BEFORE THE WASHINGTON

UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	Docket UG-040640 Docket UE-040641 (Consolidated) Volume IV Pages 377-606
In the Matter of the Petition of PUGET SOUND ENERGY, INC., For an Order Regarding the Accounting Treatment for Certain Costs of the Company's Power Cost Only Rate Filing	Docket UE-031471 (Consolidated)
In the Matter of the Petition of PUGET SOUND ENERGY, INC., For an Accounting Order Authorizing Deferral and Recovery of Investment and Costs Related to the White River Hydroelectric Project.	Docket UE-032043 (Consolidated)

A hearing in the above-entitled matter was held at 9:51 a.m. on Tuesday, December 14, 2004, at 1300 South Evergreen Park Drive Southwest, Olympia, Washington, before Judge DENNIS MOSS, Chairwoman MARILYN SHOWALTER, Commissioner RICHARD HEMSTAD and Commissioner PATRICK OSHIE.

Barbara L. Nelson, CCR
Court Reporter

The parties present were as follows:

COMMISSION STAFF, by Robert Cedarbaum, Assistant Attorney General, 1400 S. Evergreen Park Drive, S.W., P.O. Box 40128, Olympia, Washington, 98504-1028.

PUGET SOUND ENERGY, INC., by Kirstin S. Dodge and Jason Kuzma, Attorneys at Law, Perkins Coie, 10885 N.E. Fourth Street, Suite 700, Bellevue, Washington 98004.

PUBLIC COUNSEL, by Simon ffitch, Assistant Attorney General, 900 Fourth Avenue, Suite 2000, Seattle, Washington 98164.

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES, by Brad Van Cleve, Attorney at Law, Davison Van Cleve, 1000 S.W. Broadway, Suite 2460, Portland, Oregon 97205.

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JUDGE MOSS: Let's be on the record. We had some discussion off the record concerning exhibits and the Counsel were all privy to that, so they've updated their revised exhibit list, and I'll of course update that again this evening or early tomorrow morning.

I guess there are a couple of preliminary matters I want to raise. One is the question of the settlement panel of witnesses. There are a lot of parties who were absent from the hearing room who will be participating in that in one fashion or another and I'd like to give them a date certain for the presentation of that panel.

Now, I understand that Counsel's preference was to do that at the end. Does that need to be necessarily at the very end or could we set perhaps Thursday afternoon, with the anticipation that that may be the very end, but it may turn out that we have to go with a witness or two on Friday if things are delayed.

So what are Counsel's thoughts on that?

MR. CEDARBAUM: I think we're flexible. If it -- I'm sorry. I mean, I understand, I've had some e-mail from Mr. Kurtz asking about Kevin Higgins' travel, things like that, so I understand all of that. I think, from Staff's perspective, if we want to set a day and time certain, even if it preceded the last witness, that's fine.

JUDGE MOSS: Okay.

MR. CEDARBAUM: If Thursday was your preference or --

JUDGE MOSS: Well, I was just throwing that out as a suggestion. Based on the cross-examination estimates, we will finish Thursday, even allowing some several hours for questions from the bench and responses. We have only 14 hours and some odd of cross indicated, so that would -- as I said, we would finish on Thursday.

Now, I'm pessimistic about these things, so I anticipate we may end up here on Friday, as well, for at least part of the day, but if it will work to schedule this panel on Thursday, we do have at least one witness and perhaps more than one who must travel to be here. Mr. Higgins, you mentioned. So I'd like to set a date certain, and could we -- should we say Thursday afternoon or I could -- also, I should ask the preference of the bench, if the bench would like to have that panel on Friday morning. We could consider that.

Let's be off the record for a moment.

(Discussion off the record.)

JUDGE MOSS: Let's be back on the record. We've had some discussion at the bench, and I know that, since this is a settlement that is either unanimously supported or at least not opposed by any party, the only questions for the panel presumably would come from the bench.

The bench has had an opportunity to read the pre-filed testimony and of course to study the settlement that was filed and does not have questions for the panel. Mr. Cedarbaum.

MR. CEDARBAUM: That's great. But I just wanted to note, just so there are no misunderstandings, there have been some language tweakings going on with respect to Proposed Schedule 40, and I think -- you know, we're trying to work those out, and I think we will -- hopefully, we'll work those out. I think that they are just language tweakings, but I didn't want you to think that we weren't going to change a page or two in the stipulation, and maybe that would drum up some questions.

We're hoping to get that filed with you as soon as possible; we just haven't gotten the right people in the room together to finalize it yet.

JUDGE MOSS: All right. Well, it seems more likely than not that we can dispense with having the panel live, and so let's plan on that, and if things should go awry, then you let us know at the earliest opportunity, and we may need to make some alternative plans.

Now, having said all that, we have additional time reserved, we've got all of next week reserved, so there's flexibility here. But let's tentatively plan that we will not have the panel. And I will send an e-mail communication to all parties during a break today to that effect, with the appropriate caveat, all right?

MR. FFITCH: Your Honor?

JUDGE MOSS: Yeah.

MR. FFITCH: Just while we're off the record, I just wanted to --

JUDGE MOSS: No, we weren't -- I think that was on the record, wasn't it? Yeah, that's on the record. Do you want to be off the record?

MR. FFITCH: No, that's fine. Sorry. I just wanted to say, though, I've conferred with Mr. Cedarbaum on order of examination, and I wanted to defer to him this morning and let him go first, if that's all right with the bench.

JUDGE MOSS: Sure. On Mr. Gaines?

MR. FFITCH: On Mr. Gaines.

JUDGE MOSS: Yeah, that will be fine. Okay. Now, the other preliminary matter that I want to raise is the Counsel for PSE has indicated a desire to use certain illustrative exhibits, blow-up charts with Mr. Gaines. Mr. Cedarbaum -- and this was communicated to me by e-mail, and to all the parties by e-mail last week.

Mr. Cedarbaum then sent a reply to that and also copied all parties, indicating that he might have an objection to that idea, and so before we either allow or disallow, I wanted to have an opportunity for Counsel to express their thoughts on that. And so, Mr. Cedarbaum, if we could hear your objection, if any, to the potential use of those exhibits.

MR. CEDARBAUM: I guess my concern, Your Honor, was that when I received the e-mail from company counsel, it was indicated that the company wanted to use these illustrative exhibits, and I just didn't know what use they meant.

I mean, if the idea was that Mr. Gaines would take the stand and give additional direct testimony and point to these charts that are already in his pre-filed testimony, I think that's objectionable, because it's just -- it's repetitive.

On the other hand, if during redirect he was going to look at his testimony and it was proper redirect and look at a chart, if the company wanted to have a blow-up picture of that chart for his redirect, I think that's fair. I'm not sure if it's necessary, but if they want to do that, they can do that. So it really depended on what the use of it was.

JUDGE MOSS: And presumably, it could come up during cross, depending on the questions, that it would be appropriate to illustrate the witness' answer to a cross-examination question, so --

MR. CEDARBAUM: That's right. I just didn't want this to be an expansion of direct testimony that was pre-filed. That's all.

JUDGE MOSS: All right. Ms. Dodge, is that an agreeable situation?

MS. DODGE: Yes, Your Honor. We didn't have any intention of additional direct testimony. These are charts. In fact, I have a proffer, if you'd like to see it on paper, of what the charts look like, but I think it was in the e-mail, but --

JUDGE MOSS: I've seen them. I don't know if other counsel have.

MS. DODGE: They're pages seven, eight and nine, charts that are in the written materials.

JUDGE MOSS: Seven, eight and nine of?

MS. DODGE: Of, I'm sorry, Exhibit 179, Mr. Gaines' rebuttal testimony. So this is not new evidence. However, the copy quality and the definition on these charts is less than ideal, and we thought that Mr. Gaines may have occasion to refer to these on cross or on redirect, that it would be helpful to see, in a little better definition, what we're trying to show in these charts that are already in the record, or in the pre-filed record.

JUDGE MOSS: We lose the lovely four-color display on our yellow sheets here. Sure, okay. I think we all understand the ground rules for that, and that will be fine. So if there comes an appropriate point in time to put those charts up, one or more, then we can do that. And I see you have an easel available for that purpose.

MS. DODGE: Yes, and the windowsills.

JUDGE MOSS: If we need more than one, we can always use the windowsills. All right. Very well. With that understanding, then, I think that's probably the last -- yeah, that is the last matter I want to bring up as a preliminary matter this morning.

We will be talking later about the briefing schedule in light of the hearing being shorter than anticipated, but Counsel can just be thinking about that and then we'll talk about it later.

Are there any preliminary matters from counsel? Mr. Cedarbaum.

MR. CEDARBAUM: I just wanted to let the bench know and Counsel that some of the questions that I'll be asking Mr. Gaines were deferred to him by Mr. Reynolds, and they concern a confidential Exhibit 55, so I'll just defer to the company on this. I will ask him specific numbers off the yellow pages, and if it's necessary to go into a confidential session, we should do that.

JUDGE MOSS: Can you go ahead and tell us if that will be necessary to do? Exhibit 55.

MS. DODGE: I believe we will probably have to go into confidential session.

JUDGE MOSS: All right. Then I'll just go ahead and give people a heads up that, when we get into that confidential session, anybody that's in the hearing room who is not a signatory to the appropriate disclosure forms under the protective order will have to leave the hearing room and we'll proceed in closed session for the duration of that examination. We will then send somebody out to let you know when you can come back in, and the record will be under an appropriate seal for that portion of the transcript.

Moreover, I will turn off the -- or mute the conference bridge line during that period, because we cannot determine who might be listening on that line. So unfortunately, those who might have a legitimate interest and right to hear will not be allowed to do it in that fashion.

So all right, anything else?

MR. CEDARBAUM: Just on a related point, I'm going to try to ask those questions right off the bat, and obviously preliminary questions of Mr. Gaines are not confidential, but I wonder if you want to go ahead and just have those people leave the room who shouldn't be in the confidential session, and then we won't have to stop again to have that happen.

CHAIRWOMAN SHOWALTER: Can't ask them at the end?

MR. CEDARBAUM: I'm sorry?

CHAIRWOMAN SHOWALTER: It doesn't work to ask them at the end of your -- it probably wouldn't, because then somebody else will go on. I'm sorry.

MR. CEDARBAUM: I'm just trying to get done now what we have to do later.

JUDGE MOSS: Okay. We'll just do it at the -- we'll let the preliminaries go forward with everybody present. So why don't we have Mr. Gaines come to the stand and we'll get him sworn in.

Whereupon,

DONALD E. GAINES,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:.

JUDGE MOSS: Thank you. Please be seated.

THE WITNESS: Judge Moss, would it be all right if I removed my jacket?

JUDGE MOSS: Yes, it would.

MR. CEDARBAUM: While Mr. Gaines is getting settled, I will have questions on Exhibit 54 and 55, so if he doesn't have those with him, it would be timesaving if he could have them with him.

THE WITNESS: I have 55.

JUDGE MOSS: Go ahead with the preliminaries.

D I R E C T E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Gaines, do you have before you your direct testimony and rebuttal testimony, as well as the exhibits to your testimony in this matter, which have been pre-marked Exhibits 171-C through 187?

A. Yes, I do.

Q. Do you have any additions or corrections to make to any of that testimony at this time?

A. No, I do not.

Q. Are the answers to the questions in Exhibit 171-C through 187 true and accurate, to the best of your knowledge?

A. They are.

MS. DODGE: Your Honor, we offer Exhibits 171-C through 187 into evidence and offer Mr. Gaines for cross-examination.

JUDGE MOSS: And there being no objection, those exhibits will be admitted as marked.

And I understand that Mr. Cedarbaum is going to inquire of the witness first, and that he has some questions that will require us to go into confidential session. So in accordance with my prior notice to parties, if there's anyone in the room who is not a signatory to the appropriate disclosure documents under the protective order, I'll have to ask you to leave the room at this time, and we will send somebody out to allow you to return to the room at the appropriate point in time.

Let's be off the record.

(Recess taken.)

(The following pages, 394-410, are contained in a separate, confidential transcript.)

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(End of confidential portion.)

MR. CEDARBAUM: Should I just keep going or did you want to have people -- should I wait for people to come back in?

JUDGE MOSS: Oh, I don't think we had very many people leave the room, so I think you can go ahead safely.

C R O S S - E X A M I N A T I O N (CONTINUING)

BY MR. CEDARBAUM:

Q. Mr. Gaines, if you could look at Exhibit 179-C, which is your rebuttal, at page 26?

A. Just a second.

JUDGE MOSS: And while the witness is getting that, I have a question of Ms. Dodge. The copy of this testimony that I received is all on yellow paper. Now, I want to be sure, is everything that's confidential highlighted as, for example, on page 32, where there's some highlighting, so that I can be sure when I'm dealing with confidential information or not?

MS. DODGE: Yes, that's correct.

JUDGE MOSS: Okay, fine.

THE WITNESS: Could you please repeat the page reference, Mr. Cedarbaum?

Q. Twenty-six.

A. Okay, uh-huh. One moment.

MR. CEDARBAUM: Your Honor, are you -- I'm not sure if you're ready for me to ask my question.

JUDGE MOSS: Oh, I'm ready. Sure, sure, sorry.

MR. CEDARBAUM: Okay. You were writing, and I didn't know whether I should continue.

Q. Anyway, on page 26, there's a chart in the middle of the page.

A. Yes, I see it. Thank you.

Q. And this is your testimony with respect to increased benefits from increased credit rating, and what you're talking about here is the increase from the BBB- to the BBB+?

A. Yes.

Q. Is it correct that the net benefits from hedging are, by far, the majority of the benefits that you list?

A. Yes, in this table, they're the largest. There's a bunch of things that aren't included in the table that would go into that calculation that are qualitative, so I couldn't include them, but of the ones that were quantitative, that is the largest one.

Q. And for example, even at the high end of your range here, the benefits that are not attributable to hedging are, would you accept, subject to check, about three percent of the total?

A. Of the quantifiable ones that are listed there, that's probably right. There's other qualitative ones that aren't listed.

Q. And the benefits that you estimate for reduced borrowing costs and financial flexibility are one-year amounts; is that right?

A. Yes, they are. I'm following Mr. Hill's calculation. He did a one-year calculation.

Q. The line that's labeled net benefits from hedging, though, those numbers come from Ms. Ryan?

A. Yes, they do.

Q. And those are 10-year net present value amounts associated with certain hedging scenarios that she examined?

A. That I don't know. It would be a better question for her.

Q. Would you accept that subject to your check?

A. Sure, yeah.

Q. We could just find that in her testimony, presumably?

A. If it's a present value, it's an annual number, then it's brought back to today.

Q. At page 12 of your rebuttal --
A. Yes.
Q. Or that may not be the correct citation. If I could just have a moment, Your Honor. I may need to look at the direct testimony.
JUDGE MOSS: All right.
Q. Oh, I'm sorry. It is on page 12 of your rebuttal, line 12.
A. I have that reference.
Q. You refer to, and it's onto 13, really, but you refer to progress on the company's resource acquisition process with respect to a planned stock issuance; is that right?
A. Yes, I do.
Q. And so the stock issuance, according to this testimony, is contingent upon or tied to the progress of the resource acquisition process?
A. No. I wouldn't say that it's tied to that, Mr. Cedarbaum; I would say that that would be the use of proceeds from that, but it would be our intention to achieve that level regardless of where we are in the process of acquiring resources. And that's where I mentioned earlier that, when you asked me if it would be roughly $500 million of additional equity, I said perhaps more in the answer, because since the

preparation of the forecast upon which the numbers we were looking at were developed, the company announced two wind acquisitions that weren't included in that forecast, so to get up to that level, just with those resources, it may require more money. We're in the process of redoing a forecast with those in there.

And then, I don't know what Mr. Markell is planning for additional resources, so to the extent there were other ones that required capital additions, these projections may go up or may go down. I just don't know even the exact dollar amount of those resource acquisitions. I know a range.

Q. Okay.

A. But it's a large number. I mean, I can grant you that.

Q. If you turn to page 15 of your rebuttal, lines -- starting at line 14, with the question, you note that in past proceedings the company's advocated an average -- that rates be set on an average capital structure, but in this proceeding you're requesting an end-of-year capital structure?

A. Yes.

Q. And that's different than Staff in this proceeding, which is proposing an average year capital structure?

A. An average -- they are proposing an average, but it is not over the rate year.

Q. Is it correct that, for the period of time that you're looking at, whatever that period is, that if you set rates based on an average capital structure, that results in rates being equal to average cost?

A. I think I understand your question. If your question -- can I restate it for you?

Q. If you can't answer the question the way it was --

A. I can't answer it.

Q. -- given to you --

A. If you could repeat it, perhaps I could.

Q. Putting aside the period of time that we're discussing, if you set rates -- if you use an average capital structure, are you setting rates based on average cost?

A. Yes, based on average capital structure. I didn't know if you meant averaging all the other costs that go into that. But presuming if you were averaging those, as well, then yes, I would agree.

Q. And again, putting aside the time period that you're looking at, if you're setting rates based on the year-end forecasted capital structure, that could result in rates being higher than average cost?

A. Not necessarily. I mean, it could be.

Q. If this year end is higher than the average, then rates would be set on a higher-than-average cost, everything else being equal?

A. And you said if the year end number was higher --

Q. Yes.

A. -- than the average?

Q. Yes.

A. Then that number would be higher.

MR. CEDARBAUM: Your Honor, those are my questions for Mr. Gaines. I would offer Staff Data Request 275, which I think is Exhibit 57. I did not have questions on it specifically, but I would like to offer it through Mr. Gaines.

JUDGE MOSS: Okay. There being no objection, it will be admitted through Mr. Gaines.

MR. CEDARBAUM: Thank you.

JUDGE MOSS: All right. And just so I'm sure that -- you're not offering 198 through 200?

MR. CEDARBAUM: Oh, I'm sorry, I forgot about those. Yes, I am. Again, I did not ask Mr. Gaines specifically about those questions, but they are -- those data requests, but they are his responses to certain Staff data requests.

JUDGE MOSS: All right. No objection, apparently. Those will be admitted as marked. Mr. ffitch, I believe you indicated you have approximately 60 minutes of questions for this witness.

MR. FFITCH: Yes, Your Honor. It might be a bit generous. I'm not sure we'll take that full time. It's a little hard to predict, but --

JUDGE MOSS: Sure.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good morning, Mr. Gaines.

A. Hello, Mr. ffitch.

Q. I wanted to follow up just on something you were just discussing at page 12 of your rebuttal testimony --

A. All right.

Q. -- in the paragraph beginning at line eight. And it's true, is it not, that in there you're discussing -- and I guess this is confidential -- no, the unshaded text is not confidential; right?

A. That's correct.

Q. So you're discussing the timing of equity issuances to support the resource acquisition process. Do I understand correctly that the PCORC mechanism, the power cost only rate case, is also a mechanism available to the company to support the resource acquisition process?

A. To recover the costs of those resources, yes.

Q. Okay. And can you -- does that act in any way as an offsetting or a complimentary process to this effort that you're describing here? Can you describe -- explain how those two things work together?

A. I can. The -- as I understand how the power cost only or how the new resource aspect of the power cost only proceeding works is you use the last set capital structure that was approved in general rates, so presumably the outcome of this proceeding will result in a capital structure, and then any new resources that are added subsequent or prior, between that one and prior to the next rate case, go in under that capital structure. That's the recovery aspect.

So for example, were we not having this proceeding or, better yet, when we used the Fredrickson plant, when we acquired that, as Mr. Cedarbaum pointed out yesterday, and got recovery of that through that process, its recovery and its rate base addition was premised on or based on the 40 percent equity that's reflected in rates as of the last general rate proceeding.

Were the company to issue equity, as I've stated here, and were that not to be reflected rates, it wouldn't be reflected in the power cost only proceeding. So there would be a dilutive aspect in that we would have more shares outstanding as a result of the equity offering that would not be reflected in the recovery of that resource.

Q. But if you do another PCORC rate case for a new resource acquisition, the company will receive additional revenue and there is the potential for an additional rate increase for customers during that period?

A. It would be a partial cost recovery.

Q. All right. The next question I have is -- was, I believe, referred to you by -- or deferred to you by Mr. Reynolds, and that is the cumulative effect of recent changes in rates for the typical electric and gas customer.

And I was referring to the cumulative effect of gas trackers, the PCORC, any PCA change that has happened, and the rate changes from the settlement in the 2002 general rate case. And do you have the ability or have you had a chance to generate a number that represents the average rate impact on a typical customer of those changes since 2002?

A. No, I've not, but we could probably do that through a record requisition if you'd like that.

MS. DODGE: Could I suggest that Mr. Story would be in a position to answer that?

MR. FFITCH: All right. Perhaps, Your Honor, we could -- I don't know if this is a combination record requisition and deferral to Mr. Story, so --

MS. DODGE: Many of the questions were deferred to Mr. Gaines or to Mr. Story, so it may be that some of the questions need to be deferred on.

JUDGE MOSS: All right. Let's see if Mr. Story can give you your answer, and if not, then we can renew the record requisition at that point and get it that way. But Mr. Story, in the meantime, will be alert that he needs to perhaps perform some calculations so that he can give a good response.

MR. FFITCH: Thank you, Your Honor.

Q. One other question that was deferred to either you or Mr. Valdman, and I didn't ask Mr. Valdman, was the -- I'm sorry, I'm being reminded that I asked Mr. Valdman, and he referred it to you. And that's the ROE prior to the 2002 rate case. Do you have that number?

A. Are you referring to the one that's published in Exhibit 55-C, or was it -- I'm sorry, it it's probably Exhibit 54, which is non-confidential. I think that was where that question arose, but if you have a number or a cite, I'd be happy to go there. I was thinking, in 54, Mr. ffitch, you were perhaps looking on page two?

Q. I guess, first of all, my question simply is what was the last authorized return on equity prior to the 2002 rate case?

A. The one as a result during the mergers period? That would be the last prior proceeding.

Q. And that would have been in effect all the way up until the authorization of the new level in 2002?

A. Roughly five years, yes.

Q. And what was that number?

A. There wasn't one. You may recall that was a settlement, and what happened in that settlement was the customers were given the savings of the merger up front through a rate plan that had, I think, if I remember right, it had one to one and a half percent rate increases for electric customers, depending on the class of customers, and I think it had a margin reduction partway through for gas customers.

The company was exposed to, at that time, increased power cost, and was looking at three types of savings that it hoped to generate. One was the merger synergy savings, one was power cost stretch goals, and the other was other best practices, and the Commission at that time encouraged the company to do what it could to get those savings and produce that result to the bottom line, which is, in fact, what it did during that period, with more success than less success in certain years.

But there was no ROE as a result of that. It was whatever the company could produce by generating those savings.

Q. Okay. And as we saw in Exhibit 167, with Mr. Valdman, the --

A. Could I see that exhibit, please?

Q. The return on equity in 2000 was one of those successful years. I'll hold off till you get a copy of that.

A. Thank you. 2000, you said, Mr. ffitch?

Q. I was looking at 2000 on Exhibit 167. That was what I asked Mr. Valdman about. And that shows a

13 percent return on equity; correct?
A. Yes, the Value Line number is 13 percent.
Q. And your testimony is there was no specific authorized return on equity as a result of the merger?
A. That's correct.
Q. If we go back through the ROEs going back in time into the late '90s, we see some fluctuations there, both up and down; correct?
A. Yeah, yeah, we do. A lot of risk. A lot of volatility.
Q. And some pretty high ROEs, as well; right?
A. Well, I think the authorized, when I started at the company, was 16 and a quarter, so yeah, there were some that were almost as high as the authorized.
Q. When was that?
A. I think that might have been -- I'd have to double check. It was probably '80 or '81, and it may have been Cause U-8010. John Story, or perhaps here in the Commission's record room, we could check that.
Q. What was the prime rate at that time?
A. Don't remember, but it was high.
Q. So you don't recall the last authorized ROE that was in effect?
A. Yes, I do. The last authorized, which was

prior to the last case, prior to the merger, when the two companies were separate, and I could give you those cause numbers if you'd like, and the capital structure for the electric business at that time was 45 percent and the ROE was ten-five, and for the separate gas business, it was 44 percent equity and ten-five. Those decisions, I think, were around the September time frame of 1993. And I mentioned I can give you the dockets, if you'd like. I have them here.

Q. I'd be very impressed if you could give us -- oh, I thought you were going to do it from memory.

A. I would be impressed with that, Mr. ffitch. I'm not that good.

Q. Okay. If you have those, if you're about to read them, that's fine.

A. Yeah, I was going to try and hunt them down here.

MS. DODGE: Your Honor, I'd just suggest that it's not going to be hard for any of us to find docket numbers, I believe, from the last rate cases.

JUDGE MOSS: Do you need the docket numbers, Mr. ffitch?

MR. FFITCH: It was just that -- well, we can find them.

JUDGE MOSS: All right. Let's move on, then.

MR. FFITCH: Mr. Gaines had so enthusiastically volunteered.

THE WITNESS: Well, I know I have them here.

JUDGE MOSS: We hate to spoil the fun, but let's move on.

Q. All right. Mr. Gaines, you are the vice president for finance and the treasurer of Puget Sound Energy; correct?

A. That is correct.

Q. Can I ask you to turn to Exhibit 194? That's one of the Public Counsel cross exhibits, Data Request 71.

A. Yes, I have that.

Q. And in Part E of that, we asked you to list the board of directors of Rainier Receivables and its corporate officers and to cross-reference that to the Puget Energy or PSE officers and directors, and your answer is on page three of that exhibit.

A. Yes, it is.

Q. And in there, it states that you are on the board of directors of Rainier Receivables and also the president and treasurer of that corporation; correct?

A. That is correct.
Q. And Mr. James Eldredge, who is the corporate secretary of Puget Sound Energy, is also a member of the board of directors of Rainier Receivables, and in addition Mr. Eldredge is the corporate secretary of Rainier Receivables; isn't that correct?
A. That is correct.
Q. Given the fact that you are both corporate officers of Puget Sound Energy and Rainier Receivables and you both sit on the board of directors of Rainier Receivables, it's fair to assume, isn't it, that the transactions between those two entities are not true arm's length transactions between unaffiliated parties?
A. No, that's not true at all.
Q. It's your testimony that, notwithstanding your roles in both those corporations, that arm's length transactions take place?
A. Absolutely.
Q. All transactions are at arm's length?
A. Absolutely.
Q. Rainier Receivables was created to buy the receivables of Puget Sound Energy and then use that asset, the receivables, as collateral to borrow at a rate below available commercial paper; right?

A. Below the company's commercial paper rate, yes.

Q. And just to be clear, can you describe what the term receivables means in this context?

A. Yes, I can. I think it was mentioned in some place about factoring of receivables. It's very similar to that process. So it's customer account receivables and unbilled revenue that's used as the collateral to secure the borrowing to get a lower borrowing rate, much as we use the pipes and wires to use -- to securitize or collateralize the long-term debt, we use the receivables here to collateralize short-term borrowings.

THE REPORTER: Sorry. Slow down, please.

CHAIRWOMAN SHOWALTER: Oh, thank you. You need to slow down.

THE WITNESS: Yeah, yeah. What I was saying was we used the receivables from the utility to collateralize short-term borrowings, much as we use the assets, pipes and wire assets of the utility to secure -- to collateralize the long-term debt of the company. It's just collateralizing the borrowings to get a lower rate.

Q. And the receivables are an asset?

A. Yes, they are.

Q. Right? An asset of Puget; correct?
A. An asset of Puget Sound Energy.
Q. All right.
A. The utility.
Q. And again, we're -- just in sort of layman's terms, we're talking about the bills that customers pay, the flow of revenue that comes from the customer payments of their utility bills to the company, Puget Sound Energy?
A. It's the -- no, it's not the flow; it's what's been billed but yet to be paid.
Q. All right. Now, in your application to the Commission, when you requested approval of the creation of Rainier Receivables, your representation in that application was that it would create lower short-term debt cost for Puget Sound Energy; correct?
A. That, in fact, is correct.
Q. Now I'm going to ask you to turn to Exhibit 189.
A. Can you remind me which that is, Mr. ffitch?
Q. It's response to Exhibit -- or excuse me, to Data Requests Seven and 63.
A. Oh, okay.
Q. It's a combination exhibit.
A. Yeah, I've got that.

MR. FFITCH: Your Honor, I think, in my own notes, had originally put a C next to 189. I'm now looking at it and I checked it again this morning. It doesn't seem to have any confidential information in it. I would ask the company to confirm that for me. It's not listed as a C on the exhibit list, but I think it's non-confidential, but I wanted to make sure before we went ahead. I don't have any yellow paper in my copy.

THE WITNESS: I don't believe it is, but I could check with my counsel, if you'd like.

MS. DODGE: This is not a confidential exhibit.

Q. Thank you. So this is Exhibit 189. And in the Data Request 63, which is page six of this exhibit, the data request asks for Puget Sound Energy's monthly balance of short-term debt and the cost rate of that debt.

A. Now, Mr. ffitch, I'm struggling to find page six. I have one that's marked page four with a handwritten number up in the upper right-hand corner, that has the table of rates and dollars. Is that the table you're looking for?

Q. If you move to the -- this is confusing, because we combined two data requests.

A. Yes.

Q. Data Request Seven is the first one. Then the second part of the exhibit is Data Request 63. And it starts over with numbering one, two, three, four again, but in sequence, it would be --

MR. KUZMA: Your Honor, may I approach the witness, just to help --

JUDGE MOSS: It's the last page of the exhibit.

THE WITNESS: I'm just not sure it's in my book.

MR. KUZMA: Well, it's page two of Public Counsel 189.

MR. FFITCH: Actually, it would probably be more helpful if I --

JUDGE MOSS: Let's be off the record. We're off the record.

(Discussion off the record.)

JUDGE MOSS: Let's be back on the record.

Q. Okay. Just to sort of recalibrate or reset here, the Data Request 63 asks for Puget Sound Energy's monthly balance of short-term debt and cost rate of that debt; correct?

A. Yes.

Q. And that, actually -- 63 actually corrects the response in Data Request 07, which is the first four pages of the exhibit?

A. Yes, it does.

Q. And let's take a look at page eight, which was the last page of this combined exhibit. These are the corrected numbers for the short-term debt balances and cost rates for January 2002 through March 2004; correct?

A. They are.

Q. What we see there is that, from January 2002 through December 2002, the cost of short-term debt to Puget Sound Energy declined steadily from 3.86 to 2.77; correct?

A. 3.86, yes, uh-huh.

Q. And then, from that point, from December 2002, it rose dramatically to about eight percent in March of this year, correct, 7.89 percent?

A. Yes, those are the numbers.

Q. Now, Rainier Receivables was created on December 23rd, 2002, wasn't it, Mr. Gaines?

A. I would accept that.

Q. And after that point, after year-end 2002, cost of short-term debt to Puget Sound Energy began to rise, isn't that correct, as we can see from this exhibit?

A. This cost rate does. The borrowing rate doesn't.
Q. And as we said earlier, Rainier Receivables uses the accounts receivable of Puget Sound Energy as collateral to issue short-term debt at below commercial paper rates; correct?
A. Lower than the company's commercial paper rate, yes. Lower than what it could otherwise get on its own, yes.
Q. All right. Now, all of the debt issued by Rainier Receivables does not appear on the balance sheet of Puget Sound Energy, does it, Mr. Gaines?
A. It appears in the footnotes to the financial statements.
Q. But it does not appear on the balance sheet; isn't that correct?
A. That's correct. It's a sale for accounting purposes.
Q. Now, can I ask you to turn to Exhibit 194? That's Public Counsel Data Request 71.
A. I have that.
Q. And in 194, you provided balance sheets or financial statements for Rainier Receivables; correct?
A. Yes.

Q. And for the quarter ending March 31st, 2003 -- and you'll find that at page 23 of the exhibit. Do you have that?
A. I'm just trying to get there.
Q. Okay.
A. Yes, I do have page 23.
Q. And that's for the quarter ending March 3rd -- or March 31st, 2003; correct? That's the time period we're looking at here.
A. It's a snapshot on that date, yes.
Q. And there we see that company had two -- Rainier Receivables had $214.8 million of debt as subordinated notes at that time; correct?
A. Yes.
Q. Now, let's go back to Exhibit 189, to the last page of that exhibit that we were just looking at. For the March 31st, 2003 date there, or the March 2003 date, we see $34.269 million of short-term debt on the Puget Sound Energy books; correct?
A. That's correct.
Q. So this confirms, wouldn't you agree, that the debt issued by Rainier Receivables does not appear on Puget Sound Energy's books of account?
A. No, I wouldn't.
Q. You would not agree with that statement?

A. No, I believe the difference is that this is the amount -- we're looking at sort of two separate things, the way this mechanism works and the way this entity works. I believe that this is the collateralization for the amount of short-term debt outstanding that's reflected on this exhibit. So I think what we're seeing here is it's overcollateralized. In other words, there's more dollars of receivables to back up -- it's more than a one-for-one collateralization, if you will.

Q. But you've testified that the debt issued by Rainier Receivables does not appear on the balance sheet; correct?

A. It's a sale for accounting purposes, and we make an adjustment to add it back, yes (inaudible).

THE REPORTER: I'm sorry. Say that again, please.

JUDGE MOSS: We've got two people talking at once. Let's be cautious about that.

THE WITNESS: I said we -- it's the sale for accounting purposes, and we make an adjustment to add it back to the utility for rate-setting purposes.

JUDGE MOSS: Mr. ffitch, let me know when you're done with this area, please, this set.

MR. FFITCH: All right. I just have a

couple more questions, just a few more questions here, Your Honor, but --

JUDGE MOSS: Well, we need to take a break, so maybe this would be a good moment to do that.

MR. FFITCH: I can finish in just one or two more with this exhibit, and then I'll be -- but, obviously, I'm at the disposal of the bench.

JUDGE MOSS: I think we need to take the break. All right. We'll take 15 minutes. Be back at 11:15, please.

(Recess taken.)

JUDGE MOSS: We'll be on the record. And Mr. ffitch, you may resume.

MR. FFITCH: Thank you, Your Honor.

Q. Mr. Gaines, as we have been already this morning, we're talking about company receivables and the collateralization of those receivables. Are you aware that, in some regulatory jurisdictions, other utilities sell their receivables without the creation of a special purpose entity like Rainier Receivables?

A. I'm not aware of that.

Q. Are you aware that, in some jurisdictions, that factored accounts receivable are treated as zero cost capital?

A. I'm not aware of that.

Q. Isn't it the case that, in some other jurisdictions, the fact that an accounts receivable asset is monetized into short-term debt significantly impacts cash working capital? That is, instead of having to wait 30, 60 or 90 days for the collection of accounts, the income stream is sold to a third party and the utility gets that money up front, significantly reducing the lag for the receipt of the funds. Are you aware of that?

A. That's basically how it works, yes.

Q. Now, am I correct that it's your position that your choice or Puget's choice to monetize the accounts receivable does not affect your cash working capital calculation because Rainier Receivables is consolidated for regulatory purposes?

A. Well, there are two ways that one could recover the cost of that facility. One would be the way we've done it, which is, since it's set up to reduce the cost of short-term debt, which it has done, to recover it as a piece of debt and include that leverage in the capital structure, in calculating the capital structure applied to rate base and the ROR.

The other way would be to not do that. You would have a less levered capital structure, in other words, a higher equity ratio, but then you would have a working capital calculation in rate base, and you should come out about the same way either way.

Q. But your position is that, because Rainier Receivables is consolidated for regulatory purposes, the accounts receivable monetization does not affect your working cash -- working capital calculation; isn't that your position?

A. Well, when you say working capital, do you mean for rate-setting purposes?

Q. Yes.

A. I believe Mr. Story has adjusted for that, but it would be a better question for him.

MR. FFITCH: Well, in light of the response, Your Honor, we have a data request that is for this subject. We did not identify it as a cross exhibit, but we have a different answer than we got in the data request, and I could show that to the witness.

THE WITNESS: That would be helpful.

JUDGE MOSS: You're entitled to do that. Sure.

MR. FFITCH: May I have a moment, Your Honor?

JUDGE MOSS: Yes. Do you have a copy for Counsel, as well?

MR. FFITCH: Your Honor, we weren't expecting this answer, so I have to find the response.

JUDGE MOSS: Can we postpone this until after lunch, then, and take it back up then? Will that work? I believe you said you have enough questions to carry us to the luncheon hour. That way, we can come back and be better organized on the exhibit.

MR. FFITCH: That will be fine.

JUDGE MOSS: Okay.

Q. And you are the treasurer of both Puget Sound Energy and Rainier Receivables, Mr. Gaines?

A. Yes, I am.

Q. Does the negative federal tax expense generated at Rainier Receivables get utilized by Puget Sound Energy or the parent company, Puget Energy?

A. It would be Puget Sound Energy. It has nothing to do with Puget Energy.

Q. How does it get utilized by that company?

A. That's an accounting question that would be better answered by Mr. Story. I'm not a CPA.

Q. And if you need to defer this to Mr. Story, you can, but is that negative tax expense included in

this rate proceeding in any way?
A. I don't know the answer to that, I'm sorry.
Q. Is that a question for Mr. Story?
A. It would be better answered by him, yes. Thank you.
Q. Let's return to the issue of the eight percent short-term debt cost, Mr. Gaines. As you note in your response to 189, Public Counsel 63, this is the table of --
A. All the short-term debt costs that we were looking at?
Q. Correct.
A. Okay. I have that.
Q. And as you note there, the cost shot up after the initiation of the securitization facility with Rainier Receivables --
A. Well, there's a bunch of costs in here besides that. This is all short-term debt costs. There's a couple of facilities in here.
Q. Well, let me finish the question.
A. Sure.
Q. The cost shot up because the amount of short-term debt used by Puget Sound Energy was relatively small compared to the amount of the fees associated with that securitization facility;

correct?

A. That's one of the reasons, yes.

Q. Okay. Now, does Rainier Receivables pay any of those securitization fees, or do they all fall to the regulated entity, Puget Sound Energy?

A. Well, since this mechanism was set up for the sole purposes of the regulated entity, those were all costs of the utility.

Q. So that's a yes, the costs fall to Puget Sound Energy?

A. Yes, it is.

Q. And that's even though Puget has much less debt on its books than Rainier in the short-term debt category?

A. Is that limited to the time period we were just discussing?

Q. Yes.

A. Okay. Sure. Yeah, its collateralization, yeah. You know, it's very typical, Mr. ffitch, to have overcollateralization. For example, on our long-term debt, one dollar of plant secures 60 cents of debt. So it's overcollateralized by, what would that be, two-thirds or so. Very typical in a collateralized borrowing like this.

This was -- you know, this was put together at a time when the company was having difficulty in accessing the short-term capital markets. About the only way that it could do that in the volume it needed was to put a facility together that used the receivables as collateral. We had never done that before. Only proud companies with difficulties like Avista were doing this. Avista has a similar facility to this day. Were we a better credit rating, we would not have to do this.

Q. Let's turn to Exhibit 188, Mr. Gaines, Public Counsel Data Request Three.

A. I have that.

Q. And that was a data request that asked for the embedded costs of long and short-term debt and preferred stock over the past five quarters. Do you recall that?

A. I do. I have that in front of me. Thank you.

Q. And could you please turn to page 21 of that exhibit?

A. I think it has six quarters in it, Mr. ffitch.

Q. Okay.

A. Twenty-one, did you say?

Q. I stand corrected. Page 21. And that is your internal calculation of short-term debt costs at March 31st, 2003. And that's after Rainier Receivables was created; correct?

CHAIRWOMAN SHOWALTER: Are you looking at the hand-numbered pages?

Q. Whoops. I'm looking at the handwritten number, page 21, and the page is titled Puget Sound Energy Short-Term Debt Rate. Do you have that?

A. I do, yeah, and some of the shading is a bit hard to read here, but I believe it's all the facilities, Rainier Receivables, the -- looks like the $350 million line of credit we have, as well, plus commercial paper.

Q. All right. And this is after Rainier Receivables was created, obviously?

A. Yes.

Q. And in the upper left-hand corner there's a small box that shows the average amount of short-term debt from 1 April 2002 through 1 April 2003; correct?

A. Yes.

Q. And it has the average cost rates associated with that debt; right?

A. It has the borrowing rate, it looks like, yes, uh-huh.

Q. And in the next box down, we see the

commitment fee calculation, which shows the unused portion of the facility and the monthly cost associated with it, and at the bottom of that box, in the right-hand corner, we see that the annual fee, as expressed as a percentage of the total unused portion, is 0.1248 percent; right? Is that a correct description of the --

A. For the -- that appears to be for not Rainier Receivables, but for the credit facility.

Q. Right.

A. Yes.

Q. Now, this same process occurs in the third box down, on page 21 still. And there you calculate the fees associated with the securitization facility, and you express that as a percentage of the unused amount of the facility, and that fee percentage comes out to 0.982 percent in the bottom right-hand corner of that box; correct?

A. Yes.

Q. I'm sorry, let me restate that correctly. It's 0.0982.

A. Yes, I assumed you meant that, and it is lower, yes.

Q. When you add these together, the total facility fee is $444,000, which is 0.1145 percent of the total unused portion of the credit line and the securitization; right?

A. Could you repeat the question, please? It had a lot of numbers in there. It's kind of tough for me to follow.

Q. Okay. Well, I guess the core of it is that 444,000 is 0.1145 percent of 388 million?

A. I believe that's correct, yeah. Can I just do a quick calculation to verify that?

Q. Sure.

A. Yes, it's less than -- it's .11 percent, yeah.

Q. Right, thank you. And then, now, at the bottom of the page, we see the combined weighted average borrowing cost, that's the fourth column from the left, which comes from the first box on the top of the page, that's where we get the weighted cost from, and the average interest rate associated with the 12-month balance of short-term debt is shown in the next column over at the bottom, 2.4157 percent; correct?

A. Yes. Before the application of these fees, or the recovery of these fees.

Q. Okay. And then the total facility fee of 444,000 is divided by the unused portion of the

credit line and securitization facility, and that 0.1145 percent is added to the weighted cost of short-term debt to arrive at an average weighted cost of short-term debt of 2.503 percent?
A. 2.530, I believe.
Q. 2.530 percent.
A. Thank you.
Q. You're correct. And that sequence of calculations is shown across the bottom of the page; correct?
A. Yes.
Q. And now, can we turn, please, to page 31 of this Exhibit 188, and this is the calculation of short-term debt cost rates at June 30th, 2003; correct?
A. You know what, I don't -- I don't -- oh, I guess there's a date down here at the very bottom, June 30th, yes, yes. I'm getting confused, because it says July through July up top there.
Q. This is your document; right?
A. Yeah. Give me a second. Yes, it's the June calculation.
Q. Okay. And as we see here, the process is the same with the three boxes that we just went through on the previous page. We have year-end --

excuse me. We have year average balances and costs at the top, we have the middle box, the commitment fee is a percent of the total unused portion, and then the lower box is the securitization facility fee as the percentage of the total unused portion, and is that correct so far?

A. Yes.

Q. And then, at the bottom, after the calculation of the weighted average short-term interest rate, if we compare that to page 21 that we just looked at, the calculation of the average embedded cost of short-term debt appears to have been deleted. Can you explain that omission, Mr. Gaines?

A. No, I cannot explain that. I could probably do that follow-up to this data request.

Q. Okay.

A. This was not prepared by me. It's prepared by my staff.

Q. Okay. If we continue this process and turn to page 41, you see the same calculations here as in the previous exhibits that we looked at. Are you there?

A. I am.

Q. Now, if we go to the lower box of the page, the word credit agreement appears on the left side there?

A. I see that.

Q. There's a reference, and over on the right-hand side we see the same calculations on this entire page, except two of the columns used to calculate the overall cost of short-term debt appear to have been altered in some way, and I'm referring to the columns that show pound ref one?

A. Yeah, this is an Excel document, and it apparently references a source document for a number that is a reference error here when this was shipped off and printed.

Q. Now, if we go to page 46 -- are you there?

A. Yes, I am.

Q. We see that the format of the short-term debt calculation has changed. No longer is the amount of the commitment and the facility fees expressed as a percentage of the unused amount outstanding; correct?

A. Can you point me specifically where you're looking?

Q. The whole document, and we're comparing this with the three -- three previous documents that we looked at for the three previous quarters. Can you explain -- well, just verify that no longer is the amount of the commitment and the facility fees expressed as a percentage of the unused amount outstanding. That's no longer shown on this exhibit; correct?

A. I don't see that on this exhibit.

Q. Now, in a follow-up data request to this -- to this Data Request Number Three, we asked why the company had changed the manner in which it calculated short-term debt costs, and you responded there was not a change in the manner in which Puget calculated its debt cost. Is that still your response?

A. Yes, it is, yes. Just because it's not shown here doesn't mean it's changed.

MR. FFITCH: I don't have any other questions except for the outstanding matter of that other data request, Your Honor.

JUDGE MOSS: Are you ready to go with that or -- we still got got 25 minutes. I don't want to waste it.

MR. FFITCH: Your Honor, I have the data request. I don't have copies, but I can certainly show it to Counsel, and then -- this is actually pretty straightforward, did we ask this question, is this the answer that you gave, and then I could get copies provided to the bench subsequently.

JUDGE MOSS: Okay. And this is a response to a Public Counsel data request?

MR. FFITCH: Correct.

JUDGE MOSS: And I imagine the company, then, probably has a copy of it, but we can show it to them and let's see.

THE WITNESS: What number was that, Mr. ffitch?

MR. FFITCH: Response to 64.

THE WITNESS: This apparently was not one of the ones marked ahead of time?

MR. FFITCH: Yeah.

THE WITNESS: Okay. Thank you.

MS. DODGE: I just note that the sponsoring witness for this data request is Ms. Luscier.

JUDGE MOSS: Okay. Mr. ffitch, you can go ahead and provide that to the witness and ask your questions.

MR. FFITCH: May I approach the witness, Your Honor?

JUDGE MOSS: Yes, certainly.

MR. FFITCH: We're both going to have to read off of this.

JUDGE MOSS: Try to -- I know it's awkward physically, but if you can -- ah, here's another

mike. Perhaps you can just hold it.
MR. FFITCH: Thank you.
Q. Now, you have in front of you Public Counsel Data Request 64, Mr. Gaines?
A. I do. Thank you for providing it.
Q. And in that request, the fact that you -- we asked you if the fact that you have elected to monetize your accounts receivable affected your cash working capital calculation. And you indicated, Because Rainier Receivables is consolidated for regulatory purposes, there is no impact on working capital; correct?
A. What it says is, as a result, working capital is the same as if PSE did not engage in the accounts receivable securitization program.
MR. FFITCH: Okay. Thank you.
JUDGE MOSS: Does that complete your cross-examination?
MR. FFITCH: Yes, Your Honor.
JUDGE MOSS: Okay. Well, I believe, then -- let's determine whether there are questions from the bench.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. I have -- I have a few follow-up questions, which really means I didn't understand the conversation completely.

A. All right. Sorry about that.

Q. Well, it's -- believe me, it's my lack of knowledge on certain things that I think you're very familiar with.

Maybe -- the first question was you -- indicated that you felt that your role in Rainier Receivables did not affect the arm's length relationship between Rainier Receivables and Puget Sound Energy, at least that's what I heard. I heard you say yes, it is arm's length. And can you explain to me why that relationship between those two entities is arm's length, or what you meant by that?

A. Yes, what I meant was, you know, my job, as the treasurer of Puget Sound Energy, is to raise capital on the lowest possible -- at the lowest possible cost and to always maintain access to the capital markets.

We found, at the time of the collapse of the western systems power markets, that one of the ways to do that, because of our low credit rating and the fact that we'd been downgraded, was to use the receivables as collateral to collateralize our short-term debt borrowing, much as I testified we used the pipes and wire assets to collateralize the long-term debt borrowings.

We've had a lot of discussion about how the cost rates are different than the borrowing rates because of the amortization.

Q. Can you slow down a little bit?

A. Sure. Sorry.

Q. Thank you.

A. What I was saying was we've had a lot of discussion about the difference between the borrowing rates under that facility and how the cost rates are recovered because of the amortization of fixed costs. Much as you may borrow under a credit card at 10 percent and it may have an annual fee associated with it of $100 or $60 or whatever. And if that fee was expressed as a percentage of perhaps a low balance outstanding, it makes the recovery rate high to get to your $60 fee. Had a lot of discussion on that, but tries to -- seems to confuse the fact that it's a cheap borrowing source.

Going back to the question, this facility and this secure -- this subsidiary, Rainier Receivables, is simply a construct to enable the company to have a bankruptcy remote vehicle into which it can sell the receivables that are then used as collateral for the borrowing. There's other facilities like that in our company, all of our trust preferred has trusts set up, a similar sort of way. This one just happens to be a subsidiary instead of a trust that does the same thing.

Since that entity is created for the sole purpose of providing low borrowing costs, low source of short-term debt to Puget Sound Energy, it's consistent with my role as treasurer. So those interests are 100 percent aligned.

Q. I see, but that would seem to me it may not mean necessarily that you're arm's length --

A. Well --

Q. -- but that there's no conflict. From what you just said, I would have said the answer would be no, it's not arm's length, but there is no inherent conflict.

A. And perhaps arm's length here is a legal term, and being a lay person, I don't understand the definition, but I think what you said is really what I was trying to say. I think the inference is there's some nefarious calculation going on and that it's the high cost, perhaps, or that we're trying to obfuscate something by the mechanism in which it's set up through a separate entity and through a subsidiary when, in fact, that's not the case at all.

We have plenty of disclosure, and although we have to recover the costs, and expressed as a percent, that makes the recovery high. It's just simply recovering a fixed fee over a small balance.

So I think the inference there is that something wrong is going on. I sort of feel like I'm being questioned by Eliot Spitzer here, which is not the case at all. That's not what we're doing. We're simply trying to reduce our short-term debt costs. So my interests and the interests of Rainier Receivables are totally aligned.

Q. All right. And then, regarding Exhibit 189, page eight, I think there was the implication of the potential, anyway, that when Rainier Receivables was created, it coincided with an increase in the cost rate, and I have two questions.

I more or less understood you to say that if there was an increase in cost, it had to do with the company's -- PSE's underlying credit status, and in another point, you said that cost rate is not the same as the borrowing rate, and you've just said that again. And I have to confess, I'm not -- I'm understanding that there's an important distinction, but I don't quite get what it is. Maybe you could walk me through that?

A. Sure. The -- you had two questions there, really. One was that there's an increase in this cost rate depicted on page eight, and that that seemed to follow the implementation or signing of these two facilities, the credit agreement and the Rainier Receivables receivables securitization facility. I'll address that one first and then try and define the difference between the borrowing rate and the cost -- and the cost rate.

When you set up a facility, there are fixed up-front fees that you pay, facility fees, legal costs. Those fees are amortized over the life of the facility. So in a three-year facility, that's amortized over a three-year period, you know, 36 months, in other words.

What's happening here, and this will help distinguish between the borrowing rate and the cost rate for recovery purposes, is if you -- if we turn to this other exhibit, Exhibit 3, which is -- I'm sorry, it's not Exhibit 3, it's Exhibit 188, page 45, it shows the derivation of this 8.8 percent number.

The interest rate shown on that page for Rainier Receivables is, in fact, 1.35 percent. The commercial paper rate is 1.89. So in fact, it shows the borrowing rate, as I call it, this interest rate, is much lower than the company's cost of commercial paper. And it's only with the application of the amortization of these costs, the fixed costs or the up-front costs, that when you express those amortizations over the small amount of debt outstanding, that the cost rate for recovery purposes goes up.

Q. All right. But is that analogous to the credit card situation, where you were talking about the fee?

A. Yes. For example, I would suspect that if there was any fee, it may have been fully amortized in these earlier periods. And when Mr. ffitch was asking me some of these, I couldn't follow the dates, but prior to this period, I suspect those fees were fully amortized so, in other words, we weren't having to recover the $60 up-front fee.

Now, imagine if you had a credit card and it had a one percent borrowing rate and you borrowed $60, and then you had a $60 annual fee. Well, that would be a 101 percent cost rate, but your borrowing cost is really only one percent.

Q. But in that situation, if all I were ever going to do is charge $60 at the Bon, I would say I won't do this, because the fee is as much as I'll ever spend, so --

A. Exactly. You wouldn't do it.

Q. The fee is real; right?

A. The fee is real, and in fact, if you look over time, we don't just borrow the amount of the fee. I mean, this facility goes up and goes down. I think there was an exhibit that you passed out yesterday from Public Utilities Fortnightly that shows -- that stated people are -- utilities. By people, I mean utilities, are trying to reduce the amount of short-term borrowings they have, their equity ratios are going up to 51, 52 percent, that document said.

We're trying to do the same thing. We have this facility in place right -- it's got a large balance outstanding at the end of '03, $111 million. The rate -- the average debt balance used to calculate the 880 is 43 million. So there's some differences here, and we do use that and it goes up and goes down, as you can tell by this exhibit here.

But we need the availability to the capital for things like, well, when we have PCA, PGA mechanisms that are deferral mechanisms, we still have to borrow to pay those costs. We may recoup those costs later, but there's a timing value where I have to raise the capital to finance that, and I need access to the capital markets to do that.

And as a result of the company's borrowing rate, a cheap way to do that is to set up a facility like this.

Q. So is this analogous to having a credit card where there is an annual fee, and some months I might charge a lot and some months I might not, and I'm not sure if this is relevant, but some months I might pay it off all right away and maybe some others not? Is that --

A. Yes.

Q. -- sort of what this account is?

A. That's what -- that's -- well, all facilities are like that, but, yes, that's why the cost rate bounces around like that, in part, because you've got these fees that you paid up front, just think of them as structuring costs, attorneys to draft documents, these sorts of things, accounting opinions and so forth, and those are amortized over this period. They're a fixed cost, but it's being recovered over a variable balance. So sometimes, when the balance is high, the percentage would be low, and when the balance is low, the percentage is high.

Q. All right. But, then, it would still be relevant I think in the credit card analogy, as what is the fee and how high is it, and if there was a thousand dollar credit card fee, I wouldn't do it. How do I evaluate whether the fee that is here, the analogous to the $60 annual fee, how do I evaluate whether it's reasonable in this case?

A. Yeah, well, there's a couple ways that I would think that you could do that. One would be, first of all, the cost rates on page eight of this exhibit are not just Rainier Receivables, it's everything all together.

Q. Now, that was -- you're back on --

A. The exhibit, I think it's 189, is it?

JUDGE MOSS: Yes, 189.

Q. Right.

A. Let me mark that.

Q. Okay. So that this table includes more than just Rainier Receivables?

A. Yes, it does. And in fact, the other thing that I would do is go back and say, well, this is some period of time that doesn't have anything to do with the rate period, so I would then say, well, what is the cost rate that the various witnesses are using for short-term debt in this proceeding, and that is summarized in a exhibit, and they're pretty close.

My direct rebuttal testimony, which is Exhibit 179-C, and this is not one of the confidential pages, page three of 49 shows the cost rates and cost ratios that all the parties are putting forth here. We've got 4.55 by -- as a cost rate for short-term debt for Staff, and a balance or percentage capital structure for short-term debt of 3.21 percent, so the weighted cost is .15.

Public Counsel, their ratio for short-term debt is 4.36 percent, and they've got a made up cost rate of four percent, for which there's no basis. That weights out to .17 percent, so he's got a higher weighted cost than I do.

Then you come down to the PSE line of 3.09 percent, and I'm seeing a cost rate of 4.81, so you can see I have a lower balance as a percent than either of the other parties, and a higher cost rate, but the weighted cost that figures into the ROR is pretty much the same, .15.

Q. So is the implication that whatever the dispute we've just gone through, that, in the end, that the parties are proposing an amount to go into

rates which is quite close, or at least it's .15, compared to .17?
A. Yes, Staff and Public -- Staff and the company are in agreement, .15, by the time it's weighted out for the ROE, and Public Counsel has a different number that's two -- two one-hundredths of a percent different.
Q. Okay. I've got a different subject area, and that is about the effect of PCORCs.
If you could just assume that if the company gets a rate and revenue that assumes 40 percent equity ratio, now, then, if the company acquires three major facilities and serially comes back to this Commission with three new PCORCs, then what I heard you say is that, in those proceedings, we would assume the 40 percent equity, that if the company was granted recovery on the PCORC basis, yes, there would be new revenue, but -- and here's, again, where I'd like you to fill in the blanks -- but that that would only be partial recovery, you said, because we are only assuming the 40 percent.
And can you then continue on with the explanation? I heard you talk about dilution, but I frankly was not getting -- connecting every dot.
A. Okay. I'd be happy to do that. The

company's plan, and it's imperative to follow this point, because it's relative to -- important for my partial recovery statement.

Q. And can you stick with the hypothetical?

A. Yes, I will. Thank you. The company's going to get to a 45 percent equity ratio regardless of the timing of the asset acquisition. So presuming in this hypothetical, if the company financed these three new facilities that you posited with a 45 percent equity ratio, then it's getting recovery in rates of -- or revenues to reflect 40 percent equity, but, in fact, it has 45 percent outstanding, so it's not fully recovering its capital costs for those resources.

Q. Okay. But, then, doesn't this go back to the issue of what is a reasonable ratio? That is, you're saying, well, we're going to 45 over some period of time, and isn't the question to us whether you should or shouldn't get to 45, and if you should and are going there, we take that into account, but if you shouldn't and 40 percent's good enough, then we would, in essence, hold you to that in a regulatory sense. Is that correct, that --

A. I think that it is, with just one potential difference, I guess. The question, I believe, is --

certainly, for this Commission, is 45 percent the appropriate capital structure for rate-setting purposes.

The company, you know, I think we have the other witnesses who have said it's not that that's imprudent; it's just that they're not there yet, is sort of the discussion. So when you said, for rate-setting purposes, you may hold us to 40, we may elect to issue more equity and then try and recover that later, but that is certainly not the desired approach, because then we've issued equity that is not getting a return on it.

So what we're trying to do is say, well, heck, we've done a great job so far of building up from the 30 percent equity to the 40, and that's a great partial step, and we were given many years to do that and we did it in one or two, a couple years ahead of schedule, so that is the proof in the pudding that we will continue to do so.

And I tried to put forth in summary, in an exhibit, here's what the average equity ratio is across the nation. It's 49 percent, close to 50. We saw in the document yesterday, 51, 52. When we look at some of the other things people are positing, it's based on comps that are telephone companies that have no weather risk, have no commodity volatility, and so when you look at it all in aggregate, it seems, if anything, the 45 percent's probably shy. And we even had Dr. Cicchetti mentioning that he had suggested something higher, and the company, for its own reasons, elected not to request something higher and to stick with this 45.

So I think all that gets incorporated into your decision or thought process in making your decision.

Q. Now, in -- as an alternative to a PCORC, you have the option to just come in with a new general rate case three times. And wouldn't that be very similar to a PCORC if we had just gotten out of a general rate case and you would be asking for the greater equity based on actual evidence?

A. In fact, the PCORC may require a general rate case, because I believe one component of that is if the PCORC rate ends up being in excess of five percent, it requires the filing of a general rate case.

Q. So in that case, really, the PCORC would transform itself into a new general rate case, and there is your issue. Then there's lag. That's your basic issue?

A. Yes, and we've already had a lot of testimony yesterday on the company's authorized ROE's 11. We've been getting -- earning seven, so that's quite a bit of lag. It adds to that problem.

CHAIRWOMAN SHOWALTER: All right. Well, thank you.

THE WITNESS: Thank you.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. Well, very, I hope, briefly, I want to pursue the Rainier Receivables. I'm where the Chair was about -- I'm struggling to understand. Puget Sound Energy borrows short-term debt from Rainier Receivables, apparently, or you're using your receivables as a source of obtaining short-term debt. Is that a fair statement?

A. It's a middleman, I would say. The ultimate investor who has the short-term debt are clients of Bank One Capital Markets.

Q. Okay. And I was going to get to the point that Rainier Receivables has to go somewhere to get its money. So why is it more attractive to PSE to use the middleman rather than do it directly?

A. I'm going to try and answer this to the best of my knowledge, and I believe that it's probably a legal -- finance law question, but I can explain it in my understanding of that law, if you'll permit me.

The -- for the investors to really have access to that collateral and for it to be A-1, P-1 rated, which is what that commercial paper that is issued is rated at, it needs to have confidence that those receivables are always there.

What happens if we did it directly and they had -- we had gone bankrupt. It would not be separate. They would -- they could be subject to this bankruptcy thing, so you would not get the A-1, P-1, the highest commercial paper rating.

So the creation of this entity, Rainier Receivables, which is bankruptcy remote from Puget Sound Energy, and selling the receivables there, sale for accounting purposes, then using that to collateralize the borrowing says to the investor, well, look, regardless of what happens to PSE, these receivables will be there, and so therefore you can rely on that as a low risk source of collateral for backing up your loans, and therefore we can, as we pointed out on the one exhibit, borrow at 1.3 percent instead of the company's commercial paper rate, split rating of the lower A-2, P-3 rating of 1.89 percent, or 1.8, whatever the number was. And that's the purpose of this middleman, is you get the lowest cost that way.

And there's other people, as I believe Mr. ffitch pointed out, that apparently do it other ways and probably have higher costs as a result. Avista has a very similar mechanism to this that's been in place for quite some time.

Q. All right. Now, I can pursue it further, but I think that answers my general question, and I'll let it go at that. Thank you.

A. Okay. Thank you.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Gaines, just -- I'd like to address briefly the discussion you had earlier about capital structure. And I think that the -- maybe I can characterize it one certain way and you can tell me what you think about that.

And that is if we set capital structure in this case as the company's requested, which is at 45 percent, which looks at projections over the course of the rate year, the company would be financially in a better position if we chose to do it that way, am I correct?

A. You mean, as compared with picking a lower number?

Q. As compared -- well, as compared to using an average of the capital structure over the rate year?

A. Yes, the company would be at a higher -- it would be less levered, it would be in a stronger credit position.

Q. So then, if the company's equity position is expected to grow over the rate year, then the company's proposal in this case would put it in a better financial position. If the company's equity were expected to decline over the period of the rate year, then the opposite would be true?

A. It would be, mathematically. I think the other thing to bear in mind is the company has this PCORC mechanism to recover costs, and that hopefully will keep it from having to come in for general rate cases as frequently as we otherwise would. Mr. Reynolds said yesterday that we would be in probably every year. That may be general rate cases, may be PCORC rate cases.

From my projections, and I don't want to say the time, but we can see that we actually get to in excess of 45 percent, and if we were to take that beyond the rate year, that would continue, so rates are set -- we typically look at the first year, the rate year when rates are set, but this is likely to go on for some period of time. So if we say, well, heck, it's a handful of time period, let's say, until that's -- we get to that level, but it's going to be there and higher than that, then we're still not recovering all the costs, but we're just trying to take it up to a level where we are.

Q. I think I'm just looking at it more from a policy question, because you're asking for change in the way that we calculate the equity of the company for purposes of making rates, and I guess when the company's equity position was decreasing, it was better for the company to advocate an average rate over the period of the rate year. With the equity position increasing, then it's better to look at the end of the rate year in order to set it. Is that -- I mean, is that a fair characterization?

A. I wouldn't say that it is, no. I think what we're trying to do is, first of all, there's a lot of different things that happened besides just capital structure. As I mentioned in that other -- earlier proceedings, ones prior to the merger, the last time capital structure was set, we had 45 percent in rates at the electric business, 44 percent at the gas business, ten-five ROEs. At the same time, we had a PGA mechanism and we had full pass-through, dollar for dollar, of electric cost, variable electric cost. We had fixed costs recovered on a per-customer basis that had no volatility associated with it.

So here we had better protection from the volatility of the markets at a time back when -- at 45 percent and ten-five, and here we have less protection under today's PCA mechanism. It's a sharing band instead of dollar-for-dollar. We're trying to get back to that level, which the Commission approved 10 years ago, 1993.

We're facing different challenges today. We're facing a time where we have huge infrastructure investments. We've got -- Mr. Markell said -- started with a number that's confidential, but then said it could be as high as $800 million, and that's just the new resources. That's not what Ms. McLain will testify to on the pipes and wires business. Huge capital costs. We weren't facing those back then.

And I think we had Dr. Cicchetti testifying that, gee, you know, you're going to -- the company's going to lock in a borrowing cost based on whatever credit rating comes out of this, that's going to be in place for up to 30 years if we issue 30-year debt. So there's a huge benefit there, and trying to lock in the benefit with a high credit rating while rates are low, that would make a lot of sense.

So I think there's a lot of things different today than there were back then that would necessitate this higher -- even higher than what we had in 1993. And that's where we're trying to go. I don't think it's a matter of picking and choosing just given what the trend is in the rate. It's what we're facing and trying to recoup costs, rather than asking investors to front the money and not get a return on it.

We have two analysts here today that we've never had in these proceedings because of those concerns.

Q. Let's talk about the analysts just briefly -- or the investors. You're in charge of dealing with them on -- certainly the front person for the company, so to speak?

A. There's -- I do need to have a correction. Just recently, the investor relations person used to report to me and now reports directly to Mr. Valdman, but I'm still very much involved in that aspect of the business.

Q. I was going through your testimony.

A. Yeah, I'm sorry.

Q. Your pre-filed direct.

A. Yes.

Q. That was filed quite a while ago?

A. Yes, it was.

Q. Well, I guess my question, let's just ask you, you know, what you think about this, and then you can talk about maybe what investors think, see if there's a difference.

But how would you characterize the financial performance of Infrastrux?

A. I would characterize it as volatile. It's earned two cents per share on a PE number of -- Puget Energy number of shares last year, it earned ten cents per share the year prior, and those returns are volatile. I think, on a year-to-date basis, it's earned four cents this year, so it's somewhere in the middle of that range. I think it's added some volatility to the holding company's return.

Of course, that doesn't impact the utility's return, as it's separate, but I think that that -- it's volatile, I would say, and it's a business that is doing well, in that sense, compared to its peers.

Others have not had positive income in recent periods.

So I think it's doing well and it's doing as those businesses typically do, is oftentimes, over the long term, higher returns, but a lot more volatile returns.

Q. And how does the investor community view Infrastrux as part of Puget Energy's portfolio? You get reactions back from the investor community, I'm sure, on that issue, so what are they telling you?

A. Well, I think, one, they would agree with that part of my assessment. They would probably also say, Why do you have that? We hear that a lot. And there's historical reasons for that. They say, What are you going to do with it, and we try and answer those questions. So I think there's a lot of -- and they wonder, I suspect -- and I can't speak for them, so I say I suspect this. I suspect they wonder if it's worth keeping around.

Q. Well, do they look at it as a positive support for your current credit rating or do you think -- are they telling you if you shed the infrastructure, your credit rating would improve in their eyes?

A. Well, I think we need to separate, for credit rating purposes, the credit rating of Puget Sound Energy and that of the holding company.

Q. I'm not talking about the holding company.

A. Yeah, and that's not what lenders to the utility look at. They look at the utility's credit rating. And that's the credit rating that we're trying to get to BBB+ here, is the Utility's. So when you ask about Puget Energy, what are you wondering?

Q. That question that you just answered, as far as Puget Sound Energy, how do they look at it as far as does it support Puget Energy's credit rating or not?

A. I would -- I think that, at the holding company level, and I would have to go back and check this, but I believe the holding company has a one notch lower credit rating than the utility because of that business.

I do know the utility has a business position of four, which is, as we heard the other day, a little bit better than average in its Standard and Poor's credit rating, and I believe they have a higher number than that for Infrastrux, it's not published, but they've told us roughly where it would be in meetings, and it's substantially higher.

COMMISSIONER OSHIE: Okay. Thank you. No other questions.

THE WITNESS: Okay.

JUDGE MOSS: Is there going to be any follow-up? How much?

MR. FFITCH: Five or 10 minutes, I believe, Your Honor.

JUDGE MOSS: Will there be any redirect?

MS. DODGE: Yes, Your Honor, there will be.

JUDGE MOSS: And how much?

MS. DODGE: Probably about five minutes.

CHAIRWOMAN SHOWALTER: Break for lunch.

JUDGE MOSS: All right. We're going to take our break for lunch. Okay. We'll break until 1:30.

(Lunch recess taken.)

JUDGE MOSS: Let's be on the record for a housekeeping matter, please. Mr. ffitch, my notes don't indicate that you moved your exhibits at the conclusion of your cross-examination for Mr. Gaines, and so I wanted to ask you. You had referred specifically to a few that I marked, and did you want to move those?

MR. FFITCH: Yes, Your Honor, thank you. I had also discovered that oversight over the lunch.

JUDGE MOSS: So 188 through 197, all of

them?

MR. FFITCH: Yes, Your Honor.

JUDGE MOSS: Okay. Any objection? No objection. Those will be admitted, then. Thank you.

All right. We had reached the point before the lunch recess that the bench had concluded its questions, at least in terms of an initial round, and so I had asked if there were any follow-ups, and I think Mr. ffitch indicated that he might have a few. Mr. Cedarbaum, did you have any?

MR. CEDARBAUM: I don't at this time.

JUDGE MOSS: Okay. So Mr. ffitch, if you had a couple, then go ahead with that, and then we'll return to redirect.

MR. FFITCH: Just a couple. We've trimmed it down. Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good afternoon, Mr. Gaines.

A. Hello again, Mr. ffitch.

Q. You testified this morning that the Standard and Poor's business position for the company was four; is that correct?

A. That's correct, yes.

Q. Has that number changed recently?

A. Yes, it has. Earlier this year, it was five, and we talked with Standard and Poor's after our September meeting with them and pointed out some of the favorable economics of the Mid-Columbia resources, and tried to get them to reduce the risk factors, which they wouldn't do, but they did, as a result, reduce the business position or improve it to a higher level, from a five to a four, so that was -- I want to say it was October, November. It's pretty recent.

Q. That represents a lowering of risk, does it not?

A. No, it's not a lowering of risk. That would change the credit rating. This is just the business position of the company.

MR. FFITCH: May I have a minute, please, Your Honor?

JUDGE MOSS: Sure.

Q. When did that change occur, just to -- you may have just said, but just --

A. I think -- I don't remember exactly, Mr. ffitch. I think it was October or November. It's fairly recent.

Q. Was it before your rebuttal testimony was filed?

A. It was, because I used that business position for the benchmarks in the ratios that I used.

Q. All right. Thank you. Could I ask you to turn to Exhibit 357? And I've mentioned this to your Counsel. You should have that available to you.

JUDGE MOSS: Who is the witness?

MR. FFITCH: This is an exhibit of Steve Hill, Exhibit 357. It's Exhibit 7 to his testimony.

THE WITNESS: This is the one based on the C.A. Turner reports?

Q. That's correct, and I'm asking you to look at page three of Exhibit 357, which is -- that's page three of eight. It's entitled Electric Utility Industry, Common Equity Ratios. Do you have that?

A. Yes, I do.

Q. Now, you testified, in response to questions from the Chairwoman, I believe, that the industry average for U.S. Utilities for equity ratios was in the range of 49 to 50 percent, did you not?

A. Well, yes, on the basis upon which rates were set, yes.

Q. Okay. Now, I'd like you to look at this exhibit on the left side. We have electric companies and a column of equity ratio numbers, and could you please just read the BBB-rated average equity ratio for those electric companies at the bottom of the --

A. I see that, the left-hand column.

Q. -- the left-hand column.

A. It says, for the BBB-rated companies, it's 41 percent.

Q. Thank you. And then, looking to the right-hand side, we have combination gas and electric companies?

A. Yes.

Q. Could you read the corresponding BBB-rated average at the bottom of that column, please?

A. On that basis, it's 36 percent. These, of course, are not the ratios upon which rates are set, and there's substantial differences for some of these companies between what's on their books and at the holding company level, which was what Turner reports and what rates are set. For example, Aquilla --

THE REPORTER: Slow down, please.

MR. FFITCH: Your Honor, the witness is beginning to go off to sort of make a speech in response to a question that wasn't asked.

JUDGE MOSS: Mr. Gaines, let me just say that I think you did draw the appropriate distinction between the number you gave and these numbers, and so we probably don't need any more on that.

THE WITNESS: Thank you.

Q. Mr. Gaines, if I want to invest in any of these companies, including Puget Sound Energy, I have to buy stock in the holding company; isn't that correct?

A. I would presume so. I don't know the specifics of each company, but it's typically the holding company where the common stock is outstanding.

MR. FFITCH: Thank you. I don't have any other questions, Your Honor.

E X A M I N A T I O N

BY JUDGE MOSS:

Q. Okay. I have one brief follow-up, because I don't understand how the -- I had started to write four and five risk, and so then, when you said no, it's not, it's a business position, I need to understand, does that figure into the ratings in any way?

A. No, the rating is assigned a letter, you know, for example BBB+, BBB flat, BBB-, but that's really what is the indication of the risk.

The business position says, for the purposes of the benchmarks that they have, and they have a series of one to 10 business positions, what are the benchmarks that one would use for looking at this company. And PSE's is four.

JUDGE MOSS: Okay. Thank you. I think we can go to redirect.

MS. DODGE: Thank you, Your Honor.

R E D I R E C T   E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Gaines, just for a moment, before we leave Exhibit 357, page three, did you have other observations about this exhibit that you would like to address?

A. Well, I do. As I mentioned, this is not at all an example of the basis upon which rates were set. And what Mr. ffitch was asking me about, my number came from Exhibit 182, which is my DEG-12, and just to pick out a couple here that are obvious, I'll give you two examples.

MDU, which is listed on Exhibit 357, shows 62 percent equity, yet the basis upon which rates were set was 50.32. So there's a 10 percentage point difference between the two and, in fact, rates were set at the 50 percent level, lower than what's on this exhibit.

Now, another example, the one I was trying to point out, also, he has Aquilla listed here. Aquilla's shown about the third line -- fifth line down, right-hand column, at 33 percent, but, in fact, rates were set on Aquilla, in the proceeding in 2003, on a 47 and a half percent equity. So there's one where the on-the-books equity at the holding company level, that Mr. Hill has, is substantially lower than the basis upon which those two, close to 50 percent.

Just two examples that I could find in looking at these exhibits while I'm sitting here. I'm sure there's more, but I think it -- what I was trying to point out was the average upon which Commissions set rates, which is oftentimes different than what a holding company has.

Q. On a separate topic, does the credit rating of the holding company, Puget Energy, have any impact on the credit rating of Puget Sound Energy?

A. No, it does not. Investors look at, for the utility, look at the credit rating of the utility.

Q. Looking at Exhibit 189, page eight, this is the cost rate of debt that we've been looking at throughout your examination.

A. Can I have you lend me a copy of that, again? Thank you. Page eight. All right.

Q. Do you have it?

A. I do, yes. I'm sorry. Yeah.

Q. Why did the amount of borrowings for the company decrease over the time period that's shown in this chart?

A. Well, a couple of different reasons for that. One, the capital markets have become exceedingly concerned about liquidity and access to liquidity, and they don't like to see companies who are fully tapped out in terms of they borrowed right up to their credit limits. So we have been embarking on a plan to reduce the amount of short-term debt. That would be one reason.

Another reason is we have been doing some refinancings that have brought down the cost of debt from 7.4 in our pre-risk proceeding to six-eighty-eight today, below the average of eight percent. And we need to allow flexibility here when we do that.

Also, the third reason would be when we have resource acquisitions, for example, the Fredrickson resource, in that one, where we purchased a resource, we had to fund in one day $88 million, and we didn't have time in that day to complete a financing so that its proceeds would be concurrent with the timing of that payment. So we fronted that with short-term debt and then repaid that with a longer term security offering that was done a couple months later. So those would be the three main reasons.

Q. Now, why does the company continue to maintain the credit facilities it has given their -- that they cost something to maintain and given the reduced amount of short-term debt it has had recently?

A. Well, as I mentioned earlier, in response to the Chairwoman's question, my job is to maintain access to capital at all times on reasonable terms. And having this credit availability is almost like an insurance policy, I guess I'd say, where you pay a premium, so it has a cost. You hope to heck your house doesn't burn down, but if it does, you've got access to being reimbursed for this.

We have to have this availability here to handle the volatility in power costs, as I mentioned, we have mechanisms to recoup those over time, but we have to fund those balances and those borrowings, the expenses, day in and day out. We have the need for, as I mentioned in the Fredrickson case, to fund up front at times construction activity before long-term capital can be put in place. There's all sorts of items that add to volatility of the company, and to fund just the ongoing working capital needs of the company as it increases its investments, we mentioned resources, but for infrastructure, those all demand access to capital, and we need that availability there.

We may use it. There's been -- you can see here, in a three-month period, we've gone from 16,000,000 in September to 111 in December, so you can see, just in four months, five months, three months, I guess, in that case, that it's a huge swing, and that happens on an ongoing basis.

Q. Moving on to a different topic, there was some discussion of power cost only rate cases, or PCORCs, versus general rate cases?

A. Yes.

Q. As you understand it, does the PCORC actually transform into a general rate case if the rate increase impact is high enough?

A. No, what I mentioned was if a -- as I understand it, if a PCORC results in a general rate -- in a rate increase of five percent or more, so that, therefore, that proceeding would have concluded, then the company, within some period of time, has to file a general rate case. One would be separate from the other, because, one, you only know that rate increase at its termination, so it wouldn't be that you could put the two together. You wouldn't have concluded the PCORC by the time you filed the general.

Q. You're saying you would have concluded?

A. I'm sorry, yes, you would have concluded that before you even filed the general, so you wouldn't be able, actually, to put them together.

Q. And from the company's perspective, could it simply come in for rate cases for its resource acquisitions, rather than PCORCs?

A. Well, yes, I agree that we could do that. Of course, there's a huge timing difference in doing that. On a PCORC, it's an expedited treatment where only certain costs related to resources are examined, so that's a four-month process. And typically, as we're finding out in this case, a general rate case can often last 11 months, sometimes longer.

Q. On a different topic again, Mr. Cedarbaum suggested, at the beginning of the examination, that the company would need to issue approximately $500 million in equity to reach a 45 percent equity level.

Would the company actually have to issue 500 million in stock, or could it rely in part on retained earnings?

A. Well, it would rely on three things, and my work papers show this. It would rely on retained earnings, one; it would rely on common stock offerings of which there are two in the work papers filed with my direct testimony, substantially less than the aggregate amount of that difference; and it would also use dividends that investors reinvest into the business. So those would be the three main sources.

MS. DODGE: That's all I have.

JUDGE MOSS: Okay. Thank you. If there's nothing further for Mr. Gaines -- yes, there is.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. I was surprised at your answer to the question on redirect that Wall Street looks to the utility's credit rating, rather than the holding company.

We've had numerous examples in recent years of the holding company with unregulated activities pulling down the regulated company and giving it all sorts of heartburn and Wall Street heartburn. Is that really your position?

A. And I understand what you're asking and there certainly are instances, yes, and I should clarify two things. Fixed income investors, the people who buy -- this line of questioning, remember, followed a discussion of Rainier Receivables, of which we also mentioned long-term debt. That capital, which is outstanding at the utility, those investors look at the utility's credit rating. Common equity investors oftentimes look at the holding company.

Now, the difference, I would say, in our case, compared to some of the others that you may be envisioning, is that our regulated business is 90 percent plus of the holding company, and some of those other companies, it's -- the regulated utility is a small portion. Infrastrux earning two cents last year and Puget earning a dollar something is two percent, so it's a very minor -- minor impact on the company's overall results.

So it's really, when you look at the holding company's credit rating, it's a combination of the two, but Infrastrux is a very small piece of that. That's why.

JUDGE MOSS: Okay. Thank you. All right. Mr. Gaines, it appears that your examination is complete, at least for the time being, and so I'll ask that you step down, and thank you very much for your testimony.

THE WITNESS: Thank you, Judge Moss.

JUDGE MOSS: I believe -- is Mr. Hill next?

MS. DODGE: Yes.

MR. CEDARBAUM: Your Honor, Judge Moss, can we just go off the record for just a second?

JUDGE MOSS: Sure. We're off the record.

(Discussion off the record.)

JUDGE MOSS: Mr. Hill, would you please rise and raise your right hand?

Whereupon,

STEPHEN G. HILL,

having been first duly sworn, was called as a witness herein and examined and testified as follows:

JUDGE MOSS: Thank you. Please be seated.

D I R E C T   E X A M I N A T I O N

BY MR. FFITCH:

Q. Mr. Hill, could state your full name and spell your last name for the record?

A. Stephen G. Hill, H-i-l-l.

Q. And were you retained by the Public Counsel Office of the State Attorney General to testify regarding cost of capital in this matter?

A. Yes, I was.

Q. Do you have Exhibits 351 through 368 before you? Those are your pre-filed response testimony and exhibits.

A. Yes, I do.

Q. Now, do you have the exhibit numbers marked on those, or should I -- I'd be happy to give you a copy of the exhibit list, so you can cross-reference.

A. I don't have the exhibit numbers marked on them, on my copy.

JUDGE MOSS: Mr. ffitch, while you're getting situated there, I have no objection to your referring to them in both ways if it will make it easier for the witness.

MR. FFITCH: Thank you, Your Honor.

Q. Was this testimony and these exhibits prepared by you, Mr. Hill?

A. They were prepared by me.

Q. Do you have any corrections or changes to the testimony and exhibits?

A. A couple typos. One is on page 55, at line nine. The sentence should read, beginning at line nine, The price of that index of 20 percent dash negative 20 percent growth, not 205 growth.

And then the other one is -- was pointed out by Dr. Cicchetti in his rebuttal, and that's my Exhibit SGH-5, which is Exhibit Number 355, page six of that. And the treasury bond yield in the footnote on that page is incorrect. It should be 5.15, as it is in the body of the testimony and as it is in my exhibits.

Q. Any other corrections or changes?

A. No, sir.

Q. With those corrections and changes, is this testimony and are these exhibits true and correct, to the best of your knowledge?

A. Yes.

Q. If I asked you the questions contained in the testimony today, would your answers be the same?

A. Yes, they would.

MR. FFITCH: Your Honor, I would like to offer Exhibits 351 through 368.

JUDGE MOSS: Any objections? Apparently not. Those will be admitted as marked.

MR. FFITCH: Your Honor, Mr. Hill is available for cross-examination.

JUDGE MOSS: All right. And we have -- Mr.

Van Cleve has pointed out to me that ICNU has five minutes, and Ms. Dodge, do you wish to precede ICNU or follow, since you are the primary adversary here?

MS. DODGE: I would prefer to follow.

JUDGE MOSS: All right. Mr. Van Cleve, why don't you proceed with your questions.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Mr. Hill, can you tell us what your billing rate for this case was?

A. My billing rate for this case is $150 an hour.

Q. And did you pursue this case on a fixed fee arrangement or a billable hour basis?

A. A fixed fee contract arrangement. I made a bid, an original bid of right at 15,000 for the entire case, and due to the complexity of it, I had to recently ask for a $5,000 addendum to that contract.

Q. If you could refer to Exhibit 249, which, if you don't have, I can provide to you.

A. I don't have it. I've seen it, but --

JUDGE MOSS: Who's the witness, Mr. Van Cleve?

MR. VAN CLEVE: Yes, Your Honor.
JUDGE MOSS: What is the witness?
MR. VAN CLEVE: That was from Story.
JUDGE MOSS: Okay. So this is one of Mr. Story's exhibits, Number 249?
MR. VAN CLEVE: Yes, there were some questions about it yesterday.
Q. Mr. Hill, while everyone's finding Exhibit 249, let me ask you when, approximately, you were retained to work on this case?
A. It was the summer. I got the proposal in my computer. I could get an exact date, but it was sometime this summer. There were several cases ongoing in this jurisdiction, and I was contacted -- actually, I was working for the Staff and the consumer advocate on PacifiCorp, and also was asked about a Verizon case, which I was unable to do, because I was too busy, this case, and one other, Northwest Natural, I believe. PacifiCorp and Northwest Natural were settled.
Q. Okay. Do you have Exhibit 249 in front of you?
A. I do.
Q. And even though this is on yellow paper, the company informed us today that it would no longer be

considered confidential. So I'd like to direct your attention, under Pacific Economics Group, that column, which subtitles -- it says cost of capital, and it says $374,160.06. Do you see that?

A. Yes, I do.

Q. And do you think that that is a reasonable expenditure for the company's cost of capital testimony in this case?

A. No, I don't.

MS. DODGE: Objection. There's been no foundation laid that this witness has a basis for giving that opinion.

JUDGE MOSS: You might lay some foundation.

Q. Mr. Hill, how many cases have you testified in regarding cost of capital?

A. I've been testifying on cost of capital since 1980, and about 220 cases, maybe a little more.

Q. And are you familiar with what cost of capital experts generally charge for providing their services?

A. Yes, I am familiar with that.

Q. And why don't you tell us what, on an average basis, you think they generally do charge?

A. The -- my experience is that cost of capital witnesses for companies generally make two to three times what cost of capital witnesses for public advocates make, so that would be in the neighborhood of 25 to 50,000.

Prior to this case, the highest I had seen was for Mr. Hadaway. He had, I believe, a two-year contract with PacifiCorp to do all their testimony in all their jurisdictions for a quarter of a million dollars. I've never seen anything on this scale.

MR. VAN CLEVE: Thank you. I do not have any other questions.

JUDGE MOSS: Thank you. All right. Ms. Dodge.

MS. DODGE: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Hill, please turn to page five of your testimony. It's Exhibit 351.

A. I have it.

Q. Now, in the first Q and A on this page, you note that several regulatory bodies have set the authorized equity return in the single digits, and you cite several cases. And in footnote one on that page, your list includes cases involving a number of water and telephone companies, doesn't it, not just electric and gas companies?

A. Yes, telephone companies are generally considered --

Q. And I'm sorry --

A. -- to be more risky than gas companies or electric companies.

Q. That was --

JUDGE MOSS: Please don't interrupt the witness. Were you finished with your answer?

THE WITNESS: Yes, sir.

JUDGE MOSS: Did you get that, Ms. Nelson?

THE REPORTER: I did.

JUDGE MOSS: Go ahead, please.

Q. Even with respect to electric or gas companies, you agree, don't you, that the companies involved in the cases you cite were in significantly different positions than PSE with respect to their financial strength and their risk profiles?

A. Well, I believe, as Mr. Valdman said yesterday, it's very difficult to isolate companies that are exactly the same. In fact, I don't think that could be done. The point is that utilities generally have similar risk compared to other investments in the marketplace, and I'm merely showing the Commission, because I believe there's a real aversion by regulatory bodies to go below the double digit level, i.e., to single digits. I wanted to show the Commission that there have been some regulators in the country that have done that.

Q. Did you review the Commission orders that you cite in your footnote?

A. No, I did not.

Q. Are you aware, from your work in the field, that, for example, in the Connecticut case that you cite, Connecticut Light and Power, the Commission in that case noted that Connecticut Light and Power Company have reduced its operating risk by divesting itself of generation?

A. Yes, I realize some of those companies are wires companies, and I believe I gave an incorrect response to you a moment ago. One of the orders that I cite was the West Virginia water order, and I'm very familiar with that case and I have read the order in that case.

Q. Do you --

A. And although water companies are thought to generally have somewhat less risk than gas and electric companies, they are similar in risk.

Q. Do you recall, with respect to the West Virginia case, that the West Virginia Commission criticized the water company in that case for using a proxy group made up of gas companies to support its requested ROE, and the Commission determined that this was inappropriate because, quote, Natural gas investment is far riskier and not comparable to water?

A. That's what the Commission said, but the Commission in West Virginia has for years rejected other kinds of sample groups that are different than the company being regulated. And the fact that Standard and Poor's gives water utilities and gas distribution utilities similar business position rankings indicates that that's incorrect.

MS. DODGE: I have no further questions.

JUDGE MOSS: Thank you. Do we have any questions from the bench?

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Well, just following up on the last question, I understood Mr. Gaines to say that business position is not the same as credit rating, and I probably would have asked him a follow-up question if I hadn't already had my opportunity, but since you raised it, isn't there a distinction -- or what is the distinction, if any, between business position and credit rating?

A. Well, I'm afraid I have to disagree with Mr. Gaines. I believe he informed you that they weren't related. Business position was something different than a bond rating. And while that is true, and I believe there's an exhibit in Mr. Lazar's testimony, which is this new publication by Standard and Poor's, June 2nd, 2004. And the whole focus of the new Standard and Poor's rating paradigm is built around business risk position.

Now, they -- and their rating criteria, their benchmarks are segregated by business risk position. So a company, for example, a wires company or a gas distributor or water company, they generally have business risk positions from one to three.

Q. Well, is that separate or different than what we were talking about, which is -- I thought it was a rating from maybe one to 10, I wasn't sure.

A. Yeah, it does go from one to 10, but I was just -- I was going through the scale to tell you what companies are spread out that way, and then, perhaps if you were able to see the grid, Standard and Poor's lays out a grid with a one to 10 in the left-hand column, and then the benchmarks that are necessary, like the debt leverage, and the debt leverage requirements get to be greater -- I mean, the amount of common equity necessary to achieve a certain bond rating gets greater as the risk increases.

Let me say that again. As the risk increases, as the business position risk goes from one to 10, the amount of equity you need in a capital structure to attain a BBB rating increases. Your business risk increases -- business risk is really a more fundamental measure of your risk than your financial risk, because if you don't have any business risk, you can be capitalized with all debt and have a high bond rating. But the more business risk you have, for example, if you're a marketer, a gas marketer, which is at the top level of business risk, you may need a 70 percent equity ratio to get a BBB rating.

Q. Okay.

A. Okay.

Q. I'm following that. Thank you.

A. So, all right.

MR. FFITCH: Excuse me, Your Honor. Maybe the moment has passed now, but the discussion's about Exhibit 345.

CHAIRWOMAN SHOWALTER: Well, I followed the matrix, if you will.

THE WITNESS: Okay.

Q. Well, I was going to ask you about this same page five and these same companies you cited. First of all, the company has put forth, as peer groups, conceptually, electric or combined electric and gas utilities in fully-regulated states that -- that is, the utilities that are planning or likely to have expansion of infrastructure, or at least that, I think, is how the company would define its peer group.

And I want to ask you, do you think that is conceptually an appropriate peer group?

A. I don't disagree that that should be part of the consideration, or it might be part of the consideration. I'm not sure that the company's -- the company accomplished what it set out to do in that regard, but I think that even though there's been a great deal of discussion about the risk differences between wires companies and fully integrated companies, the cost of capital differences are not that substantial.

For example, I just finished testimony for Bangor Hydro Electric Company in Maine, that's a wires company. There really are very few wires companies out there to assess that are doing well enough to perform a DCF, so one has to use a sample of integrated, fully-integrated electric companies in order to get a sense of what the cost of equity is for electrics, and it's between nine and 10 percent.

Really, the only way you can quantify, then, what the wires company risk is going to be is to put that cost of capital at the lower range of what would be reasonable for a fully-integrated electric.

So while I don't disagree that that could be a consideration for forming a sample group, and I point out that I've also selected combination electric and gas companies in my sample group, I didn't pay attention to whether or not they came from a jurisdiction that was restructured or not, because I don't believe that imparts that much difference in the cost of capital.

And I will also finally note that the return rates that Dr. Cicchetti cites from the jurisdictions that are -- haven't deregulated really are simply jurisdictions that award high returns on equity. For example, he doesn't cite West Virginia. West Virginia hasn't deregulated, and they just awarded a seven percent return to a water company on equity.

Q. You're getting kind of far from my question.
A. Okay, all right.
Q. My question was is it appropriate to select, not why not to select, but is it appropriate to select utilities that are integrated and/or combined with gas in regulated states? Is that a reasonable peer group? I didn't ask you really what might -- what other groups might --
A. Yeah.
Q. -- be reasonable. I just want to know if you think that's a reasonable peer group?
A. And I do think that's a reasonable peer group, and that's the kind of peer group that I put together, as well.
Q. All right. If you had a group of 10 companies, all of which did fit the mold of integrated electric and/or combined gas and integrated electric from regulated states, why wouldn't that group be preferable to a group that included other kinds of states or utilities?
And this begs the question of whether all of the right utilities were included, such as from West Virginia, but wouldn't you want to have that as the core peer group and just make sure it's complete?
A. Well, in theory -- right. In theory, I

think you want to try to get a group of companies that closely -- as closely as possible matches the company for whom you're trying to calculate the cost of equity. The problem is, in practical application, that's very difficult to do, because -- not only because there are states that have deregulated, some have, some haven't, but there are also companies that own operations, some in states that have deregulated, some in states that haven't.

For example, AEP, they own property in Texas, which are now T and D companies, although they still haven't really separated, while at the same time they own properties in Kentucky and West Virginia, which have not deregulated and have no intention of doing so. So it's very difficult.

There are a few stand-alone wires companies. Other than that, I don't think you can really say honestly that you can choose only companies from states that are deregulated without getting other noise from other issues. Unregulated operations is one, having operations in other states that are regulated or are not -- deregulated, I mean.

So theoretically, I agree with you. Practically, it's very difficult to do that.

Q. Could you look at Exhibit 182? It's one of

Mr. Gaines' exhibits.
A. DEG-12. Is that a part of his direct testimony?
JUDGE MOSS: No, it's part of his rebuttal.
THE WITNESS: All right.
MR. FFITCH: I may be able to assist the witness if I know which -- what was originally labeled for Mr. Gaines.
THE WITNESS: DEG-13 was the original.
MS. DODGE: Twelve.
JUDGE MOSS: No, DEG-12 was Exhibit 182.
THE WITNESS: Oh, I'm sorry. Thank you, sir. I have it.
Q. My question is do you think this is a reasonable set of states to look at, and I think what I mean is every -- do you think that the states and companies that are on here are reasonable ones for us to look at in terms of what commissions did, and that's separate from another question, which is who is not on here. But as far as looking at these companies and what commissions did, is it -- do we gain some guidance by looking at this list?
A. Some guidance, yes. There are problems with this list, one of which is Wisconsin. I have a real problem with the awards that the Wisconsin Commission

provides their companies, and you see Wisconsin is entered more times than anything else on this list -- one, two, three, four, five, six -- six times. And for example, they're entered for the electric operations and the gas operations of the same company. So there's another 12 percent ROE that's stuck in the list that really should be one, not two, that drives the cost up.

If you eliminate Wisconsin from this average, the average ROE is 10.58, not 10.9. And also, Madam Chairman, you mentioned Public Utilities Fortnightly the other day, and glad to see that somebody else besides me reads that magazine. You'll know that they just published a ROE awards over the October 2003 through November 2004, and the majority of those returns, the vast majority were between 10 and 10 and a quarter. That's more recent than this list.

Q. And I'm trying to determine what's the right list versus either a list that's inapt or too narrow or too broad. You said you had trouble with Wisconsin. Is that because you disagree with what they did or just this double counting aspect that you mentioned?

A. Both. If you look at a histogram of the equity return awards, either in this Public Utilities Fortnightly article that I mentioned, which is November of this year, or Mr. Gaines' display here, and I've analyzed this before, Wisconsin is beyond the top end of the bell curve. Their numbers are outside of the mainstream of regulatory bodies in the United States. That's the primary reason that I would not include that in my consideration.

Secondarily, these orders in Mr. Gaines' list is between January 2003 and June 2004. It's a little bit different time period than the Public Utilities Fortnightly, but you have to realize, and you understand that the evidence in a hearing comes six months to nine months prior to the decision. These are all decision dates and they're based on a cost of capital that was probably higher than it is now.

So that's another factor. Cost of capital is coming down, so these older studies are based on information that could be as much as two years old here. So that's another consideration. I think the cost of capital is clearly below 10 percent for electrics, and these numbers here show that the average allowed return is from 10 to 10 and a half. I think that's too high.

Q. You said the cost of capital is coming down. It's a present tense. Do you think it is still coming down?

A. It has been, even though the short term --

Q. My question is do you think it still is?

A. Well, the most recent information that I have at my disposal is a cost of equity analysis I did for Bangor Hydro two weeks ago, it's a small wires company in Maine, looking at electric utilities, and again, these are fully-integrated electrics, and the numbers have slipped from nine to 10, and to 8.75 to 9.75, so it's below what I analyzed in this case.

And that seems to be unusual, because the fed is cranking up short-term interest rates. However, if you look at long-term treasury rates, they're not moving. In fact, they're coming down. So that tells me that investors long-term really don't have a lot of faith in this economic expansion to push up interest rates.

Q. On page five of your testimony, you have this list in the footnotes of various utilities where there was an ROE of less than 10 percent?

A. Yes, ma'am.

Q. Is there any combined gas and electric integrated utility listed there that's from a state with full regulation? I thought possibly Wyoming, Lower Valley Energy. I don't know what that does or is.

A. I don't know the answer to that question. I can find out.

Q. Well, that's all right. We're here. But maybe -- New York is a deregulated state; correct?

A. That's correct.

Q. New Jersey is a deregulated state; correct?

A. I believe that's correct.

Q. Arkansas is not, but that's a gas company; correct?

A. Yes, ma'am.

Q. Tennessee is not, and that's a water company?

A. Right.

Q. Wyoming, I believe, is not, and that's an energy company. I just don't know what that is.

A. It's probably a gas company.

Q. Colorado is not, but that's a telephone company?

A. Right.

Q. Connecticut is deregulated, I believe. Not certain. I think it is, so that would be an open question there. Do you know if that's an electric company or a wires company or a gas --

A. Connecticut Light and Power, I believe, is a wires company.

Q. Wires only?

A. I believe, but I have to double check that.

Q. Okay. New Hampshire is a deregulated state, but that's a telecom company, anyway?

A. Right.

Q. All right.

A. Well, just, there's -- never mind.

Q. All right. My broader question to you is the issue of a utility such as Puget, which has already committed -- or committed is maybe too strong a word -- is already definitely planning to expand, and this is pursuant to an integrated resource plan, and they are proceeding along.

And I am trying to think of how that should, if it should, change our thinking when we know a company is about to acquire more resources as distinct from an abstract rate case where you look back and -- look back at the test period, set the rate year as if things are going to go on indefinitely for a while.

A. Mm-hmm.

Q. I have to say, don't you think that knowing what is about to happen with the company should affect or at least affect our calculation, if not our judgment, about what it will mean to have one credit rating versus another or one picture to Wall Street versus another when they're going out in the relative near term for these new -- this new infrastructure?

A. Well, I think it -- when you say Wall Street, I assume you mean the investment community. It's always good to know more than less if you're an investor. The more certainty you have, the better off you are.

The Commission has provided some certainty to the company through this PCORC mechanism that it will be able to rate base plant additions sooner than a rate case. I don't know many regulatory jurisdictions that have that sort of risk reducing mechanism in place. I do know of one in Connecticut, Yankee Gas Company, I believe, had a similar mechanism where they had a pipeline they had to lay, and the Commission said, as you -- as is confirmed and the construction expenditures are confirmed, we'll put that in the rate base.

Q. But doesn't -- I believe Iowa has a form of, quote, unquote, prior approval and any state that has something --

A. Well --

Q. -- kind of like prior approval. I want to use that term loosely.

A. Like IRP, integrated resource plan? I mean, the big question is whether or not the Commission co-opts itself by entering into an IRP and later on can say something's imprudent because they've gotten into the plan. There are states that do have IRPs. Some commissions are actively involved in it and some are not. But I think, my understanding, and I don't have a full understanding of the PCORC situation, but I understand that to be different than an IRP.

Q. Well, in our -- with our terminology, the P is just a plan, and our companies do a plan, but then, after the plan, there is, if necessary, specific --

A. Mechanism.

Q. -- RFPs and other mechanisms for actually acquiring the resource, and it's in that connection that the PCORC arises and in that connection, I think in other states, there are various mechanisms for giving some assurance, short of a rate case many years later --

A. Right.

Q. -- that the company's on the right track.

A. Well, CWIP, for example, didn't really come into existence until the 1980s, and the building of those huge power plants. The companies were looking at huge outlays without getting any return on that, and so construction work in progress became a pretty standard regulatory tool.

Getting back to your question about what kind of risk does the investment community assess to Puget because they have stated that they're going to add plant, I think that it -- if the Commission is -- well, I don't want to say agreeable, but if the Commission is obviously supportive of the utility, which this Commission has been with the PCORC mechanism of plant additions, they recognize that, because of the market price volatility of power supply in the past, that it might be a good idea for this company to get its own generation.

You're sort of pushing the company along with your public statements about why this might be a good idea. Wall Street would see that as a good situation and not a risky situation. Here, the regulators recognize the need for a native generation, and therefore, it's likely that they will be supportive of the company. I think that's a positive thing, because, after all, the way utilities grow their earnings and the way they make money is to build plant.

It's the old-fashioned way we used to do things when regulation was going along before people thought of taking it all apart. If you want to grow your earnings, you build plant and you make more money on the billable plant. That's the way you do it.

Q. The problem I see is a chicken-egg thing, which is if the company does go out and secure or propose to secure, say, some wind generation --

A. For example.

Q. -- and then sets it up a la Fredrickson that they want to come in and get our approval, then isn't part of the problem is, when they've gone out to do that or to get it lined up, they have the, quote, old equity ratio and not the kind of new one that might follow, and so how do you get -- how do you or should you be able to get the benefit of the -- there's some Latin phrase, like ex post ante or something, on this, but, basically, if we knew now that we would approve such a thing --

A. Yes.

Q. -- wouldn't we want the benefit of the credit rating that would result if Wall Street knew in advance that that's where the equity ratio would be? Am I right or wrong on this? I really pose this as a real question, but it sounds --

A. Well, I think that if you could, simply by a stroke with a pen and allowing this company to earn a return on 45 percent equity, if you could effect a bond rating upgrade from that simple action, that might be a consideration. I frankly don't think that's a reasonable likelihood of that occurring.

I think that if the company wants to raise its equity ratio, it's looking at raising -- someone said $800 million of capital -- that number's gone from five to 800 -- over the next few years, they raise more of it -- the way to raise the equity ratio is they raise more of that capital from the equity market than they do from the debt market.

And then they'll wind up with a 45 percent equity ratio, or whatever they wind up with. Then they come back in here two years from now and say, well, our common equity ratio is 45 percent. We go, well, okay, let's see what your actual cost of capital is.

And what you're suggesting is that the company's position here is that you need to give us a

45 percent equity ratio so this credit will be loosened up and it will be easier for us to get capital.

But if you look at the way companies are capitalized, you'll see in the list that we had Mr. Gaines read that's in my testimony, those are all holding companies, but that's where they raise the capital. The holding companies issue the equity, and they're capitalized with less than 40 percent equity right now. So -- and they're building plant, they're increasing rate base, and so I don't believe the company needs the 45 percent equity ratio.

I think consumers in this state have done their job, they did their job last time helping the company out by paying rates on 40 percent when they had 30. Now I think it's up to the company to get their own capital structure up to 45.

Q. But that's quite a different rationale just now that you offered. You were saying that the ratepayers were out ahead of the company --

A. Earlier.

Q. -- earlier, and so now, as a compensating factor, the company should be out ahead, so to speak, of the ratepayers, and is that -- I understand the point, but I'm wondering if, in the end, it actually helps ratepayers? For me --

A. I think it does definitely help ratepayers.

Q. In the short run.

A. And if I gave you the impression that it was a tit-for-tat thing, I'm sorry, that wasn't my intent. It's a normal course of events, when utilities are adding plant, for some of that -- some of those monies will be internally generated monies they don't pay out as dividends, that they retain, some of those monies will come from there. Some will come from short-term debt, small amount. Some will come from preferred stock or debt and some will come from equity.

When companies are expanding, they have to raise capital in the marketplace, and that's why you need to have an investment grade bond rating for a utility. That's important, and I've said that to you in previous Puget rate cases. I think that's important.

But it's a normal course of events for the company to take their own destiny in their hands and determine how they're going to capitalize those operations. If they want a higher equity ratio, then they have to raise more equity from the capital market, and they're certainly in a position to do that. Their business position has improved from five to four, they have had a BBB bond rating with much worse common equity ratios and much lower coverages than we're recommending in this proceeding. So I think -- that's why I hesitate to ask ratepayers once again to step up to the plate, or continue to step up to the plate for the company.

And I think it would be more expensive for ratepayers, let me finally say, because I think that the cost of the common equity ratio difference between 40 and 45 outweighs the benefits.

Q. And by more expensive, surely, in the very short run, it would be more expensive, because it all translates to a higher rate. I think another question, though, is over the long run --

A. Right.

Q. -- is it? And is it also your opinion that, over the long run, assuming that there are going to be some major financings of major infrastructure, is it your opinion that the ratepayers will be better off with the lower equity ratio and the lower ROE that you suggest?

A. Yes, is the short answer to that question. The --

Q. So you're not concerned that if we adopt your proposal, that Wall Street would see this as a some kind of negative sign and, say, lower the credit rating or tighten up lending?

A. No, I'm not concerned that Wall Street, the bond rating agencies will lower the credit rating. I believe that the recommendation I've made here on behalf of the Attorney General will maintain the company's credit rating where it is.

Q. Okay. I think I wanted to ask you a couple of questions. Dr. Cicchetti was able to rebut your testimony in his rebuttal, but you haven't had an opportunity to respond to it formally. And I take it you probably read his rebuttal of your testimony pretty carefully?

A. Yes, I did.

Q. If we could turn to Exhibit 206.

JUDGE MOSS: That's his rebuttal testimony?

CHAIRWOMAN SHOWALTER: Right.

THE WITNESS: I'm there.

Q. Well, on page five, lines two to four, or maybe two to eight, he seems to be saying you're only looking at a one-notch difference, not a two, and you should be looking at two. And I wonder what your answer was to that, your response to lines two to eight?

A. Let me read this.

Q. Okay.

A. Oh, my analysis looked at -- first of all, the analysis I did in my testimony looked at the cost of setting rates with a 45 percent equity ratio and, just off the top of my head, it was something like $15 million a year to ratepayers, and the savings were less than a million, about half a million a year, given the $500 million of debt that the one might issue. And I looked at the debt cost differential as the differential between BBB and BBB+.

Now, all the company witnesses, and we heard Dr. Cicchetti here say yesterday that a move from BBB to BBB+ is about all we could expect out of this rate case. He thinks that might be a plateau, that we might move on to something higher later on. But all their testimony is about a one-notch move in the bond rating, because Puget's first mortgage bonds are rated BBB.

The corporate rating, which takes into account the fact that they have unregulated operations, is BBB-, but the first mortgage bonds, the secured debt, senior secured debt of Puget is BBB. That's an important distinction, because this has been bandied about quite a bit.

So if the BBB goes up to BBB+, the first mortgage bonds above the BBB+, that's one ratings notch. And that's what I was measuring. That's what they're talking about. But when they rebut my testimony and criticize that analysis, they always talk about two ratings notches.

And if you talk about two ratings notches and you start out talking about a BBB-, then you're into the BB range, and there's a huge cost difference between BBB and BB, and that enables the company to put some numbers in the record that I don't think are accurate.

Q. So is the short answer you are focused on senior secured debt, as distinct from corporate bond rating, is that what you were saying, or corporate credit rating?

A. Yes, ma'am. I was looking at the cost of -- if a company's going to issue long-term debt to build plant, they should issue it as cost effectively as possible and it should be secured debt. It shouldn't be debentures which are not secured.

So I was looking at the cost of how much you could save with issuing $500 million of debt if your bond rating went from BBB to BBB+, and it's about half a million dollars a year. But in order to get there, it's going to cost you 15. It doesn't seem like a good trade-off to me.

Q. What about other aspects of a credit -- of a better credit rating, such as dealing with trading partners and things like that? That is, isn't it more focused on the corporate credit rating?

A. That's -- that is more focused on the corporate credit rating, and there are advantages to that. However, I think it was pointed out earlier today that Mrs. Ryan, when she talks about that issue in her testimony, trying to quantify the cost and benefits, she finds the present value of 10 years of those savings and compares that to the one-year cost of those savings. That's really not a fair comparison.

If you want to look at 10 years, then run everything out 10 years and discount it to the present value or just look at one year. Either/or.

Q. All right. But if we were to do that exercise properly, you would say focusing on the corporate credit rating is the place to look at?

A. I think, for that kind of credit that you just discussed, the trade credit and trading partners, yes, I think corporate credit rating is where you should look.

Q. All right. Could you turn to page seven of Dr. Cicchetti's rebuttal?

A. I have it.

Q. He pointed out in his testimony that Pinnacle West is listed here with an A- rating and he thought it should not be included. And after he removed it, he made a calculation, but I wanted to ask you whether you -- whether it should be included and why?

A. I included it because it has a split rating. If you look at my testimony, and it's -- I don't have the exhibit numbers, but I'll give you my exhibit number. It's SGH Exhibit 8.

JUDGE MOSS: That's 358.

THE WITNESS: Thank you, sir. You'll see that the criteria are that the company have a BBB bond rating, and all those I selected have BBB -- at least one BBB bond rating. Pinnacle West has a BBB bond rating from Moody's and a low single A bond rating from Standard and Poor's. Dr. Cicchetti elects to report only one of those bond ratings.

And I wanted to obtain a large enough sample, so I also included the companies that had a split rating, BBB and single A. There's a couple of other of those, by the way. There's -- Cleco is one and -- Cleco Corporation is one, and I think there's one more. Progress Energy.

Q. All right. If we go to Exhibit 358, we'll see the split?

A. Yes, ma'am.

Q. Okay. Thank you. Perhaps you could turn to page 445 of Dr. Cicchetti's rebuttal.

A. I have it.

Q. And on lines five to seven, he says that you ignore the more fundamental issue of whether DCF theory fits PSE's facts. And I would like your response as to whether DCF theory does fit PSE's facts, or whether that matters?

A. It does. It does matter. I think if a company is so unusual that it doesn't pay dividends or the growth rate is highly unusual, I think that the DCF might not be an accurate measure of the cost of equity, but you have to remember here that I'm not just using Puget market data to estimate the cost of equity; I'm using the data of 10 other companies.

And so by using a sample, similar sample group, if there were any abnormalities which might cause a DCF for Puget to be odd, for some reason, then those kind of get washed out in the larger sample group.

Q. Okay. And I apologize. This was specifically about Dr. Wilson, but you were brought into the argument.

A. Well, he has the same false assumptions as I do, apparently, according to Dr. Cicchetti.

CHAIRWOMAN SHOWALTER: All right. That's all the questions I have. Thank you.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. Just pursuing from that same page, page 45 of Dr. Cicchetti's testimony, rebuttal, line 13, 14, Although PSE has positive cash and earnings, it has negative dividend growth. Do you have any comment on that?

A. It doesn't have negative dividend growth. It had negative dividend growth because it reduced its dividend a couple years ago. And in the future, it's expected to continue to grow.

Q. The Chair asked you to comment on Dr. Cicchetti's criticisms of your testimony. Mr. Gaines also directly attacked your testimony and, along with Dr. Wilson, and asserts that the -- overall, I think, paraphrasing it, that the company will be worse off with your capital structure and cost of equity. Do you have any comment on that critique?

A. Well, I'll try to be brief, although I could go on and on, I'm sure. I do not believe that's true. I believe that the capital structure the company now has, which is about 40 percent equity, is a cost-effective capital structure in that it will produce an overall return over the long-term that would be lower than one that's produced by a higher equity ratio. Although you may shave a little bit off of the debt costs, I don't disagree with that, you're going to pay a whole lot more up front for the higher equity.

So from a ratepayer's point of view, it's more cost-effective to be where they are now. They've gotten to -- they've gotten from a very serious equity deficit in the capital structure three or four years ago, down around 30 percent, now to 40 percent. They're in a position to improve their capital structure, and if they do, we could consider a higher equity ratio in the future.

But I think that 40 percent equity ratio is reasonable. Certainly a range between 40 and 45 is reasonable, but I think 40 is more cost effective in the long run.

There is also an issue about short-term debt, which I'm concerned about, and I don't want to take advantage of the Commissioner's question, and I'll just leave it at that. I think there's some questions that have not been answered about the company's short-term debt.

Q. I'll ask the question. What is your concern about the short-term debt?

A. Well, the company has created Rainier Receivables to -- in order to get cheaper short-term debt. The problem is, as I think our cross-examination showed this morning, that the short-term debt is more expensive than long-term debt, because they're piling all of the costs of those facilities on a small amount of debt that appears on Puget's balance sheet when most of the debt is on Rainier Receivables' balance sheet.

So if I'm an analyst at the Commission and I'm directed by the chairman to look at Puget and tell me how much short-term debt they've used over the past year, if I go to Puget's balance sheet, I'm not going to be able to answer that question. All I'm going to see is the short-term debt that appears on Puget's balance sheet, because the other debt that's at Rainier Receivables goes away in

consolidation. It appears on the balance sheet of the parent company, but not on Puget's balance sheet.
So from the point of view of a regulator, essentially they've created an entity that has off-balance sheet debt that you're not readily able to track. I have a problem with that.
I also have a problem with the issue of how short-term debt is calculated. If Rainier Receivables is not going to be included, then maybe they ought to pay the cost of that facility and not Puget. Why should the regulated ratepayers pay the cost of it if they're not getting any advantage from the debt. So -- and the debt exists -- the cheapness, quote, unquote, of the debt exists only because of Receivables, an asset that lives at the Puget Sound Energy level.
So Puget enables this facility to happen, but they don't get the advantage of having that short-term debt in their balance sheet. I have concerns about that, and that's one reason, in my capital structure, I make some estimates about levels of short-term debt and cost rates, because I'm not really able to discern what's going on.
Q. Well, let me ask the ultimate question. Do you agree or disagree with Mr. Gaines when he says

that arrangement allows Puget to have a lower cost for short-term debt?

A. Well, I have to disagree with that, because, first of all, he's very careful to draw a distinction between the cost of debt and the -- I forget the terminology he used, but the price, the pricing, when all of the factors are rolled into it, you know, he says, Okay, we've got short-term debt that's 1.2 percent, but the cost rate they supplied to Puget is eight percent. Well, if we're having to pay eight percent, then that's what the cost rate is.

So I guess my concern is that I haven't seen that this situation is advantageous for the company. In the projections for the rate year, the company projects so much is short-term debt and so much of it coming from the securitization facility and so much coming from somewhere else. I really don't know if they're considering all of the debt that exists at Puget, some of it, some of it at Rainier Receivables. I just don't know.

So I think that's a problem. That's why I brought it up to the Commission. And yes, our recommendations regarding short-term debt and the cost rate in this case are not that far apart. I mean, we all come to the -- hit the same mark. I merely bring it up to you because I find it troubling that there's stuff going on that's not readily discernible. That's the concern I have.

COMMISSIONER HEMSTAD: Thank you. That's all I have.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Well, that -- you just hit on the follow-up question I want to ask, because I was struggling to, as Commissioner Hemstad put it, struggling to understand all of this earlier with Mr. Gaines, and then he brought me back to Exhibit 179, page three, where the ultimate recommendation is so similar. And are you troubled as a matter of principle, but it doesn't have a real effect in this particular case? Why are we spending so much time on this issue? Of what import is it to the results that we ought to decide here?

A. Because it's important, in my view, and I am troubled on a principle basis and not because, since we're looking forward to the rate year, we can project what we think a reasonable level of short-term debt ought to be, and I don't think four percent is unreasonable, or whatever, 4.36, or whatever my number was.

It's similar, when I look back at Puget in the past, over the past five quarters, they show only about half a percent of short-term debt, but if I roll Rainier Receivables into Puget Sound Energy, then they come up to more short-term debt. And so out of that combination of that analysis, I think four point something is a reasonable amount. And the rate of four percent is less than the company, simply because I think they're overprojecting what the cost is going to be.

But on the long-term basis, we were talking about what was the long-term effect of this. The long-term effect of this is the company has a short-term debt facility that you're not going to be able to track simply by looking at the balance sheet of the regulated utility, and who knows where that short term debt's being used. I don't know where it's being used. And I think that's a concern.

CHAIRWOMAN SHOWALTER: Thank you.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Hill, I want to follow up on some questions that were asked by the Chair, and it really revolves around the discussion that you had regarding the comparable companies in the DCF analysis, and I know that there was a lot of discussion about trying to comp the companies very finely, so that there might be -- only gas and electrics might be considered or you had considered other companies, but I guess my question is, is that really more academic or -- in its import or do investors really parse their investment decisions -- do the majority of investors really parse their investment decisions that finely? Do they only look at electric and gas combos or, of electric companies, those with generation, those without?

A. I don't think that investors parse their investment decisions that finely. There are -- there's a myriad of investment factors. That's one of them. I think that an all electric fully-integrated company and a combination electric-gas company are very similar in risk.

I also, as I've tried to explain to Chairman Showalter earlier, there -- although we talk a lot about the risk differences between wires-only companies and fully-integrated companies, the actual numbers are not that great. The ROE differentials are really not that great.

They're basically, in the utility business, they have franchise service territories. A generation risk is more serious than distribution risk, because you have the very kind of risk we were talking about earlier of you have to construct generation, and unless you add generation in small increments, it's, quote, unquote, lumpy.

You have a big chunk of generation. If anybody's going to build a nuclear plant again, and I think someday, within the next decade, that will happen, but that's a huge investment. And we saw the problem in the 1970s and '80s where an investment like that would almost drown a company. I don't think we're going to see that kind of thing anymore, and there are other mechanisms in place for integrated companies to have pre-approval by regulatory bodies or special rate mechanisms by regulatory bodies.

I think certainly investors have learned and so have company management learned that they need to be protected when they go out and invest in some of these huge projects to build base load generation.

So two answers to your question. One is it's -- I don't deny that different kinds of utilities is a factor in the decision. It's one of many, many factors. And the actual cost of equity differential between those kinds of companies is not as great as we might think it is.

COMMISSIONER OSHIE: All right. Thank you. No further questions.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. I have one follow-up on that. Are you assuming that Puget has a certified franchise territory?

A. Am I assuming that Puget does? No, I'm speaking in generalities about utility operation, traditional utility operation.

Q. That, in general, utilities do?

A. Yes, in general, they do.

Q. Does it matter to you if Puget doesn't?

A. Does it matter that they don't?

Q. Yeah.

A. No, I don't believe it makes a big difference.

Q. Then is having a franchise territory significant?

A. The point I was making was that it's a utility operation that doesn't get much company-on-company competition. In some areas of the country, it's very strict. You can't go within a certain boundary. In West Virginia, it's less strict, because there are interstate pipelines that criss-cross the company -- the country -- the state, and people are able to tap onto those lines and get gas without buying from the local distributor. It's always been a big problem there. So each jurisdiction is different in that regard.

Q. Well, that seems to me that your answer just to Commissioner Oshie points out how different the different states are, that that is one of the problems here, that there are states that have restructured and states that haven't, but whether a state has or hasn't restructured, they may have different degrees of certainty that they provide --

A. Right.

Q. -- either in terms of -- and I'm really not speaking of distribution at all; I'm really speaking on the generation side. So it's difficult to --

A. Assess?

Q. Yeah.

A. Yeah. Well, for example, I'm testifying for the Georgia Public Service Commission and Atlanta Gas Light right now. That is a distribution company, obviously, but they have a great deal of protection. The Commission has set up lots of protections with their suppliers and backstops about risk, and the company really has very, very little risk that impinges on them having to do with supply. So they really are just a pipes in the ground kind of company.

And that's different than the arrangement, for example, in Connecticut with Yankee Gas.

CHAIRWOMAN SHOWALTER: Okay. Thank you.

JUDGE MOSS: All right. We didn't get into your area, Mr. Van Cleve, but I'll ask if you have any follow-up, Ms. Dodge?

MS. DODGE: Just a housekeeping matter. I'd like to move to admit Exhibits 369 and 370.

JUDGE MOSS: All right. Those will be admitted as marked. And is there any redirect, Mr. ffitch?

MR. FFITCH: No redirect.

JUDGE MOSS: All right. Well, Mr. Hill, we appreciate you being here and giving your testimony, and you may step down.

THE WITNESS: Thank you, sir.

JUDGE MOSS: Why don't we take our afternoon break while we get Dr. Wilson arranged on the witness stand, and then we'll pick up with him immediately after, at 3:15.

(Recess taken.)

JUDGE MOSS: We'll be on the record. Dr. Wilson, would you rise and raise your right hand?

Whereupon,

DR. JOHN W. WILSON,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE MOSS: Thank you. Please be seated. Mr. Cedarbaum.

MR. CEDARBAUM: Thank you, Your Honor.

D I R E C T E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. If you could please state your full name?

A. John W. Wilson.

Q. And Dr. Wilson, have you been retained by the Commission Staff to testify on cost of capital in this matter?

A. Yes, I have.

Q. Directing your attention to what's been marked for identification as Exhibit 481, is that your direct testimony in this case?

A. Yes, it is.

Q. And then Exhibits 482 through 490, are those the exhibits to your direct testimony that you reference in your direct testimony?

A. Yes, they are.

Q. And were all of these exhibits prepared by you or under your supervision and direction?

A. Yes.

Q. Are they true and correct, to the best of your knowledge and belief?

A. Yes.

MR. CEDARBAUM: Your Honor, at this time I would offer Exhibit 481 through 490.

JUDGE MOSS: And there being no objection to those, they'll be admitted as marked.

MR. CEDARBAUM: Dr. Wilson is available for cross.

JUDGE MOSS: All right. Mr. Van Cleve, you had indicated about five minutes. Do you need that?

MR. VAN CLEVE: No, Your Honor. I don't have any questions.

JUDGE MOSS: All right. Fine. Then we'll turn to Ms. Dodge.

MS. DODGE: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:

Q. Dr. Wilson, if you would turn to your testimony, Exhibit 481, at page 28?

A. Yes.

Q. And at the top of the page, just paraphrasing, you state that you and Dr. Cicchetti have a fundamental difference of opinion regarding how much this Commission should look to the rates of return that other state commissions are allowing versus how much the Commission should look to what you refer to as statistically-based cost of capital analysis?

A. Yes.

Q. And does your phrase "statistically based cost of capital analysis" mean analyses such as the DCF and CAPM analysis you performed, as well as your discussion of market-to-book ratios?

A. Those would be among the things, yes. I'm talking about doing financial analysis rather than simply doing the circular thing of adopting numbers that some other commissions adopted.

Q. Now, with respect to analyzing rates of return that investors expect to earn on equity in comparable electric and gas utilities, it's your opinion that the most relevant comparison is the return on book value divided by the market-to-book ratio?

A. I wouldn't say that that's the most -- that it's my opinion that that's the most relevant. That certainly is a measure that I would use. You can look at what expectations are published. I think everybody's referred to Value Line here. Value Line shows expectations for Puget of eight and a half, nine, nine and a half percent on equity going out into the future, but, yes, if you're looking at comparable companies, the relationship to -- the market-to-book value relationship is a relevant one.

Q. And then, turning to your testimony at page 22?

A. Yes.

Q. Okay. Here, lines 14 through 20 was I believe where you start looking at market-to-book, and at lines 19 through 20, you are referencing the latter and most relevant comparison is essentially the return on book value divided by market-to-book ratio.

CHAIRWOMAN SHOWALTER: Ms. Dodge, can you slow down and speak up?

MS. DODGE: Sure. Sorry.

CHAIRWOMAN SHOWALTER: Thank you.

Q. I don't want to retrace, but just to get our bearings, this is the section of your testimony on market-to-book ratio?

A. Yeah, it is, on comparable earnings, yes.

Q. Okay. And moving on to page 23 and 24, you advocate setting rates of return that drive prices of utility stocks toward their book value; is that correct?

A. I don't believe that commissions ought to set rates of return in order to establish utility stock prices at any particular level, so no. I think there will be a tendency for utility stocks to price near book if the allowed rate of return does reflect the cost of capital, but that's a tendency I don't recommend that commissions try to control or influence market prices or stock.

Q. At page 24 of your testimony, on lines 18 and 19?

A. Yes.

Q. Here you state your opinion that market-to-book ratios in excess of one reflect what you call excessive returns that are an unnecessary expense for ratepayers if it is reflected in allowed rates?

A. I think I said something like that, but what's the reference again, page 24?

Q. Page 24, lines 18 and 19.

CHAIRWOMAN SHOWALTER: Ms. Dodge, when you're referring to something, if you wouldn't mind waiting -- you know exactly what you're going to, but the witness probably hasn't seen it and we sure haven't.

MS. DODGE: Sure.

CHAIRWOMAN SHOWALTER: So it allows us to get on the same wavelength with you before the question proceeds. Thank you.

THE WITNESS: That statement is with respect to the illustration which I was giving above, which is that if the cost of equity is 10 percent, a 15 percent return allowance would be excessive and it would have these effects.

Q. Now, the company's market-to-book ratio is greater than one now, isn't it?

A. Yes, it is.

Q. And would you agree it's approximately 1.4?

A. I think I had the figure. Book value is around $17, so about 1.4, give or take.

Q. Were you looking at Value Line?

A. I was.

Q. And then, do you have to calculate that from

Value Line?

A. I did do that, yes.

Q. Does Value Line have that ratio?

A. It may have. I took the recent price, which is, according to this issue, which was November 12th, which was 23.45, and related it to the 2004 book value estimate of $17. I don't see the market-to-book published here, but it might be in here. There's a lot of data here.

Q. In any event, it's approximately 1.4, the market-to-book for Puget Sound Energy?

A. Yes.

Q. Are you also aware or would you agree that the current market-to-book for the utilities sector is approximately 1.6?

A. I don't have that number, but it may be that high.

Q. And this, in your opinion, means, for this Commission, that the Commission should set a much lower rate of return for Puget than it currently has?

A. Well, I think, really, what those numbers mean is that rates of return have been at levels that were set in the past. Money costs have come way down, the cost of capital has been lower in the last couple of years than it has been historically over a long, long period of time.

So in recent times, and certainly in terms of the data that are reflected in Value Line, the earnings that investors have been receiving on utility investments, given historic rate of return determinations, do tend to exceed the cost of capital. And in most cases today, allowed rates of return are above the cost of capital. So some adjustment would be appropriate, yes.

Q. It would follow, also, then, that you believe other state commissions should set their returns much lower than they have in the past in order to drive the sector toward market-to-book ratios of one?

A. Again, I don't recommend trying to drive prices of stock anywhere, but if the allowances that have been made in past rate cases and, as in your case, there have been many companies that haven't had rate cases for several years, if allowed rates of return are above the cost of capital, it would be appropriate to reduce them, and I think that that is probably generally the case in most jurisdictions. Dramatically, by large amounts, I'd have to look at individual companies, but it wouldn't surprise me that there's some where adjustments of several percentage points would be appropriate.

Q. Now, if other state commissions, as they have rate cases in the current environment, if other state commissions are not setting rates of return lower for the reasons that you advocate they should, it's your opinion that this Commission should nevertheless apply your statistical theories and adopt your proposed return on equity of nine percent, isn't it?

A. This Commission should do what it thinks is appropriate regardless of what other state commissions are doing. What other state commissions are doing, especially on something like a rate of return allowance, shouldn't be the driving force in this Commission's determinations, and I would say that it's my observation that many commissions have been, as new cases come before them, reducing historically higher rates of return.

Q. Your return on equity recommendation for Puget Sound Energy does not take into account the company's plans for resource acquisitions or for infrastructure investments, does it?

A. That's completely wrong. I mean, I took the capital structure numbers off of Mr. Gaines' own exhibits. I have the resource acquisition plans, the spending plans of the company built into my analysis. I've compared the company's spending plans with the comparable companies that the company has identified, and frankly, this company's net plant additions are not particularly remarkable.

There's only three companies out of that group of 12 that you've designated as most comparable that have smaller amounts of plant growth projected for future years. And there's a -- most of those companies have more plant growth -- more plant investment projected than Puget does. Alliant, MDU, Sierra Pacific, Wisconsin Electric and Power, Wisconsin Power and Light all, according to the Value Line documents that are in the record, have substantially larger capital expansion plans than Puget.

MS. DODGE: Could I ask that we go into confidential session? I need to get into some confidential detail.

JUDGE MOSS: Is this going to be the only segment or -- I'd like to do it all at once.

MS. DODGE: Shall I save it for the end?

JUDGE MOSS: That would be fine.

MS. DODGE: And we'll return?

JUDGE MOSS: Okay.

Q. Dr. Wilson, turning to another topic entirely, what are you charging Staff for your representation in this case?

A. My time is billed at $250 an hour.

Q. How many hours do you have into this case?

A. I would -- I'll say probably 100 or more.

MS. DODGE: We do need to go to the confidential session now. Then I'll finish up.

JUDGE MOSS: Okay. Very good. As before, anyone who's present in the room who is not a signatory to the appropriate documents under the -- the disclosure documents under the protective order will need to leave the room for our confidential session. We'll mute the conference bridge line and, of course, the court reporter understands the need to put this portion of the transcript under seal.

(The following pages, 549 through 559, are contained in a separate, confidential transcript.)

(End of confidential session.)

CHAIRWOMAN SHOWALTER: I do have a follow up question for out-of-confidential session.

JUDGE MOSS: We are out of confidential session.

E X A M I N A T I O N (CONTINUING)

BY CHAIRWOMAN SHOWALTER:

Q. All right. One of your answers was just -- it sounded like you said, well, anything from 40 to 45 is reasonable, but don't go beyond 42. And I'm having a hard time trying to discern how hard a line the various witnesses here are drawing on all sides between 40, 42, 45.

A. Go with what's real. Forty to 45 is a reasonable range. The figure of 42 percent is within that range. Forty percent's in that range. Forty-five percent's in that range, but 45 percent is not the equity capital of this company, it's far more than the equity capital of this company, and if you allow an X percent return on a 45 percent capital structure, they're going to get much more than X, because their equity capital is much less than that, and you're, in effect, going to be allowing an equity return and taxes on a debt-financed component of their rate base.

Q. So is a summary of your view that once you've crossed the 40 percent threshold, go with actual?

A. Yes.

Q. Okay. Thank you.

A. And by the same token, I would say that you don't have a need to bring an excessively high equity ratio down to a deemed equity ratio. You don't have to start thinking about that till you get to 45 or above, but you could very easily get into situations with some utilities, and perhaps some of yours in the future, where utilities are going to be proposing rates of return on 55 and 60 percent equity ratios, and that certainly wouldn't be in the best interests of ratepayers or the state's economy or any of the things that you're here to protect.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. I'll ask the same question of you that I did of Mr. Hill. Mr. Gaines says that your analyses and Mr. Hill's analyses would make the company worse off than they currently are. What is your response to that?

A. The company, according to Staff calculations, is -- has actually been earning around a 10 percent return. The figures that have been thrown around in this hearing of seven percent are because they're getting hurt pretty severely by their non-utility operations, which, incidentally, I would say, is probably an explanation of why, at a corporate level, they have this BBB- credit rating as opposed to the BBB with positive expectations at the utility level.

The company will do much better than it has done historically, Puget Energy will, if it improves the operations of its non-utility subsidiaries and affiliates. A return allowance of nine percent is a return allowance at or above the cost of capital at the present time, and I do agree with Mr. Hill that current indications do go down below nine percent in many cases, so I don't think it's going to make the company worse off.

The company won't have as much profit as if you allow them 11.75 on a 45 percent equity ratio or 15 percent on a 50 percent equity ratio. I mean, in some sense, you do have a line to draw, and the line ought to be drawn by allowing a rate of return that reflects the cost of capital.

And you know, with consideration for fixes as you had to make in the last case, but you haven't got that situation anymore, and should be reflecting actual costs here when you're looking at capital, just as you try to reflect actual costs when you look at labor or when you look at materials or when you look at fuel. All that money is is another input into the utility business that's got a cost associated with it, and you ought to allow a return that reflects that cost.

Q. You stated that the company is making a 10 percent return. Is that the utility or the parent?

A. The utility. No, you have to take all of the non-utility operations out, but the utility is doing much, much better than the non-utility operations, and you get these seven and a half, 7.7 percent numbers because you build in -- what's the company's name -- Infrastrux, and because you build in the non-utility subsidiaries of PSE. Once you factor those things out, it's around a 10 percent return for the utility operations.

Q. Well, with a 10 percent return, should a utility have a higher investment rating than Puget currently has?

A. If the -- I have no doubt that if the non-utility subsidiaries were doing as well as the utility operations, that BBB- wouldn't be there. It would be BBB or BBB+. I think that striving for a BBB+ rating is a good thing to do. But keep in mind a BBB+ rating is going to get you 20 basis points, so if they issue $300 million worth of debt, that's going to save $600,000 a year, and that's good. But if you pay them two percentage points on equity in order to do that on a $4 billion rate base, you're going to be spending 50 times as much to get the benefit as the benefit you receive. On a pre-tax basis, you're going to be paying $40 million in order to get a $600,000 benefit. That doesn't make any sense.

So I think that, at a 10 percent operating level, which they're achieving at the present time, if they can improve the circumstances with respect to their non-utility operations, they should be at a BBB+ rating, which is a good, solid rating for a utility company.

Q. I'm trying to get a handle on this rating issue. Assume that the company simply sells off its non-utility operations. Further assume that this Commission were to grant the company rates that reflected what they are requesting. Does it follow from that that they ought to have a credit rating that would be higher than BBB+?

A. I would think so. I would think so. But still, the savings of that rating are never going to pay for the equity it missed before it.

Q. Right, I was only trying to get a handle on --

A. Yeah, I think it would.

Q. -- where the rating would go?

A. It would go up above BBB+, I believe.

COMMISSIONER HEMSTAD: Thank you. That's all I have.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Dr. Wilson, I'd like to start with the question that I asked Mr. Hill, and that has to do with, really, your use of comparable utilities in your DCF analysis and where you focused on primarily electric and gas companies, which are of course comparable to PSE, but, really, the question is do you think that investors actually parse their decision-making that finely in making those investment decisions that are of real import here in this proceeding?

A. Investors look at a broad cross-section of utility companies. They do take into account, you know, whether the utility has a lot of nuclear generation, whether the utility sells both gas and electricity, whether a utility is vertically integrated or it's not vertically integrated. I think all of these things are variables that go into the informed investor's analysis, but I think that there can be much too much emphasis in cases like this arguing about what the right group of comparable companies is.

And I tried to avoid that. I just used the comparable companies that the company selected. Now, had they not made that selection, had I come in here and said, what are the 20 or the 10 most comparable companies to Puget, I probably would have come up with a different group. I might have come up with a group like Mr. Hill's.

But to avoid that problem, to avoid that argument, and I think you can work with -- you could work with all of the major New York Stock Exchange-traded companies in the electric utility industry as an analytical base. That would be fine with me. Or you can pare it down in some rational way. What the company did seemed rational to me.

Was it better than any other way? No. But it was a group of companies that I could work with and I did and didn't create that argument, because I don't think that an argument about which is the right group of companies is central to making the right decision in a case like this.

Q. Are you familiar with the rate mechanisms that we have in place in this jurisdiction? We were -- I think I might have asked Dr. Cicchetti this yesterday, that the PGA, the PCA and the PCORC, to use their acronyms, and I guess my question would be the same. I consider those mechanisms to be mechanisms that push the risk off the utility and, to a certain degree, and onto the ratepayers, a sharing here, a balance.

And are those mechanisms in place, to your knowledge, in the jurisdictions that you've used for comparables, and if or if not, how did you take into consideration the risk mitigation factor or effect in your analysis of proper rate of return on equity?

A. I would say that, for Puget, you have a broader array of automatic adjustment mechanisms than exist generally throughout the industry. Now, there are other jurisdictions that have fuel adjustments and PGA clauses, as well, not all, and even split for some utilities and done for some utilities differently than other utilities in the same jurisdiction, but there are lots of jurisdictions that have those types of mechanisms. Your PCORC mechanism is, I think, somewhat more unique, and all three of those are the kinds of things that reduce risk compared to what it had been historically.

I think, in the last 10 years, there's actually been some states that have done away with purchase gas adjustment and automatic fuel adjustment clauses. They became almost essential in the 1980s, when you had prices going up so rapidly. And many, many jurisdictions, of course, have maintained them, and you've added some other things to expand, but it's a mechanism that, over time, has shifted risks from the equity owners to customers, yes.

COMMISSIONER OSHIE: I don't have any further questions. Thank you.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. I have two follow-up questions, one on just the last. There's the issue of allocating risk, and then there's another aspect, which is what's the overall risk in the environment generally. And do you agree that in the last, say, three years, in the West, the whole environment is riskier than, say, 13 years ago, maybe we'll say?

A. I think there are things, yeah. I think that there are things that you talk about overall risks in our environment. I do some work involving the making of property casualty insurance rates, and all you have to do is look at what the insurance companies are dealing with these days in terms of terrorist risks. Terrorist risks are relevant to utilities today. You know, that was a risk that didn't exist or we didn't perceive its existence 10 or 15 years ago.

Is that a stockholder risk? Probably, it's more of a ratepayer risk than a stockholder risk, but it's got some risk connotations for stockholders, as well. So yeah, I think that, generally, if you look at those kinds of issues, an argument can be made that, defining risk broadly, yeah, it's a bigger problem than it has been historically. In terms of financial risk, probably not. We're probably not looking at the kinds of interest rate risk concerns that we had in the early 1980s. That probably has less a perception of concern than it did 20 years ago.

Q. What about the so-called credit crunch? Is there greater risk in the industry in general in terms of trading, simply because there seem to be more partners trading -- potential trading partners with financial problems?

Is that an aspect of -- what I'll call environmental risk, by which I don't mean the natural environment, but the industry environment?

A. Well, that certainly was something that, you know, came to a head with Enron. I think that steps have been taken to mitigate that problem to a significant extent. You probably have some things involving credit risks that are a bigger issue today than they were years ago. I would say that probably goes to the issue of collecting unpaid bills and things like that, as well as trading, but no, I think that -- I think that, in terms of commerce, in terms of trading, in terms of making deals or purchases of equipment, there are a lot more financial devices available to accomplish those things today than there were historically. I would say deal-making has probably got more facets, more opportunities, ways of getting things done than existed historically.

Q. You discuss the trade-offs between a better credit rating and what it costs to get that credit

rating when it comes to purchasing a big plant --
    A.   Mm-hmm.
    Q.   -- or something similar. And I think you were saying what mattered was the utility's credit rating, not the corporate credit rating?
    A.   Well, I'm not going to say that the utility is not affected by the corporate, but the corporate is not something that -- if it's something that's being dragged down, as in this case, by unregulated activity, it's not something that should be charged to the utility ratepayer.
    Q.   Okay. So --
    A.   But what's important in terms of issuing bonds is the bond rating; that's right.
    Q.   So am I right, you're saying it's not that it's not important; it's that, in this case, the differential is due to non-regulated activities? Is that what you were saying?
    A.   Yes, the difference between the BBB and BBB- is attributable to non-regulated activity.
         CHAIRWOMAN SHOWALTER: Thank you.
         JUDGE MOSS: All right. Ms. Dodge, any follow-up?
         MS. DODGE: I do. If I could have a moment to confer?

JUDGE MOSS: Sure.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:

Q. I just have a couple questions. One, I wanted to just follow up. You had just answered that you believe certainly there's some counter-party and credit risk associated with the demise of Enron, and then you mentioned, but steps have been taken to mitigate that. What did you mean?

A. I mean things that FERC has done to try to clean up the merchant power business, I mean things that Eliot Spitzer has done, I think things that the Securities and Exchange Commission has done. There is a much stronger focus, both in terms of enforcement and on the part of utilities that are transacting in the business today to make sure that you don't have the counter-party problems that you -- that you had with the Enrons.

Q. So your position is that it's -- if the bad actors are cleaned up, that there aren't counter-party or credit risks that companies need to deal with?

A. No, there's always risks, but in terms of the heightened risk, particularly wholesale gas and electricity transactions, I think that everybody agrees that that was something that was not fully anticipated, and part of the reason was that enforcement wasn't doing its job to keep bad actors from dominating the game.

Q. I wanted to turn to another topic. You made the statement here on the stand today that Puget Sound Energy's -- you believe Puget Sound Energy's actual return on equity is something like -- or has been something like 10 percent, rather than seven percent?

A. Yes.

Q. Could you point to where in your testimony you make that allegation?

A. I did not discuss that in my testimony.

Q. Have you prepared any work papers or calculations that would -- that form the basis of your allegation?

A. No, Staff has, and I think, in particular, Mr. Russell has, and I've seen them. I have not prepared them. I think Jim Russell has.

Q. Similarly, you've made the allegation on the stand today that the company's -- Puget Sound Energy's credit rating has been dragged down by its non-regulated entities. Could you point me to where in your testimony you made that allegation?

A. I don't believe I stated that in my testimony.

Q. And similarly, do you have any work papers or anything to show the basis for that allegation?

A. I don't, although I did, of course, in my testimony, emphasize that the -- that the ratings for PSE, not for Puget Energy, but for PSE, were BBB, were not BBB-, and it is only at the parent level, because the parent includes more than the utility operations that you have the lower bond rating.

MS. DODGE: I have no further questions.

JUDGE MOSS: All right. Do we have any redirect?

MR. CEDARBAUM: Yes, Your Honor, just a few areas. And for the record, I should indicate that Dr. Wilson referred to Mr. Russell's work. We can prepare -- we do have prepared a document which shows that calculation. Mr. Russell won't be on the stand until later this week. We can distribute it today. He can be questioned about it, if you wish.

MS. DODGE: The point to my questioning is that there's no basis to this allegation. It wasn't presented in Staff's case. The company has had no opportunity to rebut it in their testimony or through their witnesses, and to bring it on at this point I think is prejudicial to the company.

JUDGE MOSS: Well, it seems to me that we have the testimony that we have, and if it would be helpful to you to have the document that Mr. Cedarbaum mentioned, then he can certainly distribute it to you and you can have the benefit of it, or you can --

MS. DODGE: We would like to look at it and determine whether we'd like to put on surrebuttal.

JUDGE MOSS: Then why don't you distribute that after we finish today.

R E D I R E C T E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Dr. Wilson, you were asked, to begin with, about your hourly fee, so I guess I have to follow up on that. Is it correct that there's a maximum amount in your contract with the Commission Staff?

A. Yes, it's a not-to-exceed contract.

Q. And what is the maximum amount?

A. It's in the forties. I don't remember what it is.

Q. Would you accept, subject to your check, if I can ask my witness that, that it's 50,000?

A. Thank you.

Q. Okay. You just got a raise, I guess. You were asked about the capital structure issue and the information you used to come up with your 42 percent equity ratio recommendation, and I believe you indicated -- or is it correct that the information you relied upon was what Mr. Gaines has included in Exhibit 178-C, which was his exhibit DEG -- I'm sorry, not 178. It would be 181-C, which was his Exhibit DEG-11C?

A. Yes, that was the source of my capital structure information.

Q. So this information was available to you during the discovery process in the preparation of your testimony?

A. Yes.

Q. So --

A. It was updated at some point, but yes, it was available to me.

Q. So when you refer in your testimony to Exhibit 8-C, what you relied upon was an updated 8-C, which is now 11-C; is that correct?

A. Yes.

Q. If you could -- do you have 11-C with you, and again, that's Exhibit 181-C?

A. I believe this is the same thing as 11-C.

Mine does say 8-C on it, but I'm sure that it's the same thing. Let me get out a yellow one. I think that will probably say 11-C. I have it as it is the same. I believe that Mr. Gaines had provided an earlier copy of it that was originally designated 8-C, but it's the same as 11-C.

Q. Okay. So you're confident, though, that Exhibit 181-C was the -- is the document you used in your testimony?

A. Yeah, the numbers are the same.

Q. Okay. I'd just like to direct your attention to page two of 181-C, the lines 27 through 29.

A. Yes.

Q. Can you just -- and without referring to specific numbers, because this is confidential, but just describe your understanding of what's going on on those three lines?

A. Yes, the line 27 shows PSE common equity. As I understand, line 28 is a -- it is an adjustment for the negative retained earnings of PSE's non-utility subsidiaries. And then line 29 is a number larger than PSE's common equity, because it has had the negative earnings of the subsidiaries subtracted out. And of course, when you subtract a negative number, it's like adding a number, so in effect, line 29 is an adjusted PSE common equity giving effect to the negative retained earnings of subsidiaries, which has the effect of raising the common equity ratio of PSE.

Q. So just to summarize line 29, which has been labeled by Mr. Gaines as regulated common equity, actually includes retained earnings for unregulated subsidiaries?

A. It includes the -- yes, it includes an increase, because of the negative retained earnings of subsidiaries, and by the same token, it doesn't deduct the capital investments that PSE has made in those subsidiaries. So it is not, in my opinion, a regulated utility number. It is a PSE number that has been adjusted upwards for their negative retained earnings of the subsidiaries, and it has not been adjusted for the capital investment that's been made in the subsidiaries. That's why I did not use line 29; I used line 27 in my analysis.

MR. CEDARBAUM: Thank you. Those are all my questions.

JUDGE MOSS: If there's nothing further, Dr. Wilson, we thank you for being here and giving your testimony, and you may step down.

THE WITNESS: Thank you.

JUDGE MOSS: We had some discussion earlier off the record, and I think we do have -- we have about 45 minutes left in the hearing day and we have a number of witnesses for whom the cross-examination is designated to be quite brief, and it seems to me that we should probably move to Ms. McLain, if she's available. Is she available, Ms. Dodge? Yes?

MS. DODGE: I believe she is.

JUDGE MOSS: And then we'll have Mr. Kilpatrick. Their subject matters, as I understand it, are the same.

Whereupon,

SUSAN McLAIN,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE MOSS: Thank you. Please be seated.

D I R E C T E X A M I N A T I O N

BY MS. DODGE:

Q. Ms. McLain, do you have before you your direct testimony and rebuttal testimony in this matter, as well as the exhibits to that testimony, which have been identified as Exhibits 131-C through 141?

A. I do.

Q. Were your testimony and exhibits prepared by you or under your direction?

A. Yes.

Q. Are the answers to the questions in those exhibits true and accurate, to the best of your knowledge?

A. Yes.

MS. DODGE: Your Honor, we offer exhibits 131-C through 141 into evidence, and offer Ms. McLain for cross-examination.

JUDGE MOSS: All right. Being no objection, those will be admitted. And Mr. Cedarbaum, you have indicated about five minutes.

MR. CEDARBAUM: Actually, Your Honor, my only purpose for cross-examination was to introduce Exhibit 142 for identification, but it's possible that I may -- and I may have overlooked this, but I'm wondering whether it was added to Exhibit 140 through some revisions that were made by the company last week. I just don't recall.

JUDGE MOSS: You want to take this off the record with the company?

MR. CEDARBAUM: I can just offer 142. I'm just saying it might be duplicative.

JUDGE MOSS: Let's be off the record.

(Discussion off the record.)

JUDGE MOSS: Let's be back on the record. Staff is offering 142. Is there any objection? Being none, it will be admitted.

C R O S S - E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. I'd just ask you to clarify, Ms. McLain, in Exhibit 140, which is PSE Data Request 58 to Staff, at the last -- the last sentence of the response, there's an attached spreadsheet that's referenced?

A. Yes.

Q. And Exhibit 142 is that spreadsheet; is that right?

A. That's my understanding, yes.

MR. CEDARBAUM: Thank you. Those are all my questions.

JUDGE MOSS: Excuse me. Any questions from the bench? There being none, Ms. McLain, we thank you for being here and giving your testimony, and you may step down.

THE WITNESS: Thank you.

JUDGE MOSS: Oh, I'm sorry, I didn't offer you the opportunity for redirect. All right. I believe, then, we'll have Mr. Kilpatrick.

Whereupon,

DOUGLAS KILPATRICK,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:.

JUDGE MOSS: Thank you. Please be seated.

D I R E C T   E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. If you could please state your full name and spell your last name?

A. My name is Douglas Kilpatrick. My last name is spelled K-i-l-p-a-t-r-i-c-k.

Q. And Mr. Kilpatrick, you are appearing as part of the Commission Staff presentation in this case?

A. That's correct.

Q. If I could refer you to what's been marked for identification as Exhibit 471, DEK-1T, is that exhibit your direct testimony in this proceeding?

A. Yes, it is.

Q. And was this exhibit prepared by you or under your supervision and direction?

A. It was, yes.

Q. Is it true and correct, to the best of your

knowledge and belief?
A. To the best of my knowledge and belief, yes.
Q. Referring to Exhibits 472, 473, and 474, are these exhibits that you prepared, as well, to accompany your direct testimony?
A. Yes, they are.
Q. And are these true and correct, to the best of your knowledge and belief?
A. Yes.
MR. CEDARBAUM: Your Honor, at this time I would offer Exhibits 471 through 474.
JUDGE MOSS: And there being no objection, those will be admitted as marked.
MR. CEDARBAUM: Mr. Kilpatrick is available for questioning.
JUDGE MOSS: All right. Ms. Dodge, you had indicated about 10 minutes for this witness.
MS. DODGE: Yes, Your Honor. Thank you.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:
Q. Mr. Kilpatrick, you agree with the company, don't you, that it would be appropriate to change the current trigger that invokes the deferred accounting mechanism for catastrophic storm damage?

A. Yes, my testimony is that the current mechanism is something that can lead the company to a situation where they have significant damage to their system, yet they did not qualify it as 25 percent of customers or more out of power, and so I believe the IEEE methodology would be more representative of a better way to accomplish those triggering events.

Q. Okay. And then, looking at page 10 of your testimony, Exhibit 471?

A. Yes.

Q. The specific IEEE definition you're talking about is for, quote, major event days, end quote; is that right?

A. Yes.

Q. But Staff's proposal effectively changes the IEEE definition, doesn't it, from major event days by limiting the deferral proposal to costs that are incurred for major storm events, rather than simply major events?

A. My testimony specifically addresses the calculations used to establish reliability indexes as published by IEEE, and it is consistent with IEEE's definition of a major event day. This triggering that you're talking about, I believe, is -- relates to Mr. Russell's testimony that has to do with a threshold for deferral of costs and recovery of those deferred costs at some future time.

Q. So you're saying that Mr. Russell is the one I should address as far as changing the definition to include the storm limiter?

A. Yes, in terms of that aspect of it.

MS. DODGE: Thank you.

JUDGE MOSS: Okay. Questions from the bench? I have one.

E X A M I N A T I O N

BY JUDGE MOSS:

Q. Mr. Kilpatrick, I wasn't -- it's been a while, honestly, since I've read your testimony, so help me out. The company, I believe, as I understand it, is proposing to broaden the current treatment, if you will, to include events other than storms. That is, I think they mentioned specifically earthquake, for example, or terrorism.

Does your testimony bear on that question, as to whether the Commission should expand the deferral treatment of costs such as that and beyond storm damage to the electric system?

A. Well, it doesn't specifically expand or address that area. The IEEE methodology is basically a mathematical application to interruption information data that is collected about interruptions over the course of a year, and it doesn't matter specifically what caused that interruption. It could be from upstream loss of generation or transmission, it could be loss at the distribution level due to a storm or earthquake, perhaps, or something like that.

So the IEEE methodology doesn't specifically look at the cause of the interruption, it merely is a useful mechanism for utility companies to segment out and look at underlying causes of interruptions, and it pulls out these major event days because, from a mathematical perspective, the amount of interruption minutes associated with a major event can sort of overwhelm the way you look at other events.

Normal or other kinds of events, like failure of equipment, cross arms, or automobile accidents that cause a power pole to go down or something like that are sort of one form of cause of an interruption, and those kinds of things are generally short duration. You have a large event caused by a major windstorm, for example, you have a long duration. And if you lump all of those together, it's sort of like calculating an average of the weight of a heard of elephants plus the weight of the tick birds that eat the ticks off the elephants. If you add them all together, you can see that the overwhelming factor is the large weight of the elephant, not the number of tick birds.

Q. So if I understood your answer, then, the standard that you use could be applied regardless of the cause of the incident?

A. I believe so, yes.

JUDGE MOSS: Okay. I think that's all I had.

COMMISSIONER HEMSTAD: I had one follow up.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. Well, take the hypothetical of the equipment failure of some magnitude, but as a result of improper maintenance or, say, the imprudent operation of the power facility. How does the IEEE standard apply there?

A. What the IEEE standard does is it segments these outages into sort of short duration or smaller magnitude and larger magnitude. It allows the company then to look at the groupings individually. You can look at the tick birds and take the average weight of the tick birds and you can look at the elephants and take the average weight of the elephants without mixing the two of them. You don't discard one grouping or the other, but you merely analyze them in separate bunches.

Q. But I'm trying to get to the issue of the opportunity for recovery. In my hypothetical, what would happen?

A. Well, this methodology of looking at interruptions wouldn't -- wouldn't go to a prudence level. You'd have to dig deeper and find out the causes.

Q. Right, but so that would be a separate issue, because that was not foreclosed by the standard that you're describing?

A. Certainly not. It would not be foreclosed.

COMMISSIONER HEMSTAD: Thank you.

JUDGE MOSS: Okay. Anything else?

MS. DODGE: I just have one follow up, as far as the math of the IEEE and how it's put together.

C R O S S - E X A M I N A T I O N

BY MS. DODGE:

Q. You're aware that the company has suggested that the outage definition be slightly refined to have the one-minute versus five minutes?

A. Yes, I am.

Q. Does Staff have any objection to that?

A. No, I don't.

JUDGE MOSS: Okay. Any redirect?

MR. CEDARBAUM: No.

JUDGE MOSS: Mr. Kilpatrick, we appreciate you being here and giving your testimony. You may step down.

We hadn't gone beyond this witness, but we have 30 minutes left. Would it be most appropriate to put on -- well, we could put on Mr. Heidell or we could put on Hunt and perhaps get Hunt and Luscier. What would be appropriate?

MS. DODGE: Mr. Heidell is here and available.

JUDGE MOSS: And we have indication of 25 minutes of cross-examination for Mr. Heidell. Who is that? Is that Staff? No, 15 minutes by Public Counsel and 10 minutes by Staff. Are those reasonable estimates?

MR. CEDARBAUM: I think so.

JUDGE MOSS: Okay. Then let's have Mr. Heidell.

MS. DODGE: Somebody just walked around the corner to get him.

Whereupon,

JAMES A. HEIDELL,

having been first duly sworn, was called as witness herein and was examined and testified as follows:

JUDGE MOSS: Please be seated.

D I R E C T   E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Heidell, do you have before you your direct testimony, rebuttal testimony, and exhibits that have been pre-marked Exhibits 271 through 315?

A. Yes, I do.

Q. And were Exhibits 271 through 299 prepared by you or under your direction?

A. Yes, they were.

CHAIRWOMAN SHOWALTER: I don't think the mike is on.

JUDGE MOSS: Up is on.

THE WITNESS: Is this better?

CHAIRWOMAN SHOWALTER: Yeah.

THE WITNESS: Sorry about that.

Q. And with respect to Exhibits 300 through 315, which were the testimony and exhibits originally pre-filed by Colleen Paulson, which you have adopted, did you work with Ms. Paulson and her staff in preparing that testimony and exhibits?

A. Yes, I did.

Q. And are you familiar with the substance of and the support for Exhibits 300 through 315?

A. Yes, I am.

Q. Do you have any additions or corrections to make at this time?

A. The only -- no additions. I would want to point out that, on the rebuttal testimony, that the -- all the exhibits and revenue rate spread and rate design did not reflect the latest corrections of Mr. Story, but they are virtually the same.

Q. And in any event now, rate spread and rate design have been settled; is that right?

A. That is correct.

Q. With that caveat, Mr. Heidell, are the answers to the questions in Exhibits 271 through 315 true and accurate, to the best of your knowledge?

A. Yes, they are.

MS. DODGE: Your Honor, we offer Exhibits 271 through 315 into evidence, and offer Mr. Heidell for cross-examination, I understand on the subject of weather normalization.

JUDGE MOSS: All right. Well, I'll just point out that Exhibit Number 300 is not being used, so with the exception of that one, you have correctly identified the numbers. Are there objections to any of the exhibits?

MR. CEDARBAUM: No.

JUDGE MOSS: Hearing no objections, then those will be admitted as previously marked. And Mr. Cedarbaum, I think you have maybe 10 minutes?

MR. CEDARBAUM: Or less.

JUDGE MOSS: Or less.

C R O S S - E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Hello, Mr. Heidell.

A. Good afternoon.

Q. As your counsel just indicated, with the rate spread and rate design settlement, really the only contested issue between Staff and your area is the gas weather normalization adjustment; is that right?

A. That's my understanding.

Q. Okay. And the issue involves the company's use of a 20-year rolling average to calculate normal weather versus Staff's use of 30 years of data from

NOAA; is that right?

A. I hesitate, because the issue is actually far more complex than that.

Q. Is that a general description of where the two parties sit on the issue?

A. I'm trying to give a simple answer. Staff has argued for using 30 years versus 20, but the basis of the data are different, so you can't just take 30 years of data and put it into the company's equations.

Q. Okay.

A. Sorry to make it complicated.

Q. A lot of this is complicated. Okay. So with that understanding, then, is it correct that, in the gas weather normalization adjustment, the calculation of normal weather, however it's done, is the baseline against which actual test year temperatures is compared?

A. That is correct.

Q. And is it correct, as you described in your rebuttal testimony, that the reason why you recommend that the Commission reject the Staff's method is because there's a pending collaborative, and you would hope that the Commission would just wait for the results of that collaborative before changing the company's method?

A. That is correct. A lot of these -- there are a number of issues with the Staff's adjustment, and we believe they are highly likely to be resolved in the collaborative.

Q. And for clarification, the collaborative we're talking about is the one that was agreed to in the PCORC proceeding earlier this year that the Commission then authorized a half in its order in that case; is that right?

A. That's right.

Q. And as it was initially set up, the collaborative was limited to electric normalization; is that right?

A. I believe the order just dealt with electric.

Q. Okay. And gas was -- gas weather normalization was added by the agreement of the parties to the collaborative on an informal basis?

A. That is correct.

Q. At the time that the -- at the time the decision was made in the collaborative to add gas weather normalization to the agenda, was the current rate case already filed or not? The case was filed in April, so --

A. Yeah, the reason that I'm struggling with the answers is that I started working on this in January, and I was under the understanding in February and March that both gas and electric would be part of the collaborative, but I am not sure that Staff had that understanding.

Q. Do you know when the collaborative began specifically? When was its first meeting?

A. The -- as far as I'm aware, because Ms. Paulson was arranging the collaborative, but the first formal meeting of the collaborative was subsequent to the company filing its direct case.

Q. Was there any agreement or understanding amongst the parties or is there any agreement or understanding amongst the parties, either at the time it was established or throughout, that parties would be -- would be required to await the results of the collaborative before making alternative recommendations in this case?

A. No, I'm not aware of any such agreement.

Q. So you're not aware of anything in the collaborative itself that would preclude the Commission from considering alternative results, alternative proposals?

A. No, I'm not. Not as a result of the

collaborative.

MR. CEDARBAUM: Thank you. Those are all my questions.

MR. FFITCH: Your Honor, I apologize. If I might just ask one or two questions that I've retrieved from my notes after all.

JUDGE MOSS: All right.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good afternoon, Mr. Heidell.

A. Good afternoon.

Q. You were a witness for the company for Puget Sound Energy in the previous rate case, were you not?

A. That is correct.

Q. And this is the case that ultimately led to the 2002 settlement. In that proceeding, you were also working on rate spread rate design issues, if I recall. Is my memory correct on that?

A. That is correct, but to be more specific, I concentrated on the electric side.

Q. Okay. And at that time, were you in the employ of Puget Sound Energy?

A. No, I was not.

Q. And who was your employer at that time?

A. P.A. Consulting.

Q. Okay. And you're working still with P.A. Consulting at the present time?

A. That is correct.

MR. FFITCH: Thank you. Those are all my questions, Your Honor.

JUDGE MOSS: Okay. Anything from the bench? Apparently not. Any redirect?

MS. DODGE: No, Your Honor.

JUDGE MOSS: All right. Mr. Heidell, we appreciate you being here and giving your testimony, and you may step down.

THE WITNESS: Thank you.

JUDGE MOSS: Dr. Mariam's subject matter, I believe, is the same. Should we have him or would we want to go ahead with PSE witnesses?

MS. DODGE: We should probably go ahead with Mr. Hunt. Dr. Mariam speaks to some other matters, as well, and should probably come after Ms. Ryan.

JUDGE MOSS: I don't think Staff has any strong feelings about it, so let's have Mr. Hunt. Whereupon,

THOMAS HUNT,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:.

JUDGE MOSS: Thank you. Please be seated.

D I R E C T E X A M I N A T I O N

BY MS. DODGE:

Q. Mr. Hunt, do you have before you your direct testimony and rebuttal testimony in this matter, which have been marked Exhibits 331 through 336?

A. Yes.

Q. And were Exhibits 331 and 332 prepared by you or under your direction?

A. Yes.

Q. And with respect to Exhibits 333 through 336, which are the testimony and exhibits originally pre-filed by Ms. Michelle Clements, which you have adopted, did you work with Ms. Clements and her staff in preparing that testimony and exhibits?

A. I did.

Q. Are you familiar with the substance of and the support for Exhibits 333 through 336?

A. Yes, I helped prepare them.

Q. Are the answers to the questions in Exhibits 331 through 336 true and accurate, to the best of your knowledge?

A. Yes.

MS. DODGE: Your Honor, we offer exhibits 331 through 336 into evidence, and Mr. Hunt for cross-examination.

JUDGE MOSS: All right. No objection, those will be admitted as marked. Mr. Cedarbaum, do you have anything for this witness?

MR. CEDARBAUM: I do, Your Honor, but if I could -- we're moving too fast for me here. Okay. I'm ready. Thank you.

C R O S S - E X A M I N A T I O N

BY MR. CEDARBAUM:

Q. Hello, Mr. Hunt.

A. Hi.

Q. If you could refer to Exhibit 337 for identification, which was a cross exhibit from Commission Staff?

A. Okay. I have it in front of me.

Q. Is this the work paper, the company's work paper for its electric adjustment 210, miscellaneous operating expense?

A. I believe so. It's a work paper from the rates department, so it's not a work paper of mine -- of my own.

Q. Well, would you -- do you know or would you accept, subject to check, that the exhibit is a work paper supporting the calculation of the incentive pay adjustments for the electric and gas cases?

A. Yes.

Q. If you could look at the exhibit, the second set of columns, the right-hand of the page, it shows the 2002 total payout of $10,554,480 and change. Do you see that?

A. Yes.

Q. And then the 2003 payout is below that, and that's the $3,228,271 and change figure?

A. Right.

Q. Now, if you could go to your testimony in Exhibit 333, at page three.

A. Okay.

Q. There's a chart in the upper part of the page. The numbers that are shown for 2003 and 2002 are different than the numbers that we just referenced on your work paper --

A. Correct.

Q. -- for both years, and I'd like you to explain why those differences exist?

A. They're lower because the column, which, on page three, should say incentive plan expense is the -- excludes the capitalized portion of the total incentive payment, so that is the reason why they're lower.

MR. CEDARBAUM: Okay. Your Honor, I would offer Exhibit 337.

JUDGE MOSS: All right. Hearing no objection, it will be admitted as marked.

Q. I'd like to ask you some questions about wage increases. And is it correct that the nonunion wage increases are effective on March 1st of each year?

A. Yes.

Q. Now, if you look at pages seven and eight of your testimony, starting at the bottom of the page of page seven on to the top of page eight, you say that merit pay is distributed based on each employee's level of performance and that the increase has been budgeted at three percent since 1998. Do you see that testimony?

A. Yes.

Q. I don't know that you need to look at this, but there's an Exhibit 267 related to the subject, and I actually don't recall which witness it is, but can you accept, subject to your check, or if Counsel wants to provide that, that's fine.

MS. DODGE: I think we need to look at the exhibit, all of us, before we go on.

MR. CEDARBAUM: Okay.

JUDGE MOSS: This is one of Luscier's?

THE WITNESS: Yeah, I have it in front of me.

MS. DODGE: I'm sorry, what was the reference?

MR. CEDARBAUM: 267.

Q. I think I have to say that this was a cross exhibit we have for Ms. Luscier, who was supposed to be on, I think, before Mr. Hunt, so -- or not. Okay.

Anyway, I guess my question is, in your testimony, you reference a three percent budgeted figure, but in Exhibit 267, the amounts are all shown to be less than three percent. I'm looking at the UTC slippage effective increase column.

A. If you look at the second page of the exhibit.

MS. DODGE: You mean Exhibit 267?

THE WITNESS: Yeah, of Exhibit 267, it shows amounts during, for instance, March 2003. That would be a more appropriate comparison between the three percent merit increase pool and the -- from my testimony. So for instance, in March 2003, that the increase in that month, from March -- from February was 3.48 percent.

Q. Well, I guess I'm trying to relate this to your testimony itself, which says that the amount is -- since 1998, has been three percent, and looking at page one of 267, since 1998, those figures are all less than three percent?

A. I think that the number that is referenced in my testimony is the actual amount of salaries that is created as a pool and awarded to the nonunion employees. And slippage is a calculation that takes into account population sizes and averaging that Ms. Luscier would be better to talk about the details of, but they really are two different calculations and two different sets of numbers.

Q. Just one last question for you. Back to incentives, would you accept, subject to your check, that in the company's third quarter earnings report for this year, it reaffirmed its expectation to earn $1.20 to $1.30 per diluted share?

MS. DODGE: I'd object to the question being posed to this witness on a subject to check basis, as well.

MR. CEDARBAUM: I have the earnings report, this witness is testifying about incentive payments, and the whole issue involves earnings and how the incentives relate to that. So that's why this witness is here.

JUDGE MOSS: There is an earnings component to the incentive, isn't there?

MS. DODGE: Sure. I guess maybe the questions are backwards from where --

JUDGE MOSS: All right. Let's have the question. We'll allow it.

Q. Will you accept, subject to check, that in Puget Energy's report, third quarter earnings report, that the company announced its expectation to earn $1.20 to $1.30 per diluted share?

A. I'm not personally familiar with that earnings statement, but I would accept that, subject to check.

Q. That would be for year end 2004. Thank you. Those are all my questions.

JUDGE MOSS: Okay. Any questions from the bench? Okay. Any redirect? Any redirect, Ms. Dodge?

MS. DODGE: No.

JUDGE MOSS: Okay. All right. Mr. Hunt, we appreciate you being here and giving your testimony, and you may step down.

Well, not letting any grass grow under our feet, we have only five minutes designated for Ms. Luscier, so if she is here --

MR. CEDARBAUM: Your Honor, I don't know if Staff is the only witness -- only questioning party for Ms. Luscier, but the only -- our only point of the cross-examination was to have her identify our cross exhibit as supporting gas wage increase adjustment 2.13 work papers, and if we could just have that stated on the record, for our purposes, she doesn't need to be on the stand.

JUDGE MOSS: Can we just stipulate that exhibit in, Ms. Dodge?

MS. DODGE: Which one was it, the 267?

JUDGE MOSS: It's 267, rebuttal work paper, pages 22 and 24.1, gas wage adjustment 2.13.

MS. DODGE: That would be fine.

JUDGE MOSS: All right. Then we won't have to have Ms. Luscier. I'm sure she is disappointed.

MS. LUSCIER: Thanks.

JUDGE MOSS: And we'll take -- and likewise, Mr. Cedarbaum, I'd want to take her direct on the stipulation, all of her evidence?

MS. DODGE: Yes.

JUDGE MOSS: Okay, fine. Well, we'll -- I'm just going to mark it as admitted as of today. All right. All right. Moving right along, let's see if we have another five or 10-minute witness here. Ah, Mr. Karzmar has been waiting anxiously all day to testify. We have five minutes designated for him.

MR. CEDARBAUM: Your Honor, I should say the Staff does not have any questions, and we would stipulate his testimony in.

JUDGE MOSS: Well, Mr. Karzmar at least got to loosen his knee joints, and we will have -- oh, you know, I'm sorry. I am moving a little fast here, but I haven't been acknowledging that the bench might have questions. But I'm sure they would alert me to the fact that -- if they did.

CHAIRWOMAN SHOWALTER: We think we should call it a day.

JUDGE MOSS: I knew I shouldn't have said anything. All right. The bench has decided that they have earned a break, based on all the hard work of the last few minutes, so we will be in recess until tomorrow morning at 9:30. Thank you all very much for today.

(Proceedings adjourned at 4:55 p.m.)