## INTRODUCTION / SUMMARY

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries. My business address is P.O. Box 587, 4000 Benedict Road, Hurricane, West Virginia, 25526 (e-mail: sghill@compuserve.com).

Q. BRIEFLY, WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. After graduating with a Bachelor of Science degree in Chemical Engineering from Auburn University in Auburn, Alabama, I was awarded a scholarship to attend Tulane Graduate School of Business Administration at Tulane University in New Orleans, Louisiana. There I received a Master's Degree in Business Administration. More recently, I have been awarded the professional designation "Certified Rate of Return Analyst" by the Society of Utility and Regulatory Financial Analysts. This designation is based upon education, experience and the successful completion of a comprehensive examination. A more detailed account of my educational background and occupational experience appears in Exhibit__ (SGH-2) attached to this testimony.

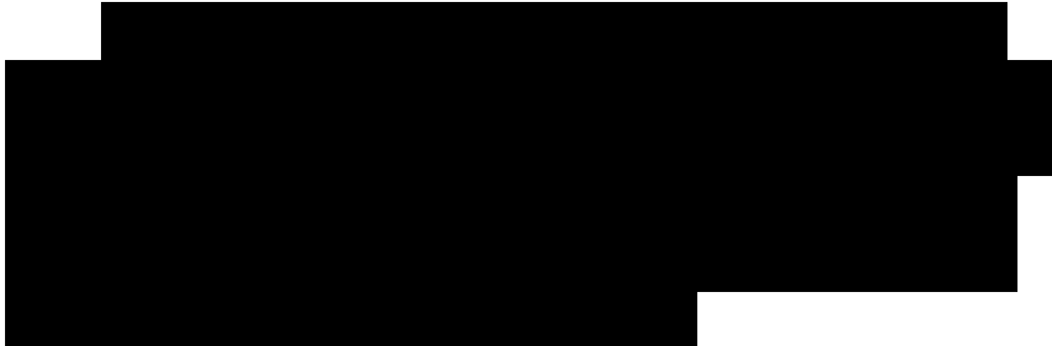
Q. HAVE YOU TESTIFIED BEFORE THIS OR OTHER REGULATORY COMMISSIONS?

A. Yes, I have appeared previously before this Commission. In addition, I have testified on cost of capital, corporate finance and capital market issues in over 195 regulatory proceedings before the following regulatory bodies: the West Virginia Public Service Commission, the Texas Public Utilities Commission, the Oklahoma State Corporation Commission, the Public Utilities Commission of the State of California, the Pennsylvania Public Utilities Commission, the State of Maine Public Utilities Commission, the Minnesota Public Utilities Commission, the Ohio Public Utilities Commission, the Insurance Commissioner of the State of Texas, the North Carolina Insurance Commissioner, the Rhode Island Public Utilities Commission, the City Council of

1 Austin, Texas, the Missouri Public Service Commission, the South Carolina Public Service
2 Commission, the Connecticut Department of Public Utility Control, the Public Utilities
3 Commission of the State of Hawaii, the New Mexico Corporation Commission, the Louisiana
4 Public Service Commission, the Public Service Commission of Utah, the Illinois Commerce
5 Commission, the Kansas Corporation Commission, the Indiana Utility Regulatory Commission,
6 the Virginia Corporation Commission, the Montana Public Service Commission, the Arizona
7 Corporation Commission, the Vermont Public Service Board, the Federal Communications
8 Commission and the Federal Energy Regulatory Commission. I have also testified before the
9 West Virginia Air Pollution Control Commission regarding appropriate pollution control
10 technology and its financial impact on the company under review and have been an advisor to
11 the Arizona Corporation Commission on matters of utility finance.
12
13 Q. ON BEHALF OF WHOM ARE YOU TESTIFYING IN THIS PROCEEDING?
14 A. I am testifying on behalf of the Attorney General of Washington, Public Counsel (PC).
15
16 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?
17 A. In this testimony, I present the results of studies I have performed related to the evaluation of the
18 request by Puget Sound Energy, Inc. (Puget, the Company) for interim rate relief. In conjunction
19 with its current rate proceeding (a $228.3 Million rate increase request), the Company has
20 asked the Commission to grant it an interim rate increase of $163.084 Million to account for a
21 projected under-recovery of its net power costs during the ten-month period from January 1
22 through October 31, 2002. The Company has requested that it be able to defer a power cost
23 shortfall of $63.435 Million which is projected to occur in January and February 2002 and to
24 increase rates to cover a projected power cost shortfall of $99.649 Million from March through
25 October of 2002.
26 In preparing my testimony in this proceeding, I have examined the Company's filing,
27 publicly available documents, and Puget's responses to Data Requests submitted by the Public
28 Counsel and the Commission Staff. I have evaluated whether or not an interim request is

1 necessary under the standards set out by the Commission in its Order in WUTC v. Pacific
2 Northwest Bell Telephone Company (Cause No. U-72-30, Second Supplemental Order,
3 October 10, 1972; hereinafter PNB).
4
5 Q. HAVE YOU PREPARED AN EXHIBIT IN SUPPORT OF YOUR TESTIMONY?
6 A. Yes. I have prepared an Exhibit (Exhibit__(SGH-1)) consisting of 12 Schedules which support
7 the analyses described in the body of my testimony. This Exhibit was prepared by me and is
8 correct to the best of my knowledge and belief. In addition, I have provided an Exhibit
9 (Exhibit__(SGH-2)) that contains my vitae.
10
11 Q. WOULD YOU PLEASE SUMMARIZE YOUR RECOMMENDATIONS, MR. HILL?
12 A. My primary recommendation is that the Commission deny the Company's request for interim
13 rate relief. I also recommend that until the Company's common equity ratio is restored to a
14 more reasonable level (40% of permanent capital), this Commission move to limit PSE's
15 dividend payment to Puget Energy so that more of the Company's earnings are retained within
16 the utility operation. Finally, if the Commission believes it necessary to protect the Company's
17 financial position by providing what the bond rating agencies would term a more "supportive"
18 interim rate decision, then I recommend that the Company be awarded an interim rate increase
19 of $29.3 Million.
20
21 Q. PLEASE PROVIDE A SUMMARY OF THE FACTORS AFFECTING THE
22 COMPANY'S REQUEST FOR INTERIM RATE RELIEF IN THIS PROCEEDING.
23 A. The financial projections provided by Company witness Hawley indicate that Puget's increased
24 operating costs (the under-recovery of its net power costs) will increase the Company's
25 leverage position and erode financial protection measures by the time the rate case decision is to
26 be rendered (October 2002). The financial benchmarks Mr. Hawley provides for the Company
27 by October 2002 show that the financial position of the Company will be below the level
28 appropriate for investment-grade debt—whether or not interim rate relief is granted (Exhibit

No.__(RLH-3).



However, while events in the western power markets in which the Company operates must be characterized as extraordinary during the past eighteen months, it is important to understand that the potential bond rating impact of the Company's recent power cost problems is due to an already weakened financial position. That is, had the Company been capitalized in a manner envisioned by this Commission when it last set rates, its is reasonable to believe that an interim rate request would be unnecessary. Moreover, the weak financial position in which the Company found itself when its power problems occurred is the result of choices made by Company management, not forces outside their control, and occurred during a time period in which the Company was prosperous.

Following the merger of Puget Sound Power & Light and Washington Natural Gas Company into Puget Sound Energy, the Company's common equity ratio and, thus, its financial protection measures eroded. Rates for the companies prior to the merger were set using equity ratios equal to 45% (electric) and 44% (gas). At year-end 1996, Puget had an equity ratio of 42.5%; but by year-end 1999, Puget's common equity ratio had fallen to 34.5%. At September 30, 2001, PSE's common equity ratio was 30.77%.

According to Mr. Hawley's Exhibit No.__(RLH-3), the debt-to-total capital ratio at year-end 1999, approximately 60%, placed Puget in the "BB" bond rating benchmark range—

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My experience with utilities that are in far worse financial condition that Puget (e.g., Western Resources, Kansas Corporation Commission Docket No. 01-WSRE-949-GI, Western Restructuring Docket) indicates that the Company would be able to access short-term debt markets.

1 or below investment grade[2]. The Company's financial position had eroded to a level of concern
2 well before its current power cost problems arose. Absent that weakened financial condition,
3 the Company would be in a much better position to weather the current power cost anomaly
4 and it is reasonable to believe that this proceeding would not have been necessary.

5 Moreover, during the period of capital structure erosion since the merger, Puget
6 continued to pay out a dividend that was roughly equal to its earnings, on average during that
7 time, adding no common equity from operating earnings to the capital mix. The Company
8 elected to maintain that very high dividend payout in an environment when many other utilities
9 have lowered dividend payout ratios in order to more effectively operate in a changing electric
10 industry. Also, Company management has eschewed public issues of common stock to avoid
11 issuing more debt and to shore up its common equity ratio, even though the Company's stock
12 has consistently traded at a level well above its book value[3]. Since the merger, the Company
13 has relied on debt to supply capital needs while simultaneously paying out all its earnings in
14 dividends. This practice has engineered a common equity ratio well below the level envisioned
15 by this Commission when rates were set—down to a level that is problematic when unforeseen
16 negative events occur.

17 Also, Company management has elected to continue to invest significant amounts of
18 common equity capital into its unregulated operations (InfrastruX) at the same time it is before
19 the Commission requesting expedited rate relief. The latest acquisition, announced December
20 12, 2001 (after the filing of this interim rate relief proceeding), was a gas pipeline construction
21 operation in New York. Thus far, Puget Energy, the parent company of Puget Sound Energy,
22 has an equity investment of about [redacted] in InfrastruX.

23 The Company would undoubtedly take the position that it can do as it pleases with

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2 [redacted]

1 unregulated monies. However, the juxtaposition of continued investment in unregulated
2 operations with Puget's claim of a utility in financial crisis provides, at a minimum, a mixed
3 message to its regulators. It also provides evidence as to the parent Company's willingness to
4 assist in the solution of its own financial problems.
5 Puget Energy's main business is its utility operations and the holding company will be
6 able to be successful only as long as the utility is successful and financially healthy. Therefore, in
7 my view, it is not unreasonable to expect the Company to participate in a solution to their
8 financial problems rather than relying solely on ratepayers, which is, in effect, what they are
9 attempting to do in this proceeding.
10 In sum, although operating cost fluctuations are causing the Company financial difficulty,
11 1) it does not rise to the level of "gross inequity" or "clear jeopardy" called for in the
12 Commission's PNB standards, in my view, and 2) the current financial situation is the result of
13 management's capital structure decisions. Therefore, from an rate equity standpoint, i.e., what is
14 a "fair" regulatory response, I believe the Commission has reason to deny the Company's
15 interim request and more fully address the Company's power cost/operating cost problems in its
16 rate case decision.
17
18 Q. WOULD THERE BE FINANCIAL CONSEQUENCES FROM A DECISION BY THIS
19 COMMISSION TO DENY THE COMPANY'S INTERIM RATE REQUEST?
20 A. Yes, it is very likely there would be. Both of the major bond rating agencies have made it quite
21 clear in their published statements that absent a positive regulatory response to the Company's
22 interim rate request (read: some interim rate relief), Puget's bond ratings would be lowered. On
23 October 8, 2001 Standard & Poor's (S&P) lowered Puget's senior securities (First Mortgage
24 Bonds) from "A-" to "BBB+" after this Commission rejected the Company's petition for
25 emergency rate relief. As a point of reference, the average bond rating in the electric utility
26 industry is between "A-" and "BBB+."[4]

[4] Standard & Poor's, "Downgrades Dominant Among U.S. Utilities in Third Quarter; Negative Trend Expected to Continue," October 5, 2001.

1 Later that same month when this Commission rejected the Company's motion for
2 reconsideration in the same pleading, S&P lowered that rating one additional notch to "BBB",
3 noting:
4
5 "The rating downgrades for Puget Sound Energy and its
6 subsidiaries reflect the absence of immediate rate relief,
7 combined with limited near-term prospects for improved cash
8 flow necessary to stabilize the company's weakened financial
9 position." (S&P Ratings Direct, October 30, 2001, provided in
10 response to PC-66-I)
11
12 Similarly, Moody's Investors Service (the other major bond rating agency), while not
13 reducing the Company's bond rating (currently "Baa1"—equivalent to a S&P rating of
14 "BBB+")[5], indicated that absent some sort of interim rate relief, bond ratings would be reduced:
15
16 "Moody's will continue to assess PSE's ability to achieve some
17 initial financial relief in the form of an interim rate hike relatively
18 early in the general rate case, or from other actions the state
19 might take within that same near-term horizon. We are
20 cautiously optimistic that PSE can be successful in this regard,
21 which we believe would put it back on track toward achieving
22 financial results more commensurate with its existing ratings.
23
24 *Absent this scenario playing out*, a rating downgrade would
25 result. Furthermore, given the importance of the final outcome
26 of the general rate proceeding to PSE's prospective credit
27 profile, it would not be inconceivable at that point to leave the
28 ratings on review for possible further downgrade, thereby
29 including the short-term rating as part of the subsequent review
30 process, while awaiting the final WUTC Order in the general
31 rate case." (Moody's Global Credit Research, Rating Action,
32 October 26, 2001, provided in response to PC-66-I, emphasis
33 added)
34

[5] Moody's Bond ratings in increasing order of risk are: Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3. Standard & Poor's corresponding ratings are: AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-.

1 Therefore, it is reasonable to believe that the Company's bond ratings would be
2 lowered were the Commission to reject Puget's interim rate request. My expectation would be
3 that, if the Commission were to deny interim rate relief, Moody's would lower the bond rating
4 of Puget's senior securities two notches to "Baa3" and that Standard & Poor's would wind up
5 at the same place, lowering ratings one notch to "BBB-". At that ratings level, the Company's
6 senior securities would remain classified as investment grade.
7 While Puget's earnings and interest coverages would suffer prior to the conclusion of
8 the rate proceeding, I believe the Company will be able to maintain an investment grade bond
9 rating for several reasons. First, the power cost anomaly experienced by the Company was due
10 to a confluence of events which is unlikely to be repeated in the future. Second, the Company
11 has the ability to lower its financial risk relatively quickly by increasing the equity portion of its
12 capital structure by selling common equity capital or reducing dividend payout, or both. Third,
13 the Company has not changed, fundamentally, in that it continues to operate in a growing service
14 territory, serving primarily residential and commercial customers with a relatively small industrial
15 exposure[6]. Fourth, I fully expect this Commission to treat the Company fairly in its concurrent
16 rate proceeding regarding its prudently incurred operating costs[7]. While it is certainly possible
17 that the bond rating agencies could lower Puget's senior securities' rating below investment
18 grade as result of this Commission's denial of its request for interim rate relief, I do not believe
19 that is the most likely scenario.
20
21 Q. IF THE RATING OF THE COMPANY'S SENIOR SECURITIES WERE LOWERED
22 BELOW INVESTMENT GRADE STATUS, DO YOU BELIEVE THAT WOULD

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[6] "Somewhat offsetting these weaknesses is [PSE's] moderately low-risk distribution and utility services strategy that is supported by minimal industrial load exposure, solid efficiency measures, and cost-containment efforts. Puget Sound Energy benefits from proximity to low-cost fuel sources, primarily hydroelectric, natural gas, and coal." Moody's Investors Service, October 30, 2001; provided in response to PC-66-I.

[7] When asked, in PC-64-I, to provide cites to prior Puget decisions in which the WUTC had not allowed the Company to recover its prudently incurred power costs, Mr. Hawley referred only to the Commission's recent rejection of the Company's emergency petition, not to any prior rate proceedings.

1 CONSTITUTE "CLEAR JEOPARDY" TO THE COMPANY AS SET OUT IN THE PNB
2 STANDARDS?
3 A. No, I do not. It is important to understand that utilities or other firms are not shut out of the
4 financial markets if their bond ratings fall below investment grade. The term "junk bonds" is
5 used as a collective noun for debt that is below the triple-B ("BBB") level and connotes a
6 security that no one would want to purchase. That is not true. In fact, according to Standard &
7 Poor's, the average bond rating of the industrial firms in the U. S. is "BB"—below
8 investment grade or classified as "junk bonds."[8] Therefore, those securities are certainly
9 marketable and a company is not precluded from financing its operations if its bond rating falls
10 below investment grade.
11 It is also true, as the Company notes in its testimony, that some investors (e.g., some
12 insurance companies, pension funds) are prohibited from investing in bonds that are rated below
13 investment grade and, for that reason, the market for those securities is more limited than for
14 investment grade debt. It is also true that, while there is not a substantial cost differential
15 between A-rated and BBB-rated debt, there is a substantial cost differential between the lowest
16 level of investment grade ("BBB-") and below-investment-grade debt ("BB+" or below). The
17 current cost rate differential between triple-B and double-B long-term debt is approximately
18 211 basis points[9]. However, it is not true that a firm is shut out of the capital markets if their
19 debt is rated below investment grade.
20
21 Q. WOULDN'T AN INCREASE IN THE COMPANY'S MARGINAL DEBT COSTS OF
22 OVER 200 BASIS POINTS CONSTITUTE "CLEAR JEOPARDY" OR "GROSS
23 INEQUITY" CITED IN THE PNB STANDARDS?

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[8] Standard & Poor's, "U.S. Utilities Credit Quality Displayed Steep Decline in 2001; Negative Trend Likely to Continue," January 18, 2002, p. 3.

[9] Bridge Information Systems, Corporate Spreads for Utilities, BondsOnline.com, 1/15/02: average yield spread above Treasuries for 30 year "BBB-" rated debt = 234 basis points; average yield spread above Treasuries for 30-year "BB+" rated debt = 445 basis points. Difference = 211 basis points..

1 A. Not in my view, no. It would definitely increase the Company's borrowing costs and those
2 costs could be passed on to ratepayers. However, even if we assume the marginal debt cost
3 differential were 300 basis points, in order for ratepayers to be indifferent to those increased
4 costs in the context of this proceeding, the Company would have to issue an additional $5.3
5 Billion in debt at those higher marginal rates. That is, in order for the increased marginal
6 borrowing costs to equal the rate increase request sought in this interim proceeding ($163
7 Million), the Company would have to issue an additional $5.3 Billion in debt ($163 Million ÷
8 300 basis points). The Company's current capital base (equity and debt) is about $4 Billion and
9 the Company's most recent long-term capital forecast indicates it expects to issue no
10 [redacted].[10] Therefore, even in the event of a bond rating reduction below
11 investment grade and the incurrence of a significant debt cost premium going forward, it is
12 unlikely that customers would incur additional debt financing costs equivalent to the rates the
13 Company requests be levied in this proceeding. From that perspective, allowing the Company's
14 interim request would impose a "gross inequity" on ratepayers rather than prevent it.
15
16 Q. IS IT YOUR BELIEF THAT SOUND REGULATORY POLICY SHOULD TARGET
17 BELOW INVESTMENT GRADE DEBT LEVELS FOR PUBLIC UTILITIES?
18 A. No. I believe that the maintenance of an investment grade bond rating is important for utility
19 operations. Utilities are inherently capital-intensive operations and, as such, often require access
20 to the capital markets. Also, as I've noted above and as the Company underscores in its
21 testimony, investment-grade debt is less costly to the Company and its customers than debt that
22 is rated below investment-grade. Therefore, the maintenance of an investment-grade rating is
23 important and actions which would jeopardize that rating should be carefully considered by
24 regulators.
25 However, that is not to say that investment-grade ratings are to be maintained
26 regardless of the circumstances. For example, if bond ratings and interest coverages were all
27 that mattered in setting rates, then we would simply replace regulation with bond rating agencies.

[10] Puget's 2001 Rating Agency Presentation, April 2001, provided in response to WUTC-43-I, p. 65.

We don't do that because regulators are charged with *fairly* balancing the interests of investors with those of ratepayers. Bond rating agencies are not concerned with rate equity, i.e., the fairness or unfairness of rates. Rating agencies are concerned, and rightly so, only with the level of protection and risk afforded their constituents—the bondholders. The issue of whether or not it would be "fair" to ratepayers to burden them with additional charges in order to provide a certain level of interest coverage, when responsibility for the lowered coverages rests with management, is not one that can be addressed by bond rating agencies or by adhering unswervingly to any certain ratings level.

Therefore, while I believe it is reasonable, even desirable, to regulate so that the regulated entity maintains investment-grade debt, that should not be an immutable regulatory standard. If financial safety margins maintained by management are too thin to prevent an unexpected occurrence from creating a heightened financial risk *and* if fair regulatory treatment then results in a bond rating that is below investment grade, so be it. If that sort of negative consequence is guaranteed out of existence by regulatory fiat, in my view, it would diminish the checks and balances against the abuse of management power which currently exist in regulation.

Q. IS YOUR PRIMARY RECOMMENDATION THEN THAT THE COMMISSION NOT GRANT THE COMPANY'S REQUEST FOR INTERIM RELIEF?

A. Yes.

Q. IF THE COMMISSION DISAGREES WITH YOUR JUDGEMENT REGARDING INTERIM RATE RELIEF, DO YOU HAVE AN ALTERNATIVE RECOMMENDATION?

A. Yes. While it is my view that, even absent interim rate relief, the Company's senior debt will not be lowered to a non-investment-grade level, I recognize that this Commission may either disagree or not want to risk that occurrence. If the PNB standards are to be interpreted in that fashion, that is certainly this Commission's prerogative. I should note that I read the purpose of the PNB standards to protect the financial health of the Company, not to recover any particular cost (in this case net power costs).

In that regard, I believe one metric with which to determine a forward-looking revenue adjustment is the Company's First Mortgage Bond Indenture coverage level of 2.0 times. According to Mr. Hawley's 2002 monthly projections, provided in response to PC-62-I,

. Therefore, increasing rates to cover the projected cumulative monthly short-fall during January through October 2002 would provide a revenue increase which addresses that short-fall in the period for which interim rates are requested. My analysis of Mr. Hawley's projections indicates that an interim rate increase of $29.3 Million will accomplish that goal.

Q. DO YOU HAVE ANOTHER RECOMMENDATION, MR. HILL?

A. Yes, as I noted above the Company's decision to maintain a debt-heavy capital structure is a fundamental reason that its power cost problems have precipitated this interim rate proceeding. In the past, this Commission has set rates under the assumption that the Company would operate with a financially balanced capital structure. However, the Company elected not to operate in that fashion.

One alternative for the Company to increase its equity investment is to pay out something less than all of its earnings in dividends. However, the Company's responses to PC-55-I and PC-73-I indicate that the impact on Puget's capital structure of continuing to pay out all of its earnings in dividends is not a factor which is being considered by the Company's Board of Directors.

Therefore, I recommend that this Commission move to ensure that the Company's capital structure will begin to be restored by limiting the level of dividends paid out by PSE to Puget Energy to an industry-average percentage of earnings. The latest data indicate that the average dividend payout ratio for the electric and combination electric/gas utility industry is approximately 57%[11]. Therefore, until the Company's common equity is restored to a level of 40% of permanent capital I recommend that the Commission limit the Company's dividend to

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[11] C.A. Turner's Utility Report, January 2002, p. 10.

1 60% of its current $1.84/share level or 60% of Income Available for Common, whichever is
2 greater.
3 Mr. Hawley projects common dividend payments during 2002 to be [redacted]. By
4 retaining 40% of those monies [redacted] annually) and using those funds, along with the
5 dividend reinvestment funds [redacted]), to buy down a similar amount of the Company's
6 debt, the Company's capital structure could be restored to a 40% equity ratio in three years.
7
8 Q. HOW IS THE BALANCE OF YOUR TESTIMONY ORGANIZED?
9 A. My testimony is presented in three sections. First I discuss the Commission's PNB standards,
10 focusing on those that I believe are most germane to my analysis in this proceeding. In that
11 section of my testimony I also discuss the bond rating impact of a decision to grant no interim
12 increase in light of the PNB standards.
13 Second, I discuss the Company's financial history showing the steady deterioration in its
14 common equity ratio, beginning in 1996. In that section of my testimony I also show capital
15 structures that would have resulted from dividend reductions and discuss Puget Energy's
16 investment in InfrastruX.
17 Third, I discuss the Company's financial projections and point out concerns I have with
18 regard to those projections. For example, there are discrepancies between the financial
19 projections provided in this proceeding and those provided to bond rating agencies a few
20 months earlier. In that section I also discuss what appears to be the Company's primary
21 operational expense problems—generation fuel expense, rather than purchased power expense,
22 as well as increases in Operating and Maintenance, Depreciation and Interest Expense.
23
24 **PNB STANDARDS**
25
26 Q. IN THE COURSE OF PREPARING YOUR TESTIMONY IN THIS PROCEEDING
27 HAVE YOU REVIEWED THE COMMISSION'S ORDER REGARDING INTERIM
28 RATE RELIEF IN CAUSE NO. U-72-30—THE PACIFIC NORTHWEST BELL CASE?

A. Yes, I have. That Order by this Commission was entered in October 1972 and set out a list of factors to be considered with regard to the granting of interim rate relief. Those factors are set out below:

- This Commission has authority in proper circumstances to grant interim rate relief to a utility but this should be done only after an opportunity for adequate hearing.
- An interim rate increase is an extraordinary remedy and should be granted only when an actual emergency exists or where necessary to prevent gross hardship or gross inequity. While we draw this conclusion from the overwhelming weight of the cases we have reviewed, it is made even more explicit in the current atmosphere through regulations of the Price Commission.
- The mere failure of the currently realized rate of return to equal that approved as adequate is not sufficient standing alone to justify the granting of interim relief.
- The Commission should review all financial indices as they concern the applicant, including rate of return, interest coverage, earnings coverage and the growth, stability or deterioration of each, together with the immediate and short term demands for new financing and whether the grant or failure to grant interim relief will have such an effect on financing demands as to substantially affect the public interest.
- In the current economic climate the financial health of a utility may decline very swiftly and interim relief stands as a useful tool in an appropriate case to stave off impending disaster. However, this tool must be used with caution and applied only in a case where not to grant would cause clear jeopardy to the utility and detriment to its ratepayers and stockholders. That is not to say that interim relief should be granted only after disaster has struck or is imminent, but neither should it be granted in any case where full hearing can be had and the general case resolved without clear detriment to the utility.
- Finally, as in all matters, we must reach our conclusions with the statutory chares to the Commission in mind, that is to "Regulate in the public interest" (RCW 80.01.040). This is our ultimate responsibility and a reasoned judgment must give appropriate weight to all salient factors. (WUTC v Pacific Northwest Bell Telephone Company, Cause No. U-72-30, Second Supplemental Order Denying Petition for Emergency Rate Relief, October 10, 1972)

Q. WITH REGARD TO DETERMINING WHETHER OR NOT THE COMPANY SHOULD BE GRANTED INTERIM RATE RELIEF IN THIS PROCEEDING WHAT, IN YOUR OPINION, ARE THE PNB FACTORS WHICH MOST DIRECTLY IMPACT THAT RECOMMENDATION?

1 A. Of course, the fourth requirement set out in PNB (the review of the Company's financial indices
2 including projected financial needs) is a fundamental part of determining the need for and impact
3 of interim rate relief. In that regard, the Company filed detailed financial projections and cash
4 flow data for the period from January through October 2002, which is the time period at issue in
5 this proceeding. I have reviewed those data and have requested and received additional
6 information regarding the Company's current and projected financial situation.
7 Although I do have some questions regarding the Company's forecasts (which I will
8 detail in the Third Section of this testimony) and disagree with some of their conclusions, I do
9 not argue with the fact that the Company is expected to experience a substantial operating
10 earnings short fall during the January/October 2002 period. Neither is it in dispute that that short
11 fall is due, to some degree, to increased net power costs incurred by the Company. However,
12 the PNB guidelines which, I believe, determine whether or not an interim increase should be
13 granted are found in conclusions 2), 5) and 6), set out in the above WUTC Order, and those
14 guidelines do not support the granting of an interim increase in this instance.
15 According to the second conclusion, interim relief should be granted in order to prevent
16 "gross inequity or gross hardship." I find that neither exists here. The Company will continue to
17 be able to meet its financial obligations, albeit at a higher marginal cost for debt capital, but that
18 does not constitute a "gross hardship" in my view. Further, the Company has an ongoing rate
19 proceeding that, at its conclusion, will address the Company's power cost requirements going
20 forward. Therefore, the current power cost under-recovery is not an on-going problem.
21 The Company would argue that the under-recovery of power costs at the level they are
22 experiencing is "gross hardship." However, regulation does not guarantee recovery of all
23 operating costs, and the electric utility business is a relatively low-risk but not a no-risk business
24 enterprise. If regulation guaranteed recovery of all costs, electric utility common equity returns
25 would be equivalent to bond returns. Equity returns are not equivalent to bond returns because
26 they recognize the potential operating risks associated with even monopoly utility operations.
27 Those risks include the potential non-recovery of operating costs.

1 With regard to the issue of inflicting "hardship" on one party or another (ratepayers or
2 investors), the cost-benefit ratio of the Company's requested interim rate increase indicates that
3 the increased rates would be more of a hardship to consumers than the increased interest costs,
4 even if 100% of the increased interest costs caused by the Company's weakened financial
5 position were passed on to ratepayers.
6
7 Q. PLEASE EXPLAIN WHAT YOU MEAN BY THAT STATEMENT.
8 A. The Company is requesting that for the January to October 2002 period, rates be increased by
9 $163 to fully cover the Company's net power costs. In a worst-case scenario, if the WUTC
10 grants no interim rate relief to the Company, Puget's senior securities might be down-graded to
11 below investment-grade debt (i.e., below "BBB-"). Current average bond yield differentials
12 indicate that the yield difference between the lowest-level investment grade debt ("BBB-") and
13 the highest level below-investment-grade debt ("BB+") is 211 basis points for 30-year bonds
14 (see Exhibit__(SGH-1), Schedule 1).
15 To be conservative, if we assume that a decision not to grant interim rate relief to the
16 Company resulted in a marginal debt cost increase of 300 basis points above the formerly-
17 available debt cost rates, Puget would have to issue a vast amount of debt to have the same rate
18 impact on ratepayers as its interim request would have. For the rate impact of debt costing
19 3.0% more at the margin than debt that Puget might issue if the interim increase is granted to
20 equal the relief Puget is seeking from ratepayers, the Company would have to issue $5.4 Billion
21 in new debt capital [$163 Million ÷ 3.0% = $5.4 Billion].
22 Given the fact that the entire capital base of Puget is currently approximately $4 Billion
23 and, absent any new nuclear power plant construction programs, its seems quite unlikely that the
24 benefit to customers of foregoing the interim rate increase would ever be outweighed by even a
25 worst-case increased debt cost. Also the Company's most recent forecasts provided to bond
26 rating agencies [redacted] (Puget's 2001 Rating
27 Agency Presentation, April 2001, provided in response to WUTC-43-I, p. 65).

1 Moreover, on the flip side of the issue, i.e., even if the Commission grants the entire
2 interim rate increase, there are no guarantees that there would be any improvement in the
3 Company's bond rating position. That is particularly true if the Company continues to pay out all
4 of its earnings as dividends, with no retention to strengthen the capital structure. The Company
5 certainly has not testified that the interim rate relief will result in improved bond ratings and
6 interest savings. Therefore, ratepayers do not receive any certain interest cost benefits if the
7 interim increase is granted and, even in a worst-case scenario, will not experience a higher rate
8 impact than that requested by the Company if the interim request in not approved.
9
10 Q. WHAT ARE YOUR COMMENTS REGARDING THE LANGUAGE IN PNB
11 CONCLUSION NO. 5?
12 A. PNB conclusion No. 5 states that interim rates are a tool that should be used to "stave off
13 impending disaster." In my view, a disaster would be eminent if a utility were unable to continue
14 operations, pay creditors or meet payroll. The potential for higher interest costs does not
15 connote a "disaster" in my opinion.
16 Conclusion No. 5 also indicates that interim rates are appropriate in cases where,
17 absent that relief, there is "clear jeopardy" to the utility and "detriment" to ratepayers and
18 stockholders. Again, my review of the Company's projected financial position does not indicate
19 that its ability to continue to provide reliable electric and gas service would be in "clear
20 jeopardy" if an interim rate increase is not granted. Also, as I've shown above an interim rate
21 increase would be a detriment to ratepayers that is far more expensive than an increase in debt
22 costs.
23 With regard to stockholders, Schedule 2 shows that the Company's stock price has
24 shown a decided upward trend over the past couple of years. While there was certainly a pause
25 in that trend when investors became aware of the Company's power cost losses, Puget's stock
26 price has since recovered and currently trades in a range at the upper end of that established
27 over the past two years. Also, financial data available on the Company's website (Advanced
28 Fundamentals – Ratios) indicates that since 1996, the Company's average market to book ratio

1 has been 1.56. A market-to-book ratio in excess of 1.0 is an indication that the returns earned
2 by the Company have been in excess of the market return required by investors—the cost of
3 capital.
4
5 Table I.
6 Puget Market-to-Book Ratios
7

| | 12/96 | 12/97 | 12/98 | 12/99 | 12/00 | Average |
|---|---|---|---|---|---|---|
| Market/Book | 1.30 | 1.88 | 1.74 | 1.19 | 1.67 | 1.56 |

8
9 On January 14, 2002, the Company's stock price was $23.41.share. The most recent Value
10 Line report on Puget (November 16, 2001, p. 1792) projects that the Company's book value
11 per share in 2002 will be $15.95. Those data indicate a current market-to-book ratio for the
12 Company of 1.47.
13 Finally with regard to PNB conclusion No. 5, interim rate relief should not be "granted
14 in any case where full hearing can be had and the general case resolved without clear detriment
15 to the utility." Again, other than the potential for higher marginal debt costs, in my view, there
16 has been no demonstration of "clear detriment" to the utility.
17
18 Q. HOW DO YOU BELIEVE PNB CONCLUSION NO. 6 FACTORS IN THE DECISION
19 THAT MUST BE MADE IN THIS CASE?
20 A. The language in PNB 6 raises two points of interest. First is the Commission's recognition that it
21 must balance the interests of the public—ratepayers and investors—in making its decision. The
22 bond rating agencies, the ubiquitous representatives of "Wall Street" do not have that charge.
23 While Moody's and Standard & Poor's are not actual participants in these proceedings they
24 are, certainly, participants in a de-facto sense because, according to the Company, it is they the
25 Commission must assuage with a "reasonable" interim rate award in order to avoid the
26 consequences of a downgrading.
27 Bond rating analysts are not concerned with the "fairness" of a regulatory decision; it's
28 not their job. They simply assess for their clients (bond investors and the companies they rate)

1 the risks associated with the company's debt. If there are less monies available to cover interest
2 requirements the company is riskier and, if the regulators do not raise rates to provide more
3 interest coverage, the company may be downgraded. The reasons for the low interest
4 coverage—e.g., bad management decisions—do not matter to the rating agencies. Their
5 response to low coverages is very simple—raise the rates, go to the deep pockets, the
6 ratepayers, and make them pay more. However, as the Commission rightly notes in PNB 6, it is
7 required to consider what is best in the public interest, and the "public" for the WUTC is not
8 just investors, it is both investors *and* ratepayers. If the avoidance of negative bond rating
9 consequences were all the Commission were required to consider, it's job would be far simpler;
10 but it, unfortunately, has a far more complex task to regulate in the public interest.

11 The second point is really a corollary of the first. The Commission notes that in
12 determining whether or not to allow interim rates it must "give appropriate weight to all salient
13 factors." In this instance, as I will explain in more detail in the next section of my testimony, one
14 of the factors which the Commission should consider is management's role in precipitating its
15 current financial situation. While management might not have reasonably expected the
16 fluctuations which have occurred in the wholesale power market, management did elect to
17 capitalize its operations with substantially less common equity capital than was envisioned when
18 rates were set in the merger agreement (Docket Nos. UE-951270 and UE-960195, Fourteenth
19 Supplemental Order Accepting Stipulation; Approving Merger). Moreover, with a thin equity
20 layer, the Company was more "at risk" for serious financial consequences were some negative
21 event to occur—which, of course, it did. Therefore, one of the factors which I believe is
22 important to the Commission's decision (and is equally as <u>un</u>important to the bond rating
23 agencies) is management's role in laying the ground work for their current financial situation.
24

25 Q. YOU MENTIONED THE BOND RATING AGENCIES AND THE TANGENTIAL ROLE
26 THEY ARE PLAYING IN THIS PROCEEDING. BECAUSE THEIR ACTIONS WILL BE
27 AN ISSUE OF THIS PROCEEDING, CAN YOU BRIEFLY PROVIDE THE

1 COMMISSION A SIMPLE OVERVIEW OF THE RATINGS PROCESS AND SOME OF
2 THEIR TERMINOLOGY?
3 A. Yes. As I noted above, the bond rating agencies primary task is to assess the risk to which a
4 particular bond investment is exposed. They sell that relative risk information about certain
5 companies to investors. Bond rating agencies also sell their services to the companies they rate;
6 that is, companies have to pay to be rated by those services. The more complex the company
7 and ratings analysis, the more expensive it is to be rated.
8 There are two kinds of risk attendant to any firm: business risk and financial risk.
9 Business risk is the risk inherent in the type of operations in which the firm is engaged. Utilities
10 have lower business risk that industrial firms because they operate, for the most part, without
11 direct competition in a franchised monopoly service territory. There are many aspects to
12 business risk. For example, a utility's service territory is a fundamental indicator of its business
13 risk. A company that operates in an economically sound service territory (e.g., western
14 Washington, Seattle) and has a customer base with very little industrial exposure has less
15 business risk than the same utility operating in an economically depressed area with a high
16 percentage of heavy industry (e.g., West Virginia). Also included in a utility company's business
17 risk is a qualitative assessment of its management and its regulators. Business risk is fundamental
18 to the assessment of bond ratings.
19 The second kind of risk assessed by bond rating agencies is financial risk. Financial risk
20 is related to the amount of debt capital used by the firm. If a firm is financed totally with equity
21 capital there is no financial risk. Of course, because common equity is a considerably more
22 expensive form of capital than is debt capital, an all-equity capital structure would be very
23 expensive compared to one that utilized a mixture of debt and equity.
24 The ratios used to measure financial risk are debt-to-capital ratio (how much debt a
25 company has compared to the total amount of capital used to finance operations), pre-tax
26 interest coverage (how many times pre-tax earnings will "cover" a firm's interest expense—
27 2.0x, read: "two times" coverage means that the pre-tax earnings available to be applied to a
28 firms interest costs is twice those costs), and funds from operations interest coverage (this

1 measure is more of a "cash flow" coverage and includes non-cash expenses like depreciation in
2 the consideration of interest coverage).
3 The various financial risk ratios published by Standard & Poor's for a utility firm with
4 the same general business risk ranking of Puget are shown on Mr. Hawley's Exhibit__(RLH-3).
5 While financial risk ratios get considerable attention because they are far more simple to report
6 that the more subjective business risk analysis, they are not more important. Both factors,
7 business risk and financial risk enter into the bond rating equation.
8 For example, if a firm has very little business risk, then that firm is able to safely utilize
9 more debt capital to finance operations than a firm that has more business risk. That is why
10 utilities generally use considerably more debt capital to finance operations than do competitive
11 industrial firms. Similarly, a firm with high business risk will not be able to use much debt capital
12 without running the risk of defaulting on the debt.
13 Although they have slightly different symbology (see Schedule 1), both Moody's and
14 Standard & Poor's have four categories of investment grade debt: triple-A (lowest risk),
15 double-A, single-A, and triple-B (highest investment-grade risk). The bond yields (the returns
16 investors require for investing in bonds) vary directly with risk. For example, Moody's recent
17 average yields for its double-A, single-A and triple-B debt are: 7.20%, 7.53% and 8.02%[12]
18 (there are no triple-A rated utilities).
19 Continuing to move down the alphabet and up the relative risk list, the rating agencies
20 classify double-B rated debt and below as "below investment grade." That debt is also
21 commonly called "junk bonds," which implies to many who are unfamiliar with the bond market
22 that those securities are not marketable. That is an incorrect assumption. As Standard & Poor's
23 notes in a recent publication regarding reductions in utility credit quality, the average bond rating
24 of industrial companies in the U.S. is "BB".[13]

[12] Utility bond yield data from Moody's.com, December 12, 01.

[13] Standard & Poor's, "U.S. Utilities Credit Quality Displayed Steep Decline in 2001; Negative Trend Likely to Continue," January 18, 2002, p. 3.

1 Of course, because the relative risk of those securities is greater, investors require a
2 higher return from those investments. Also due to the break between "investment grade" and
3 "non-investment grade", the cost rate differentials between categories is the most significant
4 (i.e., the largest) at the point between the lowest investment grade level ("BBB-") and the
5 highest below investment grade level ("BB+"). As shown in Schedule 1 the average difference
6 across all maturities between "BBB-" and "BB+" is 177 basis points, or 1.77%. That
7 differential is higher than the differential between any other adjacent bond rating categories.
8 Two other points which have relevance to this proceeding are worth note. First, my
9 discussions of the Company's bond rating focus on the rating of their senior secured debt. That
10 debt is secured by the Company's property and is the fundamental indicator of the Company's
11 risk. All of the Company's other debt (e.g., the Capital Trust debt supporting the Preferred
12 Trust Securities) is subordinate to the First Mortgage Debt and carries a lower rating. For
13 example, the current bond rating for Puget's First Mortgage debt is "BBB" and for the Capital
14 Trust debt is "BB" (PC-66-I).
15 Second, the bond rating agencies don't always agree about the level of credit risk. At
16 mid year 2001, S&P rated Puget's First Mortgage Bonds "A-", while Moody's rated them
17 "BBB+". Currently, S&P has dropped the rating to "BBB", but Moody's has not changed.
18 Sometimes, but not often, rating opinions differ dramatically,[14] underscoring the concept that
19 there is significant judgement involved in the process.
20
21 Q. HAVE THE BOND RATING AGENCIES EXPRESSED THEIR OPINION WITH
22 REGARD TO THEIR EXPECTATIONS FOR THE OUTCOME OF THIS
23 PROCEEDING?
24 A. Yes. As I noted at the outset of this testimony, both Standard & Poor's and Moody's have
25 made their opinions known, that if this Commission does not offer regulatory "support"
26 (increased rates) to the Company in this proceeding a bond rating downgrade in imminent. Both

[14] For example, according to CA Turner's Utility Reports, January 2002, S&P currently rates AES Corporation "BBB", while Moody's assigns that company a "Aa3" rating.

1 rating agencies made those comments following the Commission's refusal to grant rate relief on
2 an emergency basis in the autumn of 2001.

3 As I noted above, Standard and Poor's reduced Puget's senior security rating two
4 notches from "A-" to "BBB" following the Company's initial application for interim rates. That
5 "BBB" rating also has the qualifier of a "negative outlook," which means that the most likely
6 direction of a change in rating is downward.

7

> 8 "Puget Sound Energy's negative outlook reflects the significant
> 9 challenges that the company faces to restore its financial profile,
> 10 including the uncertain outcome of its general rate case.
> 11 Paramount to ratings stability is the need to improve financial
> 12 performance to levels commensurate with current ratings and
> 13 effectively managing its regulatory affairs. Further deterioration
> 14 in cash flow and credit protection measures would likely
> 15 precipitate a downward ratings action." (Standard & Poor's,
> 16 Ratings Direct, October 30, 2001, provided in response to PC-
> 17 65-I)

18

19 While Moody's did not elect to reduce the Company's bond rating based on the
20 Commission's actions last Fall and elected to wait for a final ratings action at the conclusion of
21 the current rate proceeding, that bond rating agency did indicate that if the Company did not
22 receive some "initial financial relief" in this proceeding that a ratings downgrade would result.
23 (Moody's Investors Service, Global Credit Research, Rating Action, October 26, 2001,
24 provided in response to PC-65-I)

25

26 Q. IF THE COMMISSION GRANTS 100% OF THE COMPANY'S REQUESTED
27 INTERIM RATE RELIEF, IS THERE ANY INDICATION THAT THE COMPANY'S
28 BOND RATING POSITION WILL IMPROVE?

29 A. No. The Company has provided no testimony to that effect and I do not believe it is likely. As
30 shown in Mr. Hawley's Exhibit__(RLH-3), [redacted]
31 [redacted]
32 [redacted]. Therefore, it is most unlikely that there

would be any positive interest cost savings benefit associated with the rate increase of roughly $163 Million requested by the Company.

Q. PREVIOUSLY YOU STATED THAT YOU WOULD EXPECT THE COMPANY'S FIRST MORTGAGE BOND RATING TO BE LOWERED TO "BBB-" IF NO INTERIM INCREASE IN GRANTED. CAN YOU EXPLAIN WHY THAT IS YOUR BELIEF?

A. Yes. There are three primary reasons why I believe that, even with no interim rate increase, the Company's senior security ratings would remain investment grade. First the bond rating benchmarks which we will all discuss, ad infinitum, in this proceeding don't tell the whole story. As I noted above, there is much more to a bond rating that the financial ratios.

For example, I noted previously that Puget was rated "A-" by Standard & Poor's until this Commission's previous decision not to allow increased rates prior to a full investigation of the Company's finances. However, during the time when the Company was rated "A-" by S&P, its financial benchmarks did not "measure up" to that rating agencies' published benchmark requirements for that ratings category.

Schedule 3 attached to this testimony shows very clearly that in the years leading up to the current situation, while S&P rated the Company's senior debt at an "A-" level, the Company's credit protection ratios were nowhere near the levels set out in S&P's benchmarks—the were well below those levels. Moreover, Schedule 3 also shows that,

.

For example, with regard to the benchmark "Funds From Operations to Total Debt", the average established by Puget in 1998, 1999 and 2000 was 12.57%. The average projected by Mr. Hawley, absent interim rate relief, is

. For "Funds From Operations Interest Coverage," Puget's historical average was 2.63 times. Mr. Hawley projects will result if rate relief is not granted. Also, the average level of total debt to total capital used by Puget over the past three years was 62.07%.

1 Mr. Hawley projects that, again absent interim rate relief, for the 12 months ended October
2 2002, that ratio will be [redacted].
3 These data indicate that the Company is able to maintain bond ratings higher than its
4 financial ratios would indicate. Schedule 3 also shows that without rate relief, except for pre-tax
5 interest coverages, the Company's financial indicators do not indicate substantially increased
6 financial risk for Puget.
7
8 Q. WHY IS THE COMPANY ABLE TO MAINTAIN BOND RATINGS HIGHER THAN
9 THE FINANCIAL RATIOS WOULD INDICATE?
10 A. The answer to that question lies in the second and third general reasons why I believe the
11 Company will maintain an investment grade bond rating even if no interim rate increase is
12 granted. The second reason is that the occurrence which precipitated the current short-fall in net
13 power costs is a temporary phenomenon. It was caused by a truly unusual confluence of events,
14 any one of which could have impacted the wholesale power markets—regulatory transition
15 snafus in California, historically lower hydro availability and spikes in the price of natural gas.
16 Those events are unlikely to occur again simultaneously in the foreseeable future. Therefore,
17 once the Company's on-going level of power costs (and other operating costs) are recognized
18 and allowed in rates as a result of the concurrent rate proceeding, the Company will be able to
19 begin to rebuild its financial position.
20 Continuing on that point of rebuilding the Company's financial position, it is important to
21 note here that bond ratings are prospective. In other words, rating agencies take into account
22 the Company's plans with regard to the intent to recapitalize its balance sheet, sell assets or, in
23 some other way, improve its financial position. As shown in my Schedule 3, in prior rating
24 agency presentations Puget's financial benchmarks did not measure up to the published level for
25 their bond rating, but the Company presented plans to reach an improved financial position. In
26 my view, there is no reason to believe that that same condition would not apply here. In fact, my
27 recommendation with regard to reducing the Company's common dividend payment would
28 effectuate just such a positive change.

1 The third reason I believe Puget can maintain an investment grade bond rating if no
2 interim increase is granted is that the Company is, from a business risk point of view,
3 substantially unchanged. The conditions regarding Puget's service territory presented to the
4 rating agencies by the Company in 2001 have not been changed by the fluctuations in the
5 wholesale power market:
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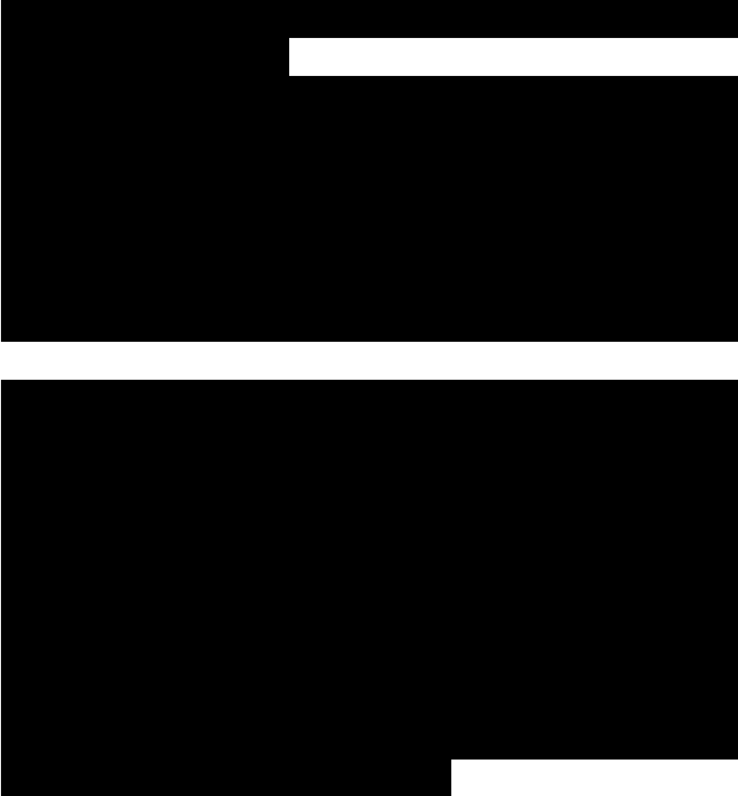

Therefore, the Company's fundamental business risk has not been affected by the wholesale power market gyrations. While the Company expects a slow-down in the economy and a lower rate of customer growth (i.e., positive growth at a slower rate), it expects its growth to exceed national averages. Also the Company's customer base has a very low level of industrial customers.[15] That fact reduces Puget's business risk compared to electric utilities that serve a higher percentage of industrial customers. These sorts of qualitative fundamental business risks, which are comparatively low, will continue to support the credit quality of Puget Sound Energy.

[15] Puget's industrial load in the future will be even lower due to the decision in Docket No. UE-001952, permitting certain industrial customers to secure power from sources other than PSE.

1 Q. EVEN THOUGH YOU BELIEVE A DECISION BY THIS COMMISSION TO ALLOW
2 NO INTERIM RATE INCREASE WOULD NOT RESULT IN A BOND RATING
3 BELOW INVESTMENT GRADE, IS IT POSSIBLE THAT A DIFFERENT OUTCOME
4 COULD RESULT?
5 A. Yes. It is possible that Puget's senior secured debt could be reduced to a level below
6 investment grade if the Commission does not allow an interim rate increase, but I would argue
7 that it is not likely. While such a scenario would cause a more substantial increase in the
8 Company's marginal cost of debt (both long- and short-term) it does not mean that the
9 Company would be unable to access the capital markets or be able to continue to meet its
10 public service obligations. Further, with the completion of the rate case, the allowance of rates
11 that are properly balanced with the Company's prudent on-going cost of service along with a
12 plan to restore the Company's capital structure to a more balanced level, Puget would be able
13 to regain investment-grade status.
14
15 Q. IF THIS COMMISSION ELECTS NOT TO FOLLOW YOUR RECOMMENDATION
16 TO AWARD THE COMPANY NO INTERIM INCREASE, HAVE YOU DETERMINED
17 AN INTERIM RATE INCREASE LEVEL WHICH WOULD MINIMIZE THE
18 POSSIBILITY THAT A BELOW-INVESTMENT GRADE BOND RATING WOULD
19 RESULT?
20 A. While it is important to understand that there are no absolutes in projecting the subjective
21 responses of a bond rating agency, I have developed an alternate recommendation which would
22 be more fair to ratepayers while affording the Company a certain level of interim rate relief. Of
23 course, it is my belief that a decline to below-investment grade status is unlikely even if no
24 increase were granted for the reasons I outlined above. However if the commission determines
25 otherwise, then as an alternative recommendation, I believe an interim increase of $29.3 Million
26 would be reasonable.
27 It is important to note here that in my discussions with the Company during the
28 preparation of my testimony, I have learned that Puget has just recently issued $40 Million of

1 Medium-Term Notes. That recent issuance reduces the Company's financing requirements over
2 the January—October 2002 period by $40 Million because that debt issuance was not included
3 in the Company's financial forecasts.
4
5 Q. HOW DID YOU ARRIVE AT YOUR SECONDARY RECOMMENDATION OF A $29.3
6 MILLION INTERIM INCREASE?
7 A. Company witness Hawley points out in his testimony that during the period for which Puget is
8 requesting interim rate relief the Company's First Mortgage Bond Indenture coverage
9 [redacted]. That means that the monies available to "cover" the First
10 Mortgage Bond interest, as defined by the Mortgage Indenture [redacted]
11 [redacted]. Of course this does not mean that the Company will not be able to make
12 its interest payments because it has more funds available than needed for that purpose. Also the
13 Indenture coverage requirements indicate that depreciation expense should be deducted from
14 the funds available for coverage. However, as the Commission is aware, depreciation is a non-
15 cash expense and cash coverage of the First Mortgage Bond interest in considerably higher than
16 that indicated by the coverage calculation set out in the Indenture.
17
18 Q. DOES THE COMPANY PLAN TO ISSUE ANY FIRST MORTGAGE DEBT PRIOR TO
19 THE COMPLETION OF THE RATE CASE?
20 A. [redacted]
21
22
23
24 Q. THEN, FOR THE PURPOSES OF DETERMINING AN INTERIM RATE LEVEL, WHAT
25 IS THE IMPORTANCE OF THE FIRST MORTGAGE DEBT COVERAGE LEVEL?
26 A. Because the [redacted]
27
28 [redacted] However, Mr. Hawley's

calculations of the income available for coverage under the Indenture and the interest expense does provide a measure with which a month-by-month interest coverage shortfall during the January—October 2001 period at issue in this proceeding can be calculated.

It is important to note that Mr. Hawley's First Mortgage Bond Indenture coverage projections are presented by month on a 12-month-ending basis. That means that for each month, the short-fall between the projected level of operating income and the operating income necessary to provide FMB Indenture coverage of 2.0 is the product of the Company's operating results of the preceding 12 months. However, allowing an interim increase of that full amount would call for recovery of revenues outside the period of inquiry (January—October 2002) in this proceeding and would not be appropriately included in an interim rate increase. Therefore, I have elected to focus on the cumulative monthly shortfall during the January—October 2002 period between the projected operating income and that necessary to provide FMB Interest coverage of 2.0 times.

Q. HAVE YOUR PROVIDED A SCHEDULE WHICH SHOWS HOW YOU CALCULATED AN INTERIM INCREASE LEVEL OF $29.3 MILLION?

A. Yes. Schedule 4 shows the analysis supporting my secondary recommendation for an interim rate increase. The analysis shown in Schedule 4 is based on the mortgage indenture coverage forecasts provided in PC-62-I by Company witness Hawley.

indicates an interim increase of $29.3 Million.

1

2 **FINANCIAL HISTORY**

3

4 Q. MR. HILL, CAN YOU BRIEFLY DESCRIBE HOW THE COMPANY'S CAPITAL
5 STRUCTURE HAS CHANGED SINCE THE MERGER?

6 A. Yes. Schedule 5 attached to this testimony shows the Company's year-end capital structure
7 each year from 1996 through 2000 and also shows its capital structure at September 30, 2001.
8 For purposes of this presentation, current maturities (long-term debt that will mature within one
9 year) are included in the balance of long-term debt.

10 Schedule 5 shows that at year-end 1996, Puget Sound Energy was capitalized with
11 approximately 42.5% common equity, 9.5% preferred stock and 48% total debt. This capital
12 structure was reasonably similar to that with which the rates were last set for Puget Sound
13 Power & Light and Washington Natural Gas when they were separate entities. According to the
14 Company's response to PC-74(b)-I, the capital structures used when rates were last set for
15 those companies were as shown in Table II, below.

16

17 Table II.
18 Capital Structures Embedded in Rates
19

| Type of Capital | Puget Sound Power & Light UE-921262 | Washington Natural Gas UE-920840 | Average |
|---|---|---|---|
| Common Equity | 45.00% | 44.00% | 44.50% |
| Preferred Stock | 8.00% | 7.69% | 7.85% |
| Long-term Debt* | 43.00% | 48.31% | 45.66% |
| Short-term Debt | 4.00% | 0.00% | 2.00% |
| Total | 100.00% | 100.00% | 100.00% |

20

21 Therefore, following the merger, the Companies' combined capital structure (at year-end 1996)
22 was reasonably similar to the capital structure determined to be reasonable in their respective
23 rate proceedings.

1 Schedule 5 shows, however that from 1996 through 2000 the Company's capital
2 structure position deteriorated. That is the amount of common equity used to finance operations
3 grew very slowly at a rate of only 0.8% per year. Puget's common equity capital increased by
4 only approximately $50 Million over that time period. Meanwhile, the Company's total debt
5 (long and short-term) increased by $1 Billion, a 64% increase in the amount of debt used to
6 fund operations. These data indicate that the Company elected to finance its operations almost
7 entirely with debt during that period.
8 Shown at the bottom of Schedule 5 is, I believe, the primary reason the Company's
9 equity capital balances did not grow. On average over the 1996 through 2000 time period,
10 Puget earned $1.85 per share and paid out very nearly 100% of those earnings to shareholders
11 in dividends, retaining essentially no earnings during that time.
12
13 Q. DIDN'T THE COMPANY ULTIMATELY INCREASE THE PERCENTAGE OF
14 PREFERRED STOCK IN ITS CAPITAL STRUCTURE, AND DOESN'T THAT LESSEN
15 THE FINANCIAL RISK OF THE INCREASE IN DEBT?
16 A. In 1996 Puget had approximately $300 Million of preferred stock. By year-end 2000, the
17 Company's preferred stock balances had declined to about $120 Million and the Company
18 added $100 Million of preferred trust securities. In 2001 Puget issued an additional $200
19 Million of preferred trust securities, reaching a preferred stock/preferred securities total of about
20 $410 Million. However, this has actually increased, not reduced, the Company's financial risk
21 because preferred trust securities are supported by debt and are given different "equity credit"
22 by the rating agencies from preferred stock.
23 Preferred stock is a hybrid security that has some aspects of equity and some aspects of
24 debt. Like debt, preferred stock has a fixed cost—a contractual payment that is agreed to by
25 the buyer and seller at the time of sale. Because of that contract preferred stock is a less
26 expensive form of capital to the firm than common stock, i.e., investors require a lower return
27 for that type of security. However, unlike debt and similar to equity, the dividend on preferred

1 stock can be omitted in times of financial distress. Also like equity, preferred stock dividends
2 are taxable.
3 Preferred trust securities are different. Those securities are supported by debt. In the
4 simplest terms a firm issues debt to itself (in the form of a capital trust) and pays the interest
5 payments on that debt. Those interest payments are dedicated to pay the preferred security
6 dividend payments to the public. The reason the securities were created is that the preferred
7 dividends are not taxable, just as the interest payments on debt are not taxable.
8 The financial risk drawback to preferred trust securities is that they are backed by a
9 debt issue and, therefore, are considered to be mostly debt when the rating agencies determine
10 debt-to-total-capital ratios. The amount of "equity credit" assigned preferred trust securities
11 varies, but it is my understanding that, on average, they are considered to be about 30% equity
12 and 70% debt in bond rating evaluations.
13 If Puget's $300 Million of preferred securities is considered to contribute $90 Million to
14 equity and $210 Million to debt, that further exacerbates the Company's move to a more
15 heavily levered (more debt-heavy) capital structure position. Between year-end 1996 and
16 September 2001 the preferred stock balance has fallen roughly $100 million (if we include the
17 $90 Million "equity credit" from the preferred trust securities), while the debt portion of
18 preferred securities has increased by $210 Million.
19
20 Q. HAS THE COMPANY CONSIDERED OTHER METHODS TO IMPROVE ITS
21 CAPITAL STRUCTURE?
22 A. Yes. In its 2000 report to the bond rating agencies (provided in response to WUTC-43-I) the
23 Company's "base case" financial projections included the sale of its interests in the Colstrip
24 generating facility for about $350 Million. The proceeds of that sale were to be used to buy
25 down debt and improve the Company's capital structure. That sale did not occur.
26 Later in 2000, apparently after it decided not to sell its interest in Colstrip, Company
27 management instituted a dividend re-investment program which, as I've noted previously is
28 expected to add approximately [redacted] annually to the Company's common equity

1 balances. While this is, of course, a move in the right direction, I do not believe it provides
2 enough positive momentum toward an improved financial profile. In sum, I believe the Company
3 is aware of its relatively weak financial position, but has not moved strongly enough to alleviate
4 the problem.

5 With regard to management's attitude toward Puget's dividend, I believe it is import to
6 point out to the Commission that my investigation indicates that Puget's Board of Directors,
7 when they approve dividend payments
8 . In PC-55-I, I asked
9 the Company if the prospect of reducing dividends had been discussed at either PSE or PE
10 board meetings and to provide board minutes which would corroborate any such discussion.
11 The Company provided excerpts related to dividend payments of both corporate entities in
12 2001
13
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22
23 If that is not the situation, and I hope that it is not, I would be pleased to see any
24 evidence to the contrary in the Company's Rebuttal Testimony.
25
26 Q. HAS PUGET ADDED EQUITY CAPITAL TO OPERATIONS OTHER THAN ITS
27 UTILITY OPERATIONS?

1 A. Yes. The Company created an unregulated subsidiary, InfrastruX, which is designed to be a
2 holding company for utility construction companies across the U.S. As of November 2001,
3 Puget Energy had invested approximately [redacted] of equity capital into InfrastruX.[16]
4 Two utility construction firms were recently purchased by InfrastruX following the
5 Federal Energy Regulatory Commission's (FERC's) decision to institute price caps in the
6 wholesale power market—the event which Puget alleges created its current fiscal problems.
7 InfrastruX acquired an electric transmission construction firm in Texas in August 2001 and a gas
8 pipeline construction firm in New York in December 2001. The gas pipeline construction firm,
9 purchased after November, would not be included in the [redacted] equity investment cited
10 above. Therefore, it is reasonable to believe that Puget Energy's total equity contribution to
11 InfrastruX currently exceeds [redacted] .
12
13 Q. IF PUGET ENERGY'S UTILITY SUBSIDIARY WERE IN A "DESPERATE" FISCAL
14 POSITION, DO YOU BELIEVE IT WOULD BE REASONABLE TO INCREASE
15 UNREGULATED INVESTMENT SIMULTANEOUSLY?
16 A. In my view, it would not. The vast majority of Puget Energy is Puget Sound Energy. Ninety-
17 eight percent of Puget Energy's 2000 revenues were from PSE. If the latter is in financial
18 trouble, so is the former. The debt of Puget Energy is subordinate to that of Puget Sound
19 Energy because the parent company's debt derives its security from the assets and earning
20 power of PSE's utility operations. Therefore, it is reasonable to believe that if the utility were in
21 serious financial difficulty, the parent company would elect to trim its unregulated investments,
22 husband its resources, and directly address its fiscal problems (while asking ratepayers for
23 assistance as well).
24 However, with this proceeding we have Company management before the Commission
25 claiming dire financial circumstances and the need for an additional $163 Million from
26 ratepayers, while at the same time, they are investing a similar amount of money elsewhere.
27 Those actions simply do not covey the message that the Company is in a serious financial crisis.

16 [redacted]

1
2 Q. DOES THE COMPANY CLAIM THAT ITS INFRASTRUX INVESTMENT IS
3 COMPRISED OF MONIES THAT ARE SEPARATE AND DISTINCT FROM ITS
4 UTILITY OPERATIONS?
5 A. Yes, in response to PC-128-I the Company indicated that the monies invested in InfrastruX
6 were derived from the sale of other unregulated investments and InfrastruX's own credit line.
7 With regard to the credit line, Company response to WUTC-24-I indicates that
8 InfrastruX's credit line is secured by Puget Energy. As I noted above, PE derives its security
9 from the utility operations of Puget Sound Energy and PE's "guarantee" is only as good as the
10 financial health of PSE allows it to be. In effect, the financial strength afforded PSE by
11 ratepayers paying their bills every month supports the credit of PE and its unregulated
12 subsidiary, InfrastruX.
13 Regarding prior unregulated investments, once dollars enter the corporate treasury,
14 whether they are from debt issuances, retained earnings, or dividend re-investments, it is not
15 possible to "color-code" those dollars in order to be able to trace where they came from when
16 they are spent. In other words, if Puget Sound Energy bought paper clips, dug a ditch or bought
17 stock in Microsoft, it would not be possible to trace the origin of the dollars used for those
18 purchases. Therefore, the Company's claim that the monies invested by Puget Energy in the
19 equity of InfrastruX were funded solely by funds available from the liquidation of other
20 unregulated investment is suspect because it is not possible to know the actual source of those
21 monies.
22 My point is simple. The determination of the source and use of monies that are
23 exchanged between corporate entities are not as black-and-white as the Company portrays
24 them to be. The equity and debt funds available to be invested in InfrastruX would not be
25 available to PE if PSE did not exist. Therefore, it is not reasonable for the Company to be
26 requesting $163 Million in interim rate relief while declaring that its continued expansion of
27 capital investment InfrastruX is of no consequence to PSE.
28

1 Q. DOES THAT CONCLUDE YOUR COMMENTS ON THE PARENT COMPANY'S
2 UNREGULATED INVESTMENT?
3 A. Yes, it does.
4
5 Q. RETURNING TO YOUR ANALYSIS OF PUGET'S CAPITAL STRUCTURE, IF THE
6 COMPANY HAD PAID OUT A SMALLER DIVIDEND AND HAD RETAINED SOME
7 OF ITS EARNINGS OVER THE PAST FEW YEARS, WOULD THAT HAVE PUT IT IN
8 A BETTER FINANCIAL POSITION PRIOR TO ITS CURRENT POWER COST
9 PROBLEMS?
10 A. Yes. Schedule 6 shows that Puget paid out between $150 and $160 Million in dividends each
11 year between 1997 and 2000. Schedule 6 also shows that if the Company had reduced the
12 dividend payout by $60 Million and had retained those monies instead of issuing long-term debt,
13 the capital structure could have been maintained at approximately 40% of total capital during
14 that entire time period. That is, a "normal" payout ratio could have resulted in a "normal" capital
15 structure and the current challenge would have been avoided.
16 For each year 1997 through 2000 Schedule 6 shows the Company's actual capital
17 structure. Also, for each year, the cumulative impact of retaining $60 Million of earning (adding
18 to the Company's equity balances) and displacing $60 Million of long-term debt financing is
19 shown. In the first year the cumulative impact is $60 Million. In the second year, because I am
20 adjusting the actual capital structure in each year, the cumulative impact of retaining $60 Million
21 in earnings each year is $120 Million, and so on.[17] The result is that by the year 2000 an annual
22 reduction in dividends of $60 Million would have added nearly a quarter of a billion dollars to
23 the Company's equity accounts and have allowed it to forego financing with a similar amount of
24 debt capital.
25 Of course this analysis is simplistic, and the results are therefore approximate. However,
26 it does show that the Company had other financing alternatives available to it that would have

[17] Actually, the impact would be slightly larger because the interest expense on the debt refinanced would be saved also. However that detail is omitted from this analysis.

1 resulted in a financial structure much better able to withstand unanticipated power cost under-
2 recoveries.
3
4 Q. WHAT IS THE AVERAGE PAYOUT RATIO IN THE ELECTRIC UTILITY INDUSTRY
5 TODAY?
6 A. Schedule 7 attached to this testimony shows that, according to the most recent data available in
7 C.A. Turner's Utility Reports (January 2002) the average dividend payout ratio in the electric
8 and combination electric and gas industry is 57%. Five of the companies listed are paying no
9 dividend, five are paying dividends in excess of 100% of earnings. When those companies are
10 eliminated, the industry average payout ratio is 56% of earnings.
11 That publication also reports that for the combination electric and gas utility industry,
12 Puget currently has the highest dividend yield in the industry, 8.9%. The average for the
13 combination utility industry is 4.3%, according to C. A. Turner's. Puget's current dividend yield
14 is currently more than double the average for the industry.
15
16 Q. DO YOU BELIEVE IT WOULD BE BENEFICIAL FOR THE COMPANY TO TRIM ITS
17 DIVIDEND PAYOUT?
18 A. Yes. With a dividend distribution which is more in line with that of the rest of the industry, Puget
19 would be able to retain some of its earnings and use those retained earnings to avoid continued
20 reliance on debt financing and shore up its financial position. As I discuss below, that would be
21 viewed positively by the market, in my opinion.
22 Mr. Hawley, in his workpapers provided in response to PC-62-I indicates that the
23 Company will pay dividends of [REDACTED] in 2002. Because dividends have approximated
24 the Company's earnings prior to 2001 I'll assume for purposes of analysis here that on a
25 normalized basis the Company's dividends approximate its earnings. If dividend payout were
26 reduced from 100% to a level near industry averages, say 60% of earnings, the divided would
27 be reduced from [REDACTED], allowing the Company to retain
28 [REDACTED] annually. Mr. Hawley also reports that the Company expects to obtain equity

investment of approximately [redacted] annually through its new dividend re-investment program. The total of those two "programs" would amount to an annual common equity increase of [redacted].

Schedule 8 shows that, beginning with the Company's projected capital structure in January 2002, [redacted] were added annually to equity capital and that same amount were used to buy-back long-term debt (holding the overall capital investment constant) the Company's common equity ratio as a percent of permanent capital would be restored to a near-40% level within three years. Schedule 8 also shows that, given those circumstances, the equity ratio could rise to a level near 45% of permanent capital within five years.

Of course, it is important to point out that this analysis does not consider short-term debt. Nor does it consider the fact that the Company's overall capital requirements would grow to some extent over that time period. Both of those factors would have an impact on what actual common equity ratio was realized in the future. Nevertheless, this analysis does show that retaining a reasonable amount of the Company's earnings would begin to move Puget's financial risks in the right direction—downward.

In addition, dividend reductions are not an uncommon occurrence in the electric utility industry these days. As shown on Schedule 9, over the past ten years approximately 45% of the investor-owned electric companies followed by Value Line have reduced dividends. That Schedule also shows that, for those companies that reduced but did not eliminate dividends, the average dividend reduction was 65%. Finally, that schedule shows that the majority of companies that reduced dividends subsequently increased the number of shares outstanding, i.e., were able to increase equity investment following the dividend reduction. The utilities that did not increase common shares outstanding following dividend reductions were engaged in share buy-back programs.

Q. DO YOU BELIEVE A REDUCTION IN PUGET'S DIVIDEND WOULD IMPACT THE STOCK PRICE?

1 A. Yes, a reduction in Puget's dividend could cause a reduction in the Company's stock price.
2 However, it has been my experience that a very high dividend yield for any particular utility
3 stock—and Puget's current dividend yield at twice the industry average certainly qualifies as
4 "very high"—is a signal that investors are already discounting the possibility of a dividend
5 reduction. The fact that investors are currently discounting the possibility of a dividend reduction
6 is evidenced by Value Line's November 2001 report on Puget. That investor service posts a
7 "split dividend" for Puget due to its belief that the dividend may be reduced. Value Line notes,
8 "The board might not be able to maintain the dividend at the current level even though
9 management has been adamant that it does not want to cut the dividend."[18] Because investors'
10 awareness of the potential for a dividend reduction exists at Puget, a dividend reduction, if it
11 does cause a downward price movement, would not result in an equal percentage reduction in
12 stock price.
13 In addition, a negative investor reaction to a dividend cut is not a given. If investors'
14 believe that the Company, by trimming dividends, is controlling its financial problems and will be
15 better off in the long run, making more certain their total return, they could react positively to
16 that news.
17
18 Q. DO YOU BELIEVE THIS COMMISSION SHOULD RESTRICT PUGET SOUND
19 ENERGY'S ABILITY TO PAY DIVIDENDS TO ITS PARENT, PUGET ENERGY,
20 UNTIL THE FINANCIAL RISK OF THE FORMER IS REDUCED TO A MORE
21 MANAGEABLE LEVEL?
22 A. Yes I do. I recommend that this Commission provide, as a condition to its Order in this
23 proceeding, a requirement for the Company to achieve a capital structure that will better
24 promote the financial safety and cost-effectiveness of its utility operations over the long run. In
25 order to ensure that end, I recommend that the Commission require the Company to pay
26 dividends to its parent Company, Puget Energy, at the rate of either 60% of its current

[18] The Value Line Investment Survey, *Ratings and Reports*, November 16, 2001, p. 1792.

aggregate dividend level ($1.84/Share) or 60% of Income Available for Common, which ever is greater.

In addition, I recommend that such a requirement remain in place until the common equity ratio of Puget Sound Energy, Inc., reaches a level of 40% of permanent capital (common equity, preferred stock, preferred securities and long-term debt). Once the Company has reached that level of reduced financial risk, I believe the dividend restriction should be eliminated.

Q. DO YOU BELIEVE A DIVIDEND RESTRICTION WOULD IMPROVE THE COMPANY'S CREDIT QUALITY?

A. Yes. Standard & Poor's recently published an article (November 9, 2001) entitled, "Regulatory Support for U.S. Electric Utility Credit Quality Continues to Wane." While that article discusses the reluctance of regulators to raise rates to protect financial measures (and mentions Washington in doing so), it also discusses measures by which the regulatory body can "insulate" the utilities under its purview. With regard to regulatory protection of utilities, S&P notes:

> "Example of proactive regulation include measures that meaningfully and timely restrict the flow of the utility's cash to its parent company, such as overhead allocation, loan and dividend restrictions, as well as equity maintenance requirements." (Op. Cit.)

Moody's also indicates that regulatory protection of credit quality can be a factor which supports credit quality.

> "Ratings Could Benefit From Regulatory Insulation
>
> Moody's determines whether state regulation of utilities protects ratings from the adverse consequenses of a merger on a case by case basis. Laws in some states prohibit a deterioration in credit quality, while other statutes are far less clear. In other instances, indenture and bank loan covenants may protect investors.

> Whether state regulation protects utilities from financial pressure must be assessed on a case by case basis…. Nevertheless, regulatory insulation has been a major reason for confirming the ratings of gas companies involved in a downstream convergence merger. Regulatory insulation, or 'ringfencing,' is when regulators explicitly or implicitly cause utilities to retain their earnings in order to ensure the financial soundness of a utility.
>
> State regulators' duty is to ensure that utilities have a balanced capital structure so that they are financially capable of providing safe and reliable service, and keep reasonable their financing costs, which are recovered in rates from their customers. Utilities are careful to maintain this balance through managing their dividends and periodic equity issues, since failure to do so may cause unwelcome regulatory procedures and public scrutiny, which may result in a negative financial impact on the utility. Furthermore, regulations provide incentives for utilities to maintain a solid base of equity, because their revenues are based on allowed returns-on-equity. (Our LDC group averages is about 46% equity, with little variation across the ratings spectrum.) State regulators also scrutinize intercompany transactions and non-utility activities. Such oversight provides bond holders at the LDC-Disco level with strong protection from any erosion of credit quality elsewhere in the company." (Moody's Investors Service, Global Credit Research, "Methodology Evolves in Rating Electric and Gas Company Combinations," December 1999, p. 9)

It is reasonable to believe, then, that a Commission condition which would require the utility to retain more of its earnings within the Company would support its credit quality.

## FINANCIAL PROJECTIONS

Q. IN PERFORMING YOUR ANALYSIS IN THIS PROCEEDING DID YOU REVIEW THE COMPANY'S FINANCIAL FORECASTS?

A. Yes, the financial forecasts are an integral part of this case in that they form the basis of the Company's request for interim relief.

Q. HAVE YOU ADJUSTED THE COMPANY'S FORECASTS IN ANY WAY?

A. No, I have not. The forecasts are complex and I did not have the time or resources to delve into the details of Puget's financial forecasting model. Therefore, for purposes of making a recommendation regarding the need for an interim rate increase in this proceeding, I have accepted the Company's forecasts.

Q. WHAT IS THE PURPOSE OF THIS PORTION OF YOUR TESTIMONY?

A. Although I continue to be of the opinion that interim rate relief should be related only to the financial position of the company, not any particular expense item, in the course of my investigation in this proceeding, I reviewed details which caused me to question certain aspects of the Company's forecasts. While I do not have answers to these questions, and they may more properly be addressed in the rate proceeding, I believe it is important to bring them to the attention of this Commission.

In reviewing the Company's financial position, I compared the Company's projected 2002 income statement with Puget's actual income statements in 1998 and 1999—time periods in which the level of total revenues were most similar to those projected for 2002. That comparison shows that, contrary to the Company's claim in this proceeding, on a per dollar of revenue basis, the Company's 2002 net fuel costs different from the levels established in 1998 and 1999. More important differences between the net income realized in 1998 and 1999 and that projected for 2002 are

In addition, my review of the Company's forecasts for 2002 provided to this Commission, when compared to forecasts for 2002 provided by the Company to bond rating agencies, found differences which tend to make the financial situation seem more critical in this venue. The Company may well have explanations for the differences in their projections. Absent a detailed study of the projections I am unable to confirm that fact and am simply bringing these differences to the attention of the Commission.

1
2 Q. PLEASE EXPLAIN WHY YOU ELECTED TO COMPARE PUGET'S 2002 INCOME
3 STATEMENT PROJECTIONS TO 1998 AND 1999 INCOME STATEMENTS.
4 A. The wholesale market began to change significantly in mid-2000, making the last half of that
5 year very different from the first with regard to Puget's normal level of off-system sales. Off-
6 system sales opportunities for Puget continued through the first part of 2001 until additional
7 California capacity came on line and gas prices subsided along with the institution of FERC's
8 price caps. Therefore, the income statements for 2000 and 2001 for Puget are affected by
9 conditions which no longer exist and are not included in the 2002 forecast. For purposes of
10 comparison, therefore, I elected to utilize the Company's income statements in 1998 and 1999.
11 With regard to off-system sales and the overall level of revenues, 1998 and 1999 are more
12 similar to the situation that will exist for Puget in 2002 that are the results for either 2000 or
13 2001.
14
15
16 Q. WHAT DOES THAT COMPARISON REVEAL?
17 A. As shown in Schedule 10 attached to this testimony, the total revenues projected for 2002
18 . The composition of those
19 revenues in 2002 is different, with
20 . (I will return to
21 the issue of the composition of the Company's sales projections subsequently.)
22 With regard to purchased power expense, at the bottom of Schedule 10 is shown a
23 ratio analysis by which we can compare the level of expenses in each year to a dollar of
24 revenue. The Company's projections show that in 2002 purchased electricity is expected to
25 cost . That amount is
26
27
28 .

1 In 1998 and 1999 the cost of purchased gas per dollar of gas revenues for Puget
2 averaged 43.5¢. In 2002 it is projected to [redacted] That
3 level of increase is commensurate with the increase in the gas revenues. However, the cost of
4 electric generation fuel per dollar of electric revenues in 2002, [redacted]
5 [redacted]
6 [redacted]
7 [redacted].
8 Although some of the increase in Electric Generation Fuel expenses is related to the
9 Company's purchase of the Encogen facility and the shift of costs associated with that facility
10 from purchased power to generation fuel (PC-134-I), [redacted]
11 [redacted]
12 [redacted]
13 [redacted] .
14 Therefore, my review of the Company's income statements prior to the time period of
15 the wholesale market change and the income statements projected for 2002 indicates that the
16 operating expense [redacted]
17 [redacted] . Moreover, it is not clear that the increase in that
18 cost parameter is related to the provision of electricity for the Company's native load. To the
19 extent that power-cost-related increases are not related to the provision of service to the
20 Company's core customers, it is reasonable that those costs not be recovered from core
21 customers.
22
23 Q. DO THOSE POWER COST FIGURES YOU JUST MENTIONED TAKE INTO
24 ACCOUNT THE COMPANY'S RESIDENTIAL/FARM EXCHANGE CREDIT?
25 A. No, they do not. As shown in Schedule 10 those credits [redacted]
26 [redacted] . That leads to a very interesting finding. As shown at the
27 bottom of Schedule 10, if we add the purchased electricity, gas, generation fuel and exchange
28 credit expense and divide that sum by the total energy sales (electricity and gas), we see that the

net power supply cost projected in 2002 equals

Q. IF NET POWER COSTS DON'T EXPLAIN THE DIFFERENCE IN PUGET'S NET INCOME BETWEEN 1998/99 AND 2002, THE WHAT DOES?

A. First, net power costs do explain some of the difference. For example, although there is a relatively small difference between the 2002 ratio of net power costs to revenues of and the same ratio in 1998 of 0.491, those ratios are multiplied by nearly $2 Billion in revenues and differences do result. In 1998, the year in which revenues are very nearly equal to those projected for 2002, power costs were roughly for Puget. Focusing on the other expense differences between 1998 and 2002, I note that Those expense increases are offset to some extent by a net tax (Federal and Other) reduction of . Therefore, compared to 1998, when revenues were the same as the revenue levels projected for 2002,

Finally, when the increase in interest cost of nearly is included (due to the addition of debt in the capital structure), the full difference in net income of approximately . Of that net income difference between 1998 and 2002, the net power cost differential

Q. AGAIN THESE COMPARISONS YOU ARE MAKING ARE BASED ON THE COMPANY'S PROJECTIONS. CORRECT?

1 A. Yes.

2

3 Q. HAS YOUR ANALYSIS REVEALED ANY INCONSISTENCIES IN THE COMPANY'S
4 FORECAST FINANCIAL DATA?

5 A. Yes. First, with regard to revenues,
6
7 . Schedule 11 shows income statement for 2001 and projections for
8 2002 taken from Mr. Hawley's workpapers (provided in response to PC-62-I). As I noted
9 previously, approximately of the revenue difference between 2001 and 2002 is
10 attributable to , as shown on Schedule 11.
11
12 .

13 However, the Company
14 . This projection is in disagreement with projections provided to bond
15 rating agencies in April 2001, shown at the bottom of Schedule 11. In the Company's most
16 recent presentation to bond rating agencies, Puget projected a
17
18
19
20 .

21 Also, with regard to industrial sales, the Company told its bond rating representatives
22 earlier in 2001 that it expected Industrial sales in 2002
23 . In its 2002 projections supplied in this proceeding, the Company projects that
24 Industrial sales will . Similarly with overall gas revenues
25 (firm, interruptible and transportation) Puget indicated to its bond rating agencies that total gas
26 sales in 2002 would . In its forecast supplied to support its interim
27 rate request, Puget projects roughly a .

Of course, it is entirely possible that the Company has developed new sales forecasts which are substantially different from those supplied to bond rating agencies a few months earlier in 2001. However, as I noted, the detail the Company's forecasts in this proceeding have not yet been analyzed and the discrepancies I have highlighted here certainly impact the apparent need for rate relief and should be explained by the Company.

Q. ARE THERE OTHER DISCREPANCIES IN THE COMPANY'S FORECASTS WHICH YOU WISH TO BRING TO THE ATTENTION OF THIS COMMISSION?

A. Yes. The data discussed above is related to projected revenues. The other discrepancy between the Company's forecast provided to bond rating agencies and that provided in this proceeding are related to operating expenses. Schedule 12 contains operating expense projections for Puget Sound Energy for 2002 from their April 2001 presentation to bond rating agencies and their November 2001 filing in this proceeding. The curious difference here is that Puget projects 2002 operation and maintenance expenses in its filing before the WUTC to be [redacted] than it projected in its presentations to bond rating agencies a few months earlier. Moreover, that differential exists even though, in its presentations to bond rating agencies, [redacted]. As evidenced by the relative levels of electric generation fuel expense, the Company is projecting a [redacted] in the forecasts it has supplied to this Commission to support its interim rate request. [redacted].

Q. DOES THIS CONCLUDE YOUR COMMENTS ON THE COMPANY'S PROJECTIONS?

A. Yes.

## SUMMARY OF RECOMMENDATIONS

1 Q. MR. HILL, WOULD YOU PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN
2 THIS PROCEEDING?
3 A. Yes. First, my analysis indicates that the Company's financial condition does not meet the
4 conditions for interim rate relief set out in this Commission's Pacific Northwest Bell standards. I
5 recommend that no interim rate relief be granted. Second, the Company has had the opportunity
6 to improve its capital structure balance, but has failed to do so, and created a financial condition
7 that exacerbated the negative impact of its net power cost difficulties. I recommend, therefore,
8 that this Commission move to protect the financial balance of Puget by requiring the Company
9 to retain some portion of its utility earnings. To that end I recommend that the dividends Puget
10 pays out to its parent company, Puget Energy be limited to the greater of: a) 60% of the current
11 $1.84/share dividend or b) 60% of Income for Common Stock. In addition, I recommend that
12 that dividend condition remain in place until Puget Sound Energy reaches a capital structure in
13 which common equity capital comprises 40% of permanent capital (common equity, preferred
14 stock, preferred trust securities, and long-term debt). Third, if this Commission, after a full
15 review of the evidence in this proceeding, determines that an interim rate increase is necessary
16 and reasonable, I recommend that an increase of no more than $29.3 Million be allowed.
17
18 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY IN THIS PROCEEDING?
19 A. Yes, it does.