

**EXHIBIT NO. ___(RKK-1HCT)
DOCKET NO. U-072375
2007 MERGER PROCEEDING
WITNESS: ROBINSON K. KUPCHAK**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**In the Matter of the Joint Application of
PUGET HOLDINGS LLC
And
PUGET SOUND ENERGY, INC.
For an Order Authorizing Proposed Transaction**

Docket No. U-072375

**PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF
ROBINSON K. KUPCHAK
ON BEHALF OF PUGET HOLDINGS LLC**

**REDACTED
VERSION**

JULY 2, 2008

PUGET HOLDINGS LLC

**PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF
ROBINSON K. KUPCHAK**

CONTENTS

I. INTRODUCTION1

II. CREDIT DOCUMENTATION3

III. FINANCING CAPITAL EXPENDITURE7

IV. MARKET CONDITIONS AND REFINANCING.....13

V. TRANSACTION STRUCTURE AND CASH FLOW FORECASTS16

VI. CONCLUSION.....21

1 **PUGET HOLDINGS LLC**

2 **PREFILED REBUTTAL TESTIMONY (HIGHLY CONFIDENTIAL) OF**
3 **ROBINSON K. KUPCHAK**

4 **I. INTRODUCTION**

5 **Q. Will you please state your name and business address?**

6 A. My name is Robinson K. Kupchak. My business address is Level 22, 125 West
7 55th Street, New York, New York 10019.

8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by Macquarie Capital (USA) Inc, as a Managing Director within
10 the Infrastructure and Utilities Group. My responsibilities principally include
11 providing strategic advice, and sourcing and executing transactions on behalf of
12 the Macquarie Capital Group and occasionally third parties.

13 **Q. Have you prepared an exhibit describing your education, relevant**
14 **employment experience, and other professional qualifications?**

15 A. Yes, I have. It is Exhibit No. ____ (RKK-2).

1 **Q. Have you previously testified or sponsored testimony before the Washington**
2 **Utilities and Transportation Commission (“Commission”) and other utility**
3 **commissions in the United States?**

4 A. I have not previously testified or sponsored testimony before the Commission.
5 I have not previously testified or sponsored testimony before other utility
6 commissions in other states.

7 **Q. Please summarize the purpose of your rebuttal testimony.**

8 A. My rebuttal testimony seeks to expand upon and clarify certain
9 misunderstandings that the Parties appear to have with regard to the Proposed
10 Transaction and various documents provided as part of the discovery process,
11 with a primary focus on the debt financing arranged for the Proposed Transaction
12 and the financial projections in the financial model.

13 The format of my testimony will be as follows: I will provide a listing of
14 statements by the Parties regarding the debt financing and financial projections
15 that I believe are inaccurate or are requiring of further clarification, and I will
16 correct those statements. The testimony will address numerous points, but will
17 primarily focus on the following topics:

- 18 1. Credit documentation;
- 19 2. Financing capital expenditure;
- 20 3. Market conditions and refinancing; and
- 21 4. Transaction structure and cash flow forecasts.

1 In terms of the \$1.4 billion term loan facility at Puget Energy, a [REDACTED] facility
2 was the longest debt facility available in the market at the date the Investor
3 Consortium signed the Merger Agreement with the ability to provide certainty of
4 funds at a predetermined interest cost at financial close. It is the intention of the
5 Joint Applicants to continuously review opportunities to pursue a longer-term
6 solution for the Puget Energy term loan beginning after financial close, including
7 evaluating undertaking a longer term bond deal.

8 In addition, the financial model provided during the discovery process details the
9 Joint Applicants' intention for PSE to continue its practice of periodically issuing
10 first mortgage bonds, freeing up additional capacity in the PSE capital
11 expenditure facility and increasing PSE's average debt term.

12 **Q. Staff witness Horton raises issues with the impact of delayed recovery of**
13 **increased energy costs on PE's access to borrowing. (See Exhibit**
14 **No. ___(WNH-1THC) at page 9, lines 6-17). How does the new Credit**
15 **Agreement address these issues?**

16 A. As detailed in the "Consolidated Working Capital", "Operating Company FFO",
17 and "Group FFO" defined terms in Section 1.01 of the executed Credit
18 Agreement, the cash flow impact of movements in gas and electricity costs that
19 flow through the Purchased Gas Adjustment ("PGA") and Power Cost
20 Adjustment ("PCA") mechanisms are intentionally excluded from the calculation
21 of the lock-up and financial covenants associated with the new debt financing

1 package.

2 **Q. Do you agree with Public Counsel witness Hill’s portrayal of the potential**
3 **consequences of a “cash lock-up” as defined in the new Credit Agreement?**
4 **(See Exhibit No. ___(SGH-1THC) at page 43, lines 19-21, and at page 43,**
5 **lines 1-9.)**

6 A. No. I disagree with a number of Public Counsel witness Hill’s assertions, which
7 basically suggest that in lock-up capital expenditures will be reduced. There are a
8 number of relevant factors, which I address here:

- 9 • Under the new Credit Agreement, if Puget Energy were
10 ever in lock-up, PSE would have the ability to spend
11 capital expenditures required to meet its public service
12 obligation; and
- 13 • The Investor Consortium is comprised of seasoned long-
14 term investors who are able to sacrifice short-term yield for
15 a long-term return; furthermore, the Investor Consortium
16 does not have a “promised yield” as asserted by Public
17 Counsel witness Hill (*see* Exhibit No. ___(SGH-1THC) at
18 page 43, line 7).

19 **Q. Did Public Counsel witness Hill accurately represent that the transaction**
20 **financial model incorrectly calculated the consolidated debt measure by**
21 **including 100% of goodwill?**

22 A. Mr. Hill inaccurately represents that Standard & Poor’s (“S&P”) includes only a
23 portion of goodwill in calculating a debt-to-capital ratio. Using this incorrect
24 methodology, he recalculates debt-to-capital ratio included in the financial model
25 and suggests that since the resulting (incorrect) metric is above the (correct)

1 metric, the Proposed Transaction is likely to put downward pressure on the bond
2 ratings of PSE.

3 Based on this methodology, Public Counsel witness Hill concludes that Puget
4 Energy's debt-to-capital ratio "will exceed the level required for a 'BBB' bond
5 rating immediately upon completion of the transaction." Exhibit No. ___(SGH-
6 1THC) at page 65, lines 22-23. This is not the case. The quote Public Counsel
7 witness Hill cites from the 2008 Standard & Poor's, Corporate Ratings Criteria
8 (page 91) and includes in his testimony (*see* Exhibit No. ___(SGH-1THC) at
9 page 65, lines 12-16) is taken out of context, as it applies solely to S&P's
10 approach to ratings notching between an operating company and a holding
11 company or priority vs. subordinated debt and does not apply to the calculation of
12 a debt-to-capital ratio.

13 As supported by the 2008 Standard & Poor's, Corporate Ratings Criteria chapter
14 titled "Ratios and Adjustments" (pages 52-53), the methodology employed in the
15 Investor Consortium financial model is consistent with the stated definitions and
16 calculation methodology required by S&P.

17 Further, the calculations used in the financial model were fully disclosed to S&P
18 and were used to determine the ratings ascribed.

1 **Q. Do you agree with Public Counsel witness Hill’s description of a ratepayer**
2 **risk when he states, “if the cash flows are not sufficient to meet the debt**
3 **requirements and construction budgets are to be met, there is no other**
4 **source for increased cash flow except the customers of Puget”?** (Exhibit
5 **No. ___(SGH-1THC) at page 11, lines 8-10).**

6 A. If necessary, the Investor Consortium would be capable of contributing additional
7 equity into PSE to the extent needed to meet cash flow requirements should they
8 be greater than what is in the current base case. It should be noted however, that
9 investors would expect to be provided a return of and on any prudent capital
10 invested. It is also important to highlight that the Joint Applicants have
11 committed to specific ring-fencing provisions, including provisions that would
12 restrict dividends being distributed out of PSE, as well as out of Puget Energy, to
13 the extent certain leverage and interest coverage requirements are not satisfied.

14 **Q. Public Counsel witness Hill dedicates a large portion of his testimony to the**
15 **concepts of “Base” and “Additional” capital expenditures as detailed in the**
16 **debt financing Term Sheet and subsequent Credit Agreement. Does he**
17 **accurately represent these concepts in his testimony?**

18 A. No, there are a number of inaccuracies.

1 Q. Would you please identify and clarify the key inaccuracies, which were not
2 discussed in the testimony of Chris Leslie?

3 A. Yes. I will identify and clarify the inaccuracies in a bullet point misstatement /
4 clarification format below:

5 • “if more of what is now deemed [REDACTED]
6 [REDACTED] the projected FFO/Interest coverages
7 would be lower and closer to the debt covenant limits, which, if violated,
8 could negatively affect Puget’s ability to fulfill its public service
9 obligations” (Exhibit No. ___(SGH-1THC) at page 42, lines 13-18.)

10 o To clarify, the Credit Agreement does not allow for a re-
11 classification of capital expenditures as related to the debt
12 covenants. The amount of [REDACTED] is an amount
13 previously agreed with the mandated lead arrangers (Barclay's
14 Capital and Dresdner Kleinwort) and is detailed in the Credit
15 Agreement. This fixed amount, [REDACTED]
16 [REDACTED], will not change, and any actual
17 deviation from future or past capital expenditure amounts has no
18 bearing on the Scheduled Base CapEx numbers included in the
19 calculations of the lock-ups or financial covenants.

20 • In describing the semantic language change from [REDACTED]
21 [REDACTED]

1 [REDACTED] respectively, Public Counsel witness Hill states, “this language
2 change shows is the degree to which the proposed transaction ... can
3 control the manner in which PSE is able to carry out its public service
4 obligations.” (Exhibit No. ___(SGH-1THC) at page 49, lines 3-12).

- 5 ○ To clarify, no restrictive covenants exist which would restrict PSE
6 from carrying out its public service obligations.
- 7 ○ The capital expenditure terminology was changed between the
8 Term Sheet and the subsequent Credit Agreement as a result of
9 input from PSE. PSE was not involved in the negotiation of the
10 Term Sheet because they were agreed to prior to execution of the
11 Merger Agreement.
- 12 ○ The rationale for the terminology change between the debt Term
13 Sheet and executed Credit Agreement was to represent the nature
14 of the capital expenditures better by using terminology more
15 consistent with the identifying language currently used by PSE.
- 16 ○ The Joint Applicants have committed to specific ring-fencing
17 provisions that provide added protections for PSE from recourse
18 related to debt raised above PSE.

1 Q. Do Parties overstate the significance of the debt-to-capital ratio of Puget
2 Energy in the Credit Agreement?

3 A. Yes. The debt-to-capital ratio of Puget Energy becomes relevant only in a very
4 limited situation [REDACTED]

5 [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]

16 It should be reiterated that it has always been the intention of the Investor
17 Consortium to continue PSE management's long-standing practice to fund all
18 capital expenditures with a combination of operating cash flow, equity and debt.
19 The financial model forecasts the average debt funding from PSE, or through
20 equity injections provided by the Puget Energy capital expenditure facility, of
21 total capital expenditures over the next 10 years at [REDACTED].

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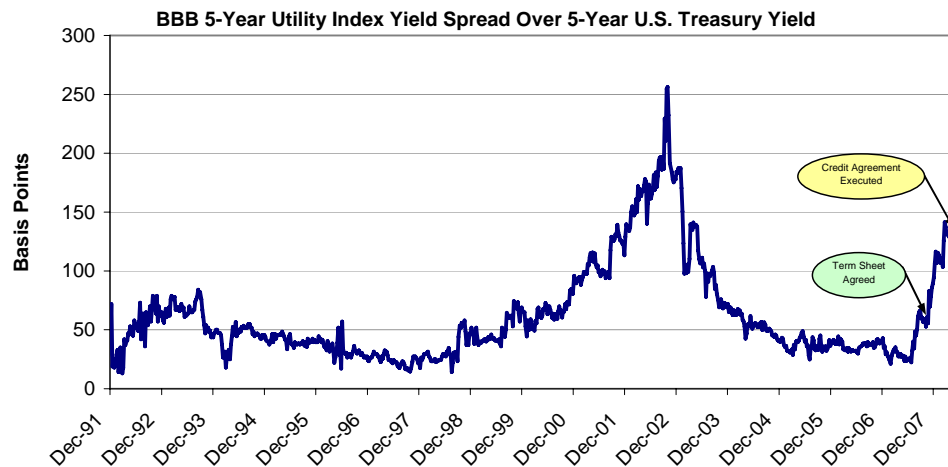
Q. Do Parties incorrectly represent certain limitations related to the utilization of the Puget Energy capital expenditure facility?

A. Yes. Public Counsel witness Hill states, “[REDACTED]”
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]” Exhibit No. ___(SGH-1THC) at page 50, lines 15-19. Public Counsel witness Hill overlooks a factual condition in the Credit Agreement—there is no linkage between the financial projections used to finance the Proposed Transaction and limitations upon future construction costs. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

1 IV. MARKET CONDITIONS AND REFINANCING

2 Q. A number of the Parties raise concerns about refinancing. In particular,
3 Public Counsel witness Hill suggests that the current economic environment
4 is “benign” (Exhibit No. ___(SGH-1THC) at page 20 line 23). How does the
5 market at the point you secured and syndicated the new debt package
6 compare to previous periods?

7 A. The Joint Applicants secured the debt commitments in late October 2007, in the
8 midst of a very challenging economic environment that could not be accurately
9 characterized as “benign”. In fact, in October of 2007, the current credit crisis
10 was well under way. The following chart sourced from Bloomberg as of June 30,
11 2008, displays the state of the market for U.S. utility debt since 1991 using the
12 five-year investment grade (BBB) utility index yield spread over the five-year
13 U.S. Treasury yield as a representative measure.



1 As can be seen, the current market environment is close to the all time high level
2 of margin over the past seventeen years, and significantly higher than the average.
3 The fact that the Investor Consortium was able to secure \$3.575 billion of
4 financing in this credit market, should provide a good degree of confidence that
5 the new facilities will be able to be refinanced over the course of the next [REDACTED]
6 years.

7 **Q. Staff Witness Schmidt concludes that, “there is a reasonable expectation that**
8 **in [REDACTED] years, when the Consortium may need to refinance its debt, interest**
9 **rates could be higher, which would impact the Consortium’s borrowing**
10 **costs, particularly as the amount of leverage increases”? (Exhibit**
11 **No. ___(RHS-1HCT) at page 9, lines 12-15). Do you agree that this is a**
12 **reasonable expectation?**

13 **A.** I agree that interest rates clearly do fluctuate over time, and there is a possibility
14 that they can go either up or down based on any number of factors. However, it is
15 important to note that the current credit environment is significantly more
16 challenging than it has been for the larger part of the last twenty years as
17 evidenced by the graph provided above. The fact that the Consortium was able to
18 secure \$3.575 billion of financing during a credit market which Staff witness
19 Schmidt describes where, “the difficulty in securing favorable pricing and terms
20 for the debt has increased significantly” (Exhibit No. ___(RHS-1HCT) at page 11,
21 lines 18-20) indicates that there is a reasonable expectation that the Joint
22 Applicants will be able to refinance at improved pricing and terms over the course

1 of the next [REDACTED] years.

2 **Q. How do you respond to Public Counsel witness Hill's assertion that "re-**
3 **financing risk does not now exist with Puget and would represent an increase**
4 **in risk to ratepayers if the transaction is allowed to proceed"? (Exhibit**
5 **No. ___(SGH-1THC) at page 21, lines 2-4.)**

6 A: I believe that a number of mitigating factors should be considered here that
7 mitigate the risk associated with refinancing Puget Energy's debt. First, the Joint
8 Applicants will have a [REDACTED]-year period to pursue a refinancing, potentially into a
9 longer-term bond opportunity to extend the maturity of the Puget Energy term
10 loan facility; in fact, certain banks have already made proposals for us to do so.
11 Second, the Joint Applicants have committed to a number of ring-fencing
12 provisions, including among others dividend restrictions at PSE and Puget
13 Energy, the filing of a non-consolidation opinion, and the insertion of an
14 independent "golden share" director whose consent would be required to initiate a
15 bankruptcy proceeding at PSE, to provide additional protections to PSE
16 customers for debt raised above PSE.

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**V. TRANSACTION STRUCTURE AND
CASH FLOW FORECASTS**

Q. Do you agree with Public Counsel witness Hill when he states that there is “effectively little difference between PSE and PE”? (Exhibit No. ___(SGH-1THC) at page 8, line 4.)

A. No. Public Counsel witness Hill overlooks the specific ring-fencing commitments offered by the Joint Applicants that Commission Staff acknowledges “appear to be sufficient to protect PSE from any adverse consequences of the unregulated activities of Puget Energy and Puget Holdings.” Exhibit No. ___THC(KLE-1THC) at page 35, lines 22-23. These ring-fencing commitments include, among others, dividend restrictions at PSE and Puget Energy, the filing of a non-consolidation opinion, and the insertion of an independent “golden share” director whose consent would be required to initiate a bankruptcy proceeding at PSE.

Q. Do you agree with Public Counsel witness Hill’s assertion that the financial model is based upon “optimistic assumptions”? (Exhibit No. ___(SGH-1THC) at page 51 line 19.)

A. No. Each member of the Investor Consortium takes risk management very seriously, and the assumptions that underlie the decision to enter into the Proposed Transaction have been subject to various tests and diligence. Various parties, including individual members of the Investor Consortium and lending

1 banks, have “stress-tested” the assumptions to ensure that the business would hold
2 up under realistic downside scenarios. Additionally, the Investor Consortium
3 consulted with numerous reputable third parties, such as KPMG, RW Beck,
4 Latham & Watkins, Concentric Energy Advisors, Mercer, and Marsh, in
5 developing the financial model and the assumptions contained therein.

6 Furthermore, Public Counsel witness Hill’s commentary regarding the
7 assumptions used by the Investor Consortium to model the Proposed Transaction
8 contains inaccuracies and mischaracterizations or misunderstandings:

- 9 • Public Counsel witness Hill states that the Investor Consortium projects
10 “ [REDACTED] .” Exhibit No. ___(SGH-1THC) at
11 page 52, line 8. The financial model provided during the discovery
12 process is an MS Excel spreadsheet, and it is not possible to model the
13 iterative process that results from the rate case litigation and settlement
14 process. Instead, the financial model projects anticipated rate increases
15 granted based upon returns and results actually approved by the
16 Commission in precedent transactions, as opposed to what was initially
17 requested by the utilities.
- 18 • Public Counsel witness Hill incorrectly states that the financial model
19 shows a “ [REDACTED] ” Exhibit
20 No. ___(SGH-1THC) at page 52, line 10. The financial model provided
21 during the discovery process actually assumes that [REDACTED]

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[REDACTED]. The rate impact of such PCORCs reflects the ability to recover generation investments without lag.

- Public Counsel witness Hill erroneously states that the financial projections assume “[REDACTED]” (Exhibit No. ___(SGH-1THC) at page 52, line 12), and indicates that the model assumes that, “PSE’s rates will be increased annually like clockwork,” (Exhibit No. ___(SGH-1THC) at page 53, line 19). [REDACTED]

[REDACTED]

- Public Counsel witness Hill states that “[REDACTED]” Exhibit No. ___(SGH-1THC) at page 52, line 13. Mr. Hill compares this number to the 0.034% preferred stock in the PSE capital structure. The financial model provided during discovery assumes that hybrid equity should be treated as preferred stock, and not long-term debt, consistent with the treatment given by the rating agencies. As a result, the financial model assumes that PSE’s capital

1 structure at March 31, 2008 included 4.5% preferred stock.

- 2 • Public Counsel witness Hill states that the assumptions underlying the
3 Treasury and LIBOR curves are based on optimistic assumptions.

4 *See* Exhibit No. ___(SGH-1THC) at page 52, line 16-17, and at page 53,
5 line 1. These assumptions detailed in the financial model provided during
6 the discovery process were sourced from Bloomberg, a commonly used
7 source in the financial industry, and are thus not optimistic but reflect
8 actual market expectations at a given point in time.

- 9 • Public Counsel witness Hill is not correct when he claims that “all capital
10 expenditures are to be funded with debt.” Exhibit No. ___(SGH-1THC) at
11 page 53, line 13-15. In the financial model provided during the discovery
12 process, the average debt funding percentage of total capital expenditures
13 over the next ten years from PSE and equity injections provided from the
14 Puget Energy capital expenditure facility is [REDACTED]; operating cash flow
15 and retained earnings comprises the majority funding source for capital
16 expenditures.

- 17 • Public Counsel witness Hill indicates that the fact that the energy hedging
18 credit facility is not used is an optimistic assumption. *See* Exhibit
19 No. ___(SGH-1THC) at page 53, lines 4-5. PSE’s existing energy
20 hedging facility is available primarily to fund unforeseen movement in
21 energy hedging positions and has not currently been utilized; therefore,

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the financial model provided during the discovery process does not reflect this facility being drawn.

- Public Counsel witness Hill indicates that the electricity and gas curves used were optimistic. See Exhibit No. ___ (SGH-1THC) at page 53, lines 6-10. The cash flow impact of movements in gas and electricity costs that flow through the PGA and PCA mechanisms are intentionally excluded from the calculation of the lock-up and financial covenants associated with the new debt financing package. Although PSE is exposed to gains and losses as a result of sharing under the terms of the PCA, [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- Public Counsel witness Hill highlights that the average dividend being distributed out of PSE over the next ten years is significantly larger than in 2007. Exhibit No. ___ (SGH-1THC) at page 53, lines 11-12. Public Counsel witness Hill overlooks however the fact that the PSE shareholder equity base is forecast to increase from [REDACTED] prior to the announcement of the Proposed Transaction to [REDACTED] in 2018, substantially increasing the required return on equity.

VI. CONCLUSION

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Q. Does that conclude your prefiled rebuttal testimony?

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A. Yes.