Exhibit No. ___(MPG-1T)
Docket Nos. U-072375
Witness: Michael P. Gorman

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	
Complainant,	)	
v.	)	**Docket No. U-072375**
PUGET HOLDINGS LLC AND PUGET SOUND ENERGY, INC.	)	
Respondents.	)	

DIRECT TESTIMONY OF

MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

June 18, 2008

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael Gorman, and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a managing principal with the firm of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth on Exhibit No.___(MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I will review the proposal by Puget Holdings LLC ("Puget Holdings") and Puget Sound Energy, Inc. ("PSE") (collectively, "Joint Applicants"), for a merger between Puget Energy and the Investor Consortium ("IC") described below headed by Macquarie Infrastructure Partners. I will review the proposed merger in terms of protection of the public interest, and preserving PSE's ability to offer high quality, reliable service under reasonable terms and prices.

Q. PLEASE SUMMARIZE YOUR FINDINGS AND RECOMMENDATIONS.

A. I recommend the Commission require certain modifications to the proposed transaction and require additional conditions on the proposed transaction if the Commission decides to approve this application. The application as filed is not in the public interest. My recommended changes to the transaction include the following:

a. Under Part Two of the recapitalization plan of Puget Energy, I recommend the Commission require the IC to increase the amount of equity capital used to purchase Puget Energy's outstanding public stock by $700 million, and decrease the amount of debt capital to fund this stock purchase by the same amount. Modifying the mix of equity and debt capital supporting the public stock purchase will maintain Puget Energy's capital structure, excluding the merger goodwill asset, at a level that is comparable to that which existed prior to the transaction. This will help eliminate the negative credit quality impact on Puget Energy and in turn PSE, caused by the proposed merger.

b. I also recommend certain modifications to the commitments the Joint Applicants have made in support of this merger. My recommended additional commitments are outlined and discussed in Exhibit No.___(MPG-3), and include the following:

   i. The ring-fencing protections should be enhanced to support PSE's and Puget Energy's credit standing in the event of financial stress, and create greater assurance that equity will not be removed from the utility if it is needed for utility purposes. The Joint Applicants' proposal primarily isolates PSE from Puget Energy in the event of bankruptcy. These additional commitments include the following:

      1. Dividend payments from PSE up to Puget Energy, and Puget Energy up to Puget Holdings should be restricted in the event specific financial targets are not met at both companies. Those targets should include a minimum investment grade bond rating of "BBB-" from Standard & Poor's, and "Baa3" from Moody's.

2. PSE should not be required to pay dividends up to Puget Energy in the event it does not meet its equity ratio target requirements, and needs additional equity funding to support its capital investment program for utility operations.

3. Puget Energy should not be allowed to pay dividends up to Puget Holdings in the event its capital structure mix falls outside of at least 40% common equity and 60% debt. Since Puget Energy's financial leverage and credit standing directly impact PSE, there should be a firm commitment to maintain an acceptable capital structure mix at PSE's direct parent company, Puget Energy.

4. Puget Holdings and Puget Intermediate (or any successor owner of Puget Energy stock) should be funded entirely with common equity unless the Joint Applicants petition the Commission for authority to change this capital structure mix. The IC has committed to maintain 100% equity capital structure of Puget Holdings for the next five years[1/]. This commitment should be changed to include Puget Intermediate, and all successor companies, for an indefinite time commitment unless the Commission approves a change.

5. In the event any services are provided from any affiliate company within the Puget Holdings structure, or any affiliate outside of that which any member of the IC retains an equity interest in, the prices and contract terms and conditions for all services should be subject to Commission

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1/ Exhibit No.__ (MPG-4)

approval. The Commission should require a demonstration that those prices are at or below market for comparable services from non-affiliated suppliers, and should be shown to be lower cost than PSE could provide the services internally.

6. For ratemaking standards, the Commission should require clear commitments that rates paid by PSE ratepayers will reflect only the following:

    a. Income tax expense that is actually paid to government taxing authorities.

    b. Cost of service principles should be followed in order to ensure that the rates of each customer class are tied to the cost of providing utility service to those customers.

    c. PSE will continue to follow least-cost integrated resource planning which will fully consider the best and lowest cost option for supply-side and demand-side resources in order to minimize its cost of service to native customers while maintaining high quality, reliable utility service. The only exception to this should be for environmental, renewal, conservation and demand response programs mandated by regulation or statute.

SUMMARY OF APPLICATION

Q. PLEASE SUMMARIZE THE JOINT APPLICANTS' PROPOSAL.

A. The IC, led by Macquarie Infrastructure Partners, will establish Puget Holdings LLC and enter into a merger agreement with Puget Energy. Under the merger agreement, the Joint

Applicants propose to transfer the ownership and control of Puget Energy and its wholly owned subsidiary, PSE, to a new company, Puget Holdings.[2/] Puget Holdings in turn will be a Delaware limited liability company that will be owned by the following indirect subsidiaries:

1. Macquarie Infrastructure Partners (31.8%)
2. Macquarie Capital Group Ltd. (15.9%)
3. Macquarie-FSS Infrastructure Trust (3.7%)
4. Canada Pension Plan Investment Board (28.1%)
5. British Columbia Investment Management Corporation (14.1%)
6. Alberta Investment Management (6.4%)[3/]

Q. PLEASE DESCRIBE THE PROPOSED TRANSACTION.

A. Puget Holdings/Puget Intermediate will be funded by the IC to acquire all the outstanding common stock of Puget Energy. Puget Energy will then cease to be a publicly traded company and will become wholly owned by Puget Holdings, LLC. The ultimate ownership structure after the transaction is outlined in the direct testimony of Christopher J. Leslie and diagrammed on Exhibit No. ___(CJL-5). The transaction funding is described by PSE witness Eric M. Markell in Exhibit No.___(EMM-1T).

Q. PLEASE DESCRIBE HOW THE TRANSACTION WILL BE FUNDED.

A. Mr. Markell describes a three-part recapitalization plan for Puget Energy at pages 23-31 of his direct testimony. Part One of the recapitalization plan included a purchase of Puget

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2/ Re Joint Application of Puget Holdings LLC and Puget Sound Energy, Inc., WUTC Docket No. U-072375 Joint Application for an Order Authorizing Proposed Transaction at 1 (Dec. 17, 2007).

3/ Id. at 5-6.

Energy's common stock of approximately $293 million, net of transaction fees.[4/] Puget Energy then invested this equity capital in PSE which in turn used it to redeem an equivalent amount of short-term debt.[5/] Step One recapitalization has been completed and is not conditioned on merger approval.

In Part Two, the IC will acquire the remaining common shares of Puget Energy for $3.5 billion, and assume all of Puget Energy's outstanding debt.[6/] The Joint Applicants propose to fund this common stock procurement with $2.8 billion of equity from Puget Intermediate/Puget Holdings, and $1.7 billion of debt issued by Puget Energy.

As part of the second recapitalization step, the IC will arrange for a new short-term credit facility for Puget Energy. Also, as part of this Part Two recapitalization step, Puget Energy will record a goodwill asset of $1.37 billion as part of the stock sale.[7/] This goodwill asset reflects the price the IC is paying above Puget Energy's book value for all the outstanding public stock of Puget Energy.

Under Part Three of the recapitalization, the IC will invest an additional $393 million in Puget Energy after the proposed transaction has closed.[8/] This additional equity investment will not be made until a "make-whole" provision has occurred, which

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4/ Exhibit No. __ (EMM-1T) at 25.

5/ Id.

6/ Id. at 27.

7/ The IC will pay $3.515 million for Puget Energy's outstanding public stock that had a book value of $2.161 million on September 30, 2007. Exhibit No. ___(EMM-4), page 2.

8/ Exhibit No. __ (EMM-1T) at 29-30.

is targeted to the redemption of certain PSE bonds.[9/] Puget Energy will then infuse the equity capital in PSE.

Q. HOW WILL PUGET HOLDINGS AND PUGET INTERMEDIATE BE CAPITALIZED?

A. In response to ICNU Data Request No. 3.40, the Joint Applicants state that Puget Holdings will be funded by 100% common equity for at least the first 5 years of the transaction.[10/]

PUBLIC INTEREST STANDARD

Q. HAVE THE JOINT APPLICANTS ADDRESSED A PUBLIC INTEREST CONSIDERATION RELATED TO THE PROPOSED TRANSACTION?

A. Yes. The Joint Applicants recognize that they must demonstrate that the proposed transaction will result in no harm to the public interest.[11/]

Further, the Joint Applicants argue that the proposed transaction will support the public interest and possibly produce ratepayer benefits as a result of the IC ownership of PSE. Specifically, the Joint Applicants state that the transaction will allow Puget Holdings to provide significant sources of capital to PSE, which will allow it to maintain high quality, reliable utility service.[12/]

Q. HAVE THE JOINT APPLICANTS ADEQUATELY SHOWN THAT THE PROPOSED TRANSACTION WILL PRODUCE NO HARM TO THE PUBLIC?

A. No. Harm to retail customers can occur if the cost of utility service increases or the reliability of service erodes. The proposed transaction threatens the public interest on both counts. Specifically, the proposed transaction will significantly leverage Puget

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9/ Id. at 30.

10/ Exhibit No.__ (MPG-4).

11/ WUTC Docket No. U-072375, Joint Application at 15.

12/ Id. at 15-16.

Energy which creates a material negative threat to the credit rating of PSE. An erosion to PSE's credit quality will increase its cost of capital and cost of service. Further, an erosion to its credit rating could limit PSE's access to external capital thus impairing its ability to fund needed infrastructure improvements, and maintain high quality and reliable utility service.

Q. THE JOINT APPLICANTS CLAIM THAT THE PROPOSED TRANSACTION WILL ENHANCE PUGET ENERGY AND PSE'S ACCESS TO CAPITAL RATHER THAN IMPAIR IT RESULT AS A RESULT OF A DOWNGRADE AS YOU BELIEVE. HOW COULD THE TRANSACTION RESULT IN BOTH OF THESE IMPACTS ON PUGET ENERGY AND PSE?

A. The Joint Applicants assert that the IC can provide capital to Puget Energy which in turn can provide it to PSE. The IC's ability to provide capital is largely attributable to the IC's current access to capital and willingness to make infrastructure investments. However, the IC is not guaranteeing to provide Puget Energy and PSE with the capital needed to make infrastructure investments indefinitely. Rather, the IC is simply committing to making investments in Puget Energy and PSE at this time.

Presumably, the IC will make investments in Puget Energy as long as the investment meets the IC's investment criteria and objectives. As such, if its cost of capital demands exceed that which PSE is allowed to recover in rates, or if other investment opportunities become more attractive than infusing additional capital in Puget Energy and PSE, then the IC may elect not to provide needed capital to Puget Energy and PSE after the transaction is completed. Hence, while this access to capital does have some benefits, it is not guaranteed and does not justify the approval of this transaction without adequate public protections.

Q. WILL THE IC CONTROL OVER PUGET ENERGY AND PSE BE A FACTOR IF IT SEEKS CAPITAL FROM THE MARKET?

A. Yes. The Joint Applicants' proposed new governance policy for Puget Energy and PSE will transfer complete control of these enterprises to the IC. Indeed, the IC will maintain all board of directors seats with one exception. That one outside board seat is intended to provide other investors some voice in the operation of Puget Energy and PSE. However, controlling interest of these enterprises will be maintained by the IC. As such, it is quite possible that the IC will operate Puget Energy and PSE as a means of maximizing their investment returns, rather than ensuring that Puget Energy and PSE are operated in a way to provide high quality, reliable service to PSE's native load customers.

This control over PSE will also be investigated by credit rating agencies in their assessment of PSE's bond ratings. If any actions take place by the IC that impair PSE's effectiveness in managing its utility, capital structure, and other components, it could cause a negative impact on the market's perception of PSE's operating risk and erode its credit rating. Specifically, Standard & Poor's "S&P" states the following about governance and management policy in the credit rating review:

> Strong corporate governance, reflected in active, independent board of directors that participate in determining and monitoring corporate controls, help to support management's credibility and corporate financial disclosure. If it is evident that a company's board is passive and does not exercise proper oversight, it weakens the checks and balances of the organization and may detract from credit quality. Included in Standard & Poor's review of corporate governance is the proportion of independent directors on the board, the breadth and depth of the directors' experience, the proportion of independent directors on the board's audit committee, and directors' compensation.[13]

[13] Exhibit No.___ (MPG-6) (Standard & Poor's Ratings Direct Research: "Assessing U.S. Vertically Integrated Utilities? Business Risk Drivers," September 14, 2006 at 6.)

As such, the IC's control over Puget Energy and PSE could increase PSE's operating risk because the market will expect that the IC will control the enterprise to manage their equity investment, and not managing the overall ongoing valuation of the enterprise.

EROSION TO PUGET ENERGY'S FINANCIAL STRENGTH

Q. WHY DO YOU BELIEVE THAT THE PROPOSED TRANSACTION WILL SIGNIFICANTLY INCREASE THE FINANCIAL RISK OF PUGET ENERGY AND PSE?

A. As shown in the table below, before the transaction, Puget Energy had a capitalization mix of 40% common equity and 60% debt. Under the recapitalization proposal, Puget Energy's capitalization mix, excluding the capital supporting the new goodwill asset, will become 71% debt and 29% equity. On a total Puget Energy basis, its capitalization mix is projected to be 58% debt and 42% equity. Puget Energy's equity/debt capital supporting utility plant, excluding the goodwill asset, before and after the recapitalization is shown in the table below.

Table 1
Puget Energy Inc.
(Millions)

Line	Description	Before Merger (1)	After Merger (2)
1	Net Utility Plant	$5,521	$5,912
2	Total Debt	3,236	4,243
3	Preferred Stock	2	2
4	Total Common Equity	2,161	3,078
5	Less Goodwill	0	1,367
6	Adjusted Common Equity	$2,161	1,711
7	Total Capital*	5,399	7,323
8	Total Adjusted Capital** (Excluding Goodwill)	5,399	5,955
9	Debt/Utility Plant	49%	67%
	Utility Capital Structure		
10	Total Debt Ratio	60%	71%
11	Common Equity Ratio	40%	29%
	Total Capital		
12	Total Debt Ratio	60%	58%
13	Common Equity Ratio	40%	42%

* Lines 4 + 3 + 2

** Lines 6 + 3 + 2

Source: Exhibit No. ___(EMM-4), Page 2, lines 6, and 60-68.

As shown in Table 1 above, the amount of debt supporting the utility net plant increases significantly under the proposed recapitalization of Puget Energy. While common equity increases by approximately $900 million, that common equity largely supports an increase in an asset recorded on Puget Energy's balance sheet associated with the merger – the goodwill asset. More importantly, the amount of total debt after the recapitalization increases by over $1 billion. This compares to an increase in net utility plant over this one-year period of only approximately $400 million. As a result, the total debt as a ratio of Net Utility Plant increases from 49% before the merger to 67% after the merger.

Based on the Joint Applicants' proposed recapitalization of Puget Energy, it will become significantly more leveraged and will erode the financial strength of Puget Energy and PSE. This in turn will cause stress on the credit rating and likely erode Puget Energy and PSE's access to external capital markets under reasonable prices, terms and conditions.

Q. IN HIS DESCRIPTION OF PUGET ENERGY'S CAPITALIZATION MIX AFTER THE TRANSACTION IS COMPLETED, JOINT APPLICANT WITNESS ERIC M. MARKELL ESTIMATED THAT PUGET ENERGY'S CAPITALIZATION MIX WILL BE 42% EQUITY AND 58% DEBT. PLEASE EXPLAIN WHY YOUR ASSESSMENT OF PUGET ENERGY'S CAPITALIZATION MIX IS SO DIFFERENT THAN THAT REPRESENTED BY MR. MARKELL.

A. The capital structure I am referring to is the capital supporting utility plant and working capital. This is the adjusted total capital shown on line 8, based on the adjusted common equity on line 6 in Table 1. The capital structure Mr. Markell references relates to total Puget Energy balance sheet, which refers to total assets including: utility plant, working capital and a new $1.37 billion goodwill asset. The ratios referenced by Mr. Markell are shown in lines 12 and 13.

In estimating the capital structure supporting Puget Energy's investment in PSE, I separated Puget Energy's common equity between the amount supporting utility plant/working capital and the amount supporting the new goodwill asset. In contrast, Mr. Markell made no distinction between the amount of common equity available to support utility plant and the amount of common equity supporting the new goodwill asset.

Q. WHAT IS A GOODWILL ASSET?

A. A goodwill asset is an accounting entry that reflects the amount of the acquisition price the IC will pay Puget Energy's public shareholders above the current book value of Puget Energy's stock. As such, the goodwill asset reflects an amount of common equity that is not capital that was used to support investments in utility plant or utility working capital requirements. It is simply an amount of equity capital that is exchanged from the IC to Puget Energy's current public shareholders. In contrast, the amount of equity capital supporting utility plant represents the proceeds of common stock sales, or retained earnings where the proceeds were directly used to fund capital investment in utility plant and working capital. As such, the amount of common equity supporting this new goodwill asset should be excluded from the amount of common equity capital supporting PSE's investment in utility plant and working capital.

Q. CAN THE NEW GOODWILL ASSET BE SUPPORTED BY A PORTION OF PUGET ENERGY'S DEBT CAPITAL?

A. No. The new goodwill asset is not an investment that produces cash flow or earnings for Puget Energy. Rather, it is only an accounting entry that has no economic value in support of Puget Energy's ongoing enterprise value. Therefore, it is not an asset that one would competently suggest could be supported by debt capital. Further, if the goodwill is written off as a result of an impairment test then the reduction in the goodwill asset will result in a reduction in common equity. As such, it is not reasonable to conclude that the goodwill asset is supported by anything other than the common equity of Puget Energy.

Q. DO CREDIT ANALYSTS ADJUST THEIR CREDIT METRICS TO REFLECT GOODWILL RECORDED IN MERGER AND ACQUISITION ACTIVITIES IN ASSESSING A UTILITY'S CREDIT STANDING?

A. Yes. In S&P's corporate credit rating criteria published in 2006, S&P stated the following concerning assessing the debt leverage risk of a utility company where it has been the subject of an acquisition or merger and a goodwill asset has been recorded.

> <u>The analytical challenge of which values to use is especially evident in the case of merged and acquired companies</u>. Accounting standards allow the acquired company's assets and equity to be written up to reflect the acquisition price, but the revalued assets have the same earning power as before; they cannot support more debt just because a different number is used to record their value. Right after the transaction, the analysis can take these factors into account, but down the road the picture becomes muddied. We attempt to normalize for purchase accounting, but the ability to relate to pre-acquisition financial statements and to make comparisons with peer companies is limited.
>
> <u>Presence of a material goodwill account indicates the impact of acquisitions and purchase accounting on a company's equity base</u>. Intangible assets are no less "valuable" than tangible ones. But comparisons are still distorted, because other companies cannot record their own valuable business intangibles, i.e., those that have been developed, rather than acquired. This alone requires some analytical adjustment when measuring leverage. In addition, analysts are entitled to be more skeptical about earning prospects that rely on turnaround strategies or "synergistic" mergers.[14/]

Based on my experience, common equity is adjusted to remove the effect of recording a goodwill asset in order to determine the leverage supporting investments in

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14/ Exhibit No.___(MPG-6) (Standard & Poor's: Corporate Ratings Criteria 2006 at 28 (emphasis added)).

utility plant. As such, in order to properly assess the debt leverage risk of Puget Energy, and the implications for PSE, it is necessary to adjust the proposed recapitalized Puget Energy in order to properly estimate the debt leverage risk of that enterprise.

Q. HAVE REGULATORY COMMISSIONS RECOGNIZED A NEED TO ALLOCATE COMMON EQUITY CAPITAL BETWEEN GOODWILL AND UTILITY OPERATIONS IN DEVELOPING A CAPITAL STRUCTURE THAT PROPERLY REFLECTS A UTILITY'S COST OF CAPITAL?

A. Yes. The Illinois Commerce Commission found that an adjustment to the utility's capital structure to remove the common equity supporting goodwill was necessary because goodwill is not a utility asset. The Illinois Commerce Commission stated the following:

> Staff, CCC, and IIEC all argue that ComEd should not earn a rate of return on plant it does not own and does not use for providing distribution services. This view comports with the language of Section 9-230 of the Act, as discussed in the *CUB* and *Illinois Bell* cases. (*See supra*.) Furthermore, ComEd's equity figure contains the net $2.634 billion in goodwill generated from the transfer of its plants. Including this figure in equity necessarily will raise the required rate of return, and therefore the rates set herein.
>
> The Commission finds that ComEd may not make such a recovery through regulated rates. Any recovery of the cost of plant owned by an unregulated generating affiliate will be recovered through the cost of power procured from such affiliate. The Commission therefore further finds that a recovery of such costs in rates by counting the goodwill in equity constitutes a double recovery, is not related to the regulated activities covered by these rates, and accordingly is neither just nor reasonable within the meaning of Section 9-201 of the Act.[15]

Further, in its next rate proceeding, Commonwealth Edison recognized this Commission practice and did not include common equity supporting goodwill in its proposed ratemaking capital structure.[16]

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[15] Illinois Commerce Commission, Docket No. 05-0597, July 26, 2006 Order at 128 (emphasis added).

[16] Illinois Commerce Commission, Docket No. 07-0566, ComEd Exhibit 9.0, Direct Testimony of Robert K. McDonald at 15 and 16.

Further, in a filing at the Federal Energy Regulatory Commission, NorthWestern Corporation, in Docket No. ER07-46-000, witness Brian B. Bird removed goodwill from common equity in developing a capital structure for setting rates for NorthWestern Corporation's transmission service rates.[17/]

Like credit analysts, these regulatory commissions recognized that goodwill is not an asset that is part of utility operations, and those assets are supported by the company's common equity capital. Further, these commissions recognized that a goodwill asset cannot be supported by debt capital. As such, an adjustment to Puget Energy's common equity to separate the common equity supporting goodwill and that supporting utility plant and working capital is necessary to fully evaluate the leverage impact from the proposed recapitalization of Puget Energy.

Q. MR. MARKELL'S PROPOSED RECAPITALIZATION SHEET FOR PSE DOES NOT REFLECT A GOODWILL ASSET AND REFLECTS AN INCREASE IN ITS COMMON EQUITY RATIO. DOES THIS SCHEDULE INDICATE THAT PSE'S CREDIT RATING AND BALANCE SHEET WILL STRENGTHEN UNDER THE PROPOSED RECAPITALIZATION?

A. No. While PSE's capital structure will have a larger common equity ratio than before the merger and it will not have a goodwill asset recorded on its balance sheet, PSE's credit strength will still be eroded due to affiliation with its direct parent company, Puget Energy, and its increased financial leverage.

This will occur because Puget Energy's primary source of cash flow to support its increased debt capital will be from dividend payments from PSE. As a result, there is a strong interconnection between the credit rating of Puget Energy and PSE. As a result, as Puget Energy's financial strength erodes, and its demands of cash flow increase from

17/ Exhibit No.___(MPG-7) (Re Northwest Corp., FERC Docket No. ER 07-46-000, Exhibit NWM-800 at 3-4 (October 17 2006)).

PSE in order to support Puget Energy's increased debt burden, then both Puget Energy and PSE's bond rating will become constrained. This is evident from a review of credit rating agencies' assessments of the proposed merger and recapitalization on Puget Energy and PSE's bond rating.

Q. PLEASE DESCRIBE THE CREDIT RATING AGENCIES' CONCLUSION OF THE PROPOSED RECAPITALIZATION ON PUGET ENERGY AND PSE'S BOND RATING.

A. Both S&P and Moody's have placed Puget Energy and PSE's credit rating on CreditWatch <u>with negative implications</u>.

S&P has said:

> On Oct. 26, 2007, Standard & Poor's Ratings Services placed the ratings of holding company <u>Puget Energy</u>, Inc. ('BBB-/--') and its electric and gas utility subsidiary <u>Puget Sound Energy</u>, Inc. ('BBB-/A-3') on CreditWatch <u>with negative implications</u>. The action follows the announcement that Puget Energy has agreed to sell itself to a consortium of private investors led by Macquarie Infrastructure Partners, an affiliate of Macquarie Bank Ltd. (A/Stable/A-1) for $7.4 billion. <u>The proposed transaction is to be financed with a significant amount of debt</u>; the company has also announced a private equity placement of $300 million with the consortium, which is not conditioned on the completion of the merger.
>
> Bellevue, Wash.-based Puget had roughly $3.2 billion of total debt outstanding as of June 30, 2007.
>
> The CreditWatch listing reflects the possibility that <u>debt ratings for Puget Energy could be lowered dependent on the final outcome of regulatory approval proceedings</u>. Importantly, the company's credit profile has been improving, which provides financing flexibility to accommodate the proposed capital structure at the current rating level. Still, Puget's consolidated credit measures post-transaction could be stretched if final terms are changed or regulatory requirements impact coverage metrics. We will update the CreditWatch status as the acquisition progresses.[18]

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[18] Exhibit No.___(MPG-8) (Standard & Poor's RatingsDirect Research Update: "Puget Energy Inc.'s 'BBB-' Rating Placed On WatchNeg Following Announcement of Proposed Sale," October 26, 2007 at 2 (emphasis added)).

Moody's has stated the following:

> Moody's Investors Service today placed the Ba1 Issuer Rating of Puget Energy, Inc. (Puget Energy) on review for possible downgrade. Moody's also affirmed the long-term ratings of its regulated utility subsidiary, Puget Sound Energy, Inc. (PSE; Baa2 senior secured), and the utility's affiliated entity, Puget Sound Energy Capital Trust III ((P)Ba1 shelf for Trust Preferred Securities), and changed the rating outlook of PSE and its affiliate to stable from positive. Moody's also placed PSE's Prime-2 short-term rating for commercial paper under review for possible downgrade.
>
> The rating action follows an announcement that a consortium of infrastructure investors led by Macquarie Infrastructure Partners has signed a merger agreement to purchase 100% of the equity of Puget Energy. The proposed transaction has an enterprise value of approximately $7.4 billion, including the assumption of PSE's estimated $2.6 billion of debt that is expected to be outstanding at the time of closing the transaction. The financing plan for the transaction includes approximately $1 billion of incremental consolidated borrowings that we assume will be issued by Puget Energy and has the potential for a widening of the rating notching between Puget Energy and PSE.
>
> The review for possible downgrade of Puget Energy reflects our concern that the proposed transaction increases Puget Energy's business and financial risk profiles. These concerns are somewhat balanced by the scale of the investor consortium's proposed equity investment in the transaction ($3.2 billion), as well as its reputation as a long-term infrastructure investor. The affirmation of PSE's long-term ratings is conditioned upon expectations that supportive regulatory treatment will continue despite the change in ownership. The review for possible downgrade of PSE's short-term rating for commercial paper and the revision of the outlook to stable from positive for PSE and its affiliates reflects high multi-year utility capital spending needs that may be a drain on liquidity as well as the expected weaker credit profile of the parent company, Puget Energy.[19]

[19] Exhibit No.___(MPG-9) (Moody's Investors Service, "Moody's may downgrade Puget Energy; affirms LT-rtgs of sub," October 29, 2007 (emphasis added)).

Q. DO YOU KNOW OF ANY OTHER EXAMPLES OF UTILITY COMPANIES WHOSE CREDIT RATING HAS ERODED AS A RESULT OF A TRANSACTION INVOLVING MACQUARIE INFRASTRUCTURE PARTNERS?

A. Yes. Duquesne Light Company was acquired by an investor consortium including the Macquarie Infrastructure investors. After that transaction took place in 2007, Duquesne's long-term corporate bond rating eroded from "BBB" down to "BBB-," the lowest investment grade rating.

S&P stated the following concerning the cause of this credit rating downgrade:

> On May 29, 2007, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on electric transmission and distribution utility holding company Duquesne Light Holdings, Inc. (DLH) and its utility subsidiary Duquesne Light Co. to 'BBB-' from 'BBB'. At the same time, Standard & Poor's removed the rating from CreditWatch with negative implications.
>
> The outlook is stable. Pittsburgh, Pa.-based DLH had $1.2 billion of total debt and $147 million in preferred stock as of March 31, 2007. Duquesne Light subsequently redeemed $11 million of preference stock.
>
> The CreditWatch removal and downgrade reflects the expected completion of an investor consortium's acquisition of DLH for about $3 billion that includes, after repayments, approximately a 50% net debt increase that in our view will constrain DLH's consolidated financial measures. The leveraging nature of the transaction, the expected credit measures, and the firm's overall financial policy are in-line with the 'BBB-' corporate credit rating. The consortium is led by Macquarie Infrastructure Partners (affiliated with Macquarie Bank Ltd.) and publicly listed fund Diversified Utility and Energy Trusts (See "Credit FAQ: The Acquisition Of Two U.S. Utilities By Infrastructure Funds" dated Jan. 31, 2007).[20]

Like Duquesne Light Company, the proposed recapitalization will result in a significant increase in the leverage of Puget Energy, and will have a negative impact on

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[20] Exhibit No.___(MPG-10) (Standard & Poor's RatingsDirect Research Update: "Duquesne Light Ratings Cut To 'BBB-', Off Watch Neg," May 29, 2007 at 2 (emphasis added)).

the credit rating of Puget Energy and PSE. As a result, the recapitalization should be modified to remove this leverage impact before the transaction is approved.

RECAPITALIZATION MODIFICATION

Q. SHOULD THE COMMISSION REQUIRE A CHANGE IN THE PROPOSED RECAPITALIZATION STRUCTURE FOR PUGET ENERGY IN ORDER TO ELIMINATE THIS CREDIT RATING EROSION RISK BEFORE APPROVING THE PROPOSED TRANSACTION?

A. Yes. The Commission should require as a condition of the merger a change in the amount of debt and equity used to acquire Puget Energy's outstanding common stock. The IC is proposing to fund the acquisition of Puget Energy's stock for $3.5 billion by the combination of an equity contribution of $2.84 billion and issuance of additional debt of $1.69 billion. As shown in the table below, if the Phase Two recapitalization is changed to increase common equity by $700 million, from $2.8 billion up to $3.5 billion, and reduce debt by $700 million, from $1.69 billion down to $990 million, then the capital structure financial leverage supporting Puget Energy's net utility plant and working capital after the reorganization would be the same as it was before the reorganization.

This modification in the recapitalization of Puget Energy would then have less of a credit rating strain on Puget Energy and PSE. However, maintaining the status quo does not result in a strengthening of the credit rating or lowering of the cost of capital for Puget Energy and PSE. Rather, it simply eliminates the detriment that will be caused by the proposed recapitalization and related overleveraging of Puget Energy.

Table 2
Puget Energy Inc.
Recapitalization Projection
(Millions)

Description	**Joint Applicants Proposed (1)**	**Modified (2)**	**Change (3)**
Net Utility Plant	$5,912	$5,912	0
Total Debt	4,243	3,544	(700)
Preferred Stock	2	2	0
Total Common Equity	3,078	3,778	700
Less Goodwill	1,367	1,367	
Adjusted Common Equity	$1,711	2,411	700
Total Adjusted Capital	5,955	5,955	0
Total Capital	7,322	7,322	0
Debt/Utility Plant	72%	60%	60%
Adjusted Capital Structure (Excluding Goodwill)			
Total Debt Ratio	71%	60%	60%
Common Equity Ratio	29%	40%	40%
Total Capital			
Debt Ratio	58%	48%	
Common Equity Ratio	42%	52%	

Source: Exhibit No. ___(EMM-4), Page 2, lines 6, and 60-68.

ADDITIONAL MERGER CONDITIONS/COMMITMENTS

Q. DO YOU BELIEVE THAT THE COMMISSION SHOULD REQUIRE ADDITIONAL COMMITMENTS FROM THE JOINT APPLICANTS BEFORE IT APPROVES THIS APPLICATION?

A. Yes. The Joint Applicants' proposed commitments in support of their application do not adequately protect the public interest. As such, in addition to changing the recapitalization mix of equity and debt described above, the application should be denied unless the commitments are modified to accomplish the following:

1. Strengthen the ring-fencing protections as proposed by the Joint Applicants.
    a. Ensure adequate financial isolation of Puget Energy and PSE in the event their credit rating becomes impaired and/or the IC refuses to make needed equity investments in Puget Energy and PSE via Puget Holdings.
    b. There should be restrictions on the ability of Puget Energy and PSE to pay dividends. These restrictions should be tied to key financial targets including minimum credit rating, and the maintenance of an appropriate capital structure at both Puget Energy and PSE.
2. The Joint Applicants should inform the Commission of any significant change to the corporate structure and ownership of Puget Holdings, Puget Energy and PSE, before the restructuring takes place.
3. Puget Holdings, Puget Intermediate or any other direct owner of Puget Energy common stock, will always be capitalized with 100% common equity unless an alternative capitalization mix is approved by the Commission.
4. The Joint Applicants should commit to appropriate ratemaking standards, including: (1) the recovery of only actual tax expense from retail customers

that is paid to government taxing authorities; (2) the maintenance of cost justified and efficient cost of service pricing for all rate classes; and (3) a commitment to follow least-cost integrated utility resource planning where the objective is to minimize PSE's cost of service using both least-cost supply-side and demand-side resources while also complying with regulatory environmental, conservation and renewable energy mandates.

RING-FENCING PROVISIONS

Q. DO THE JOINT APPLICANTS PROPOSE RING-FENCING PROVISIONS TO PROTECT PUGET ENERGY AND PSE'S CREDIT RATING?

A. Yes. Joint Applicants witness Christopher J. Leslie identifies a commitment by the Joint Applicants as follows[21/]:

1. Within 90 days of the proposed transaction, PSE and Puget Holdings will file a non-consolidation opinion with the Commission which concludes subject to customary assumptions and exceptions that the ring-fencing provisions are sufficient that a bankruptcy court would not order the substantive consolidation of the assets and liabilities by PSE with those of Puget Energy or its affiliates or subsidiaries.
2. He states that PSE will:
   - i. Maintain separate books and records.
   - ii. Agree to prohibition against loans or pledges of utility assets to Puget Energy or Puget Holdings without Commission approval, and

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21/ Exhibit No.___(CJL-1T) at 32-34.

iii. Generally hold PSE customers harmless from any business and financial risk exposures associated with Puget Energy, Puget Holdings and its other affiliates.

In the event the ring-fencing provisions fail to meet those requirements, Mr. Leslie proposes certain actions after notifying the Commission and proposing other requirements upon Commission approval to attempt to ring-fence PSE. He commits to hold customers harmless from the liabilities of any non-regulated activity of Puget Holdings and Puget Energy[22/].

Mr. Leslie believes that these commitments will insulate PSE's customers from the financial activities of entities associated with the new holding company structure. He describes these commitments as an intention to isolate PSE's regulated utility operations from any negative financial impacts flowing from non-regulated activities, and that these ring-fencing commitments will allow PSE to maintain a strong credit rating and attract capital. Finally, he asserts that they prevent the cross-subsidization of non-regulated ventures and they provide the Commission access to timely and accurate information relating to PSE[23/].

Q. DO YOU BELIEVE THE RING-FENCING PROVISIONS IDENTIFIED BY MR. LESLIE ARE ADEQUATE TO ENSURE PSE HAS ACCESS TO CAPITAL AND WILL ADEQUATELY PROTECT ITS CREDIT RATING?

A. No. Clearly, since PSE and Puget Energy's credit rating has been placed on watch with negative implications, these ring-fencing provisions are not adequate to isolate PSE from

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22/ Exhibit No.___(CJL-1T) at 33.

23/ Exhibit No.___(CJL-1T) at 34.

the proposed holding company structure. As such, additional ring-fencing protections are necessary in order to accomplish the objectives outlined by Mr. Leslie.

Q. PLEASE IDENTIFY THE ADDITIONAL RING-FENCING PROVISION COMMITMENTS YOU PROPOSE THE COMMISSION IMPOSE AS A CONDITION OF APPROVING THE TRANSACTION.

A. I propose the Commission implement the following additional ring-fencing provision commitments as a condition of approving this transaction:

1. The IC should allow the Commission the authority to impose restrictions on PSE's ability to pay dividends to Puget Energy, and Puget Energy's ability to pay dividends up to Puget Holdings in the event certain credit conditions are not met or Puget Holdings is not able to receive capital from the IC to make needed equity investments in PSE. These conditions include the following:
    a. Puget Energy should maintain a common equity ratio of no less than 40%, excluding the common equity supporting recorded goodwill. This will support its investment grade bond rating, and ability to attract capital to make investments in PSE under reasonable terms, prices and conditions.
    b. Puget Holdings must maintain an investment grade bond rating.
    c. PSE must maintain a 44% common equity ratio of total capital.
    d. A commitment that Puget Holdings/Puget Intermediate (or any successor company that owns Puget Energy's common stock) will always be capitalized with 100% common equity unless the Commission approves an alternative capitalization mix.

e. PSE will not enter any borrowing agreements, provide collateral, or encumber its assets, cash flow, or revenues in support of any affiliate company.

Q. WHY IS IT NECESSARY FOR PSE AND PUGET ENERGY TO BE ABLE TO RESTRICT DIVIDEND PAYMENTS IN ORDER TO DEVELOP APPROPRIATE RING-FENCING PROTECTIONS?

A. Public bondholders need assurance that if Puget Energy or PSE issues debt, that the cash flows produced from utility operation will be used to support the cash needs of the utility first, including capital expenditures and servicing the utility debt obligations. There should be a clear, irrevocable commitment from the IC to meet these PSE cash isolation requirements before any dividend payments will flow up the parent company structure. This restriction on the movement of cash out of the utility will enhance PSE's ring-fencing isolation from the holding company structure, and protect PSE's credit rating and access to external capital.

Q. WHY IS IT NECESSARY TO RESTRICT DIVIDEND PAYMENTS FROM PUGET ENERGY UP TO ITS PARENT COMPANY?

A. The dividend restriction is necessary in order to maintain the isolation of PSE's cash flows, and not rely on them to ultimately service debt capital used to fund the acquisition of Puget Energy's common stock. To the extent the IC can leverage Puget Holdings, Puget Intermediate, or any other successor company that owns Puget Energy stock, the primary source of cash flow to support that debt leverage will come from Puget Energy, which in turn will rely predominantly on PSE's cash flows. As such, cash flow movement between PSE and its parent company structure is necessary in order to ensure that PSE's cash flows are available to service public utility obligations. A greater amount of debt in the parent company structure will increase the demands for cash flow to move out of PSE into the parent company. As such, an appropriate capital structure is necessary to minimize this demand to move utility cash flows up the parent company level, to serve as debt used to fund the ownership of Puget Energy stock.

The Joint Applicants should also commit to setting utility prices no higher than necessary to provide fair compensation for the risk of utility service and to maintain the financial integrity of PSE.

RATEMAKING IMPLICATIONS

Q. SHOULD PSE AND PUGET ENERGY AGREE UPFRONT THAT ANY INCOME TAX COLLECTED BY PSE IN RATES SHOULD BE LIMITED ONLY TO THOSE AMOUNTS OF TAXES THAT WILL ULTIMATELY BE PAID TO GOVERNMENT TAXING UNITS?

A. Yes. To the extent PSE and Puget Energy enter into a consolidated tax filing agreement with any affiliate, it is important that the IC and Joint Applicants acknowledge that only legitimate tax expenses should be collected by PSE. Legitimate tax expenses should reflect those amounts of income taxes that are collected by the utility and actually paid to government taxing authorities.

Q. SHOULD THE JOINT APPLICANTS COMMIT TO INTEGRATED RESOURCE PLANNING FOR PSE AND A MEANS TO PROVIDE THE LEAST-COST UTILITY SERVICE TO ITS CUSTOMERS EMPLOYING THE MOST FAVORABLE SUPPLY-SIDE AND DEMAND-SIDE RESOURCES?

A. Yes. PSE's integrated resource planning should be designed to minimize its cost of service while maintaining high quality, reliable utility service. The only constraints on this would be to fulfill mandates for environmental, resource planning, or renewable energy mandates from regulatory agencies. As such, the cost recovery mechanisms, and the choice of economic conservation and demand-side management programs should be a primary concern in PSE's integrated resource planning in order to maximize the efficient use of supply-side resources by encouraging customers to maximize the efficiency of their demands on the utility system. The cost of all these optimally efficient supply and demand characteristics should then be reflected in proper cost of service pricing to native load customers.

Q. SHOULD THE JOINT APPLICANTS COMMIT TO COST OF SERVICE AND RATE-SETTING IN ORDER TO MAXIMIZE THE PRICE SIGNALS PROVIDED TO END-USE CUSTOMERS SO THEY CAN EFFICIENTLY PLACE DEMAND ON PSE?

A. Yes. Efficient price signals should be tied to the actual cost of providing service to native load customers. Customers should get accurate price signals that reflect PSE's actual cost of providing service through the periods of the year, time of day, and other variables which significantly reflect changes in PSE's cost of service. Proper cost-causation principles will provide efficient price signals to customers to allow them to maximize the efficiencies of the demands they place on the utility system which will in turn help PSE maximize the efficiency of its cost of providing service to end-use customers.

MISCELLANEOUS CONDITIONS

Q. DOES THE PROPOSED TRANSACTION REPRESENT A BALANCE OF CUSTOMER RISK AND BENEFITS THAT ARE TYPICAL OF UTILITY MERGER PROPOSALS?

A. No. In most merger petitions in which I have been involved, the application reflects rate credits, or rate freezes, which provide measurable and definable benefits to customers in support of the merger application. In significant contrast, this merger application poses significant quality of service and cost of service risk to customers with no corresponding benefits. As such, the current merger application does not reflect the same balance that other recent merger applications provide customers. Condition 16 in Exhibit No.__ (MPG-3) is therefore necessary to adequately balance the risks and benefits of the transaction.

Q. CAN YOU IDENTIFY OTHER PROCEEDINGS WHERE THERE HAVE BEEN MORE OF A BALANCE IN MERGER CUSTOMER BENEFITS TO BALANCE OUT THE RISK CUSTOMERS FACE THROUGH A MERGER APPLICATION?

A. Yes. Listed below are three recent examples of utility merger proceedings that included a rate freeze or credits as a component of merger approval:

1. KeySpan Corporation, New York State Public Service Commission, Case Nos. 06-M-0878/06-G-1185/06-G-1186. KeySpan merged with National Grid PLC. As part of the merger proceeding, KeySpan agreed to a five-year freeze in distribution rates.

2. Duquesne Light Company, Pennsylvania Public Utility Commission, Case No. A-110150F0035. Macquarie Infrastructure Partners acquired Duquesne Light Company as part of the acquisition's approval. Duquesne agreed to a three-year freeze in distribution rates.

3. PacifiCorp Power & Light Company, Washington Utilities and Transportation Commission, Docket No. UE-051090. PacifiCorp was acquired by MidAmerican Energy Holding Company. PacifiCorp committed $142.55 million of offsettable rate credits, which were to be reflected in rates. The rate credits will stay in place for at least a three-year period.

Q. COULD THE COMMISSION IMPOSE AN ADDITIONAL CONDITION ON THIS APPLICATION IN ORDER TO PRODUCE SIMILAR CUSTOMER BENEFITS TO BALANCE OUT THE SIGNIFICANT CUSTOMER RISK CREATED BY THE MERGER APPLICATION BY THE JOINT APPLICANTS IN THIS PROCEEDING?

A. Yes. My testimony above highlights many areas of risk and potential ways to mitigate this risk, but there are many areas of risk that cannot be known at this time. The Commission may decide to use its discretion and mandate a rate credit or a rate freeze, which has occurred in many previous utility acquisitions. This provision could balance customers' risk of the merger with direct merger benefits.

Q. DO YOU SEE ANY RISK TO SCHEDULE 449 CUSTOMERS IN THIS TRANSACTION?

A. Yes, given the high level of debt, the new ownership would be motivated to raise rates and impose additional costs on customers. Condition 14 in Exhibit No.__(MPG-3) are needed to ensure that Schedule 449 customers are not specifically harmed by this proposed transaction.

Q. DO YOU HAVE ANY OTHER CONDITIONS DESIGNED TO MITIGATE THE INCREASED COST PRESSURE ASSOCIATED WITH THIS TRANSACTION?

A. Yes, Condition 15 in Exhibit No.__ (MPG-3) recommends the elimination of PSE's Power Cost Only Rate Case ("PCORC") mechanism. Given the new owners' apparent intent to file frequent rate cases, the PCORC is no longer necessary. All costs, not just increasing power costs, should be carefully scrutinized in any future rate proceeding.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.