

**BEFORE THE WASHINGTON STATE  
UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND )  
TRANSPORTATION COMMISSION, ) DOCKETS UE-090704 and  
) UG-090705 (*consolidated*)  
Complainant, )  
v. ) ORDER 11  
) )  
PUGET SOUND ENERGY, INC., ) REJECTING TARIFF SHEETS;  
) AUTHORIZING AND REQUIRING  
Respondent. ) COMPLIANCE FILING  
..... )

*Synopsis: The Commission rejects revised tariff sheets Puget Sound Energy, Inc. (PSE or the Company) filed on May 8, 2009, by which the Company proposed to increase electric rates by 7.4 percent and natural gas rates by 2.2 percent. In lieu of the Company's proposed increases in rates, the Commission authorizes and requires PSE to file tariff sheets that will result in fair, just, reasonable and sufficient increases of approximately 2.8 percent for electric rates and 0.8 percent for natural gas rates. The Commission accepts a number of uncontested pro forma adjustments proposed by PSE and approves and adopts two uncontested settlement agreements that resolve, respectively, issues of electric and natural gas rate spread and rate design. Among several contested issues, the Commission denies the Company's proposed pro forma adjustments that were not demonstrated to be known and measurable and not offset by other factors. The Commission, for example, rejected PSE's proposal to reduce electric load to account for conservation load loss the Company claimed was not accounted for in the 2008 test year. However, the Commission adjusted rates through the application of a "production factor" to account for the reduced load PSE projects for the 2010-2011 rate year, including load loss attributable to conservation. The Commission sets the Company's authorized rate of return, allowing a 10.1 percent return on the 46 percent of PSE's capital structure that represents equity investment, a 6.7 percent cost of long-term debt that represents 50 percent of the Company's capital structure and a 2.5 percent cost of short-term debt that represents the balance of PSE's capital structure. Overall, this results in an 8.10 percent rate of return for the Company. The Commission determines that PSE's acquisition of the Mint Farm combined cycle combustion turbine generation facility was prudent and allows for recovery of the associated costs in rates. In addition, the Commission finds prudent on the basis of uncontested evidence the Company's acquisition of a number of other power assets and finds reasonable the sale of PSE's White River assets.*

the same challenges the Company argued would be addressed by the access to capital provided by the Puget Holdings transaction.<sup>336</sup>

267 Based on the Company's "per books" rate base, the difference between Public Counsel's recommended ROR and the Company's requested ROR is \$42.4 million in annual electric revenue and \$18.0 million in annual natural gas revenue.

### 1. Capital Structure

268 No party proposes to base capital structure for purposes of setting rates on the Company's *actual* test-period capital structure or any other measurement of the Company's actual capitalization. PSE, Staff and Public Counsel each propose a different *hypothetical* capital structure. PSE requests a 48 percent equity ratio. Staff recommends 45 percent and Public Counsel proposes 43 percent for the equity ratio.

269 Mr. Gaines testifies that the Company's capital structure during the test year included 44.67 percent equity, but he states this does not reflect the Company's current capital structure because, among other reasons:<sup>337</sup>

- The completion of the transaction to merge Puget Energy with Puget Holdings on February 6, 2009, included investment of funds into PSE used to repay short-term debt and increase PSE equity capitalization.
- PSE defeased and called for redemption of its outstanding preferred stock on March 13, 2009.
- PSE issued \$250 million of new 6.75 percent 7-year senior secured notes in January 2009.

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<sup>336</sup> *Id.* at ¶ 26 ("Puget and the Investor Consortium argued that the transaction offered it the opportunity to meet its capital expenditure requirements, very large relative to its size, through access to a significant pool of "patient capital," providing PSE a "more reliable method of obtaining needed capital now and in the future on reasonable terms without being subject to the vagaries of quarterly and annual earnings forecasts and short-term market reactions." *In the Matter of the Joint Application of Puget Holdings LLC and Puget Sound Energy*, Docket U-072375, Order 08 (December 30, 2008) at ¶ 142); *Id.* at ¶¶ 27-30.

<sup>337</sup> Exhibit DEG-1T (Gaines) at 10:3-11:17.

**DOCKETS UE-090704 and UG-090705 (consolidated)**  
**ORDER 11**

**PAGE 96**

- 270 Mr. Gaines says that at the end of the first quarter of 2009, PSE's capital structure included 52.9 percent equity. He testifies, however, that this level of equity capitalization fails to represent the capital structure likely to support utility operations during the rate year. He offers several reasons explaining why this is so, including that some of the Company's long-term debt will mature and be refinanced, Puget Energy will make equity investments in PSE, and the level of outstanding short-term debt and retained earnings will vary.<sup>338</sup>
- 271 Instead of using the test year capital structure or the actual capital structure at the completion of the merger transaction, Mr. Gaines recommends capitalization that includes 48 percent equity, 48.05 percent long-term debt, and 3.95 percent short-term debt. He says such a capital structure "will allow PSE to attract debt capital necessary to fund PSE's infrastructure and new resource construction program" and that it "appropriately balances the risks and costs of funding PSE's utility operations."<sup>339</sup> Mr. Gaines testifies that a 48 percent equity ratio is comparable to, but lower than, the 49 percent average for equity ratios approved by regulatory bodies in the United States during 2008 and the first quarter of 2009, and the 3.95 percentage of short-term debt is the mid-point of the 3 to 5 percent range of short-term debt PSE expects to use during the rate year.<sup>340</sup> Finally, Mr. Gaines testifies that Standard & Poor's and Moody's assign stable credit ratings to PSE in the BBB and Baa3 categories, respectively, and that the Company's proposed capital structure will support these ratings.<sup>341</sup>
- 272 Staff presents its capital structure recommendation through Mr. Parcell. He recommends a capital structure containing 45 percent equity based on his review of the Company's actual capital structure for the years 2004 through 2008 and his review of average capital structures allowed by regulatory bodies across the nation for the years 2004 through 2008. Mr. Parcell contends that these data justify an equity ratio of 45 percent because this is "the same capital structure ratio requested by PSE in prior cases" and "is similar to recent actual ratios and is consistent with the capital structures of other utilities."<sup>342</sup> He says that the equity ratio requested by PSE exceeds what was requested by the Company or approved by the Commission in

<sup>338</sup> *Id.* at 11:20-13:1.

<sup>339</sup> *Id.* at 12:2-13:19.

<sup>340</sup> *Id.* at 16:4-13 and 22:16:23:1; Exhibit DEG-4.

<sup>341</sup> *Id.* at 32:2-38:10.

<sup>342</sup> Exhibit DCP-1T (Parcell) at 23:13-26:7.

DOCKETS UE-090704 and UG-090705 (consolidated)  
ORDER 11

PAGE 97

recent proceedings, including the currently approved 46 percent. Staff argues that, in fact, PSE has advocated for a 45 percent equity ratio in its last 5 rate cases despite actual equity ratios that were below 45 percent. Mr. Parcell asserts that PSE's actual capital structure since the conclusion of the merger "reflects decisions made by the new owners of PSE" and "may not be consistent with the Commission's policy to balance safety and economy."<sup>343</sup>

273 Public Counsel presents its capital structure recommendation through Mr. Hill. Mr. Hill states that PSE was able to maintain a BBB corporate credit rating from December 2004 to December 2008 with an actual equity ratio of only 41.71 percent.<sup>344</sup> He testifies that PSE has actually capitalized its operations over the past several years with lower equity ratios than allowed by the Commission for rate-setting.<sup>345</sup>

274 Mr. Hill says that each percentage point of equity ratio in PSE's capital structure used for rate setting costs customers \$4.7 million annually, when income taxes are considered. He also states that the holding company structure in which PSE now resides contains substantially more debt than does PSE and that increases in PSE's equity share and return on equity serve only to service that debt.<sup>346</sup> He claims that third-party debt held by entities in the holding Company structure has increased beyond what was contemplated in the merger proceeding.<sup>347</sup> Considering these factors, he argues it is inappropriate to set rates on a capital structure similar to the regulated utility's capital structure.<sup>348</sup> Indeed, Mr. Hill says that the 46 percent equity ratio agreed to in the settlement of PSE's last rate case was too "equity rich" and that the 43 percent he recommended in that case would be appropriate to use here.<sup>349</sup>

275 Public Counsel argues that it would be inappropriate to provide more cash flow to PSE's corporate owners by now increasing the share of equity in its regulatory capital structure

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<sup>343</sup> *Id.* at 26:10-27:7.

<sup>344</sup> Exhibit SGH-1HCT (Hill) at 8:16-21. We note that this appears to be an error. PSE's corporate credit rating was BBB- during this period. This is still investment grade, but not as high a quality as Mr. Hill indicates.

<sup>345</sup> *Id.* at 8:22-9.

<sup>346</sup> *Id.* at 9:13 – 17:12.

<sup>347</sup> Exhibit SGH-1HCT (Hill) at 13:2-18.

<sup>348</sup> *Id.* at 17:16 – 18:4

<sup>349</sup> *Id.* at 18:7-22.

DOCKETS UE-090704 and UG-090705 (consolidated)  
ORDER 11

PAGE 98

because the average equity ratio in the electric industry is 44 percent, because triple-B rated electric utilities have an average equity ratio of 40 percent, because PSE has not proven any increase in operational risk since the last rate case, and because PSE says it has no concerns about funding its capital budget plans. Public Counsel argues that reducing the Company's equity ratio from 46 to 43 percent is appropriate because this level is actually higher than the average level over the last four years during which Public Counsel contends PSE maintained its financial position.<sup>350</sup>

276 Mr. Gaines contends on rebuttal that the equity ratios in the capital structures advocated by Staff and Public Counsel should be rejected because they are:

- Lower than the equity ratio approved in the Company's last general rate case.
- Lower than the common equity ratio currently employed by PSE.
- Lower than the common equity ratio to be employed, on average, during the rate year.
- Lower than the average common equity ratio recently approved by state regulatory commissions.

He argues that the Commission should reject Staff's use of comparative statistics for equity ratios of other utilities because the ratios Staff used are based on "per-books" figures that include unregulated operations.<sup>351</sup> Mr. Gaines urges the Commission to reject Public Counsel's recommended 43 percent equity ratio because he says it is not supported by any rationale other than that it is the recommendation Public Counsel made in the last rate case.<sup>352</sup> Mr. Gaines objects to the suggestion that the Company's equity ratio should be based on the ratio used over the last few years because, he says, this ignores the Company's and Commission's efforts to strengthen the Company's balance sheet and ignores the equity investments made by Puget Holdings. Taking aim at Staff and Public Counsel, Mr. Gaines contends that both parties' recommendations ignore the financial plans explained and approved as part of the

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<sup>350</sup> Public Counsel Initial Brief at ¶¶ 8-14.

<sup>351</sup> Exhibit DEG-11HCT (Gaines) at 4:8-6:11.

<sup>352</sup> *Id.* at 7:19-23.

DOCKETS UE-090704 and UG-090705 (*consolidated*)  
ORDER 11

PAGE 99

merger transaction.<sup>353</sup> He denies Public Counsel's contention that any entity in the holding company structure issued new third-party debt.<sup>354</sup>

277 Finally, Mr. Gaines contends that the capital structure, cost of equity, and other revenue adjustments proposed by Staff and Public Counsel would cause PSE's credit metrics to fall below Standard & Poor's expectations and would not allow PSE to maintain its current credit rating.<sup>355</sup>

278 *Commission Determination:* The Commission observed in its order setting rates in the Company's most recent fully litigated case that it "has approved hypothetical capital structures when there was a clear and compelling reason to do so."<sup>356</sup> In this case there appear to be two related reasons:

- 1) The Company argues persuasively that the utility's actual capitalization in the test year and early post-test year period was affected by short-term circumstances and is not representative of how it will capitalize its operations in the rate year.
- 2) There is no dispute among the parties that the actual capital structure during the test year or shortly after is not a true measurement of how the Company will, or should capitalize its operations.

Thus, we are left to answer the question of which, if any, of the proposed hypothetical structures should be accepted as appropriate for setting prospective rates.

279 The Commission approved the Company's current cost of capital in the fall of 2008 based on an all-party settlement, which included a capital structure with 46 percent common equity. Two major developments affecting the Company and potentially affecting its cost of capital have occurred since the August 2008 settlement: the completion of the sale of Puget Energy to Puget Holdings, and the financial crisis that severely affected all capital markets beginning with the collapse of Lehman Brothers in September 2008.

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<sup>353</sup> *Id.* at 6:16-7:15 and 8:18 -11:14.

<sup>354</sup> *Id.* at 11:3-20.

<sup>355</sup> *Id.* at 26:18-28-12.

<sup>356</sup> *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-060266 and UG-060267, Order 08 (January 5, 2007).

280 The Commission approved the Company's execution of the Puget Holdings transaction in December 2008. As Mr. Hill observed at hearing, the terms of the rate case settlement proposed in August 2008 were known and accepted by all parties, including the Company's potential new owners, during the Commission's review and ultimate approval of the sale of Puget Energy to Puget Holdings.<sup>357</sup> In its order approving the transaction, the Commission approved a condition that the equity-share in the utility's capital structure would not be allowed to fall below 44 percent, unless the Commission approved a lower level of equity for ratemaking purposes.<sup>358</sup> In addition, the order prohibited PSE from declaring or making any dividend distributions if its equity capitalization dropped below 44 percent, again subject to exception if the Commission approves a lower level of equity for ratemaking purposes.<sup>359</sup> Finally, the Commission directed that determination of the cost of equity in the Company's allowed rate of return in future rate cases "will include selection and use of one or more proxy group(s) of companies engaged in businesses substantially similar to PSE, without limitation related to PSE's ownership structure."<sup>360</sup>

281 Turning to the financial crisis, our record shows that the capital markets suffered significant distortions beginning in early fall 2008 and extending through much of 2009. Among these distortions was a significant increase in the "yield spread" between debt issued by the U.S. Treasury and corporate bonds, including utility bonds. Our record also shows that the capital markets have substantially recovered from the distortions caused by the financial crisis and now again reflect cost characteristics similar to, if not lower than, those extant before the onset of the crisis.

282 Our determination of an appropriate capital structure must therefore consider the following:

- All parties agreed to a capital structure with 46 percent equity prior to approval of the Puget Holdings transaction and prior to the onset of the financial crisis.

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<sup>357</sup> Tr. at 723:5-724:14 (Hill).

<sup>358</sup> *Re Puget Holdings and PSE*, Docket U-072375, Order 8, Appendix A to Stipulation, Commitment 35 (December 30, 2008).

<sup>359</sup> *Id.* Commitment 36.

<sup>360</sup> *Id.* Commitment 24, as clarified by the Commission's Eighth Condition.

- Disruptions in the capital markets have stabilized at levels similar to pre-crisis conditions.

283 Considering these factors, we determine that the appropriate equity share in the Company's capital structure should remain at the currently allowed 46 percent.

## 2. Cost of Long-Term Debt

284 In its original filing, the Company included a 6.82 percent average cost of long-term debt using the yield to maturity, maturity date, net proceeds to PSE, and coupon- rate for each existing debt issue as well as for the incremental contribution to debt cost of issuing three new debt issues to replace six debt issues that will mature before the end of the rate year.<sup>361</sup> In testimony filed September 28, 2009, Mr. Gaines revised the average cost of long-term debt downward to 6.70 percent to reflect the effect of \$350 million Senior Secured Note issued at 5.75 percent on September 11, 2009.<sup>362</sup> This is the long-term debt cost PSE's recommends in its brief.

285 Mr. Parcell testifies for Staff that the Company's proposed 6.70 percent cost for long-term debt includes the cost of two future debt issues to be sold in 2010. He argues these future issues should carry an imputed price equal to the 5.75 percent rate the Company secured for its most recent debt issue in September 2009. Staff contends that the 5.75 percent rate is the most appropriate to impute to the Company's expected rate year debt issuances because that rate is what the Company actually experienced in the capital markets.<sup>363</sup>

286 Public Counsel accepts the Company's cost of long-term debt.

287 PSE argues that the Commission should reject Staff's proposed cost of long-term debt because Mr. Parcell "arbitrarily uses the interest rate on PSE's most recent senior secured note issue."<sup>364</sup> PSE states that this rate is the lowest coupon that PSE has ever

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<sup>361</sup> Exhibit DEG-1T (Gaines) at 24:3 – 26:10.

<sup>362</sup> Exhibit DEG-9T (Gaines) at 12:4-14:11.

<sup>363</sup> Staff Reply Brief at ¶ 15.

<sup>364</sup> PSE Initial Brief at ¶ 65.