EXH. DAD-1CT
DOCKETS UE-240004/UG-240005
2024 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-240004** **Docket UG-240005**

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF

DANIEL A. DOYLE

ON BEHALF OF PUGET SOUND ENERGY

REDACTED VERSION

FEBRUARY 15, 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 Daniel A. Doyle. My business address is 355 110th Ave. NE, Bellevue, WA 98004. I am the Chief Financial Officer of Puget Sound Energy ("PSE").

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

A. Yes. Please see the First Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-2, for an exhibit describing my education, relevant employment experience, and other professional qualifications.

Q. What topics do you address in this prefiled direct testimony?

A. This prefiled direct testimony first provides an overview of the changes in the regulatory and public policy landscape in the State of Washington with the passage of the Clean Energy Transformation Act, the Climate Commitment Act, and the statute authorizing use of a multiyear rate plan. PSE projects that it must make [redacted] over the next few

years to meet the clean energy policies. The rate relief requested by PSE in this proceeding is critical if PSE is to partner with the State of Washington to make the clean energy transition a reality.

Second, this prefiled direct testimony addresses the financial challenges PSE continues to face. This prefiled direct testimony addresses PSE's (i) inability to earn its authorized rate of return, (ii) cash flow challenges resulting from the aftermath of the Tax Cuts and Jobs Act of 2017[1] ("TCJA"), and (iii) declining credit metrics. PSE must maintain a strong credit profile to partner with the Commission and the State of Washington to achieve the state's clean energy goals.

Third, this prefiled direct testimony describes how factors such as wildfire risk, imputed debt from purchased power agreements ("PPA"), and cash flow shortages increase PSE's business and financial risk profiles. PSE's massive projected capital funding necessary to acquire an unprecedented level of clean resources over the next decade will require access to external capital funding—both debt and equity—at a level that cannot be accomplished affordably without a stronger financial profile.

Fourth, this prefiled direct testimony demonstrates that PSE's currently authorized return on equity, equity ratio, and weighted average cost of equity are well below average, based on peer group comparisons, and explains why they should be

[1] Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

increased. PSE has proposed reasonable and appropriate returns on equity and equity ratios that would allow PSE to strengthen its credit metrics and meet the state's clean energy goals, all to the benefit of customers. Additionally, a financially strong PSE can more aggressively improve the reliability of its electric system through grid modernization and enhance the safety of its gas system.

Fifth, this prefiled direct testimony presents PSE's proposal to include construction work in progress ("CWIP") in rate base for projects necessary for PSE to meet the requirements of the Clean Energy Transformation Act, in general, and the Beaver Creek Wind Project, in particular, in this proceeding. Recovering construction financing costs through the CWIP in rate base methodology would allow PSE to maintain a sufficient cash flow to meet financing and construction needs as a critical partner in bringing about the clean energy transformation required by state policy. Customers also benefit through lower costs over the life of a project and do not experience "rate shock" when PSE places large capital investments into service and into rates, as compared to financing through the allowance for funds used during construction ("AFUDC") methodology.

Sixth, this prefiled direct testimony presents an overview of PSE's request in this proceeding of a rate of return on PPAs made in connection with its Clean Energy Action Plan ("CEAP") and how such a request is appropriate, credit supportive, and beneficial to customers.

Finally, this prefiled direct testimony describes the elements of the two-year rate plan requested by PSE in this proceeding. PSE has structured a rate plan that would reduce cash flow volatility and enhance PSE's financial strength and flexibility, thereby allowing PSE to manage its business prudently and respond to changing conditions and needs as they arise. PSE's proposed rate plan would enable PSE to have the financial resources needed to make the substantial investments required to meet clean energy targets and other regulatory and policy objectives while maintaining and improving service quality. Additionally, PSE is proposing low-income rates and assistance programs that significantly mitigate the energy burden for low-income and energy-burdened customers.

Q. What other PSE witnesses are testifying on finance-related issues in this general rate case?

A. The following witnesses are providing prefiled direct testimony on financial issues in this proceeding:

- the Prefiled Direct Testimony of Joshua A. Kensok, Exh. JAK-1CT, discusses PSE's rigorous and robust business planning process on which the multiyear rate plan presented in this case is based and presents PSE's five-year business plan on which the revenue requirement is based;
- the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, addresses PSE's requested capital structure and rate of return for the multiyear rate plan so PSE can access the finance necessary to meet Washington's clean energy objectives;
- the Prefiled Direct Testimony of Matthew R. Marcelia, Exh. MRM-1T, discusses the treatment of accumulated and

excess deferred tax incomes in the multiyear rate plan and likely impacts of upcoming tax law changes;

- the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, presents analyses of an appropriate return on equity for PSE;

- the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, addresses PSE's credit rating and how they affect the cost of capital and drive overall customer rates; and

- the Prefiled Direct Testimony of Stacy W. Smith, Exh. SWS-1T, addresses PSE's capital structure for the rate case, as well as processes and procedures to confirm completeness and accuracy of financial information reflected in the test year.

II. PSE'S PROPOSED RATE PLAN PROVIDES THE NECESSARY FINANCIAL STRENGTH TO ALLOW PSE TO PARTNER WITH THE STATE OF WASHINGTON TO ACHIEVE AGGRESSIVE CLIMATE STANDARDS

Q. Please discuss the major regulatory and policy issues affecting PSE's investment and financial strategy.

A. As discussed in more detail in the Prefiled Direct Testimony of Matt Steuerwalt, Exh. MS-1T, the Clean Energy Transformation Act[2] ("CETA") requires PSE's electric system to be coal-free by 2025, carbon neutral by 2030, and carbon free by 2045 while continuing to provide customers with safe, reliable, and affordable utility services. To meet the requirements of CETA, PSE must acquire a significant amount of clean energy resources in the coming years and decades and must take immediate steps and actions, including achieving a carbon-neutral

[2] *See* Washington Clean Energy Transformation Act, chapter 19.405 RCW.

electricity supply by 2030. Achieving these goals without sacrificing reliability and safety will require levels of capital investment unprecedented in PSE's history to maintain existing assets, acquire renewable and non-emitting electric generation resource, and modify PSE's transmission and distribution grids to deliver and integrate these resources.

Additionally, the Climate Commitment Act[3] ("CCA") establishes a comprehensive, market-based program to reduce carbon pollution and achieve greenhouse gas limits established in state law.[4] As a covered entity, PSE must obtain allowances to cover emissions or purchase offset credits to cover a small portion of emissions, and the total number of allowances will decrease over time to meet statutory limits.[5] Although the Department of Ecology allocates a certain number of allowances at no cost to PSE to mitigate the cost burden of the CCA program on customers, the CCA does not provide for any allocation of no-cost allowances for electric operations after 2045, and the number of no-cost allowances allocated to mitigate the cost burden on natural gas customers declines each year through 2050.[6] Accordingly, PSE must remain poised to modify operations to mitigate the impact of the CCA program on customers.

[3] *See* Washington Climate Commitment Act, chapter 70A.65 RCW.

[4] *See* Washington State Department of Ecology, *Focus on: Climate Commitment Act – Washington*, Publication 21-02-017 (July 2021 (rev. June 2022)), https://apps.ecology.wa.gov/publications/documents/2102017.pdf.

[5] *See id*.

[6] *See* Kasia Patora, *Final Regulatory Analyses: Chapter 173-446 WAC Climate Commitment Act Program*, Publication 22-02-047 (Sept. 2022), at 108-09, https://apps.ecology.wa.gov/publications/documents/2202047.pdf.

Finally, PSE has announced an ambitious plan, referred to as Beyond Net Zero,[7] to decarbonize its footprint across the business and help customers achieve their individual or corporate carbon reduction goals:

> PSE is announcing an ambitious goal and bold plan to reduce its carbon equivalent emissions to zero, and to ultimately go beyond net zero carbon by leveraging the company's energy resources and influence to help Washington State, our customers and communities reduce their carbon impacts as well. Not only will this make progress in achieving a sustainable future, but PSE's goal will help Washington State reach its 2035 GHG emission reduction goal of a 45% reduction below 1990 levels. To be successful we will need new products, partnerships and policies that reflect our shared interest in a healthy and sustainable future.[8]

Q. Please summarize what PSE proposes from a financial perspective in this two-year rate plan.

A. PSE is proposing a two-year rate plan in this proceeding, requesting an authorized return on equity ("ROE") of 9.95 percent in Year One and an authorized ROE of 10.5 percent in Year Two. PSE is requesting a hypothetical equity ratio that increases from the current authorized level of 49.0 percent to 50.0 percent in Year One and then to 51.0 percent in Year Two of the two-year rate plan.

For Year One of the two-year rate plan, PSE proposes rates that would include utility plant in service at the start of Year One, based on PSE's balance sheet as of December 31, 2024, and provisional pro forma adjustments to reflect forecasted plant additions placed in service during calendar year 2025.

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[7] Puget Sound Energy, *Pathway to Beyond Net Zero Carbon by 2045* (Jan. 2021), https://www.pse.com/-/media/PDFs/Press-release/7535_Pathway_to_Beyond_Net_Zero_Report.pdf.

[8] *Id*. at 2.

For Year Two of the two-year rate plan, PSE proposes rates that would include provisional pro forma adjustments to reflect forecasted plant additions placed in service during calendar year 2026.

Q. What revenue increase is PSE requesting in this proceeding?

A. As discussed in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, PSE is requesting a net revenue change for electric base rates of $192 million in Year One and $285.2 million in Year Two of the multiyear rate plan. On the gas side, PSE is requesting a net revenue change of $196.0 million for Year One and $25.4 million for Year Two of the multiyear rate plan.

Q. How is PSE's proposed two-year rate plan designed to enhance the cash flow and financial strength of PSE?

A. First, credit rating agencies have recognized multiyear rate plans as credit supportive measures, depending on the structure of the plan and subject to appropriate implementation.[9] The degree to which the multiyear rate plan adopted in this proceeding is credit supportive would depend on the design of the plan itself and whether it addresses PSE's persistent cash flow deficiency. PSE has designed a two-year rate plan proposal that would provide sufficient cash flow requirements necessary to provide safe, reliable, and affordable electric and gas services and meet the clean energy goals of the state.

[9] *See* the Eighth Exhibit to the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-9 (Standard & Poor's, *Puget Energy Inc. and Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation; Ratings Affirmed* (May 27, 2021), at 1).

For the initial rate year of a multiyear rate plan, the Commission must, at a minimum, include in rates the plant in service as of the rate effective date.[10] This statutory provision allows for timely recognition of capital investments in rates as of the start of the multiyear rate period, thereby reducing regulatory lag. If the Commission were to adopt the two-year rate plan proposed by PSE, PSE would include assets that are or become used and useful during the applicable rate year for rate-making purposes. The recognition of assets that are or become used and useful during the multiyear rate plan mitigates the credit challenges of cost-of-service regulation identified by Standard & Poor's Global Ratings ("S&P") and Moody's Investor Services ("Moody's"), such as regulatory lag and cash flow uncertainty.

Further, the ROEs and capital structures proposed by PSE in this proceeding are consistent with the authorized ROEs and capital structures of comparable risk utilities such that PSE is able to compete for capital and maintain access to capital markets, even when those markets are constrained. Many of these comparable risk utilities do not face obligations similar to the requirements of CETA, and PSE will require authorized ROEs and capital structures at least comparable to these comparable risk utilities to achieve the state's CETA goals.

[10] *See* RCW 80.28.425(3)(b).

Q. Is PSE making other proposals in this proceeding designed to improve PSE's financial strength and cash flow?

A. Yes. As discussed later, PSE is proposing three trackers to track and recover costs for three key areas of risk. Additionally, PSE proposes to maintain its power cost only rate case ("PCORC") to address power cost variability during this transition to cleaner energy and to include new renewable and non-emitting electric generating resources in rates in a timely manner. PSE also proposes that the Commission adopt the CWIP in rate base methodology for projects constructed by PSE to meet the CETA requirements to mitigate the impact of a large construction program on cash flow. Further, PSE proposes to continue the annual power cost update so that the Power Cost Adjustment ("PCA") baseline rate can be set as close as possible to actual power costs expected to be incurred in the rate year.

Q. How will PSE's proposed tracker mechanisms help enhance cash flows and support credit ratings?

A. In this proceeding, PSE is proposing to implement three new tracker mechanisms to address the following risks and costs:

(i) clean energy generation;

(ii) wildfire prevention-related costs; and

(iii) decarbonization costs.

PSE has designed these three tracker mechanisms to minimize regulatory lag, thereby improving PSE's cash flows and maintaining credit metrics at a level necessary to access the capital markets at reasonable costs. Please see the prefiled direct testimony of each of Susan E. Free, Exh. SEF-1T, Ryan Murphy, Exh. RM-1T, and Cara G. Peterman, Exh. CGP-1CT, for discussions of PSE's three proposed tracker mechanisms.

Q. Why is it important for the Commission to grant the relief requested by PSE in this proceeding?

A. Through adoption of the CETA and the CCA, the State of Washington has tasked electrical and gas companies, like PSE, with the responsibility of achieving the states policy objectives to decarbonize the state's electric and gas systems. PSE must make massive investments to achieve the state's clean energy objectives, and PSE must maintain adequate access to debt and equity capital on reasonable terms and conditions to achieve the state's objectives.

Regulatory approval of the proposed two-year rate plan would allow PSE to build on the strategy placed in motion in PSE's last multiyear rate proceeding to (i) provide customers with safe, reliable, and affordable electric and gas utility service and (ii) comply with the state's clean energy policies under CETA and the CCA. PSE has designed its proposed two-year rate plan to enable PSE with the financial health required to access capital markets on competitive terms as necessary to implement the clean energy objectives established by the state.

Without sufficient regulatory support in the form of this two-year rate plan, which includes an increased authorized ROE, an increased authorized equity ratio, inclusion of CWIP in rate base for projects constructed by PSE to meet CETA goals, and the three proposed tracker mechanisms, PSE would face unsustainable financial pressures that would further impair its credit ratings, erode its financial strength and integrity, and inhibit its ability to access the debt and equity capital markets at a reasonable cost. Ultimately, an inability of PSE to access debt and equity capital markets at reasonable costs would jeopardize its ability to deliver on the state's clean energy objectives.

Q. Does PSE face the same financial and operational challenges as in past years?

A. No. The expectations for PSE have fundamentally and substantially changed over the past five years. Whereas PSE must focus on the provision of safe, reliable, and affordable energy service to customers as in the past, PSE must also now partner with the State of Washington and this Commission to achieve the public policy goals of decarbonization and reduction in emissions outlined in the CETA and CCA, which I sometimes refer to as the "dual mandate." This dual mandate requires, for example, PSE to shift its generation mix and supplement its existing transmission and distribution system to support the transitioning generation mix that will rely more heavily on renewable and non-emitting electric generating resources. As a result, PSE will need to increase capital spending substantially above historical levels to acquire the necessary clean energy resources and integrate them into its delivery system. At the same time, PSE must continue to

invest in its core utility services and maintain its focus on providing safe, reliable, and affordable energy service to customers. The expectations introduced by passage of the CETA and the CCA have resulted in a monumental sea-change in the financial and operational challenges and risks facing PSE today. These financial and operational challenges and risks will continue throughout the requested two-year rate plan and for the foreseeable future thereafter.

Q. What level of capital investment will be required of PSE in the upcoming years, and how does PSE project that it will finance such investments?

A. PSE projects over the next five years (calendar years 2024-2028) that it will invest approximately [redacted] To finance this unprecedented level of capital spending, PSE projects that, over the next five year, it would

(i) issue approximately [redacted] of debt securities,

(ii) attract approximately [redacted] and

(iii) retain approximately [redacted] of net income in retained earnings and related cash flow from operations.

To place this in perspective, as of December 31, 2023, PSE projects that

(i) its end-of-period rate base for electric and gas operations is approximately [redacted]

(ii) its outstanding long-term debt is approximately [redacted] and

(iii) its outstanding common equity reserve is approximately [redacted]

More simply stated, the [redacted] of capital investment that PSE projects to make over the next five years would increase PSE's balance sheet from $15.4 billion to $21.5 billion, or approximately 39 percent. Further, the financing plans set forth above would cause PSE's outstanding debt to increase to $8.3 billion (an increase of about 52 percent) and PSE's outstanding common equity to grow to $8.1 billion (an increase of about 61 percent) over the next five years. Clearly, the operational and financial risks faced by PSE are unprecedented and not reminiscent of any operational or financial risks faced in many decades, if ever.

Q. How has the role of utilities changed in achieving broader policy objectives?

A. Traditional utility regulation has evolved in many jurisdictions to a model which seeks to incentivize and facilitate the achievement of broader policy objectives, such as grid modernization, clean energy goals, equity, and enhanced operational efficiency. In Washington, the role of public utilities has shifted from one which focuses primarily on providing safe, reliable, and affordable public utility services to one in which the utility is an essential partner in facilitating and implementing governmental policy objectives. In many ways, jurisdictions are asking utilities to act as an extension of the state to promote the public interest more broadly. This is evident in the CETA, which contains not only environmental and equity policy objectives, but also constructive regulatory mechanisms to achieve such goals,

such as multiyear rate plans, which were further clarified and required in Senate Bill 5295[11] that was passed and signed into law in 2021.

Q. How have the CETA and the CCA altered the obligations of the Commission?

A. The CETA and the CCA have now tasked the Commission with implementing environmental programs and objectives that go far beyond its traditional responsibilities of regulating safety and reliability, revenue requirement development, cost allocation, and rate design. While primarily an economic regulator, the Commission may now consider other factors in its public interest analysis as it works with the utility and its customers to implement public policy objectives. Like PSE, the Commission now has a dual mandate: it must oversee the transition to clean energy while also regulating and authorizing funding for core operations of the utility so that energy can be safely, reliably, and affordably provided to customers.

Q. Please summarize PSE's role in implementing the state's policy objectives.

A. PSE must partner with regulators and policymakers to implement the ambitious policy objectives embedded in the CETA, while also implementing more traditional policies that allow PSE to continue to provide safe, reliable, and affordable utility services. A regulatory construct that supports and enhances PSE's financial strength, flexibility, and integrity will better position PSE to

[11] Engrossed Substitute Senate Bill 5295, Chapter 188, Laws of 2021.

deliver on this broad and unprecedented dual mandate. Approval of PSE's proposed two-year rate plan would meaningfully benefit customers and the broader state interest in (i) providing customers with safe, reliable, and affordable electric and gas utility service and (ii) decarbonizing the state's electric and gas systems consistent with the policy objectives codified in the CETA and the CCA. As a partner in executing these policies, the Commission must recognize that PSE's financial strength, flexibility, and integrity are necessary preconditions to its ability to deliver on the dual mandate.

III. PSE FACES SIGNIFICANT FINANCIAL AND OPERATIONAL CHALLENGES

A. Prior Rate Case Order and Recent Financial Performance

Q. What was the financial impact of PSE's most recent multiyear rate plan proceeding in Dockets UE-220066, et al.?

A. In December 2022, the Commission approved the settlement agreement in PSE's most recent multiyear rate plan proceeding in Dockets UE-220066, et al. The two-year rate plan set forth in the settlement agreement and approved by the Commission increased revenue requirement for both PSE's electric and gas utility operations in both Year One and Year Two of that two-year rate plan. The rate relief set forth in the settlement agreement approved by the Commission was lower than PSE requested and did not alleviate pressure on key credit metrics of PSE. Further, the authorized ROE of 9.4 percent and authorized capital structure

with a 49.0 percent equity ratio were, and remain, well below comparable industry averages.

Q. How did the credit rating agencies view the outcome of the 2022 rate case?

A. S&P generally took a favorable view of the 2022 rate case outcome, noting that, "[w]e view multiyear ratemaking favorably because it promotes predictability and lowers uncertainty for the utility and its stakeholders,"[12] while noting PSE's relatively low authorized return on equity.

Moody's also commented on the credit positive nature of the outcome of the 2022 rate case:

> We view the conclusion of the 2022 general rate case as credit positive and indicates that Washington regulation has become more consistent following the state's passage of SB 5116 and SB 5295 in 2019 and 2021, respectively.[13]

However, Moody's further commented that "[p]hysical climate risk and increased exposure to demographic and social trends, such as a less supportive regulatory environment and customer affordability concerns, could weaken credit quality over the long term."[14]

Moreover, Moody's recently stated publicly that it is losing patience with the utility sector's credit metric under-performance, since the beginning of the COVID-19 pandemic. Please see Exh. DAD-3 for details of Moody's public "fire-

[12] See Exh. CGP-9, Standard and Poor's Global Ratings, *Puget Sound Energy Inc*. (May 11, 2023).
[13] See Exh. CGP-9, Moody's Investors Service, Credit Opinion, *Puget Sound Energy, Inc*., (Sept. 15, 2023), at 1.
[14] *Id.* at 7.

side chat" remarks. This signals that Moody's will likely look for more credit supportive regulatory results to improve credit metric under-performance.

While it appears that credit rating agencies took a generally favorable view regarding the outcome of the 2022 rate case, PSE and the Commission must now build on the progress made in the 2022 rate case to improve and enhance PSE's financial strength, flexibility, and integrity through higher and more sustainable cash flows from operations that will both improve PSE's credit metric performance and maintain access to competitive capital markets. These are critical financial imperatives as PSE embarks on significant capital investments necessary to successfully achieve the transition to clean energy while also making necessary investments to allow PSE to provide safe, reliable, and affordable electric and natural gas service to customers.

Q. How do credit rating agencies view the current and near-term state of the regulated public utility landscape?

A. As is described in the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, the credit rating agencies have generally been quite patient with utilities whose credit metric performance, like PSE's, have been weak or below downgrade thresholds since the COVID-19 pandemic. As described in the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, and the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, recent communiques from

Wall Street analysts suggest that the credit rating agencies may be running out of patience.[15]

As detailed in the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, the Explanatory Memorandum from PSE's Insurance Broker Regarding Increasing Liability Premiums notes that this occurs against a backdrop of perceived increased risk in the sector including:

(1) increased capital investments to fund environmental and renewable strategies and mandates;

(2) an expectation that increased capital investments cannot be financed without incremental equity financing and credit supportive regulatory decisions;

(3) an increased interest rate environment that will likely increase both the cost of debt and equity, which all else equal, will make the increased capital investment more expensive; and

(4) a growing view that wildfire risk and other climate-related risks will have a more prominent place in the future ratings processes of the credit rating agencies.

Q. How does PSE project that it will perform with respect to downgrade thresholds of credit rating agencies in 2023 and 2024?

A. [redacted] Credit rating agencies will judge the outcome of this proceeding with a laser-focused view on (i) whether PSE's credit metric performance can be sustained above downgrade thresholds

[15] *See* Exh. DAD-3.

with a reasonable margin of cushion, and (ii) whether the outcome of this proceeding will adequately address the perceived increased risks cited above in a credit supportive manner.

Q. Why is the outcome of this case important to PSE?

A. The outcome in this rate case will have a direct effect on the financial resources available to PSE as it seeks to continue to provide safe and reliable electric and natural gas services while also transitioning to clean energy. In particular, PSE needs

(i) to restore its cash flows from operations to levels that existed before enactment of the Tax Cuts and Jobs Act,

(ii) to improve its overall credit metrics, and

(iii) to improve its financial strength and flexibility to access competitive debt and equity capital markets to finance the enormous amount of clean energy resources necessary for CETA compliance as well as investments needed to maintain PSE's core utility service.

Q. Why is the Tax Cuts and Jobs Act, which was enacted more than five years ago, relevant to PSE's cash flow and credit metrics today?

A. The Tax Cuts and Jobs Act has substantially and negatively affected PSE's credit metrics, and those effects continue today. PSE's analyses suggest that the Tax Cuts and Jobs Act has effectively reduced PSE's cash flow by approximately $156 million. Please see the Prefiled Direct Testimony of Matthew R. Marcelia, Exh. MRM-1T, for an analysis and calculations regarding the impacts of the Tax

Cuts and Jobs Act on PSE's cash flow. As discussed in the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, PSE's credit metrics fell significantly as a result of the passage by the Tax Cuts and Jobs Act over the period 2018-2022 within a range of 364-415 basis points for S&P and within a range of 383-433 basis points for Moody's. Furthermore, this trend is expected to continue on a projected basis over the period 2023-2024 within a range of 375-415 basis points for S&P and within a range of 379-477 basis points for Moody's. PSE needs to recover, in this proceeding, the vast majority of that cash flow lost due to passage of the Tax Cuts and Jobs Act to improve credit metric performance to sustainable levels, with appropriate margins of cushion to mitigate against risk. PSE's requested rate plan in this proceeding would contribute to maintaining PSE's competitive access to the capital markets to finance the dual mandate. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for a discussion of PSE's credit metric performance since the passage and implementation of Tax Cuts and Jobs Act.

Q. How does PSE expect its credit metrics will perform in the upcoming year?

A. As mentioned earlier, [redacted]. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for a discussion of PSE's credit metric performance since the passage and implementation of the Tax Cuts and Jobs Act.

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Q. Why is a strong credit profile important for PSE?

A. A strong credit profile fosters PSE's long-term financial strength and flexibility. This, in turn, provides a greater probability that PSE can maintain competitive access to the capital markets to finance the unprecedented level of capital investments necessary over the next several years.

Investors rely on PSE's financial strength and credit profile when deciding whether to invest in PSE's debt and equity capital. A strong credit profile is correlative with access to lower interest rates, which can provide significant savings in debt costs over the life of the bond. Therefore, a strong credit profile would provide a direct benefit to customers. For example, the 2023 year-to-date 30-day average yield on S&P/Moody's BBB+/Baa1 rated utility bonds is approximately 5.715 percent, while the average yield on BBB-/Baa3 rated utility bonds is 6.222 percent.[16] In short, a strong credit profile matters, and PSE's credit profile must be enhanced by the outcome in this proceeding to position PSE to finance the significant capital investments necessary to achieve the dual mandate in a cost-effective manner.

Additionally, please see the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, for Witness Shipman's analysis regarding the importance of a strong credit profile and why that is necessary in today's capital intensive environment. As also discussed in the Prefiled Direct Testimony of Ann E.

[16] Source: Bloomberg, Mizuho, 30-day average as of November 21, 2023, provided as a work paper.

Bulkley, Exh. AEB-1T, equity holders will require a higher return to account for the heightened business and financial risks for which credit rating agencies are observing and tracking. Please see the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1, for an analysis regarding the heightened business and financial risks affecting the recommended return on equity for PSE during the two-year rate plan.

Q. Why are the credit metrics and financial measures important for customers?

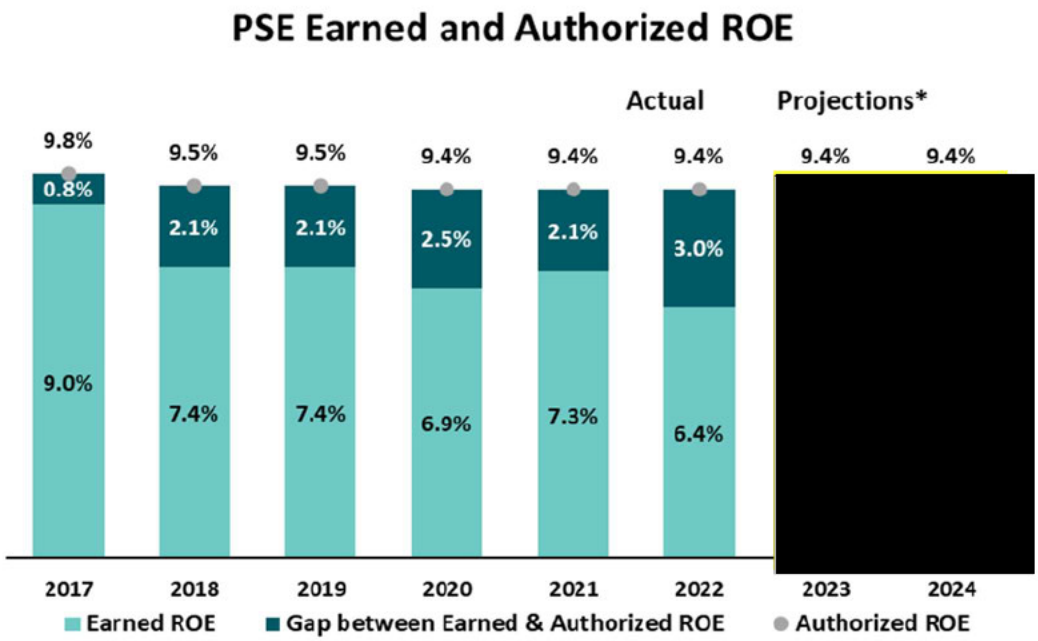
A. When PSE achieves strong credit metrics and financial measures, it can access capital at reasonable rates, thereby allowing PSE to pursue projects necessary to promote the state objectives and meet customer loads. A financially strong PSE can invest in technology to reduce greenhouse gas emissions, acquire renewable and non-emitting sources of energy, and take the necessary steps to meet the mandates of the CETA and CCA. With strong financial and credit positions, PSE can move to improve the reliability of its electric system through grid modernization, which includes investing in a more resilient and reliable grid, more aggressively. Further, PSE can continue to enhance the safety of its gas system and take steps to reduce methane emissions. In short, customers benefit substantially when PSE is financially strong. Please see the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, for Witness Shipman's analysis regarding the benefits of strong credit metrics in today's capital intensive utility environment.

B. Challenges Associated with PSE's Authorized ROE and Equity Ratio

Q. Has PSE been able to earn its authorized ROE?

A. No. PSE has not been able to earn its authorized ROE. As shown in Figure 1 below, PSE has consistently under-earned its authorized ROE throughout the 2018-2022 period and expects to under-earn, on a forecasted basis, its authorized ROE in 2023 and 2024 as well.

Figure 1. PSE Earned vs. Authorized Return on Equity 2017-2024[17]



Q. Why has PSE been unable to earn its authorized ROE?

A. PSE has been unable to earn its authorized ROE primarily due to capital investments not reflected in rate base (i.e., investments in service and used and

[17] Calculated on GAAP basis.

useful but yet do not earn a return), and the regulatory lag that remains embedded in revenue requirement despite the improvements made by the outcome of the 2022 rate proceeding.

Q. What steps has PSE taken to improve its earnings prior to and during the test year?

A. PSE has exercised discipline over costs and strived to keep rates as low as possible for the benefit of its customers. In 2023, PSE undertook a concerted effort to contain actual spending against budget targets. PSE projects this effort will yield approximately $85 million of savings. PSE incorporated this effort into the development of its 2024 budget and ensuing five-year plan (including Year One (2025) and Year Two (2026), which are the subject years of PSE's two-year rate plan proposal in this proceeding).

PSE undertook an effort to realign its cost structure with a clear focus to reduce expense spending to make "headroom" in rates for the substantial increase in capital investment that will be required to implement the dual mandate. Compared with prior spending forecasts, this effort yielded approximately $85 million of expense savings per year in each year of its five-year plan beginning with the budget for calendar year 2024, as stated in the Prefiled Direct Testimony of Joshua A. Kensok, Exh. JAK-1CT.

IV. PSE'S BUSINESS AND FINANCIAL RISK PROFILE FACE CHALLENGES AS PSE MOVES DEEPER INTO THE CLEAN ENERGY TRANSITION

Q. How does Washington's transition to clean energy, including the enactment of CETA and the CCA, affect the business risk and financial risk of PSE?

A. Washington's enactment of the CETA and the CCA increases business and financial risk of utilities at a time when PSE is seeking to replace cash flows lost as a result of passage of the Tax Cuts and Jobs Act, improve credit metrics, and position itself to competitively access the debt and equity capital markets to finance the dual mandate.

The clean energy transition will require PSE to make significant capital investments over the next three to five years to achieve the clean energy requirements outlined in the CETA. These investments will require PSE to access external capital funding, at a level that cannot be accomplished without a stronger financial profile. Specifically, PSE requires additional cash flow, comprised of a higher authorized ROE, a higher authorized equity ratio, and approval of CWIP in rate base to support its financial strength, flexibility, and creditworthiness. More specifically, PSE needs an increase in cash flow from these sources to increase its credit metric performance above downgrade threshold with a sustainable and reasonable cushion. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for calculations that support the need for increased cash flow from a higher authorized ROE, a higher authorized equity ratio, and approval of CWIP in rate base.

Q. Would PSE's proposed rate plan, if approved by the Commission, generate cash flows necessary to restore PSE's credit metrics over the course of the two-year rate plan?

A. Yes. As discussed in the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, the combination of PSE's proposed authorized ROE, proposed equity ratio, and proposal to use the CWIP in rate base methodology would increase cash flow by about $57 million in calendar year 2025 and $75 million in 2026. [redacted]

Q. Are there other business and operational risks that are continuing to increase for PSE?

A. Yes. Risks influenced by climate change, such as severe weather events and wildfires, or resulting directly from climate change, such as those due to higher temperatures and changing precipitation patterns, are increasing for all utilities, including PSE. In addition, investors, central banks, and financial regulators are increasingly recognizing the risk of climate change to the economy, the stability of the financial system, and specific industries and investments. All the major rating agencies, including S&P, Moody's, and Fitch, have incorporated Environmental, Social and Governance ("ESG") criteria into their credit rating analyses. Please see the Eighth Exhibit to the Prefiled Direct Testimony of Cara

G. Peterman, Exh. CGP-9, for each of the credit rating agency publications. For example, S&P commented in its May 2023 credit report on PSE that, "[e]nvironmental factors are a moderately negative consideration in our credit rating analysis of Puget Sound Energy."[18] Simultaneously, certain investment firms and pension funds have adopted restrictions that prohibit them from owning equity or debt in companies seen as contributing to climate change. This reduces the pool of available investors and constrains the supply of capital available at a time when utilities need to make significant investments in order to achieve public policy objectives related to the clean energy transition.

McKinsey and Company published a report in April 2019 in which the consulting firm made specific recommendations to the utility industry regarding managing climate change risk. While noting that severe weather events such as hurricanes and wildfires are getting worse, McKinsey wrote: "In other ways, too, utilities are more vulnerable to extreme weather events than in the past."[19] For example, several utilities, such as Pacific Gas and Electric, Hawaiian Electric, PacifiCorp, and Public Service Company of Colorado, have faced serious allegations that their operations have caused or contributed to wildfires that caused grave damage. The risk associated with significant liabilities related to wildfires has increased materially, and credit rating agencies and investors are beginning to take these

[18] *See* Exh. CGP-9 including *S*&P Global Ratings, *Puget Sound Energy Inc*. (May 11, 2023), at 7.
[19] *See* Exh. DAD-7 for the full text of the McKinsey and Company report, *Why, and How, Utilities Should Start to Manage Climate Change Risk*, (Apr. 2019).

risks into account in the rating process (both qualitatively and quantitatively) and as they set their return requirements.

Q. Please explain how purchased power agreements ("PPA") affect the credit metrics of PSE.

A. S&P considers the amounts paid by utilities pursuant to PPAs to be imputed debt when calculating the credit metrics for a regulated utility. In other words, S&P adds payments made by PSE under PPAs to PSE's debt balance when S&P computes the Debt / EBITDA[20] and FFO[21] / Debt ratios for PSE. As discussed in the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, S&P imputed $433 million of debt to PSE in 2022 as a result of new PPAs. This imputed debt is forecasted to grow to $942 million by 2028. All else being equal, that increase of approximately $500 million in imputed debt would impose about 140 basis points of downward pressure on PSE's FFO / Debt ratio. Earning a return on PPAs helps to offset some of this downward pressure. Thus, although PPAs are helpful to acquire renewable resources to achieve the policy objectives under CETA, they do have a negative effect on PSE's financial risk and credit metrics. This is of particular concern as PSE moves deeper into the clean energy transition and seeks to acquire new PPAs, as well as constructing or purchasing its own resources, to meet CETA targets. As discussed later in this testimony, earning a rate of return on PPAs included in PSE's Clean Energy Action Plans will establish policy for

[20] Earnings before interest, tax, depreciation, and amortization.
[21] Funds from operations.

credit rating purposes that will assist PSE in potentially obtaining relief from the rating agencies current treatment of PPAs in credit metrics.

Q. Why are PSE's authorized ROE and equity ratio important considerations for the credit markets and equity investors?

A. The authorized ROE and authorized capital structure directly affect PSE's regulatory risk profile and cash flow metrics, which are important for debt markets, as well as its earnings growth, which is important to equity investors. An overall rate of return that is commensurate with or better than industry averages indicates that the regulatory environment in Washington is supportive of PSE's financial strength and integrity and signals that PSE is not disadvantaged relative to other electric and gas utilities across the country, in terms of maintaining its credit profile or in competitively attracting debt and equity capital on reasonable terms.

The authorized equity ratio is more than just a reflection of PSE's business and regulatory risk—the authorized equity ratio has a direct effect on PSE's cash flow and credit metrics. A credit supportive ROE and equity ratio help enhance required cash flow and keep credit metrics above minimum threshold levels for PSE's ratings category. Accordingly, PSE's requested ROE and equity ratio are necessary for PSE to maintain its credit profile and access the capital markets at all times and in a cost-effective manner.

Debt investors provide approximately half of PSE's total invested capital. To maintain access to debt investors, it is also important to maintain credit metrics above a certain standard with a sufficient cushion to endure any unfavorable economic or capital market circumstances. From the perspective of equity investors, PSE's authorized ROE must be sufficient to compensate shareholders for the business and financial risks of PSE and be competitive with returns available to investors in other enterprises with comparable risk. Please see the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, for Witness Shipman's analysis regarding the importance of return on equity and equity ratio in the determination of credit supportive regulatory outcomes.

Q. Please explain the importance of financial strength for a utility such as PSE.

A. PSE is a regulated electric and gas utility that has an obligation to serve all customers, current and future, within its service territory. This responsibility remains in place no matter the state of the economy or financial markets and regardless of unexpected external events, such as major storms, economic cycles, and even such unprecedented events as the recent pandemic.

Financial strength for PSE is the result of having an authorized ROE and capital structure that provides the cash flow PSE needs to achieve target credit metrics consistent with those prior to the Tax Cuts and Jobs Act. When access to capital is constrained and market conditions are depressed, only financially strong utilities can attract capital on reasonable terms, providing those utilities with significant and potentially critical flexibility. Operating without the flexibility afforded

through a strong financial position would expose PSE and its customers to unnecessary financial risk. Please see the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, for Witness Shipman's analysis regarding the importance of a financial strength in today's capital intensive environment.

Credit rating agencies recognize that access to capital is a critical component of executing a utility's key strategies. For example, S&P has noted:

> Utilities make ongoing capital investments within their electric operations to improve and maintain service levels. As a result, they typically have negative discretionary cash flow and depend on reliable access to the capital markets to operate their businesses. In our view, if a utility's creditworthiness weakens, investor confidence could wane and a utility's access to the capital markets may be limited, potentially increasing its cost of capital, and adding considerable strain to the utility's business model.[22]

PSE's weighted authorized ROE (i.e., the authorized ROE multiplied by the authorized equity ratio) currently falls in the fourth quartile as compared to other electric and natural gas utilities, as I discuss in more detail later in my testimony. This weak financial position is unsustainable and must be bolstered for PSE to have the financial strength and flexibility necessary to safely, reliably, and affordably serve customers and fulfill the clean energy transformation.

[22] *See* Exh. CGP-10C, Standard and Poor's, *The Looming California Wildfire Season Prompts an Examination of Investor-Owned Utilities' Risks*, (June 2019).

Q. Can PSE retain its credit rating by maintaining the minimum cash flow coverage ratios?

A. No. PSE cannot retain its credit rating for long by maintaining the minimum cash flow coverage ratios. PSE projects that it would not be able to maintain its minimum cash flow coverage ratios without replacing a significant portion of the cash flow lost due to passage of the Tax Cuts and Jobs Act. Further, as I stated earlier in this testimony, the rating agencies are becoming increasingly impatient with credit metric performance below stated downgrade thresholds, which unfortunately is where PSE has found itself over the recent past and on a projected basis into the future.

Q. Could PSE retain its credit ratings if the Commission were to authorize rates at a level necessary to maintain minimum cash flow ratios necessary for PSE retain its credit rating?

A. While that would certainly help, it's only part of the ratings process. Credit metrics that fall within a certain ratings category are a necessary but not sufficient condition to achieving or maintaining a certain rating because rating agencies consider factors other than financial ratios in the development of credit ratings. As discussed in the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, a significant portion of a company's credit rating depends on the regulatory framework and other business risk considerations. In addition, if a company managed its cash flow to maintain credit metrics at the minimum threshold level, it would provide little assurance that the company could maintain those metrics

through severe operational, financial, or other business disruptions. That is why rating agencies look for credit metric cushion above downgrade thresholds. Therefore, the Commission should not authorize an ROE or an equity ratio based solely on whether they allow for credit metrics within a certain ratings category.

Q. How does the current interest rate environment affect PSE's ability to compete for capital?

A. The sustained low interest rate environment that followed the financial crisis of 2008/2009 appears to be over. Interest rates on government and utility bonds have increased substantially in 2022 and 2023. For example, current interest rates on Treasury bonds are in the range of 4.44 percent for 10-year bonds and 4.58 percent for 30-year bonds, and utility bonds yields have increased to approximately 5.93 percent for Moody's A-rated utility bonds and 6.19 percent for BBB-rated utility bonds.[23]

Against this backdrop of increasing interest rates, PSE must be able to offer current and potential equity investors a compelling reason to purchase or retain their shares. An authorized ROE of 9.40 percent when investors have the option of holding Treasury bonds at yields of 4.40 percent to 4.60 percent with essentially no risk versus a weighted equity return of approximately 4.61 (9.4 percent return on equity times a 49 percent equity ratio) does not provide a compelling reason for investors to purchase or retain their shares. Further, it is

[23] Source: Bloomberg Professional, 60-day average as of December 29, 2023, provided as a work paper.

noteworthy with respect to these Treasury rates that, on November 10, 2023, Moody's placed the U.S. government's sovereign rating on negative watch due to concerns over large fiscal deficits, higher interest rates, and the need for additional Treasury issuances.[24]

Q. What should the Commission conclude with respect to PSE's business and financial risk profile in light of the ongoing clean energy transition?

A. As discussed above, there are new and evolving business and financial risks that have a direct impact on PSE's financial profile as it seeks to acquire substantial new clean energy resources while facing decreased cash flow due to passage of the Tax Cuts and Jobs Act, and struggling credit metrics and returns from earnings. Accordingly, the Commission should approve PSE's proposed ROE, proposed equity ratio, and the proposal to adopt the CWIP in rate base methodology to provide PSE with sufficient cash flow to adequately compensate investors for assuming the new and evolving risks as PSE finances the substantial investments needed to transition to clean energy and to maintain its core utility service in a safe, reliable and affordable manner. Further, and more specifically, PSE requires an increase in cash flow from these sources to correspondingly increase its credit metric performance [redacted] with a sustainable and reasonable cushion. PSE's proposed ROE, proposed equity ratio, and proposal for the Commission to adopt the CWIP in rate base methodology

[24] *See, e.g.*, Davide Barbiscia & Andrea Shalal, *Moody's Turns Negative on US Credit Rating, Draws Washington Ire*, Reuters (Nov. 10, 2023), www reuters.com/markets/us/moodys-changes-outlook-united-states-ratings-negative-2023-11-

meet these objectives. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for calculations that illustrate how these objectives are met.

V. PSE'S REQUESTED RETURN ON EQUITY AND EQUITY RATIO ARE FAIRLY BALANCED AND APPROPRIATE IN LIGHT OF PSE'S UNPRECEDENTED NEED TO INVEST IN CLEAN ENERGY

A. Overview

Q. Please provide your understanding of the how the Commission determines the cost of capital.

A. My understanding is that the Commission follows the standards set in the U.S. Supreme Court's *Hope*[25] and *Bluefield*[26] opinions. The Commission has described these constitutional standards as follows:

> These standards entitle a utility to a rate of return that is no less and no more than:
>
> [C]ommensurate with returns on investments in 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 to attract capital.[27]
>
> 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

[25] *Fed. Power Comm'n v. Hope Nat. Gas*, 320 U.S. 591, 64 S. Ct. 281 (1944).

[26] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia*, 262 U.S. 679, 43 S. Ct. 675 (1923)

[27] *Wash. Utils. & Transp. Comm'n v. PacifiCorp d/b/a Pac. Power & Light Co*., Dockets UE-050684 et al., Order 04 ¶ 235 (Apr. 17, 2006) (quoting *Hope*, 320 U.S. at 603).

> such as are realized or anticipated in highly profitable enterprises or speculative ventures.[28]

Based on my participation in several of PSE's previous rate case proceedings, my understanding is that the Commission sets a range for a reasonable return on equity considering all evidence and selects a specific point value within the range.[29] I further understand that the Commission informs this selection with detailed model results, capital market conditions, utility-specific risks, and other considerations—including the requirement that the result yields fair, just, reasonable, and sufficient rates,[30] and the principle of gradualism to avoid rate shock to customers as well as dramatic swings that may be disruptive to a regulated utility's ability to attract and retain capital.[31]

Q. What does PSE recommend as the appropriate return on equity and capital structure to attract capital necessary to support PSE's operations?

A. As summarized in Section V.B. below, PSE has adopted the analysis and conclusion of expert witness Ann E. Bulkley that an authorized return on equity of 10.5 percent is fair and reasonable. Please see the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, for Witness Bulkley's analysis regarding the projected return on equity for PSE during the two-year rate plan. In due deference to the Commission's policy of employing gradualism in the context of approving

[28] *Id*. (quoting *Bluefield*, 262 U.S. at 692-93).
[29] *See Wash. Utils. & Transp. Comm'n v. Avista Corp*., Dockets UE-170485 et al., Order 07 ¶ 59 (Apr. 26, 2018).
[30] *See id*.
[31] *See Wash. Utils. & Transp. Comm'n v. PacifiCorp d/b/a Pac. Power & Light Co*., Docket UE-152253, Order 12 ¶ 158 (Sept. 1, 2016).

movements in ROE, and in an effort to maintain affordability in rates for customers, PSE proposes increasing its authorized ROE to 9.95 percent in Year One of the rate plan, and increasing its authorized ROE to 10.5 percent in Year Two of the rate plan.

As for capital structure, PSE proposes that the Commission authorize a hypothetical capital structure that contains an equity ratio that increases from the currently approved 49.00 percent to 50.00 percent in Year One of the rate plan, and increases to 51.00 percent in Year Two of the rate plan. Here again, PSE follows principles of gradualism and affordability to minimize impacts on rates in Year One of the rate plan.

As discussed in further detail in this section, PSE's recommendations strike a balance between the interests of PSE and its customers by maintaining overall low rates, while addressing the challenges associated with PSE's ongoing capital investment needs, struggling earnings and credit metric performance, volatility in the capital markets, high interest rate environment, and increased rating agency scrutiny.

B. PSE Requests an Authorized Return on Equity of 10.5 Percent

Q. What authorized return on equity is PSE requesting in this proceeding?

A. PSE is requesting an authorized return on equity of 10.5 percent in this proceeding, but as described above, PSE requests that the increase in ROE be phased-in across the two-year rate plan.

Q. Has PSE prepared an analysis of the projected return on equity of PSE during the rate plan?

A. Yes. PSE has retained the services of Ann E. Bulkley to prepare an analysis of the projected return on equity for PSE during the two-year rate plan. Please see the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, for an analysis regarding the projected return on equity for PSE during the two-year year plan.

Q. Please summarize Company witness Bulkley's recommended return for PSE.

A. As discussed in Ms. Bulkley's prefiled direct testimony, PSE requires an increase in the authorized ROE from 9.4 percent to 10.5 percent based on the current results of financial models used to estimate the cost of equity. Ms. Bulkley's recommendation considers PSE's business and financial risks relative to the proxy group companies that were used to establish a plausible and defensible range of results and the specific recommended ROE. In addition, PSE requires an increase in its equity ratio for ratemaking purposes from 49.0 percent to 51.0 percent over the two-year rate plan.

Q. Do you agree with Ms. Bulkley's conclusions regarding PSE's return on equity?

A. Yes. I agree with Ms. Bulkley's testimony regarding the business and financial risks of PSE, and I support her recommended ROE and capital structure for PSE. Accordingly, PSE has adopted her analysis and conclusion that an authorized

return on equity of 10.5 percent is fair and reasonable, but again, PSE requests that the increase in ROE be phased-in in two steps across the two-year rate plan.

Q. Have you prepared any peer group analyses to illustrate how PSE compares within the industry on the basis of ROE, equity ratio, and weighted equity return?

A. Yes. Please see the Third Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-4, for a peer group analysis based on the proxy group selected in the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, to analyze and recommend an authorized ROE or cost of equity for PSE in this proceeding. Exh. DAD-4 compares and ranks decisions of regulatory jurisdictions for authorized ROE, authorized equity ratios, and authorized weighted equity returns for electric and gas utilities in Ann E. Bulkley's proxy group (including PSE), during and after the test year for this proceeding using data from a database maintained by Regulatory Research Associates.

In addition, please see the Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5, for a broad industry peer group analysis of decisions of regulatory jurisdictions for authorized ROE, authorized equity ratios, and authorized weighted equity returns for electric and gas utilities during and after the test year for this proceeding. Like the Third Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-4, the analysis in the Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5, compares PSE's authorized ROE, equity ratio, and weighted equity return against a broader peer

group than witness Bulkley's proxy group using data from a database maintained by Regulatory Research Associates.

These analyses are data rich and intensive, and this prefiled direct testimony refers to them in highlight form in the sections below—as a means of readership efficiency—to discuss PSE's proposals for an authorized ROE, authorized equity ratio, and authorized weighted equity return in this proceeding. For full details of the peer group analyses, please see the Third Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-4, and the Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5.

Q. How do the peer group analyses contained in Exh. DAD-4 and Exh. DAD-5 compare to one another?

A. They are very similar, and both illustrate that PSE's current authorized ROE, authorized equity ratio, and authorized weighted equity return are well below mean and median and often rank in or near the fourth quartile in both peer groups. In this sense, the two peer group analyses corroborate each other. Again, for readership efficiency, the sections below will primarily refer only to Exh. DAD-4, which analyzes authorized ROEs, authorized equity ratios, and authorized weighted equity returns for witness Bulkley's proxy group.

Q. How do these peer group analyses reflect on PSE's current authorized return on equity of 9.4 percent?

A. PSE's current authorized return on equity of 9.4 percent places PSE near or in the fourth quartile in regard to authorized returns on equity for the electric and natural gas utilities that comprise Witness Bulkley's proxy group.[32]

Q. How does this data inform PSE's requested authorized return on equity of 10.5 percent?

A. PSE's requested phase-in of an authorized return on equity of 10.5 percent across the two-year rate plan would move PSE from the bottom quartile to the top quartile for authorized returns on equity for the electric and natural gas utilities that comprise Witness Bulkley's proxy group.[33] An authorized return on equity of 10.5 percent, phased-in across the two-year rate plan will improve PSE's comparative and competitive position in the financial marketplace to attract debt and equity capital, and is fair, just, reasonable, and sufficient. PSE's proposed authorized ROE of 10.5 percent is warranted given

(i) the expected substantial increase in PSE's capital investment program,

(ii) the demonstrated need to improve cash flow and credit metric performance,

(iii) the increased interest rate and cost of capital environment, and

[32] *See* Exh. DAD-4.
[33] *See* Exh. DAD-4.

(iv) the impacts of wildfire potential on PSE's risk profile.

PSE's proposed authorized ROE of 10.5 percent would

(i) be viewed as credit supportive by the financial community including debt and equity investors,

(ii) position PSE to attract capital at reasonable costs and competitive terms,

(iii) help replace cash flow lost by PSE due to passage of the Tax Cuts and Jobs Act, and

(iv) help sustainably increase PSE's credit metric performance above downgrade thresholds of the credit ratings agencies.

All of the foregoing are critical imperatives for PSE to implement the dual mandate successfully.

Please see the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, for a discussion of the calculation of and justifications for PSE's requested authorized return on equity of 10.5 percent.

C. PSE Requests the Ability to Maintain a Capital Structure with an Equity Ratio of 50.0 Percent in Year One and 51.0 Percent in Year Two of the Two-Year Rate Plan

Q. What is the capital structure that PSE is requesting in this proceeding?

A. PSE's is requesting a capital structure that consists of the following components:

(i) a long-term debt ratio of 48.19 percent and 47.81 percent in Year One and Year Two, respectively, of the two-year rate plan;

(ii) a short-term debt ratio of 1.81 percent and 1.19 percent in Year One and Year Two, respectively, of the two-year rate plan; and

(iii) an equity ratio of 50.00 percent and 51.00 percent in Year One and Year Two, respectively, of the two-year rate plan.

Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for a discussion and calculations of the actual capital structure of PSE during the test year and PSE's projected capital structure during the two-year rate period.

Q. Why is PSE proposing graduated increases in its authorized equity ratio, increasing from the current equity ratio of 49.0 percent to an authorized equity ratio of 50.0 percent for Year One and then to an authorized equity ratio of 51.0 percent for Year Two of the two-year rate period?

A. PSE is sensitive to the rate impact on its customers, so the proposed step-up in the authorized equity ratio will be gradual to mitigate bill impacts and promote affordability. Over the long-term, PSE expects the proposed equity ratio to provide the financial strength and flexibility needed to deliver benefits to customers.

Q. Is the proposed capital structure consisting of a 50.0 percent and 51.0 percent equity ratio in Year One and Year Two, respectively, of the two-year rate plan appropriate for PSE?

A. Yes. A capital structure that includes an equity ratio of 50.0 percent and 51.00 percent in Year One and Year Two, respectively, of the two-year rate plan is an appropriate level of equity to attract debt investment at a reasonable cost, when

coupled with a return on equity of 10.5 percent. PSE seeks the comparative and competitive financial strength and flexibility to maintain its current credit ratings, maintain competitive access to the capital markets, and restore pre-tax reform cash flow over time. Each of these are necessary imperatives that will position PSE to make the necessary decarbonization and clean energy investments for the clean energy transition, while also investing in safe, reliable, and affordable electric and natural gas energy service. Furthermore, this proposal provides substantial recognition that PSE's financial strength, flexibility, and integrity are indeed necessary and beneficial to delivering the dual mandate and also represent a critical resource that must be enhanced and maintained in the context of the proposed two-year rate plan and beyond.

Additionally, an equity ratio of 50.0 percent and 51.00 percent in Year One and Year Two, respectively, of the two-year rate plan, combined with returns on equity of 9.95 percent and 10.5 percent in Year One and Year Two, respectively, and other cash flow enhancing adjustments, will improve rate year cash flow-based credit metrics toward pre-tax reform levels. This will allow PSE to improve its credit metric performance [redacted] levels with a reasonable margin of cushion.

Q. Where does PSE's current authorized capital structure that includes an equity ratio of 49.00 percent fall within the peer group analyses?

A. PSE is in the bottom quartile of equity ratios authorized for electric and natural gas utilities that comprise Witness Bulkley's proxy group.[34]

Q. How do these peer group analyses inform PSE's requested capital structure with an equity ratio of 50.00 percent and 51.00 percent in Year One and Year Two, respectively, of the two-year rate plan?

A. In Year One of the rate plan, PSE's requested equity ratio of 50.0 percent is:

(i) 113 basis points lower than the average equity ratio of 51.13 percent authorized by regulatory commissions for the vertically-integrated electric utilities in the Bulkley peer group;[35]

(ii) 153 basis points lower than the average equity ratio of 51.53 percent authorized by regulatory commissions for vertically-integrated electric utilities during the test year;[36] and

(iii) 244 basis points lower than the average equity ratio of 52.44 percent authorized by regulatory commissions for vertically-integrated electric utilities during the second half of 2023.[37]

In Year Two of the rate plan, PSE's requested equity ratio of 51.0 percent is:

(i) 13 basis points lower than the average equity ratio of 51.13 percent authorized by regulatory commissions for

[34] *See* Exh. DAD-4.
[35] *See* Exh. DAD-4 (Table 3).
[36] *See* Exh. DAD-5 (Table 5).
[37] *See* Exh. DAD-5 (Table 6).

the vertically-integrated electric utilities in the Bulkley peer group;[38]

(ii) 53 basis points lower than the average equity ratio of 51.53 percent authorized by regulatory commissions for vertically-integrated electric utilities during the test year;[39] and

(iii) 144 basis points lower than the average equity ratio of 52.44 percent authorized by regulatory commissions for vertically-integrated electric utilities during the second half of 2023.[40]

Similarly, in Year One of the rate plan, PSE's requested equity ratio of 50.00 percent is:

(i) 152 basis points lower than the average equity ratio of 51.52 percent authorized by regulatory commissions for the natural gas distribution utilities in the Bulkley peer group;[41]

(ii) 199 basis points lower than the average equity ratio of 51.99 percent authorized by regulatory commissions for natural gas distribution utilities during the test year;[42] and

(iii) 128 basis points lower than the average equity ratio of 51.28 percent authorized by regulatory commissions for natural gas distribution utilities during the second half of 2023.[43]

Likewise, in Year Two of the rate plan, PSE's requested equity ratio of 51.00 percent is:

[38] *See* Exh. DAD-4 (Table 3).
[39] *See* Exh. DAD-5 (Table 5).
[40] *See* Exh. DAD-5 (Table 6)
[41] *See* Exh. DAD-4 (Table 4).
[42] *See* Exh. DAD-5 (Table 7).
[43] *See* Exh. DAD-5 (Table 8).

(i) 52 basis points lower than the average equity ratio of 51.52 percent authorized by regulatory commissions for the natural gas distribution utilities in the Bulkley peer group;[44]

(ii) 99 basis points lower than the average equity ratio of 51.99 percent authorized by regulatory commissions for natural gas distribution utilities during the test year;[45] and

(iii) 28 basis points lower than the average equity ratio of 51.28 percent authorized by regulatory commissions for natural gas utilities during the second half of 2023.[46]

Suffice it to say, PSE suffers comparatively to peer groups relative to authorized returns on equity and again with respect to authorized equity ratios. The proposed equity ratio of 50.0 percent and 51.0 percent in the first and second years of the rate plan (and combined with an ROE of 9.95 percent and 10.5 percent in the first and second years of the rate plan) are warranted given

(i) the expected substantial increase in PSE's capital investment program,

(ii) the demonstrated need to improve cash flow and credit metric performance,

(iii) the increased interest rate and cost of capital environment, and

(iv) the impacts of wildfire potential on PSE's risk profile.

PSE's proposed authorized ROE of 10.5 percent would

(i) be viewed as credit supportive by the financial community including debt and equity investors,

[44] *See* Exh. DAD-4 (Table 4).
[45] *See* Exh. DAD-5 (Table 7).
[46] *See* Exh. DAD-5 (Table 8).

(ii) position PSE to attract capital at reasonable costs and competitive terms,

(iii) help replace cash flow lost by PSE due to passage of the Tax Cuts and Jobs Act, and

(iv) help sustainably increase PSE's credit metric performance among the credit ratings agencies.

All of the foregoing are critical imperatives for PSE to implement the dual mandate successfully.

Q. Where does PSE's current authorized weighted return on equity of 4.61 percent fall within the peer groups?

A. PSE's current authorized weighted return on equity falls in the bottom quartile of weighted returns on equity authorized for electric and natural gas utilities that comprise Witness Bulkley's proxy group.[47] This is not surprising given that PSE's current ROE and equity ratio are similarly situated and weighted return on equity is the mathematical product of ROE and equity ratio.

Q. How do these peer group analyses inform PSE's requested weighted return on equity of 4.975 percent and 5.355 percent, respectively for the first and second years of the rate plan?

A. PSE's requested weighted return on equity of 4.975 percent for the first year of the rate plan would place PSE in the lower end of the top quartile for weighted

[47] *See* Exh. DAD-4.

returns on equity authorized for electric and natural gas utilities that comprise Witness Bulkley's proxy group.[48]

Similarly, PSE's requested weighted return on equity of 5.355 percent for the second year of the rate plan would place PSE in the middle of the top quartile for weighted returns on equity authorized for electric and natural gas utilities that comprise Witness Bulkley's proxy group.[49]

Q. Is PSE's proposed authorized weighted return on equity of 5.355 percent, phased-in across the two-year rate plan, fair, just, reasonable, and sufficient?

A. Yes. PSE's proposed authorized weighted return on equity of 5.355 percent, phased-in across the two-year rate plan, is fair, just, reasonable, and sufficient. An authorized weighted return on equity of 5.355 percent is warranted given

(i) the expected substantial increase in PSE's capital investment program,

(ii) the demonstrated need to improve cash flow and credit metric performance,

(ii) the increased interest rate and cost of capital environment, and

(iii) the impacts of wildfire potential on PSE's risk profile.

An authorized weighted return on equity of 5.355 percent would

[48] *See* Exh. DAD-4.
[49] *See* Exh. DAD-4.

(i) be viewed as credit supportive by the financial community including debt and equity investors,

(ii) position PSE to attract capital at reasonable costs and competitive terms,

(iii) help replace cash flow lost due to passage of the Tax Cuts and Jobs Act, and

(iv) help sustainably increase PSE's credit metric performance among credit rating agencies.

All of foregoing are critical imperatives for PSE to implement the dual mandate successfully.

D. PSE's Request Adequately Balances Safety and Economy

Q. What does the Commission usually consider when determining an appropriate weighted average cost of capital for a utility?

A. In selecting the appropriate capital structure, the Commission seeks to balance safety and economy:

> We develop a weighted cost of capital for the Company based on a capital structure that balances safety and economy. Capital structure, and particularly the equity ratio and cost of equity, materially impacts the price customers pay for service. Due to the relative difference between the higher cost of equity and the lower cost of debt, a capital structure with relatively more debt and less equity may result in a lower overall cost of capital. This results in lower rates for customers. This is commonly referred to as "economy." On the other hand, a capital structure with relatively more equity and less debt may result in a higher overall cost of capital and higher

> rates for customers, but enhanced financial integrity. This is commonly referred to as "safety."[50]

In other words, the economy of lower cost debt, on which PSE has an obligation to pay interest, must be weighed against the safety of relatively higher cost common equity, on which PSE does not have a legal obligation to pay a dividend and provide a return.

Q. Why is it appropriate to consider both the equity ratio in the capital structure and the return on equity in reaching an appropriate balance between safety and economy?

A. Simply put, it is the weighted return on equity that ultimately matters when balancing safety and economy in the context of overall cost of capital.

Q. Has PSE prepared an example that illustrates this perspective?

A. Yes. Table 1 below presents weighted returns on equity of various capital structures and authorized returns on equity. For purposes of this discussion, this prefiled direct testimony only focuses on the weighted return on equity for Year Two of the two-year rate plan, in which PSE is requesting weighted return on equity of 5.355 percent (based on a capital structure with an equity ratio of 51.00 percent and an authorized return on equity of 10.5 percent). Table 1 below presents combinations of equity ratios and authorized returns on equity that also

[50] *WUTC v. Pac. Power & Light Co., a division of PacifiCorp*, Dockets UE-140762, et al., Order 08 at 11 (Mar. 25. 2015) (footnotes omitted).

produce a weighted return on equity of 5.35 percent (except for minor rounding differences.)

Table 1. Weighted Returns on Equity

	Return on Equity				
	10.3%	**10.4%**	**10.5%**	**10.6%**	**10.7%**
50.0%	5.150%	5.200%	5.250%	5.300%	5.350%
50.5%	5.202%	5.252%	5.303%	5.353%	5.404%
51.0%	5.253%	5.304%	5.355%	5.406%	5.457%
51.5%	5.305%	5.356%	5.408%	5.459%	5.511%
52.0%	5.356%	5.408%	5.460%	5.512%	5.564%

A weighted return on equity of 5.355 percent reasonably balances safety and economy, in the context of total cost of capital, and this analysis illustrates that there are many combinations that can achieve a similar result. The yellow-highlighted result (aside from minor rounding differences) in the table above, is based on PSE's requested ROE of 10.5 percent and requested equity ratio of 51.0 percent in year two of the rate plan.

Q. Will the Commission's historical application of the balancing of safety and economy sufficiently improve PSE's financial strength in the context of implementing and financing the dual mandate?

A. No. As demonstrated above, PSE's authorized ROE, equity ratio, and weighted cost of equity are consistently well below industry averages based on the peer group comparisons provided in each of the Third Exhibit to the Prefiled Direct

Testimony of Daniel A. Doyle, Exh. DAD-4, and Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5. In fact, PSE performs within or near the fourth quartile across all of these measures for all of these peer group comparisons. This is no longer sustainable when PSE is poised to invest aggressively in clean energy resources and decarbonization measures in addition to its investment in safe, reliable and affordable electric and natural gas services.

PSE needs a credit supportive regulatory result from this proceeding that increases cash flow to maintain its credit profile and financial strength and flexibility to competitively access the capital markets to finance the clean energy investments on reasonable and cost-effective terms. It is my professional judgment that PSE will not be successful doing so with fourth quartile authorized ROEs, equity ratios and weighted equity returns. Debt and equity investors have choices about how and where they invest. For the future, the balance of safety and economy must be weighted more to the safety side of the equation (as requested by PSE) and coupled with an adequate and credit supportive ROE (as recommended by Witness Bulkley) that produces a weighted cost of equity that will attract and adequately compensate debt and equity investors as PSE works to implement the clean energy transformation for the benefit of customers and the State of Washington. If the regulatory result from this proceeding falls materially short of PSE's request with respect to ROE, equity ratio, and weighted cost of equity, PSE will very likely not retain its current credit ratings and will very likely be denied competitive access to the capital markets on cost-effective rates and competitive terms.

Q. Please elaborate on the your concerns about PSE's ability to competitively access the capital markets to finance the clean energy investments on reasonable and cost-effective terms.

A. Investors have options as to where to invest, and PSE is placed at a significant disadvantage when it seeks to access the capital markets from within or near the fourth quartile as discussed above. As the North Carolina Utilities Commission recently observed in a case involving Duke Energy Carolinas, LLC ("DEC") :

> Utilities must obtain capital from investors, and they seek capital from investors in competitive markets. As DEC witness and Treasurer testified:
>
> The Company competes for capital in the open market, and must appeal to debt and Duke Energy's equity investors to attract the capital it needs. As Dr. Roger Morin, a leading expert on utility finance, indicates, "[t]he … prices of debt capital and equity capital are set by supply and demand, and both are influenced by the relationship between the risk and return expected for those securities and the risks expected from the overall menu of available securities." Morin, Roger A., Modern Regulatory Finance (PUR Books LLC 2021), at 27. Investors have a variety of investment opportunities available to them, and require a return commensurate with the risk they incur. They will invest elsewhere if they feel the expected return provided by a company is inadequate, and lower credit quality weakens a company's attractiveness as an investment opportunity relative to companies with higher credit quality and similar return profiles.[51]

[51] *in the Matter of Application of Duke Energy Carolinas, LLC for Adjustment of Rates and Charges Applicable to Electric Service in North Carolina and Performance Based Regulation*, Docket No. E-7, SUB 1276 et al., Order Accepting Stipulations, Granting Partial Rate Relief (Dec. 15, 2023) at 212.

Q. Why is the capital structure proposed by PSE appropriate and reasonable for rate setting purposes in this proceeding?

A. The capital structures requested by PSE for Year One and Year Two of the two-year rate plan are appropriate and reasonable for the following reasons:

(i) a capital structure with an equity ratio of 50.00 percent and 51.00 percent for Year One and Year Two, respectively, of the rate plan, while lower than the average authorized equity ratios recently reflected in customer rates of other regulated utilities,[52] produces a competitive weighted return on equity of 4.975 percent and 5.355 percent for Year One and Year Two, respectively, of the rate plan, when combined with PSE's requested return on equity of 9.95 percent and 10.5 percent for Year One and Year Two, respectively, of the rate plan.

(ii) it appropriately balances safety and economy for customers; because when combined with a requested return on equity of 9.95 percent and 10.5 percent (for Year One and Year Two, respectively, of the rate plan), the requested capital structure with an equity ratio of 50.00 percent and 51.00 percent (for Year One and Year Two, respectively, of the rate plan) should better position PSE to maintain its current credit ratings, contribute to the restoration of pre-tax reform cash flow and competitively access the capital markets against natural gas and electric utilities across the country in order to finance the massive clean energy investment required by the CETA and the CCA.

[52] *See* Exh. DAD-5.

Q. Why does the capital structure requested by PSE in this proceeding appropriately balance the risks and costs of funding PSE's utility operations?

A. The capital structure requested by PSE in this proceeding when combined with requested returns on equity of 9.95 percent and 10.5 percent (for the first and second years of the two-year rate plan, respectively) and other cash flow enhancing adjustments in this filing, appropriately balances the risks and costs of funding PSE's utility operations for the following reasons:

(i) it will better position PSE to maintain its current credit ratings, contribute to the restoration of pre-tax reform cash flows, and competitively access the capital markets to finance the dual mandate;

(ii) it will better position PSE to satisfy regulatory commitments and debt covenants related to capital structure; and

(iii) it will allow PSE to provide electric and gas service to customers on reasonable economic terms.

Q. Does PSE intend to manage its capital structure to maintain a capital structure with an equity ratio of 50.0 percent and 51.0 percent for Year One and Year Two, respectively, of the two-year rate plan?

A. Given the unprecedented equity financing requirements described in this prefiled direct testimony, PSE requests that the Commission implement the requested equity ratios in the capital structure on a hypothetical basis. As stated elsewhere in this prefiled direct testimony, PSE projects over the next five years (2024-2028)

that it will invest approximately [redacted] on capital expenditures. To finance this unprecedented level of capital spending, PSE projects that it must issue [redacted] of debt securities, attract approximately [redacted] of incremental equity from its owners, and retain approximately [redacted] of net income and cash flow from operations. While the capital spending levels are unprecedented, so too are the financing pressures. PSE has never in its history required [redacted] of equity funding over a five year period, but that is what the dual mandate will require.

Q. How would the hypothetical equity ratio be implemented?

A. PSE requests the Commission authorize the increased equity ratio of 50.0 percent and 51.0 percent but only require PSE to maintain its dollar value equity level in the capital structure to the present 49.0 percent. This will eliminate the necessity to raise approximately another $200 million of equity, and relieve incremental financing pressures from an already monumental financing burden.

Should the Commission deny PSE's request and require that the approved equity ratio in the capital structure be maintained on the balance sheet, PSE requests that the Commission allow PSE to achieve that end over a phased-in, four-year period whereby PSE would manage the equity ratio on its balance sheet to

- 49.5 percent by year-end 2025,
- 50.0 percent by year-end 2026,
- 50.5 percent by year-end 2027, and

- 51.0 percent by year-end 2028.

This gradual approach would relieve some near-term incremental financing pressure and provide flexibility to finance the increased equity ratio on the balance sheet over time.

PSE recognizes that this request is a departure from recent past practice. That said, the financial future for the next several years, and beyond, is in no way reminiscent of the recent past. The need to spend [redacted] over the next five years to acquire clean energy resources and continue to maintain the safety, reliability, and affordability of PSE's electric and natural gas systems has changed the landscape dramatically, and that requires consideration of new policies that depart from past practice when there is good reason and logical rationale, customers are not harmed, and the public interest is served. PSE believes its request for a hypothetical increase to it equity ratio over the two-year rate plan meets these criteria.

Q. Has the Commission authorized a hypothetical equity ratio in the past?

A. Yes, it is my understanding that the Commission authorized hypothetical capital structures in the past.[53] In addition, in the final order in PSE's 2011 general rate

[53] *See, e.g., WUTC v. Cascade Natural Gas Corp.,* Docket UG-210755, Order 09 (August 23, 2022) ("The Commission has used actual, pro forma, or imputed capital structures to strike the right balance and determine overall rate of return on a case-by-case basis. In past cases, we have used a hypothetical capital structure primarily as a means to address financial hardship or tight capital markets.); *WUTC v. Avista Corporation d/b/a Avista Utilities*, Dockets UE-170485 and UG-170486 (consolidated), Order 07 ¶ 110 (April 26, 2018); *WUTC v. Puget Sound Energy*, Docket Nos. UE-011570 & UG-011571, Twelfth Supplemental Order (June 2002) and Thirteenth Supplemental Order (Aug. 2002) (authorizing a hypothetical equity ratio 40.0 percent for PSE when the actual capital structure for PSE included an equity

case the Commission recognized "an upward adjustment to the equity share in the capital structure" as one of the tools available to the Commission when addressing, inflation, high levels of plant additions, and attrition.[54]

VI. PSE'S PROPOSED INCLUSION OF CERTAIN CETA QUALIFYING CWIP IN RATE BASE IS BALANCED, CONSISTENT WITH LAW, AND APPROPRIATE IN THIS CASE

Q. What methodologies apply to the recovery of financing costs incurred by a utility during construction of plant?

A. Generally, there are two approaches to recovering financing costs incurred during construction: the AFUDC methodology and CWIP in rate base methodology. Either methodology provides the utility with recovery of financing costs incurred during construction. The difference between the two methodologies is a matter of timing of the recovery.

Q. Please describe the AFUDC methodology.

A. The AFUDC methodology is the more traditional approach to the recovery of financing costs incurred by a utility during construction. Under the AFUDC methodology, the Commission determines the AFUDC rate – a rate of interest that reflects the financing costs for a construction project. This AFUDC rate is similar to, although usually slightly lower than, the utility's authorized rate of

ratio of less than 32.0 percent); *WUTC v. Puget Sound Energy*, Dockets UE-040640 & UG-040641, Order 06, ¶ 27 (Feb. 2005) (noting that the appropriate capital structure can either be PSE's historical capital structure, projected capital structure, or a hypothetical capital structure).

[54] *WUTC v. PSE*, Docket UE111048/UG-111040 ¶ 491.

return for rate base. During the construction period, the utility places the construction costs in CWIP and calculates an AFUDC by multiplying the amounts in CWIP by the AFUDC rate. When the utility places the plant in service, it adds both the AFUDC amounts and the CWIP amounts in rate base for the plant. As the plant depreciates, the utility will recover both construction costs and AFUDC from customers.

Q. Please describe the CWIP in rate base methodology.

A. CWIP in rate base is an alternative methodology for the recovery of financing costs incurred by a utility during construction. Under the CWIP in rate base methodology, a utility adds the construction costs for plant, CWIP, to its rate base before the plant is completed and in service. After CWIP is in rate base, the utility will earn an immediate return on CWIP. The return is calculated as the product of the CWIP placed in rate base multiplied by the rate of return authorized for the utility.

Q. What methodology does PSE propose for the recovery of financing costs incurred during construction of the Beaver Creek Wind Project?

A. PSE generally proposes use of the CWIP in rate base methodology for the recovery of financing costs incurred during construction of the Beaver Creek Wind Project. PSE recognizes, however, that PSE will have accumulated financing costs for the Beaver Creek Wind Project in an AFUDC account during the pendency of this rate proceeding. Accordingly, PSE proposes

(i) to place the CWIP and amounts accrued in the AFUDC account as of December 31, 2024, in rate base,

(ii) to cease accrual of further amounts in the AFUDC account as of December 31, 2024, and

(iii) to earn its weighted average cost of capital approved by the Commission in this proceeding for the remaining construction period.

Q. Why has PSE proposed to use the CWIP in rate base methodology for the Beaver Creek Wind Project and not other projects in this proceeding?

A. PSE has proposed to include the CWIP in rate base methodology for the Beaver Creek Wind Project and not other projects in this proceeding for a number of reasons.

First, PSE recognizes that the Commission has not entertained many, if any, proposals using the CWIP in rate base methodology since the Washington Supreme Court issued its opinion in the *POWER* case, and the construction of this renewable energy project provides a good opportunity for the Commission and parties to test the usefulness of the methodology and set parameters for the inclusion of CWIP in rate base. Since the late 1970s and early 1980s, PSE, and likely other utilities in the state, have not had the significant construction programs that would necessitate the need for the CWIP in rate base methodology. This will no longer be the case, at least for PSE. The requirements of CETA, the increasing use of electric vehicles for transportation, and the likely increase in electrification of other uses of fossil fuels will drive the need for significant electrical infrastructure. The projected construction period for the Beaver Creek

Wind Project is a relatively short period, with PSE incurring the vast majority of construction costs for the Beaver Creek Wind Project during the pendency of this proceeding and the first year of the rate effective period. The Beaver Creek Wind Project has an anticipated in-service date during the first year of the rate-effective period. Given the relatively short construction period, the Beaver Creek Wind Project is a good project to reintroduce the CWIP in rate base methodology to Washington.

Second, the Beaver Creek Wind Project is the first significant construction project undertaken by PSE to meet the requirements of CETA. PSE's infrastructure needs to meet CETA are unprecedented in this state, and PSE will need to construct a significant number of those infrastructure assets—whether they be renewable or non-emitting generating resources, distributed energy resources assets, transmission assets, or distribution modernization. Many of these assets will be discrete projects with significant construction timelines, substantial utility expenditures, and a considerable amount of interest cost. As large, discrete projects, the construction costs are easy to monitor, and these assets have easily identifiable in-service dates that mark the end of construction and the in-service dates of the assets. These large, discrete projects are good candidates for the CWIP in rate base methodology.

Finally, PSE is undertaking the construction of the Beaver Creek Wind Project for the express purpose of securing renewable resources to meet the requirements of CETA and other state policies. Beaver Creek Wind Project is just the first of what

will likely be many such large, discrete PSE projects it must undertake. As discussed elsewhere in this testimony, PSE's cash flow is not as strong as it was just five years ago, for reasons beyond the control of PSE or this Commission. The CWIP in rate base methodology is a tool that allows PSE to increase cash flow to finance construction costs and cover interest payments on associated debt. This would provide greater flexibility for PSE to maintain its financial strength and flexibility, mitigate the initial rate impact on customers when the assets go into service, and allow PSE to meet the clean energy transformation targets expected by the state and its citizens.

Q. Why does PSE propose that the Commission approve the CWIP in rate base methodology instead of the AFUDC methodology for the recovery of financing costs incurred during construction of the Beaver Creek Wind Project?

A. PSE proposes that the Commission approve the CWIP in rate base methodology in lieu of the AFUDC methodology because the CWIP in rate base methodology provides many benefits to PSE and its customers when compared to the AFUDC methodology for construction financing costs. The benefits include lower capitalized costs, stable cash flows, and improved quality of cash earnings. The *Accounting for Public Utilities* treatise identifies the following benefits of including CWIP in capitalization and rate base:

- Because CWIP has the lower capitalized costs, the inclusion of CWIP in rate base actually reduces the total

cost to the utility and its customers over the life of the plant.[55]

- Inclusion of CWIP in rate base also causes increased cash flows and allows the utilities to avoid a certain amount of outside financing, which is advantageous whenever incremental borrowing costs exceed embedded costs.[56]

- Increased cash flows and less outside financing lead to an improved quality of actual cash earnings. Because securities analysts and bond rating agencies focus on cash flow and cost deferrals, the improved quality of cash earnings may allow required financings at relatively lower costs.[57]

- The greater risk associated with higher levels of non-cash earnings, such as AFUDC, would ultimately be reflected in higher rates of return required by investors.[58]

- Investors recognize that including CWIP in rate base is an important tool that supports the utility's financial integrity and attenuates some of the financial risks associated with new infrastructure investment.[59]

These benefits would improve PSE's cash flow, reduce financing costs for the Beaver Creek Wind Project, and mitigate the rate shock impact when the project goes into service.

[55] *Accounting for Public Utilities*, § 4.04[4], at 4-15.
[56] *Id*.
[57] *Id*.
[58] *Id*.
[59] *Id*.

Q. How would the CWIP in rate base methodology improve PSE's cash flow as compared to the AFUDC methodology?

A. AFUDC claimed during the construction period appears in the utility's income statement as income for the year in which claimed, but the AFUDC does not provide cash flow to the utility until the plant is in service. The effect of AFUDC on a utility's cash flow is equivalent to having a significant portion of its assets in long overdue accounts receivable, a situation that inevitably has a negative effect on credit ratings.

In contrast, the CWIP in rate base methodology provides cash flow to the utility during the construction period, which the utility can use to fund construction of the plant. In short, allowing CWIP in rate base has a distinct advantage to the utility in the form of enhanced cash flow during the construction cycle to help alleviate the financial strain of the construction project and maintain interest coverage ratios necessary to support lower financing costs.

Q. How would the CWIP in rate base methodology reduce financing costs for the Beaver Creek Wind Project as compared to the AFUDC methodology?

A. Financial analysts and credit ratings agencies view CWIP in rate base more favorably than AFUDC. As mentioned previously, AFUDC does not create current cash flow, which deprives the utility of funds during the time of construction when positive cash flow is necessary to offset the negative cash flow of the construction itself.

Generally, rating agencies are concerned with the amount of cash generated from continuing operations and the associated funds available to pay the interest on the debt. Standard & Poor's (S&P) has indicated that regulatory support for cash flow during cycles of increased construction costs is an important aspect of its analysis:

> When applicable, a jurisdiction's willingness to support large capital projects with cash during construction is an important aspect of our analysis. This is especially true when the project represents a major addition to rate base and entails long lead times and technological risks that make it susceptible to construction delays. … Allowance of a cash return on construction work-in-progress or similar ratemaking methods historically were extraordinary measures for use in unusual circumstances, but when construction costs are rising, cash flow support could be crucial to maintain credit quality through the spending program.[60]

Key financial ratios considered by ratings agencies include funds from operations ("FFO") interest coverage ratio and funds from operations as a percent of total debt. AFUDC is a non-cash item and not reflected in funds from operations. These key financial ratios (interest coverage ratio and FFO to Total Debt Ratio) will decrease when utility AFUDC becomes significant, as would take place during the construction of large utility assets in the absence of the inclusion of CWIP in rates. All else equal, this decrease will lead to a decrease in the utility's credit rating. The resulting increase in interest charges will lead to higher costs for customers.

[60] *See* Exh. CGP-10, S&P Global Ratings, *Assessing U.S. Investor-Owned Utility Regulatory Environments* (May 18, 2014), at 6.

CWIP included in rate base meaningfully enhances financing and ratings agency coverage ratios by replacing non-cash AFUDC earnings on CWIP with cash earnings on CWIP. Use of CWIP in rate base enhances debt ratings due to enhanced coverage ratios and earnings quality improvements, which thereby lowers borrowing costs.

Q. How does the CWIP in rate base methodology mitigate the rate impact when the project goes into service?

A. Under the CWIP in rate base methodology, a utility will add only construction costs to its rate base and would not accrue AFUDC. Consequently, when the plant goes into service, its rate base will consist only of construction costs and will not include any AFUDC. The elimination of the AFUDC component of construction costs reduces the total rate base value of the plant. Once the plant is in service, its impact on rates will be less if the utility used CWIP in rate base than if it used AFUDC. Furthermore, because CWIP in rate base provides a current cash return, due to its inclusion in rates, the initial rate impact to customers is reduced when the affected asset is placed into service and the full cost of the asset is included in rates. In this context, the CWIP in rate base methodology, phases-in the cost of affected assets into the revenue requirement over time and eliminates the rate shock that often accompanies placing large, costly assets into rates.

Q. Do customers pay more under the CWIP in rate base methodology than they would under the AFUDC methodology?

A. No. Customers do not pay more under the CWIP in rate base methodology than they do under the AFUDC methodology.

(i) Construction Period – During the construction period (i.e., before the plant is in service), the AFUDC methodology has no effects on rates, whereas, under the CWIP methodology, customers pay the financing costs of construction in current rates. Therefore, customers would pay more under the CWIP in rate base than they would under the AFUDC methodology during the construction period.

(ii) In-Service Period – During the in-service period (i.e., after the plant is in service and for the life of the plant), customers pay more under the AFUDC methodology than they do under the CWIP in rate base methodology. Indeed, the cumulative revenue requirement of a plant is always less under the CWIP in rate base methodology than it is under the AFUDC methodology.

Q. Why do customers pay more under the AFUDC rate base methodology over the life of the plant than they do under the CWIP in rate base methodology?

A. If one were to sum the amounts paid by customers for the construction period and the in-service period of an identical plant under both the AFUDC methodology and the CWIP in rate base methodology, the customers subject to the AFUDC methodology would always pay more, on a cumulative basis, over the construction and in-service period than they would under CWIP in rate base methodology. The reason that customers pay more over time under the AFUDC methodology is due to the "compounding" of the AFUDC in rate base over the

life of the plant after the plant goes into service. In other words, customers pay "interest on interest" under the AFUDC methodology due to the treatment of construction AFUDC financing costs as a rate base item. In addition, PSE must also collect over the in service life of the plant, as a component of depreciation expense, the AFUDC that was capitalized during the construction period.

Q. Why is it important for PSE to recover construction financing costs through the CWIP in rate base methodology when the utility has done so under the AFUDC methodology in the recent past?

A. Recovering construction financing costs through the CWIP in rate base methodology will allow PSE to maintain a sufficient cash flow to improve its credit metrics and meet its financing and construction needs as a critical partner in bringing about the transformation required under the Clean Energy Transformation Act. As discussed earlier in this testimony, the passage of the Tax Cuts and Jobs Act has had a significant effect on PSE's cash flow, and the use of the AFUDC methodology will only exacerbate the existing cash flow problem.

While the AFUDC methodology allows PSE to record the AFUDC on its income statement, this does not provide cash flow. In contrast, the CWIP in rate base methodology provides the cash flow necessary for PSE to pay for the numerous construction activities PSE must undertake to achieve the clean energy transformation.

Q. Why is cash flow important?

A. No company can operate long without impairing its financial integrity when major and increasing portions of its reported earning on the income statement reflect non-cash, bookkeeping entries. PSE requires cash to make its interest payments on debt, pay contractors and vendors of construction projects, meet operating expenses and taxes, and carry the accounts receivable. Recognition of AFUDC on the income statement cannot meet these needs.

Q. Has the industry, in general, and PSE, in particular, experienced periods where increasing construction finance costs required use of CWIP in rate base to maintain sufficient cash flows?

A. Yes, during the period of the mid-1960s to the early 1980s, the electric industry undertook many new construction programs throughout the country to meet growing needs. Among the construction projects initiated during the period was the Hydrothermal Power Program, in which Bonneville Power Administration and other utilities in the Pacific Northwest planned to build 21,400 MW of thermal power—two coal-fired plants and twenty nuclear plants—and 20,000 MW of new hydropower between 1971 and 1990, at an estimated cost of $15 billion, to supplement the Columbia River power system.[61]

[61] *See* Northwest Power and Conservation Council, *Hydrothermal Power Program*, https://www.nwcouncil.org/.

The massive construction projects and fundamental changes in the electric industry in the late 1970s caused concern among the financial community resulting from (i) rapidly rising operating and capital costs due to inflation; (ii) regulatory changes due to environmental concerns and responses to the energy crises of the 1970s; (iii) a deteriorating economy; (iv) declining electric sales as consumer electronics became more energy-efficient; and (v) a general financial deterioration of electric utilities as non-cash AFUDC entries on income statements became larger and larger percentages of utility income statements.

The Deloitte Center for Energy Solutions described the trend in the late 1970s away from the AFUDC methodology and toward the CWIP in rate base methodology in response to these financial pressures as follows:

> During the 1970s, there was a trend toward allowing CWIP in rate base and toward discontinuing the capitalization of AFUDC. The trend was the result of financial stress in the utility industry. The tremendous amounts of capital invested in CWIP produced amounts of AFUDC capitalized that often exceeded net income. Because of these conditions, many regulators concluded that the customer was better off paying for this financing cost as incurred rather than paying for the additional financing costs over the life of the assets, through capitalizing and depreciating financing costs.[62]

As of late 1979, thirty-three state public utility commissions and the Federal Energy Regulatory Commission had allowed CWIP in rate base and discontinued capitalization of AFUDC.[63] Utility commissions adopted these policies to help

[62] Deloitte & Touché USA LLP, Deloitte Center for Energy Solutions, *Regulated Utilities Manual–A Service for Regulated Utilities* (Feb. 2004), at 11.

[63] *See* Report by the Comptroller General of the United States, *Construction Work in Progress Issue Needs Improved Regulatory Responses for Utilities and Consumers*, U.S. Government Accountability Office (June 23, 1980) at 19, https://www.gao.gov/assets/emd-80-75.pdf.

utilities maintain adequate cash flow during the construction process, without which the utilities could face downgrades of fixed income rating due to the inadequate cash flow.[64]

Q. Did the Commission follow the CWIP in rate base methodology during this period of the late 1970s and early 1980s?

A. Yes. This Commission was among the many utility commissions that allowed CWIP in rate base during the period of the late 1970s and early 1980s. Various factors led the Commission to allow CWIP in rate base for electrical utilities during the 1970s and 1980s. The state had generally exhausted hydro generation possibilities, there were substantial increases in electrical consumption per capita, and a growing population placed additional strain on existing capacity.[65] As a result, electrical utilities embarked on various major construction programs to meet the projected future load growth, including large capital-intensive nuclear and coal plants.[66] The Commission recognized that a failure to pursue these projects would likely result in future unavailability of electricity.[67] As construction costs mounted and unprecedented inflation took hold, investor-owned utilities required additional rate relief provided in the form of CWIP to maintain financial positioning, continue necessary generation projects, and otherwise shore-up debt obligations.[68]

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64 *See generally id*.
65 *See WUTC v. Wash. Water Power Co.*, Cause No. U-77-53 (Mar. 24, 1978).
66 *Id*.
67 *Id*.
68 *Id*.

In Puget Sound Power & Light Company's 1978 general rate case[69] where PSE's predecessor sought funding for nuclear and coal projects, the Commission noted that it

> recognizes that continuation of the company's construction program is necessary to assure adequate future generating capacity and that the company's ability to finance its construction program would be endangered absent inclusion of CWIP in authorized rates.[70]

Accordingly, the Commission allowed a spread between AFUDC and CWIP to balance the burden of "undertaking a massive construction program to meet future service obligations" with preventing ratepayers from bearing the full financing cost of CWIP.[71]

Similarly, the Commission allowed Puget Sound Power & Light Company to allow CWIP in rate base for test year expenditures on the WPPSS No. 3 nuclear plant and on-book expenditures at Colstrip Units 3 and 4 in a rate proceeding in the early 1980s:

> The Commission is faced with a company which has a bond rating of bbb, a rating which must be retained for reasonable access to capital markets. The company is in a weakened financial condition and is still encumbered with a construction program which, while reduced significantly, is still massive and will require a high degree of investor confidence in the company in order to raise these funds. To restore Puget to financial viability the Commission has ordered:
>
> …

[69] *WUTC v. Puget Sound Power & Light Co.*, Docket U-78-21, 1970 WL 224129 (Mar. 8, 1979).
[70] *Id.* at *1.
[71] *Id*. (establishing a 0.80 spread between rate of return on CWIP and the offsetting AFUDC rate).

> (3) All the CWIP in rate base requested by Puget for its test year expenditures on WPPSS No. 3 and on-book expenditures at Colstrip Units 3 and 4. In doing so, the Commission took into consideration John King's statement in Exhibit No. 181 that "Inclusion of CWIP in rate base will effectively permit the company to bring Colstrip No. 3 in service without the need for expedited rate relief as of its in service date in January 1984."[72]

In many respects, PSE is in a similar position today. It has a similar bond rating, weakened cash flow, and is at the threshold of a massive construction program necessary to achieve the clean energy transformation required by state policy.

Q. Has the Commission recently allowed a utility to use the CWIP in rate base methodology to recover financing costs associated with construction?

A. Not to my understanding. I understand that the Washington Supreme Court issued a ruling in 1984 that held that the Commission improperly allowed CWIP in rate base for Puget Sound Power & Light Company's investment in Colstrip Units 3 and 4 and a nuclear plant even though the plants were not yet operational.[73] My understanding is that the Washington Supreme Court evaluated whether the "CWIP [was] used and useful for service within the meaning" of RCW 80.04.250 and held the Commission "erred by including [CWIP]" in rate base because the plants were not yet used and useful.[74] In effect, the Washington Supreme Court in

[72] *WUTC v. Puget Sound Power & Light Co*., Docket U-82-38, Third Supp. Order at 35 (July 22, 1983).

[73] *People's Org. for Wash. Energy Res. v. WUTC*, 101 Wn.2d 425, 430, 679 P.2d 922 (1984) ("*POWER*").

[74] *POWER*, 101 Wn.2d at 434

POWER struck down the use of CWIP on the grounds that it could not by its very nature be used and useful.

Q. Is it your understanding that the opinion of the Washington Supreme Court in *POWER* would prohibit the Commission from permitting PSE to use the CWIP in rate base methodology in this proceeding?

A. No. It is my understanding that the court's opinion in the *POWER* case addressed an earlier version of RCW 80.04.250 that did not expressly allow for the use of CWIP in rate base. I further understand that the Washington legislature responded to the *POWER* opinion by passing Engrossed Substitute Senate Bill 5770 in 1991, which amended RCW 80.04.250 to expressly allow for the inclusion of CWIP in rate base:

> The commission shall have power upon complaint or upon its own motion to ascertain and determine the fair value for rate making purposes of the property of any public service company used and useful for service in this state and shall exercise such power whenever it shall deem such valuation or determination necessary or proper under any of the provisions of this title. In determining what property is used and useful for providing electric, gas, or water service, the commission may include the reasonable costs of construction work in progress to the extent that the commission finds that inclusion is in the public interest.[75]

My understanding is that this amendment to RCW 80.04.250 made clear that the Commission could allow CWIP in rate case to the extent that the commission finds that inclusion is in the public interest.

[75] Engrossed Substitute Senate Bill 5770, Chapter 122, Laws of 1991, available at https://lawfilesext.leg.wa.gov/biennium/1991-92/Pdf/Bills/Session%20Laws/Senate/5770-S.SL.pdf.

Q. Has the Commission recognized that it has the authority to allow CWIP in rate base?

A. Yes. In PSE's 2011 general rate case final order, the Commission noted that one of the tools available to the Commission is the "inclusion of [CWIP] in rate base providing a return on investment prior to when the new plant goes into service."[76] The Commission has also suggested that CWIP is a regulatory tool that could be used in the right circumstances, but has not provided clear guidance on when the circumstances are right.[77]

Q. Are the circumstances currently right for the Commission to allow PSE to include CWIP in rate base for the Beaver Creek Wind Project?

A. Yes. Although CWIP in rate base may not have been a necessary tool for utilities since the legislature amended RCW 80.04.250 in 1991, PSE is on the threshold of undertaking substantial construction projects to meet the requirements of the Clean Energy Transformation Act. The CWIP in rate base methodology provides customer benefits whenever there is the need for large-scale multiyear investments. The methodology mitigates the need to increase rates significantly and the potential decline in utility credit quality associated with major construction program. Delaying recovery of financing costs until plant in service

[76] *WUTC v. Puget Sound Energy*, Dockets UE-111048 & UG-111049 (consolidated), Order 08 ¶ 491 (May 7, 2012).

[77] *WUTC v. Cascade Natural Gas Corp*., Docket UG-170929, Order 06 (July 20, 2018) (stating the flexible use of CWIP during periods of increased plant investment was a tool the Commission has previously used but not proposed by Cascade); *see also WUTC v. Pacific Power*, Docket UE-140762, Order 08 ¶ 20 (Mar. 25, 2015) (the Commission noted it has allowed CWIP in rate base before when explaining its flexibility with a hybrid test year).

results in a sharp spike in rates and violates the regulatory objective of seeking "gradualism" in rates. Similarly, without inclusion of CWIP in rates, the funding needed for a major construction program leads to a decline in utility credit quality and a corresponding increase in utility borrowing costs and ultimately utility rates.

Q. Has PSE analyzed the rate effects of allowing CWIP in rate base instead of capitalizing AFUDC?

A. Yes. PSE has analyzed the rate effects of allowing CWIP in rate base instead of capitalizing AFUDC for the Beaver Creek Wind Project. PSE's request for recovery of financing costs for the Beaver Creek Wind Project includes (i) capitalization of AFUDC for the construction period prior to January 1, 2025, and (ii) CWIP in rate base for the construction period on and after January 1, 2025, until completion of the project. This treatment is necessary due to the fact that PSE will not have approval for inclusion of CWIP in rate base for Beaver Creek Wind Facility until after the Commission grants such approval in this rate proceeding.

Please see the Exhibit to the Prefiled Direct Testimony of Susan E. Free, Exhibit No. SEF-25, for an analysis that compares PSE's CWIP in rate base proposal for the Beaver Creek Wind Facility to a treatment that capitalizes all AFUDC for the Beaver Creek Wind Facility and does not include any CWIP in rate base for the project.

Q. What further analysis has PSE conducted?

A. In addition to the aforementioned analysis, PSE has analyzed the rate effects of allowing CWIP in rate base instead of capitalizing AFUDC, assuming PSE had the authority to include CWIP in rate base from the beginning of construction of the project. Please see the Exh. SEF-25 to the Prefiled Direct Testimony of Susan E. Free, for a comparison of the rate effects of allowing CWIP in rate base instead of capitalizing AFUDC, assuming that PSE had authority to include CWIP in rate base from the beginning of construction of the Beaver Creek Wind Facility. Table 2, below, shows the comparison.

Table 2. Comparison of Recovery Methods for Generation Resources

Description	Conventional	Proposed (Hybrid)	CWIP in Rate Base Only (No AFUDC)
2024 Rev Req on Rate Base	$ -	$ -	$ 28,579,805
2025 Rev Req on Rate Base	29,708,951	57,253,404	54,203,639
2026 Rev Req on Rate Base	79,010,751	75,347,695	71,484,909
Tot Rev Req 2025-2026	$ 108,719,702	$ 132,601,099	$ 154,268,354
Lifetime Sum of Rev Req	$ 1,018,354,981	$ 1,000,063,659	$ 977,260,095
Net Present Value Rev Req 1st 3 years	$97,967,639	$120,430,733	$142,122,018
Net Present Value Rev Req Life	$ 663,969,973	$ 660,192,269	$ 654,212,146

Q. Have you reviewed the derivation of the discount rate that PSE witness Susan Free utilized in the calculations to compare and contrast the net present value of revenue requirements for the Beaver Creek Wind Project, assuming conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and a hypothetical CWIP in rate base treatment?

A. Yes, I have. I support the discount rate presented in that testimony.

Q. Why is the derivation of the discount rate used by PSE witness Susan Free important to the analysis?

A. To properly analyze, compare and contrast the revenue requirement for the Beaver Creek Wind Project, assuming conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and a hypothetical CWIP in rate base treatment, one must review the revenue requirements in total dollars (undiscounted) and on a discounted net present value basis that specifically takes into account the time value of money from perspective of customers. This approach gives the Commission both discounted and non-discounted financial information to assess whether to approve PSE's proposed treatment to place CWIP for the Beaver Creek Wind Project in rate base in the first year of the multiyear rate plan. A net present value analysis that takes into account the time value of money from the perspective of customers obviously requires a discount rate of some kind.

Q. Why is it necessary to derive a discount rate from the perspective of customers?

A. Analyzing the various revenue requirements assuming conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and a hypothetical CWIP in rate base treatment is, in its most basic form, an exercise of determining what level of revenue requirement will be included in customer bills. Differing levels of revenue requirement in customer bills affect customers' disposable income that is available for alternative investments. A lower revenue requirement increases the amount of disposable income that customers have available for investment as compared with a higher revenue requirement, all else equal. Accordingly, deciding how the Beaver Creek Wind Project will be treated in revenue requirements (for purposes of conventional AFUDC, the "hybrid" approach PSE proposes, and a hypothetical CWIP in rate base) is a decision that impacts customers' cash flows on the margin and ultimately the amount of disposable income they have to invest on the margin. As such, the value of the increment of capital related to the Beaver Creek Wind Project (across the three methodologies analyzed) is appropriately evaluated using a discount rate that approximates customers' opportunity cost of capital.

Q. Is there authoritative support that validates this approach?

A. Yes. The Report by the Comptroller General of the United States, Construction Work in Progress Issue Needs Improved Regulatory Responses for Utilities and Consumers, U.S. Government Accountability Office (to which this testimony

earlier refers) discusses this very point. As a prelude to presenting several net present value examples comparing conventional AFUDC and CWIP in rate base, the authors discuss the discount rate they employed in their analyses and they state in part:

> …[our] examples take into account the time value of money paid by consumers, who also have a cost of capital. If they did not have to pay utility bills, they could presumably invest the funds and earn a return. The return foregone on money paid to the utility is the consumers' cost of capital.[78]

The authors' methodology and approach to employ a discount rate from customers' perspectives in their net present value analysis is precisely consistent with my methodology and approach.

Q. Please summarize the assumptions and data inputs required to derive a discount rate that reasonably approximates customers' opportunity cost of capital.

A. There are several. First, it is important to note that it is impossible to know each customer's individual and unique opportunity cost of capital. For example, customers have differing financial circumstances, cash flow needs, and investment risk profiles that affect whether and how they might allocate available cash across various asset classes, such as debt and equity. Differing allocations across debt and equity have a direct impact to each customer's unique opportunity costs of capital. For example, a customer with a higher risk profile would likely

[78] *Report by the Comptroller General of the United States, Construction Work in Progress Issue Needs Improved Regulatory Responses for Utilities and Consumers, U.S. Government Accountability Office* (June 23, 1980) at 40, https://www.gao.gov/assets/emd-80-75.pdf.

invest a higher percentage of available cash in equities, which all else equal would result in a higher opportunity cost of capital than more risk averse customers. Accordingly, simplifying assumptions must be employed and tested for reasonableness in this regard. The approach used by PSE attempts to take this into consideration. More specifically, the approach used by PSE utilizes an asset allocation of 40 percent equity and 60 percent debt, which is tested for reasonableness against asset allocations that are much more heavily weighted to equities and are therefore much more risky.

Second, it is reasonable to simplify and limit the asset classes included in the calculation. Using an inordinate number of assets classes can become unwieldy and does not necessarily add precision to the exercise. To this end, PSE has limited the asset classes to large U.S. company stocks and long-term U.S. governmental bonds.

Finally, expected returns for stocks and bonds along with inflation expectations are required data points. In this regard, the approach used by PSE utilizes simple arithmetic averages of historical large company U.S. stock total returns and income only returns on U.S. governmental bonds as reported by *Kroll* for the period 1926-2022[79] and a projection for inflation.[80]

[79] 2022 *Kroll* SBBI Yearbook, Tables A-1 and A-7.
[80] Blue Chip Financial Forecast, Vol 42, No. 12, December 1, 2023, at 2, CPI as projected for Q4 2023.

Q. How do you calculate the discount rate used in the analysis?

A. The historical arithmetic average total return on large company U.S. stocks and the long term U.S. governmental income return over the period from 1929-2022 were 12.02 percent and 4.85 percent, respectively. As shown in Table 3 below, weighting these returns by the asset allocation of 40 percent equity and 60 percent debt discussed above, results in weighted returns of 4.81 percent and 2.91 percent for equity and debt, respectively. Summing these weighted returns results in a pre-inflation weighted expected market return of 7.72 percent. Using the current Blue Chip Financial Forecast projection for inflation of 2.9 percent, the difference between the pre-inflation weighted expected market return of 7.72 percent and inflation projection of 2.9 percent results in an inflation adjusted, customer opportunity cost of capital of 4.82 percent:

Table 3. Asset Allocation of 40% Equity and 60% Debt

		Allocation		Return		Weighted-Average Cost
A	Equity	40%	×	12.02%	=	4.81%
B	Debt	60%	×	4.85%	=	2.91%
C	**Total Return (A + B)**					7.72%
D	**Inflation (CPI)**					2.90%
E	**Opportunity Cost of Capital (C- D)**					4.82%

This is the discount rate that supports the net present value calculations used by PSE witness Susan Free with respect to the calculations for the Beaver Creek Wind Project

Q. Has PSE tested the assumed asset allocation of 40 percent equity and sixty percent debt for reasonableness?

A. As noted earlier, it is impossible to determine each individual customer's opportunity cost of capital, therefore, it is appropriate to analyze a reasonable and prudent range of asset allocations to determine whether the net present value relationships and conclusions remain consistent across the range of alternatives. An asset allocation of 40 percent equity and 60 percent debt is relatively conservative (post-inflation rate of return of 4.82 percent), which would be appropriate for an investor who is more-risk averse to the volatility in the equity markets over time. Alternatively, an asset allocation of 60 percent equity and 40 percent debt (post-inflation rate of return of 6.25 percent) provides a less risk-averse investor more access to the equity markets where higher returns are available over time than in the debt markets. It is my professional opinion that these asset allocations represent reasonable and prudent bookends of asset allocation based on mainstream investment theory and advice that dictates a well-diversified asset allocation across equities and fixed income securities.

Q. How does this provide information about whether the opportunity cost of capital of 4.82 percent is reasonable?

A. To answer this question, one must calculate an alternative customer opportunity cost of capital using an asset allocation of 60 percent equity and 40 percent debt. Table 4 below relies on the same calculation that was used to derive the opportunity cost of capital of 4.82 percent shown in Table 3 above. In Table 4, I have changed the weighting of the debt and equity returns by the asset allocation of 60 percent equity and 40 percent debt. Using this portfolio allocation results in weighted returns of 7.21 percent and 1.94 percent for equity and debt, respectively. Summing these weighted returns results in a pre-inflation weighted expected market return of 9.15 percent. Subtracting the same inflation (CPI) estimate of 2.9 percent, from the expected market return of 9.15 percent results in an inflation adjusted, customer opportunity cost of capital of 6.25 percent:

Table 4. Asset Allocation of 60% Equity and 40% Debt

		Allocation		Return		Weighted-Average Cost
A	Equity	60%	×	12.02%	=	4.81%
B	Debt	40%	×	4.85%	=	2.91%
C	**Total Return (A + B)**					9.15%
D	**Inflation (CPI)**					2.90%
E	**Opportunity Cost of Capital (C- D)**					6.25%

Q. How is the discount rate used in the analysis of the ratemaking treatment of the capital expense associated with the Beaver Creek Wind Project?

A. If one recalculates the net present values for the conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and the hypothetical CWIP in rate base treatment by (i) the identical revenue requirements in each and (ii) discounting those revenue requirements using the alternative opportunity cost of capital of 6.25 percent from Table 4 above, one could determine whether the net present value relationships and conclusions remain consistent across reasonable and prudent bookends of customer asset allocation.

Q. What do the results of this calculation tell us?

A. The net present value relationships and conclusions between the conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and the hypothetical CWIP in rate base treatment, remain consistent using either the opportunity cost of capital of 4.82 percent (asset allocation of 40 percent equity and 60 percent debt) or the opportunity cost of capital of 6.25 percent (asset allocation of 60 percent equity and 40 percent debt); stated alternatively, when using the opportunity cost of capital of 6.36 percent (asset allocation of 60 percent equity and 40 percent debt) as the discount rate, the net present value conventional AFUDC treatment ($593.6 million) is more costly than the net present value of the "hybrid" treatment that PSE proposes in its filing ($592.6 million), which in turn is more costly than the hypothetical CWIP in rate base treatment ($589.9 million). These are the same relationships and conclusions,

albeit with smaller dollar differences between the net present values of the alternative methodologies that result from using the opportunity cost of capital of 4.82 percent (asset allocation of 40 percent equity and 60 percent debt).

Q. What is your overall conclusion?

A. Utilizing either an asset allocation of 40 percent equity and 60 percent debt or an reasonable asset allocation of 60 percent equity and 40 percent debt (or any asset allocation in between these bookends for that matter) to derive a customer opportunity cost of capital will produce the same net present value relationships and conclusions between the conventional AFUDC treatment, the "hybrid" treatment that PSE proposes in its filing, and the CWIP in rate base treatment. In other words, conventional AFUDC treatment will always be more costly than the "hybrid" treatment that PSE proposes in its filing and a hypothetical CWIP in rate base treatment across the bookended range of reasonable and prudent asset allocations supported in this testimony.

Q. Are there any other considerations the Commission should evaluate concerning the inclusion of CWIP in rate base?

A. Yes. Whenever a utility is granted CWIP in rate base for a portion of its total CWIP balance, and certain of its CWIP continues to receive AFUDC, the Commission should be concerned about "double-dipping." That is, AFUDC should not be accrued on CWIP that is included in rate base while it simultaneously receives a cash return (under the CWIP in rate base methodology described above). This would result in earning a current cash return, and

simultaneously, accruing AFUDC for an *additional* return in the future—hence, the "double-dip." PSE is not interested in, and wants to provide the Commission assurance that PSE can prevent, such a result.

Q. How can PSE provide the Commission assurance that "double-dipping" will not occur?

A. PSE's Principal Accounting Officer, Stacy Smith, has devised and proffered an improvement and enhancement to PSE's internal control structure to prevent any risk of "double-dipping."

I faced this same concern, earlier in my career, when I was the Chief Financial Officer at American Transmission Company. The Federal Energy Regulatory Commission granted the CWIP in rate base methodology for American Transmission Company, prospectively, meaning all CWIP, at the time of the order, that was accruing AFUDC, would continue to do so until placed in service.[81] At the same time, going forward, future CWIP that was incurred would be included in rate base. It is important to note that American Transmission Company's revenue requirement at the time was forecasted, very similar to the two-year rate plan that PSE proposes in this proceeding. In approving American Transmission Company's proposal, the Federal Energy Regulatory Commission relied heavily on American Transmission Company's testimonial assertion that it

[81] *See Am. Transmission Co. LLC*, 107 FERC ¶ 61,117 (2004).

had improved and enhanced the internal control structure to prevent "double-dipping."[82]

This Commission can also rely on PSE's testimonial assertion, that if its proposal to include a portion of its CWIP in rate base is approved, PSE will improve and enhance its internal control system to prevent this undesirable result. Please refer to the Prefiled Direct Testimony of Stacy W. Smith, Exh. SWS-1T for a description of how PSE proposes to improve and enhance its internal control structure to prevent "double-dipping."

VII. THE COMMISSION SHOULD GRANT PSE'S REQUEST TO INCLUDE A RATE OF RETURN ON POWER PURCHASE AGREEMENTS

Q. What is your understanding of the Commission's ability to include in rates a rate of return on PPAs in an electrical company's clean energy action plan pursuant to RCW 80.28.410?

A. My understanding is that the Commission has the ability to consider and include in rates a return on PPAs for such agreements made in connection with an electrical company's Clean Energy Action Plan ("CEAP") or selected in the company's solicitation of bids for delivering electric capacity, energy, capacity and energy, or conservation.

[82] *See id* at ¶¶ 13-18.

Q. Has PSE requested in this proceeding a rate of return on PPAs made in connection with its CEAP?

A. Yes. PSE witness Susan Free sponsors testimony that includes a rate of return on three separate demand response PPAs that are connected with PSE's current CEAP. More specifically, PSE witness Susan Free includes a rate of return based on PSE's filed pretax rate of return of 7.65% on $16.6 million of aggregate annual qualifying PPA costs for a total requested dollar rate of return of $1.3 million in 2025, the first year of the multiyear rate plan. Likewise, she includes a rate of return based on PSE's filed pretax rate of return of 7.99% on $17.1 million of aggregate annual qualifying PPA costs for a total requested dollar rate of return of $1.4 million in 2026, the second year of the multiyear rate plan. It is noteworthy that the pretax rate of return is different for the two years because PSE has requested a phased-in increase in both its ROE and equity ratio across the two years of the multiyear rate plan. PSE witness Susan Free supports the calculation of the dollar returns for revenue requirement purposes and my testimony supports the use of the pretax rate of return in those calculations

Q. Why is a rate of return based on PSE's pretax rate of return on the aggregate, annual costs of the subject PPAs appropriate?

A. Section (2)(b) of RCW 80.28.410 states: "For the duration of a power purchase agreement [that corresponds to an electrical company's clean energy action plan pursuant to RCW 19.280.030(1)(l)], a rate of return of no less than the authorized cost of debt and no greater than the authorized rate of return of the electrical

company, which would be multiplied by the operating expense incurred under the power purchase agreement [may be considered and included in rates by the Commission].” As a primary consideration, based on the authoritative guidance above, it is appropriate and perfectly acceptable for the Commission to consider approving the use of the pretax rate of return to calculate and include in rates, that rate of return on the subject PPAs because the pretax rate of return is within the range that the Commission may evaluate and ultimately consider for inclusion in rates.

Second, as PSE witness Cara Peterman states in her prefiled direct testimony, and I also state elsewhere in my prefiled direct testimony, PSE is, and has been, experiencing significant and material credit metric degradation due to TCJA and other factors. One of the other factors, is the impact that PPAs and commodity tolling arrangements have on credit metrics. For example, S&P imputes a percentage of the cost of PPAs in its calculation of total debt for credit metric purposes. While Moody’s and Fitch do not take a similar approach to S&P directly, Moody’s will consider PPAs as debt if the full cost of PPAs are not passed on to customers through rates for the duration of the contract or there is risk that the regulator will reject future cost recovery of these contracts if market conditions or future laws requiring these resources change. In this context, including a rate of return on PPAs would, in my professional judgment, be a very favorable, credit supportive policy implementation by this Commission in the eyes of the rating agencies.

Q. Please say more about why you believe allowing rates of return on the subject PPAs and future qualifying PPAs would be viewed as credit supportive by the rating agencies.

A. Let me begin by saying that the Commission's history of consistently including PPAs in rates after prudence determination is impeccable. Further, once a PPA is deemed prudent, this Commission does not have a record of reconsidering and disallowing prospectively the costs of PPAs previously adjudicated as prudent. Clearly, the rigorous prudency evaluation afforded PPAs in this jurisdiction solidifies the regulatory compact—what is approved, has historically stayed approved. Based on the Commission's record in this regard, I remain unconvinced and unpersuaded that the rating agencies have an accurate finger on the pulse of the regulatory economics of PPAs in this jurisdiction. PSE has unsuccessfully challenged the rating agency's perspectives regarding the debt treatment of PPAs in the past but will continue to do so in the future. The costs of PPAs in this jurisdiction, once deemed prudent, are and have been consistently passed through to customers in rates and, based on these economic realities, it is befuddling why the rating agencies would partially or in whole consider the cost of PPAs as debt for credit metric purposes. PSE is a regulated utility with respect to PPAs and is not a power merchant that faces market volatility and related competition daily to recover the costs of its power generation resources. There is a difference and PSE will continue to push its perspectives.

PSE takes seriously its responsibility to manage credit ratings for the benefit of customers under the premise that lower ratings mean higher interest and

borrowing costs and higher rates for customers. Given the degradation of PSE's credit metrics, PSE intends to prospectively challenge the rating agencies treatment of PPAs in credit metric calculations, based on the Commission's historical treatment of PPAs and regulatory economics described above. That said, it must be understood that (1) PSE has not been successful in the regard to date and (2) the rating process is not a negotiation in any sense of the word. PSE does not participate in rating agency credit committee deliberations where the final rating and credit policy determinations (such as treatment of PPAs as debt) are made. It will take strong, compelling arguments to convince the rating agencies why longstanding credit policies relating to PPAs should no longer apply. In this connection, including a rate of return on the subject PPAs would provide a compelling, credit supportive addition to PSE's argument for credit metric relief for PPAs. Further, should the Commission approve this instant request along with the other credit supportive requests PSE has made in this filing, there will be a material improvement in the rating agencies' assessment of the overall credit supportiveness of Washington state utility regulation, which PSE witnesses Cara Peterman, Todd Shipman, and I testify is likely the most important and highly weighted component of the rating agency credit evaluation of PSE and other utilities alike.

Q. How would the inclusion of a rate of return on the subject PPAs be beneficial to customers?

A. Credit ratings and borrowing costs are directly correlated. Maintaining PSE's credit rating through the improvement in metrics and enhancing and improving

the credit supportiveness of Washington regulation can only benefit customers by keeping borrowing costs as low as possible. It is my observation that debt costs do not often receive much attention in GRC proceedings because they are "netted" into the pretax rate of return and included in the revenue requirement via multiplication of the pretax rate of return against rate base. They do not show up in the determination of revenue requirements as a separate, distinct, and transparent cost element. In this connection, the significant cost of long-term debt is one of the largest components of cost included in rates and should not be "lost" in the evaluation of this request. In my professional opinion, including a dollar-value rate of return of $1.3 million in 2025 and $1.4 million in 2026 in rates, based on PSE's filed pretax rate of return is an immaterial price to pay to improve and maintain PSE's credit metric performance, keep the cost of borrowing as low as possible, better position PSE to obtain relief from the present treatment of PPAs in credit metrics, and improve the investment community's regard for the credit supportiveness of Washington regulation.

Q. If the Commission were to determine that PSE's authorized cost of debt is a more appropriate rate of return on the subject PPAs to include in rates (instead of PSE's authorized rate of return) could the policy benefits you describe above still be achieved?

A. Yes, I believe so. Improving and maintaining PSE's credit metric performance, keeping the cost of borrowing as low as possible, better positioning PSE to obtain relief from the present treatment of PPAs in credit metrics, and improving the investment community's regard for the credit supportiveness of Washington regulation could still be achieved at a rate of return equal to PSE's authorized cost of debt. I submit that these potential policy benefits are more important than the ultimate rate of return the Commission approves on the subject PPAs in accordance with the authoritative literature quoted above. Therefore, PSE would be supportive of any rate of return the Commission orders equal to either PSE's authorized cost of debt or its authorized rate of return, or anywhere in between.

Q. Can the Commission link the achievement of these policy benefits to a decision to allow a rate of return on the subject PPA?

A. No, that would be inappropriate. While a decision to allow a rate of return on the subject PPAs would be a meaningful credit positive that would contribute to achievement of the attendant policy benefits, many other factors can and will have an impact on whether the proffered policy benefits are achieved or not. Stated alternatively, a credit negative can and will offset a credit positive within the credit rating process. Further, due to the qualitative aspects of the credit rating

process it would be difficult, if not impossible, to directly attribute any single credit positive or credit negative for that matter, to the achievement (or lack thereof) of the policy benefits proffered above.

VIII. MAINTAINING FINANCIAL STRENGTH UNDER THE DUAL MANDATE

A. Overview of the Two-Year Rate Plan

Q. Please provide an overview of the proposed two-year rate plan.

A. PSE's rate plan is a two-year proposal. The filing includes the development of the test year, pro forma adjustments through December 31, 2023, and rates for the Year One of the two-year rate plan that include plant in service through December 31, 2024. Rates for Year Two of the two-year rate plan include plant projected to go into service through December 31, 2025. PSE is requesting that rates become effective for Year One of the two-year rate plan in early January 2025.

The spending amounts incorporated in the two-year rate plan, beyond the test year and pro forma adjustments, are based on forecasts, and will be subject to refund to the extent the funds are not utilized at an aggregate level. The Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, provides a full description of the two-year rate plan.

Q. Please elaborate on the importance of including in rates the plant that is put in service each year of the two-year rate plan.

A. Over the course of the two-year rate plan, PSE will be making significant capital investments in its system. PSE is projecting capital spending of approximately [redacted] 2023 projected year-end electric and gas rate base. For the initial rate year of a multiyear rate plan, the Commission must, at a minimum, include in rates the plant in service as of the rate effective date.[83] In projecting revenues and operating expenses for Year Two of the two-year rate plan, the Commission "may use any standard, formula, method, or theory of valuation reasonably calculated to arrive at fair, just, reasonable, and sufficient rates,"[84] including the recovery of costs placed in service during the Year Two of the two-year rate plan. This is a key component of PSE's two-year rate plan. Without allowing the recovery of plant placed in service during the rate plan period, PSE would be forced to carry multiple years of investments on its balance sheet without including them in base rates until the next general rate case. Allowing the recovery of plant placed in service during the rate plan period mitigates the structural lag in reflecting investments in rate base, which is a key reason that rating agencies view multiyear rate plans as being more supportive of credit quality.

[83] *See* RCW 80.28.425(3)(b).
[84] *See* RCW 80.28.425(3)(d).

Q. What are the anticipated financial benefits under the proposed rate plan?

A. The proposed two-year rate plan will align with the five-year business plan to allow PSE to maintain access to capital on reasonable terms and continue to deliver on its dual mandate. PSE's proposed two-year rate plan will allow for timely recovery of investments, mitigate regulatory lag, and improve cash flow metrics and financial risk profile. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, in which Ms. Peterman projects that PSE's proposals will raise PSE's cash-flow credit metrics [redacted].

Q. How will the two-year rate plan enable PSE to achieve its commitment to customers?

A. PSE is committed to safety, reliability, and the successful execution of the clean energy transformation, all of which benefit customers. The proposed two-year rate plan will position PSE to achieve these commitments and incorporates necessary flexibility for PSE to meet these multiple ends.

Q. Can you elaborate on the need for flexibility in the two-year rate plan and how this benefits customers?

A. Yes. Over the course of the two-year rate plan, many factors will arise that are outside PSE's control and will cause changes in the final portfolio of projects that are needed to execute on the state objectives for the benefit of customers. It is important for PSE to have financial strength and flexibility so that it can prudently

manage its business and respond to changing conditions and needs as they arise. Although the individual projects or program spending may change due to specific project challenges that arise, the total spend included in the financial forecast should remain within the established budget parameters to deliver the identified benefits to customers. The structure of the two-year rate plan proposed by PSE provides adequate financial resources, while maintaining the flexibility to adapt the project portfolio to changing circumstances as they arise. Please see the Prefiled Direct Testimony of Joshua A. Kensok, Exh. JAK-1CT for a discussion of PSE's long-standing track record of managing budgeted spending to at or near target.

B. Financial Benefits and Effects of the Two-Year Rate Plan

Q. How does the two-year rate plan provide the financial resources needed to execute PSE's business plan?

A. The proposed two-year rate plan mitigates regulatory lag and increases PSE's cash flow, placing PSE more in line with the similarly situated utilities. As discussed in the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, in the past Washington has been more restrictive than other commissions on certain factors, including not permitting full cost recovery through the power cost recovery mechanisms or timeliness of capital cost recovery, and using modified historical test years rather than partially or fully forecast test years. The proposed two-year rate plan aligns PSE better with peer utilities, thereby placing PSE in a

better position to compete for capital with alternative debt and equity investments in the financial marketplace.

The overall level of investment included in the business plan is necessary to maintain performance standards, meet customer needs, and achieve public policy objectives. The programs that are expecting the highest levels of increased spending are related to attaining policy objectives for grid modernization and renewable energy requirements. As discussed by PSE witnesses David J. Landers, Joshua J. Jacobs, and John Mannetti, PSE expects to make investments in foundational technologies that drive data availability, integrity, and granularity essential to planning for and operating distributed energy resources, managing electric vehicle loads, and taking advantage of demand-side resources and non-wires delivery system solutions. New capital investments will require maintenance, leading to increases in fixed operations and maintenance costs. As a result, investments to meet the renewable energy requirements, including in transmission and distribution grid areas, over the next decade will require significant capital.

Moody's has characterized the CETA as a "clean energy bill with aggressive carbon transition targets," further observing that "[c]ompliance with the law will require significant investment and an overhaul of existing state electric infrastructure."[85] The proposed two-year rate plan is designed to enable PSE to

[85] Exh. CGP-9 Moody's Investors Service, *Puget Sound Energy, Inc.*, *Update to Credit Analysis* (Aug. 26, 2021).

have the financial resources needed to make the substantial investments required to meet clean energy targets and other regulatory and policy objectives while maintaining and improving service quality.

Q. Will the proposed two-year rate plan reduce PSE's risks relative to other integrated electric and gas utilities?

A. No. Although the proposed two-year rate plan reduces PSE's risks on an absolute basis compared to the risks that exist under traditional cost of service regulation, it does not reduce PSE's risk profile relative to the other integrated electric and gas utility companies. As discussed in the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, PSE's proposed two-year rate plan allows for an overall regulatory construct that is more consistent with those in place at her proxy group companies. Absent the proposed two-year rate plan, PSE would be exposed to a higher degree of business risks relative to peer utilities. Therefore, the proposed rate plan makes PSE more similar to its peer utilities as it competes with these companies for access to capital on reasonable terms. For PSE, this need to access capital is great in light of the investment needed to serve its customers as a traditional utility while also expediting decarbonization in an equitable manner as a statutory requirement.

Q. Are there ongoing risks to PSE under the proposed two-year rate plan?

A. Yes. While the proposed two-year rate plan is expected to mitigate risks related to cash flow volatility, significant risks remain for PSE. As described in more detail

in the Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-1T, inflation above historical average levels and higher borrowing costs place increased pressure on PSE's financial metrics and cause increased regulatory lag. Absent stepped rate increases to meet these challenges, PSE will not have access to capital and a reasonable opportunity to earn its authorized return.

In addition, if the Commission were to approve the two-year rate plan without PSE's proposed adjustment in the authorized ROE, equity ratio, and CWIP in rate base there is a risk that PSE's rate of return would lag the market and that PSE would not have sufficient cash flows and credit metrics to support its current credit rating and to invest as needed under the dual mandate. The cost of capital has increased for all companies, including electric and gas utilities. Further, the two-year rate plan does not eliminate the risks associated with PSE's capital expenditure plan, which entails challenges associated with permitting, siting, corporate capacity strains, supply chains, capacity, and price increases.

Q. How will the two-year rate plan contribute to PSE's financial strength?

A. PSE has structured the proposed two-year rate plan to reduce cash flow volatility and enable PSE to maintain its cash flow coverage ratios (specifically FFO / Debt) consistent with its current credit rating. This, in turn, will enhance PSE's financial strength and flexibility to make the necessary capital expenditures to continue to provide safe, reliable, and affordable energy services while also investing in the clean energy transition.

As mentioned earlier, credits ratings agencies viewed the Commission's approval of the multiparty settlement in the 2022 general rate case as constructive and credit positive. It is important for the Commission to continue to support the financial strength and flexibility of PSE by approving the proposed two-year rate plan. In its May 2023 credit report for PSE,[86] S&P has indicated that the following factors, among others, could lead to a lower rating for PSE over the next 24 months:

(i)) the regulatory construct in Washington weakens, resulting in increased business risk; or

(ii) PSE cannot earn close to its authorized ROE.[87]

S&P has further indicated that, although less likely, the rating for PSE could be raised over the next 24 months if:

(i) PSE significantly improves its management of regulatory risk, which could manifest as reduced regulatory lag;

(ii) PSE consistently earns at or above its authorized ROE; and

(iii) the Commission continues to implement the regulatory reform measures found in Senate Bill 5295 in a credit supportive manner.[88]

Q. How will PSE's proposed multiyear rate plan improve PSE's cash flow?

A. Each of the below elements of the proposed two-year rate plan would allow PSE to improve its cash flow by approximately:

[86] *See* Exh. CGP-9, Standard & Poor's Global Ratings, *Puget Sound Energy Inc*. (May 11, 2023).
[87] *See id*.
[88] *See id*.

(i) $56 million of additional cash flow from raising PSE's authorized ROE for to 9.95 percent in Year One and to 10.50 percent in Year Two of the two-year rate plan;

(ii) $22 million of additional cash flow from increasing the authorized equity ratio for PSE to 50.00 percent in Year One and to 51.00 percent in Year Two of the two-year rate plan; and

(iii) $22 million of additional cash flow adopting the CWIP in rate base methodology.

Q. Does the two-year rate plan take into consideration the need to limit bill increases, particularly for vulnerable customers?

A. Yes. PSE has designed the proposed two-year rate plan to create a balance between limiting customer bill increases and providing a fair opportunity for PSE to earn a reasonable return and have adequate cash flow and access to capital to meet the dual mandate. As discussed in the Prefiled Direct Testimony of Birud D. Jhaveri, Exh. BDJ-1T, and the Prefiled Direct Testimony of Carol L. Wallace, Exh. CLW-1T, PSE has implemented a low-income Bill Discount Rate and assistance programs that can significantly mitigate the energy burden for low-income energy-burdened customers. PSE's Energy Burden Analysis shows that 44 percent of PSE's residential customers meet the low-income criterion of 200 percent of the Federal Poverty Level or 80 percent Area Median Income ("AMI") (whichever is greater) and are therefore eligible for multiple low-income programs. PSE's new Bill Discount Rate program (which provides low-income discount rates) augments the existing PSE HELP program. Please see the Fourth Exhibit to Prefiled Direct Testimony of Carol L. Wallace, Exh. CLW-5, for a full

suite of seventeen assistance programs offered by PSE. PSE continues to work to improve access to its assistance programs with targeted education and outreach.

PSE works to ensure equitable access to its energy assistance programs. Equity aims to provide equitable distribution of energy benefits and reduce the energy burden of income qualified customers within vulnerable populations and highly impacted communities. This understanding has led PSE to take steps to resolve barriers to entry to these energy assistance programs, for example by prioritizing in person outreach to underserved communities, as detailed in the Prefiled Direct Testimony of Carol L. Wallace, Exh. CLW-1T.

Moreover, PSE has a strong and proven track record of providing energy services in both its electricity and gas operations at a reasonable rate. This is a result of disciplined operational management and cost control by PSE.

For example, PSE's cost of serving electricity increased by an annual average of only 1.46 percent from 2010 ($97.57 per MWh) to 2022 ($116.08 per MWh). This cost increase is significantly lower than average annual inflation over this period, which, itself, was low over the same period. Furthermore, the average monthly bill of PSE's residential electric customers increased from $99.26 in November 2011 to $109.09 in January 2024, an increase of only 0.78 percent annually.

For PSE's gas customers, residential customer bills have declined over the past ten years. Residential gas customers average monthly bill decreased by an annual

average of 1.91 percent—from $89.41 in November 2011 to $70.75 in January 2024.

IX. WILDFIRE INSURANCE

Q. Please discuss the need to include excess general liability insurance for wildfire activities in the Wildfire Tracker.

A. It is necessary for PSE to include excess general liability insurance for wildfire activity in the Wildfire Tracker due to the impacts of increased wildfire activity and losses in the region. The costs to obtain the same levels of insurance have increased exponentially since PSE's last rate case filing. Because insurance markets continue to be volatile, premium increases are difficult to forecast. Notwithstanding PSE's efforts to negotiate favorable rates, premiums for insurance have increased substantially and are likely to continue to increase for the foreseeable future. To manage these premiums and maintain an adequate level of insurance, PSE is requesting the authority to include insurance costs pertaining to wildfire perils in the Wildfire Tracker, for recovery through the tracker. Please see the Direct Testimony of Susan E. Free, Exh. SEF-1T, for PSE's proposed treatment of the insurance deferral through its proposed wildfire tracker.

Q. How has wildfire impacted the insurance market?

A. Wildfires have caused significant damage to communities, as seen in California, Oregon, Maui, and, closer to home, east of the Cascade Mountains. Over the last several years the frequency and scale of wildfires in Washington State has

increased, and PSE has been addressing this increased risk through investments in wildfire specific mitigation activities. Please see the Prefiled Direct Testimony of Ryan Murphy, Exh. RM-1T, for a description of PSE wildfire mitigation activities.

The wildfire activity in PSE's service territory historically has not been as catastrophic as in California, eastern Oregon, or eastern Washington. That said, more and more communities continue to find that their wildfire risk is evolving and increasing due to the ever-changing impacts of climate change on forest health and weather patterns. As wildfire activity has increased, the insurance sector has experienced payouts for wildfire damage that have ballooned into the hundreds of millions. These wildfire losses have exponentially increased the costs and ability to obtain wildfire related insurance coverage.

Q. Please describe the escalating costs of insurance.

A. The significant increases in insurance premiums that PSE is witnessing results from heightened wildfire risk in the Western U.S. due to climate change and chronic drought conditions as well as increased encroachment into wildland areas (Wildland Urban Interface). Insurer capacity restrictions and price escalations continue as severe wildfire activity has affected states outside of California, punctuated by the unexpected and tragic event in Maui and the adverse jury verdict against PacifiCorp for wildfires in Oregon.

As demonstrated in Figure 3 and Table 5 below, PSE's liability insurance costs, remained relatively stable until 2019, when material increases occurred each year from 2019 through 2023, followed by a sharp spike in 2024.

Figure 3. PSE Excess Liability Insurance Premium Trends

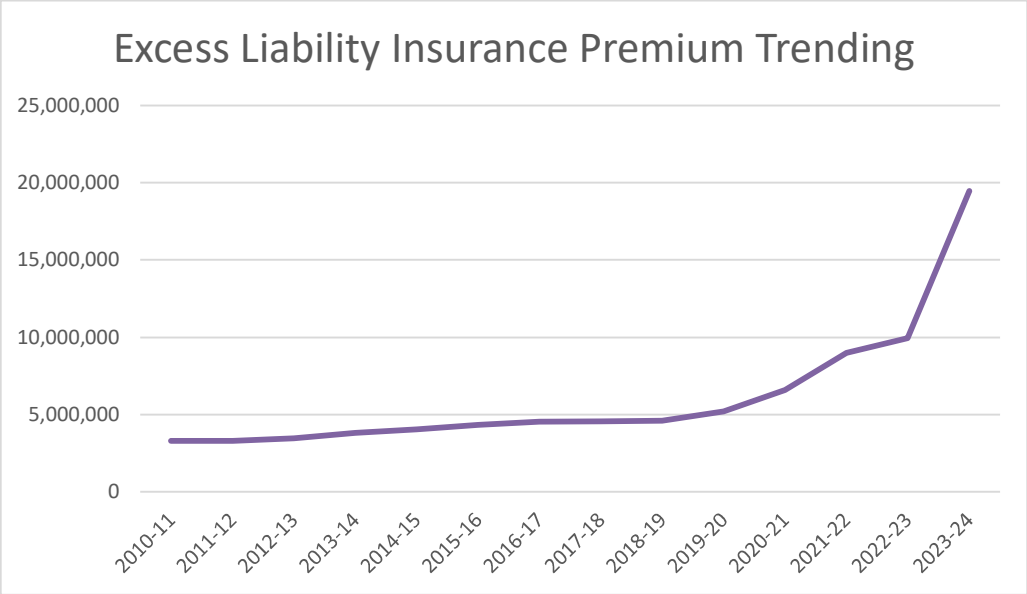

Table 5. PSE Excess Liability Insurance Premiums 2010-2011 through 2023-2024

Policy Year	Total Premiums	% Change
2010-11	3,315,479	
2011-12	3,310,513	-0.1%
2012-13	3,462,013	4.6%
2013-14	3,804,281	9.9%
2014-15	4,037,285	6.1%
2015-16	4,324,202	7.1%
2016-17	4,542,529	5.0%

Table 5. PSE Excess Liability Insurance Premiums 2010-2011 through 2023-2024

Policy Year	Total Premiums	% Change
2017-18	4,557,628	0.3%
2018-19	4,612,126	1.2%
2019-20	5,202,404	12.8%
2020-21	6,591,842	26.7%
2021-22	9,003,630	36.6%
2022-23	9,944,241	10.4%
2023-24	19,470,787	95.8%

As noted in the explanatory memorandum from PSE's insurance broker, increases in liability premiums are largely attributable to the frequency and magnitude of Western-state wildfires in recent years, as well as PSE's specific wildfire risk. Please see the Fifth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-6, for the explanatory memorandum from PSE's insurance broker.

Furthermore, the intensified litigation against other utilities in neighboring regions, including Avista in eastern Washington, Hawaiian Electric on Maui, and PacifiCorp in eastern Oregon, not to mention the litigation prosecuted against utilities in California, illustrates the drastic financial perils that utilities across the country now face. The hundreds of millions of damages awarded against utilities for wildfire losses explains why insurers now have a low appetite to underwrite the risk without substantial premium increases.

Q. How has PSE experienced the turmoil in the insurance industry due to wildlife risks faced by utilities?

A. The increases in PSE's liability policy costs illustrated in Figure 3 and Table 5 above began when one of PSE's insurers pulled out of wildfire-exposed utility business in 2019, due in large part to multiple large wildfire losses it incurred in California. This required PSE to restructure its insurance panel to maintain historical liability insurance coverage limits.

According to their internal risk modeling and underwriting guidelines, insurers began imposing new "wildfire load" surcharges on top of increases to rated premiums to offset some risk presented by utilities with operations in high-risk zones for wildfire. PSE "wildfire load" surcharge has exponentially increased in the past five years.

- PSE's initial wildfire load surcharge was $250,000 for the December 2019-2020 policy term, and
- PSE's wildfire load surcharge had increased to $2,000,000 for the December 2023-2024 policy term.

Altogether, PSE's total premiums increased dramatically for the December 2024-2025 policy term—by an extraordinary 98 percent or $9.6 million above the previous premium period. This was well beyond the premium escalation projected by PSE and was precipitated by the tragic fire in Maui and the verdict in the PacifiCorp proceeding mentioned above.

Contributing to the steep rise in PSE's premiums was the decision of one key mutual insurer decision to reduce wildfire coverage limits available to PSE from $100 million to $50 million. It was extraordinarily challenging for PSE to replace that $50 million of coverage in the commercial marketplace. As a result, PSE was ultimately required to pay much higher pricing to maintain the same coverage as in previous years.

Q. Given the dramatic increases in insurance premiums, does PSE continue to believe that maintaining adequate insurance coverage for all utility risks, including wildfire perils, is in customers' interests?

A. Yes. Notwithstanding the dramatic increases in insurance premiums discussed above, PSE continues to believe that maintaining adequate insurance coverage for all utility risks and, in particular, wildfire perils, is vital and the best interests of both customers and the public. Accordingly, PSE respectfully requests that the insurance deferral described above be included fully in rates across the two-year rate plan proposed in this proceeding.

X. CONCLUSION

Q. Please summarize your primary conclusions and recommendations.

A. The ROE and equity ratio authorized by the Commission in this proceeding must be sufficient to enable PSE to meet its dual mandate of providing safe, reliable, and affordable energy service to customers, while assisting the State of

Washington in achieving the clean energy targets and objectives of the CETA and CCA.

As discussed in this prefiled direct testimony, PSE has proposed the following tools to improve cash flow and facilitate access to capital on reasonable terms:

(i) an increase in PSE's authorized ROE to 9.95 percent in Year One and 10.5 percent in Year Two of the two-year rate plan;

(ii) an increase in PSE's authorized equity ratio to 50.0 percent in Year One and 51.0 percent in Year Two of the two-year rate plan;

(iii) approval of PSE's proposal that the Commission allow CWIP in rate base;

(iv) approval of PSE's three proposed tracker mechanisms;[89]

(v) approval of a hypothetical capital structure for ratemaking purposes, and

(vi) approval of PSE's proposal to earn a return on PPAs.

Q. Does this conclude your prefiled direct testimony?

A. Yes, it does.

[89] For details of the three proposed tracker mechanisms, please see the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, the Prefiled Direct Testimony of Ryan Murphy, Exh. RM-1T, and the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT.