

**EXHIBIT NO. ___(DAD-8T)
DOCKET NO. UE-121697/UG-121705
DOCKET NO. UE-130137/UG-130138
WITNESS: DANIEL A. DOYLE**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

DOCKET NOS. UE-121697
and UG-121705 (*consolidated*)

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

DOCKET NOS. UE-130137
and UG-130138 (*consolidated*)

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF
DANIEL A. DOYLE
ON BEHALF OF PUGET SOUND ENERGY, INC.**

DECEMBER 19, 2014

PUGET SOUND ENERGY, INC.
PREFILED REBUTTAL TESTIMONY
(NONCONFIDENTIAL) OF DANIEL A. DOYLE

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1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF**
3 **DANIEL A. DOYLE**

4 **I. INTRODUCTION**

5 **Q. Are you the same Daniel A. Doyle who provided prefiled direct testimony**
6 **and supporting exhibits on behalf of Puget Sound Energy, Inc. (“PSE”) in**
7 **these proceedings?**

8 A. Yes. I filed prefiled rebuttal testimony, Exhibit No. ___(DAD-1T), and
9 supporting exhibits, Exhibit No. ___(DAD-2) and Exhibit No. ___(DAD-3), on
10 May 8, 2013, in support of a Multiparty Settlement. I also filed prefiled direct
11 testimony, Exhibit No. ___(DAD-4T), and supporting exhibits, Exhibit
12 No. ___(DAD-5) through Exhibit No. ___(DAD-7), on November 5, 2014, as part
13 of these remand proceedings.

14 **Q. Please summarize the purpose of your prefiled rebuttal testimony.**

15 A. First, this prefiled rebuttal testimony responds to the Prefiled Direct Testimony of
16 Stephen G. Hill, Exhibit No. ___(SGH-2T), on behalf of the Public Counsel
17 Section of the Washington Attorney General’s Office (“Public Counsel”), with
18 respect to (i) Mr. Hill’s flawed analyses of the effect of decoupling on cost of
19 capital and (ii) Mr. Hill’s testimony addressing PSE’s earnings sharing
20 mechanism.

21 Second, this prefiled rebuttal testimony responds to the Prefiled Response
22 Testimony of Michael P. Gorman, Exhibit No. ___(MPG-23T), on behalf of the

1 Industrial Customers of Northwest Utilities (“ICNU”), with respect to the
2 potential effect of the decoupling mechanism on PSE’s cost of capital.

3 Third, this prefiled rebuttal testimony responds to the Prefiled Testimony of
4 Thomas E. Schooley, Exhibit No. ____ (TES-6T), on behalf of Staff of the
5 Washington Utilities and Transportation Commission (“Commission Staff”), with
6 respect to PSE’s earnings sharing mechanism.

7 **Q. Do you have any general observations with respect to the response testimony**
8 **filed by the Industrial Customers of Northwest Utilities and Public Counsel?**

9 A. Yes. Both Public Counsel and ICNU argue that the Commission should lower
10 PSE’s return on equity as a result of the implementation of revenue decoupling in
11 2013.¹ As I stated in my prefiled direct testimony,² it is PSE’s position that the
12 Commission was correct when it determined in Order 07 in this proceeding that
13 this issue should be addressed in PSE’s next general rate case, after the
14 decoupling mechanisms have been in place for a reasonable period of time:

15 Experience going forward with decoupling in place for PSE as
16 various of its debt instruments mature over the next several years
17 will provide valuable information to the Commission.³

18 However, because Public Counsel and ICNU have asked and continue to ask the
19 Commission to make a determination on the effect of decoupling on cost of

¹ See, e.g., Hill, Exh. No. ____ (SGH-2T), at page 45, lines 16-18 (arguing that “the cost of equity impact of decoupling indicates that a reasonable and conservative estimate is 35 basis points”); Gorman, Exh. No. ____ (MPG-23T), at page 4, line 18 (arguing that “[a] 20 to 30 basis point reduction in PSE’s return on equity would be appropriate”).

² Doyle, Exh. No. ____ (DAD-4T), at page 6, lines 1-19.

³ *WUTC v. Puget Sound Energy, Inc.*, Order 07 Final Order Granting Petition ¶ 105, Dockets UE-121697, et al. (consolidated) (June 25, 2013) (“Order 07”).

1 capital, PSE has filed testimony rebutting the Public Counsel and ICNU testimony
2 on this topic.

3 Public Counsel and ICNU portray a one-sided view of revenue decoupling,
4 arguing that PSE's allowed return on equity should be reduced because of
5 decoupling, with no sound basis for such a reduction. Public Counsel and ICNU
6 fail to recognize the important state policy goals that are achieved as part of the
7 Commission's approval of the decoupling mechanism and the benefits that flow
8 to customers as a result of the decoupling mechanism. Revenue decoupling is an
9 important part of the Washington State energy policy, designed to eliminate a
10 utility's reliance on increased customer energy usage as a means to recover its
11 fixed costs. It is intended to remove barriers to conservation and energy
12 efficiency—a least cost resource that benefits all customers.⁴

13 Moreover, the decoupling mechanism is balanced—its deferrals go both ways.
14 Customers can benefit under decoupling if weather is colder than normal causing
15 increased usage in the cold weather months, and PSE can benefit if the weather is
16 warmer than normal. Either way, however, the deferrals are modest and certainly
17 do not support a reduction in PSE's cost of capital.

18 Finally, PSE's revenue decoupling mechanism only applies to a subset of PSE's
19 revenues—delivery revenues which constitute approximately one-third of PSE's
20 total revenues. For these reasons, and as discussed further in the prefiled rebuttal

⁴ See, e.g., Order 07 at ¶ 112.

1 testimony filed by PSE, the Commission should not reduce PSE's return on equity
2 in this proceeding.

3 **II. INTRODUCTION OF PSE WITNESSES**

4 **Q. Is PSE offering other witnesses who present rebuttal testimony on behalf of**
5 **PSE?**

6 **A.** Yes. In addition to this rebuttal testimony, PSE is filing rebuttal testimony from
7 the following witnesses:

- 8 (i) The Prefiled Rebuttal Testimony of Dr. Roger A. Morin,
9 Exhibit No. ___(RAM-16T), rebuts the prefiled testimony
10 of Stephen Hill and Michael Gorman with respect to their
11 cost of capital analyses that advocate for a return on equity
12 below PSE's currently allowed return of 9.8 percent.
13 Dr. Morin demonstrates that the return on equity of 9.8%
14 allowed by the Commission in Order 08 in Dockets UE-
15 111048 and UG-111049⁵ remained within the range of
16 reasonableness when the Commission issued its Order 07 in
17 these proceedings and remains within the range of
18 reasonableness through the rate plan period.
- 19 (ii) The Prefiled Rebuttal Testimony of Dr. Michael J. Vilbert,
20 Exhibit No. ___(MJV-18T), rebuts the testimony of
21 Stephen Hill, Michael Gorman, and Dr. Christopher
22 Adolph with respect to the effect of decoupling on cost of
23 capital.
- 24 (iii) The Prefiled Rebuttal Testimony of Dr. Jeffrey A. Dubin,
25 Exhibit No. ___(JAD-1T), specifically rebuts the testimony
26 of Dr. Christopher Adolph with respect to his testimony on
27 statistical principles and interpretation.

⁵ *WUTC v. Puget Sound Energy, Inc.*, Order 08 Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing, Dockets UE-111048 and UG-111049 (consolidated) (May 7, 2012).

1 capital and can be substantially reduced by applying standard portfolio
2 diversification practices.

3 Second, as previously stated in earlier testimony, given that equity and debt
4 investors typically consider a long-term investment horizon, over time the effects
5 of weather will cancel out or average to be immaterial and therefore should be
6 discounted entirely when deciding an appropriate risk-return profile. Exhibit
7 No. ___(DAD-9) demonstrates this using heating degree days (“HDDs”) and
8 cooling degree days (“CDDs”) for locations within PSE’s service territory. As
9 demonstrated in this exhibit, there are material variations around the mean
10 number of HDDs and CDDs in any given year, but these variations revert to the
11 mean number of HDDs and CDDs over time. In summary, the revenues that are
12 recognized under PSE’s decoupling deferral mechanism will closely approximate
13 the trend line that averages or smoothes the effects of weather in revenue that is
14 billed to customers over time. Thus, the portion of decoupling revenue
15 adjustments attributable to weather has no material long-term effect on utility
16 revenues and can be disregarded in terms of assessing any impacts on cost of
17 capital.

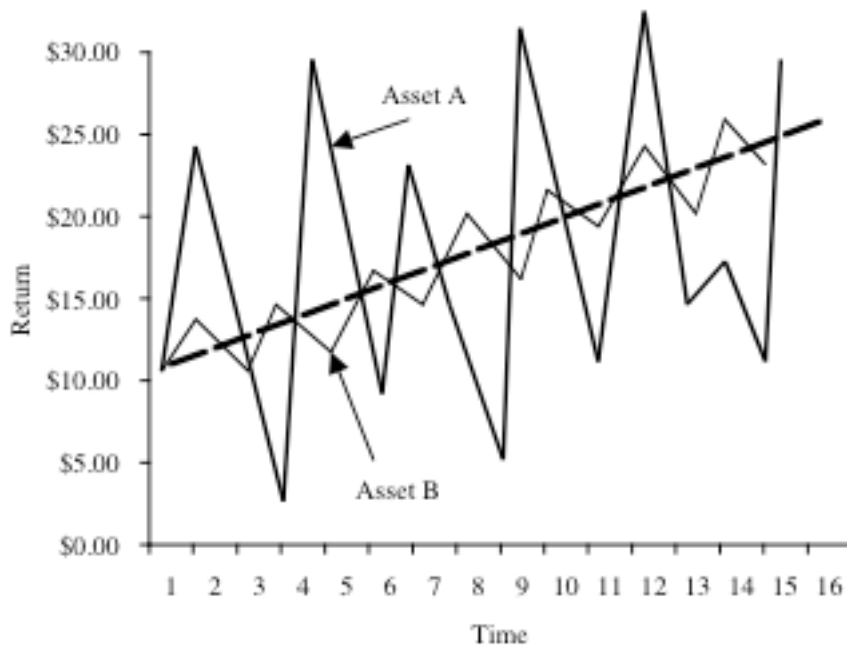
18 **Q. Has PSE identified flaws in Mr. Hill’s testimony with respect to the alleged**
19 **impact of decoupling on cost of capital?**

20 A. Yes. There are several fundamental flaws in Mr. Hill’s logic in determining both
21 the inherent impact of decoupling on the risk profile of a utility and ultimately his
22 translation and application of his assertions on risk reduction to PSE’s historical
23 financial performance as calculated in Exhibit No. ___(SGH-19).

1 **Q. Please elaborate on the flaws in Mr. Hill’s analyses.**

2 A. First, Mr. Hill uses the concepts of “revenue”, “net revenue”, “income”, “return”,
3 and “cash flow” interchangeably and incorrectly as it relates to his analysis of
4 volatility to quantify the impacts of decoupling on cost of capital. His analysis
5 erroneously relies on the assumption that there is a correlation coefficient of one
6 between the volatility inherent in (i) a utility’s revenues and net revenues and
7 (ii) its net income, returns and cash flows, in an attempt to validate his regression
8 analysis methodology for quantifying reductions to PSE’s return on equity due to
9 decoupling. For example, on pages 107 and 108 of his testimony, Mr. Hill
10 discusses risk to equity investors as one of volatility in “Return” over “Time”, as
11 shown in the chart below “Y” axis and “X” axis labeling in the graphic below,
12 taken directly from page 108 of Mr. Hill’s testimony.

13 **Chart VI**
14 **Volatility and Risk**



15

1 In summary, the case presented by Mr. Hill suggests that the more volatile the
2 returns over time, the riskier the asset becomes, thereby causing investors to
3 demand higher expected returns. In the graph above, investors in asset A would
4 therefore require higher expected returns than investors in asset B. I have no
5 quarrel with his analysis to this point. Mr. Hill continues, however, to state as
6 follows:

7 When an investor purchases a share of utility stock, he or she is
8 purchasing an expected future stream of dividends and growth in
9 that dividend, or capital appreciation when the stock is sold. That
10 dividend expectation is, in turn, dependent on the revenue *and*
11 *income* earned by the utility⁸

12 In this statement, Mr. Hill begins to improperly equate and draw parallels between
13 the volatility inherent in revenue, income and dividends (aka cash flows).

14 Although revenues, income, and cash flow are “related”, most of the operating
15 expenses (setting aside power cost and gas costs) of any utility, including PSE,
16 that are deducted from revenues to arrive at income and residual cash flows are
17 incurred and recognized independently of revenues. For example, operating
18 expenses such as line clearance expense, depreciation expense, maintenance
19 expense, current and deferred income tax expense, storm damage repair, bad debt
20 expense, and interest expense are all recorded independently of accrued revenues.

21 Because these expenses nearly always differ from what is included in the revenue
22 requirement underlying the revenues for a given period of time, it logically
23 follows that the volatility of revenues or net revenues is an *inappropriate* proxy

⁸ Hill, Exh. No. ___(SGH-2T), at page 108, lines 11-14.

1 for the volatility of income, returns or residual cash flows. Stated alternatively,
2 volatility in operating expense recognition will create variability in net income,
3 returns and residual cash flow that is different from and not present in the
4 variability of revenues or net revenues.

5 **Q. Does Mr. Hill recognize this point in his testimony?**

6 A. Yes. Mr. Hill expressly states as follows:

7 [I]t is intuitively obvious that the more the utility's revenue
8 volatility is eliminated by decoupling, the greater the risk reduction
9 caused by decoupling and the lower the allowed equity return
10 should be. *If, for example, operating costs were constant and 100*
11 *percent of the revenue variance of a utility were due to factors*
12 *eliminated by decoupling, that ratemaking mechanism could*
13 *effectively turn a utility equity investment into a bond-like*
14 *financial instrument. In that extreme theoretical instance, the level*
15 *of uncertainty regarding the expected return that normally*
16 *accompanies a utility equity investment would be significantly*
17 *reduced*⁹

18 Thus, by Mr. Hill's own admission, one must hold operating expenses constant
19 for his "extreme theoretical" methodology to hold true. In reality operating costs
20 cannot be held constant. Therefore, the volatility in revenues or net revenues is an
21 inappropriate and unacceptable proxy for the volatility of income, returns and
22 residual cash flows as a means for assessing the impact of risk or volatility on cost
23 of capital.

⁹ Hill, Exh. No. ____ (SGH-2T), at page 110, lines 5-13 (emphasis added).

1 **Q. Did PSE perform any additional analysis to confirm the contention that the**
2 **volatility of revenues or net revenues are inappropriate and unacceptable**
3 **proxies for the volatility of income, returns and residual cash flows?**

4 A. Yes. To test whether the volatility of revenues or net revenues are appropriate
5 and acceptable proxies for the volatility of income, returns and residual cash
6 flows, PSE performed two regression analyses using the same model presented
7 on page 1 of Mr. Hill's Exhibit No. ___(SGH-19). Instead of using "net
8 revenues" as the dependent variable in these analyses, PSE substituted net income
9 in one case and operating cash flow in the other.

10 **Q. Why did PSE replicate Mr. Hill's regression analyses using net income and**
11 **operating cash flow as variables?**

12 A. PSE wanted to test what Mr. Hill's model would yield using more appropriate
13 variables (i.e., net income and operating cash flow). In performing these tests and
14 providing the results, PSE neither endorses nor supports the mechanics of
15 Mr. Hill's model or the results provided. PSE simply wished to demonstrate that
16 Mr. Hill's model produces much different results if he were to substitute more
17 appropriate variables (i.e., net income and operating cash flow) for the variable
18 selected by Mr. Hill (i.e., net revenues).

19 **Q. What results would Mr. Hill's model provide if he were to use net income**
20 **rather than net revenue as the variable?**

21 A. If Mr. Hill had used net income as the variable in his model, the results would
22 have shown that the effects of weather and the economy, both of which are

1 implied in Mr. Hill's testimony as being mitigated by decoupling, have a
2 negligible effect on the variability of PSE's net income. Please see Exhibit
3 No. ___(DAD-10) for the results of the regression analysis, using net income
4 rather than net revenue as the dependent variable.

5 Mr. Hill's linear regression modelling results show an R-squared of 0.9.¹⁰ Based
6 on this R-squared value, Mr. Hill claims that changes in local weather and state
7 economic conditions account for 90% of the variation in PSE's net revenues.¹¹
8 However, rerunning Mr. Hill's linear regression model with net income—not net
9 revenue—produces an R-squared value of 0.28. Such a low R-squared value
10 indicates that changes in weather and state economic conditions have very little
11 predictive relevance to PSE's net income variability. Therefore, the significant
12 difference in the net income and net revenue regression modeling results confirm
13 my contention that many other factors differentiate the variability between net
14 revenue and net income.

15 **Q. What results would Mr. Hill's model provide if he were to use operating cash**
16 **flow rather than net revenue as the variable?**

17 A. If Mr. Hill had used operating cash flow as the variable in his model, the results
18 would have also shown that the effects of weather and the economy, both of
19 which are implied in Mr. Hill's testimony as being mitigated by decoupling, have
20 a lesser effect on the variability of PSE's net income cash flow than suggested by

¹⁰ Hill, Exh. No. ___(SGH-19), at page 1.

¹¹ Hill, Exh. No. ___(SGH-2T), at page 111, line 16, through page 112, line 6.

1 Mr. Hill. Please see Exhibit No. ___(DAD-11) for the results of the regression
2 analysis, using cash flow rather than net revenue as the dependent variable. As
3 shown in Exhibit No. ___(DAD-11), weather and the economy only explain 48%
4 of the variability in cash flows. Here again, this provides little explanatory power
5 and is of little practical use. In effect, these factors explain about as much
6 variability in cash flows as would flipping a coin.

7 Aside from the statistical invalidities of using net revenues to capture volatility for
8 evaluating cost of capital impacts discussed above, it is a well-known fact that
9 debt and equity investors and analysts utilize “bottom line”, income and cash
10 driven metrics to assess risk and impacts on cost of capital. For example,
11 Moody’s and Standard & Poor’s calculate key leverage and interest coverage
12 ratios against Cash from Operations and Funds from Operations, respectively, to
13 assess credit worthiness and default risk. Similarly, equity investors are bottom
14 line, income and cash flow focused. Net income, dividend payout ratios, cash
15 generated from operations and return on equity are all important metrics for
16 assessing the risks inherent in, and the ultimate attractiveness of, an investment.
17 In utility circles in particular, it is common knowledge that dividends are one of
18 the primary inputs to calculating discounted cash flow valuations of investment
19 valuation and cost of capital. All of these analytical perspectives include the
20 deduction of all operating and other expenses—the complete results of operations.
21 By focusing his analysis only on net revenues, Mr. Hill ignores the impact of
22 operating and other expenses. In doing so, he fails to translate the effects, if any
23 exist at all, of decoupling into metrics and terms that debt and equity investors

1 and analysts regularly utilize to assess risk and cost of capital. There is simply no
2 logical path or rationale to bridge from Mr. Hill's analysis and methodology to
3 how debt and equity investors and analysts assess risk and cost of capital.

4 **Q. What are the economic effects of Mr. Hill's recommendations relative to the**
5 **actual results of decoupling in its first year of operation?**

6 A. Mr. Hill's recommendations are economically disproportionate and illogical. In
7 my prefiled direct testimony, I indicated that the non-weather related net electric
8 and gas decoupling revenues were \$1.9 million or .06% of total operating
9 revenue, .03% of rate base, and .35% of operating income in the first full year of
10 the decoupling regime approved by the Commission in this docket.¹² Yet with
11 these actual results recorded and in the books, Mr. Hill would have this
12 Commission reduce PSE's return on equity by 35 basis points or approximately
13 \$10 million of operating income.¹³ This is a curious if not illogical result—the
14 economic effects of his recommendation are disproportionate and bear no logical
15 relationship to the actual financial results of the first year of decoupling. These
16 facts and results on their own should be reason enough for the Commission to
17 wait for the passage of time to gather more information about the potential effects
18 of decoupling. Mr. Hill recommends in his testimony that the Commission has
19 enough information and data to reduce PSE's return on equity at this time for the
20 effects of decoupling based on his analysis alone. Consistent with my prefiled

¹² Doyle, Exh. No. ___(DAD-4T), at page 25, line 21, through page 26, line 5.

¹³ Hill, Exh. No. ___(SGH-2T), at page 122, lines 1-7.

1 direct testimony and the disproportionality of Mr. Hill’s recommendation to the
2 actual decoupling results, clearly more time is needed before any adjustments are
3 made to return on equity for the effects of decoupling.

4 In light of the myriad critical flaws in Mr. Hill’s analysis, the Commission should
5 give no weight to, and completely disregard, his testimony with respect to the
6 alleged impact of decoupling on equity cost of capital.

7 **B. Mr. Hill Erroneously Disregards the Fact that PSE’s Opportunity to**
8 **Earn Its Return Has Been Skewed Towards Under-Earning Because**
9 **of the Structure of the Earnings-Sharing Mechanism Imposed on**
10 **PSE that is Negatively Skewed Towards Under-Earning**

11 **Q. Is Mr. Hill correct in asserting that PSE’s “risk is not raised by the sharing**
12 **mechanism—[PSE] is earning its investor-required return prior to sharing**
13 **any additional return above the cost of capital”¹⁴?**

14 A. No. The assertion that PSE’s risk is not increased by the earnings sharing
15 mechanism is fundamentally incorrect. In his testimony Mr. Hill references
16 *Hope*¹⁵ and *Bluefield*¹⁶ and recognizes that a utility should be given an
17 opportunity to earn returns that are sufficient to attract capital and are comparable
18 to returns investors would expect in the unregulated sector for assuming the same
19 degree of risk:

¹⁴ Hill, Exh. No. ____ (SGH-2T), at page 48, lines 14-16.

¹⁵ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

¹⁶ *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*,
262 U.S. 679 (1923).

1 A public utility is entitled to such rates as will permit it to earn a
2 return on the value of the property which it employs for the
3 convenience of the public *equal to that generally being made at*
4 *the same time and in the same general part of the country on*
5 *investments in other business undertakings which are attended by*
6 *corresponding risks and uncertainties . . .*¹⁷

7 Inherent in the opportunity to earn returns sufficient to attract capital in
8 competitive capital markets is the notion that utilities will sometimes over- and
9 sometimes under-earn their allowed returns, but, on average over time, utilities
10 should have the chance to earn their allowed returns. Mr. Hill captures this notion
11 via application of a common statistical method to measure the operating risk of a
12 utility by using calculations for statistical variance and standard deviation of
13 earnings around a normal distribution.

14 My direct testimony shows that an earnings sharing mechanism, both with or
15 without a 25 basis point “dead band”, disrupts the normal distribution of earnings
16 around the mean allowed return and has the effect of skewing the normal
17 distribution negatively towards a higher probability of occurrences where a utility
18 will not, on average, earn its allowed return.

19 Under standard statistical interpretation, the mean of a data set that is skewed
20 from normal either positively or negatively will move in the direction of the
21 skew—the side of the histogram with the most extreme values. Thus, the skew
22 created by the sharing mechanism reduces the mean or the opportunity to earn
23 allowed returns on average over time. To make the point a different way, albeit in
24 the extreme, assume the Commission required all over-earning above PSE’s

¹⁷ *Bluefield Water Works & Improvement Co.*, 262 U.S. at 692 (emphasis added).

1 7.77% rate of return to be refunded to customers. In this case, all upside potential
2 to earn over 7.77% would be eliminated and the probability histogram would shift
3 and skew completely to the left of 7.77% because there would be no opportunity
4 to earn above 7.77%. Thus, it is clear and stands to reason that sharing 50% of
5 every dollar of over earnings causes a similar directional effect—a shift and skew
6 of the mean and distribution, respectively, to the left—just not as much as 100%
7 sharing would cause.

8 **IV. RESPONSE TO THE PREFILED DIRECT TESTIMONY OF**
9 **MICHAEL P. GORMAN**

10 **Q. Are you testifying as to Mr. Gorman’s arguments regarding the potential**
11 **impacts of decoupling mechanisms on returns on equity of utilities?**

12 A. In this rebuttal testimony, I address Mr. Gorman’s suggestion that a potential
13 impact of decoupling mechanisms is to reduce utilities’ default risks. In addition
14 to this argument, the Prefiled Response Testimony of Michael P. Gorman, Exhibit
15 No. ___(MPG-23T), makes various arguments regarding the potential impacts of
16 decoupling mechanisms on returns of equity of utilities. Please see the Prefiled
17 Rebuttal Testimony of Dr. Michael J. Vilbert, Exhibit No. ___(MJV-23T), for
18 PSE’s further response to Mr. Gorman’s arguments with respect to the impacts of
19 decoupling.

1 **Q. Please describe Mr. Gorman's suggestion that a potential impact of**
2 **decoupling mechanisms is to reduce utilities' default risks.**

3 A. Mr. Gorman's testimony suggests that he agrees with Dr. Vilbert that decoupling
4 mechanisms reduce utilities' default risks:

5 [Dr. Vilbert] finds that credit ratings represent the credit rating
6 agency's estimate of the probability that an investor in a
7 company's debt will receive the promised interest and principal
8 payments. He believes that debt holders benefit from decoupling
9 and other such regulatory mechanisms because the volatility of a
10 utility's revenues is decreased, which reduces the probability of
11 default.

12 This is clearly the case for PSE.¹⁸

13 As suggested in Mr. Gorman's testimony, there is no disagreement between
14 Dr. Vilbert and Mr. Gorman with respect to this position. Indeed, Dr. Vilbert's
15 direct testimony states as follows:

16 Credit ratings represent the credit rating agencies' estimation of the
17 probability that an investor in a company's debt will receive the
18 promised interest and principal payments. In other words, the
19 credit rating represents a measure of the likelihood that the
20 company will not default. Debt holders clearly benefit from
21 decoupling and other such measures because the volatility of a
22 company's revenues is decreased which reduces the probably of
23 default.¹⁹

24 **Q. How does PSE respond to this line of argument?**

25 A. PSE has no reason to disagree with either Mr. Gorman or Dr. Vilbert in their
26 shared opinions that decoupling mechanisms reduce utilities' default risks. If and
27 to the extent that this reduction in risk to debt holders results in a lower cost of

¹⁸ Gorman, Exh. No. ___(MPG-23T), at page 57, line 22, through page 58, line 3 (footnote omitted).

¹⁹ Vilbert, Exh. No. ___(MJV-1T), at page 15, lines 16-21.

1 debt to utilities, PSE notes that these cost reductions are not immediate but are
2 instead reflected in the costs of future debt issuances. For example, PSE's debt
3 costs have not changed due to the adoption of the decoupling mechanism because
4 PSE has not issued additional debt or refinanced existing debt since adoption of
5 the decoupling mechanism. If the decoupling mechanisms were to reduce the
6 costs of PSE's debt, those reduced costs will be reflected in those issues, and
7 PSE's customers will benefit from these reduced debt costs over time. In this
8 regard, it would be premature for the Commission to reduce PSE's existing cost
9 of capital to reflect any potential reduction in risk to PSE's debt holders.

10 **V. RESPONSE TO THE PREFILED DIRECT TESTIMONY OF**
11 **THOMAS E. SCHOOLEY**

12 **Q. Do you equate the opportunity to earn an allowed return with a guarantee**
13 **that rates will not be challenged when earnings are greater than allowed as**
14 **suggested by Mr. Schooley?**²⁰

15 A. No, my prefiled direct testimony makes no such inference that the opportunity to
16 earn an allowed return with a guarantee that rates will not be challenged when
17 earnings are greater than allowed. My prefiled direct simply demonstrates that an
18 earnings sharing mechanism without a dead band above the allowed rate of return
19 changes the earnings distribution profile related to return on equity to the negative
20 and, all else being equal, changes the traditional balance that underlies a utility's
21 opportunity to earn its allowed return on equity. In other words, a utility will

²⁰ Schooley, Exh. No. ____ (TES-6T), at page 8, lines 18-20.

1 sometimes under-earn and will sometimes over-earn its allowed return on equity.
2 On balance, however, the opportunity of the utility to earn its allowed return on
3 equity would be preserved. The earnings sharing mechanism clearly alters this
4 balance. Please see Part III.B. of this prefiled rebuttal testimony for further
5 discussion of this topic.

6 **Q. What is your response to Mr. Schooley’s testimony on earnings sharing?**

7 A. I agree that the Commission Basis Report is a measure of a utility’s rate of return
8 and return on equity under adjusted or normal conditions and is filed pursuant to
9 the requirements of WAC 480-100-257 and WAC 480-90-257. In effect, the
10 Commission Basis Report rate of return and return on equity reflect what a utility
11 would have earned if its actual results were *adjusted or normalized*—just as test
12 year actual results are *adjusted or normalized* in a general rate case proceeding.

13 My analysis relates to *actual* results after incorporating hypothetical earnings
14 sharing that would be identified in a Commission Basis Report. This is an
15 important distinction because investors measure risk and its impact on cost of
16 capital on actual results not adjusted or normalized Commission Basis Report
17 results. The analysis is useful to inform the decision around where to set a
18 utility’s allowed return on equity because I focus on actual results.

19 My prefiled direct testimony demonstrated that when an earnings sharing
20 mechanism, with or without a dead band, is introduced it changes a utility’s actual

1 earnings profile and results in downward pressure on return on equity.²¹ It is
2 appropriate to consider this when establishing the appropriate allowed return on
3 equity.

4 **Q. How do you interpret Mr. Schooley’s testimony regarding the actual returns**
5 **calculated in a Commission Basis Report?**

6 A. Mr. Schooley appears to be suggesting that, if the same allowed rate of return and
7 return on equity are in effect through the entire Commission Basis Report period
8 and most importantly, a utility is experiencing zero attrition, then the rate of
9 return and return on equity reported in the Commission Basis Report will equal its
10 allowed returns.²²

11 **Q. Do you agree with this theory?**

12 A. Not completely. Weather and hydro conditions are normalized and material out-
13 of-period, non-operating, non-recurring and extraordinary items are removed in a
14 Commission Basis Report. Nonetheless, it is simply impractical to assume that all
15 costs can or will be normalized in a Commission Basis Report. Indeed, there are
16 other factors not adjusted in a Commission Basis Report that could result in a
17 utility not realizing its allowed returns.

18 **Q. Please elaborate.**

19 A. For instance, PSE has a PCA mechanism that contains a dead band and sharing
20 bands (“bands”), wherein PSE absorbs and then shares power and production cost

²¹ Doyle, Exh. No. ___(DAD-4T), at page 8, lines 18-20.

²² See, e.g., Schooley, Exh. No. ___(TES-6T), at page 9, lines 8-12.

1 over or under recoveries on a graduated basis. The effect of the PCA bands is that
2 PSE does not fully defer variations between rates and actual costs of power as is
3 done in its Purchase Gas Adjustment (PGA) mechanism. The effects of the PCA
4 bands do not get normalized in Commission Basis Reports and provide an
5 example of how the returns reported on a Commission Basis Reports for a utility
6 experiencing the conditions that Mr. Schooley appears to presume in his example
7 (i.e. same allowed returns and no attrition) may not equal its allowed returns.

8 In fact, the impact of PSE's PCA bands and the impacts of power cost variations
9 can be an increase or a decrease to its returns, which is relevant to the example I
10 provided in my prefiled direct testimony, Exhibit No. ____ (DAD-4T). On average,
11 over multiple years with the same returns in effect, it would be expected that
12 some years PSE may over-earn and some years PSE may under-earn its allowed
13 return, but on average, the actual returns would be expected to approximate PSE's
14 allowed returns.

15 **Q. Have you prepared an exhibit that demonstrates the downward pressure on**
16 **return on equity of an earnings sharing mechanism?**

17 A. Yes. Please see Exhibit No. ____ (DAD-12) for a simplified example of the
18 impacts on return on equity of PSE's current earnings sharing mechanism with no
19 dead band.

20 Exhibit No. ____ (DAD-12) begins with PSE's electric results of operations
21 reported in Docket No. UE-140536 for the twelve months ended December 31,
22 2013. As seen on rows 15 and 28, PSE was under its allowed returns by 0.21%
23 for rate of return and 0.74% for return on equity. Columns (B) and (C)

1 demonstrate that, even if PSE had enough additional net operating income to
2 achieve its allowed rate of return, it would still be under-earning its allowed return
3 on equity by 0.30%.

4 **Q. What could cause a utility to not earn its allowed return on equity even**
5 **though it is earning its allowed rate of return?**

6 A. The example provided earlier with respect to the PCA bands demonstrates one
7 reason a utility might fail to earn its allowed return on equity even though it is
8 earning its allowed rate of return. Additionally, this could occur due to attrition
9 where a utility's revenues, expense and rate base are not in alignment with the
10 rates that are in effect.

11 **Q. Please continue your explanation of your Exhibit No. ___(DAD-12).**

12 A. Columns (D) and (E) demonstrate that, if the company had enough additional net
13 operating income to achieve its allowed return on equity, then it would be over-
14 earning its rate of return by 0.15%. Column (F) demonstrates that, if PSE's
15 earnings sharing mechanism contained a 25 basis point dead band, then PSE
16 would have been allowed to keep the 0.15% rate of return above its allowed
17 return, which would in turn have allowed PSE to earn its allowed return on equity.
18 Because the Commission removed the earnings sharing dead band in this
19 example, however, PSE would not be allowed to keep the 0.15% above its
20 allowed rate of return. Column (G) demonstrates that PSE would share half of the
21 0.15%, or 0.08% with customers. In turn, this sharing reduces PSE's return on
22 equity below the allowed return on equity by 0.15%. This progression clearly
23 demonstrates that removal or narrowing of the earnings sharing dead band

1 negatively skews the distribution of PSE's opportunity to earn its allowed returns
2 on average over time.

3 **Q. What should the Commission do about the impacts of the sharing band**
4 **described above and in your prefiled direct testimony?**

5 A. PSE originally signed on to a Global Settlement that was the genesis of this
6 proceeding. As part of the final adjudication of that settlement, the Commission
7 approved an order that included an allowed return on equity of 9.8% and an
8 earnings sharing mechanism. As discussed above, that earnings sharing
9 mechanism eliminated the dead band that PSE had originally proposed, and the
10 effect of that change is important to note as the Commission hears more complete
11 testimony on the subject of whether PSE's return on equity is reasonable. That
12 said, PSE is not advocating for any change to the original terms of the
13 Commission's order. PSE believes that its allowed return on equity of 9.8% is
14 most reasonable based on the testimony of Dr. Morin and it should not be
15 changed. PSE also believes that (i) there is no reliable evidence that decoupling
16 affects return on equity in any measurable way and (ii) its allowed return on
17 equity of 9.8 percent should not be adjusted due to decoupling. PSE is willing to
18 live with the current earnings sharing mechanism approved by the Commission so
19 long as no other changes are made to its allowed return on equity of 9.8 percent or
20 the 48% equity component of the capital structure. To the extent the Commission
21 makes a change to either PSE's current allowed return on equity or capital
22 structure, then the Commission should make an offsetting adjustment to

1

compensate for the downward pressure the earnings sharing mechanism puts on

2

PSE's earnings.

3

VI. CONCLUSION

4

Q. Does that conclude your prefiled rebuttal testimony?

5

A. Yes, it does.