EXH. TAS-5CT
DOCKETS UE-240004/UG-240005 et al.
2024 PSE GENERAL RATE CASE
WITNESS: TODD A. SHIPMAN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent**	**Docket UE-240004** **Docket UG-240005** **(*consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Accounting Order Authorizing deferred accounting treatment of purchased power agreement expenses pursuant to RCW 80.28.410**	**Docket UE 230810** **(*consolidated*)**

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF

TODD A. SHIPMAN, CFA

ON BEHALF OF PUGET SOUND ENERGY

SHADED INFORMATION IS DESIGNATED AS CONFIDENTIAL PER PROTECTIVE ORDER IN DOCKETS UE-240004-05/UG-240005 ET AL.

SEPTEMBER 18, 2024

REDACTED VERSION

PUGET SOUND ENERGY

**PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF
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PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Are you the same Todd A. Shipman who submitted prefiled direct testimony on February 15, 2024, on behalf of Puget Sound Energy ("PSE") in this proceeding?

A. Yes, on February 15, 2024, I filed the Prefiled Direct Testimony of Todd A. Shipman, Exhibit TAS-1T and three supporting exhibits (TAS-1T through TAS-4C).

Q. What is the purpose of your rebuttal testimony?

A. My rebuttal testimony addresses certain issues raised in the prefiled response testimonies of the following witnesses: David C. Parcell on behalf of the Staff of the Washington Utilities And Transportation Commission ("WUTC" or "Commission"), Michael P. Gorman on behalf of the Washington State Office of the Attorney General Public Counsel Unit, Chris McGuire of the Staff of the WUTC, and Ali Al-Jabir on behalf of the Federal Executive Agencies.

II. REBUTTAL OF WITNESSES

A. Rebuttal of David C. Parcell

Q. In his response to your prefiled direct testimony, Staff witness David Parcell critiques your recitation of the circumstances surrounding the 2020 Commission rate decision for PSE and the adequacy of your review of the previous PSE rate proceeding. Do you agree with his characterization of your testimony?

A. No. My opinion about the previous rate case is literally in the last sentence of my testimony, emphasizing its outcome: "The positive momentum created by the previous rate decision for PSE should be perpetuated in this case so that ratepayers continue to realize the benefits of strong and durable financial integrity for its utility."[1] The tone and substance of my testimony was intended to fully commend the credit-supportive nature of the previous rate decision. I cited it favorably in several instances.[2]

Perhaps my discussion of the unfavorable rate decision in 2020 seems gratuitous to Parcell, but I deliberately included both my analysis and that of the rating agencies of that decision for a specific reason:

> Q. How does this evolution in the ratings and the analyses behind them inform this proceeding?

[1] Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T at 34.

[2] *See, e.g.,* Shipman, Exh. TAS-1T at 22 ("…in [Moody's] most recent credit report they acknowledge the credit-positive outcome of the most recent rate case." "The [S&P] stable outlook was vindicated by the last rate case outcome, which S&P viewed, like Moody's, as credit-supportive ….").

A. The history over the past few years is a testament to the long-term nature of ratings that I reference as an essential feature of agency opinions on credit quality. The forbearance of Moody's and S&P proved prescient as the MYRP has taken hold and the discomfort about regulatory risk has abated. The point of this overview of the ratings is that progress has been made on reducing regulatory risk but persistence is necessary to keep the momentum going as the focus shifts to the ongoing energy transformation. The burden of the large capital expenditures on PSE and its balance sheet will strain the credit profile.[3]

Because ratings agencies take a long view of the regulatory environment in which a utility operates, the Commission should also consider the long-term nature of ratings.

Q. Do you have any other general reactions to the Parcell testimony as it pertains to credit ratings?

A. Yes. When reading Parcell's testimony (and Gorman's too, for that matter, as I discuss in the next section), I sense a casual attitude about the risk of credit downgrades when making decisions in this case.[4] In addition to my response above urging persistence in this case on supporting Company efforts to contain regulatory risk, I caution the parties and the Commission on certain credit rating dynamics that I witnessed numerous times in my career at S&P that should inform the positions and decisions in this high-profile case.

[3] *Id.* at 25.

[4] *See* Prefiled Response Testimony of David C. Parcell, Exh. DCP-1T at 60-65 (In his section entitled "Comments On Company Testimony," he ignores the ongoing effect of tax reform on cash flow, and cites MYRPs and recent legislation as risk reducing while passing over the trend of credit metric degradation.)

1 First, I observed and experienced a change over time in rating agency attitudes
2 about ratings stability. They are now more prone to change ratings. They used to
3 pride themselves in "rating through the cycle" and resisting frequent upgrades and
4 downgrades.[5] Over time analysts have been increasingly encouraged to always
5 "get the ratings right," mainly due to criticism of ratings performance in the wake
6 of the 2008 financial crisis.

7 Second, I have often witnessed a conservatism in rating committees that will often
8 affect the rating. Despite the greater emphasis on reacting to all developments that
9 can affect credit quality, the credit analysts I have worked with are often disposed
10 to the downside. Rating agency receptivity to upgrades and downgrades is facially
11 equal, but in practice negative regulatory decisions are more likely to prompt a
12 rating action than positive ones. In my experience, climbing out of those kinds of
13 credit quality pitfalls can be much more difficult than falling into them. Ratings
14 restoration can take much more time even in the best cases, as a company
15 struggles to convince investors and rating agencies that the risk has permanently
16 abated. Because of this ratings inertia phenomenon, I believe that avoiding a
17 downgrade can be nearly as valuable to ratepayers as an upgrade.

[5] The S&P criteria from 2008 described the resistance to rating changes despite claims that they do not rate through the cycle. *See* S&P, *ARCHIVE | Criteria | Corporates | General: 2008 Corporate Criteria: Analytical Methodology*, February 6, 2014, pp. 12-13, available at Exh. TAS-6C.

1 **B.** **Rebuttal of Michael P. Gorman**

2 **Q.** **Is Gorman accurate when he discusses rating agency concerns about rate**
3 **affordability as a credit risk for utilities?[6]**

4 A. No. He misinterprets the rating agency language on the issue of rate affordability.
5 He asserts that "prioritizing rate affordability is a critically important aspect for
6 maintaining [PSE's] financial integrity while meeting its regulatory and other
7 obligations – rate affordability stabilizes revenue and promotes operational
8 efficiency."[7] The concern is, in fact, the opposite of his (mis)understanding.
9 Rating agencies talk of rate affordability concerns as a gentle way of expressing a
10 concern that rising costs will lead regulators to aggressively lower the costs they
11 think they have control over, like ROE and capital structure, to offset the rising
12 costs that they don't, such as fuel, purchased power, and interest rates.[8] The
13 correct takeaway from this topic is **not** that the Commission should lower the
14 authorized ROE and weaken the capital structure to improve credit quality.

15 Gorman's attempt to co-opt the rating agencies to support his arguments against a
16 stronger capital structure,[9] a return on purchased power agreements,[10] and
17 enhanced regulatory mechanisms[11] is risible. The Commission should resist his

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[6] Prefiled Response Testimony of Michael P. Gorman, Exh. MPG-1CT at 10-13.
[7] *Id.* at 2.
[8] The quotes Gorman employs from Moody's and Fitch plainly support my assertions on the issue rather than his. *See* Gorman, Exh. MPG-1CT at 12-13 (Moody's: "…increasing the level of uncertainty with regard to the timely recovery of costs for fuel and purchased power*, as well as for rate cases more broadly*." Fitch: "Authorized ROEs could prove to be sticky despite an increase in cost of capital.")
[9] Gorman, Exh. MPG-1CT at 25.
[10] *Id.* at 3.
[11] *Id.* at 6-7.

pandering to a shortsighted impulse to artificially lower revenue requirements or reject new regulatory mechanisms that would improve the PSE risk profile and its credit quality. The risk of artificially suppressing current customer bills in the name of rate affordability is that it will only lead to higher bills in the future when the costs of short-term thinking materialize in lower credit ratings and higher capital costs.

Q. In the course of his discussion of credit ratings, Gorman asserts that Washington utility regulation is among the "highest"[12] credit-supportive jurisdictions in the U.S., according to S&P Global Ratings (S&P). Is this accurate?

A. No. Gorman states: "As outlined in the figure above, Washington has a rating of 'Very Credit Supportive,' which places it among the highest rating [*sic*] credit-supportive categories of the 50 U.S. jurisdictions."[13] That statement plainly contradicts what the figure actually shows, which is that the category places Washington smack in the middle of the five possible assessment categories. The middle is not "among the highest"; in fact, according to Gorman's Figure 1, only nine states have a lower rating than Washington, with the remainder the same or better rating as Washington, and the figure's lowest rating is "credit supportive." In the most recent published assessments, Washington remains in the middle

[12] *Id.* at 11.
[13] *Id.*

category with no fewer than 23 other U.S. jurisdictions assessed higher.[14] A non-ratings arm of S&P also ranks utility jurisdictions and places Washington below the average U.S. jurisdiction.[15] I point out this discrepancy not just to correct the record, but to urge the Commission to target an improved assessment of the regulatory risk in Washington by adopting the risk-reducing proposals requested by PSE in this case. The lower risk will provide a base for higher credit ratings in the future that would benefit ratepayers and help PSE accomplish its clean energy goals.

Q. Do you have any other general reactions to the Gorman testimony as it pertains to credit ratings?

A. Yes. I reiterate my observations above in response to Parcell regarding the wisdom of avoiding ratings downgrades. Gorman relies too heavily on the stable outlooks on PSE that disguise the effects on credit quality of the 2020 PSE rate decision and the negative trends in credit metrics that his and other recommendations in this case would exacerbate.[16] He also, as I explain above, overstates the credit-supportiveness of the Washington regulatory environment to conceal the risk of negative market and rating agency reactions that would result from a decision that adopted any recommendations that impede PSE's ability to

[14] S&P Global Ratings, *North American Utility Regulatory Jurisdictions Update: Ontario Remains Unchanged, Notable Developments Elsewhere*, March 11, 2024, pp. 2-3, available at Exh. TAS-6C.

[15] S&P Global, RRA Regulatory Focus, RRA Regulatory Focus Quarterly Regulatory Evaluations, *RRA State Regulatory Evaluations – Energy*, August 7, 2024, p. 4. The "Average/3" category where the WUTC resides is the sixth of nine possible rankings, available at Exh. TAS-6C.

[16] Gorman, Exh. MPG-1CT at 8-9.

manage its risk profile. The prudent course is to avoid rating downgrades, which is more efficient and less expensive than having to restore the credit profile later.

C. Rebuttal of Chris McGuire and Ali Al-Jabir

Q. Do you concur with the risk analysis and policy recommendations of Staff witness Chris McGuire and JEA witness Ali Al-Jabir regarding trackers?

A. No. McGuire and Al-Jabir expend a considerable amount of effort and words discussing the risk management aspects of regulatory rate mechanisms that operate outside of base rates.[17] The mechanisms at issue are generically referred to as adjustment clauses, and they allow for rate changes separate from periodic base rate cases designed to better align a utility's revenues with its costs. In my experience adjustment clauses have been a common feature of all utility regulatory jurisdictions in the U.S. They have existed for decades – the energy shocks and inflationary environment of the 1970s led to widespread use.

In over almost 40 years of analyzing, participating in, and evaluating utility regulation from the perspective of an equity analyst, intervenor, fixed-income analyst, and credit-rating practitioner, the use of adjustment clauses have been an accepted and unremarkable regulatory practice that is viewed as an effective risk management tool that benefits all stakeholders. Contrary to McGuire's opinion

[17] Prefiled Response Testimony of Chris McGuire, Exh. CRM-1Tr at 29-70; Prefileed Response Testimony of Ali Al-Jabir, Exh. AZA-1T at 25-29.

and that of Al-Jabir, adjustment clauses do not shift risk, they reduce risk. That benefits ratepayers, not burdens them.

Q. Why do you contend that the risk management practice of employing adjustment clauses reduces overall risk rather than merely moving the same amount of risk from one party to another?

A. Good risk management does just that. A rate mechanism that improves a utility's ability to fully recover prudently incurred costs reduces both regulatory and financial risk[18] and thereby improves the utility's overall risk profile and its credit quality to the benefit of ratepayers. Ratepayers are not subject to any greater risk due to an adjustment clause. A well-designed adjustment clause will only allow for full recovery of prudent expenses.

Q. How do you respond to McGuire's contention that the risk implications of adjustment clauses are in general contrary to the public interest?

A. McGuire advances two public interest arguments on the matter of rates adjusting to fully recover prudently incurred costs.[19] First, he believes under-recovery of unexpected cost increases is a risk that is supposed to be borne by the utility because it is compensated for the risk through the authorized return. Second,

[18] Shipman, Exh. TAS-1T at 15, 23-24.
[19] McGuire, Exh. CRM-1Tr at 34-35.

1 exposing the utility to risk of not fully recovering unexpected costs gives the
2 utility an incentive to control costs and achieve greater operating efficiency.

3 The first is a faulty argument. McGuire alleges that "[w]ith a tracker, ratepayers
4 are harmed because they absorb some of the utility's risk yet continue to
5 compensate the utility for bearing that risk."[20] Yet cost of capital witnesses
6 regularly analyze adjustment mechanisms to assess risk as part of the analysis of
7 cost of capital, precisely because they recognize the risk-reducing effect of
8 adjustment mechanisms.[21] McGuire contradicts himself on this point later in his
9 testimony when he concedes that adjustment mechanisms can lower a utility's
10 cost of capital and its authorized returns.[22] Thus, ratepayers benefit from
11 adjustment mechanisms through a lower cost of capital while still only paying for
12 the actual, prudent costs incurred by the utility in providing service.

13 The second argument is faulty, too. Utilities have the same incentive to control
14 costs whether the relationship of costs to revenues is positive, neutral, or negative.
15 The incentive for efficiency does not only show up when they're underearning the
16 authorized return. In my experience, utility managements have shown a zeal for
17 cost-cutting as much (or more) to avoid a future rate case filing by maintaining
18 their ability to earn the authorized return as to offset abnormal costs or cost
19 increases out of their control. Ratepayers do not benefit from being shielded from

[20] *Id*. at 34.

[21] *See, e.g.,* Parcell, Exh. DCP-1T at 20-23; *see also* Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1CT at 69-70, 88-91.

[22] McGuire, Exh. CRM-1Tr at 40.

the actual cost of providing service. They will eventually experience the higher costs in rates, and in the meantime and well into the future the cost of capital will suffer to their detriment.

Q. Why do you think McGuire misperceives the true risk implications of adjustment clauses?

A. He does not frame the concept of risk correctly. He appears to think it's a matter only of under-recovery of costs over a specified period of time. To a credit analyst, risk encompasses a much broader view that equates risk with *volatility*. Volatility equals risk. A utility that sometimes over-earns, sometimes under-earns, but earns its cost of capital over time has more risk than a utility that consistently earns its cost of capital year in and year out. Any regulatory mechanism that reduces the volatility of earnings and improves cash flow improves the utility risk profile, supports credit quality and ratings, and produces a lower cost of capital for ratepayers over the long term.

Q. Can you show that your description of risk is more accurate than McGuire's?

A. Rating agency criteria and the methodologies for rating utilities verify my understanding of risk. For a utility, regulatory risk is the predominant qualitative risk in credit analysis.[23] The focus on volatility can been seen in both the S&P

[23] Shipman, Exh. TAS-1T at 10-15.

and Moody's Investor Service (Moody's) approaches to evaluating utility credit risk, and regulatory risk in particular.

S&P sets forth the assessment of regulatory risk (which it calls regulatory advantage) with four sub-factors: Regulatory Stability, Tariff-Setting Procedures and Design, Financial Stability, and Regulatory Independence and Insulation.[24] All but the fourth one pinpoint the idea of risk as volatility, as does a subsequent evaluation of business strategy. Here are a few examples:

> *Regulatory Stability*: "We …monitor the predictability and consistency of the regulatory framework over time. Greater consistency reduces uncertainty for the utility and its stakeholders."[25]
>
> *Tariff-Setting Procedures and Design*: "Our view is based on whether all operating and capital costs can be recovered in full, and how the rate scheme balances the interests and concerns of all stakeholders."[26]
>
> *Financial Stability*: "If costs are recovered in a timely manner, cash flow volatility can be avoided. We see greater flexibility as favorable, because it allows for the recovery of unexpected costs."[27]
>
> *Business Strategy*: "Ensuring that revenue changes with costs is a key regulatory risk factor…."[28]

[24] S&P Global Ratings, *Criteria | Corporates | General: Sector-Specific Corporate Methodology*, April 4, 2024, p. 147 (Section 29 | Regulated Utilities), available at Exh. TAS-6C.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id*. at 149.

1 Moody's similarly sees risk as a matter of volatility. Of the three "Scorecard
2 Factors" that inform its qualitative assessment of utility risk, two are regulatory in
3 nature: Regulatory Framework and Ability to Recover Costs and Earn Returns.[29]
4 Volatility is explicit throughout the analysis of these two factors. Here are a few
5 examples:

> 6 *Regulatory Framework*: "*Consistency and*
> 7 *Predictability of Regulation* In assessing this sub-
> 8 factor, we consider the track record of regulatory
> 9 decisions in terms of consistency, predictability and
> 10 supportiveness."[30]
>
> 11 *Ability to Recover Costs and Earn Returns*:
> 12 "*Timeliness of Recovery of Operating and Capital*
> 13 *Costs* In assessing this sub-factor, we consider
> 14 include provisions and cost recovery mechanisms
> 15 for operating costs, mechanisms that allow actual
> 16 operating and/or capital expenditures to be trued-up
> 17 periodically into rates without having to file a rate
> 18 case (this may include formula rates, rider and
> 19 trackers, or the ability to periodically adjust rates
> 20 for construction work in progress)…."[31]

21 **Q. Based upon the rating agency views on the effect of adjustment clauses, do**
22 **you support the use of such rate mechanisms and other means to reduce the**
23 **volatility of both earnings and cash flow?**

24 A. Yes. Based upon their credit-enhancing effect on the volatility of both earnings
25 and cash flow, I recommend adoption of the PSE proposals to add the Clean

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[29] Moody's Investor Service, Rating Methodology, Regulated Electric and Gas Utilities, August 6, 2024, p. 2, available at Exh. TAS-6C.
[30] *Id*. at 10.
[31] *Id*. at 11.

1 Generation Resource Tracker, the Wildlife Prevention Plan Adjustment Tracker,
2 the Decarbonization Rate Adjustment, and the requested construction work in
3 progress (CWIP) treatment for the Beaver Creek Project, as steps to better
4 manage regulatory risk. Better regulatory risk leads to a lower business risk
5 profile that will improve PSE's credit quality and cost of capital, all to the benefit
6 of ratepayers. The greater use of adjustment clauses would show that the WUTC
7 is serious about pursuing important public policy aims that can place stress on a
8 utility by offering the regulatory mechanisms to protect credit quality and ratings.

9 ## III. EFFECT OF INTERVENOR RECOMMENDATIONS

10 **Q. Do you have any opinions on the effect of the intervenor recommendations on**
11 **the credit quality of PSE and any rating implications arising from the**
12 **recommendations?**

13 A. Yes. I have reviewed the credit metric calculations performed by PSE witness
14 Cara G. Peterman accounting for the ROE and capital structure recommendations
15 of the various intervenors and the recommended denials of such risk-reducing
16 proposals as CWIP in rate base and accelerated depreciation of certain assets, as
17 well as operating and maintenance expenses. In my opinion the resulting credit
18 metrics, [REDACTED]
19 [REDACTED]
20 [REDACTED]

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3 **Q. Can you expound on the fallout from the falling credit metrics and the "other**
4 **effects" you alluded to?**

5 A. As I delineated in my direct testimony, ratings in general and the financial
6 analysis of credit metrics are not a simple or rote exercise.[32] Rating agency
7 analysts look not just at the metrics for one year or just historical or just
8 projections. They look at the whole picture and pay particular attention to trends.
9 I think any regression in financial performance or balance sheet strength would
10 alarm the rating agencies as much as the magnitude of the changes. They are
11 counting on the continued improvement in the Washington regulatory
12 environment. As I and other PSE witnesses have noted throughout this
13 proceeding, while the rating agencies have lauded the move to MYRPs, the
14 implementation and consistent execution to realize the risk benefits are more
15 important than the initial adoption of the concept. As for the other effects, again
16 as I have stressed throughout this proceeding,[33] the effect of regulatory decisions
17 and behavior on utility credit quality tend to be magnified by acting on both sides
18 of the business/financial risk equation. spotty
19 implementation of MYRPs, and the inability to earn the authorized return (another
20 ratings downgrade trigger), all coming as the broader ratings outlook for the

[32] Shipman, Exh. TAS-1T at 18.
[33] *See, e.g., id.* at 19.

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1 whole industry is deteriorating (S&P returned to a negative outlook just as I filed
2 my direct testimony),[34] would in my opinion seriously jeopardize the current
3 ratings and negate the positive momentum that has been achieved in recent years.

4 **IV. CONCLUSION**

5 **Q. Does this conclude your prefiled rebuttal testimony?**

6 A. Yes.

[34] S&P Global Ratings, *Rising Risks: Outlook For North American Investor-Owned Regulated Utilities Weakens*, February 14, 2024, available at Exh. TAS-6C.