EXH. DAD-1Tr
DOCKETS UE-190529/UG-190530
2019 PSE GENERAL RATE CASE
WITNESS: DANIEL A. DOYLE

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**Docket UE-190529** **Docket UG-190530**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

DANIEL A. DOYLE

ON BEHALF OF PUGET SOUND ENERGY

REVISED
AUGUST 22, 2019

JUNE 20, 2019

PUGET SOUND ENERGY

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DANIEL A. DOYLE

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I. INTRODUCTION

Q. Please state your name, business address, and position with Puget Sound Energy.

A. My name is Daniel A. Doyle. My business address is 355 110th Avenue NE, P.O. Box 97034, Bellevue, WA 98009-9734. I am Senior Vice President and Chief Financial Officer of Puget Sound Energy ("PSE").

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

A. Yes. Please see the First Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-2, which also describes my duties as PSE's Chief Financial Officer.

Q. What is the nature of your prefiled direct testimony in this proceeding?

A. This prefiled direct testimony addresses the following:

(i) actions taken by PSE prior to and during the test year to improve its earnings;

(ii) the request for an attrition adjustment to address the backward-looking, historical nature of traditional ratemaking;

(iii) PSE's request for a 9.8 percent return on equity and a 48.5 percent equity ratio; and

(iv) PSE's credit ratings.

Q. Please summarize your testimony

A. PSE is requesting a 9.8 percent return on equity and a 48.5 percent equity ratio. It is important to understand the context within which PSE makes this request. Tax reform had a significant negative impact on PSE's cash flow. The Prefiled Direct Testimony of Matthew R. Marcelia, Exh. MRM-1T, quantifies the test year reduction to PSE's cash flow at $107 million. This reduction in cash flow resulted in significant degradation of PSE's cash flow-based credit metrics, notwithstanding the actions taken by PSE prior to and during the test year to improve its earnings. Accordingly, PSE's requested 9.8 percent return on equity and 48.5 percent are important components of restoring the negative cash flow impacts caused by tax reform.

PSE considered the impact of two significant requests that are an integral part of this filing in connection with restoring the negative impacts of tax reform. The first is the requested attrition adjustment that will increase rate year after-tax cash flows by approximately $40 million. The second is the use of end-of-period rate base to determine the revenue requirement in this filing, which will increase test year after-tax flows by approximately $51 million. The end-of-period rate base cash flow increase includes depreciation and the after tax equity return. These two items will restore approximately $91 million of the $107 million test year after-tax cash flow deficit related to tax reform and will improve PSE's cash-based credit metrics toward pre-tax reform levels.

As discussed in this prefiled direct testimony, PSE's authorized returns on equity and equity ratios have historically been below industry averages, which has been and continues to be a credit rating negative. Over time, PSE believes its ability to compete for capital would be improved if its return on equity and equity ratio were closer to industry averages. PSE's requested return on equity of 9.8 percent would be very close to industry averages, but PSE's requested capital structure with an equity ratio of 48.5 percent would remain below industry averages.

PSE's requested capital structure with an equity ratio of 48.5 percent is consistent with a more gradual, flexible approach to improve PSE's ability to compete for capital and restore pre-tax reform cash flow and funds from operations over time. Given the significant cash flow benefits that arise from PSE's requested attrition and end of period rate base adjustments to the equity ratio toward industry averages can be made incrementally over time to mitigate rate impacts to customers.

II. ACTIONS TAKEN BY PSE PRIOR TO AND DURING THE TEST YEAR TO IMPROVE ITS EARNINGS

Q. Did PSE earn its authorized rate of return during the test year?

A. No, as discussed in detail later in this testimony, PSE did not earn either its authorized rate of return of 7.6 percent or its authorized return on equity of 9.5 percent during the test year. As reported in the Commission Basis Reports filed with the Commission on March 28, 2019, in Dockets UE-190211 and UG-190212 (the "2018 Commission Basis Reports"), PSE's earned the following rates of return and returns on equity:

(i) the 2018 Commission Basis Reports states that PSE's electric business earned a rate of return of 7.12 percent and a return on equity of 8.54 percent during the test year; and

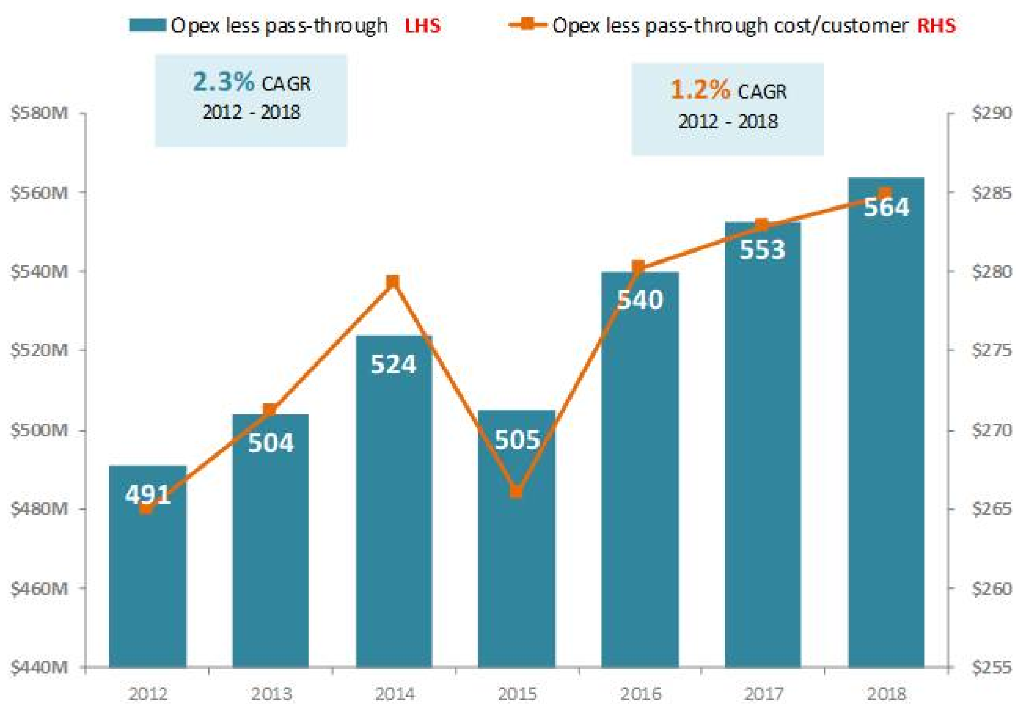
(ii) the 2018 Commission Basis Reports states that PSE's gas business earned a rate of return of 5.64 percent and a return on equity of 5.5 percent during the test year.

Q. What actions has PSE taken during the test year to improve its earnings in addition to its request for increased rates?

A. As an organization that provides essential services to its customers, it is incumbent upon PSE to provide that service at a reasonable price to customers and simultaneously maintain its financial performance to adequately reward both debt and equity investors and maintain access to the capital markets at a reasonable cost. To meet these important ends, PSE implemented a broad-based approach to manage operating expenditures. Simply put, growth in budgets and spending were targeted at the rate of customer growth during both the rate plan and test year in this proceeding. It should be noted that this approach is intended to be more of a guideline to manage spending rather than a strict target.

As illustrated in Figure 1 below, PSE continues to manage the growth of operation and maintenance expense per customer (excluding pass-through items such as low income and Commission fees) to an annual average increase of 1.2 percent compound average growth rate during the 2012-2018 period, which is under the ongoing average annual rate of inflation of 1.56 percent[1] and the customer growth rates of 1.3 percent for gas and electric combined during the same period.

Figure 1. PSE's Growth in Operations and Maintenance Costs 2012-2018



Q. Can you provide specific examples of cost efficiencies that PSE realized to manage the growth of operations and maintenance expense?

A. Yes. As shown in Figure 1 above, PSE's has managed operation and maintenance expenses to the rate of customer growth. This places an effective ceiling on cost

[1] Federal Reserve Bank of Minneapolis, *Consumer Price Index, 1913-*, available at https://www.minneapolisfed.org/community/financial-and-economic-education/cpi-calculator-information/consumer-price-index-and-inflation-rates-1913

growth and ensures that limited cash resources are driven toward higher priority initiatives for the benefit of customers.

Another example of cost-saving measures implemented by PSE to manage the growth of operations and maintenance expense is the cost efficiency and innovation program, commonly known within PSE as the "Be Excellent" program. This program has generated estimated savings totaling $11.9 million over three years (annual average savings of about $4 million). These savings have been generated from a number of small activities, including deactivating under-utilized mobile devices and identifying opportunities for process improvement and automation. The "Be Excellent" program is clearly producing tangible cost efficiency benefits.

Finally, PSE's "Get to Zero" initiative has delivered cost efficiencies, which are described in more detail in the Prefiled Direct Testimony of Joshua J. Jacobs, Exh. JJJ-1T, and the Financial Transparency and Improvement Program ("FTIP") has provided the costs saving described in the Prefiled Direct Testimony of Matthew R. Marcelia, Exh. MRM-1T.

Q. Has PSE continued to manage its cost of debt financing?

A. Yes. PSE has continued to manage its cost of debt financing. For example, the following three transactions had a material impact on cost containment in the test year:

(i) in October 2017, PSE refinanced and reduced the size of its operating company credit facility, resulting in an approximate $350,000 reduction in commitment fees annually;

(ii) in March 2018, PSE tendered and called $250 million floating rate junior subordinated notes, thereby eliminating floating interest rate risk and resulting in an approximate $625,000 in annual interest savings based on current rates;

(iii) in June 2018, PSE refinanced the 6.740% $200 million 20-year notes with new 4.223% $600 million 30-year notes, which resulted in an approximate $5 million in annual interest savings.

In sum total, these three refinancings will save customers approximately $6 million in annual pretax interest costs and eliminated some floating interest rate risk. Please see the Prefiled Direct Testimony of Matthew D. McArthur, Exh. MDM-1T, for a discussion of PSE's financings.

Q. Please describe PSE's capital investment program.

A. PSE makes significant capital investment in a number of areas, and PSE's capital investments program can be categorized into the following six major areas:

(i) **Strategic and Risk Mitigation Investments** are (a) investments that have a significant impact on how PSE does business and/or serves the customer (e.g., Get to Zero, AMI, grid modernization, integrated work management) or (b) are investments made to mitigate corporate risks identified through the company's enterprise risk management process (e.g., replacement of data centers, improving disaster recovery capabilities for PSE's information technology systems, the Lower Baker Dam re-grouting project).

(ii) **Distribution and Transmission Investments** are investments that focus primarily on electric and gas system safety, dependability, and reliability (e.g., worst-performing circuits, replacing failing underground wiring, replacing underground plastic and wrapped steel gas piping, substation and transmission upgrades).

(iii) **Regulatory and Compliance Investments** are investments that emanate from external demand and compliance requirements, which are largely nondiscretionary in nature due to tariff, regulatory, or other externally imposed compliance requirements (e.g., customer growth, public improvement work).

(iv) **Energy Delivery and Power Generation Investments** are investments required to maintain the safe, dependable, environmentally compliant and reliable operation of PSE's electric generation fleet to provide customers the most cost-effective power (e.g., routine, programmatic maintenance, replacements due to normal wear and tear, installation of performance enhancing upgrades).

(v) **Information Technology and Digital Investments** are investments in three key areas:

(a) system modernization and optimization investments to upgrade and maintain key and critical information technology applications and infrastructure platforms ensuring the availability, stability, security, and technical currency, examples of which include the energy management system, gas control system, outage management system;

(b) new system development and support which includes strategic projects such as the "Get to Zero" program, AMI, and an array of other projects such, as the FTIP; and

(c) risk mitigating projects such as replacing the data centers.

(vi) **Other Investments** are investments that arise from PSE's corporate shared services (e.g., fleet, facilities, real estate) and environmental remediation (e.g., manufactured gas plant clean-up initiatives and ash pond remediation and containment at the Colstrip Steam Electric Station).

Q. How does PSE prioritize spending within the six categories identified above?

A. As a general matter, PSE makes significant capital investment across the six categories in (i) electric distribution, transmission, and generation facilities; (ii) natural gas distribution facilities; (iii) common assets and facilities that serve both the electric and gas businesses; and (iv) information and digital technology. These investments are primarily focused on service reliability, safety, customer and public demand, management of enterprise risks, and enhancement of the customer experience.

The competition for capital across the six categories identified above is such that it is impossible for PSE to fund all requests for capital that arise in a given year. PSE prioritizes requests for capital initially within the six categories identified above and subsequently at the corporate level where differing allocations of capital are analyzed through a series of customer benefit, financial and customer rate impact filters. The allocation of capital at the corporate level requires significant judgment to ultimately balance the corporate and customer benefit received from each dollar of capital spend all the while maintaining acceptable financial performance and reasonable customer rate impacts.

For strategic and risk mitigation investments, PSE accomplishes the initial round of prioritization through significant dialogue between the Board of Directors and PSE's officer team. Due to the fact that the vast majority of these investments are high priority, the dialogue between the Board of Directors and the PSE officer team generally focuses on corporate capacity, pace of strategic and risk mitigation progress, and timing of customer rate impacts.

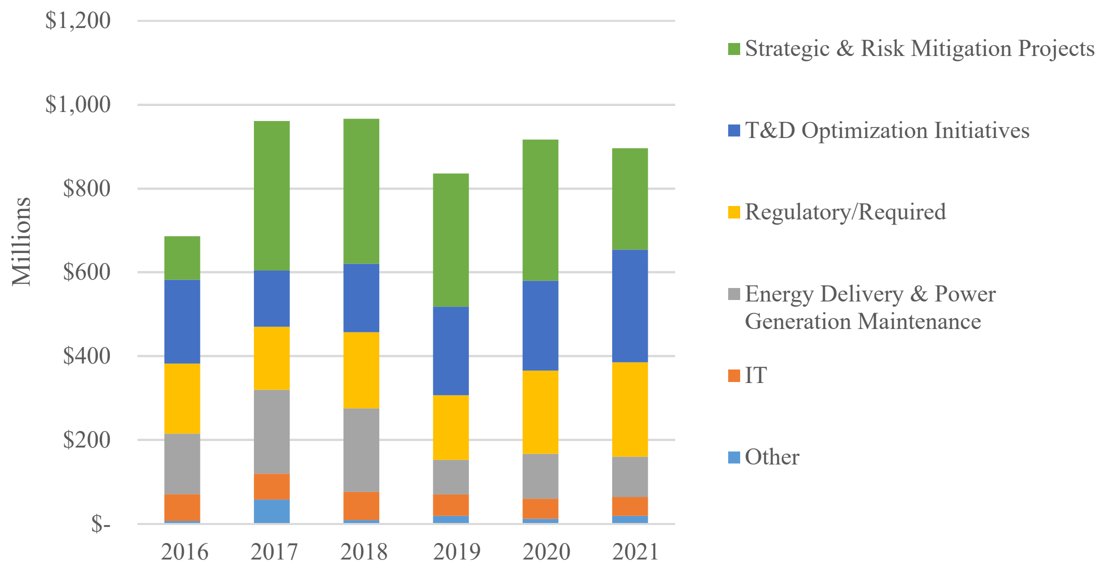
Please see the Prefiled Direct Testimony of Booga K. Gilbertson, Exh. BKG-1T, for a discussion of the prioritization process with respect to Distribution and Transmission Investments and Regulatory/Compliance Investments. Please see the Prefiled Direct Testimony of Margaret F. Hopkins, Exh. MFH-1T, for a discussion of the prioritization process with respect to Information Technology and Digital Investments.

Energy delivery and generation investments are prioritized by balancing safety, environmental compliance, and reliability (focusing on capacity factors and availability factors) to provide the most cost-effective power possible from the generation fleet. The Other Investment category is generally prioritized departmentally across PSE.

Q. Has PSE increased capital spending since its last rate proceeding?

A. Yes. PSE has increased capital spending since its last rate proceeding in Dockets UE-170033 and UG-170034 (the "2017 GRC"). Figure 2 below provides a categorization of actual capital expenditures for calendar years 2016-2018 and planned capital expenditures for calendar years 2019-2021.

Figure 2. PSE Actual Capital Expenditures (2016-2018) and Planned Capital Expenditures (2019-2021)



As illustrated in Figure 2 above, Strategic and Risk Mitigation Investments has been the category with the largest increase in capital expenditures since the 2017 GRC and captures investments made to fund diverse projects such as the (i) advanced metering infrastructure conversion, (ii) a new data center, (iii) construction of PSE's share of the Tacoma LNG Facility, and (iv) the "Get to Zero" call reduction initiative to improve the customer experience and optimize call center and field operations.

Q. What actions has PSE taken prior to the test year to improve its earnings in addition to its request for increased rates?

A. Although PSE has a long history of pursuing and realizing cost control and efficiencies, the subject was addressed directly by the Commission in connection with the company's multiyear rate plan that was in effect from July 1, 2013 through December 31, 2017. Specifically, in Order No. 07, in Dockets UE-121697 and UG-121706 (consolidated) and Dockets UE-130137 and UG-130138 (consolidated),[2] the Commission approved a multi-year rate plan for PSE and expressed an expectation that PSE would implement cost control and efficiencies during the course of the rate plan. Specifically, the Commission stated as follows:

> This multi-year rate plan will provide the Company with ample opportunity to implement efficiencies that will afford the Company with the earnings opportunities it seeks. And these cost savings, which we will monitor carefully, will then be incorporated into rates for the benefit of ratepayers.[3]

Q. Can you summarize the cost efficiencies that PSE produced during the rate plan?

A. PSE achieved the following cost savings over the course of the rate plan:

(i) PSE estimates that it saved approximately $136 million against historical operational spending trends through its efforts to limit growth in operational spending to the rate of customer growth.

(ii) PSE saved $19.3 million annually through refinancings and managing its capital structure.

(iii) PSE saved $23.7 million through its voluntary bonus depreciation elections and resulting rate base reductions, which will continue into the future.

(iv) PSE provided customers $65.9 million in interest credits through September 2016 associated with the Lower Snake River wind farm Treasury Grants related to the elimination of normalization requirements for Treasury Grants, an effort which also made it possible to repurpose Treasury Grants to offset future Colstrip Units 1 & 2

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2 *WUTC v. Puget Sound Energy, Inc.*, Order 07, Dockets UE-121697 and UG-121705 (consolidated) and Dockets UE-130137 and UG-130138 (consolidated) (“Order 07”).

3 Order 07 at ¶ 22.

decommissioning and remediation. (It should be noted that similar benefits exist with respect to Wild Horse Wind farm Treasury Grants in the amount of $8.1 million.)

(v) PSE will save customers an estimated $71.2 million nominally and $49.5 million on a net present value basis through the repurposing of certain Treasury Grants and Production Tax Credits to offset future Colstrip Units 1 & 2 decommissioning and remediation costs.

(vi) PSE restructured certain employee benefit plans. The operating expense portion of those savings are included in the $136 million discussed in (i) above. The capital component is "netted" in PSE's rate base in this proceeding. PSE expects these savings to continue into the future as well.

III. PSE IS REQUESTING AN ATTRITION ADJUSTMENT TO ADDRESS THE BACKWARD-LOOKING, HISTORICAL NATURE OF TRADITIONAL RATEMAKING

Q. Why is PSE requesting an attrition adjustment in this proceeding:

A. PSE is requesting an attrition adjustment in this proceeding to address the backward-looking, historical nature of traditional ratemaking, which contributes significantly to regulatory lag and attrition.

PSE's adjusted actual, normalized, and authorized, rate of return and return on equity performance for calendar years 2013 to 2018 for the electric and gas businesses provide evidence of the effects of traditional general rate case ratemaking on regulatory lag and attrition. Table 1 below provides PSE's adjusted actual, normalized, and authorized rates of return and returns on equity for calendar years 2013 to 2018 for the electric business.

Table 1. PSE's Adjusted Actual, Normalized, and Authorized Rates of Return and Returns on Equity for Calendar Years 2013 to 2018 for the Electric Business

	Rate of Return			Return on Equity		
Year	Adjusted Actual (1)	Normalized (2)	Authorized	Adjusted Actual (1)	Normalized (2)	Authorized
2018	7.49%	7.12%	7.60%	9.30%	8.54%	9.50%
2017	8.66%	8.11%	7.77%	11.42%	10.30%	9.80%
2016	7.90%	8.06%	7.77%	9.96%	10.28%	9.80%
2015	7.52%	8.05%	7.77%	9.13%	10.25%	9.80%
2014	7.53%	7.74%	7.77%	9.01%	9.44%	9.80%
2013	7.50%	7.56%	7.77%	8.95%	9.06%	9.80%

Notes:

(1) Adjusted actual returns: Excludes ASC 815 (formerly FAS 133) gains or losses and include tax benefits of interest.

(2) Normalized returns: 2013 - 2018 Commission Basis Reports

Table 2 below provides PSE's adjusted actual, normalized, and authorized rates of return and returns on equity for calendar years 2013 to 2018 for the gas business.

Table 2. PSE's Adjusted Actual, Normalized, and Authorized Rates of Return and Returns on Equity for Calendar Years 2013 to 2018 for the Gas Business

	Rate of Return			Return on Equity		
Year	Adjusted Actual (1)	Normalized (2)	Authorized	Adjusted Actual (1)	Normalized (2)	Authorized
2018	5.94%	5.64%	7.60%	6.12%	5.50%	9.50%
2017	8.09%	8.16%	7.77%	10.26%	10.41%	9.80%
2016	7.80%	7.93%	7.77%	9.75%	10.01%	9.80%
2015	7.62%	8.17%	7.77%	9.34%	10.49%	9.80%
2014	7.80%	7.87%	7.77%	9.56%	9.71%	9.80%
2013	7.22%	7.34%	7.77%	8.37%	8.62%	9.80%

Notes:

(1) Adjusted actual returns: Excludes ASC 815 (formerly FAS 133) gains or losses and include tax benefits of interest.

(2) Normalized returns: 2013 - 2018 Commission Basis Reports

During the years 2013 through and including 2017, PSE was operating under a Commission-approved rate plan that increased eligible electric revenues and eligible gas revenues every January 1 by 3 percent for electric operations and 2.2 percent for gas operations. The data clearly show, for both rates of return and returns on equity, that PSE slightly under-earned its authorized rate of return and return on equity during the early years of the rate plan for both electric and gas operations and began to marginally over-earn its authorized rate of return and return on equity for both electric and gas operations in the latter years of the rate plan.

The combination of the expedited rate filing increase and the annual K-factor increases from the rate plan imparted a more predictable and gradual increase to PSE's base rates as compared to increases resulting from general rate cases, which tend to be larger and less predictable from a customer perspective. In fact, had PSE filed its 2017 GRC without the benefit of the aforementioned rate plan, the requested increase would have been approximately $160 million higher, as illustrated in Table 3 below.

Table 3 Projected 2017 General Rate Case Request in the Absence of the Effects of the Rate Plan Benefits

Summary ($ millions)	2013 Expedited Rate Filing Impact	2014-2017 K-factor Impact	Total Impact
Electric	$30	$89	$119
Gas	($2)	$43	$41
Total	**$28**	**$132**	**$160**

Q. Would PSE have earned its authorized rate of return without the 2013 Expedited Rate Filing and K-factor based rate plan?

A. No. PSE would not have earned its authorized rate of return without the 2013 Expedited Rate Filing and the K-factor based rate plan. Table 4 below adjusts return benchmarks and metrics for electric operations during the rate plan by excluding the cumulative effects of the 2013 Expedited Rate Filing and the annual K-factor increases.

Table 4. PSE's Adjusted Actual and Normalized Rates of Return and Returns on Equity for Electric Operations excluding the effects of 2013 Expedited Rate Filing and K-factor Increases

	Rate of Return			Return on Equity		
Year	Adjusted Actual (1)	Normalized (2)	Authorized	Adjusted Actual (1)	Normalized (2)	Authorized
2018	7.49%	7.12%	7.60%	9.30%	8.54%	9.50%
2017	7.16%	6.61%	7.77%	8.40%	7.29%	9.80%
2016	6.67%	6.82%	7.77%	7.43%	7.75%	9.80%
2015	6.55%	7.09%	7.77%	7.13%	8.24%	9.80%
2014	6.82%	7.03%	7.77%	7.54%	7.97%	9.80%
2013	7.03%	7.08%	7.77%	7.97%	8.08%	9.80%

Notes:

(1) Adjusted actual returns: Excludes ASC 815 (formerly FAS 133) gains or losses and include tax benefits of interest.

(2) Normalized returns: 2013 - 2018 Commission Basis Reports.

Table 5 below adjusts return benchmarks and metrics for gas operations during the rate plan by excluding the cumulative effects of the 2013 Expedited Rate Filing and the K-factor increases.

Table 5. PSE's Adjusted Actual and Normalized Rates of Return and Returns on Equity for Gas Operations excluding the effects of 2013 ERF and K-factor Increases

	Rate of Return			Return on Equity		
Year	Adjusted Actual (1)	Normalized (2)	Authorized	Adjusted Actual (1)	Normalized (2)	Authorized
2018	5.94%	5.64%	7.60%	6.12%	5.50%	9.50%
2017	6.60%	6.68%	7.77%	7.28%	7.43%	9.80%
2016	6.63%	6.76%	7.77%	7.36%	7.62%	9.80%
2015	6.80%	7.35%	7.77%	7.64%	8.79%	9.80%
2014	7.33%	7.40%	7.77%	8.59%	8.74%	9.80%
2013	7.12%	7.24%	7.77%	8.15%	8.40%	9.80%

Notes:

(1) Adjusted actual returns: Excludes ASC 815 (formerly FAS 133) gains or losses and include tax benefits of interest.

(2) Normalized returns: 2013 - 2018 Commission Basis Reports.

The conclusions are obvious. Without the benefit of the 2013 Expedited Rate Filing and the K-factor increases, PSE would have substantially under-earned against its allowed rate of return and return on equity on both an actual and normalized basis for both electric and gas operations. It is important to note that neither the 2013 Expedited Rate Filing nor the K-factor increases would have been sufficient *on its own or in combination* to consistently close the return gap created by regulatory lag and attrition under traditional general ratemaking. Additionally, without the expedited rate filing or the K-factor increases, PSE would have been required to file one or more general rate cases during the rate plan period.

Q. Why do the rates of return and returns on equity for the electric and gas operations for calendar year 2018 decrease so significantly from the rates of return and returns on equity for 2017, which was the last year of the rate plan?

A. In Order 07 in Docket No. UE-121697, footnote 9, the Commission required PSE to file a general rate case no sooner than April 1, 2015, and no later than April 1, 2016. In that order, the Commission stated as follows:

> The mechanism will remain in place, at a minimum, until the effective date of new rates set in PSE's next general rate case. PSE will file a general rate case no sooner than April 1, 2015, and no later than April 1, 2016, unless otherwise agreed to by the parties to PSE's last general rate case.[4]

After a hearing on a motion to amend Order 07, however, the Commission, in its Notice of Action, dated March 17, 2016, relieved PSE of its obligation under Order 07 to file a general rate case by April 1, 2016, and instead, required the general rate case to be filed no later than January 17, 2017. PSE filed the 2017 GRC in time to meet the Commission's filing timeline. The 2017 GRC filing was based on a historical test year for the twelve (12) months ending September 30, 2016.

Importantly, the rate base in the 2017 GRC filing was calculated using the traditional average of monthly averages ("AMA") methodology. Accordingly, the revenue requirement in that general rate case filing reflected a "middle-of-the-test-year" rate base value or a rate base value that existed as of roughly March 31,

[4] *WUTC v. Puget Sound Energy, Inc.*, Docket UE-121697, Order 07 at ¶ 8 (2013).

2016. During the period April 1, 2016 through the beginning of the rate year (roughly January 1, 2018), PSE spent over $1.53 billion on capital expenditures. Very few, if any, of the return of and return on these capital expenditures were included in the approved revenue requirement that went into effect at the beginning of the rate year. This is one example of the backward-looking, historical nature of traditional general rate case ratemaking that contributes significantly to regulatory lag and attrition.

Indeed, regulatory lag and attrition were a major source of the decreased rates of return and returns on equity from 2017 to 2018 as illustrated in Tables 1 and 2 above. Regulatory lag and attrition are also major components of the underlying rationale for requesting both an attrition adjustment and the use of an end of test year rate base calculation versus the traditional AMA methodology in this proceeding.

Q. What other factors contribute to the need for an attrition adjustment?

A. A number of other factors contributed to the need for an attrition adjustment. First, under traditional ratemaking, a 27-month time span exists from the beginning of the test year to the beginning of the rate year. Although the traditional ratemaking process in Washington allows for a limited number of pro forma adjustments to capture cost growth from the test year to the rate year, those pro forma adjustments do not capture the complete impact of inflationary forces and other expense growth between the test year and the rate year. This contributes to regulatory lag and attrition.

Second, PSE, like its utility counterparts, has experienced significant increases in information technology capital expenditures in the past several years. These investments often require related software licensing and maintenance contract cost increases, in addition to the return of and return on the capital expenditures. These costs place upward pressure on operations and maintenance expense. In addition, many information technology investments are new investments versus replacements to existing technology applications. To the extent that these new investments are not captured in the ratemaking process, they contribute significantly to attrition.

Additionally, information technology investments tend to be short-lived with estimated useful lives of between three and ten years. To the extent technology investments are placed in service in between rate filings, the utility will recover neither a substantial portion of software licensing and maintenance contract cost increases nor the return of and return on the capital expenditures. For example, as mentioned in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, the typical lives of transmission and distribution assets range between 30 to 50 years, which means the annual depreciation on those assets range between two and three percent per year. However, technology investments typically have a depreciable life of ten years or less and, in many circumstances, only a three- to five-year life. Therefore, the impact of the typical 27-month regulatory lag is far greater on these short-lived assets and creates significant earnings erosion if not addressed. PSE's request for an attrition adjustment seeks to ameliorate these sources of regulatory lag and attrition.

Q. What cost increases contribute to PSE's request for increased rates that are out of the company's control?

A. Over the past several years, PSE and customers alike have enjoyed a relatively stable market for power and gas supply. As discussed in the Prefiled Direct Testimony of Paul K. Wetherbee, Exh. PKW-1CT, power costs have increased for a variety of reasons and are a major contributor to PSE's electric business rate increase.

Next, PSE estimates that tax reform reduced cash flows by approximately $107 million, which required PSE to increase borrowing to fund its operations and capital expenditure program. On the margin, PSE borrowed more than half of the estimated $107 million in reduced cash flow attributable to tax reform to fund its capital expenditure program. As shown in the Second Exhibit to Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-3, Standard and Poor's Ratings Group ("S&P") Funds from Operations to Debt (FFO/Debt) metric for PSE, after restating for the effects of tax reform, would have increased to 23.9% from the actual test year result of 21.7%. Tax reform similarly affected PSE's cash flow-based metrics for Moody's Investors Service, Inc. ("Moody's") and Fitch Ratings, Inc. ("Fitch") during the test year.

Finally, as mentioned above, PSE is allocating more of its capital expenditure program to information technology investments than was the case in prior years. As described above, the short-lived nature of these investments places significant cost pressure on depreciation and amortization, return of and return on the initial capital investment, and cost pressures relating to software licensing and maintenance contracts. Without timely rate relief, including the requested attrition adjustment, PSE will not be able to absorb these cost pressures and will be denied an opportunity to earn its allowed return on equity.

IV. PSE'S REQUESTED RETURN ON EQUITY AND EQUITY RATIO IN CAPITAL STRUCTURE

A. PSE Requests an Authorized Return on Equity of 9.8 Percent

Q. What authorized return on equity is PSE requesting in this proceeding?

A. PSE is requesting an authorized return on equity of 9.8 percent in this proceeding.

Q. Has PSE prepared an analysis of the projected return on equity of PSE during the rate year?

A. Yes. PSE has retained the services of Dr. Roger A. Morin to prepare an analysis of the projected return on equity for PSE during the rate year. Please see the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-1T, for Dr. Morin's analysis regarding the projected return on equity for PSE during the rate year.

PSE has adopted Dr. Morin's analysis and conclusion that an authorized return on equity of 9.8 percent is fair and reasonable compared to test year authorized returns on equity industry wide (average 9.6 percent) and authorized returns on equity in Dr. Morin's peer group (average 9.8 percent). It should be noted that PSE's requested weighted-average return on equity is 4.75 percent (i.e., the product of PSE's requested return on equity 9.80 percent multiplied by PSE's requested equity ratio 48.5 percent) is lower than the weighted-average return on equity of 4.86 percent for electric and gas utility cases approved nationwide for the test year. Please see Section IV.C. of this prefiled direct testimony for a discussion of PSE's requested weighted-average return on equity of 4.75 percent.

Q. What returns on equity have regulatory commissions authorized for vertically-integrated electric utilities during the test year (i.e., calendar year 2018) and the first quarter of 2019?

A. As reported by Regulatory Research Associates, a group within S&P Global Market Intelligence, the industry-average authorized return on equity for vertically-integrated electric utilities was (i) 9.70 percent during the test year and (ii) 9.72 percent during the first quarter of 2019.[5]

Q. What returns on equity have regulatory commissions authorized for natural gas utilities during the test year (i.e., calendar year 2018) and the first quarter of 2019?

A. As reported by Regulatory Research Associates, the industry-average authorized return on equity for natural gas utilities was (i) 9.59 percent for the test year and (ii) 9.55 percent for the first quarter of 2019.[6] Although PSE's request

5 S&P Global Market Intelligence, *RRA Regulatory Focus Major Rate Case Decisions — January – March 2019*, at page 4 (Apr. 11, 2019).

6 *Id*. at page 1.

B. PSE Requests the Ability to Maintain a Capital Structure with an Equity Ratio of 48.5 Percent

Q. What is the capital structure that PSE is requesting in this proceeding?

A. PSE's is requesting a capital structure that consists of the following components:

(i) a long-term debt ratio of 49.2 percent,

(ii) a short-term debt ratio of 2.3 percent, and

(iii) an equity ratio of 48.5 percent.

Please see the Prefiled Direct Testimony of Matthew D. McArthur, Exh. MDM-1T, for a discussion and calculations of the actual capital structure of PSE during the test year and PSE's projected capital structure during the rate year.

Q. Is the proposed capital structure consisting of a 48.5 percent equity ratio appropriate for PSE?

A. Yes, the proposed capital structure consisting of a 48.5 percent equity ratio is appropriate for PSE for several reasons.

First, a capital structure that contains a 48.5 percent equity ratio is lower than the actual capital structure that PSE maintained during the test year. PSE's average capital structure (calculated using an average of the monthly averages methodology) during the test year resulted in a 49 percent equity ratio, as shown in Table 6 below:

Table 6. Adjusted Test Year Capital Structure

Capital Component	Test Year (Average)
Short Term Debt	2.32%
Long Term Debt	48.67%
Total Debt	51.0%
Common Equity	49.0%
Total Capitalization	100.0%

Please see the Second Exhibit to the Prefiled Direct Testimony of Matthew D. McArthur, Exh. MDM-3, for an exhibit that illustrates the components of PSE's test year capital structure.

Second, PSE considers a capital structure that includes an equity ratio of 48.5 percent to be an appropriate level of equity to attract debt investment at a reasonable cost, when coupled with a return on equity of 9.8 percent. PSE seeks the comparative and competitive financial strength to maintain its current credit ratings and restore pre-tax reform cash flow over time.

Third, an equity ratio of 48.5 percent, combined with a return on equity of 9.8 percent and other cash flow enhancing adjustments (e.g. attrition and end of period rate base), will improve rate year cash flow-based credit metrics toward pre-tax reform levels.

Fourth, a capital structure that contains an equity ratio of 48.5 percent contains a lower equity ratio than the average equity ratios for natural gas and electric utilities approved by regulatory bodies across the country in the test year period for this proceeding.

The average authorized equity ratio for electric utility cases nationwide was

(i) 49.02 percent for the test year and

(ii) 49.51 percent for the first quarter of 2019.[7]

The average authorized equity ratio for gas utilities nationwide was

(i) 50.09 percent for the test year and

(ii) 51.40 percent for the first quarter of 2019.[8]

Accordingly, PSE's requested equity ratio of 48.5 percent is 50 basis points lower than the average authorized equity ratio for electric utility cases nationwide for the test year and more than 150 basis points lower than the average authorized equity ratio for gas utility cases nationwide for the test year.

PSE intends to move its equity ratio closer to industry averages incrementally and gradually over time to mitigate rate impacts. In turn, this will allow PSE to maintain its credit ratings and provide the flexibility to access the capital markets during varying and volatile financial market conditions to finance its operations cost-effectively.

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7 *RRA Regulatory Focus Major Rate Case Decisions — January – March 2019*, *supra* note 5, at page 3.

8 *Id.*

C. PSE Requests a Weighted-Average Return on Equity of 4.75 Percent

Q. How does PSE's requested weighted-average return on equity compare against weighted-average returns on equity authorized during the test year for electric and gas utility cases nationwide?

A. PSE's requested weighted-average return on equity is 4.75 percent, which is a product of PSE's requested return on equity 9.80 percent multiplied by PSE's requested equity ratio 48.5 percent. This requested weighted-average return on equity is lower than the weighted-average return on equity of 4.86 percent for electric and gas utility cases approved nationwide for the test year. Please see the Third Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-4, for the returns on equity, equity ratios and weighted-average returns on equity authorized for electric and natural gas utilities for the period January 1, 2018, through December 31, 2018.

Figure 3 below compares return on equity for natural gas and electric utilities authorized by regulatory bodies across the country in the test year period for this proceeding.

Figure 3. Authorized ROEs Between 1/1/2018 and 12/31/2018 Ranked from Low to High

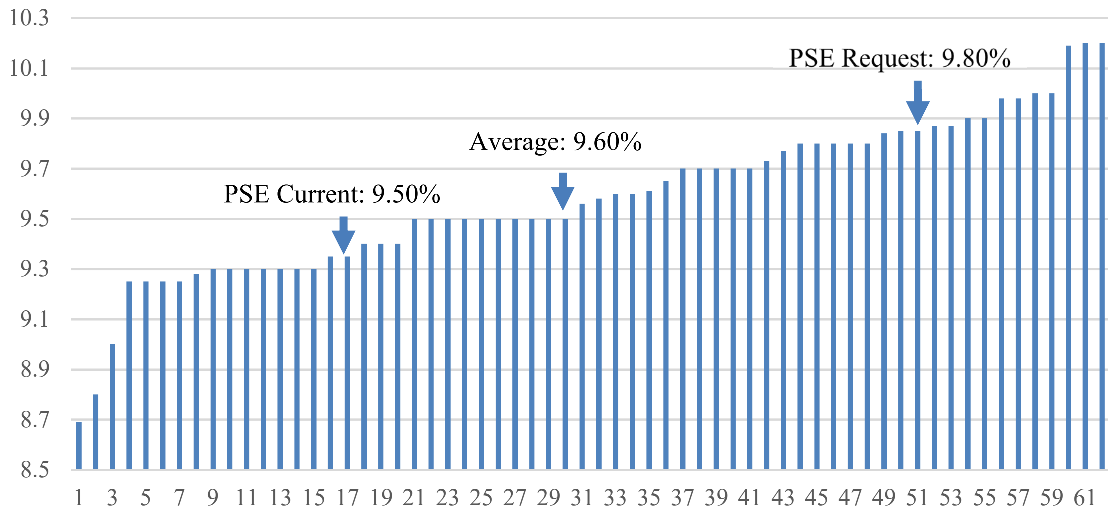


Figure 4 below compares equity ratio for natural gas and electric utilities authorized by regulatory bodies in the test year period for this proceeding.

Figure 4. Authorized Equity Ratio Between 1/1/2018 and 12/31/2018 Ranked from Low to High

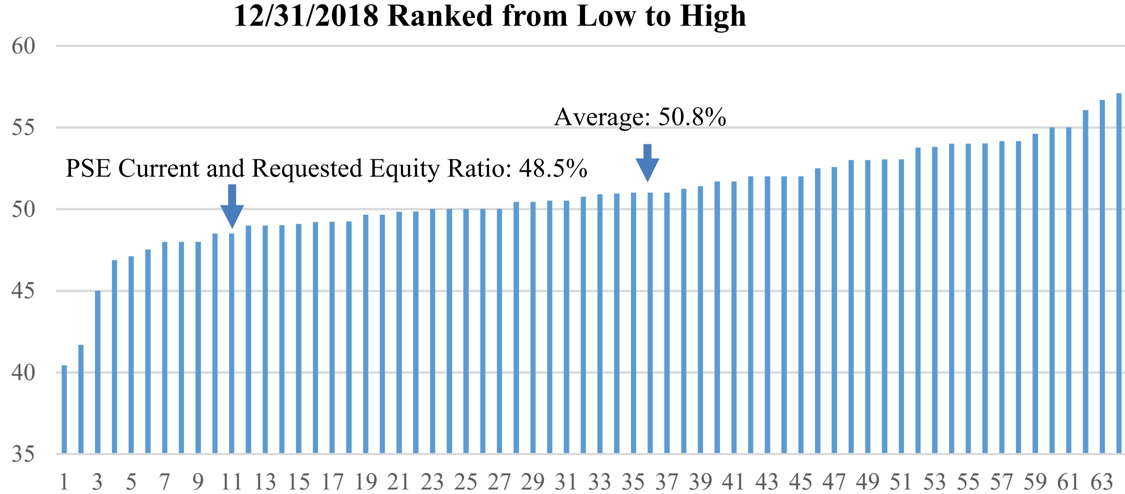
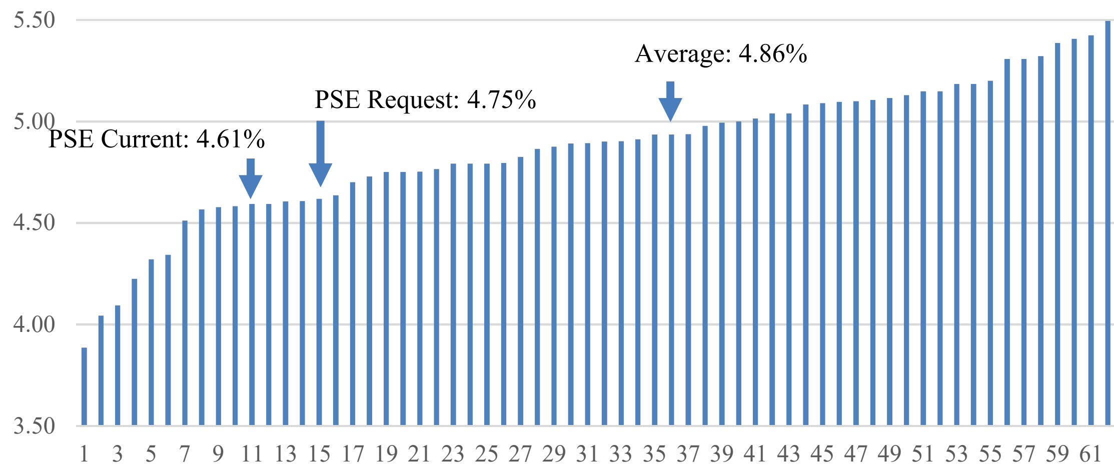


Figure 5 below compares the weighted-average returns of equity for natural gas and electric utilities approved by regulatory bodies in the test year period for this proceeding.

Figure 5. Authorized Weighted ROEs
Between 1/1/2018 and 12/31/2018
Ranked from Low to High

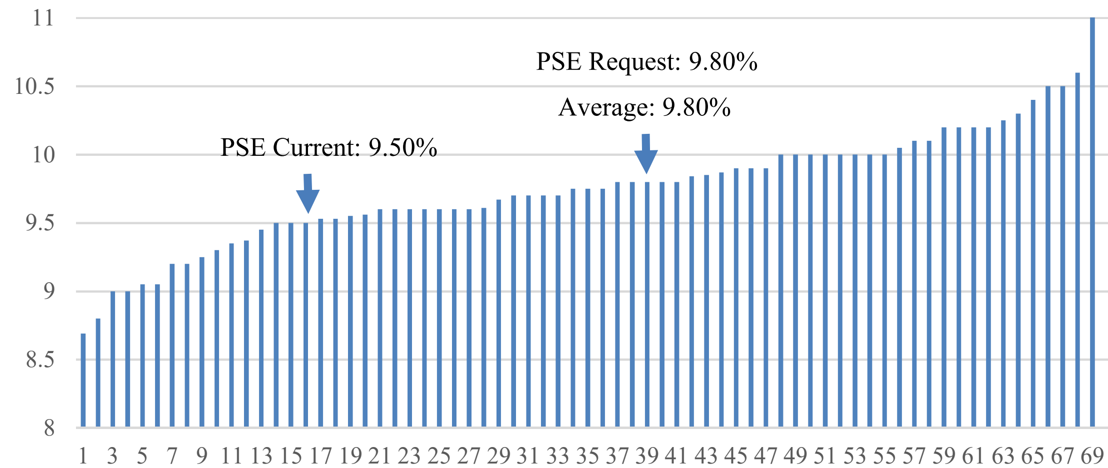


Q. How does PSE's requested weighted-average return on equity compare against those weighted-average return on equity authorized for the electric and gas utilities in Dr. Morin's proxy group?

A. PSE's requested weighted-average return on equity of 4.75 percent (which, again, is a product of requested return on equity of 9.80 percent multiplied by the requested equity ratio of 48.5 percent) is lower than the average weighted-average return on equity of 4.88 percent for electric and gas utilities in Dr. Morin's proxy group.

Figure 6 compares returns on equity for natural gas and electric utilities in Dr. Morin's proxy group.

Figure 6. Authorized ROE for Dr. Morin's Peer Group Ranked From Low to High



Please note that the data provided in Figures 6, 7, and 8 in this testimony reflects all 69 operating utilities within Dr. Morin's proxy group. As discussed in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-1T, he has selected a proxy group for PSE that consists of 20 companies. Please see the Third Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-4, for Dr. Morin's proxy group. There are, however, 69 distinct operating utilities owned by the 20 holding companies in Dr. Morin's proxy group, and the data provided in Figures 6, 7, and 8 in this testimony reflects all 69 operating utilities. Please see the Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5, for the returns on equity, equity ratios and weighted-average returns on equity authorized for Dr. Morin's proxy group of electric and natural gas utilities for the period January 1, 2018, through December 31, 2018.

Figure 7 below compares equity ratio for natural gas and electric utilities in Dr. Morin's proxy group.

Figure 7. Authorized Equity Ratio for Dr. Morin's Peer Group Ranked from Low to High

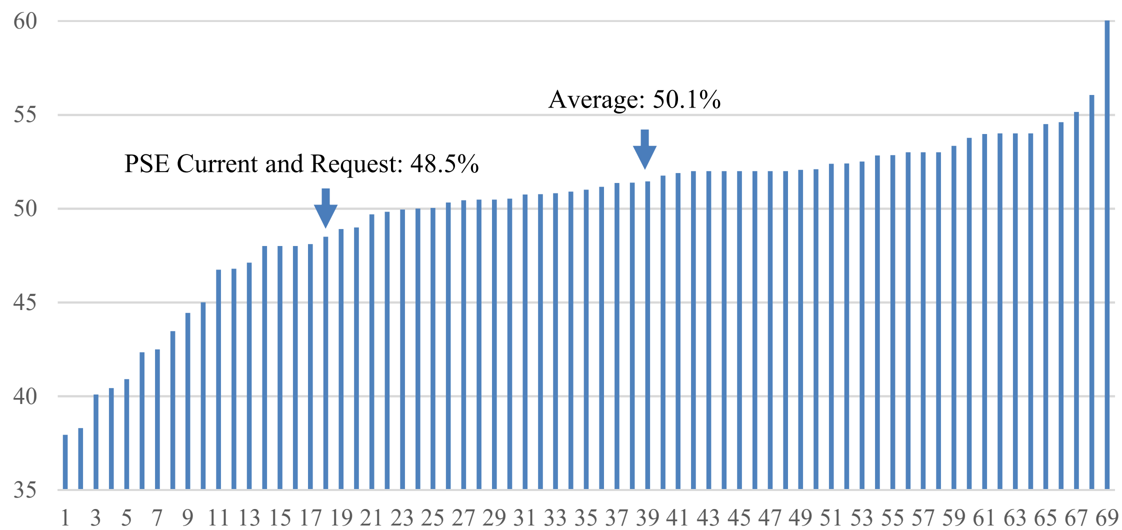
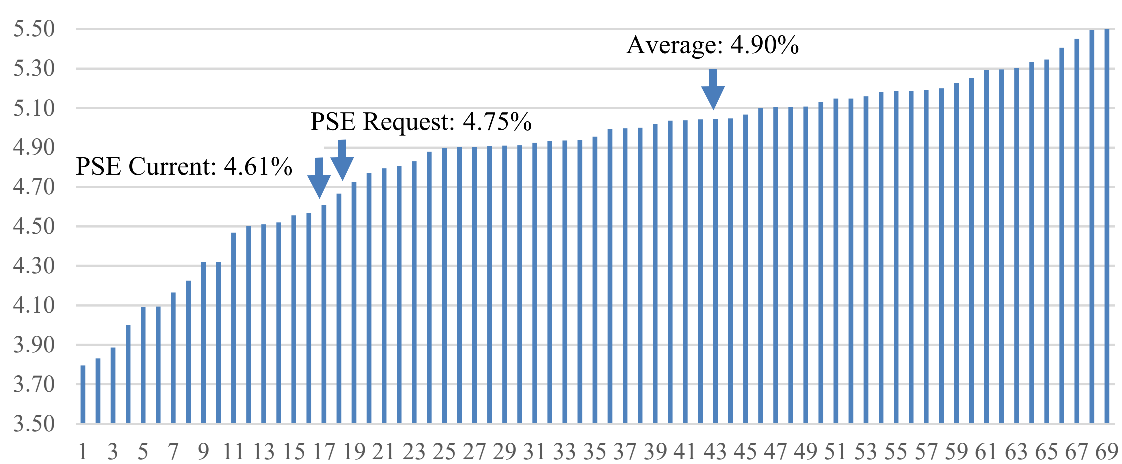


Figure 8 below compares PSE's requested weighted-average return on equity with the weighted-average return on equity for natural gas and electric utilities in Dr. Morin's proxy group.

Figure 8. Authorized Weighted-Average ROEs for Dr. Morin's Peer Group Ranked from Low to High



As can be seen in Figure 8 above, PSE's requested weighted-average return on equity of 4.75 percent is below the average weighted-average return on equity of 4.90 percent of the companies in Dr. Morin's peer group.

D. PSE's Request Adequately Balances Safety and Economy

Q. What does the Commission usually consider when determining an appropriate equity ratio in a utility's capital structure?

A. In selecting the appropriate capital structure, the Commission seeks to balance safety and economy:

> We develop a weighted cost of capital for the Company based on a capital structure that balances safety and economy. Capital structure, and particularly the equity ratio and cost of equity, materially impacts the price customers pay for service. Due to the relative difference between the higher cost of equity and the lower cost of debt, a capital structure with relatively more debt and less equity may result in a lower overall cost of capital. This results in lower rates for customers. This is commonly referred to as "economy." On the other hand, a capital structure with relatively more equity and less debt may result in a higher overall cost of capital and higher rates for customers, but enhanced financial integrity. This is commonly referred to as "safety."[9]

In other words, the economy of lower cost debt, on which PSE has an obligation to pay interest, must be weighed against the safety of relatively higher cost common equity, on which PSE does not have a legal obligation to pay a dividend and provide a return.

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9 *WUTC v. Pac. Power & Light Co., a division of PacifiCorp*, Dockets UE-140762, *et al.*, Order 08 at page 11 (Mar. 25. 2015) (footnotes omitted).

Q. Why is it appropriate to consider both the equity ratio in the capital structure and the return on equity in reaching an appropriate balance between safety and economy?

A. Simply put, it is the weighted-average return on equity that ultimately matters when balancing safety and economy in the context of overall cost of capital.

Q. Has PSE prepared an example that illustrates this perspective?

A. Yes. Table 7 below presents weighted-average returns on equity of various capital structures and authorized returns on equity.

Table 7. Weighted-Average Returns on Equity

Equity Ratio	Return on Equity: 9.30%	9.40%	9.50%	9.60%	9.70%	9.80%	9.90%	10.00%
48.5%	4.51%	4.56%	4.61%	4.66%	4.70%	4.75%	4.80%	4.85%
49.0%	4.56%	4.61%	4.66%	4.70%	4.75%	4.80%	4.85%	4.90%
49.5%	4.60%	4.65%	4.70%	4.75%	4.80%	4.85%	4.90%	4.95%
50.0%	4.65%	4.70%	4.75%	4.80%	4.85%	4.90%	4.95%	5.00%
50.5%	4.70%	4.75%	4.80%	4.85%	4.90%	4.95%	5.00%	5.05%
51.0%	4.74%	4.79%	4.85%	4.90%	4.95%	5.00%	5.05%	5.10%

PSE is requesting weighted-average return on equity of 4.75 percent (based on a capital structure with an equity ratio of 48.5 percent and an authorized return on equity of 9.8 percent.) Table 8 below presents combinations of equity ratios and authorized returns on equity that also produce a weighted-average return on equity of 4.75 percent (except for minor rounding differences.)

Table 8. Weighted-Average Returns on Equity

A Equity Ratio	B Return of Equity	C (A × B) Weighted-Average Return on Equity
48.5%	9.8%	4.75%
49.0%	9.7%	4.75%
49.5%	9.6%	4.75%
50.0%	9.5%	4.75%
50.5%	9.4%	4.75%
51.0%	9.3%	4.74%

PSE believes that a weighted-average return on equity of 4.75 percent reasonably balances safety and economy, in the context of total cost of capital, and this analysis illustrates that there are many combinations that can achieve that result.

Q. Why is the capital structure proposed by PSE appropriate and reasonable for rate setting purposes in this proceeding?

A. The capital structure requested by PSE is appropriate and reasonable for the following reasons:

(i) it is derived from actual results during the test year;

(ii) a capital structure with an equity ratio of 48.5 percent, while lower than the average authorized equity ratios recently reflected in customer rates of other regulated utilities (see Figure 4 above), produces a competitive weighted-average return on equity of 4.75 percent when combined with PSE's requested return on equity of 9.8 percent.

(iii) it appropriately balances safety and economy for customers; because when combined with a requested return on equity of 9.8 percent, the requested capital structure with an equity ratio of 48.5 percent should enable PSE to maintain its current credit ratings, contribute to the restoration of pre-tax reform cash flow and compete for cost-effective debt capital against natural gas and electric utilities across the country.

Q. Why does the capital structure requested by PSE in this proceeding appropriately balance the risks and costs of funding PSE's utility operations?

A. The capital structure requested by PSE in this proceeding appropriately balances the risks and costs of funding PSE's utility operations for the following reasons:

(i) the capital structure requested by PSE in this proceeding, when combined with a requested return on equity of 9.8 percent and other cash flow enhancing adjustments in this filing, will allow PSE to maintain its current credit ratings, contribute to the restoration of pre-tax reform cash flows, and attract debt capital necessary to fund PSE's capital expenditures and operations;

(ii) the capital structure requested by PSE in this proceeding, when combined with a requested return on equity of 9.8 percent and other cash flow enhancing adjustments in this filing, will allow PSE to satisfy regulatory commitments and debt covenants related to capital structure; and

(iii) the capital structure requested by PSE in this proceeding, when combined with a requested return on equity of 9.8 percent, will allow PSE to provide electric and gas service to customers on reasonable economic terms.

Q. Does PSE intend to manage its capital structure to maintain a capital structure with an equity ratio of 48.5 percent during the rate year and beyond?

A. Yes. Although the marginal impact of PSE's operations can cause volatility in PSE's short-term debt balances from month to month (which will create the same month-to-month volatility in PSE's actual equity ratio), the Commission can expect PSE to manage, on average and over time, a capital structure with an equity ratio that meets or exceeds the capital structure authorized by the Commission for inclusion in rates. Indeed, PSE has consistently maintained, on average, over time, a capital structure with an equity ratio that has met or exceeded the capital structure authorized by the Commission.

V. PSE'S CREDIT RATINGS

Q. What are rating agencies and credit ratings?

A. Rating agencies are independent agencies that assess risks for debt investors. The three most widely recognized rating agencies are S&P, Fitch, and Moody's. These rating agencies issue credit ratings to corporate issuers (generally referred to as the unsecured debt rating of the institution) and their individual debt securities. These ratings provide information to investors regarding risks associated with such companies and their debt securities.

Q. What are PSE's current credit ratings?

A. PSE's current credit ratings are shown in Table 9 below:

Table 9. PSE Credit Ratings

Security	S&P	Moody's	Fitch
Corporate credit/issuer rating	BBB	Baa1	BBB+
Senior Secured Debt	A-	A2	A
Commercial Paper	A-2	P-2	F-2
Bank Facilities	BBB	Baa1	BBB+
Outlook	Negative	Stable	Stable

Q. Have the credit ratings of PSE changed since the 2017 GRC?

A. No. PSE's credit ratings have not changed since the 2017 GRC. However, S&P revised PSE's outlook from stable to negative in December 2018.

Q. Why are credit ratings important to PSE?

A. Credit ratings are important because PSE will need to re-finance existing debt and access the debt capital markets anew to incrementally finance PSE's growth and utility operations into the future. In addition, credit ratings have a direct impact on PSE's liquidity position through short-term borrowings. Finally, PSE agreed to continue to be rated by S&P and Moody's in Regulatory Commitment 26 in the multi-party settlement agreement[10] approved by the Commission in Docket U-180680.

Q. Why are credit ratings important to customers?

A. Credit ratings are important to customers because they are an overall representation of a company's financial health. As a result, they are a major factor in determining the cost of capital to PSE and ultimately its customers. For example, low credit rating signifies increased risk for investors, which, in turn, results in a higher cost of capital, which increases the cost of service to customers. The converse is also true.

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[10] *In the Matter of the Joint Application of Puget Sound Energy, Alberta Investment Management Corporation, British Columbia Investment Management Corporation, OMERS Administration Corporation, and PGGM Vermogensbeheer B.V. for an Order Authorizing Proposed Sales of Indirect Interests in Puget Sound Energy*, Docket U-180680, Order 6, App. A (Settlement Stipulation and Appendices) (Mar. 7, 2019).

Q. What is PSE's view on its credit ratings at the present time?

A. PSE is seeking, at a minimum, to retain its current senior secured debt ratings of "A-", "A2", "A" and its corporate ratings of "BBB", "Baa1" and "BBB+" by S&P, Moody's and Fitch, respectively. In addition, PSE seeks to maintain its current ratings and improve its cash flow-based credit metrics to pre-tax reform levels over time. This filing makes substantial progress toward this end as explained previously in this testimony. These are important considerations as PSE accesses the debt capital market in the near term and beyond.

Q. Do the rating agencies have targets or guidelines that relate certain credit metrics with specific credit ratings?

A. Yes. On November 19, 2013, S&P issued a report that revised its ratings criteria.[11] In that report, S&P published the following table related to indicative ratios for medial volatility industries,[12] in which category PSE falls:

Table 10. S&P Select Cash Flow/Leverage Analysis Ratios–Medial Volatility Core Ratios

	FFO/debt (%)	**Debt/EBITDA (x)**
Minimal	50+	less than 1.75
Modest	35-50	1.75-2.5
Intermediate	23-35	2.5-3.5
Significant	13-23	3.5-4.5
Aggressive	9-13	4.5-5.5
Highly leveraged	Less than 9	Greater than 5.5

11 S&P, *Corporate Methodology: Ratios and Adjustments* (Nov. 19, 2013).

12 *See id*. at page 35 (Table 18 (Cash Flow/Leverage Analysis Ratios--Medial Volatility)).

Under these criteria, PSE is classified as having a Business Risk Profile of "Excellent" and a Financial Risk Profile of "Significant" with a credit rating of BBB.

Q. Does Moody's publish similar target metrics?

A. Yes. In a December 2013 report, Moody's revised its rating methodology for regulated gas and electric utilities. Moody's shows benchmark ranges for financial metrics associated with its various ratings levels.[13]

Table 11 below includes the Moody's benchmark range for certain credit ratings:[14]

Table 11. Moody's Select Key Ratios

	CFO pre-W/C to Debt	**CFO pre-W/C to Interest**	**CFO pre-W/C less Dividends to Debt**	**Debt Ratio**
"A"	22% to 30%	4.5x to 6.0x	17% to 25%	35% to 45%
"Baa"	13% to 22%	3x to 4.5x	9% to 17%	45% to 55%
"Ba"	5% to 13%	2x to 3x	0% to 9%	55% to 65%

Q. Does Fitch publish similar target metrics?

A. Yes. In March 2018 report, Fitch updated rating methodology for regulated US gas and power utilities. Fitch shows sector-specific key ratios associated with its various ratings levels.[15]

13 Moody's Investors Service, *Rating Methodology Regulated Electric and Gas Utilities* (December 23, 2013).

14 *See id.* at page ~~34~~38 (Factor 4: Financial Strength).

15 FitchRatings, *Financial Profile Key Factors* (Mar. 2018).

Table 12 below includes the Fitch benchmark range for certain credit ratings:[16]

Table 12. Fitch Select Key Ratios

	Total Adjusted Debt to Operating EBITDAR[17]	FFO Gross Adjusted Leverage	FFO Fixed Charge Coverage
"A"	3.25x	3.5x	5.0x
"BBB"	3.75x	5.0x	4.5x
"BB"	4.75x	6.5x	3.5x
"B"	6.00x	7.0x	2.0x
"CCC"	>8.00x	>9.0x	<1.0x subject to material execution risk

It should be noted that these benchmarks represent guidelines and are not strict targets as the rating process for S&P, Moody's and Fitch alike require a balance of quantitative and qualitative considerations. I explain this more completely later in this testimony.

16 *Financial Profile Key Factors*, *supra* note 15, at page 205.

17 EBITDAR is the acronym used for earnings before income taxes, interest expense, depreciation and amortization and rent expense. EBITDAR is the use of operating earnings before income taxes, interest expense, depreciation and amortization and rent expense (EBITDA) plus gross rental expense. Fitch uses EBITDAR as a metric because

> [t]he use of operating EBITDA plus gross rental expense (EBITDAR, including operating lease payments) improves comparability across industries (eg, retail and manufacturing) that exhibit different average levels of lease financing and within industries (eg, airlines) where some companies use lease financing more than others.

FitchRatings, *Corporate Rating Criteria* at 47 (Feb. 2019), available at https://www.fitchratings.com/site/search?content=research&filter=CRITERIA%20STATUS%5ECriteria%20-%20Active%2BRESEARCH%20LANGUAGE%5EEnglish%2BREPORT%20TYPE%5ERating%20Criteria%2BMARKET%20SECTOR%5ECorporate%20Finance%2BCRITERIA%20TYPE%5EMaster.

Q. What are PSE's S&P credit metrics for the test year?

A. S&P credit metrics for PSE's financial statements are as follows for the year ended December 31, 2018:

(i) Funds from operations to debt: 21.7%; and

(ii) Debt to EBITDA: 3.6x.

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the S&P credit metrics for PSE for the test year.

Q. What are PSE's Moody's credit metrics for the test year?

A. Moody's credit metrics for PSE's financial statements are as follows for the year ended December 31, 2018:

(i) adjusted cash from operations pre-working capital to debt: 20.3%;

(ii) adjusted cash from operations pre-working capital to interest: 4.8x;

(iii) adjusted cash from operations pre-working capital less dividends to debt: 16.5%; and

(iv) adjusted Debt to total capitalization: 49.9%.

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the Moody's credit metrics for PSE for the test year.

Q. What are PSE's Fitch credit metrics for the test year?

A. Fitch credit metrics for PSE's financial statements are as follows for the year ended December 31, 2018:

(i) FFO Fixed Charge Coverage: 4.4x

(ii) FFO Adjusted Leverage: 3.9x

(iii) Total Adjusted Debt to Operating EBITDAR: 3.3x

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the Fitch credit metrics for PSE for the test year.

Q. What will PSE's projected S&P credit metrics be in the rate year, assuming the revenue requirement requested by PSE in this proceeding?

A. Assuming the revenue requirement requested by PSE in this proceeding, S&P credit metrics for PSE in the rate year would materially improve as follows:

(i) Funds from operations to debt: 23.3%; and

(ii) Debt to EBITDA: 3.4x.

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the projected S&P credit metrics for PSE for the rate year.

Q. What will PSE's projected Moody's credit metrics be in the rate year, assuming the revenue requirement requested by PSE in this proceeding?

A. Assuming the revenue requirement requested by PSE in this proceeding, Moody's credit metrics for PSE in the rate year would materially improve as follows:

(i) adjusted cash from operations pre-working capital to debt: 22%;

(ii) adjusted cash from operations pre-working capital to interest: 5.2x;

(iii) adjusted cash from operations pre-working capital less dividends to debt: 18.2%; and

(iv) adjusted Debt to total capitalization: 49.9%.

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the projected Moody's credit metrics for PSE for the rate year.

Q. What will PSE's projected Fitch credit metrics be in the rate year, assuming the revenue requirement requested by PSE in this proceeding?

A. Assuming the revenue requirement requested by PSE in this proceeding, Fitch credit metrics for PSE in the rate year would materially improve as follows:

(i) FFO Fixed Charge Coverage: 4.7x

(ii) FFO Adjusted Leverage: 3.6x

(iii) Total Adjusted Debt to Operating EBITDAR: 3.2x

Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the projected Fitch credit metrics for PSE for the rate year.

Q. What other considerations do the credit rating agencies make when issuing credit ratings?

A. The credit rating agencies consider a number of categories, which can be both quantitative and qualitative in nature. For example, the credit ratings agencies also consider regulation, markets, competition, operations and management.

Q. What categories of additional consideration does S&P include in its rating analysis?

A. S&P rating methodology bases its ratings on three major categories. These categories are shown below:[18]

(i) Business Risk Profile, which assesses industry risk, regulation and competitive position

(ii) Financial Risk Analysis, which assesses commodity trackers, accounting and capital expenditures

(iii) Rating Modifiers, which assesses capital structure, financial policy, management and governance

Q. What categories of additional consideration does Moody's include in its rating analysis?

A. Moody's revised rating methodology bases its ratings on four major categories. These categories, and the weights assigned to each are shown below:[19]

(i) Regulatory Framework 25 percent

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[18] S&P Global Ratings, *Key Credit Factors for The Regulated Utilities Industry*, at pages 2-18 (Nov. 19, 2013).

[19] *Rating Methodology Regulated Electric and Gas Utilities*, *supra* note 13, at page 46.

(ii)	Ability to Recover Costs and Earn Returns	25 percent
(iii)	Diversification	10 percent
(iv)	Financial Strength, Liquidity and Key Metrics	40 percent

As indicated here, the regulatory framework and the ability to recover prudently incurred costs and earn allowed returns comprise 50 percent of Moody's ratings considerations.

Q. What categories of additional consideration does Fitch include in its rating analysis?

A. Fitch rating methodology bases its ratings on four major categories. These categories are shown below:[20]

(i) Regulation, which assesses predictability and timeliness of cost recovery, trends in authorized returns on equity, mechanisms supportive of credit worthiness

(ii) Market and Franchise, which assesses market structure, customer trends and supply-demand dynamics

(iii) Asset Base and Operations, which assesses reliability, environmental and capital and technology

(iv) Commodity Exposure, which assesses supply diversity, hedging and fuel diversity

[20] *Financial Profile Key Factors*, *supra* note 15, at page 204.

Q. How does S&P characterize the importance of supportive regulation?

A. Supportive regulation is an important component of credit assessment, including reducing the impact of regulatory lag as noted below by S&P:

> The regulatory framework/regime's influence is of critical importance when assessing regulated utilities' credit risk because it defines the environment in which a utility operates and has a significant bearing on a utility's financial performance.
>
> We base our assessment of the regulatory framework's relative credit supportiveness on our view of how regulatory stability, efficiency of tariff setting procedures, financial stability, and regulatory independence protect a utility's credit quality and its ability to recover its costs and earn a timely return. Our view of these four pillars is the foundation of a utility's regulatory support...[21]

Q. How does Moody's characterize the importance of supportive regulation?

A. The regulatory environment and how a utility adapts to that environment are the most important credit consideration as noted below by Moody's:

> The regulatory environment is comprised of two rating factors - the Regulatory Framework and its corollary factor, the Ability to Recover Costs and Earn Returns. Broadly speaking, the Regulatory Framework is the foundation for how all the decisions that affect utilities are made (including the setting of rates), as well as the predictability and consistency of decision-making provided by that foundation. The Ability to Recover Costs and Earn Returns relates more directly to the actual decisions, including their timeliness and the rate-setting outcomes. Utility rates are set in a political/regulatory process rather than a competitive or free-market process; thus, the Regulatory Framework is a key determinant of the success of [the] utility.[22]

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[21] *Key Credit Factors for the Regulated Utilities Industry*, *supra* note 18, at page 6.

[22] ~~Moody's Investors Service, *Rating Methodology Regulated Electric and Gas Utilities*, at pages 6-7 (June 23, 2017).~~*Rating Methodology Regulated Electric and Gas Utilities, supra* note 13, at page 9.

Q. How does Fitch characterize the importance of supportive regulation?

A. Fully regulated utilities are subject to conducive tariff regulations. There exists significant regulatory oversight regarding costs of service, operating performance, financing and other strategic activities. Assessing the regulatory framework in which a utility operates is one of the key factors to help with the stability of cash flows as noted below by Fitch:

> The nature of tariff-setting mechanisms, consistency in rule-making and regulatory outcomes, and the level of political influence exerted on regulations have a significant bearing on the stability of cash flows. State regulatory frameworks do not affect a competitive generator by a similar magnitude, yet regulatory and political interests can still interfere with market mechanisms...[23].

Q. What is S&P's view on the current state of PSE's regulatory environment?

A. In the Rationale section of its report dated December 14, 2018,[24] S&P states:

> While the company has taken some steps to gradually improve its management of regulatory risk, we view the regulatory environment in Washington as generally less constructive compared to other jurisdictions, in part reflecting the lack of consistency in the regulatory construct in the state. Previously, PSE benefitted from annual preset rate increases and annual revenue decoupling adjustments under its 2013 rate plan. With the expiration of this rate plan in 2017, PSE will need to seek cost recovery using more frequent Expedited Rate Filings (ERF) or general rate cases to recover its costs. This approach introduces more regulatory risk, since adverse or delayed outcomes from these filings may introduce regulatory lag, potentially constraining the company's ability to receive timely recovery of its costs.[25]

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[23] *Financial Profile Key Factors*, *supra* note 15, at page ~~203~~202.

[24] S&P Global Ratings, *Puget Energy Inc. And Subsidiary Ratings Affirmed; Outlooks Revised to Negative On Weakening Financial Measures* (Dec. 14, 2018).

[25] *Id*. at page 4.

Q. What is Moody's view on the current state of PSE's regulatory environment?

A. In the Outlook section of its report dated August 31, 2018,[26] Moody's states:

> The stable outlook reflects PSE's credit supportive relationship with the WUTC and its stable and predictable cash flow. The outlook also incorporates our view that the current regulatory relationship in Washington will support its current financial profile, including a ratio of cash flow from operations before changes in working capital (CFO pre-WC) to debt above 20% over the next 12-18 months.[27]

Q. What is Fitch's view on the current state of PSE's regulatory environment?

A. In the Key Rating Driver section of PSE's report dated October 26, 2018,[28] Fitch states:

> PE and PSE's rating and Outlook take into consideration the relatively restrictive regulation in the state of Washington.
>
> Revenue requirements in rate case proceedings are largely based on historical test years. Authorized ROEs and equity ratios are relatively low. Expedited rate filing (ERF) allows recovery of delivery revenues between general rate cases (GRCs). However, PSE recently withdrew its ERF filing to work through the details with the commission and staff, a process that Fitch Ratings will monitor closely. Additionally, a court order related to a peer utility has cast doubts on the continuation of attrition adjustments for rate base calculation.
>
> On the positive side, PSE benefits from full revenue decoupling for both electric and gas operations that mitigates revenue fluctuation from weather, conservation and changes in energy usage patterns. PSE also benefits from trackers and recovery mechanisms for power costs, conservation, property taxes, pipeline replacement, purchased gas and low income.[29]

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[26] Moody's Investors Service, *Credit Opinion Puget Sound Energy* (Aug. 31, 2018).

[27] *Id*. at page 2.

[28] Fitch Ratings, *Fitch Affirms Puget Energy at 'BBB-' and Puget Sound Energy at 'BBB+'; Outlook Stable* (Oct. 10, 2018).

[29] *Id*. at pages 1-2.

Q. Does PSE expect that its credit ratings will be upgraded during the rate year or relative near term?

A. No. PSE does not expect that its credit ratings will be upgraded during the rate year or relative near term, particularly in light of the projected rate year credit metrics set forth above. PSE does believe that the improved rate year credit metrics discussed above will go far to persuade S&P to restore PSE's outlook from negative to stable and will provide ratings adequate protection from future negative outlooks from the rating agencies. PSE desires to maintain its current credit ratings and restore, over time, its cash flow-based credit metrics to pre-tax reform levels to cost-effectively finance operations for the benefit of customers and to provide it with a measure of financial flexibility in varying and volatile economic conditions. Additionally, PSE is hopeful that the recent settlement of the Expedited Rate Filing in Dockets UE-180899 and UG-180900 and the significant and credit supportive regulatory reform aspects of the Washington Clean Energy Transformation Act (Engrossed Second Substitute Senate Bill 5116) which was signed into law by Governor Inslee on May 7, 2019, will further persuade S&P to return PSE's rating outlook back to stable from negative.

VI. CONCLUSION

Q. Does that conclude your prefiled direct testimony?

A. Yes, it does.