EXHIBIT NO. ___(DEG-9CT)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

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 DONALD E. GAINES (CONFIDENTIAL) ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 3, 2004

REDACTED VERSION

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF DONALD E. GAINES

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PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF DONALD E. GAINES

I. INTRODUCTION

Q. Are you the same Donald E. Gaines who submitted direct testimony in this proceeding on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes.

Q. Please summarize the purpose of your rebuttal testimony.

A. My rebuttal testimony responds to the assertions made by witnesses for Staff for the Washington Utilities and Transportation Commission ("Staff") and Public Counsel, focusing on the appropriate capital structure and associated costs of capital on which rates should be set in this proceeding. Specifically, I address the testimony of Staff witness Dr. John L. Wilson and Public Counsel witness Mr. Stephen G. Hill.

My testimony shows that the capital structures and associated rates of return posited by these witnesses would leave PSE in a worse financial condition than today, that PSE's creditworthiness would be degraded from present levels, and that, as a result, it would be difficult for the Company to attract capital on reasonable terms to fund its resource acquisition and infrastructure needs. My

testimony further demonstrates that the approaches taken by these witnesses ignores several important customer benefits of improved financial strength, which, when actually considered, far outweigh the costs to customers associated with strengthening the Company's financial position.

Q. Does your testimony address the appropriate Return on Equity (ROE) on which rates should be set in this proceeding?

A. No. Dr. Charles Cicchetti will address that topic. However, I use the ROE developed by Dr. Cicchetti in the determination of the Company's appropriate rate of return.

II. CAPITAL STRUCTURE & RATE OF RETURN

Q. Would you please summarize the rates of return proposed by the various parties to this proceeding?

A. Yes. Three witnesses provided testimony on the appropriate rate of return. Those witnesses were Staff witness Dr. Wilson in Exhibit No. ___(JWW-10), Public Counsel witness Mr. Hill in Exhibit No. ___(SGH-18), as modified by Public Counsel's Response to PSE's Data Request to Public Counsel No. 77 (see Exhibit No. __(DEG-10)) and myself in Exhibit No. ___(DEG-8). The rates of return are summarized below:

Table 1: WUTC Staff:

Description	Ratio	Cost Rate	Weighted Cost
Short-term Debt	3.21%	4.55%	0.15%
Long-term Debt	48.58%	6.88%	3.34%
Trust Preferred	6.32%	8.60%	0.54%
Preferred Stock (a)	0.05%	8.51%	0.00%
Common Stock	41.84%	9.00%	3.77%
Total	100.00%		**7.80%**

Table 2: Public Counsel:

Description	Ratio	Cost Rate	Weighted Cost
Short-term Debt	4.36%	4.00%	0.17%
Long-term Debt	48.86%	6.88%	3.36%
Trust Preferred	6.74%	8.60%	0.58%
Preferred Stock (a)	0.04%	8.51%	0.00%
Common Stock	40.00%	9.75%	3.90%
Total	100.00%		**8.02%**

Table 3: PSE:

Description	Ratio	Cost Rate	Weighted Cost
Short-term Debt	3.09%	4.81%	0.15%
Long-term Debt	45.59%	6.88%	3.14%
Trust Preferred	6.28%	8.60%	0.54%
Preferred Stock	0.04%	8.51%	0.00%
Common Stock	45.00%	11.75%	5.29%
Total	100.00%		**9.12%**

(a) Ratio adjusted to make total add to 100.0%.

Please note that I have also updated my Exhibit No. ___(DEG-8C) as Exhibit No. ___(DEG-11C)

Q. Would you please summarize the similarities and differences in these rates of return?

A. The Company, Staff and Public Counsel agree on the cost rates for trust preferred, preferred stock and long-term debt.

Although the short-term debt ratios and cost rates vary slightly among the witnesses, the resulting impact on the rate of return from the suggested level and cost of short-term debt is similar in each of the three proposals.

The major areas of disagreement are in the appropriate equity ratio and ROE.

Q. Please summarize your recommendation regarding the appropriate rate of return to use in determining rates in this proceeding.

A. I remain convinced that the appropriate rate of return for the Company is 9.12%. Taking into account (i) the executed treasury lock which fixes the treasury rate component of the interest rate on the planned bond issuance in 2005, (ii) the expected credit spread component of the interest rate on that issue, (iii) the costs of the Company's new $350 million credit facility and (iv) the return on equity provided by Dr. Cicchetti , the Company's requested rate of return is shown in the table below:

CAPITAL STRUCTURE AND RATE OF RETURN

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-Term Debt	3.09%	4.81%	0.15%
Debt	45.59%	6.88%	3.14%
Trust Preferred	6.28%	8.60%	0.54%
Preferred Stock	0.04%	8.51%	0.00%
Common Equity	45.00%	11.75%	5.29%
Overall Rate of Return	100.0%		**9.12%**

III. COMMON EQUITY RATIO

Q. Please summarize the differences in equity ratio between the Company, Staff and Public Counsel.

A. The equity ratio proposals can be seen in Tables 1, 2 and 3 above. To summarize the proposals, the Company has requested a capital structure consisting of 45% common equity because: 1) that is where it expects to be [redacted]; and, 2) it represents an appropriate balance of "safety and economy," putting the Company in a position to provide a number of benefits to customers while also providing a reasonable degree of protection against a downgrade to non-investment grade status. Staff witness Dr. Wilson has proposed 41.84% because that is the equity ratio he calculates as being

outstanding on average during the rate year.[1] Public Counsel witness Mr. Hill uses 40% because that is approximately where the Company is today[2].

Q. Do the equity ratios proposed by Staff and Public Counsel provide an appropriate balance of safety and economy?

A. No. The Company's credit rating is on the edge of investment grade today and these proposals would jeopardize that rating. The Company's rates are presently based on an equity ratio of 40% and a ROE of 11%. It is the product of those two numbers, 4.40%, that, when applied to rate base, theoretically produces the Company's financial result. I say theoretically because there are other factors such as weather, cost sharing mechanisms and regulatory lag that lead to financial results that are lower than the theoretical number.

From a theoretical basis, one can readily see that, unlike the Company's proposal that would strengthen PSE's credit quality, Staff's and Public Counsel's proposals undermine it. If the weighted cost of equity today is 4.40% and it results in the Company's present financial condition, a lower amount would only weaken the Company's financial results. The weighted equity ratios proposed by Staff and

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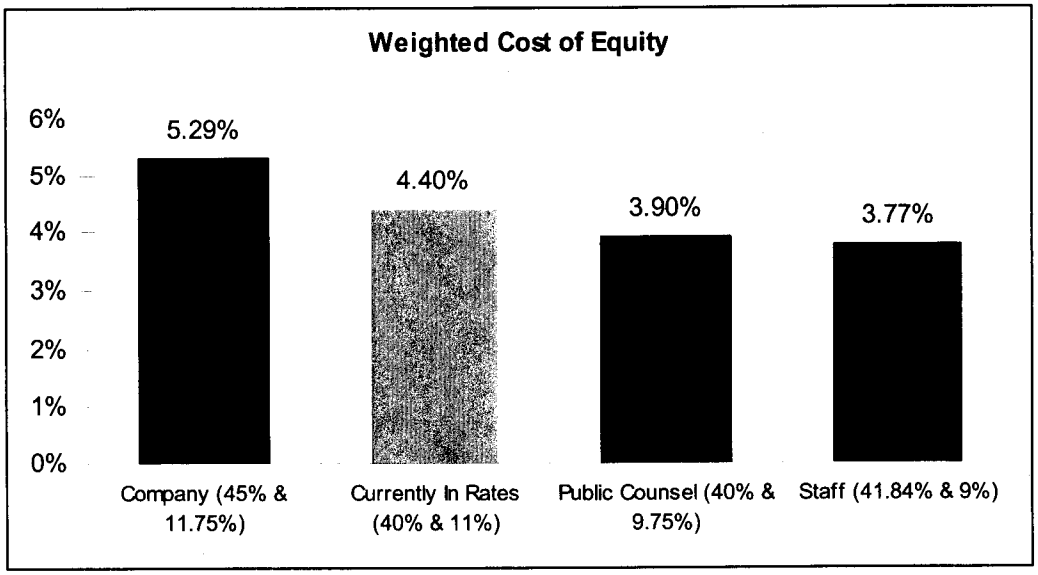
[1] "I have reviewed the Company projected capital balances for the year beginning February 2005, and I have used the average of the projected month balances for the twelve month period February 2005 – January 2006… My result is a capital structure containing 41.84% common equity, 51.69% debt and 6.37% preferred." Exhibit No. ___(JLW-1T), page 35, lines 3-15.

[2] "I recommend that rates be set for PSE using, as a basis, the Company's most recent actual capital structure, including consideration of all short-term debt… For purposes of rate setting, I recommend reducing the amount of total short-term debt in order that the common

Public Counsel are 3.77% and 3.90% respectively. Chart 1 on the following page compares these ratios.

CHART 1



The Staff and Public Counsel proposals undermine the Company's ability to further strengthen its balance sheet as it attempts to attract debt and equity capital to fund its resource acquisition and infrastructure needs as well as to gain the financial strength to further support risk management activities.

One direct way to see this is to examine credit statistics such as debt leverage and the interest coverage ratio that result from the Staff and Public Counsel's proposals. Both Staff and Public Counsel's proposals result in credit statistics that could result in a downgrade by the credit rating agencies.

This can be seen in Charts 2 and 3 below, which show the debt leverage and pre-

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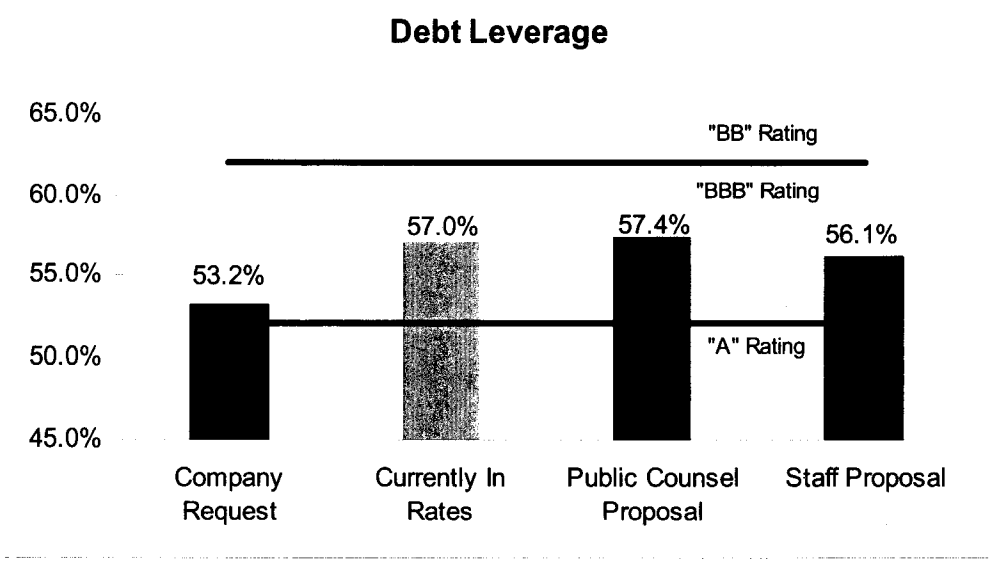
equity ratio be 40% of total capital." Exhibit No. ___(SGH-1T) page 28 line 24 through page 29, line 3.

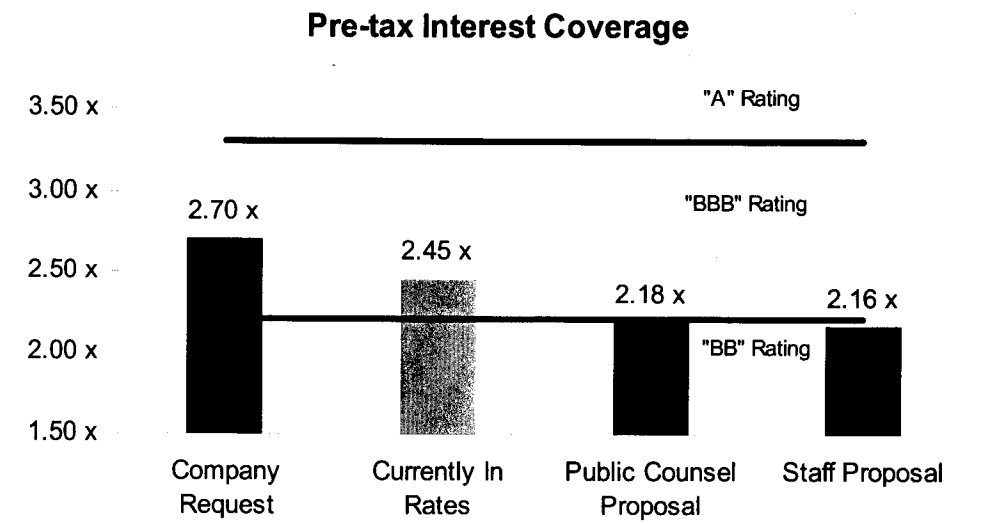
tax interest coverage ratio resulting from the capital structure and rate of return proposals, as well as that reflected in today's rates. The lines in the chart bracket the Standard & Poor's benchmark of a "BBB" rating.

CHART 2



As can be seen in Chart 2 above, Staff and Public Counsel's proposed capital structures do nothing to reduce leverage - thereby not improving the Company's credit quality. Both proposals leave the Company's debt levels at the middle of the range for the current rating (52% to 62%). High debt levels are bad for credit quality. The Company's proposal moves the debt leverage down to the lower end of the range – the end associated with a "BBB+" credit rating.

CHART 3



Worse, Staff and Public Counsel's ROE and capital structure proposals move the Company's theoretical pre-tax interest coverage below the bottom end of the range for a "BBB" rating as shown in Chart 3 above. Securities rated at the level below the "BBB" range are considered non-investment grade or "junk." The benchmark range for the pre-tax interest coverage ratio for a firm with the Company's business position is 2.20x to 3.30x. Staff and Public Counsel's proposals result in Pre-tax Interest Coverage ratios of 2.16x and 2.18x respectively. And these are the theoretical coverage ratios--the actual ratios would be lower as a result of the factors mentioned earlier -- weather, cost sharing mechanisms, and regulatory lag. Dr. Cicchetti discusses these sources of earnings drag further in his testimony, Exhibit No. ___(CJC-6T).

Q. Public Counsel witness Mr. Hill has testified that his proposal affords the Company an opportunity to achieve a pre-tax interest coverage ratio of 2.46

times.[3] Do you agree with that?

A. No. Public Counsel has ignored the impacts of the additional leverage the rating agencies impute related to the Company's purchased power contracts. Both Standard & Poor's and Moody's impute debt on purchased power contracts. Standard & Poor's refers to this on page 27 of Exhibit No. ___(DEG-5). Specifically, Standard & Poors calculates the present value of the capacity portion of purchase power payments using a 10% discount rate and a half-year convention. For contracts where no capacity payment is specified, Standard & Poor's assumes 50% of the payment is for capacity. This methodology is described in detail in a report published as far back as 1994. (*See* "Standard & Poor's Corporate Finance Criteria", at page 28 (1994).) The Company makes this calculation and includes it in its rating agency presentations, several of which were provided to Public Counsel in PSE's data request responses in this proceeding The Standard & Poor's methodology results in approximately $428.2 million of imputed debt related to PSE's existing long-term purchased power obligations. When you include the impact of imputed debt, Mr. Hill's 2.46 times coverage ratio drops to 2.16 times, below the range for an investment grade credit rating.

In addition to the imputed debt related to the Company's existing purchased power contracts, the Company may enter into new purchased power contracts as part of meeting its resource acquisition needs as Mr. Markell has testified. Any

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[3] Exhibit No. ___ (SGH-1T) page 4, lines 10-11.

new contracts will result in additional imputed debt, resulting in the need for additional equity to maintain a constant level of credit quality. This is a feature of purchased power agreements--the debt imputed by the credit rating agencies results in the need for equity *on the books* to balance the additional financial risk. As additional contracts commence, there is a need for additional equity just to maintain the comparable level of credit worthiness.

Q. Do Staff and Public Counsel suggest that the Company's requested 45% equity ratio is imprudent?

A. No, they do not. Both Dr. Wilson and Mr. Hill testify that if the Company had its requested equity ratio already in place, it would be reasonable to set rates on that level of equity. Specifically, Mr. Hill testifies: "[I]f, by the time of the next rate proceeding, the Company has achieved a common equity ratio of 45%, then it would be reasonable to consider it for ratemaking purposes." Exhibit No. ___(SGH-1T) at 24, lines 22-23.

Dr. Wilson testifies "While these percentages [the Company's requested capital structure percentages] do not represent an unreasonable capital structure per se, the common equity percentage is higher than the Company's actual common equity component at the present time and higher than projected common equity throughout 2005." Exhibit No. ___(JLW-1T) at 30, lines 8-11.

Q. Is Dr. Wilson correct regarding the Company's projected common equity ratio?

A. His statement is technically correct but misleading. Notably, Dr. Wilson's assertion that the Company will not actually achieve the requested 45% equity ratio extends only to the end of 2005, [redacted]. As described in my direct testimony in this proceeding, the Company's financing plan during the rate year includes a common stock issue that achieves [redacted]. *See* Exhibit No. ___(DEG-8C) at page 2, line 18.

It is necessary to time equity issuances to support the resource acquisition process; otherwise, the proceeds from the equity sale are not put to an efficient use. As described in my testimony as well as in Mr. Markell's and Mr. Valdman's testimonies, the Company still anticipates issuing equity sufficient to meet the requested 45% ratio [redacted], based upon the progress on its resource acquisition process since the Company filed its direct case last April.

Q. Mr. Hill has testified that the Company's requested 45% equity ratio is above that used, on average, in the utility industry.[4] Do you agree with this statement?

A. No, I do not. As set forth in my direct testimony, Exhibit No. ___(DEG-4), shows the average equity ratio on which rates were based for all electric, gas and combination utility regulatory proceedings across the nation from January 2003

[4] "The evidence available in the market indicates that the capital structure requested for ratemaking purposes by PSE contains a level of equity capital above that used, on average, in the combination electric/gas utility industry." Exhibit No. ___(SGH-1T), page 21, lines 10-12.

through March 2004. The common equity ratio averaged 49.7% -- higher than the Company's requested 45% and substantially higher than what Mr. Hill is suggesting. And this 49.7% figure is not based on any selective picking and choosing of other utilities -- this is the average of common equity ratios for all gas and electric utilities that went through rate case proceedings for which the data is available. I note as well that the ROE applied to this equity ratio for all these utilities across the nation averages exactly 11% -- higher than what both Staff and Public Counsel have testified is appropriate, yet they would apply their significantly lower ROEs to a substantially lower equity ratio.

Exhibit No. ___(DEG-4) filed with my direct testimony contained data through March 31, 2004. My Exhibit No. ___(DEG-12) is identical to Exhibit No. ___(DEG-4), except that I have now updated that exhibit to contain results through June 30, 2004 – the most recent period for which such data is available. I say where the data is available because there have been some proceedings that resulted in rate settlements that did not specify an equity ratio or return on equity. The new average ROE is 10.9%, down slightly from the 11% average in the prior exhibit, and the new average equity ratio to which that ROE was applied is 48.6%, down from the 49.7% included in my earlier exhibit. Even so, these revised averages are well above what Mr. Hill and Dr. Wilson are recommending.

As can be seen in Chart 1, above, the product of the suggested equity ratio and ROE for the Company, Public Counsel and Commission Staff have weighted-average cost of capitals of 5.29%, 3.90% and 3.77%, respectively. Exhibit No. ___(DEG-12) shows the average weighted costs of capital from recent

regulatory decisions was 5.33%, well above the proposals of both Commission Staff and Public Counsel but very close to the Company's requested 5.29%. This shows that the proposals of Commission Staff and Public Counsel are out of sync with the equity ratios and ROEs on which rates are being set across the nation.

In addition, a close examination of the new data for the second quarter of 2004 shows no instances where a state utility commission has authorized a single digit ROE, as Mr. Hill and Dr. Wilson are suggesting this Commission should do.

Furthermore, a close examination of the companies cited by Mr. Hill at Exhibit No. ___(SGH-1T) at 5, lines 5-10 and footnote 1, as having single digit allowed ROEs shows that such ROEs were applied to substantially higher equity ratios than the 45% equity ratio proposed by the Company. In fact, the average of the equity ratios from the cases cited by Mr. Hill was 54.1%, which yields an average weighted cost of equity for such companies of 5.06%. (*See* Exhibit No. ___(DEG-13).) Even though Mr. Hill's list contains water companies, pure transmission and distribution companies and telecommunications companies, this average weighted cost of equity of 5.06% is still markedly higher than the 3.90% and 3.77%, proposed by Public Counsel and Commission Staff, respectively.

Q. Do Staff and Public Counsel claim that the Company's requested 45% equity ratio represents an inappropriate balance of safety and economy?

A. No, they do not. Neither Dr. Wilson nor Mr. Hill has addressed the safety and economy of the Company's requested capital structure. They base their objections on the notion that the anticipated interest savings on the planned bond

issue resulting from the higher credit rating that would likely result from the Company's requested 45% equity ratio is less than the cost to customers of setting rates on the higher equity ratio. In essence, they have replaced the "safety and economy" standard previously used by this Commission with a simple "interest savings test" for which I am aware of no precedent.

Their simplistic test, as posited, does not take into account a number of factors that provide direct benefits to customers. The test ignores the value a higher credit rating affords customers through the Company's energy cost hedging efforts, as Ms. Ryan testifies. It also ignores the value to customers of the increased financial flexibility -- the ability to weather stormy capital markets and industry events -- such a credit rating would provide. It incompletely considers lower financing costs and provides no assessment of the volatility of credit spreads, as Mr. Valdman explains in his testimony.

Q. In past proceedings the Company has requested that rates be set on the average capital structure, but in this proceeding you are requesting that rates be set on the end-of-rate year capital structure. Why?

A. It is the Company's goal to achieve a "BBB+" credit ratio. Achieving the 45% equity ratio and having it reflected in rates, coupled with a reasonable ROE, will likely result in this credit rating over time. When a Company is growing its equity base, setting rates on the average capital structure will result in a lag where there is equity in place but it is not reflected in rates. That would result in the Company under-earning its return on equity and would hinder the Company's

efforts to strengthen its financial condition.

As can be seen on page 4 of my workpapers, the Company expects to exceed the 45% equity ratio, moving to [redacted], while achieving [redacted] in February of that year. Reflecting in rates the equity capitalization that will be in effect for the period rates will likely be in effect is balanced and reasonable, would increase the likelihood that Company could earn its rate of return, and would be viewed by the financial community as supportive of the Company's commitment to improved credit quality.

PSE is not seeking a "hypothetical" capital structure as contended by Public Counsel witness Mr. Hill. To the contrary, the Company is simply requesting that its projected actual capital structure be reflected in rates.

IV. CUSTOMER BENEFIT OF INCREASED CREDIT RATING

Q. Have you tried to quantify the cost and benefits to customers of the increase in the Company's equity ratio and credit rating?

A. Yes, I have. First, I must note that, as the Company has described in the prefiled direct testimony of Ms. Ryan, Mr. Markell, Dr. Cicchetti, Mr. Valdman and myself, there are an array of significant benefits associated with an improved credit rating.

Many benefits are not quantifiable, while others can be quantified within a reasonable range. In my testimony that follows, I summarize the range of

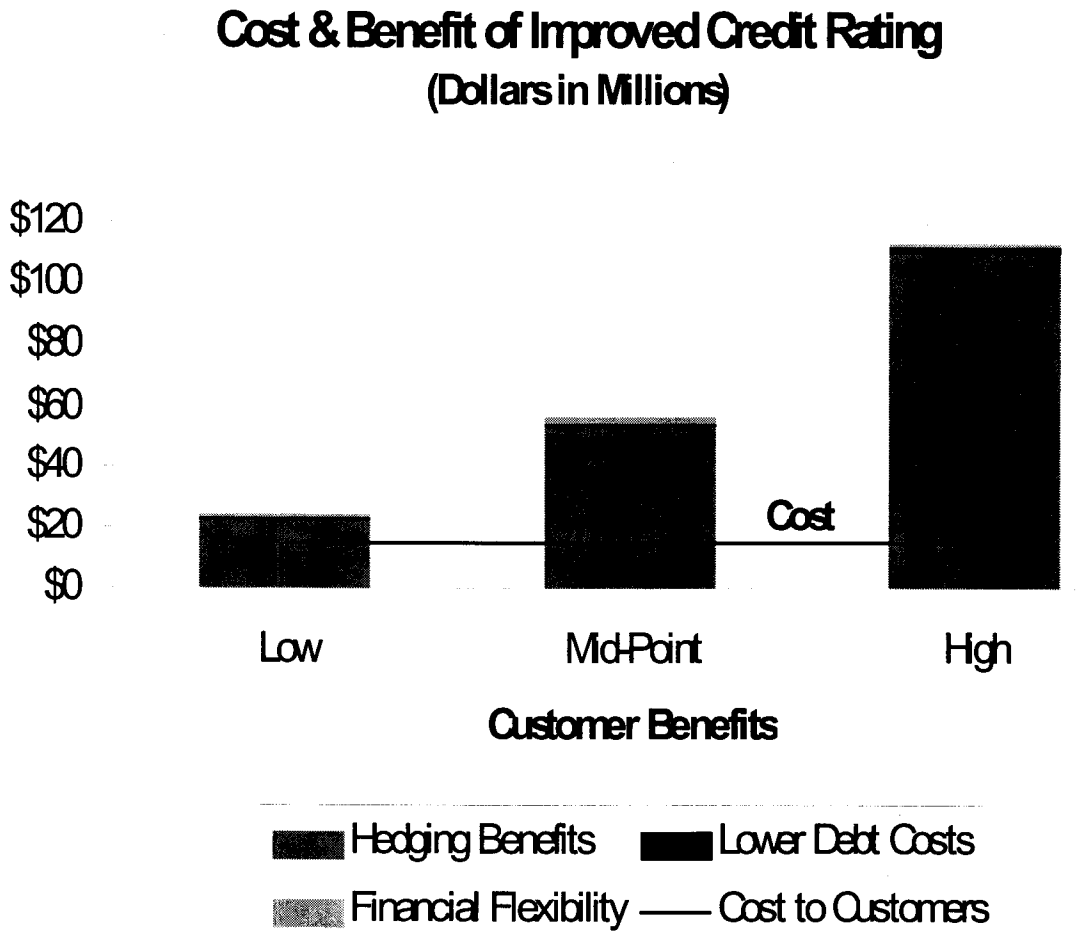
quantifiable benefits, such as increased financial flexibility, capital costs associated with the resource acquisition program and risk management, and avoiding the financial consequences of a downgrade, are discussed in the testimonies of the above witnesses and in PSE's Response to WUTC Staff Data Request No. 223, a copy of which is provided as Exhibit No. ___(DEG-14).

Consideration of the quantifiable and non-quantifiable benefits shows that the customer benefits of credit rating improvement easily outweigh its cost.

In quantifying these benefits, I have made a calculation similar to that used by Mr. Hill, but I've corrected the deficiencies in his approach. In summary, the cost to customers of the increase in the equity ratio from 40% to 45% is approximately $15.5 million and the value to customers of that higher equity ratio, on average, is approximately $62 million. In other words, the average benefit is expected to be nearly four times the cost. However, there is a range to the customer benefits, which the chart depicts. Even at the low end, the customer benefit from a higher credit rating could exceed the cost by $8 million. At the high end of the range, the consumer benefits could be more than seven times the cost.

I've prepared the chart below to visually show the customer benefits resulting from an improved credit rating and how those benefits exceed the cost of a higher equity ratio.

CHART 4



The above chart compares the $15.5 million cost of the higher equity ratio, as shown but the horizontal line, with the three types of customer benefits that I have been able to quantify (the benefits to energy hedging as described by Ms. Ryan in her prefiled rebuttal testimony, lower financing costs and increased financial flexibility). This list is not complete as there are other benefits that I have not been able to quantify.

Q. Mr. Hill claims that the value to customers of the higher equity ratio is

limited to annual interest savings of $850,000.[5] Do you agree?

A. No, I do not. There are additional customer benefits that would result from a higher credit rating. The benefit is not simply limited to savings on incremental long-term bond issues. These additional benefits include the value of the risk management capabilities associated with additional net benefits from hedging activities, a reduction in short-term borrowing costs, and, the value of financial flexibility.

Q. Have you attempted to quantify the value of these additional customer benefits?

A. Yes, I have. These benefits, which I describe below, are calculated as shown in Exhibit No. ___(DEG-15).

1. Interest Savings on Long-Term Debt

There are interest savings from a higher credit rating, however, these are not limited to the savings on the incremental bond offering as Mr. Hill describes. There is also a reduction in the cost of the Company's short-term liquidity facilities, which I will discuss later.

With a credit rating upgrade, customers would benefit from a lower cost on incremental borrowings, as Mr. Hill describes, but he has not accurately

[5] Exhibit No. ___(SGH-1T), page 23, lines 15-23.

determined that benefit. Rather than assuming $500 million[6] in incremental borrowings, I've used the Company's projected financings as described in Exhibit No. ___(DEG-8), which total $300 million. Mr. Hill describes the benefit in the coupon rate from a credit upgrade as 0.17%. I have found that to range from 0.168% to 0.244%, so I've used that range. As a result, I calculate a savings on the Company's planned financings that ranges from $504,000 to $732,000. Please note that I've limited this calculation of the customer benefit from lower interest costs just on the two bond issue planned during the rate year.

The Company has approximately $775 million of securities maturing in the next five years, and the Company faces over $1.2 billion in maturities over the next ten years. The savings to customers, over time, on refinancing those maturities would be much larger. For purposes of this testimony, however, I will follow Mr. Hill's methodology of making the calculation for a single year.

2. Reduced Short-term Borrowing Costs

Second, the Company's liquidity facilities contain a pricing grid based on the Company's credit rating. The higher the credit rating, the lower the cost. Conversely, the lower the rating, the higher the cost. As I testified in my prefiled testimony, an increase in the Company's credit rating would result in an increase in the Company's commercial paper rating. This would reduce the interest rate on

[6] Exhibit No. ___(SGH-1T), page 23, lines 19-20.

the Company's commercial paper borrowings.[7] The Company's commercial paper is presently rated "A-3" by Standard & Poor's and "P-2" by Moody's. Page 83 of Exhibit No. ___(DEG-5) shows that the Company's commercial paper rating would increase to "A-2" if its credit rating were to increase to "BBB+". Such an improvement in the Company's commercial paper rating would reduce its cost of commercial paper by approximately 0.08% to 0.15%. This range of interest rate savings, applied to the approximately $55 million[8] of commercial paper expected to be outstanding during the rate year would result in a customer benefit of $44,000 to $82,500.

The Company's liquidity facilities also contain "credit sensitive pricing" where the commitment fees paid are tied to the Company's credit rating. A commitment fee is the amount charged by banks for making credit available. At the Company's current credit ratings, the Company pays commitment fees of 0.25% on its $350 million bank credit facility and a 0.35% on its $150 million receivables securitization facility. If the Company's credit rating improved, these commitment fees would reduce to 0.15% and 0.30%, respectively. This commitment fee reduction of 0.10% in the credit agreement and 0.05% in the receivables securitization facility would reduce the total amount of commitment fees paid by $426,500 per year ($350 million x 0.10% + $150 million x 102% x 0.05%).

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[7] Exhibit No. ___(DEG-1CT), page 13, lines 1-5.

[8] Exhibit No. ___(DEG-8C), page 4, line 9, column (O).

The receivables securitization facility also contains a program fee. The program fee is paid on the amount borrowed under the facility, not on the aggregate size of the facility. At the Company's present credit rating, the program fee is currently 0.20%. If the Company were upgraded to "BBB+", the program fee would drop to 0.15%, a 0.05% reduction. The lower program fee applied to the approximately $83 million[9] of borrowings under the receivables securitization facility expected to be outstanding during the rate year would result in a customer benefit of $41,500.

As a result, the customer benefit resulting from lower short-term borrowing costs would range from $512,000 to $550,500.

In my chart, I have combined the benefits from lower short-term and long-term borrowing costs into one lower debt cost range. The total borrowing cost benefit therefore ranges from $1,016,000 to $1,282,500.

3. Net Hedging Benefits

Third, as Ms. Ryan testifies, there is a net benefit to customers of increased hedging capability that would likely result from an improved credit rating. As Ms. Ryan testifies at Exhibit No. ___(JMR-12T), these benefits range from $21.9 million to $115.3 million. Mr. Hill made no attempt to quantify this benefit. I have included this range of customer benefits in my chart.

4. Financial Flexibility:

[9] Exhibit No. ___(DEG-8C), page 4, line 10, column (O).

Fourth, as Mr. Valdman and I testified in our prefiled testimonies, there are a number of benefits associated with financial flexibility. One such benefit that can, to some extent, be quantified is having some cushion in credit rating above non-investment grade status.

Financial flexibility is needed to enable continuous access to capital markets on reasonable terms.[10] Having this cushion, having the ability to withstand financial difficulties without dropping below investment grade to "junk" status, can be quantified. This quantification is the value to customers of financial flexibility.

I have calculated the customer benefits of financial flexibility by looking at the costs that would be avoided by having a reasonable cushion above "junk" status. There are several benefits of avoiding the drop to below investment grade status. These include avoiding the incremental cost of hedging activities, as Ms. Ryan testifies, avoiding more expensive long-term and short-term borrowing costs, and avoiding the higher cost of equity investors would demand for investing in a more risky firm.

As Ms. Ryan testifies at Exhibit No. ___(JMR-12T), the loss in net hedging benefit from a credit rating downgrade is estimated to be approximately $11.6 million. Avoiding that loss is part of the benefit of financial flexibility.

Were the Company downgraded to below investment grade, its long-term borrowing costs would increase. The increased credit spread for sub-investment

grade 30-year debt has ranged from 0.046% to 1.116% over the cost of "BBB" rated bonds. Applying that range of increased borrowing costs to the Company's planned $300 million of incremental borrowings in the rate year, as described above, would increase the Company's borrowing costs from $138,000 to $3,348,000. Avoiding that increased costs is also a benefit resulting from improved financial flexibility.

The Company's short-term borrowing costs would also increase. As can be seen on Exhibit No. ___(DEG-5) at 83, if the Company's credit rating was reduced to below investment grade, its commercial paper rating would drop to "B". There is no viable market for "B" rated commercial paper. As a result, the Company would no longer have access to the commercial paper market and would be forced to meet its short-term debt needs by borrowing through its receivables securitization and bank credit agreement. A downgrade would increase the borrowing costs (interest cost and fees) under the receivable securitization and bank credit facilities by approximately $1,429,800.

As a result the total avoided borrowing costs from increased financial flexibility ranges from $1,567,800 ($138,000 + $1,429,800) to $4,777,800 ($3,348,000 + $1,429,800).

Were the Company to drop below investment grade, not only would its borrowing costs increase, but equity investors would demand a greater return on their

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[10] Exhibit No. ___(DEG-1CT), page 11, lines 4-6.

investment to compensate for the increased financial risk. Dr. Cicchetti has testified that the Company's cost of equity is presently 11.75%.

While the cost of equity would certainly increase reflecting the increased risk of the Company, there are too many unknowns to be able to quantify the increased cost. As a result, I have not included this in my calculations. But, that does not mean this cost does not exist. It simply remains one of the costs that are not quantifiable.

As a result, the benefit of having the financial flexibility to avoid a downgrade ranges from approximately $13.2 million to $16.4 million, as can be seen in Exhibit No. ___(DEG-15) on page 3

However, there is not 100% certainty that the Company would experience the type of event that would result in a downgrade. As a result, it is appropriate to adjust this range by a risk or probability factor. Assuming the Company would experience such an event once in every ten years, the probability factor would be 10%. Were the company to experience such an event once in every 5 years the probability factor would be 20%. For the purposes of this analysis, I have conservatively used a probability factor of 10%. That seems reasonable in light of the fact that the Company did experience a downgrade within the last 10-years – in 2001. Weighting the range of avoided costs from a downgrade by the probability factor yields a range from approximately $1.3 million to $1.6 million, which I use as the customer benefit of having sufficient financial flexibility to avoid a downgrade to below investment grade status. While I've weighted these

costs for the purposes of this analysis, were the downgrade to below investment grade occur, customers would experience these total downgrade costs, which I have calculated to range from $13.2 million to $16.4 million.

To summarize, the quantifiable customer benefits from a credit rating upgrade, I have prepared the table below. The details behind this table can be found in Exhibit No. ___(DEG-15).

CUSTOMER BENEFITS FROM INCREASED CREDIT RATING
(Dollars in Thousands)

Benefit	Low End of Range	Mid-Point	High End of Range
Reduced borrowing costs	$1,016	$1,050	$1,283
Net benefits from hedging	$21,900	$59,000[11]	$115,300
Financial flexibility	$1,317	$1,473	$1,637
Total	**$24,233**	**$61,523**	**$118,220**

Q. Mr. Hill testifies that cost to customers of the higher equity ratio is about $15.7 million,[12] do you agree with this amount?

A. No, I do not. There are both data errors and conceptual errors in Mr. Hill's approach. When I follow the methodology described by Mr. Hill, correcting the data errors, I calculate a cost of $19.5 million. The main difference between these amounts is the rate base value used in the calculation. Mr. Hill uses a rate base of

[11] Mid-point of the low and high end of the range.

[12] Exhibit No. ___(SGH-1T), page 23, lines 5-14 and Exhibit No. ___(SGH-7), page 4.

$2.6 billion, which appears to reflect only the electric rate base. The Company's electric rate base is $2.546 billion as Mr. Story testifies in Exhibit No. ___(JHS-E3), but I would use total gas and electric rate base. The Company's gas rate base is $1.068 billion as Ms. Luscier testifies in Exhibit No. ___(BAL-G3). The total gas and electric rate base, is therefore approximately $3.6 billion.

I have corrected another flaw in Mr. Hill's analysis. While I agree with Mr. Hill that the Company's requested capital structure produces a pre-tax overall cost of capital of 11.96%, or 11.97% as revised in this rebuttal testimony, I disagree that the Company's requested cost rates and PSE's actual average capital structure results in a pre-tax cost of capital of 11.35% as shown in Mr. Hill's Exhibit No. ___(SGH-7) at 4. Using the average capital structure Mr. Hill calculates on page 1 of that exhibit and using the Company's cost rates, I get 11.43%. As a result, the difference in the pre-tax cost of capital should be 0.54% (11.97% - 11.43%), not 0.61% (11.96% – 11.35%) as Mr. Hill testifies. The difference of 0.54% multiplied by a $3.614 billion total gas and electric rate base number results in a cost to customers, using Mr. Hill's methodology, of approximately $19.5 million.

But, Mr. Hill's methodology also contains a conceptual error. The cost to customers should not be based on the comparison of the Company's actual capital structure to its request, but on a comparison of what is presently in rates to the Company's request. Gas and electric rates are presently based on a 40% equity ratio, not the 38.97% Mr. Hill uses. The incremental cost should therefore be the cost difference in moving from 40% to 45%, not in moving from 38.97% to 45%

as Mr. Hill states. When I make that correction to his methodology, I calculate a cost to customers of $15.5 million. This can be seen on page 5 of Exhibit No. ___(DEG-15).

Q. Do others in Washington State see the value of a credit rating higher than the Company's current "BBB-" rating?

A. Absolutely. There is only one electric or gas utility that serves a large segment of the State's population that has a credit rating lower that PSE's and that utility is Avista. The two major Western Washington municipal utilities, Tacoma City Light and Seattle City Light have credit ratings at the higher "A" level. The four Public Utility Districts, three of which PSE purchases its mid-Columbia power, Snohomish County, Chelan, Douglas and Grant County PUDs, all have ratings in the higher "AA" level. Cascade Natural Gas has the Company's desired "BBB+" rating and Northwest Natural Gas has a higher "A" rating – all higher than PSE's rating. In fact, even Washington State's general obligation bonds carry at "AA" rating. I have summarized this in a table in Exhibit No. ___(DEG-16).

V. PREFERRED STOCK RATIO & COST

Q. Do Staff and Public Counsel agree with the amount of preferred stock included in the Company's capital structure?

A. Not exactly, but they are close, as can be seen in Tables 1,2 and 3 of my testimony.

Although Mr. Hill basically agrees with the amount of preferred stock that should be included in the Company's capital structure for rate making purposes, he states, "the Company's decision to eliminate $100 million of preferred stock effectively raises the total debt-to-total capital ratio and the resultant financial risk for the firm. Therefore the Company's action to reduce its preferred stock position does not square with its stated concern regarding reducing financial risk."[13] This statement does not accurately describe the Company's actions with respect to its preferred stock, nor is it consistent with Mr. Hill's testimony that preferred stock is fixed income capital.[14]

Preferred stock is not considered on a par with common stock in terms of creditworthiness by investors or the credit rating agencies. Preferred stock contains some equity-like features, such as deferrable dividends (a feature also present in the Company's trust preferred securities), but in practice, investors view preferred stock akin to fixed income securities. This fact was recognized by Moody's over five years ago. (*See* Moody's Tool Kit: A Framework for Assessing Hybrid Securities, at 5.) Standard & Poor's has a similar view, as can be seen on page 99 of Exhibit No. ___(DEG-5). As a result, the credit rating agencies do not consider it on a par with common stock when assessing the strength of the balance sheet.

The Company refinanced its preferred stock using the proceeds of a $100 million

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[13] Exhibit No. ___(SGH-1T), page 25, lines 16-19.

common stock sale. This information was contained in a news release Puget Energy issued on October 31, 2003, the title of which was "Puget Energy Agrees to Sell 4.55 Million Shares of Common Stock -- $100 million sale to fund redemption of high-cost preferred stock; nondilutive to earnings per share." As a result, the preferred stock -- a fixed income debt-like security -- was replaced with common equity. This reduced the Company's leverage and thereby also reduced its financial risk.

As a result of this redemption, the Company has very little traditional preferred stock in its capital structure. Traditional preferred stock represents less than 1% of the Company's total capitalization. Many other utilities are also reducing their use of preferred stock. A recent survey of fifty-seven gas and electric utilities' use of preferred stock shows the median amount of preferred in the capital structure was 0.6% and the average was 1.8%. The Company's use of preferred stock is therefore consistent with that of others in the industry.

Q. Does Dr. Wilson share Mr. Hill's concerns regarding preferred stock?

A. No. Dr. Wilson proposed the same preferred stock and trust preferred stock ratios and cost rates included in my direct testimony.

VI. DEBT RATIO & COST

Q. Would you please explain how Dr. Wilson's and Mr. Hill's debt ratios vary

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[14] Exhibit No. ___(SGH-1T), page 25, line 7.

from yours?

A. Yes. Dr. Wilson testified that he used the average ratios for the 12-month period from February 2005 through January 2006. Dr. Wilson also uses average PSE *consolidated* common equity, without removing the impacts of non-regulated operations.

Mr. Hill proposes that rates be set on a higher amount of debt. This mainly stems from his belief that rates should be set on the Company's most recent actual capital structure. As a result, his debt ratios are based on the Company's March 31, 2004 capitalization, using an adjusted short-term debt ratio to make his proposed equity ratio 40%.[15]

Q. Do you agree with these approaches?

A. No, I do not. Dr. Wilson's 12 month period does not reflect the rate year, which is the period March 2005 through February 2006. Dr. Wilson's approach also uses consolidated common equity of the parent company, rather than the common equity of PSE, the regulated utility subsidiary. By ending his calculations in January 2006, before the end of the rate year, he does not include the impact of the common stock issuance included in the Company's financial plan in February 2006.

Page 3 of my workpapers shows a [redacted] that results in

[redacted] or [redacted]. It is this equity issue that, when combined with retained earnings, moves the Company's equity ratio to [redacted]. Were Dr. Wilson to include that in his calculations, his debt ratios would be lower and his equity ratio would be higher, although the average would still be lower than the [redacted] amount I believe is appropriate.

Mr. Hill's use of the current actual capital structure does not reflect the capitalization that will be in effect when the rates are in effect. While he believes it inappropriate for customers to pay for equity not presently in place[16], he seems to think it acceptable that shareholders commit capital without having an opportunity to earn a fair return on it reflected in rates. As a result, he proposes that rates be set on a higher proportion of debt than will be reflected in the Company's capitalization during the rate year. This does not afford the Company an opportunity to earn its fair rate of return.

As mentioned above, Dr. Wilson uses average *consolidated* common equity of the unregulated parent company without removing the impacts of non-regulated operations. Because, in aggregate, the non-regulated operations have negative retained earnings, and therefore negative common equity, the impact of Dr.

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[15] "For purposes of rate setting, I recommend reducing the amount of total short-term debt in order that the common equity ratio be 40% of total capital." Exhibit No. ___(SGH-1T), page 29, lines 1-2.

[16] "Therefore, the further strengthening of Puget Sound Energy's balance sheet, sought by the Company is this proceeding, should not be realized through continuing to require

Wilson's methodology is to reduce the regulated utility's common equity by approximately $19.5 million.

To illustrate this approach, assume the regulated utility's common equity was $100, and non-regulated operations had equity of ($19), resulting in *consolidated* equity of $81. In this example, Dr. Wilson's approach would set rates on consolidated equity of $81, rather than the regulated utility equity of $100. His rationale for this approach is explained as follows: "Dr. Wilson is not aware of any justification for increasing the common equity ratio used for utility ratemaking to compensate for subsidiary finances."[17]

The Company has historically excluded the impacts of non-regulated results from PSE's *consolidated* common equity so that rates are set exclusively on regulated common equity. The rationale is that PSE's consolidated common equity is comprised of two parts: (i) the common equity of the regulated utility, and (ii) the common equity of non-regulated operations (such as Puget Western, Hydro Energy Development, the Washington Energy Co. non-regulated holding company (WECO), etc.). The Company's calculation appropriately excludes the impact of non-regulated operations from *consolidated* equity, to focus, for ratemaking purposes, on the common equity of the regulated utility. Were Dr. Wilson to focus on the regulated common equity, his average equity ratio would be 42.10%, rather than the 41.84% he calculates.

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ratepayers to provide returns on equity capital the Company does not have." Exhibit No. ___(SGH-1T), page 24, lines 17-20.

Q. Is the main difference between Dr. Wilson's debt ratios and yours his use of average capitalization and your use of end-of-period capitalization?

A. Yes. We both use the same projected numbers, but Dr. Wilson calculates an average where I use the end of period capitalization. For the reasons explained earlier, when the Company's equity ratio is increasing, using the average will result in the Company under-earning its rate of return. Therefore, I believe in this case, it is appropriate to set rates on the end of period capital structure.

Q. Do you agree with the costs of debt proposed by Dr. Wilson?

A. No. While Dr. Wilson apparently agrees on the cost of long-term debt, there are differences in the cost of short-term debt. Dr. Wilson proposes a short-term debt cost rate of 4.55%, while I believe the appropriate short-term debt cost rate is 4.81%.

Dr. Wilson's short-term debt cost rate is slightly lower than mine because he divides the costs, upon which we basically agree, by a higher amount of short-term debt. He uses a higher short-term debt level because he sees the projection for February 2006 is that the Company has no short-term debt outstanding. It is his belief that this overstates the cost of short-term debt.[18] The Company's

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[17] See Exhibit No. ___(DEG-10).

[18] "Because PSE includes an assumed short-term debt balance of zero for February 2006, it is my opinion that the Company's approach understates the low cost, short-term debt component of their capital structure. Also, because the short-term debt commitment fees remain fixed, understating the amount of short-term debt unduly increases the implied short-term debt cost." Exhibit No. ___(JLW-1T), page 35, lines 8-13.

projected short-term debt balance is zero in February because it is projecting to sell $90 million of common equity that month. The receipt of those proceeds, combined with cash from operations, results in the projected zero balance that month. This is a temporary phenomenon, strictly related to the sale of common equity, but it will affect PSE's cost of debt during the rate year.

Dr. Wilson and I basically agree on the short-term debt costs, but we differ slightly in calculating the cost rate that ensures those costs are adequately recovered. Interestingly, his weighted cost of short-term debt, the portion of the rate of return recovering short-term debt costs, is 0.15% which is equal to mine. So, although our methodologies differ, we end up at the same place regarding costs to be recovered.

Q. Do you agree with the costs of debt proposed by Mr. Hill?

A. No. While Mr. Hill apparently agrees on the cost of long-term debt, there are also differences in the cost of short-term debt. Mr. Hill proposes a short-term debt cost rate of 4.00%, while I believe the appropriate short-term debt cost rate is 4.81%.

Mr. Hill's testimony does not provide any support for his 4.0% short-term debt cost rate. He testifies at some length about short-term debt, baselessly accuses the Company of misusing its securitization facility,[19] finds it difficult to understand

[19] "It is also not clear whether the short-term debt issued by Rainier Receivables is being used to fund PSE's cash needs, or the needs of Puget Energy's unregulated operations." Exhibit No. ___(SGH-1T), page 26, lines 14-16.

the proper accounting treatment for this facility,[20] states that he's not convinced the Company's numbers are reasonable[21] without providing any explanation for this statement, then asserts 4.0% cost rate for which he provides no support or documentation.[22]

When asked in a data request for the derivation of this number, Mr. Hill responded by stating: "[I]t has been Mr. Hill's experience over the past 20 years of investigating utility financial management practices that 4% is a reasonable amount of short-term debt – especially in a low interest rate environment."[23] Mr. Hill's professional qualifications show that he has been employed as an engineer, a rate of return analyst and a consultant. (See also Exhibit No. ___(SGH-2).) His qualifications show no experience in either negotiating or utilizing short-term borrowing arrangements.

I do not agree with Mr. Hill's cost rate, which has no basis in fact or in the financing realities facing the Company. By contrast, I understand Dr. Wilson's approach.

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[20] "Also, given the fact that Rainier Receivables debt does not appear on PSE's books it is difficult to know if the Company is projecting its actual short-term debt usage." Exhibit No. ___(SGH-1T), page 28, lines 8-10.

[21] "With regard to short-term debt, however, I'm not convinced that the 4.71% forward cost rate proposed by the Company is reasonable." Exhibit No. ___(SGH-1T), page 29, lines 9-11.

[22] "For rate setting purposes, then I believe a forward-looking short-term debt rate of 4.0% is reasonable." Exhibit No. ___(SGH-1T), page 29, lines 17-18.

[23] Mr. Hill's response to PSE Data Request No. 49 to Public Counsel.

Q. Does this conclude your testimony on debt as well as capital structure and rate of return?

A. Yes, it does.

VII. RAINIER RECEIVABLES

Q. What is Rainier Receivables, and what is its purpose?

A. Rainier Receivables is a wholly owned, bankruptcy-remote subsidiary of PSE formed in December 2002. The initial description of Rainier Receivables by Public Counsel's financial witness, Mr. Stephen G. Hill, is, for the most part, accurate:

> the Company has elected to pledge its accounts receivable to a wholly-owned subsidiary, Rainier Receivables, which, in turn, borrows short-term debt from a consortium of banks. Because the short-term debt is, essentially, secured with the expected cash flows of PSE's receivables, as the Company indicated to the Commission when it applied for the facility, it should be able to issue short-term debt less expensively that [sic] standard commercial paper.

(Exhibit No. ___(SGH-1T) at 26, lines 1-6.) Rainier Receivables is a facility that allows PSE to achieve a very low cost of short-term capital. By using PSE's accounts receivable as collateral, PSE in essence, can provide security to lenders and achieve a lower cost of short-term debt than would be possible in the higher-cost unsecured commercial paper market or bank credit facilities.

Q. What are Mr. Hill's concerns with respect to Rainier Receivables?

A. Mr. Hill asserts two concerns regarding Rainier Receivables. First, Mr. Hill accuses PSE of accounting obfuscation that, in part, allows Puget Energy, Inc. (the parent company of PSE) to fund the activities of its unregulated subsidiary, InfrastruX, with the short-term debt of its regulated subsidiary, PSE. (*See* Exhibit No. ___(SGH-1T) at 26, line 11 through 27, line 9.) Then, Mr. Hill asserts that the use of the Rainier Receivables facility allows PSE to exaggerate PSE's short-term debt costs to such an extent that such short-term debt costs exceed PSE's long-term debt costs. (*See* Exhibit No. ___(SGH-1T) at 27, line 13 through 28, line 3.)

Q. How does Mr. Hill allege that either Puget Energy, Inc. or PSE use the Rainier Receivables facility to fund unregulated activities with short-term debt secured by the accounts receivable of the regulated utility?

A. Mr. Hill erroneously asserts that

> the short-term debt issued by Rainier Receivables doesn't appear on the books of its utility company parent. That means that it is difficult to determine for ratemaking purposes, how much short-term debt Puget is using to finance its operations. It is also not clear whether the short-term debt issued by Rainier Receivables is being used to fund PSE's cash needs, or the needs of Puget Energy's unregulated operations. Because it is PSE's receivables that are securing that debt, it should be attributed to the utility operations in determining its cost of service.

(*See* Exhibit No. ___(SGH-1T) at 26, line 11 through 27, line 9.)

Q. Does PSE use the Rainier Receivables facility permit PSE to engage in accounting obfuscation?

A. Absolutely not. The Rainier Receivables facility allows PSE to achieve a lower short-term debt cost than otherwise possible in the commercial paper or bank lending market. This is the sole purpose of this important facility. Neither Puget Energy nor PSE use the facility to engage in accounting chicanery, including funding unregulated operations with debt secured by the accounts receivable of the regulated utility.

As PSE's Treasurer, I am very alarmed and concerned about Mr. Hill's allegation. While Mr. Hill appears to understand the purpose of the Rainier Receivables facility and admits that the use of such a facility is common (*see* Exhibit No. ___(SGH-1T) at 26, lines 6-7 (noting that the "arrangement is not uncommon (in other jurisdictions it is called 'factoring' of receivables)"), Mr. Hill does not appear to understand the accounting implications of such a facility or how PSE utilizes the individual facility. Instead, Mr. Hill makes a baseless accusation of impropriety that could potentially have significant negative implications for PSE. I only wish that Mr. Hill had first met with PSE representatives to clarify his misunderstanding of the Rainier Receivables facility before making such a baseless accusation.

Q. Does either Puget Energy, Inc. or PSE disclose the uses of the Rainier Receivables facility in required disclosures under federal securities laws?

A. Yes, Puget Energy, Inc. has fully disclosed the purpose and use of the Rainier Receivables in its Securities Exchange Commission filings. Exhibit No. ___(DEG-17) contains excerpts from Puget Energy, Inc.'s Form-10K for

years 2002 and 2003. The Rainer Receivables facility is discussed in detail at pages 36 and 76 of the 2002 Form 10-K (*id.*) and at pages 43 to 44 and 83 of the 2003 Form 10-K (*id.*).

In these public filings, the Company discloses that Rainier Receivables is a wholly owned subsidiary of PSE, is a bankruptcy remote vehicle and was established solely for the purpose of selling PSE's customer receivables to a third party. In addition, PSE discloses that this arrangement is in fact similar to a secured revolving line of credit and the fees paid are comparable to interest payments. Finally, the Company discloses the amount of receivables sold as of the date of the report allowing for easy calculation of the amount of debt the Company effectively is "borrowing."

Q. Does Rainier Receivables have any short-term debt as Mr. Hill states in Exhibit No. ___(SGH-1T) at 26, line 11?

A. No. Rainier Receivables has a subordinated notes payable due to PSE. The amount outstanding changes with the level accounts receivable PSE sells to Rainier and the level of receivables sold to the bank. All of Rainier Receivables accounts are consolidated into PSE's, effectively leaving PSE's consolidated balance sheet unchanged by the establishment of Rainier Receivables except for the amount of accounts receivable actually sold to the bank. As discussed above, this amount is clearly disclosed in the Company's public 10-K and 10-Q filings.

Further, it is difficult to understand how Mr. Hill could come to the conclusion that Rainier Receivables had any outside short-term debt when the Company

provided him with the Rainier Receivables' balance sheet which clearly stated the only debt was a subordinated notes payable.

Q. Has PSE accounted for the Rainier Receivables facility in its initial filing in this proceeding?

A. Yes, PSE has fully accounted for the use of the Rainier Receivables facility in its initial filing in this proceeding, which makes Mr. Hill's accusation all the more astounding. Page 4 of Exhibit No. ___(DEG-8C) contains a detailed description of PSE's projected short-term debt costs during the rate year. As can be seen on that page, PSE's short-term debt is comprised of two components: (i) commercial paper and (ii) accounts receivable securitization. The commercial paper issuances must have a committed bank facility as back-up liquidity for which the Company's uses its new $350 million bank agreement. The accounts receivable securitization is the short-term debt made possible by the Rainier Receivables facility.

Exhibit No. ___(DEG-8C) at 4, line 11 contains the projected total short-term debt outstanding (including both commercial paper and accounts receivable securitization) for each month during the rate year. These monthly amounts are then included in the projected total short-term debt outstanding portions of the projected capital structure calculation provided in Exhibit No. ___(DEG-8C) at 2, line 5. The projected monthly short-term debt outstanding in Exhibit No. ___(DEG-8C) at 4, line 11 and Exhibit No. ___(DEG-8C) at 2, line 5, are identical, which shows that PSE included the Rainier Receivables facility in its

prefiled projected capital structure calculations.

Q. Has PSE also accounted for the Rainier Receivables facility in its proposed short-term debt costs in this proceeding?

A. Yes, Exhibit No. ___(DEG-8C) demonstrates how PSE has accounted for the Rainier Receivables facility in determining its proposed short-term debt costs. Exhibit No. ___(DEG-8C) at 4, line 10, contains PSE's projected monthly accounts receivable securitization use (i.e., borrowings) throughout the rate year, which ranges from a low of zero in February 2006 to a high of $126 million for November 2005. PSE's average accounts receivable securitization borrowing level is $83 million during the rate year. In addition, in the same Exhibit No. ___(DEG-8C) at 4, line 24, PSE shows projected monthly accounts receivable securitization borrowing rates throughout the rate year, which ranges from a low of 2.47% in February and March 2005 to a high of 3.48% in January and February 2005. PSE's average accounts receivable securitization borrowing rate is 3.12%, which is derived by dividing the total accounts receivable securitization interest expense in line 18 by the average monthly accounts receivable securitization amount outstanding in line 10. This average accounts receivable securitization borrowing rate of 3.12% is the same rate found in Exhibit No. ___(DEG-8C), at page 3, line 8.

Moreover, Exhibit No. ___(DEG-8C) at page 4, lines 28-32, shows the advantages of short-term debt associated with the Rainier Receivables facility over the short-term debt associated with commercial paper by demonstrating that

PSE's cost of commercial paper is fifty basis points above LIBOR, whereas PSE's cost of its accounts receivable securitization facility is twenty-seven basis points above LIBOR. Therefore, the use of the Rainier Receivables facility allows PSE to achieve demonstrable savings in its short-term debt costs of twenty-three basis points, nearly a quarter of one percent.

Q. If the borrowing rate for the Rainier Receivables facility is less than the commercial paper rates for the Company, why does the Company plan to use commercial paper to fund its short-term borrowing needs?

A. The Rainier Receivables facility is a limited resource. The maximum the Company can borrow is $150 million and can be less in months when the Company's customer receivables seasonally decline. The commercial paper market is then a second resource for short-term liquidity, and while at A3/P2 (split-rated), the Company's rates are higher than the accounts receivable securitization rate, the commercial paper rates are significantly less than rates under the $350 million bank agreement, which at the Company's current credit ratings is LIBOR plus 1.375%. To ensure funding in the split rated sector of the commercial paper market, it is important to maintain as consistent a presence as possible so these investors are familiar with the Company's credit risk. As such, the Company projects a $40 million minimum level of commercial paper borrowings during the rate year except in February 2006 when short-term borrowing are below this level.

Q. If PSE's average short-term borrowing rate as seen in Exhibit No. ___(DEG-

8C) at 4, lines 25 (including both costs of commercial paper and the accounts receivable securitization) for the rate year is 3.20%, then why does PSE propose the use of a short-term debt rate of 4.71%?

A. The average short-term borrowing rate (including both costs of commercial paper and accounts receivable securitization) for the rate year of 3.20% accounts only for interest expenses associated with amounts actually borrowed by PSE. In Exhibit No. ___(DEG-8C) at 3, the Company calculates the short-term debt rate including all the costs associated with the short-term liquidity facilities. In addition to an interest cost on borrowed funds, PSE must pay certain fixed fees to its lenders, both on-going commitment fees and upfront issuance fees at the time the facility is established, for the right to access the short-term debt markets. To recover through rates the full cost of its short-term funding, PSE includes these fixed costs of commitment fees and the amortization of the upfront costs in its short-term debt cost rate, which is consistent with the accounting treatment for these type of costs. The projected commitment fees during the rate year are $1,309,046 (*see* Exhibit No. ___(DEG-8C) at 3, line 14), and twelve-month short-term debt issue costs amortization during the rate year is $783,492 (*see* Exhibit No. ___(DEG-8C) at 3, line 16). These fixed costs, when combined with the interest expenses, result in a total cost of short-term debt of 4.71%. (Exhibit No. ___(DEG-8C) at 3, line 18.)

Q. Are Mr. Hill's assertions at page 27, lines 18-22 of Exhibit No. ___(SGH-1T), that the use of the Rainier Receivables facility has actually increased PSE's short-term debt costs to nearly 8%, when the current commercial paper rate

is below 2%?

A. No, Rainier Receivables has not resulted in PSE's short-term debt rate being higher than its commercial paper rate. For 2003, PSE's weighted average AR Securitization rate was 1.34% and its weighted average commercial paper rate was 1.87%, both rates under Mr. Hill's threshold rate of 2%.

Q. How, then, does Mr. Hill arrive at a commercial paper cost of nearly 8%?

A. When Mr. Hill refers to an 8% short-term debt cost he is referring to the cost rate which reflects all commitment fee and amortization of issuance costs in the calculation discussed above, divided by the amount of short-term borrowings outstanding. For 2003, the rate resulting from that calculation was 8%. That is simply reflecting the amortization of fixed costs over a very low amount of short-term debt outstanding during that period.

This is analogous to paying an annual fee of $100 for a credit card with a 10% annual interest rate. If one carries a balance of $10,000 for the year, then the interest on such balance would be $1,000 and the actual cost is 11% (($1,000+$100)/$10,000). On the other hand, if one carries a balance of $1,000 for the year, then the interest on such balance would be $100 and the actual cost is 20% (($100+$100)/$1,000). This also explains why the short-term debt rate of under 2.0% cited by Mr. Hill is somewhat misleading--the Federal Reserve's commercial paper rates are purely market rates and do not account for the access fees.

VIII. OTHER ITEMS

Q. Are there any other issues you wish to address?

A. Yes. Mr. Hill includes some testimony about alleged cross-subsidization of Puget Energy's unregulated operations by PSE's regulated ratepayers. I would like to address this topic.

Puget Energy has two investments – it owns 100% of PSE and it owns a majority (more than 90%) interest in InfrastruX, Puget Energy's only unregulated investment. The senior executives of InfrastruX and its operating subsidiaries own the remaining minority interest in InfrastruX as a form of incentive compensation.

Since its inception, Puget Energy has sold common equity to the public on two occasions and has invested all of the net proceeds into PSE. None of the proceeds were invested in InfrastruX.

Puget Energy has no long-term debt or preferred stock of its own. It's only long-term security outstanding is common stock. Puget Energy does have a small short-term debt credit facility in place. This is a $15 million, 3-year credit agreement with one financial institution. It has borrowed $5 million from that facility and has invested that amount in InfrastruX. Puget Energy has stated publicly, on numerous occasions, that it does not plan to make any additional investments in InfrastruX.

InfrastruX has a $150 million, 3-year credit facility with 17 financial institutions.

All but one of these institutions are also participants in PSE's $350 million, 3-year credit facility. These institutions look at their exposure to InfrastruX and PSE in aggregate, looking at it as exposure to Puget Energy.

The parent holding company, Puget Energy, guarantees the interest and principal payments of any borrowings under InfrastruX's credit facility. Puget Energy does not provide a guarantee to any other security holder or to the minority investors of InfrastruX.

PSE does not provide any form of guarantee to either Puget Energy or InfrastruX. PSE does not dividend cash to the parent for investment in InfrastruX. Neither Puget Energy nor InfrastruX have any claim on the dividends of PSE. In addition, PSE has no obligation to pay a dividend to Puget Energy.

Because there is no obligation or guarantee by PSE to provide funding to Puget Energy, it is inappropriate to state that the utility's customers shoulder some of the financial risk of the InfrastruX.[24] If such an instance existed where the utility or its customers had some form of obligation to repay the debts of either Puget Energy or InfrastruX, I would agree utility customers were shouldering some of the risks of Puget Energy's unregulated affiliates. This situation does not exist.

IX. CONCLUSION

Q. Please summarize your testimony.

A. The Company is requesting that rates in this proceeding be based on a 45% equity ratio as that reflects the amount of equity that it projects will be outstanding [redacted] and is necessary to attract capital to fund its resource acquisition and infrastructure needs on reasonable terms. No witness in this proceeding has found this level of equity to be imprudent.

There are substantial customer benefits resulting from an increased credit rating, which would likely result from reflecting this level of equity, along with the requested return on equity, in rates. In fact, those benefits far exceed the cost of moving from the 40% equity presently reflected in rates to the 45% requested in this proceeding.

Q. Does that conclude your testimony?

A. Yes, it does.

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[24] Exhibit No. ___ (SGH-1T), page 19, line 25 through page 20, line 2.