EXHIBIT NO. ___(DEG-14T)
DOCKET NOS. UE-111048/UG-111049
2011 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-111048** **Docket No. UG-111049**

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

JANUARY 17, 2012

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF DONALD E. GAINES

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

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

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

Q. Are you the same Donald E. Gaines who filed prefiled direct testimony, on behalf of Puget Sound Energy, Inc. ("PSE")?

A. Yes; I filed prefiled direct testimony, Exhibit No. ___(DEG-1T), and twelve exhibits, Exhibit No. ___(DEG-2) through Exhibit No. ___(DEG-13), on June 13, 2011.

Q. Please summarize the purpose of your rebuttal testimony?

A. This rebuttal testimony responds to the direct testimony of each of Michael P. Gorman, Exhibit No. ___(MPG-1T), witness for the Industrial Companies of Northwest Utilities ("ICNU"), and Kenneth L. Elgin, Exhibit No. ___(KLE-1T), witness for the Staff of the Washington Utilities and Transportation Commission ("WUTC Staff"), with respect to (i) capital structure, (ii) costs of short-term and long-term debt, and (iii) overall rate of return. This rebuttal testimony demonstrates that the Commission should accept the capital structure and rates of return recommended by PSE and reject the capital structures and rates of return proposed by WUTC Staff and Public Counsel.

II. PSE'S CAPITAL STRUCTURE REQUEST AND RATE OF RETURN

Q. What capital structure and rate of return is PSE requesting in this proceeding?

A. PSE's requested overall rate of return in this proceeding is 8.26%, as shown in Table I below and the calculations of which can be found in Exhibit No. ___(DEG-15):

TABLE I

CAPITAL STRUCTURE AND RATE OF RETURN

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	4.0%	2.68%	0.11%
Long-term Debt	48.0%	6.22%	2.99%
Common Equity	48.0%	10.75%	5.16%
Overall Rate of Return	**100%**		**8.26%**

The rate of return contains a 48.0% equity ratio. That ratio is lower than the 49.1% equity ratio upon which this Commission set rates in PacifiCorp's recent proceeding, is consistent with, yet slightly lower than, the 48.5% actual equity ratio that was in place, on average, during the test year, is consistent and slightly lower than the 48.21% average equity ratio used in setting rates of the utility subsidiaries of the group of comparable companies reviewed by Dr. Charles Olson (see Exhibit No. ___(DEG-16)), a group to which Mr. Gorman agrees, and consistent, if slightly lower than, the 48.05% average equity ratio used in setting rates of the utility subsidiaries of Mr. Elgin's group of comparable companies as shown in Exhibit No. ___(DEG-17).

Q. Is the overall rate of return PSE is requesting now lower than it was when you filed your prefiled direct testimony?

A. Yes, it is. It is lower because I have lowered the cost rates for short-term and long-term debt as well as the requested return on equity ("ROE").

Q. Is PSE requesting that rates be set using a hypothetical capital structure in this proceeding?

A. Yes. The capital structure PSE is requesting is hypothetical in that it contains less equity than that which was in place, on average, during the test period. PSE's proposed capital structure also contains more short-term debt than was actually in place, on average, during the test period. The other witnesses in this proceeding also propose hypothetical capital structures. If the Commission decides there is not sufficient evidence to support the use of a hypothetical capital structure in this proceeding, PSE requests that rates be set using the actual test year capital structure shown in my prefiled direct testimony. See Exhibit No. ___(DEG-1T), page 11, Table 2.

III. REVIEW OF MR. GORMAN'S TESTIMONY

Q. Please summarize your review of Mr. Gorman's testimony.

A. Mr. Gorman uses the short-term debt and long-term debt from my prefiled direct testimony. In response to PSE's Data Request No. 005 to ICNU, Mr. Gorman agreed with the revised lower short-term and long-term debt cost rates provided in PSE's First Supplemental Response to WUTC Staff Data Request No. 102; those cost rates are the same as what PSE is requesting now and were also used by Mr. Elgin. See Exhibit No. ___(DEG-18) for a copy of ICNU's Response to PSE Data Request No. 005. Mr. Gorman and PSE also agree that PSE's proposed hypothetical capital structure should contain 4.0% short-term debt.

The areas where Mr. Gorman disagrees with PSE's rate of return request are 1) capital structure and 2) ROE. Mr. Gorman proposes a hypothetical capital structure containing 46% common equity and 50% long-term debt. He also proposes a 9.70% ROE, or 9.50% if the Commission were to accept PSE's proposed Conservation Savings Adjustment Mechanism ("CSA").[1]

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[1] Exh. No. ___(MPG-1T), page 1, lines 18-24.

Q. Do you agree with Mr. Gorman's testimony?

A. No. Mr. Gorman's testimony should not be relied upon because it contains several material errors.

First, Mr. Gorman proposes removing non-regulated subsidiary common equity from PSE's consolidated capital structure when that equity is already removed from PSE's capital structure upon consolidation. The effect of this error is to reduce PSE's common equity twice for non-regulated utility common equity.

Second, Mr. Gorman ignores the Commissions' established practices of recognizing pension and energy hedging costs in rates. By failing to adjust the capital structure for the accounting adjustments for these items, like unrealized gains or losses on derivatives, he materially understates the equity that has been supporting and is expected to continue supporting utility operations.

Third, Mr. Gorman inexplicably proposes a hypothetical capital structure containing 46.0% common equity when his own calculations, though fraught with errors, results in a 46.7% common equity ratio.

Lastly, although Mr. Gorman says he agrees with Dr. Olson's group of proxy utilities, he fails to recognize that the equity ratio reflected in rates of the regulated utility subsidiaries of those holding company proxy companies' averages 48.21% as can be seen in Exhibit No. ___(DEG-16).

Q. Please explain why you believe Mr. Gorman adjusts PSE's capital structure twice for non-regulated common equity.

A. First of all, PSE never financed any of its non-regulated activities, Puget Western, Inc. ("PWI") or Hydro Energy Development Corporation ("HEDC") with the sale of common stock. When real estate became surplus to PSE's utility needs, it was transferred to PWI at its then-current market value. On the stand-alone books of PSE, assuming market value and book value were equal, the accounting entry for that transfer would be to debit "Investment in Subsidiary" and to credit the utilities' "Non-Utility Property" with any gain or loss deferred for refund or recovery to customers. On PWI's stand alone financial statements, the accounting entry would be to record the property as an asset (the debit) and to credit common equity. Upon the consolidation of the utility's balance sheet and PWI's balance sheets, the utility's "Investment in Subsidiary" and PWI's common equity offset one another. The resulting effect is that PWI's common equity is removed from PSE's common equity upon consolidation. The only equity item remaining on PSE's balance sheet is any retained earnings, positive or negative, from PWI's management of the property. Thus, the only adjustment needed to PSE's consolidated capital structure is to remove PWI's retained earnings.

The accounting for HEDC is similar to that of PWI – PSE's investment in HEDC and HEDC's common equity are removed from PSE's balance sheet upon consolidation. To remove it again would be to have removed it twice.

The FERC forms Mr. Gorman cites as his source state at the top of the page that the amounts reflected are for "Investments in Subsidiary Companies", but Mr. Gorman is apparently unaware that the common equity amounts are removed through the consolidation process and that the subsidiary retained earnings are recorded in PSE's common equity section in FERC Account 216.1. The result is, only subsidiary retained earnings remains on the consolidated financial statements of PSE and therefore subsidiary retained earnings need to be removed from the consolidated balance sheet to result in the equity supporting regulated utility operations.

Q. Please describe how Mr. Gorman's failure to adjust PSE's common equity for Other Comprehensive Income ("OCI") pension adjustments and derivative accounting deviates from the Commission's established practices.

A. The Commission's established practice related to pension costs is to reflect cash pension contributions in rates, averaged over a four-year period. This practice does not look at the accounting pension income or expense, it looks only at cash pension contributions. Since neither pension income nor expense is reflected in rates, it is appropriate to remove the balance sheet impact of pension accounting from PSE's common equity for rate making purposes.

The Commission's established practice for the recovery of commodity costs is to reflect in rates the actual commodity costs PSE has, or expects, to incur. These costs are recovered through the PGA and PCA mechanisms, with general rates set to reflect the expected level of electric energy costs in a base rate. Unrealized non-cash gains or losses from marking derivatives to market as required by generally accepted accounting principles are not, and should not, be reflected in rates. As a result, the impact of these non-cash unrealized mark-to-market accounting gains or losses on PSE's capitalization, generally reflected in OCI, must also be removed for rate making purposes. To not adjust for these items, as Mr. Gorman proposes, is to have the balance sheet impact of these items be inconsistent with the cost recovery of these items. Further, applying Mr. Gorman's methodology would result in falsely over-inflated equity in the capital structure in years where the non-cash and unrealized marks of derivatives result in unrealized gains rather than losses. It is appropriate to remove both the unrealized gains and losses from derivative accounting.

Q. Please explain why you describe Mr. Gorman's proposed capital structure as hypothetical.

A. Mr. Gorman calculates PSE's 13-month average capital structure for the test period as containing 46.7% common equity.[2] He then ignores his own calculations and inexplicably proposes that the Commission set rates using a 46% equity ratio described as "the same common equity ratio the Commission previously used to set PSE's rates in the last rate case."[3] By his own admission, this is neither the equity

[2] Exh. No. ___(MPG-1T), page 11, lines 20-23.

[3] Exh. No. ___(MPG-1T), page 12, lines 3-5.

ratio supporting utility operations during the test year nor is it the equity ratio that is expected to be supporting utility operations during the rate year, the first year rates from this proceeding will be in effect. It is therefore a hypothetical capital structure.

Q. Does this Commission have a policy regarding the use of hypothetical capital structures for rate making purposes?

A. Yes, it does. The Commission "has approved hypothetical capital structures when there was a clear and compelling reason to do so."[4] Mr. Gorman provides no compelling reason to deviate from using the test year capital structure in this proceeding. He states that "it reflects the most accurate estimate of PSE's actual capital structure supporting utility operations in the test year, and it is a reasonable capital structure mix."[5] Why this "mix" is the most accurate estimate of PSE's actual capital structure or is more compelling or more "reasonable" than his own calculation of 46.7% is not explained. Even though Mr. Gorman himself seems to support an actual capital structure, he inexplicably ignores the actual capital structure that he calculates, even with its inherent errors that understate equity, and proposes a lower hypothetical capital structure instead for no apparent reason.

Q. Do you agree with Mr. Gorman's assessment of how the credit rating agencies

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[4] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-060266 and UG-060267, Order 08 (January 5, 2007).

would likely respond if the Commission were to grant his proposal?

A. No. Mr. Gorman refers to statements made by Standard and Poor's ("S&P") regarding PSE's credit ratings yet fails to recognize those ratings are based, in part, on the rating agencies having seen PSE projecting a 48% equity ratio in its last two rating agency presentations and the effect on leverage of actual levels of equity recently attained. In calendar years 2009 and 2010, PSE has maintained actual average regulated equity ratios of 50.8% and 48.5% respectively. Mr. Gorman's hypothetical capital structure contains 54% debt (46% equity).

Mr. Gorman ignores S&P's statement that PSE's credit ratings are premised on S&P's expectation that Puget Energy's consolidated debt to capital being no more than 60% (see the "Outlook" section on page 4 of Exhibit No. ___(DEG-13)). This is the Puget Energy consolidated debt level that is consistent with the 48% regulated equity ratio at PSE, as can been seen on page 48 of Attachment A to PSE's Response to WUTC Staff Data Request No. 011, provided as Exhibit No. ___(DEG-19C). A lower regulated equity ratio, would result in a higher debt ratio and Puget Energy's consolidated debt ratio would exceed the 60% S&P states as being their expectation associated with the current credit ratings.

[5] Exh. No. ___(MPG-1T), page 12, lines 8-10.

Q. Do you agree with Mr. Gorman's proposed rate of return?

A. No, I do not. His overall rate of return is calculated using an inappropriate capital structure as I described above, and he uses a lower ROE than what PSE is requesting in this proceeding. Dr. Olson, PSE's cost of equity expert witness, addresses the ROE Mr. Gorman is proposing.

IV. REVIEW OF MR. ELGIN'S TESTIMONY

Q. Please summarize your view of Mr. Elgin's testimony regarding capital structure and overall rate of return.

A. Mr. Elgin agrees with PSE's proposed costs of both short-term and long-term debt and the use of 4.0% short-term debt in the capital structure. Where Mr. Elgin disagrees with PSE's request is in 1) common equity ratio (and therefore long-term debt ratio) and 2) ROE.

Like Mr. Gorman, Mr. Elgin proposes a hypothetical capital structure containing less equity than he determined by his own calculations. Worse, his calculations contain a myriad of errors, are premised upon misinterpretations of the facts, and deviate from established Commission practices. He uses a 9.5% ROE, which Dr. Olson finds inadequate, as stated in his rebuttal testimony, Exhibit No. ___(CEO-10T), and I concur with Dr. Olson's findings. The Commission should reject Mr. Elgin's proposed capital structure and related overall rate of return.

Q. Why do you describe Mr. Elgin's capital structure as hypothetical?

A. Mr. Elgin refers to PSE's actual equity ratio as of one point in time, December 31, 2010, as 46.5% and then recommends 46.0%.

There are many problems with this. First, Mr. Elgin has deviated from the established practice of calculating the capital structure that was in place "on average" during the test year. He starts by saying, "The most appropriate starting point is PSE's actual capital structure for 2010, the most recent fiscal year".[6] Then, in the very next sentence, he chooses a point in time of December 31, 2010, as if it accurately represents the full fiscal year he purports to be explaining. It is not an accurate portrayal of equity supporting utility operations during the test year. As I clearly portrayed in my prefiled testimony, 48.5% is an accurate portrayal of equity supporting utility operations during the test year. Mr. Elgin calculated an "average" equity ratio in PacifiCorp's last proceeding at 46.5% and proposed that equity ratio in that proceeding,[7] yet here in the PSE proceeding he deviates from using an average equity ratio and then inexplicably rounds down to 46.0%. He could just have easily rounded up to 47.0%. There is no explanation of why Mr. Elgin used a different calculation of equity ratio for PacifiCorp and PSE. There is no explanation of why Mr. Elgin thinks a point in time capital structure is better public policy than the capital structure that supported utility operations, on average, during

[6] Exh. No. ___(KLE-1T), page 15, lines 20-22.

the test year. Further, he conveniently ignores the equity injection that was made into PSE in early 2011. This information is readily available to even the most casual observer of PSE's public financial statements and which is reflected in quarterly state commission filings on capital structure. He does not acknowledge that PSE's capital structure contained over 48% equity on an average of the monthly averages calculation during the test year.

In PSE's prior general rate case, Dockets UE-090704/UG-090507, Mr. David C. Parcell was WUTC Staff's cost of capital witness, and his capital structure testimony utilized average equity ratios. WUTC Staff (Mr. Elgin) in this proceeding is changing its methodology while providing no support or reason for doing or why such a change is good public policy.

By ignoring the facts, Mr. Elgin simply appears to disingenuously be grasping at straws in an attempt to hold PSE's equity ratio at the level it was at prior to the injection of equity that came with the merger. It is this and the earlier infusion of equity that led to higher credit ratings and lower financing costs.

Q. Does he provide other support for his hypothetical equity ratio?

A. Yes. He takes another end of period capital structure, as of September 30, 2011, then attempts to adjust it to reflect the senior secured notes PSE issued two months

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[7] *WUTC v. PacifiCorp*, Docket No. UE-100749, Exh. No. KLE-1T, page 15, lines 1-2 and page 16, line 9.

later in November. In this erroneous calculation he begins by understating regulated equity by over $250 million, then exacerbates the miscalculation by conveniently ignoring the "use of proceeds" stated in the new issue prospectuses, which included repayment of short-term debt. As a result, these note issues were simply the replacement of shorter-term debt for long-term debt, done at a time when long-term rates were very favorable. Replacing debt for debt does not increase leverage as Mr. Elgin's adjustment implies. He also ignores the fact that PSE had net income that added to the equity ratio though retained earnings during those same two months. His grossly inadequate calculations ignore both the additional common equity and the lower short-term debt from this time period. Despite Mr. Elgin's portrayal, PSE's actual regulated equity ratio for calendar year 2011 will be, on average, in excess of the 48% requested in this proceeding.

Q. Does Mr. Elgin compare PSE's capital structure to a group of peer companies?

A. Yes, he does. But that comparison is also flawed. His comparison suffers from the same flaws Mr. Gorman made. That is, he looked at holding company capital structures, not the capital structures of the regulated utilities owned by these holding companies. Interestingly, the same AUS reports used by Mr. Elgin to derive the average equity ratios of electric companies also reported for those same companies that show the electric and combination gas and electric utilities averaged regulated ROE's of 10.72% and 10.58%, respectively (see pages 2 and 3 of Mr.

Elgin's workpapers). Those ROE's are much more in line with the 10.75% ROE the Company is requesting in this proceeding than the 9.50% Mr. Elgin proposes.

Q. Why is it inappropriate to examine holding company capital structures as justification for the capital structure of PSE?

A. Holding companies are often financed differently than their regulated utility subsidiaries. Puget Energy, the holding company that owns PSE, has debt that the Commission does not reflect in customer rates. In fact, during the merger proceeding in WUTC Docket No. U-072375, this Commission put forth a set of merger commitments, many of which were designed to keep separate the debt at the holding company from the regulated utility. As a result, it is appropriate here to keep holding company debt out of the rate making process.

Q. Did Mr. Elgin examine the equity ratios of the regulated utilities held by his group of peer holding companies?

A. No. Mr. Elgin states in response to PSE Data Request No. 041 to WUTC that he did not adjust the capital structures of his peer group of holding companies for non-utility operations. I did examine the capital structures of the utilities owned by Mr. Elgin's peer group companies, the results of which can be found in my Exhibit No. ___(DEG-17). As can be seen in Exhibit No. ___(DEG-17), the average equity ratios reflected in the rates of the utility subsidiaries is 48.05%. Even Mr. Elgin's peer companies, on average, have capital structures supported by regulation which are right in line with PSE's 48% equity ratio. Clearly, the capital structures of Mr. Elgin's peer group of holding companies do not provide credible support for the capital structures supporting the utility operations of those companies, and thus it does not provide credible evidence for comparison to PSE's regulated utility capital structure.

Q. Mr. Elgin states his equity ratio is "consistent with PSE's financial projections".[8] Is that correct?

A. No it is not. Mr. Elgin has apparently misinterpreted or misconstrued the information provided. Attachment A to PSE's Response to WUTC Staff Data Request No. 011, of which Mr. Elgin cites as support for this statement, clearly shows PSE is projecting a regulated equity ratio of 47% to 48% as the end point of each year during the five years of projections contained in that response. This can be clearly seen on page 33 of the referenced attachment, on the line labeled "Year-End Equity Ratio (Regulated)". Not shown is the fact that the regulated equity ratio is, on average during the year, 48%, which is consistent with PSE's 48% common equity request, not the 46% that Mr. Elgin claims that PSE is forecasting.

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[8] Exh. No. ___(KLE-1T), page 19, lines 22-23.

Q. Did Mr. Eglin prepare a cost-benefit analysis of his capital structure or any other study to determine if it effectively balanced safety and economy?

A. No, he did not. Although he made no calculations of his own, he did examine the calculations PSE made which showed what was at that time a $33 million present value of savings from the improved credit ratings resulting from PSE's post-merger 48% or higher equity ratio. As discussed below, that savings has since grown to over $40 million due to subsequent debt issuances.[9]

Q. Should the interest savings be adjusted for income taxes, as Mr. Elgin suggests?

A. No. The calculation shows the savings to customers from the higher credit ratings that resulted from PSE's increased equity ratio post-merger. It is a "revenue requirement" calculation, looking at the impact of the interest savings in customers' rates. Debt costs are recovered "dollar-for-dollar" through customer rates. That is, if interest costs are now $1 dollar lower, customer rates would be $1 lower. One dollar out of revenue and one dollar out of expense results in no change in taxable income. Thus, when looking at the impact from an interest savings on the rates customers pay, one must look at that savings on a pre-tax basis. Customer rates are not adjusted for the fact that interest is tax deductible because the revenue provided

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[9] Mr. Elgin did not disagree with the calculation of the significant savings but believes it needs to be adjusted for tax deductibility of interest and commented on the length of time of the embedded cost benefits.

to recover them is also taxed. Customer rates are adjusted for the tax impacts of the return on equity, because equity returns are after tax. But debt costs are not.

As Mr. Story can best describe, Mr. Elgin appears to be confused by what is called the Proforma Interest Calculation. This calculation does provide the tax benefit of interest to customers. This is necessary because interest is a below-the-line cost. The only place that interest shows up in the revenue deficiency calculation is when the rate of return is multiplied times ratebase to determine the net operating income needed to allow a company to earn its return. This net operating income is then adjusted for the test year's adjusted net operating income and grossed up for taxes. If there was not a Proforma Interest Calculation the customer would effectively be charged interest plus taxes and not just pre-tax interest. As a result, my number does not need to be adjusted for taxes as Mr. Elgin suggests.

Q. Does Mr. Elgin testify to other aspects of the interest savings?

A. Yes. Mr. Elgin complains that PSE has compared the cost of the higher equity ratio for one year with the present value savings, which cover many years.

Q. Why did PSE make such a comparison?

A. The $33 million interest savings resulted from long-term fixed rate bonds that PSE had issued to date since its credit ratings were increased. Those savings will remain in place throughout the long duration of the debt regardless of the equity ratio reflected in rates. In fact, customers will receive this benefit regardless of the equity ratio to be set in rates in this proceeding. However, it is reasonable to expect that customers now pay for the equity ratio that resulted in generating the savings already being realized and benefits which will continue well into the future. Going forward, the equity ratio may be higher or lower, but the savings endures through the 30-year lives of those bond issues. We don't know what equity ratio will be set in future proceedings, but regardless, the savings will remain. Because we are only setting the equity ratio at this time, not for 30-years in the future, it is appropriate to compare the cost of the higher equity ratio from this proceeding with the permanent interest savings it generated.

Q. Is the $33 million still accurate?

A. No. As shown in Exhibit No. ___(DEG-20), the correct number is now over $40 million. This exhibit is an update of Exhibit No. ___(DEG-3), which was filed as an exhibit to my prefiled direct testimony. The $33 million was based on the savings that result from the fixed-rate bond issues PSE had made between the time its credit ratings were increased and the date PSE filed its prefiled direct testimony. PSE has issued $295 million more fixed rate bond issues since that time. Reflecting the additional $7 million present value of the pre-tax savings from those issues increases the $33 million to $40.6 million.

Q. Does Mr. Elgin cite any benefits from the increased equity ratio PSE is requesting?

A. Yes. He states that "a more equity rich capital structure provides more financial flexibility, more financial stability and perhaps higher bond ratings."[10] I agree with these findings. Mr. Elgin does not contest these benefits from a higher equity ratio, yet he has not burdened his lower equity ratio for the fact these benefits are absent. He either needs to reflect the value of these benefits or burden his lower equity ratio for the fact that, were his equity ratio to be reflected in this proceeding, those benefits would not exist.

Q. Does Mr. Elgin make any attempt to assess the impact of his proposed capital structure on PSE's credit ratings?

A. Yes. He states that his recommended 46% equity ratio "is sufficient to support the current corporate credit rating of "BBB" and an "A-" secured rating, enabling the Company to access ANY new capital requirements…(emphasis added)".[11] This broad and overly optimistic assertion is not supported but is simply followed up with a statement that most U.S. investor-owned utilities have a BBB rating.

[10] Exh. No. ___(KLE-1T), page 54, lines 2-3 (emphasis added).

[11] Exh. No. ___(KLE-1T), page 54, lines 6-11.

Q. Do you agree with his assessment?

A. No, I do not. First, credit ratings are set prospectively. Rating agencies examine projections and PSE's projections include a 48% equity ratio. Second, Mr. Elgin's capital structure contains 54% debt. S&P has stated in its ratings reports that, for PSE to retain its credit ratings, it expects Puget Energy's consolidated debt, including the impact of off balance sheet debt, not to exceed 60%. As can be seen on page 48 of PSE's response to Commission Staff Data Request No. 011, PSE regulated equity ratio of 48% is consistent with a consolidated Puget Energy debt level of 60%. Mr. Elgin ignores this statement that came directly from the agency that provides the credit ratings Mr. Elgin cites. The fact is, prior to the merger when its equity ratio was around 46%, PSE's credit ratings were lower. PSE's credit ratings are higher now because PSE is capitalized with a higher level of equity. To state that these improved credit ratings would remain if PSE were to revert back to its pre-merger equity capitalization ignores rating agency published statements, disregards recent history and is speculative at best.

Q. Are there any other aspects of Mr. Elgin's testimony upon which you would like to comment?

A. Yes, there are three items. First, Mr. Elgin takes issue with my testimony that the 46% equity ratio that is presently reflected in PSE's rates was the result of a negotiated settlement. Second, he asserts that PSE raises the issue of attrition. Third, Mr. Elgin falsely states Ms. Harris' testimony contradicts mine.

Q. Please explain why you stated that the 46% equity presently reflected in PSE's rates was the result of a negotiated settlement.

A. Although it has no bearing on the revenue requirement in this proceeding, Mr. Elgin takes issue with my testimony that the 46% equity ratio that is presently in rates is the result of a negotiated settlement. Whatever one chooses to call it, I based my statement on two sentences from the Commission's order in PSE's 2009 general rate case. In Order 11 in that proceeding, the Commission stated, "All parties agreed to a capital structure with 46 percent equity prior to the approval of the Puget Holdings transaction and prior to the onset of the financial crisis."[12]

The Commission also stated, "Considering these factors, we determine that the appropriate equity share in the Company's capital structure should remain at the currently allowed 46 percent."[13]

Q. Please address Mr. Elgin's testimony regarding attrition.

A. I can best describe this 15+ page section of his testimony as a wondrous mosaic of confusion and bewilderment. Mr. Elgin's testimony regarding "attrition" seems to have been drafted in response to section IV of my prefiled direct testimony, titled "PSE has been under earning its ROE despite operating efficiently." Mr. Elgin criticizes PSE for not having prepared what he would deem "an attrition study" in

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[12] Dockets UE-090704 and UG-090705, Order 11, ¶282.

[13] Dockets UE-090704 and UG-090705, Order 11, ¶283.

this proceeding. This section of my testimony was never portrayed as an attrition study. It comes from an "ROE Gap Analysis", which was provided to Mr. Elgin in PSE's Response to WUTC Staff Data Request No. 090. That study shows the fact that PSE has historically under-earned its allowed ROE and describes the reasons for that under-earning. Dr. Olson refers to the fact that PSE has historically under earned its allowed ROE as resulting from "attrition". Dr. Olson's prefiled direct testimony, Exhibit No. ___(CEO-1T), uses the term "attrition", which is generally accepted as a term regarding under-earning of returns, exactly twice.

The ROE Gap Analysis and Dr. Olson's reference to PSE's chronic under-earning as resulting from attrition seems to have confused Mr. Elgin into thinking PSE was requesting an attrition adjustment in this proceeding.[14]

One does not need to prepare an analysis fitting Mr. Elgin's description of an attrition study to understand that PSE has been under-earning its allowed rate of return.

[14] Exh. No. ___(KLE-1T), page 80, line 13.

Q. On page 76 of his testimony Mr. Elgin discusses SFAS 133, the impact of non-cash unrealized gains or losses from marking derivatives to market, as being booked above the line in PSE's financial statements. Did the return on equities shown in Chart I of your prefiled direct testimony include SFAS 133?

A. No. The impacts of SFAS 133 were removed from operating income prior to the return on equity being calculated.

Q. Is PSE requesting an attrition adjustment in this proceeding?

A. No. PSE has *not* prepared an attrition study and is *not* requesting an "attrition adjustment" in this proceeding. What my testimony points out is that historically PSE has been unable to earn its authorized return despite its efforts to operate efficiently. As a result, PSE is requesting that when the Commission is presented with a range of capital structures, fair returns, or other regulatory mechanisms, it should consider PSE's under-earning when selecting results within those identified ranges. Clearly, mechanisms like the PIP program and conservation savings adjustment proposed in this proceeding help address PSE's under-earning.

PSE is making that request because, as I stated in my prefiled direct testimony, "earning a reasonable return on equity is a key component of regulated utilities credit ratings."[15] S&P agrees; in its November 7, 2008 report states "the absolute level of financial returns is less important to our analysis than how that return is earned, we recognize that, all else being equal, higher earned returns translate into better credit metrics and a more comfortable equity cushion for bondholders. ***A regulatory approach that allows utilities the opportunity to consistently earn a reasonable return is a positive factor in our view of credit quality*** (emphasis added)."[16]

Q. Mr. Elgin states that Mr. Harris's testimony contradicts your testimony. Do you agree with his assessment?

A. No. On page 75, Mr. Elgin states Ms. Harris' testimony "shows how various factors other than attrition affect actual returns" then goes on to state "This directly contradicts Mr. Gaines's and Dr. Olson's reliance upon actual returns…". The section of Ms. Harris's testimony that Mr. Elgin cites discusses the impact of temperature on PSE's recent results. Later on in her testimony, Ms. Harris lists the main drivers of the rate relief requested in this proceeding as being; 1) New generation resources, 2) Investment in Transmission and Distribution Plant, and 3) Compliance.[17] It is the lag in the cost recovery of these investments that is highlighted in the ROE Gap Analysis as the source of PSE's under-earning. As a result, despite the impacts of weather, Mr. Harris's testimony is consistent with mine.

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[15] Exh. No. ___(DEG-1T), page 24, lines 4-5.

[16] S&P Ratings Direct, "Assessing U.S. Utility Regulatory Environments", November 7, 2008, page 4.

Q. Mr. Elgin finds your use of the words "entitled" and "authorized" with respect to returns "troublesome".[18] Is his characterization of your use of these words accurate?

A. No, it is not. The section of my testimony Mr. Elgin cites as troublesome states "The Company believes it is entitled to recover the costs it prudently incurs as it provides safe and reliable service to customers and to earn a reasonable return on its investments." This is a general statement of the regulatory compact, that utilities are entitled to recover prudently incurred costs and earn a reasonable or fair return on investment. Mr. Elgin states my use of these words suggests that there is some form of guarantee. I think my ROE Gap Analysis shows there is no guarantee and my testimony makes no such statement or inference.

V. RETURN ON EQUITY

Q. Are you responding to Mr. Gorman's or Mr. Elgin's testimony regarding return on equity?

A. No. Dr. Olson is PSE's ROE witness and he will testify regarding the equity return appropriate for this proceeding.

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[17] (*See* Exhibit No. ___(KJH-1T), page 4 line 16 through page 6 line 9).

[18] Exhibit No. ___(KLE-1T), page 77, lines 14-16.

Q. Have you reviewed the range of equity returns Dr. Olson testifies are fair in this proceeding?

A. Yes. In reviewing the testimony of Mr. Gorman regarding appropriate return on equity calculated under the discounted cash flow ("DCF") model, Dr. Olson finds Mr. Gorman's 10.75% ROE reasonable. As a result, I have lowered the ROE PSE is requesting in this proceeding to 10.75% from the 10.80% contained in my prefiled direct testimony. It is noteworthy that the average ROEs of the peer companies used by Mr. Elgin and Mr. Gorman in their ROE analyses (10.40% for Mr. Elgin's peers and 10.48% for Mr. Gorman's peers, as shown in Exhibit Nos. ___(DEG-17) and ___(DEG-16), respectively) are much closer to the 10.75% PSE is requesting than the 9.5% to 9.7% that Mr. Elgin and Mr. Gorman are recommending.

Q. To summarize, what capital structure and rate of return is PSE requesting in this proceeding?

A. PSE's requested overall rate of return in this proceeding is 8.26%, as shown in Table I, below (and earlier in my rebuttal testimony), and shown in Exhibit No. ___(DEG-15):

TABLE I

CAPITAL STRUCTURE AND RATE OF RETURN

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	4.0%	2.68%	0.11%
Long-term Debt	48.0%	6.22%	2.99%
Common Equity	48.0%	10.75%	5.16%
Overall Rate of Return	**100%**		**8.26%**

VI. CONCLUSION

Q. Does that conclude your testimony?

A Yes, it does.