EXHIBIT NO. ___(DEG-1CT)
DOCKET NO. UE-06___/UG-06___
2006 PSE GENERAL RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-06____** **Docket No. UG-06____**

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

REDACTED VERSION

FEBRUARY 15, 2006

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
DONALD E. GAINES

CONTENTS

I. INTRODUCTION 1

II. CAPITAL STRUCTURE AND OVERALL RATE OF RETURN 3

III. THE COMPANY'S CREDIT RATINGS 11

IV. EFFECT OF THE COMPANY'S REQUESTED RATE RELIEF 14

V. CAPITAL COMPONENTS OF THE COMPANY'S REQUEST 18

A. The Cost of Debt 18

1. The Cost of Long-Term Debt 19

2. The Cost of Short-Term Debt 22

B. The Cost of Trust Preferred 28

C. The Cost of Preferred Stock 31

D. The Cost of Common Stock 33

E. Overall Rate of Return 34

VI. CONCLUSION 34

1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF**
3 **DONALD E. GAINES**

4 **I. INTRODUCTION**

5 **Q. Please state your name, business address and present position with Puget**
6 **Sound Energy, Inc.**

7 A. My name is Donald E. Gaines. My business address is 10885 NE Fourth Street,
8 P.O. Box 97034, Bellevue, Washington 98009-9734. I am the Vice President
9 Finance & Treasurer for Puget Sound Energy, Inc. ("PSE" or "the Company").

10 **Q. Have you prepared an exhibit describing your education, relevant**
11 **employment experience, and other professional qualifications?**

12 A. Yes, I have. It is Exhibit No. ___(DEG-2).

13 **Q. What are your duties as Vice President Finance and Treasurer for PSE?**

14 A. I have overall responsibility for raising capital in the financial markets. I am also
15 responsible for maintaining relations with credit rating agencies, commercial and
16 investment banks. In addition, I oversee the Company's financial planning and
17 tax activities.

1 **Q. Please summarize the purpose of your testimony.**

2 A. My testimony describes the capital structure and overall rate of return the
3 Company is requesting in this case and the reasons for these requests. The
4 Company's requested overall rate of return reflects significant cost savings the
5 Company has achieved through refinancing of debt issued during higher interest
6 rate environments.

7 The Company has continued its efforts over the past several years to improve its
8 financial strength, most recently by issuing $310 million in common stock before
9 the date the Company projected in its last general rate case. With an actual
10 common equity level of 44.13% as of December 31, 2005, the Company is
11 requesting the Commission's approval in this case of a 45% equity level [REDACTED]
12 [REDACTED].

13 Approval of the 45% requested equity level, along with the 11.25% return on
14 equity recommended by Dr. Roger Morin and the other regulatory mechanisms
15 and relief the Company has requested in this case, will likely place the Company
16 in a position to improve its corporate credit rating from its current "BBB-" rating
17 – just one notch above non-investment grade – to a "BBB+" corporate credit
18 rating. Such an improvement, along with the other relief the Company has
19 requested, would well position the Company to attract the extraordinary amount
20 of capital it needs to invest in new generating resources on behalf of its electric
21 customers, to invest in its gas and electric system infrastructure, and to engage in

1 wholesale market activities on behalf of its customers.

2 **II. CAPITAL STRUCTURE AND OVERALL RATE OF**
3 **RETURN**

4 **Q. What is the Company requesting for its capital structure and overall rate of**
5 **return in this proceeding?**

6 A. The Company is requesting a capital structure comprised of 45% common equity
7 with an 11.25% return on equity ("ROE"), resulting in an overall rate of return of
8 8.76%, as can be seen in Table 1 below:

9 **TABLE 1**
10 **CAPITAL STRUCTURE AND**
11 **OVERALL RATE OF RETURN**

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-term Debt	2.67%	6.22%	0.17%
Long-term Debt	47.88%	6.64%	3.18%
Trust Preferred	0.70%	8.54%	0.06%
Preferred Stock	3.75%	7.61%	0.29%
Common Equity	45.00%	11.25%	5.06%
Overall Rate Of Return	**100%**		**8.76%**

12 **Q. What factors are typically considered in selecting the appropriate capital**
13 **structure in ratemaking?**

14 A Selecting the appropriate capital structure involves balancing of safety and

1 economy. The economy of lower cost debt, on which the Company has an
2 obligation to pay interest, must be weighed against the safety of relatively higher
3 cost common equity, on which the there is no legal obligation to pay a return.

4 In the Company's last general rate case, Docket Nos. UG-040640, *et al.* (the
5 "2004 general rate case"), the Commission referred to this balance of economy
6 and safety. *See Puget Sound Energy*, Docket No. UE-040640, *et al.*, Order No. 6
7 at ¶27 (Feb. 18, 2005). The Commission also concluded that the Company's
8 equity ratio should be set at the level that is most likely to prevail, on average,
9 over the course of the rate year:

> 10 Our goal in this proceeding should be to set the Company's equity
> 11 ratio at the level that the evidence shows is most likely to prevail,
> 12 on average, over the course of the rate year.

13 *Id*. at ¶40.

14 In this proceeding, the Company is requesting an equity level consistent with the
15 basis on which the Commission set the capital structure in the 2004 general rate
16 case [redacted]
17 [redacted].

18 **Q. What is the Company's actual capital structure?**

19 A. The Company's actual capital structure at September 30, 2005 and December 31,
20 2005 were as follows:

1 **TABLE 2**
2 **ACTUAL CAPITAL STRUCTURE**

Capital Component	Sept 30, 2005	Dec 31, 2005
Short-term Debt	6.82%	0.90%
Long-term Debt	49.08%	49.71%
Trust Preferred	5.52%	5.22%
Preferred Stock	0.04%	0.04%
Common Equity	38.54%	44.13%
Total Capitalization	**100.0%**	**100.0%**

3 The above capital structure as of September 30, 2005 was the Company's capital
4 structure at the end of the test period and is also the most recent period for which
5 there are publicly available financial statements. That capital structure, however,
6 is not representative of the Company's current capital structure because the
7 Company's parent company, Puget Energy, Inc. ("Puget Energy"), sold
8 $310 million of common stock on November 1, 2005 and invested the net
9 proceeds into the Company. This investment effectively increased the utility's
10 equity ratio from nearly 39% to a little more than 44%. This is more than the
11 43% equity ratio on which rates were set in the Company's 2004 general rate
12 case.

13 **Q. Does the Company's current capital structure appropriately balance the**
14 **risks and costs of shareholder and debt funding?**

15 A. No. Although the current capital structure is an improvement over the

1 Company's position in the 2004 general rate case, it does not adequately balance
2 the competing interest of safety and economy. The Company's present capital
3 structure and coverage ratios result in a corporate credit rating of "BBB-". As
4 Standard & Poor's states in its December 30, 2005, report on the Company,
5 "[w]ith the recent equity offering, cash flow coverage and debt leverage metrics
6 are now within benchmark levels for the rating."

7 The Company needs to have a higher equity ratio to: (i) attract the capital to fund
8 the Company's infrastructure and new resource construction program, (ii) have
9 the ability to further its energy hedging strategies; (iii) offset the imputed debt
10 from purchased power agreements; and (iv) provide electric and gas service to
11 customers on reasonable terms.

12 **Q Why does the Company need a higher equity ratio for its resource**
13 **acquisition program?**

14 A. As Mr. Valdman testifies in his prefiled direct testimony, Exhibit No. ___(BAV-
15 1CT), the Company faces an unprecedented level of capital spending to support
16 new customer additions, replace aging infrastructure and to add new electric
17 generating resources. This extraordinarily high level of capital spending can not
18 be funded by internal cash flows alone. Moreover, even if additional new energy
19 resources came in the form of purchased power agreements, the Company would
20 need more equity to offset the additional fixed obligations of those agreements,
21 which the rating agencies treat as debt when looking at the Company's credit

1 metrics. As a result, the Company has been required to access the capital markets
2 to fund its construction activities, and will continue to need to do so for several
3 years. To attract the capital needed to fund this activity on reasonable terms, the
4 Company needs to reduce its risk profile, in part, though a higher equity level.

5 **Q How will a higher equity ratio support the Company's energy hedging**
6 **strategies?**

7 A. A higher equity ratio would support the Company's efforts to improve its
8 corporate credit rating from its current position at one step above non-investment
9 grade, as described in the next section of my testimony. A higher credit rating
10 would, among other things, improve the Company's ability to transact with
11 wholesale energy market counterparties that typically have stronger credit ratings
12 than the Company, as described in the testimony of Mr. David Mills, Exhibit
13 No. ____(DEM-1CT). In addition, an improved financial profile would facilitate
14 the structuring of a line of credit dedicated to energy hedging strategies.

15 **Q Why does the Company need a higher equity ratio to offset the imputed debt**
16 **from purchased power arrangements?**

17 A. Both Standard & Poor's and Moody's impute debt on purchased power contracts.
18 *See* Exhibit No. ___(DEG-3). The debt imputed by the credit rating agencies for
19 purchased power agreements results in the need for equity *on the books* to balance
20 the additional financial risk inherent in such debt. To the extent the Company
21 adds additional power resources through purchased power contracts, it will need

1 to build its equity further to balance the additional imputed debt which the rating
2 agencies would add as a result of this type of resource acquisition. In other
3 words, the Company will require additional equity as additional purchased power
4 contracts commence just to maintain the comparable level of credit worthiness.

5 Specifically, Standard & Poor's calculates the present value of the capacity
6 portion of purchased power payments using a 10% discount rate and a half-year
7 convention, reduced by a 30% risk factor in the Company's case. For contracts
8 where no capacity payment is specified, Standard & Poor's assumes 50% of the
9 payment is for capacity. This methodology is described in detail in a report
10 published as far back as the early 1990s. *See* Exhibit No. ___(DEG-3). The
11 Standard & Poor's methodology results in approximately $402.7 million of
12 imputed debt related to PSE's existing long-term purchased power obligations.
13 This amount will increase, if the Company's resource strategy includes additional
14 purchased power contracts.

15 **Q. What mix of debt and equity is appropriate for the Company?**

16 A Considering the challenges facing the Company and the much higher equity levels
17 maintained by many of its peers, as discussed below and in Dr. Morin's
18 testimony, the Company clearly needs to achieve an equity level above its current
19 44% level. While we have determined that 45% is appropriate [REDACTED]
20 [REDACTED] in this proceeding, the amount going forward could differ substantially from
21 that, depending, in part, on it's energy resource acquisitions. At the same time,

1 the Company has already increased its equity level substantially over the past
2 several years and there are practical limits on how quickly equity levels can be
3 increased.

4 Taken all together, the Company believes that a 45% equity level is an
5 appropriate next step in increasing its equity ratio. [REDACTED]
6 [REDACTED]
7 [REDACTED], I
8 have used a 45% equity level in my cost of capital calculations.

9 This level of equity, when combined with the regulatory relief requested in this
10 proceeding and an appropriate ROE, should enable the Company to continue to
11 improve its credit metrics, which in turn, will enable it to attract capital at
12 reasonable rates to fund its capital spending program and support its wholesale
13 energy market hedging activities.

14 **Q. Has the Commission's approach to setting the Company's equity levels in its**
15 **past two general rate cases been supportive in helping the Company rebuild**
16 **its capital structure?**

17 A. Yes, absolutely. In the Company's last two general rate orders, the Commission
18 approved rates based on equity levels that the Company had yet to attain, but
19 planned to achieve. In both instances, the Company exceeded those equity levels
20 and did so ahead of the expected timeline. Having the increased equity level built
21 into rates at the start enabled the Company to achieve the increased equity level

1 with minimal dilution in earnings. That, in turn, helped the Company attract
2 buyers for its common stock and exceed the most recently approved 43% equity
3 ratio.

4 **Q. How does the Company plan to achieve the requested capital structure**
5 **during the rate year?**

6 A. PSE plans to achieve the 45% capital structure [redacted]
7 [redacted]
8 [redacted].

9 **Q. How does the capital structure the Company is requesting compare to the**
10 **capital structures approved in general rate proceedings across the country?**

11 A. Exhibit No. ___(DEG-4) contains summaries of rate orders in 2005. The average
12 equity ratio approved for ratemaking purposes was 47.61%. This is more than
13 250 basis points higher than the 45% equity ratio requested by the Company in
14 this proceeding. Interestingly, the average weighted cost of equity in these cases
15 (the allowed ROE multiplied by equity ratio) is nearly identical to the Company's
16 requested 5.06% in this case (the product of the requested 45% equity ratio and
17 the requested 11.25% ROE).

18 **Q. Are you proposing the same capital structure for gas and electric operations?**

19 A. Yes. PSE is an integrated gas and electric utility. The Company is not run with
20 separate electric and gas divisions. The capital acquired to finance the Company

1 is not split between gas and electric operations. The use of proceeds from such
2 financing is not tied to any one type of commodity. As a result, a single capital
3 structure is appropriate.

4 **III. THE COMPANY'S CREDIT RATINGS**

5 **Q. What are rating agencies and credit ratings?**

6 A. Rating agencies are independent agencies that assess risks for investors. The two
7 most widely recognized rating agencies are Standard & Poor's ("S&P") and
8 Moody's Investors Service ("Moody's"). These rating agencies assign a credit
9 rating to companies and their securities so investors can more easily understand
10 the risks associated with investing in their debt and preferred stock.

11 **Q. What are the Company's current credit ratings?**

12 A. The Company's corporate credit ratings are "BBB-", as rated by S&P, and
13 "Baa3", as rated by Moody's. Mr. Bert Valdman provides a summary of all of
14 the Company's credit ratings in his direct testimony.

15 **Q. Please describe the methodologies used by ratings agencies in determining**
16 **the Company's credit ratings.**

17 A. The methodologies used to assign such credit ratings are discussed in detail in
18 Standard & Poor's 2005 Corporate Ratings Criteria, which I have included as
19 Exhibit No.___(DEG-5). The utility ratio benchmarks associated with credit

1 rating can be found on page 45. Please note when reviewing these benchmarks
2 that the Company's business position is "4".

3 **Q. Why are credit ratings important to customers?**

4 A. Credit ratings are important to customers because they are an overall
5 representation of a company's financial health. As a result, they are a major
6 factor in determining the cost of capital to the Company and ultimately its
7 customers. A low credit rating reflects increased risks for investors, which, in
8 turn, requires a higher cost of capital, which increases the cost of service to
9 customers.

10 Customers benefit when the appropriate risk profile, found by managing business
11 risk with the appropriate degree of debt leverage, supports a credit rating that
12 allows the Company to access capital at a reasonable cost. Because credit ratings
13 take into consideration these risk elements and have such a dramatic impact on
14 the cost of, and access to, capital, they are of importance to customers, especially
15 when a company is facing substantial capital investments as is PSE.

16 **Q. Do PSE's current credit ratings provide an appropriate balance of economy**
17 **and safety?**

18 A. No. A Corporate Credit Rating of "BBB-" is only one step away from non-
19 investment grade status (sometimes called "junk status"). The Company's capital
20 structure contains too much leverage, especially in light of the amount of imputed

debt the rating agencies add to total debt, in light of the tremendous capital needs the Company faces.

Q. Is the stability of the Company's credit rating also important?

A. Yes. A strong credit rating should be maintained over time as the Company requires continuous access to capital markets. When a company faces financial difficulties that threaten its credit rating, typically the capital markets will react negatively before the credit rating agencies downgrade the credit rating. However, if a company subsequently takes steps to improve its financial position and its credit rating is upgraded, the market will lag the upgrade – taking longer for the company to benefit from the reduced capital costs associated with a better credit rating. It is by maintaining a solid credit rating, over time, that a company maintains access to capital on reasonable terms.

Q. What corporate credit rating is the Company targeting?

A. While some experts (including Dr. Morin) suggest that a corporate credit rating of "A" is optimal for utilities, it is the Company's view, at this time, that a "BBB+" corporate credit rating reflects the appropriate balance of cost (economy) and risk (safety) while providing the Company with the financial flexibility needed to access the capital markets on reasonable terms. Mr. Bert Valdman describes the benefits of a "BBB+" corporate credit rating in his direct testimony.

From my perspective, a "BBB+" corporate credit rating is important because

1 "BBB+" would: (i) enable the Company to borrow at lower interest spreads;
2 (ii) provide the Company with a reasonable "ratings cushion" above non-
3 investment grade status; (iii) support the Company's anticipated resource capital
4 spending program; and (iv) facilitate expanded risk management activities.

5 IV. EFFECT OF THE COMPANY'S
6 REQUESTED RATE RELIEF

7 **Q. Assuming the Commission grants the rate relief requested in this proceeding,**
8 **would the Company's projected financial results support a "BBB+" credit**
9 **rating?**

10 A. As noted in Exhibit No. ___(DEG-5), credit rating agencies examine a number of
11 qualitative and quantitative factors in determining a credit rating, and there is no
12 formula for combining assessments of these factors to arrive at a specific credit
13 rating. However, I expect that the rate relief requested by the Company in this
14 filing, including the capital structure comprised of 45% equity and 11.25% ROE
15 along with the revised sharing bands and percentages for the Company's PCA
16 Mechanism, will provide the financial results necessary to support the Company's
17 targeted credit rating. It appears that the credit rating agencies share this view:

> 18 Consideration of a positive rating outlook will depend on more
> 19 favorable rate relief in future years (beginning with the
> 20 forthcoming GRC), consistently strong cash flow coverage
> 21 metrics, and Puget Sound Energy's ability to improve its equity
> 22 capitalization. An improved mechanism for commodity cost
> 23 recovery could also provide support for a positive outlook.
> 24 Alternatively, a negative outlook could result due to several
> 25 factors, including additional commodity cost disallowances, the

1 excessive accumulation of power cost deferrals, inadequate
2 regulatory treatment of capital additions, a disproportionate
3 reliance on debt financing to meet its capital needs, or significant
4 power cost deficits beginning in 2007.

5 Standard & Poor's, "Research Update: Puget Energy 'BBB-' Corp. Ratings
6 Affirmed; Outlook Remains Stable" at 2 (Dec. 30, 2005).

7 **Q. Can the Company achieve its targeted "BBB+" corporate credit rating**
8 **without rate relief?**

9 A. No. Without sufficient rate relief, the Company's financial results cannot support
10 a "BBB+" corporate credit rating. Moreover, as described below, the Company
11 may have difficulty maintaining its existing "BBB-" credit rating under these
12 circumstances:

13 **TABLE 8**
14 **CREDIT RATING WITH AND**
15 **WITHOUT RATE RELIEF**

Credit Metric	Absent Any Rate Relief	With Rate Relief
FFO Interest Coverage		
S&P Benchmark for BBB	2.5x – 3.5x	2.5x – 3.5x
FFO to Average Debt		
S&P Benchmark for BBB	12% – 20%	12% - 20%
Debt Leverage		
S&P Benchmark for BBB	62% - 52%	62% - 52%

16 The above table summarizes the Company's key credit metrics, as adjusted for

1 purchased power, with and without rate relief. The above table also shows the
2 S&P credit benchmarks for a "BBB" credit rating for a company with a Business
3 Position of "4". *See* page 45 of Exhibit No. ___(DEG-5).

4 Although S&P does not publish benchmark ranges for the sub-grades of "BBB-"
5 and "BBB+", those can be inferred by breaking the published benchmark range
6 into thirds, the more favorable third being the "BBB+" level and the least
7 favorable third being the "BBB-" level. With the requested rate relief, the
8 Company's Funds From Operations (FFO) interest coverage and FFO to average
9 debt and Total Debt to Total Capitalization ratios are at the favorable ends of the
10 benchmark range associated "BBB+" credit rating:

11 **FFO Interest Coverage**
12 **(Higher is Better)**

Chart Redacted.

1 **FFO-to-Average Debt**
2 **(Higher is Better)**

Chart Redacted.

Both charts are confidential.

3 **Debt-to-Capital**
4 **(Lower is Better)**

Chart Redacted.

It should be noted that achieving the requested 45% equity level alone would not result in the cash coverage levels needed to support a "BBB+" credit rating. The Company needs to earn on that equity, meaning that: (i) rates must be set at an appropriate ROE and (ii) the Company must be afforded the opportunity to actually earn that ROE. As described in Mr. Valdman's direct testimony, the Company has consistently and significantly under-earned its authorized ROE because of its significant electric and natural gas infrastructure and new resource additions, its system reliability initiatives and the current structure of the PCA Mechanism sharing bands.

V. CAPITAL COMPONENTS OF THE COMPANY'S REQUEST

A. The Cost of Debt

Q. What has the Company done to reduce its debt cost since the last general rate proceeding?

A. The Company has taken several steps to reduce its cost of debt. First, when the Company issues long-term debt, it almost exclusively issues debt secured by mortgages on its electric and gas properties. Such secured debt is typically rated one notch higher than unsecured debt and is less expensive than unsecured debt. For example, secured debt can typically be issued with a coupon rate that is 20 to 25 basis points less than unsecured debt of similar terms. That savings reduces the cost of debt to PSE and its customers.

1 The Company also looks to replace higher cost securities with less expensive debt
2 when it is able to do so. The Company currently has little callable debt
3 outstanding because the Company has refinanced certain debt issues over the past
4 two years as described below. As a result of this and other activities, the
5 Company's cost of long-term debt has declined since the last general rate
6 proceeding from 6.88% to 6.64%, a total reduction of 24 basis points. That
7 reduction, when applied to the approximately $2.6 billion of long-term debt
8 projected as outstanding on average during the rate year, represents a reduction in
9 interest expense of more than $6 million per year. The Company's debt portfolio
10 has an average life of approximately 14 years, which results in an aggregate
11 savings of about $84 million.

12 **1. The Cost of Long-Term Debt**

13 **Q. Please summarize your calculation of the cost of long-term debt.**

14 A. To calculate the cost of long-term debt, the Company calculates the yield-to-
15 maturity, or cost rate, of each debt issue using the issue date, maturity date, net
16 proceeds to the Company and coupon rate of that security. Also included in the
17 cost of long-term debt are the amortized costs of reacquired high coupon debt
18 with lower coupon debt. The proportional share that each issue's principal
19 amount represents of the total amount of long-term debt outstanding is then used
20 to weigh these cost rates. These calculations can be found on pages 6 and 7 of
21 Exhibit No. ___(DEG-6C).

1 **Q. How did you treat new issues of long-term debt?**

2 A. The Company's financial plan includes three long-term debt issues: (i) a
3 $200 million issue in June 2006, (ii) a $250 million issue in May 2006, and a
4 (iii) $125 million issue in September 2007.

5 The Company plans to use the proceeds from the $200 million issue in June 2006
6 to call the Company's $200 million 8.40% series trust preferred stock at par. The
7 replacement security is projected to carry a fixed rate of 6.542% with a 30-year
8 bullet maturity. The cost rate after debt issuance expenses is projected to be
9 5.899%. The cost rate on this issue is lower than the coupon rate due to the fact
10 that the Company entered into two forward-starting swaps to hedge the cost of
11 this security. The hedge is "in the money" because interest rates have risen since
12 the Company entered into the hedges. As a result, the payments the Company
13 expects to receive to terminate the swap are amortized over the life of the issue,
14 effectively making the all-in cost equal to the rate expected as a result of the
15 hedge.

16 The Company projects that the $250 million issue in May 2006 will have a
17 coupon of 6.582% and a cost rate of 6.645%. The Company projects that the
18 $125 million issue in September 2007 will carry a fixed coupon of 6.125% and a
19 cost rate of 6.239%. The Company projects that the proceeds from these issues
20 would be used to fund long-term debt maturities in 2006 and 2007 as well as
21 funding capital expenditures.

1 **Q. What is the purpose of interest rate hedging?**

2 A. The purpose of interest rate hedging is to remove the volatility of interest rates on
3 planned financings. As with energy hedging, the purpose is to remove volatility.
4 Sometimes these hedges will sometimes settle in the money (in which case PSE
5 receives a payment) and sometimes settle out-of-the-money (in which case PSE
6 makes a payment). For example, the Company had entered into treasury locks on
7 the $250 million senior rate note that was issued in May 2005. Because interest
8 rates had dropped by the date of the issue, the notes were issued at a coupon
9 below the hedged rate and the Company made a payment to the counterparties to
10 terminate the hedge. That termination payment, when amortized over the life of
11 the issue, puts the effective cost of the issue at the hedged rate, plus the
12 Company's credit spread.

13 The Company also entered into two forward starting swaps to hedge the rate on
14 the planned issue to refinance the $200 million 8.40% trust preferred. As
15 discussed above that hedge is presently in the money.

16 In both instances, the hedges enabled the Company to lock in favorable long-term
17 interest rates on planned financings.

18 **Q. Are there any issues of long-term debt that will mature or retire between**
19 **September 30, 2005, and the end of the rate year?**

20 A. Between October 1, 2005 and December 31, 2007, $206 million of the

Company's long-term debt will mature. The costs of the issues that mature during the rate year have been included in the calculation of the cost of long-term debt for only those months during which the bonds will be outstanding.

Q. What is the resulting cost of long-term debt?

A. The embedded cost of long-term debt is 6.64% as shown on line 37, page 6 of Exhibit No. ___(DEG-6C).

2. The Cost of Short-Term Debt

Q. Please describe the Company's short-term credit facilities.

A. The Company's current short-term credit facilities are primarily used to provide necessary working capital to fund utility operational requirements and the expected variability of such requirements. The Company has two credit facilities: (i) a $200 million accounts receivable securitization program and (ii) a $500 million unsecured revolving credit agreement with a group of banks. Both facilities carry a five-year term and expire beyond the end of the rate year.

Q. In the Company's last rate proceeding, certain questions arose regarding the Company's use of a receivables securitization facility to achieve lower borrowing rates of short-term debt. Does the short-term debt you have calculated include costs associated with such a facility?

A. Yes, the Company continues to use a receivables securitization facility as a method to lower the borrowing rate of short-term debt, with certain modifications.

1 The Company has included those costs in its cost rate for short-term debt,
2 consistent with its treatment of similar costs in the Company's last general rate
3 proceeding.

4 In the Company's last general rate proceeding, a witness for Public Counsel
5 testified that the off-balance sheet nature of the short-term borrowings through the
6 Company's receivables securitization facility that existed at that time -- through a
7 special purpose entity called "Rainier Receivables" -- was a concern. In its order,
8 the Commission noted these concerns, stating as follows:

> 9 The Commission has concerns about the Company's treatment of
> 10 short-term debt and the issues Public Counsel raised concerning
> 11 Rainier Receivables. Public Counsel and PSE brief these issues at
> 12 some length, but it is impossible to resolve their dispute on the
> 13 basis of the current record. Staff did not offer argument
> 14 concerning the issues raised by Public Counsel, but the
> 15 Commission expects to learn more about these issues from Staff,
> 16 among others, in future proceedings.

17 *Puget Sound Energy*, Docket No. UE-040640, *et al*., Order No. 6 at ¶86.

18 On December 20, 2005, shortly before the Rainier Receivables facility expired in
19 accordance with its terms, the Company replaced it with a new receivables
20 securitization facility through an entity called "PSE Funding, Inc."

21 There are several differences between the PSE Funding, Inc. facility and its
22 predecessor with respect to size, term, fees and increased average borrowing
23 availability:

	Rainier Receivables	PSE Funding, Inc.
Size	$150 million	$200 million
Term	3 years	5 years
Structuring Fees	$600,000	$150,000
Accounting	Off Balance Sheet	On Balance Sheet

More importantly with respect to the question raised in the Company's last general rate proceeding, any borrowings under the PSE Funding, Inc. facility will: (i) be "on-balance sheet" as borrowings under the new facility; and (ii) will be accounted for as loans rather than as sales of receivables.

Q. Are the $700 million in credit facilities sufficient to meet the Company's needs?

A. With respect to the Company's capital funding needs, the existing credit facilities have been sufficient. The existing credit facilities, however, have not been sufficient to cover the additional liquidity requirements associated with the risk management activities described in the direct testimony of Mr. David Mills.

The rating agencies review the adequacy of a company's liquidity facilities by stress testing the amount of credit assuming a credit rating downgrade and a major negative price movement. In performing this stress test, Standard & Poor's expects the ratio of credit used to available credit to be no less that "1.0" times coverage (i.e., the amount of credit used is no greater than the amount of credit

available). The Company's most recent stress test on September 30, 2005, showed a ratio of 0.77x. PSE's ratio was below 1.0x because the Company had a relatively large amount of short-term debt outstanding at that time. The Company has since increased the ratio to above 1.0 by using the net proceeds of Puget Energy's common stock issuance of November 1, 2005, to reduce the amount of short-term debt outstanding.

Q. Would you please expand on your point above that the existing credit facilities have been sufficient with respect to the Company's capital funding needs but not its risk management activities?

A. Both the existing $500 million and $200 million facilities are available for general corporate purposes. The $500 million unsecured revolving credit agreement is primarily used to back-up the Company's commercial paper borrowings. The Company can also use the $500 million facility to back letters of credit, which (like borrowings) reduce the amount of commercial paper that can be issued under the facility. In addition, letters of credit (like borrowing to post collateral) effectively increase the leverage of the Company, putting pressure on credit ratings.

As a result, the Company has been reluctant to post collateral for hedging transactions, thereby limiting the Company's risk management activities as discussed in the direct testimony of Mr. Mills. As a result, the Company is requesting the recovery of costs for a separate credit facility, the use of which

1 would be dedicated to the Company's wholesale energy market hedging needs, as
2 described in Mr. Mills' direct testimony.

3 **Q. How much additional bank credit could the Company likely attract for a**
4 **separate liquidity facility?**

5 A Many factors weigh into the amount of credit the Company could attract.
6 Although the Company would like to size such a dedicated facility to fit its
7 hedging needs, the Company faces certain constraints in sizing such a facility.
8 These constraints include its "BBB-" corporate credit rating, its credit metrics
9 relative to the related benchmark range for such metrics, the exposure level of the
10 banks and the comfort banks have in lending to PSE. As a result, the Company
11 believes it could establish such a line with a size of up to $200 million.

12 **Q. How is the Company planning to recover the cost of the proposed credit**
13 **facility for hedging activities?**

14 A. As mentioned earlier, the Company's existing credit facilities were sized to meet
15 PSE's working capital needs. As a result, the costs of those facilities, both the
16 amortization of the initial costs and the variable interest costs, are included in the
17 cost of short-term debt and, in the case of the variable interest rate component, are
18 based on the projected use of the facilities.

19 The Company has not included the costs of the proposed facility in the cost of
20 debt. The use of the proposed facility will vary with the Company's hedging

1 activity and the related mark-to-market values of the hedges. There may be
2 months were there is no use of the facility, in which case no incremental costs
3 would be incurred. Likewise, there may be months where the Company draws on
4 the facility to post cash collateral to a counterparty. In that instance, the
5 Company would incur interest on the borrowed funds. It is difficult to project
6 with any degree of certainty when and how the facility will be used. Since the
7 usage is not tied to the Company's borrowings to fund working capital , it would
8 be inappropriate to include such costs in the cost of debt. In addition, since the
9 use of the facility is less able to be predicted and since its use would be dedicated
10 to hedging energy costs, it seems more appropriate to recover those costs in the
11 same manner as hedging costs are recovered, which is through the Company's
12 energy costs recovery mechanisms.

13 **Q. Returning to the Company's short-term debt calculation in this case, please**
14 **describe how the amount of short-term debt in the capital structure is**
15 **determined.**

16 A. The amount of short-term debt included in the capital structure is that which is
17 expected to be outstanding, on average, during the rate year. This is determined
18 by projecting the Company's cash flows and financing activities, reflecting the
19 requested rate relief. The amount of short-term debt is that level needed to keep
20 the Company's sources and uses of cash in balance in light of these projections.

1 **Q. Please summarize your calculation of the cost of short-term debt.**

2 A. To calculate the cost of short-term debt during the rate year, the Company
3 calculates the current spread between its short-term borrowing costs and the
4 London Interbank Offered Rate (LIBOR), then applies that spread to an estimate
5 of LIBOR during the rate year. The expected cost of the Company's committed
6 credit facilities is also included in the cost of short-term debt. This calculation
7 can be seen on pages 3 through 5 of Exhibit No. ___(DEG-6C). The resulting
8 cost of short-term debt is 6.22%, as shown on line 18, page 3 of Exhibit
9 No. ___(DEG-6C).

10 **B. The Cost of Trust Preferred**

11 **Q. Please describe trust preferred securities.**

12 A. Trust preferred is a security that may contain equity-like characteristics yet the
13 cost is deductible for federal income tax purposes. On PSE's financial
14 statements, these securities are called "junior subordinated debentures of the
15 corporation payable to a subsidiary trust holding mandatorily redeemable
16 preferred securities." Because that is a rather unwieldy name, the generic title
17 "trust preferred" is often used to describe these securities.

18 In issuing trust preferred, the Company creates a trust that then issues preferred
19 stock to investors. The trust then lends the proceeds (in the form of "debentures")
20 from the sale of the preferred stock to the Company on terms (i.e. maturity,

1 interest rate, etc.) that are identical to the terms of the preferred stock. Typically,
2 these terms include a provision for interest on the loan, and dividends to
3 investors, to be deferred under certain circumstances. The Internal Revenue
4 Service allows the interest on the loan to be deductible for federal income tax
5 purposes because the Company has borrowed the proceeds from the trust.

6 **Q. Do the rating agencies treat the Company's existing trust preferred has**
7 **having equity-like characteristics?**

8 A. No. At the time the securities were issued, the agencies considered trust preferred
9 securities as having certain equity-like characteristics because: (i) the interest and
10 dividends are deferrable; and (ii) of the relatively long maturity of such securities
11 (i.e., 30 or 40 years). Their views have since changed and that this particular
12 structure of trust preferred is now considered as having no equity-like
13 characteristics. In addition, as a result of a change in accounting rules, these
14 securities are now classified in the long-term debt section of the balance sheet.
15 Having lost their equity characteristics, these securities are now relatively
16 expensive debt.

17 It is my understanding, however, there are newer structures of preferred stock
18 that, if structured properly, are viewed as having varying degrees of equity-like
19 characteristics. These are addressed in the preferred stock section of my
20 testimony.

1 **Q. How many trust preferred issues does the Company have outstanding?**

2 A. The Company has two trust preferred issues outstanding: (i) a $100 million
3 8.231% series issued June 6, 1997, and maturing on June 1, 2027, and (ii) a
4 $200 million 8.40% series issued May 24, 2001 and maturing on June 30, 2041.

5 On February 26, 2003, the Company repurchased, at a discount, $19,750,000 of
6 the $100 million trust preferred issue, and, in June 2005, the Company made a
7 tender offer to repurchase all of the remainder of the $80,250,000 of the issue.
8 Investors tendered $42,500,000 and $37,750,000 of the issue remains outstanding.

9 As described in the calculation of the cost of long-term debt above, the Company
10 plans to exercise a par call for the $200 million of 8.40% trust preferred on
11 June 30, 2006. The Company has hedged the cost of the long-term debt issue that
12 will be used to redeem the trust preferred.

13 **Q. How did you determine the costs of these trust preferred issues?**

14 A. The cost rates for trust preferred issues were calculated in the same manner as the
15 cost rates for debt issues. The specific calculations of these costs can be seen on
16 page 8 of Exhibit No. ___(DEG-6C).

17 **Q. What is the resulting cost of trust preferred?**

18 A. The resulting cost of trust preferred is 8.54%.

1 **Q. How have you included the trust preferred in the capital structure?**

2 A. Being a separate type of security, I have included the trust preferred as a separate
3 line in the capital structure. Showing trust preferred as a separate line item
4 facilitates its proper treatment in the calculation of the revenue requirement.

5 **C. <u>The Cost of Preferred Stock</u>**

6 **Q. Is the Company planning any new issues of preferred stock prior to the end**
7 **of the rate year?**

8 A. The Company is examining various structures of preferred stock to see if issuing a
9 structure that contains equity-like characteristics is reasonable. Unlike the trust
10 preferred the Company is planning to call, the Company anticipates that the
11 dividends on any new Company issuance of preferred stock should qualify for the
12 "Dividends Received Deduction" for federal income tax purposes. These types of
13 preferred stock are often referred to as "DRD Preferred".

14 As previously mentioned, it is my understanding that the rating agencies have
15 changed their views of DRD Preferred securities in the recent past. If structured
16 properly, DRD Preferred securities can receive 50% equity treatment by the rating
17 agencies. Unlike trust preferred stock (which the rating agencies treat as debt-
18 like), the agencies would consider the equity-like characteristics of the DRD
19 Preferred securities in examining the Company's credit metrics.

20 At present, the Company believes there are certain structures that may make sense

1 to utilize and has included in its financing plans a $200 million perpetual
2 preferred stock issue. The assumed cost rate is 7%, and the cost rate is expected
3 to be 7.61%, (reflecting an assumed issue cost of 2.5%) as can be seen on line 11
4 of page 8 of Exhibit No. ___(DEG-6C). However, the specifics of this issue, the
5 nature of the security (whether DRD preferred, trust preferred or even secured
6 debt), the cost rate and related terms and conditions, will be reviewed before any
7 final determination will be made.

8 **Q. Can you please show how the cost of DRD can be less expensive than a**
9 **combination of equity and debt?**

10 A. Yes. As stated above, the Company projects a $200 million issuance of perpetual
11 DRD Preferred securities at an after-tax cost rate of 7.61%. Based on my
12 understanding of the current views of the rating agencies, such an issue is
13 expected to receive 50% equity credit. Alternatively, the Company could achieve
14 the same result by issuing: (i) $100 million of long-term debt at the Company's
15 projected after-tax cost rate of 4.32%; and (ii) $100 million of common equity at
16 the after-tax cost of 11.25% proposed in the direct testimony of Dr. Roger Morin,
17 Exhibit No. ___(RAM-1T). The weighted average after-tax cost of that portfolio
18 would be 7.79% (50% of 4.32% plus 50% of 11.25%), which is 79 basis points
19 higher than the after-tax 7.0% coupon projected for DRD Preferred securities.

20 The Company's credit rating determines, to a large degree, the ability to issue
21 preferred and whether or not the above calculation will turn out favorable. A

1 higher credit rating will reduce the cost of debt and the cost of the preferred stock.
2 At present, the Company's preferred stock rating is "BB", two notches below
3 PSE's corporate credit rating and below investment grade. If the Company
4 achieved the "BBB+" corporate credit rating, two notches lower would result in
5 an investment grade preferred stock rating of "BBB-". A preferred with an
6 investment grade rating would attract more investors in addition to carrying a
7 lower coupon.

8 **Q. How is the cost of preferred stock calculated?**

9 A. The cost is calculated by weighting the cost rate of each issue by the balance
10 outstanding during the rate year. The cost of reacquired preferred stock is also
11 included. Page 8 of Exhibit No. ___(DEG-6C) shows the calculation of the
12 embedded cost of preferred stock. The resulting cost of preferred stock is 7.61%,
13 as shown on page 8, line 15 of Exhibit No. ___(DEG-6C).

14 **D. <u>The Cost of Common Stock</u>**

15 **Q. Have you prepared an analysis of the Company's cost of equity?**

16 A. No, I have not. I have relied upon the analysis provided by Dr. Morin in his
17 direct testimony.

18 **Q. Do you support his recommended ROE of 11.25%?**

19 A. Yes, I believe Dr. Morin's proposed ROE is reasonable.

1 **E. <u>Overall Rate of Return</u>**

2 **Q. What is the Company's requested overall rate of return given the proposed**
3 **capital structure?**

4 A. The overall requested rate of return for the Company is 8.76%, as shown on
5 Table 1, which applies the cost rate for each capital component to the requested
6 capital structure.

7 **Q. Do you propose the same overall rate of return for gas and electric**
8 **operations?**

9 A. Yes. PSE is an integrated gas and electric company, and the capital structure and
10 cost of capital are appropriate for the integrated company. Investors purchasing
11 the Company's securities do not care whether the proceeds are used to fund gas or
12 electric investments.

13 In addition, the 11.25% ROE recommended by Dr. Morin is based on the
14 Company's integrated operations without any distinction between gas and electric
15 operations.

16 **VI. CONCLUSION**

17 **Q. Would you please summarize your testimony?**

18 A. The Company's requested overall rate of return reflects significant cost savings
19 the Company has achieved through refinancing of debt issued during higher

1 interest rate environments. With an actual common equity level of 44.13% as of
2 December 31, 2005, the Company is requesting the Commission's approval in
3 this case of a 45% equity level [redacted]
4 [redacted]. Approval of the 45% requested equity level,
5 along with the 11.25% return on equity recommended by Dr. Roger Morin and
6 the other relief the Company has requested in this case, will place the Company in
7 a financial position that is consistent with "BBB+" corporate credit rating. Such
8 an improvement, along with the other relief the Company has requested, would
9 position the Company to attract the extraordinary amount of capital it needs to
10 invest in new generating resources on behalf of its electric customers, to invest in
11 its gas and electric system infrastructure, and engage in wholesale market hedging
12 activities on behalf of its customers.

13 **Q. Does that conclude your testimony?**

14 A. Yes, it does.

15 [BA060410035]