BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

IN THE MATTER OF THE JOINT APPLICATION OF

PUGET HOLDINGS LLC AND
PUGET ENERGY, INC.

FOR AN ORDER AUTHORIZING PROPOSED TRANSACTION

DOCKET NO. U-072375

RESPONSE TESTIMONY OF STEPHEN G. HILL (SGH-11T)

ON BEHALF OF

PUBLIC COUNSEL

August 5, 2008

NON-HIGHLY CONFIDENTIAL VERSION

Q: Please state your name and business address.

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

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

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

Q: Are you the same Stephen Hill who testified previously in this proceeding on behalf of the Public Counsel regarding the proposed acquisition of Puget Energy by an Investor Consortium led by the Macquarie Group?

A: Yes.

Q: What is the purpose of your testimony at this time?

A: I will respond to the proposed Multiparty Settlement Stipulation (Settlement Stipulation), filed July 23, 2008, and the Pre-filed Joint Testimony Supporting Settlement Stipulation (Joint Testimony) filed July 29, 2008 by Michael Early, Charles Eberdt, Nancy Hirsh, William Horton, Robinson Kupchack, Christopher Leslie, Eric Markell and Paula Pyron. The parties to the settlement: the UTC Commission Staff (Staff), the Industrial Consumers of Northwest Utilities (ICNU), The Energy Project, the NW Energy Coalition (NWEC), Northwest Industrial Gas Users (NWIGU), Puget Sound Energy (PSE), and Puget Holdings (PH), refer to themselves as the "Participating Parties," and have reached an agreement with regard to various disputed issues related to the proposed transaction—the acquisition of Puget Energy by the Investor Consortium.

Q: Have you reviewed the joint testimony of the Participating Parties?

A: Yes, I have.

Q: Do you agree that, with the additional commitments included in the Settlement Stipulation, the Macquarie-led acquisition of Puget Energy is in the public interest?

A: No. While the parties included in the settlement were able to obtain some concessions from Puget and the Macquarie-led Investor Consortium (Joint Applicants), the fundamental nature of the transaction is unchanged. This transaction is not necessitated by the public interest generally or the interests of Puget's customers. Instead it appears to benefit the private interests of an investor group that seeks, through the use of leverage and increases in financial risk, to earn a very high rate of return—much higher than is available in the public market for utility stocks.[1] The Joint Applicants have shown neither a financial nor an operational need for this acquisition. There is no demonstration that Puget is unable to raise the capital necessary to fulfill its public service obligations. PSE's CEO has publicly stated as much:

> Last month, PSE chief executive officer and president Steve Reynolds had this to say when asked what happens if the sale is rejected: "We've never said we couldn't raise the capital if the UTC said 'no.' We would continue to serve our customers," he told The Olympian's editorial board.[2]

[1] Exhibit No. ___(SGH-1THC), p. 34.
[2] "PSE sale gets two strikes," The Olympian, June 19, 2008, Available online at: http://www.theolympian.com/southsound/story/482918.html.

As I pointed out in my Direct Testimony, Joint Applicants do not claim that the Investor Consortium will supply capital more cost-effectively than the public capital markets.[3] Joint Applicants state that they have not conducted any analysis to determine whether the cost of capital for either Puget Holdings or PSE will be lower as a result of approval of the proposed transaction.[4] In fact, the Macquarie financial model on which the acquisition is predicated assumes that the cost of debt capital to the post-acquisition Puget Energy will be higher than that for Puget Sound Energy.[5]

Puget's customers would be better off with the "status quo"—a publicly-traded investment-grade utility with improving financial health, low business risk and an electric industry-average mix of debt and equity financing its operations. Allowing an investor consortium to take the Company private, to issue significant amounts of five-year term debt to finance both the acquisition and projected capital expenditures over the next ten years, remains an inferior choice for the interests of Puget's customers, even considering the concessions offered in the settlement process.

As I will discuss below, the additional financial commitments that have been offered by Macquarie and the other investors, including rate credits, dividend restrictions, capital injection, additional reporting responsibilities, and emergency equity issuance capability, are, ultimately, relatively limited measures

[3] Joint Applicants Response to Public Counsel Data Request No. 3022.
[4] Joint Applicant's Response to ICNU Data Request No. 3.56.
[5] Joint Applicant's Response to UTC Staff Data Request No. 1047.

that may incrementally change the tenor of the transaction but do not change its fundamental nature. The proposed transaction and the settlement of the proposed transaction are not in the public interest and should be rejected.

Q: One of the concerns expressed by the intervenors in this proceeding is that the proposed transaction's addition of substantial amounts of debt capital would increase Puget's financial risk. Does the additional commitment to add $200 million of equity to the transaction alleviate that concern?

A: No. First, when the amount of common equity included in the transaction is increased by $200 million and the amount of 5-year term debt issued by Puget Energy is reduced by $200 million the average debt-to-total capital ratio for Puget Energy shown in Exhibit No.__(SGH-10HC) declines only two percentage points **[HC]** (XXXXXXXXXXXXXXXX, **[HC]** and remains well below S&P's threshold for investment-grade electric utilities.

Second, Commitment No. 59, in which the offer of additional equity is made, does not specify the origin of that capital. As shown in Macquarie's financial model, the "equity" injections planned for PSE over the next ten years **[HC]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. **[HC]** If the "equity" capital injected into Puget Energy under Commitment No. 59 is likewise obtained by a loan from Macquarie Capital or some other source, that capital would actually increase the financial risk of this transaction by further encumbering the cash flows produced by PSE.

Third, even if the capital injected into the transaction actually represents original investor equity capital and not just more debt, the commitment does not include a timing requirement that the equity be in place at the time the transaction is completed. Also, there is no penalty included in the commitment if Macquarie elects ultimately not to add the equity. As stated previously, Macquarie's commitment to add equity to the transaction does not change the underlying nature of the transaction.

Q: Does Joint Applicant's Commitment No. 34 offering "rate credits" over the next ten years improve this transaction from a ratepayer perspective?

A: Any promise to reduce rates in the future over what would otherwise prevail must be considered an improvement from the original transaction. In actuality, however, this represents a very small portion of future revenues, and thus a very small commitment on the part of the Investor Consortium, which does not address the underlying danger of significantly increased debt responsibility. The projected post-acquisition increase in fixed costs (debt payments) increases the risk that ratepayers will be called on to "bail out" the utility in a difficult financial situation. As shown in Exhibit No.___(SGH-8HC) attached to my Direct Testimony in this proceeding, this is not an unlikely scenario. For ratepayers, the "rewards" of this offer are not commensurate with the additional risks imposed on them by the substantial increase in leverage assumed in the proposed transaction.

Even assuming that the Joint Applicants would continue to credit the cost of service for the expenses Puget will not incur when no longer a publicly listed stock company (see Commitment No. 34(b)), a $100 million reduction in revenues over the next 10 years, according to Macquarie's projected revenues over the 2009-2018 period represents a revenue reduction of only **[HC]** XXX **[HC]** percent.

The Joint Testimony of the Participating Parties indicates that a reduction in revenues of $8.8 million per year would reduce the pre-tax rate of return of the Investor Consortium by 24 basis points.[6] Without knowing the investors' total expected return, the relative importance of that amount is unclear. However, when that 10-year rate reduction commitment ($88 million) is divided by the product of the Investor Consortium's equity investment of $3.4 billion and the expected annual rate of return from this transaction, the total expected after-tax dollar return to the investors would be reduced by only **[HC]** X **[HC]** percent. In other words, with this concession, the equity investors expect to receive **[HC]** XX **[HC]** percent of their originally-promised return.

Even with that reduction, the expected rate of return is well above current utility returns, and at the upper end of the expected returns in the Investor Consortium's investment portfolios. This rate reduction offer can only be characterized as a modest proposal and, again, one that does not substantially change the underlying nature of the deal.

Q: One of the factors contributing to the Participating Parties' Settlement Stipulation was the agreement by the Joint Applicants to restrict cash distributions out of Puget Sound Energy and Puget Energy in order to improve its financial condition, which is set out in Commitment No. 40. In

[6] Joint Testimony, Exhibit No. ___ (JT-1T), p. 28.

your view, does this additional commitment lower the risks to ratepayers sufficiently to offset the risks inherent in the proposed transaction?

A: No. First, on this issue, it is most important to realize that a dividend restriction commitment by the Joint Applicants is necessary only because of the large amounts of debt that accompany the proposed transaction and the resulting increased potential for bond rating downgrades. Under the "status quo," this concern about bond ratings and retaining cash in the operating company is a non-issue. That is because Puget Energy, prior to the announcement of the proposed acquisition, was on a path of improving financial health. It is only because of the change in direction anticipated with this transaction—i.e., the use of significant amounts of debt capital to facilitate the transaction and to finance capital expenditures—that the bond rating of Puget is in question.

As with the other recent Commitments offered by the Joint Applicants, while the dividend restrictions will work to retain some cash in Puget Energy to slowly rebuild its consolidated financial position, that impact is relatively small.[7] In the event of a bond rating downgrade to below investment-grade, Commitment No. 40 calls for PSE to continue paying dividends to Puget Energy that are sufficient to cover the financial covenants associated with the debt residing at Puget Energy. According to Macquarie's financial projections, over the next ten years, average Funds From Operations (FFO) less nondiscretionary capital

[7] Because Puget Energy is able to control the capital structure of Puget Sound Energy and Puget Energy's only significant expenses are for debt expense, the point of concern with dividend restriction is to shore up the consolidated capital structure of Puget Energy.

expenditures (the cash flow metric used in the bond covenants) exceeds the cash lock-up coverage requirements of Puget Energy interest expense by about **[HC]** XXX **[HC]** million per quarter. Retaining that amount of cash could cause an increase in the consolidated common equity ratio of Puget Energy of approximately 2 percent annually (based on an average common equity ratio of approximately **[HC]** XXXX, **[HC]** and the average capitalization over the projected period). While that would represent an improvement in financial position for PE, it would not be a rapid improvement and would take several years to reach a level appropriate for an investment grade company.

Moreover, simply calculating what cash might be retained if Commitment No. 40 were to be implemented does not take into account the significant increase in costs associated with a loss of investment-grade bond rating status. The increased costs of capital as well as other associated cost increases could well negate any financial strength benefit afforded by the dividend restriction. As I noted in my Direct Testimony in this proceeding, a loss of investment grade bond rating would increase costs for Puget for all of the following reasons[8]:

- Higher long-term borrowing costs on long-term debt, preferred stock, hybrid securities, etc.;
- Higher short-term borrowing costs as reflected in credit facility pricing grids and likely higher spreads on commercial paper issuances;
- Potential loss of access to the commercial paper markets;
- Possible inability to renew credit facilities;
- Potential collateral calls from energy credit counter parties;

[8] *See* Exhibit No.___(SGH-1THC), p. 66, citing PSE Response to Public Counsel Data Request No. 26(d), Docket Nos. UE-072300/UG-072301.

- The demand for collateral or up-front payments by those providing new energy resources to PSE;
- Counterparties may no longer provide trade credit for energy hedging activities;
- Energy supply trading and hedging counterparties may no longer be willing to conduct business with PSE.

Finally, on the topic of dividend restrictions, one of the fundamental reasons for requiring this commitment is to limit the cash distributions to the equity investors in the event of a bond rating downgrade, thereby providing a direct incentive for the equity investors to manage the Company to avoid that situation. However, as reported in the Risk Metrics whitepaper provided as an exhibit in my Direct Testimony, a feature of the Macquarie model is the payment of cash distributions that are greater than the operating cash flow of the infrastructure investment to its investment partners.[9] If that occurs in this instance, then a dividend restriction commitment offers little incentive for the equity investors to assiduously avoid a bond rating downgrade. Providing cash distributions out of other capital rather than operating cash flow would thwart the attempt to shore up the financial position of PE by creating additional responsibility for the cash flow stream of Puget Energy.

Q: Commitment No. 39 indicates that the Joint Applicants, following completion of the transaction will use their "best efforts" to obtain ratings separation between PE and PSE. If accomplished, could this improve the ability of the

[9] *See* Exhibit No.__(SGH-5), p. 14.

dividend restriction offered in Commitment No. 40 to more rapidly improve the financial condition of PSE if its investment-grade credit rating were lost?

A: Yes. The same quarterly cash savings operating on a smaller capital base of PSE would indicate a more rapid improvement in the common equity ratio. However, if PSE looses its investment-grade credit rating, it will not be because of its capital structure (the Joint Applicant's have committed to maintaining the capital structure of the operating utility at or near current levels). If the bond rating of PSE declines below investment grade it will be because of the debt residing at the parent company level (Puget Energy or above) and the financial pressure that places on the cash flows generated by PSE. Such a down-grade would therefore indicate that the bond ratings of PSE and PE are fundamentally linked (PE and its parents have control over the financial well-being of PSE). As discussed, Standard & Poor's has already spoken regarding the linkage of Puget Energy and Puget Sound Energy.[10] Therefore, a commitment to seek a de-linking of the corporate credit ratings of Puget Energy and Puget Sound Energy, especially following completion of the transaction, does not provide additional protection relating to the proposed dividend restrictions.

Q: Does the fact that Commitment No. 36 requires the Joint Applicants to maintain a 44 percent common equity ratio at PSE following dividend distributions to Puget Energy help to protect the public interest in this transaction?

[10] See Exhibit No. __(SGH-1THC), pp. 61-63, Joint Applicant's Response to ICNU Data Request No. 3.23, Attachment E(HC), pp. 2, 3.

A: No. Puget Energy and its parent companies are able to control the capital structure of Puget Sound Energy by issuing debt and injecting that capital as equity into PSE, and, therefore, can maintain any capital structure it wishes at the operating company. The requirement that PSE have a 44 percent common equity ratio prior to issuing dividends to PE does not protect the public interest.

Q: The Joint Applicants have also agreed to insert another corporate entity between Puget Holdings LLC and Puget Energy, which they describe as "bankruptcy remote." Do you believe this commitment provides sufficient protection to make the transaction beneficial to the public interest?

A: Given the complexity of the corporate organizational hierarchy as initially proposed[11] it is difficult to understand how one more corporate entity will make any substantive difference with regard to its public interest aspects. There already exists one corporate entity between Puget Holdings LLC and Puget Energy—Puget Intermediate Holdings—the ultimate purpose of which is unclear[12]. Also, there is no indication in the commitment how the proposed additional corporate layer will be made "bankruptcy remote."

Q: The Joint Applicants have added a commitment for PSE and PE to provide financial information required by the NYSE and the SEC, and to abide by Sarbanes-Oxley requirements regarding certification of financial statements by Company financial officers. Does this commitment support the contention

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[11] *See*, Direct Testimony of Stephen Hill, Exhibit No.__(SGH-6) (chart of corporate structure).
[12] This point is discussed in my Direct Testimony, Exhibit No. ___ (SGH-1THC), pp. 30-31.

of the Participating Parties that the proposed transaction in the public interest?

A: No. While an improvement over the initial filing, this Commitment, as with many others, simply attempts to preserve the "status quo" by allowing access to the books and records of PSE and PE similar to that which the Commission and the public at large already enjoy. Also, it is important to note that Commitment No. 43 regarding continued reporting, promises that PSE will "to the extent practicable" comply with NYSE reporting requirements. At what point and for what reason those reporting requirements might become impracticable, we do not know.

In addition to the practicability qualification, the Joint Applicants continue to limit access to the books and records of Puget Holdings or "any affiliate or subsidiary companies" except to the extent that any such access is "required…to verify or examine transactions with PSE or that result in costs that may be allocable to PSE." Commitment No. 27 does not specify how the determination may be made regarding when access is "required" or what costs might be allocable to PSE. In this regard, regulatory access to financial data that could be directly related to the financial risks incumbent on PSE would be diminished if this transaction is allowed to proceed. That is, if this transaction goes forward, there will be at least two corporate levels above Puget Energy—each of which is capable of issuing debt—and this Commission will not have ready access to the financial records of either one of those entities. That regulatory situation is not in the public interest and represents a step backward from the "status quo"— a publicly-traded utility holding company with one subsidiary.

Q: Do the statements contained in Commitment No. 40, that Puget Holdings and PSE are permitted to issue new equity and "hybrid securities," ensure that the financial strength of Puget Energy can be restored if bond ratings decline or the Company is in a troubled financial condition?

A: No. First, because the managers of Puget Holdings (the Investor Consortium members) are not prohibited from issuing additional common equity to other investors or to the public does not mean that they will do so nor that they are required to if financial conditions are dire. Therefore, there is no assurance that additional equity capital would be available or even sought by the Investor Consortium to alleviate any extreme financial risk. Also, the ability to raise any meaningful amount of common equity in a "fire sale" financial situation would be problematic, at best, and provides no assurance as to the continued financial well-being of Puget.

Second, the fact that PSE is "permitted" to issue "hybrid securities" to either the public or to Puget Holdings also offers no assurance that such action will result in any increase in invested equity capital. I am not aware of a subsidiary of a privately-held holding company issuing common equity capital directly to the general public. Perhaps it has happened, and has been successful, but, if so, I am unaware of it and, in my view, it would be most unusual. Moreover, from the viewpoint of a potential investor considering such an investment, the sharing of ownership or voting rights with the private holding company investors would likely raise very difficult legal issues and pose an impediment to ready investing. As such, the value of any such equity offering would be in doubt, and the Participating Parties do not offer any examples of a similar situation or describe how such an equity issuance might work.

Finally on this point, it is interesting to note that under the proposed settlement, the financial remedy of last resort in the event of post-acquisition financial distress turns out to be issuing common equity. Joint Applicants attempt to justify the transaction by suggesting that Puget may have difficulty issuing common equity even though it is an investment grade publicly-traded utility. Why, then, is it reasonable to believe that as a below investment-grade privately-held utility the Company will be able to pull itself up by its bootstraps by issuing equity underneath its private owners? This makes little economic or business sense. In sum, I do not believe that the Joint Applicants commitment regarding additional equity investment is likely to ensure the restoration of Puget's financial strength in the event of a significant negative financial event.

Q: Is it reasonable to believe, as Commission Staff claims in their portion of the testimony supporting the settlement, that the dividend restriction commitments avoid the "impairment" of goodwill created by the acquisition?

A: No. Even excluding the increase in operating costs associated with a bond rating downgrade, a capital structure improvement occasioned by the dividend restrictions included in the Settlement Stipulation would result in a very slow recovery of Puget's consolidated financial position. Inclusion of the added costs of a sub-investment grade bond rating in the calculus would work to negate any improvement in financial position occasioned by retaining cash through a dividend restriction. Also, as noted above, the ability to actually acquire additional common equity seems problematic, and the measures offered in Commitment Nos. 36 and 40 do not, as Staff predicts, address the issue of goodwill impairment.

This subject of the goodwill that would be created by the proposed transaction provides an apt illustration of why the entire transaction is not in the public interest. By paying $30 per share price for Puget Energy, a price approximately 25 percent higher than the then-current market price, and by financing the acquisition with $1.425 billion in new debt issued by Puget Energy, the Macquarie-led investors, if this transaction proceeds, will have created an intangible $1.6 billion goodwill asset on the books of Puget Energy that is currently non-existent.

This means, very simply, that because Puget Energy is currently in sound financial shape, the cash flow stream of Puget Energy is able to support an additional $1.425 billion in debt capital. However, what that additional debt essentially winds up financing in the proposed transaction is a hypothetical goodwill asset of $1.6 billion—simply a result of the very high price paid by the investor consortium for Puget stock. Puget Energy would be much better off and the public interest would be better served if Puget Energy, absent the proposed transaction, issued $1.425 billion of additional debt, incurring the attendant financial risk, but used those monies to finance and build actual tangible assets such as transmission lines and power plants, rather than creating the hypothetical goodwill asset that will result from this proposed transaction. While the additional debt would add a similar amount of financial risk as the proposed transaction, the public interest would be better served by having those monies available to finance tangible utility assets rather than financial assets that appear only on the holding company balance sheet.[13]

Q: The Commission Staff indicates that the proposed settlement addresses the concerns it expressed in its originally-filed testimony in this proceeding. One of the Staff witnesses, Mr. Ronald H. Schmidt, in his Response Testimony, discussed Staff's concerns regarding the unprecedented volatility existing in world debt markets. Does the Joint Testimony address that issue?

A: No. Mr. Schmidt's testimony on the topic of world debt markets provided insight into the current status and ongoing volatility of those capital markets.

> The collapse of the subprime market does not mean that private equity markets will be next in line. But there are enough similarities to give one pause. The private equity investors also are looking to find ways to get higher returns through leverage, and they depend on access to credit markets to provide funds at low rates. These loans, in turn are often packaged and sold to other investors raising the possibility that the ultimate investors may not fully understand the risks of the underlying assets (as has been the case with CDOs), and may not understand the risks that contagion from problems in related sectors can suddenly affect other sectors. The search for greater returns unknowingly can lead to undeterminable levels of risk.
>
> As I will discuss next, in some portions of the private equity market, particularly those exposed to energy markets, the high leverage position of many private equity

[13] We do not suggest here that Puget should dramatically increase its leverage and increase its financial risk to unsafe levels. This hypothetical is meant only to illustrate that if the Company were to employ that borrowing ability absent the proposed transaction, it would have monies available to finance tangible utility assets rather than a hypothetical asset such as goodwill.

> investments coupled with a move to fair value accounting can force write-downs of equity and further increases leverage. This could hold the seeds of a future tidal wave of funds fleeing the sector. If this were to occur, private equity funds would face a sudden lack of liquidity that is evidenced in today's mortgage debt markets, and that could hamper their ability to refinance debt and continue to reinvest in their holdings.[14]

The transaction under review in this proceeding is predicated on the long-term availability of substantial amounts of debt capital. However, the events of the past year including near failures and U.S. Government bail-outs at major financial institutions (Bear Stearns, Fannie Mae and Freddie Mac) offer the Commission a brightly flashing danger sign regarding the Macquarie debt-based business plan for Puget. Those near-failures along with bank closings, very high commodity prices, nascent inflation, and a national and world economic environment that can only be described as poor, combine to paint a picture that calls for caution.

Now is simply not an opportune time to "bet the utility" on the stability of world debt markets. Moreover, a key question in evaluating this proposed acquisition of Puget by the Investor Consortium is: in an unsure market would an investor be more likely to invest in an investment-grade utility operation with an industry-average capital structure or in a more heavily-leveraged privately-held utility with a below investment-grade credit rating? In tough times, money will flow to firms with better credit. Puget will have better credit if it remains as it is

[14] Exhibit No.__(RHS-1T), p. 13:2-18.

now—a publicly-traded utility holding company with industry-average debt levels and healthy bond ratings.

Q: Mr. Hill, does the proposed settlement presented in the testimony of the Participating Parties provide sufficient protections to offset the risks created by the proposed transaction and make the acquisition of Puget Energy by Macquarie and the Investor Consortium in the public interest?

A: No. It would not be in the public interest, especially in the current uncertain economic environment, to reverse Puget's long-term financial improvement by approving the transaction proposed by Macquarie and the Investment Consortium. The conditions and commitments set out in the Settlement Stipulation do not sufficiently address the level of financial risk created by the proposed acquisition.

Q: Should the Commission approve the stipulation and approve the proposed transaction?

A: No.

Q: Does this conclude your testimony?

A: Yes, it does.