, the Company would be better
8 positioned to weather a credit market or industry downturn with less risk of a
9 downgrade to non investment grade (junk) status. Moreover, a stronger credit
10 rating may well expand and make more competitive the number of potential risk
11 management and power purchase counterparties available to our portfolio
12 managers.

13 **Q. Are there key components of the Company's requests that would help
14 improve the credit rating?**

15 A. Yes, many components of the Company's requests would support the Company's
16 existing corporate credit rating and support the Company's effort to improve its
17 credit rating. In August 2007, Moody's issued a report titled "Storm Clouds
18 Gathering on the Horizon for the North American Electric Utility Sector". The
19 following excerpts offer some observations from the perspective of a rating
20 agency:

1 The storm clouds referenced in this report essentially point to a potential
2 increase in the business and operating risk profile for the sector. In our
3 opinion, the rising costs and investment needs will have a direct impact on
4 all three financial statements: income, cash flow and balance sheet. As a
5 result, one of the biggest challenges for utility companies will be to seek
6 and receive timely recovery of prudently incurred expenses. In addition,
7 the substantial increases in capital expenditures will have a material
8 impact on the sector's ability to generate free cash flow. While Moody's
9 recognizes that the utility sector usually operates in a negative free cash
10 flow environment, a concern could be raised if the level of negative free
11 cash flow became large enough, or if regulatory lag was long enough, that
12 the leverage were to increase materially.

13 Exhibit No. ____(EMM-12) at 3.

14 In general, Moody's believes that the North American regulated utility sector is
15 facing a long-term period of rising operating costs, which include fuel and
16 purchased power, operating and maintenance costs, and general and
17 administrative expenses. The ability to recover these rising costs on a timely
18 basis through rate relief has increasingly become a significant determinant to
19 credit quality and highlights the importance for utility management teams to
20 maintain constructive relationships with state regulatory authorities and provide
21 reliable service to end-use customers.

22 The stable rating outlook for the sector is largely premised on our belief
23 that these costs will be recovered on a reasonably timely basis. However,
24 for those companies that are incurring large, multi-year deferral balances,
25 Moody's may begin to incorporate a higher risk profile, which would
26 create pressure to maintain a stronger balance sheet and cash flow
27 coverage metrics. The size of these potential balances should become
28 more clear over the next 18 to 24 months.

29 Exhibit No. ____(EMM-12) at 6. The themes highlighted in the Moody's report
30 support the substance of my testimony:

- 1 ▪ it is critical to have the reasonable opportunity to earn the allowed
2 ROE;
- 3 ▪ during a period of significant capital investment, it is essential to
4 have timely cost recovery to reduce regulatory lag; and
- 5 ▪ earnings volatility must be kept at reasonable levels to assure
6 consistent operating performance and stable financial metrics.

7 **Q. To what level is the Company seeking to increase its credit rating?**

8 A. In consideration of the enormous amount of capital the Company must raise in the
9 decade ahead, it may be that an “A” level corporate credit rating is ultimately an
10 appropriate goal for the Company, as described in Dr. Morin’s testimony.
11 However, given that the Company’s corporate credit rating is currently so far
12 below that level, the more realistic short-term goal continues to be “BBB+”. The
13 rate relief requested in this case, if approved, will strongly support the Company’s
14 continued effort to strengthen its financial position so that it can move closer to
15 reaching a BBB+ credit rating, which is particularly important in light of the
16 significant capital plans for the next six years.

17 **F. The Need for a Higher ROE**

18 **Q. Will a higher ROE benefit the Company’s financial stability?**

19 A. Yes. As discussed in Dr. Morin’s testimony, investors require a return
20 commensurate with the assumed risk of the investment. For PSE, Dr. Morin
21 recommends an ROE in the range of 10.8% to 11.2% as being just and
22 reasonable. As discussed above, the Company’s financial profile includes

1 significant earnings risk due to the relative size of its capital investment program,
2 power cost volatility, regulatory lag and its present corporate credit rating. An
3 authorized ROE at the higher end of the recommended range would provide the
4 Company with better financial stability for these risks and place it in a stronger
5 financial position to access the financial markets on reasonable terms throughout
6 economic and credit cycles.

7 **Q. If a higher authorized ROE is important to insure access to the financial
8 markets, why is the Company only asking to increase the authorized ROE to
9 10.8%, the bottom end of Dr. Morin's suggested range?**

10 A. The 10.8% is at the bottom end of Dr. Morin's recommended range, and an
11 authorized ROE at the top of his recommended range would certainly move the
12 Company more quickly to greater financial strength as it embarks on a \$ █
13 billion capital investment plan over the next 6 years. Mr. Gaines has testified
14 that, in light of the Company's below-industry average 45% equity ratio, an 11%
15 return on equity would make the Company's weighted equity return on par with
16 other gas and electric utilities (Exhibit No. ____(DEG-1T), pages 25-26). The
17 Company, however, is very mindful of the customer impact from the requested
18 rate increases driven by higher operating costs, higher power costs and the
19 recovery of the 2006 storm damage. To balance the interest between customer
20 rate increases and the Company's need for a just and reasonable ROE, the
21 Company is only asking to increase its authorized ROE to the low end of Dr.
22 Morin's recommended range of 10.8%.

1 As noted in the prefiled direct testimony of Mr. Gaines, Exhibit No. ____(DEG-
2 1T), such authorized ROE of 10.8%, if granted, would still leave the Company's
3 requested weighted cost of equity (4.86%) well below the average weighted cost
4 of equity (4.95%) granted recently by commissions across the nation. These are
5 the firms with whom the Company must compete for capital in the equity
6 markets. In conclusion, the capital structure and cost of equity requested in this
7 case is supportive of the Company's financial needs and is entirely consistent the
8 weighted average cost of equity determined by the marketplace of regulatory
9 commissions.

10

11 **IV. REPORT ON THE PCORC COLLABORATIVE AND**
12 **PROPOSAL FOR RULEMAKING ON FORWARD-LOOKING**
13 **TEST YEARS**

14 **Q. Has the Company prepared a report of the results of the PCORC**
15 **Collaborative that was directed to be undertaken in the final order of the**
16 **2007 PCORC proceeding?**

17 A. No, not yet. The PCORC Collaborative concluded its deliberation without the
18 parties reaching agreement on proposed revisions to the PCORC mechanism. A
19 joint, all-party report is expected to be filed with the Commission in early 2008.

20 **Q. Is the PCORC still necessary?**

21 A. Yes. As discussed in more detail in the testimony of Ms. Harris, the PCA
22 mechanism, with its defined PCORC process, remains an essential means to
timely recover the incremental cost of the Company's power portfolio arising

from new resource additions and changes to its extensive portfolio of power contracts and market purchases. In the decade ahead, this portfolio will, as described in the Company's May 2007 Integrated Resource Plan, undergo significant change in both cost and structure. These changes will need to be timely reflected in rates. Absent the PCA mechanism, or a similarly effective rate making device, the regulatory lag I described earlier in my testimony will simply worsen, exacerbating already existing financial pressures.

Q. Are there other tools that would help address the persistent problem of severe regulatory lag?

A. Yes, I believe it is appropriate for the Commission to initiate consideration of a forward-looking test year in rate cases, as is used in many other states. A forward-looking test year could provide a better match between the costs the Company incurs to provide service to its customers and the rates paid by customers. It might also simplify the entire ratemaking process, reduce the frequency of rate cases and other regulatory filings, and thus reduce the extent of time and resources interested parties must devote to such filings.

Q. Does the Company have a proposal in this regard?

A. Yes. The Company recommends and requests that the Commission initiate a rulemaking to consider adoption of a forward-looking test year for regulated utilities in the state. Since a forward-looking test year would be a departure from the Commission's current preference for a historical test year (other than for

1 projected rate year power costs), the Company has not incorporated a forward-
2 looking test year into its requested rate increase in this case.

3 **V. IMPROVED RATE DESIGN FOR BETTER RECOVERY OF**
4 **FIXED COSTS**

5 **Q. Are there any aspects of the Company's rate design proposal that deserve**
6 **particular mention at the policy level?**

7 A. Yes. In order to provide increased bill stability, more equitable rates, and better
8 recovery of the fixed costs of serving electric and gas customers, the Company is
9 proposing a larger than proportional increase in the basic charge for residential
10 electric and gas customers (with a corresponding decrease in the kWh and per
11 therm charges). In order to move demand charges for non-residential customers
12 closer to their cost of service, the Company is also proposing a larger than
13 proportional increase to these charges.

14 **Q. Would you please elaborate on the reasons why the Company is proposing**
15 **these increases?**

16 A. The residential basic charge is a charge applied to each customer each month that
17 does not vary by season or weather. The charge is meant to recover fixed costs
18 associated with providing service to a customer. These costs do not vary by the
19 amount of energy that a customer receives, the maximum amount of capacity the
20 Company must reserve for that customer (through its generation or gas supply
21 capabilities and/or its transmission/distribution capabilities), or the month service

1 is taken. Please see the prefilled direct testimony of Mr. David W. Hoff, Exhibit
2 No. ____ (DWH-1T), for a full discussion of this important issue.

3 **Q. Has the Commission recently considered the issues related to the level at**
4 **which basic charges are set?**

5 A. Yes, this Commission made progress toward setting a cost based basic charge for
6 gas in the Company's 2006 general rate case. The Company believes that another
7 meaningful step toward cost based service should be taken in this case, for both
8 electric and gas customers.

9 **VI. CATASTROPHIC STORM COSTS**

10 **Q. What is the Company proposing with respect to catastrophic storm costs?**

11 A. The ability to defer catastrophic storm costs over an extended period of time is an
12 important mechanism for the Company and its customers. This deferral
13 mechanism benefits customers because it levels the recovery of costs for
14 catastrophic storms—like the Hanukkah Eve Storm—over a longer period of
15 time. The Company is requesting a continuation of the catastrophic storm
16 deferral mechanism that was approved in the Company's 2004 general rate case,
17 but with a revision in the manner in which the dollar threshold for deferral is
18 calculated. Please see the prefilled direct testimonies of Mr. John H. Story,
19 Exhibit No. ____ (JHS-1CT) and Mr. Greg J. Zeller, Exhibit No. ____ (GJZ-1T), for
20 additional details regarding the Company's proposal and the importance of this

1 deferral mechanism for costs caused by catastrophic storms.

2 **Q. Is the Company requesting any other revisions to the catastrophic storm**
3 **deferral procedure in this case?**

4 A. Yes. The total repairs for the Hanukkah Eve storm in December 2006 cost more
5 than \$90 million. The deferrable O&M costs for this event totaled over \$83
6 million. To lessen the impact of these storm costs on customers, the Company
7 requests that these storm expenses be amortized over six years, rather than the
8 three-year amortization period approved by the Commission in the 2004 general
9 rate case.

10 **VII. PLANT DEPRECIATION STUDY RESULTS**

11 **Q. Please describe the results of the recently completed plant depreciation study**
12 **that was prepared for the Company.**

13 A. The Company's previous depreciation study was based on plant in service as of
14 December 31, 2000. In this proceeding, the Company is presenting a current
15 depreciation study based on plant in service as of December 31, 2006. The
16 depreciation study is presented in the testimony of Mr. C. Richard Clarke, Exhibit
17 No. ____(CRC-1T).

18 As explained by Mr. John H. Story, in his prefiled testimony, Exhibit
19 No ____(JHS-1CT), the overall increase in electric depreciation expense is
20 approximately \$8.1 million, of which about \$4.9 million is associated with change

in computer equipment service life, which had been up to 28 years. As explained by Mr. Karl R. Karzmar, in his prefilled testimony, Exhibit No. ____(KRK-1T), the overall increase in gas depreciation expense is approximately \$13.7 million, of which (i) \$8.1 million is associated with change in depreciation rates for gas services; and (ii) \$4.2 million is associated with computer equipment.

VIII. EXECUTIVE COMPENSATION

Q. Please discuss PSE's approach to executive compensation.

8 A. As discussed in the prefilled direct testimony of Mr. Thomas M. Hunt, Exhibit
9 No. ____ (TMH-1T), the Company compensates its executives competitively, using
10 a market comparison group of similarly sized utility companies, and following a
11 pay-for-performance philosophy for executives. Only those portions of executive
12 compensation related to utility operation and management are paid by customers.
13 Shareholders pay for the Long Term Incentive Plan, a market based pay program
14 that makes up a significant portion of executive compensation.

15 Q. Do you believe it is appropriate for customers to pay for the portion of
16 executive compensation that is requested for recovery in rates in this
17 proceeding?

18 A. Yes. While the Company understands that the level of compensation paid to its
19 executives raises questions for the Commission and some customers, we believe it
20 is fair for our customers to pay the portion of executive compensation that is
21 included in the recovery of costs requested in this case. As described by Mr.

Hunt, the Company's research indicates that it is paying a reasonable level of compensation given the competition to attract and retain executive personnel for utilities such as PSE.

In addition, the efforts of PSE's executives are focused first and foremost on the operational, financial, and other managerial efforts required to provide high quality service to the Company's customers, not shareholder return. My earlier testimony regarding 2008 budgets, earnings and regulatory lag is testament to such focus. Customers benefit from strong leadership that promotes customer service, recruits and retains a capable workforce to provide reliable and efficient operations, and works effectively with the community.

IX. LOW INCOME ASSISTANCE PROGRAMS

Q. Is the Company proposing to increase bill assistance funding to low income customers to help offset the impact of its proposed rate increases in this case?

A. Yes. The Company is proposing an increase in funding available to support the ability of its low income customers to pay their electric and natural gas bills by increasing the annual level by the percent rate increase for both the electric and gas residential classes as approved by the Commission in this proceeding.

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Q. Is the Company proposing any additional increase in bill assistance funding to low income gas customers to help offset the impact of its proposed increases in the residential basic charges?

- A. The Company is proposing an additional increase in funding available to support the ability of its low income gas customers to pay their natural gas bills in order to mitigate potential impacts resulting from the proposed increase in the basic charge. Specifically, if the Company's natural gas rate design proposal is adopted, the Company proposes that the annual cap of \$3.536 million under natural gas Schedule 129, the natural gas Low Income Program, be adjusted to reflect the rate design changes. The specific change to the cap will be based upon an analysis of the typical bill impact on low income customers associated with the Commission's approval of an increased basic charge and the corresponding reduction in the per therm charge. This increase would be in addition to the percentage increase related to the uniform percentage increase I described earlier.

Q. Is the Company making a similar proposal with respect to low income electric customers?

A. No. According to the Company's most recent data, the impact on low income customers that would result from an increase in the basic charges is expected to differ between gas and electric. Low income electric customers should tend to benefit from PSE's proposal because our data indicates they tend to use more electricity per household than the general population. Thus low income electric

customers should benefit from the relatively lower kWh charge that is being proposed in conjunction with the increase in the electric basic charge. However, the data indicates the opposite is true for low income gas customers. As a result, PSE's request for an increase in the annual cap for low income assistance is limited to the gas program.

X. THE MACQUARIE CONSORTIUM MERGER

Q. Please describe briefly the impetus for the recently announced merger transaction with the Macquarie Consortium.

9 A. As described earlier in my testimony, the Company has a very large need for
10 equity and debt capital in the decade ahead. This capital need is exceptionally
11 large relative to the size of the Company. Finding capital partners that understand
12 our business risk profile and the regulatory framework of Washington State and
13 that will reliably provide capital on reasonable terms over a sustained period of
14 time has been a persistent challenge. The Macquarie Consortium provides a
15 source of patient, knowledgeable capital committed to long-term infrastructure
16 investing.

17 Q. Does the requested increase in revenue in this case include any recovery of
18 the share price premium that the Macquarie Consortium has proposed to
19 pay shareholders of Puget Energy, Inc. or any related transaction costs of the
20 Macquarie Consortium or the Company?

21 A. No. No costs related to the proposed transaction with the Macquarie Consortium

1 are part of the revenue increase being requested in this case.

2 **XI. OVERVIEW OF OTHER COMPANY WITNESSES**

3 **Q. Would you please describe briefly the topics presented by PSE's other
4 witnesses in this case?**

5 A. The following additional witnesses present direct testimonies on PSE's behalf:

6 **Ms. Susan McLain**, the Company's Senior Vice President
7 Operations, discusses the Company's work to control costs related
8 to its electric and natural gas systems while providing high quality
9 service and reliability. She also describes the cost increases the
10 Company is facing to replace and maintain its aging infrastructure
11 and to expand that infrastructure to serve new customers.

12 **Mr. Greg Zeller**, Director of Electric Operations, describes the
13 damage that was caused by storms in 2006 and 2007, the related
14 costs, and the status of implementation of the KEMA
15 recommendations.

16 **Ms. Kimberly J. Harris**, Executive Vice President and Chief
17 Resource Officer, presents an overview of the Company's electric
18 and gas supply portfolios. She describes the magnitude of the
19 Company's need to acquire new electric resources for its
20 customers as well as some challenges the Company is facing in

1 making such acquisitions. Ms. Harris then presents an executive
2 summary of the acquisitions for the electric portfolio for which the
3 Company is seeking the Commission's approval in this case.

4 Finally, she provides an update regarding some of the Company's
5 current and former hydroelectric projects.

6 **Mr. Roger Garratt**, Director of Resource Acquisition, describes
7 in greater detail than Ms. Harris's executive summary the
8 evaluation and due diligence that the Company undertook prior to
9 acquiring the new and replacement electric resources that are
10 presented for the Commission's approval in this case. Mr. Garratt
11 also provides an update on the status of the Wild Horse Wind
12 Project as well as the outage at PSE's new Goldendale Generating
13 Station.

14 **Mr. W. James Elsea**, Financial Analysis Manager of Energy
15 Resources, describes the modeling tools and quantitative analyses
16 that were utilized by the Company to evaluate the various electric
17 resource alternatives presented for cost recovery in this case.

18 **Mr. Michael L. Jones**, Manager, Colstrip Project Operations &
19 Fuels for PSE, describes a new ten-year coal supply agreement
20 entered into by the Colstrip Project owners for the Colstrip Steam

1 Electric Station. Mr. Jones also explains the scheduling of major
2 plant maintenance overhauls for the project.

3 **Mr. David E. Mills**, Director, Energy Supply & Planning,
4 describes the structures and policies the Company has in place to
5 manage the risks and volatility in its electric and natural gas
6 portfolios and the manner in which such policies are implemented.
7 He also describes PSE's activities with respect to Renewable
8 Energy Credits and Carbon Financial Instruments. Finally,
9 Mr. Mills presents the Company's projection of power costs for
10 this case and compares them to those the Commission approved in
11 the 2007 PCORC.

12 **Mr. Donald E. Gaines**, Vice President Finance and Treasurer,
13 describes the Company's requested capital structure and overall
14 rate of return.

15 **Dr. Roger Morin**, Emeritus Professor of Finance at the Robinson
16 College of Business, Georgia State University, Professor of
17 Finance for Regulated Industry at the Center for the Study of
18 Regulated Industry at Georgia State University, and principal in
19 Utility Research International, presents his appraisal of the just,
20 fair, reasonable and sufficient rate of return on the Company's
21 combined gas and electric utility operations, with particular

1 emphasis on the fair return on the Company's common equity
2 capital committed to that business.

3 **Mr. C. Richard Clarke**, Director of Western U.S. Services for the
4 Valuation and Rate Division of Gannett Fleming, Inc., presents the
5 results of a new depreciation study that he prepared for PSE.

6 **Mr. John H. Story**, Director of Cost and Regulation, presents the
7 electric results of operations and revenue requirement, as well as
8 the allocation of common expenditures between electric and
9 natural gas. Mr. Story also presents PSE's update on the PCORC
10 Collaborative that the Commission directed the parties to convene
11 in its 2007 PCORC order.

12 **Mr. Karl Karzmar**, Director of Regulatory Relations, presents the
13 gas results of operations and revenue requirement. He also
14 discusses proposed changes: (i) in the manner in which the
15 Company recovers its costs associated with the Everett Delta
16 Pipeline Expansion, and (ii) in PSE's electric and gas working
17 capital calculation.

18 **Mr. David W. Hoff**, Manager, Pricing & Cost of Service, presents
19 the Company's electric rate spread and rate design proposals.
20 Mr. Hoff also explains why the Company is proposing larger than
21 proportional increases to the basic charges for residential electric

1 and gas customers and to the demand charges for non-residential
2 customers.

3 **Ms. Janet K. Phelps**, Regulatory Consultant in Pricing & Cost of
4 Service for the Company, presents PSE's pro forma revenue from
5 gas operations, gas cost of service study, proposed rate spread and
6 rate design for gas service, and revised gas tariff schedules.

7 **Mr. Thomas (Tom) M. Hunt**, Director Compensation and
8 Benefits, describes PSE's compensation and benefits programs and
9 how they are competitive and benefit the Company's customers.

10 **XII. CONCLUSION**

11 **Q. Please summarize your testimony.**

12 A. The Company must make significant capital investments over the next several
13 years in its gas and electric system infrastructure and in new electric generation
14 resources to continue to implement PSE's commitment to reliable service for a
15 growing customer base. As the Company's Chief Financial and Regulatory
16 Officer, it is my responsibility to formulate means and methods to enable the
17 Company to realize its authorized earnings potential and improve its
18 creditworthiness in order to raise the capital in external financial markets at the
19 lowest cost to customers that will be required for such utility investments. The

1 rate relief requested by the Company in this proceeding fairly balances the needs
2 of the business and its customers.

3 The requested relief does not address the persistent and structural problems
4 inherent with the use of a largely historic test year to set rates for a company
5 whose capital investments and growth in related operations and maintenance are
6 rapidly increasing. However, the increase in the Company's current authorized
7 ROE to 10.8%, the low end of the range supported by the testimony of Dr. Morin,
8 on the Company's proposed capital structure of 45%, would support a modest
9 increase in retained cash flow and an improved credit profile, and thereby support
10 the Company's efforts on behalf of its customers.

11 Likewise, the approval of the new resources presented by Ms. Harris and others,
12 the revised electric and natural gas rate design, deferral of catastrophic storm
13 costs and revised depreciation schedules requested by the Company in this case
14 will result in fair and reasonable rates for customers while helping provide better
15 recovery of the costs of providing electric and gas service to PSE's customers.

16 **Q. Does that conclude your prepared direct testimony?**

17 A. Yes, it does.