EXHIBIT NO. ___(BAV-4T)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: BERTRAND A. VALDMAN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UG-040640** **Docket No. UE-040641** **(*consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For an Order Regarding the Accounting Treatment for Certain Costs of the Company's Power Cost Only Rate Filing.**	**Docket No. UE-031471 (*consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For an Accounting Order Authorizing Deferral and Recovery of the Investment and Costs Related to the White River Hydroelectric Project.**	**Docket No. UE-032043 (*consolidated*)**

PREFILED REBUTTAL TESTIMONY OF BERTRAND A. VALDMAN (NONCONFIDENTIAL) ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 3, 2004

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF BERTRAND A. VALDMAN

CONTENTS

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF BERTRAND A. VALDMAN

I. INTRODUCTION

Q. Are you the same Bertrand A. Valdman who filed direct testimony in this proceeding for Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes.

Q. Please summarize the purpose of your rebuttal testimony.

A. I rebut Commission Staff and Public Counsel contentions that the Company's proposal is not necessary to rebuild its financial strength and that an improvement in PSE's credit rating is not needed. As stated in my direct testimony, Exhibit No. ___(BAV-1T), an improvement in PSE's credit rating from BBB- to BBB+ will enable the Company to finance its generation acquisition process, risk management activities, and infrastructure improvement and replacement programs at a lower cost, over time.

II. FINANCIAL WITNESSES FOR OTHER PARTIES FAIL TO ACKNOWLEDGE PSE'S SIGNIFICANT CAPITAL NEEDS OR UNIQUE FINANCIAL CHALLENGES

Q. How would you describe PSE's overall objectives?

A. PSE's CEO, Steve Reynolds, outlined in his direct testimony, Exhibit No. ___(SPR-1T), and reiterates in his rebuttal testimony, Exhibit No. ___(SPR-3T), the initiatives underway to support PSE's corporate mission: to reliably and safely serve ratepayers and to deliver a fair, competitive return to shareholders.

To achieve this corporate mission, PSE is committed to:

- replacing aged and aging gas and electric transmission and distribution infrastructure;
- installing new gas and electric transmission and distribution infrastructure to meet PSE's growing service area;
- acquiring electric generation resources consistent with the Least Cost Planning process; and
- building on existing energy price risk management programs.

These programs are capital intensive and all will require PSE to access the financial markets on reasonable terms.

As CFO, I am accountable to ratepayers and shareholders for funding PSE's capital investment program in the most responsible manner. Financing must be at the

lowest cost and on the most flexible terms. Given the long-lived nature of the assets being brought into rate base, I must ensure that PSE has continual access to financial markets in good times and in bad times. I know on what basis I can attract capital today. It is attracting capital in future years, when the bills from our infrastructure investment programs are due, that is of concern to me. Like investors and financial counterparties, my focus is on forward metrics, not current ones.

Q. What is the basis for your knowledge of the Company's ability to attract capital?

A. As a former investment banker in the Natural Resources Group of J.P. Morgan, I have extensive experience that provides me with the background to understand just what it means to attract capital on a reasonable basis and what return the market requires for PSE. As CFO of PSE, I follow and participate in financial markets to meet my responsibilities to PSE, its investors and its customers.

Q. Can PSE support its infrastructure and resource acquisition initiatives given its current financial situation?

A. Not on reasonable terms. PSE's investment initiatives require significant capital, and PSE's current financial position is weak. PSE's corporate credit rating is BBB-, one notch above sub-investment grade. PSE's corporate credit rating is the primary reference for financial markets and energy risk management counterparties. The utility balance sheet leverage as measured by the debt ratio

was 60.8% at the end of 2003, and cash flow is insufficient to fund infrastructure investments and shareholder dividends as evidenced by the $85 million deficit forecasted for 2004. Over the past three years, PSE has consistently under-earned its allowed return on equity by 3.5 percent. As Dr. Wilson correctly notes in his testimony: "[e]arned returns are not the same as required returns." (Exhibit No. ___(JLW-1T) at 28, line 7.)

While PSE's corporate credit facility was increased this year from $250 million to $350 million, and the term extended from 364 days to three years, PSE's bank borrowing capacity is dwarfed by future infrastructure capital requirements and by collateralization requirements of energy price risk management efforts. Scaling back on core investment and risk management programs would not be appropriate. Further, reducing shareholder returns by lowering dividend payout levels would also not be appropriate, especially in light of a 46 percent dividend reduction only 29 months ago and the need to attract external capital to support infrastructure projects in coming years.

Q. Does any witness for either Commission Staff or Public Counsel address how the recommendations of either party's financial witness will affect the above-described efforts?

A. No. Neither Commission Staff nor Public Counsel addresses how the financial recommendations of Dr. Wilson or Mr. Hill would affect PSE's ability to pursue the above-described efforts. Moreover, neither Dr. Wilson nor Mr. Hill addresses the impact of his respective financial recommendations on PSE's ongoing capital

programs. Instead, both Dr. Wilson and Mr. Hill approach their recommendations without any recognition or consideration of the unique capital needs and business risk position of PSE. In doing so, both Dr. Wilson and Mr. Hill arrive at the incorrect conclusion that PSE can attract sufficient capital at the low rates of returns they recommend. If their proposals were to be adopted, PSE's financial condition would weaken further (as described by Mr. Gaines in his rebuttal testimony, Exhibit No. ___(DEG-9CT)) which would put the Company at risk for a downgrade of its credit rating and jeopardize its ability to continue to meet its public service obligations.

III. THE COST OF CAPITAL RECOMMENDATIONS OF WITNESSES FOR COMMISSION STAFF AND PUBLIC COUNSEL ARE BASED ON FAULTY ASSUMPTIONS

Q. At page 5, lines 14-21 of his testimony, Exhibit No. ___(SGH-1T), Mr. Hill discusses the following standards that should be applied in setting the proper allowed rate of return for PSE:

> The Supreme Court of the United States has established, as a guide to assessing an appropriate level of profitability for regulated operations, that investors in such firms are to be given an opportunity to earn returns that are sufficient to attract capital and are comparable to returns investors would expect in the unregulated sector for assuming the same degree of risk. The Bluefield and Hope cases provide the seminal decisions [Bluefield Water Works v. PSC, 262 US 679 (1923); FPC v. Hope Natural Gas Company, 320 US 591 (1944)]. These criteria were restated in the Permian Basin Area Rate Cases, 390 US 747 (1968).

Do you agree that these are the standards that should be applied by the Commission in setting PSE's in this case?

A. Certainly. The standards listed by Mr. Hill are the standards that apply to all rates of regulated companies in the United States. The return on equity the Commission establishes for PSE in this proceeding should, and must, follow these standards. I would, however, further note that, while a regulated utility is not guaranteed the return on equity established in a rate proceeding, such utility must be given a fair opportunity to actually attain such return.

The proposals advocated by Mr. Hill and Dr. Wilson ignore risks and credit requirements specific to PSE and do not allow PSE the opportunity to earn a profit sufficient to attract capital on reasonable terms. The financial recommendations proffered by Dr. Wilson and Mr. Hill will not allow the Company a fair opportunity to earn a return sufficient to attract capital.

Q. Please provide a brief explanation why you disagree with the cost of capital recommendations of Dr. Wilson and Mr. Hill.

A. Both Dr. Wilson and Mr. Hill support their assertions by relying solely on application of certain mathematical analyses while ignoring the practical realities of PSE. Their approaches do not properly reflect actual investor expectations and considerations. They also fail to acknowledge or propose any solutions to the earnings drag that prevents the Company from having a reasonable opportunity to earn its authorized rate of return, as described by Dr. Cicchetti. Further, their

analyses are themselves flawed in many significant respects, as described in the rebuttal testimony of Dr. Cicchetti, Exhibit No. ___(CJC-6T).

Q. Mr. Hill alleges at Exhibit No. ___(SGH-1T) at 23, lines 15-18, that "the company's proposed hypothetical 45% equity capital structure dwarfs any potential interest savings on debt that might be attributable to the Company's hoped-for shift to 'BBB+' First Mortgage Debt from the 'BBB' level it now has." Do you agree?

A. No. Mr. Hill presumes a false premise by solely looking to customer benefits associated with potential interest savings on debt. Customer benefits associated with potential interest savings on debt are but one of many significant benefits that we anticipate will result from an improvement to PSE's current credit ratings. As discussed in Mr. Markell's direct testimony, Exhibit No. ___(EMM-1CT), PSE's capital resource acquisition program would benefit from a strong credit rating for the Company. A better credit rating for PSE would also alleviate some of the significant constraints placed on PSE's risk management activities by its credit standing, as discussed in Julia Ryan's direct testimony, Exhibit No. ___(JMR-1T) and illustrated in greater detail in her rebuttal testimony, Exhibit No. ___(JMR-12T). Additionally, a strong credit rating would benefit (i) the replacement and maintenance of existing infrastructure and (ii) construction of new infrastructure to meet the demands of a growing customer base, each as discussed in Sue McLain's direct testimony, Exhibit No. ___(SML-1T).

As discussed in the rebuttal testimony of Mr. Gaines, Exhibit No. ___(DEG-9CT),

the Company projects potential benefits to customers associated with an improvement of its current credit ratings could range from $24 million to $118 million. This range includes only those potential benefits that PSE has attempted to quantify and in no way captures all of the benefits that could accrue to both PSE and its customers from an improvement of the Company's credit rating.

Q. How have the financial witnesses of other parties to the proceeding reflected macroeconomic trends and PSE-specific factors in their testimony?

A. Messrs. Hill and Wilson both correctly acknowledge that:

- return on equity must be sufficient to attract capital as PSE competes for capital with other financial market participants;
- investor return requirements are driven by perceptions of risk;
- financial markets are efficient and price securities rapidly based on new information; and
- an appropriate return on equity must be considered in the context of (a) macroeconomic trends, (b) financial metrics of comparable companies, and (c) fiscal and legislative policy.

However, their recommendations fall short in certain key areas, which is disappointing. To a certain extent, this is because it is difficult to reflect day-to-day reality in financial models, a problem Mr. Hill openly acknowledges in his testimony: "As with all mathematical models of real-world phenomena, the DCF

theory does not exactly 'track' reality." (Exhibit No. ___(SGH-1T) at 30, lines 18-19.) Later, Mr. Hill reiterates the difficulty in applying financial models to practical application: ". . . there are many implementations problems when the theoretical CAPM is applied in real world circumstances . . . ." (Exhibit No. ___(SGH-1T) at 57, lines 12-14.)

Q. How familiar are you with the methodologies employed by Messrs. Hill and Wilson?

A. As a former investment banker with a career on Wall Street that spanned sixteen years and several cycles in the financial markets, I relied, in part, on mathematical models, but I also took into account the limitations and shortcomings of these types of models. Based on my expertise, I cannot fathom that any investor would use certain assumptions that Messrs. Hill and Wilson have included in their respective analyses.

Q. Could you provide a specific example where either Mr. Hill or Dr. Wilson used assumptions that an investor would not?

A. Certainly, but I should preface my response by noting that financial analysis is not a pure science. Certain key assumptions may change over time to reflect market conditions. For example, sometime in the 1990s, the 10-year U.S. Treasury came to be perceived as a better proxy for the risk free rate because it was determined that the 30-year U.S. Treasury had a slight positive correlation to equity markets.

That being said, I have difficulty in understanding why Dr. Wilson would use a 90-

day U.S. Treasury security as the proxy for the risk-free rate. (*See* Exhibit No. ___(JLW-1T) at 18, lines 10-12.) As discussed above, legitimate debate exists whether a 10-year or 30-year U.S. Treasury security is better to use in the capital asset pricing model, but use of the 90-day U.S. Treasury security cannot be taken seriously. Based on my experience, investors would reject out of hand use of the 90-day U.S. Treasury as the proxy for the risk free rate.

Q. Have you ever used the 90-day U.S. Treasury as a proxy for a risk-free asset in the capital asset pricing model?

A. No, and I have never encountered such use until this proceeding.

Q. Would investors use approaches recommended by Messrs. Hill and Wilson in determining the attractiveness of PSE's capital?

A. No, they would not. In that regard, I challenge below several conclusions reached by Messrs. Hill and Wilson and highlight important omissions. Dr. Cicchetti provides a full examination of the assumptions and methodologies employed by Mr. Hill and Dr. Wilson in his rebuttal testimony, Exhibit No. ___(CJC-6T).

A. Single Digit Returns on Equity are Not Supportive of PSE's Credit Quality

Q. Both Messrs. Hill and Wilson suggest that their recommended returns on equity can support and even improve PSE's current credit quality, would you agree?

A. No. The single digit returns on equity they propose do not support enhanced credit ratings. In fact, single digit returns on equity do not even support PSE's current BBB- rating. If adopted, a single-digit return on equity could well result in a credit downgrade to sub-investment grade, BB levels, as described in Mr. Gaines's rebuttal testimony, Exhibit No. ___(DEG-9CT). In addition, in an environment where utility companies are, on average, receiving 11% returns on equity from their regulators (*see* Exhibit No. ___(DEG-12)), this level of return on equity would be viewed by investors and analysts as punitive and wholly inconsistent with regulatory support of the Company's resource acquisition and infrastructure initiatives.

B. Cost/Benefit of a BBB+ Rating

Q. Mr. Hill alleges that the benefits associated with a BBB+ credit rating are outweighed by the costs associated with the return on equity and capital structure necessary to support such an increase. Do you agree?

A. No. The cost/benefit analysis performed by Mr. Hill is of a credit ratings upgrade

from existing BBB- levels to BBB+ levels, which was quantified as a net cost of $15.7 million by Mr. Hill (Exhibit No. ___(SGH-1T) at 23, lines 10-14), and is limited to an assessment of short-term interest cost savings. Such savings are not the primary driver of PSE's commitment to strengthen credit quality. Certainly, under near optimal conditions in the debt capital markets such as we are experiencing today, the cost of money between a BBB- borrower and a BBB+ borrower is minimal. This is reflected in what is referred to as the "credit spread": the percent differential in borrowing costs across credit ratings categories. (Every one-hundredth of a percent is referred to as a basis point.) In the current environment, the credit spread between a BBB- and a BBB+ borrower is 16 basis points. The important point is that this is not always so. There are periods when credit spreads increase, increasing the cost of money, particularly for lower-rated borrowers. The weaker the credit, the higher the borrowing cost during these periods. Importantly, utilities with weak credit ratings could well be denied access to capital markets altogether during periods of market volatility or as a result of adverse developments in the utility industry or for the Company. This point is generally acknowledged by Mr. Hill but is not incorporated into his analysis.

This could occur because of shocks to the financial markets, to an industry, or to a specific company. For example, the Asian currency crisis of 1997, the demise of the Long-Term Capital Management hedge fund in September of 1998, the Russian debt default of August 1998, and the terrorist attack on September 11, 2001, all resulted in a liquidity squeeze in financial markets as investors hoarded

cash because of heightened financial market uncertainty. This impacted all borrowers, but the borrowers with the weakest credit more severely.

First Energy's Davis-Besse nuclear reactor vessel head deficiencies in March 2002 increased the cost of borrowing and limited capital market access for utility companies with nuclear exposure until the extent of the problem was fully understood. This is an example of an industry-specific event – all companies sharing common characteristics are impacted. An unfavorable regulatory ruling, accounting uncertainty, or an operational incident all could compromise an individual company's ability to access the financial markets, as was the case recently with Sierra Pacific Resources.

Furthermore, many of the benefits of an improved credit rating have been wholly ignored in Mr. Hill's testimony. While many of these benefits are unquantifiable, Mr. Gaines and Ms. Ryan provide quantifications of those benefits that can be quantified based on reasonable assumptions.

C. Price-to-Book Multiples as a Valuation Metric

Q. How would you assess the arguments of Messrs. Hill and Wilson with respect to the use of price-to-book multiples as a valuation metric?

A. First, a practical comment: In my investment banking career I did not once use the price-to-book ratio. In my opinion, price to book has limited relevance in today's financial markets and is not used by investors in making utility sector investment

decisions.

Second, Messrs. Hill and Wilson suggest that equilibrium is reached when a utility's market to book value is 1. Yet this has not occurred for over ten years, and the current market to book ratio for the sector is 1.64 (vs. PSE's 1.38). Their market-to-book theory is also inconsistent with the following statement by Dr. Wilson: "It is the consensus of investor expectations that establishes the price of common equities, and those expectations are concerned with the future income stream." (Exhibit No. ___(JLW-1T) at 10, lines 2-5.) If financial markets are efficient and investor expectations establish the price of common equities and market to book ratios of utility sector companies have traded in the 1.5 range for the past ten years, it simply does not follow that equilibrium is reached when market-to-book ratio is 1.

There are a number of financial metrics that investors use to track financial performance and support investment decision-making. These metrics do not include price-to-book; rather, they are: forward price to earnings multiples, some form of a cash flow per share multiple, and key credit leverage and fixed charge coverage ratios.

Please see the prefiled rebuttal testimony of Dr. Cicchetti, Exhibit No. ___(CJC-6T), for additional discussion regarding the infirmities of the market-to-book metric in establishing utility rates.

D. PSE's Price-to-Earnings Multiples as Evidence of Successful Trading Performance and Ability to Attract Capital

Q. Messrs. Wilson and Hill contend that Puget Energy's recent P/E multiple of 16.3x is evidence of the Company's ability to attract capital. Would you agree?

A. No. First, 16.3x is a recent, historical Puget Energy P/E ratio. Investors make investment decisions on a company's future earnings prospects, so the relevant P/E ratio to consider is not the current P/E but projected P/Es. As Mr. Hill states in his testimony: "It is the consensus of investor expectations that establishes the price of common equities, and those expectations are concerned with the future income stream." (Exhibit No. ___(SGH-1T) at 10, line 2.) Puget Energy's 2005 P/E is 13.3, as compared to 16.1 and 13.9 for the Philadelphia Utility Index and the S&P 500, respectively.

Second, P/E is made up of two components: (1) price and (2) earnings. A high P/E ratio could therefore mean one of two things: (1) a high price in relation to earnings or (2) low earnings in relation to price. Puget Energy's current P/E ratio of 16.3 is high because of low earnings. These low earnings are the result of factors that prevent PSE from actually earning its allowed rate of return such as warm weather, the absence of a weather normalization mechanism, and delayed recovery of infrastructure development. In addition, Puget Energy's current P/E ratio of 16.3 included regulatory disallowances.

In the same context, Mr. Hill states the following:

> Regarding analysts' buy or sell recommendations, Puget again exhibits a more advantageous position than the sample group. According to data available from First Call/Thomson Financial (August 30, 2004), the average consensus recommendation for the sample group is 2.8. That amounts to an average "hold" recommendation, because a consensus analyst ranking from 1.6 to 2.5 indicates a "buy" recommendation and from 2.6 to 3.5 constitutes a "hold" recommendation, i.e., neither buy nor sell. The current consensus analyst's recommendation for Puget is 2.5—at the upper end of the "buy" range. Again, Puget is ranked as more attractive to investors than the sample group on average.

(Exhibit No. ___(SGH-1T) at 33, line 18 through 34, line 2. The number of buy, hold, or sell recommendations should be viewed in the context of how many firms publish research on a particular company. Some firms are narrowly covered and so a single buy recommendation would indeed be meaningful. Others are more broadly covered and a single buy recommendation in a universe of many hold or sell recommendations would be much less relevant. Puget Energy is perceived by the financial markets as a company that is likely to issue equity capital in the future to support infrastructure investment initiatives and resource acquisition programs. It is no surprise then that Puget Energy is widely covered and has ten firms that publish equity research, which is the same as the average number of analysts covering the companies in the S&P Utility Index. Currently, only three of the ten firms have a buy recommendation for Puget Energy.

Please see the prefiled rebuttal testimony of Dr. Cicchetti, Exhibit No. ___(CJC-6T), for additional discussion regarding the infirmities of using PSE's price-to-earnings ratio as demonstrating its financial strength.

IV. RISKS SPECIFIC TO PSE

Q. Above, you state that "Dr. Wilson and Mr. Hill support their assertions by relying solely on application of certain mathematical analyses while ignoring the practical realities of PSE." How do the financial markets treat companies in PSE's financial position?

A. Financial markets are frequently volatile. During periods of volatility, financial markets are particularly risk averse, and companies with weak financial positions--as measured by credit rating and earnings power--have difficulty raising funds on a competitive basis or can be shut out completely. This is acknowledged by Dr. Wilson in his testimony: "It may also be true that, when financial markets are especially risk-adverse, companies with high equity ratios may have greater access to new debt and equity capital." (Exhibit No. ___(JLW-1T) at 31, lines 14-16.) Assuring liquidity, the ability to access financial markets on a competitive basis at any time, is the core responsibility of the finance area.

Q. What are specific risks associated with PSE in particular that cause concern among investors?

A. Every company is unique, and has strengths to leverage and weaknesses to manage. There is a context that is unique to PSE and must be acknowledged when considering the need for financial strength, market access, and the cost of money:

- a rapidly growing customer base;

- new electric generation to address a growing short position and increased investment in electric and gas transmission and distribution systems to address customer growth;

- dependence on secondary wholesale markets to supplement other power resources, which results in energy price volatility for customers and can create a need for expanded risk management programs; and

- a weak financial position and reliance on external capital.

Q. Please describe the strengths of PSE.

PSE serves a dynamic region. Population growth during 1990-2000 of 1.9% exceeds the national average of 1.3%, and natural gas and electric customer growth during the twelve months ended September 2004 was 3.6% and 2.1%, respectively, exceeding the national average of 2.4% for gas during 2002 over 2001 and 1.7% for electric from 2000 to 2001. PSE's average power costs are low compared to the national average because of the abundance of hydroelectricity in the region. These are competitive strengths that differentiate PSE from utility peers and have been recognized by financial markets. But high customer growth and reliance on hydroelectricity present operational and financial challenges as well.

Q. Please describe these challenges associated with PSE's resource portfolio.

A. PSE must invest in transmission and distribution infrastructure and system upgrades to deliver energy to a rapidly expanding service territory. With rates determined by an historical test year, PSE recovers these investments with a lag.

In other words, shareholders fund the interim period between the in-service date of the infrastructure and the inclusion of the investment in rates. The amounts involved are significant given the size of the capital investment program. PSE's actual return on equity over the last three years has averaged 6.88%, trailing its allowed return on equity of 11% by 4.12%. PSE's actual rate of return over the last three years has averaged 7.89%, trailing its allowed rate of return of 8.76% by 0.87%. As a result, PSE is forced to "chase" its allowed return.

Q. Please describe these challenges associated with hydroelectricity.

A. Hydroelectricity is finite and currently represents 40 percent of PSE's generation supply portfolio--under normal weather conditions. Over the past two years, dry weather conditions have reduced hydroelectricity available to PSE by roughly half, increasing PSE's cost exposure to wholesale power market prices. In general, wholesale market power is priced by natural gas, and natural gas prices in 2004 are at historic highs. Importantly, natural gas prices have been extremely volatile. Forward natural gas price markets suggest that these pricing levels and volatility will persist. The net result: higher energy costs for PSE customers. A thoughtful risk management program, such as the one we currently have in place at PSE, can help mitigate this critical ratepayer issue. An improved credit rating would facilitate PSE's ability to expand the implementation of its risk management program.

An additional consideration is that two-thirds of PSE's power supply is secured through long-term contracts. Credit rating agencies view long-term power supply

contracts as a fixed charge obligation similar to debt. For example, for every $1 of cost to PSE associated with these contracts, Moody's attributes 30 cents of debt. PSE's must size its equity capital base accordingly. Importantly, the bulk of this contractual power is secured from parties that are in a much stronger financial position than PSE. This is evidenced by their credit ratings. The average credit rating of PSE's counterparties for hydroelectric power supply, primarily Washington state municipal power entities, is A. (*See* Exhibit No. ___(DEG-16).) The average credit rating of PSE's counterparties for non-hydroelectric power and natural gas supply is BBB+. Because of this gap in credit quality between PSE and its counterparties, it is more likely than not that PSE will have to make some form of concession in the future. At this juncture, this amount is difficult to quantify but is an issue that is of concern to me.

The region's future electricity needs will have to be supported by new generation resources other than hydroelectricity. PSE's short energy position is growing, as described on page 6 of Mr. Markell's direct testimony (Exhibit No. ___(EMM-1CT)): 355 aMW by 2008 and 1,380 aMW by 2013. Management must address this situation now and proceed to secure a supply portfolio that is cost competitive and diverse in terms of fuel supply. This will require significant capital and an adequate credit rating.

Q. Please describe the risks associated with PSE's current financial status.

A. Due largely to PSE's high reliance on purchased power and the limited amount of electric generation plant in rate base, PSE's depreciation expenses are very low,

resulting in extremely low cash flow, particularly relative to other comparable electric and gas utility companies. As a result, PSE cannot support the investment needs described above through internal cash flow and must rely on external capital. This high reliance on financial markets, relative to comparable companies, makes accessing capital markets on reasonable terms extremely important.

PSE has consistently under-recovered its authorized return on equity since 2002. This has been caused by a combination of factors including

- absorption of $40 million in excess power costs under the PCA mechanism,
- the impacts of warm weather under a heavily volumetrically-dependent rate design, and
- regulatory lag in recovering infrastructure investments.

Additionally, PSE absorbed a large disallowance associated with Tenaska fuel management of approximately $41 million, pre-tax. As a result, since 2002, PSE has consistently under-recovered its authorized return on equity by an average of 3.5 percent or 350 basis points. Investors are very concerned with the continued ROE under-recovery and with the regulatory risks associated with the power cost volatility described above. Their view, rightly, is that every utility should be in a position to earn its authorized ROE. In order to access capital markets on reasonable terms, it is important for PSE to have a fair opportunity to consistently earn an allowed rate of return on equity that meets investor requirements.

Q. Do you have any opinion regarding how investors will weigh the relative strengths and weaknesses of PSE?

A. Yes, I do. I believe that investors will assimilate these PSE-specific issues and build an analytical framework to quantify risks and potential financial returns unique to PSE. As noted by Mr. Hill in his testimony: "A widely accepted tenet of modern finance is that U.S. capital markets are informationally efficient and news that impacts stock valuation is quickly assimilated into stock prices." (Exhibit No. ___(JLW-1T) at 12, lines 7-9.)

Investors will consider qualitative factors such as management's credibility, and regulatory environment, as well as quantitative factors such as future price/earnings ratio, and cash flow per share. Investors will compare PSE's risk/reward potential with other opportunities in the utility sector as well as with other opportunities in the broader financial markets. As noted by Dr. Wilson in his testimony: "Comparable rates of return from alternative investment opportunities determine the return level that investors can expect to obtain in competitive capital markets at any time." (Exhibit No. ___(JLW-1T) at 26, lines 16-18.)

In addition, overall macroeconomic conditions will drive investment decisions. As noted by Mr. Hill in his discussion of investor cost of equity expectations:

> Because this exercise is, necessarily, based on understanding and accurately assessing investor expectations, a review of the larger economic environment within which the investor makes his or her decision is most important. Investor expectations regarding the strength of the U.S. economy, the direction of interest rates and the level of inflation (factors that are determinative of capital costs) are

key building blocks in the investment decision.

(Exhibit No. ___(SGH-1T) at 6, lines 16-21.) In general, utilities are viewed by investors as bond equivalents because of their dividend yield. During periods of increasing interest rates, investors generally tend to shift their capital from utilities to risk-free government investments. The opposite is true during periods of flat or declining interest rates.

Current uncertainty over the ultimate direction of interest rates given high commodity prices, looming fiscal and trade deficits, and the potential repeal of the recently enacted favorable dividend tax legislation are current investor concerns. This will impact how investors allocate capital to the utility sector and their expected returns from investments in the utility sector. We must acknowledge the fact that interest rates are near 45 year lows and that the probability is high that increases in interest rates in the future are more likely than not. In short, I have significant concerns whether or not the utility sector will remain attractive to investors at current risk/return levels.

Q. How will the likely rise in interest rates affect the relative attractiveness of utilities as investments?

A. A compelling case can be made that utilities will have to increase their total returns to attract capital. Mr. Hill states in his testimony that "capital costs are lower than they have been in more than thirty years." (Exhibit No. ___(SGH-1T) at 8, lines 8-9.) It is no coincidence that a number of utilities have increased their dividends to

boost the yield component of total return. Interestingly, there is an historic correlation between increases in interest rates and increases in utility stock yields. Historically, on average, for every one percent increase (or decrease) in U.S. Treasury yields, the average large-cap utility sector dividend yield increased (or decreased) by 0.85%. The statistical correlation of this relationship was 0.96.

An increase in dividend yield suggests one of two things: (i) either utilities increase their dividend payout levels (an option available to utilities that are at sufficiently strong credit rating levels and have excess cash flow) or (ii) utility stock prices decrease resulting in an increase in yield. (There is an inverse relationship between stock price and yield.) Under either scenario, the cost of capital is higher.

As CFO, it is my responsibility to ensure that PSE has access to financial markets on a competitive basis during periods of market stability and during periods of market volatility. This is especially so given the magnitude of the capital investment that will be required and PSE's dependence on external sources of financing given weak internal cash flow generation capacity.

V. ALLEGATIONS WITH RESPECT TO PSE'S USE OF THE RAINIER RECEIVABLES ACCOUNTS RECEIVABLE SECURITIZATION FACILITY

Q. Would you please respond to Mr. Hill's allegations with respect to PSE's use of its accounts receivable securitization facility, Rainier Receivables?

A. In essence, Mr. Hill alleges in Exhibit No. ___(SGH-1T), that PSE uses the Rainier Receivables accounts receivable securitization facility to (i) dissimulate PSE's actual debt capitalization and (ii) fraudulently fund Puget Energy's non-regulated utility infrastructure construction services business, InfrastruX. This is an outrageous allegation because PSE's use of the Rainier Receivables accounts receivable securitization facility is fully disclosed in PSE's financial statements and fully accounted for in PSE's rate filing before the Commission. Fortunately, this conclusion is so lacking in credibility and so poorly supported that it has received no consideration from financial markets.

For the Commission's benefit, Mr. Gaines's rebuttal testimony, Exhibit No. ___(DEG-9CT), steps through the details of Mr. Hill's erroneous allegations.

VI. CONCLUSION

Q. Please summarize your rebuttal testimony.

A. PSE must confront unique challenges as it embarks on major infrastructure investment programs to support growth in the region and expands existing risk

management platforms to limit energy price shocks for customers. The greatest risk to the success of these important initiatives is PSE's current weak financial position that, under certain circumstances, could limit access to external capital markets, especially given looming macroeconomic and fiscal uncertainties. Management is committed to these strategic programs and to strengthening PSE's credit quality to achieve them and has taken aggressive steps to rebuild the Company's financial strength. The financial recommendations put forward by Messrs. Hill and Wilson are based on flawed logic, are inadequate, and would severely weaken PSE. Importantly, they would severely compromise management's ability to execute the utility's strategic plan. PSE's success can be secured by thoughtful regulatory policies that set an allowed ROE that can actually be achieved and that thicken equity capitalization above existing levels.

While PSE's proposal includes a modest long-term rate increase for customers to support the Company's financial integrity, significant benefits accrue to customers over the long term, resulting in lower rates and less risk over time. In order to fulfill our public service obligations as outlined by Steve Reynolds, PSE must give significant and contractual access to capital markets on reasonable terms to support resource acquisition and infrastructure investment programs. This is a critical opportunity: a small amount of rate relief can provide customer benefits for years to come.

Q. Does that conclude your testimony?

A. Yes, it does.

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