BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Docket Nos. UE-090704 and UG-090705
Puget Sound Energy, Inc.'s
2009 General Rate Case

PUBLIC COUNSEL DATA REQUEST NO. 162

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(Morin Direct, p. 5, l. 4-12)

Regarding a comparison of Dr. Morin's testimony in this proceeding and that offered in Docket Nos. UE-072300 and UG-072301, please respond to the following questions:

a) Why is methodological consistency important in cost of capital analysis?

b) Dr. Morin reports an 11.1% result for his Historical Risk Premium Electric Utility Industry analysis in this proceeding. Is it correct to understand that that analysis is based on utility bond yields, while the "Risk Premium Electric" analysis presented by Dr. Morin in Docket Nos. UE-072300 and UG-072301 was based on U.S. Treasury bonds? If not, please explain why not.

c) Is it true that, if Dr. Morin had based his Historical Risk Premium Electric Utility Industry analysis in this proceeding on U.S. Treasury bonds instead of utility bond yields (as he did in Docket Nos. UE-072300 and UG-072301), his result for that analysis would have been 9.7%? If not, please explain why not.

d) In his testimony in Docket Nos. UE-072300 and UG-072301, Dr. Morin used a risk premium methodology based on the historical difference between the ROEs allowed by regulatory commissions and long-term Treasury bond yields. Is it correct to understand that there is no such analysis in his testimony in this proceeding?

e) Is it true that if the "Allowed Return" risk premium of 5.6% determined in Dr. Morin's analysis in Docket Nos. UE-072300 and UG-072301 were added to Dr. Morin's value for the current long-term T-Bond yield (3.6%), the cost of equity indication would be 9.2%? If not, please explain why not.

f) Is it true that in Docket Nos. UE-072300 and UG-072301 (at page 56 of his Direct Testimony) Dr. Morin averaged the results of his CAPM, Risk Premium and DCF methods, but does not do so in this proceeding? Please explain why.

g) Is it true that averaging the results of each of Dr. Morin's CAPM, Risk Premium and DCF results in the instant proceeding results in an average cost of equity estimate of 10.7%? If not, please explain why not.

Response:

a) Methodological consistency is important for reasons of professional credibility and robustness to varying economic circumstances.

b) It is correct that the historical risk premium electric utility industry analysis results of 11.1% in this proceeding are based on utility bond yields, whereas the risk premium electric analysis presented in WUTC Docket Nos. UE-072300 and UG-072301 was based on U.S. Treasury bonds. As stated in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), a historical risk premium analysis using government bond yields is inappropriate given the current state of the capital markets:

Q. What is currently happening in the debt and equity markets?

A. As discussed earlier, in the past six months, the financial markets, both in the U.S. and abroad, have become extremely volatile, unpredictable, and have displayed unusual behavior. The debt markets have witnessed record high yield spreads (the incremental yield over Treasury rates needed to issue debt) and a more severe differentiation between the spreads charged to companies with different levels of credit. In light of a fundamental structural upward shift in risk aversion as capital markets are re-pricing risk, capital has become, and will continue to be, more expensive for all market participants, including utilities.

Q. Dr. Morin, given the current state of the capital markets at this time, is your historical risk premium analysis using government bond yields appropriate?

A. No, I do not believe it is. Trends in utility cost of capital are directly reflected in their cost of debt and are not directly captured by a risk premium estimate tied to government bond yields. This is especially germane in the current financial crisis where corporate spreads have reached record levels. Because a utility's cost of capital is determined by its business and financial risks, it is

> reasonable to surmise that its cost of equity will track its cost of debt more closely than it will track the government bond yield. To guard against this possibility, I have replicated my historical premium analysis using the utility bond yield instead of the government bond yield.

Exhibit No. ___(RAM-1T) at page 39, line 18, through page 40, line 16.

c) It is true that, if Dr. Morin had based the historical risk premium electric utility industry analysis in this proceeding on U.S. Treasury bonds instead of utility bond yields, the result for such analysis would have been 9.7%. For reasons explained in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), and as quoted above, given the current state of the capital markets, a historical risk premium analysis using government bond yields is no longer appropriate. Trends in utility cost of capital are directly reflected in their cost of debt and are not directly captured by a risk premium estimate tied to government bond yields. This is especially germane in the current financial crisis, where corporate spreads have reached record levels. Because a utility's cost of capital is determined by its business and financial risks, it is reasonable to surmise that its cost of equity will track its cost of debt more closely than it will track the government bond yield. Therefore, in contrast to past testimonies, Dr. Morin no longer performs his historical risk premium analysis using government bond yield, but relies on utility bond yields instead. Please see PSE's Response to Public Counsel Data Request No. 162(b), above.

d) It is true that Dr. Morin used a risk premium methodology based on the historical difference between the returns on equity allowed by regulatory commissions and long-term Treasury bond yields in WUTC Docket Nos. UE-072300 and UG-072301 but does not provide such analysis in this proceeding. To avoid circularity of reasoning and in light of the relative scarcity of regulatory decisions since the commencement of the financial crisis in September 2008, Dr. Morin did not use the allowed return risk premium analysis.

e) It is true that if the allowed return risk premium of 5.6% determined in Dr. Morin's analysis in WUTC Docket Nos. UE-072300 and UG-072301 were added to Dr. Morin's value for the current long-term T-Bond yield (3.6%), the cost of equity indication would be 9.2%. As stated above, however, Dr. Morin did not use the allowed risk premium analysis in this proceeding to avoid circularity of reasoning and in light of the relative scarcity of regulatory decisions since the commencement of the financial crisis in September 2008. Please see PSE's Response to Public Counsel Data Request No. 162(d), above.

f) It is true that, in WUTC Docket Nos. UE-072300 and UG-072301, Dr. Morin averaged the results of his Capital Asset Pricing Model ("CAPM"), Risk Premium

and Discounted Cash Flow ("DCF") methods but did not average the results of his CAPM, Risk Premium and DCF methods in this proceeding. Averaging the results of the CAPM, Risk Premium and DCF methods in this proceeding would not be appropriate, however, because, as stated in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), less weight should be accorded to the CAPM results under present economic circumstances:

Q. How much weight should be accorded to the CAPM results under current market circumstances?

A. The CAPM estimates are not significantly above the cost of new debt capital and likely understate the cost of equity capital under current unsettled capital market conditions. I believe that less weight should be accorded to the CAPM results under present circumstances for two reasons. First, because the betas employed in the CAPM analysis are estimated over five-year historical periods, the impact of the ongoing financial crisis is not yet fully captured in the five-year historical betas. Second, government interest rates have decreased substantially following the Federal Reserve's expansionary policies designed to jumpstart the stalled economy, thus lowering the CAPM results. At the same time, the cost of corporate debt and the cost of equity for utilities have increased significantly, as evidenced by the record high corporate yield spreads discussed earlier in my testimony, and by the DCF results for utilities that have increased significantly by some 150–200 basis points in response to lower stock prices (higher dividend yields) following the financial crisis. The DCF analysis is presented below.

This anomaly between actual market costs and the estimation techniques used in this proceeding puts PSE at significant financing risk. As such, much less weight should be accorded to the CAPM method at present. As I mentioned above, there is a fundamental structural upward shift in risk aversion as capital markets are repricing risk, and capital has become, and will continue to be, more expensive for all non-government market participants over the next 18–24 months at least.

Exhibit No. ___(RAM-1T) at page 37, line 13, through page 38, line 13.

g) It is true that averaging the results of each of the CAPM, Risk Premium and DCF results in the instant proceeding would result in an average cost of equity estimate of 10.7%. As discussed above, however, averaging the results of the CAPM, Risk Premium and DCF methods in this proceeding would not be appropriate because, as stated in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), less weight should be accorded to the CAPM results under present economic circumstances. Please see PSE's Response to Public Counsel Data Request No. 162(f), above.