

**EXHIBIT NO. ___(EMM-6)
DOCKET NO. UE-07___/UG-07___
2007 PSE GENERAL RATE CASE
WITNESS: ERIC M. MARKELL**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

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

**FIFTH EXHIBIT (NONCONFIDENTIAL) TO THE
PREFILED DIRECT TESTIMONY OF
ERIC M. MARKELL
ON BEHALF OF PUGET SOUND ENERGY, INC.**

DECEMBER 3, 2007

Equity Research
Company Update
Estimates Change
Target Price Change

Puget Energy
PSD, \$24.62, Hold
Rate Order Indicates Only Modest Improvement

January 8, 2007

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Ticker	PSD
Market Cap (M)	\$2,865.8
Price	\$24.62
52-Wk. Range	\$26-\$20
Rating	Hold
Price Target	\$24.50
Shares Out (M)	116.4
Dividend	\$1.00
Yield	4.1%
Trading Volume(M)	0.451
Market	NYSE

Sector Opinion:

The electric utility industry continues its fundamental improvement and expansion, largely by pursuing "back to basics" investment strategies in its core regulated businesses of distribution, transmission, and in some cases generation. We see this expansion, which is largely recession-proof, leading to higher earnings and higher share prices. However, interest rates have a legacy impact on utility shares, and higher rates can dampen their trading. We saw rates spikes in the summer of '03, spring of '04, and again in spring '06, temporarily depress utility prices. However, recent trading had indicated a moderation of the yield on the 10-year Treasury, which currently trades at about the 4.66% level. We continue to focus on those utilities with the strongest projected earnings growth paths and relatively modest valuations. Accordingly, at this time we would focus purchases on two of our Southwestern names under coverage, **PNM Resources** (PNM-\$30.36-Buy) and **UniSource Energy** (UNS-\$36.26-Buy), as well as **WPS Resources** (WPS-\$54.05-Buy) that we recently initiated coverage on.

Action

Hold. PSD's core utility Puget Sound Energy (PSE) finally received its rate order from Washington State regulators last Friday afternoon. Though there was modest improvement in ROE and equity component of capital structure, several mechanisms proposed by PSD to mitigate hydro-related earnings volatility as well as regulatory lag were unfortunately rejected. We lower 4QE two cents from \$0.55/shr to \$0.53 reflecting lost sales during December storm. We also raise our price target from \$23.75/shr to \$24.50 based upon capitalizing our unchanged 2008E of \$1.70/shr at 14.5x rather than 14.0x reflecting improved industry valuations, though still a discount to our average 15.0x industry multiple. Maintain Hold rating on PSD.

	Fiscal Year Dec	Fiscal Year			Calendar Year			Curr. Qtr.	Next Qtr.	Yr. Ago Qtr.
	\$	F05A	F06E	F07E	C05A	C06E	C07E	4Q06E	1Q07E	4Q05A
Revenue	Current	—	—	—	—	—	—	—	—	—
	Previous	—	—	—	—	—	—	—	—	—
EPS	Current	—	1.48	1.61	—	1.48	1.61	0.53	0.74	—
	Previous	1.42	1.52	1.61	1.42	1.52	1.61	0.55	0.74	0.52
Dividend	Current	—	—	—	—	—	—	—	—	—
P/E	Current	NM	16.6	15.3	NM	16.6	15.3	—	—	—

Revenues in millions, except when noted.

- **Rate order – received last Friday.** On Friday, PSD core utility Puget Sound Energy (PSE) received the order in its general rate case filed last February, which sought 11.25% ROE on 45% equity.
- **Good news – improved profitability.** The order adds 10 bps to return to 10.4% ROE (+2¢/shr), and 1% to ROE component of capital structure to 44% (+4¢/shr). These were anticipated, as well as approval of all capital projects. Higher flat-rate customer charges protect an estimated \$20-25 million in revenues from business volatility.
- **Bad news – regulatory lag to continue.** Regulators rejected PSE's proposed gas and electric depreciation tracker. Management has estimated historic test years cost PSE about 100 bps of return per year, and the tracker would have mitigated part of this.
- **More bad news – earnings volatility to continue.** Regulators rejected two PSE-proposed mechanisms that would have reduced earnings volatility, the gas decoupler for both weather and conservation, and a revised PCA.
- **On balance – improvement less than expected.** We had already modeled in some financial improvement and approval of capital projects. However, we also hoped PSE would get at least one of the proposed mechanisms, particularly gas decoupling.
- **4Q storm damage – costs deferred.** Severe, mid-December wind storm that knocked out 2/3s of PSE's 1 million electric customers will have little 4Q impact, as \$7 million annual threshold already hit due to 1Q storms. Lost sales, however, prompts us to lower our 4Q estimate two pennies to \$0.53/shr.
- **Summary and recommendation – Hold.** Rate order as expected on profitability, thus we maintain our 2008E of \$1.70/shr upon which our price target is based. Moreover, we raise that target from \$23.75/shr to \$24.50 based upon capitalizing that estimate at 14.5x rather

than 14.0x, reflecting improved industry valuations (though still a discount to our average 15.0x industry multiple). With PSD close to price target, we maintain our **Hold** rating.

Details

Last Friday, Puget Sound Energy (PSE), the core utility of **Puget Energy (PSD-Hold)** received the final order in its pending general rate case (GRC) with the Washington Utilities & Transportation Commission (WUTC). The order was issued via web-site posting at about 2:00 pm EST, and about an hour later PSD shares weakened, indicating that at least some investors were disappointed in the decision.

So were we. While certain elements were modestly positive, like higher ROE and equity component of capital structure, three important mechanisms proposed by the company to cut attrition and earnings volatility were all rejected by the Commission. As a result, PSE faces continued regulatory earnings lag and earnings volatility with this order.

Financials – modest improvement. On the positive side, from a financial perspective, there were two modest improvements. First, the authorized ROE was boosted 10 bps from 10.3% in the last GRC to 10.4% in this one. This authorized ROE is in line with national averages. Second, equity was raised from 43% to 44% in this rate case, which was PSE's actual equity on 6/30/06. This compares favorably with the national average equity of 43.1% as of 12/31/05 (per EEI data).

There were other positives. Earnings volatility is reduced modestly as flat-rate customer charges were raised. This move protects an estimated \$20-25 million in revenues from business volatility. In addition, all capital projects were approved, including the large Wild Horse wind power project that went into service in late December.

Revenue – increases. As for revenue requirements, last February Puget Sound Energy filed for about \$148.8 million in additional electric revenues and \$51.3 million in gas revenues. In June, about \$95 million of relatively routine energy-related electric revenues were approved, and last Friday \$17.2 million and \$31.3 million of additional electric and gas revenues, respectively, were approved.

Proposed mechanisms – all rejected. On the negative side, the order did nothing to help mitigate the company's chronic problem of earnings attrition off the authorized ROE, better known as "regulatory lag." In addition, it did little to reduce earnings volatility from hydro exposure and other business risks beyond its control. The WUTC rejected PSE's proposals for three mechanisms that would have helped that. We had hoped something might have been approved here---perhaps the conservation decoupler had a chance---but the final order rejected that proposal along with the rest.

Depreciation tracker to mitigate regulatory lag - rejected. This proposal would have allowed the company to collect revenues sufficient to cover depreciation (though without return) as "used and useful" utility investment enters service. For example, PSE put a new \$22 million substation into service in November 2005, less than two months after the end of the 9/30/05 historic test year used in this GRC. A tracker would have generated revenues to cover its depreciation expense. With rejection, that expense will not be covered by revenues until the next GRC decision, perhaps 1-2 years away. The bottom line is an erosion of profitability off

the authorized ROE. Other regulatory jurisdictions try to better match revenues and costs with trackers and forecast test years, but not Washington State, where neither are used.

Gas decoupler – rejected. By proposing this mechanism, PSE tried to de-link its gas revenue requirement from volumetric sales, which would have eliminated earnings volatility from weather variations and customer conservation. Many view decoupling as the elegant solution to the dilemma faced by all utilities---that they have to promote energy conservation on the one hand while needing a certain amount of sales to meet authorized levels of profitability on the other. Regulators rejected this, ironically citing PSE's excellent record in conservation, among other reasons.

Revised PCA mechanism – rejected. In Washington, power costs are not simply passed through to customers, subject to audit, like many other states. In Washington, power costs are projected by use of a baseline (currently about \$56.50/MWH), with actual costs above or below the baseline subject to a complex shareholder/rate payer sharing mechanism call the Power Cost Adjustment, or PCA. In theory, it should work smoothly, with shareholders benefiting in as many years as they get hurt. In practice, chronically bad hydro conditions coupled with high, gas-driven replacement power costs have almost consistently hurt PSD earnings in recent years.

PSE's current mechanism starts with a \$20 million annual deadband in which shareholders bear 100% of the burden, followed by 50% sharing of the next \$20 million, and 10% sharing of the next \$80 million, for \$38 million in annual exposure up to \$120 million. Management's proposal to lower this annual exposure to \$22.0 million was rejected, because regulators though this would transfer too much risk to the rate payer. We note that in the PCA there is potential upside for PSD shareholders, because in good hydro years the mechanism would likely works in their favor. The problem is that there have been many more bad hydro years than good hydro years in the recent past. The impact of \$20 million in deadband costs is about \$(0.10) per share.

Bottom line – the Commission still doesn't get it. The WUTC may think that by adding 10 bps to ROE and one percentage point to equity it is improving the finances of the company in a meaningful way. However, we believe it is missing the point that both equity and fixed-income investors in PSD securities are more concerned about the regulatory lag and volatility that chronically damage the company's earnings stream. In this 2006 rate case management proposed three mechanisms to mitigate these negatives. Regulators rejected all three, including the gas conservation decoupler (three-year pilot program) that was recommended by a commission staff not particularly known for generosity to investors. Despite hopes surrounding the relatively new Chairman Sidran and Commissioner Jones, this order indicates more continuity with the past than a bolder new direction. Accordingly, we shall continue to rate the regulatory climate in Washington State as "Below Average" on a national level.

Housekeeping item - 3Q result. The 3Q came in at \$0.06 per share, two cents below our estimate of \$0.08 per share. These results were largely in line with expectations for this seasonally unimportant quarter.

2006E - down modestly. With 3Q coming in two cents below our estimate, and our 4Q estimate lowered by two cents due to storm-related lost revenue, we lower our 2006 estimate from \$1.52 per share to \$1.48. This does not impact valuation, which is based upon our unchanged \$1.70 per share estimate.

Summary and recommendation – Hold. From a profitability standpoint the rate order was as



expected, enabling us to maintain our 2008E of \$1.70/shr, upon which our price target is based. Moreover, we raise our price target from \$23.75/shr to \$24.50 based upon capitalizing our unchanged 2008E of \$1.70/shr at 14.5x rather than 14.0x reflecting improved industry valuations, though still a discount to our average 15.0x industry multiple. We maintain our Hold rating.

RISKS

- ▶ **Valuation risk.** The shares of Puget Energy trade on projections of future earnings. If these projections fail to materialize as expected, there is price risk in the stock.
- ▶ **Interest rate risk.** Utility stocks are often viewed as yield vehicles. As such, they are susceptible to changes in interest rates, and a rising interest rate environment will put downward pressure on utility shares, including Puget Energy.
- ▶ **Regulatory risk.** We view the Washington Utilities and Transportation Commission as tilted toward consumer interests and away from shareholder interests. Thus, we rate the regulatory environment for utilities operating in Washington State (Puget Sound Energy's sole state jurisdiction) as "Below Average" on a national basis. We believe PSE is more likely to receive adverse regulatory rulings than the average utility.

Appendix I
Puget Energy - Earnings Model and Valuations
(in \$ millions, except per share figures and percentages)

2005A					
Subsidiary	Equity	ROE	tax	Income	Valuation
PSE - electric	\$ 1,176	8.9%		\$ 104.3	Utility earnings (\$ mils) \$ 145.2
PSE - Tenaska disallowance	\$ (4.7)		40.0%	\$ (2.8)	Utility EPS \$ 1.41
PSE - gas	\$ 493	8.9%		\$ 43.8	Assigned multiple 14.0x
Total Utility Income	\$ 1,669			\$ 145.2	Utility value per share \$ 19.72
+ InfrastruX (discontinued)				\$ -	Unregulated earnings (\$ mils) \$ -
Total Unregulated Income				\$ -	Net unregulated earnings (\$ mils) \$ -
Total Operating Income				\$ 145.2	Unregulated value per share \$ -
- Holdco/other				\$ 1.0	Assigned multiple 14.0x
Earnings				\$ 146.2	Unregulated value per share \$ -
Earnings per Share				\$ 1.42	
Avg. Diluted Shs Out (mils)				103.1	Sum-of-the-Parts Valuation \$ 19.72

2006E						
Subsidiary	Rate	%	\$	ROE	Income	Valuation
PSE - electric	\$ 3,046	43.0%	\$ 1,310	9.7%	\$ 127.0	Utility earnings (\$ mils) \$ 167.4
PSE - gas	\$ 1,155	43.0%	\$ 497	9.2%	\$ 45.7	Utility EPS \$ 1.44
PSE - Tenaska disallowance			\$ (8.8)	40.0%	\$ (5.3)	Assigned multiple 14.0x
Total Utility Income	\$ 4,200.7				\$ 167.4	Utility value per share \$ 20.14
+ InfrastruX - sold					\$ -	Unregulated earnings (\$ mils) \$ -
Total Unregulated Income					\$ -	Unregulated EPS \$ -
Total Operating Income					\$ 167.4	Assigned multiple 14.5x
- Holdco/other					\$ 5.0	Unregulated value per share \$ -
Earnings					\$ 172.4	
Earnings per Share					\$ 1.48	Sum-of-the-Parts Valuation \$ 20.14
Avg. Diluted Shs Out (mils)					116.4	

2007E						
Subsidiary	Rate	%	\$	ROE	Income	Valuation
PSE - electric	\$ 3,533	44.0%	\$ 1,555	9.4%	\$ 146.1	Utility earnings (\$ mils) \$ 190.2
PSE - gas	\$ 1,189	44.0%	\$ 523	9.3%	\$ 48.7	Utility EPS \$ 1.61
PSE - Tenaska disallowance			\$ (7.7)	40.0%	\$ (4.6)	Assigned multiple 14.5x
Total Utility Income	\$ 4,722.7				\$ 190.2	Utility value per share \$ 23.37
+ None					\$ -	Unregulated earnings (\$ mils) \$ -
Total Unregulated Income					\$ -	Unregulated EPS \$ -
Total Operating Income					\$ 190.2	Assigned multiple 14.5x
- Holdco/other					\$ -	Unregulated value per share \$ -
Earnings					\$ 190.2	
Earnings per Share					\$ 1.61	Sum-of-the-Parts Valuation \$ 23.37
Avg. Diluted Shs Out (mils)					118.0	

2008E						
Subsidiary	Rate	%	\$	ROE	Income	Valuation
PSE - electric	\$ 4,099	44.0%	\$ 1,803	9.4%	\$ 169.5	Utility earnings (\$ mils) \$ 215.8
PSE - gas	\$ 1,225	44.0%	\$ 539	9.3%	\$ 50.1	Utility EPS \$ 1.70
PSE - Tenaska disallowance			\$ (6.4)	40.0%	\$ (3.8)	Assigned multiple 14.5x
Total Utility Income	\$ 5,323.7				\$ 215.8	Utility value per share \$ 24.64
+ None					\$ -	Unregulated earnings (\$ mils) \$ -
Total Unregulated Income					\$ -	Unregulated EPS \$ -
Total Operating Income					\$ 215.8	Assigned multiple 14.5x
- Holdco/other					\$ -	Unregulated value per share \$ -
Earnings					\$ 215.8	
Earnings per Share					\$ 1.70	Sum-of-the-Parts Valuation \$ 24.64
Avg. Diluted Shs Out (mils)					127.0	

Sources: Management comments, company and regulatory documents, and analyst estimates
Maurice E. May - Power Insights - (508) 636-9934.
Updated - January 8, 2007.



Regulatory Required Disclosures

Analyst Certification

I hereby certify that the views expressed in the foregoing research report accurately reflect my personal views about the subject securities and issuer(s) as of the date of this report. I further certify that no part of my compensation was, is, or will be directly, or indirectly, related to the specific recommendations or views contained in this research report.

By: Maurice E. May

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Rating	Count	Percent	IB Serv/Past 12 Mos.		Rating	Count	Percent	IB Serv/Past 12 Mos.	
			Count	Percent				Count	Percent
BUY[BUY]	148	44.18	0	0	BUY[BUY]	6	54.55	0	0
HOLD[HOLD]	154	45.97	0	0	HOLD[HOLD]	4	36.36	0	0
SELL[SELL]	33	9.85	0	0	SELL[SELL]	1	9.09	0	0



Soleil Securities Rating and Price Target History for: PSD



Ratings Key: B - BUY H - HOLD S - SELL

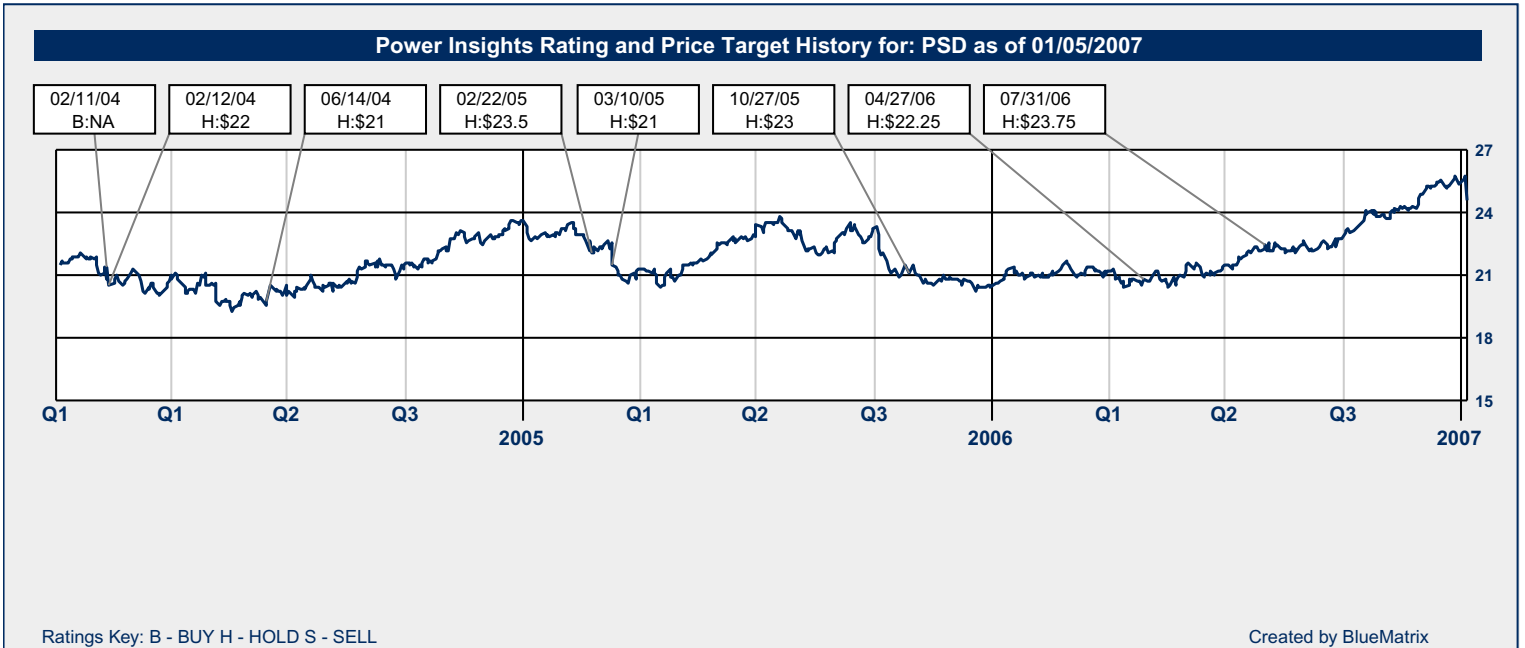
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Companies Mentioned

Puget Energy (PSD, \$24.62, Hold, NYSE)



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