BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of PUGET HOLDINGS LLC AND PUGET SOUND ENERGY, INC. For an Order Authorizing Proposed Transaction	DOCKET NO. U-072375

BRIEF

ON BEHALF PUBLIC COUNSEL

SEPTEMBER 24, 2008

NON-CONFIDENTIAL

I. INTRODUCTION

1. In this docket, the Commission is presented with one of the most important decisions in its recent history, whether to approve a fundamental change in the character of Washington's oldest and largest utility company, Puget Sound Energy.[1] Puget and the Macquarie-led Investment Consortium, the Joint Applicants, justify the proposal with eloquent appeals based on exigent capital needs, reassurances that obligations will be met, and promises of benefit. The package has an appealing ring on the surface, but when each element of this package is examined, the claims ring hollow.

2. The Company never satisfactorily answers the threshold question – why is the transaction needed in the first place? Puget's enormous capital needs turn out to be no more than the industry average and not much increased over recent levels. Improved access to capital turns out to be an "intention" not a "commitment." The Investor Consortium does not offer more cost-effective capital, and yet exposes Puget to very substantial refinancing risk. The "deep pocketed" investors have not committed to add **[Begin Highly Confidential]** XXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]**. The supposedly strengthened balance sheet is actually substantially weaker if all the debt in the corporate structure is considered. Currently healthy credit ratings are jeopardized. The advertised retention of local board members obscures the marked reduction in local board member numbers, the loss of board independence, and the inception of a board with a large majority appointed by Macquarie and its Canadian investors.

[1]The acquisition involves both Puget Sound Energy (PSE) and its parent, Puget Energy. Unless the context requires otherwise, this brief will refer to "Puget" as the acquired company.

3. The proposed acquisition fails the "no harm" test. It unnecessarily exposes Puget and its customers to significantly increased financial risk. That risk is inherent in the leveraged structure of the sale. Additional serious risks result from Puget's increased exposure to global credit markets under this deal. These risks are particularly heightened at a time when credit markets face their worst crisis in decades. The commitments proposed in the settlement are not adequate to protect Puget and its customers from the harm posed by this sale. The transaction as proposed is not in the public interest and, therefore, should not be approved.

II. THE LEGAL STANDARD

4. The proposed acquisition of Puget Energy and Puget Sound Energy by the Macquarie-led Investor Consortium requires the approval of the Commission because it results in a change of control of Puget. The change of control, at its essence, results from the purchase by the new owners of Puget's stock.[2] Joint Applicants acknowledge and no party challenges Commission jurisdiction to approve, reject, or modify the transaction. The applicable statutory standard is that the transaction must be in the public interest. As stated in the Commission rules, if, after a review of the application and exhibits, "the Commission finds the proposed transaction is not consistent with the public interest, it shall deny the application."[3]

5. As a general matter, the Commission has, in a series of decisions since at least 1997, interpreted the public interest test as a "no harm" standard.[4] Under the "no harm" analysis, the Commission has stated that a merger: (1) should not harm customers by causing risks or rates to

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[2] Chapter 80.12 RCW; RCW 80.12.020. *In re Application of PacifiCorp &Scottish Power PLC*, Docket No. UE-981627 (*Scottish Power)*; Second Supplemental Order, pp. 8-16.

[3] WAC 480-143-170. RCW 80.01.040 (3) provides that the utilities and transportation commission shall "regulate in the public interest[.]".

[4] *In re Application of Puget Sound Power & Light and Washington Natural Gas*, UE -951270 *et al.*, Fourteenth Supplemental Order, pp. 19-20 (*Puget/WNG Merger*; *Scottish Power*, p. 2).

increase compared to the status quo; (2) with proposed conditions, should strike a fair balance between interests of customers, shareholders, and the general public that preserves affordable, efficient, and reliable service; (3) does not distort competition; and (4) is consistent with UTC jurisdiction and oversight.[5] The applicants bear the initial burden of demonstrating that the transaction does no harm to the public interest.[6]

6. Public Counsel, Commission Staff, and Industrial Customers of Northwest Utilities (ICNU), after reviewing the application in this case and conducting extensive discovery, reached a common conclusion. The proposed acquisition, even with the initial ring-fencing and other commitments proposed, posed a serious and substantial increase of risk to Puget and in turn to its customers. The substantial weight of the evidence in the case, therefore, shows that Joint Applicants have not met their initial burden to show that the acquisition of Puget would not harm the public interest. The legal issue facing the Commission, then, is whether the commitments proposed in the settlement eliminate those risks. If, after review, the Commission concludes that there remains a net increase in the level of risk and that there is any harm to the public interest, the transaction as proposed cannot be approved.[7]

7. Under WAC 480-07-750, the Commission has the discretion to approve, reject, or modify the proposed settlement. Since approval of the settlement "as filed" in this case will result in approval of the proposed transaction, the standard for the decision to approve is the same public interest test that applies to any merger or sale transaction before the Commission. In making that decision, the Commission must consider the full record before it, including not only the

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[5] *Puget/WNG Merger*, pp. 19-20. The Commission also noted the applicability of the state energy policy considerations in RCW 80.28.074.

[6] *In re application of PacifiCorp & Scottish Power PLC*, Docket No. UE-981627 (*Scottish Power)*, Third Supplemental Order, p. 2.

testimony supporting and opposing the settlement, but the more detailed testimony supporting and opposing from all parties, including evidence offered by Public Counsel as an opponent of the settlement under WAC 480-07-740(2)(c).

8. Two nearby states have rejected merger proposals that presented many of the same characteristics as this request. In 2007, the Montana Public Service Commission rejected an application by Babcock & Brown to acquire Northwestern Corporation, applying a "no harm" test.[8] In 2005, the Oregon Public Utility Commission rejected Texas Pacific Group's proposal to purchase Portland General Electric as an asset from the Enron bankruptcy, applying Oregon's "net benefit" standard.[9] Both proposals were highly leveraged transactions that raised many of the same issues presented in this case, including ring-fencing and other matters. While these are not governing authority, the similarities provide useful guidance in analyzing issues in this case.

III. JOINT APPLICANTS HAVE ESTABLISHED NO OPERATIONAL OR FINANCIAL JUSTIFICATION FOR THIS TRANSACTION

A. Access to Capital Is The Only Rationale Offered to Justify The Transaction.

9. The Joint Applicants' chief, indeed the only real, rationale offered to justify the transaction is improved access to capital. There is no claim of operational necessity or efficiency. Puget states it expects that it will need to raise significant amounts of new external capital over the next several years and argues its needs are so substantial that it "puts the Company and the region at risk."[10] The need is described as "enormous" by Macquarie witness

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[7] The Commission under the rule could then reject the settlement outright and the proceeding and parties would return to the *status quo ante*, or the Commission could impose additional conditions.

[8] *In the Matter of the Joint Application of NorthWestern Corporation and Babcock & Brown Infrastructure Limited et al For Approval of Sale and Transfer*, Montana PSC Docket No. D2006.6.82, Order No. 6754e (August 1, 2007)

[9] *In the Matter of Oregon Electric Utility Company, LLC et al.*, Oregon PUC Docket No. UM 1121, Order 05-114 (March 10, 2005).

[10] Exh. No. 131, p. 5:3 (Reynolds Direct).

Christopher Leslie.[11] Joint Applicants argue that, if approved, the transaction will provide access to major sources of capital that are focused on long-term investment.[12] They claim that the transaction will insulate Puget from the risks and difficulties of raising capital in the public markets as they do now, and that this offers the best alternative available to Puget to finance its growth.[13]

10. These assertions simply do not hold up under scrutiny. After analyzing these claims and presenting competing evidence, Commission Staff has concluded that "the Joint Applicants' 'access to capital' argument that underlies the proposed transaction is not compelling; there are no impediments to PSE's ability to raise sufficient capital on reasonable terms absent the transaction." [14] As the following discussion shows, this conclusion is amply supported by the record.

11. If Puget is able to raise necessary capital on its own, there is no reason to consider adding substantially more debt and resulting to risk Puget's consolidated capital structure or to engage in the task of crafting a difficult and complex framework of protections in the hope that the risk can be contained.

B. Puget Is Able To Access Capital in The Public Markets.

12. Statements from Puget's own officers and board members contradict the dire scenario they have laid out, with its implication that PSE is no longer able to access capital from the public markets. For example, in his Direct Testimony PSE's Chief Executive Officer (CEO) and Board Chairman, Steve Reynolds, indicated his "concern" regarding Puget's ability to raise

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[11] TR. 463:22 (Leslie).
[12] Exh. No. 131T, p. 7:6-13; Exh. No. 71T, p. 10:18-22, p. 11:1-2 (Markell Direct).
[13] Joint Application for an Order Authorizing Proposed Transaction (Joint Application), ¶ 34.
[14] Exh. No. 131, p. 39:15-17 (Elgin Direct).

capital on its own.[15] When asked, however, if PSE could continue to access capital markets as a publicly traded company as it has in the past, he answers "Yes, in the current structure, PSE can obtain capital through the current markets [.]" while then arguing that the size of need and the risks of the public market are problematic.[16] In June, the *Daily Olympian* reported that:

> Last month, PSE chief executive officer and president Steve Reynolds had this to say when asked what happens if the sale is rejected: "We've never said we couldn't raise the capital if the UTC said 'no.' We would continue to serve our customers," he told The Olympian's editorial board.[17]

13. When questioned at the hearing by Commissioner Jones, Puget board member Phyllis Campbell acknowledged that PSE in the past has been able to raise sufficient equity[18] and again on redirect by Ms. Carson she stated: "we could have raised the equity."[19] Chief Financial Officer (CFO) Eric Markell's testimony raised the spectre that with continued reliance on public financing "at some point the impact grows to a level that imperils the ability of the utility to access capital, and thereby imposes great risks to customers as well"[20] When Commissioner Jones challenged the statement, Mr. Markell conceded that he was only talking about "access on reasonable terms." [21]

C. There Is No Persuasive Evidence That Access to Capital on Reasonable Terms is Unavailable.

1. Joint Applicants do not even claim that they will provide access to capital on better terms.

[15] Exh. No. 131, p. 4:7-17 (Reynolds Direct).
[16] *Id,* p.6:11- p. 7:13.
[17] Exh. No. 261, p. 2:19-23, citing "PSE sale gets two strikes," The Olympian, June 19, 2008, Available online at: http://www.theolympian.com/southsound/story/482918.html.
[18] TR. 991:10-11 (Campbell)(acknowledging sufficient, but arguing increasingly difficult in future).
[19] TR. 1023:10-21 (Campbell) (raising the issue of reasonableness).
[20] Exh. No. 75CT p. 10:10-13 (Markell Rebuttal). *Cf.* Exh. No. 84 (explaining that $5.7 billion in construction needs will be financed "in a similar manner" with or without the merger).
[21] TR. 672:16-673:10 (Markell).

14. Notwithstanding the broad assertions that this transaction offers PSE much-needed improved access to capital, Joint Applicants themselves have acknowledged that "neither Puget Holdings LLC (Puget Holdings) nor Puget Sound Energy conducted any analysis to determine whether the costs of capital for Puget Holdings or PSE will be lower as a result of approval of the proposed transaction."[22] Furthermore, Joint Applicants admitted in response to Public Counsel discovery that "[t]he Joint Application does not state that the Macquarie Group and other members of the Investor Consortium would be able to supply capital to Puget Sound Energy, Inc. (PSE) more-cost effectively than the capital markets generally."[23] Commission Staff's analysis of this issue also reviews Joint Applicants' responses to Staff data requests on this point and concludes: "the Joint Applicants failed to provide any dispositive analysis in support of their conclusion that the proposed sale offers superior access to capital for PSE compared to the *status quo*."[24]

2. PSE has consistently been able to raise capital at least up to the present day on reasonable terms.

15. Puget has raised capital and provided returns to investors through two World Wars and the Great Depression. Despite the rhetoric of its witnesses, Puget has presented no hard evidence that the terms for raising capital have been unreasonable in recent years. It is undisputed that Puget has raised $800 million in the public capital markets since 2002,[25] starting at a time shortly

[22] Exh. No. 251, pp. 40-42 (Hill Direct), citing PSE Response to ICNU Data Request No. 3.56.
[23] *Id.*, p. 41:4-8 citing PSE Response to Public Counsel Data Request No. 3022.
[24] Exh. No. 161, p. 27:20-22 (Elgin).
[25] TR. 556:18-557:14 (Leslie); TR. 603:17-20 (Reynolds); Joint Applicants prefer to use the figure of $500 million for past issuances, subtracting the approximately $300 million issued in late 2007 on the ground it was related to the acquisition. Joint Applicants cannot deny however that this $300 million was raised in the public markets. If the transaction were not pending, given the stated need for capital, Puget would likely have pursued such an issuance in any event. If Joint Applicants are suggesting that the so-called "patient investors" would not have invested $300 million if the acquisition deal were not in the offing, that is directly inconsistent with the assertion that these parties are eager to invest their large resources in Puget.

after the Western energy crisis and the Enron bankruptcy when markets had reason to be skittish about investing in energy companies. In the recent past, markets have been valuing the utility industry strongly and capital has been available on reasonable terms at least up to 2007 when the transaction was announced, as Mr. Markell himself testified.[26] This level is **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXX **[End Highly Confidential]** [27]

16. PSE witnesses have agreed, whenever directly questioned on the point, that terms for access to capital have been reasonable. In discussing the "very large deal" through Lehman Brothers to raise $310 million in 2005, Mr. Reynolds did not identify any major problems with the terms of the transaction, opining that "from a Puget stand point we fixed a good price and the business risk was transferred to Lehman Brothers to a large degree."[28] Ms. Campbell agreed that the terms were reasonable.[29] Mr. Reynolds volunteered, in discussing the $800 million raised since 2002 that PSE has made "remarkable progress" in improving its balance sheet,[30] which would seemingly not have been possible if reasonable terms were not available for capital.

17. Commissioner Jones examined Mr. Markell about his effort in a part of the rebuttal testimony to show inability to issue capital at reasonable terms, but found his reliance on a selective number from a single year to be perhaps "inaccurate or misleading."[31] Mr. Markell also was able unable to explain why his analysis relied on book value, while PSE witness Mr. Pettit

[26] Exh. No. 75CT, p. 11:1-6 (Markell Rebuttal) (also stating that the "favorable" market situation might deteriorate).
[27] TR. 557:7-14 (Markell).
[28] TR: 605:7 – 606:1 (Reynolds).
[29] TR. 1005:13-16 (Campbell).
[30] TR. 604:3 (Reynolds).
[31] TR. 675:19-677:24 (Markell); referencing Exh. No. 75C, p. 9:1-11 (Markell Rebuttal).

disparaged it.[32] He acknowledged that in the private placement recently arranged with the Consortium, the price per share that was arranged was $23.67 – a price above book value.[33]

3. PSE has been able to offer above market returns to its investors.

18. During the period since 2002, while rebuilding its balance sheet, PSE has at the same time been able to pay an above average dividend yield to its investors, as Mr. Reynolds admitted somewhat reluctantly at the hearing.[34] Board member Phyllis Campbell agreed that prior to the time the transaction was announced and over the years Puget has provided an above-average dividend yield.[35]

4. Puget's capital needs are not unique in the utility industry.

19. Commission Staff testimony and exhibits establish that the credit metrics of the electric industry are sufficient in today's environment given the general need of the industry to make major investments in new infrastructure.[36] For example, Standard & Poor's has addressed the key issues facing the electric industry involving new facilities and the rising cost of construction and concluded that the challenges are manageable.[37] The record contains several articles from S&P from late 2007 and early 2008 which provide overviews of the access to capital for the utility industry, viewing the industry's ability to withstand challenges in a positive light.[38] S&P observes , for example,

> With a large plate of construction projects identified, electric utilities will need to be able to continue sourcing capital. Beginning in the fourth quarter of 2007,

[32] TR. 677:5-21 (Markell).
[33] TR. 678:4-11 (Markell).
[34] TR. 616:11-617:3 (Markell).
[35] TR. 993-994 (Campbell).
[36] Exh. No. 161, p. 22:2-7 (Elgin Direct).
[37] *Id*, p. 21:1-5 (Elgin Direct).
[38] Exh. No. 169.

> investors seeking to hold investment-grade debt began finding solace in electric utilities, diversifying away from financial institutions; *a continuation of this trend bodes well for the industry's financing plans in the coming years.*[39]

20. In other words, the market is responding well to the utilities' need for capital. Investors are finding utilities attractive in comparison to the financial sector, as opposed to fleeing the utility sector, as Joint Applicants repeatedly suggest. With regard to Puget specifically, S&P stated prior to the announcement of the acquisition that the Company had a "strong business profile," and while noting that its capital requirements are "very high," did not attach any particular concern to that fact or conclude that the capital needs placed Puget or the region at risk.[40]

21. A related point is that the growth which Puget describes in negative terms as a problematic challenge actually has substantial benefits for the Company and its shareholders. Growth, properly managed, provides opportunities for Puget to grow earnings, book value, and ultimately share value. A growing company is arguably more attractive to those seeking to invest capital.[41]

5. Puget is an attractive investment and its regulated status provides for access to capital on reasonable terms.

22. The consistent theme of the Joint Applicants that Puget will have difficulty raising capital defies common sense. It is a fully regulated investment grade utility with a regulatory environment that receives positive ratings.[42] In today's uncertain and volatile economic climate it represents a safe and reliable investment, and in Puget's case, one with consistently above-

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[39] *Id.* (emphasis added).
[40] Exh. No. 161, p. 21:9-22:3 (Elgin Direct).
[41] Exh. No.161, p. 25:4-26:6 (Elgin Direct).
[42] Exh. No. 49, p. 38.

average dividend yields.

23. Under Washington's regulatory scheme, Puget as a regulated utility is required to provide facilities and service that is safe, adequate and efficient as well as just and reasonable, and the *quid pro quo* is that the Commission by law must set rates that will allow the Company to attract capital on reasonable terms. [43] As Staff points out: "It makes no sense to argue that PSE needs 'improved' access to capital when the basic premise of regulation is to provide a public service company access to capital on reasonable terms.[44] The evidence that the Commission has done this successfully is the investment-grade ratings afforded to this Company prior to the announcement of this transaction.

24. It is Puget's very desirability as an investment that has attracted Macquarie and its consortium.[45] In this regard, Commissioner Jones asked Macquarie witness Mr. Leslie:

> Q. If Macquarie believes, and if you have advised the other three members of the investment consortium, that PSE is an attractive investment, why don't you and the other members of the investor consortium simply buy stock in the public markets and supplement your existing $300 million investment through the private placement?
>
> A. The mandate that we have as Macquarie Infrastructure Partners in many ways would not permit that[.][46]

In his lengthy continued response, Mr. Leslie essentially elaborates that the purpose of this investment is different, it is in the alternative class of investments that includes leveraged buy outs, commodity funds, real estate, infrastructure, hedge funds and private equity.[47] Implicit in

[43] RCW 80.28.010(1), (2).
[44] Exh. No. 161, p. 26:21-27:2 (Elgin Direct).
[45] Exh. No. 31T, p. 5:8-9 (Leslie)(the Investor Consortium is "eager to invest additional funds in such businesses…."); *Id.*, pp. 18-19 ("we are particularly attracted to the near 100% regulated nature of the Puget Energy business…").
[46] TR. 834:2-9 (Leslie).
[47] TR. 835:25-826:13 (Leslie).

this statement, and expressly reflected elsewhere in the record, is that the investment goal of this entire transaction is, through leverage, to achieve significantly higher rates of return than the public market investment suggested by Commissioner Jones.

25. This single exchange encapsulates the key issue in the case --- this transaction is not occurring because of any real problems for PSE in attracting capital, it is happening for the sole purpose of creating an opportunity for above-public market, leveraged rates of return for these investors, combined with a generous 25 percent gain for shareholders, and very healthy change of control payments to officers.[48]

26. Board member Ms. Campbell was questioned at some length regarding how seriously the board considered the "stand-alone" option of continuing Puget in its current form. While she discussed a number of factors, it is fair to conclude from her answers that the real choice for the board was between "the stand-alone business cases versus the $30 a share price offer."[49] Simply continuing as a healthy investment grade utility able to pay above average dividends did not compare to the opportunity for a 25 percent immediate profit for shareholders. This also outweighed any concern about Macquarie's difficulties in the global capital markets, of which she acknowledged their awareness.[50] As she pointed out, "our primary fiduciary obligation is to shareholders and to the duty of loyalty to the company, which is primarily the shareholders."[51]

27. The frequently expressed concern about raising capital doesn't seem to have been a key factor in this final decisional calculus, given that Ms. Campbell was unable to explain in any clear fashion why the board believed that this transaction would provide for Puget's

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[48] Exh. No. 412C.
[49] TR. 1010:16-17 (Campbell).
[50] TR. 1010: 19-1011:16 (Campbell).
[51] TR. 1014:22-1015:1 (Campbell).

infrastructure needs, even at one point describing the $3.4 billion equity infustion to purchase the company as "contributing to the capital expenditures program."[52]

6. The level of commitment to capital expenditures is limited at best.

28. A further problem with the Joint Applicants' case is that, even if one accepts for purposes of argument that the acquisition offers improved access to capital, the actual level of commitment to provide capital is questionable and limited at best. Commitment No. 2 of the settlement merely states that Puget's capital needs will be considered a high priority by the Board of Puget Holdings. No specific commitment is made. Although the external financing need of Puget is said to be $3.5 billion, the Joint Applicants only agree to provide a $1.0 billion capital expenditure facility at closing which may or may not be drawn down at that time and which only has a five year term.[53] The $750 million "accordion" feature is also undrawn.[54]

29. There is "no mention" in the transaction commitments of the total projected capital expenditure amount of $3.4 billion asserted by Puget.[55] There is no commitment to the Puget business plan or to the integrated resource plan.[56] Finally, the transaction financial model contains as a fundamental assumption that **[Begin Highly Confidential]** XXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]**[57]

30. Testimony from the two Macquarie witnesses is not reassuring on this point. Macquarie

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[52] TR. 1008:12-13, *see generally* 1006:13-1008:18 (Campbell).
[53] TR. 544:18-546:19 (Elgin).
[54] When asked about the enforceability of the $1.0 billion funding commitment, Mr. Elgin cited the Commission's general statutory authority to order PSE to make certain kinds of investments, RCW 80.28.010. TR. 543:17-22. This is no different than the *status quo*. Public Counsel is not aware of any case in which the Commission has ordered capital expenditures by a regulated utility under this statute on this scale against its will. This falls very far short of an express commitment by the Joint Applicants.
[55] TR. 544:18-23 (Elgin).
[56] TR. 544:24-546:19.
[57] Exh. No. 51, p. 77; TR. 808:11-14 (Leslie).

witness Mr. Leslie, when asked what investments the consortium was committing to stated that:

> *[I]t doesn't rise to the level of a regulatory commitment I believe*, but it's the commercial commitment of the parties in moving into this transaction is to stand behind the funding of that capital expenditure program. So that is our intent in this transaction, *and that's probably the better way to describe it, as a commercial intent as opposed to a firm commitment.*
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> Q. (Commissioner Jones) So it's a commercial intent instead of a firm commitment and what you commit to in transaction commitment number 3 is $1.4 Billion [?]
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> A. (Mr. Leslie) That's correct.[58]

31. Additional questions are raised by Macquarie's segregation of future capital expenditures into Discretionary" and "Non-discretionary" investments later re-labeled "Base Capital Expenditures" and "Additional CapEx" after questions by Staff and Public Counsel.[59] The majority of investments, including those related to meeting growth, one of the chief reasons cited for Puget's capital needs, fall into the latter category. While Joint Applicants explain away the classification as having nothing to do with operational decisions, questions remain. If as Joint Applicants assert, the classifications are related to the lenders' financial metrics and coverages, then Puget's ability to meet these metrics will affect lenders' willingness to allow draws on existing facilities, or issue new debt for discretionary versus non-discretionary investments, as Mr. Hill explains in detail in his Direct Testimony.[60]

32. Ultimately operational decisions involving major capital expenditures will be governed by the board. The PSE Board is essentially the same as the Puget Holdings Board, with its

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[58] TR. 549:13-550:24 (Leslie)(emphasis added). *See also* Examination of Mr. Kupchak by Chairman Sidran, TR. 551:12- 552:4 (Kupchak).
[59] *See generally* Exh. No. 47, pp. 4-5, and App. C (Detailed RW Beck review of specific Puget plant forming basis of division of dollars between discretionary and non-discretionary; Exh. 51, pp. 77-78 (discussion of terms in the lenders Confidential Information Memorandum).
[60] Exh. No. 251, p. 49. *See generally,* pp. 43-51.

majority of Investor Consortium representatives, which has broad authority regarding Puget's business plan, its financing, and its management.[61] These classifications are another basis for questioning the actual scope and level of commitment to capital expenditure by the buyers.

33. Finally, the record reflects that Macquarie establishes **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential].**[62]

7. The record does not establish that the transaction will offer access to "patient" capital.

34. Joint Applicants place much reliance on the assertion that the Investor Consortium will offer "patient" capital. There are a number facts in evidence that call this into question. Macquarie Capital Funds has only been engaged in infrastructure investing since 1996.[63] Macquarie's acquisitions of U.S. regulated utilities are quite recent.[64] As the model reflects, this transaction is specifically tied to a finite term of ten years, plus possible extensions, for the equity investors**.** After that, in order for the equity investors to receive their **[Begin Highly Confidential]** XXXXXXXXXXXXXXX **[End Highly Confidential]**, the investment in Puget must be liquidated in some fashion, either by sale or other means. The Private Placement Memorandum expressly describes the **[Begin Highly Confidential]** XXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

[61] Exh. No. 36, p. 3.
[62] Exh. No. 50, p. 32 (Section 3.3); TR. 751:2-752:19.
[63] Exh. No. , p. 31, p. 11:7. The Macquarie Group has been active in North America since 1994. *Id*, p. 9:10.
[64] *Re Duquesne Light Holding Company Acquisition By Merger* Penn. PUC, Docket A-110150F0035 et al., Order, April 24, 2007; *Joint Application of Kelda Group, Inc. and Macquarie Utilities, Inc. for Approval of Change of Control (Aquarion),* Conn. Dept. of Public Utility Control, Docket No. 06-06-18, Decision, October 18, 2006; *In re*

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XXXXXXXXXXXXXXXXXX. **[End Highly Confidential].**[65] As discussed elsewhere in the brief, the equity investors have **[Begin Highly Confidential]** XXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** and the only debt capital currently in place has only a five year term, with the availability and term of future debt capital currently uncertain.

8. The relative size of Puget's claimed capital needs are exaggerated and the support offered by Mr. Pettit is analytically flawed.

35. Puget's capital needs are not unique in the utility industry, as discussed above. Nor are Puget's need for significant capital unprecedented in company history. During the 1970s and early 80s, Puget and other Washington IOUs experienced significant growth in rate base and were able to successfully meet external capital needs.[66]

36. Another threshold problem with Puget's representations, identified by Commission Staff, is that they compare the Company's expected capital needs of $3.4 billion to its book equity of $2.1 billion. This overstates the magnitude of the need. It is more appropriate to compare Puget's capital needs to its total capitalization of $7.6 billion to identify the impact of the capital budget on PSE's total investment to provide service.[67]

37. Puget witness Justin Pettit exaggerates the relative scale of Puget's capital needs by overstating the size of Puget's future need while understating the industry averages. The exaggeration of the equity needs is demonstrated as follows. First, in measuring the size of

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Application of The Gas Company et al., and Macquarie Gas Holdings for Approval of Transfer, Hawaii PUC, Docket No. 05-0242, Decision and Order, 22449, May 3, 2006.
[65] Exh. No. 50, p. 43.
[66] Exh. No. 161, p. 24:11-25:2 (Elgin Direct).
[67] Exh. No. 161, p. 20:6-11 (Elgin Direct).

Puget's future equity needs, Mr. Pettit used an amount of **[Begin Highly Confidential]** XXX XXX **[End Highly Confidential]** projected over the next five years (2009-2013), citing Puget's 2007 Business Plan Update, which contains the projected capital needs.[68] The Puget Business Plan, however, calls for issuance of only **[Begin Highly Confidential]** XXXXXXX **[End Highly Confidential]** in equity over the next five years. This discrepancy was confirmed by CFO Eric Markell at the hearing.[69] Mr. Pettit's inflated equity issuance projection for Puget produces a five-year equity issuance as a percent of market value for Puget of **[Begin Highly Confidential]** XXXX. **[End Highly Confidential]**[70] Using the correct amount of equity to be issued indicates a corrected five-year figure of **[Begin Highly Confidential]** XXXXXXXXX XXXXXXXXXXXXXXXXX. **[End Highly Confidential]** As shown below, in fact this is about average for the industry.

38. Exhibit No. 118 contains the data on which Mr. Pettit's analysis was based.[71] The exhibit, which contains analytical data for the past fifteen years, shows that, over the past ten years for the electric industry, the average amount of common and preferred equity issued every year as a percent of market capitalization was 4 percent. Therefore, the five-year industry metric for that parameter would be 20 percent.[72] [4% x 5]. However, the last significant capital expansion in the electric industry was during the 1980s into the mid 1990s, and during the last ten years there was little construction activity.[73] That fact is shown in the declining equity

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[68] Exh. No. 76C.
[69] TR. 674:3-10. The difference between the actual amount of equity to be issued by Puget and that included in Mr. Petitt's analysis is that Mr. Pettit has included Puget's projected issuance of **[Begin Highly Confidential]** XXX XXXXXXXXXXXXXXX **[End Highly Confidential]** as if it were equity. Puget has recently issued such securities, and those securities are neither common equity capital nor preferred equity capital, they are debt capital, as confirmed by Puget Treasurer Don Gaines. Exh. No. 26.
[70] Exh. No. 111CT, p. 12, chart.
[71] Exh. No. 118.
[72]TR. 643:18-22 (Pettit).
[73] TR. 654:25-655:19 (Pettit).

issuances from the early 1990s forward as reflected in Mr. Pettit's data.[74] If one simply averages all of the data reviewed by Mr. Pettit (using the last 15 years instead of the last 10) the average yearly equity issuance for the industry rises to 6.55 percent of market capitalization. A five-year equity issuance metric based on that longer-term industry data would produce a 5-year industry-average equity issuance figure of 32.75 percent [6.55 percent x 5].[75]

39. Mr. Pettit's data, therefore, show that the average five-year equity issuance for the electric industry, 32.75 percent, is actually higher than the figure for Puget -- 30.8 percent. Accordingly Puget's actual projected issuances are in line with the historical average for the industry and not, as Mr. Pettit suggests, a statistical outlier.

IV. THE PROPOSED ACQUISITION INCREASES FINANCIAL RISK TO PUGET AND ITS CUSTOMERS

A. A Reversal of Course: Shrinking Equity Balances and Strained Payout Ratios.

1. Puget has just spent six years successfully restoring the strength of its balance sheet.

40. Puget Energy has, over the past six years, substantially lowered its financial risk by increasing its common equity ratio. This occurred as the result of an agreed equity rebuilding program adopted by the Commission in the 2002 general rate case. PSE's equity ratio has increased from less than 35 percent at that time to 44.7 percent prior to the filing of this docket and the pending GRC.[76] This financial improvement had, prior to the announcement of the

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[74] Exh. No. 118, p. 3.

[75] Of course, this value includes the later 1990s and early 2000s with very little construction activity and probably understates the amount of common equity that would be typically issued by an electric utility in a construction program. For example, Attachment A to Exh. No. 118 (Mr. Pettit's data) shows that the total percent of equity issued by the industry over the 1993-1997 periods was 54.12 percent of market capitalization—much higher than Puget's projected equity issuance total (30.75 percent).

[76] Exh. No. 231.

proposed transaction, brought the Company to a point where Moody's Investors Service placed Puget on review for a potential credit rating increase.[77]

41. The proposed transaction will use $1.225 billion (formerly $1.425 billion) of debt issued by Puget Energy to finance the sale to Macquarie. It adds an additional $1.0 to $1.75 billion of debt capital as the **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]** In this way, the transaction reverses Puget's corporate direction of lowering financial risk. Adding $2.25-- $3.0 billion of debt capital to Puget's current capital structure significantly increases financial risk to PSE even though all of that debt will not reside on PSE's books. That is because PSE is the only source of cash to meet the additional debt service requirements occasioned by that higher debt load.[78]

42. The rating agencies reacted accordingly to the financial structure planned for this transaction. Upon announcement of the potential acquisition of Puget by the Macquarie-led investor consortium PSE's credit rating improvement was reversed and Puget Energy's credit rating was placed on watch for possible downgrade by both Moody's and S&P.[79] As Standard & Poor's noted in an October 22, 2007 letter to Macquarie representatives,

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[77]Exh. No. 251. p. 9:15-18 (Hill Direct).
[78]TR. 737:7-739:19.
[79]Exh. No. 161, p. 29:6-14 (Elgin Direct); Exh. No. 172: S&P ("Credit Watch with Negative Implications"), Moody's (statement it "may downgrade Puget Energy").
[80]Exh. No. 54 HC, Attachment E, pp. 2-3.

43. At the end of 2007, Puget Energy's common equity ratio was 44.7 percent.[81] Immediately following the closing of the proposed transaction, Puget Energy's consolidated common equity ratio (absent consideration of the "goodwill" created by the transaction) will be 36 percent of total capital.[82] That, as noted by the bond rating agencies, represents a significant change in financial risk. Moreover, that common equity ratio continues to decline, according to Macquarie's financial projections, reaching **[Begin Highly Confidential]** XXXXXXXX **[End Highly Confidential]** by 2013 –the time period when all of the debt issued by PE is scheduled to be re-financed.

2. The addition of goodwill to Puget's balance sheet is a "distortion" of its financial structure.

44. As Commission Staff and Public Counsel have both noted in their testimony, the role of "goodwill" in this transaction is important to understand because it represents a material change to Puget's books.[83] "Goodwill" is an asset created on the books of an acquiring firm and represents the difference between the price paid for the firm and its actual value.[84] Post-closing, the books will show a significant investment in an intangible asset, "goodwill," in the amount of $1.225 billion.[85] This represents the premium the Investor Consortium is paying over the value of PSE's stock. Staff concluded that the debt, which effectively finances the goodwill "does not provide any incremental benefit to the public. It merely changes the ownership of Puget Energy

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[81] 2007 S.E.C Form 10-K, p. 72.
[82] Exh. No. 259HC (Hill). As discussed below, the debt/equity ratio is affected by the additional $200 million equity commitment, but not significantly.
[83] Exh. No. 161, p. 15:20 (Elgin Direct).
[84] Exh. No. 117; Exh. No. 251HCT (Hill Direct), p. 65).
[85] This amount was originally $1.425 million but would be reduced by the agreement to add $200 million in equity.

through issuance of an additional $1.225 billion of debt to pay the substantial premium to shareholders,"[86] thereby creating the goodwill asset on Puget's books.

45. Joint Applicants' witness Pettit confirmed that goodwill is a hypothetical asset with little value, explaining the "[g]oodwill is a distortion because it has no value [.]"[87] This is important because if the goodwill is not included when assessing Puget's financial strength, it further weakens an already heavily leveraged financial structure vis a vis the credit rating metrics.

46. Puget states its principle objective in this case is to provide a stable source of capital to fund new utility infrastructure. If, however, Puget's regulated operations can support not only its existing debt, but also an additional $1.225 billion in new debt immediately upon closing, Public Counsel agrees with Staff that "the public interest is better served if this new debt is used to support investments in new utility infrastructure for PSE, rather than a $1.4 billion investment in an intangible asset on Puget Energy's books in order to pay off Puget Energy shareholders."[88]

3. Joint Applicants' proposed dividends post-closing demonstrate an increase in financial risk.

47. The financial risks of the proposed transaction are underscored by comparing the promises made by Macquarie to the investors in the Investor Consortium with Puget's current treatment of its public equity investors:

- Macquarie, in its presentation to potential private equity investors promises those investors an average annual yield of **[Begin Highly Confidential]** XX **[End Highly**

[86] Exh. No.161, p. 15:14-16.
[87] Exh. No. 117, p.1; Mr. Kupchak's disagreement with Mr. Hill regarding rating agencies treatment of goodwill appears in consistent with Mr. Pettit's Exh. No. 117.
[88] Exh. No. 161, p. 16 (Elgin).

- **Confidential]** percent.[89] As described by Applicant's witness Leslie[90] those payments **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXX **[End Highly Confidential]**
- Based on a **[Begin Highly Confidential]** XX **[End Highly Confidential]** percent yield and the $30 per share stock price that the Investor Consortium has offered, this represents an expectation on the part of the private equity investors of an annual dividend of **[Begin Highly Confidential]** XXX **[End Highly Confidential]** per share.[91] Puget Energy's current dividend per share is $1.00. Macquarie is indicating to its prospective investors that it will increase Puget's annual dividend by **[Begin Highly Confidential** XXXXXX. **[End Highly Confidential]**
- Puget Energy's earnings per share in 2007 were $1.56 per share.[92]
- Macquarie's promised annual dividend to the Investor Consortium implies a dividend payout ratio of **[Begin Highly Confidential]** XX**[End Highly Confidential]** percent of earnings.[93]

48. The significance of the dividends planned by Macquarie for the post-sale Puget will, therefore, be readily apparent. Increasing dividends to more than **[Begin Highly Confidential]** XXX **[End Highly Confidential]** percent of earnings, effectively paying dividend distributions

[89] Exh. No. 49HC, p. 13.
[90] Exh. No. 55HC.
[91] TR. 770:23-771:7 (Leslie).
[92] Exh. No. 405, 2007 SEC Form 10-K, p. 70.
[93] Applicants' witness Leslie attempted to make the case that Puget's earnings, over time, would "grow into" its dividend responsibilities. TR. 774:3-22. However, Puget Board Member Campbell indicated that Puget's future earnings were expected to be "flat". TR. 1006:8.

out of operating cash flow, is a recipe for further financial deterioration for the company.[94] This represents another way in which the Macquarie and the Investor Consortium plan will reverse the financial direction and well-being of Puget Energy.

49. If Puget, as a stand-alone company, were to propose a financial plan to nearly **[Begin Highly Confidential]** XXXX **[End Highly Confidential]** dividends while adding substantial amounts of debt, it is difficult to believe such a plan would receive Commission approval. Nevertheless, that is the essence of what is being sought with this transaction. Although it is "dressed up" with multiple corporate layers so that not all of the debt resides at the PSE level and the cash flows distributed to the investors are not easily located, the risks of such a business plan are not eliminated by "shuffling the pieces." The overall financial risks will increase because of this transaction. PSE is the only entity involved that is capable of meeting all the promised payments to debt and equity investors—and ratepayers are the ones who will, ultimately, have to provide those monies.

50. In fact, Puget director Campbell explained at the hearing why a stand-alone Puget would never propose such a highly leveraged approach to acquiring new capital. Ms. Campbell was asked "why not just have Puget borrow all the dollars that are needed for future capital expenditures?" Her answer is telling:

> The Company has traditionally had a balanced, a balanced portfolio of equity and debt. And as you know, we have looked to maintain a certain equity ratio in the company. So if you asked me the question as to why wouldn't we just go out and borrow in the capital markets, and we are subject to the rating agencies rating of the company. We're always concerned about debt ratings of the company. *And continuing to denigrate the capital structure would have affected our overall ratings, which would have increased our cost of the capital in the debt market, coupled with the fact that the debt markets are increasingly difficult to access.* So

[94] *See* TR. 774:23-775:24 (In questioning on this point, Mr. Leslie would only observe that Puget has many options to fund its investments today --- an "infinite number of scenarios"--- including "broad license to borrow funds.")

> it has to be a balance of equity and debt, and having debt only was never an option.[95]

It is difficult to overstate the significance of this answer. Ms. Campbell is entirely correct in every respect. Yet, she and Puget and the Investor Consortium, seem to ignore that the very scenario she describes is the plan for the new Puget. The debt/equity ratio *will* in fact be out of balance, the predicted denigration of the capital structure *has already* resulted in negative ratings impacts, there is no dispute that the cost of debt *will be* higher. If relying solely on debt was "never an option" then why is Puget supporting the sale of the company in this fashion?

51. Only if one accepts the Joint Applicants' invitation to don blinders and look only at the PSE level, ignoring the actual financial structure of this transaction, can we ignore Ms. Campbell's incisive critique of the impact of this approach to acquiring capital.

B. Other Factors Also Increase Risk.

1. The refinancing risk is substantial and is not cured by the new commitments in the settlement.

52. There are other factors, beyond those overarching risks of strained payout ratios and shrinking equity balances cited above, that add to the risk inherent in the transaction.

53. All of the debt expected to be issued by Puget Energy (transaction debt as well as capital expenditure debt) is five-year term debt. That debt will all have to be re-financed within five years after the close of the transaction. This debt is intended to support long-lived utility assets, and re-financing that debt long before the full depreciation of the plant it supports is risky. While U. S. Treasury interest rates are still relatively low (as the Fed continues to try to stimulate a sluggish economy and address the current financial crisis), it is far from clear that such will be

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[95] TR. 1017:5-1018:9 (Campbell).

the case in five years. Interest rates could be much higher than they are now, meaning that continued debt financing of Puget would be far costlier than called for by the assumptions in Macquarie's financial model.[96] Also, if the Macquarie "infrastructure model" falls out of favor or international debt markets continue to experience turmoil, debt re-financing may not be available to Macquarie, or may be available only at a very high cost.[97]

54. All of this creates a clear risk of harm to the public interest.[98] In order to address the refinancing risk, Joint Applicants have agreed to Commitment 57 which states that they have an "objective…to refinance the term loan of Puget Energy using medium-term or long-term financing."[99] They will "develop a plan" and make it available. This commitment does precisely nothing as a practical matter to address this risk. There is no binding or enforceable commitment to do anything. The structure of the transaction does not change. The debt will have to be refinanced in the next five years in the same markets regardless of this "commitment." The inescapable financial realities are not changed one iota.

55. Staff witness Mr. Horton identified this "refinancing risk" as one of the chief financial risks of the transaction. His testimony discusses the viability of a possible condition on the sale that would require the term of the transaction loans to be extended to a longer period to mitigate the risk.[100] Mr. Horton, however, testified that the changing the maturity of the bank loans from 5

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[96] Macquarie's financial model assumes that **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXX. XXXXXXXXXXXXXXXXXX**[End Highly Confidential]** Exh. No. 251HCT, p. 52 (Hill Direct); Exh. No. 52HC, p. 13.
[97] Exh. No. 191 , p. 7:12-20, p. 10:12-22. (Schmidt Direct).
[98] Exh. No. 161, p. 29:21 (Elgin).
[99] On its face, the commitment did not even include all the debt to be refinanced, a fact pointed out on questioning from the bench. TR. 553:22-22-554:25 (Kupchak).
[100] Exh. No. 181, p. 16, p. 18:17 (Horton Direct).

to 10 years would not totally mitigate the financial risk to PSE:

> [W]hile the change in the maturity reduces the refinancing risk to some degree, it merely delays the refinancing risk by 5 years, from 2013 to 2018. Under the status quo, PSE would typically match the term of any new loan with the life of the facilities, and any new equity capital that Puget Energy would issue would be a permanent source of capital.[101]

This shows the ineffectual nature of Commitment 57. First, it does nothing to remove the need to refinance all of the debt within the next five years – the risk identified by Horton's testimony. Second, even if some of the debt is replaced, for example, by a medium term seven year loan in 2009, that loan will still need to be refinanced in 2016, simply delaying the risk as Mr. Horton describes. Indeed, there would be double risk – first at the initial refinancing, then again at the 2016 refinance. The Staff's brief portion of the Joint Testimony on this issue does not address this in any way, simply describing the commitment and stating that it mitigates the risk.[102] The Joint Rebuttal Testimony makes no mention of the issue. There is no acknowledgment of the problem identified by Mr. Horton in his initial testimony. The refinancing risk is not sufficiently mitigated by the settlement commitment.

2. The assets of Puget [Begin Highly Confidential] XXXXXXXXXXXXXXX XXXX[End Highly Confidential].

56. The security for the debt projected to be issued by Puget Energy is **[Begin Highly Confidential]** XXXXXXXXXXXXXXX. **[End Highly Confidental]**[103] If reality is substantially different from the financial projections offered by Macquarie's financial model, which is not unlikely, it is well within the realm of probability, based on prior Puget revenue

[101] *Id.*, p. 19: 1-7.
[102] Exh. No. 302, p. 39: 1-9.
[103] Exh. No. 51, p. 23.

volatility, that Puget Energy would violate its debt covenants. If Puget Energy does not have sufficient cash to cover its debt interest requirements, it will be in default of its debt agreements and the ownership of PSE will fall to the consortium of banks that provided debt capital to Puget Energy. In that event, it is unclear whether any of the "ring fencing" measures created in the Stipulation would be in effect.

3. The financial margins are thin.

57. The financial margins regarding debt payment requirements projected in the Macquarie financial model, which, as explained in more detail below, are based on benign economic conditions and assumptions favorable to operational continuity, are thin and are likely to be violated in real-world conditions. Public Counsel witness Hill shows that, based on Puget's actual historical revenue volatility, the chances are approximately **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXX**[End Highly Confidential]** [104] Such a violation would trigger cash sweep or default restrictions. The Joint Applicants offered no quantitative response to Mr. Hill's testimony regarding the probability of this event.[105]

C. The Transaction Ring Fencing Commitments Do Not Adequately Remove or Neutralize the Risk.

58. While the settlement stipulation contains a number of commitments that make incremental changes to the transaction, the fundamental nature of the acquisition is unchanged. The increased harm to the public interest posed by the acquisition is not offset or adequately

[104] Exh. No. 258HC.
[105] Exh. No. 260HC, p. 4:12 (Hill Response To Settlement).

mitigated by the proposed conditions.

1. The $200 million equity infusion.

59. Commitment No. 59 agrees to increase the amount of common equity involved in the transaction by $200 million and to decrease the amount of debt issued under the Holdco term loan from $1.425 billion to $1.225 billion. Joint Applicants, Staff, and the other settling parties argue that this adequately addresses the concern about excessive amounts of debt. The commitment does not make a significant difference to the debt/equity ratio of Puget, however. Even when $200 million of new equity is added to the capital structure, the average debt-to- total capital ratio for Puget Energy declines only two percentage points **[Begin Highly Confidential]** XXXXXXXXXXXXXXXX[106] **[End Highly Confidential].** This remains well below S&P's threshold for investment grade electric utilities.[107] The Joint Applicants would need to add at least $500 million in equity to this transaction to address this problem, as well as agree to maintain a minimum 40 percent equity ratio for Puget Holdings and its subsidiaries on a consolidated basis, as discussed below.[108]

2. Dividend restrictions and other ring fencing commitments.

a. Dividend restrictions.

60. As an initial matter, it bears repeating that under the *status quo* with a healthy Puget, ratings downgrades and concerns about retaining cash in the operating company are non-issues. Ring-fencing and dividend restrictions are only under discussion at all because the transaction

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[106] *See* Exh. No. 259HC (Puget Acquisition: Calculation of Debt/Capital Ratio Based on Macquarie Projections).
[107] *Id.*, ll. 12-13. Exh. No. 49, p. 56 (Presentation to Potential Equity Investors: Debt Analysis) *See also,* Exh. No. 52HC, p. 178 (financial model outputs compared to S&P BBB thresholds).
[108] TR 1037:7-10 (Hill).

increases financial risk due to the large amounts of debt and the increased potential for rating downgrades.[109]

61. The dividend restrictions in Commitment No.40 provide limited positive benefits. Even if PSE is downgraded, it is still permitted under Commitment No. 40 to make all payments required to service debt at Puget Energy or to satisfy financial covenants in the credit facilities of Puget Energy. To the extent the commitments allow PSE to retain some cash to rebuild the consolidated financial position, that impact is small and slow to take effect, as detailed by Public Counsel witness Stephen Hill. Mr. Hill calculates that the equity ratio would increase only 2 percent annually.[110] At the same time, there would be a significant increase in costs accompanying a rating downgrade. Mr. Hill details the negative consequences for Puget from the loss of an investment grade rating, including: higher borrowing cost on long term debt, and on short tem debt, potential loss of access to commercial paper markets, inability to renew credit facilities, collateral calls from counter parties, demands for prepayment from new energy resource counter parties, and unavailability of credit for hedging activities.[111]

b. Permission to issue equity.

62. Joint Applicants now describe the transaction as providing more options by allowing Puget to access both the private equity and the public markets.[112] This is a mischaracterization. Commitment No. 35 represents only that Puget Holdings is not prohibited from issuing equity to

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[109] Ironically, Standard & Poor's warns that ring-fencing may actually increase risk in the sense that it can harm the parent's credit rating by restricting cash flow, another risk not present for Puget under its current configuration. Exh. No. 169, p. 6

[110] Exh. No. 261HC, p. 8:5 (Hill Response to Settlement).

[111] *Id.,* p. 8:15-9:7.

[112] Response of Puget Holdings et al. In Opposition to Public Counsel Motion To Reopen The Record, ¶ 21. Contrast this with Mr. Leslie's statements about the "infinite range of scenarios" currently available to Puget. TR. 775:7-24.

third parties or the public markets. It offers another weak reed, the assurance that PSE, while a subsidiary of a non-listed private equity conglomerate, could issue "hybrid securities" to third parties and the public markets. Nothing in these provisions provides any commitment or assurance that equity would be available from or sought by the Investor Consortium in a case of extreme financial risk.

63. Investors have always been "permitted" in the sense of being able to inject more capital into this transaction. The issue is that they are not interested in doing so. As Mr. Leslie, explained, when asked by Commissioner Jones why the investors did not simply purchase Puget stock, investing equity is not consistent with the intentionally leveraged structure of the acquisition. Injection of more capital impairs the investors expected high leveraged rates of return. While the investors reassure the Commission that they would certainly step in to protect their investment, it is noteworthy that "trust us" does not translate in to a binding commitment. They might step in,[113] but they might also choose not to put good money after bad, as Mr. Horton notes in rejecting the efficacy of equity infusion requirements.[114] The risk that they may not is a new risk that falls upon the customers, created by this transaction that did not exist before.

c. Ratings separation.

64. Joint Applicants and Staff place major emphasis on the issue of ratings separation. Commitment No. 39 provides that Joint Applicants will seek separation, and the Joint Applicants' Rebuttal Testimony on settlement issues reports that **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

[113] TR. 1034:14 (Hill).
[114] Exh. No. 181, p. 17:2-14 Horton Direct).

XXXXXXXXXXXXXXXXXXXX **[End Highly Confidential].** While ratings separation would have some benefit for PSE, as Mr. Hill acknowledges, any downgrade that occurs for PSE will occur because of the debt at the parent level, indicating that the ratings remain linked. Ratings separation is not the same as full ratings de-linking and separation does not remove the risk of downgrades at the parent level, which can still affect the subsidiary.[115] The degree of separation can also vary. As long as the ratings of the parent negatively affect the ratings of PSE, there is harm. There is no assurance in **[Begin Highly Confidential]** XXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]** Ultimately, Puget Holdings remains in complete control of the financial structure and well-being of PSE. Public Counsel notes that Moody's **[Begin Highly Confidential]** XXX XXXXXXXXXXXX**[End Highly Confidential].**[116]

d. Minimum equity ratio.

65. Commitment 36, requiring Joint Applicants to maintain a 44 percent equity ratio at PSE also has little value. PSE's parent can issue debt in order to inject any amount of "equity" capital it chooses at the operating company level. As noted, there are no plans to **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** Any capital raised to maintain these commitments will be **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** in Puget.

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[115] Exh. No. 251, p. 69:15 (**[Begin Highly Confidential** XXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXX**[End Highly Confidential**)

[116] Exh. No. 8HC, p. 2.

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66. There is no commitment to maintain a balanced level of debt and equity in Puget Holdings as a whole. That would defeat the essential purpose of this leveraged buy-out transaction by impairing the expected high internal rate of return. The Macquarie-led investors are acting on the express expectation that the Washington Commission will not look at the consolidated equity ratio for the new Puget they seek to create.[117] While it may not be consistent with the investors' desires for this transaction, a balanced financial structure for Puget would be require a commitment to maintain a minimum consolidated equity ratio of 40 percent.[118]

e. Non-consolidation and bankruptcy protection.

67. The bankruptcy protection commitments in the settlement contain a number of limitations that leave PSE and its customers exposed. Commitment No. 8 requires Puget to file a non-consolidation opinion with the Commission within 90 days of closing, which would state that,"subject to customary assumptions and exceptions," the ring-fencing provisions are sufficient to prevent consolidation of PSE's assets with those of Puget in the even of a bankruptcy. Joint Applicants acknowledge that the existence of a non-consolidation opinion, however, does not prevent a PSE bankruptcy.[119]

68. If a non-consolidation opinion cannot be obtained, Joint Applicants promise, in Commitment No. 25 to notify the Commission and to propose and implement new ring-fencing provisions. Of course, at that point, the transaction would have been approved. The willingness of the new Puget, and the ability of the Commission, to set new requirements is subject to some doubt. The Commission would have little or no practical ability to unwind the transaction, even

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[117] Exh. No. 49HC, p.39; TR. 777:17 – 782:4 (Leslie). Mr. Leslie also acknowledges that investors are interested in whether the UTC uses the utility only or the consolidated tax rate, the former generating a lower tax burden.
[118] TR. 1037:9 (Hill).
[119] Exh. No. 251, p. 70:14-17.

if Puget Holdings could not obtain a non-consolidation opinion and would not agree to new Commission conditions.

69. Commitment 16 provides that the organizational documents for PSE will not permit PSE to consent to the institution of bankruptcy proceedings, or to its inclusion in bankruptcy proceedings, without unanimous consent of the PSE board, including its Independent Director. What the commitments do not provide is a guarantee that the Puget Holdings will not include PSE in a petition for bankruptcy protection. If the Board, dominated by representatives of the Investor Consortium, can persuade the Independent Director to agree, the parent can nevertheless "consolidate" PSE into a Puget Holdings bankruptcy, while remaining in full compliance with the settlement commitments. The creation of a fifth Puget entity "Equico" does nothing to change this.[120]

V. THE PROPOSED SALE WILL INCREASE CAPITAL COST

70. As noted by Puget Board member Ms. Campbell, the purpose of maintaining a balanced capital structure is to minimize the overall cost of capital.[121] When capital structures are out of balance with too much debt or too much equity, overall capital costs rise. The fact that the proposed sale raises capital costs is demonstrated in several ways.

71. First, the new transaction debt to be issued by PE will have a cost rate approximately 100 basis points higher than new debt to be issued by PSE,[122] because the transaction will push the bond rating of the parent company Puget Energy further into the "BB" or junk-bond status.[123]

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[120] Exh. No. 261, p. 11:6-16.
[121] TR. 1017:16-1018:9 (Campbell).
[122] Exh. No. 19, p. 8; Exh. No. 51, p. 19 TR. 791:5-795:5.
[123] Exh. No. 49, p. 56.

72. Second, the new debt to be issued by PSE, arranged by Macquarie to replace PSE's old debt facilities, will carry a cost rate higher than the debt it will replace.[124]

73. Third, the planned re-financing of $375 million of PSE long-term debt concurrent with the transaction is uneconomic. When Commission Staff asked Joint Applicants to provide any cost-benefit analysis by PSE supporting the buy-back of that $375 million of debt, the Joint Applicants replied that PSE had performed no such analysis, because absent the planned merger, there were no plans to buy-back that debt.[125] Also, PSE will have to pay an additional $19 million of pre-payment expenses to re-fund this debt [126]—an expense it would not incur if the transaction is denied. Staff testimony concludes there is "no evidence that this plan [to retire the $375 million in long-term debt] is prudent or appropriate for ratemaking purposes."[127]

74. Fourth, as discussed earlier in this brief, when asked whether or not the proposed transaction would afford PSE access to more cost-effective capital, the Joint Applicants indicated that lower-cost capital was not a goal for this transaction.[128] Indeed, as discussed, the financial model assumes that cost of debt post-acquisition will be higher.

75. Fifth, the cost of equity will be higher. It is axiomatic that as leverage increases and financial risk increases, the cost of equity capital will increase. The very high return on equity expected by the Investor Consortium to result from this transaction is commensurate with the high degree of leverage as well as the fact that a private equity transaction such as this is "illiquid." As shown in the Presentation to Potential Equity Investors, the annual return promised by Macquarie to the investors is **[Begin Highly Confidential]** XXXXXX. **[End**

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[124] Exh. No. 86; TR. 794:22-795:5.
[125] Exh. No. No. 87.
[126] Exh. No. No. 87, p. 2 and Attachment A.
[127] Exh. No. 161, p. 39 (Elgin Direct).
[128] Exh. No. 251HCT, pp. 40-41(Hill Direct); Exh. No. 83; Exh. No. 171.

Highly Confidential][129] That return is an annual rate of return based on an annual yield and an assumed sale price at some point in the future. As a result of the new rate credit commitment the IRR is incrementally reduced by 24 basis points,[130] still more than **[Begin Highly Confidential]** XXX **[End Highly Confidential]** basis points above the cost of equity used in the proposed settlement of Puget's current rate proceeding.

76. Macquarie witness Mr. Leslie attempted on the witness stand to claim that an IRR (Internal Rate of Return) was somehow not an "annual rate of return" because it was based on a distant expected sale price and the return realization would not occur until that sale.[131] This Commission is quite familiar with the nature of Discounted Cash Flow (DCF) calculations from its many rate proceedings. DCF analysis is much like an IRR calculation.

77. As with the DCF an IRR calculation finds the discount rate that equates the present value of the asset with the future cash flows expected from the purchase of that asset. With a DCF analysis, those cash flows are the annual dividends expected and a stock price at some point in the future. The discount rate that equates those future cash flows to the current stock price is the cost of equity capital—an annual rate of return required by investors to purchase that stock.

78. Macquarie's IRR result presented to investors is no different, conceptually. The current price is the amount that the Investor Consortium expects to provide to buy Puget Energy; the annual distributions or dividends are the periodic cash flows received by the investors. Those promised amounts are **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** of the purchase price annually[132]; and the projected sale price is the value of Puget Energy projected

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[129] Exh. No. 4 , p. 13.
[130] Exh. No. 302, p. 28:10.
[131] TR. 767:3-770:3 (Leslie).
[132] As discussed above, this translates to a future dividend of **[Begin Highly Confidential]** XXX**[End Highly Confidential]** compared to the current level of $1.00 per share.

by Macquarie at some point in the future. The annual rate of return that discounts all of those projected cash flows (distributions and ultimate sale of Puget) back to the current purchase price is **[Begin Highly Confidential]** XXXXXX. **[End Highly Confidential]** This is the expected internal rate of return in Macquarie's proposed acquisition of Puget Energy (exclusive of the the rate credit impact). This fact explains Mr. Leslie's circuitous answer to the question of why Macquarie and other consortium members don't simply buy Puget stock in the public market. [133] They prefer to advocate for this private acquisition of the company structured as a leveraged buy-out because – simply put – this way they can make a lot more money.

VI. THE FINANCIAL MODEL THAT SUPPORTS THE TRANSACTION IS UNRELIABLE

A. The Macquarie Financial Model Has Many Troubling Aspects.

79. If there is one document in this case that is central to judging the viability of the proposed transaction it is the financial model engineered and used by Macquarie. The model has been used by Macquarie to represent the financial projections for a post-transaction Puget both to equity and debt investors as well as the parties in this proceeding. The Joint Applicants supplied both an electronic and a paper copy of the financial model in Exh. No. 52HC.[134]

80. A close examination of Macquarie's financial model reveals several factors that underscore the tenuous nature of the predicted success of this transaction:

[Begin Highly Confidential]

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[133] TR.834:2-836:13.
[134] The paper copy of the financial model, showing financial projections through 2013, does not contain all the data included in the electronic model, which projects financials for Puget through 2018.

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- XXXXXXXXXXXXXXXXXXXXXXXXX;
- XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXX[135]
- XXXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]**

81. The financial model projects a successful outcome for the acquisition over the next ten years, but those results are questionable. Macquarie, itself, advises prospective investors that it **[Begin Highly Confidential]** "XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXX[136] **[End Highly Confidential]** If the financial forecasts on which the projected viability of the transaction is based are not reliable, the transaction should not proceed.

B. The Model Assumptions Are Unrealistic.

82. Turning to the details of the financial model, as Public Counsel witness Mr. Hill pointed out,[137] the assumptions on which the Macquarie financial model is based include:

[Begin Highly Confidential]

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[135] Exh. No. 251HC, pp. 55:9-59:11 (Hill Direct); Exh. No. 258HC.
[136] Exh. No. 52HC, p. 2. Mr. Leslie dismisses this as a "standard disclaimer." TR. 803:13-14.
[137] Exh. No. 251HC, pp. 51:10-54:7.

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1. The Model makes incorrect assumptions about power cost recovery.

83. The Macquarie model unrealistically tends to stabilize projected financials by including **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]**[138] It is little wonder that the projected financial results for Puget are subject to only small variations due to changes in power costs (no matter how large those costs are assumed to be). When Public Counsel requested that the Applicants run more severe "tests" of the model[139] (e.g., power cost increases of 50 percent, doubling of inflation and interest rates), the projected financial results were **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXX. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly**

[138] Exh. No. 52HC, p. 102, which shows the Profit and Loss statement for PSE on a quarterly basis, includes a revenue line item called the "Cost of Electricity."
[139] Exh. No. 6 HC.

Confidential] [140] On cross-examination, Mr. Kupchak, presented as the expert on Macquarie's financial model, had little understanding of how Puget's PCA provides for delayed recovery of power costs. [141]

84. Particularly surprising for a Pacific Northwest utility, when asked to assume a low hydro generation condition, the Joint Applicants replied, **[Begin Highly Confidential]** XXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[142] XXXXXXXXXXXXXXXXXXXX**[End Highly Confidential]**

2. The Model relies upon a schedule of [Begin Highly Confidential] XXX [End Highly Confidential] rate cases and Commission rate awards of [Begin Highly Confidential] XXXX [End Highly Confidential].

85. Joint Applicants do admit there is one factor that will cause the financial model projections to show negative results --- **[Begin Highly Confidential]** XXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[143]. XXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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[140] As the Applicants state in Exh. No. 67HC, Attachment A, Scenario B Assumptions, **[Begin Highly Confidential]**XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXX. **[End Highly Confidential]**

[141] TR. 912:24-915:11.

[142] Exh. No. 67, Scenarios C and D.

[143] As shown in Attachment A to Exh. No. 67HC.

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XXXXXXXXXXXXXX **[End Highly Confidential]** [144]

86. The model also projects that this Commission will allow **[Begin Highly Confidential]** XXXXXXt **[End Highly Confidential]** of the new Puget's rate requests in these annual cases. Regulatory commissions rarely award **[Begin Highly Confidential]** XXXXXXX **[End Highly Confidential]** of utility rate requests and, according to the UTC/Puget rate case history included in Macquarie's presentation to equity investors[145] this Commission has awarded Puget markedly less than **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** of its requested rate increases since 2002.

87. This projection is now incorporated as a fundamental assumption in the financial projections used to persuade debt and equity investors to commit to this transaction. This introduces an entirely new dynamic for PSE and its parent board about when it is necessary to file a rate case. Even more concerning, this places an entirely new set of pressures on this Commission and PSE ratepayers to provide the rate increases projected by the Joint Applicants. The rationale for doing so will be to avoid putting Puget into "cash lock up" trouble with its lenders.

88. Another curious aspect of Macquarie's financial Model is that it shows Puget's revenues growing nearly twice as fast as its expenses from 2008 through 2013. [146] Under cost-based regulation, of course, the revenues allowed are based on the utility's actual costs. Consistent

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[144] Exh. No. 66HC.
[145] Exh. No. 49HC, p. 36,
[146] Exh. No. 52HC, p. 6.

with this, the rate of increase in Puget's revenues over the past five years was virtually identical to the rate of increase in its operating expenses (which one would expect under efficient regulation).[147] Mr. Leslie agreed with these premises, but when asked why the model showed revenues growing dramatically faster than costs, was unable to provide coherent explanation.[148]

89. Both the testimony of Mr. Leslie and Mr. Kupchak, and the assumptions underlying the model underline the disconnect between the financial model at the core of this transaction (a product of Macquarie's understanding of regulation) and reality. A serious concern is whether these projections that are incorporated as financial assumptions will drive PSE rate filings over the next five or ten years, rather than legitimate cost recovery.

3. The Model contains errors.

90. Public Counsel witness Stephen Hill noted in his Direct Testimony that Macquarie's financial model projected that Puget would to pay an average annual dividend of **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]**.[149]

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[147] Exh. No. 65; TR. 807:22-25.

[148] TR. 806:18-807:7. **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXX. **[End Highly Confidential]** TR. 807:9-10. Regulatory lag causes the revenues for an incurred expense to be collected after the expense is incurred and could, in no conceivable way, cause Puget's revenues to grow more rapidly than its expenses, much less at twice the rate. **[Begin Highly Confidential]** XXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential**

[149] Macquarie witness Kupchak responded to that point at page 22 of his Rebuttal, Exh. No. 11CT. In response to Mr. Kupchak's rebuttal, Public Counsel asked in Data Request No. 3206 (Exh. No. 23HC, original response July 17, 2008) if the amount of dividends shown in the financial model for PSE in 2008 **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** was correct. Mr. Kupchak responded in the affirmative— that number was correct. Public Counsel, in preparation for the hearing informed the Joint Applicants that Mr. Kupchak's response to Public Counsel Data Request No. 3206 would be used in his cross-examination.

91. During cross-examination, however, Mr. Kupchak indicated for the first time that the 2008 dividend number provided in discovery was not correct.[150] Mr. Kupchak later testified that there was an error in that the model was creating cash flows that the Company would not actually have and, thereby, overstated the dividend by paying out cash that did not actually exist.[151] Joint Applicants now state that the correct PSE dividend projected for 2008 is **[Begin Highly Confidential** XXXXX **[End Highly Confidential].[152]** None of the other annual projections were corrected. **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]**

92. On the last day of hearing, in preparing their response to the model error in projected **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** Joint Applicants discovered a **[Begin Highly Confidential** XXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** Apparently, this error was not known in advance.

93. Interestingly, before the dividend error came to light in cross examination, Mr. Kupchak was asked to explain why the **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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[150] TR. 901:17-902:17 (Kupchak).
[151] TR. 1056:16-19 (Kupchak).
[152] Exh. No. 23, First Supplemental Response provided August 27, 2008.

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XXXXXXX.[153] **[End Highly Confidential]** Mr. Kupchak went on to identify the key factor in this review, in his opinion:

[Begin Highly Confidential]

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[End Highly Confidential

94. Although the Macquarie financial model was supposedly reviewed "thoroughly" by all the equity investors (including Mr. Leslie as head of MIP), the banks that propose to lend money to this transaction and even Macquarie's accountant KPMG, nobody caught **[Begin Highly Confidential XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXX**[155]**XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXX**[156]**XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXX [End Highly Confidential]** [157]

95. In summary, the financial model on which the proposed transaction is grounded and which projects positive results in spite of much larger debt loads and dividend payments to investors, is suspect. The assumptions on which the model is based and the manner in which Washington regulation is "modeled" works to create positive results for the projected financials

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[153] TR. 889:24-890:12.
[154] TR. 890:21-891:8.
[155] TR. 1051:8-1053:6.
[156] TR/ 1058:20-24.
[157] TR. 1057:10-13.

for Puget. However, reality is different from a financial spreadsheet, making Macquarie's cautionary statement to investors that **[Begin Highly Confidential]** XXXXXXXXXXXXXXX XXXXXXXXXX **[End Highly Confidential]** a factor to which this Commission should pay heed.

VII. NATIONAL AND INTERNATIONAL FINANCIAL MARKET RISK

A. The Macquarie Model - - Question Marks.

96. If the proposed transaction for Puget is approved and is implemented as planned, **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** will be provided with debt capital. That fact is a key aspect of the Macquarie Infrastructure Model—Macquarie buys infrastructure assets (airports, toll roads, utilities) that have relatively stable income streams and then leverages those income streams by financing the purchase with debt and using additional debt to provide capital expenditures.[158] The use of debt capital in this fashion works to raise equity returns to Macquarie and its investment partners and co-owners.[159]

97. The Macquarie Model has historically done well in infrastructure projects and has a strong reputation for selecting attractive projects and generating high returns for investors. As a result Macquarie likely has enjoyed a "reputational" effect that has allowed it to find more favorable debt rates.[160] Serious questions have been raised, about the Macquarie model, however, in terms of its sustainability and because of certain components of the model

[158] Exh. No. 417, p. 4.
[159] Exh. No. 251, p. 15:8-17:11 (Hill Direct).
[160] Exh. No. 191, p. 20:9-18 (Schmidt).

structure.[161] Some critics have referred to Macquarie as a "giant house of cards,"[162] or a "Ponzi scheme."[163] In an April 2008 article on the Macquarie Group, *The Economist* commented that: "[p]art of the secret of [Macquarie's] success was financial innovation -- once thought of as a mark of brilliance, but a stigma since last year owing to the leverage it had concealed across the financial system. Macquarie**'** mix of businesses behaves a bit like overlapping shadows; it is hard to know where one begins and another ends."[164]

98. Concerns about the Macquarie model fall into the following main categories: sustainability (including payment of dividends from both assets and debt capital); inflation of asset prices; high management fee structure; accounting practices that provide an overly robust picture of profitability; and governance and transparency concerns.[165]

B. The Macquarie Model Creates Additional Financial Risk For Puget.

99. Staff witness Dr. Schmidt's testimony is important in analyzing the significance of this information. Dr. Schmidt identified the following primary *increased* risks that result from this transaction compared to those faced by PSE if it remains public traded:

(1) Because the new owners will depend on financing from the private equity market, there is a risk of major loss of investor confidence from market-driven shocks;

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[161] Exh. No. 191, p. 21:8-21; Exh. No. 194.
[162] Exh. No. 417, p. 2.
[163] Exh. No. 254, p. 2
[164] Exh. No. 417, p. 2.
[165] RiskMetrics Group, Infrastructure Funds: Managing, Financing and Accounting, in Whose Interests? Exh. No. 255, p. 37; *See* Exh. No. 251, pp. 23-28 (general discussion of concerns discussed in financial media). Exh. No. 139, p. 3 (Wall Street Journal article). As the Private Placement memorandum details, the Macquarie model discloses a broad array **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Highly Confidential]** Exh. No. 50, pp. 66-68.

(2) Higher leveraged entities have greater exposure to interest rate risk, and in the current state of financial markets interest rates are likely to be volatile;

(3) Higher leveraged entities are more exposed to energy price fluctuations;

(4) The risk of a reversal in Macquarie's reputational advantage that could raise concerns about its future access to capital on favorable terms.[166]

100. Dr. Schmidt was asked at the hearing whether the testimony he had provided describing these risk factors remained accurate given the passage of time since it was initially filed in June and he confirmed his testimony remained accurate.[167] He specifically testified that it is still "definitely true" that interest rates are volatile[168] and that the risks in the energy markets continue to be "very large" and "remain extremely volatile."[169] Public Counsel's exhibits regarding developments in the financial markets support Dr. Schmidt's and Mr. Hill's testimony regarding global market risk. They support a conclusion that these risk factors have intensified rather than abated.

101. Staff witness Elgin testified that the acquisition is harmful to the public interest by creating additional risk in three areas: (1) "the reliance on global markets to fund the purchase of Puget Energy and provide PSE's new equity needs" addressed by Dr. Schmidt; (2) additional risk related to the particular transaction, addressed by Mr. Horton; and (3) the risk created by the significant new levels of debt.[170] Dr. Schmidt was not asked to testify as to whether his external risk issues were addressed by the settlement.

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[166] Exh. No. 191, pp. 4-5.
[167] TR. 870:1--874:11.
[168] TR. 871:1.
[169] TR. 873:19-874:6.
[170] Exh. No. 161, p. 6:8-19 (Elgin).

102. Staff may seek to argue, as Mr. Cedarbaum did at hearing, that Mr. Horton is now the witness to address these areas,[171] but the record reflects to the contrary. The settling parties' joint testimony contains a list of Staff concerns that are said to be addressed by the settlement. This global market risk issue, though clearly identified as a separate area of concern in the direct testimony, is not mentioned. Nothing either in the Joint Testimony supporting the settlement, or in Mr. Horton's separate statements, rebuts the specific risks addressed by Dr. Schmidt.

103. Nothing in the settlement agreement changes the reliance of the new owners on the national and international credit markets to finance the transaction, to finance new capital, and to refinance the debt in the next five years.

C. The International Financial Crisis Bears Out Concerns Raised About The Macquarie Model.

104. The primary reason for Macquarie's stumble is that chief element of the Macquarie model's financial engineering is debt. Macquarie does not deny that financing this transaction involves the investors' global relationships with lending institutions, although it argues that it has "superior" relationships and an exceptional track record.[172] Debt is the Achilles heel of the Macquarie model —debt must be available and relatively cheap for the model to work. Macquarie's prosperity has recently faltered, as have the fortunes of imitators like Babcock & Brown.[173] By August 22, 2008, the Friday before the hearing began in this case, Babcock & Brown's chairman and chief executive had resigned and its share price had dropped 92 percent since the beginning of the hearing. In an article that day entitled "Shaking Up the Macquarie Model," the *Wall Street Journal* took an overview of the status of the model. The article notes a

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[171] TR. 882:7 –883:1.
[172] TR. 466:3-10.
[173] Exh. No. 194.

"sharp turn of fortunes" with the Macquarie Group Ltd losing 38 percent in share value in 2008, and increasing investor skepticism.[174]

105. Public Counsel offered at the hearing evidence that national and global financial markets problems had continued and worsened since Staff and Public Counsel testimony was filed.[175] Since the hearing in this case, the turbulence of national and international financial markets has become much more serious.

106. To say that events during the week of September 15 have been dramatic is to engage in understatement. Lehman Brothers Holding, Inc. filed for Chapter 11 bankruptcy,[176] Merrill Lynch was purchased by Bank of America,[177] leaving only two of Wall Streets five major brokerage houses standing (with the earlier failure of Bear Stearns). American International Group (AIG) stock plunged and faced a cash crisis, ultimately averted by federal intervention.[178] Global stock markets plunged. By the end of last week, the federal government was beginning to craft a much broader "bail out" plan for the financial sector, the largest in history.[179]

The turmoil in the debt markets can affect Macquarie's ability to borrow and, in fact, had already done so even prior to last week. In describing why Macquarie ultimately agreed to pay $30 per share of Puget Energy to purchase that company instead of the originally agreed $32 per share, witness Campbell indicated that, even before recent events, the debt market crisis made the debt

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[174] Exh. No. 239.
[175] Exh. Nos.195-200, 235-238 (News articles on world economic trends, Fannie Mae and Freddie Mac, credit unions problems, Merrill Lynch, and IndyMac failure)
[176] Exh. No.502.
[177] Exh. No. 504.
[178] Exh. No. 506. AIG's crisis shows the potential pressures placed on regulatory restrictions meant to protect subsidiaries of ailing companies. New York's governor and state insurance regulator were reported ready to waive regulatory prohibitions and allow AIG to borrow $20 billion from its subsidiaries, although that would place the policy holders of the subsidiary operating insurance companies at risk. Exh. No. 505.
[179] United States Department of the Treasury, Statement of Secretary Henry M. Paulson Jr. On Comprehensive Approach to Market Developments, September 19, 2008. http://www.ustreas.gov/press/releases/hp1149.htm.

capital sought by Macquarie to complete this transaction more expensive: “debt was not only harder to access, it was more expensive, considerably more expensive than in the capital markets.”[180]

107. Macquarie has not been immune from the past week’s developments. The Macquarie Group “took a pummeling in the debt and equity markets,” amid concerns about the Group’s capacity to refinance debt, sell assets and maintain earnings.[181] *The Australian* commented:

> In these uncertain times, the worst thing a company can do is have too much debt, hold a portfolio of declining asset values, lack transparency and fail to provide earnings outlooks.
>
> Babcock and Brown and Macquarie Group have these characteristics in spades and if they want to escape a further stock price battering, they will need to start selling assets and do some swift refinancing deals.[182]

108. On September 17, Standard and Poor’s, while reaffirming the existing ratings for Macquarie Group Ltd., revised the outlook from stable to negative, implying a one-in-three chance of a downgrade.[183] On September 18, Moody’s Investors Service announced a downward revision of the outlook for Macquarie Group to stable from positive.[184] Both rating agencies review a number of strengths which they identify in Macquarie’s position, but also list areas of potential concern. Standard & Poor’s states that “[t]he negative outlook reflects a potential weakening in the Macquarie group’s operating and financial flexibility due to the heightened

[180] TR. 1020:3-5.
[181] Exh. No. 509. p. 1. *The Australian,* September 17, 2008.
[182] *Id.* In a press release on the same day, Macquarie called specific statements in this story about amounts to be refinanced “false.” The release did not respond to the statement made above. Exh. No. 513.
[183] Exh. No. 515.
[184] Exh. No. 514.

dislocation of the global financial markets in recent days [.]"[185] Standard & Poor's also notes that:

> The rating on Macquarie group entities could be lowered if the global financial market conditions deteriorate further, so as to put significant pressure on Macquarie's long term business model, and the group's funding and liquidity. The ratings are also likely to be lowered if investor sentiment materially worsens, or if the group's reputation is significantly damaged from events such as operational failures, or a perceived conflict of interest between Macquarie's role as originator, advisor, and asset manager.[186]

109. All of these risk factors for Macquarie downgrades are the same risk factors that identified in earlier testimony from witnesses in this case and in the analysis of knowledgeable analysts. These are risk factors the Puget does not currently face and that would be added to Puget's risk profile if this transaction were approved.

110. In their response to Public Counsel's Motion to Reopen, Joint Applicants argue that the events of the past week are not relevant at all, or that if they are considered, they provide a reason to approve the transaction because it provides more options for Puget to raise capital.[187] This latter argument twists the transaction out of any recognizable shape. Other than the equity used to purchase Puget, the entire transaction, as well as the future capital expenditure program, is built on **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXX **[End Highly Confidential]**. This is increased exposure that Puget does not now have. To characterize as desirable the exposure of Puget to new leverage risk in a market which is suffering the most serious contraction of access to debt capital, perhaps since the Great Depression, defies basic laws of economics and finance.

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[185] Exh. No. 515.
[186] *Id.*
[187] Response of Puget Holdings, ¶¶ 21, 24.

111. Joint Applicants also mischaracterize and overstate the degree to which the new Puget would have access to the public capital markets. There is no provision for public market financing as an every day business option for Puget. PSE is limited to issuing "hybrid securities." Puget Holdings commits to no more than "not prohibiting" the issuance of equity.

112. Re-levering Puget in a time of unprecedented upheaval in the debt markets is not in the best interests of the Company or its customers. Puget will be better-off as a stand alone electric and gas utility with a balanced capital structure than it would be as part of a debt-dependent international financial conglomerate.

VIII. GOVERNANCE ISSUES

A. The Acquisition Will Result in Significant Negative Changes in Governance for Puget.

113. From the outset of this proceeding, Joint Applicants have asserted that the approval of the acquisition will have no effect on the operations or regulation of Puget Sound Energy, that it will be "business as usual" and that the status quo will be maintained.[188] The Joint Applicants assert that local control of PSE will continue. In his direct testimony, Mr. Leslie states that the "governance and decision-making structure of PSE will essentially be unchanged" if the acquisition is approved. [189] A review of the record indicates otherwise. The new Puget will be different in several key respects that are not beneficial for the Company or its customers.

- Macquarie and the Canadian investors will hold a majority (9 of 11) in seats on the Puget Holdings board;
- There will be dramatic reduction in local representation on the board.

[188] *See e.g.* Exh. No. 131, p.10:9-11:7 (Reynolds Direct).
[189] Exh. No. 31, p. 20:18.

- None of the Puget boards will meet New York Stock Exchange (NYSE) requirements for board independence either generally or on key committees.

Concerns about governance in the Macquarie model are not unique to this proceeding. Financial analysts and commentators have identified this issue as a matter of general concern with Macquarie. The detailed RiskMetrics analysis of the Macquarie model devoted significant discussion to the problems of governance the model creates, identifying transparency and governance issues as one of the chief areas of concern identified by RiskMetrics in its analysis.[190] A RiskMetrics analyst has referred to the Macquarie model funds as "governance Frankensteins."[191]

1. Investor control.

114. Macquarie represents in the Macquarie Infrastructure Partners Private Placement Memorandum that "[w]here practicable, MIP intends to seek significant influence over the management, operations, and strategic direction of its Portfolio Investments."[192] As Macquarie witness Christopher Leslie put it: "Why would someone pay us if we couldn't do anything about our investment?"[193]

115. The new governance structure to be adopted for Puget reflects and expressly provides for this exercise of control by the new owners. Post-acquisition, Puget Holdings replaces the current parent, Puget Energy, as the new ultimate parent of PSE. Puget Holdings will be governed by a "Board of Managers" of up to 12 members effectively equivalent to a Board of Directors.[194]

[190] Exh. No. 255, p. 37.
[191] Exh. No. 239, p. 3.
[192] TR. 494, Exh. No. 50, p. 11 (confidentiality waived).
[193] TR. 495:19-20.
[194] TR. 710:4-9, Exh. No. 408.

Nine of these members will be appointed by the Investor Consortium – five by the Macquarie investors and four by the Canadian investors. A board of 11 is currently contemplated with two added members: a current PSE local board member and the PSE CEO (currently Steve Reynolds), although the Board can have up to 10 managers representing the Investor Consortium.[195]

116. Under this arrangement, the investor representatives have a numerical majority on the board and their 9 of 11 seats constitutes 81.8 percent of the board. The number of votes for the Independent Managers is yet to be determined but will be set by unanimous vote. [196] Any action by the Puget Holding board requires at least a 55 percent vote, which effectively means that the non-local Investor Consortium board members, who hold 81.8 percent of votes, can take action without approval of the local Puget representatives. "Certain significant corporate decisions" require a "supermajority" of 80 percent, which also can be achieved without the Puget local representatives.[197] While Exh. No. 408 states that "it is intended" that at least one local director would also need to participate in the supermajority, that requirement is not currently contained in the settlement stipulation. If adopted it would be subject to an exception for actions required for compliance with regulatory or legal matters, which would presumably include every issue addressed in the transaction commitments, for example.

117. A different category of decisions called "certain critical corporate actions," such as financing and other Member-related matters would require both board approval and a vote of 80 percent of the members. It is not clear how this relates to the "supermajority" requirement. The

[195]TR. 727:13-17; Exh. No. 408.
[196] Exh. No. 408.
[197] Exh. No. 408.

definition of "certain critical corporate actions," and presumably "certain significant corporate decisions," will not be decided until the final LLC agreement is adopted and so remains unknown at the time for making a decision on the application.

118. The Puget Holdings Board of Managers, with its majority of investor representatives, will have broad authority to

- Review, approve, and/or amend the PSE Business Plan
- Establish policies and procedures for implementing the business plan
- Review and approve material transactions (including acquisitions, divestitures, asset transfers, winding up of businesses, financings and grantings of security)
- Recruit, evaluate performance of, compensate and contract with the CEO and CFO of PSE
- Acquire, issue and dispose of securities
- Establish accounting policies, derivative programs, and tax strategies
- Declare dividend distributions[198]

It is contemplated that boards of Puget Holdings, Puget Intermediate Holdings, Equico, Puget Energy and PSE will be made up of essentially the same people: nine investor-appointed members, and two Puget members (three at the PSE level). The new Macquarie and Canadian investor-controlled board will have substantial ability to direct business decisions for the all the new Puget entities they have acquired or created in the above listed areas. As discussed above, at present there is no stated commitment and no certainty about the level of influence or control

[198] Exh. No. 36, p.3.

that the local directors will have in corporate governance. This is a material change from how Puget is governed today.

2. Loss of local control.

119. Representatives of Joint Applicants have frequently attempted to reassure the Commission and the public that the PSE Board will retain local members. These statements are misleading and obscure the actual changes planned for the board by suggesting that the strong local membership of the board will remain. As Steve Reynolds detailed at the hearing, the current PSE/Puget Energy Board consists of 10 members, at least seven of whom have local ties.[199] If the acquisition is approved, only three at most will be residents of the region, and these only at the PSE level.[200] On the Puget Energy board, only two are required to be local residents. In fact, notwithstanding Exh. No. 408, the settlement stipulation contains no requirement whatever that any member of the Puget Holdings Board be a regional resident. The limited remaining regional representation only occurs to the extent that the PSE, Puget Energy, and Puget Holdings boards are essentially the same people. There is also no definition in the agreement of what the term "regional" means.

3. Loss of independence.

120. PSE and Puget Energy are currently required by the rules of the New York Stock Exchange to have a majority of independent directors. An independent director is defined generally as a director who has "no material relationship with the listed company either directly or as a partner, shareholder or officer of an organization that has a relationship with the

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[199] TR. 581-582

[200] Commitment 41.

company. "[201] The purpose of NYSE corporate governance structure generally is to provide greater shareholder protections in the wake of corporate scandals such as Enron and Worldcom.[202] The independent director requirements in particular are intended to increase the quality of board oversight and to lessen the possibility of damaging conflicts of interest.[203]

121. Post-acquisition, Puget is no longer required to have a majority of independent directors. Instead, it now commits to have only two independent directors as defined by NYSE standards.[204] This commitment does not expressly apply to Puget Holdings or any entity above the Puget Energy level.

122. PSE and Puget Energy are also currently required by NYSE rules to constitute key committees entirely with independent directors, including the Nominating/Governance Committee, the Compensation Committee, and the important Audit Committee. Post-acquisition, Puget will no longer meet this requirement, and states only that these committees "will not be composed entirely of independent directors."[205] Puget CFO Eric Markell acknowledged at hearing that these departures from the NYSE independent director requirements are changes from the *status quo*.[206]

123. The resulting loss of independence for its directors exposes Puget to greater business risk. Without independent directors there is loss of an important structural protection against self-dealing, conflicts of interest, a loss of the higher quality of board oversight that the NYSE rules

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[201] Exh. No. 36, pp. 9-11 (PSE/PE Corporate Governance Guidelines 2/27/06).
[202] Jerry W. Markham, *Mutual Fund Scandals – A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 Hastings Bus. L.J. 67, 95 (2006).
[203] Corporate Governance Rules Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors, August 1, 2002, at 3. Availalble at http://www.nyse.com/pdfs/corp_gov_pro_b.pdf.
[204] Exh. No. 81, p.1.
[205] *Id*, pp. 2-3.
[206] TR. 660:1-663:2. Exh. No. 423, Joint Applicants were asked to clarify their commitments in this area and confirmed that they will no longer adhere to the NYSE independence standards for audit committee membership.

are designed to achieve. This is tangible harm that will arise from this transaction, even with the commitments offered.

B. Reporting Requirements.

124. As a general proposition, the new commitments regarding financial reporting are an improvement over those originally offered. They do no more, however, than attempt to replicate the level of transparency and completeness of financial reporting that the Commission and public already enjoy with respect to Puget.

IX. JURISDICTION AND ENFORCEMENT

A. Overview.

125. A fundamental issue that the Commission must address in reviewing every merger or acquisition transaction is the question of Commission authority over the surviving entity. The critical inquiry is whether, as a result of the transaction, the Commission's ability to regulate in the public interest, pursuant to its authority under Title 80 RCW will be impaired. If the ability to regulate is harmed, then the transaction is not in the public interest and must be rejected.[207]

B. The Scope of Jurisdiction Under the Commitments Is Unclear At Best.

126. The terms of the commitments raise a number of questions about Commission authority and jurisdiction, as the Commissioners explored in questioning during the hearing. In reviewing the commitments and the Joint Applicant statements as to Commission authority, it is very important to look carefully at the statements made, to specific wording used and terms agreed to, and to the presence of conditional language. The transaction introduces complexity, uncertainty, and potential grounds for dispute on a range of topics.

1. Change of Control.

127. Commitment 26(b)(2) requires notification of change of effective control of any material part of PSE. The definition of "material" was a subject of discussion at the hearing and ultimately led to Bench Request No. 19.[208]

2. What laws are "applicable?"

128. Commitment No. 28(c) states explicitly that "PSE and Puget Holdings will comply with all applicable provisions of Title 80 RCW. As Chairman Sidran noted, the limitation to statutory provisions that are "applicable" is unclear.[209] This phrasing creates ample room for debate in future cases about the scope of Commission authority, a possibility highlighted by the Joint Applicant's response to the question of whether RCW 80.08.020 would apply to Puget Holdings. RCW 80.08.020 states that the power of public service companies to issue evidence of ownership (e.g. stocks) and indebtedness (e.g bonds, notes) is a special privilege subject tp very broad supervision and control by the State.

129. At the hearing, both Staff witness Elgin and Joint Applicant's counsel expressed doubt about whether the statute would apply to Puget Holdings (not withstanding the language of Commitment 28), since Puget Holdings is not a public service company. Ms. Carson was not able to say whether the Joint Applicants would agree to be bound by the provision. [210] In the response to Bench Request No. 20, Exh. No. 420, Joint Applicants appear to significantly pull back from what looks like the broad assurance of Commitment 28(c). Based on this response, it

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[207] *Puget/WNG Merger*, p. 20.
[208] TR. 481:20 – 483:7.
[209] TR. 483::10-484:4
[210] TR. 489:17-494:14.

does not appear that Puget Holdings agrees to be subject to RCW 80.08.020, or any other provision of Title 80, with a few stated exceptions.

3. Other regulatory requirements.

a. Compelling attendance of witnesses.

130. Commission Chairman Sidran asked if, pursuant to Commitment No. 31, the Commission "enforcement authority also extended to requiring the attendance of witnesses at hearings if those witnesses were beyond the borders of the state of Washington or outside the United States."[211] The response from Puget counsel Ms. Carson was qualified:

> Yes, the Commission does have authority to request witnesses to appear *for matters that relate to Puget Sound Energy. And I can't address the international law issues of that* but as Mr. Leslie has said, the investors are cooperative in that regard, they understand the Commission's right to question *regarding matters that relate to Puget Sound Energy* and its my understanding they will make themselves available.[212]

What is noteworthy about this answers is that Puget is careful to make sure that the acknowledgement of authority is limited to "matters that relate to Puget Sound Energy" only, not to Puget Holdings or any other entity in the corporate structure. There is a statement that investors are voluntarily willing to attend hearings if requested, but there is not an outright acknowledgement that they can be compelled to do so, and there is a suggestion that there may be international law issues that could be raised in response to such a request. All these statements cast doubt on the actual scope of the commitment.

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[211] TR. 473:12-15.

[212] TR. 474:7-15 (emphasis added).

b. Access to Books and Records.

131. Commitment No. 27 (b) purports to provide access to books and records of both PSE and Puget Holdings, to the extent "required to be accessed to verify or examine transactions with PSE, or that result in costs that may be allocable to PSE." The unanswered question is to what extent the Commission will have access to any books and records of the business entities in the ownership structure above Puget Holdings. There is no commitment to provide access to such books and records in the settlement stipulation. The importance of this access was raised by Chairman Sidran in questioning of Mr. Leslie regarding certain financial reports provided to limited partners mentioned in the Private Placement Memorandum.[213] While Mr. Leslie agreed that the Commission would be provided these particular reports, there is nothing beyond this to allow the Commission broad access to important financial information held by the entities which now, or in the future may, be owners of Puget.

C. General Concerns About The Ability to Regulate a Macquarie-Owned Entity.

1. The vastly increased complexity of the corporate structure by its very nature will harm the Commission's ability to regulate Puget.

132. Puget currently consists of the parent, Puget Energy, and its wholly owned corporate subsidiary. Post-acquisition the ownership of Puget will take on a dramatically more complex corporate structure. Appendix B to the Joint Settlement depicts how Puget itself will change from two to five corporate entities.[214]

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[213] TR. 492:15-493:23; Exh. No. 50, p. 49.

[214] One of these new entities, Puget Intermediate Holdings, is stated to have the purpose of "provid[ing] structural flexibility for future corporate transactions, which could include, for example, *the acquisition of another business.*" Exh. No. 409 (emphasis added). The record does not disclose what type of business is contemplated. The express inclusion of this option raises more questions about the complexity of the new corporate structure that the Commission will be required to regulate.

133. Above the Puget level, the Appendix shows the six new ownership entities, but only in simplified form. Exh. No. 256 is the accurate depiction of the corporate structure that would be in place post-closing, except for the insertion of Equico. [215] This chart shows 15 Macquarie entities that are in the ownership structure above Puget. According to Mr. Leslie, this is "a matter of ordinary corporate structuring for transactions of this nature."[216] One of the entities, Macquarie Capital Group, will sell its interest in Puget Holdings prior to or immediately after the closing.[217]

134. Macquarie Infrastructure Partners, the lead actor for Macquarie in this transaction, alone consists of six separate entities, a number of which, as the lines indicate, have overlapping and interconnected ownership relationships between themselves. To add to the complexity, the entity employing chief witness for Macquarie in this case, Christopher Leslie, as CEO, Macquarie Infrastructure Partners, Inc., is not shown on the chart at all. While MIP, Inc, is not on the chart, it is still a manager of the three Macquarie entities. When, as just noted, Macquarie Capital Group sells its interest, it is expected to sell to MIP I (the six MIP entities shown on the chart) and, it appears, ultimately to a fund called MIP II. Mr. Leslie explained as follows:

> It's our expectation that as additional funds are raised in MIP II that Macquarie Capital's piece will be transferred into MIP II. So all of the elements will remain under the broad control of Macquarie generally, and Macquarie Infrastructure Partners, Inc., specifically, MIP Inc., is the same MIP Inc. [sic], is the manager of MIP I and MIP II.

This discussion raises a number of issues: (1) The actual post-closing ownership structure may be different than the one presented in this application. (2) Public Counsel is not aware of any

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[215] Exh. No. 42 is a depiction of the entire Macquarie Group, a very large international organization with hundreds of individual companies and numerous different subsidiaries. This particular structural organization of the Macquarie Group was put in place last year. TR. 712:10-713:3.

[216] TR. 706:25-707:1.

[217] TR. 720:13-17.

prior reference to MIP II and it is not clear who its investors are or whether it presently exists. (3) The role an entity, MIP Inc., which is not in the ownership structure, but which has managerial control over the MIP entities that are the next owners of the new Puget, to say the least, unclear.

135. The introduction of this level of complexity into the ownership structure of Puget will inevitably introduce new challenges and problems into the Commission's regulation of Puget and enforcement of the commitments in the settlement. Access to personnel, access to financial records, understanding understand financial relationships and activities, analysis of affiliate transactions, cost allocations, financing, governance, and investment within this corporate structure will make be rendered more difficult than it is under the *status quo*, and hence will be a harm created by the transaction. With all the will in the world, the Commission's level of resources and expertise to deal with a corporate owner like Macquarie and the Investor Consortium will be challenged.

2. Macquarie witness testimony has raised other "red flags."

136. In addition to the above issues, the testimony during the sale case raised new "red flags" in a number of respects that should alert the Commission to potential problems with regulating a Macquarie owned entity.

137. The complexity and lack of transparency in the Macquarie model was reflected in the descriptions of the employment status and roles of the Macquarie witnesses. In his direct testimony, Christopher Leslie describes himself as one of the Executive Directors of Macquarie

Group. When questioned about this at the hearing, however, he described this as simply a "term of convenience," because he is employed by Macquarie Holdings.[218]

> And in presenting myself to the world, I am obviously an employee of Macquarie, as far as the world is concerned. The group affords me the privileges of an executive director…the highest designation within the organization. So I present myself in that manner. And have a broad affiliation with that group.

He goes on to say, that his day-to-day roles is as CEO of MIP, Inc. However, when asked:

> Q. (Public Counsel) So does that mean that technically no, you are not an executive director of Macquarie Group Limited?
>
> A. (Leslie) Seems surprising that I wouldn't know the answer to that question., but it's the idea of being an executive director of Macquarie Group Limited—yes, I am an executive director of Macquarie Group Limited *as broadly defined.*
>
> Q. In the way that you have just qualified it?
>
> A. *Yes, I think in terms of being an agent of the parent company abroad in the world, that's a correct characterization.*[219]

To summarize, Christopher Leslie is an executive director of Macquarie Group Limited "broadly defined," an executive director of Macquarie Capital,[220] "legally" an employee of Macquarie Holdings, USA, Inc., and CEO of Macquarie Infrastructure Partners, Inc. In addition, he has board positions with all of the MIP entities shown on Exh. No. 256, and it is planned that he will be on the board of all five Puget entities. He is also the Chairman of the Board for ten of the twelve infrastructure investment holding companies in which MIP fund is an investor, although no longer for Puget, where the original plan for him to serve as board Chairman has been dropped.[221]

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[218] See Exh. No. 256.
[219] TR. 713:4-715:15.
[220] TR. 714:23-25.
[221] It is not at all clear, therefore, that any board chairman, officer, or principal of a Macquarie entity that will actually own Puget has testified in this proceeding. Mr. Leslie is a single board member only of the MIP entities. MIP Inc., of which he is the CEO, is not in the ownership structure. Mr. Kupchak's role is as a financial advisor.

138. The other witness for Macquarie, Robinson Kupchak, also appeared to be unclear about his employment status and had difficulty explaining the corporate organization. **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXX[222] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXX**[End Highly Confidential]**

3. The Macquarie "consciousness."

139. The record also raises questions about exactly "who Macquarie is," who the Commission is dealing with now, and would be dealing with in the future as the majority owner of Puget. Macquarie makes inconsistent statements about its role in this transaction. When it wishes to emphasize the alleged improvement in access to capital, Macquarie points to its size and global reach as a factor that supports approval.[223] However, when the question is how to measure the

[222] TR. 924:13-21.

[223] Exh. No. 31, pp. 15-16; TR. 465:17-19 ("Macquarie and its Canadian partners have about half a trillion dollars in assets under management.")

health or stability of the Macquarie model, and whether that is relevant to approval, Mr. Leslie testified that MIP "stands aside and apart from the Macquarie Group more broadly. So regardless of the fortunes of the Macquarie Group, MIP stands alone."[224]

140. On the other hand, when Mr. Leslie was asked by Chairman Sidran about what constitutes materiality in terms of change of control among Macquarie ownership entities, his answer was:

> I would like to suggest, given the dynamics of the Macquarie Group, that if we were to rearrange amongst affiliates, as is in contemplation here potentially, that that potentially doesn't change anything in a practical sense.
>
> *Macquarie is a single consciousness at the management level*, and we cannot abide, for example differences in opinions between two funds that may be invested in the same deal. It's not possible for a single organization to hold two states of mind.[225]

These statements appear to conflict. They create the impression that Macquarie is presenting itself in different ways to the Commission, depending on what they believe the Commission wants to hear.

141. Taken together, the number of questions and "red flags" in the record adds up to a troubling indication about the future ability to regulate the new owners, about managerial fitness and about the relationship that investors, in particular Macquairie will have with the Commission and the regulatory process. There has been confusion about the scope and interpretation of commitments, with many being modified even on the witness stand. The Joint Applicants have pulled back from the application of some commitments by Puget Holdings. They have presented

[224] TR. 847:22-848:7.
[225] TR. 862:4-14. (emphasis added).

a financial model to lenders and investors which they acknowledged to have **[Begin Highly Confidential]** XXXXXXXXXXXXXXX **[End Highly Confidential]** that only came to light at the hearing,[226] and may or may not be disclosed to investors.

142. The picture of Macquarie that emerges in this case seems unfortunately consistent with concerns raised by other observers of the Macquarie model. The complexity and opacity of the corporate structure is present here, for example, in the tangles of the MIP structure (MIP I), managed by MIP, Inc. (not on the chart), with MIP II in the wings, perhaps. It is telling that neither Mr. Leslie, nor Mr. Kupchak can even explain with certainty or clarity where they fit into the corporate hierarchy. Macquarie itself is represented at one moment as the potential source of many billions in capital, financial expertise, and management know-how for Puget, or as having nothing to do with MIP when it is time to evaluate any risk created by Macquarie's role. Macquarie, and MIP will let Puget operate as a locally managed *status quo* company, except that Macquarie has committed to its investors that it will exert significant influence over Puget decisions. All of this presents a daunting prospect for the future regulation of Puget.

X. THE ADDITIONAL PROPOSED COMMITMENTS DO NOT ELIMATE THE RISK OF HARM TO PUGET AND ITS CUSTOMERS

A. Transaction Costs and Payments to Executives.

143. The transaction costs for this acquisition are very large, totaling over $145 million dollars. This substantially exceeds the entire dividend paid by Puget to its shareholders in 2007. Over half of this amount, $77 million, goes to Macquarie in fees. An additional $27.3 million

[226] Moreover, Joint Applicants were **[Begin Highly Confidential** XXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXX. **[End Highly Confidential]**

represents payments to Puget executives.[227] As his share, CEO Steve Reynolds will receive, if this transaction is approved, $9.6 million. Mr. Reynolds will actually receive over double that amount, in excess of $20 million upon approval, when his Puget stock is purchased for a premium.[228]

144. Joint Applicants point to their agreement that none of these costs will be recovered in rates. Customers are still affected in important ways, however. First, the expectation by senior management at Puget that they will receive such significant payments creates a bias. Any advocacy they undertake in support of this acquisition must be viewed in that light. They cannot be objective witnesses on the issue of whether this transaction is in the public interest.[229] The same applies to the Macquarie witnesses, whose organization will receive $77 million upon approval of the transaction for their costs. Second, as Mr. Markell testified at the hearing, the $145 million transaction costs are being paid with both debt and equity by the new investors. Even though Joint Applicants provide an assurance that these will not be included in rates, a portion of the new debt burden being placed on Puget and its customers by this transaction is directly attributable to these fees. As a result, part of the new risk being placed on Puget by this transaction is attributable to these fees.

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[227] Exh. No. 90.
[228] Exh. No. 260, p. 1.
[229] *See generally* Exh. No. 412, Mr. Reynolds stated at the hearing that his opinion of whether the acquisition should be approved was not influenced by the expectation of receiving $9.6 million. Exh. No. 412, TR. 591:2-10. Officers receive an aggregate $12 million on change of control without termination, and over $36 million with termination.

B. Rate Credits.

145. Rate credits provide little solace or mitigation for ratepayers. Under Puget's business plan, a rate case is planned to take place every year through at least 2013.[230] A $100 million rate credit, spread over 10 years, compared to to the Puget revenues projected by Macquarie for that period indicates that the credit represents a revenue reduction of only **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential].** The settling parties indicate that the true rate credit component[231] of this reduction amounts to a 0.24 percent reduction in rate of return. As Mr. Hill calculates, with this concession, investors still can expect to receive **[Begin Highly Confidential** XXX **[End Highly Confidential]** of their predicted rate of return.[232] From the customer perspective, the credit represents only about $10 per year, less than $1.00 per month (conservatively assuming only one million customers), to be offset against Puget plans for rate cases on an annual basis years into the future. No reasonable observer could conclude, as Joint Applicants argue, that these rate credits will "provide the economy of the Puget Sound region with a sizeable economic stimulus over the next decade." [233]

C. Low Income and Environmental Commitments.

146. Though other "community benefit" commitments are generally unobjectionable, they do not provide a basis for approval of this acquisition. Many if not most of these commitments

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[230] Exh. No. 76C, p. 6.
[231] $1.2 million of the amount is a cost savings that had already been, appropriately, committed to ratepayers, due to costs that would no longer be incurred with the end of public trading of Puget Energy stock.
[232] Exh. No. 260, p 6:11-12.
[233] Exh. No. 304, p. 19:9-11 (Joint Rebuttal).

simply arise from and amount to a reaffirmation of Puget's existing obligations as a public utility. They do not constitute customer benefits in any sense.[234]

147. The commitment to increase funding for low income customer programs is essentially identical to that agreed to between PSE and the Energy Project in the pending general rate case. The funding increases are paid for entirely by other ratepayers, with no added commitment or "concession" from the new investors.[235]

148. The energy efficiency/environmental commitments all are items that could have been negotiated with Puget absent this transaction and are essentially designed to ensure that the new owners maintain Puget's current level of commitment, an issue that does not arise if Puget continues on a stand-alone basis.

XI. PUBLIC COMMENT

149. The Commission held four public comment hearings in this case, two in Olympia, and one each in Bellingham and Bellevue, with a high level of attendance.[236] In addition, the Commission received extraordinarily large numbers of written comments. A total of 4,447 public comments were submitted in Exh. No. 400, with 4,287 opposing the sale of Puget, and 28 comments supporting the sale.

150. The overwhelming sentiment expressed by those testifying at the hearings, as well as in the written comment, is strong opposition to approval of the transaction. Janet Winnt, testifying in Olympia on June 4, expressed the sentiments of many:

> "I'm opposed to the proposed sale of Puget Sound Energy to a private foreign investor consortium, and I seriously question why the Federal Energy Regulatory

[234] The issues addressed by Public Counsel witness Barbara Alexander's testimony in this case have been resolved in the pending general rate case settlement on service quality. Exh. Nos. 241-243.
[235] TR. 511:18-512:10 (Eberdt); Exh. No. 421.
[236] The first three hearings were took comment on both the merger and the general rate case.

> Commission approved this merger. I believe that the merger would ultimately adversely impact the over 1 million citizens of Washington State who rely on electricity and natural gas currently provided by PSE. In this modern world, gas and electricity are needs, not wants.
>
> I believe the merger would result in increased rates at a time when many in this state are already struggling to make ends meet. Those in lower income brackets would be most adversely affected. For some, rate increases would be the straw that breaks the camel's back, literally shoving people out of house and home and into the streets. As a citizen of Washington state and a PSE consumer, I'm also concerned that foreign ownership of utilities would result in reduction of oversight and local control of management decisions." [237]

151. This application has drawn much public attention and concern. Attached to the brief as Appendix A is a summary of information regarding the hearings and the written comments, with selected excerpts of the public statements received opposing the sale.

XII. CONCLUSION

152. The strong preponderance of the evidence in the record shows that Puget is able to raise capital necessary to meet its projected capital expenditure requirements, and that the Joint Applicants do not offer a superior or more cost-effective alternative. Approval of this acquisition will increase the business and financial risk of Puget to the detriment of its over one million customers and the Company's own financial health. Approval will ensure that Puget's executives receive substantial monetary rewards, ensure that Puget's stockholders get an immediate 25 percent return on their stock, and that the members of Investor Consortium receive a return on their Puget investment that is substantially above the current cost of capital for a company like Puget.

[237] TR. 309:9-310:18.

153. The long list of commitments offered by the Joint Applicants do not provide a "balancing" of the interests of ratepayers with those of stockholders (old and new) and Company management. Ratepayers are left as the ultimate guarantor to absorb the increased costs and risks of the post-transaction Puget. The proposed transaction is not in the public interest and should be rejected.

DATED this 24th day of September, 2008.

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