BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

IN THE MATTER OF THE JOINT APPLICATION OF

PUGET HOLDINGS LLC AND
PUGET ENERGY, INC.

FOR AN ORDER AUTHORIZING PROPOSED TRANSACTION

DOCKET NO. U-072375

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1T)

ON BEHALF OF

PUBLIC COUNSEL

JUNE 18, 2008

NON-HIGHLY CONFIDENTIAL VERSION

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EXHIBIT LIST

Exhibit No. ___ SGH-2	Education and Employment History of Stephen G. Hill
Exhibit No. ___ SGH-3	Private Equity Buyouts of Public Utilities: Preparation for Regulators (NRRI, December 2007)
Exhibit No. ___ SGH-4	"Would You Buy A Bridge From This Man?," Fortune, October 2007
Exhibit No. ___ SGH-5	Infrastructure Funds: Managing, Financing and Accounting – In Whose Interests? (RiskMetrics Group, April 2008)
Exhibit No. ___ SGH -6	Post-transaction Corporate Structure (Organizational Chart)
Exhibit No. ___ SGH-7HC	Transaction Financing Chart
Exhibit No. ___ SGH-8HC	Puget Acquisition: Revenue Volatility
Exhibit No. ___ SGH-9HC	Puget Acquisition: Calculation of Debt Capital Based on Macquarie Projections
Exhibit No. ___ SGH-10	Puget Acquisition: Calculation of Debt Capital Based on Macquarie Projections

1 **I. INTRODUCTION / SUMMARY**

2 **Q: Please state your name and business address.**

3 A: My name is Stephen G. Hill, and my business address is P.O. Box 587, Hurricane,
4 West Virginia, 25526 (e-mail: hillassociates@gmail.com).

5 **Q: By whom are you employed and in what capacity?**

6 A: I am self-employed as a financial consultant and am principal of Hill Associates, a
7 consulting firm specializing in financial and economic issues in regulated
8 industries.

9 **Q: On whose behalf are you testifying?**

10 A: I am testifying on behalf of the Public Counsel Section of the Washington
11 Attorney General's Office (Public Counsel).

12 **Q: Please describe your professional qualifications.**

13 A: After graduating with a Bachelor of Science degree in Chemical Engineering
14 from Auburn University in Auburn, Alabama, I was awarded a scholarship to
15 attend Tulane Graduate School of Business Administration at Tulane University
16 in New Orleans, Louisiana. There I received a Master's Degree in Business
17 Administration. More recently, I have been awarded the professional designation,
18 "Certified Rate of Return Analyst" by the Society of Utility and Regulatory
19 Financial Analysts. This designation is based upon education, experience and the
20 successful completion of a comprehensive examination. For the past several
21 years, I have been a member of the Board of Directors of that national
22 organization.

1 I have testified on cost of capital, corporate finance and capital market
2 issues in more than 250 regulatory proceedings in more than 30 regulatory
3 jurisdictions over the past twenty-five years. Recently, the National Regulatory
4 Research Institute (NRRI), the research arm of the National Association of
5 Regulatory Utility Commissioners (NARUC), commissioned me to review private
6 equity participation in utility mergers and acquisitions and to prepare a white
7 paper providing regulators an overview of that process. That paper, entitled
8 "Private Equity Buyouts of Public Utilities: Preparation for Regulators," was
9 published by NRRI in December 2007.
10 A detailed account of my educational background and occupational
11 experience appears in Exhibit No.___ (SGH-2), attached to this testimony, and the
12 NRRI paper regarding private equity buyouts of public utilities is attached as
13 Exhibit No.___ (SGH-3).
14 **Q: Have you testified before this commission?**
15 A: Yes, I have appeared previously before this Commission on behalf of Public
16 Counsel and for the Commission Staff.
17 **Q: Have you prepared exhibits in support of your testimony?**
18 A: Yes, my narrative testimony is presented as Exhibit No. ___ (SGH-1THC).
19 Exhibit Nos. ___ (SGH-2) through Exhibit No.___ SGH-10) contain additional
20 information supporting certain aspects of my narrative testimony in this
21 proceeding. These Exhibits are drawn from published sources, information
22 provided in data responses or, in certain instances, were prepared by me and are
23 correct to the best of my knowledge and belief.

1 **Q: What is the purpose of your testimony in this proceeding?**

2 A: On December 17, 2007 Puget Sound Energy, Inc. (PSE) and Puget Holdings, LLC
3 (PH, together, the Joint Applicants or Applicants), filed a request for this
4 Commission's approval of an October 25, 2007, merger agreement between the
5 two entities. Puget Sound Energy, of course, is the corporate entity directly
6 regulated by this Commission. PSE's current parent company, Puget Energy
7 (PE), is also intimately involved in the proposed transaction. If this Commission
8 grants approval, Puget Energy will be merged into Puget Holdings LLC, with the
9 latter becoming PSE's ultimate parent company.

10 Puget Holdings LLC is a Delaware limited-liability company owned by a
11 consortium of investors led by three Macquarie Group companies, referred to in
12 the Joint Application as the "Investor Consortium."[1] The Macquarie Group is a
13 multi-national banking and investment corporation, headquartered in Australia.

14 I have been asked by the Public Counsel to review the Joint Application
15 and determine if the acquisition of Puget Energy (PE) and its only subsidiary
16 Puget Sound Energy (PSE) by a consortium of private equity investors led by
17 Macquarie is in the public interest.

18 **Q: How is your testimony organized?**

19 A: My testimony is organized into four additional sections. In Section II of my

20

21

[1] Macquarie Infrastructure Partners (31.8% ownership of Puget Holdings LLC), Macquarie Capital Group (15.9%), Macquarie-FSS Infrastructure Trust (3.7%), Canada Pension Plan Investment Board (28.1%), British Columbia Investment Management (14.1%) and Alberta Investment Management (6.3%).

1 testimony, I summarize the manner in which private equity buy-outs of public
2 utilities are structured and show how the proposed acquisition of Puget by
3 Macquarie follows that general structure, which uses debt to partially fund the
4 acquisition and, therefore, is termed a leveraged buy-out or LBO. Also, I discuss
5 the "Macquarie model," its use of debt financing, its complexity and how it is
6 perceived by some in the investment community.

7 Section III of my testimony outlines particular details of the proposed
8 transaction and the financial projections on which the transaction is based. In that
9 Section, I show that the average cash flow margins above the levels at which the
10 new debt lenders will initiate "cash sweep" procedures is very thin, and is likely
11 to be violated if the volatility of Puget's revenue stream is similar to what it has
12 been in the past. Section IV of my testimony discusses the bond rating companies'
13 review and analysis of the proposed transaction as well as private equity deals in
14 general. Finally, in Section V of my testimony I address issues related to the
15 Applicants' "ring fencing" proposals.

16 **Q: Does your review of the testimony and evidence in this proceeding indicate**
17 **that the acquisition of Puget by the investor consortium led by Macquarie is**
18 **in the public interest?**

19 A: No, it does not. An extensive review and analysis of the Joint Applicant's
20 testimony, responses to hundreds of data requests, Puget Energy board minutes
21 related to the acquisition, presentations made by Macquarie to equity and debt
22 investors, long-term financial projections by Puget and Macquarie, opinions of
23 bond rating agencies, and much additional related information, reveals that this

1 transaction in not in the public interest and should be rejected by this
2 Commission.

3 **Q. How do the Joint Applicants define "the public interest"?**

4 A: Although on page 1 of the Joint Applicants' application for Commission approval,
5 they refer to their proposed transaction as being "consistent with the public
6 interest," when asked to define "the public interest," the Applicants objected to
7 defining that term—twice.[2] Instead of providing their own definition, the Joint
8 Applicants reference one prior Commission order on the topic, which does not
9 define the term "public interest", but does indicate that a merger or acquisition
10 should, in satisfying an "initial burden," cause "no harm" to the public interest.[3]

11 However, prior to the case cited by the Applicants, the Commission
12 provided more detailed guidelines regarding their requirement of "no harm" to the
13 public interest as an initial burden of proof for merger applicants. In the Order
14 that approved the merger that created PSE as it now exists, this Commission set
15 out the following standards:

16-20
- The transaction should not harm customers by causing rates or risks to increase, or by causing service quality and reliability to decline, compared with what reasonably could be expected to have occurred in the absence of the transaction.

21-25
- The transaction, with conditions required for its approval, should strike a balance between the interests of customers, shareholders, and the broader public that is fair and that preserves affordable, efficient, reliable and available service.

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[2] PSE Responses to Public Counsel Data Request Nos. 3001 and 3133.
[3] Specifically, the Applicants cite: *In re Application of PacifiCorp and ScottishPower PLC,* Docket No. UE-981627, Third Supplemental Order (April 2, 1999), at p. 2.

1 The jurisdictional effect of the transaction should be
2 consistent with the Commission's role and
3 responsibility to protect the interests of Washington
4 gas and electricity customers.[4]
5
6 The application currently before the Commission—a Macquarie-led
7 acquisition of Puget Energy (and Puget Sound Energy)—fails to meet the
8 Commission's standards set out above. This transaction would increase financial
9 risks to Puget, including the risk of a bond rating downgrade or intervention by
10 the bondholders in the operations of Puget—the increased costs of which would
11 ultimately be passed on to customers. Those increased risks are prohibited by the
12 Commission's "no harm" standard.

13 **Q: What are your overall concerns with the proposed transaction?**

14 A: My concerns are explained in more detail in the body of this testimony. In very
15 general terms, the proposed transaction should not be approved because:

16 - The transaction is dependent on substantial amounts of debt financing.
17 The bond rating agencies have recognized that the proposed debt
18 issuances represents a significant departure from Puget's current
19 financial strategy, and the bond rating has turned negative, indicating
20 that there has already been harm from the proposed transaction.

[4] *In the Matter of the Application by Puget Sound Power & Light Company and Washington Natural Gas Company for an Order Authorizing Merger*, Docket No. UE-960195, Fourteenth Supplemental Order Accepting Stipulation; Approving Merger, Feb. 5, 1997, pp. 19, 20) The Commission also included a standard related to electric competition, which appears to be moot at this point in time and is not cited here.

1 • The transaction reverses a carefully crafted and successful effort that
2 began in early 2002 under Commission oversight to rebuild Puget's
3 financial strength.
4 • The transaction does not balance the interests of shareholders and
5 ratepayers. Puget's shareholders, Puget's executive officers and the
6 investor consortium will realize significant financial gains while
7 Puget's ratepayers receive no direct benefit and must shoulder the
8 additional financial risk caused by the transaction debt.
9 • The commitments offered in the transaction do not provide real
10 benefits and do not offset the additional risks caused by the
11 transaction.
12 • The projected cash flow margins above transaction debt service
13 requirements, when compared to Puget's actual historical operating
14 results, are too small to provide assurance that financial covenants will
15 not be violated, cash flows restricted and operational stability
16 endangered.
17 • The transaction will make Puget a privately-held company, for which
18 detailed quarterly and annual financial information will no longer be
19 publicly available.
20 **Q: In discussing the proposed transaction, you have referred to "Puget",**
21 **without indicating whether you are referencing Puget Sound Energy (PSE)**

1 **the regulated subsidiary or Puget Energy (PE) the parent holding company.**
2 **Why?**
3 A: First, although they are separate legal entities and have different financial
4 statements, there is effectively very little difference between PSE and PE. The
5 regulated subsidiary, PSE, is Puget Energy’s only asset and only source of cash.
6 Any obligations undertaken by PE have to be paid for with cash generated by
7 PSE. The members of the board of directors of PE are also the members of the
8 board of directors of PSE, and most of the executive officers of Puget Sound
9 Energy are also the executive officers of the current parent (Puget Energy). The
10 same individuals run both companies.
11 Second, Macquarie and its equity investors are not offering to buy the
12 common equity of Puget Sound Energy, the regulated entity, they are offering to
13 buy the outstanding common stock of the parent, Puget Energy, which owns all
14 the stock of its only subsidiary: PSE. Therefore, both companies are intimately
15 involved in this transaction. PSE has the ability to generate cash flows through
16 regulated revenue streams thus providing the real value in the transaction, but the
17 acquisition must be effectuated through the parent holding company, Puget
18 Energy. If the transaction is allowed to proceed, Puget Energy will be merged
19 into Puget Merger Sub (which is currently a wholly-owned indirect subsidiary of
20 Puget Holdings LLC) and the latter will cease to exist, making Puget Energy a
21 wholly-owned indirect subsidiary of Puget Holdings LLC. Therefore, unless it is
22 necessary to distinguish between the activities of PE and PSE, when referring to

1 the acquisition of "Puget" by Macquarie I am referring to both the parent and
2 subsidiary.

3 **Q: Please briefly explain why the use of additional debt financing is**
4 **problematic?**

5 A: The use of too much debt and the resulting increase in fixed-cost obligations
6 increases financial risk. This increased risk makes raising capital more expensive
7 and increases the probability that a negative operating event could result in default
8 and the serious financial difficulty that would ensue. This Commission
9 understands the dangers of excessive debt leverage, and in order to avert those
10 dangers, has helped Puget improve its financial position since its 2001 interim and
11 general rate case. In the interim phase of that case, in a Commission-approved
12 settlement with Public Counsel, Commission Staff and other parties, PSE agreed
13 to a multi-year "equity growth tracker" plan to allow Puget to build back its
14 financial health. Puget strengthened its common equity ratio while ratepayers
15 contributed by paying rates based on a hypothetical common equity ratio.[5] As a
16 result, this Commission (and Washington ratepayers) had, by mid-year 2007,
17 assisted this Puget to a position in which its bond rating outlook was "positive"—
18 indicating a potential bond rating upgrade.

19 It is concerning, therefore, that the Puget's bond-rating outlook turned
20

[5] In other words, rates were higher than they would have been based on PSE's actual equity ratio, which had fallen to unbalanced low levels, while debt levels were excessively high. The higher rates, based on equity the Company did not actually have, helped PSE recovery financial soundness. PSE also cut dividends as part of the plan. *See, WUTC v. PSE*, UE-011570, et al., Ninth Supplemental Order, Appendix A, p. 6.

1 "negative" upon the announcement of Macquarie's intended acquisition of Puget,
2 indicating that there has already been harm to the financial position of Puget as a
3 result of the proposed transaction. An approval by this Commission, and
4 Macquarie's projected financial plan for Puget would affect a march backward for
5 Puget and its customers to a level of financial risk from which Puget, through
6 much effort, has only recently emerged.

7 **Q: Does this transaction "strike a balance between the interests of consumers,**
8 **shareholders and the broader public that is fair," as set out in this**
9 **Commission's "no harm" standards?**

10 A: No. While the private interests of Macquarie, the investor consortium, Puget
11 Energy equity investors, and Puget executive management are well served by this
12 transaction (i.e., they all will make substantial amounts of money if the
13 transaction proceeds), the interests of consumers are not "fairly balanced." In
14 fact, consumers' interests are jeopardized by the amount of additional debt
15 intended to be used to finance this transaction and the subsequent capital
16 expenditures.

17 As a result of the proposed transaction, the officers of Puget realize large
18 payments, the stockholders of Puget get a 25 percent increase in the value of their
19 stock, Macquarie collects its management fees and there are costs savings
20 expected with regard to taxes and operating costs. Customers on the other hand
21 receive no such benefits. They receive only the increased risks that obtain from
22 the use of more debt leverage.

1 Also, as noted above, ratepayers have, since 2002 provided the Puget a
2 return on common equity it did not have in order to shore up its financial position.
3 Macquarie now proposes to use Puget's newly improved financial position to
4 issue more debt, leverage the equity return allowed PSE to a higher level, and
5 send the Puget back to a much weaker financial status—with ratepayers as the
6 ultimate "deep pocket." While the Applicants maintain that customers will be
7 protected from any increased capital cost that may arise from the proposed
8 transaction, if the cash flows are not sufficient to meet the debt requirements and
9 projected construction budgets are to be met, there is no other source for increased
10 cash flow except the customers of Puget. In my view, this falls outside a
11 reasonable definition of a "fair balance" of consumer and investor interests.
12 Finally, the fact that this transaction will transform Puget Energy into a
13 private company that is owned by only a few investors and which is not publicly-
14 traded, violates the "no harm" standard regarding the Commission's responsibility
15 to protect the interests of Washington's gas and electricity customers. That is
16 because access to public available detailed financial and operational information
17 about Puget and its private holding company will be significantly reduced or
18 eliminated if the acquisition is approved. Puget Holdings LLC (the proposed
19 privately-held parent of Puget Sound Energy) will not be required to publish
20 annual and quarterly reports to the SEC or annual reports or proxy statements to
21 shareholders, disclosing detailed financial information; nor will that company be
22 subject to Sarbanes-Oxley requirements regarding corporate officers' certification
23 of financial reports. Moreover, the inter-corporate relationships extant in the

1 Macquarie organization and its infrastructure acquisition model are very complex,
2 making it difficult for this Commission to know the extent of the financial
3 obligations on Puget's cash flows and the ultimate risks to Washington's gas and
4 electricity customers. That lack of reliable publicly-available data and the
5 complexity of the financial relationships and responsibilities affecting PSE's
6 potential parent company (Puget Holdings LLC) represents an impediment to
7 informed regulation and a harm to the public interest.

8 **II. PRIVATE EQUITY BUYOUTS OF PUBLIC UTILITIES**

9 **Q: Please describe, in simple terms, how a private equity firm purchase of a**
10 **public utility is structured.**

11 A: In a private equity buyout, the acquiring "firm" is a group of investors. These
12 investors are known as the equity partners. The group includes the general
13 partner (who has responsibility for managing the investment, i.e., determining
14 how the acquired firm will be operated), plus other partners (called limited
15 partners) who contribute capital, but are otherwise passive owners. The general
16 partner agrees to invest the funds committed by the general partners and, because
17 the partnerships are set for a finite number of years, also agrees to return capital to
18 the limited partners within a certain time period. The expectation, of course, is
19 that the value of the investment will grow and, at the end of the term, will be
20 worth more than the initial investment, thus providing the investment partners
21 their promised return. Therefore, each partnership is effectively a closed-end
22 fund with a finite life.

1 In the case now before the Commission, Macquarie is the general or lead
2 partner and the other members of the Investor Consortium are the limited
3 partners. The equity partnerships as well as the debt agreements are set for a
4 certain number of years (which will be detailed in the next Section of my
5 testimony), at which time they have to be re-financed. Applicants' witness Mr.
6 Leslie, Macquarie Infrastructure Partners' Chief Executive Officer, indicates:

7 The fund itself, and if I take Macquarie Infrastructure
8 Partners, which is the potential shareholder here, as an
9 example, the fund itself is a limited liability partnership.
10 The legal structure is not that different to private equity, to
11 be honest. Aside, while we go to some lengths to
12 distinguish ourselves from private equity on an investment
13 philosophy basis, legally, the structure of the fund is
14 similar.[6]
15
16 Today's private equity buyouts use a financing method introduced in the
17 1980s—the leveraged buyout (LBO). In an LBO, a proportion of the monies
18 necessary to complete the transaction (i.e., purchase the target company's
19 outstanding stock) is provided by debt capital (leverage). One of the methods by
20 which one firm acquires another is to purchase the stock of the target company.
21 With an LBO, the monies used for the purchase of the target firm's stock come, in
22 part, from equity capital provided by the acquiring firm (the equity partners), but
23 are also supplied by debt capital. The debt capital that is used to buy the target
24 firm is issued upon completion of the acquisition and is secured, ultimately, by
25 the income stream of the acquired firm. This acquisition debt can be made to
26

[6] Leslie testimony before the New Hampshire PSE in Docket No. DW 06-094, p. 18, provided in PSE Response to Public Counsel Data Request No. 3104.

1 reside on either the target company balance sheet or that of the parent/acquiring
2 company, but, in either event, it becomes the responsibility of the merged
3 company.
4 **Q: Is the Macquarie-led acquisition of Puget a leveraged buyout (LBO)?**
5 A: Yes it is. At page 12 of the Joint Application, the Applicants indicate that the
6 acquisition is funded with $3.6 Billion of equity from the Investor Consortium as
7 well as $1.6 Billion of newly issued debt, which is in addition to PSE's
8 outstanding debt of $2.6 Billion.[7] The newly issued debt will reside at the parent
9 company of PSE (which will be a new company called Puget Energy upon
10 completion of the transaction). The acquisition is to be funded, in part, with debt
11 (increasing consolidated debt levels by more than 50 percent) and the investors
12 are using the debt capacity existing at Puget Energy to provide the additional
13 monies necessary to buy the Puget.
14 Although there is a lower percentage debt and a higher percentage of
15 equity involved in this initial part of the transaction than, for example, the recent
16 Kohlberg, Kravis, Roberts and Co. (KKR) purchase of TXU, the Macquarie-led
17 acquisition of Puget is a leveraged buy-out. It is important to understand,
18 however, the debt initially issued at the Puget holding company level to help fund
19 the acquisition is not the only debt that will reside there. In the Joint Application,
20 the Applicants note at page 17 that, upon closing, the parent company will issue at
21

[7] In PSE Response to Public Counsel Data Request No. 3142, Applicants' witness Markell, in a sources and uses of cash analysis, indicates that the Investor Consortium will contribute $2.8 Billion in equity at closing, while borrowing $1.4 Billion.

1 least an additional $1.4 Billion of debt to fund capital expenditures. This amount
2 of debt, in combination with the debt issued to help fund the buyout will more
3 than double the amount of debt now outstanding at Puget Energy.
4 Leverage—added debt capital at the parent company level—is a key
5 operative factor in this Macquarie-led buyout of Puget. Moreover, as I will show
6 subsequently, the use of debt is a key factor in the Macquarie infrastructure
7 investment model.
8 **Q: What are the advantages of financing with debt?**
9 A: In Exhibit No. ___ (SGH-3) attached to this testimony, at pages 11 through 13, I
10 discuss in some detail how leverage works to the benefit of equity investors. I will
11 only summarize those issues here. The use of leverage (debt) has two primary
12 benefits to the owners of a firm (in this instance Macquarie and the Investor
13 Consortium). First, the use of debt capital can increase equity returns—the more
14 debt used, the higher the equity return can be raised. If, for example, a regulatory
15 commission allowed a $1 Billion utility a 10 percent return on a 50 percent
16 common equity ratio ($500 Mill. equity / $500 Mill. debt) the after-tax cash
17 available from that equity return allowance to the utility would be $50 Million per
18 year [$1 Bill. x 50% x 10%].
19 If a group of investors buys the $500 Million of equity in our hypothetical
20 utility with $250 Million of equity and $250 Million of debt (at a debt cost rate of,
21 say, 5%), applying the $50 Million after-tax cash stream delivered by the utility to
22

1 that financing mix would result in an equity return to the investors of $37.5
2 Million [$50 Mill. cash – debt cost ($250 Mill. x 5% = $12.5) = $37.5 Mill.] That
3 $37.5 Million applied to the investors' equity contribution ($250 Million) would
4 produce a return on equity of 15 percent. By financing the purchase of the utility
5 equity investment with debt, the investors have increased or "levered up" the
6 return from the utility operation by 50 percent—from the 10 percent authorized by
7 the regulatory body to an actual return of 15 percent.
8 Second, the use of debt capital also lowers income tax costs to the new
9 equity owners. As we noted in our example, the investors would receive an after-
10 tax cash stream from the utility of $50 Million annually. However, in ratemaking,
11 equity return allowances are adjusted upward to include the income tax
12 responsibility associated with the allowed return. In reality, then, the owners get a
13 cash stream from the utility of $50 Million (equity return) plus approximately $27
14 Million for income taxes [$50 Mill. / (1-35% tax rate) = $76.9 Mill.].
15 However, the investor group, due to the additional debt they have used to
16 buy the utility equity, will not pay all of the $27 Million in taxes on the equity
17 return because, 1) the holding company pays taxes, not the utility and 2) the
18 investors' holding company has additional debt expense to deduct prior to paying
19 income tax. Deducting an additional $12.5 Million in interest expense ($250
20 Mill. debt x 5% debt cost) from the pre-tax utility return of $76.9 Million
21 produces a taxable return to the equity owners of $64.4 Million and a tax
22 responsibility of $22.5 Million [$64.4 x 35% = 22.5 Mill.]. That amount of taxes
23 ($22.5 Mill.) is less than the taxes included in the rates of the regulated subsidiary

1 ($27 Mill.). Through the use of additional leverage the equity owners reduce their
2 income tax costs by $4.5 Million annually [$27 Mill. tax expense included in
3 utility return - $22.5 actual tax expense paid by investors = $4.5 Mill.]. Adding
4 that additional $4.5 Million amount to the previously derived after-tax return of
5 $37.5 Million produces an actual total after-tax return of $42 Million, or a 16.8
6 percent return on the investors' $250 Million equity investment.

7 In this example, the twin effects of additional leverage (raising equity
8 returns and lowering tax expense) work to increase what is a 10 percent
9 authorized return on equity to the utility to a 16.8 percent return to the equity
10 investors. This simple example represents the primary monetary advantages of an
11 LBO.

12 **Q: Are there operational benefits to an LBO?**

13 A: Yes, there are operational cost savings. For example, firms that are privately held
14 are relieved of their responsibility to provide public disclosure of their operating
15 and financial activity through published Annual Reports or proxy statements to
16 shareholders or quarterly, annual or other detailed financial reports to the
17 Securities and Exchange Commission.[8] Also, private firms do not have to hold
18 analyst presentations or meetings for thousands of stockholders, or be listed on
19 the stock exchange. In PSE Response to Public Counsel Data Request No. 3029,

[8] For example, Duquesne Light, which was recently (May 31, 2007) acquired by Macquarie, no longer publishes annual or quarterly reports on the S.E.C website. The most recent 10-Q available for Duquesne was published prior to the acquisition, at the end of the first quarter of 2007.

1 PSE identified $1.2 Million in annual costs related to public notification
2 requirements, which will be unnecessary if the merger is allowed to proceed.[9]
3 In theory, there are also advantages to an LBO with regard to private
4 management's ability to focus on long-term strategies without having to meet
5 relatively short-term public investor expectations. However, given the behavior
6 of private equity management with regard to strategic options, there are those in
7 the financial community that are concerned that LBO financial theory and fact
8 may not be congruent.

> 9 LBO theory is based on the expectation that the benefits of
> 10 leverage are twofold: it creates discipline within the
> 11 corporate organization and it provides higher returns for the
> 12 private equity firm. It is also frequently argued that the
> 13 benefits of becoming a private company allow the
> 14 management team to invest over a longer time horizon,
> 15 unburdened by the demands of short-term focused public
> 16 shareholders and without the expenses associated with
> 17 public reporting requirements (i.e., Sarbanes Oxley and the
> 18 like). Additionally, private equity firms assert that they
> 19 have a unique ability to obtain good managers for their
> 20 investments, a claim based mostly on their willingness to
> 21 provide exceptional rewards for strong performance but
> 22 also on their good relationships with business leaders….
> 23 While Moody's would agree that leverage is likely to
> 24 impose discipline and provide higher equity returns, the
> 25 current environment does not suggest that private equity
> 26 firms are investing over a longer term horizon than do
> 27 public companies, despite not being driven by the pressure
> 28 to publicly report quarterly earnings. We also question
> 29 whether there is sufficient evidence to prove that the higher
> 30 returns provided to private equity are driven by stronger
> 31 management teams or because, in a benign and liquid credit
> 32 environment, leverage by itself can provide substantial
> 33 returns to shareholders. Moreover, many private equity
> 34 firms pay themselves annual management fees as well as

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[9] PSE did not provide the level of expected cost savings for the parent, PE, therefore, the total annual cost savings may be greater.

> investment banking fees (for acquisitions, for example) increasing returns to the private equity firms…. We are less optimistic about the willingness of the private equity firms to inject capital in the future, if necessary, at a rate different from that of a strategic owner/operator would.[10]

Q: What are the drawbacks of an LBO?

A: Debt is the essential element in a leveraged buyout, and debt is the primary drawback to that type of financial arrangement. First, debt costs are fixed and revenue streams are volatile. As a firm increases its debt burden it is also increasing its fixed costs, thereby raising the probability that a volatile revenue stream will, at some point, not provide enough monies to meet those fixed debt costs. In that event, if it is severe enough, bankruptcy results.

Of course, because regulated utilities operate as effective monopolies in franchised service territories and because the product they produce is fundamental to societal function, the revenue streams of utilities are relatively stable compared to most other companies. For that reason, utilities are capitalized, on average with 50 percent to 60 percent debt capital, while industrial companies utilize approximately 40 percent debt to capitalize their operations. Still other firms, such as "dot-com" or technology companies with more volatile income streams use less debt. Apple, Inc., for example, has no long-term debt.

However, in a private equity buyout of a utility operation, debt is added to an already relatively debt-heavy capital structure. While utility revenue and income streams are relatively stable they do, from time to time, experience

[10] Moody's Investors' Service, Special Comment: "Rating Private Equity Transactions," July 2007, p. 2.

1 volatility. Therefore, increasing the debt responsibility encumbering a utility's
2 revenue and income stream increases the probability of a lower bond rating or
3 even default.

4 Second, the debt used in an LBO is relatively short-term debt. As the
5 Applicants note at page 17 of the Joint Application, Puget Holdings intends to
6 provide debt capital to fund PSE's capital expenditure program, debt which will
7 have a term of "not less than three years." While the details of the debt agreement
8 show that the expected term of the debt will be **[HC]** XXX **[HC]** years not three,
9 that is still a relatively short time period compared to the life of utility assets.
10 Utilities traditionally use longer-term debt to finance utility assets in order that the
11 duration of the liabilities supporting the assets is similar to the useful life of those
12 assets. The reason for that is simple: matching the duration of assets and
13 liabilities avoids re-financing risk. Even though the Macquarie-led consortium
14 intends to hedge the variable rate debt they will issue if the transaction is allowed
15 to proceed in order to reduce interest rate volatility during the time when the debt
16 is outstanding, they will have to re-finance the entire amount of debt **[HC]** XXX
17 **[HC]** years from the transaction date.

18 If, as Macquarie assumes in their financial projections (discussed in detail
19 in the next Section of my testimony), inflation rates **[HC]** XXXXXXX **[HC]** and
20 interest rates **[HC]** XXXXXXXXXXXXXXX **[HC]** from the current low levels,
21 re-financing approximately $2.5 Billion of **[HC]** XXXXXXXXXXXXX **[HC]**
22 debt should not be problematic. However, if the economic environment is less
23 benign than that which currently exists, refinancing the transaction and capital

1 expenditure debt could be far more costly than envisioned in Macquarie's
2 financial projections, or even impossible. That re-financing risk does not now
3 exist with Puget and would represent an increase in risk to ratepayers if the
4 transaction is allowed to proceed. If the cash flows are unable to sufficiently cover
5 higher debt expenses, in order to alleviate that situation, one of two things must
6 happen: 1) planned construction expenditures must be curtailed or 2) the new
7 owners will have to turn to ratepayers to provide those funds.
8 Third, the current status of the capital markets does not bode well for the
9 continuation of a relatively benign credit environment. The turmoil in the
10 national and international debt markets initiated by what has come to be known as
11 the "sub-prime mortgage crisis" has underscored the extent to which the capital
12 markets are supported by debt. Most recently this was made evident by the
13 financial collapse of Bear Stearns, one of the largest brokerage and investment
14 banking firms in the world. Without the cash available to pay its debts Bear
15 Sterns was on the verge of collapse, and absent the unprecedented intervention of
16 the Federal Reserve, that firm's collapse would have caused similar failures
17 throughout the financial system.

18 Bear Stearns failed because its investors no longer believed
19 it could repay its loans — even its short-term, overnight
20 loans. Even worse, investors concluded the bank no longer
21 could stand behind the complex agreements it had with
22 other financial institutions. And Bear Stearns had a web of
23 intertwined agreements with other banks, investment
24 houses and corporations.[11]
25

[11] USA Today, http://www.usatoday.com/money/industries/banking/2008-03-17-bear-stearns-bailout_N.htm.

1 A recent New York Times article confirms the reach of the credit market
2 difficulties:

3 The credit crisis paining Wall Street is reaching out across
4 the nation, afflicting municipalities, hospitals and cultural
5 touchstones like the Metropolitan Museum of Art.
6 In recent days another large but obscure corner of
7 the financial world has come under acute stress. Alarmed
8 by the running turmoil in the debt markets, investors have
9 refused to buy certain securities that not long ago many
10 regarded as equivalent to cash.
11 Even though the securities are long term, banks
12 hold auctions periodically to set the interest rates. During
13 the last three days, almost 1,000 of these auctions failed
14 because there were not enough buyers. The banks that
15 marketed the instruments, known as auction-rate securities,
16 also declined to buy.
17 The Port Authority of New York and New Jersey
18 now finds itself paying a rate of 20 percent on $100 million
19 of its debt, almost quadruple its costs a week ago. The
20 Metropolitan Museum of Art is now paying 15 percent on
21 auction securities. It is unclear how long such high rates
22 will persist, or when the market for these instruments will
23 revive, if at all.[12]
24
25 Private equity firms, with their extensive reliance on debt financing, are
26 vulnerable to credit difficulties:

27 Carlyle Capital reports it is attempting to convince lenders
28 holding $16 billion in securities not to liquidate the
29 company's remaining collateral. The company is a listed
30 mortgage-bond fund managed by the Carlyle Group. The
31 Carlyle Group already has loaned Carlyle Capital $150
32 million to cover debt obligations since July 2007. In the
33 past several days it failed to meet margin calls with four
34 banks. The fear in the market according to informed reports
35 is that its entire portfolio, recently valued at $21 billion,
36 could be sold off in a distress sale, putting major downward
37 pressure on all mortgage bonds globally. A collapse at
38 Carlyle would hit the value of all fixed-income securities,

[12] "Municipalities Feel Pinch as Another Debt Market Falters," *New York Times*, February 15, 2008, http://www.nytimes.com/2008/02/15/business/15muni.html.

> which have already dropped sharply as banks pull back on their lending, and force a new global round of asset sales.[13]

In sum, the current status of the credit markets does not augur well for Macquarie's assumption embodied in their financial projections for this deal that the interest rate environment will continue to be benign and credit will remain plentiful. In simple terms, doubling the size of the debt burden on Puget's assets now, in this unstable capital market environment, is a very risky strategy.

Q: Have the risks of LBOs and Macquarie's version of that strategy been recognized in the financial media?

A: Yes. For example, in October 2007, *Fortune* published an article about Macquarie entitled "Would You Buy A Bridge From This Man?" in which it referenced a presentation made by Jim Chanos in May of 2007 at a conference for hedge fund managers in New York.[14] Mr. Chanos is president of Kynikos Associates who, according to *Fortune*, "earned worldwide fame for being an early critic of Enron." In that article, the following comments regarding the fees Macquarie charges its partners and the amount of debt used in acquisitions were attributed to Mr. Chanos:

> The shareholders pay Macquarie management fees that are based on the size of the fund, meaning that Macquarie has an incentive to add to its collection. (The funds also pay fees based on their performance, but as Macquarie gets bigger, those are dwarfed by the base fees.)
> The shareholders pay Macquarie investment-banking fees too - any deal that a fund does, from the acquisition of an

[13] "Bush Family Private Equity Fund in Deep Trouble as Financial Tsunami Rolls On," Global Research, March 10, 2008, http://www.globalresearch.ca/index.php?context=va&aid=8295)

[14] The entire *Fortune* article about Macquarie is attached as Exhibit No. ___ (SGH-4).

1 asset to a refinancing to its ultimate disposition - results in
2 fees to Macquarie. In the past two years Macquarie
3 Infrastructure Group (MIG) - the oldest and largest fund -
4 has paid Macquarie a total of almost A$150 million in
5 banking fees and another A$273 million in management
6 fees. [The “A” before the dollar amount indicates those
7 amounts are denominated in Australian dollars.]
8 That the funds are fee factories for Macquarie wouldn't be
9 so much an issue - sure, it's more rapacious than your
10 average private equity firm, but only a little - if it weren't
11 for another part of the picture. That's debt.
12 Macquarie uses debt of as much as 85% to purchase an
13 asset and pay for the necessary capital expenditures. This
14 debt is hard to see, because it doesn't reside on Macquarie's
15 books. You won't even see it by looking at the financial
16 statements for the funds.[15]
17
18 With regard to the debt policies of Macquarie, *Fortune* reports the
19 following (again citing Mr. Chanos):
20 Over time the debt held by assets has often increased, not
21 decreased, because Macquarie adds to it partly to pay
22 shareholders their promised dividends. That's because the
23 assets themselves don't deliver enough cash. …
24 So Macquarie borrows more money and uses it to pay the
25 dividend now, much the way a homeowner might take out a
26 home-equity line to pay a credit card bill.[16]
27
28 *Fortune* also reports that other investors are skeptical about the Macquarie model.
29
30 While Chanos may have been the first to say it and is one
31 of the few who is willing to say it publicly, he's not alone in
32 his skepticism about Macquarie Bank.
33 "This is a no-holds-barred bet on the credit markets," says
34 another person who is short the stock. The skeptics don't
35 merely argue that the firm's earnings will fall - which will
36 happen to every financial services firm in a downturn - but
37 that something more dire could happen.
38 It's not that they can lay out how events will unfold.
39 Macquarie is too complex. Figuring out the firm is "like

[15] *Id.*, p3.
http://money.cnn.com/2007/09/17/news/international/macquarie_infrastructure_funds.fortune/index.htm
[16] *Id.*

> wrestling in the dark with a ghost," says another skeptic. It's just that from the outside, there's enough that seems flammable, from the funds to the parent company's 88% debt-to-capital ratio, to make people willing to bet that in a tough market, something, anything, will catch fire and set off a chain reaction.[17]

Q: Did Macquarie respond to the comments in the article?

A: Yes. When Macquarie CEO Allen Moss was questioned by the *Fortune* reporter about Mr. Chanos' comments and concerns he stated "We think a lot differently about people who are genuine stakeholders vs. people who have a passing casual interest. It's the same criticism that was being made in Australia five years ago. It is noise, but no more than noise." Mr. Moss was effectively saying that Mr. Chanos, a short-seller who makes money if the stock price declines, was simply trying to enrich himself by making those comments in order to drive down Macquarie's stock price. Following the publication of the *Fortune* article, the debate between Chanos and Macquarie spilled over into CNBC's investor-oriented television show "Squawk Box," with separate interviews with Mr. Chanos and a senior Macquarie executive. (The transcripts of those interviews, as well as a letter from Macquarie to Chanos regarding errors in his "Squawk Box" interview, are provided in the Applicant's response to ICNU Data Request No. 3.13).

Q: Have investor services also published comments about the Macquarie infrastructure model?

[17] *Id.*, p. 4.

1 A: Yes. RiskMetrics Group is an investor-service company with offices in North
2 America, Europe, Asia and Australia, which provides risk management, corporate
3 governance and financial research analysis to its clients. According to its website
4 (http://www.riskmetrics.com/serve/index.html) the firm serves 42 of the 50
5 largest hedge funds, 34 out of 50 of the largest mutual funds, 70 of the 100 largest
6 investment managers and all of the 10 largest global investment banks. Attached
7 as Exhibit No. ___ (SGH-5) to this testimony is an April 2008 report by
8 RiskMetrics Group (RMG) entitled, "Infrastructure Funds: Managing, Financing
9 and Accounting, In Whose Interests?" In that publication, RiskMetrics Group
10 discusses the Macquarie model and outlines many of the same concerns voiced by
11 Mr. Chanos.

12 Acknowledging that Macquarie pioneered the asset-manager model for
13 infrastructure investment, which is now being copied by other investment firms,
14 RiskMetrics Group uses the Macquarie model to discuss its investment concerns
15 related to that model. The investor concerns outlined by RiskMetrics are related
16 to 1) sustainability, 2) asset prices, 3) management fees, 4) accounting practices
17 and, 5) transparency (governance).

18 In the paper, RiskMetrics Group confirms that Macquarie often pays
19 dividends to investors out of capital (borrowed funds) as well as from cash flows
20 generated, is paid management fees that are more than double traditional
21 investment-banking fees (making the acquisition strategy fee-driven rather than
22 operational-result-driven), uses high levels of debt to fund investments, uses a
23 complex corporate inter-relationship that is not transparent, and is able to book

1 profits merely by re-valuing assets. RMG concludes its analysis, which includes a
2 case study of the Macquarie model, by stating:

3 This paper has highlighted a range of concerns about the
4 infrastructure fund model. Several of the issues discussed
5 in the paper relate to the sustainability of the model. For
6 example, the predictable and steadily growing cash flow
7 associated with infrastructure assets is commonly
8 highlighted as a basis for providing an attractive, and
9 steady, yield. However, the yield delivered by several
10 infrastructure funds is sourced from operating cash flows of
11 the fund's assets *and* from capital. Other investment-
12 related issues identified in the paper are a danger of
13 overpaying for assets; fee structure that deliver high fees
14 and provide an incentive to increase a fund's size; and
15 accounting practices that have the capacity to provide an
16 overly robust picture of a fund's profitability. The paper
17 also describes a series of additional concerns with the
18 infrastructure model – concerns of a governance nature.
19 For instance, the existence of 'special shares' in some funds
20 which entitle the external manager to appoint a majority of
21 the fund's directors; and concerns about insufficient
22 alignment between the interests of the external manager
23 and fund investors.[18]
24
25 Therefore, there is concern regarding the "Macquarie model" of
26 infrastructure investment not only because of the reliance on debt financing and
27 the point of view of the customers of the asset being acquired (e.g., Puget), but
28 also from an investor standpoint as discussed in detail in the RMG paper. The
29 key issue in that regard is whether or not the infrastructure model pioneered by
30 Macquarie—one that requires continual new acquisitions through leveraged
31

[18] RiskMetrics Group, "Infrastructure Funds: Managing, Financing and Accounting, In Whose Interests?" April 2008, p. 38, attached as Exhibit No. ___(SGH-5).

1 financing—is sustainable. The fact that there are legitimate questions regarding
2 the ability of the model to sustain itself, which must certainly be exacerbated in
3 the current global debt market unrest, provides additional indications that this
4 Commission should not approve the requested transaction.

5 **III. SPECIFICS OF THE REQUESTED TRANSACTION**

6 **Q. How will the corporate structure of Puget be arranged if the requested**
7 **transaction is allowed to proceed?**

8 A. As noted in Puget Energy's February 15, 2008, Proxy Statement to investors,
9 there are four corporate organizations involved in the merger. First is Puget
10 Energy, which is referred to as "the Company" in the merger documents. Second,
11 Puget Holdings LLC, a Delaware limited liability company, formed for purposes
12 of completing the transaction and being the ultimate owner of the assets of Puget
13 Energy, is referenced as "the Parent." Third, Puget Intermediate Holdings, Inc., is
14 a Washington corporation and a wholly-owned subsidiary of "the Parent," also
15 formed for completing the transaction. The fourth corporation is Puget Merger
16 Sub Inc., also a Washington corporation, and a wholly-owned subsidiary of Puget
17 Intermediate Holdings.

18 If the transaction is approved, upon completion of the merger, Puget
19 Energy will be merged into Puget Merger Sub Inc., the latter will cease to exist in
20 name, and its name will be changed to Puget Energy. The post-transaction
21 corporate structure will appear as shown, in a simplified version, on Appendix B

1 attached to the Joint Application. Upon completion of the transaction, Puget
2 Holdings LLC will be the ultimate parent, which will own 100 percent of Puget
3 Intermediate Holdings. Puget Intermediate Holdings will own 100 percent of
4 Puget Energy, Inc., which will own 100 percent of Puget Sound Energy.
5 The ownership hierarchy will actually be more complicated than that
6 depicted in Appendix B of the Joint Application. In PSE Response to Public
7 Counsel Data Request No. 3012, the Joint Applicants provided a post-merger
8 corporate structure showing the wholly-owned intermediate subsidiaries of the
9 ultimate owners, which is attached to this testimony as Exhibit No. ___ (SGH-6).
10 That Exhibit shows the Macquarie ownership of Puget Holdings is particularly
11 complicated with many inter-related subsidiaries, holding companies and
12 partnerships taking part in the investment. This complexity makes it difficult to
13 ascertain the risks and obligations that accompany the ownership share of
14 Macquarie Infrastructure Partners, which could, ultimately, inure to Puget and its
15 ratepayers.
16 With regard to the corporate structure from Puget Holdings downward to
17 Puget Sound Energy, in PSE response to Public Counsel Data Request No.
18 3004(c) the Joint Applicants indicate that, "it is anticipated that the members of
19 the Board of Directors of Puget Holdings will also serve on the Boards of
20 Directors of Puget Intermediate, Puget Energy, Inc., and Puget Sound Energy,
21 Inc." With the boards of directors of those four corporations being the same as
22 the Parent, under the direction of Macquarie (the lead investment partner),
23 Macquarie will be able to determine how capital is transferred from one

1 subsidiary to another and how that capital is utilized in the Puget family of
2 companies.
3 For example, while there are no plans for Puget Intermediate Holdings to
4 issue debt, the Joint Applicants indicate that there are no restrictions regarding
5 issuing debt by Puget Intermediate Holdings (or Puget Holdings, see PSE
6 Response to Public Counsel Data Request No. 3150 (d), (e)). If that corporate
7 intermediate were to borrow capital from, say, another Macquarie fund (or any
8 other source), and then contribute that capital to Puget Energy as equity, it would
9 appear to improve the debt/equity balance of Puget Energy while actually placing
10 further fixed demands on the cash stream produced by the ultimate cash generator
11 of this deal—PSE. In other words, the multiple corporate layers, all with the
12 same directors, can also add to the difficulty of determining the risks to which the
13 cash flows generated by PSE are subjected.
14 When asked in PSE Response to Public Counsel Data Request No. 3150
15 (c) to explain the function of Puget Intermediate Holdings, the Applicants
16 responded as follows:

17 Puget Intermediate shall be an intermediate entity that will
18 provide structural flexibility for future corporate
19 transactions. It shall have no separate operations,
20 employees or third party financing. Its only subsidiary
21 shall be Puget Energy.
22
23 When asked whether Puget Intermediate Holdings would be able to invest
24 in other Macquarie subsidiaries, the Applicants responded as follows:

25 Each of Puget Holdings and Puget Intermediate are special
26 purpose entities created by the Investor Consortium…to
27 invest in Puget Energy. Although there are no restrictions

> on the ability of Puget Holdings or the Investor Consortium from making any other investments, any decision to have Puget Holdings enter into another investment would require approval of the Investor Consortium.

When asked in PSE Response to Public Counsel Data Request No. 3034(d) if the Commission would have access to the financial data, filings and board minutes of Puget Intermediate Holdings, the Applicants did not respond directly to that question and, instead, stated:

> PSE will provide Commission Staff and Public Counsel access to books and records (including those of Puget Holdings or any affiliate or subsidiary companies) required to be accessed to verify or examine transactions with PSE, or that result in costs that may be allocable to PSE. The Proposed Transaction will not result in reduced access to the necessary books and records that relate to transactions with PSE, or that result in costs that may be allocable to PSE, and the Proposed Transaction and resulting corporate structure will not be used by PSE as a basis to oppose requests for such books and records made by the Commission or by Commission Staff or Public Counsel.

With three corporations sitting above Puget Sound Energy (and many more above that) it is quite possible that additional obligations could be entered into or debt incurred that could affect the risk of the whole Puget enterprise but which do not initially result in costs "allocable to PSE," and, thus, would go unnoticed by this Commission according to the Applicant's commitment. Just as this Commission now requires access to the books and records of PSE's direct parent company (Puget Energy), if this transaction is allowed to proceed, it should require no less of Puget Intermediate Holdings and Puget Holdings, LLC.

Q: Can you describe in more detail how a Macquarie equity partnership is structured?

1 A: Yes. In PSE Response to Public Counsel Data Request No. 3005, when asked to
2 provide a description of the limited partnership agreement referenced at page 5 of
3 the Joint Application, the Applicants provided a copy of the Private Placement
4 Memorandum (PPM) for Macquarie Infrastructure Partners (MIP). That
5 document provides insight into Macquarie's infrastructure model and the risks
6 and rewards that pertain to it. While some of the details disclosed in the private
7 placement memorandum (such as Macquarie's fees) are discussed in the RMG
8 publication attached in Exhibit No. ___ (SGH-5), and, thus, are not confidential,
9 the Applicant's private placement memorandum is classified as "highly
10 confidential" and the information cited from it must be redacted in the public
11 version of this testimony.
12 First, because one of Macquarie's key marketing points in their
13 infrastructure investment model is that they are long-term investors, it is
14 important to understand that the investment partnerships have a finite life. Under
15 "Key Features" of the partnership on page 2 of the PPM, Macquarie notes to its
16 potential investors that the term of the partnership is **[HC]** XXX **[HC]** years, with
17 possible extensions of up to **[HC]** XXXXXX **[HC]** years. While that investment
18 period is longer than the investment horizon of other private equity firms (which
19 is usually five years), it is not permanent.
20 Moreover, because it is for a finite period, the partnership has to ultimately
21 liquidate the investment in order to return capital to the investment partners: **[HC]**
22 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
23 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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15 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
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18 XXXXXXXXXXXXXXXXXXXXXXX **[HC]** [20]
19
20 While Macquarie may not choose to liquidate its investment in Puget by
21 taking Puget public and may, instead, elect to re-finance it and re-sell it to another
22 group of partners or another subsidiary of Macquarie, it will, at some point have
23 to return the capital invested to the current members of the Investor Consortium.
24 However, because Macquarie has been in existence since the mid-1990s, its
25 holding-period agreements are beginning to cause that company to liquidate some
26 of its assets, as reported by RMG:

27 As it matures, the infrastructure fund may build up a
28 sizeable portfolio of assets, some of which can be traded
29 (sold) to raise cash as debt related to other assets falls due
30 for repayment. Some of the more mature funds do have a
31 significant number of assets, as do trade those assets.
32 MIG's [Macquarie Infrastructure Group] 2005 annual
33 report disclosed that, since it listed nine years earlier, it had
34 acquired interests in 28 toll roads in eight countries, but at
35 year-end it had interests in 14 roads in six countries. [Ref:

[19] PSE Response to Public Counsel Data Request No. 3005, Attachment A, p. 22.
[20] PSE Response to Public Counsel Data Request No. 3005, Attachment A, p. 49.

1 MIG Annual Report 2005, pp. 1, 3]. A year later, it had
2 interests in 11 roads in seven countries [ref: MIG Annual
3 Report 2006, p. 1] [21]
4
5 According to the Applicant's response to Public Counsel Data Request
6 No. 3008, Attachment A, which is a copy of Macquarie's presentation to the
7 Investor Consortium regarding the Puget acquisition, Macquarie's "base case"
8 projections indicate that investors can expect an annual yield of about **[HC]** X
9 XXXX [**HC]** and an overall return (IRR – or internal rate of return upon
10 liquidation) of **[HC]** XXXXXXX **[HC]** On page 56 of Attachment A to PSE
11 Response to Public Counsel Data Request No. 3008, Macquarie projects that,
12 through **[HC]** XXXXXXXXXXXXXX, **[HC]** revenues will grow annually at
13 **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**
14 while operating costs **[HC]** XXXXXXXXXXXXXXXXX, **[HC]** and will
15 generate "cashflow available for equity" to provide the Investor Consortium an
16 average annual yield on its $3.5 billion investment of about **[HC]** XXXXX. **[HC]**
17 Given that annual yield, in order to achieve a **[HC]** XXXXXXXXXXXXXX
18 XXXXXXXXXXXXX **[HC]** the common equity value of Puget will have to be
19 approximately **[HC]** XXXXX **[HC]** Billion.[22]
20 Macquarie also indicates to the Investor Consortium that by **[HC]** XXX
21 **[HC]** common equity capital will represent only **[HC]** XXXX **[HC]** of total
22 capital. However, PSE Response to Staff Data Request No. 1047, Attachment A,

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[21] RMG Report, Exhibit No. ___ (SGH-5), p. 21.
[22] **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXX. [**HC]**

1 which is its financial model for the Puget acquisition indicates that amount of
2 equity includes the goodwill associated with the acquisition. Absent the inclusion
3 of goodwill, Puget Energy's common equity **[HC]** XXXXXXXX **[HC]** Billion,
4 is projected to comprise only **[HC]** XXXXXXX **[HC]** of total capital.[23]
5 Therefore, in order for this deal to deliver the returns promised investors,
6 Macquarie projects to liquidate the investment at a market-to-book ratio of **[HC]**
7 XXXXXXXXXXXXXXXXXXXXXX. **[HC]** In paying $30 for Puget, which
8 had a $19.45 book value in 2007, Macquarie provided a market price for Puget of
9 1.5 times its book value. Macquarie's valuation projections for Puget in the
10 future are optimistic, as are many of the assumptions on which its financial model
11 of this deal rests, as I discuss in detail below.

12 **Q: What other information does Macquarie provide its equity investment**
13 **partners?**

14 A: Macquarie informs its partners that it will require fees for its services, which in
15 this case are **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
16 **[HC]**[24] In the case of the proposed Puget transaction, which is approximately a
17 $7 Billion transaction, Macquarie will make approximately **[HC]** XXXXXX
18 **[HC]** per year in management fees [$7 Billion x **[HC]** XXXXXX. **[HC]**
19 Macquarie will also receive **[HC]**XX **[HC]** percent of the net profits that exceed a
20

[23] The book value of common equity (absent goodwill) projected by Macquarie **[HC]** XXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX**[HC]**

[24] PSE Response to Public Counsel Data Request No. 3005, p. 1.

1 hurdle rate of **[HC]** XXXXXXXXXXX, **[HC]** with an **[HC]** XXXXXXXX
2 XXXXX **[HC]** if those monies are not available in the initial years. Macquarie
3 also indicates to its equity partners that the **[HC]** XXXXXXXXXXXXXXXXXX
4 XXXXXX**[HC]** will be the preferred provider of financial advisory and
5 investment banking services and will receive additional fees for that service.
6 Finally, Macquarie indicates to its equity partners that there may also other
7 services provided, for a fee, by **[HC]** XXXXXXXXXXXXXXXXXXXXX
8 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXX. **[HC]**
10 This information confirms that in the RMG report (Exhibit No. ___ (SGH-
11 5)), which shows that the Macquarie model includes a fee structure that is higher
12 than that of other investment banking firms. While that is not problematic as long
13 as it is fully disclosed (as it is) and investors are willing to pay those fees, it does
14 raise the question as to whether or not the Macquarie model is "driven" by those
15 fees or by the value imparted by the successful operation of the underlying assets.
16 The concern expressed by RMG is that the fee structure, which provides the
17 steady, reliable income to Macquarie, encourages overpaying for assets, which, in
18 turn, endangers the ultimate success of the infrastructure deals entered into.
19 Macquarie also, in full disclosure in its Private Placement Memorandum,
20 informs its potential equity partners as to the risks and potential conflicts of
21 interest that pertain to an investment in the Macquarie infrastructure model, some
22

of which are set out below: **[HC]**

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17 XXXXXXXXXXXXXXXXXXXXXXXXXX
18 **[HC]**[26]

19 **Q: Does this conclude your discussion of the details of an equity partnership**
20 **arrangement with Macquarie?**

21 A: Yes, it does, in very limited fashion. Macquarie provides considerably more
22 information to its potential equity partners than I have outlined here. For example,
23 Macquarie provides information regarding its history, managerial expertise,
24 details of Puget's operations and WUTC policy (e.g., basing rates on subsidiary
25 capital structures rather than parent company capitalization, allowing effective tax
26 rates of the regulated subsidiary to be included in rates, and relying on a "no
27 harm" standard rather than affirmative benefit in approving acquisitions.[27]
28
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[25] **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**

[26] Private Placement Memorandum, Macquarie Infrastructure Partners, Risks and Conflicts of Interest, pp. 47-59, provided in PSE Response to Public Counsel Data Request No. 3005.

[27] PSE Response to Public Counsel Data Request No. 3008, Attachment A, p. 35).

1 However, Macquarie is also required to disclose the risks that apply to an
2 infrastructure investment like the Puget acquisition, some of which are outlined
3 above and, I believe, are pertinent to the Commission's determination of whether
4 or not this transaction is in the public interest and the requirement that any such
5 transactions not increase risks.

6 **Q: Did Macquarie provide an informational memorandum regarding the Puget**
7 **acquisition to potential debt investors?**

8 A: Yes. In PSE Response to Public Counsel Data Request No. 3027, as Attachment
9 A, the Applicants provided the January 2008 Confidential Information
10 Memorandum for **[HC]** XXXX **[HC]** Billion of Senior Credit Facilities. That
11 debt-offering memorandum provides the debt investors much of the same
12 operational information about Puget and financial projections as provided to the
13 equity investors. It describes in more detail, of course, the debt requirements
14 associated with the proposed transaction.

15 As outlined in the memorandum, the debt to reside at Puget Energy (which
16 is termed "HoldCo" in the debt memorandum) consists of two facilities: a **[HC]**
17 XXXXXXXXXXXXXXXXXXXXXXXX **[HC]** (used to facilitate the purchase
18 of Puget, including retiring**[HC]** XXXXXX **[HC]** of Puget's currently
19 outstanding senior debt); and a **[HC]** XXXXXXXXXXXXXXXXXXXXXXXX
20 XXXXXXXX **[HC]** (for capital expenditures).

21 In addition, the debt memorandum calls for **[HC]** XXXXXXXXXXXXX
22 XXXX **[HC]** to reside at the Puget Sound Energy level (termed "OpCo" in the
23

1 memorandum). That debt is to replace PSE's current similar debt facilities and is
2 to consist of three parts" 1) **[HC]** XXXXXXXXXXXXXXXXXXXXXX
3 XXXXX **[HC]** (to fund capital expenditures), 2) **[HC]** XXXXXXXXXXXXX
4 XXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]** to fund working capital
5 requirements, and 3) **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXX
6 **[HC]** (for energy hedging operations). A diagram of the Puget Holdings/Puget
7 Intermediate Holdings/ Puget Energy/Puget Sound Energy post-acquisition
8 corporate structure showing the new debt facilities, the replaced debt facilities and
9 the remaining debt facilities is shown in Exhibit No. ___ (SGH-7HC).

10 **Q: Are the new term facilities requested by Macquarie to replace Puget's**
11 **current term facilities more cost-effective than those current facilities?**

12 A: When asked that question, the Applicants responded as follows:

13 The existing PSE credit facilities, and their pricing, were
14 negotiated prior to the sub-prime mortgage crisis. As a
15 result of the sub-prime mortgage crises, there has been a
16 repricing of risk in the capital markets. Absent the merger,
17 were PSE renegotiating its credit facilities today, the cost
18 would be higher than that of PSE's current facilities.[28]
19
20 That response indicates that the new facilities will have a higher cost rate than
21 PSE's old facilities. It is also important to understand that lowering capital costs is
22 not a goal of this transaction, as evidenced in the Applicant's response to data
23 requests.

24 Neither Puget Holdings LLC ("Puget Holdings") nor Puget
25 Sound Energy, Inc. ("PSE") conducted any analysis to
26 determine whether the costs of capital for Puget Holdings

[28] PSE Response to Public Counsel Data Request No. 3027(b).

1 or PSE will be lower as a result of approval of the proposed
2 transaction. [29]
3
4 The Joint Application does not state that the Macquarie
5 Group and other members of the Investor Consortium
6 would be able to supply capital to Puget Sound Energy, Inc.
7 ("PSE") more cost-effectively than the capital markets
8 generally.[30]
9
10 Also, as noted above, a portion of the **[HC]** XXXXXXX **[HC]** of term
11 debt to be issued by Puget Energy at the time of the merger is to be used to buy-
12 down **[HC]** XXXXXXX **[HC]** of long-term debt currently outstanding at Puget.
13 When asked by the Staff in, PSE Response to Staff Data Request No. 1016, to
14 provide any cost-benefit analysis by PSE supporting the buy-back of that debt
15 (i.e., showing that issuing new debt to buy back the debt to be retired makes
16 economic sense) the Applicants replied that PSE had performed no such analysis,
17 because absent the planned merger, there were no plans to buy-back that debt.

18 Q; **Please continue with your discussion of Macquarie's debt offering**
19 **memorandum.**

20 A: The debt memorandum provided in PSE Response to Public Counsel Data
21 Request No. 3027 indicates that the security offered for the debt requested is
22 **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
23 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
24 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
25 XXXXXXXXXXXXXXXXXXXXXXXXXXX. **[HC]** The debt memorandum
26

[29] PSE Response to ICNU Data Request No. 3.56.
[30] PSE Response to Public Counsel Data Request No. 3022.

1 projects that the **[HC]** XXXXX **[HC]** debt to be issued by HoldCo (Puget
2 Energy) will be rated **[HC]** XXXXXXXXXXXXXXXXX
3 XXXX.**[HC]** As such, that debt will carry a higher cost rate than the debt that
4 will be issued by Puget Sound Energy.
5 The debt covenants associated with the HoldCo [PE] transaction and
6 capital expenditure debt call for group funds from operations (FFO) **[HC]** XX
7 XXXXXXXXXXXXXXXXXXXXX**[HC]** to group interest ratio of **[HC]** XXX
8 **[HC]** or higher in order to avoid a "cash lock-up," which is discussed below. The
9 FFO/interest coverage limits for default are slightly lower at **[HC]** XXX.**[HC]**
10 Macquarie's projections show, given their assumptions, that cash flow levels are
11 sufficient to meet those requirements. However, the amount of Puget's projected
12 capital expenditures designated **[HC]** XXXXXXXXX **[HC]** is considerably
13 smaller than the total amount of Puget's projected capital expenditures. If more
14 of what is now deemed [**HC]** XXXXXXXXXXXXXXXXXXXX **[HC]** were re-
15 designated as **[HC]** XXXXXXXXXXXX **[HC]** the projected FFO/interest
16 coverages would be lower and closer to the debt covenant limits, which, if
17 violated, could negatively affect Puget's ability to fulfill its public service
18 obligations.
19 Q: **What are the consequences of a "cash lock-up" as defined the transaction**
20 **debt agreements?**
21 A: As described on page 17 of the debt offering memorandum[31], if the operational
22

[31] Attachment A to PSE Response to Public Counsel Data Request No. 3027.

1 metrics of Puget Energy fall below certain levels[32] **[HC]** XXXXXXXXXXX
2 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
3 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
4 XXXXXXXXXX [**HC]** Any such event would prevent distributions to investors
5 (including the Manager, MIP), which, in turn, could create pressure to lessen
6 capital structure spending at PSE in order to free up more cash flow in order to
7 provide the investors their promised yield. In the alternative, Macquarie could
8 issue additional debt to provide those returns to investors, making total interest
9 requirements higher and more difficult for PSE's cash flows to cover.

10 **Q: What are Puget's [HC] XXXXXXXXXXXXXXXXXXXXXXXXXXXXX**
11 **XXXXXXXXX [HC] as defined by Macquarie in its debt offering**
12 **memorandum.**

13 A: As set out at pages 73 and 74 of the Attachment A to PSE Response to Public
14 Counsel Data Request No. 3027, Macquarie defines **[HC]** XXXXXXXXXXX
15 XXXXXXXXXXXXXXXXXXXXXX **[HC]** as follows:

16 **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
19 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
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[32] **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXX **[HC]**

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XXXXXX **[HC]**

As shown in the above quote from the debt memorandum related to the pending Puget acquisition, with **[HC]** XXXXXXXXXXXXXXXXX **[HC]** projected at **[HC]** XX **[HC]** Billion and **[HC]** XXXXXXXXXXXXX XXXXX **[HC]** projected to be **[HC]** XXXXXXXXXXXXX **[HC]**—most of Puget's capital expenditures are classified as **[HC]** XXXXXXXXX **[HC]** by Macquarie. Therefore, if more capital expenditures were re-classified as **[HC]** XXXXXXXXX, **[HC]** it would be more likely for this project to violate the debt covenants, which are calculated as FFO less **[HC]** XXXXXXXXXXXX **[HC]** capital expenditures divided by total interest expense.

Also, it is important to point out that if Puget wants to spend borrowed money for what are designated **HC]** XXXXXXXX**[HC]** capital expenditures,

which are the majority of such expenditures, it has to pass additional financial tests not required for the **[HC]** XXXXXXXXXX **[HC]** expenditures. The most recent Debt Financing Commitment Letter, provided in PSE response to Public Counsel Data Request No. 3050 (First Supplemental Response), with regard to spending on significant **[HC]** XXXXXXXXXX **[HC]** capital expenditures, indicates as follows:

[HC]
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1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
2 XXXXXXXXXXXXX[33] XXXXXXXXXXXXXXXXXX
3 XXXXXXXXXXXXXXXXXXXXXX **[HC]**[34]
4
5 Finally on this point, just to be clear as to the origins of the terms **[HC]**
6 XXXXXX **[HC]** and **[HC**]XXXXXXXXXXX, **[HC]** the debt term sheet
7 provided in PSE Response to Public Counsel Data Request No. 3050, also notes,
8 at page 20, **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
10 XXXX **[HC]**

11 **Q: Have you been able to identify which of Pugets's particular capital**
12 **expenditure projects are classified as [HC]** XXXXXXXX **[HC] and which**
13 **were classified as [HC]**XXXXXXXXXXXX **[HC]**

14 A: No. When asked to explain in detail the distinction between **[HC]** XXXXXXX
15 **[HC]** and **[HC]** XXXXXXXX **[HC]** capital expenditures, the Applicants
16 responded that those were not terms used by PSE:

17 The terms "Non-Discretionary Capex" and "Discretionary
18 Capex" are used solely in connection with the financial
19 projections prepared by the Consortium for purposes of the
20 debt memorandum and are not descriptive of the standards
21 employed by PSE for capital planning purposes, capital
22 budgeting purposes or making operational decisions.[35]
23
24 Following up its question, PSE Response to Staff Data Request No. 1077
25

[33] "Mandatory" capital expenditures in this document (PSE Response to Public Counsel Data Request No. 3050) have the same definition as "Non-discretionary" capital expenditures set out the quote from the debt offering memorandum (PSE Response to Public Counsel Data Request No. 3027).
[34] PSE First Supplemental Response to Public Counsel Data Request No. 3050, Attachment A, p. 8.
[35] PSE Response to Staff Data Request No. 1075.

1 requested more detailed information regarding the capital expenditure
2 distinctions, including a list of which projects were **[HC]** XXXXXXX **[HC]**
3 and which were **[HC]** XXXXXXXXX **[HC]** The Applicants responded:

4 Puget Sound Energy, Inc. ("PSE") does not use the
5 definitions of "discretionary" and "non-discretionary" in
6 relation to capital expenditures. The terms "discretionary"
7 and "non-discretionary" in relation to capital expenditures
8 were used in the negotiations of the acquisition debt
9 facilities, and these terms are included in the calculation of
10 free cash flow in the coverage ratios included in the debt
11 facilities.
12
13 In PSE Response to Public Counsel Data Request No. 3166, which also
14 requested clarification of those terms, the Applicants provided the same response
15 as provided in PSE Response to Staff Data Request No. 1077. Following a
16 meeting with the Puget, Staff and Public Counsel attorneys trying to discern the
17 details of the classification, the Applicants provided a supplemental response to
18 Public Counsel Data Request No. 3166.
19 In PSE Supplemental Response to Public Counsel Data Request No. 3166
20 indicates that the terms **[HC]** XXXXXXX **[HC]** and **[HC]** XXXXXXXXXX
21 **[HC]** capital spending in the debt agreements have now been changed to **[HC]**
22 XXXXXXXXXXXXXXX **[HC]** and **[HC]** XXXXXXXXXXXX **[HC]**
23 However, a review of the new document reveals that the name change is the only
24 difference. **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
25 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
26 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
27 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**

1 In the May 16, 2008 Credit Agreement between Puget Merger Sub and
2 several banks provided with the PSE's supplemental response to Public Counsel
3 Data Request No. 3166, the additional requirements (cited above) related to
4 spending the **[HC]** XXXXXXXXXXXXXX **[HC]** remain in place. That document
5 references as foundation Macquarie's financial model (which uses the terms **[HC]**
6 XXXXXXXXX **[HC]** and **[HC]** XXXXXXXXX **[HC]**). Also the cash flow
7 coverage ratios first subtract **[HC]** XXXX **[HC]** (formerly **[HC]** XXX
8 XXXXXXX **[HC]** capital expenditures from FFO before calculating the interest
9 coverage. Therefore, the amounts of **[HC]** XXXXXX **[HC]** and **[HC]** XXX
10 XXXXXXX **[HC]** capital expenditures are the same, the additional restrictions
11 for large **[HC]** XXXXXXXX **[HC]** expenditures are the same, but the parties to
12 the pending transaction are now calling those expenditures something else.
13 It appears the semantic change in the debt language occurred because of
14 the interest by the Staff and Public Counsel in the classification of PSE's
15 projected construction budget into two tiers, and the notion that some of the
16 capital spending projected for PSE, could be considered to be "**[HC]**
17 XXXXXXXXX **[HC]** That interest arose because PSE's projected capital budget
18 and the need for capital is a primary motive force in this proposed transaction. If
19 most of the projected capital spending is **[HC]** XXXXXXXXX **[HC]** then the
20 primary reason for the proposed transaction has less weight. Therefore,
21 apparently concerned that this Commission would view the determination that any
22 part of PSE's current Integrated Resource Plan would be considered **[HC]**
23 XXXXXXXXXX **[HC]** Macquarie and its lenders have changed the words to

1 something else. However, the two-tiered nature of the projected capital
2 expenditures and the details of the debt agreements remain exactly the same.
3 **Q: What do you believe is the significance of this semantic difference in the debt**
4 **language?**
5 A: What this language change shows is the degree to which the proposed transaction
6 with the Macquarie-led consortium, through its use of substantial amounts of debt
7 financing and the protections that must be offered those lenders, can control the
8 manner in which PSE is able to carry out its public service obligations. It also
9 shows, in a very explicit way, why this Commission must look beyond the
10 regulated subsidiary to the financial details of its would-be parent companies in
11 order to understand and assess the risks to which the regulated subsidiary is
12 exposed.
13 For example, if, following the merger, Puget builds or invests in a
14 combined-cycle gas fired generation facility, it will need to draw down monies
15 from the transaction debt arranged by Macquarie. However, because such an
16 expenditure would be classified as **[HC]** XXXXXXXXXXXXXXXXXXXX
17 **[HC]** CapEx" those monies will not be available to fund that capital expenditure
18 if the consolidated equity ratio of Puget Energy (the borrower) falls below **[HC]**
19 XXXXX **[HC]** of total capital. This additional requirement is set out on page 61
20 of Attachment A, PSE First Supplemental Response to Public Counsel Data
21 Request No. 3166, the Credit Agreement between Puget Merger Sub and the
22 transaction debt lenders.

1 Although Macquarie's financial projections (provided in PSE Response to
2 Staff Data Request No. 1047), with the inclusion of "goodwill" in the amount of
3 common equity, show that Puget Energy's common equity ratio approaches **[HC]**
4 XXXXXXXXXXXXXXXXXX **[HC]** it does not fall below that level. If
5 however, through some unforeseen event that impacts common equity balances, it
6 does, then monies to build or invest in any such planned generation asset will not
7 be available from those debt facilities.
8 Also, as I will show below, given the historical volatility of Puget's
9 revenues and energy costs, the margin above which cash lock-up events occur
10 (FFO less **[HC]** XXXXXXXXXXXXXXXX **[HC]** is relatively small and is
11 likely to be violated. Such an event would prevent the equity investors from
12 receiving expected cash distributions and could, in turn, put pressure on PSE to
13 curtail **[HC]** XXXXXXXXXXXXXXXXXXXXXXXX **[HC]** construction
14 expenditures in order to improve investor cash flow metrics.
15 Finally, the debt commitments require that the final construction costs for
16 any large **[HC]** XXXXXXX **[HC]** capital expenditure be no more than **[HC]** XX
17 XXXX **[HC]** greater than those included currently in Macquarie's current
18 financial projections. If the costs of construction **[HC]** XXXX **[HC]** double from
19 what is currently expected, those additional costs cannot be funded by this debt.
20 Thus, this "debate" over what to call the two types of capital expenditures,
21 reveals that the restrictive covenants in the debt issued by Puget Energy and
22 engineered by Macquarie, can have a direct affect on whether PSE is able to
23 fulfill its public service obligations. PSE would not be making those decisions;

1 nor would this Commission; rather Macquarie and the banks from which it
2 intends to draw the transaction debt would be making those decisions. Therefore,
3 this Commission must look beyond the corporate boundaries of the regulated
4 subsidiary, PSE, because its ability to safely and efficiently provide service to
5 Washington ratepayers can be directly affected by the debt arranged by
6 Macquarie and incurred by Puget Energy.
7 **Q: Does this conclude your comments regarding the details of the debt issuance**
8 **contemplated for the requested transaction?**
9 A: Yes, it does.
10 **Q: Have you had an opportunity to review the financial modeling undertaken by**
11 **Macquarie in projecting the post-acquisition Puget Energy's cash flows,**
12 **interest coverage and capital structure metrics over the next ten years?**
13 A: Yes, I have. In PSE Response to Staff Data Request No. 1047, Macquarie's
14 representative, Mr. Leslie, provided the financial model for the transaction. That
15 model projects, by month, quarter and year, through December 31, 2018 the cost
16 of service, tariffs, operating costs, taxes, income statements, cash flow statements,
17 and balance sheets for Puget Sound Energy and Puget Energy.
18 My review of Macquarie's post-merger financial projections found them
19 to be based on optimistic assumptions. Also, a detailed review of the cash flow
20 outputs of the model indicates that the average cash flow coverage of interest
21 necessary to avoid cash lock-up by the transaction debt lenders is relatively thin.
22 The amount of revenue or expense fluctuations necessary to move from the
23 average cash flow coverages projected by Macquarie (under optimistic

1 assumptions) to levels that violate bond lock-up limits, when viewed in the
2 context of Puget's actual historical revenue and expense volatility, indicates that
3 the cash flow coverage requirements are likely to be violated.

4 **Q: What are the assumptions that underlie Macquarie's projected "base case"**
5 **financials that you believe are optimistic.**

6 A: The financial projections that support the proposed transactions are based on the
7 following assumptions, among many others: **[HC]**

8 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
11 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
12 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX;[36]
14 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
15 XXXXXXX[37]
16 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
19 XXXXXXX
20

[36] Current level of PSE preferred stock is 0.034 percent; see PSE Response to Staff Data Request No. 189 in PSE General Rate Case Docket Nos. UE-072300 and UG-072301. [

[37] Public Counsel recommended debt ratio in Docket Nos. UE-072300 and UG-072301 is approximately 57 percent of total capital.

1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
2 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
3 XXXXXXX.[38];
4 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
6 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
7 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
8 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
11 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
12 XXXXXXXXXXXXXXXXXXXXXXXXX[39] XXX
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
14 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
15 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**
16 If the financial and economic environment in which Puget Energy operates
17 over the next ten years is as benign as that projected in Macquarie's base case, in
18 my view, it will be surprising. I do not believe it is reasonable to assume that
19 PSE's rates will be increased annually like clockwork in the fashion predicted.
20 Nor is it reasonable to assume, given current $130/barrel oil prices (which are
21

[38] **[HC]**XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**

[39] The dividend paid in 2007 was $108 Million. (Puget Energy 2007 S.E.C. Form 10-K, p. 84)

1 double what they were a year ago), that inflation and interest rates will remain
2 low and stable over the next decade. The same is true for the gas and electricity
3 prices that Puget will incur over time. Therefore, if the assumptions underlying
4 the financial projections that are the foundational support for the propriety of this
5 transaction are likely to be incorrect, then the financial picture becomes much
6 more difficult to predict and the probability of a positive outcome for the
7 transaction more tenuous.

8 **Q: Doesn't Macquarie, in its presentations to investors, test the assumptions in**
9 **its model and show that even if some assumptions are violated the**
10 **transaction continues to meet the debt indenture tests?**

11 A: Yes, however there are two points to note in that regard. First, the "tests"
12 themselves are rather benign. For example, in the Confidential Information
13 Memorandum, dated January 2008, which was sent to the transaction debt
14 investors, Macquarie indicates that it performed a sensitivity analysis.[40] One of
15 the tests assumed that **[HC]** XXXXXXXX **[HC]** of requested rate case revenues
16 were allowed instead of the "base case" **[HC]** XXXXXX **[HC]** Another assumed
17 that following the current rate case, in future rate cases, the ROE was **[HC]**
18 XXXX XXX **[HC]** basis points, i.e. to be **[HC]** XXXX **[HC]** above ten-year T-
19 Bond yields instead of **[HC]** XXXXXX **[HC]** In another test, Macquarie
20 assumes power costs increase **[HC]** XXXXXXXXXXXXXXXXXXXX. **[HC]**
21 While all of those factors appear to be legitimate tests of the outcome of the
22 model, all are

1

[40] PSE Response to Public Counsel Data Request No. 3027, p. 80.

1 rather tepid. What happens to the model results, for example, if **[HC]** XXXXXX
2 **[HC]** of requested rate case revenues are allowed, or if power costs spike 200
3 percent beginning next year, or if inflation jumps to 8 percent? We don't know
4 the answer.
5 Second, it appears Macquarie tested different assumptions one at a time,
6 and did not test multiple dislocations to its model assumptions. For example,
7 what if PCORC were abolished and interest rates doubled next year? Again, we
8 don't know.
9 **Q: Were you able to test the model yourself by substituting different**
10 **assumptions?**
11 A: No. The spreadsheet provided in PSE Response to Staff Data Request No. 1047
12 would not update when different values were substituted for the "base case"
13 assumptions. As of this writing, Public Counsel is attempting to have different
14 scenarios tested by the Joint Applicants.
15 However, I was able to test the "base case" results against the volatility
16 inherent in Puget Energy's historical record of operations. The results indicate
17 that the debt service cash flow margins created even under the assumptions
18 included in Macquarie's base case projections are too thin to insure that they will
19 not be not violated when compared to the level of volatility experienced in the
20 past by Puget.
21 **Q: Please explain how you analyzed the cash flow margin projections in the**
22 **Macquarie financial projection model.**

1 A: The Macquarie financial model, with its "base case" assumptions, projects that
2 over the ten-year life of the equity partnership, the average FFO les **[HC]**s XXXX
3 **[HC]** Capital Expenditures divided by total interest for Puget Energy will be
4 **[HC]** XXX. **[HC]** The cash lock-up threshold is **[HC]** XXX **[HC]** and the default
5 threshold is **[HC]** XXX. **[HC]** A further examination of the projected data show
6 that over the projected period, the average annual FFO less **[HC]** XXXX **[HC]**
7 CapEx is **[HC]**XXXX **[HC]** Million and the average consolidated (Puget Energy
8 and Puget Sound Energy) interest expense is **[HC]** XXX **[HC]**Million. In order
9 to trigger the cash lock-up provisions of the transaction debt covenants, the
10 average FFO has to decline to **[HC]** XXXXX **[HC]** the interest expense, or **[HC]**
11 XXXXXXXXXXXXXXXXXX **[HC]** To reach that critical threshold would
12 require an annual reduction in cash flow of **[HC]** XXXXXXXXXXXXXXX
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]** In order to trigger a
14 default, the average cash flow would have to decline by **[HC]** XXXXXXXXXXX
15 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
16 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**
17 A cash flow variance of **[HC]** XXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXXXXXXXXXXXX **[HC]** seem to be rather large
19 variances that are not likely to occur. However, when we examine Puget's
20 historical revenue and gas and electric cost volatility, that sort of swing in annual
21 levels is not unusual. In fact, a reduction in annual revenues or an increase in
22 costs of gas and electricity of **[HC]** XXX **[HC]** Million is well within one
23 standard deviation from the trend of those costs, according to Puget's actual

1 historical results. Those actual historical results indicate that **[HC]** XXX **[HC]**
2 Million swings, through either revenues or costs fluctuating alone or together,
3 should be expected to occur in the future. Moreover, if they do occur in the future,
4 the debt financing proposed by Macquarie in this transaction will be in trouble,
5 creating financial difficulties for PE and, ultimately, PSE.

6 Exhibit No. ___ SGH-8HC), page 1 provides a graphical depiction of
7 Puget Energy's annual revenues from 1998 through 2007, as indicated in its
8 Annual Reports. Also shown is the linear trend of revenues during that ten-year
9 period as well as a parallel line on either side of the trend, which is one standard
10 deviation away from the trend line. Within +1 and –1 standard deviation,
11 assuming normal distribution, we can be 95 percent certain that the Puget's
12 revenues will be within that range about two-thirds of the time. Also shown on
13 page 1 of Exhibit No. ___(SGH-8HC) is a line labeled "Average Lock-up
14 Threshold," which shows a level of revenues that is **[HC]** XXX **[HC]**Million less
15 than the historical trend. That lock-up threshold line lies inside the one standard
16 deviation boundary, which means that a revenue variance of that magnitude is not
17 unlikely.

18 As shown on page 2 of Exhibit No. ___ (SGH-8HC), one standard
19 deviation about the historical revenue trend is **[HC]** XXX **[HC]** Million. Because
20 the **[HC]** XXX**[HC]** Million revenue variance shown on the chart on page 1 of
21 Exhibit No. ___ (SGH-8HC) is **[HC]** XXXXXXXXXXXXXXXXXXXX **[HC]**
22 about the trend, Puget Energy's revenues are likely to be **[HC]** XX **[HC]** Million

1 above or below the trend line **[HC]** XXXXX **[HC]** of the time.[41] That, in turn,
2 means that the variance is likely to be greater that the lock-up threshold **[HC]**
3 XXXXXXX **[HC]** of the time, and the transaction debt bond covenants, in that
4 not uncommon instance, would be violated. It is also noteworthy that, a **[HC]**
5 XXX **[HC]** Million variance, which would put Puget Energy in default, is also
6 within one standard deviation of the historical variance in revenues.

7 **Q: Have you made a similar analysis of Puget Energy's costs of purchased**
8 **power and gas?**

9 A: Yes. Again taking data from the Puget's annual reports over the past ten years,
10 page 3 of Exhibit No.___ (SGH-8HC) shows the actual historical purchased gas
11 and electricity costs and the trend in those costs. Also shown are a boundary one
12 standard deviation above and one standard deviation below that trend. Once
13 again, a **[HC]** XXX **[HC]** Million variance (in the case of expenses, the type of
14 variance that would negatively affect cash flow would be a positive variance) falls
15 within one standard deviation from the trend. As shown on page 4 of Exhibit No.
16 ___ (SGH-8HC), given Puget's historical power and gas expenses, one standard
17 deviation from the trend in those costs is **[HC]** XX **[HC]** Million. A commodity
18 cost variance of that amount, which reduced cash flows by a like amount, would
19 cause Puget to default on its proposed transaction debt.

20 In sum, while Macquarie's projections, which show a "cushion" of
21 approximately **[HC]** XXXXXXX **[HC]** Million annually in cash flows that
22

[41] Hemtoberger, Billingsley and Craft, Statistical Inference for Management and Economics, Allyn and Bacon, Inc., Boston, MA, 1975, pp. 284-287.

1 exceed the interest coverage requirements of the transaction debt, those amounts
2 are relatively small when measured against the actual historical volatility
3 experienced by Puget. A variance of that amount for either revenues or purchased
4 power and gas costs is not uncommon. This analysis, based on Puget's
5 operational history, indicates there is a measurable, non-trivial statistical
6 probability that the year-to-year volatility of revenues and/or expenses is likely to
7 cause conflict with the cash flow coverage covenants of the proposed transaction
8 debt.

9 **Q: Does this conclude your comments regarding the details of the proposed**
10 **transaction?**

11 A: Yes.

12 **IV. BOND RATING CONSIDERATIONS**

13 **Q: Have both Moody's and Standard & Poor's reviewed the proposed**
14 **transaction?**

15 A: Yes Macquarie and Puget approached both Moody's and Standard & Poor's, prior
16 to their initial merger announcement, for a preliminary indication of the
17 transaction's impact on the credit ratings of Puget Energy and Puget Sound
18 Energy. The Applicants presented the bond rating agencies initially with two
19 different financing scenarios—one in which most of the debt at PSE would be
20 retired and the majority of the post-transaction debt would reside at the parent
21 company (PE) level, and one in which most of the debt would reside at PSE.

22 Reviewing those two scenarios, **[HC]** XXXXXXXXXXXXXXXXX
23 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

1 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
2 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
3 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]**

4 Following that preliminary review, the Joint Applicants then presented the
5 bond rating agencies another financing scenario, which is effectively the same as
6 that included in the financial projections sent to the equity and debt investors, and
7 in which most of the consolidated debt continues to reside at the PSE level. **[HC]**
8 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[HC]** In
11 an October 19, 2007 private letter to Macquarie, Moody's noted: **[HC]**

12 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
13 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
14 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
15 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
16 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
19 XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
20 XXXXXXXXXXXX **[HC]** [42]
21

22 Following that letter, on October 30, after the announcement of the
23 merger, Moody's published a bond rating report on Puget Sound Energy
24 confirming that company's corporate credit rating of Baa3, changing the rating to
25 "stable" from "positive" and noting that the corporate credit rating for Puget
26 Energy was under review for possible downgrade. In that public document,
27

[42] PSE Response to ICNU Data Request No. 3.23, Attachment B (HC).

1 Moody's notes that the possible downgrade of Puget Energy is due to the increase
2 in PE's business and financial risk caused by the proposed transaction. However,
3 Moody's does not discuss **[HC]** XXXXXXXXXXXXXXXXXXXXXXXX
4 XXXXXXXXXXXXXXXXXX **[HC]** as they did in the private letter to
5 Macquarie. In that October 30, 2007, report on Puget Sound Energy, Moody's
6 does note that a possible downward rating change for PSE could result from:
7 "adding material debt at the parent holding company to the point of creating an
8 undue amount of pressure for higher dividends to the parent could lead to a
9 negative rating action." As noted in the previous section of this testimony, PSE's
10 dividends to Puget Energy in 2007 were $108 Million, and Macquarie projects
11 that over the next ten years, if the transaction proceeds, PSE's dividends to Puget
12 Energy will average **[HC]** XXXX **[HC]** per year. Given the facts that Puget
13 Energy will add an additional **[HC]** XXXXX **[HC]** to the amount of debt
14 discussed in Moody's published bond rating report and will roughly**[HC]** XXX
15 **[HC]** the dividends paid by PSE to PE, it appears that there is an increased
16 probability that PSE's corporate credit rating could eventually be downgraded if
17 the requested transaction is allowed to proceed.
18 **Q: What was Standard & Poor's response to the Macquarie financial**
19 **projections for acquiring Puget Energy?**
20 A: Standard & Poor's has a different view of parent-subsidiary relationships than
21 Moody's. S&P's position is that because the parent company has ultimate control
22 over the subsidiary, unless there is some substantial barrier to limit that

1 relationship, the bond ratings of the parent and subsidiary will be considered
2 together, not separately.

> 3 A strong subsidiary owned by a weak parent generally is
> 4 rated no higher than the parent. The key reasons:
> 5 • The ability of and incentive for a weak parent to
> 6 take assets from the subsidiary or burden it with
> 7 liabilities during financial stress: and
> 8 • The likelihood that a parent's bankruptcy would
> 9 cause the subsidiary's bankruptcy, regardless of its
> 10 stand-alone strength.
> 11 Both factors argue that, in most cases, a "strong" subsidiary
> 12 is no farther from bankruptcy than its parent, and this
> 13 cannot have a higher rating….
> 14 For example, some regulated utilities are strong credits on a
> 15 stand alone basis, but often are owned by companies that
> 16 finance their holding in the utilities with debt at the parent
> 17 company…, or that own other, weaker business units. To
> 18 achieve a rating differential from that of the consolidated
> 19 group requires evidence—based on the specific regulatory
> 20 circumstances—that regulators will act to protect the
> 21 utility's credit profile.[43]

22
23 In its October 22, 2007 private letter to Macquarie, reviewing the
24 financing scenario that most closely resembles that proposed in this transaction,
25 S&P noted the following: **[HC]**

26 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
27 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
28 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
29 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
30 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
31 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
32 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
33 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
34 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
35 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
36 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
37 XXXXXXXXXXXXXXXXXXXXXXXXXX
38

[43] Standard & Poor's, Corporate Ratings Criteria, 2006, pp. 85, 86, 88.

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2 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
3 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
4 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
6 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
7 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
8 XXXXXXXXXXXXXXXXXXXXXXXXXXX[44] **[HC]**
9
10 **Q: Did Standard & Poor's review the "ring fencing" provisions offered by the**
11 **Joint Applicants to determine if the bond ratings between PE and PSE would**
12 **remain linked?**
13 A: Yes, and S&P determined that the ring fencing proposals offered by the Joint
14 Applicants were **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
15 XXXXXXXXXXXXX **[HC]** That letter, dated December 27, 2007, was
16 provided in PSE Response to ICNU Data Request No. 3.23, Attachment F(HC),
17 and will be discussed in more detail in the final section of my testimony.
18 **Q: Has there been a more recent S&P credit report on Puget Energy?**
19 A: Yes; the most recent credit rating report on Puget Energy was published by
20 Standard & Poor's on March 26, 2008 and was provided by Puget in a PSE
21 Supplemental Response to Public Counsel Data Request No. 7 in the concurrent
22 general rate case. The most recent corporate credit rating for Puget by S&P is
23 "BBB-" and the Company is on "credit watch with negative implications."
24 The Credit Watch listing reflects the possibility that debt
25 ratings for Puget and PSE could be lowered contingent on
26 the final outcome of regulatory merger approval
27 proceedings….Puget's expected consolidated credit
28 measures post-transaction will be stretched and the final

[44] PSE Response to ICNU Data Request No. 3.23, Attachment E(HC), pp. 2, 3.

1 regulatory order could weaken anticipated cash flow
2 coverage metrics….
3 Capital requirements are very high at PSE, with capital
4 expenditures of $2.7 billion planned for 2008 and 2009
5 related to system upgrade needs, customer growth, and
6 further resource additions. Ongoing periodic debt and
7 equity funds are expected to finance this growth.[45]
8
9 This report, in similar fashion to the Moody's report, elects to discuss only
10 the transaction debt that will reside at PE (the initial $1.425 Billion), and does not
11 discuss the additional **[HC]** XXXXXX **[HC]** that will also ultimately reside at
12 PE, except to say that "credit measures will be stretched."
13 S&P's most recent bond rating for PE also assumes that the capital
14 funding will be derived in a balanced fashion, i.e., with "ongoing periodic debt
15 and equity funds." However, **[HC]** XXXXXXXXXXXXXXXXXXXXXXX
16 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
17 XXXXXXXXXXXXXXXXXXXX **[HC]** Therefore, S&P expectations as to
18 "balanced" funding are **[HC]** XXXXXXXXX **[HC]** and, if this transaction is
19 allowed to proceed, the likelihood that S&P's PE/PSE bond rating will decline
20 increases as more and more debt is added to the parent company capitalization.
21 Finally, it its private letter opinion to Macquarie, S&P notes that it places
22 **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
23 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
24 XXXXXXXXXXXXXXXXXX **[HC]**[46] In its financial projections for the Puget
25 acquisition, Macquarie notes that one of S&P's threshold criteria for a "BBB"

[45] S&P Ratings Direct, Puget Energy, Inc., March 26, 2008, pp. 2, 3.
[46] PSE Response to ICNU Data Request No. 3.23, Attachment E(HC), p. 3.

1 bond rating is a debt-to-capital ratio of 60 percent for an "excellent" business risk.
2 That is, total consolidated debt can be no more than 60 percent of total capital in
3 order to maintain a "BBB" bond rating.
4 In the financial model, supplied in PSE Response to Staff Data Request
5 1047, Attachment A(HC), Macquarie shows that for the Parent (Puget Energy),
6 the consolidated debt/capital ratio averages about**[HC]** XXXXXXX **[HC]** over
7 the ten-year projected period. While that seems close enough to "pass muster,"
8 Macquarie has incorrectly calculated the consolidated debt measure by including
9 100% of "goodwill" in the amount of common equity used in the calculation.[47]
10 However, in calculating a debt-to-capital ratio, Standard & Poor's includes only a
11 portion of goodwill in the calculation.

12 Goodwill especially is suspect, considering its likely value
13 in a default scenario. In applying the notching guidelines,
14 Standard & Poor's generally eliminates from total assets
15 goodwill in excess of a "normal" amount—10% of total
16 assets. [48]
17
18 When the financial projections are corrected so that only 10 percent of the
19 total assets are goodwill, as recommended by S&P, Puget Energy's debt-to-capital
20 ratio begins in 2008 at **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
21 **[HC]** by 2018.[49] In other words, the financial metrics of Puget Energy will
22 exceed the level required for a "BBB" bond rating **[HC]**
23 XXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXX **[HC]**

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[47] Goodwill is "the excess of the cost of an acquired entity over the net or the amounts assigned to assets acquired and liabilities assumed." (PSE Response to Public Counsel Data Request No. 3087)
[48] Standard & Poor's, Corporate Ratings Criteria, 2006, p. 49.
[49] Exhibit No. ___ (SGH-9HC).

These data also indicate that the transaction is likely to put downward pressure on the bond rating of Puget Energy and its subsidiary, Puget Sound Energy. Moreover, because PSE's corporate credit rating is currently at the lowest "BBB" level, any downward movement would be to the non-investment grade level.

Puget Energy's Vice President of Finance and Treasurer, in PSE Response to Public Counsel Data Request No. 026(d) in the concurrent Rate Case, lists the difficulties that would be caused by a reduction in PSE's bond rating:

> The primary result of a lower PSE credit rating would be to detrimentally impact PSE's access to capital on reasonable terms and potentially to make it difficult for PSE to carry out its public service responsibilities. The actual effects would be determined, in part, by the level of the downgrade. The impact of a downgrade would include, but would not be limited to, the following:
>
> - Higher long-term borrowing costs on long-term debt, preferred stock, hybrid securities, etc.;
> - Higher short-term borrowing costs as reflected in credit facility pricing grids and likely higher spreads on commercial paper issuances;
> - Potential loss of access to the commercial paper markets;
> - Possible inability to renew credit facilities;
> - Potential collateral calls from energy credit counter parties;
> - The demand for collateral or up-front payments by those providing new energy resources to PSE;
> - Counterparties may no longer provide trade credit for energy hedging activities;
>
> Energy supply trading and hedging counterparties may no longer be willing to conduct business with PSE.[50]

Q: What are your summary comments with regard to the current bond ratings of PE and PSE?

[50] PSE Response to Public Counsel Data Request No. 26(d) in Docket Nos. UE-072300/UG-072301.

1 A: The Joint Applicants have utilized a financial structure for their proposed
2 acquisition that has allowed the bond rating agencies to maintain the lowest-level
3 investment-grade rating for PSE, however, Moody's had increased the credit
4 rating spread between PSE and PE. That is, in reaction to the proposed
5 transaction, Moody's has kept the credit rating of PSE at current levels while
6 lowering the credit rating of the parent, PE.
7 S&P, on the other hand, keeps both parent and subsidiary at the same
8 "BBB-" level, but that rating agency has placed them both on a negative watch for
9 possible downgrade. The reason for those rating changes is the amount of debt
10 used in the initial purchase of Puget—$1.425 Billion. However, that initial
11 transaction debt, is far less then the **[HC]** XXXXXXXX **[HC]** or more that will
12 ultimately reside there.[51]
13 While S&P assumes that Puget will finance capital expenditures with debt
14 and equity and Moody's expects "balanced" financing of future construction,
15 **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
16 **[HC]** Also, while S&P expects Puget Energy to maintain "BBB" credit metrics,
17 its debt-to-capital ratio **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXX
18 XXXXXXXXXXXXXXX **[HC]** according to the financial model and the manner
19 in which S&P calculates that benchmark. This transaction and the additional
20 financial leverage it is expected to use has already increased the risk of Puget, as
21 seen in the rating agencies' pull-back from "positive" outlooks to "stable" or
22

[51] **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX**[HC]**

1 "negative." Accordingly, if allowed to proceed, this transaction will continue to
2 increase the financial and business risk of Puget and, according to the
3 Commission's standards, imparts an unacceptable harm to Puget and its
4 ratepayers.

5 **V. RING FENCING MEASURES AND OTHER COMMITMENTS**

6 **Q: Have the Joint Applicants offered any measures designed to insulate PSE**
7 **from any financial difficulties that may exist at the parent companies' level?**

8 A: Yes. In Appendix C of the Joint Application the Applicants list 31 commitments
9 related to the proposed transaction. As I have noted previously in this testimony,
10 many of those commitments are essentially promises to continue to operate as
11 Puget would on a stand-alone basis.

12 Some of the commitments offered by the Applicants are intended to lessen
13 the financial linkage between Puget Sound Energy and its parent companies in
14 order that, if the parent companies face financial difficulties, those financial
15 difficulties will not also threaten PSE's regulated operations. That protection is
16 termed "ring-fencing." However, in my view, those ring-fencing commitments
17 will not protect PSE in the event of financial difficulties at Puget Holdings, Puget
18 Intermediate Holdings or Puget Energy (the parent companies of PSE).

19 **Q: Have the bond rating agencies commented specifically on the Applicants ring**
20 **fencing proposals or commitments?**

21 A: Yes. As mentioned above, in a December 27, 2007, letter responding to
22 Macquarie's request that Standard & Poor's review the commitments set out in
23 Appendix C of the Joint Application, that bond rating agency found that those

1 commitments would not justify de-linking the credit rating of Puget Sound
2 Energy from that of its direct parent, Puget Energy. Standard & Poor's initial
3 review of the transaction, as noted previously, indicated that PE and PSE would
4 maintain the same credit rating and both would be put on ratings watch for
5 possible downgrade as a result of the propose transaction. Following Macquarie's
6 inquiry as to whether or not its "Appendix C" commitments would change the
7 linkage between PE and PSE, Standard and Poor's stated: **[HC]**

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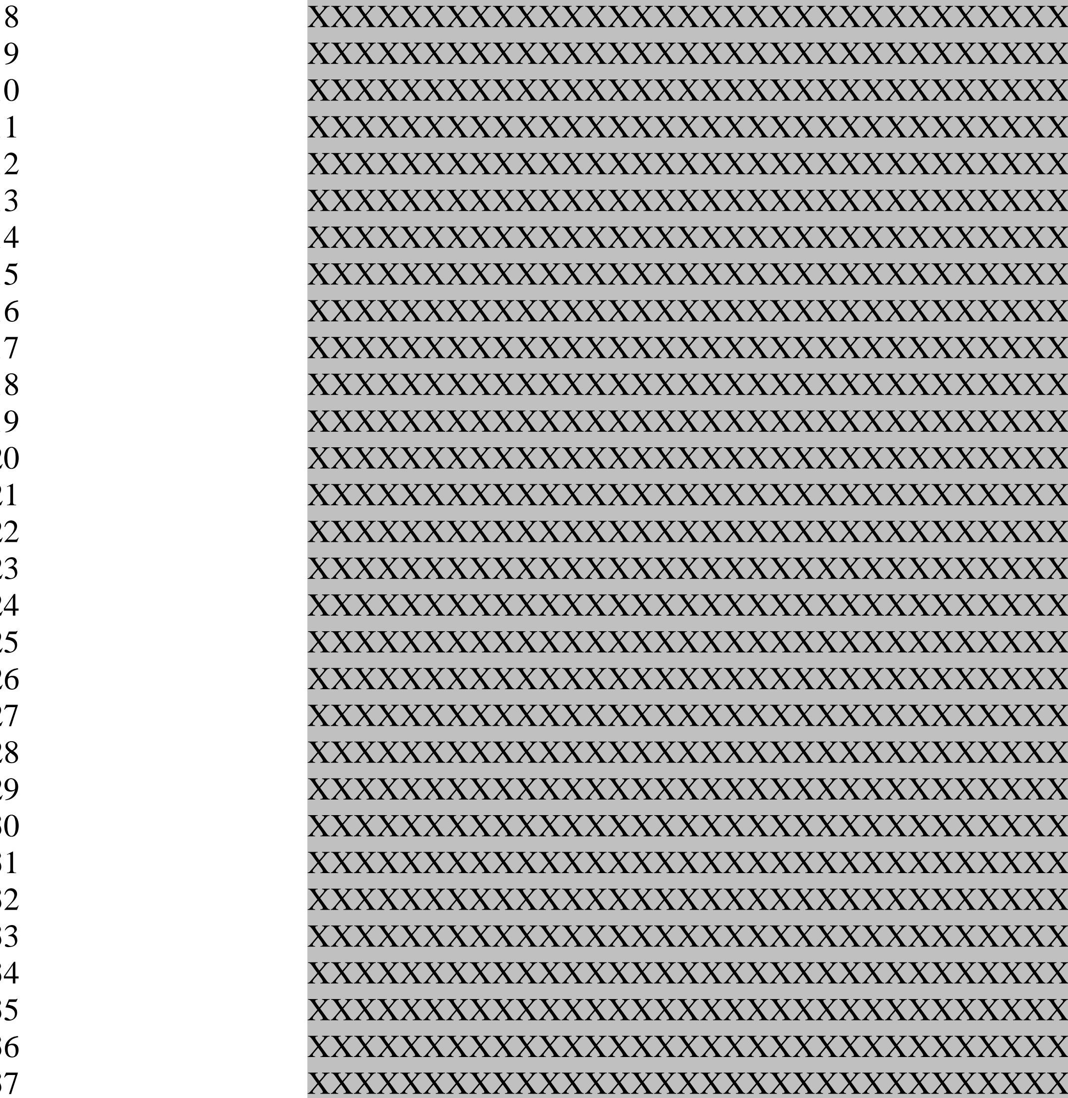

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8 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
9 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
11 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
12 XXXXXXXXXXXXX **[HC]**[52]
13
14 With regard to a "non-consolidation opinion," the Applicants confirm that
15 such an opinion will not prohibit a PSE bankruptcy filing:

16 No, a non-consolidation opinion does not ensure that a
17 bankruptcy court judge would prevent consolidation.[53]
18
19 In PSE Response to Public Counsel Data Request No. 3030, when asked
20 to define a non-consolidation opinion, the Applicants referenced the non-
21 consolidation opinion regarding MDU Resources Group and Cascade Natural Gas
22 filed with the Commission in Docket No. UG-061721, which was included as
23 Attachment A to that data response. That non-consolidation opinion, authored by
24 Puget's law firm, Perkins, Coie, states as follows:

25 We note that the question of whether the assets and the
26 liabilities of Cascade will be substantively consolidated
27 with those of MDU Resources is inherently fact-specific.
28 Other than as specifically provided herein, we cannot opine
29 as to what action a court will take in the future when
30 reviewing actions that have not occurred as of the date
31 hereof. We express no opinion as to the substantive
32 consolidation of the assets and the liabilities of Cascade
33 with those of MDU Resources, if such consolidation is

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[52] December 27, 2007 letter from Standard & Poor's to Macquarie, PSE Response to ICNU Data Request No. 3.23, Attachment F (HC), p. 2
[53] PSE Response Public Counsel Data Request No. 3100(c).

> done in a manner that is not prejudicial to Cascade's creditors.[54]
>
> Therefore, such an opinion offers no guarantee against consolidation of PSE's assets with those of Puget Holdings in a worst-case scenario.

Also, the commitment to maintain a particular common equity ratio at PSE offers no real credit protection for PSE, its current bondholders or its customers. That is because, as I have discussed previously, the immediate parent company, Puget Energy, can maintain any particular capital structure at PSE by issuing debt and then lending those monies to PSE or contributing those monies to PSE's equity accounts. However, the only source of funds to pay the debt costs incurred by the immediate parent is the cash flows of PSE, which are ultimately provided by ratepayers. Therefore, whether the cash flow streams of PSE are leveraged at the subsidiary level or at the parent company level that leverage adds financial risk to the regulated subsidiary—PSE. In that way, the promise to maintain a certain subsidiary capitalization structure does not provide financial risk protection to PSE, as recognized by S&P.

Q: Are there other aspects of the Applicant's ring fencing commitments on which you wish to comment?

A: Yes. Many of the "books and records" commitments offer the Commission complete access only to the extent that transactions or particular costs may be allocable to Puget Sound Energy. For example, at page 23 of the Joint Application, the Applicants offer the commitment that "PSE will provide

[54] PSE Response to Public Counsel Data Request No. 3030, Attachment A, p. 2.

1 Commission Staff and Public Counsel access to books and records (including
2 those of Puget Holdings or any affiliate or subsidiary companies) *required to*
3 *accessed to verify or examine transactions with PSE, or that result in costs that*
4 *may be allocable to PSE."* (emphasis added). That is simply not sufficient and
5 represents a degradation of the current access to information. In addition it is
6 worth noting that the comprehensive and mandatory SEC filing requirements,
7 with their accompanying penalties for misrepresentation, provide a strong
8 additional and independent safeguard for the accuracy and completeness of the
9 Puget parent company information that is absent from the simple bilateral offer of
10 access to information made here.

11 This Commission should have complete access to the books and records of
12 Puget Energy, Puget Intermediate Holdings and Puget Holdings, without
13 condition. For example, if following approval of the proposed transaction, Puget
14 Intermediate Holdings borrows an additional $300 Million to further recapitalize
15 operations, the additional debt costs would further encumber the cash flow stream
16 generated by Puget Sound Energy endangering its financial stability, but would
17 not necessarily be "allocable" to PSE.

18 Further assume that Puget Intermediate Holdings used the $300 Million to
19 invest in a very risky enterprise, raising the consolidated business risk of the
20 enterprise. This Commission would never know because the Applicants have
21 offered to inform the Commission of such investments only if they comprise more
22 than 5 percent of the capitalization of Puget Holdings (Commitments 27(b); $7
23 Billion x 5% = $350 Million).

1 If the Commission is to effectively regulate the only subsidiary of three
2 parent companies, it must have access to all the available financial and
3 operational data of all of those companies. That is because, again, the only
4 company in the group that actually creates cash flow is the regulated entity—
5 PSE—and parent company activities and the financial needs created by them,
6 must be funded from those regulated cash flows and can have a significant impact
7 on utility operations.

8 Finally, as Standard & Poor's notes, if any financial or ring-fencing
9 commitments are to have any real ability to affect the linkage between parent and
10 subsidiary, there must be serious and well-defined consequences for violating
11 those commitments. For example, in the Commission-approved "equity growth
12 tracker" designed to restore Puget's common equity ratio several years ago, there
13 were real and well-defined consequences for not reaching certain capital structure
14 ratios (rate reductions).[55] The results were positive—the capital structure goals
15 were reached ahead of schedule. However, in the commitments offered by the
16 Applicants in this proceeding, there are no consequences for any failure to meet
17 the proposed commitments.

18 **Q: Do the applicants offer a list of "commitments" they believe will provide**
19 **benefits to customers?**

20 A: Yes, however those commitments do not serve to offset the harm caused by the
21 proposed transaction. The Joint Applicants commitments effectively require the
22

[55] *WUTC v. PSE*, UE-011570 et al., Ninth Supplemental Order, Appendix A, p. 6.

1 new owners to operate Puget in the same safe, efficient manner now employed by
2 Puget. For example, they state: "Puget Holdings acknowledges PSE's obligations
3 under Washington's Renewable Portfolio Standard and commits to support PSE
4 with additional expertise and capital as necessary to enable PSE to fulfill those
5 obligations."[56] If and only if Puget did not intend to fulfill is renewable resource
6 obligations would this "commitment" provide a benefit to customers and the
7 citizens of Washington. There is no evidence that such is the case.
8 Also, at page 6, lines 8-13 of Mr. Stephen Reynolds testimony in this
9 proceeding, he testifies that the proposed transaction would enable PSE to remain
10 an "environmental steward" and to offer service from a team of "high quality
11 local employees." When asked in PSE Response to Public Counsel Data Request
12 No. 3062 if, absent the merger, PSE would be unable to be an environmental
13 steward or to employ high quality local employees, Mr. Reynolds responded that
14 his testimony does not indicate that PSE would unable to perform those tasks.
15 Therefore, it is reasonable to assume that PSE would perform those tasks and the
16 "commitment" offered is of no tangible benefit.
17 At page 9 of his testimony, Mr. Reynolds indicates that, with the
18 transaction, customers can expect the current Service Quality measures to remain
19 in place. When asked in Public Counsel Data Request No. 3065 if, absent the
20 merger, Puget would not continue Service Quality measures upon expiration, he
21 responded, "PSE places a high priority on the SQI process and has never said it
22

[56] Joint Applications, p. 18, ll. 2-4.

1 would not want to continue them." Again, no tangible benefit is apparent.
2 Also at page 9 of his testimony in this proceeding, Mr. Reynolds indicates
3 that the proposed transaction will enable Puget to finance more of its own
4 resources. Mr. Reynolds was asked in PSE Response to Public Counsel Data
5 Request No. 3066 if Puget, absent the merger, would be unable to finance the
6 construction of its own generation. In response, he notes that, to date, PE and
7 PSE have successfully funded all capital needs including generation sources, but
8 he was "concerned" about the size of Puget's capital plan and timely access to the
9 capital markets. Mr. Reynolds' concern regarding Puget's capital budget does not
10 amount to reliable evidence that the Puget executives are *unable* to finance its
11 necessary construction expenditures. Moreover, in the final analysis, Mr.
12 Reynolds' concern for Puget's capital expenditure program as well as his support
13 for all aspects of the proposed transaction must be evaluated in light of the fact
14 that he will receive payments totaling more than $20 Million if this transaction is
15 approved.[57]
16 Finally, in PSE Response to Revised Staff Data Request No. 1053, the
17 Applicants state that the commitments included in their Application in this
18

[57] Puget Energy February 8, 2008 Proxy Statement, S.E.C. Form DEFM14A, pp. 48-52. [Stock Options - $2,247,000; Performance Shares -$4,315,078, $2,403,223, $2,611,775; Restricted Stock and Stock Units - $751,110; Change of Control Agreements - $7,800,983; total =$20,132,169] Of course, a certain amount of those stock-related funds would be due Mr. Reynolds eventually. However, 1) because of the merger all stock and stock options must be liquidated, 2) the value of that stock is increased beyond the pre-announcement price by 25 percent through Macquarie's offer to pay $30/share for Puget Energy stock, and 3) the merger triggers a $7.8 Million change-of-control payment. These payments represent a substantial monetary incentive for Mr. Reynolds to recommend that this Commission approve the merger. Other PSE executives also would receive significant payments if the merger is approved. Exhibit No. ___ (SGH-10).

1 proceeding are a "re-affirmation" of Puget's obligations:

2–10
> A clear commitment to PSE's current requirements was a critical issue in negotiating the terms of the transaction. With this objective in mind, the senior executives of PSE worked with the Investor Consortium to develop a list of commitments that include some of the most basic and sensitive obligations that PSE has in its commitment to render gas and electric service to its customers in Washington State. These Commitments are intended to be a clear re-affirmation of such obligations.

11

12 In sum, the commitments offered by the Joint Applicants are not supported
13 by reliable evidence that consumers will be any better off following approval of
14 the requested transaction, i.e., there is no showing that Puget would not fulfill the
15 same commitments absent the merger. Also, Puget has not offered any evidence
16 to support the position that the current management team is not capable of
17 securing financing for Puget's projected capital budget. Therefore, those
18 commitments offered by the Joint Applicants do not offset the harm to the public
19 interest described above and, again, the transaction should not be approved.

20 **Q: Does this conclude your discussion of the commitments offered by the**
21 **Applicants in this proceeding?**

22 A: Yes, it does. I do not believe the commitments offer PSE substantive protection
23 from potential financial difficulties at the parent companies

24
VI. CONCLUSION

25 **Q: Please summarize your concerns and recommendations regarding the**

26

1 **proposed transaction between Puget and the Macquarie-led investor**
2 **consortium?**
3 A: In my opinion, the proposed transaction, as I have outlined in this testimony, fails
4 to meet the required standard that it is in the public interest. This Commission's
5 "no harm" standard requires that any such transaction should not harm customers
6 by causing risks to increase. The proposed transaction has, simply by being filed,
7 already negatively affected Puget's bond rating and has potential to further and
8 significantly increases risk and harm to the public interest if approved. I believe
9 the increases in risk are of a magnitude that cannot be adequately mitigated by the
10 proposed ring-fencing provisions. The Joint Applicants have not established that
11 there are benefits in terms of access to capital or otherwise that offset the harm of
12 increased risks to the public. It is my recommendation that the transaction should
13 not be approved.
14 **Q: Does this conclude your testimony, Mr. Hill?**
15 A: Yes, it does.