EXH. TAS-1T
DOCKET UG-230968
WITNESS: TODD A. SHIPMAN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**DOCKET UG-230968**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF

TODD A. SHIPMAN

ON BEHALF OF PUGET SOUND ENERGY

SEPTEMBER 12, 2024

PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Todd A. Shipman. My business address is 51 Woodsneck Rd., Orleans, Massachusetts 02653. I am a Principal with Utility Credit Consultancy LLC.

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

A. Yes. Please see Exh. TAS-2.

Q. What are your current professional activities?

A. After retiring from S&P Global Ratings ("S&P"), I became a management consultant specializing in advising utilities and other entities on credit and ratings issues, balance sheet management, and capital markets strategies. I was also an adjunct faculty member in Boston University's Questrom School of Business, where I taught advanced undergraduate courses in corporate finance and capital markets.

Q. What are your qualifications as an expert witness on credit rating matters?

A. I spent over 20 years at S&P, a major ratings agency that has been in business over 150 years and issues more than one million ratings on over $46 trillion of debt across all global capital markets. I am qualified to opine on utility credit quality and ratings because of the degree and scope of my involvement in rating utilities and other energy companies over many decades. In the final decade or so, I was the Sector Specialist on the North American utilities team. In that role, I was the lead analyst charged with ensuring ratings quality and the training and development of new analysts. I also chaired a vast majority of the rating committees conducted over more than a decade. The chairperson role is critical to achieving effective committee deliberations and assuring a fully vetted ratings opinion. Along with the primary analyst, the chairperson has the most influence over the ratings that emerge from each committee.

I was the primary analyst on over 150 different issuers during my time at S&P. Between the two roles, my work had a direct effect on the ratings of every investor-owned utility in the U.S. and Canada over the course of decades, and therefore the rates of a majority of electricity customers in North America. During this time S&P comprehensively revised and updated its corporate ratings criteria, and I led the effort in creating the criteria used to establish ratings on all utilities across the globe. I was also responsible for outreach efforts to investors and the regulatory community. As an analytical leader in corporate ratings and later infrastructure/project finance ratings, I was involved in many cross-sector ratings

activities. For instance, I performed a lead analytical role in the development and application of global ratings criteria for hybrid capital securities such as preferred stock.

Q. Please summarize the purpose of this prefiled rebuttal testimony.

A. This prefiled rebuttal testimony addresses Commission Staff's misperception of the true risk implications of adjustment mechanisms by failing to frame the concept of risk correctly in addressing PSE's proposed Climate Commitment Act ("CCA") risk-sharing mechanism. Commission Staff appears to view risk solely as under-recovery of costs over a specified period of time. Instead, the Commission should adopt a broader view that equates risk with *volatility*. 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. The adjustment mechanism that is Schedule 111 reduces the regulatory risk, which leads to a lower business risk profile that will improve PSE's credit quality and cost of capital, all to the benefit of customers. The ongoing use of adjustment mechanisms like Schedule 111 that allow costs to be tracked and recovered accurately from customers without subjecting the utility to additional volatility would demonstrate that the Commission is serious about pursuing important public policy aims that can place stress on a utility by offering the regulatory mechanisms to protect credit quality and ratings.

II. THE COMMISSION SHOULD REJECT COMMISSION STAFF'S MYOPIC VIEW OF RISK AND ADOPT A BROADER VIEW THAT EQUATES RISK WITH VOLATILITY

Q. What is your understanding of Commission Staff's position in this proceeding?

A. Commission Staff makes two proposals in its testimony. One proposal addresses more immediate concerns and recommends that the Commission implement PSE's proposed risk-sharing mechanism beginning January 1, 2025, but replace PSE's proposed earnings test with Commission Staff's modified earnings test.[1] The second proposal addresses more long-term concerns and suggests that the Commission eliminate Schedule 111 (deemed the "CCA tracker") by Commission Staff and include CCA compliance costs in PSE's base rate revenue requirement in a future general rate proceeding.[2]

Q. Does this prefiled rebuttal testimony address both proposals?

A. No. The Prefiled Rebuttal Testimony of Christopher T. Mickelson, Exh. CTM-4T, addresses Commission Staff's recommendation that the Commission replace PSE's proposed earnings test with Commission Staff's modified earnings test. This prefiled rebuttal testimony does not address Commission Staff's proposed modified earnings test.

[1] *See* McGuire, Exh. CRM-1T at 32:1-4.
[2] *See id*. at 31:21-23.

This prefiled rebuttal testimony addresses the considerable amount of effort and words in Commission Staff's testimony that discuss the risk management aspects of regulatory rate mechanisms that operate outside of base rates.[3] The mechanisms at issue are generically referred to as adjustment mechanisms, 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 mechanisms 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 of adjustment mechanisms.

Q. How do you respond to the assertions of Commission Staff that adjustment mechanisms shift risk from utilities to customers?

A. In over almost 40 years of analyzing, participating in, and evaluating utility regulation from the perspective of an equity analyst, intervener, fixed-income analyst, and credit-rating practitioner, the use of adjustment mechanisms has been an accepted and unremarkable regulatory practice that is viewed as an effective risk management tool that benefits all interested parties. Contrary to the assertions of Commission Staff,[4] adjustment mechanisms do not *shift* risk, they *reduce* risk, and the reduction of risk benefits, not burdens, customers.

[3] *See* McGuire, Exh. CRM-1T at 4:20 – 33:23.
[4] *See*, *e.g.*, *id*. at 5:1 – 9:19.

Q. Why would you assert that the common risk management practice of employing adjustment mechanisms reduces overall utility risk rather than merely moving the same amount of risk from one party to another?

A. Good risk management practices, such as adjustment mechanisms, reduce risk. A well-designed adjustment mechanism will allow for full recovery of prudent expenses, thereby improving a utility's ability to fully recover prudently-incurred costs reducing both regulatory and financial risk to the utility. This reduction in regulatory and financial risk to the utility will, in turn, improve the utility's overall risk profile and credit quality to the benefit of customers. Customers are not subject to any greater risk due to an adjustment mechanism.

Q. How do you respond to Commission Staff's contention that the risk implications of adjustment mechanisms are, in general, contrary to the public interest?

A. Commission Staff advances two public interest arguments on the matter of adjustment mechanisms that adjust rates to fully recover prudently-incurred costs. First, Commission Staff apparently believes that the 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 on equity.[5] Second, Commission Staff expresses a belief that exposing a utility to the risk of

[5] *See*, *e.g.*, McGuire, Exh. CRM-1T at 7:18 – 8:3.

not fully recovering unexpected but prudently-incurred costs provides an incentive to the utility to control costs and achieve greater operating efficiency.[6]

The first public interest argument posited by Commission Staff is faulty. Commission Staff alleges that "[w]ith a tracker, ratepayers are harmed because they absorb some of the utility's risk yet continue to compensate the utility for bearing that risk."[7] Yet cost of capital witnesses in general rate proceedings regularly analyze adjustment mechanisms to assess risk as part of the analysis of cost of capital, precisely because cost of capital experts recognize the risk-reducing effect of adjustment mechanisms.[8] Indeed, Commission Staff's testimony contradicts itself on by conceding that adjustment mechanisms can lower a utility's cost of capital and its authorized returns.[9] Thus, customers *benefit* from adjustment mechanisms through a lower cost of capital while still only paying for the actual, prudent costs incurred by the utility in providing service.

The second public interest argument set forth by Commission Staff is also faulty. Utilities have the same incentive to control costs whether the relationship of costs to revenues is positive, neutral, or negative. The incentive for efficiency does not appear only when utilities under-earn the authorized return. In my experience, utility managers have shown a zeal for cost-cutting as much (or more) to maintain

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6 *See*, *e.g.*, McGuire, Exh. CRM-1T at 8:4-10.

7 *Id*. at 8:1-3.

8 *See In the Matter of the Petition of Puget Sound Energy and Northwest Energy Coalition for an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms*, Dockets UE-121697 & UG-121705 (consolidated), Order 15 at ¶155 (June 29, 2015); *see also* Martin, Exh. JLM-1T.

9 *See*, *e.g*., McGuire, Exh. CRM-1T at 17:11-18:2.

the ability to earn authorized returns and avoid future rate case filings as they do to offset abnormal costs or cost increases beyond their control. Customers do not benefit from being shielded from the actual, prudently-incurred costs of providing service. Customers will eventually experience these costs in rates and at costs of capital that are higher than otherwise would have existed if the risk had been managed appropriately through an adjustment mechanism.

Q. Why do you think that Commission Staff misperceives the true risk implications of adjustment mechanisms?

A. Commission Staff appears to misperceive the true risk implications of adjustment mechanisms by failing to frame the concept of risk correctly. Commission Staff appears to view risk solely as under-recovery of costs over a specified period of time. To a credit analyst, however, 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. Would credit analysts find your description of risk to be more accurate than Commission Staff's?

A. Yes. Consulting the rating agency criteria and methodologies for rating utilities verifies my understanding of risk. For a utility, regulatory risk is the predominant qualitative risk in credit analysis. The focus on volatility can been seen in both the S&P 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.[10]

All but the fourth sub-factor 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."[11]

[10] S&P Global Ratings, *Criteria | Corporates | General: Sector-Specific Corporate Methodology*, at 147 (Section 29 | Regulated Utilities) (Apr. 4, 2024).

[11] *Id.*

- *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."[12]

- *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."[13]

- *Business Strategy*: "Ensuring that revenue changes with costs is a key regulatory risk factor…."[14]"

Moody's similarly sees risk as a matter of volatility. Of the three "Scorecard Factors" that inform its qualitative assessment of utility risk, two are regulatory in nature: Regulatory Framework, and Ability to Recover Costs and Earn Returns.[15] Volatility is explicit throughout the analysis of these two factors. Here are a few examples:

- *Regulatory Framework*: "For the Consistency and Predictability sub-factor, we consider the track record of regulatory decisions in terms of consistency, predictability and supportiveness."[16]

- *Ability to Recover Costs and Earn Returns*: "The criteria we consider include provisions and cost recovery mechanisms for operating costs, mechanisms that allow actual operating and/or capital expenditures to be trued-up periodically into rates without having to file a rate case (this may include formula rates, rider and trackers, or the ability to periodically adjust rates for construction work in progress)…."[17]

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[12] *Id.*
[13] *Id.*
[14] *Id*. at 149.
[15] Moody's Investor Service, *Rating Methodology, Regulated Electric and Gas Utilities*, at 6 (Sept. 10, 2020).
[16] *Id*. at 10.
[17] *Id*. at 12-13.

III. CONCLUSION

Q. Based upon the rating agency views on the effect of adjustment mechanisms, would you support greater use of adjustment mechanisms and other means, such as PSE's Schedule 111, to reduce earnings and cash flow volatility?

A. Yes. Based upon their credit-enhancing effect on earnings and cash flow volatility, I would recommend that the Commission retain Schedule 111 proposed by PSE to better manage regulatory risk. Better regulatory risk leads to a lower business risk profile that will improve PSE's credit quality and cost of capital, all to the benefit of customers.

Q. Does that conclude this prefiled rebuttal testimony?

A. Yes.