EXHIBIT NO. ___(DEG-1CT)
DOCKET NO. UE-04____/UG-04____
2004 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-04____** **Docket No. UG-04____**

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

REDACTED VERSION

APRIL 5, 2004

1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY OF DONALD E. GAINES**

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1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY OF DONALD E. GAINES**

3 **I. INTRODUCTION**

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

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

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

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

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

13 A. I have overall responsibility for raising capital in the financial markets. I am also
14 responsible for maintaining relations with credit rating agencies, financial
15 analysts as well as commercial and investment banks. In addition, I oversee the
16 Company's budgeting activities.

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

18 A. The purpose and primary conclusions of my testimony are summarized as
19 follows: (i) to describe the capital structure and rate of return the Company is

1 requesting; (ii) to describe the steps the Company has taken, and will take, to
2 improve its financial strength; and (iii) to provide the details on the cost of capital
3 calculations.

4 ## II. CAPITAL STRUCTURE AND RETURN ON EQUITY

5 **Q. What capital structure and overall rate of return are the Company**
6 **requesting in this proceeding?**

7 A. The Company is requesting a capital structure comprised of 45% common equity
8 with an 11.75% return on equity, resulting in an overall rate of return of 9.12%, as
9 can be seen in the Table 1 below:

10 **TABLE 1**
11 **CAPITAL STRUCTURE AND**
12 **OVERALL RETURN ON EQUITY**

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Debt	48.65%	6.76%	3.29%
Trust Preferred	6.31%	8.60%	0.54%
Preferred Stock	0.04%	8.51%	0.00%
Common Equity	45.00%	11.75%	5.29%
Overall Rate Of Return			**9.12%**

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

15 A Selecting the appropriate capital structure involves a balancing of risk and cost.

1 In Puget Sound Power & Light Company's 1992 general rate case, the
2 Commission referred to this balance of economy and safety. The Commission
3 said:

4 The Commission determines an appropriate balance of debt and
5 equity within the capital structure on the bases of economy and
6 safety. Because the composite cost of debt is generally less than
7 that of equity, overall capital costs can be expected to decrease as a
8 greater portion of the capital structure is composed of debt. The
9 economy of lower capital cost must be balanced against the safety
10 of the capital structure.

11 The concept of "safety" refers to the fact that the company has no
12 legal obligation to pay a return to the holders of common stock. In
13 dire financial circumstances, a company can reduce or suspend the
14 payment of dividends to the owners of common stock without the
15 legal consequences that would flow from a failure to pay interest
16 on debt. In return, holders of common equity generally demand a
17 greater return than do lenders who have a claim on the company's
18 earnings.

19 *Puget Sound Power & Light Company*, Docket No. UE-921262 (1993).

20 As the Commission observed, a capital structure with a high equity component
21 does not take advantage of lower cost tax-deductible debt, resulting in relatively
22 high capital costs to customers. Incorporating too much debt leverage into the
23 capital structure adds risk, and as the Commission observed, this can result in dire
24 financial consequences.

25 **Q. How has the Commission struck this balance in the past?**

26 A. In its 1992 general rate case, Puget Sound Power & Light Co. was authorized a
27 capital structure of 45% equity. This was done in the context of the Company

1 operating under a periodic rate adjustment mechanism ("PRAM"). Similarly, in
2 its 1992 general rate case, Washington Natural Gas was authorized a capital
3 structure of 44% equity and operated with a Purchased Gas Adjustment ("PGA")
4 mechanism. In its approval of the settlement of PSE's last general rate case in
5 2002, the Commission approved an imputed capital structure of 40% equity with
6 a requirement that the Company attain a 39% ratio by December 2005.

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

8 A. As of December 31, 2003, the Company's capital structure was as follows:

9 **TABLE 2**
10 **ACTUAL CAPITAL STRUCTURE AS OF DECEMBER 31, 2003[1]**

Capital Component	Percentage
Debt	52.8%
Trust Preferred	7.3%
Preferred Stock	0.0%
Common Equity	40.0%
Total Capitalization	**100.0%**

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

13 A. Although the current capital structure is an improvement over the Company's

[1] As filed with the Securities and Exchange Commission in the Company's 10-K for calendar year 2003.

1 position in the last general rate case, it does not adequately balance the competing
2 interest of safety and economy. The Company's present capital structure and
3 coverage ratios result in a corporate credit rating of "BBB-". As of December 31,
4 2003, the Company's debt-to-total capital ratio, including the imputed debt related
5 to purchase power agreements, was 57.3%, which is outside the S&P benchmark
6 range of 57.0% to 49.5% for a "BBB" credit rating. With the Company's
7 requested capital structure, its debt-to-total capital ratio, including the imputed
8 debt related to purchase power agreements, would be 52.8%, which is near the
9 midpoint of the S&P benchmark range for "BBB". This would likely support a
10 corporate credit rating of "BBB" or "BBB+". Were the Commission to grant the
11 Company's request, the combination of the equity ratio and ROE included in its
12 filing would likely result in ratios that support the reasonable "BBB+" credit
13 rating.

14 To the extent the Company meets its resource needs through purchased power
15 contracts rather than (or in addition to) asset acquisitions, the Company will need
16 additional equity to offset imputed debt related to purchased power contracts.
17 *See* Exhibit No. ___(DEG-3). The need for additional equity to offset this
18 imputed debt is true for any rating category (e.g., it would take more equity on the
19 books to offset the imputed debt and attain the desired "BBB+" corporate credit
20 rating), as described in Section IV below.

21 As Mr. Bert Valdman testifies, Exhibit No. ___(BAV-1T), the Company needs to
22 have a 45% equity ratio to (i) have the appropriate balance of safety and

1 economy; (ii) offset the imputed deb
2 arrangements; (iii) enable the Company's resource acquisition program and
3 energy hedging strategies; and (iv) provide services to customers on reasonable
4 terms.

5 **Q. Does the Company plan to achieve the requested capital structure █**
6 **████████████████████████?**

7 A. Yes. PSE will achieve this capital structure as a result of debt maturities and
8 retirements, retained earnings, additional equity issued to meet the requirements
9 of the dividend reinvestment plan, and through sales of common stock.

10 **Q. How does the capital structure the Company is requesting compare to the**
11 **capital structures approved in general rate proceeding across the country?**

12 A. Exhibit No. ___(DEG-4) contains summaries of rate orders since January 1, 2003.
13 The average equity ratio approved for ratemaking purposes was 49.8%. This is
14 nearly 500 basis points higher than the 45% equity ratio requested by the
15 Company in this proceeding.

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

17 A. Yes. PSE is an integrated gas and electric utility. The Company is not run with
18 separate electric and gas divisions. The capital acquired to finance the Company
19 is not split between gas and electric operations. The use of proceeds from such
20 financing is not tied to any one type of energy. As a result, a single capital
21 structure is appropriate.

1 **III. THE COMPANY'S CREDIT RATINGS**

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

3 A. Rating agencies are independent agencies that assess the risks for investors. The
4 two most widely recognized rating agencies are Standard & Poor's (S&P) and
5 Moody's Investors Service (Moody's). These rating agencies assign a credit
6 rating to companies and their securities so investors can more easily understand
7 the risks associated with investing in their debt and preferred stock.

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

9 A. The Company's corporate credit ratings are "BBB-", as rated by S&P, and "Baa3",
10 as rated by Moody's. Mr. Bert Valdman provides a summary of all of the
11 Company's credit ratings in his testimony.

12 **Q. Please describe the methodologies used by ratings agencies in determining**
13 **the Company's credit ratings.**

14 A. The methodologies used to assign such credit ratings are discussed in detail in
15 Standard & Poor's 2003 Rating Methodology, which I have included as
16 Exhibit No.___(DEG-5).

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

18 A. Credit ratings are important to customers because they are an overall
19 representation of a company's financial health. As a result, they are a major factor
20 in determining the cost of capital to the Company and its customers. A low credit

1 rating reflects increased risks for investors, which, in turn, requires a higher cost
2 of capital, which increases the cost of service to customers.

3 Customers benefit when the appropriate risk profile, found by managing business
4 risk with the appropriate degree of debt leverage, supports a credit rating that
5 allows the Company to access capital at a reasonable cost. Because credit ratings
6 take into consideration these risk elements and have such a dramatic impact on
7 the cost of capital, they are of importance to customers.

8 **Q. Do PSE's current credit ratings provide an appropriate balance of economy**
9 **and safety?**

10 A. No. A Corporate Credit Rating of "BBB-" is only one step away from
11 noninvestment grade status (sometimes called "junk status"). The Company's
12 capital structure contains too much leverage, especially in light of the amount of
13 imputed debt the rating agencies add to total debt, as reflected in Section IV
14 below.

15 **Q. Is the stability of the Company's credit rating also important?**

16 A. Yes. A strong credit rating should be maintained over time as the Company
17 requires continuous access to capital markets. When a company faces financial
18 difficulties that threaten its credit rating, typically the capital markets will react
19 negatively before the credit rating agencies downgrade the credit rating.
20 However, if a company subsequently takes steps to improve its financial position
21 and its credit rating is upgraded, the market will lag the upgrade – taking longer

1 for the company to benefit from the reduced capital costs associated with a better
2 credit rating. It is by maintaining a solid credit rating, over time, that a company
3 maintains access to capital on reasonable terms.

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

5 A. While some experts suggest that a corporate credit rating of "A" is optimal for
6 utilities,[2] it is the Company's view, at this time, that a "BBB+" corporate credit
7 rating reflects the appropriate balance of cost (economy) and risk (safety) while
8 providing the Company with the financial flexibility needed to access the capital
9 markets on reasonable terms. Mr. Bert Valdman provides a detailed analysis of
10 the need for a "BBB+" corporate credit rating in his testimony. From my
11 perspective, a "BBB+" corporate credit rating is important because "BBB+"
12 (i) provides lower interest spreads; (ii) provides the Company with a reasonable
13 "ratings cushion" above noninvestment grade status; (iii) supports the Company's
14 anticipated resource acquisition program and infrastructure investments; and
15 (iv) facilitates expanded risk management activities.

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[2] See Roger A. Morin, PhD, *Regulatory Finance: Utilities' Cost of Capital* 457-470 (1994), which I have attached as Exhibit No. ___(DEG-6).

1 **A. Provide Cushion From Noninvestment Grade Status**

2 **Q. Why is it important to the Company to be further above noninvestment**
3 **grade status?**

4 It is very important that the Company have some cushion in its credit rating above
5 noninvestment grade status because the Company needs continuous access to
6 capital markets on reasonable terms. There are many risk factors that can cause a
7 downgrade to a company's credit rating. One notch above noninvestment grade
8 provides no flexibility to deal with these factors. These factors include (i) credit
9 market events; (ii) fluctuations in power costs; (iii) regulatory and political
10 events; (iv) changes in tax laws; (v) unanticipated wholesale market
11 developments; and (vi) force majeure events. At noninvestment grade status,
12 spreads are extremely wide and volatile, and market access can be unpredictable
13 and quite constrained.

14 **Q. How does the Company's targeted credit rating compare to noninvestment**
15 **grade status levels?**

16 A. The Company's targeted "BBB+" corporate credit rating is three notches above
17 noninvestment grade status.

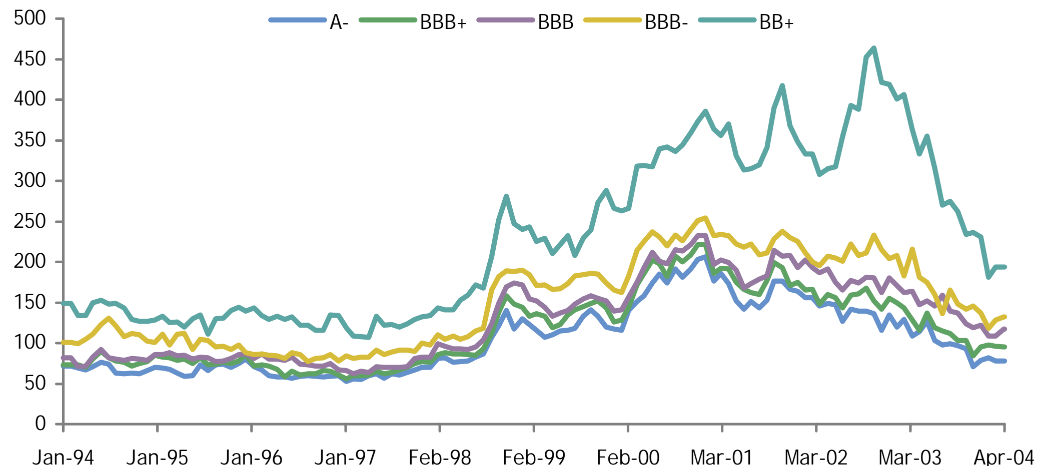
18 **B. Lower Spreads**

19 **Q. How does this targeted credit rating reduce the Company's borrowing costs?**

20 A. A higher credit rating results in lower borrowing costs. The credit spread for

1 noninvestment grade status is much larger than "BBB+" and can vary
2 substantially over time. This can be seen in the following chart, which contains
3 historical credit spreads over Treasury securities from January 1994 to April 1,
4 2004.

5 **TABLE 3**
6 **CREDIT SPREAD OVER TREASURY SECURITIES**



7 The volatility in noninvestment grade status, "BB+", is also dramatic. From the
8 chart above, one can see the spread between "A-" and "BBB+" remains fairly
9 constant and narrow. However, the spreads between these ratings and "BB+" is
10 wide and has varied substantially. When these spreads contract or expand is
11 unpredictable. Such wide spreads have a huge impact on borrowing costs.

12 **Q. How would an upgrade to the Company's targeted credit rating affect the**
13 **Company's commercial paper rating?**

14 A. A company's commercial paper rating is based on its corporate credit rating. This
15 relationship can be seen in the graphic in Exhibit No.___(DEG-5), page 83. At

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1 the Company's current corporate credit r

2 rating is "A-3". As can been seen in that

3 "BBB+" would result in a higher commercial paper rating of "A-2". The higher

4 commercial paper rating would reduce the interest rate on the Company's

5 commercial paper borrowings and provide greater access to the commercial paper

6 market, which is the least-cost short-term borrowing source available to the

7 Company.

8 **C. Support Resource Acquisition Program, Infrastructure Investments**

9 **and Risk Management Activities**

10 **Q. How would the Company's targeted credit rating support the Company's**

11 **resource acquisition program and infrastructure investments?**

12 A. As discussed in the testimony of Mr. Eric Markell, Exhibit No. ___(EMM-1CT),

13 the Company is facing significant capital requirements for its resource acquisition

14 strategy ranging from $[redacted] million to $800 million by 2008. The Company

15 needs to access both equity and credit markets to finance these acquisitions. A

16 portion of these costs will be financed with debt. Using the recent credit spread

17 between BBB+ and BB+ of 99 basis points, from the above table, and the

18 Company's requested debt ratio of 48.65%, the annual interest savings to

19 customers resulting from the higher credit rating is approximately $2.2 to

20 $3.9 million per year.

21 The above-referenced benefit to the Company's resource acquisition program

1 holds true to the financing of all infrastructure investment as well.

1 **Q. How would the Company's targeted credit rating support the Company's**
2 **resource risk management activities?**

3 A. As discussed in the testimony of Ms. Julia Ryan, Exhibit No. ___(JMR-1T) the
4 Company's ability to hedge its power costs is constrained, in part, by its current
5 relatively low credit ratings. The amount of open credit available for hedging
6 increases as the Company's credit rating improves.

7 **Q. How does the Company propose to finance the capital and credit needs**
8 **described by Mr. Eric Markell and Ms. Julia Ryan?**

9 A. The Company has developed a financial plan that is projected to grow the equity
10 ratio of the Company to 45% by [REDACTED]. Through a balanced
11 approach in managing its debt portfolio, growth of equity through the sale of
12 stock, and earnings retention, the Company plans on meeting the requirements for
13 a BBB+ corporate credit rating. The ability to recover costs as requested in this
14 filing are part of this plan. Thus, as the Company makes new resource
15 acquisitions and funds its other operations PSE will actively strive to maintain
16 this appropriate balance between debt and equity in our financing decisions. The
17 Company's goal is to manage this balance so that the Company will maintain at
18 least a "BBB+" rating.

1 **IV. EFFECT OF THE COMPANY'S**

2 **REQUESTED RATE RELIEF**

3 **Q. Assuming the Commission grants the rate relief requested in this proceeding,**
4 **would the Company's projected financial results support a "BBB+" credit**
5 **rating?**

6 A. As noted in Exhibit No. ___(DEG-5), credit rating agencies examine a number of
7 qualitative and quantitative factors in determining a credit rating, and there is no
8 formula for combining assessments of these factors to arrive at a specific credit
9 rating. However, I expect that setting rates as requested by the Company in this
10 filing, including the capital structure comprised of 45% equity and 11.75% return
11 on equity, will provide the financial results necessary to support the Company's
12 targeted credit rating.

13 The tables below show the four primary statistics used by Standard & Poor's in
14 evaluating credit ratings. These are: (i) pre-tax interest coverages; (ii) funds from
15 operation ("FFO") interest coverage; (iii) FFO to average debt; and (iv) debt to
16 total capitalization. Exhibit No. ___(DEG-7) page 1 shows Standard & Poor's
17 benchmark ranges for these statistics at various business positions.[3] As shown in
18 the charts below, the Company is currently at or below thresholds for a "BBB-"

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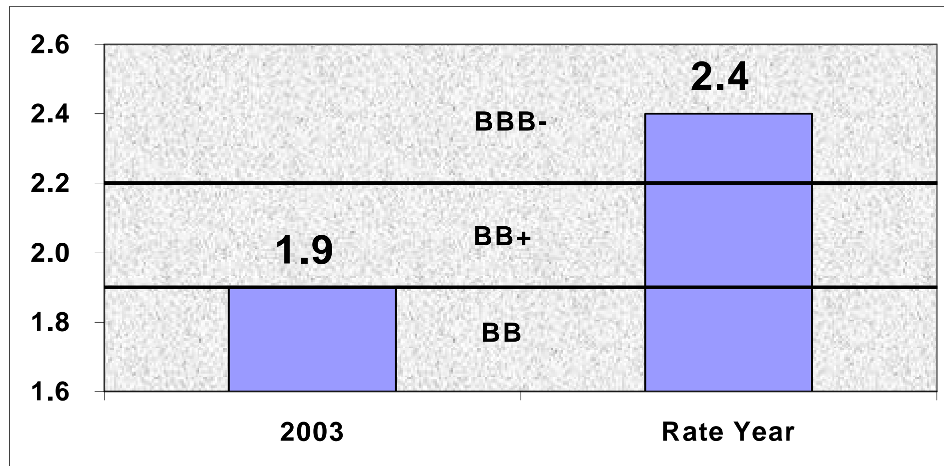
[3] Page 2 of Exhibit ___(DEG-7) is the email from the Company's analyst at Standard and Poor's that transmitted the Financial Targets matrix to me. Although dated 2001, these remain the current Standard and Poor's Financial Targets.

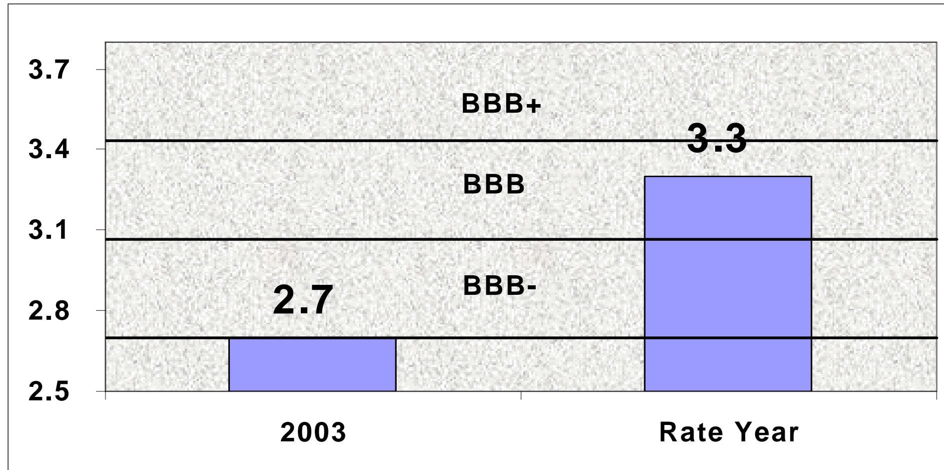
1 rating based on quantitative factors alone demonstrating the importance of
2 qualitative factors to the ratings process. The tables also show that if the
3 Company's request is granted as filed, the first three coverage ratios increase
4 significantly and the debt to total capitalization drops significantly. While we
5 cannot say with certainty what the rating agencies will do, the requested rate relief
6 and resulting improvements in quantitative factors, the ratios, when combined
7 with qualitative factors would provide the Company with a reasonable chance of
8 attaining its targeted "BBB+" credit rating.

9 **TABLE 4**

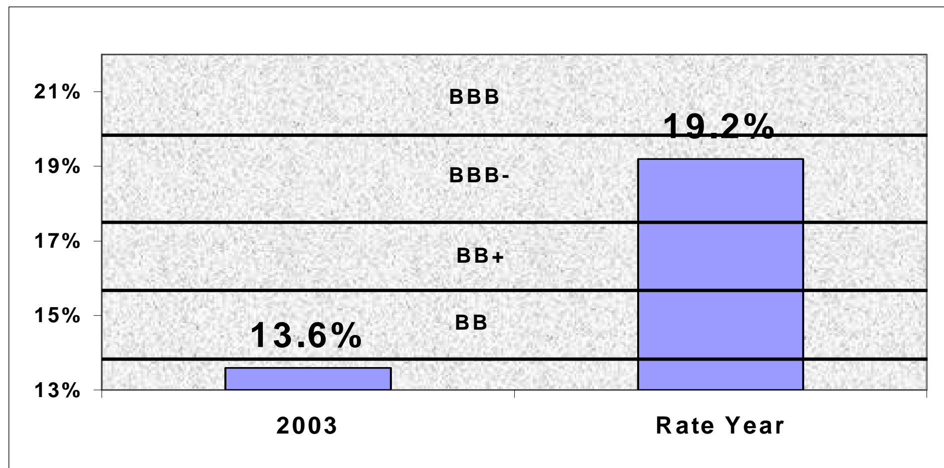


10 **PRE-TAX INTEREST COVERAGE**

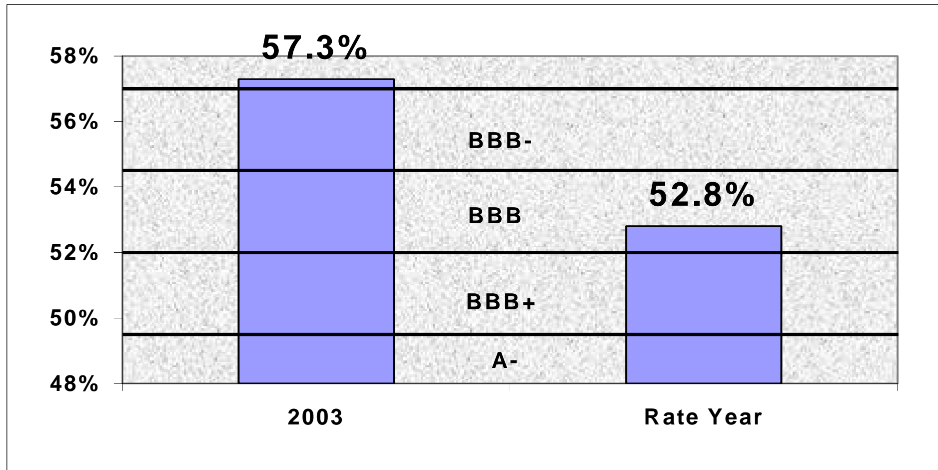
1 **TABLE 5**
2 **FFO INTEREST COVERAGE**



3 **TABLE 6**
4 **FFO TO AVERAGE DEBT**



1 **TABLE 7**
2 **DEBT TO TOTAL CAPITALIZATION**



3 **Q. Can the Company achieve its targeted "BBB+" corporate credit rating**
4 **without rate relief?**

5 A. No. Without sufficient rate relief, the Company's financial results cannot support
6 a "BBB+" corporate credit rating, and the Company may even have difficulty
7 maintaining its "BBB-" credit rating. Table 8 is a simple comparison of one key
8 credit statistic with, and without, the requested rate relief.

1 TABLE 8
2 CREDIT RATING WITH AND
3 WITHOUT RATE RELIEF

Capital Component	Absent Any Rate Relief	With Rate Relief
Weighted Return on Equity	[REDACTED]%	[REDACTED]%
Tax impact	/ 0.65	/ 0.65
Pre-tax Weighted ROE	= [REDACTED]%	= [REDACTED]%
Cost of Debt & Trust Preferred	+ 3.83%	+ 3.83%
Pre-Tax Cost of Capital	= [REDACTED]%	= [REDACTED]%
Cost of Debt & Trust Preferred	/ 3.83%	/ 3.83%
Pre-Tax Interest Coverage (Absent Imputed Debt)	[REDACTED]x	[REDACTED]x
S&P Benchmark for BBB	2.2x – 3.3x	2.2x – 3.3x

4 Without any rate relief, the Company would likely earn a [REDACTED]% return on equity.
5 Without reflecting the requested 45% equity ratio in rates, the Company's equity
6 ratio would likely remain about 40%. Using that return on equity, equity ratio
7 and its anticipated capital costs, this theoretical calculation results in a pre-tax
8 interest coverage ratio of [REDACTED]x. This is below the S&P benchmark range for a
9 credit rating in the "BBB" range and compares to a pre-tax interest coverage ratio
10 of [REDACTED]x, using the Company's requested equity ratio of 45% and return on equity
11 of 11.75%.

12 Additionally, the pre-tax interest coverage ratio of [REDACTED]x presumes the Company
13 can actually achieve an allowed return on equity of 11.75%. As Dr. Cicchetti

1 describes, there are many policies that restrict the Company's ability to achieve its
2 allowed rate of return on equity. In addition, the rating agencies impute
3 approximately $█ million of debt related to PSE's existing long-term
4 purchased power obligations. That amount is expected to be $█ million by the
5 rate year. Including this imputed debt, the above theoretical █x coverage ratio
6 (with rate relief) becomes █x, a drop of about █x. Applying that spread to the
7 theoretical █x coverage ratio (without rate relief), the actual would more likely
8 be █x, a level consistent with a noninvestment grade status, or "BB" credit
9 rating.

10 To the extent the Company adds additional power resources through purchased
11 power contracts, through the resource acquisition program described in Mr. Eric
12 Markell's testimony, it will need to build its equity further to balance the
13 additional imputed debt which the ratings agencies would add as a result of this
14 type of resource acquisition.

15 **V. STEPS TAKEN BY THE COMPANY TO STRENGTHEN**
16 **ITS FINANCIAL CONDITION**

17 **Q. Please describe steps taken by the Company to strengthen its financial**
18 **condition since filing its last general rate proceeding in September 2001.**

19 A. Since the last general rate case, PSE has taken three major steps to build and
20 maintain greater financial strength. It has: (i) reduced the common stock
21 dividend, (ii) reinvested earnings in excess of the dividend, and (iii) sold common

1 stock.

1 My testimony in PSE's prior rate proceeding included a table of the Company's
2 capital structure as of September 30, 2001. That Capital structure is shown below
3 in Table 9, as well as the capital structure at the end of 2003. As Table 9 shows,
4 the Company's equity ratio has increased from 31.7% to 39.2 % over that time
5 period. The table reflects the receivable sold through the Company's accounts
6 receivable securitization program as short-term debt. This 39.2% common equity
7 is well in excess of the benchmark of 34.0% included in the rate settlement. In
8 fact, it is in excess of the final benchmark of 39.0% at December 2005.

9 **TABLE 9**
10 **IMPROVEMENT OF COMPANY'S CAPITAL STRUCTURE SINCE**
11 **ITS LAST GENERAL RATE PROCEEDING**[4]

Capital Component	09/30/01 UE-011570 and UG-011571	12/31/03
Short-term Debt	7.1%	2.8%
Long-term Debt	51.5%	51.0%
Trust Preferred	7.1%	7.0%
Preferred Stock	2.6%	0.0%
Common Equity	31.7%	39.2%
Total Capitalization	100.0%	100.0%

12 To increase the Company's equity ratio, the Company reduced its common stock
13 dividend, reinvested earnings in excess of that dividend, issued common stock to

[4] Includes, in short-term debt, accounts receivables sold under the receivables securitization facility.

1 fund the requirements of the dividend reinvestment plan (DRIP), and completed
2 two significant common stock offerings. In total, the Company has increased its
3 common equity by more than $250 million.

4 In April 2002, the Board of Directors of Puget Energy reduced the dividend rate
5 for common stock for Puget Energy to 25 cents per share ($1.00 annualized rate)
6 from its previous level of 46 cents per share ($1.84 annualized rate). Going
7 forward, that reduction retains approximately $84 million dollars per year, in light
8 of the nearly 100 million common shares outstanding.

9 Between September 30, 2001 and December 31, 2003, the Company reinvested
10 approximately $18 million in excess of its common and preferred stock dividends.
11 Included in that amount is approximately $35 million of stock issued to
12 shareholders who elected to reinvest their dividends.

13 Puget Energy also made two common stock sales and invested all of the proceeds
14 into its utility subsidiary, PSE. In October 2002, Puget Energy sold a block of
15 5 million shares of common stock to J.P. Morgan Securities Inc., as sole
16 underwriter for the offering. Puget Energy invested the net proceeds of
17 approximately $115 million into PSE, which used the proceeds to reduce the
18 utility's debt.

19 In November 2003, Puget Energy sold a block of 4.55 million shares of common
20 stock to funds managed by Franklin Advisers, Inc. Puget Energy invested the net
21 proceeds of about $100 million into PSE, which used the proceeds to redeem

1 $93.75 million of outstanding 7.75% Series Preferred Stock and 7.45% Series II
2 Preferred Stock.

3 In addition to replacing its high cost preferred stock, the Company also de-levered
4 over this time period. Total debt outstanding was reduced by more than
5 $300 million. The Company also reduced the cost of the remaining debt
6 outstanding, as discussed in more detail below.

7 **Q. Have such actions improved the Company's financial strength?**

8 A. Yes, the Company's financial health has improved since the settlement of its last
9 general rate case. The Company met the equity targets established by the
10 Commission two years ahead of schedule. Still, for the reasons described in my
11 testimony, PSE must do more to improve its financial health.

12 **VI. THE COMPANY'S PLAN TO STRENGTHEN ITS**
13 **FINANCIAL CONDITION**

14 **Q. Please describe the Company's plan to strengthen its financial condition.**

15 A. To further rebuild the Company's financial strength, PSE is focused on increasing
16 its equity ratio to 45% by ████. To get to that level, the Company would
17 need to issue approximately ████ of common stock and the Company
18 needs to earn its requested ROE on that equity. Table 10 below shows the
19 Company's projected capital structure at ████.

1 **TABLE 10**
2 **THE COMPANY'S PROJECTED CAPITAL STRUCTURE**
3 [REDACTED][5]

Capital Component	09/30/01	12/31/03	[REDACTED]
Short-term Debt	7.1%	2.8%	[REDACTED]%
Long-term Debt	51.5%	51.0%	[REDACTED]%
Trust Preferred	7.1%	7.0%	[REDACTED]%
Preferred Stock	2.6%	0.0%	[REDACTED]%
Common Equity	31.7%	39.2%	[REDACTED]%
Total Capitalization	100.0%	100.0%	100.0%

4 **Q. What are the Company's plans to achieve the requested capital structure?**

5 A. The Company ended calendar year 2003 with a 40% equity ratio. The Company
6 plans to achieve the requested 45% equity ratio by [REDACTED]. It will
7 do so through a combination of (i) producing and retaining earnings in excess of
8 the dividend; (ii) issuing new shares to fulfill the requirements of the DRIP; and
9 (iii) offering one or more issues of common stock.

10 **VII. CAPITAL COMPONENTS OF THE COMPANY'S REQUEST**

11 **A. The Cost of Debt**

12 **Q. What has the Company done to reduce its debt cost since the last general**
13 **rate proceeding?**

[5] Includes, in short-term debt, accounts receivables sold under the receivables securitization facility.

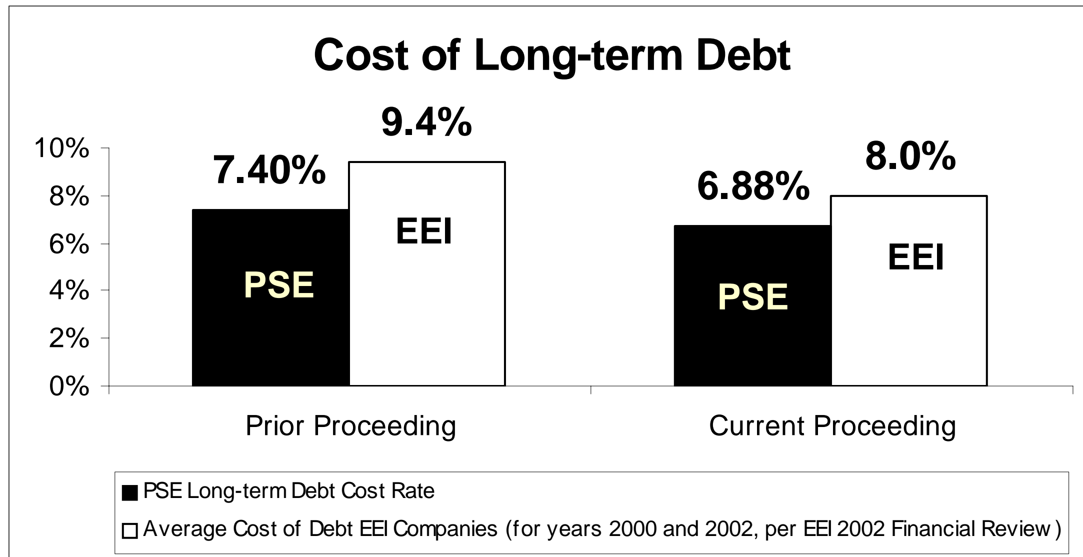
1 A. The Company has taken several steps to reduce its cost of debt. First, when the
2 Company issues long-term debt, it almost exclusively issues debt secured by
3 mortgages on its electric and gas properties. As a gas and electric distribution
4 business, the Company has plenty of property to use as collateral to secure its
5 debt.

6 Because of the collateral backing, secured debt is typically rated one notch higher
7 than unsecured debt and is less expensive than unsecured debt. In the debt capital
8 markets, secured debt can typically be issued with a coupon rate that is 10 to
9 20 basis points less than unsecured debt of similar terms. That savings reduces
10 the cost of debt to PSE's customers.

11 The Company also looks to replace higher cost securities with less expensive debt
12 when it is able to do so. Although very little of the Company's debt is callable,
13 the Company has aggressively refinanced its debt over the past two years as
14 described below. As a result of this and other activities, the Company's cost of
15 debt has declined since the last general rate proceeding. The cost of long-term
16 debt has declined from 7.40% to 6.88%, a total reduction of 52 basis points. That
17 reduction, when applied to the approximately $2 billion of long-term debt that
18 will be outstanding on average during the rate year, represents a reduction in
19 interest expense of approximately $10 million per year. This cost rate is also
20 substantially below that of other utilities.

21 The following chart reflects the cost of debt and how it has changed since the
22 Company's last general rate proceeding.

1 **TABLE 11**
2 **COST OF LONG-TERM DEBT**



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

4 A. The cost of long-term debt was calculated in similar manner to its calculation in
5 prior rate proceedings. To calculate the cost of long-term debt, the yield-to-
6 maturity or cost rate of each debt issue is calculated, using the issue date, maturity
7 date, net proceeds to the Company and coupon rate of that security. Also
8 included in the cost of long-term debt are the amortized costs of reacquired high
9 coupon debt with lower coupon debt. The proportional share that each issue's
10 principal amount represents of the total amount of long-term debt outstanding is
11 then used to weigh these cost rates. These calculations can be found on pages 8
12 and 9 of Exhibit No. ___(DEG-8C).

1 **Q. How did you treat new issues of long-term debt?**

2 A. The Company's financial plan includes two long-term debt issues. These are a
3 $200 million issue in April 2004 and a $100 million issue in September 2005.
4 The $200 million issue in April 2004 is projected to carry a fixed rate of 6.25%
5 with 30-year a bullet maturity. The cost rate after debt issuance expenses is
6 projected to be 6.324%. Proceeds would be used to fund long-term debt
7 maturities from December 2003 through December 2004 and the early redemption
8 of a $55 million callable first mortgage bond. The $100 million issue in
9 September 2005 is projected to carry a fixed rate of 6.25% with 10-year bullet
10 maturity. The cost rate after debt issuance expenses is projected to be 6.387%.
11 Proceeds would be used to fund long-term debt maturities in 2005 and capital
12 expenditures including those to fund a portion of the expected resource additions
13 described by Mr. Eric Markell.

14 **Q. Are there any issues of long-term debt that will mature or retire between**
15 **December 31, 2003, and the end of the rate year?**

16 A. Between January 1, 2004 and February 28, 2006, $129.5 million of the
17 Company's long-term debt will mature. In addition, the Company plans to
18 [REDACTED]
19 [REDACTED]. This is
20 the only issue of long-term debt that is callable through the end of the rate year.
21 After which, the only remaining callable issues are the pollution control bonds,
22 callable beginning in March 2013 and the trust preferred, callable in part

1 beginning June 2006. The costs of the issues that mature during the rate year
2 have been included in the calculation of the cost of long-term debt for only those
3 months during which the bonds will be outstanding.

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

5 A. The embedded cost of long-term debt is 6.88% as shown on line 40, page 8 of
6 Exhibit No. ___(DEG-8C).

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

8 A. The Company's current short-term credit facilities are primarily used to provide
9 necessary working capital to fund utility operational requirements and the
10 expected variability of such requirements. The Company has two credit facilities;
11 a $150 million accounts receivable securitization program and a $250 million
12 unsecured revolving credit agreement with several banks, the latter of which
13 expires in June 2004 The Company is presently in the process of renewing this
14 agreement and hopes to increase the size of the facility at that time.

15 **Q. Are the $400 million in credit facilities sufficient to meet the Company's**
16 **needs?**

17 A. The existing credit facilities have been sufficient to meet the Company's working
18 capital needs, but have not been sufficient to cover the additional credit
19 requirements associated with the risk management activities described in Ms.
20 Julia Ryan's testimony. The $250 million unsecured revolving credit agreement is
21 primarily used to back-up the Company's commercial paper borrowings but also

1 contains the ability to issue up to $50 million in letters of credit. These can be
2 used for any purpose; however, using the facility for letters of credit reduces,
3 dollar for dollar, the amount of money that can be borrowed, or the amount of
4 commercial paper than can be issued, under the facility. In addition, letters of
5 credit, like borrowing to post collateral, increase the leverage of the Company,
6 putting pressure on credit ratings. As a result, the Company has been reluctant to
7 post collateral for hedging transactions, thereby limiting the Company's risk
8 management activities as discussed in the testimony of Ms. Julia Ryan.

9 The Company's $250 million credit agreement will expire on June 15, 2004.
10 When the Company renews this facility, it hopes to increase the letter of credit
11 limits to meet its growing working capital needs. Notwithstanding the
12 Company's plan to increase the size of its credit facility, even larger credit
13 facilities and letter of credit limits are necessary if the Company were to post
14 collateral to support its risk management activities. The Company's anticipated
15 larger credit facilities will be insufficient to provide support for both working
16 capital and risk management activities.

17 **Q. Why does PSE not want to post collateral?**

18 A. Posting collateral to facilitate risk management activities "squeezes" the credit
19 facilities available to meet working capital needs. If the Company were to
20 commit its credit facilities to facilitate risk management activities, then such
21 facilities would not be available for working capital needs and the variability of
22 such needs. There can be wide swings between the cash amount the Company

1 pays for gas and electricity and what is reflected in rates at the time. While the
2 PGA mechanism allows the Company to true-up such gas costs, the Company
3 must have the cash to cover the deficit in the interim. Similarly, although the $40
4 million PCA Mechanism cap provides some protection to the Company from
5 excess power costs, it is a deferral mechanism that provides for future recovery.
6 In the interim, the Company must use cash or borrow to pay for gas and power
7 purchases when it needs the resources.

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

9 A. To calculate the cost of short-term debt during the rate year, the Company
10 calculates the current spread between its short-term borrowing costs and the
11 London Interbank Offered Rate (LIBOR), then applies that spread to an estimate
12 of LIBOR during the rate year. The expected cost of the Company's committed
13 credit facilities is also included in the cost of short-term debt. This calculation
14 can be seen on pages 3 through 7 of Exhibit No. ___(DEG-8C). The resulting
15 cost of short-term debt is 4.71%, as shown on line 18, page 3 of Exhibit
16 No. ___(DEG-8C).

17 **Q. What is the overall cost of debt as part of your rate of return calculation?**

18 A. The overall cost of debt is 6.76%.

1 **B. The Cost of Trust Preferred**

2 **Q. Please describe trust preferred securities.**

3 A. Trust preferred is a security that contains equity-like characteristics yet the cost is
4 deductible for federal income tax purposes. Historically, on PSE's financial
5 statements, these securities are called "corporation obligated, mandatorily
6 redeemable preferred securities of subsidiary trust holding solely junior
7 subordinated debentures of the corporation." Because that is a rather unwieldy
8 name, the generic title "trust preferred" is often used to describe these securities.
9 As a result of a change in accounting rules, these securities are now included as
10 part of long-term debt.

11 In issuing trust preferred, the Company creates a trust that then issues preferred
12 stock to investors. The trust then lends the proceeds from the sale of the preferred
13 stock to the Company on terms (i.e. maturity, interest rate, etc.) that are identical
14 to the terms of the preferred stock. Typically, these terms include a provision for
15 interest on the loan, and dividends to investors, to be deferred under certain
16 circumstances. Because the Company has borrowed the proceeds from the trust,
17 the Internal Revenue Service allows the interest on the loan to be deductible for
18 federal income tax purposes. Because the interest and dividends are deferrable,
19 and because of the relatively long maturity (i.e. 30 or 40 years), the credit rating
20 agencies consider the securities as having certain equity-like characteristics.

1 **Q. How many trust preferred issues does the Company have outstanding?**

2 A. The Company has two trust preferred issues outstanding. These include a $100
3 million 8.231% series issued June 6, 1997 and maturing on June 1, 2027 and a
4 $200 million 8.40% series issued May 24, 2001 and maturing on June 30, 2041.
5 The Company repurchased, at a discount, $19,750,000 of the $100 million trust
6 preferred issue on February 26, 2003, leaving $80,250,000 of that issue
7 outstanding.

8 **Q. How did you determine the costs of these two issues?**

9 A. The cost rates for these two issues were calculated in the same manner as the cost
10 rates for debt issues. The specific calculations of these costs can be seen on pages
11 10 and 11 of Exhibit No. ___(DEG-8C).

12 **Q. What is the resulting cost of trust preferred?**

13 A. The resulting cost of trust preferred is 8.60%.

14 **Q. How have you included the trust preferred in the capital structure?**

15 A. Being a separate type of security, I have included the trust preferred as a separate
16 line in the capital structure. Although trust preferred contains equity-like
17 characteristics (e.g. deferrable interest and dividends), the cost of these securities
18 is deductible for federal income tax purposes. Showing trust preferred as a
19 separate line item facilitates its proper treatment in the calculation of the revenue
20 requirement.

1 **<u>C. The Cost of Preferred Stock</u>**

2 **Q. Please review the Company's refinancing program with respect to preferred**
3 **stock.**

4 A. Since the last general rate proceeding, the Company has redeemed two of its
5 higher cost preferred stock issues. Specifically, the Company has redeemed the
6 7.75% Series Preferred Stock and the 7.45% Series II Preferred Stock. As a
7 result, there are two remaining series of preferred stock as shown on page 10 of
8 Exhibit No. ___(DEG-8C).

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

10 A. The cost of preferred stock is calculated in the same manner as has been done in
11 prior rate proceedings. The cost is calculated by weighting the cost rate of each
12 issue by the balance outstanding during the rate year. The cost of reacquired
13 preferred stock is also included. Page 11 of Exhibit No. ___(DEG-8C) shows the
14 calculation of the embedded cost of preferred stock. The resulting cost of
15 preferred stock is 8.51%, as shown on page 10, line 8 of Exhibit No. ___(DEG-
16 8C). However, with such a small amount of preferred stock outstanding, the
17 weighted cost of preferred is effectively zero.

18 **<u>D. The Cost of Common Stock</u>**

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

20 A. No, I have not. I have relied upon the analysis provided by Dr. Charles Cicchetti,

1 in his testimony, Exhibit No. ___(CJC-1T).

2 **Q. Do you support his recommended return on equity of 11.75%?**

3 A. Yes, I believe Dr. Cicchetti's proposed return on equity is reasonable.

4 **E. Overall Rate of Return**

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

7 A. The overall requested rate of return for the Company is 9.12%, as shown on
8 Table 1, which applies the cost rate for each capital component to the requested
9 capital structure.

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

12 A. Yes. PSE is an integrated gas and electric company. As such, the capital
13 structure and cost of capital are appropriate for the integrated company. In
14 addition, the 11.75% return on equity recommended by Dr. Cicchetti was based
15 on the Company's stock price without any distinction between gas and electric
16 operations.

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

18 A. Yes, it does.

19 [BA040940.001 / 07771-0089]