Revisions to the Prefiled Rebuttal Testimony and Exhibits of Dr. Charles J. Cicchetti

A. No. It is true that Public Law 108-~~2~~427 (signed into law on May 28, 2003) reduced the taxable rate on dividends and capital gains to 15%.[1] However, Mr. Hill's argument ignores the fact that some investors do not pay the higher tax brackets that the change in the tax law was designed to help. This is particularly the case for pension funds and other similar institutional investors that hold large percentages of utility stocks and that pay no taxes until dividend income is withdrawn. These fund-related investors effectively pay no taxes at all. Consequently, the change in the tax laws would have no effect whatsoever on their tax liability and, under Mr. Hill's logic, would have no effect on their return expectations or requirements. For many other small investors, such as many retirees, utility stocks are often held for their dividends and the tax law change will have no discernable effect on their investment requirements or expectations because they are likely in low or no income tax brackets. Further, the current reduction in dividend taxes only applies for five years. Mr. Hill vastly overestimates the effect that the change in the tax laws has on utility investor expectations and requirements. He also ignores two other facts. First, PSE cut its dividend. This reduced PSE's value for dividend-seeking investors. Second, the tax reduction also applies to capital gains on stocks, which makes Mr. Hill's assertions concerning dividend yields misleading.

D. Market-to-Book Ratios

Q. Mr. Hill places significant weight on market-to-book ratios (MBR). Do you

[1] The tax on dividends will be reinstated in 2009, unless the tax cut is reauthorized.

rate base financing. This is not the situation in which PSE finds itself. Nevertheless, utility stocks trade in a market where there is high correlation with each other within the group of utilities. This pushes most utilities to have an MBR greater than one.

In PSE's case, investing more in traditional rate base means future earnings growth and likely future dividend and cash per share growth. If regulators set a just and reasonable return, PSE will keep its MBR above one due to rate base growth and future cash flow. Table 6 shows these data for PSE.

Table 6

	2004/2005 In Millions of Dollars	2005/2006 In Millions of Dollars
Capital Expenditures	$604.3	$360.4
Depreciation	$168.4	$225.4
	2004	**2005**
Cash Flow per Share	$4.05	$4.45
Earnings per Share	$1.25	$1.55

For PSE, capital expenditures exceed depreciation. This suppresses MBR relative to others and is consistent with PSE's relatively lower MBR (1.28) compared to Mr. Hill's sample group (1.45). That said, PSE expects to grow cash flow and earnings per share as it finances much of this growth out of increased retention and recent dividend reductions.

Q. What is the fifth assumption that would cause MBR to exceed one.

A. The fifth assumption is that when cash flow per share exceeds earnings per share

Q. How would you propose to releverage Beta if the Commission uses a Beta estimate for a peer group of companies that have relatively more equity than PSE?

A. Let's suppose by way of example that published peer companies are used to estimate PSE's beta. Let's also suppose that a peer group has 50% debt (D) and that PSE has 60% debt (DP). Let's further assume a 35% tax rate and .760 Beta for the peer group. I would support and propose to calculate an unlevered peer group beta (β_u) as follows:

$$\beta_u = \beta/[1+((d/1-D)*(1-T))]$$

$$\beta_u = .76/[1+((.5/.5)*(1-.35))]$$

$$\beta_u = .4606$$

I would relever β_u for PSE using PSE's debt (DP)(.6) as follows:

$$B_{PSE} = \beta_u [1+(DP/1-DP)*(1-T)]$$

$$B_{PSE} = .4606 [(1+.6/.4)*(1-.35)]$$

$$B_{PSE} = .9097$$

The difference would add 105 basis points to PSE's CAPM for these particular facts. I would propose a similar adjustment if peer companies are used to estimate PSE's Beta, since the peer group would likely have thicker equity than PSE as I previously discussed in detail.

Q. Did you include flotation costs in your ROE estimate?

A. No.