

**EXH. KKH-1C
DOCKETS UE-22 ___/UG-22 ___
2022 PSE GENERAL RATE CASE
WITNESS: KAZI K. HASAN**

**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 (CONFIDENTIAL) OF

KAZI K. HASAN

ON BEHALF OF PUGET SOUND ENERGY

REDACTED VERSION

JANUARY 31, 2022

PUGET SOUND ENERGY

**PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF
KAZI K. HASAN**

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PUGET SOUND ENERGY

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1 **PUGET SOUND ENERGY**

2 **PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF**

3 **KAZI K. HASAN**

4 **I. INTRODUCTION**

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

7 A. My name is Kazi K. Hasan. My business address is 355 110th Ave. NE, Bellevue,
8 WA 98004. I am a Senior Vice President and the Chief Financial Officer of Puget
9 Sound Energy (“PSE” or the “Company”).

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

12 A. Yes, I have. Please see the First Exhibit to the Prefiled Direct Testimony of Kazi
13 K. Hasan, Exh. KKH-2, for an exhibit describing my education, relevant
14 employment experience, and other professional qualifications.

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

16 A. The State of Washington’s Clean Energy Transformation Act (“CETA”) requires
17 PSE’s electric system to be coal free by 2025, carbon neutral by 2030, and carbon
18 free by 2045 while continuing to serve customers with safe, reliable, and

1 affordable utility service. PSE must acquire a significant amount of clean
2 resources in the coming decades, and must take steps immediately to meet
3 requirements under CETA, including achieving a carbon neutral electricity supply
4 by 2030. Achieving these goals without sacrificing reliability and safety will
5 require significant investment from PSE. These investments are required to
6 maintain existing assets, to acquire CETA-related resources, and to modify PSE's
7 transmission and distribution grids to accommodate new CETA-qualifying
8 resources.

9 Further, PSE recently made a commitment to decarbonize its footprint across the
10 business and help customers achieve their individual or corporate carbon
11 reduction goals. This aspirational commitment is referred to as Beyond Net Zero
12 ("BNZ") and will likewise require investments to meet these decarbonization
13 commitments.

14 In addition, the State of Washington's Climate Commitment Act ("CCA") will
15 reduce greenhouse gas emissions from the state's emitting sources and industries.
16 While the specific rules are currently in development, PSE must take steps to
17 enable its electric and gas systems to meet the requirements of the CCA.

18 PSE is proposing a multiyear rate plan, requesting a 9.9 percent return on equity,
19 and an equity ratio that increases from the current authorized equity ratio of 48.5
20 percent to 50.0 percent over the course of the multiyear rate plan. For the first
21 year of the multiyear rate plan, rates will include plant that is in service at the start

1 of the first rate year, December 31, 2022, and provisional pro forma adjustments
2 to reflect forecasted plant additions for 2023. For the second year of the multiyear
3 rate plan, rates will include provisional pro forma adjustments to reflect
4 forecasted plant in service during 2024; for the third rate year, rates will include
5 provisional pro forma adjustments to reflect forecasted plant in service during
6 2025. Making the right investments to achieve the state's clean energy objectives
7 requires that PSE maintains adequate access to capital on terms that are
8 acceptable. The multiyear rate plan presented in this case is designed for these
9 purposes. Regulatory approval of PSE's multiyear rate plan will allow the
10 Company to put methodical and cost-effective plans in motion to begin to achieve
11 the state's clean energy goals today. Without sufficient regulatory support, PSE
12 will face financial pressure that will inhibit its ability to access the capital markets
13 at reasonable rates and jeopardize its ability to deliver on policy objectives.

14 **Q. What topics do you address in your testimony?**

15 A. First, I describe that prevailing regulatory conditions are not sustainable to allow
16 PSE to deploy financial resources to the productive ends that customers and
17 policymakers want us to pursue. Second, I address the shift in the utility's role
18 from one in which it only provides energy products to a model in which it must
19 also implement public policy objectives. Third, I discuss PSE's proposed
20 multiyear rate plan and why it is necessary to meet these objectives. Fourth, I
21 discuss PSE's proposed return on equity and capital structure. Fifth, I discuss

1 PSE’s proposal to update power costs on an annual basis in PSE’s power cost
2 adjustment (“PCA”) mechanism.

3 **II. PRIOR RATE CASE DECISION AND THE FINANCIAL CHALLENGES**
4 **FACING PSE**

5 **A. The Impact of the Prior Rate Case Order**

6 **Q. What was the financial impact of the Company’s 2019 general rate case**
7 **outcome?**

8 A. In PSE’s last general rate case, the Company’s rate request was intended to help
9 mitigate the effects of tax reform, which PSE now estimates reduced cash flows
10 by approximately \$149 million per year.¹ The tax law change required the
11 Company to increase borrowing to fund its operations and capital expenditure
12 program. However, the rate relief approved by the Commission was much lower
13 than PSE requested, due in large part to the COVID-19 pandemic, placing
14 significant pressure on key credit metrics. Despite a subsequent order clarifying
15 changes in the deferred income tax calculation and power costs, the allowed rate
16 increases were still significantly below requested amounts. In addition, the return
17 on equity of 9.4 percent and 48.50 percent equity ratio authorized in that case are
18 below the industry average, and the proposed attrition adjustment designed to
19 mitigate regulatory lag was rejected. As a result, Standard and Poor’s (“S&P”)
20 placed PSE on CreditWatch Negative reflecting the increased possibility of a

¹ See Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1T.

1 downgrade due to an order that “was significantly weaker than expected in that
2 the company requested a nearly \$200 million rate increase and only received \$2
3 million[,]”² and Fitch Ratings (“Fitch”) revised its outlook to “negative.”³ While
4 PSE was removed from CreditWatch following a clarification order from the
5 Commission, significant regulatory concerns remained. Moody’s Investors
6 Service (“Moody’s”) identified a key credit challenge as “[i]ncreasing regulatory
7 lag, exacerbated by unfavorable July 2020 rate case outcome.”⁴ Similarly, S&P
8 pointed to the Company’s “minimal financial cushion at the current rating level
9 and broader uncertainty about the Company’s ability to effectively mitigate
10 regulatory lag.”⁵ With allowed rate increases significantly below requests,
11 continued concerns around regulatory lag, and strained credit metrics, PSE had to
12 align its capital spending with the rate outcome.

13 **Q. What were the practical implications to PSE’s operations and capital**
14 **spending plans following the outcome of the last general rate case?**

15 A. Because the last general rate case provided for substantially lower revenues than
16 requested, and the financial resources available to PSE are a finite resource, PSE
17 had to minimize both operating expenses and capital expenditures in order to

² Exh. CGP-10 at 9 (Standard & Poor’s, *Puget Energy Inc. And [Subsidiary] Ratings Placed On CreditWatch Negative Over Regulatory Concerns*, July 23, 2020, at 1 [clarification added]).

³ Exh. CGP-10 at 19-29 (FitchRatings, Rating Action Commentary, *Fitch Affirms Puget Energy and Puget Sound Energy; Outlook Revised to Negative*, July 27, 2020).

⁴ Exh. CGP-10 at 36 (Moody’s Investors Service, *Puget Sound Energy, Inc., Update to credit analysis*, August 26, 2021, at 2).

⁵ Exh. CGP-10 at 14 (Standard & Poor’s, *Puget Energy Inc., [Puget] Sound Energy Inc. Ratings Affirmed; Off CreditWatch On Clarification Order; Outlook Negative*, August 21, 2020, at 2 [clarification added]).

1 ensure sufficient operating cash flow to maintain credit metrics. In some cases,
2 spending on planned projects was delayed or deferred. In addition, cost controls
3 were implemented to limit operating expenses and capital costs to dampen the
4 impacts on cash flows. To the extent other capital projects were delivered under-
5 budget, the savings could not be reinvested in other opportunities to improve
6 customer benefits, but rather used to offset the effects of the general rate case
7 outcome, specifically, to avoid further deterioration of credit metrics.

8 PSE also looked for other opportunities to reduce operating expenses and capital
9 expenditures. PSE worked internally to constrain spending by [REDACTED] from
10 2020-2022, where [REDACTED] came from restraining growth in O&M expenses
11 and [REDACTED] came from capital expenditure reductions. The Company
12 reviewed all vacancies, and reassessed and limited its use of outside services. In
13 addition, non-essential maintenance (not time critical ones) was deferred, and the
14 scope of several programs were scaled back or reprioritized (e.g., Data Center
15 Hardware Refresh, Pole Replacements, and Worst-Performing Circuits). All these
16 mitigating efforts were conducted without any major deterioration of safety and
17 reliability of our operations and customer service.

18 **Q. Can PSE continue to delay projects and spending as it has been doing?**

19 A. No. While the Company understood the Commission's objective to limit customer
20 rate impacts amidst the uncertain economic conditions, and PSE was able to
21 manage temporarily, the decisions to delay spending cannot be maintained

1 indefinitely without continuously degrading service quality, reliability, and safety.
2 As described in the Prefiled Direct Testimony of Dan'l R. Koch, Exh. DRK-1T,
3 PSE's performance has lagged in certain areas such as avoiding lengthy outages
4 for residential customers, which PSE is addressing through its reliability,
5 resiliency, and grid modernization efforts. Moreover, as the Company begins its
6 ambitious programs to meet its Beyond Net Zero ("BNZ") objectives and comply
7 with CETA requirements, including meeting net zero electricity supply goal by
8 2030, it is imperative that PSE have sufficient capital available to meet these
9 decarbonization mandates and objectives while also funding projects for
10 continued safe and reliable service.

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

12 A. The outcome in this rate case will have a direct effect on the financial resources
13 available to PSE as it seeks to carry out the ambitious public policy objectives
14 discussed above while providing safe and reliable electric and natural gas services
15 to customers. Additionally, as noted by Moody's, "[t]he outcome of PSE's next
16 regulatory proceeding will be important to its credit profile going forward."⁶ A
17 strong credit profile fosters the long-term financial health of the Company. This in
18 turn provides a greater probability that PSE can maintain access to capital markets
19 at reasonable rates so it can make the investments necessary to meet its
20 customers' evolving needs. Investors rely on PSE's strength in credit profile when

⁶ Exh. CGP-10 at 35 (Moody's Investors Service, *Puget Sound Energy, Inc., Update to credit analysis*, August 26, 2021, at 1).

1 deciding whether to invest in PSE's debt capital. A strong credit profile is
2 associated with access to lower interest rates, which can provide a significant
3 savings in debt costs over the life of the bond. As such, a strong credit profile
4 provides a benefit to customers.

5 **Q. If PSE received a similar decision in this case, what financial policy would be**
6 **expected?**

7 A. Consistent with the Company's financial strategy following the last case, PSE
8 would have to minimize both operating expenses and capital expenditures to
9 maintain credit ratings and have access to the lowest cost debt given financial
10 constraints. In that scenario PSE's ability to make the investments necessary to
11 achieve the CETA mandates on a priority basis would be severely compromised.
12 In addition, while PSE always seeks to maintain safe, clean, and reliable energy
13 services for its customers as a priority and fundamental mandate, this would be a
14 challenge with limited financial resources and would likely cause a delay in
15 several projects with continuing deterioration of its assets and systems. PSE
16 cannot continue to delay projects without a decline in service performance.

1 **B. Challenges Associated with PSE’s Return on Equity and Equity Ratio**

2 **Q. Are PSE’s return on equity and equity ratio important considerations for the**
3 **credit markets?**

4 A. Yes. The rate of return and capital structure directly affect PSE’s regulatory risk
5 profile and cash flow metrics. A rate of return that is commensurate with or better
6 than industry averages indicates that PSE is supported by the Commission in its
7 regulatory proceedings and not disadvantaged relative to the industry in
8 maintaining its credit profile. In addition, not only is the equity ratio an indication
9 of regulatory risk, but it also has a direct effect on cash flow and credit metrics. A
10 supportive return on equity and equity ratio help enhance required cash flow and
11 keep credit metrics above minimum threshold levels in PSE’s ratings category. As
12 such, the requested return on equity and equity ratio are needed for PSE to
13 competitively access the capital markets at all times. Debt investors provide
14 approximately half of PSE’s total invested capital. To maintain access to debt
15 investors, it is important to assure credit metrics above a certain standard with a
16 sufficient cushion to endure any unfavorable circumstances. As described by
17 S&P, the prior general rate case decision left PSE with a “minimal financial
18 cushion at the current rating level[.]”⁷

⁷ Exh. CGP-10 at 14 (Standard & Poor’s, *Puget Energy Inc., [Puget] Sound Energy Inc. Ratings Affirmed; Off CreditWatch On Clarification Order; Outlook Negative*, August 21, 2020, at 2 [clarification added]).

1 **Q. Can PSE retain its credit rating by maintaining the minimum cash flow**
2 **coverage ratios provided by the credit rating agencies?**

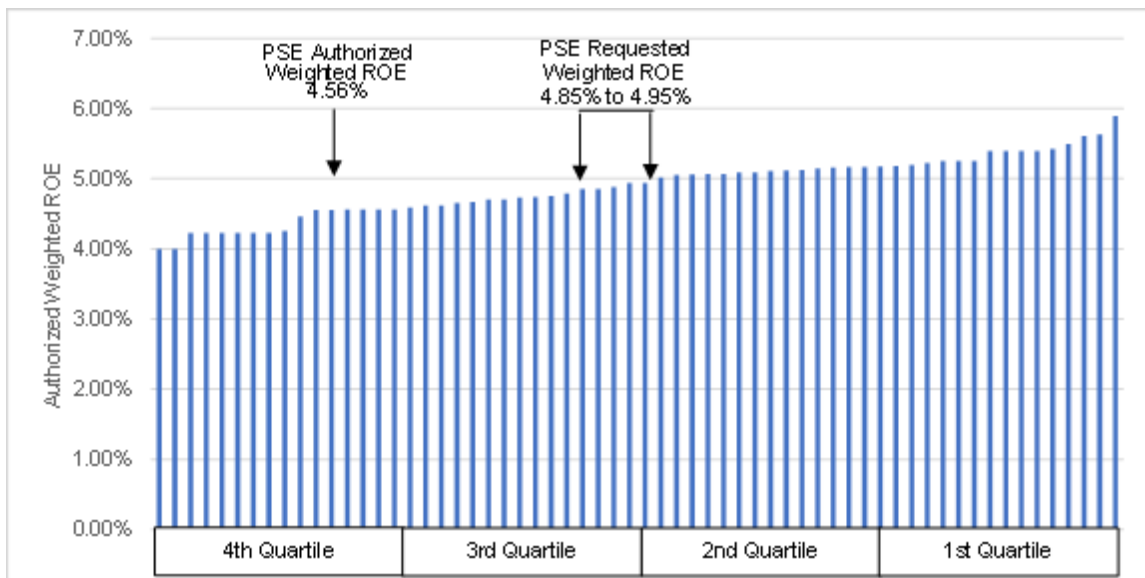
3 A. Not necessarily. The fact that a company's credit metrics fall within a certain
4 ratings category does not mean that the company necessarily would achieve or
5 maintain that rating because rating agencies consider factors other than financial
6 ratios in the development of credit ratings. As discussed in the Prefiled Direct
7 Testimony of Todd A. Shipman, Exh. TAS-01T, a significant portion of a
8 company's credit rating is determined based on the regulatory framework. In
9 addition, if a company managed its cash flow to maintain credit metrics at the
10 minimum threshold level, it would provide little assurance that the company could
11 maintain those metrics through severe operational, financial, or other business
12 disruptions. As such, the return on equity and equity ratio should not be
13 established based solely on whether they allow for credit metrics within a certain
14 ratings category.

15 **Q. How does the Company's authorized return on equity compare to the**
16 **industry average?**

17 A. As discussed in the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T,
18 PSE's current return on equity of 9.4 percent is below the national average. In
19 fact, only 20 percent of all vertically integrated electric utility return on equity
20 decisions in 2020 were lower than PSE's authorized return on equity of 9.4
21 percent. Similarly, only 36 percent of all gas utility return on equity decisions

1 were lower than PSE's authorized return on equity.⁸ When combined with the
 2 authorized common equity ratio of 48.50 percent, PSE's allowed weighted return
 3 on equity was in the bottom quartile for all electric and gas utility returns
 4 authorized in 2020. By comparison, PSE's requested weighted return on equity of
 5 4.85 percent to 4.95 percent is within a range that captures the lower end of the
 6 second quartile to the higher end of third quartile, as shown on Figure 1, below.

7 **Figure 1. Authorized Weighted Returns on Equity in 2020**
 8 **Ranked Low to High⁹**



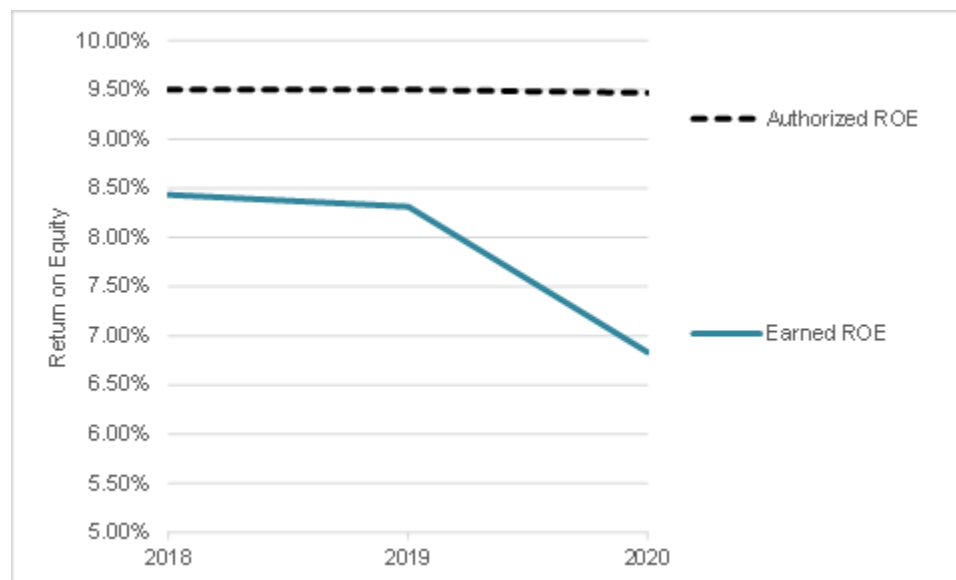
9
⁸ Source: S&P Capital IQ Pro, Regulatory Research Associates. This is part of a licensed, subscription service subject to copyright protection but will be made available for review upon request pursuant to WAC 480-07-510(i)(iii).

⁹ Source: S&P Capital IQ Pro, Regulatory Research Associates. Rate cases with ROEs determined by formulas or including explicit penalties were excluded. In addition, rate cases in Arkansas, Florida, Indiana, and Michigan have been excluded from the Figure since the authorized capital structure approved in the cases includes deferred taxes and other credits at zero or low cost. The additional items have the effect of reducing both the equity and debt ratios used to establish the rate of return which, in turn, produces results that are not comparable to allowed equity ratios in other states. 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 **Q. Has the Company been able to earn its authorized return on equity since the**
2 **last multiyear rate plan ended in 2017?**

3 A. No, it has not. As shown in Figure 2, PSE has consistently under-earned its
4 authorized return on equity.

5 **Figure 2. PSE Earned vs. Authorized Return on Equity 2018-2021¹⁰**



6
7 **Q. Why has PSE been unable to earn its authorized return on equity?**

8 A. PSE has been unable to earn its authorized return on equity primarily due to
9 investments that are not reflected in rate base (i.e., investments that do not earn a
10 return), including investment in construction work in progress and growth in rate
11 base since the 2017 general rate case. Significantly, PSE is carrying over four
12 years of investments on its balance sheet, dating back to the 2017 general rate
13 case, since the Commission did not authorize all investments to be reflected in

¹⁰ Calculated on a CBR basis.

1 rate base in its final order in the 2019 general rate case. In addition, depreciation
2 expenses have been higher than the amount authorized in the last general rate
3 case.¹¹

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

6 A. As I previously discussed, PSE has implemented significant cost cutting measures
7 and delayed capital projects prior to and during the test year in this case in an
8 attempt to improve its earnings. However, despite these measures, PSE has been
9 unable to earn its authorized rate of return.

10 **Q. How is the proposed rate request designed to improve the financial strength**
11 **of PSE relative to the 2019 general rate case?**

12 A. First, the potential for a multiyear rate plan has been recognized by the credit
13 rating agencies as a potential credit supportive measure, depending on the
14 structure of the multiyear rate plan,¹² and subject to appropriate implementation.
15 The degree to which it is ultimately credit supportive will depend on the design of
16 the plan itself. PSE's proposed multiyear rate plan is designed to enable the
17 Company to spend sufficient financial resources to maintain safe, clean, reliable,
18 and affordable energy services and meet policy objectives. In addition, the
19 statutory provision that requires the Commission, at a minimum, to include in

¹¹ SEC Form 10-K, Puget Sound Energy Inc., for the fiscal year ended December 31, 2020, at 40.

¹² See Exh. CGP-10 at 30 (Standard & Poor's, *Puget Energy Inc. And Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation; Ratings Affirmed*, May 27, 2021, at 1).

1 rates the plant in service as of the initial rate year of a multiyear rate plan will
2 allow for timely recognition of investments in rates. If the multiyear rate plan is
3 adopted as proposed by PSE, which allows assets that are used and useful during
4 the applicable rate year to be included for rate-making purposes in that rate year,
5 this would mitigate many of the credit challenges observed by S&P and Moody's
6 such as reducing regulatory lag, improving cash flow predictability, and
7 enhancing cash flow.

8 Further, the proposed return on equity and capital structure are consistent with
9 similarly situated utilities such that PSE is able to compete for capital and
10 maintain access to capital markets, even when capital markets are constrained.

11 Notably, PSE has an added mandate —to achieve CETA requirements—that most
12 other similarly situated utilities do not have within the timeframe stipulated under
13 CETA, and which requires massive investments over the coming years.

14 Also, the proposed annual update to the power cost baseline rate in the PCA
15 mechanism, discussed by PSE Witness Janet Phelps, will mitigate volatility and
16 liquidity risk.

17 **Q. Why are the credit metrics and financial measures that you discuss**
18 **important for customers?**

19 A. When PSE achieves these financial measures, it has access to capital at reasonable
20 rates, which allows PSE to pursue the projects that are important to its customers
21 and that promote state energy policy. A financially strong PSE can move more

1 aggressively to improve the reliability of its electric system through grid
2 modernization, which includes investing in a more resilient and reliable grid. PSE
3 can continue to enhance the safety of its gas system and take steps to reduce
4 methane emissions. PSE can invest in technology to reduce greenhouse gas
5 emissions, acquire renewable and nonemitting sources of energy, and take the
6 necessary steps to meet the mandates of CETA and the CCA. In short, customers
7 benefit when PSE is financially strong.

8 **III. ACHIEVING REGULATORY AND POLICY OBJECTIVES**

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

10 A. Traditional cost of service regulation has evolved in many jurisdictions to a model
11 which seeks to incentivize and facilitate the achievement of broader policy
12 objectives such as grid modernization, clean energy goals, equity, and enhanced
13 operational efficiency. The role of public utilities shifts from one which focuses
14 primarily on providing a product to one in which the utility also facilitates or
15 implements policies and acts as an extension of the state to broadly promote the
16 public interest. This is evident in CETA, which contained not only environmental
17 and equity policy objectives, but also constructive regulatory mechanisms to
18 achieve such goals, which were further clarified in Senate Bill 5295 that was
19 passed and signed in 2021. A utility’s need to address public policy objectives in
20 addition to its conventional responsibilities related to providing safe and reliable
21 service is sometimes referred to as a “dual mandate.”

1 **Q. What is PSE’s role in implementing policy goals?**

2 A. PSE is a partner with regulators and policymakers in executing objectives that are
3 deemed to be in the public interest. Restoring PSE’s financial strength will
4 position the Company to deliver on public policy objectives. PSE’s financial
5 strength provides a benefit to customers in facilitating clean energy goals. For
6 example, it is the balance sheet strength of PSE that enables power purchase
7 agreements (“PPAs”) to be executed in support of its clean energy action plan, or
8 for PSE to execute on self-build clean energy projects. As a partner in executing
9 policies, PSE’s financial strength should be recognized as both a benefit in
10 delivering policy goals, but also a resource that must be maintained.

11 **Q. What can the Commission do to help PSE maintain its financial strength**
12 **when it enters into clean energy PPAs to achieve CETA’s objectives?**

13 A. The Commission can authorize PSE to earn a return on clean energy PPAs, which
14 is consistent with CETA. PPAs are off-balance sheet financial obligations. As
15 such, the credit rating agencies view them as debt-like obligations and can impute
16 them as debt for the purpose of credit analysis. While the balance sheet strength
17 of PSE enables clean energy PPAs to be executed, if PSE is not compensated for
18 entering such financial obligations, PPAs will only serve to weaken the
19 Company’s financial strength as any debt does. As provided by RCW 80.28.410,
20 PSE is allowed to earn a return on PPAs it executes in implementing its clean
21 energy action plan pursuant to RCW 19.280.030(1)(l). By allowing PSE to earn a

1 return on PPAs, this compensates the Company for accepting the financial
2 obligation of a PPA and allows PSE to maintain its financial strength while
3 transitioning to 100 percent clean energy. This is discussed in more detail in the
4 Prefiled Direct Testimony of Todd A. Shipman, Exh. TAS-01T.

5 **Q. How are customers benefitted when PSE enters into PPAs to acquire clean**
6 **power?**

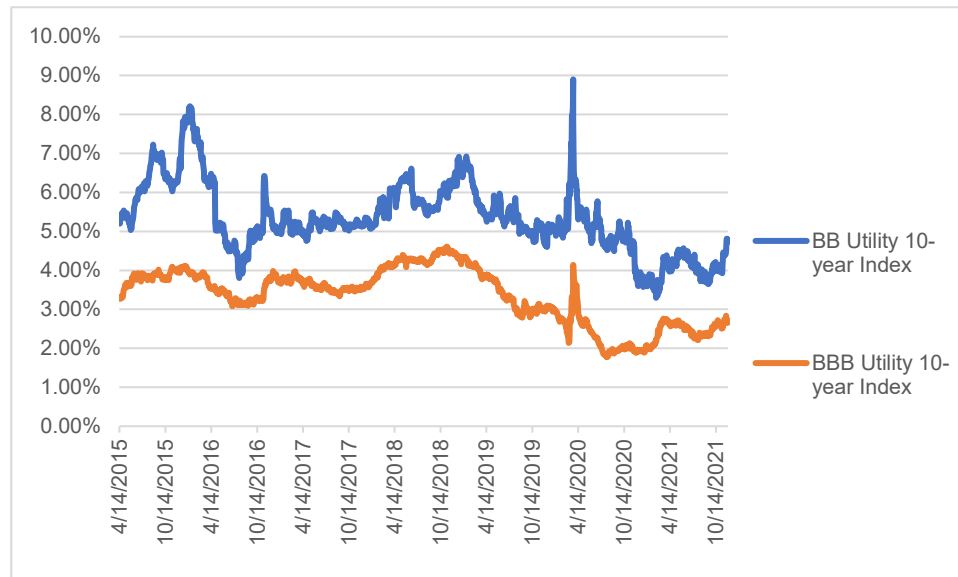
7 A. By entering into PPAs with clean energy project developers, PSE is allowing its
8 balance sheet strength to facilitate project financing and delivering lower overall
9 costs to customers. PSE represents a creditworthy counterparty that reduces
10 financing costs to project developers. Absent a signed PPA, a developer's
11 financing costs would likely be substantially higher, potentially below
12 investment-grade, increasing the overall project costs. As such, by enabling
13 project developers to access lower financing costs, PSE is reducing the overall
14 project costs of delivering clean energy and providing a benefit to customers.

15 **Q. Can you quantify the benefits that an investment-grade credit rating**
16 **provides?**

17 A. As shown in Figure 3 below, since 2015, there has been a credit spread of
18 approximately 200 basis points between BBB-rated utility debt (investment-
19 grade) and BB-rated utility debt (non-investment-grade). PSE currently holds
20 approximately \$4.8 billion of debt instruments, projected to grow to \$5.7 billion
21 over the course of 2023-2025, as presented by PSE witness Cara G. Peterman in

1 her testimony and exhibits. A 200 basis point change in the cost of debt amounts
2 to approximately \$98-\$118 million of additional costs that customers will bear.

3 **Figure 3. Credit Spread for BBB and BB Rated Utility Debt¹³**



5 **Q. How does CETA affect the relationship between PSE and the Commission?**

6 A. The Commission is now tasked with implementing programs and goals that go far
7 beyond revenue requirement development, cost allocation, and rate design. The
8 Commission will need to support and balance the effects on both the utility and
9 the customer while public policy mandates are implemented. PSE' requested
10 multiyear rate plan—including its proposed return on equity and capital
11 structure—will allow PSE to maintain the financial strength necessary to deliver
12 on CETA while also providing safe and reliable energy services to its customers.

¹³ Source: Bloomberg Professional. 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 **IV. THE PROPOSED MULTIYEAR RATE PLAN ALLOWS PSE TO**
2 **MAINTAIN FINANCIAL STRENGTH WHILE PROVIDING SERVICE THAT**
3 **BENEFITS CUSTOMERS AND CARRIES OUT STATE ENERGY POLICY**

4 **A. Overview of the Multiyear Rate Plan**

5 **Q. Please provide an overview of the proposed multiyear rate plan.**

6 A. The multiyear rate plan is a three-year proposal. The filing includes the
7 development of the test year, pro forma adjustments through December 31, 2021,
8 and rates for the initial rate year that include plant in service through December
9 31, 2022 and plant that is projected to go into service in calendar year 2023. Rates
10 for each of the second and third rate years of the multiyear rate plan include plant
11 projected to go into service during each respective rate year. PSE is requesting
12 that rates become effective for the first rate year on January 1, 2023. The spending
13 amounts incorporated in the multiyear rate plan, beyond the test year and pro
14 forma adjustments, are based on forecasts, and will be subject to refund to the
15 extent the funds are not utilized at an aggregate level. The Prefiled Direct
16 Testimony of Jon A. Piliaris, Exh. JAP-1T, provides a full description of the
17 multiyear rate plan including PSE's proposal as to how to address inflationary
18 pressure outside PSE's control if it proves not to be transitory and continues
19 throughout the case.

1 **Q. Does PSE have a specific proposal to address these inflationary pressures**
2 **during the multiyear rate plan?**

3 A. At the present time, PSE has not included a specific proposal to address
4 inflationary pressures during the multiyear rate plan. PSE is continuing to
5 monitor uncertainty of how inflation may impact PSE's costs as forecasted during
6 each year of the multiyear rate plan. PSE believes the public interest would be
7 better served by the Commission and parties continuing to monitor this evolving
8 situation during the pendency of this case and to address it, to the extent
9 necessary, later in this case. PSE believes it would not be prudent at this time for
10 the parties to debate prematurely over rate year inflation rates and potential
11 solutions to address unforeseen cost pressures.

12 **Q. When and how does PSE contemplate these inflationary factors will be**
13 **incorporated into the case?**

14 A. As explained in the testimony of PSE's witness Jon A. Piliaris, inflationary
15 pressure could have significant impact on PSE's cost structure for each of the rate
16 year within the multiyear rate plan, which is currently an evolving phenomenon.
17 PSE expects that over next six to nine months more will be known on how
18 inflationary pressures could potentially impact all of PSE's cost structure and how
19 best to address the concerns considering the customer rates impact while
20 implementing CETA mandate. PSE would propose revisiting this issue
21 incorporating specific adjustment proposals either through supplemental

1 testimony, approximately one month before response testimony is due, or as part
2 of its rebuttal testimony in this case. PSE recognizes that the later this can be
3 addressed during the pendency of the case, the more that will be known about the
4 inflation related impact, which may limit the time available for parties to evaluate
5 the proposals, however, it is the Company's intent to allow a reasonable period
6 for parties to examine PSE's proposal when made through supplemental
7 testimony. The Company believes that either path should allow parties to this
8 case reasonable period of time for discovery prior to hearings.

9 **Q. Please elaborate on the importance of including in rates the plant that is put**
10 **in service each year of the multiyear rate plan.**

11 A. Over the course of the multiyear rate plan, PSE will be making significant capital
12 investments in its system. The law requires the Commission to include in rates the
13 plant that is in service at the start of the rate year, December 31, 2022, and allows
14 for plant that will be placed in service during each year of the multiyear rate plan
15 to be included in rates. This is a key component of PSE's multiyear rate plan.
16 Without this, PSE would be forced to carry multiple years of investments on its
17 balance sheet without including them in rates until the next general rate case. This
18 component of the multiyear rate plan eliminates the structural lag in reflecting
19 investments in rate base and provides the streamlining expected by the credit
20 rating agencies.

1 **Q. What are the financial benefits that are anticipated under the proposed rate**
2 **plan?**

3 A. The proposed multiyear rate plan will align with the five-year business plan to
4 allow PSE to maintain access to capital and continue to deliver on its commitment
5 to provide safe, clean, reliable, and affordable energy services. PSE's proposed
6 multiyear rate plan will allow for timely recovery of PSE's investments and
7 improve the Company's cash flow metrics and credit profile.

8 **Q. How will the multiyear rate plan enable PSE to achieve its commitment to**
9 **customers?**

10 A. PSE is committed to operational excellence, continuous improvement, and
11 efficient service, and PSE's proposed multiyear rate plan will position the
12 Company financially to achieve these commitments. This proposed multiyear rate
13 plan incorporates necessary flexibility for PSE to meet the evolving needs of its
14 customers, including its obligations under CETA to meet net zero electricity
15 supply requirements by 2030. Over the course of the multiyear rate plan, many
16 factors will arise that are outside the Company's control and will cause changes in
17 the final portfolio of projects that are needed to execute on PSE's objectives. It is
18 important to have flexibility so that PSE can prudently manage its business and
19 respond to changing conditions and needs as they arise. While the specific
20 individual projects or program spending may change due to specific project
21 challenges that arise, the total spend included in the financial forecast should

1 remain within the established budget parameters to deliver the identified benefits
2 to customers. The structure of the multiyear rate plan proposed by PSE provides
3 adequate financial resources to the Company, while maintaining the flexibility to
4 adapt the project portfolio to changed circumstances as they arise.

5 **B. Financial Benefits and Effects of the Multiyear Rate Plan**

6 **Q. How does the multiyear rate plan provide the financial resources to execute**
7 **PSE's business plan?**

8 A. The proposed multiyear rate plan will reduce regulatory lag and cash flow
9 volatility, placing PSE more in line with the similarly situated utilities. As
10 discussed in the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T,
11 under the status quo, Washington has been more restrictive than other
12 commissions on certain factors, including not permitting full cost recovery
13 through the power cost recovery mechanisms or timeliness of capital cost
14 recovery, and using modified historical test years. The multiyear rate plan
15 proposed by PSE will align PSE with peer utilities. The overall level of
16 investment included in the business plan is necessary to maintain performance
17 standards, meet customer needs, and achieve policy objectives. While PSE has
18 been able to achieve efficiencies for the last several years and will be able to carry
19 forward some of those sustainable cost savings, it is not possible to continue to
20 find endless efficiencies in the same areas. For example, in the Prefiled Direct
21 Testimony of Joshua A. Kensok, Exh. JAK-1T, Mr. Kensok outlines standard

1 annual inflationary cost increases for PSE labor of 3.5 percent and outside
2 services of 2 percent. These cost categories made up nearly 80 percent of PSE’s
3 O&M budget in 2020 and account for approximately \$54 million worth of
4 increased expense in the 2023 rate period compared with 2020 actuals before
5 considering new areas necessary to incur costs to implement policy objectives,
6 such as CETA. The programs that are expecting the highest levels of increased
7 spending are related to attaining policy objectives related to grid modernization
8 and renewable energy requirements. As discussed by PSE witnesses Catherine A.
9 Koch and William T. Einstein, the Company is expecting to make investments in
10 foundational technologies that drive data availability, integrity, and granularity
11 essential to planning for and operating distributed energy resources (“DERs”),
12 managing electric vehicle loads, and taking advantage of demand-side resources
13 and non-wires delivery system solutions. New capital investments will require
14 maintenance needs leading to increases in fixed O&M costs. As a result,
15 investments to meet the renewable energy requirements, including in transmission
16 and distribution grid areas, over the next decade will require significant capital
17 investments. Moody’s recently pointed to CETA as a “clean energy bill with
18 aggressive carbon transition targets,” further observing “[c]ompliance with the
19 law will require significant investment and an overhaul of existing state electric
20 infrastructure.”¹⁴ The proposed multiyear rate plan is designed to enable PSE to
21 have the financial resources needed to make the significant investments required

¹⁴ Exh. CGP-10 at 39 (Moody’s Investors Service, *Puget Sound Energy, Inc., Update to credit analysis*, August 26, 2021, at 5).

1 to meet clean energy targets and other regulatory and policy objectives while
2 maintaining and improving service quality.

3 **Q. Will the proposed rate plan reduce PSE's risks relative to typical utility**
4 **risks?**

5 A. No, it will not reduce PSE's risks relative to similar utilities. While the proposed
6 rate plan will reduce risks on an absolute basis compared to the risks that
7 currently exist, it does not reduce risks relative to the typical utility company. As
8 discussed by PSE witness Ann E. Bulkley, the lack of full cost recovery through
9 fuel cost recovery mechanisms or timeliness of capital cost recovery and the use
10 of modified historical test years in Washington is more restrictive as compared to
11 the recovery mechanisms available in other jurisdictions. PSE's proposed
12 multiyear rate plan, which is consistent with recently enacted state law, allows for
13 an overall regulatory construct that is more consistent with those in place for her
14 proxy group companies. Absent the proposed multiyear rate plan, PSE would be
15 exposed to a higher degree of risks relative to peer utilities. Therefore, the
16 proposed rate plan will bring PSE in line with peer utilities. However, PSE has a
17 dual mandate of serving its customers as a traditional utility, while also expediting
18 decarbonization in an equitable manner as a statutory requirement.

19 **Q. Are there risks to PSE under the proposed multiyear rate plan?**

20 A. Yes. While the proposed multiyear rate plan is expected to mitigate risks related
21 to cash flow volatility and predictability, significant risks remain for PSE. As

1 described in more detail by PSE witness Todd Shipman, inflation and increased
2 borrowing costs place increased pressure on financial metrics, and without
3 stepped rate increases to meet these challenges, PSE will not have a reasonable
4 opportunity to earn its return. In addition, absent any adjustment in the return on
5 equity and the equity ratio over the multiyear rate plan, there is a risk that PSE's
6 rate of return will lag the market, and lag significantly, in the event interest rates
7 continue to increase as expected. Further, the multiyear rate plan does not
8 eliminate the risks associated with PSE's capital expenditure plan, which entails
9 challenges associated with permitting, siting, corporate capacity strains, supply
10 chains, capacity, and price increases.

11 **Q. Will the multiyear rate plan contribute to PSE's financial strength?**

12 A. Yes. The proposed multiyear rate plan is structured to reduce volatility and enable
13 PSE to maintain its cash flow coverage ratios to meet the expectations of the
14 credit rating agencies. In May 2021, S&P revised its Outlook for PSE from
15 Negative to Stable recognizing the recent passage of Senate Bill 5295 establishing
16 the potential for a credit supportive multiyear rate plan. This credit positive
17 development is based on certain expectations under the multiyear rate plan.
18 Specifically, S&P noted "[w]e expect the commission will approve the MYRPs,
19 reducing regulatory lag and cash flow volatility."¹⁵ Therefore, the expected
20 improvements to PSE's credit profile are predicated on a constructive and credit

¹⁵ Exh. CGP-10 at 30 (Standard & Poor's, *Puget Energy Inc. And Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation; Ratings Affirmed*, May 27, 2021, at 1).

1 supportive multiyear rate plan being accepted by the Commission. In fact, S&P
2 notes a downside scenario that could cause lower ratings if the Commission “does
3 not implement SB 5295 in a credit-supportive manner that includes the use of an
4 MYRP.”¹⁶ As such, it is important to recognize that the adoption of a multiyear
5 rate plan in and of itself is not necessarily credit supportive. Rather, the multiyear
6 rate plan must reduce cash flow volatility and provide greater stability and
7 predictability with sufficient cushion to weather any unforeseen markets,
8 economic, business, or operational disruptions. PSE’s proposed multiyear rate
9 plan that allows for timely recovery of plant in service and regular updates to
10 power costs is designed to achieve these outcomes as demonstrated by PSE
11 witness Cara G. Peterman in Exh. CGP-1T.

12 **Q. Why is flexibility important in the proposed multiyear rate plan and for**
13 **PSE’s financial strength?**

14 A. PSE’s current business plan serves as the foundation of the multiyear rate plan.
15 The Company’s five-year business plan builds on the facts, circumstances, and
16 current understanding of the activities necessary to carry out PSE’s dual mandate
17 obligations related to providing safe, reliable, and affordable service, and meeting
18 CETA and other public policy objectives. It is highly likely that activities
19 embedded in the current business plan could change as time progresses leading to
20 delay or cancellation of some activities. New opportunities to pursue and

¹⁶ Exh. CGP-10 at 31 (*Standard & Poor’s, Puget Energy Inc. And Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation; Ratings Affirmed*, May 27, 2021, at 2).

1 unforeseen circumstances may also arise that result in changes in timing for
2 expenditures and changes in the costs to complete these tasks, as is the case in the
3 normal course of business.

4 The structure of the proposed multiyear rate plan provides PSE with sufficient
5 flexibility to respond to changes in circumstances as needs and activities evolve.
6 PSE's request in this case also recognizes that the costs of goods and services
7 change over the term of the rate plan, in addition to changes to such price levels
8 between filing and resolution of the multiyear rate plan, as discussed in the
9 Prefiled Direct Testimony of Jon A. Piliaris, Exh. JAP-1T. This flexibility allows
10 PSE to optimize the project portfolio and provide the best value to customers.

11 **Q. Does the multiyear rate plan take into consideration the need to limit bill**
12 **increases, particularly for vulnerable customers?**

13 A. Yes. The proposed multiyear rate plan is designed to create a balance between
14 limiting customer bill increases and providing a fair opportunity for PSE to earn a
15 reasonable return. As discussed in the Prefiled Direct Testimony of Birud D.
16 Jhaveri, Exh. BDJ-1T, and the Prefiled Direct Testimony of Carol L. Wallace,
17 Exh. CLW-1T, PSE is proposing low-income rates and assistance programs that
18 significantly mitigate the energy burden for low-income and energy-burdened
19 customers.

20 Moreover, PSE has a strong and proven track record of providing energy services
21 in both its electricity and gas operations at a reasonable rate. This is a result of

1 disciplined operational management and cost control by PSE. PSE's cost of
2 serving electricity increased by an annual average of 0.73 percent from \$97.57 per
3 MWh in 2010 to \$104.96 per MWh in 2020. This cost increase is significantly
4 lower than average annual inflation over this period. PSE's residential electric
5 customers' average monthly bill increased from \$99.26 in November 2011 to
6 \$112.15 in November 2021, increasing 1.76 percent annually. For PSE's gas
7 customers, residential customer bills have declined over the past ten years.
8 Residential gas customers average monthly bill decreased by an annual average of
9 1.63 percent from \$89.41 in November 2011 to \$79.70 in November 2021.

10 **Q. What is your conclusion with regard to the multiyear rate plan and its effect**
11 **on PSE's financial profile?**

12 A. Within this context of historically managing customer rates, PSE needs to
13 maintain its financial strength to provide power and gas for its customers safely
14 and reliably while implementing decarbonization and equity mandates under
15 CETA. The inclusion of used and useful property in rates at the start of the
16 multiyear rate plan and during each year of the multiyear rate plan: 1) allows PSE
17 an opportunity to earn its allowed return throughout its proposed multiyear rate
18 plan; 2) provides PSE the ability to fund critical operational programs for the
19 benefit of customers, including CETA investments; and 3) enables PSE to
20 maintain the credit profile required by the rating agencies, its financial liquidity,
21 and its access to debt capital markets. For these reasons, I believe that PSE's
22 proposed multiyear rate plan is reasonable, appropriate, and necessary to

1 successfully achieve the Company's objectives while maintaining PSE's financial
2 strength.

3 **C. PSE Has Incorporated Lessons Learned From Prior Multiyear Rate Plans**

4 **Q. What was PSE's recent experience with multiyear rate plans?**

5 A. PSE entered into a multiyear rate plan commencing on July 1, 2013 through
6 December 31, 2017 ("2013-2017 multiyear rate plan"). During that period, PSE's
7 delivery revenues increased on January 1 in each year, by 3.0 percent and 2.2
8 percent, for electric costs and gas costs, respectively. In addition, the Commission
9 approved an incremental increase of approximately \$30 million in rates effective
10 July 1, 2013, at the start of the multiyear rate plan, through an expedited rate
11 filing. PSE's financial performance during this period consistently improved, and
12 in later years of the multiyear rate plan, the Company earned its allowed rate of
13 return as reported through its Commission Basis Reports ("CBR"). In 2017, PSE
14 returned excess earnings to customers.

15 **Q. Are there insights gained from the implementation of the 2013-2017**
16 **multiyear rate plan?**

17 A. PSE gained significant insights from the 2013-2017 multiyear rate plan that were
18 used to design the proposed multiyear rate plan presented in this case. First, it is
19 important to observe that PSE began earning its allowed return on a CBR basis in

1 the latter years of the last multiyear rate plan. In essence, PSE’s revenues “caught
2 up” to its actual cost of service only towards the end of the multiyear rate plan.

3 Second, it demonstrates the structural regulatory lag inherent in the modified
4 historical ratemaking structure. For example, while PSE’s revenues caught up to
5 its actual cost of service in the latter years of the 2013-2017 multiyear rate plan,
6 specifically in 2017, the 2017 general rate case set rates on a test year ended
7 September 30, 2016, essentially eliminating the revenue requirements that existed
8 in 2017 due to the structural regulatory lag of approximately 15 months embedded
9 in the test year.

10 Third, the rates of the 2013-2017 multiyear rate plan were augmented by the rates
11 under the expedited rate filing that took effect along with the multiyear rate plan
12 on July 1, 2013. This expedited rate filing avoided building excess regulatory lag
13 into the multiyear rate plan by adjusting PSE’s revenue requirement for changes
14 in rate base and other cost of service items since the implementation of PSE’s
15 prior 2011 general rate case. Without this expedited rate filing, PSE would have
16 substantially underearned its allowed rate of return on a CBR basis (i.e., the
17 revenues in each year of the multiyear rate plan would have been reduced by
18 approximately \$30 million).

19 Based on these lessons learned, it is an important feature of PSE’s proposed
20 multiyear rate plan that rates include all plant in service at the start of the initial
21 rate year, and during each rate year, to help mitigate regulatory lag.

1 **D. The Multiyear Rate Plan Is Tied To PSE’s Five-Year Business Planning**
2 **Process**

3 **Q. You have testified that PSE’s business plan is aligned with and forms the**
4 **foundation for the multiyear rate plan. Can you elaborate on the**
5 **development of the business planning process?**

6 A. The five-year business planning process represents the implementation of PSE’s
7 strategic vision, which is developed by senior management and is presented to
8 PSE’s Board for review and ultimate approval. Once the strategic vision is
9 approved, the planning breaks down into two primary components: operational
10 planning and financial planning across the five-year planning horizon. PSE
11 witness Joshua A. Kensok, along with other Company witnesses, present
12 testimony that explains how PSE develops, prepares, and governs operational
13 planning and how those operational plans translate into O&M and capital budgets
14 across the planning horizon.

15 In addition, as part of the five-year planning process, the Financial Planning and
16 Analysis (“FP&A”) department prepares balance sheets, income statements, cash
17 flow statements, EBITDA statements, cash available for distribution statements,
18 and accompanying analyses of credit metrics, debt covenant compliance, merger
19 commitment compliance, among others. These deliverables are prepared,
20 reviewed and analyzed iteratively as PSE works with its Business Planning
21 Committee, which consists of members of the PSE Board of Directors, to develop

1 a five-year plan that is viable and financeable and can ultimately be approved by
2 the full Board of Directors.

3 **Q. What makes a five-year plan viable and financeable?**

4 A. For a plan to be viable and financeable, it is critical that PSE remains financially
5 liquid across the planning horizon to maintain the flexibility to manage the many
6 exogenous impacts and changing business conditions, which are discussed in
7 detail by PSE witness Joshua A. Kensok. Additionally, across the planning
8 horizon, it is imperative that PSE maintains competitive access to the capital
9 markets to finance its operational plans and the necessary O&M and capital
10 budgets to achieve those plans, including the Company's strategic vision over
11 time. Maintaining liquidity and competitive access to the capital markets requires
12 PSE to develop a five-year plan that accomplishes several financial imperatives,
13 including:

- 14 1. Maintain credit ratings that allow competitive access to capital markets.
- 15 2. Maintain debt to total capitalization performance to enable access to its
16 revolving lines of credit.
- 17 3. Maintain financial performance against a myriad of debt covenants,
18 merger commitments, and legal parameters to avoid events of default and
19 limit equity distributions to service debt and pay dividends to equity
20 owners.

21 This component of the financial planning process requires significant professional
22 judgment and experience to develop a financial plan with adequate, but not
23 excessive, financial and operating flexibility or cushion.

1 **Q. What is an example of the specific financial considerations you evaluate**
2 **when developing the financial plan?**

3 A. As discussed above, maintaining liquidity is a critical component of any financial
4 plan. PSE maintains liquidity primarily through access to its revolving line of
5 credit. This is a short-term, financing facility that backstops the Company's
6 ability to issue commercial paper, and the facility provides liquidity itself when
7 PSE does not have access to the commercial paper markets. PSE must maintain a
8 debt to total capital ratio of less than 0.65 to 1 to maintain access to the revolving
9 line of credit facility. PSE has historically maintained a planned and actual debt to
10 total capital ratio of approximately 0.531 to 1 to maintain financial operating
11 flexibility and cushion to manage exogenous impacts in changing business
12 conditions over time. PSE has proposed in this proceeding to increase its equity
13 percentage in the capital structure to 50 percent over the course of the multiyear
14 rate plan, which would provide additional financial operating flexibility and
15 cushion during the multiyear rate plan and into the future.

16 An additional consideration regarding liquidity is the composition of the bank
17 group syndicate that finances PSE's \$800 million revolving line of credit. During
18 the 2008 financial crisis, many utilities suffered reduced liquidity as a result of the
19 failures of Lehman Brothers and Bear Stearns. To the extent a utility had either of
20 these banks as part of its bank group syndicate, that utility would have suffered a
21 reduction in borrowing capability from its revolving line of credit and, therefore, a
22 reduction in liquidity. PSE has appropriately diversified the bank group that

1 finances its revolving line of credit such that the failure of any one bank in the
2 group will not have a material impact on the Company's liquidity.

3 **Q. What are your conclusions with regard to the implementation of the**
4 **multiyear rate plan and how it will complement the financial planning**
5 **process?**

6 A. PSE's financial planning process begins with the Company's strategic vision and
7 cascades into operational planning and financial planning across the five-year
8 planning horizon. Operational planning drives the development of O&M and
9 capital budgeting across the planning horizon; however, the strategy, operational
10 plans, and O&M and capital budgets must be supported by a viable and
11 financeable financial plan that solves for the complex array of financial
12 constraints and parameters before a plan will be approved by the Board. O&M
13 and capital budgets are important, but they are not the driving influence behind
14 whether a plan is viable and financeable. It is important to understand the
15 complex dimensions of creating a five-year plan, the Company's ability to
16 manage exogenous impacts and changing business conditions across the planning
17 horizon, and the critical necessity of a viable and financeable financial plan to
18 appreciate PSE's ability to 1) propose a reliable multiyear rate plan and 2)
19 substantially deliver on the commitments embedded in that multiyear rate plan.

1 **E. Deferrals Are Insufficient to Address Cash Flow Concerns**

2 **Q. In terms of liquidity, how helpful are the various existing and statutory**
3 **deferral mechanisms vis-a-vis PSE's proposed multiyear rate plan?**

4 A. While deferral mechanisms allow for the eventual recovery of expenditures, they
5 do not provide the cash flows necessary for maintaining financial strength.
6 Deferred expenditures are therefore funded by debt and equity investors, on which
7 they do not earn a return. As shown in Table 1, below, deferrals can require
8 significant funding from investors, and can be volatile on a year-to-year basis.
9 Significantly, the deferrals in Table 1 do not earn the fully-authorized rate of
10 return and, therefore, serve as a drag on PSE's credit metrics.

Table 1. Deferred Amounts 2017-2021

Deferred amounts (\$000s)	2017	2018	2019	2020	2021	Average
Power cost - Customer Portion	4,576	4,734	41,744	45,331	38,358	26,949
Power cost - PSE Portion	22,414	25,905	57,128	77,429	108,805	58,336,
Gas cost (PGA)	(16,050)	9,921	132,766	87,655	57,934	54,445
Electric Decoupling	8,177	16,516	26,425	50,695	22,084	24,779
Gas Decoupling	64,295	35,507	8,584	21,362	20,536	30,056
Electric Vehicle	-	-	1,430	2,210	2,468	1,221
AMI	-	-	14,845	22,652	23,036	12,106
GTZ	-	-	22,148	53,235	50,471	25,171
LNG	-	-	-	335	1,764	419
Storm deferrals	128,508	118,330	121,893	108,491	127,789	121,002

Table 1. Deferred Amounts 2017-2021

Deferred amounts (\$000s)	2017	2018	2019	2020	2021	Average
Environmental	3,431	1,417	978	4,535	5,301	3,133
Low Income Sch. 129	(13,525)	(24,978)	(18,014)	(19,002)	(28,955)	(20,895,)
CACAP 2	-	-	-	-	21,753	21,753
Covid Deferral	-	-	-	-	3,656	731
Total	201,826	187,354	409,930	454,932	455,005	341,810

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Recognizing that debt is serviced with cash, not earnings, debt investors are particularly concerned with mechanisms that do not improve cash flow metrics. To compensate investors for such investments, deferred expenditures need to earn a return or have immediate recovery.

In contrast, the proposed multiyear rate plan provides investors an opportunity to earn a reasonable return by incorporating investments in rates on an ongoing annual basis rather than deferring these investments for recovery several years later.

V. PSE'S REQUESTED RETURN ON EQUITY AND CAPITAL STRUCTURE

Q. How does a company's return on equity and capital structure contribute to its financial strength?

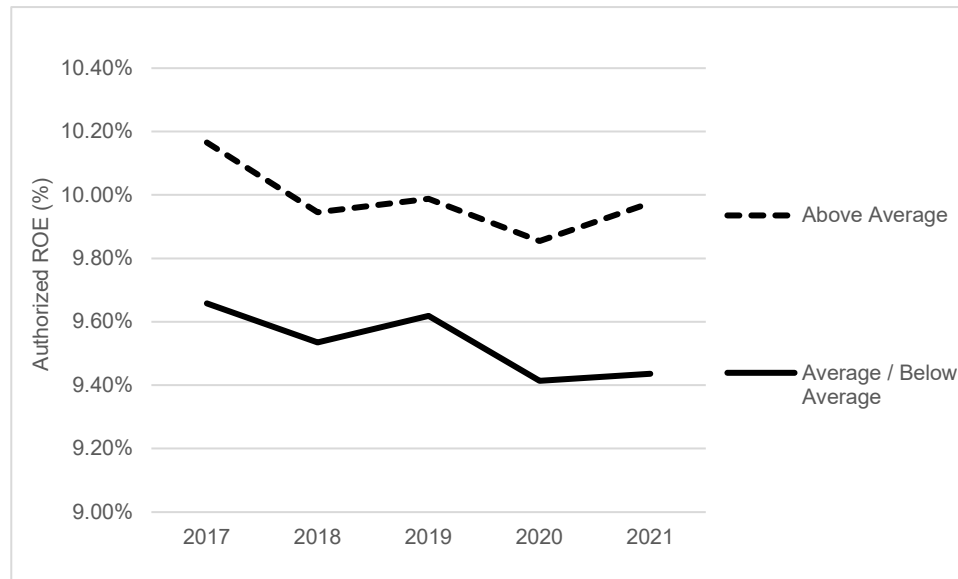
A. A company's allowed return on equity and capital structure determine its earned rate of return. An adequate rate of return is necessary to maintain the financial integrity of the utility so it can sustain its credit metrics. Utilities must compete

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for investments with utilities in other jurisdictions, as well as other competing investment opportunities in other industries. An inadequate return and deteriorating credit metrics inhibit a utility’s ability to compete for capital. As described by PSE witness Todd A. Shipman, investors view the return on equity and capital structure as bellwethers in assessing regulatory risk in addition to their importance in forecasting financial performance. Figure 4 demonstrates that returns on equity have been an average of 45 basis points higher in jurisdictions rated “Above Average” by Regulatory Research Associates (“RRA”), indicating a relatively more constructive, lower-risk regulatory environment. As shown in Figure 4, higher authorized returns on equity are generally consistent with investors’ view of the relative risk of the regulatory environment. A higher return on equity therefore indicates a lower risk to investors allowing utilities to better compete for capital.

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Figure 4. Authorized Returns on Equity and RRA Rankings¹⁷



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In addition, from the standpoint of fixed-income investors, return on equity and capital structure decisions have a direct effect on cash flow and credit metrics.

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Credit rating agencies have expressed concerns about the cash flow metrics that

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could be resolved through constructive regulation with respect to the authorized

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return on equity and the equity ratio. According to a recent report by S&P Global,

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credit ratings for North American utilities “weakened sharply in 2020,” and “the

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percentage of North American regulated utilities with a negative outlook or on

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CreditWatch with negative implications surged from 18% in 2019 to 36% in

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2020.” The report also indicated “that the number of downgrades exceeded the

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number of upgrades by a wide margin in 2020 for the first time since 2010.” On

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the causes, S&P stated, “[t]he main causes of weakening credit quality reflected

¹⁷ Source: S&P Capital IQ Pro, Regulatory Research Associates. 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 environment, social, and governance ('ESG') risks, regulatory issues, and
2 companies' practice of strategically managing financial measures close to their
3 downgrade threshold with little or no cushion." Significantly, the novel
4 coronavirus pandemic "was not the culprit for weaker credit quality" the report
5 states.¹⁸ Given the pressures cited by S&P on utility credit quality, it is
6 increasingly important to consider a rate of return and capital structure that
7 directly affect the Company's cash flow metrics.

8 Capital access is important at all times, and a supportive regulatory climate can
9 support a company's need to access capital in the midst of uncertain economic
10 conditions. Favorable market conditions cannot be expected to persist in
11 perpetuity. When markets deteriorate, borrowing costs can increase, and access to
12 the capital markets can be limited. Given that capital is a finite resource, if capital
13 costs increase, this limits a company's funds available to deliver on its capital
14 plan. However, a utility that is financially strong has a higher likelihood of
15 maintaining access to capital at reasonable terms when markets deteriorate.

16 **Q. What is the authorized return on equity PSE is requesting in this**
17 **proceeding?**

18 A. PSE has adopted PSE witness Ann E. Bulkley's analysis and conclusion that an
19 authorized return on equity of 9.9 percent is fair and reasonable, if not

¹⁸ Standard & Poor's, "Utility sector's credit ratings weakened sharply in 2020: S&P Global Ratings," January 21, 2021. 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 conservative, based on her market analyses. In addition, the requested return on
2 equity is consistent with returns on equity industry wide and authorized returns on
3 equity in the peer group identified by Ms. Bulkley. As discussed above, PSE's
4 prior weighted return on equity authorization was in the bottom quartile of rate of
5 return authorizations in 2020, and notably, most utilities are not required to
6 operate under a dual mandate of delivering safe, clean, reliable, and affordable
7 energy services, as well as deliver on ambitious state mandates as required under
8 CETA. As such, PSE's currently authorized return is less credit supportive than
9 the industry average. In addition, the combination of a 50 basis point increase in
10 return on equity and an equity ratio increase to 50.00 percent over three rate years
11 only partially replaces the loss of cash flow resulting from the passage of the Tax
12 Cuts and Jobs Act ("TCJA") (implemented in 2018), which is estimated to be
13 \$149 million.

14 **Q. Why does PSE require an authorized return on equity higher than its**
15 **currently authorized return on equity?**

16 A. A return that is credit supportive will help PSE maintain access to capital at
17 reasonable terms as the Company delivers on its capital investment plan. As
18 described by PSE witness Todd A. Shipman, the authorized return on equity
19 conveys the regard that the regulator has toward the investors that are furnishing
20 the capital needed to maintain safe, clean, reliable, and affordable energy services
21 and achieve other public policy goals. In attracting capital, PSE must compete
22 with alternatives in other sectors in which investors have an opportunity to earn

1 significantly higher returns. As PSE implements CETA and the requirements of
2 the CCA and other transformational legislation, significant investments will be
3 required. This is in addition to the necessity to maintain the safety, security and
4 reliability of PSE's operations and service delivery. As discussed by PSE witness
5 Ann E. Bulkley, elevated levels of capital expenditures can adversely affect the
6 Company's risk profile by increasing the risk of under recovery or delayed
7 recovery of the invested capital, and an inadequate return can cause credit metric
8 to deteriorate due to adverse cash flow impact. A return on equity commensurate
9 with the risks borne by the Company provide PSE access to capital through the
10 business cycle at an acceptable interest rate. Without adequate financial strength,
11 it is common for companies to terminate or cancel projects, especially during
12 tumultuous or volatile market conditions. As such, it is necessary for PSE to
13 maintain its financial strength so it is able to deliver on the state's environmental
14 and equity policy objectives in addition to maintaining safe, clean, reliable, and
15 affordable energy services through temporary market conditions that may
16 constrain capital access.

17 As an example, PSE witness Ann E. Bulkley observes that PSE's ratio of capital
18 expenditures as a percentage of net utility plant is above the proxy group average,
19 indicating a greater risk relative to the proxy group. In fact, as shown in Exh.
20 AEB-10, only one company, NextEra Energy, Inc. ("NextEra"), exceeds PSE's
21 level of capital expenditures. As NextEra seeks to raise capital to fund its
22 ambitious capital plan, it is noteworthy that its utility operations are in the state of

1 Florida, which is rated “Above Average” by RRA,¹⁹ indicating a relatively more
2 constructive, lower-risk regulatory environment. In addition, NextEra’s utility
3 Florida Power and Light Company (“FPL”) was recently authorized a return on
4 equity of 10.60 percent and a return on equity allowance up to 11.70 percent over
5 a four-year rate term.²⁰ Compared to PSE, NextEra has a significant advantage as
6 it seeks to raise capital, as PSE’s currently authorized and actual return on equity
7 are more than 100 basis points lower than the authorized return on equity for
8 NextEra’s utility company.

9 **Q. What are some potential factors beyond PSE’s control that could diminish its**
10 **financial strength or otherwise constrain capital access?**

11 A. While PSE has a spending plan to deliver safe, clean, reliable, and affordable
12 energy services, as well as deliver on state mandates, spending requirements can
13 change. Unplanned weather patterns (e.g., major storms and heat waves) can
14 increase operating expenses and may require additional capital investments. In
15 addition, regulatory outcomes, including this general rate case, can limit PSE’s
16 financial flexibility. As discussed above, PSE was required to delay or defer
17 several projects as a result of the last general rate case. Finally, capital market
18 conditions can become volatile causing investors to become more risk-averse and

¹⁹ Source: S&P Capital IQ Pro, Regulatory Research Associates. 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).

²⁰ Florida Public Service Commission, Docket No. 20210015-EI, Order No. PSC-2021-0446-S-EI, issued December 2, 2021, at 17, <https://www.floridapsc.com/library/filings/2021/12919-2021/12919-2021.pdf>.

1 requiring higher returns to make investments in utilities, which leads to a higher
2 cost of debt and equity.

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

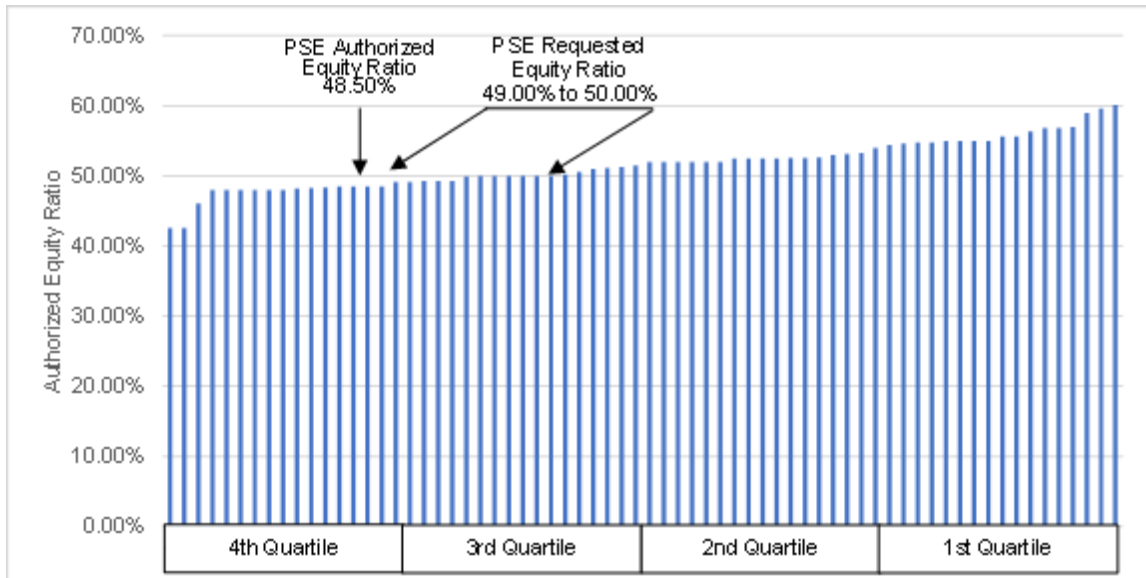
4 A. PSE's is requesting a capital structure that consists of the following components
5 in the initial rate year:

- 6 (i) a long-term debt ratio of 48.6 percent,
- 7 (ii) a short-term debt ratio of 2.4 percent, and
- 8 (iii) an equity ratio of 49.0 percent.

9 To further support the Company's financial strength, the Company proposes that
10 the equity ratio increase by .5 percent each year to an equity ratio of 50.0 percent
11 in the final year of the multiyear rate plan. Gradually moving the equity ratio
12 closer to industry averages will mitigate customer rate impacts while allowing
13 PSE to maintain its credit ratings, achieve a safety cushion in cash flow and
14 provide the flexibility to access the capital markets during varying and volatile
15 financial market conditions to finance its operations cost-effectively. As shown in
16 Figure 5, PSE's recently authorized equity ratio of 48.50 percent was in the
17 bottom quartile of all capital structure authorizations in 2020. The gradual change
18 proposed in the multiyear rate plan would move the equity ratio closer to industry
19 averages, but still below the average authorized equity ratio as well as mitigate the
20 effects of the TCJA on cash flow metrics.

21

1 **Figure 5. Authorized Equity Ratios in 2020**
 2 **Ranked Low to High²¹**



3
 4 **Q. Why is PSE requesting this increase in its equity ratio?**

5 A. As discussed in the testimony of PSE witness Cara G. Peterman, cash flow has
 6 declined since 2018 because of the passage of the TCJA (implemented in 2018)
 7 and the minimal revenue increase received from the 2019 general rate case order
 8 in July 2020. These have caused credit metric performance to decline. Each of the
 9 credit rating agencies has indicated that the TCJA is having an overall negative
 10 credit impact on regulated operating utilities and their holding companies due to
 11 the reduction in cash flow that results from the change in the federal tax rate and

²¹ Source: S&P Capital IQ Pro, Regulatory Research Associates. Rate cases in Arkansas, Florida, Indiana, and Michigan have been excluded from the Figure since the authorized capital structure approved in the cases includes deferred taxes and other credits at zero or low cost. 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 the loss of bonus depreciation.²² To mitigate the anticipated weaker credit
2 metrics, S&P expected that utilities would offset the revenue reductions from tax
3 reform with equity issuances. Consistent with that expectation, S&P reported that
4 in 2018 regulated utilities issued nearly \$35 billion in equity, which is more than
5 twice the equity issuances in either 2016 or 2017.²³ Consistent with that approach,
6 PSE is proposing to finance its operations with a capital structure consisting of a
7 49.0 percent to 50.0 percent equity ratio over the course of the multiyear rate plan.

8 **Q. Is the proposed capital structure consisting of a 49.0 percent to 50.0 percent**
9 **equity ratio appropriate for PSE?**

10 A. Yes, it is appropriate for several reasons. First, as demonstrated by PSE witness
11 Ann E. Bulkley in her testimony and exhibits, a 49.0 percent to 50.0 percent
12 equity ratio is within the range of the peer group operating utilities. In fact, it is
13 below the average for the peer group operating utilities and, therefore, somewhat
14 conservative. In addition, the proposed capital structure has a direct effect on the
15 Company's credit metrics. As discussed by PSE witness Cara G. Peterman in
16 Exh. CGP-1T, the proposed capital structure and return on equity will improve

²² Standard & Poor's Ratings, "Industry Top Trends 2019, North America Regulated Utilities", November 8, 2018; FitchRatings, Special Report, What Investors Want to Know, "Tax Reform Impact on the U.S. Utilities, Power & Gas Sector", January 24, 2018., Moody's Investors Service Rating Action "Moody's changes outlooks on 25 US regulated utilities primarily impacted by tax reform" January 19, 2018. Moody's Investors Service Outlook, Regulated utilities- "US 2019 outlook shifts to negative due to weaker cash flows, continued high leverage", June 18, 2018. These are part of licensed, subscription service subject to copyright protection but will be made available for review upon request pursuant to WAC 480-07-510(i)(iii).

²³ Standard & Poor's Ratings, "Industry Top Trends 2019, North America Regulated Utilities", November 8, 2018. 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 PSE's credit metrics utilized by S&P, Moody's, and Fitch. This will help PSE
2 maintain access to capital markets at reasonable rates and mitigate the effects of
3 the TCJA on cash flow metrics. Finally, it is consistent with PSE's actual capital
4 structure during the test year of 49.0 percent and the projected capital structure of
5 PSE during each year of the multiyear rate plan. As such, to the extent the
6 authorized equity ratio does not reflect PSE's actual equity ratio, equity investors
7 will earn a debt return for a portion of their investment contributing to the
8 Company underearning its authorized return on equity. In addition, as described
9 by PSE witness Todd A. Shipman in Exh. TAS-1T, for fixed-income investors,
10 the equity component in the approved capital structure is significant, as the utility
11 will be constrained in managing its balance sheet by the regulatory capital
12 structure. The authorized capital structure, like the return on equity, indicates a
13 regulator's interest in attracting capital to provide safe, clean, reliable, and
14 affordable energy services and delivering on policy objectives.

15 **Q. How does PSE's proposed rate of return compare to PSE's prior authorized**
16 **rates of return?**

17 A. As demonstrated by PSE witness Cara G. Peterman, PSE's requested rate of
18 return for 2023, the first year of the multiyear rate plan, is the same as PSE's
19 authorized rate of return in 2020. Further, PSE's requested rate of return for 2025,
20 the third year of the multiyear rate plan, is the same as PSE's authorized rate of
21 return in 2019. PSE has been able to reduce its cost of debt in recent years so that

1 the overall proposed rate of return requested in this case is consistent with the rate
2 of return authorized by the Commission in recent years.

3 **Q. Do the proposed graduated increases in the equity ratio from 49.0 percent to**
4 **50.0 percent mitigate the rate impact to customers?**

5 A. Yes. PSE is sensitive to the impact of rates on its customers, so the proposed step-
6 up in the equity ratio will be gradual to mitigate bill impacts. Over the long-term,
7 PSE expects the proposed equity ratio to provide the financial strength to deliver
8 benefits to customers.

9 **Q. How do customers benefit from PSE's financial strength?**

10 A. PSE seeks the financial strength to maintain its current ratings and to weather
11 volatility in today's uncertain capital markets. These benefits are enduring
12 throughout the long-term while the bonds remain outstanding despite what may
13 happen to the Company's credit ratings or equity ratios in the future. Further, the
14 benefits will continue to increase as the Company continues to issue additional
15 debt to fund investments that provide safe and reliable service to its customers at
16 these current credit ratings.

17 Higher credit ratings have many additional benefits for PSE and customers
18 including:

19 1. Lower short-term debt borrowing costs that come as a result of the
20 Company having ratings-based pricing in its credit facilities;

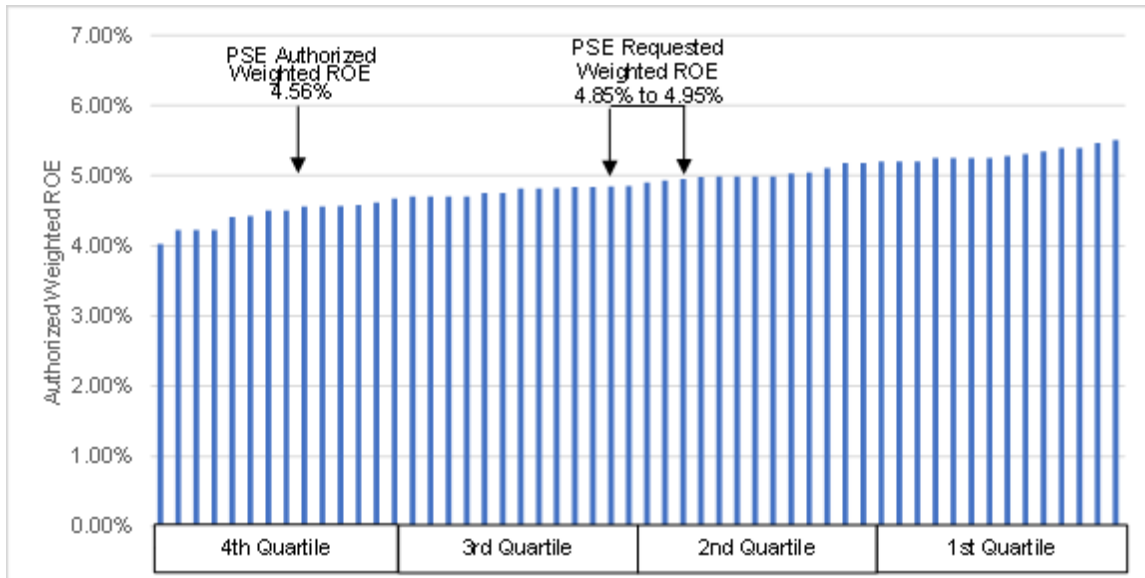
- 1 2. The ability of the Company to more reliably access the commercial
2 paper market and do so at lower borrowing costs;
- 3 3. Benefits that accrue from having energy hedging counterparties grant
4 increased trade credit when entering into hedging transactions with
5 PSE; and
- 6 4. More reliable access to capital in times of uncertainty by remaining
7 investment grade, even in the event the Company were to receive a
8 one notch downgrade several years from now.

9 In addition to the benefits associated with a higher credit rating, the proposed
10 equity ratio will enable PSE to implement the necessary transformation under
11 CETA. The clean energy objectives proposed under CETA are intended to
12 provide benefits to customers as well.

13 **Q. How does PSE's requested weighted-average return on equity compare to**
14 **weighted-average returns on equity authorized during the test year for**
15 **electric and gas utility cases nationwide?**

16 A. PSE's requested weighted-average return on equity is 4.85 percent in the first rate
17 year and increases to 4.95 percent in the third rate year, which is a product of
18 PSE's requested return on equity multiplied by PSE's requested equity ratio. As
19 shown in Figure 6, this requested weighted return on equity is consistent with the
20 second and third quartiles of the weighted returns on equity for electric and gas
21 utility cases approved nationwide in 2021.

Figure 6. Authorized Weighted Returns on Equity in 2021
Ranked Low to High²⁴



Q. Does the return on equity and capital structure requested by the Company in this proceeding appropriately balance the risks and costs of funding PSE’s utility operations?

A. Yes, it does. With respect to the equity ratio, the Commission balances safety and economy—the safety that results from an equity cushion high enough to absorb losses with the economy of lower cost debt. PSE’s capital structure appropriately balances these factors. The requested capital structure recognizes the change in economic conditions, and the requirements on PSE to (i) continue to serve its

²⁴ Source: S&P Capital IQ Pro, Regulatory Research Associates. Rate cases from with ROEs determined by formulas or including explicit penalties were excluded. In addition, rate cases in Arkansas, Florida, Indiana, and Michigan have been excluded from the Figure since the authorized capital structure approved in the cases includes deferred taxes and other credits at zero or low cost. 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 customers with acceptable reliability and service quality, while (ii) achieving new
2 legal requirements under CETA, and the significant capital requirements to fund
3 investments in the near future. The proposed capital structure is consistent with
4 PSE's projected actual capital structure during each year of the multiyear rate
5 plan. The capital structure requested by PSE in this proceeding, when combined
6 with a requested return on equity of 9.9 percent and other cash flow enhancing
7 adjustments in the multiyear rate plan will allow PSE to maintain its current credit
8 ratings and attract debt capital necessary to fund PSE's capital expenditures and
9 operations. In addition, the proposed equity return will allow PSE to satisfy
10 regulatory commitments and debt covenants related to capital structure. As
11 previously discussed, PSE's authorized and proposed weighted average return on
12 equity is below the industry average. Notably, PSE's proposed rate of return is
13 consistent with the Commission authorized rate of return in 2019 and 2020.
14 Overall, this request is reasonable, consistent with peer utilities, and enables the
15 Company to provide safe, clean, reliable, and affordable energy services.

16 **VI. PSE'S PROPOSAL REGARDING THE POWER COST ADJUSTMENT**
17 **MECHANISM AND ANNUAL UPDATES TO POWER COSTS**

18 **Q. Please describe the Power Cost Adjustment ("PCA") mechanism and how**
19 **risk is shared between PSE and customers.**

20 A. The PCA mechanism provides for risk sharing for variations in power costs. It
21 allows for variations in power costs to be apportioned between the Company and
22 customers. This PCA mechanism has been in place for a number of years and

1 performed reasonably. However, in recent years the introduction of significant
2 intermittent renewable resources, volatility in oil and gas markets, and the
3 shutdown of coal based generating facilities have resulted in increasing volatility
4 in power prices. As more renewable resources are added to the power grid, along
5 with uncertain oil and gas markets, the market power prices are expected to
6 continue to be volatile.

7 As discussed by PSE witness Ann E. Bulkley, the majority of regulated utilities
8 have power cost adjustment mechanisms that pass-through power costs, dollar for
9 dollar without sharing bands. The PCA mechanism requires the Company to
10 absorb \$17 million of costs above the baseline rate before customers begin to
11 share in the costs. As discussed by PSE witness Ann E. Bulkley, 93.94 percent of
12 the operating companies held by her proxy group are allowed to pass through fuel
13 costs and purchased power costs directly to customers, without deadbands or
14 sharing bands. Only seven states have fuel cost recovery mechanisms with sharing
15 bands. Therefore, the PCA mechanism represents an incremental risk relative to
16 the proxy companies identified by PSE witness Ann E. Bulkley. As presently
17 constructed, the PCA mechanism exposes PSE to volatile power costs, which
18 creates both a financial risk and a liquidity risk.

1 **Q. Does PSE have a proposal for the manner in which power costs are updated**
2 **in the multiyear rate plan?**

3 A. Yes, as discussed in the Prefiled Direct Testimony of Janet K. Phelps, Exh. JKP-
4 1T, the current regulatory framework does not provide for timely inclusion of new
5 resources or changing costs of existing power cost resources in rates. Therefore,
6 PSE is proposing that variable power costs be updated on an annual basis and that
7 the power cost only rate case be retained to periodically update the fixed costs
8 associated with new and existing resources. This proposal is important to address
9 the volatility in power costs as well as to allow PSE to more timely address
10 changes to variable power costs inputs and to reflect new clean energy resources
11 and PPAs in rates in a timely manner.

12 **Q. Isn't PSE able to defer the costs of new clean energy resources under CETA?**

13 A. Yes, but deferrals do not provide sufficient protection of PSE's financial strength.
14 In recent years, the PCA mechanism has caused multi-year deferrals, creating
15 financial stress on PSE. As discussed above, deferrals do not provide the cash
16 flows necessary for maintaining financial strength. As such, deferred costs are a
17 drag on PSE's credit metrics.

1 **Q. What is PSE's request with respect to the continuation of the power cost only**
2 **rate case?**

3 A. As previously noted, the power cost only rate case should be retained for periodic
4 updates to fixed costs associated with new and existing resources. Further, should
5 the Commission decline to approve PSE's proposal to annually update variable
6 costs in the PCA baseline rate, the power cost only rate case should remain in
7 place in its current form, to periodically update all power costs, as discussed by
8 PSE witness Janet K. Phelps.

9 **Q. How would PSE's proposed changes mitigate its exposure to volatility in**
10 **power costs and support PSE's financial strength?**

11 A. Power costs can be volatile and therefore unpredictable creating financial risk and
12 liquidity risk for PSE. More frequent updates and more timely recovery of PSE's
13 power costs increases cash flow predictability and therefore improves the
14 financial stability of PSE. In addition, the proposals will bring PSE closer to peer
15 utilities and support the Company's overall credit profile.

16 **Q. Would PSE's proposal be beneficial to customers?**

17 A. Yes. PSE's proposal would be beneficial to customers in several ways. As
18 previously discussed, the proposal improves PSE's financial strength by allowing
19 more timely recovery of power costs and thus allows PSE to execute on programs
20 and projects that benefit customers including acquiring new clean energy

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resources to meet the mandates and timelines of CETA. Additionally, PSE’s proposal provides more accurate and timely price signals to customers and enhances intergenerational equity. Further, the proposal would move away from large, unplanned surcharges resulting from large power cost deferrals, like those that have occurred in the last two years. These benefits are discussed in more detail in the Prefiled Direct Testimony of Janet K. Phelps, Exh. JKP-1T.

VII. CONCLUSION

Q. Does this conclude your prefiled direct testimony?

A. Yes, it does.