

**EXH. TAS-1T
DOCKETS UE-22 ___/UG-22 ___
2022 PSE GENERAL RATE CASE
WITNESS: TODD A. SHIPMAN**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY,

Respondent.

Docket UE-22 ___

Docket UG-22 ___

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

TODD A. SHIPMAN, CFA

ON BEHALF OF PUGET SOUND ENERGY

JANUARY 31, 2022

PUGET SOUND ENERGY

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PUGET SOUND ENERGY

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1 **PUGET SOUND ENERGY**

2 **PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF**
3 **TODD A. SHIPMAN, CFA**

4 **I. INTRODUCTION**

5 **Q. Please state your name and business address.**

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

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

10 A. Yes. It is Exh. TAS-2.

11 **Q. What are your professional activities?**

12 A. After retiring from S&P Global Ratings (“S&P”), I became a management
13 consultant specializing in advising utilities and other entities on credit and ratings
14 issues, balance sheet management, and capital markets strategies. I served for a
15 time as an adjunct faculty member in Boston University’s Questrom School of
16 Business, where I taught advanced undergraduate courses in corporate finance
17 and capital markets.

18 **Q. Please summarize the purpose of this prefiled direct testimony.**

19 A. Credit ratings provide a valuable benchmark for utility regulators to assist in their
20 decision making by offering an objective perspective on a utility’s risk profile

1 over a long-term time horizon. Ratepayers have an interest in reducing a utility's
2 risk because it directly affects the cost of service that they bear, most directly in
3 the cost of capital but also throughout a utility's operations. A full understanding
4 of credit ratings, the factors that affect ratings, and the significant effect that
5 regulatory decisions and behavior have on ratings will assist the stakeholders in
6 this proceeding achieve an outcome that will benefit ratepayers now and for many
7 years in the future.

8 PSE's credit profile and ratings are stable but under pressure because of cash-flow
9 problems and increasing financial burdens from the state policy to transition to a
10 clean energy future for Washington. Rating agencies are looking for the
11 Washington Utilities and Transportation Commission ("WUTC" or
12 "Commission") to follow through on the promise of lower risk for PSE and its
13 ratepayers that the legislature has initiated. Doing so, by adopting the proposed
14 multi-year rate plan ("MYRP") supported by the authorized return and capital
15 structure in the proposal, will stabilize PSE's credit profile and ratings on behalf
16 of ratepayers. The flexibility inherent in the proposed MYRP and the financial
17 support needed to overcome the stress of rising inflation and increased risk from
18 purchased-power agreements ("PPA") are crucial to PSE's ability to manage the
19 increased risks that the rating agencies and investors foresee.

20 A constructive decision in this proceeding will validate perceptions of positive
21 momentum on risk reduction in Washington and reinforce the leading role that the
22 WUTC is taking in managing the environmental, social, and governance ("ESG")

1 risks that the investment community is increasingly focusing on. The advantages
2 emerging from this proceeding will produce benefits not just for PSE ratepayers,
3 but for all Washington ratepayers and the state as a whole.

4 II. CREDIT RATINGS AND CAPITAL MARKETS

5 **Q. What is a credit rating, and what distinguishes it from other measures of the**
6 **financial condition of a utility?**

7 A. A credit rating summarizes credit risk, which is the ability and willingness of an
8 issuer of fixed income securities to fulfill its contractual financial obligations in full
9 and on time. Ratings address the relative probability that an issuer or an issue will
10 experience default, *i.e.*, the failure to pay either the required periodic payment or
11 the principal when it matures under the terms of the security.

12 Credit ratings reflect a more extended view of financial health than other, more
13 familiar financial measures such as quarterly financial results, earnings-per-share,
14 rate of return for a particular reporting period, and the market prices of a
15 company's securities. Ratings are also an independent opinion offered by firms
16 that have no financial stake in the outcome of its analysis. The long-term and
17 independent nature of credit ratings make them an ideal benchmark to help utility
18 regulators navigate the many decisions they must make as they balance competing
19 interests. As disinterested observers with a long-term mindset, rating agencies are
20 well aligned with the sensibilities of regulators.

1 **Q. What is a credit rating agency?**

2 A. The primary role of a credit rating agency is to provide an assessment of the
3 creditworthiness of a company or a financial instrument to facilitate access to
4 fixed income capital markets at the most efficient cost. The agencies publish
5 analyses of the issuers and issuances to communicate to the market with more
6 detail the nuances of the current ratings, the analysis behind them, and the
7 important factors driving the ratings and that could change ratings. Ratings are
8 expressed in a series of letters, numbers, and/or symbols to encapsulate the
9 relative creditworthiness of the entity or issue. The ratings scales of the two major
10 rating agencies, S&P and Moody's Investor Service ("Moody's"), appear in
11 Exh. TAS-3.

12 Ratings in the BBB/Baa category and above are considered "investment-grade"
13 by market participants. Ratings below BBB-/Baa3 are known as "speculative-
14 grade," or colloquially "junk," securities. Because a significant number of
15 prominent and active investors are precluded from holding speculative-grade
16 issues, the difference between investment-grade and speculative-grade ratings is
17 profound and is recognized as such by rating agencies and market participants.

18 **Q. Are credit ratings a useful and accurate measure of a company's risk profile**
19 **and financial strength?**

20 A. Yes. The risk of default is a good proxy for overall risk and an issuer's financial
21 strength. The default experience of issuers validates the usefulness of credit

1 ratings as a measure of risk. According to Moody's, from 1994 through 2020 the
2 five-year average, volume-weighted corporate bond default rate increases from
3 one rating category to the next lower one in the ratings scale, from a low of 0.4%
4 for the Aaa category to 39.3% for the combined "Caa-C" categories.¹ In other
5 words, the risk to investors gets worse as you go down each step in the rating
6 scale. This track record is the main reason investors pay attention to credit ratings.
7 They have proved to be a reliable and transparent measure of risk over a long
8 period of time.

9 **Q. Who uses credit ratings?**

10 A. Investors use credit ratings when making investment decisions on choosing
11 companies for investment and the price that they will demand to lend to or invest
12 in a company. Ratings are helpful because they are based on a consistent approach
13 to assessing risk across time. Investors generally fall into two basic categories
14 with distinct risk characteristics: fixed-income investors (*e.g.*, lenders or
15 bondholders) that extend capital to a company in exchange for a fixed return and
16 the right to be repaid the original investment, and equity investors that receive
17 only a residual return after all expenses are paid with no ability to force return of
18 the investment. Fixed-income investors use ratings as one (very important)
19 consideration when deciding whether, and at what cost, to lend capital to a utility.

¹ See Moody's Investors Service, *Sector-In-Depth, Default Trends – Global, Annual Default Study: Following a sharp rise in 2020, corporate defaults will drop in 2021*, (Jan. 28, 2021), at Ex. 48.

1 Both fixed-income and equity investors use the credit analyses performed by
2 rating agencies to help them understand the overall risk of an issuer.

3 **Q. How is a credit rating determined?**

4 A. Ratings are established by a committee of analysts that specialize in the industry
5 or industries of the rated entity. When warranted, other analysts with relevant
6 expertise in other areas needed to accurately assess the risk of an issuer will
7 participate in the committee. Ratings conform to common standards of credit risk
8 across all issuers, industries, and markets by employing consistently applied
9 ratings criteria.

10 **Q. What kind of analyses go into a credit rating?**

11 A. The basic analysis is two-fold. The quantitative side of the analysis examines
12 financial ratios and other metrics to analyze the financial risk of the issuer. The
13 qualitative side is the assessment of business risk, which is built up from the broad
14 macro risks at the country and industry level. After the broad risk environment is
15 determined, the committee examines the issuer's individual business risk within
16 that business and economic environment.

17 Business risk and financial risk can be viewed as complementary sides of the total
18 risk of an entity, so that more risk on one side must be offset by less of the other
19 risk to arrive at a particular rating. Because utilities are tightly regulated on
20 financial matters that limit how much financial metrics can vary over time, I have

1 found that it is more often the qualitative business risk analysis that drives ratings
2 outcomes in this industry.

3 **Q. What business risk considerations constitute the qualitative side of credit**
4 **analysis?**

5 A. For a utility, the main business risks are regulatory risk, operating risk, and cash-
6 flow diversity. The first, regulatory risk, is *the* major factor in the analysis.
7 Evaluating regulatory risk almost invariably circles back to cost recovery, notably
8 full recovery of a utility's cost of capital through a reasonable authorized return
9 on equity. The nature and pace of the process of recognizing an incurred cost as
10 recoverable through rates is the paramount business-risk factor for a utility credit
11 analyst. The other elements of regulatory risk, such as the political influences on
12 regulation, are analyzed to discern the risk surrounding the ultimate factor of
13 covering all costs sufficiently to earn a reasonable return on investment.

14 **Q. How is regulatory risk analyzed?**

15 A. In the Moody's methodology for utilities, regulatory risk constitutes over 80
16 percent of business risk, and for S&P, it is 60 percent.² Each focuses on the basic
17 regulatory framework, including (1) the legal foundation for utility regulation, (2)
18 the ratemaking policies and procedures that determine how well the utility is
19 afforded the opportunity to earn a reasonable return with a reasonable cash
20 component, and (3) the history of regulatory behavior by the governing bodies

² Moody's, *Rating Methodology, Regulated Electric and Gas Utilities*, (Sept. 10, 2020), at 4; S&P, *Criteria | Corporates | General: Corporate Methodology* (May 27, 2021), at 22 (Table 12).

1 applying those laws, policies and procedures. Then they examine the mechanics
2 of regulation, particularly the rate-setting process.

3 **Q. After the broad framework is analyzed, how is regulatory risk determined?**

4 A. Rating agencies examine the mechanics of regulation, particularly the rate-setting
5 process, as they refine their view of regulatory risk. Rate cases take up much of
6 the analysis, but the totality of a utility's tariff schedule is assessed to capture the
7 effect on business risk of revenues generated outside base rates. Creditors, and
8 therefore rating agencies, attribute less risk to tariff provisions that operate outside
9 the rate case cycle and adjust rates automatically or with some flexibility to match
10 revenues with expenses, thereby minimizing regulatory lag. Decoupling
11 mechanisms, fuel clauses, and other varieties of riders prevail across the utility
12 industry and are the most common kind of rate mechanisms that stabilize earnings
13 and cash flows to the benefit of the business risk profile.

14 **Q. Are the framework and the mechanics of regulation the only considerations**
15 **that go into determining regulatory risk?**

16 A. No. Rating agencies also look holistically at the consistency and transparency
17 displayed in a regulatory jurisdiction.³ Rating agencies rate many types and tenors
18 of fixed income securities, but they regard debtholders who extend credit over
19 long periods as their primary audience and strive to rate long-term debt as

³ Moody's, *Rating Methodology*, at 4; S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments* (May 18, 2015), at 2.

1 accurately as possible over the longest timeframe as possible. Utilities ultimately
2 fund capital expenditures with long-dated maturities to match the long-lived
3 assets they are supporting, and utility investors value ratings that are forward-
4 looking and stable. Regulatory frameworks and practices that allow rating
5 agencies to confidently project future cash flows and debt leverage will naturally
6 be accorded a better business risk profile. This predictability offers creditors the
7 ability to assess risk accurately over most of the debt's term and improves the
8 ability of the company to manage its business activities and capital program for
9 the long-term benefit of its customers.

10 **Q. How do credit ratings and actions affect a utility and its customers?**

11 A. The most immediate effect is on a utility's cost of capital. Fixed-income investors
12 and other creditors consult ratings to assist them in determining the price they will
13 charge the utility for the use of their money. The total price is the combination of
14 the interest rate of the instrument and its initial value in relation to the stated
15 amount on the instrument. There is an inverse relationship between debt cost and
16 ratings: the higher the rating, the lower the cost. Equity investors (that is,
17 stockholders) also use credit ratings as a risk guide to help them decide when and
18 how they will offer their capital to a utility. The more risk they detect, the greater
19 return they will require to compensate them for bearing that risk. The effect is not
20 as direct or precisely quantifiable as it is with fixed-income instruments, but in my
21 experience equity investors often take notice of credit ratings and react to ratings
22 upgrades and downgrades.

1 **Q. How does regulation influence the credit rating of a utility?**

2 A. Regulatory behavior acts on both sides of the credit rating equation. The manner
3 of establishing rates and the level and timing of cost recovery has a direct effect
4 on a utility's ability to earn its authorized return on equity ("ROE") and produce
5 enough earnings and cash flow to support its credit metrics and ratings. A fully
6 compensatory rate of return, including a capital structure that offers more risk
7 protection to bondholders and other creditors, are features of a credit-supportive
8 regulatory environment. Further, the same regulatory actions that affect a utility's
9 ability to earn a competitive ROE also have a compounding effect on business
10 risk, magnifying the ratings impact of regulatory decisions and behavior that fall
11 outside expectations or norms.

12 **Q. Does any aspect of the regulatory process and decision-making exert an**
13 **especially strong influence on a utility's credit rating?**

14 A. Yes. Rate cases are monitored by investors, and the authorized ROEs and the
15 approved capital structure that are included in a rate decision are used as
16 bellwethers in assessing regulatory risk in addition to their importance in
17 forecasting financial performance. From the standpoint of fixed-income investors
18 and the credit metrics they surveil, those two elements of the revenue requirement
19 calculation have an obvious impact. More supportive determinations of those
20 inputs give a utility a better chance to earn its cost of capital and provide more
21 operating cash flow to support credit quality.

1 From the financial markets' perspective, the authorized ROE is the most
2 prominent feature of a rate case decision after the amount of the revenue
3 requirement increase or decrease. The authorized ROE conveys the regard that the
4 regulator has toward the investors that are furnishing the capital needed to
5 maintain safe and reliable utility service and achieve other public policy goals. An
6 in-depth analysis of all aspects of the rate decision is required to understand fully
7 the ratings implications of the outcome and assess the utility's ability to earn its
8 return in the wake of the decision. However, the authorized return is widely used
9 by investors to make preliminary judgments about the relative supportiveness of a
10 regulatory jurisdiction. As such, it is an important signaling device to the
11 investment community and can affect the cost of capital and customer utility rates
12 over the long-term.

13 **Q. Why are both ROE and the capital structure important?**

14 A. For fixed-income investors, the equity component in the approved capital
15 structure takes on added importance, as the utility will be constrained in managing
16 its balance sheet by the regulatory capital structure. The utility has no incentive to
17 inject more equity capital to support credit quality and improve ratings than the
18 amount the regulator deems sufficient for ratemaking purposes. The ROE/equity
19 ratio combination is an effective communication tool to underscore a regulator's
20 interest in attracting capital to provide safe, reliable and innovative utility service
21 in a jurisdiction.

1 Together, the authorized ROE and the common equity component of the capital
2 structure exercise considerable influence on the rating agencies' perceptions of
3 regulatory risk and therefore on credit quality. As noted earlier, the two have a
4 direct effect on cash flow and credit metrics. In addition, the setting of the two
5 combine to shape opinions in the investment community of the overall regulatory
6 environment for utilities. Thus, the ROE and capital structure decisions touch
7 both the qualitative and the quantitative aspects of credit analysis (see
8 immediately below). The effect of a regulator's ROE and capital structure
9 decisions on ratings is closer to exponential rather than linear and reinforces the
10 importance of the decisions, positively or negatively, on a utility's cost of capital.

11 **Q. Will the ROE and capital structure determinations in this proceeding carry**
12 **the same degree of importance to the rating agencies?**

13 A. No. The ROE and capital structure decisions will attract *more* attention than they
14 would in a typical rate case. PSE is authorized and earns returns that are sub-par
15 in the opinion of the rating agencies, so restoring its ability to earn returns in line
16 with its ratings will be a major consideration in future ratings decisions by the
17 rating agencies. Further, the core issue behind the Company's weak credit
18 metrics—the cash-flow shortfalls arising from tax reform—is often remedied
19 through thicker equity ratios. A stronger capital structure for PSE that is
20 specifically targeted to offset cash-flow problems would signal to the rating
21 agencies that supporting PSE's credit quality is a shared goal of the Company and
22 its regulators.

1 **Q. Why do you think PSE's ROE is deficient?**

2 A. In addition to how PSE stacks up poorly compared to peers, which is covered in
3 other testimony,⁴ the rating agencies cite this factor in their credit reports on the
4 Company. Moody's noted it in their review of the 2020 rate decision ("[t]he
5 commission also authorized a below industry average return on equity of
6 9.4%..."⁵). S&P focuses more on PSE's earned returns in its analysis and cites as
7 a key risk the "[h]istorically challenging regulatory environment in Washington"⁶
8 that in its downside ratings scenario would manifest as "inhibit[ing] the utility's
9 ability to earn close to its authorized return on equity."⁷ From a broader
10 perspective, the arm of S&P apart from the ratings business that evaluates utility
11 regulation for investors finds that "[r]ecent authorized equity returns generally
12 have been below industry averages at the time of adoption."⁸

13 **Q. How will the capital structure decision factor into the rating agencies' views**
14 **of PSE's regulatory risk and ratings coming out of this proceeding?**

15 A. The signaling effect of the thickness of the equity ratio is just as powerful as the
16 authorized ROE's effect, although it often gets overlooked. For PSE, it takes on
17 added weight because of its struggles with cash flow in recent years. The lean

⁴ See Prefiled Direct Testimony of Kazi K. Hasan, Exh. KKH-1T; Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T.

⁵ See Ninth Exhibit to the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-10.

⁶ S&P, *Puget Sound Energy Inc.* (March 24, 2021), at 3.

⁷ *Id.* at 4.

⁸ S&P Capital IQ, Regulatory Research Associates, <https://www.capitaliq.spglobal.com/web/client?auth=inherit#industry/commissiondetails?ID=4081515&Type=1&State=WA> (Last accessed Jan. 19, 2022). This is part of a licensed subscription service subject to copyright protection but will be made available for review upon request pursuant to WAC 480-07-510(i)(iii).

1 cash flows arising from the effects of tax reform and the 2020 rate decision have
2 depressed credit metrics and pressured the PSE credit profile, as I explain in the
3 next section of my testimony. A stronger capital structure, with its conspicuous
4 injection of equity capital to reduce the risk profile, is one of the most effective
5 ways to allay concerns of rating agencies and investors by demonstrating
6 regulatory support of a utility's financial integrity.

7 **Q. How do you know the rating agencies would respond favorably to adoption**
8 **of PSE's proposal to improve its capital structure?**

9 A. In the commentaries when first reacting to tax reform, Moody's and S&P offered
10 examples of the types of regulatory actions that could mitigate the effect on credit
11 quality. More equity in the capital structure is prominent among the constructive
12 steps they offered as examples.⁹

13 **Q. What financial considerations constitute the quantitative side of credit**
14 **analysis?**

15 A. Credit analysis is distinguished by its emphasis on cash flow. Recognizing that
16 debt is serviced with cash, not earnings, credit analysts strive to understand the
17 cash-flow dynamics of a company's financial results as much as or more than the
18 accounting-derived earnings. The most recent example that highlighted this
19 dichotomy is the effect of the Tax Cut and Jobs Act of 2017 ("TCJA") on utilities,

⁹ Moody's, *Rating Action: Moody's changes outlooks on 25 regulated utilities primarily impacted by tax reform* (Jan. 19, 2018), at 1; S&P, *U.S. Tax Reform: For Utilities' Credit Quality, Challenges Abound*, (Jan. 24, 2018), at 4.

1 which placed downward pressure on utility ratings because of its negative cash-
2 flow impact despite relatively neutral earnings implications. In the case of PSE,
3 TCJA has reduced cash flows annually by approximately \$149 million,¹⁰ which
4 has and will continue to depress the most important cash flow credit metrics.

5 The primary measure that rating agencies use as a base for most cash-flow metrics
6 is cash flow from operations (“CFO”) or some derivation of it.¹¹ The other major
7 element of financial risk to a credit analyst is the total amount of debt or debt-like
8 obligations on the issuer’s balance sheet and from other activities. Items that the
9 rating agency regards as debt-like are underfunded pension obligations, lease
10 liabilities, long-term power purchase obligations, and deferred taxes.

11 Credit metrics are calculated for both historical periods and future forecasts and
12 fall into two basic types: leverage and coverage ratios. Since ratings are forward-
13 looking, the forecast is given more weight in the analysis. Leverage metrics
14 attempt to assess the relative burden of debt and other fixed-income obligations
15 compared to the financial responsibility being carried by shareholders. Coverage
16 metrics are something of the opposite, gauging the more immediate question of
17 how cash flow compares to the need to service the fixed-income obligations in the
18 near term.

¹⁰ See Prefiled Direct Testimony of Matthew R. Marcellia, Exh. MRM-1T.

¹¹ For Moody’s it is called “CFO pre-working capital-to-debt.” S&P has a similar measure, called “funds-from-operations,” or FFO, which they also compare to the overall debt burden.

1 **III. THE COMPANY’S RATINGS AND OUTLOOK**

2 **Q. What are Puget Sound Energy’s (“PSE” or “Company”) credit ratings?**

3 A. I focus on those of the primary rating agencies with the broadest global reach,
4 Moody’s and S&P. They issue ratings that investors rely on the most. Moody’s
5 affirmed its issuer rating on PSE, ‘Baa1’, in 2020.¹² S&P’s issuer rating on the
6 Company is ‘BBB’.¹³ Both rating agencies carry stable outlooks on PSE, although
7 S&P’s was only changed from a negative outlook this year in the wake of the
8 promise of Senate Bill 5295 (SB 5295) to stem the perception of eroding
9 creditworthiness.¹⁴ The fundamental opinions of PSE’s creditworthiness are
10 identical, which is reflected in the S&P stand-alone credit profile (“SACP”) of
11 ‘bbb+’.¹⁵ The SACP is comparable to the Moody’s approach to rating an issuer
12 with less emphasis on the influence of the corporate structure.¹⁶ The short-term
13 ratings are equivalent (‘A-2’/‘P-2’).

14 **Q. What are the main drivers of the rating agencies’ opinions of PSE’s credit**
15 **quality?**

16 A. The BBB/Baa1 view of PSE’s credit profile and the expected stability are
17 grounded in analyses that (1) overlook some near-term weaknesses in favor of

¹² Peterman, Exh. CGP-10 (Moody’s, *Rating Action: Moody’s affirms the ratings of Puget Energy and Puget Sound Energy; outlooks stable* (Aug. 25, 2020)).

¹³ S&P, *Puget Sound Energy Inc.* (Mar. 24, 2021).

¹⁴ Peterman, Exh. CGP-10 (S&P, *Research Update: Puget Energy Inc. And Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation: Ratings Affirmed* (May 27, 2021)).

¹⁵ S&P, *Puget Sound Energy Inc.* at 9.

¹⁶ The SACP is an intermediate determination in S&P’s ratings methodology that signifies what an issuer’s rating would be absent extraordinary parental support. S&P, *General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating*, September 25, 2020.

1 expectations that the causes of the weaknesses are transitory and (2) assume the
2 WUTC will follow through on the credit-positive framework that the legislature
3 has crafted in recent years to ease the transition of the energy infrastructure in the
4 state. Once the lingering concerns of those weaknesses are resolved, I believe the
5 rating agencies will then pivot to concentrating on the longer-term issue of the
6 pressure that the energy transformation in Washington will put on utility credit
7 quality as more capital is required to execute that transformation.

8 **Q. What are the near-term weaknesses, and why are they considered to be**
9 **temporary?**

10 A. The primary weaknesses cited by Moody's appear on both sides of the risk
11 equation that I discussed in my explanation of credit ratings in the previous
12 section. Moody's regards PSE's credit metrics as weak for its ratings and expect
13 them to remain so over the ratings horizon.¹⁷ It is a testament to the long-term
14 nature of ratings that I reference as an essential feature of agency opinions on
15 credit quality that Moody's has been patient on PSE's financial performance. The
16 key to that patience is tied to the other weakness that Moody's sees in the
17 Company's credit profile: the inconsistency in the regulatory treatment it has
18 experienced.¹⁸ They expect the drag on the credit metrics and overall regulatory
19 risk to abate. As stated in their analysis when affirming ratings in 2020, "[t]he
20 stable outlook reflects our expectation that this financial weakness will be

¹⁷ Peterman, Exh. CGP-10 (Moody's, *Credit Opinion, Puget Sound Energy, Inc., Update to credit analysis* (Aug. 26, 2021)).

¹⁸ *Id.*

1 temporary and that regulatory support for the utility will improve once the
2 pandemic passes and the economy recovers.”¹⁹

3 S&P’s focus is more on the qualitative side of the ratings analysis, and in
4 particular PSE’s regulatory risk. Its unease with this side of the risk analysis,
5 which recall exerts more influence on the risk profile of a utility than the financial
6 side, is discerned in S&P’s use of a modifier in its analysis that drops the PSE
7 stand-alone credit profile out of the equivalent of an ‘A’-category rating.²⁰ Since
8 the Company’s credit metrics amply support the credit profile, the only reason
9 S&P would invoke that negative “comparable ratings analysis” modifier is
10 considerable doubts on the strength of its regulatory risk. Like Moody’s, only
11 more so, S&P is relying on progress in reducing regulatory risk. The S&P ratings
12 affirmation and return to a stable outlook earlier this year was clear on this
13 point.²¹

14 **Q. What follow through do you think the rating agencies are factoring into**
15 **current ratings and outlooks?**

16 A. My read on the rating agencies’ inflection point on their confidence in the PSE
17 credit profile is the outcome of this proceeding. As S&P stated when announcing
18 the revised outlook in May:

19 We expect Puget will file its first MYRP in January 2022, with new
20 rates effective the following year. Under the new legislation, utilities
21 must file an MYRP between two and four years long. We expect the

¹⁹ Peterman, Exh. CGP-10 (Moody’s, *Rating Action*, (Aug. 25, 2020), at 1).

²⁰ S&P, *Puget Sound Energy Inc.*, (Mar. 24, 2021), at 9.

²¹ Peterman, Exh. CGP-10 (S&P, *Research Update* (May 27, 2021), at 1).

1 commission will approve the MYRPs, reducing regulatory lag and
2 cash flow volatility. Furthermore, power costs are trued-up after the
3 second year, improving cash flow predictability. *We believe*
4 *Washington's new law, predicated on the commission implementing*
5 *it in a credit supportive manner, could improve the regulatory*
6 *environment.*²²

7 The S&P stable outlook assumes improving financial measures,²³ along the same
8 lines as Moody's expectations. While the two rating agencies stress different
9 aspects of the two-sided ratings analysis, one the qualitative side and the other the
10 quantitative side, I think it reinforces my contention that the interaction of the two
11 is key to understanding the ratings dynamic. Any improvement in regulatory risk,
12 which is the main component of a utility's business risk, will tend to also result in
13 better financial performance. By concentrating on controlling risk, the WUTC can
14 provide the tools to PSE to help it manage regulatory risk and strengthen its credit
15 metrics that will lead to a better credit profile and keep credit ratings stable.

16 **Q. Are there issues in this case that the rating agencies will focus on as they**
17 **review PSE's risk profile?**

18 A. Yes. Paramount among them are the ROE and capital structure, for the reasons I
19 cited in the discussion above on regulatory risk. Additionally, based on my
20 experience as a ratings analyst I have identified two other issues that will draw the
21 attention of the rating agencies as this proceeding unfolds. Resolving them in a
22 credit-supportive manner will remove some of the lingering doubts the agencies
23 have about the PSE rating. The first is the important task of effectively

²² *Id.* (emphasis added).

²³ *Id.* at 2.

1 implementing the proposed MYRP which includes reflecting plant in service as of
2 January 1, 2023, to reduce regulatory lag. The second is the regulatory treatment
3 of PPAs.

4 IV. MULTIYEAR RATE PLANS AND RATINGS

5 **Q. Why is the MYRP implementation so important to the rating agencies’
6 perception of regulatory risk in Washington?**

7 A. Implementation of the multi-year rate plan is important as a general matter
8 because the promise of lower risk can turn into the opposite if the details are not
9 attended to. It is also important in this situation because the rating agencies have
10 placed inordinate emphasis on the MYRP as a pathway to better risk management
11 for PSE. This is evident in the excerpt from the latest S&P credit report quoted
12 above.²⁴ Moody’s, too, in its latest credit report cites the potential for well-
13 designed MYRP to “enhance the consistency and predictability of utility
14 regulation.”²⁵ Those two principles form the bedrock for evaluating regulatory
15 risk from a ratings perspective.²⁶

16 **Q. How do the rating agencies analyze the risk of a MYRP?**

17 A. The agencies recognize the two-edged-sword nature of setting rates for multiple
18 years in their ratings methodologies. Depending on the regulator’s approach, a

²⁴ See S&P, *supra* note 13.

²⁵ Moody’s, *Credit Opinion* (Aug. 26, 2021), at 5.

²⁶ Moody’s, *Rating Methodology*, at 4; S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, at p.2.

1 MYRP can either reduce or exacerbate regulatory lag. Regulatory lag arises from
2 a mismatch between a utility's rates and its costs. Addressing the issue of
3 regulatory lag is the surest way to improve regulatory risk for a utility because it
4 dampens cash-flow volatility and improves cash-flow generation. Regulatory lag
5 is normally a matter of rate-setting mechanics: how rate cases are filed,
6 conducted, and completed will determine whether rates are based on the most
7 current and accurate set of cost inputs. Introducing a multi-year concept into the
8 process is nominally something that would worsen risk due to the inherent
9 inflexibility of fixing rates over a long period with no ability to revisit them. Thus,
10 preserving some flexibility that accompanies the positive risk attributes of a
11 MYRP (performance incentives and the like) is key to managing the risk.

12 **Q. How do you know the rating agencies view a MYRP with some reservations**
13 **about their risk?**

14 A. You can find it in their rating methodologies and criteria. Moody's discussion on
15 the topic is contained in a ratings factor called "Ability To Recover Costs And
16 Earn A Return."²⁷ Moody's looks for:

17 provisions and cost recovery mechanisms for operating costs,
18 mechanisms that allow actual operating and/or capital
19 expenditures to be trued-up periodically into rates without
20 having to file a rate case (this may include formula rates, rider
21 and trackers, or the ability to periodically adjust rates for
22 construction work in progress) as well as the process and
23 timeframe of general tariff/base rate cases –those that are fully
24 reviewed by the regulator, generally in a public format that
25 includes testimony of the utility and other stakeholders and

²⁷ Moody's, *Rating Methodology*, at 12.

1 interest groups. We also look at the track record of the utility
2 and regulator for timeliness. For instance, having a formula
3 rate plan is positive, but if the actual process has included
4 reviews that are delayed for long periods, it may dampen the
5 benefit to the utility. In addition, we seek to estimate the lag
6 between the time that a utility incurs a major construction
7 expenditure and the time that the utility will start to recover
8 and/or earn a return on that expenditure.²⁸

9 Moody's does not define what it means by formula rates, but it is clear in context
10 it is referring to setting rates outside of a general rate case, much like the MYRP
11 proposed by PSE. S&P couches its criteria in similar terms, where it appears
12 under two "pillars": "[t]ariff-setting procedures and design-recoverability of all
13 operating and capital costs in full" and "[f]inancial stability-timeliness of cost
14 recovery to avoid cash flow volatility".²⁹ The financial stability pillar also
15 highlights the flexibility that I assert is crucial to contain utility risk.³⁰ S&P
16 expounds on the risk of a MYRP, which it regards as a species of incentive
17 regulation, in a separate commentary that stresses the need for symmetry and a
18 design that limits any divergence between revenues and costs.³¹

19 **Q. Does the WUTC have the ability to consider risk-reducing flexibility in**
20 **approving a MYRP for PSE?**

21 A. Yes. The legislation that provides for MYRPs can help reduce regulatory lag,
22 according to Moody's.³² An example of built-in flexibility that reduces risk is to

²⁸ *Id.*

²⁹ S&P, *Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry* (July 7, 2021), at 3.

³⁰ *Id.* (under a sub-factor called "Flexibility to allow for recovery of unexpected costs if they arise").

³¹ S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, at 3-5.

³² Peterman, Exh. CGP-10 (Moody's, *Credit Opinion* (Aug. 26, 2021), at 5).

1 start with the most current and accurate rate base (adjusted for plant in service as
2 of January 1, 2023) and then reflect *pro forma* rate base additions in each year of
3 the plan, as explained in the Prefiled Direct Testimony of Susan E. Free, Exh.
4 SEF-1T. The legislation contemplates that kind of flexibility.³³ I encourage the
5 parties to incorporate as much flexibility as possible in the MYRP to promote the
6 financial integrity of PSE while the plan is in effect.

7 **Q. Does the current macroeconomic environment affect your views on the**
8 **imperative for flexibility in the MYRP?**

9 A. Yes. The actions the Federal Reserve is contemplating in response to
10 macroeconomic trends, in particular the rising risk of elevated inflation, makes
11 the need for MYRP flexibility all the more acute. Inflation above a nominal
12 degree taking hold in an economy places enormous risk on regulated utilities.

13 **Q. What developments in the U.S. economy and Federal Reserve policy are you**
14 **referring to?**

15 A. In its latest communications, the Federal Reserve has signaled a greater
16 willingness to raise interest rates and unwind some of the extraordinary measures,
17 such as expanding its balance sheet with purchases of financial assets, that have
18 been the hallmark of monetary policy in the aftermath of the 2008-2009 economic
19 crisis.³⁴ In my opinion, these extraordinary measures have injected and

³³ RCW 80.28.425(3).

³⁴ Federal Reserve, *Federal Reserve issues FOMC statement*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Dec. 15, 2021), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20211215a.htm>.

1 maintained elevated levels of capital market risk that will become more evident as
2 the Federal Reserve attempts to extricate itself from the unique position in which
3 it has left itself.³⁵ The cause of the change in the Federal Reserve’s thinking is the
4 worst inflation picture since the early 1980s. The annual inflation rate in the U.S.
5 hit 6.8 percent in November 2021.³⁶ According to S&P in its latest overview of
6 credit conditions in the U.S., their overall favorable view is clouded by a high risk
7 of inflation: “As persistent price pressures combine with continued supply
8 constraints, investors could soon demand significantly higher returns for the risks
9 they’re assuming because of fears of runaway inflation, escalating credit
10 concerns, or an unexpected adverse event....”³⁷

11 **Q. Why is inflation peculiarly harmful to regulated utilities?**

12 A. Regulatory lag. As damaging as regulatory lag is under mildly inflationary
13 economic conditions, continued inflation at today’s levels would be absolutely
14 devastating to utility credit quality. Unregulated firms in general have the ability
15 to contemporaneously pass higher costs to consumers as inflation builds. A utility
16 can be faced with a situation where its costs significantly diverge from the levels
17 that rates are based upon, leading to persistent and widening underearning and
18 cash flow problems. If this coincides with a period of high capital spending, such

³⁵ For instance, the Federal Reserve balance sheet now sits at almost nine trillion dollars, more than double the size of pre-pandemic asset holdings that were already over four times the size of the balance sheet that existed before the 2008-2009 recession. Federal Reserve Bank of St. Louis, *Assets: Total Assets: Total Assets (Less Eliminations from Consolidation)*, FRED (last visited Dec. 30, 2021), <https://fred.stlouisfed.org/series/WALCL>.

³⁶ U.S. Bureau of Labor Statistics, *TED: The Economics Daily* (Nov. 15, 2021).

³⁷ S&P, *Global Credit Outlook 2022: Aftershocks, Future Shocks, and Transitions | Credit Conditions North America: As Recovery Rolls On, Inflation Risks Remain* (Dec. 1, 2021), at 66.

1 as we are now experiencing as the clean energy transition is unfolding, the
2 inflationary pressures compound as spiraling input costs combine with ongoing
3 regulatory lag to outpace the ability of the utility to accurately reflect the costs in
4 rates.

5 **Q. As you noted, it has been decades since inflation has been an issue. How can**
6 **you be confident it would affect utilities like PSE?**

7 A. I experienced the phenomenon first-hand. I initially followed the industry in the
8 mid-1980s as a regulatory analyst at a firm that provided research on utility
9 regulatory developments to the investment community. I reported and analyzed
10 rate case decisions and other regulatory behavior at the tail end of the era of high
11 inflation and double-digit interest rates. Capital expenditures were high due to a
12 peak in the generation construction cycle that was exacerbated by inflationary
13 pressures. In some cases, utilities were forced to “pancake” rate filings—that is,
14 file a new case while the previous one was still in process—in a futile attempt to
15 overcome regulatory lag. The concern about inflation has also captured the
16 attention of rating agencies. For instance, S&P published a report in 2021 entitled
17 “Will Rising Inflation Threaten North American Investor-Owned Regulated
18 Utilities’ Credit Quality?” and answered in the affirmative.³⁸ S&P listed a few
19 utilities that were more susceptible to inflation risk and included PSE, saying

³⁸ S&P, *Will Rising Inflation Threaten North American Investor-Owned Regulated Utilities’ Credit Quality* (July 20, 2021), at 5.

1 “inflation combined with regulation [sic] lag could lead to a weakening of credit
2 quality.”³⁹

3 **V. PURCHASED POWER AGREEMENTS AND RATINGS**

4 **Q. How are the risk of PPAs regarded by rating agencies?**

5 A. While the rating agencies recognize that PPAs can mitigate some risks, on
6 balance they mostly view PPAs as risk-additive for vertically-integrated electric
7 utilities. S&P explicitly adjusts reported financial information to account for the
8 added risk of PPA obligations when they are “very material,”⁴⁰ and in fact they do
9 so for PSE.⁴¹ Moody’s also analyzes PPA obligations in its rating process: “PPAs
10 are recognized qualitatively to be a future use of cash whether or not they are
11 treated as debt-like obligations in financial ratios.”⁴² I understand that Moody’s
12 analysts regularly look at financial metrics with and without a PPA adjustment as
13 part of the review of a utility to assess the financial effect of the obligation,
14 regardless of whether a formal adjustment is made.

15 **Q. What are the implications of PPA obligations to the credit profile of PSE?**

16 A. Since the fixed, long-term obligation that most PPAs impose on a utility act as a
17 damper on the PSE credit profile, either qualitatively or quantitatively or both,

³⁹ *Id.* at 5.

⁴⁰ S&P, *Guidance | Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments* (June 7, 2021), ¶ 190.

⁴¹ S&P Capital IQ, *Puget Sound Energy, Inc.*, CREDITSTATS DIRECT (last visited Jan. 6, 2021), <https://www.capitaliq.com/CIQDotNet/Financial/BalanceSheet.aspx?CompanyId=1779517&mode=creditstatsdirect>.

⁴² Moody’s, *Rating Methodology*, at 42 (Appendix E).

1 actions to counteract that effect are necessary to preserve credit quality and
2 ratings. A standard pathway for restoring the credit profile is to strengthen the
3 capital structure, which PSE is proposing in this case.⁴³ Allowing a return to be
4 earned on PPAs (as provided in RCW 80.28.410) would be another effective tool
5 to promote ratings stability. The rating agencies would view that favorably, as
6 well as the signal that it would send that preserving utility credit quality is a
7 crucial piece of the state's overall effort to modernize its energy economy.

8 **VI. THE WASHINGTON REGULATORY ENVIRONMENT**

9 **Q. How do investors and rating agencies view the regulatory environment in**
10 **Washington state?**

11 A. The rating agency that publishes regulatory rankings, S&P, regards Washington
12 as being about average among U.S. and Canadian jurisdictions.⁴⁴ Consistent with
13 its outlook on PSE, S&P moved the state into the middle of its assessments of
14 regulatory jurisdictions in its latest review:

15 We revised our regulatory jurisdiction assessment on
16 Washington state to very credit supportive from more credit
17 supportive. This reflected our view that the Washington
18 regulatory construct has strengthened. Gov. Jay Inslee
19 recently signed Senate Bill (SB) 5295 into law. It includes
20 the mandatory filing of multiyear rate plans and
21 performance-based rate making that we view as credit
22 supportive. We expect the multiyear rate plans will enable
23 utilities to reduce regulatory lag and smooth cash flow
24 volatility. Utilities now must file a multiyear rate plan that
25 is in place from two to four years. Furthermore, power
26 costs may be trued-up after the second year, improving

⁴³ Hasan, Exh. KKH-1T.

⁴⁴ S&P, *Updated Views On North American Regulatory Jurisdictions - June 2021* (June 29, 2021).

1 cash flow predictability. We view this as a more credit
2 supportive tariff-setting design. Recoverability of operating
3 and capital costs could improve long-term capital
4 attraction.⁴⁵

5 The other major ranking of utility regulators is published by another arm of S&P,
6 under its Market Intelligence service in a group called Regulatory Research
7 Associates (“RRA”). The RRA ranking has a broader perspective than the credit
8 rating listing, with more of an equity investor view, and it is a relative ranking
9 instead of the absolute tabulation of the credit analysts. RRA places Washington a
10 little lower in its ranking, called “Average/3” in its nomenclature.⁴⁶ It equates to a
11 slightly below-average position among U.S. regulatory jurisdictions. Like the
12 rating agencies, RRA also detects the prospect for improvement in the
13 Washington regulatory environment and highlighted Washington in its most
14 recent overview of the states as a “state to watch.”⁴⁷

15 **Q. What is your take-away from the two S&P rankings and commentaries of**
16 **Washington?**

17 A. I see positive and sustainable momentum building at both the rating agencies and
18 the rest of the investment community for a reassessment of the regulatory risk that
19 utilities in Washington are exposed to. Executing on the promise that SB 5295
20 and predecessor legislation Clean Energy Transformation Act (“CETA”) hold for
21 supporting PSE’s efforts to manage its regulatory risk will solidify credit ratings

⁴⁵ *Id.* at 5.

⁴⁶ S&P Market Intelligence, *RRA Regulatory Focus, State Regulatory Evaluations* (Sept. 8, 2021).

⁴⁷ *Id.* at 8.

1 to the benefit of its ratepayers as well as its creditors. PSE's proposed MYRP that
2 includes in rates all plant in service by the start of the MYRP and plant projected
3 to be put in service during each year of the MYRP, as well as annual updates to
4 the variable rates in the baseline rate of the power cost adjustment mechanism and
5 retention of the power cost only rate case to update fixed costs associated with
6 new generation resources, will also bolster the current views, set forth above, that
7 Washington regulation is becoming more credit-supportive. A MYRP that
8 operates efficiently to reduce regulatory lag and easing the strain that PPAs place
9 on PSE's balance sheet by strengthening the capital structure and allowing a
10 return on future PPAs would reinforce the positive trend. The resulting
11 improvement in credit quality will benefit ratepayers for many years to come as
12 the transition to a cleaner energy future is executed while minimizing the cost of
13 capital.

14 **Q. In light of the risks and requirements that CETA imposes on PSE and recent**
15 **rating agency reactions to CETA, can you opine on what might be a credit**
16 **supportive application of the MYRP?**

17 A. Given CETA's risks and requirements and the structural lag inherent in
18 Washington's historical regulatory regime, allowing plant in rates in a manner
19 that substantially eliminates structural regulatory lag related to post-test-year
20 investments and a MYRP that substantially replicates PSE's forecasted cost of
21 service during the MYRP would be viewed as credit supportive and in line with
22 the rating agency expectations I outline above.

1 **Q. Do you see any other credit rating trends affecting utilities like PSE that the**
2 **WUTC should take notice of?**

3 A. Yes. A growing area of risk management that has captured the attention of rating
4 agencies is known as ESG, an acronym for environmental, social, and governance
5 risks. The ESG framework for evaluating utility risk is really a means to organize
6 thinking around risks that have always been a part of assessing a utility's risks.
7 The rating agencies are raising the importance of these factors by segregating and
8 spotlighting them in response to investors becoming more attuned to the risks.
9 Regulators can facilitate a utility's ability to manage ESG risks by recognizing
10 their importance and factoring the materiality of ESG risk into its decisions.

11 **Q. If the risks preexisted the ESG phenomenon, why are they demanding**
12 **greater attention?**

13 A. The ESG effort does not merely repackage the risks. It changes how investors and
14 rating agencies view them and factor them into their analyses. For example, "E"
15 risks have affected utility operations for decades, but the emphasis that ESG
16 brings to environmental issues has accelerated a transformation to an almost
17 exclusively carbon and climate change focus and away from traditional concerns
18 about air and water quality.⁴⁸

⁴⁸ See, e.g., Moody's, *Regulated electric utilities—US: Intensifying climate hazards to heighten focus on infrastructure investments* (Jan. 2020) (Sector In Depth); Moody's, *Regulated electric and gas utilities—US: Grid hardening, regulatory support key to credit quality as climate hazards worsen* (Mar. 2020) (Sector In Depth).

1 Another example is “S” risks, which are less susceptible to quantification and
2 have always posed a challenge to analysts. Moody’s has drawn attention to how
3 COVID-19 represents a social risk to utilities. Managing that risk by assisting
4 customers struggling to deal with the economic fallout from the pandemic
5 illustrates how a risk fits into the ESG paradigm and how managing it with
6 regulatory support can have “positive ESG implications.”⁴⁹ PSE and the
7 Commission responded to the pandemic by deferring a rate order and instituting
8 customer assistance programs such as the crisis affected customer assistance
9 program and a voluntary moratorium on disconnects. Those actions, along with
10 the low-income components of CETA, display an astute appreciation for the
11 management of social risks.

12 **Q. What specifically can the WUTC do to incorporate ESG risks into its**
13 **decision making?**

14 A. The initiatives that began when CETA and SB 5295 were enacted form a good
15 foundation for the WUTC to address ESG concerns as it implements those laws.
16 S&P provided guidance in an ESG commentary in 2021 on what areas its utility
17 analysts will focus on when evaluating ESG risks. Climate change, energy
18 transition, sustainability, and continued evolution on ESG disclosures and
19 transparency will increasingly play a part in S&P’s risk assessments of utilities.⁵⁰

⁴⁹ Moody’s, *Regulated electric and gas utilities—US: Supporting customers during coronavirus outbreak to have positive ESG implications* (Apr. 23, 2020) (Sector Comment).

⁵⁰ S&P, *How ESG Factors Are Shaping North American Investor-Owned Utilities’ Credit Quality* (April 28, 2021), at 7.

1

VII. CONCLUSION

2

Q. Does this conclude your testimony?

3

A. Yes.