EXHIBIT NO. ___(DDW-3)
DOCKET NO. UE-04_____
2004 PSE PCA 2 COMPLIANCE
WITNESS: DURGA D. WAITE

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of PUGET SOUND ENERGY, INC. For Approval of its 2004 Power Cost Adjustment Mechanism Report	Docket No. UE-04_____

SECOND EXHIBIT TO PREFILED DIRECT TESTIMONY OF DURGA D. WAITE (NONCONFIDENTIAL) ON BEHALF OF PUGET SOUND ENERGY, INC.

AUGUST 31, 2004

United States
Natural Gas-Integrated

Merrill Lynch *Comment*

16 June 2004

Sam Brothwell
Director
(1) 212 449 9703
Sara Nainzadeh
(1) 212 449 9050

Puget Energy Inc.

At Least It's Over With **BUY**

Reason for Report: Final Order on Power Cost Case; $43.1M Write Down

Volatility Risk: MEDIUM

Price: $21.15

12-Month Price Objective: $23.00
Date Established: 11-May-2004

Estimates (Dec)	**2003A**	**2004E**	**2005E**
EPS:	$1.26	$1.48	$1.68
P/E:	16.6x	14.3x	12.6x
GAAP EPS:	$1.26	$1.25	$1.68
GAAP P/E:	16.6x	16.9x	12.6x
EPS Change (YoY):		23.0%	12.9%
Consensus EPS: (First Call: 26-May-2004)		$1.54	$1.74
Cash Flow/Share:	$4.09	$4.79	$4.94
Price/Cash Flow:	5.1x	4.4x	4.2x
Dividend Rate:	$1.00	$1.00	$1.00
Dividend Yield:	4.8%	4.8%	4.8%

Opinion & Financial Data

Investment Opinion:	B-1-7
Mkt. Value / Shares Outstanding (mn):	$2,027.3 / 97
Book Value/Share (Dec-2003):	$17.57
Price/Book Ratio:	1.2x
ROE 2004E Average:	NA
Total Debt / Capital:	54.1%
Est. 5 Year EPS Growth:	8.0%
Est. 5 Year Dividend Growth:	0.0%

Stock Data

52-Week Range:	$24.40-$20.51
Symbol / Exchange:	PSD / New York
Institutional Ownership-Vickers:	46.5%
Brokers Covering (First Call):	8

Highlights:

- Late last week, Washington regulators issued a final order in PSD's arcane power cost recovery rate case. A portion of the costs associated with a prior gas supply contract buyout were disallowed, leading to a $43M ($0.28/share) write-off this year. We are lowering our 2004 GAAP estimate to $1.25 from $1.55, and our ongoing estimate to $1.48 from $1.55.
- Prospectively, the order calls for continued partial disallowance of these costs, which appears to cause an ongoing earnings drag of nearly $0.07 in 2005E, and in the $0.06 cent area in 2006E. There is the potential for some modest mitigation, but we are taking our 2005E down to $1.68 from $1.75. While this is unpleasant, at least this issue has been laid to rest and quantified.
- Importantly, this ruling is separate from and does not affect the general rate increase request the company filed in 4/04. That case will be decided later this year.
- *Lower numbers again; why not downgrade the stock?*
  - We believe downside is fairly well protected here with shares still trading at a discount to the group on our lower earnings outlook.
  - The 4.7% yield is decent and sustainable.
  - The pending *general* rate case (a totally separate proceeding) has the potential to provide a decent kick to earnings in mid-2005.
  - The power cost case has been an overhang on what we believe is still a fundamentally constructive regulatory relationship and climate.
- Despite the lower earnings outlook, we think our $23 price objective is achievable in a 12 month timeframe. New general rates should take effect next year but the impact won't be fully reflected until 2006E, when earnings could move back to the $1.80--$1.85 area.

Refer to important disclosures on page 4. Analyst Certification on page 3.

Shouldn't Have Been This Complex

On May 14, the Washington Utilities and Transportation Commission issued a final order in Puget Sound Energy's power cost only rate case. At that time, we interpreted the order as generally positive given its preservation of the $200M-plus regulatory asset associated with the 1997 buyout of a gas supply contract associated with a 245MW power supply agreement with Tenaska (the Tenaska agreement). We also noted that there could be devils in the details. There were.

A Bit of Background

What should have been a simple rate base addition of a modest power plant purchase turned into a complex proceeding that unearthed a six year old legacy regulatory issue. Back in 1991, PSD entered a twenty year agreement to purchase power (245MW of capacity and 216MW of electrical energy) from independent generator Tenaska. The power is supplied from a natural gas fired combined cycle plant. In 1997, PSD decided, with regulatory approval, to buy out the rather pricey gas supply contract associated with this power supply agreement. That buyout created a $200M plus regulatory asset that has basically sat on the books ever since. (Recall that there was a rate moratorium following the Washington Energy merger, and that the 2002 rate settlement didn't directly address this issue, but rather rolled it into the power cost tracking mechanism that was created at that time.

Late last year, Puget acquired half of the 250MW Fredrickson power plant, which triggered the "power cost only" rate case. It was anticipated then that this proceeding would narrowly address the incorporation of the new plant into rates; that was done, but the regulators bifurcated the case to separately address the Tenaska regulatory asset and the prudence of PSD's decisions surrounding it.

Our initial read of the May 14 order and discussions with regulatory staff suggested that the likely immediate financial impact was minimal, given that the adjustments were being made to PSD's power cost tracking mechanism, which had already hit its $40M cumulative three year sharing cap. Puget was less sanguine, and was concerned that the order could trigger write-downs and a possible ongoing earnings drag. The company petitioned the Commission for reconsideration of the order.

Last Thursday night, the Commission denied the petition for reconsideration but did clarify the accounting and earnings impact of the order. Based upon PSD's interpretation of the order it now appears that:

- The Tenaska regulatory asset, which stood at $228M at the end of June 2003, will be recovered in rates and amortized through 2011.
- While the corpus of the asset will be recovered in rates, the return ***on*** the Tenaska regulatory asset (at a weighted average cost of capital of 7.3% net of tax) was fully disallowed for the first period of the power cost adjustment (PCA) mechanism which ended in June 2003. This results in a $25.6M (pre-tax) hit to the PCA.
- The Commission further indicated that half of the return ***on*** the Tenaska regulatory asset would be denied prospectively.
- Applying this logic, PSD determined that $12.1M would likely be disallowed for PCA Period 2, which ends in June of 2004.
- Prospectively, an $11.3M reduction to the return on the Tenaska asset would apply to PCA Period 3, which will run from July 2004 through June 2005.

This is all very confusing, but it does provide some clues as to what's going on and the attendant impact on baseline utility revenues. The regulatory asset stood at $228M at the end of June 2003. It amortizes through 2011, which would imply a yearly rate in the $28M area. As such, the impact of the prospective disallowance tapers off as the regulatory asset gets smaller. This is illustrated for Periods 1, 2, and 3 of the PCA in Table 1 below.

Table 1: Regulatory Asset Disallowance

	Period 1 7/02—6/03	Period 2 7/03—6/04	Period 3 7/04—6/05
Regulatory Asset	$228M	~$200M	~$172M
Return on Asset (Pre-tax)	$25.6M	$24.2M	$22.6
Disallowance	100%	50%	50%
Pre-tax income impact	$25.6M	$12.1M	$11.3M
Earnings impact, July—June	$0.17	$0.07	$0.07

Source: ML Estimates, PSD 8-K

Table 2: Earnings Impact

	2004	2005	2006
Write-off for prior periods:			
Period 1 Disallowance	$25.6M		
Period 2—2nd ½ of 2003	$5.6M		
Total write-off	$31.6M		
Per Share	$0.21		
Current Earnings Impact:			
Period 2—1st ½ of 2004	$6.1M	$5.6M	$5.3M
Period 3—2nd ½ of 2004	$5.6M	$5.3M	$4.9M
Total per Calendar Year	$11.7M	$10.9M	$10.2M
Per Share	$0.07	$0.07	$0.06

Source: ML Estimates

■ Mitigation

The order makes things even more complex by providing the opportunity for Puget to mitigate the prospective

(Continued)

disallowance on the regulatory asset if the company is able to procure natural gas for Tenaska at a price that—as we understand it--beats the original pricing in the contract plus the return on and of the regulatory asset. Our sense is that this bogey could be in the high $5.00 to even $6.00 per Mcf area, although there are many moving variables. Moreover, given our outlook for natural gas prices in the coming year, we think any potential mitigation is likely to be very modest.

■ **Now, about that write-off**

Refer to Table 2. Puget added the $25.6M, the $12.1M, and ½ of the $11.3M (representing the half that would be denied in calendar year 2004) to arrive at the $43.3M (pretax) write off it is taking against earnings this year. That hit will knock about $0.28 off earnings, so PSD lowered its 2004 guidance to a range of $1.20 to $1.30 from a prior range of $1.50 to $1.60.

Change to our 2004E

Fine, but our objective is to zero in on a starting point for *baseline earning power*. As reflected in Table 2, there are two components to the $43.3M write-down:

- $31.6M between July 2002 and December 2003 (in other words, the $25.6M plus ½ of the PCA Period 2 charge that affects 2003)
- $11.7M for the back half of Period 2 and the first half of Period 3 that will affect current year results. Put another way, that would be ½ of $12.1M plus ½ of Are you with us so far?

For purposes of resetting our 2004E, we treat the first item ($31.6M or $0.21/share) as a one-off charge associated with prior periods, while the second ($11.7M or $0.07/ share) as a drag to current year results. As such, we are adjusting our 2004E to $1.48 from our prior $1.55.

And What of 2005 and Beyond?

From the new 2004 baseline, there are a couple of earnings drivers going into next year:

- Adding back the roughly $0.05 hit stemming from storm damage to the electric utility system early this year, and;
- The 2005 impact of the general rate case that Puget filed earlier this year. As filed, that case would add around $40M to net income (about $0.40/share). We believe PSD has put forth a solid case, but recognize that rate cases almost always settle out for less than the ask. However, we believe the company's request to boost its common equity ratio to 45% is persuasive in the context of the Commission's intent to improve the utility's financial health, credit quality, and financial flexibility, and that this is the single biggest component of the overall contemplated increase to net income that the rate case is seeking.

As such, we believe that 2/3 to ¾ of the requested increase could be realized. That could add $0.10 to $0.15 of incremental earnings in 2005E, given that new rates would likely not be implemented until the second quarter. That, coupled with the add-back of storm costs and normal service area growth, points to a roughly $0.20 earnings increase in 2005E off of our 2004 baseline, which as noted above has been reset to $1.48. As such, we are taking our 2005E to $1.68 from the prior $1.75. Here again, the delta reflects the ongoing hit from the disallowed return on the Tenaska asset described above, which we estimate to be in the $0.07 area next year, moving toward $0.06 in 2006 as shown in Table 2. E

Stock Outlook

Given that we're once again having to adjust our numbers down on PSD, why stick with the stock?

- At current levels, we think the stock is discounting earnings in the $1.50 to $1.60 area given an average group multiple in the low teens. As noted above, we think the real potential is closer to $1.80.
- The current 4.8% yield appears secure and provides a floor for the shares.
- We continue to view the Washington regulatory climate as constructive and improving.

Price Objective and Risks

Our $23 PO is 13.7X our 2005E and just under 13X our estimated full-year earning power for the company with our anticipated rate increase. This lies between the gas and electric utility group averages. With the current $1.00 dividend, we continue to see low double digit upside in a twelve month timeframe.

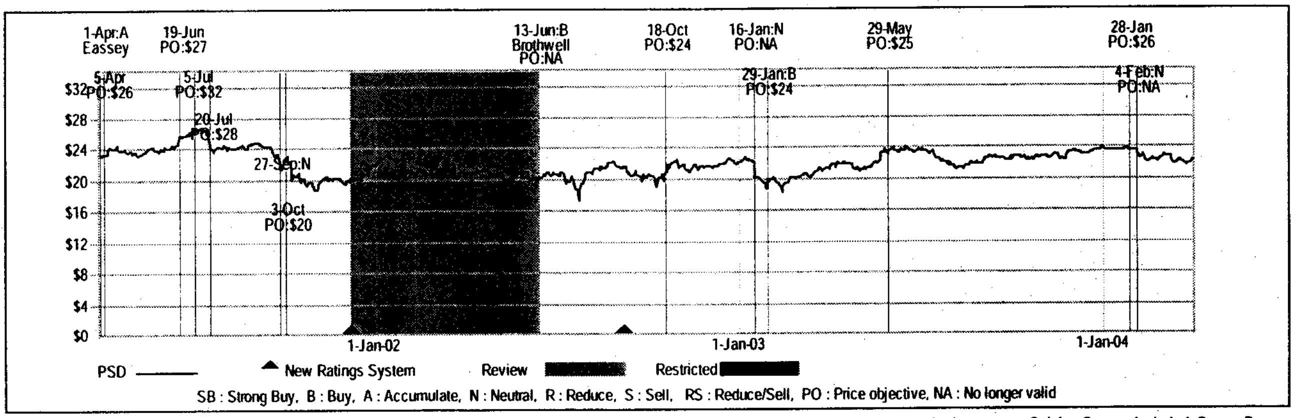
Risks to our price objective include regulatory treatment in the currently pending general rate case, weather, and natural gas and power price swings.

Analyst Certification

I, Sam Brothwell, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Important Disclosures

PSD Price Chart



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Investment Rating Distribution: Energy Group (as of 31 March 2004)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	67	47.18%	Buy	23	34.33%
Neutral	67	47.18%	Neutral	20	29.85%
Sell	8	5.63%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 31 March 2004)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1085	44.03%	Buy	362	33.36%
Neutral	1215	49.31%	Neutral	306	25.19%
Sell	164	6.66%	Sell	28	17.07%

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