

**Exh. KM-1T
Docket UG-230968
Witness: Kody McConnell**

**BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY,

Respondent

DOCKET UG-230968

TESTIMONY OF

KODY McCONNELL

**STAFF OF THE
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Staff Response to the Risk Sharing Mechanism Proposed by Puget Sound Energy

July 18, 2024

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	PURPOSE AND SCOPE.....	2
III.	ANALYSIS OF PROPOSED RSM STATISTICAL MODEL	3
IV.	ANALYSIS OF PROPOSED EARNINGS TEST	6
V.	ALTERNATIVE SHARING CAP DESIGN	9
VI.	STAFF RECOMMENDATION.....	10

1 **I. INTRODUCTION**

2

3 **Q. Please state your name and business address.**

4 A. My name is Kody McConnell, and my business address is 621 Woodland Square
5 Loop SE, Lacey, Washington, 98503. My business mailing address is P.O. Box
6 47250, Olympia, Washington 98504-7250. My business email address is
7 kody.mcconnell@utc.wa.gov.

8

9 **Q. By whom are you employed and in what capacity?**

10 A. I am employed by the Washington Utilities and Transportation Commission
11 (Commission) as a Regulatory Analyst in the Energy Rates & Services Section.

12

13 **Q. Would you please state your educational and professional background?**

14 A. I received my undergraduate education in interdisciplinary social sciences from the
15 Washington State University College of Arts and Sciences and my graduate
16 education in public administration from the Sol Price School of Public Policy at the
17 University of Southern California and in accountancy from the Business School of
18 Rutgers, The State University of New Jersey. Prior to my employment with the
19 Commission, I held positions in municipal legal affairs with Jefferson County,
20 Washington (2006-2010) and public works and utilities administration with the City
21 of Edmonds, Washington (2011-2015). I also have professional experience in the
22 successful formation and development of private-sector businesses (2016-2023). I
23 have been in my current position with the Commission since December 1, 2023.

1 **Q. Have you previously testified before the Commission?**

2 A. No.

3

4 **Q. Have you prepared any exhibits in support of your testimony?**

5 A. No.

6

7

II. PURPOSE AND SCOPE

8

9 **Q. What is the purpose of your testimony?**

10 A. My testimony contributes to Staff's analysis of the risk-sharing mechanism (RSM)
11 presented in the direct testimony of Puget Sound Energy (PSE or Company) witness
12 Christopher T. Mickelson.¹

13

14 **Q. What is the scope of your testimony?**

15 A. I begin my testimony with an overview and assessment of the statistical model
16 proposed by PSE to track and assess carbon emissions allowance costs at auction. I
17 then provide an overview and assessment of the earnings test proposed by the
18 Company to govern the application of the proposed RSM. Next, I discuss possible
19 modifications to the Company proposed earnings test to more equitably capture risk.
20 Lastly, I present the recommendation of Staff.

21

¹ Mickelson, Exh. CTM-1CT.

1 **III. ANALYSIS OF PROPOSED RSM STATISTICAL MODEL**

2

3 **Q. Can you briefly describe the statistical design of the proposed RSM model?**

4 A. Yes. PSE’s proposed RSM model provides a mechanism for sharing financial risks
5 associated with acquiring compliance instruments (allowances or offsets) under the
6 CCA. In essence, it uses historical allowance price data to both develop compliance
7 cost baseline forecasts and as the statistical basis for constructing the sharing bands.

8 PSE’s model design is based upon a box-and-whisker (i.e., boxplot) statistical
9 analysis utilizing data points from daily prices per metric ton carbon dioxide
10 equivalents (MTCO_{2e}) in the allowance markets over each CCA compliance period
11 along with compliance instrument acquisition volumes and other associated costs.²
12 The frequency distribution for these data is then used to establish the RSM sharing
13 bands. PSE’s proposed mechanism passes 100 percent of compliance costs through
14 to ratepayers for auction instrument purchases priced below the 75th percentile, 90
15 percent of compliance costs for auction instrument purchases between the 97.5th and
16 75th percentiles, and 80 percent of compliance costs for auction instrument purchases
17 above the 97.5th percentile.³

18 At the end of each annual compliance period, actual market prices the
19 Company paid for CCA compliance instruments would be compared to the baseline
20 forecast to determine whether the Company paid more or less than the amounts
21 predicted by the statistical model. This variance between actual and anticipated

² Mickelson, Exh. CTM-1CT at 4:8-17.

³ *Id.* at 14-15.

1 compliance costs is then run through the Company's proposed sharing bands to
2 determine allocation of costs between the Company and ratepayers.

3
4 **Q. Does Staff see merit in the statistical design of PSE's proposed RSM model?**

5 A. In general, yes. As a threshold matter, Staff agrees with the Company that the design
6 of the RSM should be focused on allowance instrument market financial risks rather
7 than total emission variance risk. With respect to the model itself, Staff believes that
8 PSE's proposed statistical design and model inputs are appropriate as they adopt a
9 backward-looking approach to reflect actual market dynamics and avoid reliance on
10 projections. Staff also agrees with the Company that larger datasets encompassing
11 full compliance periods improve statistical analysis and finds PSE's reliance on the
12 statistical analysis of allowance price datasets to be a reasonable approach for
13 designing a RSM and its associated sharing bands. The Commission has noted, in
14 similar context, that modeled results are generally acceptable if the model inputs are
15 reasonable.⁴

16
17 **Q. Is the RSM model proposed by the Company properly risk-sharing?**

18 A. Yes. The model described in PSE witness Mickelson's testimony, Exh. CTM-1CT,
19 provides for risk-sharing. The proposal focuses on sharing the upside price risk of
20 the CCA allowance instrument auction between shareholders and ratepayers rather
21 than attempting to share the overall cost of compliance. Because the cost of the

⁴ *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-090134, UG-090135 & UG-060518, Order 10, 22, ¶ 49 (Dec. 22, 2009).

1 carbon transition will ultimately be reflected in general rates, it will eventually be
2 borne primarily by ratepayers as a function of PSE's overall cost of providing utility
3 service. An effective CCA RSM will work to ensure that the Company is
4 incentivized to operate with maximal compliance efficiency. As Chapter 70A.65
5 RCW provides for significant penalties for general emissions compliance failure, the
6 RSM serves as a supplementary motivator to ensure ratepayers are not penalized
7 should the Company fail to adequately strategically manage its compliance risk.

8
9 **Q. Does Staff have any concerns with PSE's proposed RSM?**

10 A. Yes. Aside from Staff's concerns with the design of PSE's proposed earnings test
11 (which I address separately below), Staff is concerned that the complexity of PSE's
12 proposed RSM could make the operation of the mechanism difficult to understand,
13 communicate to ratepayers and the public, and implement. Given the eventual
14 trajectory of utility base rate absorption of decarbonization costs over the compliance
15 periods reflected in CETA and CCA, the long-term institutionalization of the
16 proposed statistical model presented by the Company is not in the public interest.

17
18 **Q. Can the RSM model be described as performance-based regulation (PBR)?**

19 A. This is a complicated answer because academic opinions vary. Staff believes that a
20 PBR, strictly-speaking, should provide at least an opportunity for an investor-owned
21 utility to increase its net earnings beyond its authorized rate of return. PSE states it
22 has no desire or intention to increase its net earnings through the implementation of

1 this mechanism.⁵ The proposed RSM instead predominantly functions to pass-
2 through the majority of compliance costs caused by unanticipated and unhedged
3 upward price excursions while conversely ensuring that a collapse in allowance
4 auction and market prices and the concomitant compliance costs accrues solely to the
5 benefit of ratepayers by reducing the overall amount of pass-through costs.

6 7 **IV. ANALYSIS OF PROPOSED EARNINGS TEST**

8
9 **Q. Please describe the earnings test in the Company's proposed RSM model.**

10 A. The Company proposes to make the application of its proposed sharing bands subject
11 to a financial earnings test. Specifically, the Company proposes no cost-sharing or
12 risk-sharing should occur unless total rate of return exceeds those authorized by the
13 Commission in the Company's latest general rate case. Essentially, PSE seeks to
14 bracket its risk regardless of the results of the statistical distribution of compliance
15 instrument prices described in the proposed RSM model.

16
17 **Q. What is Staff's response to PSE's proposal to implement an earnings test?**

18 PSE's proposed earnings test is incompatible with equitable risk-sharing. With its
19 proposed earnings test, PSE is, in effect, attempting to put into place a secondary
20 mechanism that would function to shield PSE from the risk that the Company would
21 absorb under its own proposed RSM. In effect, with PSE's proposed earnings test

⁵ Mickleson, Exh. CTM-1CT at 3:10-11

1 the Company must over-earn for ratepayers to qualify for any relief from exposure to
2 CCA compliance cost variance risk, obviating the real assumption of meaningful risk
3 by the Company and shifting the risk balance back towards ratepayers.

4 Within the context of CCA cost recovery, to the Company the “risk” is that,
5 if significant enough, upward price excursions could have a material adverse effect
6 on the Company’s earnings. As explained in the testimony of Staff witness
7 McGuire, at present PSE is entirely shielded from this risk. That is, with a CCA
8 tracking and true-up mechanism that does not include a risk-sharing mechanism,
9 variance risk is borne in full by ratepayers. And the fact that currently variance risk
10 is borne in full by ratepayers is the *reason* a risk-sharing mechanisms is needed, the
11 Company must share in the burden of variance risk. Yet with its proposal to
12 implement an earnings test, PSE is attempting to avoid sharing in that burden.

13
14 **Q. Is an earnings test appropriate for capping shareholder financial risk related to**
15 **complying with the requirements of the CCA?**

16 A. There is some merit to the notion that there should be a relationship between the
17 potential adverse earnings impact of an identified risk and whether shifting some of
18 that risk onto ratepayers if justified. When designing a risk-sharing mechanism for a
19 specified category of costs (such as CCA compliance costs), an earnings test might
20 seek to limit the adverse earnings impacts specifically caused by potential, material
21 increases to those specific costs. In that way, variance risk can be shared fairly and
22 equitably between utility and ratepayers while providing the utility with protection
23 from potentially large earnings reductions caused by extreme cost variances.

1 PSE's proposed earnings test does not examine the relationship of CCA
2 compliance cost variances to earnings impacts. Rather, PSE's proposed earnings test
3 examines the Company's overall earnings and then conditions its CCA risk-sharing
4 mechanism on those earnings. PSE's proposed earnings test is divorced from CCA
5 compliance cost variance risk and, therefore, it is not designed to address the risk
6 that CCA compliance cost variances will materially adversely impact the Company's
7 earnings or limit the Company's exposure to that risk. As a result, PSE's proposed
8 earnings test would not be appropriate to apply to any risk-sharing mechanism the
9 Commission might authorize in this proceeding.

10
11 **Q. Can you provide examples of analogous circumstances or programs?**

12 A. Staff compared PSE's proposed RSM model to the mechanisms currently used to
13 manage and control wholesale net purchased energy costs. While these risk sharing
14 mechanisms employ sharing bands to distribute costs or savings, they do not utilize
15 earnings tests. There are similarities between the markets for energy and emissions
16 which will continue to inform this discussion. Similar to wholesale energy markets,
17 carbon emissions markets expose PSE to potential risks that can be largely outside of
18 its ability to influence or control in the short term and can have significant impacts
19 on its rate of return. A significant distinction between the two is that express public
20 policy broadly directs PSE's strategic decision-making in its carbon emissions
21 market activity. While this was not historically as true of their activities in wholesale
22 energy markets, this is changing with implementation of new legislation such as the

1 Clean Energy Transformation Act (CETA) that mandate portfolio standards for
2 distinct categories of generated and distributed electricity.

3
4 **V. ALTERNATIVE SHARING CAP DESIGN**

5
6 **Q. Has Staff considered an alternative approach to the Company proposed RSM?**

7 A. Yes. In the event the Commission wishes to order PSE to establish a RSM but finds
8 PSE's proposed earnings test unacceptable, Staff believes it should implement an
9 alternative design utilizing a cost sharing cap that is placed upon the Company's
10 annual return on equity (ROE).

11
12 **Q. Does this potential alternative limit Company exposure to financial risk?**

13 A. Yes. The sharing cap will govern Company financial exposure for the compliance
14 periods by limiting it to a total of 10 basis points of ROE per calendar year, i.e.,
15 10 basis points of 2023 ROE + 10 basis points of 2024 ROE + 10 basis points of
16 2025 ROE + 10 basis points of 2026 ROE = Total 4-year compliance period cost.

17 The current CCA compliance periods are four years long. Should the carbon
18 emissions market linkage between California, Quebec, and Washington occur, our
19 state would have to transition to a three-year compliance period to synchronize with
20 its parallel markets. Following linkage, the RSM would utilize 10 basis points of
21 equity per year for the three-year period.

1 **VI. STAFF RECOMMENDATION**

2

3 **Q. What is Staff’s recommendation regarding a CCA compliance cost tracker and**
4 **proposed RSM?**

5 A. As explained in the testimony of Staff witness McGuire, Staff recommends that the
6 Commission order PSE in its next general rate case to eliminate Schedule 111 and
7 instead include CCA compliance costs into the Company’s base rate revenue
8 requirement calculation. If CCA compliance costs are embedded in base rates rather
9 than recovered through a tracker, then establishing a risk-sharing mechanism is
10 unnecessary.

11 However, if the Commission declines to order PSE to eliminate the CCA
12 tracker, establishing a risk-sharing mechanism is essential. Therefore, in the event
13 the Commission allows PSE to continue collecting CCA compliance costs through
14 Schedule 111, Staff recommends that the Commission order PSE to implement
15 effective January 1, 2025, PSE’s proposed risk-sharing mechanism modified to
16 remove the proposed earnings test and replace it with Staff’s sharing cap proposal.

17

18 **Q. Does this conclude your testimony?**

19 A. Yes.