EXHIBIT NO. ______ (DEG-8)
DOCKET NO. UE-011570 (INTERIM)
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

EXHIBIT TO REBUTTAL TESTIMONY OF DONALD E. GAINES
ON BEHALF OF PUGET SOUND ENERGY, INC.

FEBRUARY 11, 2002

Investment Banking
Corporate and Institutional
Client Group
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Merrill Lynch

February 8, 2002

Donald E. Gaines
Vice President
Puget Sound Energy, Inc.
One Bellevue Center
411 108th N.E., 15th Floor
Bellevue, WA 98004

Re: Puget Energy, Inc. ("Puget") Request for Interim Rate Relief at Puget Sound Energy, Inc. a Wholly Owned Utility Subsidiary; UE-011570

Dear Mr. Gaines:

You have asked me to address the following questions in connection with the above-referenced matter. In responding to these questions, I have reviewed the Testimony of Lisa A. Steel and the Testimony of Stephen G. Hill filed in UE-011570. I understand that you intend to make reference to this information, as an aspect of your preparation of rebuttal testimony.

By way of background, I am a Managing Director in the Global Energy & Power Group in the Investment Banking Division of Merrill Lynch & Co., Inc. ("Merrill Lynch"), which conducts a global securities business. Since 1995, I have been the lead investment banker on more than 15 offerings of common stock and equity linked securities that raised more $3.4 billion for utilities. I have also acted as the lead banker on a number of common stock offerings in the Pacific Northwest including transactions for: Cascade Natural Gas, Puget and Northwest Natural Gas. I also served as the Chairman of the Equity Commitment Committee for Merrill Lynch (1995-1998). The Equity Commitment Committee at Merrill Lynch must approve all equity offerings where the firm participates as a lead underwriter. In my capacity as Chariman of the ECC, I was able to participate in the discussion/approval surrounding each of the more than 1,200 underwritings that Merrill Lynch executed during 1995-1998. A copy of my resume is attached for your reference and information.

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1. **In your opinion, what are the conditions for a successful equity offering for a utility company such as Puget?** The investor in power sector stocks, such as Puget, is generally seeking assured current dividend with modest appreciation in stock price (a.k.a. Competitive Total Return). The assurance of a dividend, or dividend yield, is the most important component of Total Return, since the investor, be it an institutional fund or individual investor, is counting heavily on that current yield to derive their Competitive Total Return, given that future price appreciation is difficult to estimate. Therefore, the first criteria for a successful offering for a power company, such as Puget, is that the current level of the dividend be reasonably assured, with minimal chance that it will be reduced during the investment horizon (typically one to two years). Furthermore, I generally advise clients not to sell common stock during a rate proceeding. In my experience, the uncertainly with respect to the future earnings capability of a company and its ability to pay dividends pending a final rate decision makes it difficult to recommend purchasing common stock to investors until the company can claim that the rate proceeding is final.

With regards to the process of selling common stock, underwriters and the issuer are responsible for making the investor fully aware of the risks involved in the security. The offering document or prospectus must disclose all information concerning the risks inherent to purchasing the security. In particular, if the company and its underwriters believe there is a risk that the current dividend level may not be maintained, then such risk and the reasons why it may not be maintained must be disclosed. During the pendancy of a rate proceeding, a company will have difficulty estimating its final earning power. As a result, the prospectus must warn investors that the current dividend level may not be maintained once the rate proceeding is made final. In addition, the uncertainty surrounding the final rate decision must be repeated in sales presentations to institutions and individuals. In my experience, it is difficult to convince an investor to purchase a security if one of the prime reasons for purchasing it remains uncertain.

2. **What Concerns Do Investors Currently Have About Power Company Equity Securities?** Investors in power company stocks are keenly aware of the regulatory developments that are currently shaping the power markets and are particularly aware of the challenges facing utilities in the western United States. The Wall Street analyst community and the press have devoted a considerable amount of time to discussing how the utilities in the west have had difficulty recovering purchased power costs on a timely basis. Recently, investors have

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witnessed how un-recovered power costs contributed to the eventual bankruptcy of a utility (PG&E) and investors are now more focused than ever on the decisions of various state and federal authorities. For example, the rate caps imposed by the Federal Energy Regulatory Commission ("FERC") gave investors the impression that every utility in the western United States had the same problem, regardless of the state which had local jurisdiction. Subsequent to imposition of the rate caps, the investors saw that the caps had a very different impact on utilities in the Pacific Northwest versus those California. With the FERC caps in place, balance and traditional rate making were disturbed and confusion for investors resulted. This confusion has made it more difficult to sell to investors the debt and equity securities of utilities in the western United States unless there were regulatory certainty for that particular utility. Further, investors find it illogical that a gas utility can recover its fuel costs on a relatively current basis, but some electric utilities are not allowed to recovered purchased power costs on a current basis. The result of this confusion is that many investors are avoiding additional investment in power companies in the western United States and those that are willing to invest are seeking greater returns, as well as more information about how the utility is regulated and what is the regulatory climate in the jurisdictions where the utility operates.

3. **What is your opinion of the proposal of the Staff or Public Counsel with respect to Puget proceeding with a common stock offering once an interim rate increase has been granted?** I recommend that Puget not proceed with a public common stock offering until the Commission had reached a final decision in the utility's request for general rate relief. Because rates granted in an interim proceeding can be subject to review and a possible refund in a general-rate proceeding, I do not believe that Puget could make a credible story as to why an investor should invest in its common stock prior to a final decision by the Commission. Furthermore, until the utility has received the final decision on its rates it cannot be assured that it will be allowed to keep the interim rate relief. In the absence of a final order, Puget and its underwriters will have to fully disclose these risks to investors, as well as warn investors that Puget might have to reduce or suspend the dividend on the common shares. Such a warning would make the stock difficult to sell in significant quantities at a price that would be considered fair to existing shareholders.

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4. **What impact do you believe that Staff or Public Counsel's recommended relief (if adopted) would have upon investor confidence in the Company or the Commission?** In light of the risks described in paragraph 2 as well as securities law disclosure requirements, if the recommended proposals were adopted by the Commission and Puget attempted to sell common stock, the prospectus for such sale would have to disclose, along with other information, the following risks:

- The utility has not received a final rate order from the Commission and that Puget cannot determine its longer-term dividend policy until it receives such order.
- Depending on the final rate order, Puget may be able to maintain the new dividend level, or may be required to reduce or eliminate the dividend.
- The interim rate relief is 25% (or less) of what Puget requested and there can be no assurance that Puget will have sufficient funds to maintain its current operations or finance on reasonable terms, prior to the final rate order.
- It is possible that the Puget's credit rating could decline below investment grade, reducing/changing the investor base for its debt securities and also making it more difficult to enter into purchased power contracts on reasonable terms.

In light of the Puget's current financial condition and level of rate relief, the above warnings would make the stock extremely difficult to sell in significant quantities at a price that would be considered fair to existing shareholders.

5. **Following the public release of the staff and public counsel recommendations, Puget's stock was trading above book value. Is this atypical?** No. Practically all power company common stocks are presently trading above book value since investors are seeking assured returns in the form of dividends. However, investors have choices in where to invest their monies. If there are substantial concerns over the future earnings capability and dividend paying ability of a company, investors will simply invest in the stocks of other companies without dividend risk. Moreover, in light of the uncertainly surrounding Puget's rate proceedings and the certainty that Puget will be exposed to power cost risk through October of 2002, if the interim relief proposals of Staff or Public Counsel are adopted, I believe that there is a risk that Puget's stock price could decline to a level at or below book value.

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Very truly yours,

Anthony V. Leness

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Anthony V. Leness

Managing Director

Mr. Leness is a Managing Director in the Global Power & Utility Group at Merrill Lynch and is responsible for relationships with electric, gas, combination companies and their non-utility affiliates. Mr. Leness joined White, Weld & Co., Incorporated in 1963 in the electric utility group, and subsequently worked on a broad spectrum of utility, energy and industrial corporations, both in capital markets area and on advisory and M&A transactions. In 1978, with the merger of White, Weld into Merrill Lynch, Mr. Leness became a Managing Director of Merrill Lynch Investment Banking, and from 1982 to 1987 was in charge of the Natural Resources Group, and in 1990, joined the Global Power & Utility Group. In addition to his investment banking responsibilities, Mr. Leness was Chairman of the Equity Commitment Committee for Merrill Lynch from April of 1995 through August of 1998. This committee must approval all equity offerings where the firm participates as a lead underwriter. Mr. Leness received a BA Cum Laude from Harvard College in 1961 and served as an officer in the US Navy from 1961 until 1963.