EXH. DAD-7T
DOCKETS UE-190529/UG-190530
UE-190274/UG-190275
2019 PSE GENERAL RATE CASE
WITNESS: DANIEL A. DOYLE

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**Docket UE-190529** **Docket UG-190530 (*Consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life IT/Technology Investment**	**Docket UE-190274** **Docket UG-190275 (*Consolidated*)**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF

DANIEL A. DOYLE

ON BEHALF OF PUGET SOUND ENERGY

JANUARY 15, 2020

PUGET SOUND ENERGY

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF DANIEL A. DOYLE

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1 **PUGET SOUND ENERGY**

2 **PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF**
3 **DANIEL A. DOYLE**

4 ## I. INTRODUCTION

5 **Q. Are you the same Daniel A. Doyle who submitted prefiled direct testimony on**
6 **June 20, 2019, on behalf of Puget Sound Energy ("PSE") in this proceeding?**

7 A. Yes. On June 20, 2019, I filed the Prefiled Direct Testimony of Daniel A. Doyle,
8 Exh. DAD-1T, and five supporting exhibits, Exh. DAD-2 through Exh. DAD-6,
9 on behalf of PSE. Also, I filed a revised Prefiled Direct Testimony of Daniel A.
10 Doyle, Exh. DAD-1Tr, on August 22, 2019.

11 **Q. What is the purpose of your rebuttal testimony?**

12 A. First, this rebuttal testimony recommends that the Commission approve PSE's
13 proposed attrition adjustment in this proceeding. Notwithstanding arguments of
14 other parties to the contrary, PSE would have *chronically under-earned* its
15 allowed rate of return and return on equity for calendar years 2013-2018 without
16 revenues from the 2013 expedited rate filing and ensuing K-factor increases.
17 Traditional regulatory mechanisms fail to address the full scope of regulatory lag
18 facing PSE, and the Commission can address regulatory lag while achieving
19 regulatory efficiency by adopting PSE's attrition adjustment in this proceeding.

20 Second, this rebuttal testimony discusses PSE's proper implementation of the
21 normalization rules of the Internal Revenue Service.

Finally, this rebuttal testimony provides evidence that the weighted-average returns on equity proposed by the regulatory staff of the Washington Utilities and Transportation Commission ("Commission Staff") and The Public Counsel Unit of the Washington Office of the Attorney General ("Public Counsel") are far below industry averages and are not supportive of PSE's current credit ratings

II. THE COMMISSION SHOULD APPROVE PSE'S PROPOSED ATTRITION ADJUSTMENT

A. PSE Would Have Chronically Under-Earned Its Allowed Rate of Return and Return on Equity for Calendar Years 2013-2018 Without Revenues from the 2013 Expedited Rate Filing and Ensuing K-Factor Increases

Q. Do other parties to this proceeding agree with the position that PSE is unable to earn at or near its authorized rate of return?

A. No. Commission Staff refers to Tables 1 and 2 of my Prefiled Direct Testimony, Exh. DAD-1Tr, and reaches the following conclusion:

> These tables show that, with the exception of 2018, on a normalized basis PSE has earned at or above its authorized return for every year since 2014, which, in the commission's words, "militates against the use of an attrition allowance."[1]

Commission Staff continues by quoting a Commission order from PSE's 2011 general rate proceeding that "a demonstrated inability of a utility to earn at or near its authorized return over a period of years … ." is required to demonstrate

[1] McGuire, Exh. CRM-1T, at 23:6-8.

chronic under earnings and that the Commission should therefore reject PSE's proposed attrition adjustment.[2]

Public Counsel similarly replicates PSE's actual versus earned returns from Tables 1 and 2 of my direct testimony, and concludes as follows:

> PSE's Commission Basis Reports do not support a finding that PSE has significant periods of under-earning. To the contrary, the data shows PSE has over-earned in four of the last five years … .[3]

Unlike Commission Staff, Public Counsel makes no attempt to utilize the analyses of earned versus authorized returns as a rationale for why the Commission should deny PSE's proposed attrition adjustment.

The testimony of the Alliance of Western Energy Consumers ("AWEC") also refers to Tables 1 and 2 of my direct testimony, Exh. DAD-1Tr, and concludes that "[c]learly PSE's electric operations actual earned return on equity reasonably aligned with its authorized return on equity."[4] Unlike Commission Staff, AWEC makes no attempt to utilize the analyses of earned versus authorized returns as a rationale for why the Commission should deny PSE's proposed attrition adjustment.

Q. Are these parties correct that PSE is able to earn at or above its authorized return?

A. No. PSE's ability to achieve its authorized return between 2014 and 2017 results directly from PSE's 2013 expedited rate filing and the rate plan (including the "K-

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2 McGuire, Exh. CRM-1T, at 18:20-21.
3 Garrett, Exh. MEG-1T, at 14:18-20.
4 Gorman, Exh. MPG-1T, at 11:16-17.

factor") in place between 2014 and 2017. The statements by each of Commission Staff, Public Counsel, and AWEC ignore this important point and apparently would have the Commission believe that the evaluation of whether or not PSE is *chronically* under-earning against its allowed return benchmarks should include consideration of revenues earned as a result of the 2013 expedited rate filing and the 2014-17 rate plan, which included an annual "K-factor". These assertions ignore the fundamental point that such revenues would not have been possible under traditional rate making principles. Accordingly, these assertions are seriously flawed and derive from an inappropriate context from which to evaluate chronic under-earning considering the period in question was not based on traditional ratemaking principals and therefore should not be a basis to determine PSE's need for an attrition adjustment, similar to the one that PSE requests in this proceeding.

Q. Has PSE requested an expedited rate filing or rate plan with a "K-factor" in this proceeding?

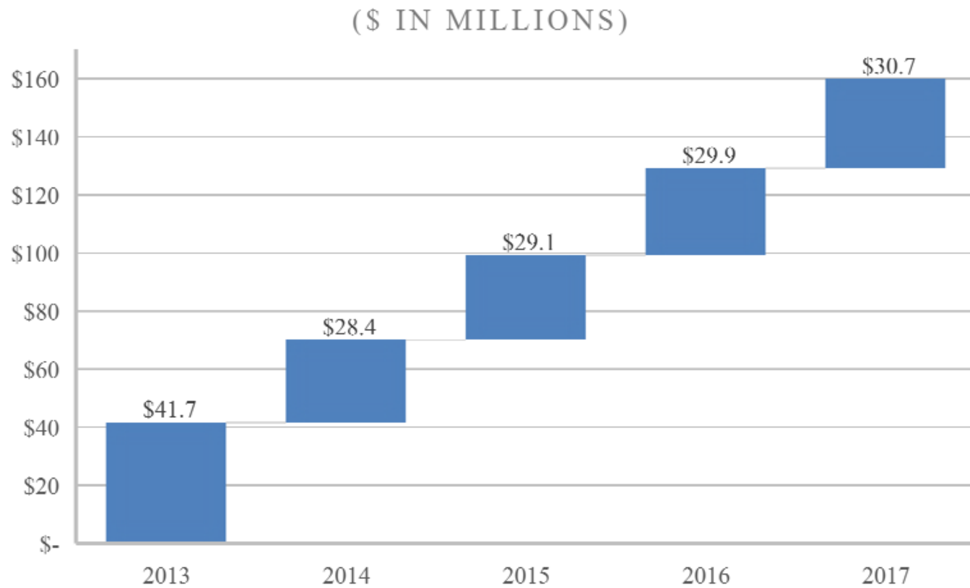
A. No. PSE has not requested an expedited rate filing or rate plan with a "K-factor" in this proceeding, and no similar mechanisms are currently in effect. PSE has filed a request in this proceeding for a traditional general rate case increase, including consideration of an adjustment to address the combined effects of attrition and regulatory lag that it would have, has, and will continue to experience under traditional ratemaking principles under current conditions. Absent serious consideration and approval of an attrition adjustment, the primary tool available to PSE to mitigate rising costs and the continuing effects of attrition

1 and regulatory lag, in the rate year and beyond, is to file traditional (and likely
2 back to back) general rate case proceedings. It would be inappropriate to suggest
3 that revenues from the 2014 through 2017 period are indicative of PSE's earnings
4 potential under traditional ratemaking principles under current conditions.
5 Furthermore, these assertions ignore the fact that, absent the 2013 expedited rate
6 filing and the 2014-17 rate plan, PSE would have chronically under-earned its
7 authorized rate of return over the same period.

8 **Q. Has PSE analyzed what its earnings would have likely been over the 2013**
9 **through 2018 period absent the 2013 expedited rate filing and the 2014-**
10 **2017 rate plan?**

11 A. Yes. Table 3 in the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1Tr,
12 states that PSE's request for rate relief in Dockets UE-170033 & UG-170034
13 would have been approximately $160 million higher without the benefit of the
14 2013 expedited rate filing or 2014-17 rate plan. Figure 1 below illustrates the
15 annual and cumulative incremental revenues for the years 2013 to 2017
16 attributable to the 2013 expedited rate filing and the ensuing K-factor increases:

1 **Figure 1. Incremental Revenues for Calendar Years 2013 to 2017 for the**
2 **Combined Gas and Electric Businesses Attributable to the**
3 **2013 Expedited Rate Filing and K-Factor Revenues**



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5 Additionally, Tables 4 and 5 in the Prefiled Direct Testimony of Daniel A. Doyle,
6 Exh. DAD-1Tr, clearly demonstrate that, absent the benefit of the 2013 expedited
7 rate filing and the K-factor increases, PSE would have substantially under-earned
8 against its allowed rate of return and return on equity on both an actual and
9 normalized basis for both electric and gas operations. Figures 2 and 3 below
10 present the same information in graphical form and clearly illustrate the
11 significant and chronic gap between PSE's actual and normalized vs. authorized
12 rates of return and return on equity for the electric and gas businesses combined,
13 when adjusted to remove revenues provided by the 2013 expedited rate filing and
14 subsequent K-factor adjustments:

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Figure 2. PSE's Adjusted Actual, Normalized and Authorized Rates of Return on Equity for Calendar Years 2013 to 2018 for the Combined Gas and Electric Businesses

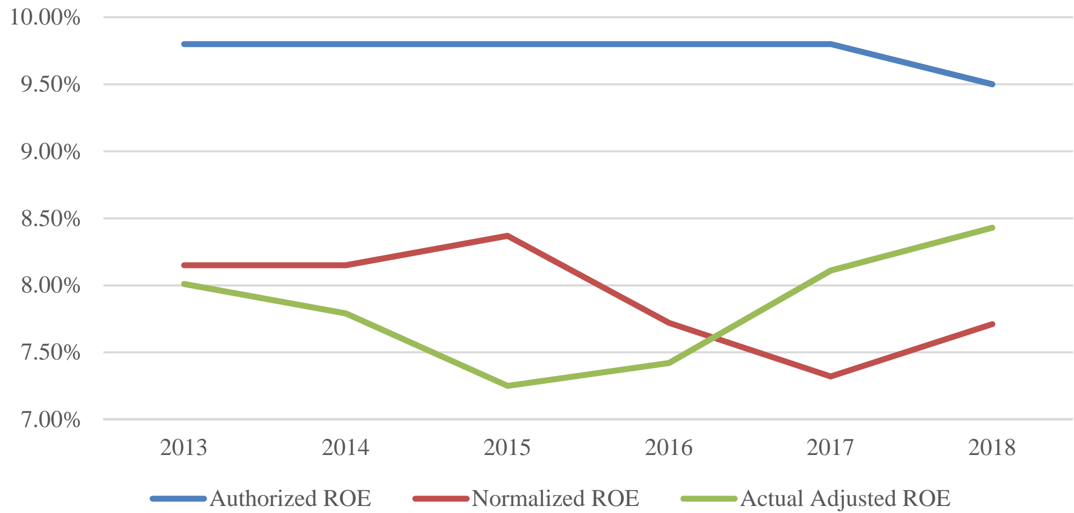

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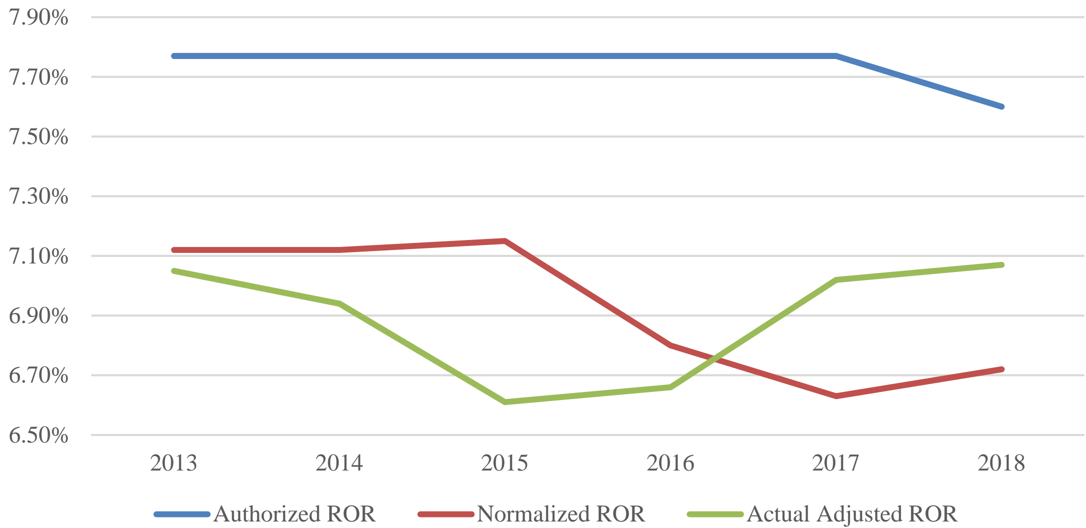
Figure 3. PSE's Adjusted Actual, Normalized and Authorized Rates of Return for Calendar Years 2013 to 2018 for the Combined Gas and Electric Businesses



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1 On average over the six-year period presented, PSE's electric operations would

2 have under-earned:

3 (i) its authorized rate of return on an adjusted actual basis by
4 0.79 percent,[5] which suggests an average under-earning of
5 10.2 percent;[6]

6 (ii) its authorized rate of return on an adjusted normalized basis
7 by 0.79 percent,[7] which suggests an average under-earning
8 of 10.2 percent;[8]

9 (iii) its authorized return on equity on an adjusted actual basis
10 by 1.79 percent,[9] which suggests an average under-earning
11 of 18.3 percent;[10] and

12 (iv) its authorized return on equity on an adjusted normalized
13 basis by 1.77 percent,[11] which suggests an average under-
14 earning of 18.3 percent.[12]

15 Over the 6-year period presented, there was *not one year* during which PSE's

16 electric operations would have earned its authorized rate of return or its return on

17 equity on either an adjusted actual or normalized basis. These data and

18 observations, both quantitative and qualitative, strongly support the conclusion

19 that PSE's electric operations would have *substantially* under-earned its allowed

20 rate of return and return on equity over the timeframe presented absent the

21 2013 expedited rate filing and K-factor increases.

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[5] 7.74% - 6.95% - 0.79%.
[6] 0.79% ÷ 7.74% = 10.2%.
[7] 7.74% - 6.95% - 0.79%.
[8] 0.79% ÷ 7.74% = 10.2%.
[9] 9.75% - 7.96% = 1.79%.
[10] 1.79% ÷ 9.75% = 18.3%.
[11] 9.75% - 7.98% = 1.77%.
[12] 1.77% ÷ 9.75% = 18.3%.

1 Similar conclusions can be reached with respect to PSE's gas operations. On
2 average, over the six-year period presented, PSE's gas operations would have
3 under-earned

4–6 (i) its authorized rate of return on an adjusted actual basis by 1.00 percent,[13] which suggests an average under-earning of 12.9 percent;[14]

7–9 (ii) its authorized rate of return on an adjusted normalized basis by 0.90 percent,[15] which suggests an average under-earning of 11.6 percent;[16]

10–12 (iii) its authorized return on equity on an adjusted actual basis by 2.23 percent,[17] which suggests an average under-earning of 22.9 percent;[18] and

13–15 (iv) its authorized return on equity on an adjusted normalized basis by 2.00 percent,[19] which suggests an average under-earning of 20.5 percent.[20]

16 Further, over the six-year period presented, there was *not one year* in which PSE
17 would have earned its authorized rate of return or its return on equity on either an
18 adjusted actual or normalized basis. These data and observations, both
19 quantitative and qualitative, strongly support the conclusion that PSE's gas
20 operations would have *substantially* under-earned its authorized rate of return and
21 return on equity over the timeframe presented by a much greater margin than
22 PSE's electric operations.

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[13] 7.74% - 6.74% = 1.00%.
[14] 6.74% ÷ 7.74% = 12.9%.
[15] 7.74% - 6.84% = 0.90%.
[16] 6.84% ÷ 7.74% = 11.6%.
[17] 9.75% - 7.52% = 2.23%.
[18] 2.23% ÷ 9.75% = 22.9%.
[19] 9.75% - 7.75% = 2.00%.
[20] 2.00% ÷ 9.75% = 20.5%.

1 Given the dispersion of PSE's earnings results would have been skewed so
2 significantly toward under-earnings, one can reasonably question whether PSE
3 could have realistically had an opportunity to earn its authorized rate of return and
4 return on equity. Based on this analysis, it is convincingly clear that, absent the
5 2013 expedited rate filing and ensuing K-factor increases, PSE would have
6 *chronically* under-earned in comparison with its authorized rate of return and
7 return on equity for the 2013-2017 period.

8 Tellingly, none of Commission Staff, Public Counsel, or AWEC refute—or even
9 attempt to refute—the chronic under-earnings that would have occurred in the
10 absence of the 2013 expedited rate filing and the K-factor increases, as presented
11 in Tables 4 and 5 in the Prefiled Direct Testimony of Daniel A. Doyle,
12 Exh. DAD-1Tr. Public Counsel comes closest by summarily suggesting that,
13 absent the 2013 expedited rate filing and K-factor increases, PSE would have had
14 the opportunity to contain costs to earn its allowed rate of return:

15 PSE should have, and likely would have, adjusted its spending in
16 those years to better match its resources. This is what would've
17 happened in a competitive environment, which is the standard to
18 which PSE must be held.[21]

19 At best, this statement is an implicit admission that PSE would likely have
20 chronically under-earned its authorized rate of return over the 2013-2018 period,
21 absent the 2013 expedited rate filing and K-factor increases. At worst, this
22 statement reflects a profound misunderstanding of cost and risk management and
23 adequate, appropriate, and, in some cases, required levels of customer service.

[21] Garrett, Exh. MEG-1T, at 15:4-6.

1 Finally, PSE has already constrained costs within the multi-year rate plan period.
2 PSE's K-factor increases were set at a level based on a Consumer Price
3 Index (CPI) increase, less a productivity factor. This basis was used in order to
4 encourage cost savings during the rate plan period.[22]

5 **Q. Could PSE have earned its authorized rates of return and returns on equity**
6 **solely through cost reductions?**

7 A. No. PSE could have never achieved either its authorized rates of return or
8 authorized returns on equity solely through cost reductions. Figure 4 below
9 quantifies the level of cost reductions (annually and cumulatively) that PSE would
10 have had to realize to earn its authorized rates of return during the period 2013
11 through 2018.

[22] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy*, Dockets UE-130137 & UG-130138, Order 7 at ¶ 172 (June 25, 2013).

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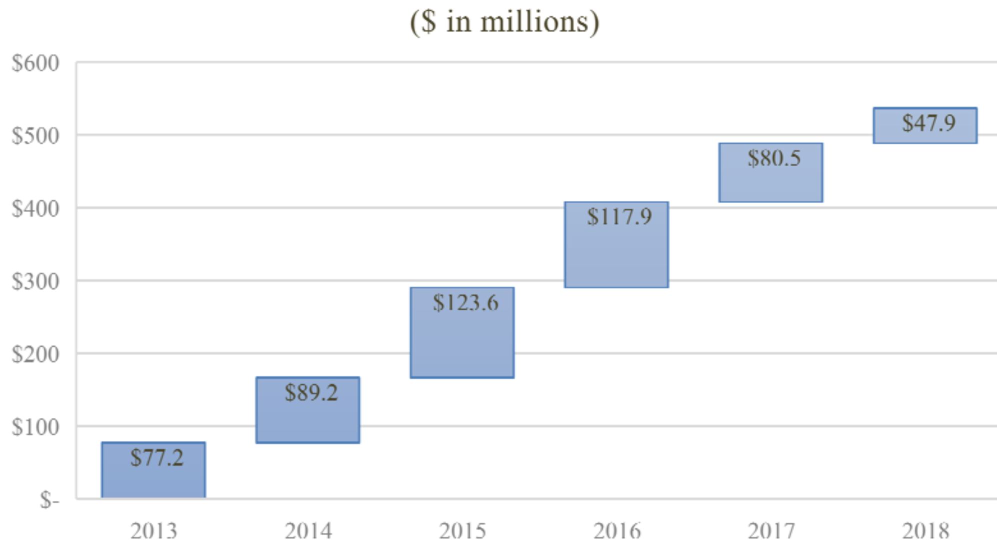
Figure 4. Required Cost Reductions for PSE to Earn its Authorized Rate of Return for Fiscal Years 2013 to 2018



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4 Figure 5 below quantifies the level of cost reductions (annually and cumulatively)

5 that PSE would have had to realize to earn its authorized returns on equity during

6 the period 2013 through 2018.

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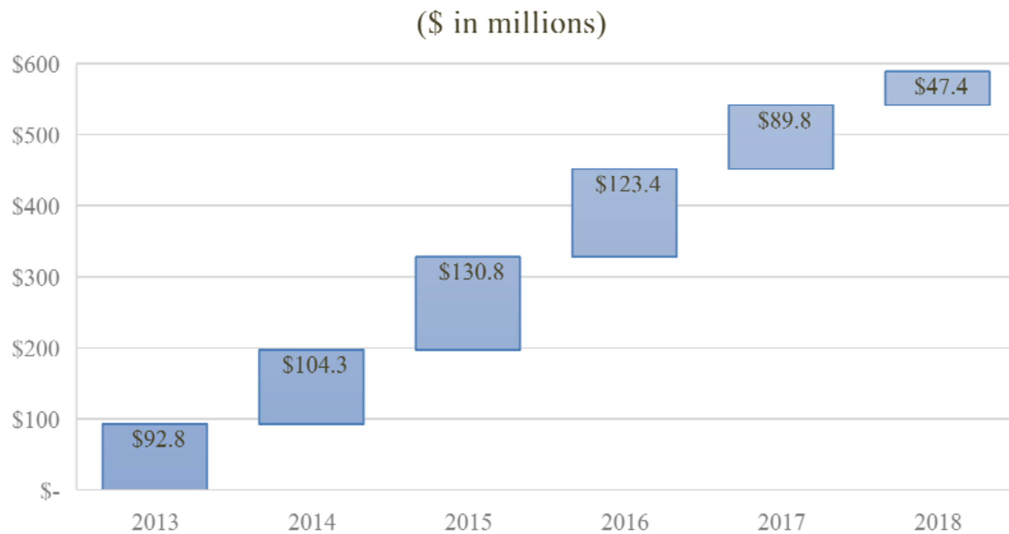
Figure 5. Required Cost Reductions for PSE to Earn its Authorized Return on Equity for Fiscal Years 2013 to 2018



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1 As shown in Figure 4 above, PSE would have needed to reduce expenses by an
2 average of $90 million annually (and approximately $530 million over the six-
3 year period) to earn its authorized rate of return on an annual basis. As shown in
4 Figure 5 above, PSE would have needed to reduce expenses by an average of
5 $100 million annually (and approximately $600 million over the six-year period)
6 to earn its authorized returns on equity. For context, Figures 6 and 7 below
7 compare the required expense reductions relative to PSE's total annual operating
8 expenses during the six-year period.

9 **Figure 6. Disparity between Authorized and Actual Rates of Return as a**
10 **Percentage of Annual Operating Expense for Fiscal Years 2013 to 2018**

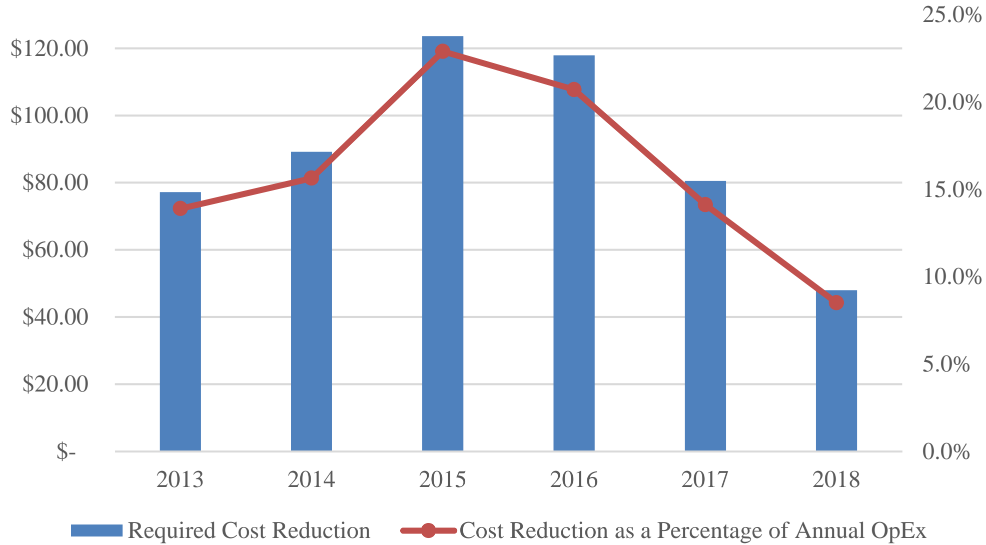

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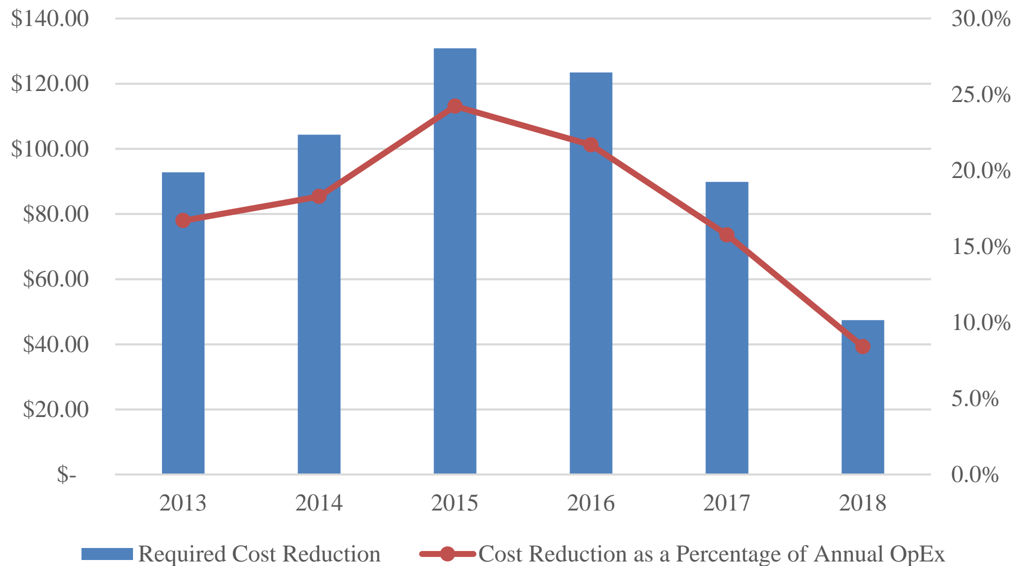
Figure 7. Disparity between Authorized and Actual Returns on Equity as a Percentage of Annual Operating Expense for Fiscal Years 2013 to 2018



Simply put, PSE could not have achieved savings of these magnitude, even under the most extreme austerity measures and had it done so, the impacts on customer service would have been draconian and untenable.

Q. Has PSE been able to continue to earn its authorized returns since the expiration of the 2014-17 rate plan and K-factor increases?

A. No. As shown in Figures 8 and 9 below, PSE has not been able to earn either its authorized rate of return or authorized return on equity since the expiration of the 2014-17 rate plan and K-factor increases.[23]

[23] Amounts for 2019 presented in Figures 8 and 9 are based on a simplified preliminary calculation of normalized results for the twelve months ended November 2019, as supported by the Prefiled Rebuttal Testimony of Susan E. Free, Exh. SEF-17T.

Figure 8. PSE's Normalized as Compared to Authorized Rates of Return for Calendar Years 2010 to 2019 for the Combined Gas and Electric Businesses

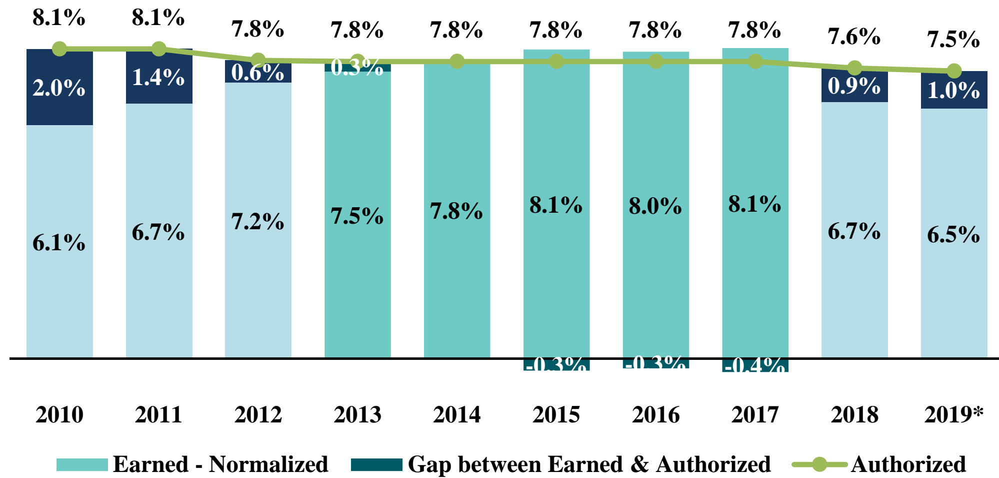
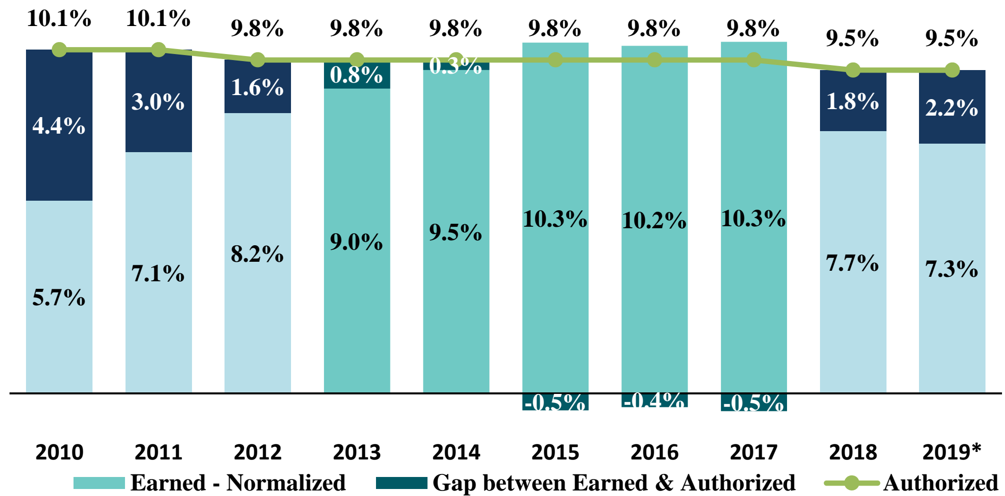


Figure 9. PSE's Normalized as Compared to Authorized Return on Equity for Calendar Years 2010 to 2019 for the Combined Gas and Electric Businesses



Both Figures 8 and 9 demonstrate that

(i) PSE has consistently under-earned both its authorized rates of return and authorized returns on equity due to the effects of lag and attrition during periods in which PSE has relied on traditional ratemaking methodologies for rate increases, and

1 2 3 4 5 (ii) PSE has had the opportunity to earn at, or near, its authorized rates of return and returns on equity when it has been able to generate revenues through use of non-traditional ratemaking methodologies, such as the 2013 expedited rate filing and ensuing K-factor increases.

6 The 2013 expedited rate filing and ensuing K-factor increases better aligned
7 PSE's base rate revenues with its underlying cost of service, over time, in a
8 manner that significantly reduced the magnitude of PSE's 2017 general rate case
9 filing by approximately $160 million. With the expiration of the 2014-17 rate plan
10 and K-factor increases, PSE, once again, began to under-earn its authorized rate
11 of return and return on equity in calendar year 2018 and continued to under-earn
12 these authorized returns on a more significant basis in calendar year 2019.

13 The evidence is irrefutable—traditional ratemaking methodologies do not, and
14 cannot, keep pace with the impacts of regulatory lag and attrition, which can only
15 leave PSE with the specter of *substantially and chronically* under-earning its
16 authorized rate of return and authorized return on equity. Accordingly, there
17 exists a compelling, fundamental basis for strong consideration and approval of
18 PSE's request for an attrition adjustment.

19 20 **B. Traditional Regulatory Mechanisms Fail to Address the Full Scope of Regulatory Lag Facing PSE**

21 **Q. Is AWEC correct in suggesting that existing regulatory mechanisms are**
22 **adequate to cover changes in costs that occur after the historical test year?**

23 A. No. The assertion in the AWEC testimony that there exist "post-test year
24 regulatory mechanisms that have protected [PSE's] ability to recover its cost of
25 service and earn its approved rate of return after a rate case due to specific cost

changes"[24] is simply incorrect. A majority of PSE's "post-test year regulatory mechanisms" have been in place for many years. Notwithstanding these mechanisms, PSE would have and continues to chronically under-earn its authorized rates of return and authorized returns on equity. Absent non-traditional ratemaking methodologies, such as PSE's proposed attrition adjustment, the 2013 expedited rate filing, and the ensuing 2014-2017 K-factor increases, PSE will continue to substantially and chronically under-earn its approved return benchmarks, even with the "post-test year regulatory mechanisms" to which the AWEC testimony refers.

Q. Do other parties to this proceeding rely on the Commission's historical consideration of attrition adjustments in opposing PSE's proposed attrition adjustment?

A. Yes. Commission Staff's testimony provides a high-level discussion of the Commission's historical consideration of attrition adjustments. Commission Staff first asserts that the Commission "has expressly approved an attrition adjustment once and only once since 1992 …"[25] and continues by stating that "[t]he only attrition allowance authorized by the commission in the last quarter century was determined by the Court of Appeals to be unlawful."[26]

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[24] Gorman, Exh. MPG-1T at 5:8-10.
[25] McGuire, Exh. CRM-1T, at 16:17-18.
[26] *Id.* at 17:14-15.

Q. Have conditions changed that may warrant reconsideration of attrition adjustments by the Commission?

A. Yes. There are several distinguishing factors that warrant Commission approval of PSE's proposed attrition adjustment.

First, the Commission should consider the modern regulated utility marketplace, replete with dramatically-changed customer expectations, the need of the industry to address climate change, and differing costs and cost of service challenges. The challenges facing PSE today are dramatically different than the challenges that faced either Puget Sound Power & Light Company or Washington Natural Gas Company in 1990. The Prefiled Direct Testimony of David E. Mills, Exh. DEM-1T, summarizes the modern utility environment and the challenges facing PSE as follows:

> PSE is filing its rate case in a time of increasing uncertainty but also great opportunity. While utilities around the country are still called upon to provide their services in the safest, most dependable and most efficient way possible, they are increasingly being asked to do so in the face of mounting financial and competitive pressure. Utilities are also challenged to provide reliable utility service in a way that protects the environment. Customers are demanding cleaner energy sources and the Washington clean energy transformation act requires electric utilities to work towards eliminating greenhouse gas emissions.
>
> …
>
> Information technology and the use of digital tools are rapidly becoming essential in order to achieve PSE's core mission of providing safe, dependable and efficient service to customers and providing customers choice as to how they interact with PSE. These technologies have much shorter depreciable lives than traditional utility assets, and the current utility regulatory model with its modified historical test year creates challenges in terms of PSE's ability to recover its technology investments.

…

> PSE, its stakeholders, and regulators must be willing to explore new, flexible, and dynamic approaches to the regulatory paradigm that will meet customers' changing needs and choices while also allowing PSE to comply with clean energy legislation and operate as a financially healthy utility that can reliably provide energy service to its customers and the region.[27]

The Commission must permit the ratemaking methodologies to evolve along with the utility industry, and approval of the proposed attrition adjustment is a necessary step to modernize ratemaking methodologies.

C. The Commission Can Achieve Regulatory Efficiency by Adopting PSE's Attrition Adjustment in this Proceeding

Q. Could PSE address regulatory lag by filing multiple expedited rate proceedings?

A. Yes. However, Ms. Free discusses the shortcomings of these types of filings. Notwithstanding these short-comings, PSE could file multiple expedited rate proceedings to address regulatory lag. The potential availability of seriatim expedited rate filings, however, still relies on a process that is historically based and does not address attrition and regulatory lag in the rate year. To the extent the Commission concludes there is a substantial basis for considering an attrition adjustment in this proceeding (which PSE believes is the case), delaying approval of an appropriate attrition adjustment to a future regulatory proceeding (i) would not address the impacts of regulatory lag and attrition that will continue during the rate year and beyond and (ii) postpones the regulatory lag and attrition issues

[27] Mills, Exh. DEM-1T, at 4:8 – 5:19.

presented by PSE to a future regulatory proceeding. PSE strongly encourages the Commission to address the impacts of regulatory lag and attrition in this proceeding and believes that PSE's proposed attrition adjustment achieves better regulatory efficiency, in the form of minimized future rate filings.

D. Commission Staff Misconstrues PSE'S Testimony Concerning Cost Increases

Q. Does Commission Staff express incredulity regarding the potential of PSE's proposed attrition adjustment to address cost pressures facing PSE?

A. Yes. Commission Staff questions whether PSE's proposed attrition adjustment will address the cost pressures facing PSE:

> PSE does not explain how most of the costs it identifies are related to attrition or remedied by an attrition allowance. In responding to the question of '[w]hat cost increases … are out of the company's control,' PSE witness Doyle lists three broad categories:
>
> 1. Increase to power costs;
> 2. Reduced cash flows due to the Tax Cuts and Jobs Act (TCJA); and
> 3. Increased investment in information technology.[28]

This testimony excludes important context and only partially quotes a question from my direct testimony, which actually states as follows: "What cost increases contribute to PSE's request for increased rates that are out of the company's control?"[29] This question—and the corresponding response—addresses the context for PSE's overall request for a rate increase, not PSE's proposed attrition

[28] McGuire, Exh. CRM-1T, at 25:3-9.
[29] Doyle, Exh. DAD-1Tr, at 21:1-2.

adjustment specifically. Indeed, the conclusion to this section of my direct testimony, is instructive and states as follows:

> Without timely rate relief [emphasis added], including the requested attrition adjustment, PSE will not be able to absorb these cost pressures and will be denied an opportunity to earn its allowed return on equity.[30]

Nowhere in PSE's testimony does PSE link increased power costs, reduced cash flows due to the Tax Cuts and Jobs Act of 2017 ("TCJA"), or increased information technology investment as support for PSE's requested attrition adjustment.

E. Additional Customer Protections Could Be Implemented if the Commission Desires

Q. Does PSE have any comment on references or allusions made by several parties regarding the lack of customer protections should PSE's proposed attrition adjustment result in excess earnings?

A. Yes. First and foremost, the present excess earnings[31] sharing mechanism, which allocates 50 percent of every dollar earned over and above PSE's authorized rate of return to the separate and distinct benefit of electric and gas customers, provides adequate customer protection against excess earnings regardless of the cause—not just those that might or could emanate from the approval and implementation of an attrition adjustment. That said, PSE is fully aware that

[30] Doyle, Exh. DAD-1Tr, at 22:2-4.

[31] Excess earnings is defined as the amount of actual net operating income calculated for earnings sharing purposes that is in excess of the allowed net operating income, which is calculated as the product of the rate base from the Commission Basis Report multiplied by the blended authorized rate of return during the reporting year.

attrition adjustments have not been widely used in the state of Washington in the recent past. Therefore, there will likely be "experimental" or uncertain aspects or components of any attrition adjustment or policy that the commission might approve in this proceeding.

PSE has thoughtfully considered this and proposes a solution if the Commission were concerned regarding the effect of the proposed attrition adjustments. Specifically, PSE could implement excess earnings sharing bands to provide additional customer protections against over earning. PSE believes it would be appropriate to consider changing PSE's present earnings sharing mechanism to include the following excess earnings sharing bands:

Table 1. PSE's Proposed Changes to Its Earnings Sharing Mechanism If the Commission Were to Adopt PSE's Proposed Attrition Adjustments

Sharing Band	Electric ($ in million)	Gas ($ in million)
1st Band – 50 percent	$0 – $7.650	$0 – $3.000
2nd Band – 75 percent	$7.651 – $15.300	$3.001– $6.000
3rd Band – 90 percent	> $15.301	> $6.000

Q. Please describe the mechanics of these proposed changes to PSE's earnings sharing mechanism if the Commission were to adopt PSE's proposed attrition adjustments.

A. This proposal sets the sharing bands based on increments of 3 percent of net operating income, after interest expense deductions and have been calculated, based on PSE's initial revenue requirement filing in this proceeding. For example, the "ceiling" for the first sharing band would be $7.650 million and

$3.000 million, which represent 3 percent of net operating income, after interest expense deductions for electric and gas operations, respectively. The customer's share of excess earnings in this first band ($0 - $7.650 million for electric operations and $0-$3.000 million for gas operations) would be 50 percent of all excess earnings.

Likewise, the "floor" for the second sharing band would be $7.651 million for electric operations and $3.001 million for gas operations, and the "ceiling" for the second sharing band would be $15.300 million for electric operations and $6.000 million for gas operations. This "ceiling" represents an incremental 3 percent (or 6 percent between the two bands) of net operating income, after interest expense deductions for electric and gas operations. The customer's share of excess earnings in this second band ($7.651 - $15.300 million for electric operations and $3.001 - $6.000 million for gas operations) would be 75 percent of all excess earnings.

Finally, the customer's share of all excess earnings above and beyond $15.300 million for electric and $6.000 million for gas would be 90 percent.

Please see the First Exhibit to the Prefiled Rebuttal Testimony of Daniel A. Doyle, Exh. DAD-8, for an example calculation of PSE's proposed changes to PSE's earnings sharing mechanism if the Commission were to believe it necessary to institute if it were to adopt PSE's proposed attrition adjustments.

Again, PSE believes that the present excess earnings sharing mechanism, which allocates 50 percent of every dollar earned over and above PSE's authorized rate

of return to the separate and distinct benefit of electric and gas customers, provides adequate customer protection against excess earnings regardless of the cause—not just those that might or could emanate from the approval and implementation of an attrition adjustment. However, PSE understands and agrees that any attrition adjustment approved by the Commission in this proceeding would be an incremental regulatory policy, which does not exist today. Accordingly, PSE does not think it is unreasonable to respond with an incremental customer protection should the Commission believe it is appropriate to do so. Therefore, PSE has proposed the modifications to its excess earnings sharing mechanism discussed above to serve that purpose.

III. PSE PROPERLY IMPLEMENTED THE IRS NORMALIZATION RULES

Q. Please describe the positions of other parties with respect to PSE's amortization of protected EDIT during the period beginning January 1, 2018, and ending on February 28, 2019.

A. Commission Staff proposes that the Commission require PSE to create a separate EDIT account on its balance sheet, separate EDIT amortizations from it federal tax adjustment, and continue to return EDIT to customers through Schedule 141X:

> Staff recommends the Commission require PSE to (1) create a separate EDIT account on its balance sheet, (2) separate EDIT amortizations/reversals from [PSE's] federal tax adjustment, and (3) continue to return EDIT to customers on Schedule 141X. Additionally, Staff recommends the Commission order PSE to update Schedule 141X annually to include the following year's

1 EDIT amortization amount, consistent with the average rate
2 assumption method (ARAM).[32]

3 Commission Staff's testimony acknowledges that the Internal Revenue
4 Service (IRS) has yet to issue guidance on the application of the Tax Cut and Jobs
5 Act of 2017 normalization requirements.[33] Commission Staff concludes by
6 asserting, without support, that any violation by PSE of the IRS normalization
7 rules resulting from a Commission order in this proceeding could fall within an
8 IRS safe harbor for unintended violations "if there were a swift correction":

9 Even if the Commission were to inadvertently cause the Company
10 to violate any IRS requirements, the IRS has provided a safe harbor
11 for unintended violations, in Rev Proc 2017-47.4 This means the
12 Company could avoid consequences if there were a swift
13 correction.[34]

14 Public Counsel proposes that the Commission require PSE to place $34.1 million
15 of EDIT amortization in a regulatory liability account to be returned to customers
16 over a two-year period:

17 I recommend that the Commission require PSE to restore the
18 protected EDIT reversals (amortizations) from January 2018
19 through February 2019 to a regulatory liability account to be
20 returned to ratepayers over a two-year period. Now that the ARAM
21 reversal period has passed for these amortizations (January 2018
22 through February 2019), the funds can now be treated as unprotected
23 EDIT and can be returned to ratepayers over any period the
24 Commission determines appropriate.[35]

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[32] Steward, Exh. CSS-1T, at 6:6-12.
[33] *Id.* at 7:11-14.
[34] *Id.* at 7:15-18.
[35] Garrett, Exh. MEG-1T, at 55:16-21.

1 Unlike Commission Staff, Public Counsel incorrectly asserts that the refund of
2 protected EDIT amortization for the period January 1, 2018, through February 28,
3 2019, would not violate IRS normalization rules.[36]

4 Finally, AWEC proposes a multistep approach. AWEC proposes, in addition to
5 the amounts PSE already included in base rates in its revenue requirement, the
6 amortization of an additional amount of EDIT amortization for January 1, 2018
7 through February 28, 2019, over a four-year period, and including the amount in
8 Schedules 141X for electric and gas services, so that the amounts can be tracked
9 and distinguished from the amount of ARAM amortization considered in base
10 rates.[37] Then, AWEC proposes the application of an offsetting adjustment to
11 account for the increase in rate base associated with the additional EDIT
12 amortization.[38] Finally, AWEC proposes that either (i) the sur-credit decline each
13 year to account for the increasing rate base or (ii) calculation of the rate base
14 impacts on a levelized basis over the four-year amortization period.[39] Like
15 Commission Staff—but unlike Public Counsel—AWEC acknowledges the fact
16 that the IRS announced in Notice 2019-33 that it is drafting, but has not yet
17 issued, guidance on the application of the TCJA normalization requirements.[40]

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[36] Garrett, Exh. MEG-1T, at 60:10 – 61:2.
[37] Mullins, Exh. BGM-1T, at 31:3-5.
[38] *Id*. at 31:11-13.
[39] *Id.* at 31:13-16.
[40] *Id.* at 27:5-11.

1 **Q. How does PSE respond to these proposals?**

2 A. Before proceeding, it might be useful to briefly summarize why the normalization
3 rules exist in the first place. In 1954, Congress passed tax legislation that allowed
4 for the use of accelerated depreciation for tax purposes as a means of stimulating
5 corporate capital investment and the U.S. economy. Over the next 15 years, both
6 the IRS and Congress closely monitored the extent to which both utilities and
7 their regulators adopted the practice of passing back the benefit of accelerated
8 depreciation immediately in rates, otherwise known as "flow-accounting". Over
9 that 15-year period, both Congress and the IRS recognized and became
10 increasingly alarmed by the pervasive adoption of flow-through accounting in the
11 utility sector, which had created a substantial and unintended consequence (from
12 allowing accelerated depreciation in 1954) in the form of a substantial "transfer
13 payment" of tax liability from utilities to all other U.S. taxpayers.

14 The use of flow-through accounting reduced tax revenues in the utility sector (i.e.,
15 lower current tax expense due to accelerated depreciation results in lower utility
16 rates to customers and less taxable revenue to the IRS) and those reduced tax
17 revenues would have to be collected from other U.S. taxpayers, all else being
18 equal, for the government to pay its bills. Given the capital-intensive nature of the
19 utility industry (recall that as the 1970s approached, the permitting, siting, and
20 construction of expensive nuclear generating facilities became in vogue), the IRS
21 realized that the resulting transfer payments referenced above could become
22 increasingly significant, harmful, and unfair to non-utility U.S. taxpayers and was
23 simply not sustainable tax policy.

1 From this analysis and the obvious tax equity considerations, the IRS
2 normalization rules were born, and, in the first instance, prohibited the use of
3 flow-through accounting by utilities in connection with the adoption or continued
4 use of accelerated depreciation for tax purposes. Further, the normalization rules
5 also govern the inclusion deferred tax expense related to the use of accelerated
6 depreciation in rates and also the reversal of accumulated deferred taxes in rates
7 over the remaining book lives of assets, after those assets become fully
8 depreciated for tax purposes. The ARAM rules build off of this latter concept.
9 That is, to the extent that tax reform (reduction in tax rates) creates EDIT, those
10 EDIT are passed back to customers ratably over the remaining book lives of the
11 corresponding assets at the time they become fully depreciated for tax purposes.
12 Importantly, this treatment mandates the reversal of accumulated deferred income
13 taxes, EDIT included, over the same timeframe and in the same amounts had tax
14 reform (reduction in tax rates) never occurred in the first place.

15 In the final analysis, the IRS normalization rules exist to prevent unintended
16 consequences in the form of transfer payments from utility taxpayers to all other
17 U.S. taxpayers, and actively prevent both utilities and their commissions from
18 creating those transfer payments, by (1) eliminating flow-through accounting in
19 all of its forms and permutations and (2) requiring the very specific application of
20 the accounting and ratemaking protocols that comprise the normalization rules.

21 With this background, PSE fundamentally disagrees regarding the interpretation
22 and proper application of the applicable IRS normalization rules. Further, as
23 discussed below, neither customers nor the IRS have been harmed by PSE's

amortization of protected EDIT, and no refunds of these amounts are appropriate or required.

The Prefiled Direct Testimony of PSE witness Matthew R. Marcelia, Exh. MRM-1T, provides a detailed discussion of the IRS normalization rules, and the applicable components of the rules germane to this discussion are as follows:

> 1. The reversal of protected EDIT under the ARAM construct must begin on the effective date of tax reform for those vintages of property that have been fully depreciated for tax purposes.
>
> 2. Whenever the reversal of protected EDIT are included in rates as a cash refund to customers, the consistency requirements embedded in the IRS normalization rules require that base rates be updated to synchronize depreciation expense, current and deferred tax expense, accumulated deferred income tax balances including EDIT, and rate base.

Q. Did PSE begin the reversal of protected deferred taxes on the effective date of tax reform for those vintages of property that were fully depreciated for tax purposes at the time?

A. Yes. PSE began the reversal of protected deferred taxes on the effective date of tax reform for those vintages of property that were fully depreciated for tax purposes at the time. PSE properly amortized approximately $34.1 million of EDIT during the period January 2018 through February 28, 2019. The amortization of protected EDIT during that period related to all vintages of protected property that were or became fully depreciated for tax purposes. This is the proper ARAM accounting treatment until and when all components of the

1 consistency rules are updated and simultaneously placed in rates, which occurred
2 in connection with PSE's 2018 ERF settlement.

3 **Q. Did PSE update base rates to synchronize depreciation expense, current and**
4 **deferred tax expense, accumulated deferred income tax balances including**
5 **protected EDIT, and rate base?**

6 A. Yes. PSE's treatment of protected EDIT follows the consistency requirements of
7 the IRS normalization rules, which require utilities to update base rates in
8 accordance with the consistency requirements of the normalization rules when
9 including the amortization of protected EDIT in rates. As a practical matter, utility
10 cost of service will increase over time due to inflation, new investments, and
11 growth in rate base. Practically speaking, the IRS normalization rules require
12 utilities to synchronize increases in utility cost of service and rates when passing
13 back EDIT. Accordingly, it would be a violation of the consistency requirements
14 of the normalization rules to include the pass back of EDIT without a
15 corresponding and simultaneous update of base rates (specifically rate base,
16 depreciation expense, ADIT, and tax expense)..

17 Assume for the purposes of analysis that PSE had updated base rates on the
18 effective date of the TCJA (January 1, 2018). PSE's last general rate proceeding
19 in Dockets UE-170033 & UG-170034 was based on a test year ended
20 September 30, 2016. Between September 30, 2016 and January 1, 2018, PSE
21 made over $1 billion in capital expenditures not included in rate base as of
22 January 1, 2018. It is plausible, if not likely, that any increase in rates associated
23 with a $1 billion increase in rate base and the remaining cost of service items

1 specified in the consistency rules, could offset all or a significant portion of the
2 pass back of protected EDIT in rates on that date. Therefore, it is reasonable to
3 conclude that PSE's amortization of protected EDIT outside of rates for the period
4 beginning on January 1, 2018, and ending on February 28, 2019:

5 (i) did not harm customers because any inclusion of pass back
6 of protected EDIT in rates is required to have been offset
7 by updates to cost of service and increased rates in
8 conformity with the consistency requirements of the IRS
9 normalization rules;

10 (ii) did not harm the IRS because tax revenues were not
11 adversely affected by including the pass back of protected
12 EDIT without complying with the consistency requirements
13 of the IRS normalization rules.

14 (iii) conformed with the ARAM accounting procedures
15 mandated by the IRS normalization rules and resulted in
16 accurate financial statements on both a GAAP and
17 regulatory basis and also an accurate 2018 tax return that
18 was filed accurately and in conformity with all aspects of
19 the IRS normalization rules.

20 Importantly, PSE's external auditors determined, in connection with their audit of
21 PSE's financial statements for calendar year 2018, that PSE's application and
22 implementation of the IRS normalization rules was correct, a fact that is
23 conveniently over looked by all other parties in this proceeding. In addition, this
24 external review and determination provided me in my role as Chief Financial
25 Officer of PSE and in connection with my signing, under penalties of perjury for
26 knowingly falsifying or filing an incorrect tax return, of PSE's corporate tax
27 return for calendar year 2018 with independent comfort that PSE properly
28 implemented the complex IRS normalization rules.

1 Accordingly, any refund of the protected EDIT amortized for the period
2 beginning January 1, 2018, through February 28, 2019, is unnecessary,
3 inappropriate, and would result in a clear misapplication of the IRS consistency
4 provisions of the normalization rules for the reasons set forth in this prefiled
5 rebuttal testimony and in the Prefiled Rebuttal Testimony of Matthew R.
6 Marcelia, Exh. MRM-11T.

7 **Q. How does PSE respond to Public Counsel's assertion that PSE's proposal "is**
8 ***not* consistent with the treatment being ordered in other states … [and]**
9 **utilities across the country have been able to defer all of the benefits of the**
10 **TCJA … without running afoul of any normalization rule violations"?[41]**

11 A. First, Public Counsel's suggestion is a gross mischaracterization and ascribes an
12 improper motive to PSE. PSE did not, as suggested by Public Counsel, reverse or
13 amortize protected excess EDIT to shareholders or for the benefit of
14 shareholders.[42] Public Counsel is free to disagree with PSE's interpretation of the
15 IRS normalization rules under the TCJA, which are complicated and the guidance
16 for which, as discussed above, are currently under development but not yet issued
17 by the IRS. Public Counsel should not, however, blithely ascribe an improper
18 motive to PSE, such as taking a results-oriented position to enrich its

[41] Garret, Exh. MEG-1T, at 66:23-26.

[42] *See*, *e.g.*, *id.* at 50:10-12 (stating that the PSE "is improperly transferring these tax benefits to its shareholders by amortizing the amounts over-collected from ratepayers as current income to PSE"); *id.* at 51:1-2 (stating that "[t]hese funds are not a convenient source of income for PSE to amortize into income for the benefit of its shareholders during the interim period between rate cases"); *id.* at 66:22-23 (stating that "PSE's attempts to reverse (amortize) the protected excess EDIT to shareholders is *not* consistent with the treatment being ordered in other states").

1 shareholders. PSE and I take great exception to that insinuation. PSE simply
2 followed and properly implemented the ARAM accounting rules and began to
3 amortize protected excess EDIT on January 1, 2018 for those vintages of property
4 that were fully depreciated for tax purposes, until all components of the
5 consistency rules were updated and simultaneously placed in rates, which
6 occurred in connection with PSE's 2018 ERF settlement. PSE was following what
7 it understands to be proper interpretation and implementation of the IRS
8 normalization rules.

9 Second, the treatment ordered by other state commissions is not determinative
10 with respect to the proper application of the IRS normalization rules. As
11 mentioned in the testimonies of each of Commission Staff and AWEC, the IRS
12 indicated in its Notice 2019-33 that it is drafting guidance on the application of
13 the TCJA normalization requirements. PSE believes that such guidance will
14 affirm PSE's interpretation of the IRS normalization rules.

15 Third, misapplying the IRS normalization rules does not qualify as an
16 "inadvertent" misapplication of the rules, as Commission Staff suggests. I
17 completely agree with the Prefiled Rebuttal Testimony of Matthew R. Marcelia,
18 Exh. MRM-11T, in this regard. Accordingly, the Commission should take little
19 comfort that "a swift correction" of any misapplication would likely absolve PSE
20 from a normalization violation and the penalties that could be imposed.

21 Finally, the adjudication of whether any of the states to which Public Counsel
22 refers have run afoul of any normalization rule violations will not be known for
23 some time. Those issues will be reviewed, assessed, and opined upon in

connection with future IRS audits of individual utility tax returns, which will not take place for up to three years, and certainly not before the IRS issues its guidance on TJCA referred to above. Accordingly, the Commission should take no comfort at this time that a normalization rule violation has or has not occurred in any of the states to which Public Counsel references in its testimony.

Q. Does PSE agree with Commission Staff's proposal to "order PSE to update Schedule 141X annually to include the following year's EDIT amortization amount"[43]?

A. No. Commission Staff's proposal to order PSE to update Schedule 141X annually to include the following year's EDIT amortization amount would violate the form and intent of the of the consistency requirements of the normalization rules. Once rates are set to synchronize simultaneously all components of the consistency rules (as they were in connection with PSE's 2018 ERF settlement), it is simply inappropriate to "cherry-pick" (amongst the components of the consistency rules) and annually adjust the future pass back of EDIT in rates (via Schedule 141X in this case) without simultaneously adjusting all other components of the consistency rules. I completely agree with Mr. Marcelia on this point and the strongly urge the Commission to reject this proposal.

[43] *See* Steward, Exh. CSS-1T at 6:9-11.

IV. THE WEIGHTED-AVERAGE RETURNS ON EQUITY PROPOSED BY COMMISSION STAFF AND PUBLIC COUNSEL ARE FAR BELOW INDUSTRY AVERAGES AND ARE NOT SUPPORTIVE OF PSE'S CURRENT CREDIT RATINGS

Q. Please summarize the weighted-average returns on equity resulting from the return on equity proposals of Commission Staff and Public Counsel.

A. As discussed in the Prefiled Rebuttal Testimony of Dr. Roger A. Morin, Exh. RAM-12T, Commission Staff proposes an authorized return on equity for PSE of 9.2 percent, and Public Counsel proposes an authorized return on equity for PSE of 8.75 percent. Both parties adopt PSE's proposed capital structure that includes an equity ratio of 48.5 percent. The resulting weighted-average return on equity proposed by Commission Staff is 4.46 percent,[44] and the weighted-average return on equity proposed by Public Counsel is 4.24 percent.[45] Both of these proposed weighted-average return on equity rates are significantly lower than the weighted-average return on equity of 4.61 percent proposed by PSE.[46]

The weighted-average returns on equity of 4.46 percent proposed by Commission Staff, if adopted, would be the seventh lowest authorized weighted-average return on equity of the 62 natural gas and electric utilities provided in Figure 5 of the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1Tr.[47] The weighted-average returns on equity of 4.24 percent proposed by Public Council, if adopted, would be the fourth lowest authorized weighted-average return on equity of the

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44 *See* Parcell, Exh. DCP-1T, at 2:19.
45 *See* Woolridge, Exh. JRW-3.
46 *See* McArthur, Exh. MDM-8, at 1.
47 *See* Doyle, Exh. DAD-1Tr, at 29:3.

1 62 natural gas and electric utilities provided in Figure 5 of the Prefiled Direct
2 Testimony of Daniel A. Doyle, Exh. DAD-1Tr.[48] Their proposed weighted-
3 average returns on equity are well below both (i) the average weighted-average
4 return on equity of 4.86 percent for the 62 natural gas and electric utilities
5 provided in Figure 5 of the Prefiled Direct Testimony of Daniel A. Doyle,
6 Exh. DAD-1Tr[49] and (ii) PSE's proposed authorized return on equity
7 recommendation of 4.61 percent.

8 **Q. What impact would the weighted-average returns on equity proposed by**
9 **Commission Staff and Public Counsel have on PSE's attempt to recover lost**
10 **cash flows from tax reform?**

11 A. As noted in the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1Tr, tax
12 reform resulted in a reduction of PSE's cash flows of $107 million, creating
13 significant degradation of PSE's cash flow-based credit metrics.[50] This rate filing
14 is critical to restoring cash flows due to the negative impacts of tax reform. The
15 proposed weighted-average returns on equity of 4.46 percent and 4.24 percent of
16 Commission Staff and Public Counsel, respectively, would lower the requested
17 revenue requirement and related cash flows by an estimated $19 million and
18 $36 million, respectively. Please see the Second Exhibit to the Prefiled Rebuttal
19 Testimony of Daniel A. Doyle, Exh. DAD-9, for a calculation of the impact of

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48 *See* Doyle, Exh. DAD-1Tr, at 29:3.
49 *See id.* at 29:3.
50 *See id.* at 2:5-14.

Commission Staff's and Public Counsel's weighted-average return on equity proposals.

Not only would these lower returns on equity reduce requested cash flows, but they would also have a negative impact on PSE's credit metrics. For example, Public Counsel's proposed weighted-average return on equity of 4.24 percent would lower the Standard & Poor's Funds from Operations to Total Debt (FFO/Debt) Ratio by an estimated 74 basis points and Moody's Cash Flow from Operations Before Changes in Working Capital (CFO Pre-WC/Debt) metric for PSE by 79 basis points.[51]

The weighted-average returns on equity proposed by Commission Staff and Public Counsel raises several concerns. First, the utility industry is very capital intensive, and those required capital investments must be financed by both equity and debt. A weighted-average cost of equity that departs so significantly from industry averages would only serve to increase the cost of debt capital that PSE must raise and recover from customers in rates.

Second, a low weighted-average return on equity could negatively affect PSE's credit ratings and the rating agencies overall view of regulation in the state of Washington. All three credit rating agencies have noted the importance of a supportive regulatory environment and opined that unfavorable rate proceedings

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[51] *See* Doyle, Exh. DAD-8, at 3:3 and 6.

1 could lead to negative credit rating implications.[52] Currently, Standard and Poor's
2 has a negative outlook for PSE, which is on the edge of a downgrade.[53] Neither
3 Commission Staff nor Public Counsel address Standard and Poor's negative
4 outlook for PSE. Obviously, any negative credit implications can only increase
5 the cost of debt capital that PSE must raise, and customers must subsequently pay
6 for in rates.

7 Third, the weighted-average returns on equity proposed by Commission Staff and
8 Public Counsel do not provide an appropriate balance between safety and
9 economy. In contrast, the weighted-average return on equity of 4.61 percent
10 proposed by PSE reasonably provides an appropriate balance between safety and
11 economy and allows PSE to recover, over time, the reduced cash flow caused by
12 tax reform.

13 **Q. Is AWEC correct in suggesting that PSE's existing regulatory mechanisms**
14 **are adequate to support PSE's current credit ratings because they fall in the**
15 **"Rating Target Range" of the Third Exhibit to the Prefiled Response**
16 **Testimony of Michael P. Gorman, Exh. MPG-3?**

17 A. No. Section VI of the relevant AWEC testimony focuses only on credit metrics
18 and indicated that the credit metrics are supportive of PSE's current ratings

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52 *See, e.g.*, S&P Global Ratings, *Puget Energy Inc. And Subsidiary Ratings Affirmed; Outlooks Revised to Negative On Weakening Financial Measures* at 4 (Dec. 14, 2018); Moody's Investor Service, *Credit Opinion: Puget Sound Energy, Inc.* at 2 (Aug. 29, 2019); FitchRatings, *Corporates: Puget Sound Energy, Inc.* at 2 (July 27, 2018).

53 *See, e.g.*, S&P Global Ratings, *Puget Energy Inc. and Subsidiary Ratings Affirmed; Outlooks Revised to Negative On Weakening Financial Measures* (Dec. 14, 2018).

1 because they fall in the "Rating Target Range" of the Third Exhibit to the Prefiled
2 Response Testimony of Michael P. Gorman, Exh. MPG-3.[54] Moody's CFO pre-
3 WC/Debt ratio, however, is on the low end of the range and has recently dropped
4 below the range. The "Rating Target Range" of 13-22% is for all Baa ratings,
5 which includes Baa1, Baa2 and Baa3. PSE's current rating is Baa1. According to
6 the most current Moody's credit report for PSE issued in August 2019,[55] one of
7 the factors that could lead to a downgrade is the fact that PSE's ratio has dropped
8 below 20 percent. For example, PSE's CFO pre-WC/Debt as of end of the test
9 year (i.e., December 31, 2018) was 20.3 percent. In contrast, PSE's CFO pre-
10 WC/Debt as for the twelve months ending June 30, 2019, was 18.5 percent. The
11 reduction in cash flow and reductions in rates caused by the TCJA, as well as
12 increased costs from investment, are pushing PSE's credit metrics below the
13 benchmark and could cause a downgrade.

14 **Q. Do credit ratings agencies consider factors other than credit metrics when**
15 **issuing credit ratings?**

16 A. Yes. As discussed in my direct testimony, credit rating agencies consider a
17 number of categories, not just credit metrics, which can be both quantitative and
18 qualitative in nature. The following provides a summary of major categories that
19 three rating agencies consider when issuing credit ratings:

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[54] *See generally* Gorman, MPG-1T, at 16:18 – 18:3.

[55] Moody's Investor Service, *Credit Opinion: Puget Sound Energy, Inc.* (Aug. 29, 2019).

1 S&P rating methodology bases its ratings on the following three major

2 categories:[56]

3 (i) Business Risk Profile, which assesses industry risk,
4 regulation and competitive position

5 (ii) Financial Risk Analysis, which assesses commodity
6 trackers, accounting and capital expenditures

7 (iii) Rating Modifiers, which assesses capital structure, financial
8 policy, management and governance

9 Moody's revised rating methodology bases its ratings on the following four major

10 categories:[57]

11 (i) Regulatory Framework 25 percent

12 (ii) Ability to Recover Costs 25 percent
13 and Earn Returns

14 (iii) Diversification 10 percent

15 (iv) Financial Strength, Liquidity 40 percent
16 and Key Metrics

17 Fitch rating methodology bases its ratings on the following four major

18 categories:[58]

19 (i) Regulation, which assess predictability and
20 timeliness of cost recovery, trends in authorized
21 returns on equity, mechanisms supportive of credit
22 worthiness

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56 *See* S&P Global Ratings, *Key Credit Factors for The Regulated Utilities Industry* at 2-18 (Nov. 19, 2013).

57 *See* Moody's Investors Service, *Rating Methodology Regulated Electric and Gas Utilities* at 46 (Dec. 23, 2013).

58 *See* FitchRatings, Financial Profile Key Factors at 204 (Mar. 2018).

1 (ii) Market and Franchise, which assesses market
2 structure, customer trends and supply-demand
3 dynamics

4 (iii) Asset Base and Operations, which assesses
5 reliability, environmental and capital and
6 technology

7 (iv) Commodity Exposure, which assesses supply
8 diversity, hedging and fuel diversity

9 **Q. How important is a supportive regulatory environment and ability to recover**
10 **costs/earn returns in credit rating analysis?**

11 A. As stated above, the regulatory framework and the ability to recover prudently
12 incurred costs and earn allowed returns comprise 50 percent of Moody's ratings
13 decisions, which is higher than the weight for financial strength, liquidity and key
14 metrics (40 percent). Although Standard & Poor's does not publish publicly the
15 weights assigned to its major categories, regulation is assessed in its business risk
16 profile, as one of the three major categories. Fitch does not publicly publish the
17 weights for its major categories either, but one of the major categories is
18 regulation, which assess predictability and timeliness of cost recovery, trends in
19 authorized returns on equity, mechanisms supportive of creditworthiness.

20 The importance of regulatory environment is evident in rating agencies' annual
21 credit report. Standard & Poor's credit report issued in December 2018 stated that
22 PSE has an "Excellent" business position with a "Significant" financial position
23 ranking. The report, however, lowered PSE's outlook to "Negative" and stated the
24 primary reason for negative outlook as follows:

25 While the company has taken some steps to gradually improve its
26 management of regulatory risk, we view the regulatory environment

> in Washington as generally less constructive compared to other jurisdictions, in part reflecting the lack of consistency in the regulatory construct in the state. Previously, PSE benefitted from annual preset rate increases and annual revenue decoupling adjustments under its 2013 rate plan. With the expiration of this rate plan in 2017, PSE will need to seek cost recovery using more frequent Expedited Rate Filings (ERF) or general rate cases to recover its costs. This approach introduces more regulatory risk, since adverse or delayed outcomes from these filings may introduce regulatory lag, potentially constraining the company's ability to receive timely recovery of its costs.[59]

In Fitch's credit report issued in July 2018, two out of five future developments that may, individually or collectively, lead to negative rating action are as follows:

> (i) If the outcome of future rating proceedings is materially unfavorable
>
> (ii) If Washington's regulatory environment deteriorates materially.

In sum, the credit ratings agencies pay close attention to, and their ratings for utilities reflect, the regulatory environment in which utilities operate. Utilities operating in jurisdictions that allow predictable and timely recovery of costs and authorized rates of return that are consistent with their peers receive better credit ratings.

Q. What are other factors that affect PSE's ability to compete for capital?

A. PSE's size, regulatory diversity, and scope of operations have a significant impact on the overall credit rating process and directly impact PSE's credit rating, as well as its ability to acquire capital.

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[59] S&P Global Ratings, *Puget Energy Inc. And Subsidiary Ratings Affirmed; Outlooks Revised to Negative On Weakening Financial Measures* at 4 (Dec. 14, 2018).

1 In the rating methodology "Key Credit Factors For The Regulated Utilities
2 Industry" published in November 2013, Standard & Poor's stated as follows:

3 A utility that warrants a Strong or Strong/Adequate assessment has
4 scale, scope, and diversity that support the stability of its revenues
5 and profits by limiting its vulnerability to most combinations of
6 adverse factors, events, or trends.

7 …

8 We generally believe a larger service territory with a diverse
9 customer base and average to above-average economic growth
10 prospects provides a utility with cushion and flexibility in the
11 recovery of operating costs and ongoing investment.[60]

12 For Moody's, ten percent of its rating is based on diversification. In its
13 2017 Rating Methodology report for regulated electric and gas utilities, Moody's
14 stated as follows:

15 Diversification of overall business operations helps to mitigate the
16 risk that economic cycles, material changes in a single regulatory
17 regime or commodity price movements will have a severe impact on
18 cash flow and credit quality of a utility. Diversity among regulatory
19 regimes can mitigate the impact of a single unfavorable decision
20 affecting one part of the utility's footprint.[61]

21 Finally, Fitch has a similar criteria. In its 2018 Corporate Sector Navigator report
22 for US Utilities, Power and Gas, Fitch suggests that a utility that is smaller in size
23 and possesses limited diversification would be viewed more negatively from a
24 credit perspective.

25 Simply put, size, regulatory diversity and scope of operations matter when it
26 comes to the credit rating process and the ability to attract that capital at

[60] Standards & Poor's Ratings Services, *Key Credit Factors For The Regulated Utilities Industry* at ¶¶32, 34 (2013).

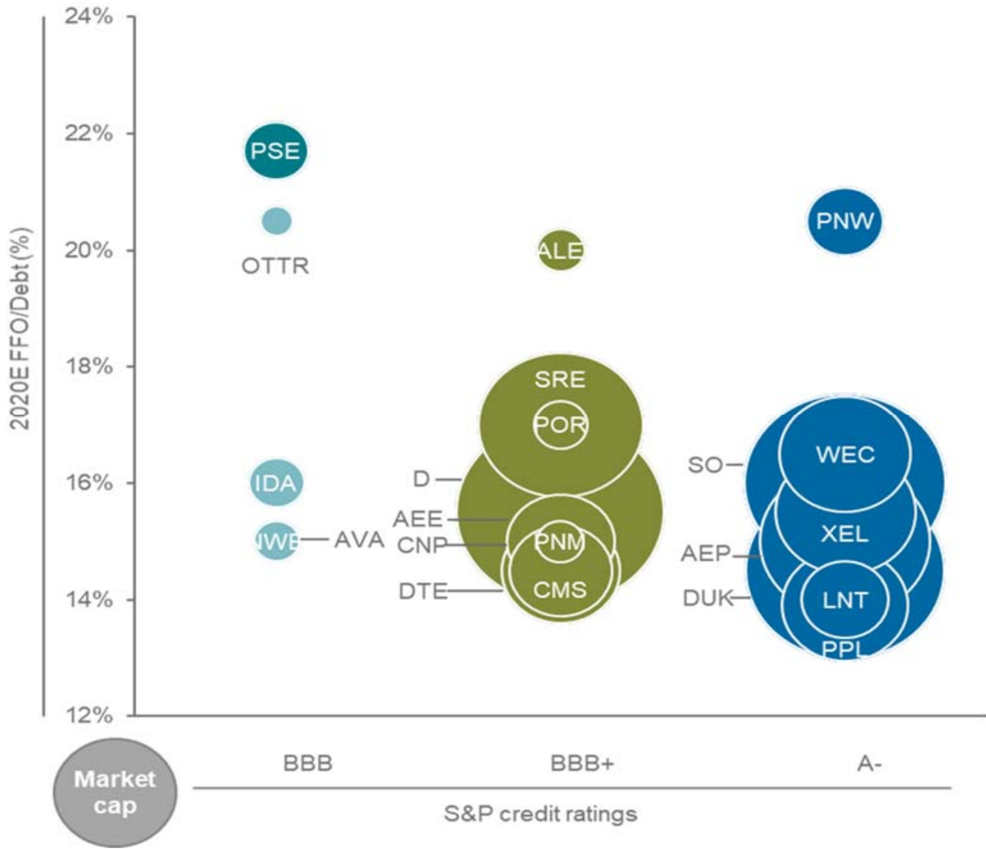
[61] Moody's Investors Service, *Regulated Electric and Gas Utilities* at 19 (2017).

1 reasonable and attractive prices. AWEC, Commission Staff and Public Counsel
2 ignore these important ratings criteria.

3 **Q. Does PSE have any evidence regarding the impacts of size, regulatory**
4 **diversity and scope of operations on its credit ratings?**

5 A. Yes. Figure 10 below presents Standard & Poor's FFO to Debt ratio for PSE's
6 peers and their size (market cap) and S&P credit ratings:

7 **Figure 10. FFO/Debt at Each S&P Rating**



8

9 Based on the data in Figure 10 above, it is clear that utilities with larger market
10 capitalization will generally and consistently have a higher credit rating than their
11 smaller counterparts. Further, the larger utilities also tend to have greater

1 regulatory diversity and broader scope of operations. Clearly, PSE suffers in
2 comparison to the overall market place based on its more limited size, regulatory
3 diversity, and scope of operations.

4 There is little PSE can do to alter its present circumstance in these areas, which
5 are largely the result of dramatic industry consolidation over the past several
6 decades. Couple this with a low weighted-average return on equity in the range
7 proposed by Commission Staff and Public Counsel, and it is irrefutable that PSE
8 would be disadvantaged in its ability to attract that capital at reasonable costs in
9 comparison to its peers.

10 In the face of these collective data, there is no sound rationale either quantitative
11 or qualitative that supports why PSE should be required to compete for debt
12 capital in the marketplace with a weighted-average return on equity that is
13 substantially below industry averages, as recommended by Commission Staff and
14 Public Counsel. This is particularly true when PSE is disadvantaged from a credit
15 ratings perspective due to its size, regulatory diversity and scope of operations.
16 Accordingly, the Commission should (i) reject the weighted-average returns on
17 equity proposed by Commission Staff and Public Counsel and (ii) adopt the
18 weighted-average return on equity of 4.61 percent proposed by PSE in this
19 proceeding.

20 V. CONCLUSION

21 **Q. Does that conclude your rebuttal testimony?**

22 A. Yes, it does.