

**BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY,

Respondent.

DOCKET UG-230968

OPENING TESTIMONY

OF

WILLIAM GEHRKE

ON BEHALF OF

JOINT ENVIRONMENTAL ADVOCATES

July 18, 2024

**OPENING TESTIMONY OF WILLIAM GEHRKE
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TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	CCA OVERVIEW	2
III.	PSE’S RISK-SHARING MECHANISM PROPOSAL	11
	<i>A. OUTLINE OF PSE’S RISK-SHARING MECHANISM</i>	11
	<i>B. PROBLEMS WITH PSE’S RISK SHARING MECHANISM.</i>	14
IV.	JEA’S RISK-SHARING PROPOSAL	21
V.	CONCLUSION	30

**OPENING TESTIMONY OF WILLIAM GEHRKE
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LIST OF EXHIBITS

- | | |
|------------|-------------------------------------|
| Exh. WG-1T | Opening Testimony of William Gehrke |
| Exh. WG-2 | PSE Emissions in 2050 |
| Exh. WG-3 | Risk-Sharing Mechanism |

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is William Gehrke, and I am a Senior Technical Analyst at the NW Energy Coalition (“NVEC” or the “Coalition”). My business address is 811 1st Ave., Suite 305, Seattle, WA 98104.

Q. Please describe your background and experience.

A. I received a bachelor’s and a master’s degree in economics from Florida State University. In 2016, I was a utility analyst for the Florida Public Service Commission. From 2017 to 2023, I worked as an economist for Oregon’s residential consumer advocate. In my career, I have worked on rate-making, planning, and policy dockets before the Washington Utilities and Transportation Commission, Oregon Public Utilities Commission and the Federal Energy Commission. I have been in my current role for NVEC since 2023.

Q. On whose behalf are you testifying?

A. I am testifying for the Joint Environmental Advocates (“JEA”), which includes Climate Solutions, NVEC, and Washington Conservation Action.

Q. What is the purpose of this opening testimony?

A. My testimony responds to PSE’s testimony on a risk-sharing mechanism for the CCA. The first section provides an overview of CCA provisions relevant to my testimony, the second section provides an overview of PSE’s risk-sharing mechanism, and the third section provides an overview of JEA’s risk-sharing mechanism.

1 **II. CCA Overview**

2 **Q. What is the Climate Commitment Act?**

3 A. The Washington legislature passed the CCA in 2021 to gradually reduce carbon
4 emissions in the state's economy. For more details on the Climate Commitment
5 Act, refer to Lauren McCloy's testimony.

6 **Q. What compliance requirements are outlined in the CCA?**

7 A. Covered entities are subject to four-year compliance periods.¹ The first compliance
8 period spans January 2023 to December 2026. The second compliance period will
9 span January 2027 to December 2030. As part of their annual compliance
10 obligation, covered entities must ensure that thirty percent of their covered
11 emissions² from the previous calendar year are accounted for by November 1.³
12 After a four-year compliance period is complete, a covered entity must
13 demonstrate that it has sufficient compliance instruments to offset its actual
14 covered emissions for that compliance period by the following November 1.⁴

15 This means that on November 1, 2024—the first year of the CCA's first
16 compliance period—PSE will need to have 30% of its covered emissions for 2023
17 in its compliance account. And by November 1, 2027, PSE would need to
18 demonstrate that it has met its obligations for the first compliance period by having

¹ WAC 173-446-600.

² Covered emissions means the emissions described in WAC 172-446-060 for which a covered entity has a compliance obligation under this chapter.

³ WAC 173-446-600 (3).

⁴ WAC 173-446-600 (4).

1 sufficient compliance instruments in its compliance account associated with its
2 covered emissions.

3 **Q. How can PSE comply with the CCA?**

4 A. PSE can do the following in response to the CCA:

5 (1) Reduce system emissions: the fundamental goal of the CCA program is to
6 reduce emissions associated with the natural gas system.

7 (2) Acquire Compliance Instruments

8 (a) Offsets⁵: offsets are a vehicle for investing in programs that sequester
9 greenhouse gases. They are not additive to the cap in the CCA program.
10 This means that if a covered entity uses an offset, Ecology will reduce
11 the total number of allowances available in that compliance period
12 proportional to the number of offsets used. PSE can cover up to five
13 percent of their allowances through offsets for the first compliance
14 period and up to four percent through offsets for the second compliance
15 period.

16 (b) Allowances: an allowance is an instrument that permits the holder to
17 emit up to one metric ton of carbon dioxide.⁶

18 **Q. What is the primary way that covered entities can acquire allowances?**

19 A. The primary way covered entities such as PSE acquire allowances is through

⁵ WAC 173-446-500.

⁶ WAC 173-446-400 (1).

1 Ecology's Cap-and-Invest auction process.⁷ Ecology is required to offer four
2 auctions per calendar year.⁸ During each compliance period, there are sixteen
3 Ecology Cap-and-Invest auction processes.

4 **Q. What role do no-cost allowances have for PSE?**

5 A. As a natural gas supplier, PSE is allocated no-cost allowances.⁹ The amount of no-
6 cost allowances that PSE receives from Ecology is based on a determination of
7 PSE's baseline emissions prior to the implementation of the CCA determination.¹⁰
8 The number of no-cost allowances PSE receives declines over time. In 2023, PSE
9 will be required to consign 65% of no-cost allowances to auction. The consignment
10 percentage will increase by 5% annually until 2030, when PSE must consign all
11 no-cost allowances.¹¹

12 In PSE Exhibit TLF-10, the Company detailed a forecast of the no-cost
13 allowances available to the Company. PSE is required to use these allowances to
14 benefit ratepayers and either use them for compliance or consign them to auction.¹²
15 Thus, if PSE does not use a no-cost allowance for compliance, PSE must sell the
16 no-cost allowances through the Ecology auction consignment process. Once
17 Ecology sells PSE's consigned allowances, PSE receives revenue associated with

⁷ WAC 173-446-300.

⁸ WAC 173-446-300 (1).

⁹ WAC 173-446-240.

¹⁰ PSE's baseline emissions are based on historical emissions from 2015-2019.

¹¹ UG-230968 – PSE Exhibit JK-1T, Page 28, Table 2.

¹² WAC 173-446-240(3).

1 the sale of the consigned allowances and can use the consigned allowance revenue
2 to mitigate the price impacts of the CCA or fund decarbonization projects.

3 **Q. What is Ecology’s Cap-and-Invest auction process?**

4 A. Ecology’s general allowance auction process is not a conventional revenue-
5 maximizing auction. In Ecology’s auction format, bidders submit demand
6 schedules specific to the quantity of allowances demanded at various price levels.
7 These schedules indicate the allowances participants seek to purchase at different
8 price points. The demand schedules are reconciled with supply to determine a
9 market price at the marginal bid, the lowest accepted bid price, also known as the
10 auction settlement price. All bids above the market price are awarded allowances.
11 Bids offered at a price lower than the auction’s cleared marginal price are not
12 granted an allowance.¹³

13 **Q. What impact do vintages have on allowances used for compliance?**

14 A. Except in the case of APCR allowances detailed later in this testimony, covered
15 entities may not use an allowance from a future allowance vintage year to meet
16 current or past compliance obligations under the CCA.¹⁴ For example, a covered
17 entity cannot use a 2027 vintage allowance to meet a 2023 compliance need.

18 **Q. Are there any restrictions on bid prices and quantities in a Cap-and-Invest
19 auction?**

20 A. Yes. All auctions are subject to price ceilings and floors.¹⁵ The auction price floor

¹³ WAC 173-446-357.

¹⁴ WAC 173-446-080 (6).

¹⁵ WAC 173-446-335.

1 for 2023 was \$22.20 per allowance, and the auction ceiling price for the calendar
2 year 2023 was \$81.47 per allowance.¹⁶

3 The auction price ceiling and price floors are not static. These price controls
4 increase annually by 5%, plus the annual change in Consumer Price Index for All
5 Urban Consumers (CPI-U).¹⁷

6 There are limits to how many allowances a party can bid for in an auction.
7 In 2023 and 2024, covered entities cannot hold more than 10% of allowances
8 offered in a single auction. Beginning in 2025, covered entities are restricted from
9 acquiring over 25% of the allowances available in each Cap-and-Invest program
10 quarterly auction.¹⁸

11 **Q. Can non-covered entities participate in the auction process?**

12 A. Yes. Apart from covered entities, a separate group of auction participants known as
13 general market participants can also choose to purchase allowances at auction.¹⁹
14 General market participants do not need to comply with the CCA by purchasing
15 allowances. They primarily interact in the Ecology auction process to buy and sell
16 allowances to profit in sales on the secondary market.

17 **Q. What is the secondary market for carbon allowance costs?**

18 A. Rather than purchasing allowances directly from Ecology's auction process,
19 covered entities can buy and trade allowances from other covered entities or

¹⁶ WAC 173-446-335 (1). WAC 173-446-335 (4).

¹⁷ WAC 173-446-335 (2). WAC 173-446-335 (5).

¹⁸ This change is subject to SB 6058 going into effect.

¹⁹ WAC 173-446-055.

1 general market participants in the secondary market. The secondary market is
2 helpful for covered entities because it provides a venue besides Ecology auctions to
3 acquire allowances.

4 **Q. How does the secondary market work?**

5 A. The secondary market is an alternative avenue for covered entities to acquire
6 allowances and fulfill their obligations under the CCA. In specific cases, a covered
7 entity may need particular vintage year allowances to demonstrate compliance with
8 the CCA. For instance, as a covered entity approaches the final compliance
9 deadline (Nov. 1, 2027) within the initial compliance period (2023-2026), it is
10 required to exhibit to the regulatory body, Ecology, that it possesses adequate
11 allowances in its compliance account to meet its covered emissions targets. The
12 covered entity may therefore seek that vintage year allowance on the secondary
13 market if it needs to meet its compliance obligation.

14 **Q. How does the Department of Ecology mitigate primary auction and secondary
15 market prices for allowances in the CCA program?**

16 A. Ecology has implemented safeguards to mitigate price escalations for the CCA
17 within the program's design. The program is structured to control compliance
18 prices in several ways. First, auctions have a maximum ceiling price in rules,
19 which impacts compliance prices by serving as a maximum limit on allowance
20 costs in the primary markets. The primary market price ceiling indirectly
21 moderates secondary prices. Second, Ecology's Cap-and-Invest program addresses
22 price increases in the primary auction through the allowance price containment
23 reserve (APCR) auction process. Third, the program uses price ceiling unit sales.

1 The APCR and price ceiling units are discussed below.

2 **Q. What is the APCR?**

3 A. Ecology reserves a portion of total allowances for each year of the compliance
4 period to be used in the APCR. These allowances are specifically reserved to help
5 covered entities manage their CCA compliance costs or assist covered entities in
6 complying with the CCA. APCR allowances are distributed through APCR
7 auctions.²⁰ APCR auctions occur under three circumstances:

8 (1) When allowance prices in Ecology’s auctions hit a certain price “tier”, as discussed
9 further below and dubbed “APCR conventional auctions,”

10 (2) When new covered entities enter the program and allowances in the “emissions
11 containment reserve” are exhausted, and

12 (3) Once a year prior to the compliance deadline, discussed further below and dubbed
13 “APCR compliance auctions.”

14 **Q. Is the APCR unlimited in allowance availability?**

15 A. No. Ecology allocates a set number of allowances to the allowance price reserve
16 account. Ecology can vary this allotment for each compliance period. For instance,
17 during the initial compliance period, Ecology moved five percent of the allowances
18 in the annual allowance budget for each year of the period.²¹

19 **Q. What is the APCR Tier 1 price?**

20 A. The Tier 1 price is set at \$46.05 for 2023.²² Like the auction floor and ceiling

²⁰ RCW 70A.65.150

²¹ WAC 173-446-370 (1)(c)(i).

²² WAC 173-446-370 (4)(b)(i).

1 prices, the Tier 1 price is not static and increases annually in percentage terms,
2 with the change being 5% plus the annual change in CPI-U inflation since
3 December.

4 **Q. What is the APCR Tier 2 price?**

5 A. In 2023, the APCR Tier 2 price was \$59.17.²³ Like the APCR Tier 1 price, Tier 2
6 is not static and increases annually in percentage terms, with the change being 5%
7 plus the annual change in CPI-U inflation since December.

8 **Q. When does Ecology hold a conventional APCR auction?**

9 A. Ecology holds a conventional APCR auction when the settlement price of a
10 quarterly Cap-and-Invest auction exceeds that Tier 1 price.²⁴ The Tier 1 price is the
11 reserve price that will trigger a conventional APCR auction. In 2023, two
12 conventional APCR auctions occurred, one on August 9th, 2023, and another on
13 November 8th, 2023.

14 **Q. What are APCR compliance auctions?**

15 A. As detailed above, covered entities are subject to compliance deadlines. Annual
16 compliance deadlines occur in November of the year following the compliance
17 year. APCR compliance auctions help provide allowances to covered entities who
18 need additional allowances to meet compliance deadlines. APCR compliance
19 auctions are planned to occur each year before compliance deadlines.²⁵ The next
20 APCR compliance auction will occur prior to the 2023 annual compliance deadline

²³ WAC 173-446-370 (4)(b)(ii).

²⁴ RCW 70A.65.150

²⁵ WAC 173-446-370 (2)(c).

1 of November 1, 2024.

2 **Q. What happens when Ecology calls an APCR auction?**

3 A. The APCR auctions are not like Ecology's Cap-and-Invest quarterly auctions.
4 Under this auction format, only covered entities can participate in the APCR
5 process. Allowances sold under the APCR auctions are under the cap and are
6 drawn from the APCR. Covered entities can only offer bids at two price levels:
7 APCR Tier 1 and APCR Tier 2. A covered entity can enter multiple bids in an
8 APCR auction at Tier 1 or Tier 2 prices. There are no purchase limits on covered
9 entities in the APCR process.²⁶

10 **Q. What is the intended impact of the APCR auction process?**

11 A. APCR allowances have no vintage and are eligible for compliance at any time.²⁷
12 Since Tier 1 and Tier 2 prices for APCR auctions are set by rule and not market
13 forces, the APCR auctions serve as a relief valve on price increases by issuing
14 allowances at fixed Tier 1 and Tier 2 prices to only covered entities. As noted
15 earlier in the testimony, the APCR is not unlimited. Both compliance APCR
16 auctions and conventional APCR auctions draw from the same reserve to offer
17 allowance units for sale.

18 **Q. What are price ceiling units?**

19 A. Price ceiling units are the final safeguard offered in the CCA program. For them to
20 be sold, the APCR account needs to be depleted before the final compliance

²⁶ WAC 173-446-370 (4)(a).

²⁷ WAC 173-446-370 (1)(a).

1 deadline for a compliance period. Price ceiling units are only provided before the
2 final compliance deadline in each compliance period. Only covered entities with
3 sufficient eligible compliance instruments in their compliance accounts can
4 participate in a price ceiling unit sale. Price ceiling units are priced at Ecology's
5 ceiling price for the compliance period. Price ceiling units are the most expensive
6 compliance instrument covered entities can acquire.

7 **Q. What are the penalties for not holding sufficient compliance instruments to**
8 **match a covered entity's covered emissions?**

9 A. If a covered entity does not have sufficient compliance instruments in its
10 compliance accounts to meet compliance deadlines, the non-compliant covered
11 entity must provide four penalty allowances for each shortfall of the compliance
12 instrument during the compliance period.²⁸ If a covered entity fails to submit
13 penalty allowances, the party receives a \$10,000 per day per violation fine.²⁹
14 Additionally, if a natural gas supplier fails to comply with the CCA, that entity no
15 longer receives no-cost allowances.³⁰

16 **III. PSE'S RISK-SHARING MECHANISM PROPOSAL**

17 **A. *OUTLINE OF PSE'S RISK-SHARING MECHANISM***

18 **Q. What is Puget Sound Energy's proposed risk-sharing mechanism?**

19 A. PSE proposed a risk-sharing mechanism that compares the weighted average cost

²⁸ WAC 172-446-610 (1).

²⁹ WAC 172-446-610 (3).

³⁰ WAC 173-446-240 (2)(ii)(d).

1 of compliance for PSE in a year versus secondary market prices. Any sharing that
2 would occur in PSE’s risk-sharing mechanism would be subject to an earnings test
3 that would only allow risk sharing if PSE is earning more than its authorized rate
4 of return on average over the compliance period.

5 **Q. What is the average annual compliance cost?**

6 A. The average annual compliance cost is the average cost of all CCA compliance
7 instruments PSE obtains for a year.

8 **Q. What did PSE analyze when creating its risk-sharing mechanism?**

9 A. The Company analyzed the daily prices of allowances on the secondary market for
10 2023. PSE sharing bands were created based on statistical analysis of secondary
11 prices.

12 **Q. What are PSE’s sharing bands in its proposal?**

13 A. The Company proposed a framework for calculating percentiles of historical
14 secondary market purchase prices and then establishing three “sharing bands.”³¹

15 The first sharing band is called the “Deadband,” which spans from the third
16 quartile of the secondary market price data to the auction floor price.

17 The second sharing band, “A1,” spans from 1 penny above the Deadband
18 ceiling to the 97.5 percentile of secondary market prices.

19 The third sharing band, “A2,” spans from 1 penny above the 97.5 percentile
20 of secondary market prices to the auction ceiling price of the compliance period.

21 **Q. How does PSE’s proposed risk-sharing mechanism function?**

³¹ A band is a way of grouping values into ranges, between two defined limits, that enables certain types of statistical analysis.

1 A. PSE's risk-sharing mechanism is backwards looking. PSE's mechanism essentially
2 compares the average annual compliance cost to sharing bands and provides cost
3 sharing only if two conditions are met: 1) if annual average compliance costs fall
4 within specific sharing bands, and 2) if the Company meets a self-selected earnings
5 test.

6 Regarding the first condition of specific sharing bands: if the average
7 compliance cost in a year is within the "Deadband" of PSE's risk-sharing
8 mechanism, customers would bear 100 percent of costs. If the average compliance
9 cost is within the "A1" band, customers would bear 90% of costs, and the
10 Company would bear 10% of costs. If the average compliance cost is within the
11 "A2" band, customer would bear 80% of costs and the Company would bear 20%
12 of costs.

13 As to the second condition, PSE proposes that the risk-sharing mechanism
14 be subject to an earnings test. The Company bears no costs if its earnings fall
15 below its authorized rate of return on average over the compliance period.

16 **Q. What is the earnings test for PSE's risk-sharing mechanism?**

17 A. PSE's proposed earnings test assesses earnings over four years by summing the
18 allowed net operating income for that period and comparing it to the restated net
19 operating income from the adjusted commission basis reports for the same period.
20 According to PSE's proposal, if the average four-year earnings during the
21 compliance period fall below the company's authorized rate of return, PSE does not
22 bear any costs. The company only bears costs under this mechanism if the average
23 earnings under the commission basis reports exceed its authorized rate of return.

1 ***B. PROBLEMS WITH PSE'S RISK SHARING MECHANISM.***

2 **Q. Can you summarize your concerns with PSE's risk sharing mechanism?**

3 A. As I describe below, my concerns relate both to PSE's methodology and to the
4 equities behind risk sharing. The metrics used necessarily skew in PSE's favor, and
5 the mechanism virtually guarantees that PSE will not be obligated to share any
6 risk. Additionally, PSE's proposed method of CCA compliance ignores its
7 responsibility to shoulder some risk associated with its emissions and results in
8 unfairness to PSE customers.

9 **Q. What are the issues with using the average annual compliance price to**
10 **evaluate how PSE's portfolio performed?**

11 A. PSE's proposed risk-sharing mechanism is triggered when the average annual
12 compliance price surpasses the 75th percentile of secondary market prices in the
13 compliance period. With no-cost allowances, APCR allowances, and the expertise
14 of PSE's trading team, PSE will effectively show strong performance compared to
15 the average annual compliance price metric. This means that PSE will be unlikely
16 to share in any risk.

17 APCR allowances and no-cost allowances influence the average annual
18 compliance cost. APCR allowances ensure that covered entities can obtain
19 adequate allowances at reasonable fixed prices to fulfill their compliance
20 obligations. It's important to note that APCR allowances are not accessible to
21 general market participants who engage as counterparties in the secondary market.
22 The price certainty associated with APCR prices will assist PSE in managing the
23 risk of a high average annual compliance price. PSE's natural gas operations also

1 benefit from no-cost allowances, granting the Company a financial advantage over
2 other covered entities and allowing it to be more cautious in acquiring allowances.
3 In the short term, these no-cost allowances reduce PSE's compliance requirements,
4 as the Company is not obligated to purchase the full quantity of allowances
5 required to cover its emissions. PSE's capacity to acquire no-cost allowances will
6 enable PSE to mitigate the risk of facing high average annual compliance prices in
7 the near term.

8 In addition, PSE is an experienced entity that engages in trading activities
9 within commodity markets. The Company's Energy Supply Merchant department
10 plays a critical role in managing PSE's carbon position for its natural gas LDC
11 operations. One of the responsibilities of this department is to secure allowances in
12 way that minimize the risk to shareholders. PSE's Energy Supply Merchant
13 department strategically acquires allowances to manage carbon positions,
14 considering least cost and least risk factors, and monitoring market price trends for
15 efficient decision-making. If PSE's risk sharing mechanism were adopted, PSE
16 would respond by acquiring allowances against an average annual compliance
17 price metric to minimize risk to investors.

18 In summary, the combination of natural gas no-cost allowances, APCR
19 allowances, and the expertise of PSE's trading team allows PSE to effectively
20 demonstrate strong performance against the average compliance cost metric and
21 thereby evade any risk sharing.

22 **Q. Is PSE's earnings test an appropriate condition of the risk-sharing model?**

23 A. No. PSE's earnings test is meant to reduce risk to the Company. PSE's earning test

1 ensures that risk sharing would only occur in the unlikely event that PSE overeans
2 on average during the compliance period.

3 Though earnings tests are typically based on a calendar year, PSE averages
4 the earnings test over several years. PSE's proposal to average earnings over the
5 compliance period reduces the likelihood of PSE bearing any risk under its risk-
6 sharing mechanism. For example, suppose one follows PSE's method for
7 calculating average earnings. In that case, the Company might encounter a year of
8 extremely low earnings, lowering the average earnings over the compliance period.
9 The year of low earnings would make it more likely for PSE's earning test to be
10 triggered for the entire four-year compliance period, preventing PSE from
11 incurring costs under PSE's risk-sharing mechanism.

12 PSE's earnings test shifts the risk away from the Company's investors, as it
13 only imposes risk on the Company when it earns excessively for the entire
14 compliance period. Risk sharing is unlikely to occur because of the averaging of
15 net income or earnings over the compliance period when assessing costs under
16 PSE's earnings test.

17 **Q. Should PSE's risk sharing mechanism be implemented?**

18 A. No. Not only does PSE's risk-sharing mechanism fail to use appropriate metrics, it
19 also does not fairly represent the interests of customers. It's unlikely that *any* risk-
20 sharing will take place under PSE's proposed mechanism.

21 JEA are not in favor of PSE's suggested risk-sharing mechanism due to its
22 failure to incentivize PSE to decrease emissions in accordance with state
23 objectives. In fact, if PSE's natural gas system emissions increase under PSE's risk

1 sharing mechanism, PSE could pass all costs of the CCA program on to customers
2 as long as the Company manages CCA compliance costs in comparison to prices in
3 the secondary market and does not overearn on average over the compliance
4 period.

5 **Q. Does PSE recommend that the Commission adopt any risk-sharing**
6 **mechanism?**

7 A. No. It is clear that PSE views the CCA as a pass-through cost.³² PSE does not
8 recommend that the Commission adopt a risk-sharing mechanism.³³ PSE only
9 offered a risk-sharing mechanism due to the Commission ordering it to propose
10 one. PSE designed a risk-sharing mechanism that would not result in CCA risk
11 sharing due to its earnings test and design.

12 **Q. How has PSE sought to justify passing through CCA compliance costs to**
13 **customers?**

14 A. PSE, alongside other Washington energy utilities, has stated that customers should
15 solely bear CCA compliance costs because customers are the polluters. Therefore,
16 PSE argues that CCA costs are passthrough costs that customers create and these
17 costs should only be borne by customers.

18 **Q. What is JEA's response to PSE's position?**

19 A. JEA oppose the notion that PSE's natural gas customers should bear the entire
20 burden of carbon regulation. The CCA has imposed carbon regulations on PSE's

³² UG-230968 – PSE Exhibit CTM-1T, Page 3, Lines 11.

³³ UG-230968 – PSE Exhibit MS-1T, Page 16, Lines 10-11.

1 natural gas operations; utilities are the “covered entities” responsible for
2 compliance by statute. PSE has been aware of its natural gas operations'
3 contribution to greenhouse gas emissions for decades.³⁴ PSE has also been aware
4 of the CCA’s emissions reduction goals and requirements since at least the bill’s
5 enactment in 2021—two years before compliance obligations even commenced.
6 With the implementation of the CCA, PSE is now accountable for decarbonizing
7 its business operations.

8 In 2023, PSE had 873,000 customer accounts. A significant proportion of
9 natural gas customers, whether homeowners or renters, lack the means or ability to
10 independently transition their residence away from fossil gas. Additionally, a
11 significant number of customers do not have the option to choose whether to
12 connect their homes to the natural gas system. For instance, building developers,
13 not homebuyers, often make decisions about which source of energy to use when
14 constructing buildings to sell. Indeed, it has been a common and decades-long
15 practice nationwide for gas utilities and gas industry associations to promote fossil
16 gas use in homes by providing incentives to builders, contractors, and real estate
17 agents.³⁵ JEA wish to emphasize to the Commission that PSE has realized profits

³⁴ See David Anderson, Matt Kasper, & David Pomerantz, *Utilities Knew: Documenting Electric Utilities’ Early Knowledge and Ongoing Deception on Climate Change From 1968-2017*, Energy and Policy Institute (July 2017), <https://energyandpolicy.org/utilities-knew-about-climate-change/>.

³⁵ See, e.g., Dharna Noor, *Revealed: US Utility Firms Offer Builders Cash and Trips to Fit New Homes With Gas Appliances*, The Guardian (Dec. 21, 2023), <https://www.theguardian.com/us-news/2023/dec/21/new-home-builder-contractor-fossil-fuel-utilities-natural-gas> (detailing incentives that include a Punta Cana vacation earned by

1 and will continue to do so from its historic natural gas system expansion and pro-
2 gas programs, advertising, and lobbying.

3 Natural gas customers have varying levels of access to capital, use natural
4 gas in different ways, and receive natural gas services under different rate
5 schedules. Yet under PSE's passthrough proposal, customers bear all the risks
6 associated with the CCA and the costs of energy decisions that many customers did
7 not have the agency to create. PSE (and predecessors to the Company) have had a
8 role in the current carbon costs facing the Company through their choices to
9 promote and expand the natural gas distribution system.

10 **Q. How does PSE plan to respond to the CCA as a covered entity?**

11 A. PSE's 2022 Integrated Resource Plan (IRP) reveals that the Company intends to
12 continue relying on fossil-derived fuels for the foreseeable future, primarily
13 favoring natural gas. As illustrated in WG Exhibit-2, PSE's planned carbon
14 emissions trajectory indicates that the Company aims to emit 4.1 million metric
15 tons of carbon in its preferred portfolio by 2050, with natural gas operations
16 accounting for 82% of Washington State's total carbon emission targets.³⁶ PSE has
17 yet to establish long-term plans to abate natural gas emissions, a decision that
18 contradicts statewide goals and should not be condoned by the Commission.

accumulating points per home installed with gas air and water heating, offering training programs to builders that emphasize the supposed benefits of gas appliances, promoting the use of gas water heating appliances by falsely claiming their superior efficiency, and encouraging false marketing such as claiming that fossil gas is helping reduce overall emissions or ignoring that gas homes are typically more expensive to build).

³⁶ Corrected Appendix F Data Input File to PSE's 2023 Final Gas Utility Integrated Resource Plan, Docket UG-220242.

1 Besides being contrary to statutory goals and to customer interests, PSE’s current
2 plan reflects a moral hazard.

3 **Q. What is “moral hazard”?**

4 A. Moral hazard is the tendency to take more risk when not exposed to the
5 consequences of that risk. PSE is committed to maintaining the operations of its
6 natural gas system without significantly reducing emissions in alignment with state
7 goals. The Company intends to predominantly use CCA allowances to comply
8 rather than pursue the CCA’s goals of decreasing system emissions. PSE will have
9 to acquire significant allowances to comply with CCA under its current plan while
10 statewide allowances decrease in availability, and is presuming that customers will
11 bear all the cost and risks of their current compliance path.

12 **Q. Who is the best party to respond to Washington’s state climate goals?**

13 A. PSE is the party best equipped to decarbonize the natural gas energy system
14 comprehensively. With 873,000 customers using natural gas in diverse ways and
15 possessing varying income levels and access to capital, PSE is the most capable
16 organization to orchestrate a systematic approach to decarbonizing the natural gas
17 system. Moreover, PSE possesses the financial capacity to invest in this
18 decarbonization effort and has proven expertise in effectively managing its energy
19 system. Compared to having a diverse group of customers responding to a price
20 signal, a coordinated approach from PSE to decarbonize its natural gas system is a
21 better method to promote the decarbonization of the energy system.

22 **Q. How should the Commission motivate the Company to actually reduce**
23 **emissions?**

1 A. Regarding CCA compliance, the Commission should impose a tailored risk-sharing
2 mechanism on PSE. A risk-sharing mechanism is imperative to prompt PSE to take
3 immediate action to reduce emissions. It is crucial to incentivize PSE to decrease
4 the emissions from its natural gas system to meet statewide statutory goals and to
5 protect the health and wellbeing of PSE customers and all Washingtonians.

6 As a business, PSE will respond to the incentives established by the
7 regulatory process. The Washington Legislature has granted broad authority to the
8 Washington Utilities and Transportation Commission, which is charged with
9 setting just and reasonable rates. Therefore, to achieve this goal, PSE must bear
10 risk associated with CCA compliance costs, and the Commission should ensure
11 there is a mechanism in place that balances utility and customer interest and
12 ensures a reasonable and equitable approach. JEA propose such a mechanism.

13 **IV. JEA’S RISK-SHARING PROPOSAL**

14 **Q. Please summarize your testimony on this matter.**

15 A. JEA recommend that the Commission adopt our proposed risk-sharing mechanism
16 for CCA costs. The model is based on price ceiling units and a modified earnings
17 test, and has the Company bear 30% of costs associated with costs nearing the
18 price ceiling.

19 **Q. What is JEA’s initial proposal for a risk-sharing mechanism?**

20 A. JEA’s risk-sharing mechanism involves a comparison of compliance instrument
21 unit costs to specific sharing bands, namely the “deadband” and “band alpha”.
22 These bands dictate the degree of cost sharing. The “deadband” encompasses unit
23 costs ranging from the auction floor price to one cent below the 97.5 percentile,

1 with customers bearing 100% of the unit costs. The “band alpha” encompasses unit
 2 costs from the 97.5 percentile to the ceiling price in the compliance period, with
 3 customers bearing 70% of the unit costs and the Company bearing 30%.

4 All costs charged to the Company will be apportioned over the compliance
 5 period for earnings assessment.³⁷ Once compliance costs are allocated to each year
 6 of the compliance period, the earnings test will be established at 50 basis points
 7 lower than PSE’s natural gas operations’ authorized return on equity. Furthermore,
 8 if the compliance period’s duration changes under CCA rules, the language in the
 9 rate schedule should be flexible to accommodate such changes while maintaining
 10 the risk-sharing mechanism. Refer to Exhibit WG-3 for a walkthrough of JEA’s
 11 risk-sharing mechanism.

12 **Q. What is a graphical representation of JEA’s proposal?**

Compliance Period Max Ceiling Price	
Band Alpha PSE 30% / Customer 70%	97.5th Percentile
Deadband No Sharing	
Compliance Period Minimum Market Floor Price	

³⁷ For example, suppose PSE were allocated \$100,000 in expense in the third compliance period. Assuming a four-year compliance period, each year in the third compliance period would reflect \$25,000 in expense.

1 **Q. How will the sharing bands be calculated?**

2 A. JEA's sharing bands are based on the Company's statistical analysis framework.
3 JEA propose to use the daily prices per metric ton of carbon dioxide in the
4 secondary market over the four years of the compliance period as inputs into the
5 sharing bands calculation.

6 JEA's risk-sharing mechanism has two bands: Band Alpha and the
7 Deadband. Band Alpha applies to compliance costs from the 97.5 percentile of
8 secondary market prices in the compliance period to the compliance period ceiling
9 price. All other unit cost compliance period expenditures are in the Deadband and
10 are borne by customers.

11 **Q. What are the differences between PSE's proposal and JEA's proposal?**

12 A. JEA's proposal has the following differences:

13 (1) It evaluates performance based on the unit cost of the compliance
14 instrument.

15 (2) It suggests increasing the sharing ratio between customers and the
16 Company for Band Alpha and extending the Deadband to range from the
17 minimum market floor price to the 97.5th Percentile.

18 (3) It employs an alternative earnings test.

19 (4) It is calculated on the actual length of the compliance period, rather than on
20 a four-year basis.

21 **Q. What incentive does PSE have without a risk-sharing mechanism?**

1 A. Some parties believe PSE bears the risk of noncompliance penalties, incentivizing
2 PSE to pursue compliant utility actions.³⁸

3 **Q. Is this accurate?**

4 A. As detailed above, the Climate Commitment Act does include penalties for
5 noncompliance. However, unless PSE does not properly calculate how many
6 allowances it needs and fails to get enough compliance instrument, its gas
7 operations will be able to comply with the CCA under current rules. PSE has a
8 dedicated Energy Supply Merchant department that manages PSE's participation in
9 carbon auctions and markets and devises procurement strategies for carbon
10 allowances. PSE has access to accountants and trading experts that will allow PSE
11 to track and respond to carbon compliance costs.

12 **Q. What options are available to enable PSE to comply with CCA compliance
13 deadlines?**

14 A. PSE has numerous options to comply with the CCA compliance deadlines.

15 (1) Reducing emissions

16 (2) Purchasing offsets

17 (3) Purchasing allowances through the auction process

18 (4) Purchasing allowances through the APCR Auction process

19 (5) Purchasing allowances through the secondary market

20 (6) Using no-cost allowances for compliance

³⁸ Alliance of Western Energy Consumers Comments, Docket U-230161 (Nov. 3, 2023)
available at
[https://apiproxy.utc.wa.gov/cases/GetDocument?docID=132&year=2023&docketN
umber=230161](https://apiproxy.utc.wa.gov/cases/GetDocument?docID=132&year=2023&docketNumber=230161). ³⁹ PSE Natural Gas Tariff Schedule 111.

1 (7) Acquiring price ceiling units

2 There are several opportunities for PSE to meet compliance guidelines.

3 **Q. Which of these compliance actions does JEA propose tying compliance risk**
4 **to?**

5 A. JEA recommend that the risk-sharing mechanism distribute risk based on PSE's
6 use of near-price ceiling units. This is because, under the current tariff, PSE could
7 pass back 100% of price ceiling unit costs to customers.³⁹ By way of illustration:
8 suppose in future, due to maintaining high covered emissions rather than pursuing
9 the CCA goals of emission reductions, PSE still requires sufficient compliance
10 instruments after the last APCR auction and before the compliance deadline and
11 secondary allowances are not available at a reasonable price. In that case, PSE
12 would need to acquire price ceiling allowances in order to comply with the CCA.
13 Under the current tariff PSE proposes, PSE could pass back 100% of price ceiling
14 unit costs to customers despite having ignored the purpose of the CCA and having
15 to acquire expensive allowances.

16 As described above, PSE states it bears the risk of noncompliance penalties;
17 some may argue this is sufficient to incentivize compliant utility action. However,
18 this example shows that penalties are unlikely to serve as incentive because the
19 presence of price ceiling units virtually eliminates noncompliance penalties for
20 PSE at the final compliance deadline.

³⁹ PSE Natural Gas Tariff Schedule 111.

1 **Q. What incentive does tying the risk-sharing mechanism to price ceiling units**
2 **have on PSE?**

3 A. The Commission should discourage PSE from using price ceiling units to meet the
4 long-term CCA compliance requirements. Price ceiling units are the most
5 expensive option for short-term CCA compliance and should only be used as a last
6 resort. Furthermore, they do not contribute to long-term emissions reduction. If
7 PSE depends on price ceiling units for CCA compliance, it can continue
8 technically meeting its compliance requirements without truly considering low-cost
9 decarbonization options and its role in sectoral emissions as the statewide cap
10 decreases. Therefore, PSE should be dissuaded from using price ceiling units for
11 long-term compliance purposes. That is why JEA recommend narrowly tailoring
12 the risk sharing mechanism to price ceiling unit purchases.

13 **Q. How have JEA narrowly tailored the risk-sharing mechanism?**

14 A. To narrowly tailor the risk-sharing mechanism, JEA have decided to increase the
15 sharing ratio to 30% for Band Alpha and expand the unit cost range of the
16 Deadband.

17 **Q. Why did JEA expand the unit cost range of the deadband?**

18 A. Initially, JEA considered only implementing a sharing band at the highest unit cost,
19 but ultimately chose to extend Band Alpha to cover prices up to the 97.5th
20 percentile. This is to prevent PSE from evading the risk-sharing mechanism by
21 purchasing an allowance close to, but not exactly, the price ceiling unit cost and
22 thereby avoiding risk sharing.

1 **Q. Why do JEA recommend evaluating the risk-sharing mechanism on a per-unit**
2 **basis?**

3 A. Previously, JEA suggested that the Commission assess the risk associated with the
4 Company by using price ceiling units. By comparing unit costs against sharing
5 bands, risk sharing can be linked to purchases of price ceiling units. If the average
6 annual compliance cost is employed as a risk-sharing method, the costs of price
7 ceiling units would be smoothed out in the average compliance cost, which would
8 obscure proper analysis. To evaluate risk based on price ceiling units, JEA advise
9 examining compliance costs on a unit basis.

10 **Q. How would that work in a risk-sharing mechanism?**

11 A. After emissions occur, PSE has to use allowances or offsets to demonstrate
12 compliance with the CCA. Each compliance instrument has a specific unit cost.
13 Rather than using the average annual compliance cost against sharing bands, JEA
14 recommend that unit cost of compliance instruments is compared against the
15 sharing bands.

16 **Q. What is the PSE's authorized rate of return?**

17 A. PSE's authorized rate of return is a blend of the authorized return on equity and
18 return on debt. It is the weighted average financing cost of these two components
19 determined during the general rate case. As of 2024, PSE's current authorized rate
20 of return is 7.16%.

21 **Q. What is JEA's earnings test?**

22 A. JEA recommend setting the earnings test for the risk-sharing mechanism at a level
23 50 basis points lower than the Company's authorized return on equity annually.

1 JEA's earnings test does not rely on the rate of return metric, preferring to use
2 return on equity. This preference is based on the understanding that equity holders
3 bear the costs under a risk-sharing mechanism. Using return on equity to assess the
4 earnings test is a more transparent approach. Exhibit WG-3 details how the
5 earnings test would operate for the risk-sharing mechanism.

6 **Q. What is the basis for JEA's earnings test?**

7 A. The Commission typically sets a return on equity during general rate case
8 proceedings, but there's a range of reasonable values for this. JEA suggest an
9 earnings test of 50 basis points lower than PSE's return on equity in the risk-
10 sharing mechanism. Having the earnings test at the Company's authorized return
11 on equity or at the Company's authorized rate of return doesn't fairly balance the
12 interests of customers. JEA picked 50 basis points as a moderate level of risk
13 sharing, emphasizing the need to balance the interests of customers and the
14 Company. In JEA's risk-sharing mechanism, PSE faces risk when purchasing
15 compliance cost units near or at the cost of high-cost price ceiling units.

16 **Q. Can the earnings test be calculated using the Company's actual equity?**

17 A. Yes. Under WAC 480-90-257, PSE files a commission-basis report that details the
18 calendar year's results of operation. In this annual report, PSE reports its return on
19 actual common equity as part of that report.

20 **Q. Is there a portion of PSE's earnings test that JEA support?**

21 A. Yes. Under RCW 80.28.425(6), PSE must defer all revenues over 50 basis points
22 greater than its authorized rate of return. PSE has stated that it would oppose any
23 method requiring PSE to refund revenues 50 basis points greater than its authorized

1 rate of return. JEA understand the Company's concern, and would support the
2 Company's proposal to not allow risk sharing to occur if PSE historical earnings
3 are greater than 50 basis points above its authorized rate of return on an annual
4 basis.

5 **Q. Why does JEA's proposal change the calculation based on the actual length of**
6 **the compliance period, rather than on a four-year basis?**

7 A. The current length of CCA compliance periods is four years. In 2024, the
8 Washington Legislature passed SB 6058 to facilitate linkage with the California-
9 Quebec market. Suppose Washington enters a linkage agreement, and the linked
10 jurisdictions do not amend their rules to synchronize with Washington's
11 compliance periods. In that case, the Department of Ecology must amend its rules
12 to shorten the CCA's compliance period to three years. Due to the possibility of
13 potential changes in the future, JEA recommend that the CCA compliance risk-
14 sharing mechanism not be tied to a four-year compliance period but to the actual
15 length of compliance periods.

16 **Q. In sum, why is JEA's risk-sharing mechanism proposal a better option?**

17 A. The effectiveness of JEA's risk-sharing mechanism is evident in its reasonable
18 long-term approach. JEA's risk-sharing mechanism is associated with a limited
19 commitment to using price ceiling allowance purchases. It is worth noting that
20 JEA's risk-sharing approach is specifically targeted to disincentivize acquisition of
21 price ceiling units, representing the program's most costly short-term compliance
22 resources, while continuing to ensure shared risk between the utility and its
23 customers.

1 In the event that PSE must procure expensive short-term price ceiling
2 allowances to uphold high covered emissions instead of working towards the
3 CCA's emissions reduction objectives, PSE would directly bear the risk of these
4 costly compliance purchases. JEA's risk-sharing mechanism places risk on the
5 Company, as opposed to the Company's proposal, which solely poses a risk when
6 the Company consistently overearns throughout the compliance period.

7 **V. CONCLUSION**

8 **Q. What are your recommendations?**

9 A. JEA recommends that the Commission adopt, at a minimum, JEA's risk-sharing
10 mechanism for CCA costs.

11 **Q. Why should the Commission adopt JEA's risk-sharing mechanism?**

12 A. The risk-sharing proposal presented by JEA is reasonable and should be embraced
13 by the Commission. PSE is obligated to adhere to state targets aimed at curbing
14 statewide emissions, particularly those stemming from fossil fuels. JEA's proposed
15 mechanism entails an appropriate distribution of risk and cost between the utility
16 and its customers. JEA's approach disincentivizes costly short-term compliance,
17 aligns PSE's incentives with state statutory requirements, and balances risk
18 between the Company and customers.

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

20 A. Yes.