EXH. JLM-1T
DOCKET UG-230968
WITNESS: JAMIE L. MARTIN

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

JAMIE L. MARTIN

ON BEHALF OF PUGET SOUND ENERGY

SEPTEMBER 12, 2024

PUGET SOUND ENERGY

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I. INTRODUCTION

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

A. My name is Jamie L. Martin, and my business address is Puget Sound Energy, P.O. Box 97034, Bellevue, Washington 98009-9734. I am employed by Puget Sound Energy ("PSE") as Senior Vice President and Chief Financial Officer.

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

A. Yes, I have. It is Exhibit JLM-2.

Q. What is the purpose of your prefiled rebuttal testimony?

A. This prefiled rebuttal addresses the proposal of Commission Staff that the Commission include Climate Commitment Act ("CCA") compliance costs in base rate revenue requirement for natural gas operations in the next general rate proceeding. The Commission should resist any attempt to incrementally add, delete, or materially restructure adjustment mechanism and other tools and practices in a manner that increases volatility and risk regarding cash flow, earnings, and returns on equity. If adopted, Commission Staff's proposal would

increase the volatility of PSE's cash flow, earnings, and return on equity above and beyond what PSE expects to experience in 2024, to the detriment of the PSE and its customers.

II. COMMISSION STAFF'S PROPOSAL TO INCLUDE CCA COMPLIANCE COSTS IN BASE RATE REVENUE REQUIREMENT IS ILL-CONCEIVED AND SHOULD BE REJECTED

Q. What is PSE's understanding of Commission Staff's testimony regarding PSE's proposal to recover compliance costs associated with the Climate Commitment Act?

A. Commission Staff's testimony primarily criticizes the use of an adjustment mechanism (Schedule 111) to account for and recover CCA compliance costs prudently incurred by PSE. Commission Staff recommends that the Commission:

(i) adopt PSE's proposed risk-sharing mechanism, beginning January 1, 2025, but substitute Commission Staff's proposed earnings test for PSE's proposed earnings test within PSE's proposed risk-sharing mechanism,[1] and

(ii) the Commission eliminate the adjustment mechanism beginning as of the rate effective date of PSE's next general rate proceeding and instead incorporate prospective CCA compliance costs in the PSE base rate revenue requirement calculation for natural gas operations.[2]

A majority of Commission Staff testimony discusses a proposed framework and attendant recommendations for broad Commission policy related to adjustment

[1] *See* McGuire, Exh. CRM-1T at 3:11-15.
[2] *See id*. at 3:8-10.

mechanisms and proposes that the Commission adopt such framework in this proceeding.[3]

Q. How should the Commission respond to Commission Staff's broad policy recommendations and framework for adjustment mechanisms?

A. The Commission should disregard Commission Staff's broad policy recommendations and framework for adjustment mechanisms in this proceeding. This proceeding is in response to the Commission's requirement that PSE propose a risk-sharing mechanism as part of Schedule 111. PSE has proposed a risk-sharing mechanism, and Commission Staff has recommended implementation of PSE's proposed risk-sharing mechanism but has suggested some modifications to the earnings test elements of the risk-sharing mechanism. Consideration of PSE's proposed risk-sharing mechanism and Commission Staff's proposed modifications thereto are appropriate for the Commission to address in this proceeding.

This proceeding should not address broad and far-reaching implications of regulatory tools such as adjustment mechanisms and why, how, or when the Commission should adopt them. Commission Staff's proposal is beyond the scope of this proceeding and could, if implemented, affect existing regulatory mechanisms of PSE and other public service companies. The Commission should consider PSE's proposed risk-sharing mechanism on its merits, without regard to

[3] *See*, *e.g.*, *id*. at 4:20 – 33:23.

the broader theoretical arguments proposed by Commission Staff, which are beyond the scope of this proceeding and would require extensive time to develop an appropriate record based on input from many entities and organizations that are not a party to this limited proceeding.

Q. How does PSE respond to the testimony of Commission Staff regarding "variance risk"?

A. Commission Staff incorrectly suggests[4] that returns on equity compensate utilities for assumed "variance risk" associated with "[t]he difference between the actual costs and the level of costs embedded in rates . . . ."[5] This statement represents a fundamental misunderstanding of bedrock principles related to risks and returns in regulatory law.

Regulatory bodies establish returns on equity at levels sufficient for utilities to attract the necessary capital to construct and maintain a safe and reliable system while not charging customers more than is necessary. Establishing returns on equity in a regulatory concept is a question of capital attraction, which involves a comparison of risks among alternative investments. Investors have a finite amount of capital, and investors who make investments in a utility forego the option of making alternative investments. Investors will only make investments in a utility if they can expect returns commensurate with comparable investment options with

[4] *See*, *e.g.*, *id*. at 5:21 – 8:13.
[5] *Id*. at 6:5-7.

corresponding risks—a bedrock regulatory principle memorialized by the U.S. Supreme Court in the *Bluefield Water Works*[6] opinion issued over a century ago:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public *equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties*; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.[7]

The U.S. Supreme Court more succinctly summarized this principle eighty years ago in the *Hope Natural Gas*[8] opinion:

> [T]he *return to the equity owner should be commensurate with other enterprises having corresponding risks*. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.[9]

The *Hope Natural Gas* standard is the one against which the Commission must evaluate returns.

Q. How does the *Hope Natural Gas* standard relate to Commission Staff's discussion of adjustment mechanisms and "variance risk"?

A. The *Hope Natural Gas* standard is relevant because regulatory bodies establish returns on equity by establishing returns "commensurate with other enterprises having corresponding risks."[10] The Commission traditionally established returns on equity for PSE based on a comparison of returns of other utilities in the United

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6 *Bluefield Water Works Improvement Co. v. Pub. Serv. Comm*., 262 U.S. 679 (1923).
7 *Id*. at 692 (italics added).
8 *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
9 *Id*. at 603 (italics added).
10 *Id*.

States. The adjustment mechanisms challenged by Commission Staff, however, are common and used by every state utility commission in one form or another. These adjustment mechanisms have expanded significantly over the past five decades, and the utilities in the proxy groups used by the Commission to establish returns on equity have similar adjustment mechanisms of various forms and degrees. They are not unique to PSE, unlike the risks associated with the Cap-and-Invest and Cap-and-Trade programs unique to utilities serving loads in Washington and California, respectively. Moreover, regulatory commissions regularly consider the potential risk-reducing impacts of adjustment mechanisms in establishing utility returns on equity.

Q. Has this Commission considered the potential risk-reducing impacts of adjustment mechanisms in establishing utility returns on equity?

A. Yes. In approving PSE's electric and natural gas decoupling mechanisms in Dockets UE-121697 and UG-121705, the Commission considered whether the risk-reducing nature of decoupling required an adjustment to PSE's return on equity and determined as follows:

> We believe it is correct that cost of capital analysis cannot be expected to produce results that support measurement of decrements to ROE ostensibly due to approval of one risk mitigation mechanism or another. Nor would cost of capital analysis be adequate to the task of identifying increments to ROE that might be considered due to some measure of additional risk a company takes on at some point in time. The Commission has never tried to account separately in its ROE determinations for specific risks or risk mitigating factors, nor should it. Circumstances in the industry today and modern regulatory practice that have led to a proliferation of risk reducing mechanisms being in place for utilities throughout the United States

> make it particularly inappropriate and unnecessary to consider such an undertaking. The effects of these risk mitigating factors was by 2013, and is today, built into the data experts draw from the samples of companies they select as proxies.[11]

In short, the Commission determined that the cost of capital and peer group studies it considers when setting returns on equity implicitly captures the risk-reducing impacts of adjustment mechanisms. Therefore, the existence of adjustment mechanisms with risk-reducing impacts does not suggest that utilities with such mechanisms are somehow overearning returns on equity that reflect the existence of such mechanisms. In other words, the risk-reducing impacts of adjustment mechanism and approved returns on equity established by regulatory bodies are largely in balance because the latter incorporates the existence of the former.

Q. Has the Commission evaluated the risk-reducing impacts of Schedule 111 in establishing PSE's authorized return on equity?

A. No. The Commission has not evaluated the risk-reducing impacts of Schedule 111 in establishing an authorized return on equity for PSE, nor should the Commission do so:

> The Commission has never tried to account separately in its ROE determinations for specific risks or risk mitigating factors, nor should it.[12]

[11] *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) (footnotes omitted).

[12] *Id*.

Instead, returns on equity authorized by the Commission should reflect returns commensurate with other enterprises having corresponding risks (i.e., peer group studies) often used by the Commission in general rate proceedings.

Q. Should the Commission "require [risk-sharing mechanisms] when it authorizes all such [adjustment mechanisms]"?[13]

A. If the Commission were to adopt Commission Staff's proposal, the Commission would nullify its existing practice of addressing specific risks and risk-mitigating measures, such as adjustment mechanism, through comparisons of returns commensurate with other enterprises having corresponding risks (i.e., peer group studies) often used by the Commission in general rate proceedings. Risk-sharing mechanisms of the type addressed in this proceeding are not commonly required by state regulatory commissions.[14] Accordingly, the impacts of risk-sharing mechanisms of the type addressed in this proceeding are not adequately reflected in the returns on equity established by the Commission for PSE.

If the Commission were to adopt Commission Staff's proposal and require a risk-sharing mechanism for all adjustment mechanisms implemented by PSE and approved by the Commission over the decades, then PSE's cash flows, earnings, and returns on equity would become more volatile relative to peer utilities across

[13] McGuire, Exh. CRM-1T at 25:21-22.

[14] *See, e.g.*, S&P Global Market Intelligence, Adjustment Clauses: A State by State Overview, Regulatory Focus Topical Special Report (Jul. 18, 2022). *See also*, S&P Global Market Intelligence. RRA Regulatory Focus: Adjustment Clauses: A State-By-State Overview (Sept. 12, 2017), available at https://www.spglobal.com/marketintelligence/en/documents/adjustment-clauses-state-by-state-overview.pdf.

the United States. Adoption of this proposal could create a serious and potentially material disconnect when the Commission considers cost of capital studies and peer group analyses when establishing returns on equity for PSE in future general rate proceedings. The cost of capital studies and peer group analyses would not implicitly consider the risk increasing aspects of risk-sharing mechanisms not common in the industry.

Q. Are there any problems associated with Commission Staff's recommendation to incorporate CCA compliance costs in the base rate revenue requirement calculation for natural gas operations?

A. Yes. Commission Staff's recommendation to incorporate CCA compliance costs (both the costs of allowances and decarbonization costs) in the base rate revenue requirement calculation for natural gas operations fails to recognize the impossibility of incorporating pro forma adjustments in setting base rates. CCA allowance costs currently reflect prices established at auction pursuant to rules established by the Washington Department of Ecology and could, in the future, reflect decisions made in California and the Province of Quebec. Additionally, the greenhouse gas emissions associated with natural gas deliveries are almost entirely dependent on average daily temperatures in the PSE service territory.[15] Neither the potential impacts of policies in other parts of North America nor the annual average daily temperature in the Puget Sound region can be forecasted with any reasonable degree of precision, and it is unclear to PSE how either

[15] *See*, *e.g.*, Kuzma, Exh. JK-3T.

element could satisfy the "known and measurable" requirements for pro forma adjustments.

To illustrate the difficulty associated with establishing CCA compliance costs as a pro forma adjustment, please consider the current costs recovered in Schedule 111 in 2024. Schedule 111 currently reflects projected costs from CCA allowance purchase and projected revenues from CCA allowance consignments based on settlement prices for CCA allowances (vintage 2023) established in the following Washington Department of Ecology auctions that occurred in 2023:

Table 1. CCA Allowance Settlement Prices in General Auctions Conducted by the Washington Department of Ecology in Calendar Year 2023[16]

Auction	Date of Auction	Settlement Price
Auction #1	February 28, 2023	$48.50
Auction #2	May 31, 2023	$56.01
Auction #3	August 30, 2023	$63.03
Auction #4	December 6, 2023	$51.89

[16] *See* Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #1 February 2023 Summary Report*, Pub. No. 23-02-022 (Mar. 7, 2023); Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #2 May 2023 Summary Report*, Pub. No. 23-02-057 (June 7, 2023); Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #3 August 2023 Summary Report*, Pub. No. 23-02-060 (Sept. 6, 2023); Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #4 December 2023 Summary Report*, Pub. No. 23-02-063 (Dec. 12, 2023).

That was the best available pricing information at the time of establishing Schedule 111 for calendar year 2024. CCA allowance (vintage 2024) settlement prices in the first three general auctions are substantially lower than the projections currently reflected in Schedule 111:

Table 2. CCA Allowance Settlement Prices in General Auctions Conducted by the Washington Department of Ecology in Calendar Year 2024[17]

Auction	Date of Auction	Settlement Price
Auction #5	March 6, 2024	$25.76
Auction #6	June 5, 2024	$29.92
Auction #7	September 4, 2024	$29.88

If Commission Staff's proposal to include CCA compliance costs in the PSE base rate revenue requirement calculation for natural gas operations were currently in place, PSE would become beneficiary of a significant over-recovery. The existence of an adjustment mechanism in Schedule 111 allows for the return of this significant over-collection to customers with interest. PSE urges extreme caution as the Commission evaluates the potential for recovery for uncertain and unknown CCA compliance cost in the base rate revenue requirement for natural gas operations.

Furthermore, the Commission Staff proposal fails to incorporate the dramatic volatility in CCA allowance prices over the past eighteen months or how that price volatility could play out over the next few years if the state does establish

[17] *See* Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #5 March 2024 Summary Report*, Pub. No. 24-14-022 (Mar. 7, 2023); Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #6 June 2024 Summary Report*, Pub. No. 24-14-027 (June 12, 2024); Washington Department of Ecology, *Washington Cap-and-Invest Program Auction #7 September 2024 Summary Report*, Pub. No. 24-14-050 (Sept. 11, 2024).

linkage with similar programs in California and Quebec. Moreover, Commission Staff's proposal fails to analyze, or even acknowledge, (i) the potential increase in volatility in CCA compliance costs as no-cost allowances to utilities and energy-intensive trade-exposed (EITEs) are reduced and eliminated are reduced, (ii) the risks that decarbonization programs and technologies may fail to achieve the emission reductions anticipated, or (iii) a sizable number of customers may elect not to adopt successful decarbonization programs and technologies. Simply put, these are the very real risks and provide the ample reasons why PSE should recover CCA compliance costs in an adjustment mechanism.

Q. Does PSE have other concerns regarding Commission Staff's proposal to include CCA compliance costs in base rate revenue requirements?

A. Yes. Commission Staff's proposal lacks necessary financial analyses, and Commission Staff suggests that the Commission impose the policy proposal incrementally without analyzing the contextual impact of the Washington regulatory requirement. Stated alternatively, Commission Staff asks the Commission to approve a policy proposal for all adjustment mechanisms without any analysis of how that policy proposal will interact with other cost recovery mechanisms and regulatory policies. PSE does not believe the Commission should entertain Commission Staff's proposal in general or in this proceeding in particular.

Q. Can you provide an example to explain this point?

A. Yes. It would be instructive to analyze why PSE is under-earning its allowed rate of return in calendar year 2024, including the seven items listed below.

First, in the final order in the 2019 general rate case, the Commission required PSE to defer the return on its AMI investments until all the AMI equipment was fully installed and the Commission could evaluate the use cases for the equipment. Because of this requirement imposed by the Commission, PSE continued to defer its return on equity on its AMI investments in the settlement in its 2022 general rate case. In addition, PSE continued to defer a return on its investment in Tacoma LNG Project as part of that same negotiated settlement. Under generally accepted accounting principles, PSE cannot record, in its income statement and results of operations, any equity returns that are not included in rates. As a result, PSE's allowed rate of return under earned by a combined after-tax total of $18 million or 33 basis points.

Second, in January 2024, PSE's electric and gas operating systems set record peaks during an extended winter cold streak. On the electric side of the business, even though PSE served every kilowatt hour of demand, PSE incurred a $36 million pretax loss to the net income and results of operations in these extraordinary conditions due to the continuing impacts of the PCA sharing bands. On a forecasted basis, all else equal, PSE expects to incur an after-tax $28 million reduction to net income and a 52 basis point reduction to its otherwise allowed return on equity.

Third, during the second quarter of 2024, the Commission ruled on PSE's final prudence and inclusion of the Tacoma LNG investment into rates. In doing so the Commission disallowed $15 million of PSE's deferred equity returns,[18] which it could not heretofore include in earnings due to the restrictions of generally accepted accounting principles as described above. This resulted in a $12 million after-tax reduction to PSE's net income and a 22 basis point reduction to its otherwise allowed return on equity.

Fourth, PSE's AFUDC returns on equity and debt on CWIP were insufficient to reflect, in its income statement and results of operations, what PSE would have recovered in rates were CWIP in rate base treatment allowed. AFUDC creates drag due to the lower than authorized rate of return used in regulatory-required AFUDC rates. In essence, PSE's deploys capital at a higher cost than the AFUDC calculation allows PSE to record. This creates a regulatory drag of $54 million reduction to PSE's net income or a 99 basis point reduction to its otherwise allowed return on equity.

Fifth, PSE incurred below the line expenses, which have been historically denied inclusion in rates, in the after-tax amount of $26 million or 47 basis points of under-earned return on equity. The vast majority of these expenses relate to PSE's long-term incentive compensation plan, governmental affairs and lobbying, and a $10 million investment in Energy Northwest's efforts to develop small modular

[18] *WUTC v. PSE,* Docket UG-230393 Order 07 ¶ 153 (April 24, 2024) (allowing deferred O&M expenses and deprecation, but not a return on the investment for the period up to January 11, 2023).

reactor that could generate up to 960 MW of electricity. PSE's investment secures an option and a priority claim on future developed capacity for the benefit of customers should the technology prove viable and cost-effective. These expenses are not included in rates based on long standing commission policy and state law. PSE raises them here because they represent legitimate and necessary costs of doing business and because they are not included in rates, they represent an annual regulatory policy drag on PSE's ability to earn its allowed equity return.

Sixth, PSE incurred unrecoverable regulatory interest expense on refundable PGA regulatory liabilities. This reduced net income and results of operations by $6 million after tax and ten basis points of under earned return on equity.

Seventh, PSE expects that it will incur O&M expenditures, over and above what it has embedded in its current revenue requirement, by $23 million pre-tax or $18 million after tax, which equates to 33 basis points under earned return on equity. PSE has no choice but to incur these expenses to operate its business. The additional O&M expense was used to fund necessary work in the business including customer outage response and wildfire prevention. As I discuss in more detail later in my testimony, further cuts to O&M expense in the rate years are not sustainable. Table 3 below breaks out these causes of under earning.

Table 3 – 2024 Under Earning Analysis

	2024 ROE Under Earning Analysis (After Tax)	
1	Deferred Return on Equity-AMI and LNG	$18
2	PCA PSE Share	28
3	LNG Deferred Equity Return Disallowance	12
4	AFUDC/CWIP Regulatory Drag	54
5	Below-the-line expenses	26
6	Unrecoverable Regulatory Interest Expense	6
7	Excess O&M spending vs. Rate Recovery	18
8	Total Regulatory Lag and Drag	
9		
10	Regulated AMA Equity	$5,437
11		
12	Allowed Return on Equity %	9.40
13	Total Lag and Drag-Return on Equity Lost %	2.96
14	Net, Earned Return on Equity %	6.44

III. CONCLUSION

Q. What are PSE's conclusions with respect to the proposal of Commission Staff?

A. The root of Commission Staff's proposal that the Commission include CCA compliance costs in base rate revenue requirement for natural gas operations in the next general rate proceeding is that, except in limited circumstances, customers should not be burdened with what Commission Staff calls "variance risk" because customers are compensating utilities for bearing that risk in the form of returns on equity. If adopted, Commission Staff's proposal would increase the volatility of PSE's cash flow, earnings, and return on equity above and beyond what PSE expects to experience in 2024. The Commission should resist any attempt to incrementally add, delete, or materially restructure

adjustment mechanism and other tools and practices in a manner that increases volatility and risk regarding cash flow, earnings, and returns on equity.

Q. Does that conclude this prefiled rebuttal testimony?

A. Yes.