EXHIBIT NO. ___(JP-1CT)
DOCKET NO. U-072375
2007 MERGER PROCEEDING
WITNESS: JUSTIN PETTIT

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 (CONFIDENTIAL) OF
JUSTIN PETTIT
ON BEHALF OF PUGET HOLDINGS LLC AND
PUGET SOUND ENERGY, INC.

REDACTED
VERSION

JULY 2, 2008

PUGET HOLDINGS LLC AND
PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

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

A. My name is Justin Pettit and I am a Vice President at Booz and Company ("Booz"). My business address is 101 Park Avenue, New York, NY 10178.

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

A. Yes, I have. It is Exhibit No.___(JP-2).

Q. Please describe your business experience.

A. I lead Booz's Corporate Finance practice focused on corporate strategy and corporate finance, for a wide range of clients in utilities, consumer, and industrial sectors, across the U.S., Asia, Europe, and South America. I advise boards of directors and senior executives on valuation and business strategy, Merger and Acquisitions ("M&A") and other major capital decisions, capital markets issues, optimal capital structure, and financial policy. I was previously executive director and global head of strategic advisory for UBS Investment Bank, where I advised companies on M&A and capital strategies including equity capital markets, debt capital markets, hybrids and structured products, hedging, and other transactions. I have also been published in over a dozen business journals, including *Harvard Business Review, Strategy + Business, The Journal of Applied Corporate Finance, Industrial Management, AirFinance Journal, and Financier Worldwide.* Recently I authored Strategic Corporate Finance: Applications in Valuation & Capital Structure (Wiley 2007).

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to rebut assumptions underlying the testimony of Mr. Ronald H. Schmidt and Mr. William N. Horton on behalf of Commission Staff, and Mr. Stephen Hill on behalf of Public Counsel, that Puget Sound Energy, Inc. ("PSE" or the "Company") faces more financial risk if the Proposed Transaction is approved than it faces on a stand-alone basis. Specifically, my testimony focuses on the risks PSE faces as a stand alone company with significant capital needs. I will address the following points:

1) The size of PSE's capital needs is problematic relative to its market capitalization,

2) It is not appropriate to compare PSE's total external capital needs to its book equity to accurately gauge the relative magnitude of its estimated capital needs,

3) The growth in PSE's capital budget is not necessarily beneficial to shareholders,

4) PSE faces significant risk of not obtaining access to capital at reasonable terms, and

5) A partnership with the Investor Consortium may provide PSE

greater access to capital compared to the *status quo*.

My testimony also evaluates the implications and risks to PSE were it to execute its business plan on a stand-alone basis. In other words, I have been asked to assume that Puget Energy ("Puget Energy") would continue to be an independent publicly-traded utility holding company with PSE as its principal operating subsidiary. As part of this analysis, I have considered the amount of capital required, the terms of that capital, the impact of serial external financings on the potential cost of that capital, the timeliness of accessing that capital, and the overall implications to the financial health of PSE were it required to access that capital on a stand-alone basis.

Q. Please summarize your testimony.

A. First, Puget Energy faces external equity financing requirements that are among the largest in the utility industry in relation to Puget Energy's equity market capitalization and daily trading volume. Second, empirical research shows that large equity offerings by seasoned issuers (other than equity offerings representing a recapitalization, which is not the case with Puget Energy), can be shown to adversely affect shareholder value and the marketability of the new shares. Third, any erosion in PSE's financial position or outlook is likely to exacerbate the difficulties that Puget Energy already faces in its financing program. Taken together, I conclude that PSE faces risks if it undertakes its external financing program under Puget Energy as a stand-alone company and that the proposed merger with the Investor Consortium mitigates these risks.

Q. How is your testimony organized?

A. Section II of my testimony provides a discussion of the trends in financing the requirements of the utility sector. Section III provides my understanding of PSE's capital needs and expected financing requirements based upon its business plan. I then analyze PSE's capital plan along three dimensions:

1) Section IV of my testimony addresses the impact of this capital plan on the accessibility of capital and terms;

2) Section V addresses the potential impact of this capital plan to PSE's valuation, and;

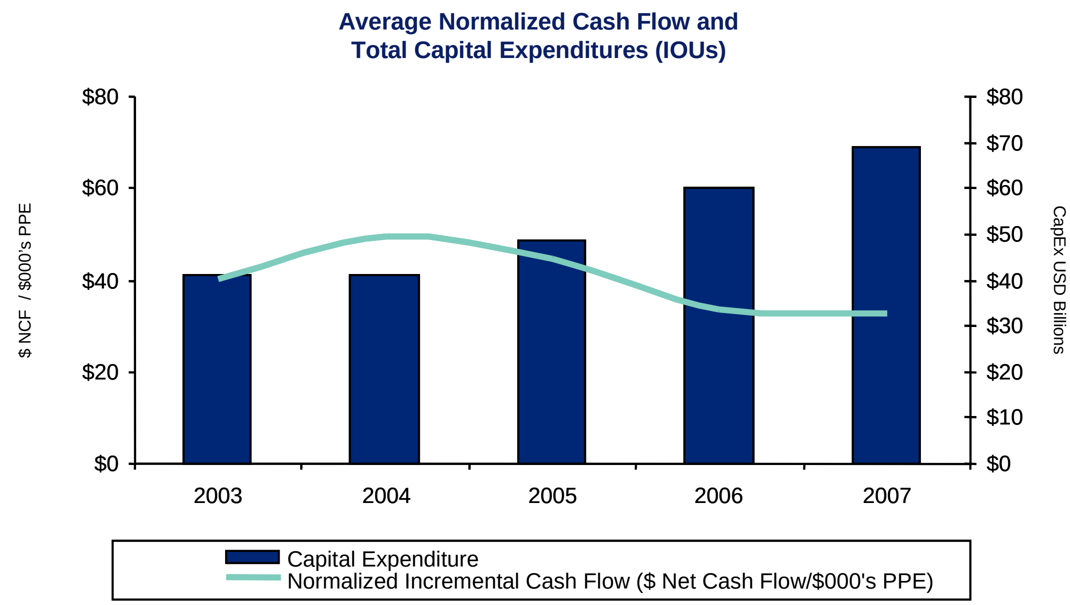
3) Section VI addresses the potential marketability of PSE's capital.

Please note that because Puget Energy issues equity to the public markets on behalf of PSE, I refer to Puget Energy when I discuss equity offerings.

II. TRENDS IN UTILITY CAPITAL REQUIREMENTS

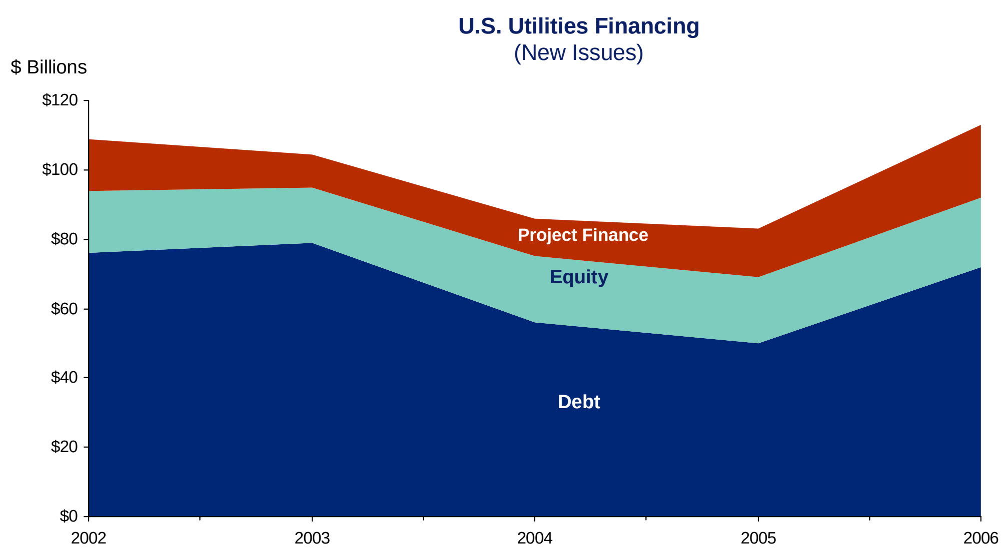
Q. What have been the recent trends in utility capital consumption?

A. Over the last five years, domestic investor-owned utilities ("IOUs") have increasingly relied on external sources of capital because capital spending has increased about 50% over the period, while cash generated from operations in relation to property, plant and equipment balances has decreased, as shown on the chart below.



Source: EEI, "Credit Ratings", Q4 2007; Booz Allen Analysis
Note: Cash Flow = EBITDA – Interest Expense – Short-term & Long-term Debt-Income Tax

During this same time period, U.S. utilities (i.e., investor-owned, municipals, cooperatives) have tapped the markets for over $100 billion per year, from a combination of debt, equity and project financing, as shown on the chart below.



Source: Morgan Stanley, S&P, Booz analysis

Q. What capital requirements are expected in the future?

A. The industry is widely anticipated to have a significant need for new capital as several influences converge. As electricity demand continues to grow, generation reserve margins across the U.S. are declining, requiring generation investment across a variety of technologies (nuclear, gas, renewable energy, coal). Environmental regulations are requiring retrofits on existing generation to become compliant. New and upgraded transmission investment is required to connect these sources of generation and relieve constraints on the existing transmission system to more efficiently transmit power. Migration to a more digital distribution network ("smart grid") is also claiming its spot in the queue for capital. The chart below shows a break down of projected capital expenditures for the utility industry.

Utility Industry Projected Capital Expenditures
(2007 – 2022 $'s Billions)

Source: CERA

III. OVERVIEW OF PSE CAPITAL REQUIREMENTS

Q. Please summarize PSE's capital requirements.

A. PSE has prepared a business plan that includes management's estimates of the capital expenditures required to execute this plan. Management has estimated that $5.7 billion of capital expenditures are required between 2008 and 2013 to continue to meet the needs of its customers.

PSE management estimates that approximately $[redacted] of this capital requirement can be provided through internally generated funds, resulting in a requirement to access the capital markets for the remaining $[redacted] of capital required. *See* Exhibit ___(EMM-6C). The company forecasts that $[redacted] of this will be financed with debt, leaving $[redacted] that will need to be financed with primarily equity and equity-like securities.

Q. How does PSE compare in size relative to other U.S. utilities?

A. PSE's equity market capitalization prior to the deal announcement (October 25, 2007) was $2.8 billion, based on 117.3 million shares outstanding at $24 per share (three month trailing average). Compared to the market capitalization of the 73 investment grade, domestic, publicly-traded utilities, PSE is the 39th largest utility. PSE's asset base as of March 31, 2008 was $7.7 billion. Compared to asset levels of all publicly-traded utilities, PSE is the 40th largest utility, within the same group of 73 companies. Additionally, Puget Energy's average daily stock trading volume during the last 3 months was approximately $10.3 million, making it the 39th largest in terms of dollar-trading volume.

Q. Why is this information relevant?

A. The relative size of an equity issue (relative to the issuer's equity market capitalization, and relative to the issuer's average daily trading volume) is a key determinant of its ability to execute the equity issue (and thus impact terms and ease of execution) and the resulting financial impact on the stock. In PSE's case, the capital needs are large relative to its size ($2.8 billion market capitalization), creating potential problems or risks in the execution of this business and financing plan. Additionally, equity issuance tends to depress returns which are measured in the academic literature as cumulative equity returns versus a baseline comparator such as the broader market or relevant industry index. This downward pressure is even more so with larger individual offerings. I investigate this in more detail later in my testimony. The exception – which is not applicable to PSE – tends to be re-equitization (large issues of equity for companies that have too much debt and too little equity) transactions associated with distressed balance sheets.[1]

[1] Paul Asquith and David W. Mullins, Jr. found that the announcement of equity offerings reduces stock prices significantly, "Equity Issues and Offering Dilution," *Journal of Financial Economics,* Volume 15, Issues 1-2, January-February 1986. Tim Loughran and Jay R. Ritter found that companies issuing stock have been poor long run investments for investors, "The New Issues Puzzle," *The Journal of Finance,* Vol. 50, No. 1, pp. 23-51 (March 1995).

Q. Do you agree with Commission Staff's assertion that is it appropriate to compare PSE's total external capital needs ($[redacted]) to its book equity ($2.1 billion) to accurately gauge the relative magnitude of its estimated capital needs?

A. No, it is not appropriate to compare PSE's total external capital needs of $[redacted], which references both debt and equity (i.e. an unlevered figure), to its book equity of $2.1 billion, which references only equity (i.e. a levered figure). Furthermore, book equity numbers tend to be distorted by accounting conventions, non-economic events, and artifacts of the past (e.g. non-cash charges, accruals and reserves, book gains and losses, goodwill, accounting for off-balance sheet liabilities such as operating leases and under-funded pension liabilities, changes in accounting conventions (FS 106, FS109), etc.). Accordingly, the market value of equity tends to be a more meaningful number in economic terms. From a capital markets perspective, practitioners use size metrics that compare the equity capital needs to the market capitalization of the equity, and to the average daily trading volume. As described earlier, this is exactly what we did.

Q. Do you agree with Staff's opinion that PSE's capital budget growth over the next few years is beneficial to shareholders?

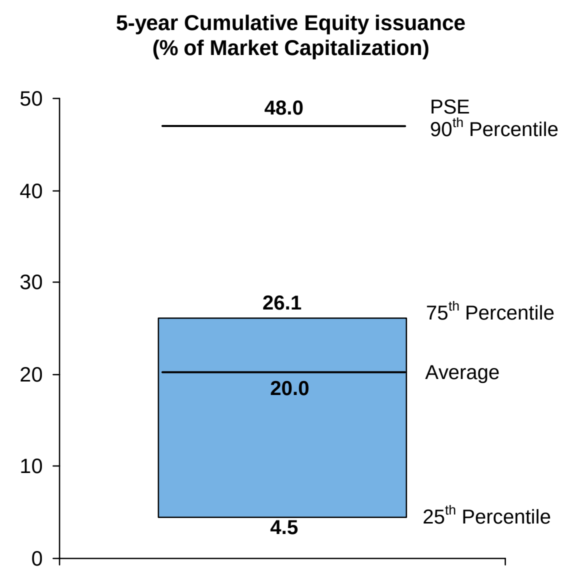
A. No, in fact, capital budget growth can be bad for shareholders if the risk and investment is not appropriately compensated. PSE faces significant risk that in today's economic climate with escalating energy costs, the regulatory lag may be significant, and it will be difficult to recover its full cost of investment in a timely manner. For example, this appears to have been the case in the 1970-1974 period, when large capital investment was undertaken by regulated power utilities in a period of rising energy costs, rising inflation, and significant regulatory lag. Shareholders were punished with a 29% drop in the market multiples of utility stocks, with the average price-to-book ratio falling from 1.4x to 1x. I will reference this period of heavy capital investment and its implications for PSE later in my testimony.

IV. ACCESS TO CAPITAL

Q. What analysis did you perform to evaluate PSE's capital needs?

A. In the market generally, the average deal size for primary issuance of seasoned equity (primary means it raises cash for the issuer; seasoned means it is already a public entity and therefore not an IPO) is about 4% of market capitalization, or about 13 days of trading volume, based on 90-day trailing average daily trading volumes in the power sector over the last ten years. For PSE, an equity issue of this size would be about $[redacted] per deal.

Puget Energy's estimated equity issuances per its business plan average approximately $[redacted] from 2009 through 2013, well above the industry average deal size. Assuming [redacted], PSE's equity needs represent a 99th percentile transaction in terms of relative size among regulated power companies. In other words, 99% of all equity offerings in the sector would be smaller than what PSE needs to raise, in relative terms. Practically speaking, the PSE equity financing would be executed in a series of tranches over time, to enable the market to digest this level of issuance. However, even on a cumulative 5-year basis, the PSE needs represent 90th percentile equity needs, excluding equity issue for balance sheet repair by severely overleveraged power companies. This is depicted on the following chart:.



Note: Analysis based on a set of comparables utility companies over the last 10 year period, PSD strategic plan; PSD market cap and daily volume average of the last three months
Source: Capital IQ; Booz & Company analysis

Q. Do you agree with Commission Staff's opinion that PSE will be able to access capital at reasonable terms in order to fund new facilities?

A. No, even in a strong market, for an overhang – (amount of equity issuance that is likely to be offered and therefore dilute existing shareholders) – of this size, the timing, pricing and other terms would likely be compromised. In a challenging market resulting in a "flight to quality" (where investors migrate to high quality stocks with predictable earnings, prospects and needs), weakness in terms such as pricing, constraints or limitations placed on the issuer would be exacerbated and timing of the issuance delayed. In this case, it seems quite likely that Puget Energy's estimated equity issuances will be a significant challenge.

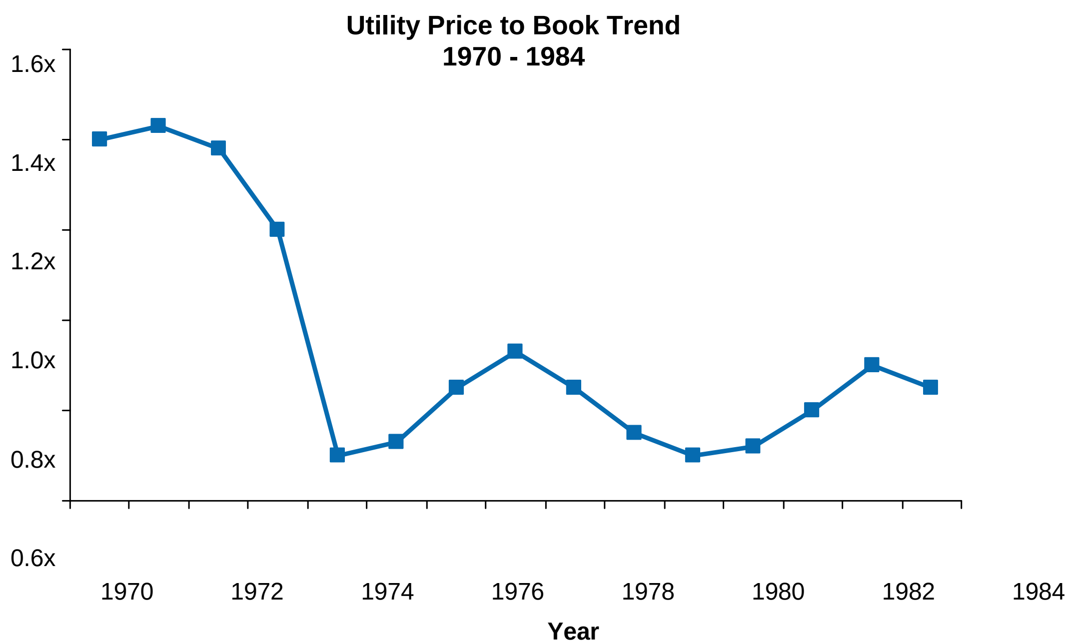
Q. Staff asserts that PSE's predecessor, Puget Sound Power & Light Company ("Puget") was able to finance its external capital needs at a time when it doubled the amount of net plant in service in each consecutive five-year period between 1975 and 1979, and therefore, financing growth should not be a significant issue for PSE in today's environment. How have the capital markets changed since the 1970s and what are the implications for PSE's capital raise?

A. There has been significant change in the capital markets over the past three decades. This change affects utilities' fixed income and equity financing options. Overall, the change in macroeconomic conditions, such as the decrease in interest rates, compression of credit spreads, and globalization of financial markets, have modified the financing choices of utility companies.

For example, from a fixed income (debt) perspective, in 1970, 97% of utility credits were rated (by S&P) A or better, with 14%% AAA. But by 2007 the proportion of AAAs had slipped to 0.1%, and only 30% were rated A or better.

This erosion in financial strength makes it more difficult for issuers to continue to rely so heavily on debt, and increases the need for more equity in the future.

On the equity side, price to book ratios dropped significantly, from 1.4x in 1970, to 1.0x after 1974. This appears to have been caused by a period of sustained capital expenditures, rising costs and interest rates (inflation), and an unfavorable regulatory response that made it difficult to fully recover this investment, culminating in eroding equity values. The chart below shows the utility price to book ratio during this time period.



Source: FactSet; Lehman Brothers

Indeed, over the past twenty years there has been a gradual but significant decrease in the level of equity issuance by utility companies. In the early 1990s, average annual equity issuance by power utilities still represented roughly 10% of market capitalization. That figure now stands at 4%. In this environment, issuing large amounts of equity is increasingly challenging. As I described earlier in my testimony, the industry is entering another period of sustained capital investment that under similar conditions could lead to similar erosion in equity values, as witnessed during the 1970s.

Q. Witness William Horton suggests that "Under the status quo, Puget Energy and PSE have direct access to the capital markets for debt and/or equity. Puget Energy and PSE have developed these funding relationships over the years and … they tend to be more resilient than wholesale relationships in the international markets." (page 8, lines 19-22). Do you agree with Mr. Horton's conclusion.?

A. No, I do not agree. Mr. Horton's conclusion is inconsistent with established corporate best practice. In particular, companies typically add more classes of securities, develop more sources of capital, and make themselves attractive to more types of investors. This is done with the intent of being able to raise larger amounts of capital more efficiently, and to ensure that it can do so under a variety of market conditions. For example, tapping into global capital sources provides the advantage of diversification of sources – some markets may be very active at certain times while others are not; and then the situation can change. The globalization of capital sources and uses has been shown to lead to a reduction in risk and greater access to capital.[2] A relationship with a global entity such as the Investor Consortium provides access to global capital sources and institutional relationships advantaged by greater bargaining power with financial intermediaries.

Q. How do you respond to Public Counsel's assertion that the Joint Applicants have not established that there are benefits in terms of access to capital or otherwise that offset the harm of increased risks to the public? Are there advantages to using other, non-public sources of equity?

A. As stated earlier, more sources of capital and more types, is better. Furthermore, the literature has documented that non-public equity tends to outperform public equity.[3] And in collaboration with INSEAD, our own, as yet unpublished, research also found this to be true. In many ways financial sponsors have become the "patient" money. Access to, and cost of, equity is no longer affected by short term market swings, and capital investment tends to be based on longer term prospects rather than near term earnings consequences and short term factors (like weather). Business planning tends to be longer term in nature with investment decisions based on expected project returns.

[2] Rene M. Stulz notes that globalization brings significant benefit to investors, "Globalization of Capital Markets and the Cost of Capital," Journal of Applied Corporate Finance, Vol. 8, No. 3, Fall 1995.

[3] World Economic Forum, "The Globalization of Alternative Investments," working paper, *The Global Economic Impact of Private Equity,* WEF 2008.

V. VALUATION

Q. What steps did you take to evaluate the risks to PSE were it to execute its business plan on a stand-alone basis?

A. I undertook a relative valuation analysis in which I analyzed cross-sectional (a comparison of data across the industry at a single point in time, like today) and time-series data (a comparison of data across time for a single company or industry index) of large equity issues to gauge the effect on returns to shareholders of external financings such as those planned by Puget Energy.

Q. What are the conclusions of this type of analysis?

A. As noted earlier, academic research has shown that on average, issuers of equity see their share prices drop after the announcement of their intent to issue significant amounts of equity. We found similar results. For example, in the cases of Southwest Gas Corporation (August 1998), Southern Union Company (July 2004) and Integrys Energy Group (November 2005) the average decline in share price was over 5% versus the Dow Jones utilities index in the week around the announcement. The relative sizes of equity issued by these companies places each of them in the top quartile (largest 25%) of the industry over the last 10 years.

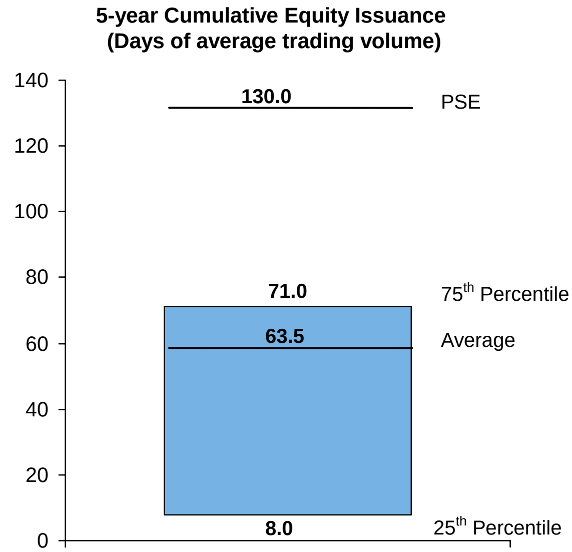
Q. What other conditions can typically exacerbate the wealth destruction associated with large equity issuance?

A. Unexpected lower earnings and compressed multiples are some of the factors that could magnify the negative effects of large equity issuances. Equity dilution is not well received by investors, and issuing equity under a lower valuation multiple situation will only exacerbate the problem. Only companies that require a significant strengthening of their balance sheet (i.e. a major recapitalization to recover from financial distress) tend to benefit (in terms of stock price) from large equity issues. This is not the case for PSE. Mr. Eric M. Markell discusses the implications of the Company's future equity issuances on a stand-alone basis in light of the Company's earnings prospects and current market multiples in his rebuttal testimony submitted in this proceeding, please see Exhibit No. ___(EMM-5CT).

VI. MARKETABILITY

Q. How much new equity are investors willing to absorb if a utility's need for equity is large relative to its size?

A. The average deal size for primary issuance of seasoned equity is about 4% of market capitalization, or about 13 days of trading volume, based on my analysis of the utility sector over the last ten years. For PSE, this would represent about $[redacted] per deal. The average cumulative five-year capital raise, for primary issuance of seasoned equity, is about 20% of market capitalization, or about 64 days of trading volume. For PSE, this would equate to approximately $[redacted] in total. However, expressing Puget Energy's five-year cumulative equity issuance in terms of the number of days of average trading volume, compared to the same metric for the industry, shows that Puget Energy is at the very high end of the scale in relation to other issuers, as shown on the chart below.



Note: Analysis based on a set of comparables utility companies over the last 10 year period, PSD strategic plan; PSD market cap and daily volume average of the last three months
Source: Capital IQ; Booz & Company analysis

Q. Does this present a problem?

A. It can – it will depend on the equity story, the track record, and the market at that time. In other words, PSE management must overcome the challenges it will face in raising equity based on its existing business plan and capital needs. However, a 90th percentile capital raise is likely to push investor appetite for the name to its limits, leading to an erosion in deal pricing, terms and speed of execution.

Q. Does the competition for capital present a problem for PSE?

A. As stated earlier, the sector is facing a major capital spending cycle over the next several years. PSE will need to compete for capital with much larger companies, all of whom are investing to meet the needs of their customers. PSE's equity story will need a more compelling vision for the use of proceeds than investors' next best choice, or PSE will face a flight of capital. Ultimately, it is the pricing, terms and timing of the equity issuance that suffers the most.

VII. CONCLUSION

Q. Please summarize your testimony.

A. I find the size of PSE's capital needs for the next five years to be extreme. Without the benefit of a financing partner, the Company faces a challenging road ahead with significant financing risk. This risk is likely to manifest in less than optimal pricing, terms and speed of execution in its financing.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.